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NFLX - Q2 2009 Netflix Earnings Conference Call

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CORPORATE PARTICIPANTS

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Reed Hastings
Netflix - CEO

Barry McCarthy
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PRESENTATION

Operator

Good day, everyone. Welcome to the Netflix second quarter 2009 earnings conference call. (Operator Instructions) At this time, for opening remarks and introductions, I'd like to turn the call over to Deborah Crawford, Vice President of Investor Relations. Please go ahead.

Deborah Crawford - *Netflix - VP IR*

Thank you and good afternoon. Welcome to Netflix second 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 earnings call. We will make forward-looking statements during the call regarding the Company's future performance. Actual results may differ materially from these statements due to risks and uncertainties related to the business. A detailed discussion of such risks and uncertainties is contained in our filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K filed with the Commission on February 25th, 2009.

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. A rebroadcast of this call will be available at the Netflix website after 6:00 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 at dcrawford@netflix.com. And now I would like to turn the call over to Reed.

Reed Hastings - *Netflix - CEO*

Thank you, Deborah and welcome everyone to our call. As I say on each call, our goal is to grow revenue, subscribers and earnings every year while expanding into instant streaming. We continued to execute well in Q2 and Netflix is on track for a record year in 2009.

In Q2, we generated revenue of $408 million, up 21% from a year ago. Operating income was $53 million, up 54% from a year ago. Net income was $32 million, up 22% year-over-year and EPS was $0.54, up 29% year-over-year. Driving these results was a 26% year-over-year growth in subscribers, offset by a lower ARPU due to the growing popularity of our lower price plans that include unlimited content delivered both by streaming and DVD by mail.

We believe that the inclusion of streaming in our service has broadened the appeal of Netflix and is driving growth. In our most highly penetrated market of the San Francisco Bay Area, where 20.7% of households now subscribe to Netflix versus 9.1% nationally, the tech innovation factor around streaming is very high and high speed cable broadband is widely available and despite all of that or perhaps because of it, growth in our subscribing households in the Bay Area is increasing at about two percentage points per year. We believe the Bay Area is a leading indicator of Internet behavior elsewhere in America and are thus encouraged by these large and growing penetration rates.

As in prior quarters, our shipments of DVD and Blu-ray discs experienced solid growth year-over-year and we continue to expect disc shipments for Netflix to grow for many years as video stores close. Our Saturday shipping rollout across our 58 distribution centers is now more than half complete and we expect to have upgraded all of our distribution centers to Saturday shipping by the end of Q3.

Last quarter we made some adjustments to our Blu-ray pricing to reflect the higher prices that studios charge for high-definition content and we're pleased with the results. As Blu-ray player prices continue to fall, we are hopeful adoption will accelerate and we offer an unparalleled Blu-ray rental experience.

In terms of our DVD based competitors we continue to see rapid growth for Redbox and an offsetting decline in video store rentals. Essentially, both Netflix and Redbox are going at the expense of video stores.

One more remarkable milestone for Netflix last quarter was the progress made in the Netflix prize competition. As you may have read, it appears an amazing team of researchers from around the world has qualified to win the $1million prize for improving recommendations. We will announce the Netflix prize winner later in Q3, as the competition is still open until this Sunday, followed by a validation period of a few weeks, but needless to say, this competition has been thrilling. The knowledge this prize contest has developed is already contributing to the improvement of movie choosing at Netflix and there is more to come.

At the heart of Netflix is the proposition that of the 100,000 movies we offer, there are a unique few hundred that each person will love. The algorithmic skills that we are developing apply equally to the movies that you watch instantly or watch on DVD or watch on Blu-ray, and they allow us to provide more satisfaction from any given set of content than any competitor. The Netflix prize algorithm is only a small, but significant part of our total personalization efforts, but these efforts as a whole are a behind-the-scenes driver of our incredibly high customer satisfaction which we are always striving to improve.

In terms of streaming viewing, the strong growth trends continue in instant streaming to our subscribers and in online video overall. Due to the consumer attraction of our strong value, DVDs by mail quickly and movies and TV episodes streamed instantly for one low monthly fee. More and more CE companies are looking to integrate the Netflix streaming client into their devices.

In Q2, we announced and launched Netflix ready devices with a range of partners. They include Sony Bravia TVs, a wide variety of Samsung home theater systems and Blu-ray disc players and LG digital televisions, home theater systems and Blu-ray disc players. We are on pace to have more and more CE products include the Netflix client every quarter. The more devices that support the Netflix client, the more subscribers have easy access and the less dependent we are on any one device.

We're excited in particular by two big improvements to streaming coming in Q3. Microsoft is rolling out Version 3 of Silverlight, which significantly speeds up video playback so there is less frame dropping for smoother video on PCs and Macs and in mid-August, Microsoft Xbox is rolling out their new experience, which includes a new Netflix client where subscribers can choose movies right on the Xbox, rather than going to their laptop to add to their queue.

When we think about the right amount to spend on streaming content each year, we consider not only the retention benefits from more viewing, the acquisition benefits of more subscribers and the cost benefits of DVD shipment substitution, but also the positive effects on the CE ecosystem.

Given our momentum to date, we are continuing to push up our streaming content spending, consistent with our goals for next year of maintaining 10% operating margins and strong subscriber growth.

Thank you for listening and now I'll turn it over to our CFO, Barry McCarthy.

Barry McCarthy - *Netflix - CFO*

Good afternoon, folks, and thank you for joining today's call. Last quarter I said we were confident in our ability to deliver strong revenue and earnings growth and the results we announced this afternoon achieved that objective.

Year-over-year growth in revenue net income, EPS and free cash flow all accelerated again this quarter as compared with the year-over-year growth we achieved in last year's second quarter. SAC reached a record low $23.88 in Q2, a remarkable achievement for a consumer business in this difficult economic climate. We attribute strong growth and low SAC to the broadened appeal of our service because of our investment in streaming, low prices and the halo effects of market leadership. The financial implications for future Netflix profit are significant.

On the Q4 call, I said SAC would remain below $30 for the balance of 2009 and on the Q1 call, we lowered that estimate to $28, quite a bit higher than the $24 SAC we reported today. For the remainder of the year, we expect SAC to increase in Q3, before dropping again in Q4.

Turning from SAC to other categories of expense, gross margin was 34.1% in the quarter, a 230 basis point improvement versus last year's Q2, despite the year-over-year growth in content spending for streaming and the postal rate increase in May. The year-over-year improvement was primarily attributable to the popularity of our lower price plans, which have higher gross margins, and in addition, like Q1, our margins continue to benefit from our ability to create demand for catalog title.

On a sequential basis, DVD usage was seasonally lower than Q1, which was a net positive for gross margins and in line with our expectations and historical patterns of usage. We saw no discernible increase in usage related to people spending more time at home in the current economic climate.

As expected, churn grew slightly in the quarter as it did in last year's second quarter. This was primarily the result of a seasonal shift in channel mix for gross subscriber acquisitions. We saw a similar mix shift in last year's second quarter and we expect churn to decline to near Q1 levels in Q4.

Our effective tax rate for the second quarter was 38.8%. The reduction from our Q1 rate relates to several discrete Federal and State incentive tax credits recorded during the quarter. As expected, our Q2 tax rate increased significantly from last year's 26%. By way of reminder, last year's second quarter had the cumulative benefit of prior period R & D tax credits. For the remainder of the year, we expect our effective tax rate to be approximately 40.5%.

Free cash flow of $26.3 million established a new high watermark for Q2 results which more than doubled on a year-over-year basis. On a sequential basis, free cash flow increased 74%. This increase followed a well established pattern related to the seasonal slowdown in Q2 subscriber growth, the reduction in marketing expense and the resulting increase in net income.

Finally, during Q2, we repurchased 1.6 million Netflix shares at a cost of $73 million with an average cost of $44.56. That summarizes my comments on Q2 performance and now I'll comment on the implications of that performance for Q3 and full-year guidance.

Those of you familiar with our business model are accustomed to seeing well established seasonal pattern of slower net sub growth, higher churn, higher operating margins in Q2, followed by accelerating subscriber growth, lower churn and lower operating margins in Q3 and Q4. As I said on last quarter's earnings call, we expect that historical pattern to repeat itself again this year.

Today's earnings release revises upward our full-year guidance for subscribers, revenue, net income and EPS. We remain optimistic about the outlook for the second half of the year.

From a year-over-year subscriber perspective, Q3 will be an easier comp than Q4. Last year subscriber growth slowed to 23% year-over-year in Q3, probably because of the Summer Olympics, the weak economy and the shipping outage, but growth reaccelerated in Q4 to 26% year-over-year behind the lift from our launch on Xbox 360. We've maintained that momentum ever since and as you can see in today's guidance update, we expect to continue grow strongly through Q3 and Q4 with minor differences in year-over-year subscriber growth. At the end of the day, whether we grow subscribers at last year's 23% to 26% rate, or slightly faster or slightly slower, it's still impressive growth, particularly in this economy.

Looking back over the last several years, we have steadily increased operating margins from 7% to 8% to 9% to what we expect will be a little over 10% this year. We think 10% is about as rich as we should run for the next few years, as the streaming opportunity develops, so looking forward, we hope to land at about 10% operating margins on an annual basis. This will give us plenty of investment power to grow the subscriber base, revenues, earnings and EPS.

In closing, Q2 like Q1 produced strong results and solid progress towards accomplishing the financial and strategic goals we established for the year. The model is working well. Our streaming initiative is on track. We're strategically well positioned and confident about our future growth and profitability.

That concludes my remarks and now I'll turn the call back over to Deborah to lead us through the Q&A. Deborah?

QUESTIONS AND ANSWERS

Deborah Crawford - *Netflix - VP IR*

Great. The first question is from Christa Quarles at Thomas Weisel Partners. Can you talk about the quality of the new subscriber that comes in through your less expensive marketing channels?

Reed Hastings - *Netflix - CEO*

Christa, it's Reed here. The quality by that, you must mean the retention characteristics. In general, the lower programs can have two effects. One is the people have tighter budgets, the negative -- the positive effect is it's such an incredible value that the retention can be strong. What we try to do is get subscribers to the right program for them and offer them a number of options to maximize by quality the profits and satisfaction around that subscriber.

Deborah Crawford - *Netflix - VP IR*

The second question she had was with regards to Redbox. Redbox claims that 5% or so of their customers are coming from you. Are you seeing that?

Reed Hastings - *Netflix - CEO*

Definitely the subscribers who leave us who used to go to video stores now go to Redbox, not surprised by the 5%, and as Barry mentioned at a recent investor conference, we don't see in the two markets that Redbox outlines as very strong penetration for them, Houston and Salt Lake City, we don't see any material degradation in our growth. So it appears that Redbox and Netflix are both growing at the expense of video stores.

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Barry McCarthy - *Netflix - CFO*

And I would add one additional thought which is that for a long time, we've seen a fairly high percentage of Netflix subscribers who have continued to rent DVDs from video stores and so to the extent that Redbox is acquiring share from video stores, they may see some of those customers active as Redbox customers in lieu of store rental, while they remain Netflix subscribers.

Deborah Crawford - *Netflix - VP IR*

The next question is from David Miller at Caris & Co. and his question is with regards to Epix. Our understanding of the structure of Epix is that there will also be a streaming component to the Epix subscription that will compete head on with Netflix. Given that, what is it about the Netflix streaming service other than price that you feel will be superior to Epix? And also do you see negotiating a streaming rights deal for Epix some time before they launch?

Reed Hastings - *Netflix - CEO*

Well, on the first count, Epix plans are a little unclear to everyone in terms of for example, pricing, so we'll really have to see. As you'll remember, Starz also offered their own subscription service for a while, Vongo, and discovered they could make more money wholesaling that to a range of players including us. Certainly Epix, which has a lot of great content, it is something that we would like to carry, but at this point we don't have anything to announce.

Deborah Crawford - *Netflix - VP IR*

The next couple of questions are from Youssef Squali at Jeffries & Company. How do the terms of your agreement with Sony differ from what Redbox just signed? Does that give you an opportunity to improve your content cost?

Reed Hastings - *Netflix - CEO*

So, we don't know what the deal is between Sony and Redbox other than the 8-K that Redbox filed, but we're very happy with our Sony deal and Sony relationship that's continuing to work very well for us so don't see an impact either way from the Redbox Sony deal.

Deborah Crawford - *Netflix - VP IR*

His second question is with regards to Starz. When does that contract come up for renewal? How confident are you in your ability to renew it on similar terms?

Reed Hastings - *Netflix - CEO*

Well, when we extend or renew that contract in the future, hopefully we'll be a lot bigger and we'll be able to pay them more money. Part of our goal is life is making subscribers really happy, but part of it is also making content suppliers happy and we definitely look forward to being able to pay them more money and still grow our profits over time. So, we're not even going to try in the future to extend it on the "same terms." How much larger and how much more expensive it is depends somewhat on our subscriber base size. It's a multi-year agreement, but we haven't disclosed anymore than that.

Barry McCarthy - *Netflix - CFO*

And let me jump in and add something I think many participants on the call are aware of, but to reemphasize that the attractiveness or not of the terms in a licensing deal for streaming content is all about our ability to create demand for content with our subscriber base, and so if we're not very smart about the way we license content and then it mostly goes unutilized on the website and that hasn't been a very good economic transaction. On the other hand if there's broad based appeal and we are able to engage the subscriber base in the content, then it's been a very good investment for us, independently of the terms of any individual contract.

Deborah Crawford - *Netflix - VP IR*

The next question is from Eric Wold at Merriman Curhan Ford. In regards to the increased churn were there any specific trends you saw around that number? For example, greater churn at certain price points or areas of the country, was churn noticeably higher during the beginning or the end of the quarter?

Barry McCarthy - *Netflix - CFO*

No, no particular terms of note.

Deborah Crawford - *Netflix - VP IR*

Ralph Scharkart at William Blair. Is Netflix moving closer to streaming becoming a standalone business versus its current service status? What sort of metrics are you waiting for to turn streaming into a viable standalone business?

Reed Hastings - *Netflix - CEO*

The great thing about streaming is that it's instant and unlimited, but the less ideal part about streaming is that we don't have all of the content that we have on DVD, and when we talk to our subscribers about streaming only, they really want a lot of content, and given the mixed nature of the content availability on streaming, our subscribers are very happy with a hybrid solution that gives a really unique differentiator that the new releases are available on DVD, a lot of the catalog on streaming, so the hybrid is the really core of what we're focused on. We may at some point test streaming only, but we don't believe it will be particularly consequential.

Deborah Crawford - *Netflix - VP IR*

He had a second question with regards to international expansion. Netflix has stated its desire to move in this direction one day. Is there any metric hurdle time frame for when you might pursue international markets and does the streaming service accelerate this market opportunity?

Reed Hastings - *Netflix - CEO*

The real framework at which we look at it is when do we have enough money in the P&L to be able to do the substantial investments to begin that global expansion, so it's as streaming develops and frankly as our subscriber base develops, that we have enough horsepower to be able to do the substantial investments in other countries where we don't yet have a brand presence, so that's the gating factor so to speak.

Deborah Crawford - *Netflix - VP IR*

The next question is from Andy Hargreaves at Pacific Crest Securities. And it's with regards to content acquisitions. Can DVD acquisition costs continue to decline or are you near a baseline from which it must grow inline with subscriber addition?

Reed Hastings - *Netflix - CEO*

Our mission over the next couple of years is to take our COGS, which is about half postage and half DVDs and streaming, and move that more and more to studio revenue, as opposed to postal revenue, as we do more streaming. So we look at it and say, we want to make that shift happen to where the studios are getting about 2/3 of revenue and we're not having to ship DVDs and that's of course a long term vision.

So, are DVDs bottomed out? I'm not sure, but really most of the energy we're putting in is growing our streaming spending and then the studios get the advantage of if they get paid on DVD for a title and then they get paid again on the same title under streaming, so that's the real focus for us.

Deborah Crawford - *Netflix - VP IR*

The next question is from George Askew at Stifel Nicolaus. Please provide us with an update of the current number of online titles available for streaming at Netflix. Also, is there a churn number available of streaming titles, or is the universe is streaming titles available today the same as the universe available one quarter or one year ago?

Reed Hastings - *Netflix - CEO*

We don't focus much on title count. It hasn't changed hugely in the last couple months. What we're really focusing on is getting the right content on the right terms, the content that subscribers really want to watch, and does it change? Yes, for example, with the Starz content we get a constant flow of new content coming in through that, so there's a lot of freshness in the existing titles.

Deborah Crawford - *Netflix - VP IR*

The next question is from Nat Shimler at Merill Lynch . What was a bigger driver of the nearly 18% year-over-year drop in subscriber acquisition costs? A higher percentage of growth additions coming in the door for free or decreased media

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Reed Hastings - *Netflix - CEO*

I'd say that the biggest effect on SAC is scale, brand awareness. We've been working on this business for a long time, building a great reputation and there's more and more subscribers and more and more prospects still about it and more reference points from their friends and that increases the overall efficiency and some of that is manifested as lower word-of-mouth or better word-of-mouth, but it's really a scale effect of brand leadership.

Deborah Crawford - *Netflix - VP IR*

The next question is from Tony Wible at Janney Montgomery Scott. Have you seen any evidence of consumers trading down on their subscription plans as they stream more content on the digital streaming service?

Reed Hastings - *Netflix - CEO*

Tony, it's Reed here. No one particularly moves up or down. The effect we do see is more people going to the lower price plans than in the future, whether that's because it's unlimited streaming or because of the economy and that's driving the ASP down slightly, but once people are in a plan, there's as much moving up as there is moving down, so they offset each other pretty well.

Deborah Crawford - *Netflix - VP IR*

The next question is from John Blackledge at Credit Suisse. Would the streaming initiative be used to increase pricing or offset ARPU declines on the different subscriber plans versus being priced or offered as a stand alone product in the near term or over time?

Reed Hastings - *Netflix - CEO*

The streaming initiative, we got a couple of wins out of that in terms of retention, acquisition, DVD usage substitution. And strategically, we think of low price as a great competitive weapon, if we can competitive moat, if we can get a very large subscriber base with aggressive prices, it's harder to attack our franchise. So, we're continuing to look for ways at which we could grow the subscriber base even faster on lower prices, by for example, emphasizing our lower price plans.

Barry McCarthy - *Netflix - CFO*

I'm going to jump in. In addition, I think there's generally a perception that the decline in ARPU is a bad thing in the business, but if you look at the last page of the earnings release, just above the churn line, you'll see a new metric that could have been calculated in previous quarters from the data we supplied, which is gross profit per paid subscriber -- average gross profit per paid subscriber and if I'm recalling correctly, I don't have it in front of me, it was about $4.53. Yes, $4.53 a quarter in Q2 this year up from $4.39 a year ago. So even though ARPU is going down, the business per subscriber has been getting more profitable even as the appeal of the lower price plans and the growth and the functionality of the business in streaming is a net positive in terms of subscriber growth.

Reed Hastings - *Netflix - CEO*

Gross profit percent.

Barry McCarthy - *Netflix - CFO*

Yes.

Deborah Crawford - *Netflix - VP IR*

The next question is from Barton Crockett of Lazard Capital. Your subscriber growth in 2009 has been great. Any early thoughts about your ability to maintain that pace in 2010?

Reed Hastings - *Netflix - CEO*

Barton, if you'd asked us last year would we still be writing for like the eighth and ninth quarter at 25%, we would be, that's a little wishful thinking, so it's hard for us to tell too. I will say that the tailwinds from video store closures and from the growth in streaming have been very positive influences for us, so we're probably more optimistic than we have been in the past, but our year ahead predictability on that is frankly not much better than anybody else's.

Deborah Crawford - *Netflix - VP IR*

The next question is from Michael Pachter at Wedbush Morgan Securities with a more specific question on ARPU. Could you please explain the decline in ARPU in the context of the increase in the Blu-ray surcharge? Is it attributable to an increased rate of $8.99 sign ups, low acceptance of the Blu-ray option, late quarter additions or some other reason?

Reed Hastings - *Netflix - CEO*

Well, Michael it's a good question. It's not late quarter additions. The BluRay price increase helped. The ARPU decline would have been larger without it, but not hugely materially. And it is mostly the second of your questions, which is that it's more people taking the lower price plans than in the past, and again as a competitive barrier, we're happy about that.

Deborah Crawford - *Netflix - VP IR*

The next question is from Anil Gupta at Oppenheimer & Company. Can you remind us about the impact of consumer electronic deals on subscribers in Q3 of 2008 and Q4 of 2008?

Reed Hastings - *Netflix - CEO*

The Xbox was launched in Q4 of 2008, so that was a help in Q4. Immaterial in Q3 of 2008.

Barry McCarthy - *Netflix - CFO*

And remember that consumer electronic devices largely are purchased around the holidays, so unless you tap into a large installed base, like we did in Q4, with a launch on Xbox 360, growth associated with CE devices would come after the holiday sell-through.

Deborah Crawford - *Netflix - VP IR*

The next question is from Doug Anmuth at Barclays Capital. Is there anything in particular that's weighing on Q3 earnings given the subscriber and revenue increases?

Barry McCarthy - *Netflix - CFO*

If I were to rephrase the question and ask it in this way, could earnings be higher? The answer is yes. Which begs the question why aren't they and the answer is because every year, we begin by deciding what the earnings growth target is going to be and the goal we've set is an operating margin of 10%, which allows us to grow earnings in the kind of round number, 20% range fast, very fast. And for strategic reasons, we've made the decision as a management team to invest what could be more earnings and a faster earnings growth rate in the future profitability of the business by acquiring more content, growing the streaming initiative, providing a better service. And that's the reason that Q3 earnings is not higher.

Reed Hastings - *Netflix - CEO*

And more marketing, right? In Q3, also taking up marketing.

Barry McCarthy - *Netflix - CFO*

Yes. Thank you.

Deborah Crawford - *Netflix - VP IR*

The next question is from Mark Mahaney at Citigroup. What impact on your customer base in terms of additions, churn or ARPU, have you seen in the areas where Saturday shipments have rolled out?

Reed Hastings - *Netflix - CEO*

Mark, it's Reed. We don't have a good enough control to be able to tell precisely. What we have found is when we convert an entire area from two-day delivery, put in the hub, we get a real material benefit. And by extension, we think when we take roughly a 10% of the shipments and give them better service, we'll get a positive effect also, but I think it's relatively -- we know it's a positive but we're unable to tell you exactly how much.

Deborah Crawford - *Netflix - VP IR*

The next question is from Michael Olson of Piper Jaffray. Growth margin was essentially flat quarter-over-quarter, which is surprising given the normal seasonal down-tic in Q2 and the postal rate increase in the quarter. Can we expect gross margin in Q3 to be up quarter-over-quarter as it typically is?

Barry McCarthy - *Netflix - CFO*

Well, we don't guide to gross margin. There generally is a seasonal increase in DVD usage, you should factor that into your model and your thinking about margins. I think that's all we plan to say about it.

Deborah Crawford - *Netflix - VP IR*

The next question is from Dan Ernst at Hudson Square Research. DVD usage was lower seasonally, but you did add a record number of subscribers last quarter and as I recall new subs tend to have higher utilization as they run through your broad library. Was that not the case with these new subscribers?

Reed Hastings - *Netflix - CEO*

Remember that in the COGS, there's DVD usage and streaming and as we take up streaming investments, that has an influence on COGS also, and that may be what's causing the model for you to not align as well as you want.

Barry McCarthy - *Netflix - CFO*

But that still is the general trend that DVD usage declines, let's say during the first year of a subscriber's life on a monthly basis.

Deborah Crawford - *Netflix - VP IR*

The next question is from Jim Friedland at Cowen & Company. What percentage of users are on a Blu-ray plan?

Reed Hastings - *Netflix - CEO*

Jim, what we've said in the past is it's nearly 10% and it's still at nearly 10%.

Deborah Crawford - *Netflix - VP IR*

The next one is from Michael Pachter. Given weakness in advertising sales at most media outlets, should we expect to see advertising spending decline year-over-year at holiday, since Netflix gets the same benefit for fewer dollars?

Reed Hastings - *Netflix - CEO*

No, Michael. We could do that, in other words, we could take the great rates available and spend less and earn more, but we're choosing to keep earnings growing very nicely, but not at the maximum rate possible and we'll be spending as we would, but getting more growth and more reach for our dollars than we would in the past.

Deborah Crawford - *Netflix - VP IR*

The next question is from Mark Mahaney at Citigroup. Explain why long term operating margins should be capped at 10% given what should be clear marketing spend leverage in the model?

Reed Hastings - *Netflix - CEO*

Mark, not clear how long we'll keep them capped at 10% when you say long term, but if you mean the next few years, there's a lot of investment that we think is very smart to do in streaming and as well as the global expansion. So, that's what's leading us to not want to at this point run richer than 10%. In the long term, as we think about it, sort of 5 to 10 years I would agree with your thesis.

Deborah Crawford - *Netflix - VP IR*

The next question is from Walter Winnitzki of Nicusa Capital. I apologize if I didn't pronounce your last name correctly. Can you share with us the subscriber reactivation rate?

Barry McCarthy - *Netflix - CFO*

I think what we said publicly, I think you're talking about customers who joined the service, who we can identify as having been a previous subscriber. And that's -- we had said in the past running about a third, it continues to run about a third and then there's a subset of new subscribers who are pretty confident and joined before, but we're not able to identify then as a rejoin because the credit card has change, address has changed, that sort of thing.

Deborah Crawford - *Netflix - VP IR*

The next question is from Rich Ingrassia at Roth Capital. Last quarter you said you had no interest in entering the kiosk business. Has that sentiment changed at all now that it appears studios are warming up to the concept?

Reed Hastings - *Netflix - CEO*

No, not particularly, Rich. The kiosk businesses are very good -- vending machine businesses, Coinstar has been doing vending machines on a global basis for a long time. They have a wide range of vending solutions and presumably they will come up with more and more vending innovations. So, they're organized horizontally as a vending machine company. We're organized vertically and we happen to be in DVDs now and it's DVD and streaming as a movie brand and Netflix will always be in movies, not in various ways to ship or move discs or any other aspect. So, the businesses are really organized quite differently and we have no incentive to go into kiosks, or putting all of our innovation efforts on going into streaming.

Deborah Crawford - *Netflix - VP IR*

The next question is from Gil Simon at Apex Capital. Barry mentioned taking up marketing spending Q3, which is consistent with seasonality. Blockbuster has recently been spending more dollars on marketing as well. Is their higher spend noticeable in your markets, could it have any impact on marketing cost?

Reed Hastings - *Netflix - CEO*

It's always a bit of a wildcard what Blockbuster is going to choose to do. It really depends on the level of spending. If they decide to spend like they spent back in 2007, then that's something that we would notice. At the current levels, not particularly.

Deborah Crawford - *Netflix - VP IR*

The next question is from Barton Crockett at Lazard. Explain what is driving the more optimistic view of subscriber growth for the year, given that Q2 came in at the high end of your guidance.

Reed Hastings - *Netflix - CEO*

Well, that would seem to be reinforcing Q2 came in at the high end of guidance and that's part of what gives us confidence on the rest of the year. But, the wonderful things that we don't seem to be affected by the recession, I don't think were particularly helped either, but to be able to grow 25-26% in subs in this climate is a wonderful thing.

Barry McCarthy - *Netflix - CFO*

I'd say also as the year unfolds and we have more insight into what the next several months will look like, we sometimes have the opportunity to be more aggressive than we had been six months ago when we begin to talk about what the year might hold for us. So, businesses continue to perform remarkably well, the calendar year has progressed, we've made remarkable progress with the streaming initiatives on several different fronts, so that's given us reason to feel more optimistic than we did six months ago about our ability to execute through the remainder of the year.

Deborah Crawford - *Netflix - VP IR*

The next question is from Christa Quarles at Thomas Weisel Partners. Are you happy with your churn rates as they stand now? How do you benchmark your churn relative to other consumer businesses?

Barry McCarthy - *Netflix - CFO*

I think it's a false dichotomy to benchmark versus other businesses. If you think about churn relative to the value proposition of the service, so -- and the rate of growth in subscribers, and not in the abstract. So for instance, it may be that over time, with the growth in streaming that we've become more transactional and at a lower price, and with many more subscribers, and we see an increasing number of subscribers coming in and out of the service. That would result in a higher churn rate and it could result because it's more transactional and there's lower barriers to entry, but it may result in a significantly more profitable business.

And we think about the -- I think a business with those attributes would also have significantly lower subscriber acquisition cost, so we think about the interplay between gross margin SAC churn, which you heard me say at nauseum, as the key drivers as the business in terms of overall profitability and not through churn in the abstract. Because churn in the abstract always would lead me down the path of concluding that lower is better, but that may not lead to a better economic model in the context of SAC and gross margin.

Reed Hastings - *Netflix - CEO*

And when we're referring to transactional in that context, we mean it as pay-per-view. We mean that a streaming subscriber might join stay with us for the fall, be off for the summer, join winter, come back in the spring. And we make it very easy for people to enter and exit the service. And so, that drives SAC down because you have a lot of rejoin activity and it drives churn up. So, we may end up in a place where SAC is lower than it would otherwise be and churn is a little higher than it would otherwise be. But, most importantly, we're operating the way consumers want us to operate. Not trapping them in a service. And so, we're focused on matching what they want out of the service.

Barry McCarthy - *Netflix - CFO*

My last observation, is obvious on its face, which is the churn is also a function of new subscriber growth. So, if we're going to shrink the subscriber growth from 20% plus to 2%, we're going to see a dramatic decrease in churn because older customers churn slower than new customers, but nobody on this call thinks that would be a good idea either.

Deborah Crawford - *Netflix - VP IR*

The next question is from Youssef Squali at Jeffries. Now that you're going to be halting improvements in operating margin at approximately 10% for the next few years, is most of that investment going into content acquisition or international expansion and how do we track your success now that the investment amount will become substantially more material than before?

Reed Hastings - *Netflix - CEO*

Most of it will go into content and how you track our success is, are we growing the top line significantly? Which because we're staying approximately 10% operating income -- grow operating income, very significantly. So, ultimately it comes down to earnings and EPS growth, which we have ambitious plans for.

Deborah Crawford - *Netflix - VP IR*

Next question from Anil Gupta at Oppenheimer & Company. Was the split of rental transaction, 70% library or catalog and 30% new release?

Barry McCarthy - *Netflix - CFO*

Yes, that's correct.

Deborah Crawford - *Netflix - VP IR*

And then from John Blackledge at Credit Suisse, what percent of the subscribers are using the streaming service currently?

Reed Hastings - *Netflix - CEO*

We said in the past that millions of the subscribers -- of our subscribers are using it and that's what we'll say today also.

Deborah Crawford - *Netflix - VP IR*

I think that's it for questions.

Reed Hastings - *Netflix - CEO*

Well, thank you all for joining us this afternoon. To recap the conversation, our business has continued to perform very strongly in Q2. Our outlook for the full-year is on track for record net additions. Consumers are responding strongly to the Netflix proposition, of unlimited movies delivered in two ways, DVDs by mail and streaming, for one low price and I look forward to updating you on our continued progress in October. Thank you.

Operator

Again ladies and gentlemen, this does conclude today's conference call. Thank you for joining us today.
