FINAL TRANSCRIPT

Thomson StreetEvents℠

NFLX - Q3 2009 Netflix Earnings Conference Call

Event Date/Time: Oct. 22. 2009 / 10:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Deborah Crawford
Netflix - VP IR

Reed Hastings
Netflix - Co-Founder, CEO

Barry McCarthy
Netflix - CFO

PRESENTATION

Operator

Good day, everyone, and welcome to the Netflix third quarter 2009 conference. As a reminder, today's call is being recorded. At this time for opening remarks and introductions, I would like to turn the conference over to Deborah Crawford, Vice President of Investor Relations. Please go ahead, ma'am.

Deborah Crawford - *Netflix - VP IR*

Thank you and good afternoon. Welcome to Netflix third quarter 2009 earnings call. Before turning the call over to Reed Hastings, the Company's Co-Founder and CEO, I'll dispense with the customary cautionary language and comment about the Webcast for this earnings call. We will 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 findings with the Securities and Exchange Commission, including our annual report on Form 10-K filed with the Commission on February 25, 2009.

10 p.m. Pacific Time. The earnings release, which includes a reconciliation of all non-GAAP financial measures to GAAP, and this conference call are available at the Company's investor relations Website at www.netflix.com. A rebroadcast of this call will be available at the Netflix Website after 6:00 PM Pacific Time today. Finally, as we noted in the press release, we are going to conduct the question portion of the Q&A via e-mail. Please e-mail your questions to me dcrawford@netflix.com And now, I'd like to turn the call over to Reed.

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

Thank you, Deborah. And welcome, everyone, to our call. As I say every quarter, our goal is to grow revenue, subscribers and earnings, while we expand into streaming. In Q3, we again delivered on that goal and Netflix is on track for a record year in 2009. In Q3, we grew our subscriber base 28% over the prior year due to our compelling consumer proposition of unlimited streaming and unlimited DVD rentals for $9 a month. In Q3, we generated record revenue of $423 million, up 24% from a year ago. Operating income was $49.3 million, up 45% from a year ago. Net income was $30.1 million, up 48% year over year. And EPS was $0.52, up 58% year over year.

Of the 115 million estimated households in America, 9.6% now subscribe to Netflix. In the greater San Francisco Bay area, which we believe is the leading indicator of Internet behavior elsewhere in America, 21.2% of households now subscribe to Netflix, up 13% or 240 basis points from 18.8% one year ago. As you can see from these metrics, our momentum is strong and growing. In terms of our DVD-based competitors, we see no change in trend. Stores are closing, while DVD by mail and kiosks are growing. Our disc shipments continued to increase last quarter and we expect disc shipments for Netflix to grow for several more years, as video stores close and as our subscriber base expands.

Our rollout of Saturday shipping is now complete across our 58 distribution centers. And we've been working on automation of our distribution centers for many years. And shortly, we'll place a roughly $40 million automation order for rental return machines that can accept the returning DVDs, open them, clean them, inspect them and prepare them for reshipment. These machines will save us some money and improve the quality of our service. They make financial sense because our DVD shipment volume is still growing and we expect to be renting DVDs until 2030. This is the last of our DVD automation projects and these machines will be installed over the next 18 months.

Stepping back to look at the DVD market as a whole. The studios are wrestling with declines in DVD sales, while the DVD rental market has been modestly growing. Some of the sales decline is due to tighter consumer budgets and some of it is due to the emergence of $1 rentals. One of the mitigating steps that some studios are considering is introducing a DVD retail sales-only window for a few weeks. The vast majority of DVD sales happen in the first few weeks of a title's release. By way of comparison, the book industry generally releases more expensive hardback versions first and then releases the less expensive paperback version of its best selling books. If studios adopted this model, it would likely increase studio profits on DVDs.

In the EU, due to different law, studios can and do dictate differential sales and rental purchasing terms. And some studios use sales-only windows in the EU today. In the US, however, unlike the EU, rental firms can purchase DVDs at retail and rent them legally. So, rental and retail are offered concurrently to the consumer, even though this is not likely the profit maximizing strategy for the studios. Occasionally, a studio tries to find ways to restrict a rental firm's ability to buy at retail but retail is so big and diffuse, this strategy has never worked.

Four years ago, Blockbuster, in an attempt to have an exclusive in rental, paid the Weinstein Company to block all purchases of their films by Netflix. This attempted blockade continues today but we've never had a problem buying Weinstein DVDs, such as the academy award winning "Vicky Cristina Barcelona," through retail and third parties. Along the way, we've also found that buying used copies of Weinstein titles was very attractive and saved us money. The larger a title is, the better our used purchase works because there is liquidity in the supply chain.

Returning to the theme of rental or segments of rental coming after DVD sales in the US. We are fortunate that this would be a voluntary option for us and would only happen if it made economic sense. If some studios choose to support a sales-only window and rental and delay rental, it would shrink the rental market a bit but it would grow sales revenue for those studios. If we can agree on low enough pricing for delayed rental, it could potentially increase profits for everyone.

Because we are less dependent on new releases than our DVD-based competitors, we may be in a position to move to this model earlier than our DVD-based competitors. A short sales-only window would be a benefit to DVD sales and therefore, to the health of the whole DVD ecosystem. Plus, it would allow us to spend less on discs and more on streaming content. For now, there's a lot of modeling and strategic discussions going on and we'll see if sales-only windows become a reality at some studio or two over the next year.

In terms of streaming, we continue to spend heavily on streaming content. We think our new content deals will pay off in terms of greater consumer appeal and therefore, more CE companies will want to include our service in their TV's, their Blu-Ray players and their video game consoles.

How do we gauge our success with streaming? Mostly, we focus on the overall health of the business, growing earnings, revenue and subscribers. But the percentage of subscribers watching instantly is a good early proxy metric for streaming success. Title count for streaming is not a good proxy, since quality is more important than quantity. And device partnerships also need to be weighted by volume. We'll be using title count and platform count metrics less going forward.

And instead, we're going to expand our quarterly disclosure to include what percentage of subs watch instantly at least one TV episode or movie in the quarter. Or to be precise, streamed at least 15 minutes of such content in a quarter. One year ago, approximately 22% of our subs instantly watched a TV episode or movie in Q3. Most of those 22% watched more than one TV episode or movie but all 22% instantly watched at least 15 minutes. For Q3 of this year, that figure has grown to about 42% of subscribers. When you consider that our sub base is 28% larger than a year ago, this means that the raw count of subscribers engaged in streaming has more than doubled over the last year.

Eventually, there will be seasonality in this number, as there is with DVD usage but in the near term, it is a good marker of increasing streaming adoption. For comparison, nearly every subscriber took one or more DVDs in the quarter, which is testament to the importance of the hybrid model. We don't see watching one TV show or movie in a quarter as sufficient but it's a good start and we hope to expand the numbers of subs doing at least that as we move forward.

When I look at our forecast for 2010 and beyond, I'm struck by the fact that we expect our postal expense will be approximately $600 million and growing as our disc shipments grow. We expect it to be over $700 million the following year in 2011. In the long-term, as we license more and more content for streaming and as consumers use streaming more, that enormous and growing postal expense will start to flow to content owners and we will become one of the studios' and networks' largest customers. The rate of evolution for this depends both on how much streaming content we can license and how many homes have a Netflix-ready device or enjoy watching video on a laptop.

As Internet video develops, we're sometimes asked if Netflix is a threat to cable companies over time? Well, cable has several businesses. As to their video business, Internet video, such as Hulu, Netflix and MLB.com are, of course, over the long-term a possible substitution threat for some customers. For the cable broadband business, however, Internet video is not a threat but instead is the killer app driving adoption of high-end broadband packages. The broadband business for cable has one huge advantage over the video business. No content costs and therefore, huge gross margins.

In terms of broadband competitors, other than fiber, none of the other companies or technologies such as DSL, satellite Internet, power line Internet or wireless are very promising for streaming high-definition content. So, while cable video has intense competition from local fiber and two national satellite companies, cable broadband has only local fiber to contend with for true high-speed Internet. As we see it, the growth of Internet video is likely to boost overall cable profits. If we are right, satellite will shrink in subscribers eventually. And we should, over time, be able to do co-promotional deals with cable and fiber broadband providers, as our service is one of the Internet videos' key applications that showcases the high-end broadband packages.

In terms of subscriber guidance, you will notice that we raised our Q4 numbers. We intend to launch a partnership with a CE firm later this year that has a material installed base and growth from that partnership is now included in our guidance for Q4. We will have more to say about this partnership shortly but no more on this call, for contractual reasons.

Looking at next year, given our success to date on streaming with domestic consumers, with global studios and with global CE companies, we are planning our first international effort in the second half of 2010, which would include streaming but not DVD. Our basic approach is to start small, prove out our model and then expand into other countries one by one. For competitive reasons, we won't be more specific at this time about which market is first in our expansion.

We intend to maintain a 10% operating margin in the business overall as we expand internationally. And we believe our global expansion is compatible with 10% annual operating margins. At this point, we don't see any need to invest more aggressively than this enables. We will understand more about our potential to become a global firm after we have succeeded in some specific international markets.

To close, Internet video is growing industry-wide and our strategy of not competing in the big crowded markets of pay-per-view and ad-supported video is working well for us. Commercial-free movie subscription is big enough for us and in that segment, Netflix has many unique strengths. Thank you for listening. And now, I'll turn it over to Barry.

Barry McCarthy - *Netflix - CFO*

Echoing Deborah's comments, I'd like to also thank you for joining today's call. As Reed said, we've made great progress in transitioning our business model to a hybrid service, which includes both streaming and DVD distribution of content. We made our first investment in streaming content 11 quarters ago in early 2007. For competitive reasons, we've said little about our progress to date, including subscriber engagement with streaming and the economic model associated with the hybrid service or how it will scale.

Today, for the first time, Reed talked a bit about the substantial degree of subscriber engagement with our streamed content, even as DVD shipments continue to grow strongly. And he disclosed our plans to make Netflix available on an additional device in Q4, which will accelerate our already fast sub growth. You see that faster growth reflected in our upwardly revised guidance for Q4, our third consecutive quarter of upwardly revised guidance. For the full year we are now projecting net sub growth of more than 2.7 million subscribers, measured from the midpoint of guidance. That's 77% higher net sub growth than the midpoint of our January full-year guidance forecast.

I think it's clear from our Q4 guidance, as well as our Q3 results, that the consumer appeal of streaming is broadening our available market and contributing importantly to our strong growth in revenue, net income and EPS, as well as subscriber growth. The business continues to outperform our expectations and I'd like to spend a few moments talking about the key drivers of performance for the quarter. Next I'll update you on our guidance for Q4, comment briefly on our expectations for Q1 of next year, and close by summarizing our share activity last quarter.

For Q3, gross and net subscriber additions accelerated on a year-over-year basis for the second consecutive quarter. Acquisition was strong across all marketing channels. Organic growth, related to the broad appeal of the streaming service, sustained the trend of year-over-year decreases in SAC. Record low Q3 SAC of $26.86, down 17% year over year and up slightly, as expected, from Q2. As we said last quarter, we expect SAC to drop in Q4. Momentum associated with the launch of a new CE device will be the primary contributor to lower SAC in Q4.

Gross margin of 34.9% improved 80 basis points sequentially. In spite of a small seasonal increase in DVD usage, lower content spending on DVD was the primary driver of the sequential margin expansion. Free cash flow in the quarter was $25.5 million, down 3% on a year-over-year basis and 3% sequentially. Increased CapEx for DVD almost entirely offset the growth in net cash provided by operating activities. And together with an increase in purchases of hardware, explains the decline in free cash flow on a year-over-year basis. The sequential decline in free cash flow is also related primarily to increased CapEx spending for DVD and hardware purchases to support growth, partially offset by an increase in cash provided by operating activities.

And now, a word about our upwardly revised Q4 guidance. Another CE device launch means accelerating sub growth. The threshold questions are; When will we launch in Q4 and how broadly will our service appeal to the installed base of device owners? There remains some uncertainty about the answer to both questions and this uncertainty is reflected in our Q4 subscriber guidance. Launch of the new partnership has important implications for next year's Q1 growth and profit. We're expecting to grow much faster than the Street's consensus forecast and as a result, the consensus Street estimate for subscriber growth and marketing expense is too low. And the consensus Street estimate for operating income and EPS growth is too high, as compared with our expectations for the business.

As many of you know from historical experience, Netflix marketing expense climbs as a percent of revenue in periods of rapid sub growth. This pressures margins and net income. In addition, because we're forecasting faster sub growth, I expect Q1 operating margins to decline slightly on a year-over-year basis. As is our custom, we'll provide more complete Q1 and full year guidance when we report Q4 results in January but we remain committed to approximately 10% operating margins for the full-year 2010.

In closing, I'd like to update you on the status of our stock buyback efforts. Since inception of our first buyback program in Q2 of 2007, we've repurchased a total of 17.8 million shares, for a net reduction in total outstanding shares, including stock option grants, of 18%. In total, we've spent approximately $545 million, which is more than we had in total assets at the end of the third quarter. In Q3, we repurchased 3 million Netflix shares at a cost of $130 million. In the process, we completed the buyback authorized in December of 2008 and began repurchasing shares under the $300 million buyback authorization we announced in August. Under the $300 million authorization, we have repurchased a total of 2.7 million shares at a cost of $122 million, including 1.2 million shares purchased Q4 to date.

Last quarter, we announced plans to modestly leverage our balance sheet to fund future share repurchases and that remains our objective. We recently closed a $100 million revolving credit agreement with Wells Fargo and B of A to begin the process of leveraging the balance sheet, and we'll likely consider additional debt financing.

In summary, the business has outperformed our expectations and growths is accelerating. At the same time, we're making great progress with our streaming initiative. The model is strong and the balance sheet is healthy. That concludes my prepared remarks and now, I'll turn the call back over to Deborah for the Q&A portion of the earnings call. Deborah.

QUESTIONS AND ANSWERS

Deborah Crawford - *Netflix - VP IR*

Thanks, Barry. The first question is from Christa Quarles at Thomas Weisel Partners. She's asking for an update on Epix. Is there still a possibility to strike a content arrangement?

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

It's Reed. And we're talking to a really broad range of content providers all the time, trying to work out deals. So, nothing specific or no specific comment on Epix but we're always talking to all of them.

Deborah Crawford - *Netflix - VP IR*

And her second question, does the new CE deal cover international and does the new Xbox deal extend internationally?

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

Well, we'll be able to give you more details on international probably later next year. For now, we just wanted to give everyone a heads up that it's coming and it fits within the 10% operating margin model.

Deborah Crawford - *Netflix - VP IR*

The next question is from David Miller at Caris & Company. Can you confirm whether or not you have you re-upped with Microsoft on your Xbox streaming deal? If so, can you disclose economics?

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

Can't disclose on either of those.

Deborah Crawford - *Netflix - VP IR*

The next question is from Steven Frankel at Brigantine Advisors. At this point, does Watch Instantly have more impact on customer attention or customer acquisitions?

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

There's no easy way to separate the positive impacts of streaming between acquisition, retention and also on DVD substitution or costs, because we don't have a set of customers that are not permitted to get streaming to compare it with. So, what we're seeing is we're investing a lot in streaming and the overall subscriber base is growing at fantastic and accelerating rates. So, we're very encouraged by that. The streaming is getting used broadly. We talked about a year ago, roughly 20% and now over 40% of subscribers using it. So, we're feeling very good about that evolution. But we don't -- without a control group we can't be certain which of those attributes are most affected by streaming.

Deborah Crawford - *Netflix - VP IR*

He had a second question. If most of the new customer acquisitions tend to be at the lowest cost monthly plans, does the Company need to modify its customer acquisition methods to lower SAC in order to maintain margins?

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

We're extremely happy with our customer acquisition engine and it's working very well for us.

Deborah Crawford - *Netflix - VP IR*

The next question is from Ralph Schackart at William Blair. If competing digital service offerings are rolled out on Blu-Ray, HDTV, cell phones, et cetera, both electronic sell-through and digital VoD, will this be complementary to the Netflix digital service or a competing digital service?

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

We look at pay-per-view and advertising supported video as mostly complementary. Obviously, there is some substitution for time but they're different enough models that co-existed on many systems quite well. We're staying focused on the one segment of subscription with commercial free. There are other companies, Hulu, YouTube, et cetera on the advertising and then many firms on the pay-per-view, Amazon, Blockbuster, et cetera. So, I would say, it's substantially complementary to the degree that those other services are on devices.

Deborah Crawford - *Netflix - VP IR*

The next question is from Youssef Squali at Jefferies & Company. Q4 guidance implies net margins of 5.3% at the midpoint, the lowest we've seen in seven quarters. What is driving that?

Barry McCarthy - *Netflix - CFO*

We're on a pace to slightly overshoot the 10% operating margin that we've guided to for the full year. And in my remarks, I implied that we would be taking steps to further leverage the balance sheet. And so, those costs fall between the operating margin and the net income line. And so, you see that reflected in net income as a percent of revenue but then there will be some additional reductions, if we incur those expenses, in the number of outstanding shares, which would offset those costs before they show up in the P&L.

Deborah Crawford - *Netflix - VP IR*

His second question. Both Comcast and Time Warner Cable are preparing to launch online, on-demand services, allowing their subscribers to stream TV content at no extra charge. How do you expect that to effect your own subscriber sign-ups and their proposition from the streaming service?

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

We'll have to see over time. The demos that we've seen early of the Comcast experience are quite impressive. They're doing a great job through the Fancast outlet of offering the shows that you subscribe to on cable. So, their advantage is that they've also got customers as cable subscribers. Our advantage is we've also got them as DVD subscribers. And it may be that there's really not much conflict, that people subscribe to cable to get all the sports and all the incredible variety. And they subscribe to Netflix to get the DVDs. And they use our streaming and cable streaming quite comfortably.

So, we'll have to see how that evolves. Presumably, over time, cable will expand beyond the particular footprints. Right now, most of the models are -- you can only use it at home. You can't use it when you're at a hotel, the portable, the Internet focus, which of course, our service you can. Those are probably things on the margin. I think the core thing is that consumers may not see it as a conflict. They'll think of Netflix as streaming and DVD and they subscribe to that. And they think of cable as all the sports programs, the 100 channels and they'll stay subscribing to that.

Deborah Crawford - *Netflix - VP IR*

The next question is from Mark Mahaney at Citigroup. What are the top three complaints that you hear from your existing Watch Now customers and what are you doing to address them?

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

Mark, we really don't have Watch Now customers. We have Netflix customers and well, virtually everybody does DVD and then an increasing percentage do streaming. But if you mean; What are the complaints about the streaming service? Probably at the top of the list of desired improvements would be more content and broader content selection. Other ones would be on more of my TVs or more TVs. So today, we're on a few devices. We're trying to get that expanded to many more devices and we're making great progress on that.

So first, is content. Second, is platforms. And then third, is being able to choose right on the TV. We made a real step forward on our Xbox user interface where you can, on Xbox, choose the particular movies, as opposed to choose them on the PC and then watch them on the device. That technology for choosing on the TV is something we'll spread to other devices and other platforms. That will continue to make progress. So, those would be the big three that we're working on.

Deborah Crawford - *Netflix - VP IR*

The next couple of questions are from Barton Crockett at Lazard Capital Markets. The first, the Starz deal, Liberty's CEO Greg Maffei stated at the company's recent investor day that Netflix should pay more for Starz content. Can you update us on your outlook for retaining Starz content and the amount you may have to spend for that? Do you expect to retain Starz content through all of next year?

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

The Starz deal is a multiyear and we feel good about it. So, no issues there.

Deborah Crawford - *Netflix - VP IR*

The second question is regarding the share repurchase and debt facility. You spent $130 million on share repurchases this quarter and exited with $156 million of cash and short-term investments. You have another $100 million available under your new debt facility. Under what circumstances would you tap that facility to fund more share repurchases and how much cash and investments do you intend to keep on the balance sheet?

Barry McCarthy - *Netflix - CFO*

Well, we do have a minimum number of -- a minimum amount of cash that we intend to keep on the balance sheet but we are not commenting about that publicly. To rephrase the question. I think they're asking; Would we be prepared to buy at current levels? And the answer is, yes. And if the question were; Why? The answer is because we think it's a good value, obviously.

Deborah Crawford - *Netflix - VP IR*

The next question is from Doug Anmuth at Barclays. Is lower fulfillment due to fewer discs and a shift to streaming? Your 11.7% operating margin was much higher than the 10% outlook that you laid out last quarter. How should we think about that going forward before the international launch? There's two parts.

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

Let's see, about the 10% operating margin. We said on last quarter's call that we were targeting an annual average on a calendar year basis. So, there would be some variations quarter to quarter. And with respect to fulfillment expense, I think the question was; Why was it down Q over Q?

Deborah Crawford - *Netflix - VP IR*

Right. Due to fewer discs and shift to streaming.

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

Not so much. Last quarter, we wrote off a prototype expense to the automation that we spoke about. And we moved a very large facility into the Midwest and this quarter, saw some labor savings associated with that transition.

Barry McCarthy - *Netflix - CFO*

Last quarter in that, you mean Q2, right?

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

Thank you. Yes.

Deborah Crawford - *Netflix - VP IR*

The next question is from Tony Wible at Janney Montgomery Scott. Your guidance on subscribers and revenues to seems to imply ARPU will decline more in Q4. If this is the case, it would also imply that you're expecting the year-over-year decline in ARPU to accelerate in the fourth quarter? Is this correct? And if so, what is the driver? Are there seasonal factors or are subscribers downgrading their plans?

Barry McCarthy - *Netflix - CFO*

The subscribers are not downgrading their plans, existing subscribers are not downgrading their plans, one. Two, let's remember that historically and our expectations are that Q4 growth will have a heavy back-end seasonal component to it. And so, those subscribers remain in their free trial period often when we cross the quarter boundary and generate no revenue. We expect and you should expect ARPU to continue to decline for the foreseeable future. We are very excited about that. If it happens, we will grow rapidly. And if we grow rapidly, we will grow operating profit quickly at roughly a 10% operating margin.

Deborah Crawford - *Netflix - VP IR*

He had a second question. What percentage of your rentals are new releases versus catalog and has this ratio changed with newer subscribers being added?

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

No, there's no material change. It generally can vary somewhat quarter to quarter based upon what new releases are offered but on a long-term basis, a trend is approximately a third of the DVD shipments.

Deborah Crawford - *Netflix - VP IR*

The next questions are from Imran Khan at JPMorgan. How much should we expect you to boost marketing in the coming quarter? Also, how much have you benefited from lower prices on display inventory online?

Barry McCarthy - *Netflix - CFO*

Well, we don't guide to marketing spending, just like we don't guide to SAC. So, seasonally, marketing spending tends to increase in Q4 primarily because consumers are active in Q4 and it's efficient spending. If we -- if the business is running more -- let's say generating more profits than we forecast in the course of the quarter, we will probably have the opportunity to accelerate our marketing spending by reallocating what would be profit. So, that we land the business at about the 10% operating margin for the year. And if not, we would trim our sails a little bit. Historically, we've had the opportunity to increase spending as the quarter progresses.

Deborah Crawford - *Netflix - VP IR*

And a second question from Imran Khan. What are the drivers of greater use of the streaming product?

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

Just to go back on those display -- a question on display ad rates helping us or not. And we haven't seen any material change that helps us or hurts us. And then; What are the material barriers?

Deborah Crawford - *Netflix - VP IR*

What are the drivers of greater use of the streaming product?

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

That's really the same one, two, three that I listed earlier, which is one is content, two is platforms and three is movie choosing on the devices.

Deborah Crawford - *Netflix - VP IR*

The next question is from Daniel Ernst of Hudson Square. First, in the June 2009 quarter, net subscribers grew 71% year over year. And in the September quarter, you just reported they grew 95% year-over-year. Do you think that acceleration is more a function of weaker competition or more a function of increasing attractiveness of your service?

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

When you do the derivative of the derivative, it can get tangled up in some eye popping numbers that you quote. We kind of look at the year-over-year subscriber growth rates, which also tell a wonderful story. We've been increasing those growth rates 24%, 25%, 26%, 27%, now 28% for Q3. And so, that strengthening is a combination of weakening competition in terms of video stores and the power of streaming. There's no particular way for us to separate those two. Anecdotally, it feels a lot more like streaming is having a big positive impact with consumers. But for whichever cause, we're very thankful to see the accelerating subscriber and revenue growth.

Deborah Crawford - *Netflix - VP IR*

He has a second question. Those of us that track the industry are aware that Redbox is having some issues with the studios but do you think that their customers are aware? And/or has that harmed the customer experience? If the answer is yes, has that been a benefit to you?

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

Don't have any insight on Redbox's customers.

Deborah Crawford - *Netflix - VP IR*

The next question is from Michael Olson at Piper Jaffray. You said you were increasing spending on streaming but nearly all subscribers are still using DVD by mail. Can you just talk about, conceptually, how you are continuing to grow gross margin while at the same time spending on new content for Watch Instantly if subscribers aren't using DVD by mail to a lesser degree?

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

Well, we're getting more efficient in our DVD usage and buying. That helps. And that's probably the core way that fits in. As we grow the subscriber base, we're able to rent DVDs that either have been fully depreciated or are post-rev share from several years ago. So, there's a nice benefit with rapid growth associated to our P&L that gives us some room to essentially purchase the content twice. We're purchasing the content on DVDs across the board. And then, some period later, we're purchasing some of that content again on streaming.

We think we'll be able to continue to do that, to basically grow our streaming spend aggressively, while not aggressively growing our DVD spend. And that will create some tensions with some studios but that's the basic mix. And when you look at the possibilities of our studio and network spend five years from now, we may be -- well, we'll almost certainly be in the top five customers and we may be in the top three, behind Best Buy and Wal-Mart.

Deborah Crawford - *Netflix - VP IR*

The next question is from Brian Fitzgerald at UBS. Reed has mentioned in the past that an ala carte pricing plan is something that Netflix considers in mind from time to time. Any update thoughts here?

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

Ala carte can mean several things. If ala carte is thought of as pay-per-view, that's not something that we're considering or have thought about or would. If ala carte means streaming only without the DVD service, it's something we think about and look at, we're open-minded to. So far, we just haven't seen much demand. Nearly everybody wants to also get DVDs. All the new releases are on DVD, the vast catalog is on DVD. So, when there's demand, it will make sense for us to meet that demand for streaming only.

Deborah Crawford - *Netflix - VP IR*

The next question is from Jason Helfstein at Oppenheimer & Company. At current prices, is it likely Netflix will acquire more new release or premium content for streaming in the near term? Can you walk us through how you determine whether you will or will not acquire a movie for streaming, i.e. "Transformers 2"?

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

The way we look at content is; How much is it going to get viewed? How impactful and how positive is it for consumers and what's it cost? And as we take up the spending, we try to find the best deals in the market. So, we don't particularly look for new releases versus old or anime versus drama. We really look at what our subscribers are watching and try to get more of that.

Deborah Crawford - *Netflix - VP IR*

The next question is from Eric Wold at Merriman Curhan & Ford. Although churn came down sequentially, it remains elevated compared to prior periods. As Netflix continues to gain market share and at the same time face competition from Redbox, what do you consider to be a healthy and sustainable churn level?

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

You want to take it Barry?

Barry McCarthy - *Netflix - CFO*

Over the next couple of years, we're going to learn quite a bit about -- as we expand the marketplace with the appeal of Watch Instantly, we'll learn quite a bit about the behavior of the new consumer demographic. And we will learn quite a bit about what the acquisition costs are associated with growing our subscriber base, as we continue to improve the quality of Watch Instantly service. So, it remains to be seen. There are two theories. One, is, as the subscriber base continues to mature, churn is going to ratchet down a little bit. Another theory is it becomes a more transactional subscription. And with a slightly younger demographic, they may come in and out more rapidly but at a lower SAC. So, at a high level, we're very optimistic about the way that the economic model is evolving and our ability to drive future profit. There will be some puts and calls for sure on the interplay between SAC and churn.

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

And if churning customers hated us and never were willing to come back, we would be pretty concerned about the churn rates but that's not the case. Churning customers love the service. They're either just not watching movies right now at all or they can't afford it. They've been laid off. And they indicate, in both cases, high likelihood to come back. So, really think of it as some customers will come in and out, seasonally. And the substitute metric that will give you a more accurate read on the business is household penetration or regional penetration. How is the sub base growing relative to the population at any point in time? And then, it doesn't get so tangled in the churn calculation.

Deborah Crawford - *Netflix - VP IR*

The next question is from Heath Terry at FBR Capital Markets. Is the rollout of Saturday's shipping increases the number of discs per month being used by customers?

Barry McCarthy - *Netflix - CFO*

Not that we can tell.

Deborah Crawford - *Netflix - VP IR*

He also had a second question. What impact do you anticipate your DVD processing automation to do to operating costs at the Company?

Barry McCarthy - *Netflix - CFO*

It will bring them down.

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

Yes but I would say that the postal costs are rising, even though next year it is flat, it will be offsetting. So, it's not a huge leverage. From a modeling standpoint, it's not material. We bring it up because there's a little bit of CapEx associated with it, the $40 million next year, which we haven't had historically. But other than that, it's a good service improvement. It's a symbol that we are continuing to invest in the DVD side and we think that makes sense. But unlike the other factors that we talked about, unlikely to be a material driver.

Barry McCarthy - *Netflix - CFO*

I would say, it's noteworthy for its symbolism. I think we're going to earn a very attractive rate of return on the investment. From an investor perspective, it begs the question whether or not margins will expand. And since margins are a managed outcome, to the extent that we're able to shift costs out of operations, we'll shift them into making it a more compelling service in the form of more compelling content to drive streaming adoption.

Deborah Crawford - *Netflix - VP IR*

The next question is from Nat Schindler, BofA Merrill Lynch. Your DVD library acquisitions had been decreasing year-over-year fairly substantially for the last six quarters until this quarter, when they jumped significantly. The same is true with CapEx spending. What drove the increases and do you believe your capital investment levels were appropriate over the last 18 months?

Barry McCarthy - *Netflix - CFO*

Well, we're enormously pleased with how the business is performing. And we're projecting rapid growth and confident that the infrastructure we built for the business will comfortably support the levels of growth that we're projecting. So in answer to the question; Did we invest sufficiently in the business over the last 18 months? I think the answer is emphatically, yes. Whether or not in any particular quarter, CapEx is up or down, associated with DVD purchases, depends entirely on which studio is hot and which is not and who we're rev sharing with and who we're not. We manage the business to ship from first queue metric and that metric is performing really well versus our internal objective.

So, service levels are good. CapEx happens to be up because the studio that we acquired some content from has a particularly hot hand and we want to make sure that we maintain the ship from first queue metric. So, I don't think you can extrapolate a trend from that single data point.

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

And remember that the vast majority of DVD acquisition is new releases and the depreciation for new releases is 12 months accelerated. So, it's barely CapEx.

Deborah Crawford - *Netflix - VP IR*

The next question is from Ben Rose at Battle Road Research. Can you comment on the Company's future plans to develop and produce original content for video streaming, ala the upcoming "Splatter Series"?

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

We don't have any plans to produce content generally. From time to time, our marketing group does something unique like the collaboration with Roger Corman. But that's aimed around customer acquisition and attention, as opposed to a core part of the service.

Deborah Crawford - *Netflix - VP IR*

The next question is from Scott Devitt at Morgan Stanley. Can you talk about the cost of debt and whether you would expect leverage to be accretive to EPS?

Barry McCarthy - *Netflix - CFO*

Let's have that conversation on next quarter's call.

Deborah Crawford - *Netflix - VP IR*

He had one more question. Could you talk about the constraints involved in gaining distribution on other gaming devices i.e. PS3 and Wii?

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

Well, there's two parts. One, as we've said, is our Xbox deal is exclusive at the current time. And then, two, would be deals with the other game companies that made sense to them. So, just as you probably would expect.

Deborah Crawford - *Netflix - VP IR*

The next question is from Doug Anmuth at Barclays Capital. Based on your comments on 1Q, it seems like you'd be doing a lot of co-marketing with the CE partner. Is this right? Because you're marketing, as a percentage of revenue, dropped substantially in 4Q '08 and 1Q '09 as the Xbox kicked in.

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

Could you reread the first part of the question?

Deborah Crawford - *Netflix - VP IR*

Sure. Based on your comments on 1Q, it seems like you'd be doing a lot of co-marketing with the CE partner. Is this right? Because your marketing, as a percentage of revenue, dropped substantially in 4Q '08 and 1Q '09 as the Xbox kicked in.

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

So, we do co-marketing with all of our CE partners. We'll probably add several this quarter, if it's like every other quarter. We flagged one as a material installed base. And that that was the underlying reason our guidance was higher than it would have been by historical standards.

Barry McCarthy - *Netflix - CFO*

I would say, Doug, in my comments about Q1, I am not trying to signal to you a shift in our cost structure or the economics around subscriber acquisition. I'm trying to signal that there's going to be much more growth than the Street is expecting. And that there will be marketing costs associated with the growth. But I'm not trying to signal to you that we're breaking the model or that we are spending an exorbitant amount on a per-subscriber basis that's going to be a big tax on the business.

Deborah Crawford - *Netflix - VP IR*

The next question is from Jim Friedland at Cowen and Company. What percentage of users are on Blu-Ray subscriptions?

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

Blu-Ray stayed pretty steady for us, just under 10%. And no particular change. That will probably go up with the holiday season and these fantastic deals on Blu-Ray players.

Deborah Crawford - *Netflix - VP IR*

A follow-up question from Christa Quarles at TWP. What subscriber growth estimate were you referencing for 2010 that is too low? She just wants to make sure she's on the right page.

Barry McCarthy - *Netflix - CFO*

You mean specifically a number? Specifically, Street expectations.

Deborah Crawford - *Netflix - VP IR*

The next question is from Brian Fitzgerald at UBS. Does the Watch Instantly viewing match your DVD business, i.e. 80% older titles and 20% are newer releases?

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

No, in the narrow sense, we have virtually no new releases on streaming. So it doesn't match. In a broad sense, you always have some titles that contribute a lot. And other titles sort of long tail that contribute less, in which case, you get a similar scale effect.

Deborah Crawford - *Netflix - VP IR*

Another question from Brian Fitzgerald at UBS. In terms of ala carte services and digital formatting standards, namely Disney's Keychest and the DECE or digital entertainment content ecosystem, do you see one DRM initiative as gaining more attraction?

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

No, because we're a subscription, we're not active participants in those very important efforts to establish a standard for digital ownership and what the standard will be.

Deborah Crawford - *Netflix - VP IR*

The next question is from Mark Mahaney at Citigroup. Why not expand internationally with physical DVDs as well?

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

You could. It's a perfectly reasonable argument. There's some good markets but the postal systems in many nations make that tricky. And streaming is a huge opportunity. So, we're focused on that, which of course, there are not as many constraints and so it's a larger available market.

Deborah Crawford - *Netflix - VP IR*

The next question is a follow-up question from Barton Crockett at Lazard. If Netflix has delayed access to new DVD releases, as Warner is suggesting, how much would subscriber growth slow? Clearly, new DVDs are a minority of usage but important to users and later access could make the service less appealing.

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

It could depend on a range of things. We're focused on making the service better. And depending on the way a deal is structured, if it's only a few weeks' delay, it may work out that it's actually an overall better experience. Because it could be that at the several week mark that then we have a very large supply of content on discs. So, there's a lot of ways to cut that. We're not going to do anything that would materially harm the customer experience.

We're focused -- we've got those huge customer sat ratings. We're continuing to focus on great customer satisfaction. But it is true that there may be ways to put together a deal that helps studios sell more DVDs, helps us be more efficient on our rental expense. And then, allows us to put that expense into streaming. And if we did something, it would only be because we are confident it would not negatively affect our growth.

Deborah Crawford - *Netflix - VP IR*

And I think we have time for one more question. It's Scott Devitt at Morgan Stanley. Can you update us on San Francisco household penetration and rest of country household penetrations?

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

Yes, that was in my script. So, just refer back to that.

Deborah Crawford - *Netflix - VP IR*

That's it. I think we're out of time.

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

Well, thank you all for joining us on the call. We continue to be very excited about the progress we're making. Our DVD proposition is very strong and growing. Our streaming is adding to that. And we feel blessed to be growing at these enormous rates. And with that, I'll look forward to talking with you all in the quarter.

Operator

Once again, that does conclude today's conference. We thank you all for joining us.
