

FINAL TRANSCRIPT

Thomson StreetEventsSM

NFLX - Q2 2010 Netflix Earnings Conference Call

Event Date/Time: Jul. 21. 2010 / 10:00PM GMT



Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

CORPORATE PARTICIPANTS

Erin Kasenchak
Netflix - Director - IR

Reed Hastings
Netflix - Founder, Chairman, CEO

Barry McCarthy
Netflix - CFO

PRESENTATION

Operator

Good day, everyone, and welcome to Netflix' second quarter 2010 earnings Q&A session. Today's call is being recorded. At this time for opening remarks and introductions, I'll turn the call over to Erin Kasenchak, Director of Investor Relations. Please go ahead.

Erin Kasenchak - *Netflix - Director - IR*

Thank you, and good afternoon. Welcome to the Netflix second quarter 2010 earnings Q&A session. We released earnings for the second quarter at approximately 1.05 PM Pacific time today. Earnings press release, management's commentary on the quarter's results and the webcast of this Q&A session are all available at the Company's investor relations website at ir@Netflix.com.

Like last quarter, this call will consist solely of Q&A, and we are going to conduct the Q&A via e-mail. Please e-mail your questions to ir.Netflix.com. 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 22, 2010.

A rebroadcast of this Q&A session will be available at the Netflix website after 6 PM Pacific time today. Before moving into Q&A I'd like to turn the call over to Reed for a few opening remarks.

Reed Hastings - *Netflix - Founder, Chairman, CEO*

Welcome, everyone, and let's jump into the questions. Erin?

QUESTIONS AND ANSWERS

Erin Kasenchak - *Netflix - Director - IR*

Great. First question is from Steve Frankel at Brigantine Advisors. Does the recent content deal with Relativity Media signal a material increase in the overall content expenditures, or a continuation of the trend of shifting investment from physical to digital?

Reed Hastings - *Netflix - Founder, Chairman, CEO*

Steven, it's a little of both. We have been investing more in streaming content quarter after quarter, year after year, as we get revenue growth and confirmation that the streaming content investment is a smart one, and Relativity does indicate a material



Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

step up in that. Most of that doesn't come in until Relativity delivers the films, so that would be next year and beyond, so there's no material step up this year for Relativity, but we are out looking for more content and unique to Relativity, is that it's completely exclusive for Internet subscription to Netflix, so the first of essentially a slight shift in our strategy, which is to also be licensing exclusive content, in addition to non-exclusive content.

We don't see a big radical shift. It's a thing we're doing some of the content on movies and TV shows exclusively now, which as you know, opens new content availability, because much of the content in the pay TV window is sold exclusively.

Erin Kasenchak - Netflix - Director - IR

The second question is what is the percentage of subscribers on Blu-ray plans?

Reed Hastings - Netflix - Founder, Chairman, CEO

Steven, it's a little over 10%.

Erin Kasenchak - Netflix - Director - IR

Great. Next question is from Dave Miller at Caris & Company. Can you confirm whether or not the introduction of the iPad app has resulted in additional subs beyond your expectations, or whether the Netflix app has resulted in already existing subs acquiring the iPad?

Reed Hastings - Netflix - Founder, Chairman, CEO

Well, Dave, every new platform, whether that's the Wii, the iPad, all of the platforms, do both. They help us with existing subscribers getting more value from the Netflix service, and they help us attract new subscribers, and the iPad was a big success for us as the Wii was, and as really all of our platforms have been.

Erin Kasenchak - Netflix - Director - IR

Next question is from Youssef Squali at Jefferies & Company. How is the rate of activations on the Wii versus what you have seen for the Xbox in the first 90 days?

Reed Hastings - Netflix - Founder, Chairman, CEO

Youssef, we don't break out platform specifics, but I would say that we were very happy with Xbox when it came out and we've been very happy with the PS3, and now we're very happy with the Wii. They all have large installed bases, and that's a meaningful way for our subscribers to get value from our service, and watch great movies and TV shows.

Erin Kasenchak - Netflix - Director - IR

His second question. Is there a sub-segment of subscribers who only stream the service, and stop ordering DVDs? If so, can you quantify?

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

Barry McCarthy - Netflix - CFO

The majority of subscribers do both, stream and take DVDs.

Erin Kasenchak - Netflix - Director - IR

Next question from Ryan Hunter at Wedge Partners. Are the marketing expenses associated with the Canadian expansion already factored into your operating margin guidance for 2010?

Barry McCarthy - Netflix - CFO

Yes, it is.

Erin Kasenchak - Netflix - Director - IR

And what percentage of your CDM partners will support Canadian subscribers?

Reed Hastings - Netflix - Founder, Chairman, CEO

Assuming you meant CDN there, in which case there's no real issue. The Internet, our providers such as Akamai, Limelight and others, work fine in Canada.

Erin Kasenchak - Netflix - Director - IR

Great. Next question is from Ben Rose at Battle Road Research. As Netflix gears up to enter the Canadian market and presumably other foreign markets, what is the most significant content delivery challenge facing the Company? Do you expect higher content delivery unit costs than you have in the US?

Reed Hastings - Netflix - Founder, Chairman, CEO

Delivery, if by delivery, one means the cost of streaming, it's a fairly small part of the total picture, so I would say in Canada, the challenges are licensing the right content at the right cost, and then taking advantage of the right marketing channels at the right cost. Those are the two primary drivers, the content and the marketing.

Erin Kasenchak - Netflix - Director - IR

Next question is from Dan Ernst at Hudson Square. Question is on accessing rights to digital content for instant watch. Does the size of your subscriber base, relative to large cable and satellite carriers, factor at all into your ability to gain such rights? And if you looked at your top 500 titles across the year, what percentage of those are now available for instant watch?

Reed Hastings - Netflix - Founder, Chairman, CEO

Well, let's see. Our relative size isn't a direct impact, Dan. It's more the absolute size of our checks, so if the biggest check we can write for a piece of content is \$10,000, it's a long shot to get it, but if the biggest is \$20 million for some piece of content, we're pretty likely to outbid anybody else, so it's as you would expect in that way, so there's an indirect influence around our revenue or our content spending budget, the larger that it is, the more effective we can be. And then you ask about the top 500. I'm not sure how to answer that exactly, but I would say that the power of Netflix is to take a lot of content that may not

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

be the hottest content, and make it feel like it's an incredible service to subscribers. That's where we add value as a service, and when one is merely carrying the hottest content on the planet, there's not as much of a profit opportunity in that because you have to pay the content owner, well the content owner has earned most of the value generated, and they do extract that. So our key is not around top 500. Our key is direct and what percent of our subscribers are streaming, can we keep them actively streaming, because if they are actively streaming and taking DVDs, then they will retain better, and you can see that in the year-over-year improvements in retention that we've generated.

Erin Kasenchak - Netflix - Director - IR

The second question is related to churn. A second area of interest is on churn. What are the top two areas a customer goes to instead of Netflix when they leave? Also, of the customers you've added over the last year, what percentage of those have been Netflix customers previously?

Reed Hastings - Netflix - Founder, Chairman, CEO

Well, our rejoin rate is usually around a third, and plus or take five points and on the first part of the question, what was that again?

Erin Kasenchak - Netflix - Director - IR

Where are the top two places that people go when they churn?

Reed Hastings - Netflix - Founder, Chairman, CEO

When we ask them, and it's a little bit of a choppy answer I could give you, because we ask about movies, where do you get movies from? Which is going to be a different answer from where you get TV shows from, but if you ask where we get movies from, consumers say the kiosks, the \$1 rental and that's the big one, and it's still rising. Almost everything else is in the noise.

Erin Kasenchak - Netflix - Director - IR

Great. Next question from Jeff Rath at Canaccord. Free subscribers, as a percentage of paying subscribers, have reached the highest level ever for Netflix. What's causing this, and how should we expect this to trend for the remainder of 2010?

Reed Hastings - Netflix - Founder, Chairman, CEO

It's not a huge difference in general, that's a reflection of our growth rates. So our growth rates astoundingly have been moving up all year long, and we expect them to continue to grow, and a higher growth rate will be associated with the higher rate of free trials at any point in time. Did you want to--?

Barry McCarthy - Netflix - CFO

That's pretty much it. Seasonality contributes ever so slightly to the number of revenue months generated in the quarter, which bears on the mix of free and paid. Q2 tends to be slightly back-end loaded, Q3 is pretty much flat line through the quarter, Q4 is back-end loaded, but Reed described the predominant influence which is sub growth.

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

Erin Kasenchak - Netflix - Director - IR

Great. The next question is from Nat Schindler at B of A-Merrill. The dramatic increase in subscriber guidance, up 1.2 million on top and bottom end of guidance for year-end, coupled with limited increase in revenue guidance, suggests that you now view ARPU coming down much faster than you did before. What has changed?

Barry McCarthy - Netflix - CFO

I would say not so much. The only thing that's changed in the business, and it's quite a significant change is the accelerated growth, and we attribute that to streaming and streaming implies for one out unlimited price point. So I said on the Q3 call a year ago, that if prices decline rapidly towards that one-out unlimited plan, we'll be very excited, that's great news for the business because it means that streaming is resonating with consumers, and likely we will see accelerating growth, and in fact we are seeing accelerated growth. So if you are doing a year-over-year comp, it helps to remember that we initiated in part a Blu-ray price increase in Q2 a year ago for two months of the quarter, and then three months of the quarter in Q3, and so that dampens the effect of the shift towards the one-out plan, but absent that effect, we're tracking year-over-year say Q3, Q4 I think will be on par. One to another.

Reed Hastings - Netflix - Founder, Chairman, CEO

And now we do expect as streaming continues to be as successful as it has been for us, that our \$8.99 one-new plan will be a larger and larger percentage both of sign ups and therefore the installed base. We're not seeing any material migration of the installed base. That has stayed pretty constant, when people come in on a certain plan they stay with it, so it's just that new subscribers are predominantly coming in on the unlimited streaming, one DVD at a time plan.

Barry McCarthy - Netflix - CFO

I want to remind everyone that I think the purer indicator of the growth potential of the business is subscriber growth. We've had lots of discussion about ASP over time and its decline, and because of that discussion, we added a metric which was gross profit per paying sub, and on a year-over-year basis, we actually saw an increase of about \$0.30 in that metric, so even though ASP is going down, and revenues aren't growing slower than subscribers are growing, in terms of gross profit dollars, we're adding more per new sub in Q2 of this year than we did a year ago.

Erin Kasenchak - Netflix - Director - IR

Great. His second question. How do you get visibility into Q4 subscriber growth, or in other words, how do you get comfortable with out-quarter guidance?

Reed Hastings - Netflix - Founder, Chairman, CEO

We have lots of confidence about next weeks outcome, declining less, ability to be accurate next month, and as you point out, declining less ability the following quarter. It's really a continuum. The trend lines that are propelling Netflix's acceleration have been a very steady strong acceleration since the beginning of the year at least, and that's what gives us confidence that it's not one short-term aspect and while we're not able to, we're choosing not to predict continued acceleration of growth in Q4, that is our model or our expectation, and guidance is that growth will remain at a very strong 48%, 49% subscriber growth in Q4. It's because of the continuity and the steadiness of our acceleration to date, as opposed to, say we're banking on CPM rates or some specific aspect of Q4.

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

Erin Kasenchak - Netflix - Director - IR

Our next question is from Jason Helstein at Oppenheimer. Can you update us on our three to five year outlook for operating margins?

Reed Hastings - Netflix - Founder, Chairman, CEO

Jason, by update that implies that we've said something about that in the past, which I don't believe we have. In general, we would hold the domestic business, we would want that to steadily improve, probably at a fairly modest rate, because the top line is expanding so dramatically. The global operating margin would depend upon international, and at what rate it was prudent to invest.

Erin Kasenchak - Netflix - Director - IR

Great. Next question, from Scott Devitt at Morgan Stanley. Given that the three largest devices, installed bases, Xbox, PS3 and Wii have already launched, how should we think about the subscriber contribution from the initial launches versus follow on contribution from the existing installed base, versus incremental growth in the console-installed base?

Reed Hastings - Netflix - Founder, Chairman, CEO

Scott, we've been very happy that the Xbox, which is our longest-standing device relationship, we continue to see substantial growth in the number of Xbox users and Xbox activations for Netflix, and that's partially because they are continuing to sell more new devices into the market at a considerable rate, and it's partially because we're marketing our service to people, who include current Xbox owners. So both install bases, Netflix and Xbox are growing and from that we're seeing continued growth. So we look at it, and we think we will continue to generate substantial growth from all three of the game platforms, because all three are growing.

Erin Kasenchak - Netflix - Director - IR

While Netflix may have the scale to aggressively acquire streaming content, availability of content appears limited due to the exclusivity agreements between premium TV networks and most major studios. Are there other buckets of content similar to Relativity Media that are not tied up in exclusive agreements? Or will Netflix need to pursue another Starz-like distribution deal, with the likes of Epix or Showtime in order to dramatically expand the content library?

Reed Hastings - Netflix - Founder, Chairman, CEO

Again, you want to separate that out between TV shows and movies, so in movies, there's a small number of makers, and as you mentioned, a number of exclusive deals, and so we are definitely interested in licensing from HBO, from Epix, from Showtime. In addition, there are pockets of content like Relativity that fall on the movie side. On the TV network side, there's a vast array of content and providers and exclusives are of the type that our movies are much less common, and there's a lot of incremental ability for us to generate new profits for those networks, because we focus on the prior season. We try to be particularly careful about not conflicting with cable networks, which focus on the newest episode, and we focus on the prior season and generating incremental viewing better than anyone from that prior-season viewing, and you will see us continue to expand on that in the coming years.

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

Erin Kasenchak - Netflix - Director - IR

Great. Our next questions are from Doug Anmuth at Barclays. You're changing tone now from three months ago, in terms of shifting spend from marketing to content spending. Seems like you were more definitive about the second half content spend increase after Q1 than now.

Barry McCarthy - Netflix - CFO

Well, there was no intended shift in tone, Doug. We expect to significantly increase the spending on streaming in the second half of the year as compared with the first half of the year and the first half was a big increase over the second half of the prior year, so as the business scales in terms of subscribers, it generates for us more and more capacity to reallocate spending, and so that's our plan.

You're probably referring to the language in my commentary, which said that if we're not successful in licensing additional content, then we will spend that money on marketing and grow this sub growth.

I was trying to inoculate us against creating expectations on the part of investors that in the absence of increased content spending, it would all fall to the bottom line because I didn't want earnings expectations to run away from us. It was another way of reminding folks that earnings is a managed outcome and we consciously, every quarter, make a choice between how much earnings to deliver on the bottom line, and how much to invest quarterly in growth either in the form of marketing or making the service better to drive additional sub growth.

Reed Hastings - Netflix - Founder, Chairman, CEO

And Doug, I would say the same, which is we got a consistent strategy, which is content gets first dibs on the budget and marketing spends what's left over and content tries to only buy efficiently, what they don't want to do is spend inefficiently and so that combination works well. It worked well for us in Q2, and will work well for us the rest of the year.

Erin Kasenchak - Netflix - Director - IR

Great. His second question. In deals like Relativity and others, how does the timing of content payments work in terms of cash payments and financial statement recognition? How lumpy are payments here, and when would you start to actively begin talking to Starz about renewing?

Barry McCarthy - Netflix - CFO

Well, let me take the accounting and cash flow part of the question. Of course, we don't make disclosures on a deal by deal basis, but in general, and by way of reminder, if we negotiate a multi-year deal for streamed content and if we're not able to allocate value for the deal to individual titles, then we amortize the cost of the license agreement on a straight line basis over the term, and the cash flow aspects of the deal are each unique to an individual deal and can vary quite a bit. Nothing about any of the deals that we've negotiated today changes in any significant way the cash flow attributes of the business.

Reed Hastings - Netflix - Founder, Chairman, CEO

And what was the second part?

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

Erin Kasenchak - Netflix - Director - IR

When might you start discussions about the Starz renewal?

Reed Hastings - Netflix - Founder, Chairman, CEO

On these Hollywood-type deals you're always in discussions; that never ends. So at no particular time does it begin or end.

Erin Kasenchak - Netflix - Director - IR

Great. Next question, from Mark Mahaney at Citigroup. With the slowdown in growth of DVD shipments, are we at an inflection point where we could start to see DVD shipment growth flat-line or even start to decline, and streaming really start to take off, or is this more of a function of limited content acquired during the quarter if DVD shipments could continue to grow and/or even accelerate?

Reed Hastings - Netflix - Founder, Chairman, CEO

Well, Mark, DVD shipments are growing. We don't expect them to flatten this year. As we said, the growth is less than we thought, so that would imply the peak would be earlier than we had thought. We'll know more each quarter on do those trends continue. And yes, there's great news in this, which is if churn stays low and DVD shipments grow slower than revenue, then that frees up a lot of money for marketing, for content, both growth-oriented investments, or for earnings. So good outcomes in all cases, if essentially, streaming is substituting for DVD as it seems to be happening for us.

Erin Kasenchak - Netflix - Director - IR

Great. His next question. You said over the next two quarters you will spend on content and marketing, especially streaming content, in order to drive subscriber growth. What metrics will you be looking at in order to determine where you focus your spend, could we expect other forms of marketing spend like more TV, print, mobile advertising?

Reed Hastings - Netflix - Founder, Chairman, CEO

We're very happy with the mix of marketing that we're doing and if we spent more you would see us be doing more online and more TV, but no radical changes. It's simply getting more impressions of the great advertising that we've got.

Erin Kasenchak - Netflix - Director - IR

Great. Next question, from George Askew at Stifel Nicolaus. You state in your commentary that you see TV shows as equally important to the franchises as movies. Within the watch instantly library, could you share with us the mix of content between TV shows and movies?

Reed Hastings - Netflix - Founder, Chairman, CEO

George, we don't break it out, the mix of content, and because TV shows are a smaller unit, you get unit viewables, hours of viewing, hours of viewables, all different kinds of measures, but what I can tell you is they're both very big for us, and both very substantial, and we continue to expand both on the movie side and on the TV show side.



Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

Erin Kasenchak - Netflix - Director - IR

His next question is based on what you know about the Hulu-Plus subscription offering, do you view it as a substitute or a complement to the Netflix streaming service?

Reed Hastings - Netflix - Founder, Chairman, CEO

It's a potential significant competitor, and it is the direct competitor, it's movies and TV shows streaming, so subscription, and we take it seriously as a direct competitor.

Erin Kasenchak - Netflix - Director - IR

Great. Next question is from Ralph Scharkart at William Blair. Does the Digital Entertainment Content Ecosystems recent branding campaign, and stated goal of rolling out a standard digital platform for new release movies, change Netflix stand on offering new digital movies/VOD? If not, what is the rationale given Netflix membership in the DECE?

Reed Hastings - Netflix - Founder, Chairman, CEO

Well, we've often addressed this topic. Just what's our relationship to pay-per-view and sometimes called download to own, which are two variances, a \$4 variance and a \$20 variance, and that is that there are many companies in that business, Amazon, Apple, Sony, Microsoft, CinemaNow and others, it's well addressed. We don't know how to add any particular value to that space, and we're really focused on subscription, and we've got such a big opportunity in subscription that this year, our growth is accelerating dramatically, and so we don't see any need or desire to expand our available market. We're just very focused on subscription.

Erin Kasenchak - Netflix - Director - IR

Next question, from Tony Wible at Janney Montgomery Scott. Will Netflix have exclusive access to all of the Relativity films or only the single production films? Will the joint production films still go to HBO and Starz?

Reed Hastings - Netflix - Founder, Chairman, CEO

Tony, Relativity does as you know a broad range of production and then we did a deal for some of the content, but we're not the sole distribution partner or sole pay TV partner for Relativity-produced films.

Erin Kasenchak - Netflix - Director - IR

Great. Next question, from Justin Patterson at Morgan Keegan. You mentioned a new PlayStation user interface coming this Fall. Will that require access to the premium PlayStation Plus subscription service? Should we think about a new user interface for Wii in the coming months too?

Reed Hastings - Netflix - Founder, Chairman, CEO

On the PS3, we'll have more to say about that when we roll it out, and that will be before the -- or we expect it to be before the next call. In terms of the Wii user interface, like all of our user interfaces, we're working on improvements, but we have nothing to announce today.

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

Erin Kasenchak - Netflix - Director - IR

Next question is from Wayne Chang at Canaccord. Could you speak both qualitatively and quantitatively on the success you are seeing with regards to activation on web-enabled televisions from manufacturers you mentioned, i.e. Samsung, Sony, VIZIO, et cetera?

Reed Hastings - Netflix - Founder, Chairman, CEO

Wayne, we focus on three broad categories, the video game consoles that have large install bases, and upgradability over the Internet so I give them a big advantage. Second category is Blu-ray and that advantage is, they are all Internet connected. because it was part of the Blu-ray security spec, and they are relatively low in price, so they are easy to upgrade if you've got a big TV, say already in place. The third category is the one you asked about, Internet TV, which is just emerging now. We've been very happy with some of the early progress from Sony and VIZIO and others, but that category in the very long term is likely to be the leading category, but at this point, it's still nascent, and that works for us fine. We're doing significant investments in all three of those broad areas.

Erin Kasenchak - Netflix - Director - IR

Great. The next question is from Barton Crockett at Lazard. Can you offer a prediction of when Netflix will be recognizing more expense in the income statement from an online content, when it occurs from the direct content cost of DVDs, excluding postage.

Barry McCarthy - Netflix - CFO

I don't think we're going to comment on it at this time.

Erin Kasenchak - Netflix - Director - IR

His next question, regarding cord cutting. Do you see any evidence that Netflix subscribers are inclined to either cancel multi-channel video subscriptions, or to pare back use of premium services such as Starz, Encore, HBO?

Reed Hastings - Netflix - Founder, Chairman, CEO

No, we haven't seen any evidence of that and there's no evidence in the total numbers of those firms in last quarter's financials and total subscribers, so total multi-channel video subscribers is continuing to grow in the US. Premium subscribers is not showing any decline, so I don't think there's any material cord cutting. I think what's happening is the multi-channel video, such a broad package with an incredible array of products, that we're a tiny little fraction of that, and our subscribers view us as a supplemental service, and because it's a modest cost at \$9 a month, it works for them and their budget.

Erin Kasenchak - Netflix - Director - IR

Next question, from Mike Olson at Piper Jaffray. Have you ever considered raising the price of the subscription to fund content acquisition, and does Hulu introducing a \$9.99 a month plan that is also ad-supported, change your thinking on your monthly fees?

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

Reed Hastings - *Netflix - Founder, Chairman, CEO*

Well, Hulu doesn't change our thinking at all. They're just at this early stage, too small to matter. But generally, we ask ourselves every quarter, should we cut price, should we raise price, should we add more content, shrink the content? We think through every quarter, in what way should we be evolving the business model, so nothing particularly at this point, but it is always a ongoing question we ask ourselves.

Erin Kasenchak - *Netflix - Director - IR*

His next question is, while the various metrics will bounce around from quarter to quarter and due to seasonality, is it fair to say that as long as a subscriber base continues to migrate to increased usage of streaming in favor of DVD, that gross margin, churn and SAC should all continue to improve on a year-over-year basis in the foreseeable future? What could cause this not to happen?

Barry McCarthy - *Netflix - CFO*

Well, as we make the service better, Michael, I have every reason to believe that if we're successful in increasing subscriber engagement with the service that we'll see improvements in churn and we stand to see improvements in SAC. I don't expect to see continued improvements in gross margin, and I think we would probably do ourselves a disservice and slow our growth if we were to starve the content spend, and in order to manage the gross margin in the business to higher levels. So in lieu of gross margin, I encourage you to think of the operating margins, as we're clearly making tradeoffs between, as we have through our entire history, on SAC, churn and gross margin, all for the purpose of managing ourselves to an operating margin that strikes the right balance between growth and profit. So by way of example, last quarter I told you to expect us to manage the business to an 11% operating margin for the year.

Now we're growing faster, and having more success doing it than we imagined, and to the mid point of guidance, our net income implies an operating margin of about 12.5%, so clearly business is running, at least year-to-date, more profitably than we expected and at least in the current quarter, gross margin both because of plan mix shift and because of substitution behavior, is more profitable than we had expected. Now in a perfect world, if we time content spending and marketing spending and align it with perfect foresight in our forecast, that wouldn't have happened, and we would have reinvested that money and had faster sub growth still.

Reed Hastings - *Netflix - Founder, Chairman, CEO*

Mike, to repeat what Barry said, we do look at operating margin as an important discipline but not gross margin, so if we found the right content deals, we would easily take half of the marketing budget and flip it into content, if we thought that's going to help us grow even more than that marketing budget, so you could see big swings that way, if we think it's in our interest in terms of growth and consistent with our operating margin goals.

Erin Kasenchak - *Netflix - Director - IR*

Great. The next question is from Imran Khan at JPMorgan. Can you talk about how much of the increase in churn was driven by seasonality versus other factors?

Reed Hastings - *Netflix - Founder, Chairman, CEO*

Well, I think we saw 30 basis points of seasonal increase a year ago, and we saw 20 basis points, roughly of seasonal increase this year, I'm talking about Q over Q, so on a net basis, I think we're better by about 10 basis points, and all of the trend lines for

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

the individual plan types and usage types, hybrid versus just going the rest of it, suggest to me as my commentary indicates, that we'll continue to see improvement in churn through the remainder of the year.

Erin Kasenchak - Netflix - Director - IR

Great. Next question is from Brian Fitzgerald at UBS. It will be a year from launch, April, before a user interface upgrade to the Wii. Is the driver there exclusivity/deal terms or related to R&D priorities?

Reed Hastings - Netflix - Founder, Chairman, CEO

Brian, there's no limit on our ability to innovate on the Wii. Once the new PS3 launches, that will convert from a disc-based user interface to a downloadable user interface, which makes the cost of upgrading very small for PS3. At this point, the Wii is forecast to still remain a disc-based model and that is some practical constraint to the timing and frequency of upgrades, so that's the only material difference going forward.

Erin Kasenchak - Netflix - Director - IR

Next question is from John Blackledge from Credit Suisse. What is driving streaming content purchase decisions? Is it about acquiring as much quality content Netflix can get at fair value, or are the initial viewing trends from subscribers shaping purchasing decisions?

Reed Hastings - Netflix - Founder, Chairman, CEO

The two factors are how much budget we have for streaming content, and then, can we get it? You refer to fair market value but really can we just get an agreement of a price that works for us both, and if so, then we do that deal.

Erin Kasenchak - Netflix - Director - IR

Next question is from Ed Williams at BMO. How quickly do you think you might be able to expand outside of Canada into other international markets?

Reed Hastings - Netflix - Founder, Chairman, CEO

Ed, we're going to take a look and see how we do in Canada with a pure streaming model and see if we've got the right amount of content, the right marketing approach and we'll take a look at those results, and then try to figure out what that means for our opportunity in other countries, so until we get a couple months after the launch, we're going to be sitting still.

Erin Kasenchak - Netflix - Director - IR

His second question. Can you provide some color on the usage patterns of watch instantly? Specifically, are new subscribers using the service differently than those that have been subscribers for a longer period of time? Is there a measurable base of subscribers who are exclusively using watch instantly?

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

Reed Hastings - *Netflix - Founder, Chairman, CEO*

Ed, to the last part, almost everyone takes both DVDs and streaming, and partially that's because DVDs have all the new releases, so there's a pretty big sector of content there that's DVD-only. But in terms of viewing patterns, newer subs as a class are more streaming-centric and partially it is because when they came to Netflix and established their habits, we have great streaming, whereas if you joined us five years ago, you're used to us as a DVD business, so if a thousand people that are with us to join five years, you get fewer that are as streaming-centric as you do in the new subs, but pretty much as you would expect. The migration is happening in all classes, and it's increasing amongst all classes.

Erin Kasenchak - *Netflix - Director - IR*

Next question is from Jim Friedland from Cowen. Would you ever offer new release titles on the pay-per-view basis on the digital video service?

Reed Hastings - *Netflix - Founder, Chairman, CEO*

Jim, you probably put that question in before I answered it a few minutes ago, so I'll go to the next one.

Erin Kasenchak - *Netflix - Director - IR*

Next question, from Andy Hargreaves from Pacific Crest. Does your increased focus on TV content change conversations with content providers, since it is potentially more competitive with their broadcast or affiliate fee businesses?

Reed Hastings - *Netflix - Founder, Chairman, CEO*

Andy, we have that potential if we weren't focused on prior season instead of current season. On current season, you do get potential competition, which is essentially the DVR model, the advertising model, all of those things. But on prior season, we're able to create value that wasn't there before and generate incremental profits for the content owner, and so there's not a conflict there.

Erin Kasenchak - *Netflix - Director - IR*

Next question, from Heath Terry at FBR. Can you break down the components of the increase in SAC, rising ad cost, mix of higher bounty deals, or lower response rate to non-bounty deals, TV/radio?

Reed Hastings - *Netflix - Founder, Chairman, CEO*

I could, but then I would get skewered by CMO also, and I'm going to take a pass on that. Your walk away should be that there's nothing that's happening in the marketplace particularly that's increasing our costs of doing business, so the increase in SAC is strictly a managed outcome, Leslie would say she starts with the lowest cost of subscriber acquisition and then layer on layer she builds out our acquisition channels, as the budget permits. And there are quarters like Q4 when consumers are very active, and the cost of acquisition is relatively low and there are an abundance of marketing opportunities available to her, and it just so happens that Q2 is the slowest quarter by far, and so an aggressive spend in Q2 is a little bit like pushing on a water balloon.

Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

Barry McCarthy - *Netflix - CFO*

And so Heath, if we ever drop the marketing budget on a year-over-year basis and have SAC increase, then you could worry about that case, kind of what's happening, it's harder to get subs, but when you increase marketing dramatically on a year-over-year basis as Barry said, depending on how much you increase it, that's what's driving the SAC up on the margin.

Erin Kasenchak - *Netflix - Director - IR*

Next question, from Nat Schindler of B of A-Merrill. With churn ticking up for the first time sequentially in four quarters, admittedly due to seasonality, do you think we are at or near the low for churn on a seasonally-adjusted basis, or over the long term will continued streaming usage drive this churn even lower?

Barry McCarthy - *Netflix - CFO*

Well, some of it is seasonality and some of it is growth. If we had had slower growth, since new subs churn at a much higher rate than mature subs, like a 10% rate versus a 1.5% rate. If we had seen slower growth we would have seen slower churn. Now, the question was have we seen an all-time low in seasonality?

Erin Kasenchak - *Netflix - Director - IR*

Could it continue to decline.

Barry McCarthy - *Netflix - CFO*

Yes. I think so. Could churn continue to decline on a seasonal basis. Yes. If consumers, if -- let's see, if we continue to improve the overall quality in the service in a way that increases subscriber engagement with the service, then the answer is yes. Certainly in the current competitive environment. If the competitive environment shifts dramatically or if we make bad decisions about how we invest in the quality of the service and we're not successful in increasing engagement, then the trend could reverse, no questions.

Reed Hastings - *Netflix - Founder, Chairman, CEO*

And Barry, if our sub growth keeps on accelerating, if we have 49%, that could also have an effect on the public churn.

Barry McCarthy - *Netflix - CFO*

Yes, although we are forecasting faster growth and lower churn.

Erin Kasenchak - *Netflix - Director - IR*

Great. Our last question comes from Andy Hargreaves, Pacific Crest. Last quarter you said the goal was to hold second-half marketing expense below second half 2009 marketing expense on an absolute basis, is this still the case?

Reed Hastings - *Netflix - Founder, Chairman, CEO*

Barry and I are looking at each other like did you say that? I don't think we said that, Andy, and going forward, what we're looking at is, if we can spend it on content efficiently, we'll spend it on content, and that would have reduced marketing. If we don't



Jul. 21. 2010 / 10:00PM, NFLX - Q2 2010 Netflix Earnings Conference Call

find the right deals, then we'll end up spending it on marketing, so if you add up the sum of those, marketing plus COGS, that's where that will stay, it's not a consistent part of the P&L, but it's a tradeoff between on the margin, marketing expense and streaming content.

Erin Kasenchak - Netflix - Director - IR

Great. So before we conclude the call, I'd like to just turn it back over to Reed for a few closing remarks.

Reed Hastings - Netflix - Founder, Chairman, CEO

Thank you all for attending the call and continue to give us feedback on the format if you like, and again, what we've heard that it's more efficient for all of you and it's quick for us, and I hope that it gets a higher quality of total information out, so thank you for attending, and we'll talk to you again next quarter.

Operator

Thank you. Ladies and gentlemen, this does conclude today's program. Thank you for your participation, and have a wonderful day. Attendees, you may now disconnect.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2010, Thomson Reuters. All Rights Reserved.