

# FINAL TRANSCRIPT

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## NFLX - Q1 2009 Netflix Earnings Conference Call

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## CORPORATE PARTICIPANTS

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*Netflix - IR*

**Reed Hastings**

*Netflix - Co-founder, CEO*

**Barry McCarthy**

*Netflix - CFO*

## CONFERENCE CALL PARTICIPANTS

**Christa Quarles**

*Thomas Weisel Partners - Analyst*

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*FBR Capital Markets - Analyst*

**Mark Mahaney**

*CitiGroup - Analyst*

**Youssef Squali**

*Jefferies & Co. - Analyst*

**Barton Crockett**

*Lazard - Analyst*

## PRESENTATION

**Operator**

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

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**Deborah Crawford - Netflix - IR**

Thank you, and good afternoon. Welcome to Netflix's first 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 filings with the Securities and Exchange Commission, including our annual report on Form 10K filed with the commission on February 25, 2009.

We released earnings for the first quarter at approximately 1:05 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](http://www.netflix.com). A re-broadcast of this call will be available at the Netflix website after 6 p.m. 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](mailto:dcrawford@netflix.com). And now, I'd like to turn the call over to Reed.

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

Thanks, Deborah. And welcome, everyone, to the call. As I say on each of these calls, our goal is to grow subscribers and earnings every year while expanding into streaming video. We continued to execute well against that goal in Q1, and Netflix is on track for a record year in 2009 on all dimensions. In Q1, we grew subscribers from 9.4 million to 10.3 million. The 920,000 net additions were the largest in our history, and were 20% higher than Q1 a year ago. Net income grew to \$22 million, up 68% from the prior year. EPS grew to \$0.37, up 76% from a year ago.

While it's clear that instantly streaming movies and TV episodes to subscribers' laptops and TVs is energizing our growth, what is also happening is that our subscribers in total are renting more DVD and Blu-Ray movies than ever. In fact, not only did our DVD shipments grow on a year-over-year basis, but our year-over-year disc shipments grew more in Q1 than the prior year Q1. We believe Netflix DVD and Blu-Ray rental will continue to grow for many years, as video stores close and as consumers get increasingly comfortable with eCommerce and the Netflix unlimited rental offering.

Given that physical shipments will grow for many years, we are continuing to invest in our disc operations. For example, we recently moved our central operations distribution center, where we receive discs from the studios' replicators, from Sunnyvale, California to a lower-cost and larger space outside Columbus, Ohio. Another investment example, is that we've been working for the past few years on perfecting automated optical inspection for returned discs to more accurately determine which discs should be discarded, repaired or sent back out to another subscriber. And now we're finally beginning the nationwide roll-out of that system. This automated inspection of returned discs will improve our subscriber experience and reduce the number of discs we scrap.

A final investment example is that we have been testing Saturday shipping. In other words, moving from five-day shipping to six-day shipping, and over 2009 we'll be expanding that program to all 58 of our shipping centers. For consumers, it means that putting a movie in the mail on Friday will generally result in a new movie arriving Monday instead of Tuesday. But more broadly, Saturday turnaround will be another wow factor for our subscribers. By continuing to invest in improving the Netflix DVD and Blu-Ray experience for our members, we think we can capture a larger share of subscribers' overall spend on entertainment.

With the strong growth in Blu-Ray, we felt Q1 was the right time to put in place more realistic Blu-Ray pricing. We landed on a 20% to 25% premium for high-definition Blu-Ray, which is in line with the high-definition premium consumers pay in other channels, but is less, unfortunately, than the price premium we currently pay to some studios for Blu-Ray relative to DVD. If we can get our Blu-Ray cost premium more in line with what consumers are willing to bear relative to DVD, then we can be much more aggressive in promoting Blu-Ray adoption to our 10 million-plus subscriber base. This is the critical time period for Blu-Ray, and we hope to be able to make more progress this year and play an even larger role in the success of Blu-Ray.

The key take-away here is that there is still a lot of growth in rental by mail. The studios clearly have a vested interest in extending the life of DVD and Blu-Ray, and that's good for Netflix as well. Our subscribers are drawn by our library of more than 100,000 titles in the user-friendly interface that helps our customers find TV shows and movies they will love. Bundling that offering with the growing selection of streaming content for one low subscription fee, gives our subscribers a seamless way to expand their habits to include Internet delivery. And that gives us a significant competitive advantage as streaming gains traction.

In terms of competition, the rise of kiosk, \$1 new release rentals has been notable. In exit surveys of cancelling Netflix subscribers, kiosk is more and more frequently named as where they will go now for movies. And by the end of the year, kiosks will likely be our number one competitor as video stores fall inversely. There are already more kiosks in America than video stores. If kiosk companies are able to further refine their systems to be able to profitably support lower-traffic locations, then over the next three years we may see a kiosk in every 7-Eleven, every Starbucks and every airline gate.

The long-term effects of ubiquitous \$1 new-release DVD rental are not positive for us or the industry as a whole. In particular, the economic engine in the film industry is new-release, DVD and Blu-Ray sales. We don't focus on new releases, and they are less than a third of our rentals. So we are not very cannibalistic of new-release sales, especially in comparison to kiosk rentals.

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Despite kiosk growth, however, we had a record quarter, and we expect to have a record year because our differentiators continue to be our vast selection, over 100,000 titles, the convenience of mail and streaming, that you don't have to drive anywhere to receive or return a Netflix disc and our unlimited rentals for one flat fee.

Turning to streaming, the overall consumer embrace of online video is growing rapidly. Between Netflix, MLB.com, Hulu, YouTube, Amazon, Apple and others, consumers are watching more and more online video, and the quality of that video is improving. It's not hard to believe that online video will grow substantially every year for a very long time in the same way that cell phone minutes and browser usage have grown steadily over long periods of time. Laptops are getting cheaper and faster and smaller. Streaming to TV screens is also growing as we and others are getting simple software clients built into a wide range of consumer electronic devices. It's important for Netflix at this early stage to be spending aggressively on streaming content in order to ensure we are well-positioned as the industry evolves. But that means we are essentially buying many titles twice now. We buy a title once on DVD and Blu-Ray. And then we buy it again later, for streaming, even though at that point we usually have many excess physical units of that title in our distribution centers. It's great for content owners and okay for Netflix since we save so much on postage and handling.

In Q1, we continued to make good progress on expanding our streaming content, recently adding, for example, the first nine seasons of the animated hit "South Park". We licensed both TV shows and movies from the networks and studios. Many of the movies are not able to be licensed directly from the studios because the studios have licensed the big movies exclusively to networks such as Starz. Our belief is that since these networks have never missed an opportunity to expand distribution, starting with cable, then adding satellite, and then Telco, all of which compete with each other, that the networks will look to grow their distribution via Internet retailers such as Netflix in the years to come. This will help grow those networks' revenues by reaching new audiences of Internet-centric customers, and will contribute to the overall health of the channel distribution business, the benefit of which comes to the content creators in higher content fees. We are looking to a day when we have plentiful movie and TV show content for streaming. By us carrying entire channels, like we do today with Starz Play, the online version of Starz, and by us licensing the content from the channels, like we do now with NBC, CBS, the Disney Channel, Nickelodeon, Comedy Central and others, we will simply be a fourth option for consumers and a fourth and growing revenue source for networks and studios.

Strong content also has the benefit of making our service more attractive to consumer electronics companies, and we are buried with requests to embed our software in a wide range of devices. It will take us some time to get it all delivered, but it's possible that within a few years, nearly all Internet-connected CE devices sold will include a Netflix streaming client. When we think about the right amount to spend on streaming content each year, we consider the benefits of -- upon the CE deals because it helps us get those CE deals, as well as the retention benefits for more viewing, the acquisition benefits of more subscribers and the cost benefits of DVD shipment substitution. Given our momentum to date, we are continuing to push up our streaming spending, consistent with our earnings goals, which Barry will elaborate on.

It's easy to focus on the Internet as an efficient technology for content delivery. But the broader aspect of the Internet is as a social medium with a sense of community. The future of Internet television is not 1,000 linear channels where the transmission layer is IP instead of something else. The future of Internet TV -- it's closer to Facebook and YouTube and Netflix than the standard grid video product that one gets today from cable, satellite, Telco. Internet TV is about catering to the Internet generation, as much as it is about delivering video over IP. The social side of the Internet is evolving rapidly, and we are evolving with it. As Internet TV becomes more personal, social and portable to all of one screens, the old video grid will have less and less relevance to Internet-centric consumers. And the long-term outlook for Internet TV is very promising.

We are especially fortunate as Internet TV develops to have a thriving by-mail offering that gives us the financial strength to deliver strong earnings growth while also investing in the future. Internet TV on a global basis is an enormous opportunity. And we're excited about being one of the early leaders in this space. Thank you for listening. And now I'll turn it over to our CFO, Barry McCarthy .

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**Barry McCarthy** - *Netflix - CFO*

Thanks for joining today's call, especially folks on the East Coast where it's getting late. One year ago, on the 2008 Q1 earnings call, growth was a key theme. And now, one year later, the same theme describes our Q1 performance and our upwardly revised full-year guidance. Q1-ending subscribers grew by 25% year-over-year, 400 basis points stronger than last year's Q1 growth rate. The growth rate in revenue, net income and EPS also accelerated by nearly twice their growth rates of one year ago and free cash flow grew by 212% in Q1, more than one-and-a-half times last year's year-on-year growth rate. I'll have more to say about growth rates in a moment when I talk about guidance.

Overall, the Q1 numbers tell a clean and unambiguous story of strong momentum, driven by consumer attraction to our unlimited rental proposition and a strong underlying financial model, so my comments will be relatively brief. I'll highlight a few key metrics, then I'll discuss our upwardly-revised guidance and lastly I'll update you on our stock re-purchase activity.

In addition to the record high sub-growth Reed already spoke about, we also saw record high revenues, record low SAC, record high first quarter net income and EPS and record high first quarter free cash flow. Gross margin of 34.2% improved 250 basis points on a year-on-year basis, despite the growth in content spending for streaming and the postal rate increase in May of last year. The two primary drivers of margin expansion were, one, the popularity of lower-priced plans, which have higher gross margins. And, two, the continued realization of scale economies associated with driving the long tail of DVD catalog content which I spoke about on last quarter's earnings call.

Overall disc usage in the quarter was on par with our expectations and historical patterns of usage, with no discernible increase related to cocooning in the current economic climate. This seasonal usage pattern explains the sequential decline in gross margin of 100 basis points, which we directionally guided to on last quarter's call. SAC declined again this past quarter to an all-time low of \$25.79. The weak advertising climate, plus strong growth across paid acquisition channels, combined with organic growth, drove record low acquisition costs. We expect to see continued low SAC for the remainder of the calendar year. On last quarter's call, I said SAC would remain below \$30 for the balance of the year. Our updated view is that SAC will likely remain below \$28 through year end.

Free cash flow of \$15 million established a new high watermark for Q1. Two years ago we generated negative free cash flow of \$18 million in the first quarter. Last year the number turned positive, with \$5 million of free cash flow. And this year we tripled that number on the heels of a record Q4. On a sequential basis, free cash flow declined as expected. This decrease was primarily attributable to an increase in content spending and a decline in deferred revenue related to the seasonal decline in gift subscription sales. Despite our stock repurchase activity, which I'll discuss in a moment, our balance sheet remains strong, with \$286 million in cash and short-term investments and no debt.

That summarizes my comments on Q1 performance, and now I'd like to talk about the implications of that performance for Q2 and full-year guidance. Those of you who are familiar with our business model are accustomed to seeing a well-established seasonal pattern of slower net sub-growth, higher churn and higher operating margins in Q2, followed by accelerating subscriber growth, lower churn and lower operating margins in Q3 and Q4. We expect that seasonal pattern to repeat itself again this year. And like last year, our guidance assumes that gross margin will decline in response to another postal rate increase in May.

Last quarter, I described our full-year subscriber guidance as somewhat conservative due to the economic climate and because of the increased complexity around Internet streaming. Today's earnings release upwardly revises our full-year guidance for subscribers, revenue, net income and EPS. And this reflects our increasingly positive outlook for the second half subscriber growth.

For the remainder of 2009, subscriber and revenue year-over-year growth rates should plateau near current levels. And year-over-year growth rates for net income and EPS, which have increased significantly in each of the last three quarters, are likely to slow as we ramp our investment spending on licensed content for Internet delivery.

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Now, if the business continues to outperform our upwardly revised guidance, you should expect us to continue to manage the business with one eye on incremental profit, and one eye on faster growth. This would roughly translate on average, to operating margins of about 10% for the full year, with some variability around this average on a quarterly basis. Ten percent represents a continuation of a steady four-year trend of expanding operating margins.

Finally, I would like to update you on our stock re-purchase program. During Q1, we re-purchased 1.2 million shares at a cost of \$43 million, with an average cost of \$36.29. We anticipate re-purchasing up to an additional \$132 million during 2009.

In closing, Q1, like Q4, produced strong financial results. In this economic downturn, where flat is the new up, we continue to see solid momentum in the business quarter to date, and remain confident in our ability to deliver the financial results summarized in today's guidance, which roughly equates to 20-plus percent year-on-year growth across our forecast metrics. That concludes my comments on the quarter, and now it's time to answer your questions. In order to answer as many questions as possible, we ask you to e-mail them to [dcrawford@netflix.com](mailto:dcrawford@netflix.com). Deborah will read the questions out loud. Reed and I will do our best to answer them. So Deborah, over to you for the first question please.

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## QUESTIONS AND ANSWERS

**Deborah Crawford** - *Netflix - IR*

Great. The first question comes from Christa Quarles at Thomas Weisel Partners. First, will the Blu-Ray price increases be able to stem the ARPU declines over the next several quarters? How should we think about ARPU trending over time?

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**Barry McCarthy** - *Netflix - CFO*

Let's see. We'll continue to see ARPU, I suspect that we'll continue to see ARPU decline as long as the 1- and the 2-out plans remain popular. I would remind you that those plans carry higher gross margins, than, say, the higher-price plans like the 3-out and the 4-out, which is helping gross margin expand and increase profitability. The rate of decline will slow somewhat because of the Blu-Ray price increase.

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**Deborah Crawford** - *Netflix - IR*

And the next question is a (static) -- I'll just go in order. Can you update us on your hardware partner relationships? Is there much in the pipeline at this point? That's the first part.

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

Yes, there's tremendous amount of partnerships in the pipeline. We're working with everyone you would be expecting us to work with, and we're very happy with the way that's coming together.

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**Deborah Crawford** - *Netflix - IR*

And then the second part of her second question, concerns over the Xbox renewal in the second half of 2009.

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

Don't have any comment on that.

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**Deborah Crawford** - *Netflix - IR*

The next set of questions is from Eric Wold at Merriman Curran & Ford. With 600,000 subscribers added from year-end to February 12, and 300,000 added from there through quarter-end, it seems as though subscriber growth trends may have slowed in the back half of the first quarter. Any thoughts if that was the case and why that may be?

**Barry McCarthy** - *Netflix - CFO*

This is Barry. On last quarter's call I spoke about the historical seasonal pattern of subscriber growth, and by way of reminder we tend to see from slowest to fastest by quarter - Slow growth in Q2, faster grow in Q3, faster growth in Q4, fastest growth in Q1 of the following year. The important insight is that Q4 growth tends to be back-end loaded following the holidays, and the Q1 growth tends to be front-end loaded, which is a carry-over of the prior year's holiday. And so the pattern of growth that we saw in Q1 of this year was very similar to what we expected, slightly more momentum than we forecast when we gave guidance on last quarter's call, which is why we ended in the high-end of the range of our guidance.

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

And the pattern throughout the quarter followed the prior year's Q1s for the last five or 10 years. So there's nothing unusual in the pattern of the low-end of subscribers during Q1.

**Deborah Crawford** - *Netflix - IR*

The next question is from Barton Crockett at Lazard. The amortization of content library fell to \$49 million this year, from \$58 million last year, even though revenue and subscribers are higher. Why is that?

**Barry McCarthy** - *Netflix - CFO*

I commented on that in my script. By pointing out to you that we have -- and in last quarter's script - when I talked about the investment we've made in improving merchandising on the site and monetizing the long-tailed content. And that's contributing to margin expansion and helping us manage the content acquisition expense.

**Deborah Crawford** - *Netflix - IR*

And also from Barton Crockett regarding subscriber guidance. The first quarter subscriber count came in at the high end of your guidance, but the full-year guidance was raised by 500,000 to 600,000. Can you talk about what changed from the last time you guided to now to motivate you to raise full-year subscriber guidance?

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

I think we've just gotten incrementally confident in the roll-out of subscribers throughout the year. We've continued to feel good about our position relative to the impact of the economy, relative to the new initiatives that we have moving. So it's a cumulative set of things as opposed to any one specific thing that gives us confidence in our new and raised guidance.

**Deborah Crawford** - *Netflix - IR*

From Youssef Squali at Jeffries & Company. Would we see a fee-based service for online-only streaming by year end?

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

Streaming-only is something that we look at from time to time. It's not on the short list of things. When we talk to subscribers, they're very focused on the hybrid aspect of what we do, offering both DVD and streaming. And that's because streaming only has the older content. It doesn't have the new releases. So the beauty of our subscription is to be able to rent the new releases on DVD and Blu-Ray, and then use that selection of catalog on streaming. So for now, with our streaming content where it is, the combination of DVD rental and streaming is really what consumers are interested in.

**Barry McCarthy** - *Netflix - CFO*

So by way of extension, it's our view that if we launch the streaming-only product it would be an interesting sweetener but a relatively small percentage of the total subscriber base. I get the sense people ask the question, they imagine that the introduction of a streaming-only product would cause a large shift in subscriber mix, away from hybrid to streaming only. And we have a very different perception of opportunity for incremental growth that streaming-only provides.

**Deborah Crawford** - *Netflix - IR*

The next are two questions from Doug Anmuth at Barclays. First, what gives you confidence that digital content acquisition model won't shift toward variable with usage? And are you seeing higher renewal costs on any digital content that you've recently renewed?

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

Let's see. On the first, there's a mix of content that's available in the market, and it's really set by -- the types of licensing that's done is set by the competitive frame. If it's content that mostly is sold to TV channels, then it's mostly sold on a flat rate basis. If it's content that's brand new release, it might be sold on a more pay-per-view basis. So it's not driven by us or by the Internet. It's driven by what the market is by the other buyers. Second question was in terms of renewing deals, have prices gone up. And the answer is in some cases they have. We've got a bigger subscriber base and we're able to pay more. We look at that as a win-win. The point of our business is to be able to grow very large on streaming and to pay the studios a large percentage of that, which gets us more and more content, so that's natural. It would be unnatural if it didn't happen, and the only thing that we have to watch out for is that it doesn't grow at some faster rate than our business or somehow negatively impacts our gross margins which, you can see, is not happening.

**Deborah Crawford** - *Netflix - IR*

Second question from Doug. What can you share with us about newer subscribers who are heavier digital users in terms of churn, ARPU, disc activity, profitability?

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

For competitive reasons, we're not going to break out the different characteristics of different sub-segments of the subscriber base.

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**Deborah Crawford** - *Netflix - IR*

Mike Olson had a gross margin question. Gross margin has been down an average of 3% sequentially in the last three March quarters. Why was it down only 1% this quarter? What do you expect for gross margin trends to be through the remainder of the year, keeping in mind normal seasonality would suggest up from this level? Again, Mike Olson from Piper Jaffray.

**Barry McCarthy** - *Netflix - CFO*

Well, we don't guide to gross margin. I did talk about my expectations for gross margin through the remainder of the year, resulting from the postal -- expected postal rate increase in May. To the extent that gross margin fell less than you expected, you should look to our content spending, which ties back to our ability to monetize the long tail -- sorry, as the principal driver and in spite of the increased investment we're making in licensing of ED content.

**Deborah Crawford** - *Netflix - IR*

The next question is from Ken Smith at Munder. And it's his usual question about the penetration rate in the Bay Area and the rest of the country.

**Barry McCarthy** - *Netflix - CFO*

The Bay Area penetration rate at the end of Q1 rose to 20.3% from 19.4% in Q4, and the rest of the country at the end of Q1 was 8.9%, up from 8.1% in Q4.

**Deborah Crawford** - *Netflix - IR*

The next question is from Mark Mahaney at CitiGroup. Can you provide some color on the contribution that streaming-related devices had on subscriber additions in the quarter?

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

Mark, it's hard to be precise on it, but we think it's definitely very positive, having these Blu-Ray devices that you turn on and you got Netflix right on the home screen. In Q4, there's a big benefit from Xbox, upgrading in the installed base, and that continued to help us through into Q1. So the more devices, especially devices that have the Netflix logo on the home screen, where you're a click away from streaming, the better. So it's definitely a very positive part of the ecosystem for us.

**Deborah Crawford** - *Netflix - IR*

The next question is from Michael Pachter at Wedbush Morgan Securities. How should we think about the incremental cost of Saturday fulfillment? Probably fixed rent and postage/envelopes, but higher personnel. By what percentage?

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

Personnel is not too bad because you're basically -- it's really, Michael, related to the expansion of the number of shipments. That's the biggest impact. And number of shipments narrowly hurts the P&L. What we've seen is, every time we've opened a new distribution center, we've expanded overnight delivery and increased shipments, and then we get paid back with more retention and lower SAC in that area. So think of this as like one more distribution center that's opened up. And the more and more our distribution centers are around automation, the more and more the extra hours are fairly minimal because there's

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not too many people, but we're getting more usage out of the existing automation equipment. So overall, it's a fairly minor effect, but I think it will be definitely be a positive one.

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**Deborah Crawford** - *Netflix - IR*

The next question is from Kwang Kim at Eaton Vance He says having been a user of Netflix Watch Instantly, I'm thoroughly impressed with the service. What are the dynamics involved in adding titles to watch instantly? First question.

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

It's mostly money. We just have to spend more money to get more content. So there are a couple of special cases, but mostly, as we grow, as we get more usage, we're able to pay the studios more money. And we are continuing to grow the content as we have been over the last two years.

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**Deborah Crawford** - *Netflix - IR*

The second question is do you have any idea what the profitability is with kiosks?

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

No, I don't.

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**Deborah Crawford** - *Netflix - IR*

The next question is a follow-up from Mark Mahaney at CitiGroup. Why will SAC remain below \$28 through the balance of the year? What are the new marketing efficiencies?

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**Barry McCarthy** - *Netflix - CFO*

Well, there are no new marketing efficiencies as compared with Q4 and Q1. So it's a continuation of the relatively weak economic environment and the relatively low cost of advertising. And, secondly, and importantly, it's the benefits associated with the organic growth that comes with consumer excitement related to the streaming product offering that's driving the current rate of SAC and informs our expectations for SAC for the remainder of the year.

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**Deborah Crawford** - *Netflix - IR*

The next question is from Handy -- sorry, from Andy Hargreaves of Pacific Crest. Why has fulfillment expense continued to climb as a percentage of revenue? Are there specific investments that are having a meaningful impact right now? Does leverage kick in at some point?

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**Barry McCarthy** - *Netflix - CFO*

Well, it was up only slightly in the current quarter, and that related to some duplicate expenses associated with moving a central ops facility from one part of the country to the other. And then, particularly on a sequential basis, there's a usage increase in Q1 that happens every Q1, and that boosts fulfillment expense some in the current quarter.

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**Deborah Crawford** - *Netflix - IR*

The next question is from Larry Witt at Morningstar. This is with regards to ARPU. Are new subscribers coming in at lower prices and are existing subscribers trading down?

**Barry McCarthy** - *Netflix - CFO*

Well, let me take the second part of the question first. I haven't looked at the trading up, trading down data in a quarter but last quarter when I looked at it, the trading down was almost completely inconsequential, so small that we could ignore it completely as a contributing factor to shifts in ARPU. So 1- and the 2-out plan are very popular amongst new subscribers. And so when reasoning from first principals-- when the mix of the existing subscribers by price points roughly equal the mix of new subscribers then you'll stop seeing a movement in ARPU, assuming the churn rates from new and existing subscribers are roughly equal, which they won't be. So you should expect it to continue to move from time to time. My own view is that the presence of a 1-out plan and the presence of the 2-out plan, let's say in comparison to the 3-out plan, increases the net profits of Netflix. Because in the absence of a 1-out plan, those subscribers wouldn't be Netflix members. In other words, we're not seeing substitution behavior between a 3-out customer and a 1-out customer. So as long as the 1-out and the 2-out customers are profitable, and on a percentage basis they're more profitable than 3-out customers, then the presence of those subscribers increases the enterprise value of Netflix.

**Deborah Crawford** - *Netflix - IR*

The next is a follow-up from Doug Anmuth at Barclays. Does full-year subscriber growth guidance overall take into account additional device deals beyond what you've already announced?

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

It takes into effect the deals that we are pretty certain will launch this year. So things that we have a high expectation of in the year are baked in. Any deals that are speculative or uncertain at this point would not be baked in.

**Deborah Crawford** - *Netflix - IR*

Okay. The next question is from Dan Ernst at Hudson Square Research. You guys always seem to have a good sense of competition on the physical front. Do you have a sense of what competition is looking like on the digital front, particularly from Amazon and Apple?

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

I would say the over-arching thing is that the competition on the digital front that exists today, which is the advertising-based free streaming from Hulu and YouTube and the pay-per-view from Amazon and Apple. All three of us are three drops of water in an ocean of viewing that's mostly TV viewing. All of us are competing with the five hours a day that's in a typical American household of watching television. And so we hardly notice each other. Mostly what we're doing is all trying to figure out what fraction of the giant ocean of TV viewing can we capture by creating better experiences. So I think we all recognize in the long term there will be some competition between us and between the different segments of pay-per-view, subscription and ad-supported. But for now, we're all so tiny relative to TV viewing that that's where our energies are focused.

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**Deborah Crawford** - *Netflix - IR*

The next question is from Brock Saunders at CitiGroup. Can you talk about what you're seeing in terms of credit card delinquencies? How do current credit card delinquencies compare to historical trends?

**Barry McCarthy** - *Netflix - CFO*

We are not seeing a big increase.

**Deborah Crawford** - *Netflix - IR*

The next question is from Nat Schindler at Merrill Lynch. How much of the drop in SAC do you attribute to the draw in streaming service versus the drop in advertising prices?

**Barry McCarthy** - *Netflix - CFO*

I would say -- I don't have anything to add to the comment that I've already made about SAC. So it would be very hard to know. I'm not going to hazard a guess.

**Deborah Crawford** - *Netflix - IR*

Okay. The next question is from Tony Wible at Janney Montgomery Scott. I'm just looking for the question. Sorry, there's multiple questions here. I want to make sure it's one we haven't asked before. Have you seen any lower disc consumption on subs using the streaming service?

**Barry McCarthy** - *Netflix - CFO*

Well I did, on last quarter's call, say that we had seen some early data, and there was reason to be optimistic. We won't have anything further to say about that on a quarter-to-quarter basis until or unless there's something definitive. And then we may have something to say about it, or we may not depending on competitive circumstances. I think you can tell from our guidance that we're continuing to feel in general at a high level without attributing it to individual aspects of the way in which the business is operating, pretty optimistic about the overall health of the business financially through year-end.

**Deborah Crawford** - *Netflix - IR*

From Rich Ingrassia at Roth. What is the Blu-Ray subscriber count now, and have you allowed for any attrition in the second quarter due to the price increase?

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

We're happy with the Blu-Ray subscriber base. It will continue to grow as new players come out that are lower and lower priced. The big driver of Blu-Ray adoption is player prices falling. And in terms of Q2, our expectations are based upon what we've seen, which is exactly as we would have thought and predicted.

**Barry McCarthy** - *Netflix - CFO*

So the answer to the second question is yes.

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**Deborah Crawford** - *Netflix - IR*

So Youssef Squali at Jeffries has a follow-up question related to the Xbox deal. Does the Xbox deal restrict you in some way to tie up with other game console manufacturers? If so, then how long does the exclusivity last?

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

Youssef, it is exclusive for us currently, and we're not commenting on the other terms, for example, how long is that exclusive in effect for at this point.

**Deborah Crawford** - *Netflix - IR*

Another follow-up question from Nat Schindler at Merrill Lynch. The midpoint of subscriber and revenue guidance assumes, and this is according to his calculation obviously, that 2Q ARPU of \$13.01, which is a sequential drop after a sequential increase in Q1. What changed in Q1 to raise ARPU over Q4, and what is assumed in the Q2 guidance to cause the drop?

**Barry McCarthy** - *Netflix - CFO*

I think this will be the last question we'll take on ARPU. The impact in Q4 to Q1 was the benefit of the Blu-Ray price change and --

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

The Blu-Ray price change from six months ago.

**Barry McCarthy** - *Netflix - CFO*

Right. Thank you. And the change in ARPU from Q1 to Q2 reflects a mix of new subscribers versus existing base, one. Two, Q2 has a different -- we get this question often. Q2 has a very different pattern of subscriber additions than does any other quarter, and so the number of revenue months always distorts the ARPU calculation. So be careful in running your models. It tends to be very back end loaded.

**Deborah Crawford** - *Netflix - IR*

Next question is from Christa Quarles at Thomas Weisel Partners. As streaming becomes a bigger component of the mix is the streaming infrastructure disadvantage relative to the larger players with more scale, and does HD usage change your answer to this question?

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

Can we have the question again.

**Deborah Crawford** - *Netflix - IR*

As streaming becomes a bigger component of the mix, is the streaming infrastructure disadvantage relative to the larger players with more scale. and does HD usage change your answer for that question?

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

Most of us who are streaming are contracted with Limelight, Akamai, Level 3 and others. And I presume the larger that you are, the better prices you can get, kind of normal commercial leverage. But I don't see that that's going to be a material difference because the cost of streaming is quite low relative to content. So it's really -- content acquisition is where the difference is, and the advantage of the scale may or may not come in.

**Barry McCarthy** - *Netflix - CFO*

Do you want to comment on our scale, or no? No.

**Deborah Crawford** - *Netflix - IR*

Okay. Operator, we would like to open the call for a few final questions, just in case anyone has an additional clarification or I missed your question. Thank you.

**Operator**

(Operator Instructions). And we'll go first to Christa Quarles with Thomas Weisel Partners.

**Christa Quarles** - *Thomas Weisel Partners - Analyst*

I wanted a little bit more clarification as to why the lower usage plans are more profitable. Are you taking -- I assume you're not taking SAC into account when you recognize that profitability. Is there just lower usage throughout the month? Thanks.

**Barry McCarthy** - *Netflix - CFO*

Yes, basically that's it. I'm talking specifically about the gross margin, Christa.

**Christa Quarles** - *Thomas Weisel Partners - Analyst*

Yes.

**Barry McCarthy** - *Netflix - CFO*

On those plans, as compared with, say, a 3- and a 4-out plan. So it just happens that the relationship between the revenue per disc shipped as compared with the cost per disc shipped is higher on the lower-price plans than it is on the 3-out plans.

**Christa Quarles** - *Thomas Weisel Partners - Analyst*

And are those the folks who are generally moving over to kiosk or is it -- is there any distinction?

**Barry McCarthy** - *Netflix - CFO*

No, no distinction that I'm aware of.

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**Christa Quarles** - *Thomas Weisel Partners - Analyst*

Got it. Thanks.

**Barry McCarthy** - *Netflix - CFO*

And I should add that the gross margin -- the relationship between the gross margin and the lower-price plans and say the 3- and the 4-out plan has not shifted over time. It's always been more profitable.

**Operator**

And we'll go next to Heath Terry with FBR Capital Markets.

**Heath Terry** - *FBR Capital Markets - Analyst*

Great. Thank you. I was wondering, given the shifting of the international landscape that we've seen in the last few months, does that change at all your level of interest or your perspective on potentially entering those markets at some point? And if so, do you feel like looking at that, that your technology and scale that you've built here in the US gives you enough of an advantage over those incumbent players?

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

Heath, it's Reed. I'm not exactly sure which international changes. Since the market has been in such turmoil, I guess you could choose any. But it's a background influence, and we remain in the camp of some day we would like to be a global Company like other Internet companies. But for now we're focused on expanding our share in the US.

**Heath Terry** - *FBR Capital Markets - Analyst*

Okay. Thanks.

**Operator**

And we'll go next to Mark Mahaney with Citi.

**Mark Mahaney** - *CitiGroup - Analyst*

Reed, you talked a lot about the development of the kiosk market. Do you have any data, have you seen any evidence on how much overlap there would be with the (audio difficulty).

**Deborah Crawford** - *Netflix - IR*

Mark, we can't hear you. Sorry, I don't know if you're on a speaker phone or if you can repeat your question, but you trailed off.

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**Mark Mahaney** - CitiGroup - Analyst

Sorry about that. Can you hear me now?

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

No, I'm afraid, Mark, if you e-mail that in, but I'm guessing that it was something about kiosks and penetration.

**Deborah Crawford** - Netflix - IR

E-mail it to me and I'll ask it. Next question.

**Operator**

We'll go next to Youssef Squali with Jeffries & Company.

**Youssef Squali** - Jeffries & Co. - Analyst

Yes. thanks. By the way, I think everybody hears the same kind of noise you guys are hearing. Barry, I hate to beat a dead horse here, but just going back to ARPU one last time maybe just to clarify. When you instituted the \$1 increase in ARPU for Blu-Ray, that had had a positive impact on ARPU. Now, and I guess in a few weeks, you're going to be instituting a 20% to 25% increase, which comes out to potentially more than \$1. How would that not impact -- positively impact the ARPU for Q2 and Q3. and frankly beyond, until the lower-price plans kind of catch up with it. And then Reed, you said something that I thought was really interesting about how even the 20% to 25% premium you were going to be charging for high-def Blu-Rays would not be enough to kind of cover what Netflix pays the studios if I understood that correctly. Maybe you can help us understand kind of the magnitude of that delta. That would be very helpful. Thanks.

**Barry McCarthy** - Netflix - CFO

Well, the first -- the answer to the first part of the question is that the Blu-Ray price change does help ARPU, meaning without it, ARPU would be lower than we expect it to be. It may be that your expectations and our forecasts are slightly out of alignment on the degree of impact associated with growth in Blu-Ray subscribers and price points.

**Youssef Squali** - Jeffries & Co. - Analyst

Wouldn't you expect a sequential increase -- \$1 increase, I'm not talking about percentages -- the sequential increase in ARPU?

**Barry McCarthy** - Netflix - CFO

Well, we don't guide to ARPU, so I'm not going to say any more about it than that.

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

Youssef, on what I said on Blu-Ray content is that from some studios, the Blu-Ray surcharge is much higher than works for us under the 20% to 25% consumer premium. There's still some diversity of opinion in studios. And so it gives us a sort of split cost in various ways. We're hoping to be able to resolve those issues so that it's not substantially less profitable for us than standard-def,

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and then we have an incentive to promote it. So we're -- the whole industry I think is in the middle of working out what will be the pricing.

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**Deborah Crawford** - *Netflix - IR*

The next question, Mark Mahaney just e-mailed me from CitiGroup. Do you think there is any natural overlap between the Netflix and kiosk customer base? In other words, are you seeing signs that Netflix customers see kiosk as a pure complement versus perhaps a competing offering?

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

There certainly are a number of subscribers who say that, current Netflix subscribers who say they supplement, especially for the new -release and last-minute from kiosks. And that's a very positive relationship. There's other subscribers who say gee, all I want are the new releases, and so I'm going to cancel Netflix and that's not a positive. So it's a mix of those two. I would say that the silver lining, Mark, is it hits video stores, we think, much harder than it hits us. And to the degree that kiosks grow as rapidly as the kiosk companies say, it's going to result in more quick and larger closures of video stores than we would have otherwise seen. So in the end we may get a net benefit but it's a little hard to tell.

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**Barry McCarthy** - *Netflix - CFO*

Mark, you should also remember that the -- for the subscribers who are now supplementing their rental activity with kiosk, which Reed made reference to, those same customers used to exhibit the same behavior but with video stores. So it's not that supplementing is a new behavior, it's just where they go to supplement has shifted from stores to kiosks.

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**Deborah Crawford** - *Netflix - IR*

Operator, we'll take one more question.

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**Operator**

And we'll go next to Barton Crockett with Lazard Capital.

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**Barton Crockett** - *Lazard - Analyst*

Okay. Great. Thanks for taking the question. I thought the kiosk comment was very interesting, and I was wondering, Reed or Barry, it seems that the growing popularity of \$1 new-release rentals can't be good for the new release sell-through business for studios. Do you expect the studios to try and do something to squelch the growth of the kiosk business, like more of what Universal is trying to do with Red Box? Or do you think ultimately that they won't be able to do anything or don't want to do anything.

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

Barton, we don't have special insight into that. We don't track kiosks all that closely, except as it affects our business. So I wanted to be clear with investors that it's having a rising impact as video stores are shrinking. But in terms of how the industry feels about it and sell-through, I would refer you probably over to the studios for that.

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**Barton Crockett** - *Lazard - Analyst*

Okay. All right. Thank you very much.

**Operator**

That concludes today's question-and-answer session. At this time I would like to turn the call back over to Mr. Reed Hastings for any closing remarks.

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

Well thank you everyone for joining us this afternoon. To recap, the business continued to perform strongly in Q1, and our outlook for the full year improved. The DVD-by-mail business continues to grow rapidly, and we expect that trend to continue for the foreseeable future. At the same time, it's clear that instant streaming is energizing our growth. I look forward to updating you on our continued progress in July. Thank you very much.

**Operator**

And that does conclude today's call. We do appreciate everyone's participation. You may disconnect at this time.

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