Winter 2011

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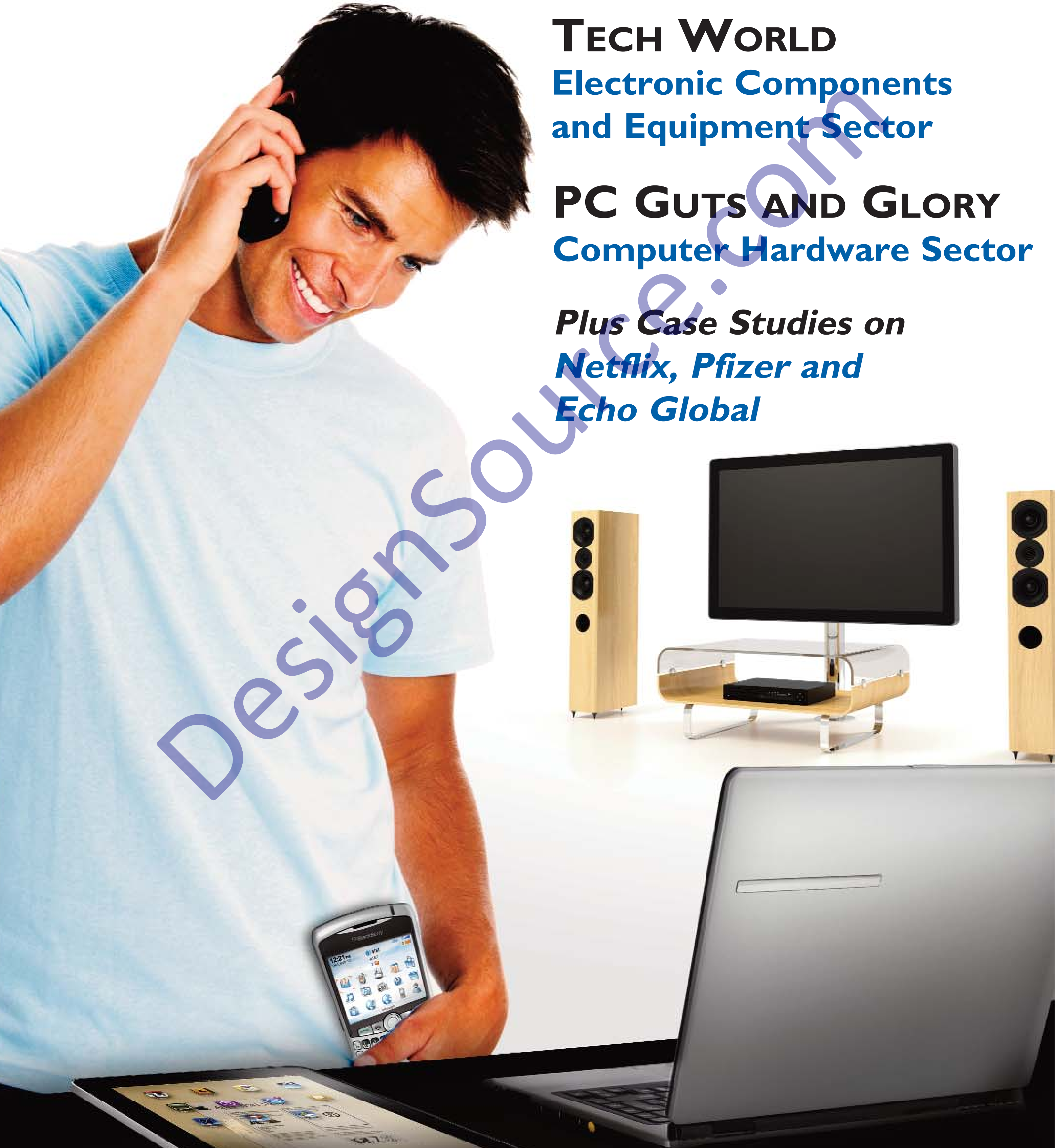


# Netflix

## Is this hot stock going to pay off or flame out?


Netflix has put together an impressive record of growth with its innovative movie rental service. For a monthly fee (usually $8 - $16) subscribers can rent an unlimited number of movies and TV shows from Netflix's "library." Customers can either receive a DVD in the mail or stream content over the Internet to their computer, television or smartphone.

During the last decade, the subscriber base for the company's rental service increased from 100,000 to almost 17 million. This unusually strong growth has made Netflix a stock market darling. In the last two years, while the market gained little, the stock's price has increased from $20 to $170. Now, however, Netflix's stock exhibits classic signs of overpricing.

(1) **Visual.** Chart 1 shows that the recent price has been well above the projected earnings per share (EPS) profile. This indicates that growth in the stock's price has outpaced growth in the company's earnings, a situation that cannot persist. Over the longer term, it is growth in EPS that drives growth in a stock's price.

(2) **High Multiple.** At the recent price, the stock trades at more than 45 times projected EPS for 2011. That's more than three times the price-earnings valuation of the S&P 500 (13 times projected 2011 EPS).

### Growth Prospects

Growth in the company's subscriber base is driven by:

1. Advertising, strong brand recognition and positive word-of-mouth promotion.
2. Consumer electronics partners. Users of set-top boxes (from Apple TV, Google TV and others) and gaming consoles (from Microsoft, Nintendo and Sony) can watch Netflix's content on their televisions.
3. International Expansion. Netflix recently launched its online streaming service in Canada and expects to introduce its services overseas in 2011.

**Improving Profitability.** The company spends more than $500 million per year on mailing DVDs. This expense is expected to decline significantly as more subscribers choose streaming instead of DVD technology. The company predicts that during the fourth quarter more Netflix content will be consumed via streaming than on DVD.
Streaming is also "scalable." Movies and TV shows are licensed from studios at a fixed cost. As Netflix expands its subscriber base, the cost of content per subscriber falls.

However, the future is not all rosy for Netflix. Impediments to further growth include:

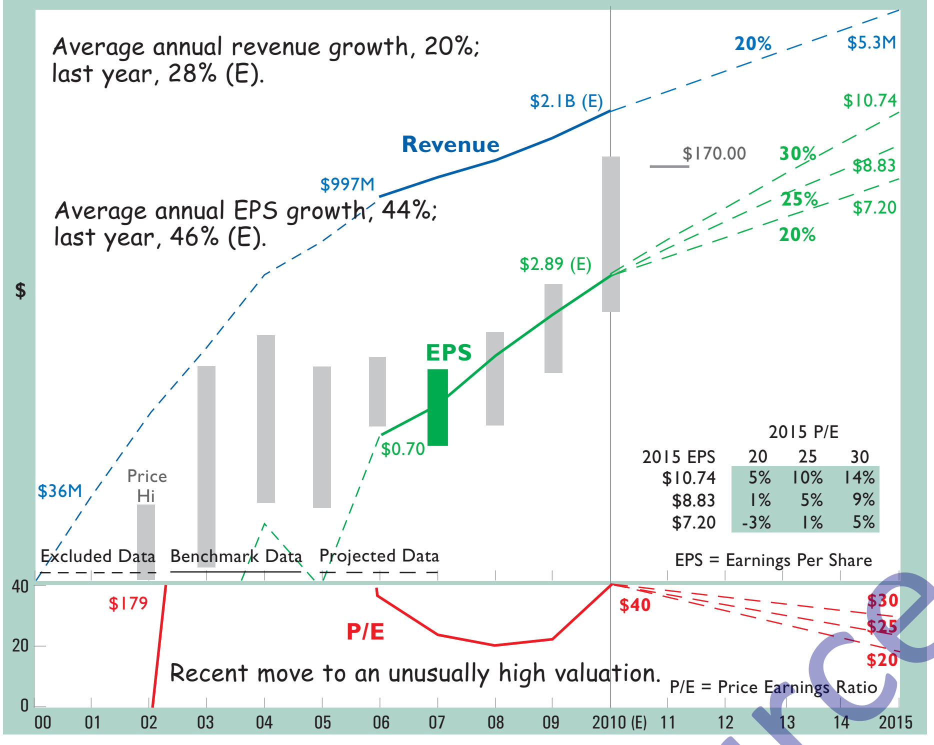
**Increased Competition.** Until recently, Netflix's revenue and earnings growth were driven principally by its video-by-mail business, where it faces little competition. In the future, growth is expected to come principally from its streaming business. In addition to cannibalizing its video-by-mail business, streaming technology opens the "playing field" to competitors such as Amazon.com Inc., Hulu LLC. and others.

As well, cable companies (e.g. Comcast Corp. and Time Warner Inc.) are improving their delivery of movie and TV content to limit the loss of customers to Netflix and other streaming services.

In the battle for "eyeballs" among cable companies and streamers, selling prices are expected to fall. In addition, competition may drive up the prices that streamers and cable companies will have to pay to movie and TV studios for content.

## Growth Fundamentals

Chart 1: Netflix Inc. (NFLX on NASDAQ; FYE December 31)




| 2015 EPS | 2015 P/E 20 | 25 | 30 |
|---|---|---|---|
| $10.74 | 5% | 10% | 14% |
| $8.83 | 1% | 5% | 9% |
| $7.20 | -3% | 1% | 5% |

## Financial Fundamentals

Chart 2: Earnings Retention Ratio (1 - Dividend Payout Ratio)

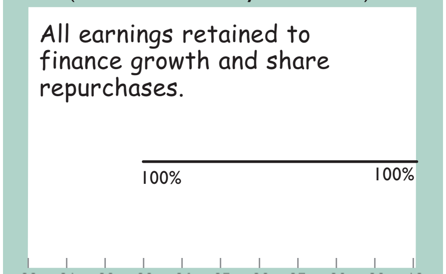
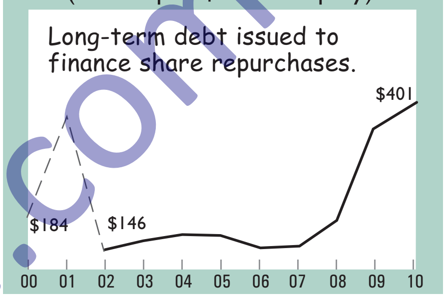



Chart 3: Reliance on Debt Financing (Assets per $100 of Equity)




## Operating Fundamentals

Chart 4: Asset Turnover (Revenue per $100 of Assets)

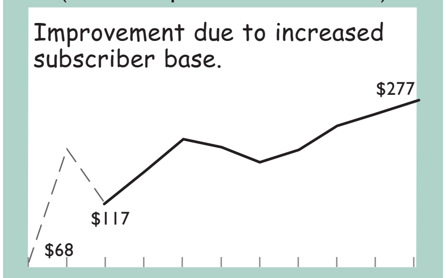
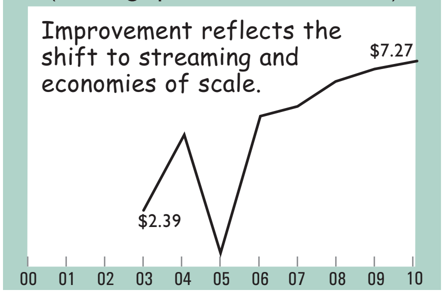
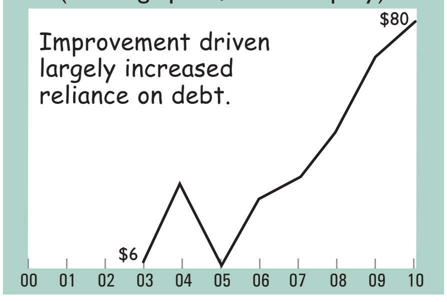



Chart 5: Net Profit Margin (Earnings per $100 of Revenue)




## Composite Fundamental

Chart 6: Return on Equity (Earnings per $100 of Equity)




**The Law of Diminishing Growth.** There are about 115 million households in the U.S., and approximately 15% subscribe to Netflix's service. In the absence of significant international growth, Netflix would have to increase its penetration to roughly one-third of U.S. households during the next five years to sustain its 20% historical revenue growth rate.

For context, the company's most mature market is the Bay Area (e.g. San Francisco and Oakland). There, about 23% of households are Netflix subscribers.

**Reliance on Debt.** Since 2007, Netflix has significantly increased its use of debt to finance EPS-enhancing share buybacks (see Chart 3). This means it now has less capacity to use debt financing to support future growth.

### Investment Merit

The table in Chart 1 reports the stock's projected rate of return — from the recent price — based upon nine possible combinations of future EPS and valuation.

The only combination that produces a somewhat attractive rate of return requires EPS growth to average at least 30% over the next five years and a P/E ratio of 30 times EPS in 2015. Such growth and valuation are typically unsustainable for such a lengthy period, frequently because they attract significant competition.

A more probable scenario might involve a still high 20% growth rate and a P/E ratio of 20. In that event, a five-year investment in Netflix produces a negative rate of return.

### What to Do

Investors owning Netflix might consider taking profits by selling at least some of their position. Potential investors might wait until the stock's price declines to the vicinity of the projected EPS profile before starting a position. Even then, it is always prudent to build a position in a stock gradually, with a series of modest purchases.

# Check the Front and Rear View

## Bonds beat stocks of late, but dividend-stock ETFs may shine.


### Bonds Outperforming Stocks

Investors have moved their money into bonds en masse. In fact, the Investment Company Institute reports that worldwide net sales of bond funds were $700 billion during the past two years compared to net redemptions of $11 billion from equity funds. This recent enthusiasm for bonds is largely attributable to the higher returns (price appreciation plus interest) from bonds during the last ten years.

For example, a broadly-diversified portfolio of Canadian bonds, as represented by the iShares DEX Universe Bond Index Fund, has earned an average annual return of about 6.5% during the last decade. That's significantly better than the 3.5% return delivered by Canadian blue chip stocks in the iShares S&P/TSX 60 Fund. In addition to the higher return, bond investors enjoyed significantly less volatility.

### Bond Fundamentals

However, investors considering bonds in their portfolio should be careful not to be caught looking through the rear view mirror. With 1, 5 and 10 year government bonds yielding 1.3%, 2.4% and 3.1% (respectively), there is little chance of significant further decline.

However, yields can go much higher if large doses of fiscal and monetary stimulus eventually produce high rates of inflation. In that event, prices for previously-issued long-term bonds will decline significantly.

### Today's Better Alternative

Currently, the stocks of many high-quality companies are delivering yields (from dividends) that beat those of long-term bonds. Even better, a company's cash dividend often increases over time which increases the yield realized on the stock's purchase price. There is no opportunity for any increase in the interest paid on a typical bond.

### Stock Selection

Investors interested in selecting dividend stocks might begin looking for candidates among ShareOwner's Portfolio Building Service (PBS). Table 1 shows the service's highest yielding stocks from recent prices.

All other things equal, Canadian taxpayers might prefer Canadian dividend-paying stocks because of their favourable tax treatment relative to dividends from foreign companies. However, this preference does not apply in the case of tax-sheltered accounts such as retirement savings accounts and tax-free savings accounts.

### Stock Portfolios

Investors less engaged in the stock market can still benefit from today's relatively attractive dividend yields via an exchange-traded fund (ETF) that's focused on delivering dividend income.

Such funds own a broadly-based selection of stocks with relatively high current dividend yields and strong prospects for future increases. Accordingly, ETFs are a convenient way to purchase a diversified portfolio of income producing stocks. Unfortunately, this convenience comes at the expense of an annual management and expense ratio (MER).

**Table 1**
**20 Highest Yielding Stocks in the Portfolio Building Service**

| Company | Symbol | Yield (%) |
|---|---|---|
| CML Healthcare | CLC-UN | 8.6 |
| Northwest Income Fund | NWF-UN | 6.6 |
| AGF Management | AGF-B | 6.3 |
| Manitoba Telecom | MBT | 5.8 |
| TransAlta | TA | 5.5 |
| Sun Life Financial | SLF | 5.0 |
| IGM Financial | IGM | 4.9 |
| Great-West Lifeco | GWO | 4.7 |
| Husky Energy | HSE | 4.7 |
| AstraZeneca | AZN | 4.7 |
| TMX Group | X | 4.7 |
| Power Financial | PWF | 4.6 |
| Telus | T | 4.6 |
| Bank of Montreal | BMO | 4.6 |
| CIBC | CM | 4.5 |
| Entergy | ETR | 4.5 |
| Paychex | PAYX | 4.5 |
| US Ecology | ECOL | 4.4 |
| Reitmans | RET.A | 4.3 |
| Lockheed Martin | LMT | 4.2 |

Source: ShareOwner

*continued on page 10*

# Aging Pharma Icon Cuts Costs

## A once-hot drug-maker scrambles as growth flags.

Pfizer, Inc. is one of the world's largest developers of pharmaceuticals and biologics (medicinal products based on DNA technology). The company's cholesterol-fighting Lipitor is the best-selling prescription drug in the world. It also makes many other widely used drugs such as Viagra (erectile dysfunction) and Celebrex (arthritis). In addition, Pfizer sells general consumer health-care products and animal pharmaceuticals.

### The 1990s

The discovery, development and marketing of Pfizer's popular drugs during the 1990s led to a long stretch of strong growth (see chart); average annual growth in revenue and earnings per share (EPS) grew 14% and 18%, respectively.

By the end of the '90s the consensus of analysts' estimates for long-term EPS growth was still 20% per year. However, investors were paying as much as $50 of market price for each $1 of Pfizer's EPS. That is a rich price/earnings (P/E) ratio for a company growing earnings at 20%. High P/E ratios can be fragile and subject to sharp declines — especially if a company fails to deliver the expected EPS growth.

*Note that when the P/E ratio is 2.5 times the projected growth rate many investors consider a stock to be overpriced. Typically, high-growth stocks are considered fairly valued when the P/E ratio is about equal to the company's projected growth rate.*

### Y2K and Beyond

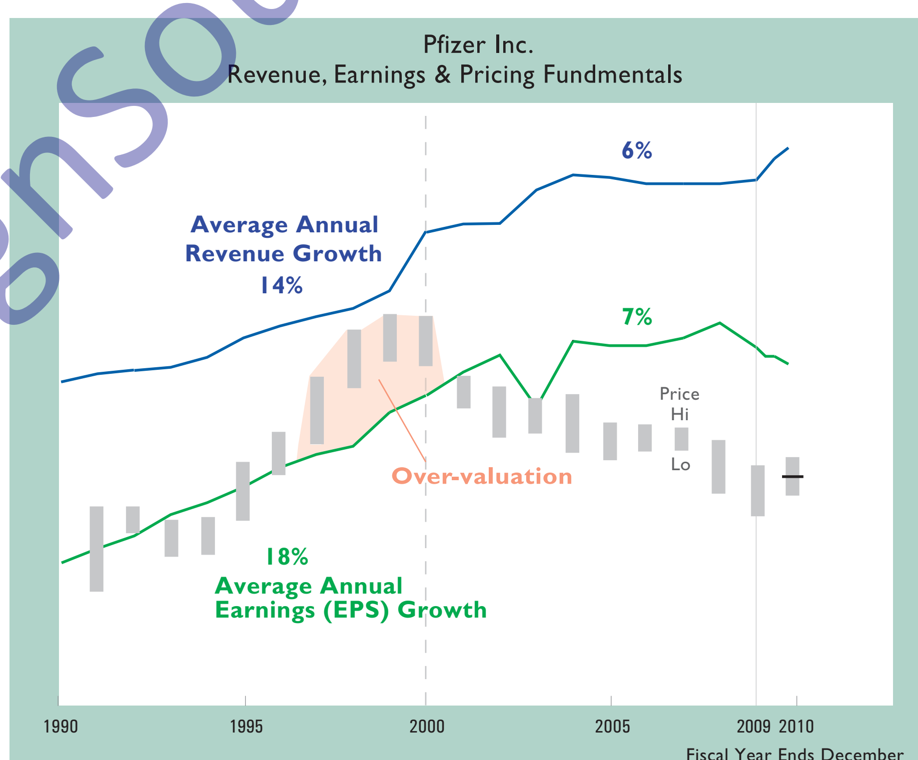
When the tech bubble burst, the market's valuation of Pfizer's EPS fell along with those of other stocks. Even though EPS growth surpassed expectations during 2001 and 2002, Pfizer's P/E fell to about 20. Then, the 2003 acquisition of Pharmacia Corp. (for $56 billion, all in shares) and the subsequent sharp reduction in EPS growth (average 1% since 2004) caused a steady decline in the P/E ratio to about $10 of market price for every $1 of EPS by 2009.

Of course, what counts is what lies ahead, not behind.

### Growth Prospects

Pfizer's future growth in revenues and EPS is uncertain.

**Patent Protection Expiring.** Lipitor accounts for 20% of Pfizer's sales. It has already lost patent protection in Canada and Spain and will lose it in the U.S. in



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2011. Patents for several other important drugs will also expire soon.

As generic drug makers such as TEVA Pharmaceuticals, Inc. begin selling equivalent drugs at lower prices, unit sales and profits for branded drugs typically decline sharply.

In addition, Pfizer's biologic products are currently well protected from generic copycats. There is concern, however, that this protection will not last. Legislation is being considered that would allow for generic biologics.

**Pipeline.** Pfizer needs new drugs to offset the loss of revenue to generic competitors. In 2009, it acquired Wyeth — a leader in developing vaccines and biologics — to bolster its pipeline. The cost was $43 billion in cash plus $25 billion in shares.

The combined company has 115 drugs in clinical trials (Phases 1 through 3), which are expected to yield 15 to 20 applications for drug approvals to the U.S. Food and Drug Administration over the next two years. At least a few of these applications are expected to result in blockbuster drugs.

It should be noted, however, that many drugs in development do not reach the market. For example, safety issues caused Pfizer to recently halt late-stage clinical trials for what was considered a potential blockbuster heart medication.

**Costs.** Since the Wyeth acquisition, Pfizer has been cutting costs by closing facilities and laying off staff. Annual savings of between $4 billion and $5 billion are expected by 2012.

### What to Do?

In the absence of several new blockbuster drugs, growth investors have little reason to expect a return to attractive revenue, earnings and price growth for this large pharmaceutical company — even with its strong research infrastructure. Still, investors looking for income might view Pfizer's 4% dividend yield favourably and take comfort in its $25 billion in cash.

## Case Study: A Small Cap Stock

# Echo Global Logistics Inc.

### Echo Global's magic slots cargo in trucks, planes and ships across the world.

Echo is a transportation logistics company. It doesn't own trucks, trains, planes or ships. Instead, it uses a proprietary communications platform to match shippers of goods (e.g. manufacturers and distributors) with carriers (e.g. truckers and railroads).

### Shippers

Echo arranges for the transport of all manner of large and small products (e.g. parcels, appliances and auto parts). Small and mid-sized shippers find this third-party service particularly appealing because it helps them reduce costs by: (1) avoiding a significant upfront investment in their own logistics capabilities; (2) operating with a relatively small logistics staff; and, (3) paying less per shipment.

Typically, shippers order Echo's services by telephone or the Internet from a dedicated sales agent or team. Once contracted, Echo manages the shipment until final delivery. It bills the shipper and pays the carrier, retaining the difference as profit.

Additional services include: tracking, reporting and compliance, freight bill auditing and claims processing.

**Transactional (60% of revenues).** This revenue comes from some 15,000 shippers — mainly small and mid-sized businesses. These customers tend to order only occasionally and have no long-term contract with Echo.

**Enterprise (40%)** About 140 shippers hire Echo on 3-year contracts to take care of some or all of their transportation requirements. Echo says the renewal rate on these contracts is "nearly 100%."

### Carriers

About 20,000 carriers are connected to Echo's technology platform. This keeps Echo up to the date on carrier's location and available capacity. Echo uses this information to find the lowest-cost carrier with capacity in the required area.

Almost 90% of the shipments arranged by Echo are transported by truck. The balance involves intermodal shipments (e.g. from truck to rail to ship).

Carriers join Echo's network because they can: (1) obtain shipments without a marketing and sales effort; (2) operate fuller trucks or trains; and, (3) delegate services (e.g. shipment tracking and freight audit) to Echo.

### Business Model

Echo's brand of logistics is a relatively low-risk business. When the economy slows and transportation shipments decrease, Echo isn't stuck with expensive, underutilized transportation assets (e.g. trucks and rail cars).