Global Innovation

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Netflix: A binge-worthy profit series

Innovation cash kings of the next decade - *In this series we look at the standout companies that are 'pivoting to profit' and are at an inflection point of converting customer-driven innovation into shareholder value. In the last of this series, we take a closer look at Netflix.*

In late June this year, a familiar face returned to our screens – Harvey Specter –the leading character in hit legal drama, Suits. Harvey charmed viewers for eight years while Suits ran on US cable networks until 2019, and subsequently when the program streamed on platforms including Amazon Prime and Peacock.

Yet in late June the show rose once from the ashes to become the number one streamed TV show in the US for 13 consecutive weeks – a record according to Nielsen tracking services. What happened in late June? Suits was launched on Netflix. That Netflix could reignite consumer engagement so sensationally with a series already widely consumed and offered by its competitors speaks to the strength of the company's distribution reach and leading user interface in spades.

The genesis of Netflix's competitive edge stretches back to its roots in 1997, when it disrupted the DVD rental market by successfully counterposing then market-leading video and DVD chain Blockbuster (which eventually filed for bankruptcy in 2010). Blockbuster failed to respond to the competitive threat posed by Netflix's DVD postal rental offering since – as per classic disruption theory – it targeted only a consumer niche within the market. There was uncertainty as to whether a subscription service would prove to be a viable business model, added to which, if Blockbuster adopted Netflix's approach, it believed this would serve to legitimise it. What this enabled Netflix to do, having established a foothold in the market, was pioneer the first streaming service to customers in 2007. Others followed suit, but lacked the pre-existing customer base of Netflix who were already used to a monthly subscription model.

This history lesson is informative for three key reasons. Firstly, it showcases how innovation is embedded in the DNA of the company. Secondly, Netflix has 16 years of streaming media experience, which has over time led to predictable operations and costs – a stark contrast to many new entrants whose streaming divisions are not profitable. Finally, the company has a large customer base built over many years. Today, four out of five Americans subscribe to Netflix. Amazingly, the average American subscribe to four or more streaming services, but Netflix commands about double their viewing time – c.8% share of TV viewing time compared to c.4% for its closest competitor. The fact that Netflix has maintained its leadership amid a proliferation of streaming services speaks to its ability to provide continued customer value. Customer loyalty may be fickle in streaming, but that is where Netflix's content delivery network comes into play.

The company has invested heavily in exclusive rights and originals over the past decade, spending c.$17 billion on content in 2021 and 2022 – a level we will continue to see over the coming years. 'Wednesday' and 'Stranger things' are but a few examples in the rapidly growing and popular Netflix original library, but importantly this intellectual property provides operating leverage: owned content spend is a fixed cost, so as subscriber volumes increase, the cost per user declines and Netflix's profit margins grow. $17 billion is a hefty sum for competitors to match.

This leading content has long formed the lifeblood of Netflix's growth flywheel, attracting its 247 million users to the platform and retaining them in the Netflix ecosystem. But Netflix's track record of monetising these members has been patchier. This is starting to change. Earlier this year the company announced it was finally cracking down on password sharing: those of us who reaped the delights of Netflix's library without paying a penny are no longer afforded this loophole. Recent results demonstrate that the initiative is decidedly working: 8.8million paid subscribers were added to the platform in Q3 of this year (smashing estimates to the tune of c.1million), with the crackdown on paid-sharing cited as the driving force.

At the same time, the company is extending its pricing ladder (crucially retaining its low entry price point of $6.99), the benefits of which we will see start to see flow through to profits next year. And lastly, Netflix is tapping into a $180 billion addressable advertising opportunity across linear and connected TV (excluding China and Russia). Although it is early days, the company's ad-supported tier is growing at 70%. Importantly, this offering fuels both growth and profits: priced as low as $6.99 a month, this is meaningful value creation for customers, neutral at present to unit economics, yet carries huge profit potential given the growing attraction to brands of placing their ads next to Netflix's content slate.

Where to from here? Investors have been patient with Netflix's journey to profitability, but the company has come a long way from 2016 when it began investing heavily behind its global rollout: operating margins have increased from 4% to over 22% today, aided by ongoing expense management, while free cash flow is set to reach $6.5 billion this year, having only turned positive for the first time in 2020. With membership plan evolution, pricing and advertising emerging as powerful pillars of the company's monetisation engine, we believe that profit-accretive membership growth has much further to run. To paraphrase management on their third quarter earnings call*, we are in full agreement that Netflix is nowhere near a profit margin ceiling.

*Source: netflix-inc-q3-2023-earnings-call-oct-18-2023.pdf (q4cdn.com)

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Key Risks

Past performance does not predict future returns. You may get back less than you originally invested.

We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

The Funds managed by the Global Innovation Team:

- May hold overseas investments that may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of a Fund.
- May have a concentrated portfolio, i.e. hold a limited number of investments. If one of these investments falls in value this can have a greater impact on a Fund's value than if it held a larger number of investments.
- May encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.
- Outside of normal conditions, may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash.
- May be exposed to Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.
- Do not guarantee a level of income.

The risks detailed above are reflective of the full range of Funds managed by the Global Innovation Team and not all of the risks listed are applicable to each individual Fund. For the risks associated with an individual Fund, please refer to its Key Investor Information Document (KIID)/PRIIP KID.