



3 Things to Watch When Netflix Reports Earnings

Description

Netflix ([NASDAQ: NFLX](#)) reports third-quarter earnings after the market closes Wednesday, and nervous investors will be watching this one closely — with an eye toward more than revenue and earnings.

After all, the company's shares are down more than 25% since July, and that drop came after Netflix met second-quarter expectations for revenue (\$4.9 billion) and exceeded analyst estimates for earnings (\$0.60 per diluted share). The decline seems to result from two things: a big miss in expected subscriber growth and fears that tougher streaming competition from heavyweights **Disney**, **Apple**, **Amazon**, and others will hurt Netflix.

So let's take a look at three metrics: subscriber growth, content costs, and debt. They provide a deeper look at Netflix's long-term prospects and the impact tougher competition might be having on the company.

Subscription growth

Netflix doesn't have a complicated business model. The company produces revenue when people pay for a subscription to watch its streaming content. So when net subscriber growth hits a speed bump, the stock price takes a hit.

The second quarter's speed bump looked more like a concrete barrier, as U.S. subscription counts declined by 126,000. Though that's a small number on a base of 60 million subscribers, it's the first drop in net U.S. subscriptions since 2011's [Qwikster nightmare](#). The torrid international growth also slowed, falling 40% short of the company's estimate. Overall, Netflix's 2.7 million net new subscribers was barely more than half its forecast of 5 million.

The fear is that Netflix's [\\$2 price increase](#) in January might have turned off subscribers at a time when stiff competition is about to launch. Management also said second-quarter content didn't lead to as many subscriptions as expected.

Now investors want to see if third-quarter releases of original-content hits like *Stranger Things* season 3 and the final season of *Orange Is the New Black* have recharged subscriber growth. There have been [some signs](#) that this may be the case, and management [reported](#) in July that the third quarter had begun with more typical subscriber growth.

Metric	Q3 2019 Estimate	Q3 2018 Actual	Change
Revenue	\$5.25 billion	\$3.99 billion	32%
Earnings per share	\$1.04	\$0.89	17%
U.S. subscriber growth	800,000	1 million	(20%)
International subscriber growth	6.2 million	5.1 million	22%
Total subscriber growth	7 million	6.07 million	15%

DATA SOURCES: Netflix and Yahoo! Finance.

The company is forecasting an addition of 7 million subscribers, with 6.2 million coming internationally. That's 15% growth year over year and would give Netflix 158.6 million global subscribers. (The next-highest streaming competitor is Amazon Prime Video, with more than 100 million subscribers, although it's unclear how many actively use the service, which comes with an Amazon Prime subscription.)

Beyond third-quarter subscriber growth, Netflix also is expected to provide a fourth-quarter estimate. As [CEO Reed Hastings noted](#) recently, the competition will get tougher in November, when Apple TV+ (Nov. 1) and Disney+ (Nov. 12) launch new streaming services. This will be the first quarterly forecast that includes those competitors, and it offers a glimpse into how Netflix management views the possible effect on subscriber growth.

Content costs

Netflix's content costs have been soaring, and they'll probably go higher as it produces more original shows to attract subscribers domestically and globally.

The company spent \$6.3 billion through the first six months of 2019 and might end up spending \$15 billion this year. Wednesday's report will provide more clarity on that amount. For perspective, Netflix spent \$8.9 billion on content in 2017 and \$12 billion in 2018.

Netflix increased content spending even before there was so much competition. As other streaming services prepare to launch, costs will keep going up as a result of bidding wars for the most popular shows. For instance, the platform eventually will lose sitcoms *The Office* and *Parks and Recreation* to NBCUniversal's Peacock; but Netflix won the bidding rights to *Seinfeld* — reportedly for [more than \\$500 million](#), a price three times higher than what Hulu paid in 2015.

In the meantime, Netflix also has been spending internationally, where its growth has been strongest. In the trailing 12 months, the company has added 18 million international subscribers, compared to about 3 million in the U.S. And it has increased spending to produce content for specific international markets, [like India](#).

The content costs are important to watch, because companies like Disney, Apple, Amazon, **AT&T** (HBO's owner) and **Comcast** (Peacock's owner) will [continue to spend heavily](#) in the quest for subscribers. The difference between those companies and Netflix? They aren't reliant exclusively on subscriptions for revenue. If Apple doesn't have hit shows, it still has iPhones. If Netflix doesn't have hit shows, it has a big problem. Content costs must do two things: fuel subscriber growth and give Netflix the ability to raise subscription rates without losing customers.

Debt fueling growth

Netflix has built a huge subscriber base, but it's used debt to fuel that growth. In the last two years, the company's debt has ballooned from \$4.8 billion to \$12.6 billion.

That's not a problem for a company that produces [free cash flow](#) — the amount of money that's left after all expenses are paid. However, Netflix is now cash flow negative, burning through more than \$3.2 billion in the 12 months that ended June 30.

In the short term, that's not a big cause for concern, because Netflix had \$5 billion in cash reserves at the end of the second quarter. In the long term, it's important to keep an eye on debt. If Netflix's subscriber growth falls short of expectations, investors could look at mounting debt and negative free cash flow and begin to wonder: How can this company keep paying rising costs for content, marketing, and other expenses to fuel the high growth investors have come to expect?

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4. NASDAQ:NFLX (Netflix, Inc.)
5. NYSE:DIS (The Walt Disney Company)
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