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# EDITED TRANSCRIPT

NFLX - Q3 2012 Netflix, Inc. Earnings Conference Call

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## CORPORATE PARTICIPANTS

**Ellie Mertz** *Netflix Inc - VP Finance & IR*

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

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

## CONFERENCE CALL PARTICIPANTS

**Mark Mahaney** *Citigroup - Analyst*

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

**Youssef Squali** *Cantor Fitzgerald - Analyst*

**Douglas Anmuth** *JPMorgan - Analyst*

**Richard Greenfield** *BTIG - Analyst*

**Andy Hargreaves** *Pacific Crest Securities - Analyst*

**Anthony DiClemente** *Barclays Capital - Analyst*

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

**Tony Wible** *Janney Montgomery Scott - Analyst*

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

## PRESENTATION

### Operator

Good day, ladies and gentlemen, and welcome to the Netflix third-quarter 2012 earnings Q&A session. At this time, all participants are in listen only mode. Later, we will conduct a question-and-answer session and instructions will follow at that time. As a reminder, this conference call is being recorded. I would now like to introduce our host for today's conference, Ellie Mertz, Vice President of Finance and Investor Relations. Please go ahead.

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### Ellie Mertz - Netflix Inc - VP Finance & IR

Thank you, and good afternoon. Welcome to the Netflix' third-quarter 2012 earnings Q&A session. I am joined here by Reed Hastings, CEO, and David Wells, CFO. We announced our financial results for the third quarter at approximately 1 PM Pacific time today. The shareholder letter and the Q3 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 email. Please e-mail your questions to [IR@Netflix.com](mailto:IR@Netflix.com). After email Q&A, we will also open up the phone lines for additional questions not covered by the email Q&A or the letter.

(Operator Instructions)

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 are filed 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've organized the email questions by topic as we've received them this afternoon so let's start with questions on domestic subscribers.



## QUESTIONS AND ANSWERS

**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Question one. Your original thesis was three years for full brand recovery. Is this still the case? Can you recover faster?

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

It's Reed here. I'd say the three-year model is consistent with what we are seeing. We've made substantial progress as you can see in the engagement metrics. We feel really good about the originals particularly *Arrested Development* because of its broad existing reputation in terms of burnishing our reputation but three years is still the right time frame.

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

And this David. I would add, like I've said before, that we are seeing recovery and our brand reputation metrics the likelihood to recommend but it's not at the level that it was pre-price change of July last year so there's still some room for recovery but we've seen it trend in the right direction.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

What change, as you move through this year, that has caused you to miss your earlier guidance of 7 million net domestic streaming adds by so much?

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

Well we were within the range our guidance from 90 days ago but not within the annual guidance that we gave at the end of Q1. And roughly I think we're feeling our way along, as the streaming market grows, and we miss predicted it. I would call that more of a forecasting error than anything else. When we think about growing 5 million net additions in this year, if we had predicted 5 million, I think we'd all be feeling good that that's great growth so we own it in terms of that forecast, but in terms of actual performance of the business to grow 5 million net adds, domestic, is substantial and we feel good about that and about the growth next year.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Follow-on question. What does the new subscriber guidance of 5 million compared to the prior guidance of 7 million suggest about the addressable market opportunity you have?

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

Well, I think it makes it a little bit harder. We think hard about the 60 to 90 million. We'll approach it not as fast as we would have if we had done 7 million this year. But the long term of every household becoming an internet video household, I mean that's definitely happening and going to happen. People are using internet video in huge numbers and that's only starting and we continue to lead the market in a big way. So I'd look at the long-term picture as very strong and not changed.

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**Ellie Mertz** - Netflix Inc - VP Finance & IR

You predicted that the London Olympics might dampen subscriber additions and/or engagement in the third quarter. Did that play out in your actual data?

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**David Wells** - Netflix Inc - CFO

Yes it did. We had a strong July, a soft August and then a slower bounceback in September.

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**Ellie Mertz** - Netflix Inc - VP Finance & IR

How can you improve involuntary churn rates in more mainstream lower income households Why don't I take this one. Some of the color that we've seen in terms of trends over the last couple of years is an increased use of debit cards and prepaid cards over credit cards. And the unfortunate thing about these different payment methods is that they have lower approval rates and so what we've been doing is looking at a host of different things to improve those approval rates and in particular looking to recover as many failed transactions as we can. So we are hopeful that there's a little bit of room that we have there to improve the overall invol churn rates. Let's move to questions about content. You have the advantage of perfect information on what your consumers watch. You have licensed a wide range of content, some of which is not viewed all that much. With this information, how do you intend to handle negotiation when deals come up for renewal? Would you pay less for certain content or pay the same or more but require programmers to provide you with newer, fresher, better content?

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**Reed Hastings** - Netflix Inc - CEO

We don't get the luxury of regarding programmers to do anything. We certainly look at the viewing as an indicator and that limits what we are willing to pay for certain content and if that doesn't present a clearing price and there's someone else willing to pay that much for the content, then the programmer will go to someone else. So I would say it's an informed auction market. We do have a lot of data that's very helpful in our overall programming but it's a pretty straightforward auction, highest bidder gets the content kind of market.

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**Ellie Mertz** - Netflix Inc - VP Finance & IR

Question on streaming hours. You have not talked about monthly or quarterly streaming hours since your comment about June 2012. Could you update us on recent activity?

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**Reed Hastings** - Netflix Inc - CEO

Sure. We were over 3 billion hours in Q3 which we feel great about and it's continuing to grow.

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**Ellie Mertz** - Netflix Inc - VP Finance & IR

With two thirds of viewing now television, are you limiting the size of the audience that you appeal to by not having the more in-demand or on-demand film content that helped build your DVD and then streaming businesses. How would that impact your cost of content?

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**Reed Hastings** - Netflix Inc - CEO

I think we're expanding our market with our TV series. If you look on cable or satellite, what gets watched more, TV shows get watched a lot more than movies so I think there's a big expansion in addressable market both in the sense for any consumer's time and in terms of people who are interested in the Netflix service. And we are trying to be very strong, both in movies and in TV shows, and we are only getting stronger as we grow.

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

As a reminder here too that even in our DVD business, about a third of those DVD shipments were new releases and two thirds were things that didn't fall into a new release category or older content so many subscribers just want something good to watch. They're less engaged in terms of caring about the freshness of the data of the content.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Next a question on fixed versus variable licensing. And (inaudible) structure some of its recent deals, [a ethics] to have a variable component on pricing based on subscribers. Given the lack of visibility you now have on future [subs], is this something you would be willing to do? You have always resisted and it has worked to your advantage as you grew faster than constant providers anticipated.

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

We are very happy with knowing exactly what our commitments are and we do not have any plans to change our licensing structure and the people that we generally bid against other networks are in the same model where they are bidding fixed fee.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

In terms of the goal to focus on licensing only the contents, reviewers when you negotiate with the studios to license content, their goal is to follow up together as much content as they can to maximize the value of the deal. How you balance your desire for more efficient spend with the studios' desire to bundle more content?

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

We really look at packages as a whole so we will estimate for a given package how much viewing it will generate which includes the stuff that's most appropriate for our members and the stuff that's less appropriate and then we try to figure out a clearing price for that set of content. And then there's the back and forth about well if you added this or took out this depending on are they revenue motivated or package motivated, and that's all part of the give-and-take across the hundreds of different agreements that we have.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Disney's current output deal with Starz ends in 2015 with the [veils still entry] Starz until the end of 2016. Why should Disney choose Netflix versus renewing with Starz or starting their own streaming movie service?

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

Well, I think in each market and country, there's a different set of content at a different time but in the US context, the Disney deal comes up in 2015, so it's a little premature but we would certainly be bidders for that for other pay one deals as we have been in the past.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Can you discuss the device mix of content consumption? How are tablets and smart phones varying in terms of consumer hours streamed?

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

Tablets are growing and smart phones are growing. You probably would expect that. Tablets are a little bigger than smart phones for us but the big viewing is really on the television. Smart TVs, game consoles, Apple TV, Roku, BluRay players, all the things that bring Netflix to the big screen.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Moving to questions about original content. How do you quantify the success of proprietary content terms of consumption and financial investment?

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

We look at originals like we do third party license content in terms of how much it's going to be viewed or how much it is viewed relative to its cost, so that's the primary measure and then outside of that, we do expect some ancillary PR value, public relations value, and subscriber excitement around the originals but we don't rely on that in terms of a primary relative measure.

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

That's right. The base case is that it's good content that we are producing and the upside is that it transforms the consumer's relationship with Netflix because it's only available on Netflix. It's not also on cable and also on DVD and also on pay-per-view. It's really fully totally unique, only on Netflix within our territories.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Investors are quite surprised that you are releasing all the episodes of House of Cards at once [during] they will watch all of the episodes over a weekend or two and then [sure n off]. That we are excited that Netflix is the first TV producer to put the consumer first and give them the content the way they want to consume it. How do you look at the trade-off between churn and hooking people on Netflix' other content if you are willing to bomb through 13 hours of House of Cards?

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

Well, we do want to hook people but we want to hook them for the long-term. We think we hook them for the long-term by treating them right and making all those episodes available at once. And obviously, there's later Arrested Development, and Hemlock, and Orange is the New Black, and then a season two of House of Cards, and so if we do our job right, there's always a reason to be a Netflix member on the original side in addition to the license side so I don't think it would be material to be joined only for House of Cards and then exit so that makes us comfortable with this very consumer first trade-off.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

The original content efforts, to what extent do you have ownership rights that could generate additional revenue, syndication, DVD, licensing, et cetera?

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

It's a great discussion item for us over time but on this first-round, we are a licensee in a certain window and so we are not essentially a producer that then manages and profits from those ancillary rights.

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**Ellie Mertz** - Netflix Inc - VP Finance & IR

Moving to questions about international. [Previously], you commented that the Nordics had the most content of any international launch. Can you quantify the level of content and or magnitude of that spend versus other regional launches?

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**Reed Hastings** - Netflix Inc - CEO

No. We've been very successful in the Nordics. We're very happy with that. I don't have any specific quantification in terms of dollars or title count that will be helpful. We do feel like market-by-market, we are learning and getting better at the right content mix both to attract the subscribers and economically and we look forward to having a fuller update for you on Nordics once we're a quarter in, in January.

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**David Wells** - Netflix Inc - CFO

I'd say the basis for making those statements is an amalgam of metrics. It's not any one particular title count or dollar spend. Our experience has been when we look at box office or Nielsen ratings or other types of metrics, that it's a combination of all of those in terms of the subscriber perception of content quality.

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**Ellie Mertz** - Netflix Inc - VP Finance & IR

[In] early years, Netflix incurred significant losses in starting up its DVD by mail service. As you look at international streaming, do you see parallels to the start up of DVD or are you encountering significantly more challenges?

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**Reed Hastings** - Netflix Inc - CEO

I think it parallels with DVD or parallels with any successful business which is you establish a new market and there's losses for some time period and then the key thing is the durability of the profit stream after that. We never invested in having DVD expand around the world because that one of the mail system's difficulty but two is the profit stream wasn't going to be that long. In contrast with streaming, if we are able to establish a significant market share in franchise in a market, and we manage that well, that should be multi-decade profit stream and so that DCF on that is enormous which is what gives us the confidence to make these big and aggressive investments in establishing our leadership in these markets.

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**Ellie Mertz** - Netflix Inc - VP Finance & IR

Have you considered taking on partners and structuring JVs in certain countries? This appears like it could have three benefits, gain traction in countries where you have no brand equity, minimize the level of investment, and could accelerate Netflix' global ambition.

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**Reed Hastings** - Netflix Inc - CEO

Well, it's definitely a factor for example when we look at Asia and some of the more challenging markets where US firms have had a tough time and had progress in that. In Europe, most of the consumer firms have really been able to execute much better, faster by keeping those wholly-owned and that's our model for now.

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**Ellie Mertz** - Netflix Inc - VP Finance & IR

Assuming that you are able to maintain positive consolidated earnings for 2013, what would be the maximum number of countries or regions you would consider launching into?

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

I'm not sure I would approach that in terms of a maximum number. We look at a territory launch that could have four countries in the case of the Nordics, but it's sold as a content block so I think that what we said is we are focused on global profitability but also on a path to profitability for our large existing markets and so those are the two gating conditions that we'll be looking for in terms of finding that next market.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

With regards Latin America, what steps are you taking to improve payments? Have you considered a drive for many markets within Latin America? Have you considered bundling your offerings other than that market to improve your ability to collect? I can answer the payment side On the payment side, we've been looking across a host of options to expand our ability to collect payments from subscribers. Let me give you some examples of things that we are doing. In Mexico, what we found is that not all debit cards are accepted for e-commerce and so we've been working directly with the banks to allow them to -- I should say allow us to accept debit cards online, and in Brazil what we're looking to do this current quarter is to expand the payment methods that we offer including things like direct debit and (inaudible) expand and address the market that will folks who have the ability to pay for our service.

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

And then in terms of bundling, that's not something that we are actively engaged in. We are looking at payment with other subscription services and trying to think that through. And then in terms of withdrawing, we are not thinking about that. All of our content agreements cover the entire region and are long-term in nature. So we are making great progress on the revenue side so we are continuing to invest on that basis.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

If you return to profitability for the overall -- if the return to profitability for the overall business takes three quarters or more, is there a risk that you missed an opportunity to have first-mover advantage in continental Europe, that is, first-mover advantage, not matter, and (inaudible) had first-mover advantage in UK, and you came later and surpassed them.

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

It's a matter of debate for us. Certainly, first mover helps but it really depends on how big a scale you get. So if a competitor gets to a great scale in one of those markets before we do, we would tend probably to focus on other markets. So it's a there's no easy answer to that one. It's something we try to balance which is a rate of investments on the current business versus the risk of competitors getting ahead. So far, we would like to set up a trade off that we've made.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Moving to questions about the product. How do you think about improving the platform from here to stay ahead of where the competition is going?

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

We're making a great progress on the algorithms that drive the merchandising and I know they're invisible to all of you just like the Google search algorithms are invisible. The UI is not the main focus because it's pretty easy to copy and our main focus is showing the right content to the right person. When you turn on Netflix, whether that's on an iPad or a PS3, you can see 15 or 20 block shots and if those are the right 15 or 20 block shots for you, for your mood, for the time of day, we are very likely to get a play. If those aren't the right box shots, then we are much less likely to get a



play and then that builds our engagement and the more people watch, the more they retain and so that's really him the importance of the algorithm development and testing that we do.

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

I would also say that for some subscribers, we're constantly testing user interfaces. There's a lot of exciting user interfaces coming up enabled by devices that enable gesturing, [waste] and other things. You'll see us continue to experiment and play with those types of interfaces in tests and if we find one that will continue to innovate in those areas.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Amazon Web Services had another significant outage this week. Did this impact Netflix in any way? If not, will that [give] Netflix planning for random outages or do you [not using psycho] services in the first place? Do these events affect your confidence in using services like Amazon's AWS for critical infrastructure and customer facing functions?

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

AWS has done a great job for us as they have for other customers by having an architecture that isolates [thugs] and so it's built upon the notion that occasionally data centers will go down and they give you the components to build around that. That would be true if they were our own data centers or if there were AWS, and in a recent outage that they had, our customers were not materially affected. The traffic switched over smoothly as it's designed to to other Amazon data centers so we are extremely happy with the decision to expand within the Amazon Web Services footprint.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Next question is on competition. Can you compare the value proposition of your streaming offering to that of Amazon today? Is the gap closing?

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

Amazon Prime is two different markets that we compete with Amazon in. One is in the UK, and there are -- there's almost no content that's on both services so think of it as two really different services in terms of content. And we believe our viewing is higher. We think our content is better. We are growing faster, but it's a real head-to-head battle. We are both at the same price point roughly speaking within 20% of the state and standalone services. In the US, Amazon has bundled with Prime and it's got a subset of our content and then depending on how you want to think about the price of Prime as an annual \$79 payment or free with free shipping, you get the different views on it. But as we said in the latter, most of our subscribers want us to have more content. They're not particularly motivated by a service that has a significant subset of our content. So at this point, it's not anything that we can measure affecting us directly.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Another related question. (Inaudible) saying in an interview that Amazon had [best bar] not had much of an impact on Netflix' growth trajectory. Given what are seeing now in terms of slowing subscriber growth and lower guidance, does this change Netflix' view at all in terms of how many customers may be choosing alternative providers?

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

We asked ourself the same question, obviously, but in every data source that we look at, those are unrelated. I think as Amazon builds up their original content, which they are very actively engaged in and they'll get exclusive deals against us, they'll more and more be a different service than ours. And then many subscribers potentially will subscribe to both, so I think that's the way that it evolves over time like it has in the UK.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Now a few questions on the financials. Will the Company be disclosing its obligations related to original content production costs?

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

Well, yes we are in the sense that the obligations that we signed up for on originals were included in our streaming obligations table so they're already in there. We don't break them out. We will provide more color as they get more and more material.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

You talked about your expectations for negative free cash flow for the next several quarters as you ran spending on originals but eventually you expect to return to positive free cash flow. Looking to the confidence that you'll be able to return to positive free cash flow, is it a slowdown on contents then or acceleration in subscriber growth or both?

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

I wouldn't characterize either of those that way. I would say that were focused on three things from a cash flow perspective. One is our growth in profitability in the US and what that looks like. The second is our international investments and the losses related to those, and how they play out over time. And then the third is our growth in originals, which takes more cash than ordinary types of content deals. So you put all three of those together and we want to maintain a comfortable margin and I think those statements are based on the fact that I think that we are in a position where we can grow next year under various scenarios and expand our content expense, not slow it down but to slow down the acceleration of the content expense, in addition to finding our international investments in originals.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Can you help us quantify the original content cash outlays in 2013? Understanding that they will be higher than the P&L expense?

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

What we said about those before is we do have some output style deals that have more cash than expense and those are have been about 10% in terms of content cash relative to the expense. Originals will mean that that ratio goes up anywhere from 10% to 20%. But probably not more than 20%.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

20% in excess of the P&L.

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

Correct.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

How might we think of contents then growing year-over-year in 2013?

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

Hopefully, content spend will grow substantially. That's what continues to make our service better and that's built into our plan. But we don't believe that we are over-committed. We have some flexibility there depending on what the growth is because we are very conscious of the variability in our growth outcomes and you can see that in the fact that while we are short on total subscriber growth this year, we are hitting our contribution margin targets. So that's a demonstration of the flexibility that we have on the cost side.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

On the cost side, what was the driver of the uptick in acquisition of [PC&E]?

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

Cashbox is related to our OpenConnect program.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

And finally, there's an increasing talk that Netflix will eventually have to raise prices to increase [arvo]. We've heard from management that this option is off the table with the brand seemingly recovering from 2011's events. Is this something that is being discussed? Would it be unrealistic to expect an increase before 2014? Obviously, it cannot stay \$7.99 forever.

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

We are very excited about the \$7.99 price point and we have no plans to change that. Consumers value the incredible bargain that that is and that helps our growth so we see increased monetization from increased growth rather than any change in price.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

At this time I'd like to turn the call over to the operator and we will begin taking live, call-in questions.

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**Operator**

(Operator Instructions)

Mark Mahaney, Citi.

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**Mark Mahaney** - Citigroup - Analyst

Great. Thank you. As the usage models which is more and more towards TV viewing, could you talk about the impact that could have on the business model in terms of margins, visibility, into revenue and into profits, and maybe any pricing options that that would give you. Thank you.

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**Reed Hastings** - Netflix Inc - CEO

Mark, there's no fundamental difference in the way that we license TV shows from the way that we license movies, in other words, it's a fixed payment per year per time period. The only difference I suppose is we will do a contract that will have, if there's a season three, season four, season five, it's built in, so I suppose there's a little bit of difference there but fundamentally, it's content over some time period. The great experience about the TV shows in discovering them is being able to go all the way back to the pilot and really get a lot of fantastic viewing out of it which creates a differentially better experience than any other provider. So that's the big asset of it.

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**Mark Mahaney** - Citigroup - Analyst

Thank you, Reed.

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**Operator**

Scott Devitt, Morgan Stanley.

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**Scott Devitt** - Morgan Stanley - Analyst

Thanks. I have a couple. First on the domestic streaming subs. You mentioned the Olympics as a factor. You also mentioned the change in seasonality earlier in the year so I was just wondering given the way that you exited 3Q and the very back-end loaded nature of 4Q how you approach the fourth quarter guide for streaming subs? And on that topic as it relates to early 2013 as well as more of the originals in the US market, House of Cards and Arrested Development start to flow through potentially, do you anticipate that that drive subs and bucks seasonal trends or is content and original content not necessarily a direct driver of subs? And then secondly, if Fox I think recently opted to renew HBO within exclusive long-term deal? It was like 2 to 3 years ahead of the renewal. I'm just wondering why you think they would opt to do that rather than giving Netflix a chance to bid for the rights. Thanks.

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**David Wells** - Netflix Inc - CFO

Hi Scott. This is David. I can take sort of part A and B and I'll let Reed take the part C. Part A, the seasonal pattern is still in place. That is, that we still see greater sub additions in the fourth quarter and the first quarter than in the second quarter and the third quarter. So I think even our midpoint of our guide implied that seasonal patterns will still be in place. The Olympics sort of affected the monthly progression of acquisitions through Q3 but overall seasonality have net additions is still in place. And then your part B on originals and content, the originals we're very excited about. We think that they will drive a lot of consumer excitement in it, but on the grand scheme, it's likely to be less than -- certainly less than 10% of hours viewed next year and maybe even less than 5% viewed, so in terms of our planning I don't expect that to drive a ton of additional adoption.

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**Reed Hastings** - Netflix Inc - CEO

Scott, it's Reed. You're very gracious because I imagine what you really feel is why do we make seasonality excuses and then Olympics excuses and aren't you getting kind of tired of it? We are tired of making those excuses as opposed to getting back to our track record. On the seasonality -- or the originals like David said, we may have an upside from it but we're not going to bake that into our spending plans. They are getting into unknown territory in terms of how many people come to us for House of Cards or Arrested or others, so we'll gain from experience in that and then that will help us understand how much more investment we should do in originals after that, but at this point, in Q1, we will think of it just as upside. And

then in Fox and HBO, I'm not sure, maybe the deal from HBO was good enough but I think you'd really have to ask them or Fox. And we'll take it from there.

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

Thanks. If I could squeeze one last one in. With social integration update, you talked about historically there are restrictions in the US. Is there any update to that?

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

No. There's a bill in Congress now that is pending before the Congress and it's anybody's guess if they are going to pass it in a lame-duck session and then that would enable all different types of consumer permissions for sharing which would be useful in the Facebook context but also useful in any kind of net Abrowse, various types of scenarios where people want to allow a feed to go to a service to help them. So were optimistic but you know when it comes to the Congress, it's hard to predict. And then in terms of outside the US, we are continuing to learn on our international markets. We have seen some nice take up in Brazil which is a very social place obviously as well as in the UK. So we continue to work on it but no one yet has cracked the formula, us or anyone else, in terms of real explosive generator so it's in the category of a little bit positive and we are continuing to work on it.

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

Thank you.

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**Operator**

Youssef Squali, Cantor Fitzgerald.

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**Youssef Squali** - *Cantor Fitzgerald - Analyst*

A couple of questions. I want to go back to one of the first questions that was asked about the three years needed to restore your image. How did you get to that determination that it should take you guys about three years and why isn't it taken shorter since you guys have basically arguably after a year, people start forgetting, and to the extent of the quality of content keeps improving, it would kind of get restored faster than that. And I have a follow-up.

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

Youssef, let's hope you're right. But it's not something we wanted to count on. Three years is something we felt comfortable we could deliver on in terms of our reputation and some people do forget in one year other people take a longer time. So we are just going to have to work really hard on providing our great value and stick to our netting and then the brand will steadily recover and if it's sooner than three years, that's great.

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**Youssef Squali** - *Cantor Fitzgerald - Analyst*

You don't think that's an indication rather of just maybe perceived lower -- perceived lower quality of content?



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

No. The best indicator of our perceived quality of content is how much we're getting viewed. How often you go home, it's Wednesday night, and you want to pick something to watch, you have to decide are you going to pick up your cable or satellite remote, are you going to put on a DVD, or are you going to watch Netflix. And the more of those moments of truth that we win, the more people are engaged with our service and the more they retain and the more they tell their friends about Netflix, and so our primary driver is winning those moments of truth, which if you think about it is based upon your expectation of finding something good. And the better that those first 20 titles are for you, the more likely you are to turn it on Netflix first as opposed to one of the other entertainment options first. And so because our engagement is higher than it's been in the past, we are really confident substantially up over 30%, we feel really good about that in terms of our content mix getting better and better.

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**Youssef Squali** - *Cantor Fitzgerald - Analyst*

And David, if I just may, could you maybe just talk about trends of usage and consumption of exclusive versus non-exclusive content? Or maybe partly that would be the mix in your content and your content cost between the two?

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

We are seeing engagement across both exclusive and non-exclusive categories. So in some cases, the exclusive content may cost more but it's viewed more because it's worth more. You know the consumer doesn't -- isn't able to get that somewhere else. So you can infer from that in some exclusive categories have had higher viewing but we are seeing user hours across non-exclusive content as well. In fact, at this point in time, there's more non-exclusive content on Netflix than there is exclusive content and our hours continue to go up. And then your second part of your question was around cost. Is that right, Youssef?

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**Youssef Squali** - *Cantor Fitzgerald - Analyst*

Right.

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

In terms of -- there's an expectation that we'll move to exclusive over time, and that means that the cost will be -- we'll pay more for exclusive content.

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**Youssef Squali** - *Cantor Fitzgerald - Analyst*

But you feel that you're basically -- if you looked at an ROI for exclusive versus non-exclusive, you don't think the ROI on the exclusive is lower just because you're paying more for it?

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

No. We look for engagement across that category of exclusive so we look for deals and types of content that works well relative in that exclusive class and we think that there is a point where we are not going to be 100% exclusive but we will move more and more towards exclusive content as a differentiator, and it is important for us.

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

And you said, it's Reed, you really want to keep in mind how many different flavors of exclusive there are. You know, there's exclusive for online. There's exclusive against DVD. There's exclusive against cable. There's cable with TV everywhere and without, so there's a lot of different options and degrees as opposed to a simple non-exclusive, exclusive.

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**Youssef Squali** - *Cantor Fitzgerald - Analyst*

Okay. Thank you very much.

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**Operator**

Doug Anmuth, JPMorgan

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**Douglas Anmuth** - *JPMorgan - Analyst*

Thanks just wanted to ask a couple things. In your letter, you talk about it long term domestic market opportunity potentially being 2 to 3x that of linear HBO. I'm just curious how you get there. So if we think about broadband households, it would seem that the numbers approaching the number of cable households but at the same time there's still a limited amount of time in the day and a limited amount of disposable income so I'm trying to understand how you get comfortable with that market opportunity being 2 to 3x. And then secondly, can you just update where you are in terms of your personalized plans, what you might do around the dual streaming? Thanks.

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

Sure. In terms of the 60 to 90, we've got that online strategy deck which outlines some of it. I'll run through it quickly. Which is if you think about us versus linear HBO, we are able to be consumed on multiple platforms, you know, laptop, tablet, phone. Short of the on-demand with an on-demand brand, we have much broader content range including a lot of kids content and we have a lower price than HBO. So it's extrapolating those factors that make us feel comfortable about the 2 to 3 acts or 60 to 90 million. In terms of broadband households, we do have the assumption that all households become broadband households. And that will happen over the next 5 or 10 years and so that doesn't become a practical limiter in the same way that cable is in every household. So that we will equal essentially HBO in terms of addressable market but because of lower price and the other factors have a larger actual market. And then on a personal stream plan, that's still something that's in development. We've been prioritizing some other things because it's a fairly minor issue so it maybe sometime this quarter or next quarter.

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

I think you'll see some testing this quarter and then depending on the actual performance of that, we will let out accordingly.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Okay. Thanks, guys.

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**Operator**

Richard Greenfield, BTIG

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**Richard Greenfield** - *BTIG - Analyst*

A couple questions. One just the explosion of tablets. Reed, you talked before about how TV is still the primary viewing place that you need to get to to drive your business but with such a -- we're seeing so many different companies launch cheaper and smaller tablets to get them into more people's hands across the globe. Am just wondering how you think that tablet rollout impacts Netflix' subscriber growth over the course of the next couple of years relative to the importance you place historically on the TV. And then just two and somewhat related, you resigned from the Microsoft Board. I guess a lot of people are curious what should we read into that if anything. Thanks.

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

Sure. On the Microsoft Board, I'm on six different boards and I felt like this was a good time because Microsoft is strong coming out with Windows 8. For me to trim that back and to focus more on Netflix, so that's the story there. In terms of the tablet question, it's definitely growing for us. The question is, is it a straight substitute for a laptop as it grows? In which case it doesn't particularly affect us. Or is it a net addition because it's a better consumption of the typical laptop? We think there's some truth to the latter. The other scenario where tablets are really interesting are choosing on the tablet and then consuming on a TV. So one second screen scenario that people talk about is you watch on the TV and then all the supplemental information, the history of the actors, et cetera, is on your tablet. That's nice. But what we see as a big opportunity is using the power of touch to really choose what you want to watch and then to be able to select it and then it's automatically playing on your TV. We've got a demonstration of that now on iPad and Android with the PS3 and that's something that we are working with all the CE ecosystem to build in so that over the next several years this becomes a general capability for Netflix choosing which is to be able to get used to the power of touch in the intimacy but then be able to enjoy the large-screen audio and video experience.

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**Richard Greenfield** - *BTIG - Analyst*

Thanks.

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**Operator**

Andy Hargreaves, Pacific Crest.

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**Andy Hargreaves** - *Pacific Crest Securities - Analyst*

Just wanted to ask on the international stuff. How long would you stay in the market before you decided the profit potential wasn't worth the ongoing investment and things weren't going the way you thought?

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

Andy, there's very little chance of that happening because we've got long-term content deals that we paid on. So it's not an active topic. As long as the revenue growth is good and there's no competitor ahead of us where we have to face the decision of doubling down or not, it's clearly the right economic course to push forward and to derive the benefit and we look at Latin America will be an awesome profit source for us with a great service over time, like it is for DirectTV today, And then in the UK, it's a more competitive dynamic but we are really making great progress so both are really important to us. And of course Canada already is very successful.

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**Andy Hargreaves** - *Pacific Crest Securities - Analyst*

And on the US marketing expense, it looks like that's come down through the years just on a run rate basis from where you were in Q1. Is that accurate and can you just walk us through how you're thinking about your marketing domestically?

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

The markets that we've already got a very large share. There's less need to spend in marketing along the margin than in new markets where we are just getting established. So you are seeing a little bit of that.

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

We are just dating inefficiency in terms of word-of-mouth being more and more effective.

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**Andy Hargreaves** - *Pacific Crest Securities - Analyst*

And then just last, for clarification. Was that 3 billion number you guys gave in terms of hours viewed, was that global or just US?

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

All the numbers that we've been talking about are global. So the 1 billion for June, the over 3 billion for the quarter Q3, are global.

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**Andy Hargreaves** - *Pacific Crest Securities - Analyst*

Okay. Thank you.

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**Operator**

Anthony DiClemente, Barclays.

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**Anthony DiClemente** - *Barclays Capital - Analyst*

Question about your comments about Hulu and the release talked about it being a wild card and you said in terms of US viewing, who is your closest competitor. And so I just wanted to ask a little more about that. Is there anything that you can add as to why Hulu's programming is more substitutable for Netflix than let's say Amazon or HBO and what makes them a global wild card?

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

What makes them the wild card is the ownership owned by three of the largest content companies in the world. In terms of their viewing, I think their closest to us because they focus on television like we do now. So they've got a good match in that way. And then they have the -- in addition to some of the TV shows, they have some currencies in sort of catch-up mode where they have last five episodes and then falls off the service but so you can think of it as almost 2 different markets or segments but they get a lot of viewing on that new TV.

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**Anthony DiClemente** - *Barclays Capital - Analyst*

Thank you, Reed. And then one more just back to I guess one of the earlier questions about the studio output deals. It does just seem as though with FX and Starz and Fox and Warner that many of the majors are spoken for. Is there anything you can add to the comment that you plan to bid for further deals? Can you talk about other deals that could be coming up? Are there more so smaller studio output deals? Is it -- are we talking I guess Universal could be coming up? Can you just give us a little more in terms of elaboration on that comment that you wrote?



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

Sure. There's small ones potentially. Again, I think you're probably asking US because that's our biggest market.

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**Anthony DiClemente** - *Barclays Capital - Analyst*

Yes.

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

In the US, there's some smaller ones where we can work on and then there's Universal, Disney, Sony, all which come up over the next five years but none of them are going to change. It wouldn't be live for us on the new movies in the next two years, so I don't think it's probably hugely material to your piece as it is for the long-term good for us to be a [better] there.

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**Anthony DiClemente** - *Barclays Capital - Analyst*

Do DreamWorks animation movies go live soon, is that right? Just remind us on that one.

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

It's in 2013, Anthony, so we've got -- it comes up in 2013 so as soon as it depends on what your definition of soon is.

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

We can ask what was the first one coming through on that deal.

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**Anthony DiClemente** - *Barclays Capital - Analyst*

Right but it's -- it's for any movies released in 2013 as opposed to just starting in 2012 right so it wouldn't actually -- it would be any theatrical films released in 2013 be eligible for the subsequent pay TV output window? Is that correct?

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

That's right.

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**Anthony DiClemente** - *Barclays Capital - Analyst*

Okay. Thanks a lot. Okay. Thanks, guys.

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

Anthony, just one final comment. We do have existing deals that have plenty of film output coming through but you guys focused on additional things that we could add but there's deals with Film District, Open Road, Relativity and others that are flowing film to the side now.

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**Anthony DiClemente** - *Barclays Capital - Analyst*

Sure, thanks.

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**Operator**

Jason Helfstein, Oppenheimer & Company.

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

Thanks. Most of the questions have been answered. Just a quick one. So in the release, you do get some color about you don't see long term churn as an issue and you continue to see gross acquisitions up in the air on a year-to-year basis. Do you have any regrets just given it all pulling the stops for not putting out gross edge in churn anymore just given additional metrics might help reduce the volatility in the stock and help people understand and alternatively how about providing churn kind of on a trailing 12-month basis or something? Just trying to get your thoughts about that. Thanks.

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

I don't have any regrets in providing it, Jason. I think the volatility was introduced in the 7 million and not meeting the 7 million. So I don't think that would've helped.

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

Okay. Thank you.

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**Operator**

Tony Wible, Janney.

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**Tony Wible** - *Janney Montgomery Scott - Analyst*

In the past you guys of given penetration of the service in the San Francisco Bay area. Can you guys give what that adoption number is today for just the streaming component? And same question is, have you guys seen any change in attitudes on the content producers in light of some of the recent ratings weakness? Have they been more eager to cut digital deals to kind of fill what may be a revenue shortfall or are they becoming a little bit more wary? Any color would be helpful. Thank you.

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

Toney, in terms of the regional penetration, we used to do that because on the DVD side we had several years of overnight delivery in the San Francisco Bay area but not the rest of the country so it was several years ahead. There's not an equivalent market where we had streaming before another market. So we don't internally nor externally focus on a sort of market level prediction. In terms of that content producers, you get a wide mix. You get some who are concerned for all the reasons that you addressed and some that are more interested in the digital revenue so the great news for us is there's no single producer. It's a material part of our content. There's many different producers from many different companies. So that helps us and they are all looking for the best dollar and then were up better for that content.

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**Tony Wible** - *Janney Montgomery Scott - Analyst*

Great. Thank you.

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**Operator**

Heath Terry, Goldman Sachs.

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

I was just wondering if you could give us a bit of an update in terms of what you are seeing in the device ecosystem going into the holiday season. What kind of device penetration you're expecting, both television as well as to the extent that there's a mobile metric that you could provide as well relative to what we saw last holiday season? Particularly for the remote Netflix buttons.

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

Heath, its Reed. We'll have more Netflix buttons on more smart TVs than we've ever had. Smart TVs, as you know, are becoming our larger percentage of all TVs. It's becoming pretty standard and built-in. So that's a significant positive. There's Wii U we're releasing shortly. It's a new game console and so we'll see if that takes off and provides us a special lift and then mobile is -- been very strong for several years and continues to be strong. I don't see a huge like [Seaview] related hockey stick to that part of the business.

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**Ellie Mertz** - *Netflix Inc - VP Finance & IR*

Okay, that's going to be the last question for today. Reed, would you like to provide any closing remarks?

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

I just want to thank you all for the questions. We are continuing to work very hard and look forward to being in a better place relative to our guidance a quarter from now. We certainly try very hard every quarter in a doesn't feel great to come in in the lower half but it is what it is and we are moving forward.

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**Operator**

Ladies and gentlemen, thanks for participating in today's program. This concludes the program. You may all disconnect.

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