Netflix Investors – Method or Madness?

On April 15, Netflix's stock price closed at $475.46. The next day it closed at $562.05, a whopping +18.2% increase on the day. Based on Wall Street's consensus estimate of what the company might earn over the next 12 months, the stock trades at a forward price to earnings (P/E) multiple of 157.3. Sounds crazy, doesn't it? What are these investors thinking?

There is no doubt, they are entertaining very high expectations. Assume investors who bought the stock on April 16 paid on average $535 per share. If the stock price grows to $1,400 over the next ten years, these investors would have earned a return of +10.1% p.a., a rate of return that does not justify the risks embodied in a stock trading at a P/E of more than 150.0.

Furthermore, assume the P/E multiple at the end of year 10 is 20.0, a reasonable assumption. A 20.0 P/E and a price of $1,400 can only mean one thing. Earnings per share (EPS) in year 10 would have to be $70.00 ($1,400/$70.00 = 20.0). EPS was $4.32 in 2014. To arrive at earnings of $70.00 in ten years' time, one has to assume a growth rate of +32.1% p.a. – see below (CAGR = cumulative annual growth rate).

The table below shows very high growth rates during the first five years, but rates taper off to +15% by year 10. It is unlikely that earnings will grow uniformly at +32.1% in each of the next ten years.

Netflix Growth Projections

Year	0	1	2	3	4	5	6	7	8	9	10	CAGR 10 Yr
EPS	$4.32	**$7.13**	**$11.05**	$16.02	$20.83	$27.07	$33.84	$42.30	$50.76	$60.92	**$70.00**	**32.1%**
Growth Rate		65.0%	55.0%	45.0%	30.0%	30.0%	25.0%	25.0%	20.0%	20.0%	14.9%	

Alternatively, one could assume a growth rate that fluctuates between +27% and +37% over the next ten years as depicted below.

Netflix Alternative Growth Projections

Year	0	1	2	3	4	5	6	7	8	9	10	CAGR 10 Yr
EPS	$4.32	**$5.50**	**$7.50**	$10.00	$13.50	$18.00	$24.00	$31.00	$40.00	$55.00	**$70.00**	**32.1%**
Growth Rate		27.3%	36.4%	33.3%	35.0%	33.3%	33.3%	29.2%	29.0%	37.5%	27.3%	

How realistic are these growth expectations? Monster Energy, the beverage company, grew their earnings at a rate of +38.1% p.a. over the past ten years as shown below. In other words, it can be done. Monster's current P/E is 50.3.

Monster Energy's Actual Growth Rates

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	CAGR 10 Yr
EPS	$0.11	$0.33	$0.50	$0.76	$0.56	$1.11	$1.14	$1.53	$1.86	$1.95	$2.77	**38.1%**
Growth Rate		**195.5%**	52.3%	52.5%	-26.5%	99.1%	3.2%	34.2%	21.6%	4.8%	42.1%	

Should Netflix generate the kind of earnings growth projected above, it could have a P/E in excess of 20.0, judged by Monster's current multiple. If the stock's P/E is 30.0, ten years from now, investors currently buying at $535 could earn a return of +15% p.a.

In summary, this is most probably what Netflix investors are hoping for: Netflix could earn $70.00 per share in ten years' time and trade at a P/E multiple between 20.0 and 30.0. At 20.0, the return would be +10% p.a. and at 30.0, the return would be +15% p.a. To meet investor expectations, Netflix would have to grow earnings at a rate of more than +30% p.a. over the next ten years. If not, EPS would fall short of $70.00.

Unlike the assumptions above and what Monster actually reported in earnings growth in 2005 (+195.5%), according to Wall Street's consensus estimates, Netflix is projected to earn $1.82 and $3.62 in 2015 (year 1) and 2016 (year 2), respectively, well short of our projected $7.13/$5.50 and $11.05/$7.50, respectively. The highest estimate, among the 30 analysts, for 2015 and 2016 came in at $5.12 and $7.88, respectively. In the near-term, those who own the stock are hoping for EPS to come in between $5.50 and $7.55 over the next two years to keep their hopes up.

Investing at these multiples and with such high expectations is too speculative for us, but as the above analysis shows, Netflix shareholders will tell us that there is some method in their madness. We'll keep an eye on this "road map" to see how closely reality matches expectations in future years. In the meantime, Amazon is determined to "out-flix" Netflix. A battle royal is in progress that could turn the best plans of mice and men on their head.