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NFLX - Q4 2012 Netflix, Inc. Earnings Conference Call

EVENT DATE/TIME: JANUARY 23, 2013 / 11:00PM GMT



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PRESENTATION

Operator

Good day, ladies and gentlemen, and thank you for standing by and welcome to the Netflix fourth-quarter 2012 earnings Q&A session. At this time, all participants are in a listen-only mode. Later we'll conduct a question-and-answer session and instructions will follow at that time. (Operator Instructions) As a reminder, today's conference may be recorded.

It's now my pleasure 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 fourth-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 fourth quarter at approximately 1 PM Pacific time today. The shareholder letter and the Q4 financial results and the webcast of this Q&A session are all available at the Company's investor relations website at ir.netflix.com. As is our standard practice, we will begin the call with questions received via e-mail. Please e-mail your questions to ir@netflix.com. After e-mail Q&A, we will also open up the phone lines for additional questions not covered by the e-mail Q&A or the investor letter. The dial in number is with our -- is in our investor letter, but let me repeat it now. Please call 760-666-3613 if you would like to get in the queue.

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



Now let's move directly to questions. As is our standard practice, we've organized the questions by topics as we've received them this afternoon via e-mail.

QUESTIONS AND ANSWERS

Ellie Mertz - *Netflix - VP Finance & IR*

First topic, question is on the domestic streaming. To what extent would you attribute the growth in subscribers to mobile, particularly tablet adoption? How much is usage is over mobile devices? Same question for connected television.

Reed Hastings - *Netflix - CEO*

Both the rise of tablets, phones and the rise of smart TVs are very helpful to us and they're really the beginning of a trend around Internet connected ecosystems with devices. And certainly the more convenient those devices get, the more people will feel comfortable watching and enjoying content on a wide range of devices. Some day including Google glasses, Internet watches, all kinds of scenarios over the next five years. And as well as multi-screen scenarios where you use your tablet or phone to choose content on the TV. So what we'll see over the next couple years when we saw in this fall also was more and more consumer adoption of Internet connected screens which are both tablets and smart TVs.

Ellie Mertz - *Netflix - VP Finance & IR*

What's the percentage likelihood that you increase the price of your streaming plan over the next 12 months or even over the next 24 months?

Reed Hastings - *Netflix - CEO*

We're happy at \$7.99 and not speculating on the future.

Ellie Mertz - *Netflix - VP Finance & IR*

You talked about improvements in both voluntary and involuntary retention. Can you give us some color on where churn levels are relative to historical numbers? Are you back to pre fall 2011 levels?

Reed Hastings - *Netflix - CEO*

That was a really different business when it includes DVDs, so I'm not going to focus on that comparative reference. But what we are doing is seeing nice improvement again relative over this last year when we've been on the straight streaming side. And we'll continue to look at that. The fundamental though is not to focus, or we don't focus, on churn because we really want to make it easy to quit. I know that sounds strange. But we spend a lot of time so that if you leave, you have a really good experience and that makes you much more likely to come back in. And we think that's the right way to build a long-term growth in paid ads but it does result in easy exit.

David Wells - *Netflix - CFO*

I would say that our [regionally] continue to be a very strong channel for acquisition, and that continues to be the case. We've seen that in Q3, Q4, all the way through the quarter and that's a function of that, of people flowing in and out of the service. And because we make it easy, they don't feel trapped by a contract and it's very easy for them to come back in the service when their lifestyle warrants signing up again.

Ellie Mertz - Netflix - VP Finance & IR

How much confidence do you usually have at this point going into Q1 relative to other quarters given all the sub adds that come in early January from holiday devices?

Reed Hastings - Netflix - CEO

It's marginally better than other quarters in terms of percentage of the quarter's numbers that have come in by the 20th, but it's not hugely material.

Ellie Mertz - Netflix - VP Finance & IR

Moving to questions about content. First, questions on the Disney deal. You made a bold and expensive move with your output deal with Disney. Presumably the magnitude of the Disney deal will result in your devoting less content dollar resources elsewhere, even accounting for subscriber growth. What type of content are likely to be sacrificed as a result?

Reed Hastings - Netflix - CEO

Well the way pay one deals work is you pay per film, and so they'll flow in 2016 that would hit in the second half of 2016 are relatively small in total payments, and you don't really get a full load of the payments until 2018. So it's a long way off. We've got a lot of content to look at between now and then in terms of what generates the most viewing and satisfaction, and a lot of flexibility to build the best service that we can by that point.

Ellie Mertz - Netflix - VP Finance & IR

What changed the attractiveness of the Disney content, which last year only accounted for 2% of your streaming hours? Was it solely the ability to be exclusive? Was it the Lucasfilm acquisition?

Reed Hastings - Netflix - CEO

It is pretty amazing that the Disney content when it was on our service from Starz was only 2%. And it shows you how much incredible great content that we have, that content as good as the Disney content could only be 2%. Going forward, in addition to the straight Disney content, were the Disney Marvel content and the Lucasfilms, so it'll be bigger than it would have otherwise. But the rest of our content is growing. The big thing that we're excited about with the Disney content, once it eventually flows in, is it's fully exclusive to Netflix. And as we've been talking about, we're more and more interested in exclusive content.

David Wells - Netflix - CFO

Yes, I think it hits that point of differentiation that we've articulated before as part of our content strategy. And that exclusivity allows us to have that differentiation in the long term.

Ellie Mertz - Netflix - VP Finance & IR

How are the terms and conditions of exclusive pay one deals such as the recent Disney deal similar to or different from typical content deals?

Reed Hastings - *Netflix - CEO*

We don't typically discuss terms on individual deals. I would say that deals like the Disney deal and other output style deals tend to be more cash intensive up front but other than that are not remarkable anywhere.

David Wells - *Netflix - CFO*

And you pay per film based upon the box office performance.

Ellie Mertz - *Netflix - VP Finance & IR*

Are there any material holes in your content library still in terms of studios or categories you feel you need to have?

Reed Hastings - *Netflix - CEO*

I would say there's much more than holes. There's vast amounts of additional content that we want to acquire as we grow. And the virtual cycle for us is to gain more subscribers and get more content, gain more subscribers, get more content. And what propels our growth is that continuing content. There's no specific hole as we'd like to get more movies. We'd like to get more prior season television. We'd like to have more originals. And in general as we grow, we'll be able to deliver on that more and more for consumers.

Ellie Mertz - *Netflix - VP Finance & IR*

Netflix described its library in terms of three groupings, movies, serialized TV and proprietary content. The first two buckets are extremely large compared to proprietary content, should we expect a large slate of proprietary content that launches in the future? Does your hierarchy suggest that despite being small, that proprietary content's value is on par with movies and serialized TV?

Reed Hastings - *Netflix - CEO*

Well, it's early for us on the proprietary original content. We'll know a lot more maybe on the July call after we've launched House of Cards and after we've launched Arrested. So we'll be able to comment a little more and at that point we'll make decisions about how much we want to invest in it, do we want to increase the investment, keep it about the same, do less, we'll have a lot more knowledge. So we'll take our time and for the next six months just focus on the current originals.

David Wells - *Netflix - CFO*

And I'd say the bar on that, we've said this before, but it's what articulating again, the bar on the originals is that it performs in similar to other third-party licensed content that is exclusive. If the originals are exclusive for us and they are we would look to do that better inside, if we can't, then we wouldn't pursue that. There's the brand halo effects and the PR effects that you get from it and those are very, very attractive. But that comes from the exclusivity as well.

Ellie Mertz - *Netflix - VP Finance & IR*

Leads to more questions on originals. This year you'll have four new original series of Netflix plus Lilyhammer. What are your plans for 2014? Presumably you have some idea now given the long lead times on original programs. What percent of content cost do you envision for original programming next year?



Reed Hastings - *Netflix - CEO*

Again, we haven't made the decisions for next year in terms of what percent of the budget would be original content. We're going to look at the results, look at the viewing, the overall press attention, subscriber acquisition trends, all of the factors before making those decisions.

Ellie Mertz - *Netflix - VP Finance & IR*

How do you plan to market House of Cards? How does your approach to marketing the show differ from how traditional cable networks market their shows? Do you envision creating a section to highlight original programming within the Netflix service over time?

Reed Hastings - *Netflix - CEO*

The huge benefit is that we don't have to advertise 8 PM on a Thursday night, tune in. We get to let people know about the show and they can watch it any time at their leisure. And so that lets us be much more efficient in our marketing and much less focused on a specific date and time. Mostly we're going to be able to generate tremendous demand through our service, by targeting the specific online ads on the service, the content for the people who it will be relevant for. So we'll get tremendous viewing from our 33 million mobile members. Then in addition, we're also generating a lot of attention in certain cities doing highly concentrated large scale promotion to be able to see what the effects (inaudible) to stimulate the creative community awareness and generally build a lot of buzz around those shows. So we're very much looking forward to that launch.

Ellie Mertz - *Netflix - VP Finance & IR*

For a few of Netflix's upcoming original programs, please discuss the specific rights Netflix owns and the monetization strategies of the other rights holders. Which monetization channels, if any, does Netflix view as most complementary to its streaming business over time?

Reed Hastings - *Netflix - CEO*

I think that's something we'll learn over time. If you look at HBO, they experimented and have had great success with DVD as a channel for their content. They did some syndication but then they pulled back on some of that and I'm sure we'll try some of the same things, trying to see what makes sense. The current originals mostly were a first window licensor. And for example, on House of Cards, Media Rights Capital owns the other rights and will be monetizing those downstream from us. So we'll try different structures as we go forward, but primarily we're focused on monetization on our platform.

Ellie Mertz - *Netflix - VP Finance & IR*

You said that Arrested Development could bump subscriber growth in Q2. Can you point to any good data that supports this view? Expressions of interest by Netflix subscribers, surveys that point to interest or anything like that? How would you compare interest in Arrested Development to interest in other originals cued up this year like House of Cards and Hemlock Grove?

Reed Hastings - *Netflix - CEO*

Well it's a great question. In the case of Hemlock Grove, it's a new property like House of Cards and the same with Orange Is the New Black. So that'll take some time to develop for those shows. Arrested is unique because it's already got a big brand and so it's going to be more front loaded in its overall viewing and attention. In terms of hard data, it's very hard to predict what will happen in terms of membership in Q2. So I think what we'll do is we'll be cautious. It's not particularly built into our forecast and then we'll see what happens in Q2 and then from that basis we'll have -- be able to project going forward.



Ellie Mertz - Netflix - VP Finance & IR

Question on accounting for originals. Over what period of time are you amortizing the up front cash spend on important originals this year, particularly Arrested Development and House of Cards?

David Wells - Netflix - CFO

The accounting for originals is similar to or is consistent with the accounting for our full library which means we amortize is straight line over the license period. I would say the question was asked about amortizing the cash. It's not the cash that gets amortized, it's the extent of that full title. And so when we have quarters like Q4 and you talked about Q1 being intensive for originals, we'll pay depending on the terms of the deal, heavy upfront payments, even upwards of 50%, and then that content will come in the window later in the year. So you'll see the cash come out in terms of the cash flow but there's no offsetting expense. Some of it flows into prepaid content as you see and you'll see that cash be less as we go through the year and the expense starts to catch up.

Ellie Mertz - Netflix - VP Finance & IR

As you look at original Netflix content, what are your expectations for how it will perform in the US and international markets?

Reed Hastings - Netflix - CEO

Very strong.

Ellie Mertz - Netflix - VP Finance & IR

How do you decide which original programming to invest in and stream? Do you look to reach certain segments of your sub base or best available programming or other factors?

Reed Hastings - Netflix - CEO

Well, again, we're at very early stages. I think Ted's done -- Ted Sarandos has done a great job of different types of content. Hemlock Grove and House of Cards are quite different, I think you'll be very pleased with Orange Is the New Black. So -- and of course, Arrested Development will be a huge winner. So I think it's too early for us to have any great confidence. We're staying flexible learning and we'll grow into original program step by step.

Ellie Mertz - Netflix - VP Finance & IR

A few questions on competition. Do consumers need to choose between Netflix and Amazon? In the past you've referred to HBO and Netflix along the lines of baseball and football. Do you feel that way about Amazon too? As Netflix and Amazon both have exclusive content and original content, will it make sense for consumers to have both rather than choose between them? Do you think the two services will take on different identities and be the two leading visual cable networks for the future?

Reed Hastings - Netflix - CEO

Well some of this is already happening in the UK where LOVEFiLM, SKY, TV Now and Netflix have nearly no overlapping content. And the press tone is shifting in ways to being -- getting both or getting all three as they're different channels, basically serving someone's total needs. Now of



course, not everybody has infinite budget. When anybody's budget is tight, there's real competition for choosing us if you need to choose. But I do think that many people will choose to get multiple services, like we compete with HBO. Today in the United States, Amazon prime's content has started to be mostly a subset of ours and is then going to add original content, and clearly we've done the same. And so I think over time there's a pretty good likelihood that we'll compete like we compete with HBO, that is we'll all have different shows and all be competing for dollars and attention, but not have the same content.

Ellie Mertz - Netflix - VP Finance & IR

Can you help us understand your methodology behind the top 200 title comparative analysis? Do you use ratings, actual viewings, et cetera?

David Wells - Netflix - CFO

We use actual viewing hours in Q4 on our Netflix service. So in the US those would be for each title in there, not just a season but a title, an entire show, how many hours that was viewed basically during Q4, and that's the methodology behind it.

Ellie Mertz - Netflix - VP Finance & IR

Moving to questions on international. On previous calls Reed has stated his intentions to continue to reinvest in international expansion once you get back to profitability. Can you update us on your current thinking on this topic?

David Wells - Netflix - CFO

I could let Reed speak or I can reiterate what we said last quarter which was there's two gating items or gating conditions. One is global profitability, which we're really pleased that we continued to demonstrate even with the Nordics launch in Q4. And the second condition being that we're pleased with the path of our existing investments. So those two conditions still hold.

Ellie Mertz - Netflix - VP Finance & IR

Two quarters ago Reed spoke about raising the content spend in the UK. Do you have a sense whether the expanded offerings in the UK have impacted subscriber growth or churn in any meaningful way?

Reed Hastings - Netflix - CEO

Yes, absolutely. We've continued right from inception, and frankly in all of our territories, in Canada, Latin America and different nations in Europe to expand the content. And expanding the content has definitely increased viewing, decreases churn, makes the service better. So we're very eager and ambitious to get more and more content on all of the services including the UK.

Ellie Mertz - Netflix - VP Finance & IR

Has the competitive environment in the UK evolved over time? In the UK are you seeing different levels of net adds, churn, et cetera given the potentially more competitive environment?



Reed Hastings - *Netflix - CEO*

(Inaudible) will change in the UK (inaudible) from our launch at the same price they've always been at, has been Sky's TV Now which launched in the fall. So that's increased there, it's active marketing going on between us. And as far as we can tell, those services are doing well also. It comes back to us, it may not end up as a (inaudible). We want to get the biggest piece of the pie, but it may be that people subscribe to multiple services.

Ellie Mertz - *Netflix - VP Finance & IR*

Can you tell us if the payment changes made in Latin America had a material impact on sub growth in Q4 or will it help the Q1 numbers?

Reed Hastings - *Netflix - CEO*

Helped a little bit in Q4. Will help a little bit more in Q1. And we've still got progress to go.

David Wells - *Netflix - CFO*

And I'd say it was an incremental improvement.

Ellie Mertz - *Netflix - VP Finance & IR*

What penetration of sub levels do you need in any given country, in say Europe or Latin America, to reach breakeven? Approximately what is the time to achieving that now?

Reed Hastings - *Netflix - CEO*

It will depend by market. In some markets, we'll get there relatively quickly, others will take longer. And there's no precise level of penetration. It depends for example in Latin America, we'll end up at breakeven at lower overall household penetrations because the Internet is at lower penetrations. So I would think each market is unique in this way.

Ellie Mertz - *Netflix - VP Finance & IR*

In the past you said you believe that [books] can grow if domestic sub base two to three X out of HBO long term. What are your expectations in the various international markets that you've entered?

Reed Hastings - *Netflix - CEO*

Well let's see our hopes would be that we should get to similar house Internet or broadband household penetration levels as we can in the US. But until we actually prove that that's possible, we're a little cautious on forecasting it. So in principle, when you look at Internet usage or YouTube usage or our television, paid television or free television, it's pretty ubiquitous across all these societies. So the notion that over 10 or 20 years, Internet TV is as strong around the world as it is in the US is pretty sound.

Ellie Mertz - *Netflix - VP Finance & IR*

Can you achieve long-term international contribution margins equivalent to the US without the same amount of scale in (inaudible)?



Reed Hastings - *Netflix - CEO*

No, I think we would need the same amount of -- the contribution margin is a factor of the scale, so I think we would need to get to that scale. It's scale and competition and we're adding competition. So those two things are the primary determinants of long term margin.

Ellie Mertz - *Netflix - VP Finance & IR*

You expect more modest quarter-over-quarter improvements in international losses beyond Q1, is that because of lower sub add expectations or an increase in spending relative to sub growth?

Reed Hastings - *Netflix - CEO*

A little bit of both.

Ellie Mertz - *Netflix - VP Finance & IR*

Now to a question on the DVD business. You appear to be marketing DVD subscriptions to streaming only subscribers again. We're noticing more e-mail promotions, offering a free month trial to the DVD program. Do you really want to push people back to DVDs? And isn't it a bit confusing to consumers given your intense focus on streaming being the future of media consumption?

David Wells - *Netflix - CFO*

I would say this is, this is David here, I would say it was a program that we did around the holidays and into January. I think you'll see us use it sporadically. I wouldn't describe it as a large program. It was incrementally positive to our DVD subscriptions and we faced a lot of criticism 12 to 18 months ago that we weren't doing enough in terms of monetizing some of the failed search opportunities on the DVDs, on the website and so forth. And I think we've cleaned a lot of that up and the e-mail program campaign that you were talking about is in evidence of us doing a little bit. We [AV] test a lot of this and usually when we do something, it's going to be an incremental positive.

Ellie Mertz - *Netflix - VP Finance & IR*

We have a question on Open Connect. Could super HD and 3D streaming theoretically be extended to ISPs without Open Connect without significant engineering investments? Asked another way, is Open Connect a prerequisite for technical reasons or more for strategic reasons?

Reed Hastings - *Netflix - CEO*

Well it's a mix of both. I think what companies do with new features like super HD is they focus on newer platforms, whether that's Siri only available on an iPhone 5, say, or something like that. It both gets people to adopt the new platform and allows you from an engineering side to concentrate on a simpler use case. And being able to support super HD and 3D is demanding. And Open Connect is free to all ISPs. So we don't anticipate much of a problem and I think what we'll find is by doing that we can be more efficient, not going through middlemen.

Ellie Mertz - *Netflix - VP Finance & IR*

A question on streaming delivery costs. Did Open Connect drive delivery costs down in Q1, or excuse me, in Q4 or was it better pricing from suppliers?



David Wells - Netflix - CFO

Delivery costs, I'm not sure you could read into that as a result. I would say that our Open Connect program has investments that are front loaded. So to the extent that we're rolling out our Open Connect program there's a little bit of expenses that are loaded into Q4 and into [2013] depending upon the pace of our roll out and that those should moderate going forward.

Reed Hastings - Netflix - CEO

I think the question is reference to a letter, we said that the US contribution margin was better because of some delayed expenses that'll show up relative to planning in Q1 than Q4.

David Wells - Netflix - CFO

Thank you for the clarification. So timing around expenses for Q4.

Reed Hastings - Netflix - CEO

But in general, delivery is something that's relatively small percentage of our total cost and works quite well. So it's relatively inconsequential.

Ellie Mertz - Netflix - VP Finance & IR

A question on the social experience. Please assess Netflix's experience with social media integration in international markets. Could you provide some common examples of how Netflix uses social media in international markets? How do you expect social integration to impact your US business?

Reed Hastings - Netflix - CEO

It'll be a nice thing for us. I don't think it's going to be huge. It hasn't been huge for us internationally. It's really segmented. There's a section of a group within each country that loves social and they're really into it on Netflix and probably every other site that they use. And then there's a lot of people for whom that's not why they're there at Netflix in terms of the social aspect, and of course over time those ratios will shift. But for now, all of our social work really caters to a specific, typically younger but very social sense of demographic. So it's a good investment, it's making good progress. We're thankful that DPPA passed, the change to it. And we'll continue to make progress on this front.

Ellie Mertz - Netflix - VP Finance & IR

Now questions on the financials. How should we be thinking about 2013 in terms of profitability and margins? Similar to 2012 as a heavy investment year or a year where we start seeing leverage in the model, if so, how much?

David Wells - Netflix - CFO

We should see leverage in the model. We haven't made decisions in the back half of the year on international expansions, so obviously that will matter as well.

Reed Hastings - Netflix - CEO

We'll probably have 7 million reasons not to give full year guidance right here. So we'll avoid doing that this year.

Ellie Mertz - Netflix - VP Finance & IR

We might also make the point that we saw considerable leverage in the model in 2012 in our Domestic streaming segment where we saw 700 basis points of margin expansion.

Reed Hastings - Netflix - CEO

Yes, we can be confident that it won't be as big as that.

Ellie Mertz - Netflix - VP Finance & IR

As profits overall are somewhat exceeding guidance, do you think you might increase investments in marketing, content and/or additional country rollouts in the near to medium term?

Reed Hastings - Netflix - CEO

No, that's not directly affecting us. We're -- as we outlined in the letter, we're feeling good about those plans.

Ellie Mertz - Netflix - VP Finance & IR

You talk about the goal of 100 basis points of contribution margin expansion sequentially in Domestic streaming but you don't indicate how far out that goal extends. Can you talk about what your thinking is related to long term i.e. multiple years out Domestic streaming contribution margins?

David Wells - Netflix - CFO

It'll be a function of competition and how much of the market, the total addressable market that we can collect. So for right now we're focused on the target of expanding that routinely by growing faster basically than our content by expanding our content expense.

Ellie Mertz - Netflix - VP Finance & IR

What is the size of the off balance sheet content liability?

David Wells - Netflix - CFO

So I think the question usually I get on this is related to the contractual obligations table. The streaming obligations were \$5 billion as of 9/30, so as of the end of Q3. That corresponds to a \$5.6 billion number as of the end of 12/31. \$2.5 billion of that is on the balance sheet, so \$3.1 billion is not on the balance sheet.

Ellie Mertz - Netflix - VP Finance & IR

Do you expect to be free cash flow positive for the full year?

David Wells - Netflix - CFO

We don't provide full year guidance on it.



Ellie Mertz - Netflix - VP Finance & IR

Can you give a sense of how much money you plan to raise in the debt offering? Would you consider using stock? Would the potential new debt financing be straight set or could it be convertible debt? When would it occur?

David Wells - Netflix - CFO

So no on stock, no on convert. I think the plans that we put in there are still an opportunity, an exploration based and it's really based on the 20 plus year lows that we see in the debt market. It's a good time to lock in very low cost, long-term capital. So we'd be remiss in not looking at that opportunity.

Ellie Mertz - Netflix - VP Finance & IR

Will additional financing be needed if you decide to open new international markets in late 2013 or early 2014?

David Wells - Netflix - CFO

No.

Ellie Mertz - Netflix - VP Finance & IR

Your marketing cost in Domestic streaming has fallen 24% year over year, yet you've been able to grow your top line significantly. How sustainable is your Q4 marketing spend and how do you think you're gaining efficiencies in marketing?

David Wells - Netflix - CFO

Very sustainable on the Q4 marketing spend. And the second part of that?

Reed Hastings - Netflix - CEO

At what efficiencies. The main efficiency comes because most marketing is our members telling their friends about Netflix. It's not the ads that we pay for. And as we have more and more members, and as they are happier and happier with the service, then that benefits the growth and then you don't need as much paid marketing.

David Wells - Netflix - CFO

I would say also we put in the letter about we're expanding our content expense and that has benefits in terms of getting people excited about the site, retaining better, all of that is a quasi marketing expense.

Reed Hastings - Netflix - CEO

Is Arrested Development a marketing expense or a content expense?



Ellie Mertz - Netflix - VP Finance & IR

Will the Company break out cost of subscription versus fulfillment expense for the quarter?

David Wells - Netflix - CFO

Not likely. Fulfillment has grown to be a pretty relatively small portion of our cost of revenues and our DVD business continues to scale down. It's a small portion of cost of revenue.

Ellie Mertz - Netflix - VP Finance & IR

Great, that's the end of our e-mailed questions. Now we'll turn it back over to the Operator to take live call-in questions.

Operator

(Operator Instructions) Mark Mahaney, RBC.

Mark Mahaney - RBC Capital Markets - Analyst

Great, thanks and congrats on the quarter. I don't think I've said that on an earnings call in five years and Reed I know you don't run the business near term, but congrats on the quarter anyway. In terms of rebuilding the brand, Reed, you talked 1 year ago, 1.5 years ago and said it'd be a multi-year process in terms of rebuilding the brand. As you think about and survey your customer base now, do you think you've rebuilt that, the brand hits that you -- do you think you've recovered that brand hit that you took in the wake of the controversies?

Reed Hastings - Netflix - CEO

No, not entirely, Mark. There's still an echo and a bruise and so we still are extremely thoughtful and careful about what we're trying to do because it wouldn't take much to have the issue flair up again or for us to lose trust. You might say we're on probation at this point, so we're out of jail but we've still got as we initially talked about a three-year time frame, we've still got 1.5 years of probation.

Mark Mahaney - RBC Capital Markets - Analyst

In terms of the content requirements or likes, the wants of your subscriber base, have you seen a noticeable change in the satisfaction level of your subscribers with current content or do you still see -- there's always been a gap, but do you think that that gap's narrowed a little bit over the course of the last three to six months?

Reed Hastings - Netflix - CEO

Yes, that would be mostly what drives the improvement in involuntary retention is that satisfaction with the content. In addition it's satisfaction with the user experience, how quick and easy it is to choose, how well the personalization works, how well the streaming works. So that all comes together and that's giving the satisfaction.

Mark Mahaney - RBC Capital Markets - Analyst

Thank you.

David Wells - *Netflix - CFO*

Mark, I would say that the other contributor to that is people when -- two to three years ago when they first experienced the streaming offering had expectations of a DVD full content library. I would say those people are starting to be a little bit more aware of what's available in an Internet channel and an Internet network offering like we have. So the expectations gap might be narrowing as well.

Mark Mahaney - *RBC Capital Markets - Analyst*

Thank you, David.

Operator

Doug Anmuth, JPMorgan.

Doug Anmuth - *JPMorgan - Analyst*

Wanted to ask about content costs, the outlook for 2013 if you could give us some sense of how you're thinking about the increase here and perhaps in relation to what you did from 2011 to '12? And then secondly, can you give some more detail on how you improved that involuntary retention, you mentioned processing payments and recovering members better, so if you could give some more color there. Thanks.

Reed Hastings - *Netflix - CEO*

Sure, Doug. In terms of content costs, what -- we continue to expand our content library so we expect that to continue to increase. It's going to increase slower than revenues. So from that, you can infer that the year-over-year increase for 2013 will be less than the increase that we saw in 2012. And then the second piece of that question was around how we improved involuntary retention number. Then that was through looking at a number of optimizations in terms of how we handle folks that go on payment hold.

Doug Anmuth - *JPMorgan - Analyst*

Thank you.

Operator

Youssef Squali, Cantor Fitzgerald.

Youssef Squali - *Cantor Fitzgerald - Analyst*

Reed, you spoke about offering more personalization on the site, and if my memory serves me right, I think last time you talked about it was several quarters ago. And I think you talked about maybe offering personalization at least of queues by year end. So one, wanted to see what the holdup there was? And second, what other ways can you improve personalization on the site? Then I have a follow up.



Reed Hastings - *Netflix - CEO*

Youssef, we're still in testing on the feature that's sometimes called profiles where you set up an explicit view I would say you, your kids, your spouse and each then person gets their own area. And we're trying to find models that give great benefits to consumers but are also really simple. And so that's where we're involved in a lot of testing and when we get that to a great state then we'll roll it out to everyone.

Youssef Squali - *Cantor Fitzgerald - Analyst*

Is that still an imminent internal launch or has the date on that been now put back on hold?

Reed Hastings - *Netflix - CEO*

It's not imminent, we're still in testing mode. We think we've got -- in something like that, you don't want to roll it out and then change it a lot so you want to do all the tuning in test mode. So sometime over the year I'm sure we'll launch it assuming we find a model that works really well with our testing. But it's not imminent.

Youssef Squali - *Cantor Fitzgerald - Analyst*

Okay, great. And then lastly, as you integrate with Facebook for more sharing or social personalization, I was wondering if you'd have any interest in participating in Facebook's Gifts program which is something I'm sure you're aware of that they launched not too long ago, and they have other retailers like iTunes, et cetera, is there anything that would preclude you from wanting to participate or be on that program?

Reed Hastings - *Netflix - CEO*

No, there's nothing that would preclude us.

Youssef Squali - *Cantor Fitzgerald - Analyst*

Is there interest on your end?

Reed Hastings - *Netflix - CEO*

I should know more about it as a Facebook Board member but it's very new, and so I'll take your hint that it's a good thing and I'll go spend some time on it.

Youssef Squali - *Cantor Fitzgerald - Analyst*

Great, thanks a lot. Congrats.

Operator

Scott Devitt, Morgan Stanley.



Scott Devitt - Morgan Stanley - Analyst

Reed, now that the US business has gotten back to this level of strong growth, I was wondering if you could revisit that US market opportunity, how you're thinking about it, that \$60 million to \$90 million figure and the points of friction that you're facing from here to grow that US sub base to a much larger level? And then secondly for David, in the 1Q guide I think you noted that 2Q you're not specifically attributing any subs to Arrested Development, but is that also the same thing for House of Cards, is there no specific attribution for House of Cards in 1Q? And are you planning any specific TV spend for either of those two shows? Thanks.

Reed Hastings - Netflix - CEO

Scott, I think about it in terms of the content layers. So we're at \$27 million domestic now. So the question is do we have good enough content to say get to \$40 million? And then with that incremental content budget, can we improve the content such that with that incrementally better service we can get to \$50 million? And then similarly, we've got more money, we can spend on more content. So that's one big growth factor. And second is the overall change to Internet TV. It's not just us that's benefiting from this. If you look at Hulu's numbers over last year, they doubled from 1.5 to 3 million subscribers. So people around the world are interested in Internet television because you can click, watch, pause, control, choose, it's just a better paradigm. And so as that tailwind continues to develop, that's very helpful.

And then finally, it's what happens in the consumer electronics space. It was only six or seven years ago that the iPhone came out. We've had tremendous -- we're now on iPhone 5. So if you think about six or eight years from now, by extension we'll be at the iPhone 10 and how incredible will that be for not only viewing video but maybe controlling video around all of your house and choosing and how immersive and all of that helps Internet video services like our own. So those are the three big vectors, the content growth as we grow, the general trend towards Internet TV and the consumer electronics ecosystem.

David Wells - Netflix - CFO

And then Scott on your second set of questions, on House of Cards, we think it's going to be a pretty small benefit for Q1. We talked about how overall it's a generally small share of hours. Really happy about the quality and the fan fare that we're getting with the show and there'll be some publicity, but overall pretty small benefit we think to subscriber additions. Then TV spend for House of Cards, there'll be some media spend likely very little TV, but focused again on influencers in big markets.

Reed Hastings - Netflix - CEO

So would it be fair to say David that it's a very small impact of House of Cards that's modeled into our guidance forecast? And since we have no data to base it on, that's the conservative and correct approach. But some of us are optimistic that it may in fact be substantial, but we really don't know and we don't want to count on it until it happens.

David Wells - Netflix - CFO

I would say that's fair.

Scott Devitt - Morgan Stanley - Analyst

Great. Thank you.

Operator

Tuna Amobi, S&P Capital IQ.



Tuna Amobi - *S&P Capital IQ - Analyst*

So again this question is for David. As I think about how you manage your working capital and swings resulting from the content licensing payments for originals, I'm wondering if there's perhaps a better parameter that can aid reduce the swings in free cash flow, not necessarily quarter to quarter, but as you think about some of the levers that you might have? For example, perhaps deferred revenues and some other items, I'm wondering if this is the best way to think about that, just managing it to the P&L expense as opposed to something that gives you a little bit more control? Granted that the originals are the highest swing factors. Any thoughts on that would be helpful.

David Wells - *Netflix - CFO*

Well, I think that the only -- I'm not quite clear on your question, but if we looked into alternate methods in terms of joint ventures and other vehicles to reduce that cash consumption up front might be the only available method to us and that -- we prefer the simplicity and we may get there sometime down the road. But in terms of the present course, overall the content spend on originals is a relatively small part. It's outsized in terms of our cash because it's so lumpy up in the first couple quarters.

Tuna Amobi - *S&P Capital IQ - Analyst*

And a follow up on that on how you think about managing the risk of your original content in terms of shows that you actually collaborate with third-party producers versus shows that you actually own outright, and how does that factor into your calculations of costs per viewing hours in terms of your commitment to either kinds of shows? Thank you.

Reed Hastings - *Netflix - CEO*

It's Reed here. The good news is any one show isn't an ongoing commitment, so it's a relatively fixed amount. And it might be that at some point we produce a show that's not very good. But what that really means is we only get a little bit of viewing on it as opposed to a lot of viewing. And when you think about the size of any single original and the size of our total multi-billion dollar per year content budget, it's not a huge risk.

Tuna Amobi - *S&P Capital IQ - Analyst*

Thank you.

Operator

John Blackledge, Cowen and Company.

John Blackledge - *Cowen and Company - Analyst*

The first on streaming content spend. Given the current level of streaming content spend after several years of large step-ups, is there a normalized longer term rate of growth or range of growth that we should be considering, or will we potentially see lumpiness on a year in, year out basis dependent on available content? And then for David, as we think about a potential debt raise, is there a certain level of cash on the balance sheet that you're comfortable with? Thank you.



Reed Hastings - *Netflix - CEO*

In terms of the lumpiness, I presume there will be some quarters where it's a little bit lumpy where we sign a big deal. But generally any big deal we would know about several quarters in advance, so we would have that visibility to build in and to let everybody know and then return to the margin expansion that we're targeting. And we're feeling our way along as we grow in the market and create a new service. And that's why we're focused on the 100 basis points a quarter versus some specific operating model, because we want to get the operating model to be better and better and better. And to do that we have to really feel our way along to make sure that it's consistent with increasing viewing and with really good improving involuntary retention. I'll turn it over to David on the cash.

David Wells - *Netflix - CFO*

And John on the cash, as long as the costs are low, more cash is better. But I would say this is again about the opportunity presented by the debt market and the ability to get really low cost, long-term capital. And for us to preserve the flexibility of -- if we see massive success with originals, to preserve the flexibility to expand that program and to develop more down the road. So I don't think there's a magic number, this is about long-term planning for the business.

John Blackledge - *Cowen and Company - Analyst*

That's great. Thanks so much.

Operator

Carlos Kirjner, Sanford Bernstein.

Carlos Kirjner - *Sanford C. Bernstein & Co. - Analyst*

One on content and one on the market potential. First on content. When you lost Starz, you said it accounted for a small portion of viewership time and hence it's loss had really (inaudible) customer acquisition churn et cetera. Suggesting that no specific content deal has material impact on the customer metrics. If you can't lose any specific content deal with limited impact on the metrics how do we think about a positive impact of content deals such as Disneys or Time Warners where presumably you are paying a premium for example for exclusivity or even how we think about investment in original content? On the market potential, if you grow your content offer as you described a few minutes ago and succeed in getting 50 million or 60 million households in the US, how do you think the cable companies would do -- would change their (inaudible) pricing levels or structure? Thank you.

Reed Hastings - *Netflix - CEO*

Sure, Carlos. That's a good question which is why do we talk so much about the increases of content about propelling our growth but when we lose content we say it doesn't really matter. And I think in the insight is your part about any specific piece of content. I think if we lost enough content, that would definitely decrease viewing. And similarly, when we increase content we have to increase it by a lot to make a difference, adding just one movie or something like that or one show isn't going to make a huge difference. The general view we have is sometimes the content additions are so small, 1% of viewing, that we're not going to see a big difference but that'll accrete and if we do a lot of that, that will help.

And then second, in terms of if we get to 50 or 60 million, how does the relations with cable networks change. I think as long as we're building great audiences for them, if you look at what we've done for Breaking Bad in terms of building a bigger audience for it debuting on AMC and if you look at Mad Men, that's a great [win-win]. Where we're incredibly good at the prior season, they got the current season and they get bigger and bigger audiences. And then second, if it's off air like ABC's Lost, then I think it's pure incremental money for them, the fact that we're able to monetize it live. So we don't see a huge conflict there in that licensing dynamic.



Carlos Kirjner - Sanford C. Bernstein & Co. - Analyst

Reed, do you think there's a conflict potentially with the cable companies like Comcast and Time Warner Cable and Cox if you increase your subscriber levels and using their products to transmit the [beats] for the year and it could then change the pricing of cable broadband access?

Reed Hastings - Netflix - CEO

The cable broadband is very profitable for them and the more that people want to do high definition Skype and high definition Netflix, it's inevitable that there's going to be new high speed packaging that are more successful for those ISPs. And so they've got an incredibly profitable great business doing data and that's great for them. It doesn't conflict with us. In fact, we like high definition Skype are a critical application to help them drive more adoption of the higher end packages. And in that way we work really well with them.

Carlos Kirjner - Sanford C. Bernstein & Co. - Analyst

Thank you.

Operator

Tony Wible, Janney.

Tony Wible - Janney Montgomery Scott - Analyst

Do you guys believe that Amazon was in there bidding for the Disney content and what's your appetite for chasing down Sony pay one?

Reed Hastings - Netflix - CEO

Tony, we don't know on Disney, Amazon. And Sony pay one, our appetite's just like it was for Disney, it's strong and we're interested and we'll see how it works out. There's no specific piece of content that we must have and it'll just be a bidding negotiation.

Tony Wible - Janney Montgomery Scott - Analyst

Perfect. Thank you.

Operator

Nat Schindler, Bank of America.

Nat Schindler - BofA Merrill Lynch - Analyst

So if you look at your net sub adds and then estimate some gross sub add that you had coming in for the quarter. In domestic streaming, you said in the past that 30% of those or a third roughly you've touched within the last year and are returns. Has that number changed? And could you think longer than a year, how much of your market of the total market have you touched at this point do you believe over the course of your business?



Reed Hastings - *Netflix - CEO*

It all depends on, Nat, on how you count an entity. You count a household where (inaudible) and they try both onto separate e-mail. Lots of people have multiple e-mail addresses and several of them are willing to enter multiple credit cards to get multiple free trials. So there's no clean notion that we could tell you how many e-mail addresses have we touched. But mapping that into people and households is pretty tricky.

Nat Schindler - *BofA Merrill Lynch - Analyst*

Makes sense. Thank you.

David Wells - *Netflix - CFO*

Yes, so Nat on your first question, it's stayed roughly about the same as a percent.

Nat Schindler - *BofA Merrill Lynch - Analyst*

Okay.

Operator

Daniel Ernst, Hudson Square.

Daniel Ernst - *Hudson Square Research - Analyst*

First big picture on how you're looking at the business and growth, profitability has been reasonably above expectations the last couple quarters and guidance is up for the coming quarter and historically you guys have attempted to manage, perhaps not making too much profits and always are willing to invest in growth and how you're thinking about that in terms of new market roll outs or acquiring new content to really continue to separate yourselves from the competition? Color on investing profit expectations versus growth investments. And then secondly, in a related comment, back in the day, eight, nine years ago we used to get market by market updates, you're at X percent penetration in San Francisco and we've got to profitability in X number of months. And can you give us some directional color like that on some of your international markets in Europe and maybe an update on Latin America there?

And then third, a viewership question, I know people ask what's that for and you can't really give us a lot of color. But what is the mix of viewing between connected devices to the TV, the Xboxes and Apple TVs and DVD players and TVs that have Netflix built in versus tablets and computers? And how does that look domestic versus international where perhaps some of those devices are less connected to TVs in Europe or in Latin America? Some color on how that mix and usage is. Thanks.

Reed Hastings - *Netflix - CEO*

Daniel, you started it off very nicely about talking about our growth above expectations last year, but I think you have us confused with a different company since last year was difficult on that front. But in general, we're pioneering this new service, Internet TV, as are other firms. And from a macro level, there's a lot of great growth vectors because the Internet makes certainly user experiences much more enjoyable at lower cost and that's what's propelling our growth and we are very excited about the growth.

In terms of penetration, in the DVD days we were operating in the San Francisco area for several years with local delivery before we were doing the rest of the country. So that's why we used that as the comp. We don't really have an equivalent. Each -- the US is reasonably uniform in terms



of DVD viewing. Each nation is quite different and you wouldn't want to say every nation's going to be like Canada. And so there's no useful proxying in that way.

And then finally, your question was on viewership and some nations are more smart TV centric and some are more PS3 centric and Xbox centric, but overall you see a lot of similar trends which are tablets are growing somewhat in the absolute and somewhat as a replacement of laptops. Smart TVs are selling, people want to use them, Netflix is the most important application on the smart TV. And then all of the individual devices like an Apple TV (inaudible) are doing well. So the whole Internet getting to every screen is just a big secular story that's happening and benefiting us.

Daniel Ernst - Hudson Square Research - Analyst

Great, thanks. And maybe to clarify, we were talking about the last four quarters being profits above expectations and your guidance there for next quarter.

David Wells - Netflix - CFO

Yes, Daniel, let me take a stab at that in your part A. I don't -- we haven't -- as in the past, Netflix has been very good about thinking about that next incremental \$1 million or \$5 million investment, is it better in content, is it better in marketing, is it better in improving our interface in our product. We continue to do that. You're never perfect in finding out that optimal frontier point. But we still continue to think like that in terms of that additional investment, whether it's better placed in an existing market, in a new market, in our product or in our content offering in domestic or international.

Ellie Mertz - Netflix - VP Finance & IR

Great, thank you. That's all the questions we have time for. Reed, would you like to offer some closing remarks?

Reed Hastings - Netflix - CEO

Youssef, if you're still on, we are on Facebook Gift and I'm sure it's a huge opportunity. Thank you all for visiting with us in the conference and we look forward to seeing you.

Operator

Thank you again, ladies and gentlemen, this does conclude today's program. Thank you for your participation and have a wonderful day.

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