Why We're Long Netflix and Short Green Mountain Coffee Roasters

November 13, 2011

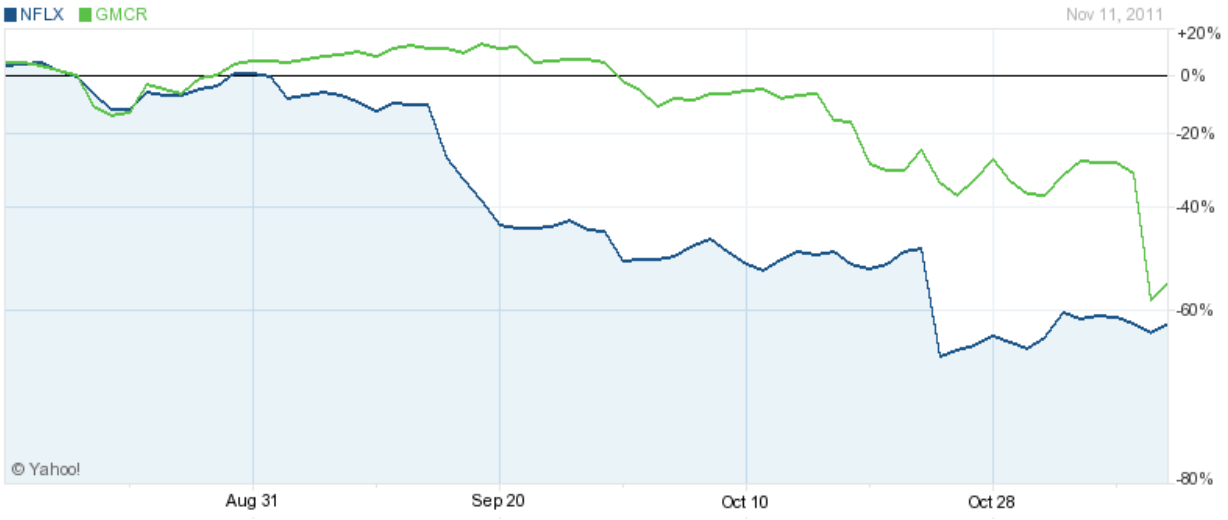
T2 Partners LLC
The GM Building
767 Fifth Avenue, 18th Floor
New York, NY 10153
(212) 386-7160
Info@T2PartnersLLC.com

Netflix and Green Mountain Coffee Roasters are former market darlings whose stocks have collapsed in recent months, wiping out a combined $23.2 billion in market capitalization from their peaks ($11.7 and $11.5 billion, respectively). By many metrics, both stocks appear cheap and the terrible headlines are attractive to value investors like us, who like to buy when others are selling in a panic. For example, BP was one of our biggest winners in 2010 (click here to read our analysis at the time). The company, its CEO and the stock were all universally hated, with endless negative headlines (similar to Netflix today), which provided a wonderful opportunity to buy the stock far below its intrinsic value. We love situations like this – as long as we're convinced that there's a good company and a cheap stock once one cuts through all of the noise.

So are Netflix and Green Mountain similar opportunities today? Yes and no. We've analyzed both companies carefully and concluded that Netflix is an attractive investment at today's price, so funds we manage own the stock, but Green Mountain isn't, we remain short it. Allow us to explain why.

Similarities

The stocks of both Netflix and Green Mountain over the past three months have suffered similar declines, as this chart shows:



In addition, the companies are remarkably similar in revenues and profitability over the past 12 months:

	NFLX	GMCR
Revenues	$2,925	$2,651
Operating Income	$393	$369
Net Income	$238	$201
Operating Margin	13.4%	13.9%
Net Margin	8.1%	7.6%
All figures are in millions, over the trailing 12 months		

Yet here the similarities end. Let's take a look at both companies.

Netflix
When Netflix fell 35% in one day last month to under $80, we purchased it aggressively, not as a short-term trade, but with a multi-year horizon. Over the next few quarters, the company will likely lose money as it invests in international growth and struggles to overcomes its missteps over the past few months. Ultimately, however, we think Netflix is an excellent company and that the market has overreacted to all of the recent negative news, thereby providing us the chance to own it at a cheap price, for reasons we discuss below in Appendix A.

Green Mountain
In contrast, we are not only still short Green Mountain's stock, but it remains our largest short position, even after last Thursday's 40% decline. Our reasons are superbly articulated in the 110-slide presentation that Greenlight Capital's David Einhorn gave on the company at the Value Investing Congress last month. Even if you don't have a position in the stock, it's worth studying as a brilliant piece of analytical work – and it's a must-read if you have a position. Although we were already short Green Mountain, after seeing Einhorn's presentation we concluded that it was an even better short than we realized and increased the size of our investment, which has paid off handsomely.

There's a saying that pigs get fed and hogs get slaughtered, so why don't we cover our short and take our profits? After all, the stock, at $43.71, is now trading at "only" 16.8x the midpoint of the company's guidance for next year, and at 12.5x Einhorn's estimate of the company's long-term earnings power of $3.50 (see page 66 of his presentation).

The answer is that we think only the first shoe has dropped and there are more to come.

Netflix vs. Green Mountain
Here is a summary of our concerns about Green Mountain, with a comparison to Netflix:

- Green Mountain gave strong guidance for next quarter and year, which we think, in light of the company's performance last quarter, is too high and will need to be reset downward. Analysts remain bullish. In contrast, Netflix has given very poor – and, we believe, conservative – guidance that we think the company can exceed, and analysts are significantly more bearish.

- Though it has similar revenues and profits, Green Mountain's market cap, at $7.0 billion, is nearly 50% higher than Netflix's $4.7 billion, which means there's more downside and less likelihood of an acquisition.

- Green Mountain's business is highly dependent on two key patents, both of which expire on September 16, 2012. Contrary to the company's and bullish analysts' views, we believe that soon after these patents expire, there will be significant competitive pressures that will meaningfully impact Green Mountain's profitability and growth. Netflix faces no patent risk though it, too, faces many competitive threats.

- There is an ongoing SEC investigation at Green Mountain and we think Einhorn's presentation provides a detailed roadmap that will, in our opinion, likely lead the SEC to uncover various accounting shenanigans. Netflix faces no such risk.

- Green Mountain has spent $1.4 billion in cash on three richly-priced acquisitions over the past two years, which raises questions about organic growth and earnings quality. Einhorn notes: "The very

high allocations to Goodwill raise suspicion about subsequent earnings quality." (See page 53 of his presentation.) In contrast, Netflix has made no acquisitions in recent years.

- Green Mountain inventories and cap ex have been growing much faster revenues: last year, on a 95% revenue increase, inventories rose 156% from $262 million to $672 million, while cap ex rose 125% from $126 million to $283 million. The result has been severely negative free cash flow and a significant worsening of the balance sheet over the past two years, which raises questions about how the company will fund its cap ex plans for next year. The trends at Netflix are precisely the opposite.

Netflix vs. Green Mountain: A Comparison of Balance Sheets and Cash Flows

The last bullet point warrants further discussion because, while the two companies have similar income statements, their balance sheets and cash flows diverge massively. Netflix has a healthy net cash position of $166 million, while Green Mountain has $561 million in net debt. And Netflix has healthy operating cash flow, which substantially exceeds both net income and cap ex, resulting in free cash flow of $201 million, whereas Green Mountain is the reverse, with free cash flow of *minus* $282 million. This chart shows the data for both companies over the past 12 months:

	NFLX	GMCR
Cash & Cash Equiv*	$366	$13
Debt	$200	$574
Net Cash (Debt)	$166	($561)
Operating Cash Flow	$349	$1
Cap Ex**	$148	$283
Free Cash Flow	$201	($282)
* For GMCR, excludes $28M of restricted cash		
** For NFLX, cap ex includes "Acquisitions of DVD content library"		
All figures are in millions, over the trailing 12 months		

The balance sheet and cash flow numbers are critical because both companies are making large investments to grow their businesses: in Netflix's case, signing deals for streaming content and growing internationally and, in Green Mountain's case, primarily to "increase our portion pack packaging" and "expand our physical plants." Both companies (and stocks) are at risk if they run into trouble financing these investments.

Given Netflix's strong balance sheet and free cash flow, we think it's highly likely that the company will be able to fund its growth, even if it loses more subscribers than the company (and we) expect (within reason). In contrast, Green Mountain is at much higher risk, both because of higher planned expenses and also a far weaker balance sheet and cash flow statement.

As noted above, in last week's earnings release, Green Mountain said "For fiscal 2012, we currently expect to invest between $630.0 million to $700.0 million in capital expenditures to support the Company's future growth." That's a *huge* amount of money for a company that only had $201 million of net income last year and less than $1 million of operating cash flow.

Our question is, where are they going to get the money? They've guided to $2.55-$2.65 in EPS in the next 12 months, but we are highly skeptical that the company will meet this guidance, and it also excludes some very real cash expenses like "acquisition-related transaction expenses; legal and

accounting expenses related to the SEC inquiry and the Company's pending litigation." In addition, the company's balance sheet is consuming huge amounts of cash: due mainly to the rise in inventories and, to a lesser extent, accounts receivable, operating cash flow over the last 12 months was a mere $785,000 – basically zero. Nor was this an exception: in the prior year, the company had $80 million in net income yet operating cash flow of *minus* $3 million. On top of this are numerous richly priced acquisitions, which consumed $908 million in cash last year and $459 million the year before.

To summarize, over the last two years, Green Mountain has generated $281 million of net income, yet *lost* $2 million of operating cash flow, plus spent $410 million on cap ex and another $1,367 million on acquisitions – a total cash burn of *$1.8 billion*! This chart shows the company's accelerating cash burn over the past three years:

	GMCR ('09)	**GMCR ('10)**	**GMCR ('11)**
Operating Cash Flow	$38	($3)	$1
Cap Ex	$48	$126	$283
Free Cash Flow	($10)	($129)	($282)
Acquisitions	$41	$459	$908
FCF Minus Acquisitions	($51)	($588)	($1,190)

So how has Green Mountain funded these huge cash flow deficits? By using cash, taking on debt, and issuing stock. Over the past two years, the company has seen its net cash position go from +$164 million to -$561 million, a swing of $725 million, plus it's raised $990 million by selling stock, as this chart shows:

	GMCR ('09)	**GMCR ('10)**	**GMCR ('11)**
Cash & Cash Equiv*	$242	$4	$13
Debt	$78	$354	$574
Net Cash (Debt)	$164	($350)	($561)
Issuance of Common Stock	$395	$9	$981
* Excludes restricted cash			

In summary, we question how Green Mountain will fund its $630-$700 million cap ex plan over the next 12 months. Even if one believes the midpoint of the company's guidance of $2.60/share, this only translates into $414 million of net income, plus the balance sheet is likely to continue consuming cash. We think investors will not look kindly on more debt, nor issuing stock at depressed prices, yet the company almost certainly will have to do one or the other.

Conclusion

We're long Netflix because we think the bad news is out, we like the company's balance sheet and cash flows, and see few red flags. In contrast, with Green Mountain, we think there is much more bad news to come, are very concerned about the company's balance sheet and cash flows, and see many red flags.

Appendix A: Why We're Long Netflix

Netflix has encountered a rough period recently – mostly of its own making – but ultimately we believe it's an excellent company – something we acknowledged when we were short it, but didn't fully appreciate at the time. Once we did, we covered. Here's what we wrote in our article, *Why We Covered Our Netflix Short*, published on Feb. 9, 2011 (posted here):

> …while we acknowledged in our December article that Netflix "offers a useful, attractively-priced service to customers, is growing like wildfire, is very well managed, and has a strong balance sheet," we now believe that it is an even better business than we gave it credit for. The company has enormous momentum and substantial optionality (for example, international growth), and management is executing superbly.

Obviously the momentum has been broken due in large part to management not executing superbly, but we still think it's an excellent company – and credit Reed Hastings for quickly acknowledging and fixing the Qwikster mistake.

We were short it primarily because of the extreme valuation of the stock – but now that it's down nearly 75% from its peak less than four months ago, we think it's downright cheap. Here is an article that captures many of the reasons we're bullish, which concludes:

> And one of the reasons everyone thought Reed Hastings was a genius, by the way, was Reed Hastings' demonstrated willingness and ability to suffer short-term pain in exchange for presumed long-term gain.
>
> How did everyone learn that about Reed Hastings?
>
> They learned that back in early 2004, when Reed Hastings slashed Netflix's prices and ramped up marketing spending to compete with a new DVD service from Blockbuster that many people thought was going to destroy Netflix.
>
> Reed Hastings' price cuts and spending increases did not go over well with Netflix's shareholders. In fact, as you can see in the chart below, Netflix's stock fell even more then than it has now: 75%+

But Reed Hastings was right. The company that was supposed to kill him, Blockbuster, went bust. And Netflix's stock went on to soar 30X from the 2005 low.

Now, thanks to the stumbles of the past few months, everyone thinks Reed Hastings is a bonehead again.

And maybe, this time, Reed Hastings will turn out to be a bonehead.

But this observer, anyway, is not going to be betting against him. Especially because Reed Hastings has already demonstrated his ability to *bet the company and be right*. And because Netflix's future — streaming over the Internet instead of cable networks — already looks to be a pretty good and pretty big business.

In addition to the points in the article, we'd add the following:

- With 23.8 million subscribers (excluding 1.5 million international ones) and a market cap of $4.7 billion, Netflix is being valued at $199/subscriber, a very low figure relative to other media companies.

- Its shrunken market cap means that Netflix would be a bite-sized acquisition for any number of much larger companies like Apple ($357B market cap), Google ($197B), Amazon ($99B), Disney ($68B) Comcast ($61B), or Time Warner ($35B). We don't think an acquisition is likely, but it probably puts a floor under the stock.

- By all accounts, streaming usage is growing very rapidly – 30-40% annually we'd estimate. It seems likely that Netflix will get the lion's share of this because there are no meaningful competitors. A key pillar of our short thesis last year was the rapid emergence of numerous competitors, but it just hasn't happened. Hulu Plus, which is owned in part by Comcast and Disney, just passed the one million paying subscriber mark, not even 5% of Netflix's level.

Amazon is offering free streaming videos to Amazon Prime members and boasted in its recent earnings release of a library of "more than 12,000 movies and TV shows from partners such as CBS, FOX, PBS, NBCUniversal, Sony, Warner Bros., and many more," but Netflix in its earnings release said "we have not seen much usage of Amazon Prime in our research." If Comcast, Disney or Amazon wanted to get serious about this nascent market, it would be much easier and less costly just to buy Netflix.

- This is a really rough number, but we think Netflix should eventually be able to earn $5-6 of contribution profit per customer per month (a bit less than half of average revenue of approximately $12.50) if – and this is a big if – it can grow its subscriber base meaningfully over time. This translates into $1.3-$1.7 billion of contribution profit (again, excluding Netflix's nascent international operations).

- We think Netflix was smart to raise its price – our only critique is how Reed Hastings communicated it. Had he done a better job explaining it, perhaps fewer customers would be so furious. It might not be too late to send out a letter like this one:

  Dear Netflix subscribers,

  I understand that many of you are upset by our recent price increase. We didn't want to do it, but it was necessary. Allow me to explain...

  For many years, we had only the DVD-by-mail service and made a reasonable profit charging $9.99/month (for our basic plan). We knew, however, that the future lay in streaming: it's obviously far better to click a few buttons and watch a movie immediately rather than have to wait for it to come in the mail and then have to mail it back.

  But streaming developed slowly thanks to technological barriers (which thankfully are falling rapidly) and the difficulty of licensing content (which remains difficult and expensive). In the early days of our streaming service, it wasn't a great product: few of our customers had the internet bandwidth to download movies quickly and in high definition, and our content library was very limited. Thus, we gave it away to all of our subscribers, and this worked beautifully for a number of years: millions of our existing subscribers began using streaming and millions more signed up for Netflix to access our convenient streaming library of over 15,000 titles.

  But the overwhelming popularity of our streaming service created a dilemma: our subscribers wanted more and more streaming content, but unlike DVDs, where we can simply buy a DVD and send it again and again to our customers, with streaming the law requires that we negotiate licensing deals with the content owners. Not surprisingly, seeing our millions of customers and understanding that streaming is the future, they began to demand higher and higher prices for their content. We don't begrudge them, but this dramatically increases our costs if we want to make available to our subscribers the most popular movies and TV shows (which we do!). Meanwhile, the costs to provide our DVD-by-mail service certainly weren't going down. Thus, we had no choice but to charge separately for our two services.

  I think $7.99/month for unlimited streaming or unlimited DVD rentals is a bargain – we just can't afford to provide both for that price. I hope you understand.

- Note that the price increase only affected subscribers who were getting both the streaming and DVD services (they were paying $9.99 and now have to pay $7.99 for each service or

$15.98, a 60% price increase). Streaming-only and DVD-only customers didn't see a price hike and these subscriber numbers are growing quickly, especially the streaming-only, which is the future of the company. Based on the company's guidance and our own estimates, we think that the number of streaming-only customers will rise 29% from 9.9 million at the end of Q3 to 12.8 million at the end of Q4, due to both new subscribers as well as current streaming and DVD customers dropping the DVD portion. The net result is that the total number of subscribers will remain roughly flat in Q4, but the mix will shift to more streaming and fewer DVD customers (who will be far more profitable, thanks to the price hike). We think these trends bode well for the company over time.

In summary, the question for Netflix (and its shareholders) is whether the company gets back into a virtuous cycle, whereby more and more streaming subscribers lead to more money to pay for better content, which in turn drives even more subscribers. Thus, the key number to watch over the next year is the number of streaming subscribers, not profits or total subscribers (though DVD subscribers are also important, as this business is a cash cow that can fund the growth of the streaming business).

We believe that the anger many Netflix customers feel will fade as they realize that the company offers two great services at very reasonable price points, and that robust subscriber growth will resume in 2012.

Finally, as background:

- Our original article on *Why We're Short Netflix*, published on Dec. 16, 2010, is posted here.
- Reed Hastings's response on Dec. 20, 2010, *Cover Your Short Position. Now.*, is posted here.
- Our article on *Why We Covered Our Netflix Short*, published on Feb. 9, 2011, is posted here.