

**Subject:** Why Netflix is a high risk bet

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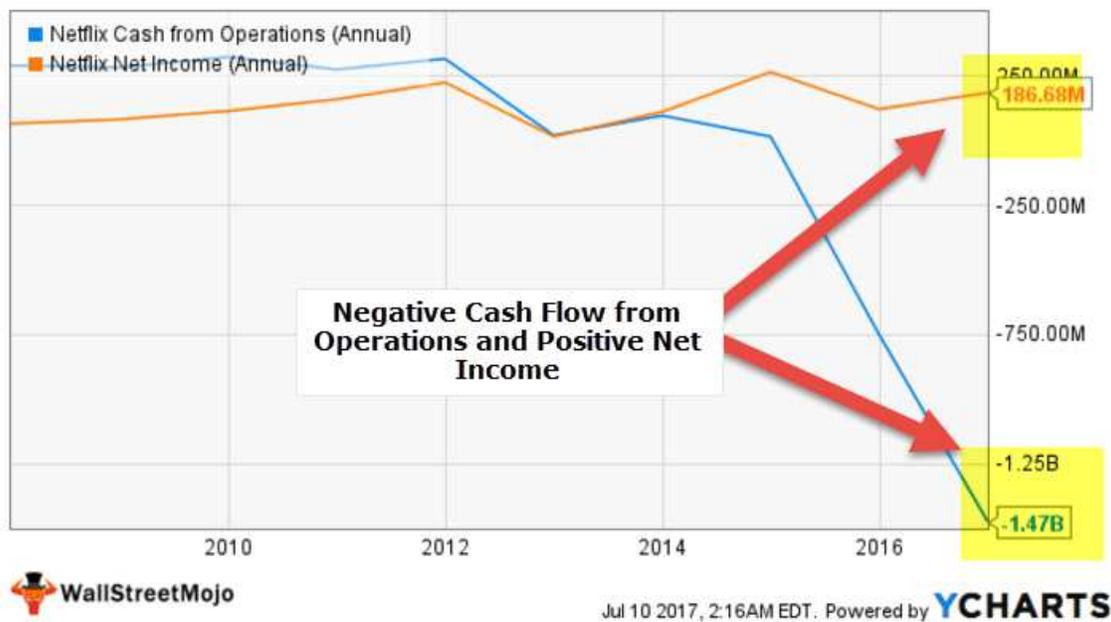
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## **Netflix has become a Wall Street darling the last few years.**

And why not. The company has been a terrific growth story. For the past 10 years Netflix has grown its user base 30% per year. The average American watches more content via streaming than cable TV. Over the last 5 years they have reported \$1.2B in net income. And up until now Netflix has dominated the streaming space. The stock price has reacted accordingly ramping up from \$50 a share 5 years ago to \$376 today. But there are some problems with these numbers. They must be taken with a large grain of salt.

Lets examine that \$1.2B net income figure. While that looks great the reality is Netflix is hemorrhaging cash. Over the same period Free Cash Flow has been a **negative** \$5B. That's a pretty large disparity. Here's the graph.....



So why is this so?

Netflix spends enormous amounts on content, in 2018 over \$8B. Instead of deducting this amount from net income Netflix amortizes the expense over a number of years. The company says that the useful life of the content is longer than one year so they spread it out over 10.

This isn't illegal but it is quite aggressive. If the content does not perform down the road the company could be looking at huge writedowns.

Management points out that Disney does the same thing. That might be true but the problem is Disney has multiple other sources of income that more than offset what's invested in content. Netflix is a high wire act without a net.

And speaking of Disney they will launch their own streaming service this year. Sad for Netflix as Disney is a customer and probably won't be one for long.

So while Netflix is a great story here are the problems:

- 1) Competition is heating up from better financed competitors and it will be fierce.
- 2) Losing .25 cents for every \$1 invested in not a long term sustainable business model.
- 3) Netflix is totally reliant on coming up with new content as they cannot rely on

other sources of income or its own library of content.

When the bear market does come I think Netflix will be the poster child of what not to own.....

Maybe they should call their next streaming offering **Look out Below.**

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