

FINAL TRANSCRIPT

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NFLX - Q1 2011 Netflix Inc Earnings Conference Call

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CORPORATE PARTICIPANTS

Ellie Mertz

Netflix - VP - Finance, IR

Reed Hastings

Netflix - CEO

David Wells

Netflix - CFO

PRESENTATION

Operator

Good day, everyone, and welcome to the Netflix first-quarter 2011 earnings Q&A session. Today's call is being recorded.

At this time for opening remarks and introductions, I'd like to turn the call over to Ellie Mertz, Vice President of Finance and Investor Relations. Please go ahead.

Ellie Mertz - *Netflix - VP - Finance, IR*

Thank you, and good afternoon. Welcome to the Netflix first-quarter 2011 earnings Q&A session. We announced our financial results for the first quarter at approximately 1.05 PM Pacific time today. The shareholder letter and Q1 financial results and the webcast of this Q&A session are all available at the Company's investor relations website at www.ir.netflix.com. As is our standard practice, 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 18, 2011. A rebroadcast of this Q&A session will be available at the Netflix website after 6.00 PM Pacific time today. Now let's move directly to the questions. We've organized the questions by topic this time and will start with content questions. Here we go.

QUESTIONS AND ANSWERS

Ellie Mertz - *Netflix - VP - Finance, IR*

As you acquire digital content rights what level of competition are you seeing during the negotiations?

Reed Hastings - *Netflix - CEO*

There's a substantial level of competition as you would expect. Not only amongst the online players but against cable networks and sometimes in partnership with cable networks in the window sharing. So content owners want to get the best price for their content, as you would expect, and they're pretty sophisticated about making sure they've got all of the possible offers on the table.



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Ellie Mertz - Netflix - VP - Finance, IR

A related question, how much risk is there that Amazon will outbid Netflix for digital rights to Starz content?

Reed Hastings - Netflix - CEO

I'm not sure that Amazon specifically is a different risk I would say in general, Starz like any other content provider wants to get most money for their content. The Starz deal is non-exclusive today, so it could be across a range of providers, it could be a single, but I don't think I'd particularly single out Amazon as a risk factor relative to say Hulu Plus or Dish or anybody else.

Ellie Mertz - Netflix - VP - Finance, IR

Okay. In the past, Reed has commented that shutting down Red Envelope and Netflix lack of interest in producing content or licensing previously unreleased content was a bet on creativity and was outside of Netflix circle of confidence. How can you reconcile these previous remarks with the recent move to invest in the House of Cards series?

Reed Hastings - Netflix - CEO

Well there is a slight shift there which is we're willing to try a little bit more riskier work than we've done with a little bit of our budget and then we're going to see how it goes. So it's sort of how we approach international when we tried Canada first before getting too committed. And our theory is that with serialized content, we may be able to build an audience very effectively because with on-demand you can get back to the first episode as momentum around the series builds. I don't know if it's anything we'd bet the farm on but we're certainly willing to try it with a small percent of the budget in House of Cards and then two or three other smaller ones that we would look for. And if we're successful with it, then we would expand our circle of confidence a little bit more, a little bit more. So we'll take it step by step, year by year.

David Wells - Netflix - CFO

Just to add to that, this is David, in the House of Cards deal, it was a pre-packaged deal that came to us, we weren't looking for -- out there looking for creative talent or directors or a script. It's a small nuance but it was an important one for us and the fact that we weren't having to manage the larger part of the creative process.

Ellie Mertz - Netflix - VP - Finance, IR

An additional question on House of Cards. Are you seeking to buy domestic or global rights to House of Cards? Is your intent to keep House of Cards exclusive to Netflix or actually presenting a series on Netflix where you look to sell subsequent rights to other cable or broadcast networks or online services?

Reed Hastings - Netflix - CEO

Well, House of Cards doesn't start until the fall of next year, so it will be a couple years out before we're faced with those decisions and we've licensed it for multiple territories.

Ellie Mertz - Netflix - VP - Finance, IR

Okay. Press speculation puts your spend on Mad Men at nearly \$1 million per episode which seems to be lower than recent syndication deals for procedurals but higher than deals for some other low-profile serialized series. Why did you just decide to

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pay for exclusivity and should we think of your Mad Men deal as typical of some other TV deals you may be doing going forward or was this a unique case?

Reed Hastings - *Netflix - CEO*

We don't comment on the specific deal terms of any of our deals.

Ellie Mertz - *Netflix - VP - Finance, IR*

Can you share any data that supports your view that putting a previous season on Netflix grows audience for a current season of a show? Wouldn't Netflix also diminish sales of prior-season DVDs?

Reed Hastings - *Netflix - CEO*

Well what we've seen as an example with Spartacus is we've seen something even more aggressive which is we have current season with Spartacus that's a Starz original that's been very successful and now it's one of the highest rated shows on cable despite the fact, or maybe because of the fact, that it's also on Netflix. And so I think in general, it's opened our eyes to the fact that more and more awareness of a given show sometimes creates more viewing on both cable and on MVPD and on Netflix.

Ellie Mertz - *Netflix - VP - Finance, IR*

Given the size of your subscriber base, is it getting easier to negotiate content deals or is there still a level of animosity with some content owners that must be worked through?

Reed Hastings - *Netflix - CEO*

Well I don't think there's any animosity. It's only a question of is our check big enough. And so as we get a larger subscriber base, that becomes easier to write bigger checks and it's very respectful I would say across-the-board.

Ellie Mertz - *Netflix - VP - Finance, IR*

Within the topic of international. In terms of international expansion and content acquisition in non-US markets, what type of expenditures do you anticipate making for locally relevant content and how might deals for foreign outlets differ from domestic deals?

Reed Hastings - *Netflix - CEO*

Well we're not sure of how much local content will be important for Netflix. With Canada we've got a fair amount of Canadian content and it's quite successful for us. In our new territories we'll also license some local content. And then we'll feel our way along as we see what our subscribers are viewing and what they enjoy.

David Wells - *Netflix - CFO*

I'd say that there's an opportunity here outside the US in some markets in -- with respect to some local content, there might not be a secondary market or a third or fourth sort of channel for the content owners so to the extent that we might be the only syndicated buyer in the market, it's going to work well for us in terms of the economics.

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Ellie Mertz - Netflix - VP - Finance, IR

Will new geographies take priority over the US as you build out content, or should we continue to expect the US to see the bulk of the spending?

Reed Hastings - Netflix - CEO

I think you should think about them as separate. We'll run the US around 14% operating margin and spend on content in accordance with that. And in international, we'll spend as we see appropriate to launch the service where we've obviously got spending ahead of revenue. And then as rapidly as possible within eight quarters in our target model, get each territory to be positive operating margin. In Canada, we've been very successful and we intend to be at breakeven on an operating contribution basis within four quarters of launch which is in Q3 and really quite extraordinary and that's probably too high a bar for every international territory, but eight quarters feels good.

Ellie Mertz - Netflix - VP - Finance, IR

On the topic of Canada, can you provide a little color on how the ISP bandwidth caps in Canada have impacted consumer behavior? What percentage of your Canadian customers are using the new "managed video quality tool" and watching lower quality video? Also do you believe ISPs in the US or other countries are thinking of capping bandwidth in a similar strict fashion?

Reed Hastings - Netflix - CEO

Well we don't have any indication that in the US, low, call it below 100 gigabytes data caps are going to become a significant offering. In Canada, we switch the defaults so that virtually everybody is on our low data usage, slightly lower video quality plan, and it is helping both directly in terms of usage and indirectly in terms of the general fear of usage charges. So it's a mitigator, I'm not sure I would call it a solution, it helps. I think the right solution over time is that Canadians enjoy great uncapped Internet like the rest of the developed world.

Ellie Mertz - Netflix - VP - Finance, IR

A related question, how have usage patterns in Canada performed relative to your expectation given the various cap rates, such as the more modest subscriber growth performance relative to your expectations?

Reed Hastings - Netflix - CEO

I think what drove overshoot on the forecast is we just don't have any seasonal data so the growth was very consistent throughout the quarter and we're really happy with it. And it's a pretty small percentage, but we just don't have multiple years of year-on-year data. In terms of the caps, they play a role but they played a role from inception. The caps were not something that were new this quarter, the caps had been in effect for a year or more in Canada.

David Wells - Netflix - CFO

And just to add to that, we achieved 8% of broadband household penetration in Canada in seven months. It took us six years in the US to get there and just so that you're not -- you don't feel like we're sort of trying to make our sales feel better on a forecast, we're happy about the business, we think we've got a great business going in Canada and we're excited about going forward.

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Ellie Mertz - Netflix - VP - Finance, IR

Another related question. The shareholder letter mentioned the seasonality curve in Canada, can you elaborate on this comment? Is your initial sense that the market's similar to other colder regions or subscriber growth is more tepid in the warm months?

Reed Hastings - Netflix - CEO

We'll know a year and a half from now after we've gone through -- the initial seasonality is masked by the launch and so you really can't get a clean read until at least a year from now about the beginnings of the seasonality effect.

Ellie Mertz - Netflix - VP - Finance, IR

Is it reasonable to assume that Netflix could enter as many as two international markets or more per year starting in 2012?

Reed Hastings - Netflix - CEO

If we continue to see the kind of success that we've seen in Canada, we think it will be very smart for us to move at least that fast, yes.

Ellie Mertz - Netflix - VP - Finance, IR

We noted a high probability of success in our second international market driving early content commitments for a third market. What are the data points that you focus on to define success prior to launching in the market?

Reed Hastings - Netflix - CEO

The reason that we feel a high degree of confidence is how well Canada has done, how well our licensing has gone for content in our second international market and our qualitative focus group work on the reactions in that market for our service. So those are all very healthy indicators that we'll enjoy success.

David Wells - Netflix - CFO

And those qualitative factors have a lot to do with how much that content is going to cost us relative to where we think we could price it and the consumer's willingness to pay based on their other entertainment alternatives. And we've grown more I think confident over the last year given where we think those economics are going to work out.

Ellie Mertz - Netflix - VP - Finance, IR

Moving to the topic of subscribers and subscriber metrics, do you think we will get tiered pricing for multi-user households from Netflix by year end? In that case how big of an addressable market is it?

David Wells - Netflix - CFO

Well what we said before was that the individual subscriber market is a two to three or a few year, I think is how we characterize it in the last investor letter. And we haven't changed our point of view. This is that gradual evolution, it's not going to be an immediate 90 or 180 day thing from Netflix. And I think pricing is certainly part of that evolution, changes to the interface are

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part of that evolution, changes to how we, if and when we enforce concurrent stream limits either per device or by account. So there's lots of things for us to figure out and tease out. We wouldn't want to alienate the subscriber or the consumer as we go through those and I think that we'll evolve to those over the next couple of years.

Ellie Mertz - *Netflix - VP - Finance, IR*

Can you share any details on Facebook integration that you are working on? What would be the primary objectives of the same, enhance your recommendation engine or drive engagement or acquire subscribers?

Reed Hastings - *Netflix - CEO*

It's better for us to share those details when we launch that, so I'll defer that.

Ellie Mertz - *Netflix - VP - Finance, IR*

Are you starting to see DVD subscribers trade down from multi-out subscriptions?

David Wells - *Netflix - CFO*

I don't think so. In fact, what we've said before is that basically downward migration and upward migration are cancelling each other and that's what we continue to see. With respect to the price change, we saw behavior that was more linked to the immediate announcement than to the credit card change, meaning when a subscriber actually got the change to the price on the bill, it wasn't as much activity as when they were notified of the change.

Ellie Mertz - *Netflix - VP - Finance, IR*

So related to the price increase, was the price increase a contributor to the increase in churn or was it more of a normal seasonal pattern?

David Wells - *Netflix - CFO*

Normal seasonal pattern. It's also a factor of the tremendous growth we saw in Q1. If you've followed our Company for a long time you'll note that when we grow quickly, our churn goes up because the retention rates of early subscribers are lower than those subscribers that have been around for 12 or more months and we continue to see that.

Ellie Mertz - *Netflix - VP - Finance, IR*

Another question on churn. Can you comment some on the churn rates for streaming only customers in the US? Is it above or below the average? Do you expect a decline over time as customers are maybe testing out the service today?

Reed Hastings - *Netflix - CEO*

What we said is streaming only has a higher churn rate, it's easier to get in of and out of, so it's the same as we said last quarter.

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David Wells - Netflix - CFO

Yes, and we've said before that the streaming-only plan actually crossed over the DVD only, so that is retention for streaming-only subscribers is actually at higher rates than DVD-only subscribers. It's going to be slightly lower than hybrid but it's better.

Ellie Mertz - Netflix - VP - Finance, IR

And a final question on churn. It still seems like the overall churn rate for the Company is still high relative to other MVPD companies and causes you to re-spend SAC dollars on customers that have already been Netflix subscribers in the past. If the customer satisfaction is very high on your streaming product, shouldn't your churn maturity decline over the next 18 months in the United States?

Reed Hastings - Netflix - CEO

Well, given how stable churn has been the last two years, I'd be hard put to think why it should suddenly decline in the next 18 months. And the question refers to us like other MVPD and MVPD is a much different service, it's premises-based, it's more expensive and it's more considered an essential service, so it's really just quite different in all those dimensions. We have a low subscriber acquisition cost and we have higher churn and people do test out the service, come back, go out, go in, and that's fine, because our overall growth, our net ads, are continuing to increase.

Ellie Mertz - Netflix - VP - Finance, IR

Moving to the topic of SAC. Why did the domestic SAC rise so much quarter over quarter? What should be the right base level going forward, Q4's \$10.87 or Q1's \$14.38?

David Wells - Netflix - CFO

Well there's no such thing as a right base (inaudible) going forward. But what we said in the last quarters' investor letter and we reiterate in this investor letter is that we identified the fact that we would have additional money. We would love to spend it on streaming content because of the complexity of those contracts, there's more lead time required and therefore, we put the money into marketing so the higher SAC sequentially from Q4 to Q1 is somewhat of an artifact of additional marketing dollars we spend up to the efficient point in Q1 and we'll continue to make that tradeoff going forward. Now what we said in the investor letter, just to remind folks, is that we're going to raise streaming costs. We planning to do that, we're going to continue to do that and to-- we should see marketing as a percentage of revenue somewhat mollified relative to Q1.

Ellie Mertz - Netflix - VP - Finance, IR

As subscribers have grown due to streaming, how has the demographics of the Netflix subscriber changed? Is the demographic in Canada comparable to the US?

Reed Hastings - Netflix - CEO

Yes, there's no material difference there.

Ellie Mertz - Netflix - VP - Finance, IR

Can we get US and Bay Area household penetrations?

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Reed Hastings - *Netflix - CEO*

We've gotten the question before and I'll respond by saying that the penetration in the US is 21%. You can calculate that for yourself by looking at the 22.8 million US subscribers and taking it over roughly 110 million households. The reason that people ask us this is we've given out the area before because when you launch the DVD service, back in 1999, we started in the Bay Area and we had thought at the time that the Bay Area would be a good proxy for the rest of the country. We've come and evolved that notion to believe that that's not necessarily the case, especially with the streaming product that we've launched nationally. So in terms of penetration it's 21% US.

Ellie Mertz - *Netflix - VP - Finance, IR*

The letter to shareholders mentions that you expect DVD shipments to decline slightly year over year. In the past Netflix has announced various milestones in DVD shipments such as the one-billionth, February 2007, and the two-billionth, April 2009, it shipped. When did Netflix ship the three billionth disc? Are there other notable DVD milestones?

Reed Hastings - *Netflix - CEO*

Our focus is really on streaming at this point, so I don't anticipate that we would have or would make those kind of announcements.

Ellie Mertz - *Netflix - VP - Finance, IR*

Moving to the topic of competition can you speak to the competitive landscape and how serious a threat it is today versus say a year ago, especially with Amazon's free video streaming offering and with Dish streaming HBO's content and Starz channels for free?

Reed Hastings - *Netflix - CEO*

Well in a big market it attracts a lot of competition and I think it's pretty clear to everyone that online video is a big opportunity, there'll be a number of substantial competitors. If Dish launches something into the Blockbuster brand that'll be the newest entrant. And clearly, Hulu Plus and Amazon may or may not have been having success but they haven't held us back at all that you would expect to the growing market because in Q1, domestically, our net adds were up over 90%, so we feel great about that.

Ellie Mertz - *Netflix - VP - Finance, IR*

You mentioned Dish as a competitor, could you elaborate? Blockbuster is currently a VOD product white labeling sonic technology, do you expect that to change?

Reed Hastings - *Netflix - CEO*

We really don't know what Dish is up to but presumably, they paid a couple hundred million for Blockbuster, not for its technology but for its brand. It's a well-known brand and they would do that, it would be consistent to do that if they had plans to launch a service with a fair amount of content and a fair amount of marketing, such that it would make sense to pay \$300 million to be able to use the Blockbuster brand.



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Ellie Mertz - *Netflix - VP - Finance, IR*

One more question on competition, how do you look at HBO and HBO Go as a competitive product as it prepares to expand across the many platforms Netflix currently occupies?

Reed Hastings - *Netflix - CEO*

Well, HBO Go is an implementation of TV everywhere. A consumer can't subscribe to HBO Go directly, and so it really doesn't compete today. I would say the overall effort that TV Everywhere is making is how to improve MVPD. And one aspect of that is HBO Online and-- but for example, in the Comcast implementation, you don't use HBO Go, the user interface, you use the extremity user interface. And so I think you'll see different implementations and the only-- the competitive threat to take out of that for us is TV Everywhere.

Ellie Mertz - *Netflix - VP - Finance, IR*

Moving on to questions about the financials. In response to questions since last quarter regarding a significant increase in AP, the Company indicated that "largely payments are short timing-- are at a short timing at the end of the quarter that could reverse itself in Q1". Can the Company indicate why this did not reverse in Q1 and instead AP increased further?

David Wells - *Netflix - CFO*

So I was responding to the sequential increase in AP last quarter. I entered it somewhat narrowly in saying that the two contracts that drove that AP increase were going to reverse themselves out in Q2 and they did. On top of that, in addition to that, we signed a bunch of new content deals that we discussed in the investor letter, and to the extent that the deals were within a year, with identified titles, it drove the AP up.

So let me answer this in a general sense. Cash payments for content increased \$130 million year over year versus the \$110 million year-over-year increase in the expense associated with that content. So to the extent that we've talked about close matching of our payment terms with our expense, we are continuing to execute on that, we ran a little bit ahead in Q1. In terms of a sequential increase, the cash out the door for content was roughly in line with the expense increase. So I think that you should see the accounts payable and the associated long-term accrued payable line increase with our continued investment in streaming content. I don't think you'll see it increase at quite the same rate going forward as you saw in the last couple quarters, but it will go up.

Ellie Mertz - *Netflix - VP - Finance, IR*

Can you explain the large sequential and year-over-year drop in acquisitions for the DVD content library?

David Wells - *Netflix - CFO*

I'm sorry, repeat that one.

Reed Hastings - *Netflix - CEO*

I can handle that. There's a mix there when you do a rev share title, most of the expense, essentially all of it, does not go through that line. So that can be a shift towards rev share from all purchasing DVDs.



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Ellie Mertz - Netflix - VP - Finance, IR

On the streaming side, are storage and encoding costs typically fixed or variable and are they significant relative to content delivery cost?

Reed Hastings - Netflix - CEO

They're not significant.

David Wells - Netflix - CFO

No, not significant.

Ellie Mertz - Netflix - VP - Finance, IR

As far as the G&A increase in the quarter, what are your expectations going forward?

David Wells - Netflix - CFO

So mostly headcount. There was some increase related to stock comp expense due to employees taking more equity compensation versus cash compensation but mostly a head count increase.

Ellie Mertz - Netflix - VP - Finance, IR

Why is fulfillment cost still growing? Do you expect it to slow as DVD shipments decline?

David Wells - Netflix - CFO

Fulfillment cost as a percent of revenue is actually declining. Fulfillment, the absolute fulfillment cost is growing because we shipped more in the quarter and we have more subscribers that have more credit card expense associated with them, with their revenue. But as a percent of revenue it's actually been declining over the last six quarters or so.

Ellie Mertz - Netflix - VP - Finance, IR

Next question, if you are a growth Company, why are you dividending cash out to shareholders rather than reinvesting it back into the business?

Reed Hastings - Netflix - CEO

We're generating cash flow and we anticipate continuing to generate cash flow.

David Wells - Netflix - CFO

And I think we're doing both. I think we're trying to draw a fine distinction between being a pure Company that invests everything we possibly have in the growth and also returning some to shareholders. So I think it's consistent with the strategy that we've

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had for quite some time of trying to draw both, to do both, be a growth Company and also make sure that we're not setting up a false promise to return earnings down the road.

Ellie Mertz - *Netflix - VP - Finance, IR*

Let's change to a handful of miscellaneous questions. When will we start seeing Netflix streaming on Android devices? Will future versions of Android solve the DRM issues that present making Netflix widely available on the platform?

Reed Hastings - *Netflix - CEO*

We're working hard on Android and don't have any news at this call, it's a big priority for us, and stay tuned.

Ellie Mertz - *Netflix - VP - Finance, IR*

Device partnerships have been a significant component of building out the footprint of streaming subs domestically and it seems that it could be used as a valuable tool in building out the international footprint. To what extent will your US device partnerships be applicable internationally or what will it take to build out a similar ecosystem with devices?

Reed Hastings - *Netflix - CEO*

We very much expect to work with our CE partners around the world and certainly in Canada, we've already done that, with specific Canadian implementations across all of our major CE partners and there's now many, many devices in the Canadian market and that's a good blueprint for what we'll be doing going forward.

Ellie Mertz - *Netflix - VP - Finance, IR*

In the press release, you say TV shows and feature films are consumed in equal volumes, is that true domestically and in Canada?

Reed Hastings - *Netflix - CEO*

It's approximately true in both, yes.

Ellie Mertz - *Netflix - VP - Finance, IR*

Moving to a marketing question. Do you know what is likely to be a very lucrative up front process for both broadcast and cable networks come this May and June, do you see paying what is rumored to possibly be as high as low teens price hikes for the network and inventory, excuse me, for network ad inventory for marketing purposes or will you just bypass network television spending and gear your marketing spend more towards lower CPM alternative such as outdoor radio?

Reed Hastings - *Netflix - CEO*

We always try to market most efficiently as we can and sometimes if one channel, say outdoor or online or print or network, were to increase in cost, it would get less of our total dollars, so it's a big broad mix of what's the two primary components for us are online and television, not necessarily network but cable offering.

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Ellie Mertz - *Netflix - VP - Finance, IR*

Great. Okay, that's the last question for today. We'd like to thank everyone for your time and we look forward to speaking with you again next quarter.

Reed Hastings - *Netflix - CEO*

Thanks, everyone.

David Wells - *Netflix - CFO*

Thank you.

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.

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