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# EDITED TRANSCRIPT

NFLX - Q1 2012 Netflix, Inc. Earnings Conference Call

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## PRESENTATION

### Operator

Good day, everyone, and welcome to the Netflix first quarter 2012 earnings Q&A session. Today's call is being recorded. At this time, for opening remarks and introductions, I would like to turn the call over to Ellie Mertz, Vice President of Finance and Investor Relations. Please go ahead.

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### Ellie Mertz - Netflix Inc - VP, Finance & Investor Relations

Thank you and good afternoon. Welcome to the Netflix first quarter 2012 earnings Q&A session. I'm joined here by Reed Hastings, CEO, and David Wells, CFO.

We announced our financial results for the first quarter at approximately 1 PM Pacific time today. The shareholder letter and the Q1 financial results and the webcast of this Q&A session are all available at the Company's investor relations website at [ir.netflix.com](http://ir.netflix.com). As is our standard practice, we will begin the call with questions received via e-mail. Please e-mail your questions to [ir@netflix.com](mailto:ir@netflix.com). After e-mail Q&A, we will also open up the phone lines in case there are additional questions not covered by the e-mail Q&A or letter. The dial-in number is within our investor letter, but let me repeat it now. Please call 760-666-3613 if you would like to get into the queue.

We may make forward-looking statements during this call regarding the Company's future performance. Actual results may differ materially from these statements due to risks and uncertainties related to the business. A detailed discussion of such risks and uncertainties is contained in our filings with the Securities and Exchange Commission, including our annual report on Form 10-K filed with the Commission on February 10, 2012. A rebroadcast of this Q&A session will be available at the Netflix website after 6 PM Pacific time today.

Now, let's move directly to questions. As is our standard practice, we have organized the questions by topic as we received them via e-mail this afternoon. So the first topic we will take questions on is domestic streaming. First question -- why are you so confident that gross add trends result from seasonality and not full-in growth? How can you be confident in 7 million net additions for the year?



**Reed Hastings** - *Netflix Inc - CEO*

Well, we had a fantastic Q1, adding nearly 3 million members to our global subscriber base. We had strong results in all of our territories, including the US. Our gross adds are consistent with our historic patterns. Our churn is consistent with our historic patterns, and we are feeling very good about the year.

If you look at adding 7 million net adds, which is our target for the year, and you compare that to 2010, where we also added 7 million net adds, in 2010, that was 7 million on top of 12 million starting numbers. This year, that 7 million on top of 22 million starting members. It's a mathematical effect, if that's true, with steady churn, that in adding 7 million on top of 12 million versus 7 million on top of 22 million, that there will be a significantly increased seasonality of net additions. So, the business is performing exactly as we had hoped. We are continuing to execute on all of the key dimensions, but the artifact of having 7 million net adds on 22 million increases the seasonality relative to 2010. And we tried to demonstrate that or illustrate that in our appendix, showing this phenomena.

So I would say everything is consistent with what we have been hoping for, and so that's why we feel good about the year continuing like this. And I would say probably secondarily, all of the macro vectors are very good, which is, broadband is continuing, we are getting better and better content, viewing is at record levels, and consumers want click-and-watch on-demand Netflix Internet television.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

A follow-up question to that. What would be the earliest indicator that you can or can't achieve that 7 million net US streaming sets goal for 2012?

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**David Wells** - *Netflix Inc - CFO*

I think the earliest indicators will be our net additions in Q2 going into Q3. So, in looking at -- as we continue to see the same net addition rate, both with the strength of the new members that we are bringing on to the space and the user engagement that we see, both with new members and existing members, if those trends continue forward, we would expect to be continually confident in our ability to add 7 million members.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Can you discuss the rate within the quarter of subscriber additions? Was there seasonality within the quarter?

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**Reed Hastings** - *Netflix Inc - CEO*

There was seasonality, if you want. There is variation month to month, week to week, that follows pretty typical patterns. And all of those patterns have stayed consistent, are going consistently. And again, the main consternation that we've picked up is, well, if gross adds are steady and following the traditional seasonal patterns, why is the net adds different? Why are the net adds diverging? The answer is just a factor as -- to slightly repeat myself -- of the math of it's on top of 22 million instead of on top of 12 that we have tried to demonstrate in the appendix the way that works. Do you want to add to that?

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**David Wells** - *Netflix Inc - CFO*

No.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

So, another question on that. Churn spiked after the price increase but remains above the historic levels. Will churn come down, or is streaming only structurally higher churn? Please explain your rationale.



**David Wells** - *Netflix Inc - CFO*

Just on the prior question, too, I think the prior question asked narrowly what the seasonality in Q1. It followed the prior seasonal pattern, so just to make sure we answered that question. And then could you ask that question one more time?

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Sure. Churn spiked after the price increase but remains above historic levels. Will churn come down, or is streaming only structurally higher churn? Can you explain?

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**Reed Hastings** - *Netflix Inc - CEO*

What we've said before is streaming only does have a slightly higher churn rate than our DVD service did, sort of part of our legacy. It's easier to come in and out of that service than the DVD -- having the DVDs at home and having to mail them. We would anticipate that that ease continues forward, but we do retain subscribers that have been with us longer at higher rates than subscribers that join our service. So as the base ages, the retention rate -- the overall retention rate improves. Therefore as the -- as an age basis, that retention rate will improve, just like it did with our DVD service.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

How should we think about 2Q seasonality this year relative to last year, when you added 1.8 million subscribers on a similar overall space?

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**Reed Hastings** - *Netflix Inc - CEO*

In last year, 2011, we were on track for 11 or 12, arguably, net adds on a starting base of 19, and so that roughly parallels the 7 million net adds on 12 million from 2010. And it's the ratio of net adds to the starting base that's different this year, and that's what creates the variation in net additions. So this year, we are at 7 million -- targeting 7 million net additions on 22, and that's what's different from last year. So again, it comes back to essentially these unintuitive math effects, if you've got consistent churn across the year, that the net adds seasonality increases. Again, the easiest way to see that is in the three tables at the very end of the letter, where we've abstracted some examples to try to get comfortable with that phenomena. So we feel very much that we are on track for the 7 million net additions for the year.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

With regard to the upside in contribution margins for the US streaming business, was there a timing issue associated with content costs?

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**David Wells** - *Netflix Inc - CFO*

We talked about in the letter, streaming content costs were lower, some customer service costs were lower, and some delivery costs were lower. On the content side, we actually were pretty close to what we expected in terms of expense, but because it's such a large number, if you're slightly under that, it can be meaningful in terms of contribution margin. And most of what I saw was several small deals got pushed into Q2 or getting closed as of the end of the quarter.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Is the domestic streaming outlook tied at all to HR 2471, meaning do you assume passage of this amendment at some point?

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**Reed Hastings** - *Netflix Inc - CEO*

HR 2471 is our bill to amend and improve and modernize the [VPVA], and though there's no assumption built into the numbers of that passing.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

At current churn levels, over 20 million people will turn off the US streaming service at some point. Are you concerned that the large number of people that are trying Netflix and unsubscribing will ultimately prevent you from reaching your target of 60 million to 90 million US subscribers? But alternatively, how much of churn is people turning the service off and on repeatedly?

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**Reed Hastings** - *Netflix Inc - CEO*

Lots of churn is people turning the service on and off. In other words, you join for three months, then you are not using it or you run out of money, then it's off for three months, then it's back on. Because we only offer a free trial to new members, subscribers, particularly who are economically sensitive, price-sensitive have an incentive to then start Netflix again under a different e-mail address than they have had before. So, there's no real clean counting of that dimension. What we feel great about is the very strong gross adds, the churn that's in line with our historic trends. So we're feeling quite good about the numbers.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Question on domestic costs. You've hiked your Q4 2012 domestic streaming contribution profit assumption to 17%. What's the biggest driver of that? Is it streaming content costs coming in lower than anticipated? Do you expect continued contribution margin expansion in 2013?

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**David Wells** - *Netflix Inc - CFO*

The biggest driver or deals that we thought would close slightly earlier than they did, and that has a carry-forward effect from Q1 to Q2. So I would say that's the largest driver of that contribution margin outperformance.

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**Reed Hastings** - *Netflix Inc - CEO*

And in terms of 2013, we haven't given any guidance. We would like to see the 100 basis points per quarter go on for as long as we can, but we are going to have to feel our way through that year by year.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

In January 2012, Netflix indicated that over 2 billion hours of content had been streamed globally in Q4. You alluded to continued growth in Q1 2012. Can you provide any more color as to the increase in streaming hours per sub per quarter sequentially?

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**Reed Hastings** - *Netflix Inc - CEO*

There's a reasonable amount of seasonality in viewing times in northern climates with the long nights, so we really compare this on a year-over-year basis as opposed to sequentially. But I can tell you that Q1 was an all-time record for us in total viewing and in viewing per members. But in Q2 because of the seasonal -- again, we will compare that on a year-over-year basis.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

Moving to a question on profit outlook. Do you still anticipate net income losses for all of 2012, i.e., will losses in the fourth quarter international eat up the surprisingly high profit delivery in Q2 2012 and, presumably, 3Q in 2012? Do you expect to lurk around breakeven in 2013 as you reinvest domestic profits into international expansion?

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**David Wells** - Netflix Inc - CFO

So I think we addressed this in the letter, but in terms of Q2 profit expectation, if you take the midpoint of guidance, there's a modest net income profit. What we said is we would continue to launch international markets and stay about roughly break even. So, with the Q4 launch, we would probably be facing a small loss rather than breakeven and then work our way back to breakeven.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

We'll move to questions on content. Do you expect to slow the growth in US streaming content spend? And do you believe there is a certain terminal amount of content that is needed to sustain any number of subscribers, whether it be 25 million or 40 million subscribers? Said another way, do you think Netflix has to spend considerably more on content to grow from 25 million to 40 million subscribers?

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**Reed Hastings** - Netflix Inc - CEO

Well, we are growing content spend and content offering very aggressively going forward. And revenue is growing faster than that, so that's where we get the widening margin. But we have a smallest fraction of the total amount of content that we would like to eventually have. So, we will continue to grow the investment in content quite aggressively, slightly less than the rate of revenue growth.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

You secured the DreamWorks animation output deal well before the 2013 start date. Are there other studio output contracts that are coming up for renewal such as Fox, Universal, Disney, and Sony? Are these all beginning 2014 or '15? Will they similarly be bid out well before the start date? Do existing pay cable channels have right of first refusal?

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**Reed Hastings** - Netflix Inc - CEO

It's highly variable by deal. 2014 to 2015 are when most of them come up. And as far as I know, no one else has the right of first refusal.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

What is the current status of EPIX content as it relates to exclusivity and what you intend to do going forward?

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**Reed Hastings** - Netflix Inc - CEO

EPIX is on cable, and it is on EPIX HD, which is the TV everywhere extension of EPIX, and it's on Netflix. That is all that it is on right now. And then as we go forth, with EPIX we are in a broad range of discussions about how to operate most effectively for both of us.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

Here's a handful of questions about originals. How significant to overall views are exclusive or original content?

**Reed Hastings** - *Netflix Inc - CEO*

Well, see, exclusive and original are two different things. So, Breaking Bad is exclusive but not original, as an example. Originals are just beginning, so all we've got up is Lillyhammer. So it's not yet hugely significant, but as we add in the next couple originals coming later this year, that will build to a nice percentage of our total viewing.

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**David Wells** - *Netflix Inc - CFO*

And I would say we look at the performance of those pieces of content like any other piece of content in terms of cost per hours viewed and its efficiency. So across that class of content, we would expect to compare it against other like content.

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**Reed Hastings** - *Netflix Inc - CEO*

So we think we can produce content at no greater cost than that per hour of viewing, essentially, than it would cost to get licensed. And then we have the advantages of the brand halo as well as the defensive hedge if we need it over time.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Can you discuss how successful Lillyhammer was, maybe helping to place it in perspective for its views versus other shows?

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**Reed Hastings** - *Netflix Inc - CEO*

You know it was quite successful for the amount that we invested in it, the amount of the cost. And it parallels some of the other premium exclusive content that we got, like a Breaking Bad, in terms of its ratio of cost to viewing. So we feel really good about that our first shot out. And as House of Cards and the other originals that we have come forth next year, we'll be very excited about those also.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

You said that costs associated with originals will ramp in 2013. Any way we can quantify the impact of that?

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**Reed Hastings** - *Netflix Inc - CEO*

It's really just part of content costs. That is, we will spend in the neighborhood of single-digit percentages of our total spending -- content spending for next year on a P&L basis will be originals. So for us, it's just another source of content.

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**David Wells** - *Netflix Inc - CFO*

And I think what we said in the letter is that free cash flow -- that cash will actually ramp as originals ramp into 2013. So the costs are already baked into our assumptions around content expenses. It's the cash that will ramp noticeably in the back half of the year.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Here are some more questions. Netflix appears increasingly focused on exclusivity, especially compared to 12 to 18 months ago. Should we expect the vast majority of your content to be exclusive by year-end 2013? In turn, is it reasonable that content spending will continue to move notably higher next year, as well as due to healthy sub growth?



**Reed Hastings** - *Netflix Inc - CEO*

As we move up the content by economic strata, you start off with kind of the low-end, non-exclusive content. And then as you want to get shows like Mad Men, you have to outcompete with other cable networks to get those shows in syndication. And those are exclusive licenses, and so we have started doing more and more of those. As we want to do direct deals with movie studios like DreamWorks automation, the other bidders will not take that content if we also have it, so those are de facto exclusive. So this exclusive trend has been going on towards more and more exclusive and will continue as we climb the economic strata and have better and better content. It's a natural outcome of us being a network like other cable networks, all of which are exclusive against each other. I don't think we will have all of our content exclusive, really, at any point in time, because we'll continue to also have a broad range of non-exclusive content. But certainly, there will be more and more that is exclusive.

**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Can Netflix survive as a middleman? I define middleman as an intermediary between content owner and end user. Is the Company's largely middleman status the reason for its apparent evolution to, at least in part, original programmer? How long do you think it will take to become a credible peer to HBO, which has had smash hit originals such as the Sopranos and Sex and the City?

**Reed Hastings** - *Netflix Inc - CEO*

Well, there are lots of middlemen that are hugely successful in many different industries, and sometimes they verticalize the production and they have store brands for various items. And it doesn't mean that their middleman or retail status is weakened. They do that to strengthen themselves. And if you think about HBO, initially, it was almost all licensed content, and then they grew in as they gained scale to also doing produced content. But still the majority of HBO's budget is on content produced by others, by the major studios. So yes, we feel very comfortable about being an aggregator that packages together an incredible set of content, provide a great value for consumers, and that's a great position to be in.

**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

What is the balance of streaming content as of 3/31/2012 that are not currently reflected on the balance sheet?

**David Wells** - *Netflix Inc - CFO*

I think that's referring to the content contractual obligations, and at the end of Q1 that was \$3.7 billion, which compares to \$3.9 billion as of the end of 2011 and \$1.8 billion a year ago. So it's down slightly from the end of the year. As we moved content from that table and onto the balance sheet, it became in window essentially in that asset recognition criteria.

**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Now just as a follow-up to that. If you include what's in that note to the financials, if you add to that the accounts payable, you would see that our total minimum commitment for streaming content is flat quarter-over-quarter.

The biggest complaint I hear that is Netflix has a weak library of streaming content. While keeping prices low is a strategy that seems to be working well, it prohibits a very common complaint from being addressed. Has Netflix proposed the idea of a tiered subscription plan for online access? A silver, gold, and platinum plan which open up an increasingly larger and more popular library could both address this issue and increase profitability. Has this ever been considered?



**Reed Hastings** - *Netflix Inc - CEO*

No, we're very focused on keeping our proposition extremely simple. We think that that is the right strategy when we are in this rapid phase of growth of the market, to have a single \$8 unlimited product in the marketplace. Eventually, in the next curve model, in the tail phase when a market matures, then you look to segment in various ways. But knock on wood, we are a long way from that, and we will continue to focus for the foreseeable future on a clean, simple proposition.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Cable ratings for many networks have declined this year. Do you believe networks are attributing this to Internet TV, and could it impact pricing on renegotiating TV content deals?

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**Reed Hastings** - *Netflix Inc - CEO*

You know, I'm not sure why cable network ratings are -- some are up and some are down. I think it's mostly due with the individual programming. If you've got incredible programming, there's several examples where the ratings are up. And in terms of how it affects us, we've got the ability to pay, because we've got a larger subscriber base than anybody else. So to the degree that the prices are higher, we are still able to deliver on the consumer proposition.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Let's move to questions about competition. Are you still thinking Amazon will do a stand-alone streaming product outside of Prime?

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**Reed Hastings** - *Netflix Inc - CEO*

Our understanding is that that will still happen, yes. In terms of particular time frame, we're not sure on what that might be.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

You have talked a lot about net neutrality. What do you see as the most realistic and/or likely path toward enforcement of net neutrality?

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**Reed Hastings** - *Netflix Inc - CEO*

I'm not sure at this point. I think we are broadly socializing the idea of what's neutral and what's not. And we documented one clear example where we think this is not at all neutral. And we are engaged in a public discussion, essentially, of the issues, so we will see how that plays out.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

A related question. Why are you so concerned about Comcast and bandwidth caps? If one hour of streaming time takes up a mere gigabit of bandwidth and the Comcast monthly bandwidth cap is 250, implying 8.3 hours per day of viewing time, why the concern, especially if you believe that the Netflix streaming product is vastly superior to Xfinity?

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**Reed Hastings** - *Netflix Inc - CEO*

I think the concern we have is with the principles of net neutrality. Obviously, with a high enough cap, it kind of doesn't matter. But if something is accepted with one cap, we may find the next year that the cap is much lower. And so, I think we have to really try to figure out the principles and

advocate for those upon which will allow operating. I would agree it's not a near-term issue with the 250 gigabyte cap, but the core principle is important anyway, which is the cap should be applied equally or not at all.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

I was wondering what Netflix will do to increase and hold existing subscriber base in the US and elsewhere with so many other companies entering the streaming video business.

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**Reed Hastings** - *Netflix Inc - CEO*

Well, I think what's happening is everyone's realizing that consumers want click-and-watch on-demand, and so there is a lot of announcements of everything from startups to large companies. And we've been focused on this market for a very long time and have some substantial advantages because of that in terms of the breadth of our integration in the various devices, in terms of our on the remote control buttons that we have on smart TVs, in terms of our integration into all of the game consoles. We have big advantages in terms of the development of our website and the core service, the algorithms and the personalization. We have incredible content. It's not as broad as we will eventually have, but it's much broader than any competitor. So, often what happens is when there is a lot of attention on the market, there are new competitors, but the leader gets the majority of the benefits of that. And it's our job to continue to deliver for consumers so that we're chosen more often than anybody else.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Let's turn to questions about international. What have you learned from existing market launches that you apply to the thought process of selecting your next international market, that you have indicated you will launch in Q4 of this year?

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**Reed Hastings** - *Netflix Inc - CEO*

Well, again, really happy with the UK and Ireland, just great results there. We've got great results in Canada. And in Latin America, we will get there eventually, but it's going to be longer and harder than we initially thought. So we will tend to be more towards developed markets that are more like Canada, UK, and Ireland than strong emerging markets like Latin America.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Your international expense guidance on January's Q4 call forecast \$5 million for subtitling. Yet your release today, only months later, says you incentive capitalized such expenses. Why change from past in media expensing to a more aggressive income presentation?

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**Reed Hastings** - *Netflix Inc - CEO*

The costs were immaterial in the past. They rose in Q1, as we talked about in the letter, getting more towards 100% of our offering in Latin America subtitles, so we faced increased cost in Q1. And the prospect, as we launch additional non-English markets, is that these costs will be material. So from an accounting standpoint, when they are low, they don't matter, you don't have a policy. When they become material, and in bulk they are material and they stay material, there's more argument that they be capitalized. And we looked at this and we needed to create a policy in Q1, and we didn't have that accounted in our forecast.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

A question on Latin America. In Latin America, we fully understand the limitations of infrastructure, credit cards and broadband hindering uptake. What I would like to know is, what about the progress there gives you confidence that it will succeed, albeit at a slower pace than you had initially expected, as opposed to not work at all?

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**Reed Hastings** - Netflix Inc - CEO

In Latin America, we are seeing very nice revenue growth. It's just not as fast as we anticipated in terms of catching up to the content. So, if there were a situation where we didn't have revenue growth, that would worry us. But that's not the situation that we have. We're seeing very much revenue growth, and we're continuing to improve, whether it is payment, whether it's the streaming delivery, all the other systems.

And second, there is no competitor that is ahead of us. If we were resoundingly beat in some nation by some other competitor, that would have us maybe rethink how long it would take us to get to profitability. But again, that hasn't happened. So for now, we've got a rapidly growing business. It is still running at a loss, and it's going to take longer, we think, than the two years to get there. But the vectors are all in the right direction.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

Could the iTunes integration be extended beyond Apple TV to iPhones and iPads, too, in order to ameliorate the e-commerce payment problems in Latin America and elsewhere?

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**Reed Hastings** - Netflix Inc - CEO

There's a number of integrations we could do. One would be in the iTunes aspect. Others would be with ISPs. Others would be with cable companies. So we're looking at those broadly. And each one will have a small, positive effect, but there will be no one breakthrough or silver bullet.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

I would just add, as we say in the letter, we are obviously open to other people billing on our behalf, but also in Latin America, we're looking to improve the payment options that we offer to the consumer to solve the problem ourselves.

The letter said you were looking to expand into additional European markets beginning in Q4 of this year. If you can't be more specific, can you talk about the characteristics of that market?

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**Reed Hastings** - Netflix Inc - CEO

I think that's probably just a duplicate question, so let's just go to the next.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

What is the incremental impact of your decision to enter another international market on the expected full-year results for 2012 on a consolidated basis? Should we see an investment along the lines of Latin America and the UK, or smaller?

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**David Wells** - Netflix Inc - CFO

We haven't provided guidance on that. What I said earlier was that we would be looking to fight back to a global consolidated breakeven after the market launch in Q4.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

How are you finding the entry and expansion into each country, and how many additional countries planned for this year and next?

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**Reed Hastings** - *Netflix Inc - CEO*

Well, fundamentally we're funding it with the domestic profit streams. So our domestic business is showing great growth in both revenue and contribution margin. And so we're using those profits to fund the international expansion, and it's metered by that -- by our view of staying approximately breakeven on a global basis.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Has your view of international competition changed in recent months?

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**Reed Hastings** - *Netflix Inc - CEO*

No, not particularly. We anticipated that in markets that we don't get to for a few years, there will be stronger local competition than in markets we get to soon. I think that's probably pretty obvious. That's really the only aspect of it.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Do you expect to see any different seasonal patterns in international markets? I know it would not show today because of the higher gross phase you are in but would still like to know if there are any quarters with tailwinds or headwinds.

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**Reed Hastings** - *Netflix Inc - CEO*

Well, from a diversification standpoint, if we were as big in the Southern Hemisphere as Northern, they would balance each other. So it's definitely linked to length of the winter, length of the night, and it would be and is reversed seasonality from the Northern Hemisphere than the Southern. But on a practical basis, with the US just under 90% of the business, it's the dominant aspect is the US seasonality.

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**David Wells** - *Netflix Inc - CFO*

And I would say that a pronounced weather pattern is one aspect of it, but as we contemplate other markets, we look at the seasonal TV viewing behavior, the seasonal rental behavior on video on demand, things like that. Some of these countries are tropical. They don't have a pronounced winter, summer, and they may follow the same pattern in terms of the Northern Hemisphere. But it's early to tell.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Well, the sub trajectory in the UK appears far better than in Latin America initially. Can you give us a sense of what usage looks like? How much time are UK subscribers spending with the service?

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**Reed Hastings** - *Netflix Inc - CEO*

Usage has been very strong. I don't want to give, for competitive reasons, specific numbers, but we've been very pleased with that active usage and growing usage as we add more and more content and continue to flesh out the devices, in particular to getting on the smart TVs.



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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

Moving to some questions on DVD. Why are you so confident that the DVD will not fall off as fast going forward as it did in the past couple quarters? Even if churn is going down, is it not getting hard to find new growth additions for DVD plans?

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**David Wells** - Netflix Inc - CFO

Well, we are confident, because the retention of those subscribers is improving from Q4 to Q1. And we may see some seasonality around Q2. But in general, the number of subscribers we're losing on the hybrid side are not the step change we experienced from Q4 to Q1, largely because people were deciding whether or not they wanted to pay \$16 for a hybrid service when we made the changes in July, and they sort of rationalized those decisions over Q3 and Q4. So, increasingly fewer and fewer people are having to make that decision or have already made that decision about whether it's a value to them to pay \$16 for the service. And that's what drives, largely, that sort of decreasing rate of decline.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

With the Quickster episode fresh in mind but also considering the high overhead costs of DVD shipping, would you consider spinning off or selling the DVD division? The cash could be put toward faster overseas expansion. Maybe the DVD and streaming services could still be tightly coupled with the right contracts in place.

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**Reed Hastings** - Netflix Inc - CEO

No, we are not thinking of that.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

Moving to some miscellaneous questions. Are the terms of your Apple TV deal for new member sign-ups similar to the 30% revenue Apple has with other content providers?

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**Reed Hastings** - Netflix Inc - CEO

On those types of contracts, we're prevented from commenting by confidentiality, so we can't say.

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**Ellie Mertz** - Netflix Inc - VP, Finance & Investor Relations

In late November, you announced the closing of \$200 million worth of convertible notes. The notes could be converted after six months, assuming certain conditions were met. The six-month anniversary will end during the second quarter. Given that the shares appeared to be above the conversion price, do you expect these shares to be converted? And if so, when?

Yes, so the convert is first convertible six months after issuance, which was November, which places us in May. The Company has the option of converting those shares at 30% over the conversion price, which is about \$11, and the earliest we could do --

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**David Wells** - Netflix Inc - CFO

\$11.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

\$111, thank you. The earliest we could do that would be July, if the stock had stayed above that the price for 50 of the prior 65 trading days.

What should we assume for forward tax assumptions?

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**David Wells** - *Netflix Inc - CFO*

Around 38%.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

And higher in Q2?

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**David Wells** - *Netflix Inc - CFO*

Correct. It will play a little bit as we --

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**Reed Hastings** - *Netflix Inc - CEO*

We should be so lucky to be paying taxes.

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**David Wells** - *Netflix Inc - CFO*

I was just about say that that rate moves around a little bit as we come from a loss into a profit, prospective, but around 38%.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Great. That's all we have right now for e-mail questions, so at this time, I would like to turn it back over to the operator, and we will begin taking live call-in questions.

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## QUESTIONS AND ANSWERS

### Operator

Thank you, ma'am. (Operator Instructions). Our first question here in queue is Jason Helfstein with Oppenheimer. Your line is open. Please go ahead.

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**Jason Helfstein** - *Oppenheimer & Co. - Analyst*

Thanks. I will ask two questions, but I am not sure what was hit. With respect to what you talked about with Apple TV now taking sign-ups on the TV, should we assume that you're paying a similar 30% revenue share with Apple and that's kind of taken into account when you think about adding customers that way? And then my second question, you kind of had a positive take on social integration in the UK and Ireland but didn't give any specific metric. I'm wondering if there's any other type of metrics you can give out as far as maybe what percent of users are uptaking the social functions. Thanks.



**Reed Hastings** - *Netflix Inc - CEO*

Jason, it's Reed. We did just answer the Apple question, which was no comment. And then, on the UK Facebook success we've had, we haven't characterized any specific metrics. And for competitive reasons, we're not further elaborating.

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**Jason Helfstein** - *Oppenheimer & Co. - Analyst*

And then maybe -- maybe one other follow-up. That functionality you are offering in the UK, is that more of a passive functionality such as we are seeing like with Spotify, or it an active sharing functionality where the user is prompted each time to decide whether or not they want to share their viewing habits?

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**Reed Hastings** - *Netflix Inc - CEO*

It's passive in the way that you used that word, like Spotify US, if you're using that, where your viewing history is optionally shared with your friends.

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**Jason Helfstein** - *Oppenheimer & Co. - Analyst*

Okay. Thank you.

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**Operator**

Thank you, sir. Next question here in queue is Mark Mahaney with Citi. Please go ahead. Your line is now open.

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**Mark Mahaney** - *Citigroup - Analyst*

Thanks. Two questions. I think, Reed, last fall in reaction to some of the controversy, I think you made a statement to the effect it might take a while for the brand and the relations and the trust with consumers to build back up. When you think about your DVD streaming net adds goal of 7 million for the year and what you have done year-to-date, do you think you've already overcome some of those concerns, that backlash from the fall of last year? Or do you still think that that's still a subdued growth number, that you could do better once you've regained the full trust of consumers? And could you just quickly talk about usage on tablet devices and if that's had a material impact on those overall viewing minutes? Thank you.

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**Reed Hastings** - *Netflix Inc - CEO*

Again, Mark, the brand recovery is partway complete. We had said it would probably take three years, with the bulk of the recovery in the first year. That still seems to us to be the correct model. So, we're feeling good about the progress we've made. We do -- we are conscious that it's tender and that we have to be extremely diligent and thoughtful in the way that we act as we build back our brand reputation.

And then, in terms of tablets, it's a great and growing viewing source for us, but we haven't characterized with any specifics any of the particular devices, again, for competitive reasons. We are on both Android and iPad.

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**Mark Mahaney** - *Citigroup - Analyst*

Okay. Thank you.

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**Operator**

Thank you, sir. Next question here in queue is Richard Greenfield with BTIG. Your line is open. Please go ahead.

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**Richard Greenfield - BTIG - Analyst**

With consumers using Netflix so much, I think the numbers you broke out essentially equate to over an hour per day actually now. Shouldn't churn be going down meaningfully? When you made that comment about in 2012 if you added 7 million subs assuming flattish churn, why shouldn't we see churn go significantly down as the amount of usage per customer per month or even per day just continues to scale upwards? And just as a follow-up to that, could you just give us some sense on -- for subscribers canceling now, what is the main reason people are canceling out of streaming-only service? Thanks.

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**Reed Hastings - Netflix Inc - CEO**

Rich, you know the average consumer is watching, as you said, nearly an hour a day, and then they are not canceling. So, the cancellations is amongst people who aren't watching much. So our job is to get those light users that are not very active to be watching more. And the other phenomena is as the server gets better known and more popular, that expands the circle of people who join it, who maybe aren't as much in entertainment as the initial 20 million or 25 million. And so it's natural that as the service expands its reach, that there is continued churn as people try it, figure out if it's for them right now. And if not, they get off. So that's where that phenomena is from.

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**Richard Greenfield - BTIG - Analyst**

Does that imply that the median is dramatically above the mean in terms of usage?

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**Reed Hastings - Netflix Inc - CEO**

No. It's just that it's not exactly a bell curve, because it's got the skew on the big end. But it's -- the median is not wildly different. It's just that there'll be 20% of people that don't watch much, and most of the churn will come from them. And then, you asked the question, when people quit, what do they cite? And the two big ones are not watching enough and don't have any money, which we see also

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**Richard Greenfield - BTIG - Analyst**

And when you say not watching enough, is that just because the programming -- they can't find something they like, or they're just isn't enough content in total?

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**Reed Hastings - Netflix Inc - CEO**

It's a mix of those. If you think about the moments of truth for a member, at any point in time they can watch Netflix or they can watch cable or they can watch their DVR or they can watch a DVD or they can watch Hulu. And we have to win enough of those moments of truth to keep the subscriber active. And one of the ways we win is to have a really broad selection, personalization, ease of use, and other ways just to have it, like being able to see the red Netflix button on the remote control.

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**Richard Greenfield - BTIG - Analyst**

Thanks.

**Operator**

Thank you, sir. Next question here in queue is Anthony Diclemente with Barclays. Please go ahead. Your line is now open.

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**Anthony Diclemente - Barclays Capital - Analyst**

Thank you. Reed, you just mentioned that one of the big reasons for churn is people not having any money. So I wonder if you would consider -- you've considered that if Xstream Pics, for example, is at \$4.99 and let's say Amazon comes out with a carveout Prime streaming service at something lower than \$7.99, have you thought about or would you consider adjusting your price point? And the second question would be, I think Mark asked about usage on tablets, and I would just ask, has the subscriber acquisition channel changed with the explosion in mobile? Is that something that you can comment on in terms of where you are getting gross add connects from? That would be great as well. Thanks a lot.

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**Reed Hastings - Netflix Inc - CEO**

We're feeling great about our \$8 price, because we can then get lots and lots of content for our subscribers. So, no anticipated changes there. And then in terms of subscriber acquisition, mobile is a good source for us. Video, disproportionately, is watched on television, so things that are TV-based sign-up, like on the game consoles, like Apple TV, are really the brand center and the biggest drivers of potential opportunity.

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**David Wells - Netflix Inc - CFO**

Anthony, this is David. That hasn't changed, right? That's consistent with what we've said in prior quarters, and it's not a big acquisition driver. It's a big value driver for our subscribers.

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**Anthony Diclemente - Barclays Capital - Analyst**

Yes. Okay, thanks.

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**Operator**

Thank you. Next question here in queue is Heath Terry with Goldman Sachs. Your line is open. Please go ahead.

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**Heath Terry - Goldman Sachs - Analyst**

Great, thanks. I was just wondering if you could give us a sense, just purely on a relative basis, if you see any difference in the levels of churn between your users that are engaging you through multiple devices like connected television sets, tablets, handsets versus your more PC or kind of game console customers?

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**Reed Hastings - Netflix Inc - CEO**

Yes. It's exactly as your intuition is probably leading you, which is if you use Netflix on lots of devices and if you use it for lots of time, you are more engaged with the service and you are less likely to churn. So, that's definitely an indicator.

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**David Wells** - *Netflix Inc - CFO*

Heath, this is David. Teasing out people who don't use it a lot but have a lot of connected devices, that's probably not a common case. So, people who use a lot of devices tend to watch a lot of hours.

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**Heath Terry** - *Goldman Sachs - Analyst*

Great. Thank you.

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**Operator**

Thank you, sir. Next question here is queue is Doug Anmuth with JPMorgan. Your line is open. Please go ahead.

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**Doug Anmuth** - *JPMorgan - Analyst*

Thanks for taking the question. Just wanted to ask about the deleverage in the DVD business. Is that just too early about the declining sub numbers, or is there anything else we should be thinking about here? And how are you thinking about distribution centers going forward and any other costs you may be able to take of the business along the way? Thanks.

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**David Wells** - *Netflix Inc - CFO*

Hi, this is David. I will take that one. I would say that in general in the DVD business, the big driver is the rate of subscriber decline. There's some other smaller things out there like postage rates and the fact that we would expect an annual postal increase going forward, which we have in the past. I would say it the other aspects are there were some minor things on -- just as you would do shipments, you lose some scale advantages, but those are small relative to the subscriber decline. And that's why we put in the letter that we would expect that the margin would stay relatively flat through 2012.

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**Doug Anmuth** - *JPMorgan - Analyst*

Okay, thank you.

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**Operator**

Thank you, sir. Next question here in queue is John Blackledge with Credit Suisse. Please go ahead. Your line is open.

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**John Blackledge** - *Credit Suisse - Analyst*

Thanks. Thank you. Two questions. The first one is, do you feel like the 7 million net domestic streaming add guide is a comfortable target? And did you guys consider maybe giving a range for the year, similar to the range that you give on a quarterly basis? That's one, and then the second one is, what's the demand for personalized accounts domestically, and is that something we may see introduced at some point? Thanks.

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**Reed Hastings** - *Netflix Inc - CEO*

John, yes, we're feeling comfortable on the 7 million. And you could put a range on if you want, but it doesn't really change the goal. So we thought we would just be straightforward about what our goal is. And in terms of the personalized accounts, that is something that we're developing a number of versions of. We will be doing some consumer testing with different versions of that going forward. But there's unlikely to be any revenue

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associated with that. That is, we're mostly focused on how do we improve the experience, and we'll see that in retention and acquisition at this point.

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**John Blackledge** - *Credit Suisse - Analyst*

Great, thank you.

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**Operator**

Thank you. Next question here in queue is Scott Devitt with Morgan Stanley. Your line is open. Please go ahead.

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**Scott Devitt** - *Morgan Stanley - Analyst*

Hi, thanks. Really just wanted to ask the 7 million sub question a different way. When you go back to 2010 when you added the 7 million subs, you had two things, the bundled product at \$9.99 and pretty significant distribution tailwind because of mostly the game consoles that were coming online and just starting to benefit the business. So when you look at that 7 million number for '12, what do you think are the comparable catalysts that give you the comfort to get to that type of sub number for the year? Thanks.

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**Reed Hastings** - *Netflix Inc - CEO*

Scott, I would say it's mostly based on how we did in Q1 and then -- which helps us feel good about it being on track for that 7 million. And then secondarily, in terms of the macro climate, it's the increased integration with smart TVs. If you go into a Best Buy today, we've got a stronger presence than we've ever had in the integration with both smart TVs and Blu-Ray.

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**Scott Devitt** - *Morgan Stanley - Analyst*

Thank you.

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**Operator**

Thank you, sir. Next question here in queue is Barton Crockett with Lazard Capital Markets. Please go ahead. Your line is now open.

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**Barton Crockett** - *Lazard Capital Markets - Analyst*

Okay, great. One quick one and then one broader. To understand the net income view for the balance of the year, when you talked about global breakeven with the fourth quarter launch of an international market, is that breakeven for the fourth quarter or breakeven for the year?

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**Reed Hastings** - *Netflix Inc - CEO*

You could think about it as breakeven on some rolling basis or approximately breakeven on some rolling basis, or it's will go under and then come up and go under and then come up. But ordinarily, and when I made that comment, it was on the quarter.

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**Barton Crockett** - *Lazard Capital Markets - Analyst*

Okay. So you're not saying breakeven for the year? You're not really saying anything about the year, I guess, at this point.

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**Reed Hastings** - *Netflix Inc - CEO*

That's correct.

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**Barton Crockett** - *Lazard Capital Markets - Analyst*

Okay. And then, I was also wondering, the surge in streaming usage, you guys have had a very significant share of prime time hours streamed content. Are you seeing any noticeable deterioration in quality of service to consumers? The cable companies have warned about brownouts as you see a video surge. There's other streaming services coming up. Do you see any negative performance in the quality of your service or do you anticipate anything as your usage ramps as others ramp?

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**Reed Hastings** - *Netflix Inc - CEO*

Barton, the technology underlying the Internet and fiber optics is absolutely mindblowing. So, you can take our peak viewing on a Saturday night, 100% of our global viewing, and can still fit into a single fiber-optic. So, I don't anticipate any brownouts. I anticipate continued growth of the broadband power being released as more and more we become a fiber-optic nation and a fiber-optic world.

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**David Wells** - *Netflix Inc - CFO*

I would add to that, Barton, that you're starting to see the ISPs compete on speed. It's in their -- prominently featured in their advertising, so it would feel a little inconsistent to be trying to advertise and compete on speed, at the same time warning your consumers that you are going to face shortages of the product.

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**Barton Crockett** - *Lazard Capital Markets - Analyst*

Okay, great. Thank you.

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**Ellie Mertz** - *Netflix Inc - VP, Finance & Investor Relations*

Great. That's all the time we have for questions today. I'm going to turn it back over to Reed Hastings for some closing remarks.

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**Reed Hastings** - *Netflix Inc - CEO*

Well, thanks, everyone. As I said at the beginning, we had a great Q1. We were thrilled by it in terms of our UK launch, in terms of our growth around the world, in terms of getting to great viewing records in Q1. And we are on track for breaking those records in Q2 on a year-over-year basis. So, we're excited about that.

The odd thing about our numbers I realized is that with stable seasonality in gross adds, we see increased seasonality in net adds. And that is this mathematical artifact that we tried to document. I know it's got some people concerned, but we feel great about our progress in being on track for our 7 million net adds for the year. With that, I want to thank everyone for being on the call and look forward to catching up with you.

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**Operator**

Thank you. Again, ladies and gentlemen, this does conclude today's program. Thank you for your participation, and have a wonderful day. Attendees, you may disconnect at this time.

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