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Q1 2008 Netflix Earnings Conference Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Netflix first quarter 2008 earnings release 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, Inc. - VP, Investor Relations***

Thank you, and good afternoon. Welcome to Netflix's first quarter 2008 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 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 Investor Relations Web site at www.netflix.com. A rebroadcast of this call will be available at the Netflix Web site after 3:30 p.m. Pacific time today.

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 10-K filed with the Commission on February 28, 2008.

And now, I would like to turn the call over to Reed.

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

Thank you, Deborah, and welcome everyone. Our goals at Netflix are simple, to be a great Internet movie service by combining DVD-by-mail with Internet streaming and to deliver growing EPS and subscribers every year. In Q1, we made significant progress on those goals and our momentum is reflected in our increased subscriber guidance for 2008.

We currently expect at the midpoint of our guidance, 9.4 million subscribers by year end, an increase of 26% from 2007. In terms of EPS growth at the midpoint of our guidance we expect $1.23 in EPS for the year, up 27% from 2007. In Q1, the most telling metrics were subscriber net additions at 764,000, SAC at less than $30, and churn at 3.9%.

All three were record performances over our six years as a public Company. We have been executing very well for many quarters as we steadily improve our service metrics, our customer satisfaction, and our competitive strength. Q1 was consistent with this strong trend, as opposed to something new. But in late December, our most direct competitor further rationalized their pricing which contributed to our Q1 surge in growth.

Some of the positive impact from our competitors' price hike will be long lasting and some of it was a one-time benefit as their subscriber base responded to their price increase. So while Q1 was an all-time record in net additions, we don't expect Q2 to be a record second quarter or 2008 to be a record year in terms of net additions. In addition, we are planning on spending slightly less on marketing over the next three quarters than in the comparable periods of 2006, our biggest net additions year.

We are very pleased, however, with our strong growth expectations of approximately 160,000 net adds for Q2 and 1.9 million for the full year, assuming the midpoint of our guidance because these growth levels are allowing us to aggressively fund our instant watching efforts. On the industry front in Q1, the High Def format war ended which is great for consumers and great for those of us with a vested interest in disc-based movie watching.

Over the coming years, Blu-ray DVD players will fall in price and become more widespread. With the success of Blu-ray and its emerging economic importance to the studios, the DVD market is more likely than ever to remain enormous for many years into the future. As you are aware, purchasing Blu-ray DVDs costs more, both at retail and wholesale, than standard definition DVDs. Consumers are used to paying more for high definition content in every other channel including video rental stores, video on demand and cable channels.

Because of the higher cost of Blu-ray and the consumer expectations around High Def content, we are planning on implementing a modest monthly premium for access to Blu-ray some time this year. Today, the percentage of our subs who rent Blu-ray is in the low single digits, but it is sure to grow going forward.

While the success of Blu-ray is important to us, just as important are the improvements we have made to watching instantly over the Internet. Our selection continues to grow and we now have over 9,000 movies and TV episodes available. Today, our instant watching functionality is only available on Windows PCs which works well for our subscribers who is are comfortable watching video on their lap tops and for our technophile members who hook up their computers to their TVs.

We have been happy, we have been very happy with the response to date amongst these groups. And viewing is growing rapidly. For many subscribers, however, watching instantly will expand in relevance as we make TV viewing easier and cheaper.

As we talked about last quarter, we have adopted a partnership strategy in terms of Internet TV connectivity. As we increase our online content spending, our service becomes more attractive to consumers which in turn makes us more attractive to CE partners. In particular, we want our clients' software integrated into Internet connected Blu-ray players, game consoles, TVs, and stand alone set top devices.

In January, we told you we were working with LG Electronics for a second half of 2008 product launch. At this point, I can tell you we have LG plus three additional partners actively working on integrating our technology into their products. Three of the four partners are major companies which each sell millions of devices per year and will enable the Netflix functionality in some of those devices likely in Q4 of this year. The fourth partner is a small company which will likely launch sooner than Q4.

Understandably, there has been investor excitement and along with it rumors about who we have partnered with. Despite our great success attracting major partners, about which you will see announcements in the coming quarters, these partnerships only demonstrate our success at providing Internet delivered content to our subscribers at no additional charge. Nothing about these agreements will be material to our financial results for the foreseeable future.

While our efforts are a necessary first step as we expand into Internet delivery, providing free access to content is not a long-term formula for profitable growth. My second observation is that while we are off to a good start, providing consumer access to Internet-delivered content on their TVs will require many partnerships in addition to the big ones to be announced this year.

My third and final observation is these partnerships have some execution and implementation risks as with all new technology. We will take it year by year and model by model as we and our CE partners come to understand the opportunity better. The big challenge for us remains the same as it was when we first launched our Internet delivery initiative, to satisfy ourselves and our shareholders that our online content spending will result in increased subscribers and profits.

Despite my warnings to you about the many hurdles ahead, I would say we are thrilled with the progress we have achieved to date. Of course, as we succeed at new and improved consumer models for online movie enjoyment we are sure to attract more competition. Our competitive advantage is that if a consumer spends time on the Internet and enjoys movies, they are likely to be or become a Netflix subscriber.

As we grow a larger subscriber base, our ability to offer both online streaming and DVD-by-mail at one low price means that we have a major advantage over any stand alone Internet delivery service, at least for the many years ahead, while DVD is significant. In addition, the Netflix Web site, which we constantly improve, includes billions of movie ratings, millions of customer reviews, and an engaged community which makes it particularly well suited for choosing movies to instantly watch.

Let me wrap up where I began. Our goals are to be a great Internet movie service by combining DVD-by-mail with Internet streaming and to grow subscribers and EPS every year. The midpoint of our 2008 guidance of 27% EPS growth and 26% sub growth showed the effectiveness of our approach. And now, I'll turn the call over to Barry.

Barry McCarthy ***Netflix, Inc. - CFO***

Thank you, Reed, and good afternoon, everyone. Three quarters ago on the July earnings call, we announced a price cut on some of our most popular subscription plans. Lower prices, we said, was an investment in faster growth.

Faster growth is also what we expected when we raised guidance in February of 2008. Faster growth is what we reported today and faster growth is what we are forecasting for the remainder of 2008, both because of the ongoing benefits from lower prices and because of the current competitive environment.

For the first time in six quarters, we saw an acceleration in year-over-year sub growth in Q1 to 21%. Growth and net subscriber additions set an all-time time, churn returned to its all-time low of 3.9%, and SAC reached a six-year low of $29.50. Looking back on our history as a public Company, I would say that on balance, this was one of our strongest quarters. We even saw strong growth in the Bay area, our highest penetrated market, where household penetration reached 18.6%, up from 17.6% in Q4.

Growth was also strong in rest of the country, where average household penetration reached 7%, up from 6.3% in Q4. My remarks today will cover our Q1 performance.

Next I will talk about our updated guidance for the remainder of the year and lastly I will comment on the $150 million buyback we announced in March. And rather than repeat the information presented in today's earnings release, my comments will focus, instead, on four metrics. These are gross margin, marketing spend, other income, and free cash flow.

Gross margin of 31.7% declined 210 basis points sequentially in Q1. All of the decline was caused by a seasonal increase in disc usage which resulted in higher postage and packaging expense and fulfillment expense in quarter. These costs were partially offset by an expansion in margin relating to content cost which declined sequentially as a percent of revenue. The seasonal increase in usage in Q1 was in line with our expectations.

Marketing expense of $55 million increased $3 million sequentially, but declined by $17 million on a year-over-year basis for reasons I will explain in a moment. But first I want to remind you that not only was this quarter's SAC of $29.50 the lowest it has been since Q1 of 2002, but it also declined 15% sequentially and 38% on a year-over-year basis. Lower SAC was driven by changes in the competitive environment combined with the July 2007 price decrease, both of which contributed to better response rates to Netflix advertising and more organic growth.

For the remainder of the year, we expect lower marketing expense on a year-over-year basis, along with faster subscriber growth. Given the trend towards lower SAC over the last two quarters, the question investors often ask me is why aren't you spending more money on marketing to grow faster? The answer is we are investing more to grow faster, quite a bit more actually. So let me explain where.

Last July, we said there are two ways to invest in faster growth, one, more marketing spending, or, two, price cuts. The path we chose was price cuts and judging from our accelerated growth these past two quarters, the investment seems to be working well. Interest and other income of $7.7 million grew 55% sequentially in Q1 as we realized $4.3 million in gains from the sale of short-term investments.

Next quarter and for the remainder of the year we expect other income to consist primarily of interest income without the benefit of additional one-time gains. Free cash flow of $4.7 million in the quarter was $22.7 million better than the negative cash flow we saw in last year's first quarter and several million dollars better than we expected. Like last year, we saw a decline in free cash flow from Q4 to Q1. This seasonal decline was caused by a decrease in cash from operations as gift subscription sales slowed.

We also increased our CapEx spending on content to support new subscriber growth and brought 80,000 square feet of new office space online here in Los Gatos. That concludes my comments on our Q1 performance, and now I'd like to share a few observations about guidance.

Like last quarter, our guidance for the balance of 2008 assumes the market continues to grow. As in past years, we expect much of our subscriber growth will be front end and back end loaded in Q1 and Q4 respectively reflecting the historical pattern of seasonal growth. For the same reasons, we expect Q2 will again be our slowest quarter of subscriber growth.

We expect to end Q2 with 8.3 million to 8.5 million subscribers and to end the year with an upwardly revised 9.1 million to 9.7 million subscribers. Revenue growth will continue to lag subscriber growth on a year-over-year basis throughout 2008 because of the price reduction we implemented in Q3 of last year. But we expect both subscriber growth and revenue growth to accelerate on a year-over-year basis in every quarter of the year. With the growth of the growth accelerating in Q3 as the effects of last year's price decrease disappear. In other words, the second derivative will increase a bunch in Q3.

Gross margins will remain steady for the calendar year with a slight uptick in Q4, despite the cost of our growing library of content rights to Internet-delivered movies and TV content, and despite an expected increase in postage expense of $0.02 per round trip mailer beginning next month.

With respect to guidance, I want to make a brief comment about expected tax rates. We determined that some of our research and development efforts in recent years qualify for federal and state tax credits. We anticipate filing appropriate refund claims in Q2. The credits attributable to 2007 and prior years will be recorded as a one-time benefit in Q2 and those benefits will lower our effective tax rate in Q2 to roughly 26%.

For Q3 and Q4, we expect the tax rate to return to a normalized rate of 41% because these tax credits are no longer available at the federal level. And finally, I'd like to provide an update on the status of our stock buyback programs. During the first quarter of 2008, we announced and completed a $100 million buyback program repurchasing 3.8 million shares at an average cost of $25.99 and raising our cumulative share repurchases to 8.6 million shares at a total cost of $200 million, and an average cost of $23.31 per share.

In March, we announced an additional share repurchase program of $150 million. All $150 million remains available to buy back shares. In closing, I would like to summarize my remarks this is way. We are off to a strong start in 2008. Operating results were strong in Q1.

We reported strong results for three consecutive quarters and this momentum is reflected in the upwardly revised guidance we issued in today's earnings release. Today we reported record growth in gross and net subscriber additions, a reacceleration in subscriber growth, the lowest SAC we have ever reported as a public Company and record low churn.

These metrics show the model is working well. At the same time, the market for DVD-by-mail subscription services remains strong and the competitive landscape remains favorable. Finally, as Reed mentioned, we're on track with our expansion into Internet video delivery and pleased with our success to date. That concludes my prepared remarks. Thank you all for joining us today, and now, operator, I think we're ready to take some questions.

QUESTIONS AND ANSWERS

Operator

The question-and-answer session will be conducted electronically. (OPERATOR INSTRUCTIONS) We'll pause for just a moment to assemble the roster. We'll take our first question from Doug Anmuth, Lehman Brothers.

Doug Anmuth ***Lehman Brothers - Analyst***

Thank you. I have two questions.

First one is regarding Blockbusters' online subs, and can you talk, Barry, about how you would think about them if they were potentially to come for sale in the market? And then, secondly, in terms of the profitability outlook that you have for 2008, it's a little bit lower than we would have expected given some of the increase in subscribers and also in revenue.

What else in particular is keeping down the profitability a little bit and how much is that due to higher than expected digital spending for the year? Thank you.

Barry McCarthy ***Netflix, Inc. - CFO***

Hi, Doug, Barry. Let me do the second part of the question which is profitability, and I will flip the first part of the question over to Reed to deal with Blockbuster on line sub in the event of sale.

With respect to profitability, the model from our perspective, from an operating perspective is actually performing extremely well. And to the extent that earnings for the calendar year are on a trajectory less than you were expecting probably the differential relates to the amount of spending that we are actually doing as compared with our forecast to bring onstream the capability to deliver movies over the Internet to different devices.

Primarily, the spending is on the content side, and as Reed said and I reiterated we are enormously pleased with the progress we are making there.

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

Doug, it is Reed. A couple of years ago we were able to work out a soft landing for Wal-Mart.com because they had made a strategic decision that it didn't make sense for them, if for some reason Blockbuster made such a decision we could probably work something out. But they have been in the business for a couple of years. They have a big investment in their model. I would anticipate them to stay in the business for the foreseeable future.

Doug Anmuth ***Lehman Brothers - Analyst***

Okay. Great. Thank you.

Barry McCarthy ***Netflix, Inc. - CFO***

Doug, Barry. Let me make one additional point about profitability. People who have been following us for a long time realize this and investors who are new to us may not. Because we expense 100% of the cost of acquiring subscribers when they walk in the door there tends to be an inverse relationship in the current period between subscriber growth and profit. So it is several quarters before an acquired subscriber becomes profitable. To the extent that subscriber growth is running stronger than forecast, that pressure is in the current period, the P&L. So if for instance our subscriber growth is stronger than you were forecasting, it stands to reason that our net income would be lower than you were forecasting.

Doug Anmuth ***Lehman Brothers - Analyst***

Got you. Great. Thank you.

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

Next question, operator.

Operator

Okay, just one moment. I apologize. We are experiencing some technical difficulties. Please stand by.

One second. You are holding for the Netflix conference. We are experiencing some technical difficulties. We will try to get this resolved shortly. We thank you for your patience in holding, and please continue to stand by.

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

Operator, if you want to e-mail us the next question, maybe we could answer it that way.

Operator

I will try. Just one moment. Again you are holding for the Netflix conference. We will be resuming shortly. We thank you for your patience in holding.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

So a more productive way to keep this moving might be to have people e-mail me the questions. My e-mail address is dcrawford@netflix.com and then we can just address them in order.

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

Okay. If the operators come back, we will flip back to the voice.

Operator

Thank you, Ms. Crawford, and I will let you know when our computer system has updated.

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

So we will see which analysts can type their BlackBerry message fastest to us.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Okay, so, Brian Pitz at Banc of America, can you talk about where the growth in subscribers is coming from? Is it from offline or new users? To what extent did hollywood Video impact your growth?

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

Brian, certainly Hollywood's closures of stores helps, but when we have done specific studies of neighborhoods, we haven't seen a super strong correlation. So I would call it a positive background influence as opposed to a specific big driver.

We definitely saw a positive increase beyond our initial expectations for the quarter because of the Blockbuster price increase. So that was the other contributor. Other than that, no material difference from the standard flow of the past couple of quarters.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Okay, Brian, I'm going to do one more for you and then I am going to keep going. Next question from Brian at B of A.. Can you comment on if you have seen any decrease in online advertising CPC, CPM rates due to a weaker economy?

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

It is Reed again. No material change for us in the advertising climate.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Dan Ernst at Hudson Square. Can you quantify online spend? Where is it accounted for?

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

Online content I think that is, Barry.

Barry McCarthy ***Netflix, Inc. - CFO***

Assuming the question is online content, Dan, it is accounted for in the cost of revenue line.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Okay. From Michael Olson at Piper, when you said gross margin will remain flat for the rest of the year with a slight uptick in Q4, just to clarify, are you saying Q2 and Q3 gross margin will be flat with Q1?

Barry McCarthy ***Netflix, Inc. - CFO***

I am, yes.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Second question. What kinds of devices will the partners integrate Netflix with? Is it stand alone set top boxes or devices that consumers are already buying like flat panel TVs or Blu-ray players?

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

We see the largest opportunity in multifunction devices such as Internet connected TVs, Internet connected Blu-ray players, Internet game consoles. But the set top into stand alone is a little more flexible. So some of the early partners may do those because they're easier to get to market. But it will be a mix and over time, I think, the volume will be in the hybrid devices.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Okay. This is from Heath Terry at CSFB. With the benefit from the lower tax rate to net income, why isn't there more of a positive impact on to net income guidance? Is there an offset in some other part of the expense structure?

Barry McCarthy ***Netflix, Inc. - CFO***

Heath, Barry. No, there's no offset someplace else in the expense structure. It's just that we continue to invest stronger in growth and we continue to invest strongly in delivering ED content to increase the number of titles that we have licensed. So, said in the alternative, if net income, if we forecast lower net income, as a result, say, of a higher tax rate, some place in the P&L we would be paring our investment in future growth.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Okay. From Andy Hargreaves at Pacific Crest Securities. What other models are you considering for instant watch? Do you expect to have a distinct model for CE customers versus current customers?

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

Andy, I'm not sure exactly what you meant by CE customers. I'm going have to guess a little bit here. But today, consumers who are Netflix subscribers can rent DVDs and then in the same subscription for the same place also watch movies on their PC.

What we would like to be able to do is make that watch movies extend to be able to watch movies on other devices. So think of it as a different viewing option, not a different subscription or commercial option.

Barry McCarthy ***Netflix, Inc. - CFO***

All under the subscription rubric?

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

As Barry said all under the subscription rubric. Our focus as a brand is really around unlimited subscription entertainment.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Lloyd Walmsley at TWP. You increased your subscriber guidance but maintained net income guidance. Are you seeing something in terms of SAC or lower content cost making you comfortable you can increase subscriber growth and maintain profitability? Second question, are you seeing lower online advertising prices or is it content driven?

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

Do you want to do the first part, Barry?

Barry McCarthy ***Netflix, Inc. - CFO***

Sure. The, let's see. The model is more profitable than we were expecting it to be and that enables us to increase the growth and maintain the profitability.

It is also true that we are seeing better yields on the advertising we are doing and more organic growth as I mentioned in my comments for this call, all of which enables the economic model to deliver incremental sub growth without a deterioration in profitability.

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

I think, it's Reed here, an extension of that Lloyd, it is not fundamentally, it's not that we are getting lower CPMs materially. It is that the CPMs we're buying are more effective with a better competitive climate and are increasing brand awareness and reputation.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

From Tony Wible at Citigroup. Any change in thoughts on kiosks? Do you see them them as a greater threat or as a potential viable distribution model?

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

Tony, it is Reed. I don't see them particularly viable for us or important to us. They're viable, I think they will be around for a long time, and as I said in the last call, they hurt us a little bit and they help us a bunch in terms of triggering store closures because the kiosks focus really on the top 50 titles, they're very new release focused in their business. So it is a net benefit to us we believe.

Barry McCarthy ***Netflix, Inc. - CFO***

I would say absent of competitive threat to the economic well being of the business which we don't see. We have the resources to make one large strategic investment. We have chosen to make that investment in growing our ability to deliver content over the Internet to TV sets and other devices in lieu of reinvest doubling down in the physical world.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Okay. Derek Brown from Cantor Fitzgerald, two questions. First, is watch instantly usage incremental to disc usage or replacement of disc usage or can you tell? Two, will BBI to go through with acquisition of Circuit City, how could you see this helping/hurting your business?

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

Derek, it is Reed. On the incremental versus replacement, we can't tell at this point. The types of consumers that are active users of instant watching are different types of users than others. So there's no clean control group.

We are optimistic over time that there's only so many hours that people are going to watch content that there will be a substitution effect. Second, in terms of Blockbuster and Circuit City, not sure what it means. It is just too early to tell. We will see what they decide to do.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

From Ken Smith at Munder Capital. Can you comment on average revenue per subscriber? It appeared to be down sequentially quite a bit.

Barry McCarthy ***Netflix, Inc. - CFO***

Ken, Barry. Two comments. One is I think sequentially, not so much.

About on par with prior quarters and, secondly, you may recall that there have have been sources of ancillary revenue from advertising and from an affiliate called Red Envelope and both those lines of business have pared back their revenues. So it made the drop in ARPU look different than it would have looked if you were looking strictly at the ASP for the subscription business which was almost flat.

So, I am not concerned about it. I would encourage you to not be either. Said differently, no structural change in the mix by price point of new subscribers, and no structural changes other than improvement in churn in the installed base.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

From Youssef Squali at Jefferies. On gross margins, 31.7% is the lowest you have had in seven quarters. Can you speak to why usage has increased? Second question, Redbox is getting a lot of traction. How do you see your value proposition versus theirs?.

Barry McCarthy ***Netflix, Inc. - CFO***

Let Reed do Redbox and I will do usage. Usage is actually down. It is down for two reasons. One because of the plan mix towards lower price points and lower caps, and then, secondly, because aging of the subscriber base.

So, and content costs in the aggregate have increased over what they have been, say, three years ago because of the investment we are making in the rights for Internet delivery. So, this really gets back to the question that Derek has which is about switching, if any, substitution between users of Internet-delivered movies and TV content and DVDs. And, this is a realtime experiment.

We are driving strong growth and profitability from the core DVD business and in effect, investors have a free option for the moment on our ability to grow the, the business of delivering movies over the Internet to television sets. And we will only know over time how we need to fine tune that value proposition so that it works for consumers and works economically for Netflix.

So the short answer is usage is trending down, up seasonally as we expected, exactly what we expected, and increased in content spending around growth of the new initiative.

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

And, Youssef, you asked about Redbox and I think I answered that. I think your question was probably just written before I did that.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Next is from Jim Friedland at Cowen. Will you disclose percent of customers using instant watching target titles for year end on instant watching? That's the first question. The second is quarter-over-quarter growth in R&D was up a lot if Q1 this year and last year. Is there anything seasonal about spending in R&D or should we expect steady increase each quarter in R&D?

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

Jim, overall, I would expect R&D pretty steady. We do do the annual salary reviews at the end of Q4 Company-wide. So maybe that's a trigger for it.

In terms of usage we have been very pleased with the adoption of the instant watching by our consumers, but we have chosen to not give out specific metrics on that. Similarly with target titles. We are up to 9,000 titles, up from I think it was 2,000 or 3,000 when we launched a year and a half ago. So we have made great progress and we continue to make great progress.

Barry McCarthy ***Netflix, Inc. - CFO***

Jim, I have been here almost nine years and I used to tease Reed that we never met an engineer he didn't want to hire. Not having, that notwithstanding we have been pretty disciplined about the investment spending in R&D.

We are crawling at aggressively, but those investments we have recouped in longer subscriber lifetimes and increased subscriber profitability with reductions in retention by making the features and functionality on the Web site more attractive to consumers and better (inaudible) utilized our investment in the DVD library, one. Two, we also are making an engineering investment associated with driving content to the Internet and some of the increase you are seeing reflects that R&D investment.

So the bulk of the investment spending to drive content across the Internet to TV sets and the like is content and the other part of that shows up in R&D.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

All right. Dan Ernst just had a clarification from Hudson. I meant can you quantify the level of online content spend?

Barry McCarthy ***Netflix, Inc. - CFO***

For competitive reasons, Dan, we are ducking that question.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Next question is from [Neil Warner] at Foxhill Capital. What percentage of your customer base do you think will be renting Blu-ray by the end of the year?

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

Neil, I would guess it is still in the single digits. Christmas there will be a lot of players sold. So right at the end of the year it is a little bit of a fluctuation or improvement there, but probably single digits.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Okay. Next question from Barton Crockett. ARPU declined Q-over-Q, (inaudible) had said before mix change leveling out. That not the case now, wouldn't seasonally the trend have been to increase? I don't see that from here. That's the first question.

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

The mix change, I don't think we have said in the past, Barton, that the mix change had leveled out. Even when the mix change does level out because of differences in churn rates due to different subscriber ages of new subscribers and old subscribers there will tend to be a slight differential. The majority of the change that you saw this quarter in ARPU is not due to revenue changes or pricing changes in the subscriber base. It is due to add revenue and other revenue which in aggregate account for the decline in ARPU sequentially.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Next question, also from Barton, $4.3 million not in cash gain from sale of short-term investments. What was that, was that contemplated in guidance?

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

It wasn't originally contemplated in guidance, but as the quarter progressed two things happened. We increased, we decided to increase our investment in marketing spending above the levels that we had forecast when we gave guidance.

Secondly, we forecast as the economy improves and increase in interest rates. From my perspective it was a good opportunity for us to realize a gain in our investment portfolio that might not be there in quarters to come. So, we used the sale of the gain on the, in the investment portfolio to, in effect, fund some incremental investing in additional marketing and faster growth and to hold the P&L cost.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

From Doug Anmuth at Lehman Brothers. Is there any significant change in your view on digital spend for '08 versus what you saw three months ago? Let's start there.

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

No, Doug. I would say our spending plan is about what we thought it would be three months ago and it does continue to proceed nicely for us as we have seen the validators of the significant usage, and it is because we have a lot of online content that we have been able to get these great partnerships that we will be talking about later this year.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Next question also from Doug at Lehman. Any change in competitive landscape in last three months, seeing Blockbuster be any more aggressive with spending?

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

Well, obviously Blockbuster has changed many times and they may change again. But for the last three months there have been fairly minimal amounts of marketing from Blockbuster.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

From Youssef Squali at Jefferies, and after this I think we can go to the operator to see if there are any final questions. Last one that I have here. From Youssef Squali, your GAAP net income for fiscal year '08 is unchanged, but your GAAP EPS is lower. Why is that, is it option related?

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

Great question. Thanks for asking. Yes, it is.

We use a Treasury method and because the price of the underlying stock has increased, under the Treasury method it takes fewer options for a net exercise. As a result, the number of outstanding shares is assumed to be greater which has resulted in, I think, it is a $0.01 decrease in the projections for EPS on the same GAAP net income.

Deborah Crawford ***Netflix, Inc. - VP, Investor Relations***

Operator, can we open it back up or do you want me to continue reading questions?

Operator

We can open it back up. (OPERATOR INSTRUCTIONS) We will pause for just a moment. First, we will hear from Tony Wible with Citi.

Tony Wible ***Citigroup - Analyst***

Good afternoon. I was hoping you guys could comment on if you have seen any change in some of the metrics, in some of the share gain subs, and some of the newer subs coming on, do they have any better or worse ARPU, margin or churn trends? I know it is maybe a little early on the churn question, but any color would be helpful.

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

Tony, it is Reed. No, we don't see any difference in the kind of character of the new subs in the share gain over Q1 than in prior quarters.

Tony Wible ***Citigroup - Analyst***

And what do you still feel is the best use of cash after you burned through the $150 million, roughly, that is remaining?

Barry McCarthy ***Netflix, Inc. - CFO***

More buyback.

Tony Wible ***Citigroup - Analyst***

More buyback. All right. Thank you.

Operator

Next we will hear from Lloyd Walmsley, Thomas Weisel Partners.

Lloyd Walmsley ***Thomas Weisel Partners - Analyst***

Great. I was wondering if you guys could comment on the landscape for digital content rights acquisition, and in particular, if you see any changes coming out of the new pay TV plans announced yesterday by Paramount, MGM and Lionsgate? And then if you could perhaps as a follow-up to that just talk about how you have structured those deals in terms of fixed costs versus variable cost driven by usage?

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

Lloyd, it is Reed, obviously, there's a lot changing in terms of the specific new Viacom, MGM, Lionsgate initiative. It is too early to tell what the impact of that will be in the marketplace, and then we contract for content, try to go get the best deal we can.

Sometimes that's fixed, sometimes it is pay-per-view, sometimes it's other mixed models. We are pretty flexible on that in the search for a good deal. Operator, I think we will take one last question if we have one, otherwise we will.

Operator

We will take one final question from Heath Terry, Credit Suisse.

Heath Terry ***Credit Suisse - Analyst***

Great.

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

Heath, take us home.

Heath Terry ***Credit Suisse - Analyst***

All right. I was going to ask, the watch instantly customers that you have got, can you give us an idea of what kind of, if you are seeing any difference in the churn rate among those that are using watch instantly and what kind of penetration you are getting for the service among the subscriber base?

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

Heath, it is Reed, you know, we are really excited by the usage because you don't keep using something unless you are satisfied with it. But, again, without a control group to identify what the compare the churn to the base of people who watch a lot of movies and watch content on their PC are different than other subscribers. So we can't tell you kind of the direct retention impact.

But we can tell you that the usage has really impressed us, that there is many more people willing to watch a lot more content than we thought on the PCs, and we are looking forward to them expanding that to the television and the more that people interact with Netflix, the more they feel good about it -- consumers, and the more they tell their friends about it. So very confident that it is a positive influence for us, but without the control group can't give you a perfect sense of the number, the size of that gap.

Heath Terry ***Credit Suisse - Analyst***

Great. Thank you.

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

Well, thank you everyone for joining us on the call. I'm sorry for those technical difficulties, but you all got your questions in very well, and we look forward to talking to you over the quarter and on our next call. Thank you.

Operator

That does conclude today's Netflix conference. We thank you all for joining us.

THOMSON REUTERS

PLACEHOLDER TRANSCRIPT

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Barry McCarthy *Netflix - CFO*

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Barton Crockett *JPMorgan - Analyst*
Doug Anmuth *Lehman Brothers - Analyst*
Tony Wible *Citigroup - Analyst*
Michael Olson *Piper Jaffray - Analyst*
Lloyd Walmsley *Thomas Weisel Partners - Analyst*
Jim Friedland *Cowen and Company - Analyst*
Andy Hargreaves *Pacific Crest Securities - Analyst*
Derek Brown *Cantor Fitzgerald - Analyst*
Brian Fitzgerald *Banc of America Securities - Analyst*
Larry Witt *Morningstar - Analyst*
Ken Smith *- Analyst*
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Daniel Leonard *First Analysis Securities - Analyst*
Ryan Hunter *- Analyst*

PRESENTATION

Operator

Good day, everyone. Welcome to the Netflix second quarter earnings conference call. Today's call is being recorded.

At this time, for opening remarks and introductions, I would like to turn the call over to Deborah Crawford, Vice President of Investor Relations. Please go ahead.

Deborah Crawford ***Netflix - VP of IR***

Thank you and good morning. Welcome to Netflix's second quarter 2008 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 10-K filed with the Commission on February 28th, 2008. We released earnings for the second quarter at approximately 4:00 a.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 8:30 a.m. Pacific time today.

Finally, as we noted in the press release we issued earlier this morning, we are going to conduct the question portion of the Q&A via email. Please email your questions to me at dcrawford@netflix.com. If you recall, last quarter technical difficulties forced us to take questions via email and Reed and Barry responded to them on the call. As it happens, we received a lot of positive feedback last quarter, so we're going to try it again this quarter. Please let us know what you think. Now I would like to turn the call over to Reed.

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

Thanks, Deborah and welcome, everyone. Our goal with Netflix is very simple, to materially grow subscribers and EPS every year while expanding the unlimited enjoyment we offer with DVD by mail to also include unlimited internet streaming. Once again, our quarterly results reflect strong progress towards this goal. We delivered our lowest ever SAC as a public company, profits at the top end of our guidance, and ending subscribers above the midpoint of our guidance. In addition, we made significant progress on our expansion into streaming with a launch of the Netflix player by Roku, the announcement of our X-Box partnership last week and our continued growth in the number of movies and TV episodes available to our subscribers for unlimited streaming. We discussed at length our views on the market and how we are approaching it at our Investor Day about eight weeks ago. In summary, we think that DVD by mail will continue to grow for five to 10 years, despite overall DVD rental flatness, as ecommerce continues to grow generally and as video store economics force more store closures.

As we expand more into streaming, we are improving our core consumer proposition of unlimited enjoyment for a low monthly fee by combining unlimited DVDs by mail with unlimited streaming. We don't plan to enter the pay-per-view segment, where Apple, Amazon, Sony and others focus, or the ad supported segments where Hulu, YouTube and others compete. Both of those segments will likely be substantial, but our subscription segment will also be large and will provide Netflix plenty of room for growth over the coming years. In order to succeed broadly with streaming, we need it to be easy and inexpensive for consumers to watch internet video on their television screen.

Specifically, our goal is to have our streaming software integrated into Blu-ray players, game consoles, connected to DVD and stand-alone internet devices. Our substantial streaming content, available to consumers on an unlimited viewing basis, makes it attractive for consumer electronics companies to integrate our streaming software, because it increases the attractiveness of their devices, and we promote their devices to our large subscriber base. Our results to date with this approach have been excellent, starting with the launch of the Roku box in May. This $99 box allows Netflix subscribers to instantly stream movies and TV episodes to their TVs. It's been a huge hit with strong reviews, strong sales, and great subscriber satisfaction. Roku purchasers are streaming video to their TVs and getting great value from the unlimited streaming portion of their Netflix membership. In the future, Roku boxes will support other internet video content and migrate from being a Netflix only player to a general internet video player, which will increase Roku sales and therefore the number of TVs we can stream to.

We also have a technology partnership with LG Electronics, which we'll be discussing in more detail soon, one other similar partner not yet announced, and the X-Box partnership which we announced last week. The X-Box partnership means that with Microsoft's late fall software update to over 10 million domestic X-Box 360s, Netflix members can stream movies and TV episodes to their TVs, as long as they are also X-Box LIVE Gold members. As with our streaming to the Roku box and to the PC, there is no extra Netflix charge for the unlimited streaming. While our strategy is to achieve ubiquity, we were willing to do an exclusive partnership in the game console segment because of the very large installed base of 10 million households that X-Box has developed. We believe this will be our only exclusive deal in any segment. Since the X-Box software update is scheduled for late fall, its impact during this calendar year is unclear.

While this functionality will certainly increase streaming amongst our current subscribers, we and Microsoft have yet to really understand how much it will drive additional LIVE Gold subscriptions, new console sales, and how much it will drive additional Netflix subscriptions. As we both learn more about the attractiveness of this joint functionality with consumers, we will use that information to determine the extent of our promotional activities over the next year. In the best case, substantial cross-promotion in 2009 will make economic sense for both parties in terms of increased efficient growth.

Between the large and growing X-Box installed base, the strong sales of Roku boxes and the anticipated sales of the Netflix ready LG device, we are off to a very solid start. As I mentioned earlier, as we increased the number of connected TVs, we are also increasing the content we are making available. In fact, over the last 18 months we've grown our number of choices from 2,000 to over 12,000, and we plan to continue to increase the amount of content available. This planned investment is already factored into our earnings guidance.

Shifting to the competitive climate, Blockbuster remained active in DVD by mail over the quarter. Our guidance for the year assumes that they continued to stay active at similar levels for the rest of the year. The rise of DVD rental kiosks in supermarkets, while new competition for us in the short term, is a bigger competitor for new release focused video stores and should accelerate store closures over the coming years. In addition, the rise of DVD rental kiosks shows that the DVD franchise is still very strong with mainstream consumers. In the long term, we think it is likely that DVD by mail and DVD rental kiosks will continue to increase their share of the DVD rental market at the expense of stores.

To close, our goal is to materially increase subscribers and EPS every year as we expand into streaming and this quarter we continued to make excellent progress towards that goal. Thank you and now I would like to turn the call over to Barry for a more detailed discussion of our Q2 results.

Barry McCarthy ***Netflix - CFO***

Thank you, Reed and good morning, everyone. My remarks will cover three areas, our Q2 performance, our guidance for the remainder of the year, and an update on the share repurchase program we announced in March.

Like last quarter, our Q2 financial performance was strong, with revenue above the midpoint of guidance and net income and EPS at the high end of the range of our guidance. This year's second quarter followed a well-established seasonal pattern of slower subscriber growth and increased profitability, which we spoke about on last quarter's earnings call. Seasonally slower subscriber growth was accompanied by record high operating profit of $33.5 million, when you exclude one-time items from prior year comparisons, and strong free cash flow of $12.5 million. Free cash flow nearly tripled sequentially and I'll say more about that in a moment, in spite of our growing investment in content rights to distribute internet-delivered movies and TV content. Gross margin was 10 basis points higher than it was in Q1, as expected.

Looking at the components of cost as a percent of revenue, we see that a small increase in content spending was offset by an equally small decline in both fulfillment and shipping and packaging expense, despite the postal rate increase in May. We expect gross margin to be up slightly in Q3 and Q4, despite our ongoing investments in internet delivered movies and TV content. Excuse me. With the seasonal decline in subscriber acquisition in Q2, our marketing expense declined by $15 million or 27% sequentially to just under 10% of revenue. As a percent of revenue, this represents the lowest quarterly marketing spend in our history as a public company. In Q2 we expensed $40.1 million on marketing. That's $5.2 million less than we expensed in Q2 of last year or about an 11% decrease in marketing expense. What's remarkable about the lower spending is that gross subscriber additions continue to grow anyway on a year-over-year basis. SAC declined again this quarter to just under $29, the lowest SAC has ever been since taking the Company public in 2002. This seasonal decline in marketing spending was the primary contributor to the increase in operating income in the quarter.

A second large contributor to the increased profitability in Q2 was the expected decline in our effective tax rate from 41% to 26% in Q2. This was something we discussed with you on last quarter's earnings call. The tax rate decline relates to a one-time R&D tax credit and we expect a return to 41% into Q3 and Q4. Free cash flow of $12.5 million in Q2 nearly doubled from a year ago and nearly tripled sequentially. Higher net income was the primary contributor to the sequential growth in free cash flow, coupled with a $10 million sequential decline in content spending. These sources of cash were offset by a decline in AP and accrued expenses of $11 million. On a year-over-year basis, there were three primary contributors to the growth in free cash flow. First, the increase in depreciation on PP&E and the amortization of content. Second, the growth in AP plus accrued expenses, net of excess tax benefits on stock comp. And lastly, the growth in long-term income taxes payable, related to the R&D tax credit. Although this is the second consecutive quarter of exceptionally strong free cash flow growth, I don't expect these hyper growth rates of 100%-plus to continue through in Q3 and Q4. When the dust settles and we look back on the year's results, year-over-year growth and free cash flow for the full year of 35% to 45% seems possible.

Today's earnings release includes subscriber revenue net income and the EPS guidance for the third and fourth quarters. Today, we reaffirmed our year-end subscriber and net income guidance, tightened our full year revenue guidance, and raised our guidance for EPS, reflecting our expectations for a lower weighted average share count by year end.

It's worth mentioning that we expect year-over-year revenue growth to accelerate in Q3 and again in Q4 as the effects of last year's Q3 price decrease slip away for comparison purposes. And by the way, we saw year-over-year revenue growth begin to accelerate this past quarter from 7% in Q1 to 11% in Q2, the first acceleration in the last seven quarters.

With regard to our share count, I'd like to talk briefly about the status of our share repurchase program. In March, we announced an additional share repurchase program of $150 million. All $150 million is currently available to buy back shares. No shares were repurchased last quarter because we closed the trading window pending the Microsoft announcement on July 14th. If the trading program had been open during the quarter, we would have been buyers of Netflix stock at these prices.

That concludes my prepared remarks. Now it's time to answer your questions and, as Deborah mentioned at the beginning of our call, we would like you to email your questions to dcrawford@netflix.com as we did last quarter. Deborah will read the questions out load and

Reed and I will do our best to answer them. As Deborah mentioned, we received lots of positive feedback on this approach last quarter and were able to answer more questions from more investors than we typically get to. So we thought we'd try this format again. So Deborah, over to you for the first question.

QUESTIONS AND ANSWERS

Deborah Crawford *Netflix - VP of IR*

Thank you. The first question is from Barton Crockett at JP Morgan.

Barton Crockett *JPMorgan - Analyst*

First question, what drove down stocks, lower pricing of media i.e. lower Yahoo! CPMs or was advertising simply more effective? Could that be a function of better word of mouth, impact of service cuts or greater consumer interest, perhaps due to higher gas prices?

Reed Hastings *Netflix - Co-Founder & CEO*

It's Reed, Barton. I don't think it's the outside advertising climate which hasn't shifted materially for us. It's mostly that we are spending less marketing as a percentage of revenue, so we're trying to push the market less hard than we have in the past. Second, better competitive climate than last year and then third, we made a big investment with lower prices last year, last Q3, we lowered our prices and we think of lowering prices as a marketing investment, although it's not reflected in fact. So those three factors have helped us to achieve this very efficient sub $30 SAC.

Barton Crockett *JPMorgan - Analyst*

Also, talk about the expected subscriber and economic impact of the X-Box deal. Is there one other major announcement still to come with another partner this year?

Reed Hastings *Netflix - Co-Founder & CEO*

Barton, I answered that question. You sent it in just before I read the script, but I think I've covered that. That this year, hard to tell because it's a late fall update. Next year we're optimistic that the cross-promotions will be economically efficient for both parties.

Barton Crockett *JPMorgan - Analyst*

Shutting down red envelope, talk about why.

Reed Hastings *Netflix - Co-Founder & CEO*

On red envelope, we did some experiments, tried to figure out an economic model that was scalable and sensible, unable to do that. We decided to close it down and all the closure costs are baked into our current guidance.

Barton Crockett *JPMorgan - Analyst*

Are DVD trends being impacted by gas prices or the economy?

Reed Hastings *Netflix - Co-Founder & CEO*

We don't comment on usage.

Deborah Crawford *Netflix - VP of IR*

Next set of questions from Doug Anmuth at Lehman Brothers.

Doug Anmuth *Lehman Brothers - Analyst*

The fact that it's lowest ever for Netflix as a public company, why not push the marketing a little further for more subs ahead of the back half?

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

That's an interesting question and something we debate, which is the balance of really earnings versus growth. And certainly there are good arguments that we could have taken, generated less earnings and pushed more into growth. But at the end of the day, we think it's better to stick to our earnings targets, despite these great opportunities. And it does give us substantial room for growth so I don't feel like we're making bad choices, but it is a very attractive opportunity when SAC is as low as it is.

Doug Anmuth ***Lehman Brothers - Analyst***

Is it becoming more competitive to partner with CE manufacturers now that Amazon has turned to streaming, i.e., and signed a deal with Sony and possibly others?

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

Well, Amazon's pay-per-view stream service is very nicely implemented and I think what we're going to see is them also emerging to various devices. Again, that's really the pay-per-view new release focus content and in many ways you need that, you need our subscription service and you need ad supported content from, say, Hulu and NBC.com and ABC.com and others to really form a total internet video solution on these devices. So I don't think it's competing against each other. We're not trying to block them. I don't know of them trying to block us. These are really different segments, the ad supported, the pay-per-view segment and the subscription segment.

Doug Anmuth ***Lehman Brothers - Analyst***

Finally, can you provide more color on digital usage? What percentage of subscriber bases stream are digital users turning less and using fewer discs? What percentage of total usage is digital?

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

Like eight weeks ago, we haven't given any color on the specific trends around watching, it's just too early to tell and we don't have a control group that doesn't get instant watching. So there's really no easy way for us to say anything conclusively. We're very encouraged by the usage, people are watching, are instant watching in significantly and growing numbers. That's very exciting. But at this point we don't have any specific numbers to provide.

Deborah Crawford ***Netflix - VP of IR***

From Tony Wible of CitiGroup.

Tony Wible ***Citigroup - Analyst***

Can you speak to if you have seen higher DVD consumption trends in your core DVD subscriber base over the past quarter versus last year to adjust for seasonality?

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

Tony, thanks for the question. Again, we're not commenting on usage specifically.

Deborah Crawford ***Netflix - VP of IR***

This is from Michael Olson at Piper Jaffray.

Michael Olson ***Piper Jaffray - Analyst***

Any more details you can provide on potential pricing changes for Blu-ray or Watch Instantly? Is there a threshold of Blu-ray or Watch Instantly subscribers that you are looking to reach before raising prices or what is the trigger for those potential changes?

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

We'll be commencing the testing of Blu-ray price increases very shortly. Depending on the test results of those, then we'll move forward with implementing.

Michael Olson ***Piper Jaffray - Analyst***

Next question also from Michael Olson. What should we expect for gross margin going forward? Is there any potential to get back to the 33% to 34% level of '07 or should we expect it to be kept at 32% in the near term? What is keeping the ceiling on gross margin?

Barry McCarthy ***Netflix - CFO***

Well, as I said in my remarks, we expect gross margin will increase next quarter, which is a change from our expectations in Q1. And I expect it to be up in Q4 as compared with the current quarter, although not quite as strong as it was in Q3.

As relates to the question around how high can gross margin go, answer it this way. If gross margin rose to 35% or 36%, it would not necessarily mean that the business is more profitable. There's a relationship that we've continued to explore during our history as a public company between customer SAT and gross margin. And in some respects, they're inversely related and since customer SAT drives at least indirectly SAC, and retention which drives lifetime value, sometimes the business is more profitable with lower SAC, higher retention, lower churn, higher lifetime value and lower gross margin. And we learned that experience when we launched Hubs and we're exploring those interrelationships again with the launch of the Watch Now service. So it remains to be seen what will happen with gross margins over time. So at least through year end, we expect some improvement. What the implications are for '09 and '10, it depends on the interrelationship between lifetime value, SAC and gross margin, as we expand the number of titles available for internet downloading and as the number of devices available for people to view that content on their TV sets increases.

Deborah Crawford ***Netflix - VP of IR***

Next question is from Lloyd Walmsley at Thomas Weisel Partners.

Lloyd Walmsley ***Thomas Weisel Partners - Analyst***

As new subscribers come in, do you have any intelligence on where they are coming from? Do you think a weak economy may be driving subscribers off pay TV to Netflix? Do new subscribers tend to use the service more and are your most profitable subscribers, those who use the service very little, leaving the service as they cut costs?

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

Lloyd, I don't see anything related to the depressing economic picture that we face, which is tempting to put a lot of -- to read the tea leaves about how it's affecting Netflix. But we're not really able to tell is that why we're going so strongly or would we have been growing even more strongly if the economy had been strong. In terms of where subs are coming from, no real changes. New subscribers do use more than older subscribers. But that's been true for 10 years for us. So no material change there. Overall, the wonderful thing about the Netflix business is we appear to be substantially unaffected by this significant economic negative climate. So we're very happy about that.

Lloyd Walmsley ***Thomas Weisel Partners - Analyst***

Second question, what percentage of the subscriber base is using Blu-ray?

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

Blu-ray usage has continued to be very low -- low single digits. It's something that has promise over the next couple years, particularly through this Christmas season and beyond, if player prices fall significantly. This will be the first Christmas coming up where there is dedicated players that are at more aggressive prices.

Deborah Crawford ***Netflix - VP of IR***

Two questions from Jim Friedland at Cowen and Company.

Jim Friedland ***Cowen and Company - Analyst***

As digital demand ramps, what will the impact be on your infrastructure needs? How should we think about CapEx growth over the next couple of years?

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

In terms of CapEx for digital delivery, very little impact. Most of that delivery infrastructure is through third party CDMs. So no particular connection there.

Jim Friedland ***Cowen and Company - Analyst***

Second question. How long does the exclusivity on the X-Box deal last?

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

We haven't commented on the particulars of the duration.

Michael Olson ***Piper Jaffray - Analyst***

Another question from Michael Olson at Piper. Why was other income so low in this quarter and what should we expect it to be the rest of this year?

Barry McCarthy ***Netflix - CFO***

Well, Michael, follow up if I don't address your question specifically. There's the combination of other interests -- it's mostly interest rates are down, long story short.

Deborah Crawford ***Netflix - VP of IR***

Questions from Andy Hargreaves at Pacific Crest Securities.

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

Why was the content library on the balance sheet down so much Q over Q? Sorry, why was the content library on the balance sheet down so much Q over Q?

Barry McCarthy ***Netflix - CFO***

Well, we spent less on new content and it was a relatively weak new release box office and -- one. Two, the two components that -- two, content acquisition, we buy some content outright that affects CapEx. We also rev share content with studios. So sometimes there's switching of -- from a CapEx versus a P&L perspective, depending on which particular studio is in rev share and which is not and which particular studio is hot from a new box office perspective and who is not. So to be explicit, if a particular studio has a rev share agreement with Netflix and that studio has a number of new release titles which are hot and that new content is being acquired in the form of rev share, those expenses will show up in the P&L and the cost of revenues. And conversely if there are a number of new titles from a studio which are popular and we're buying them outright, then that will show up in the statement of cash flows and content acquisition.

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

Next question, direction of disc usage.

Barry McCarthy ***Netflix - CFO***

I guess probably all these questions piled up. Stick with the same perspective of us not commenting specifically on usage.

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

Will there be meaningful cost savings from the end of red envelope?

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

No.

Deborah Crawford ***Netflix - VP of IR***

Next question is from Derek Brown at Cantor.

Derek Brown ***Cantor Fitzgerald - Analyst***

Recent article indicated the number of Roku units sold at about 100,000. Can you confirm that figure or say whether it's close? Can you provide any type of color on the behavior changes i.e. more digital, less DVD of Roku owning subscribers?

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

No, we're not giving any comment on number of Roku sold. What was the second question?

Barry McCarthy ***Netflix - CFO***

Behavior.

Deborah Crawford ***Netflix - VP of IR***

Roku.

Barry McCarthy ***Netflix - CFO***

Box owners.

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

It's something we're starting to look at, but we have to be careful about overreading it, because the first people to buy Roku boxes of course are not typical people. So they're not necessarily representative of what we're going to see as that market expands. So while we're looking at it, we don't think it's particularly significant.

Deborah Crawford ***Netflix - VP of IR***

Okay. Next question is from Brian Fitzgerald at B of A Securities.

Brian Fitzgerald ***Banc of America Securities - Analyst***

With the previous announcement of the streaming service, Roku and LG, the service is naturally governed as there is a delay as this hardware gets deployed, with the X-Box being deployed at 12 million X-Box live subscriptions potentially at once. We have seen you doing full (inaudible) the acceptance traction on the X-Box. Can you give us a sense of the traction or speed of adoption you expect on the X-Box and any potential expenses around the big inflection in usage?

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

Yes, you're right, that there's a real step function there as Microsoft releases their update to the X-Box in the late fall. We think we're well-prepared for that, both in terms of the loads on our various servers and in terms of our financials and that's all built into our guidance.

Brian Fitzgerald ***Banc of America Securities - Analyst***

You used to provide us with number of streams to date and we were hoping you could give us some kind of update on this.

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

Yes, very early on we were disclosing number of streams. But we haven't -- what we tried to give investors some awareness of it, that the content investment is really to drive the number of partnerships and the number of seats of internet connected TVs and that's really the point of this aggressive early investment in content so that's why we're talking about the various deals that are signed and in process. And that's really the payback on this big content investment.

Brian Fitzgerald ***Banc of America Securities - Analyst***

Last question from B of A. Amazon streaming VOD has a library of 40,000 versus Netflix's 12,000 in the Watch Now library. Can you explain to us what the major difference is between online pay-per-use 40,000 versus an online subscription model at 10,000 that would allow for one library to be so large relative to the other?

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

I don't have a good answer for you on that yet. It's something we'll look at as we get to use the Amazon 40,000 more. Obviously YouTube has 400 million titles, but you have to think about the weight of the titles in some context. So a straight title count isn't probably a very interesting way to look at these things. The way we look at it for the Netflix service is providing enough content that subscribers are very excited about staying as a Netflix subscriber. So that's the basic subscription calculus. Again, we see the Amazon, Apple, pay-per-view model, the Hulu, ABC advertising supported model and the Netflix subscription model as three different segments of the overall internet video market.

Barry McCarthy ***Netflix - CFO***

Having said that, I think the 40,000 for Amazon is an aspirational number that's been understood to be the current title count. I think actually the current title count is in the 5,000 range.

Deborah Crawford ***Netflix - VP of IR***

From Michael Olson at Piper.

Michael Olson ***Piper Jaffray - Analyst***

Is there any share repurchase factored into the guidance for the second half of '08 EPS?

Barry McCarthy ***Netflix - CFO***

Yes, I mentioned -- probably Michael sent that in before my comments -- but we expect the weighted average share count to decline through the end of the year related to share repurchase.

Deborah Crawford ***Netflix - VP of IR***

From Larry Witt at Morningstar.

Larry Witt ***Morningstar - Analyst***

With Blockbuster on the sidelines for now, why not hold down the accelerator on marketing to gain more share?

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

Larry, it's Reed. I think I covered that just a moment ago, which is it's tempting but instead of doing that we are preserving our earnings guidance and it's one of those many balances of earnings and growth.

Barry McCarthy ***Netflix - CFO***

This is Barry. Second point Reed previously made is that there are two ways to invest in growth. One is direct marketing spending, the other is the subsidy of lower prices and so in the third quarter last year we made a significant investment in incremental growth by lowering the pricing and only partially paying for it with reductions in marketing spending. So while we're all very enthusiastic about the reductions in marketing spending, we continue to cross-subsidize the business, if you will, with price reductions from a year ago.

Deborah Crawford ***Netflix - VP of IR***

From Ken Smith at (inaudible).

Ken Smith ***- Analyst***

What was the Bay Area household penetration and rest of country penetration?

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

The Bay Area penetration was up 20 basis points to 18.8% from 18.6% and rest of country was up 20 basis points from 7% to 7.2% in the end of Q2.

Deborah Crawford ***Netflix - VP of IR***

From Michael Pachter at Wedbush.

Michael Pachter ***Wedbush Morgan Securities - Analyst***

Microsoft told us that in surveying its X-Box live membership it felt that just under 1 million of its customers were Netflix customers. Have you conducted a similar survey?

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

No, we don't have access to the Microsoft user base, so are unable to do that survey, Michael. And whatever the current numbers are, it's more interesting thinking about the potential, both as Microsoft markets the Netflix service to get LIVE Gold upgrades and also to sell consoles against their competitors and as we advertise the X-Box console as a way to get instant streaming. So we're mostly excited not about the current installed base but about the future overlap that we can both generate.

Deborah Crawford ***Netflix - VP of IR***

From Larry Witt at Morningstar.

Larry Witt ***Morningstar - Analyst***

What are your expectations for future capital expenditures on technology regarding the Watch Now service? And do you plan on providing better quality streaming in the future and what are the implications of additional spending on this?

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

Yes, we're continuing to improve the quality of the streaming but not using our own capital. Mostly it's through better use of the CDM market, better integration with the CDMs, better monitoring, so that's how we're achieving that. So it's a straight P&L model as opposed to anything capitalized or on the balance sheet.

Deborah Crawford ***Netflix - VP of IR***

From Derek Brown at Cantor Fitzgerald.

Derek Brown ***Cantor Fitzgerald - Analyst***

Can you help us understand the framework of the digital content deals you are striking? Are they pure revenue share? Are there substantial upfront costs you are incurring for first time access to the content?

Barry McCarthy ***Netflix - CFO***

Derek, Barry. We are trying to be purposely vague in responding to that question, which I know continues to be frustrating for you. The content deals in some respects at a high level are similar to DVD, meaning there's some revenue sharing and there's some fixed fee payment. Now, if you -- so let's see. From a P&L perspective, if the service were to grow at, say, twice the rate of adoption that we are projecting, the obvious concern on the part of investors and the management team would be that P&L expenses would run away from us and we would badly miss our guidance. And we've been mindful of that in our negotiations with studios for content deals and I don't anticipate that happening.

Deborah Crawford ***Netflix - VP of IR***

From Lloyd Walmsley at Thomas Weisel Partners.

Lloyd Walmsley ***Thomas Weisel Partners - Analyst***

Your competitors have been paying about 50% rev share splits in physical rentals. What are you seeing from studios in terms of increasing splits in rev share? How often are rev share terms negotiated with studios? If you have been seeing increasing rev share costs, how has this impacted gross margins? If not, how might this going forward if pricing were to increase for you in rev share?

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

We haven't seen any material change in the rev share climate for our purchasing so we're continuing to build our library and our relationships with studios. So no material change there.

Barry McCarthy ***Netflix - CFO***

This is Barry. As compared with the brick and mortar world, we have a much higher percentage of content that's purchased outright than rev share, because we have the luxury from a free cash flow perspective of being able to acquire the content outright. So we're -- if that phenomenon were to emerge in our world, then probably it would have less of an impact on P&L than it would be if we had a very high percentage of content acquired on rev share.

Deborah Crawford ***Netflix - VP of IR***

I believe this is our final question. If anybody has additional questions please e-mail them to dcrawford@netflix.com. The question I have is from Daniel Leonard.

Daniel Leonard ***First Analysis Securities - Analyst***

Can you speak further on share buyback program and when you can initiate purchases again?

Barry McCarthy ***Netflix - CFO***

Well, we can initiate purchases when the window opens. The window will open on Monday absent a particular transaction that would require the Company for legal reasons to, because it possesses material non-public information, to not participate in the market and, if we were to possess that information, of course I wouldn't comment on it. But I expect that the window will open Monday.

Barton Crockett ***JPMorgan - Analyst***

Another question from Barton Crockett at JP Morgan. Blockbuster is showing a beta version of new download service Movie Link. Can you talk about how that compares to your service?

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

Barton, I haven't used the new Blockbuster service. So I'm just going by the press reports and from being a customer of Movie Link and Movie Link is a pay-per-view model, so it competes with Amazon or Apple in that segment. So I imagine they've done a good job. Movie Link had been well-implemented before. So we look at it and say it's another pay-per-view service and that's fine. It's just not in our segment.

Deborah Crawford ***Netflix - VP of IR***

Final question from Ryan Hunter.

Ryan Hunter ***- Analyst***

You mentioned DVD kiosks having a competitive impact on DVD stores. How do you see this model impacting Netflix?

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

Ryan, something that we've looked at extensively, using the areas of the country that have high kiosk penetrations, would be where and how it affects Netflix and we haven't yet been able to detect any change in those areas. So we're relatively comfortable that as kiosks grow, it doesn't present a direct threat to our business. We'll continue to watch that. It's still early in the DVD rental kiosk market, but obviously the secondary benefit will come later which is with accelerated store closures which will help us.

Deborah Crawford ***Netflix - VP of IR***

I believe that's the last question. Thank you everybody.

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

With that, let me thank everyone for joining us for this early morning call and look forward to talking to you all next quarter.

THOMSON REUTERS

PLACEHOLDER TRANSCRIPT

Q3 2008 Netflix Earnings Conference Call

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CORPORATE PARTICIPANTS

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Reed Hastings *Netflix - President and CEO*
Barry McCarthy *Netflix - CFO and PAO*

CONFERENCE CALL PARTICIPANTS

Mark Mahaney *Citi - Analyst*
Brian Pitz *Banc of America Securities - Analyst*
Youssef Squali *Jefferies & Company - Analyst*
Barton Crockett *JPMorgan Chase & Co. - Analyst*

PRESENTATION

Operator

Good day, everyone, and welcome to the Netflix Third Quarter 2008 Earnings Conference Call. Today's call is being recorded. At this time, for opening remarks and introductions, I would like to turn the call over to Deborah Crawford, Vice President of Investor Relations. Please go ahead, Ma'am.

Deborah Crawford ***Netflix - VP of Investor Relations***

Thank you and good afternoon. Welcome to Netflix's third quarter 2008 earnings call. Before turning the call over to Reed Hastings, the Company's co-founder and CEO, I will 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 10-K filed with the Commission on February 28, 2008.

We released earnings for the third quarter at approximately 1:05 PM Pacific time. The earnings release, which include the 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 5 PM Pacific time today.

Finally, as we noted in the press release we issued earlier today, we are going to conduct the question portion of the Q&A via e-mail. Please e-mail your questions to me at dcrawford -- D-C-R-A-W-F-O-R-D -- @netflix -- N-E-T-F-L-I-X -- .com. And now I would like to turn the call over to Reed.

Reed Hastings ***Netflix - President and CEO***

Thanks, Deborah, and welcome, everyone. I'll talk briefly about Q3 and then turn to what I imagine is on everyone's mind -- namely, how the recession will affect Netflix.

In Q3, we added 261,000 net subscribers, down 9% on a year-over-year basis, while our total subscriber base grew to us 8.7 million, up 23% from a year ago. Our EPS was strong at $0.33, up 43% from $0.23 one year ago.

We continue to improve the Netflix service by adding more content that can be watched instantly on PCs and TVs. We are now up to more than 12,000 choices and with the recent addition of content from Starz, CBS and Disney Channel have increased the strength of our offering materially.

In Q3, we were very happy with a sales momentum of the $99 Roku device, which provides an inexpensive method for instantly streaming movies and TV episodes from Netflix to the television. Additionally, in early October LG Electronics released the BD300 -- the first Blu-ray player to include instant streaming from Netflix.

Part of our long-term strategy is to get our streaming client embedded in as many Blu-ray players as possible. LG Electronics was our first such partner. And we will announce more Blu-ray partnerships as they are ready for consumers.

In addition to getting embedded in Blu-ray players, our partnership with Microsoft Xbox will help us gain more traction with consumers. Next month, Microsoft will release a free software upgrade for all Xbox 360 users that includes instant streaming from Netflix.

Xbox 360 owners will have to connect their console to the Internet and join the $50 per year Xbox Live Gold in order to access Netflix streaming. We will know more about its successes and potential a few quarters after it launches.

While our initiatives to deliver content to the TV are gaining real momentum, consumer comfort with watching video on a laptop is also growing. So we are continuing to invest in improving laptop-oriented streaming from Netflix.

This quarter, we will begin the rollout of our second generation player software which runs both -- which runs on both Windows and Intel Macs. It is a huge step forward for online video players; and we will be announcing the details shortly.

Two of the most significant events in the quarter were our deal to distribute the Starz play content and Starz's separate decision to close Vongo. Starz is a very successful subscription content wholesaler, who had been operating a direct-to-consumer extension called Vongo.

Until recently, it looked like we might -- in a streaming world -- end up competing with the pay television networks going direct-to-consumer. Since they have the major studios new release content locked up on long-term exclusive deals, this would have led to a very fragmented set of consumer options and slowed the adoption of Internet delivery. So this pivot, where Starz distributes hits Starz play service through Netflix, is very significant.

Our value ad is in our Website, in our on-demand streaming model and in our linking with DVD rental. With this new model, we think we can generate increased profits for Starz, increased profits for Netflix and, over time, for the studios.

Now, on to the impact of the recession on our business. A quarter ago in July, I told you that we appear to be substantially unaffected by the been economic climate.

Since July however, the economy has deteriorated markedly. It now appears that the recession means continued subscriber growth for Netflix, but not as fast as last year. This quarter to date, our net ads are positive. In other words, we are growing but our net and so far this quarter are about 30% less than one year ago.

For reference, our Q4 subscriber guidance is for our net ads for the fourth quarter to be between 60% below last year net ads on the low-end to 6% above last year's net ads on the high-end. The good news is that our earnings in Q4 will come largely from existing subscribers and not from new subscriber growth. So Q4 earnings are substantially insulated from the current climate.

This is the real power of the subscription model. If there is any effect from slower growth now, it would be more likely to boost Q4 earnings than to shrink them. A small contributor to earnings in Q4 will be our $1.00 per month surcharge for those subscribers who have elected to enable access to the more expensive Blu-ray high-definition content.

We expect to have about 0.5 million Blu-ray enabled subs during this quarter. And this number will grow over time as Blu-ray player prices fall from $500 to $300 and below.

In summary, we are in the midst of challenging times that have shaken consumer confidence across the country. But the fact is that people continue to be attracted to the Netflix service and our business continues to grow, in both subscribers and earnings.

While the economic environment is out of our control and volatile, what is in our control is executing on our strategy, delivering great service with DVDs and instant streaming, and remaining flexible in a fluid environment.

At this point, I'll pass it over to Barry.

Barry McCarthy ***Netflix - CFO and PAO***

Good afternoon and thank you for joining today's call. Two weeks ago, we preannounced Q3 results in our Q4 guidance.

As you know from today's earnings release, Q3 results were in line with our preannouncement. Today's release also updated our subscriber and revenue guidance for Q4 which I will say more about in a moment.

As we discussed, sub growth slipped below our expectations in Q3. And that is disappointing news. The good news is that, in a difficult economic environment, which contributed to slower-than-expected subscriber growth, we managed to grow subscribers by 23% year-over-year. And Q3 financial results demonstrated that our business model is healthy and functioning well.

In Q3 we continue to effectively manage our cost structure and delivered healthy earnings as profit margins expanded 70 basis points on a year-over-year basis. Net income grew by 30% year-over-year to $20.4 million and EPS grew by 43% year-over-year to $0.33. This represents an acceleration of growth in both net income and EPS on a year-over-year and a sequential basis.

With free cash flow of $26.2 million in Q3, the second-highest quarter of free cash flow in our history, with $251 million in cash and short-term investments, and with a pristine balance sheet, the business is well positioned from a financial standpoint to continue to execute on core strategic objectives for growing the business. Reed summarized those objectives on our last earnings call when he said our goal at Netflix is to materially grow subscribers and EPS every year, while expanding the unlimited DVD by mail service to also include unlimited Internet streaming.

My remarks today will focus first on our Q3 performance. Second, I will comment on our Q4 guidance. And, lastly, I will update you on the progress of our stock buyback efforts last quarter.

Because Reed has already commented on subscriber growth, my comments will address the other key drivers of financial performance last quarter. With respect to Q3 results, gross margin was an important contributor to strong earnings.

On a Q over Q basis, gross margin increased by 240 basis points higher than we had initially expected. The primary contributor to margin growth was lower content costs, reflecting a seasonally weak near-release calendar. We saw that weakness play out in the mix of near release versus catalog shipments with catalog shipments reaching an all-time high as a percent of total shipments last quarter.

DVD usage was in line with our expectations last quarter. We have not and we are not seeing increased levels of DVD usage as consumers trend discretionary spending outside the home, in response to economic pressures.

Churn for the quarter was 4.2%, the same as it was in Q3 of last year and in Q2 of this year. While we are pleased the churn did not increase, we had expected the aging of our subscriber base to produce a slightly lower churn rate in Q3. The state of the economy may explain the modest headwind we have experienced with churn in Q3, and expect to experience in Q4, given the economic climate.

And now a word about SAC. Q3 saw the first increase in the last six quarters. That is the bad news.

The good news is that SAC declined [to] 15% on a year-over-year basis which means our economic model remains healthy. And we've maintained our financial discipline, as we continue to grow the subscriber base.

The primary reason for the increase in Q3 SAC was the decline in acquisition rates across all channels, including word-of-mouth. Once again, likely attributable in large part to the economy.

Earlier in my remarks, I commented on our strong balance sheet. And I want to spend a moment talking about the composition of last quarter's cash and short-term investments which totaled $251 million at quarter end, 62% of which was held in cash, commercial paper and US government and agency paper.

We have no exposure to the sub-prime workers market and limited exposure in the asset-backed market. Our portfolio is conservatively invested and appropriately guided. And notwithstanding the substantial disruption in credit markets, I think we're in pretty good shape.

Today's earnings release lowered our Q4 guidance for ending subscribers and revenue. As Reed mentioned in his remarks, like everyone else, we are concerned about the state of the economy; the impact on overall consumer spending; and the economy's impact on our growth rate.

However, on balance, we are generally optimistic about our relative growth prospects in the current economic environment, because Netflix offers consumers a great service and a good value. And we remain confident we can manage spending and meet our Q4 earnings goals like we did in Q3. By continued deterioration of the economy in general and consumer spending in particular could slow the rate of subscriber growth.

Finally I would like to update you on the status of our stock buyback program. In March of this year, we announced an additional share repurchase program of $150 million. This past quarter we repurchased three million shares at the average cost of $30.09 per share, which leaves $60 million available to buy back additional shares under the current authorization.

Our Q3 buyback raised our cumulative share repurchases to 11.6 million shares at the total cost of $290 million and an average cost of $25.06 per share.

In closing, we believe the fundamentals of our business model are sound. Our expense structure is appropriately sized to manage our planned growth as well as our strategic objectives, even in these uncertain times. We are fortunate that our business continues to generate strong free cash flow and that our balance sheet remains healthy.

That concludes my prepared remarks. Now it's time to answer your questions.

As Deborah mentioned at the beginning of our call, we would like you to e-mail your questions to dcrawford@netflix.com as you did last quarter. Deborah will read the questions out loud and Reed and I will do our best to answer to them.

So, Deborah, over to you for the first question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Mark Mahaney with Citi.

Mark Mahaney *Citi - Analyst*

A cost question. In a severe recessionary environment, subscription models should hold up well. But in a very limited growth scenario, severe recessionary, very limited growth scenario, how much leverage do you have over all the cost items?

In other words, with almost no record growth can you still deliver material earnings growth? Thank you.

Barry McCarthy *Netflix - CFO and PAO*

If we maintain our spending discipline at the subscriber level from acquisition standpoint, then we've got a fair amount of leverage. And I am highly confident. We've never lost that discipline, but if we did and we could -- a short thesis on the business has always been that marketing expenses would spiral out of control, and the margins on the business would implode.

So we use a macroeconomic model. It informs us about the lifetime value of the subscriber. We limit the amount of money we are willing to spend at the margins to acquire a subscriber with the knowledge of lifetime value, which is why I'm pretty confident that we will remain disciplined in terms of how much we are willing to spend at the margin to acquire a sub.

Mark Mahaney *Citi - Analyst*

Thank you Barry.

Barry McCarthy *Netflix - CFO and PAO*

So all of the other costs of business, essentially, we think of as variable. Although that is not entirely true. For instance, the depreciation expense on acquired DVDs is not exactly a variable expense.

But the postage and the packaging and the direct labeler all variable expenses associated with getting DVDs out the door. Then the other big expense item are heads.

So if you can control your marketing spending at the margin and you control your fixed costs around headcount, you pretty much have your arms around the business. Provided of course you continue to provide a good service, subscribers remain happy, and they stick with you.

Now since more than half of our subscriber base has been with us for more than a year, it would take an enormous shock to the consumer ecosystem for the majority of our subscriber base to blow up and leave the service. Not likely to happen.

Mark Mahaney *Citi - Analyst*

More shock than we have seen already?

Barry McCarthy *Netflix - CFO and PAO*

More shock than we have seen already.

Reed Hastings *Netflix - President and CEO*

Who's next? Anyone?

Operator

Brian Pitz with Banc Of America.

Brian Pitz *Banc of America Securities - Analyst*

Just a quick follow-up. Any additional color on the onetime charges this quarter? Thanks.

Barry McCarthy *Netflix - CFO and PAO*

I described them as onetime charges. And then I said you could count on seeing them on an ongoing basis and I'm sure I sounded like a fool. Least I felt like one.

The majority of the expense savings in G&A related to the decision to exit the Red Envelope business. That will be ongoing savings. There was a smaller onetime charge that was associated with Corporate Events that goes away. But the majority of the savings, I think, will be with us on a go forward basis.

Operator

Youssef Squali of Jefferies & Co.

Youssef Squali *Jefferies & Company - Analyst*

Thank you very much, great job. So as you conduct to these exit reviews with customers online, I was wondering if you noticed any pickup in people maybe leaving Netflix to go to the cheaper alternatives like the Red Boxes of the world?

I think historically you've talked about how I guess a year and a half ago or two years ago they [weren't] (inaudible) radar screen and the last six to 12 months they became more relevant. Where do they sit right now?

Reed Hastings ***Netflix - President and CEO***

The Red Box has increased in those exit surveys. But when we look at certain areas of the country have very high Red Box penetration. And when we try to see if we can see any increased churn in those areas relative to areas that don't yet have kiosks, we are unable to detect any change in the underlying retention.

So it seems to me that it's a substitute for the stores. That it's the same people were leaving, but they are going to go to the kiosk instead of a store as opposed to something that inflates our churn.

Youssef Squali ***Jefferies & Company - Analyst***

Okay. Thanks.

Operator

Barton Crockett with JPMorgan.

Barton Crockett ***JPMorgan Chase & Co. - Analyst***

Thanks for taking the question. I will try to clarify the one that I mangled in the email. What I was trying to get at is, with the $1.00 extra you are charging for the Blu-ray availability, you know it is basically charging people for something that they used to get as part of their standard subscription.

So what I'm trying to figure out is, in your view of it, does that extra $1.00 result in basically slowing subscriber growth, because people are having to pay more for something they used to get as part of the standard feature or increasing churn? Or does the opposite happen? Do you use that extra $1.00 charge to buy more product, make it a better service and improve subscriber growth and lower churn?

Barry McCarthy ***Netflix - CFO and PAO***

You imply that doing the $1.00 surcharge is like a takeaway or something to the subscriber base, but almost none of the subs had a Blu-ray player. So to them, they were never introduced to the feature.

The vast majority of our subscribers will only ever know Blu-ray as the $1.00 surcharge in this brief intro period that we had for the last nine months where it was too small to even figure out how to charge someone. You know, it will be inconsequential.

So I think when you look at local videos store, they tend to only charge a $1.00 more for the Blu-ray rentals. High-definition content table and otherwise and on the Internet cost more. So it will seem completely natural to the subscribers that the Blu-ray high-definition content has a small premium attached to it.

Barton Crockett ***JPMorgan Chase & Co. - Analyst***

That's helpful. And then a follow-up question, if I could.

What is going to be the gross margin impact of that higher price? Is it [going] to be offset with more spending on Blu-ray product or is it actually going to be something that boosts the gross margin?

Reed Hastings ***Netflix - President and CEO***

We kept our Blu-ray stock levels at pretty good shape for the last six months and we will continue to go on. I think it will be very slow as we get from 0.5 million to 1 million subscribers. It will ease in over time.

As to whether in the end it's positive or negative to current gross margin it's positive or negative to DVD economics is uncertain. It depends on the pricing of DVD movies compared to Blu-ray movies. And we are unsure if the current Blu-ray pricing, which is a considerable premium, will sustain as that becomes a mass product. You'll probably recall from DVD in its entry 10 years ago that it started off premium priced and then came down.

So it's a bit of an open question on what's going to happen with Blu-ray software.

Barton Crockett *JPMorgan Chase & Co. - Analyst*

That's great. Thanks a lot.

Operator

There are no further questions at this time.

Reed Hastings *Netflix - President and CEO*

Great. Well, thank you, everyone, for joining us on the call and I look forward to talking to you, with you again in a quarter.

Operator

That does conclude today's conference. We do thank you for your participation. You may disconnect at this time.

QUESTIONS AND ANSWERS

Deborah Crawford *Netflix - VP of Investor Relations*

The first question comes from Colin Sebastian at Lazard Capital Markets. Can you please comment on pricing trends in your online marketing spend [so] it's on search and display ads?

Reed Hastings *Netflix - President and CEO*

We haven't seen any material softening of those rates, such that it would improve our efficiency where we are watching the trends and hopeful of that from our sake as the buyer of such. But nothing is broken yet.

Deborah Crawford *Netflix - VP of Investor Relations*

The next set of questions comes from Youssef Squali of Jefferies.

First -- can you speak to usage during the quarter? Is there a way to parse that lower usage from the Olympics/blackout in August versus the effective lower-priced plan?

Reed Hastings *Netflix - President and CEO*

Short answer is no, not really.

Deborah Crawford *Netflix - VP of Investor Relations*

Second question -- as we looked at fiscal year '09 knowing what we know today about the economy and and the consumer, do you expect the year to be better or worse than '08 in terms of customer add?

Reed Hastings *Netflix - President and CEO*

That depends quite a bit on the economy. So, normally, we expect a relatively similar economy to what we currently have. And I think for obvious reasons it's not healthy at this point so we will be able to update you on '09 in January.

Deborah Crawford *Netflix - VP of Investor Relations*

Next from Brian Pitz at Banc Of America Securities.

We have seen a sharp drop-off in the retail sector in late August and September even impacting other online names such as eBay. We were hoping you would comment on subscriber adoption trends in September/October versus July/August, particularly since you have lowered [sub] guidance in the past two weeks. We see that October is much worse than previous expectations.

Reed Hastings ***Netflix - President and CEO***

In my comments -- probably the question was sent in before the comments, for the first time we broke out what we've done in the first part of October. So for the first three weeks of October we're trending approximately 30% below a year ago in terms of growth, in terms of net additions. So our growth is positive and it's 70% as big as one year ago October.

Deborah Crawford ***Netflix - VP of Investor Relations***

Next also from Brian Pitz at Banc Of America Securities.

Will the Starz (inaudible) significantly higher costs than your existing online content? In part because the titles appear to be new releases and less "longtail". Can you tell us anything about this idea or perhaps if the model is a rev share versus fixed fee versus something else?

Reed Hastings ***Netflix - President and CEO***

We don't break out details of the contract, but all of the costs of it are built into our guidance for the quarter.

Deborah Crawford ***Netflix - VP of Investor Relations***

Michael Olson at Piper Jaffray -- why was G&A so low? Is that sustainable?

Reed Hastings ***Netflix - President and CEO***

Michael, there are a number of onetime events in the quarter. The largest of which was our decision to exit Red Envelope business and those reduced our -- on an ongoing basis and spending levels in Q&A.

Deborah Crawford ***Netflix - VP of Investor Relations***

Also from Michael Olson -- what is the percentage of customers using Watch Instantly? Have you seen a drop-off in DVDs by mail for those customers?

Barry McCarthy ***Netflix - CFO and PAO***

We've seen a growing adoption of the Watch Instantly as we've got more platforms and more contact and expect that to continue. You can't really see a drop-off in DVD usage, because the people who go for online streaming are a different type of person.

So there's no good control of what those people would have done. So there's no easy way to tell that. What we are feeling good about is with the new Starz content, the breadth of what we have from Disney Channel is we are getting more and more watching which is exactly what we're aiming for.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Jim Friedland at Cowen, what drove the sequential increase in SAC? Was it related to the macroenvironment?

Reed Hastings ***Netflix - President and CEO***

As I said in my comments, there were two effects in the quarter and one is that response rates were down. And secondly we saw less by way of word-of-mouth growth than we thought we would. So the mix of free versus pay was lower than we thought it would be in the quarter, which contributed on average to higher SAC.

Deborah Crawford ***Netflix - VP of Investor Relations***

Also from Jim Friedland, DVD purchases are down 2% year-over-year for the first nine months of the year. Are subscribers watching less content due to the aging based our is the mix shifting to revshare?

Barry McCarthy ***Netflix - CFO and PAO***

That varies quarter to quarter, and because the revshare mix is fluid as -- both as studios which in or out of revshare or as studios with revshare have a hot hand. You really can't get a read by just looking at the -- essentially the CapEx on it. So overall I would say it is pretty steady, which would be our spending.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Barton Crockett at JPMorgan, regarding the Blu-ray price hike, the idea of percent uptake price hike offset by more products purchases. Does it help ARPU potential for offset and lower subscriber growth and higher trends from price sensitivity? Or the opposite -- lower churn, better subscriber growth because of more product?

Barry McCarthy ***Netflix - CFO and PAO***

Could you summarize that, Deborah? I think the question is, what's the overall impact from Blu-ray adoption? And the answer is, remains to be seen. There's still a relatively small percentage of the subscriber base signed up for Blu-rays. Reed mentioned them in his remarks and we think it would be still relatively small come year-end.

Deborah Crawford ***Netflix - VP of Investor Relations***

Well okay.

Barry McCarthy ***Netflix - CFO and PAO***

Deborah's going to clarify.

Deborah Crawford ***Netflix - VP of Investor Relations***

Barton, if you have a clarification, would you please e-mailed to me and then I'll get to it. Let's go on to the next one also from Barton Crockett. What was the gross margin impact of the $6.5 million service credit? Did usage go down? Is it sustainable?

Barry McCarthy ***Netflix - CFO and PAO***

Usage did go down because, during the shipping interruption, we didn't ship DVDs. We have a rough estimate of what the impact on profit is, but it's hard to know.

So I don't consider it to be a contributor to higher gross profit in the quarter. Probably the opposite, but it's just -- it would be an -- it's an estimate [on my part].

Deborah Crawford ***Netflix - VP of Investor Relations***

From Michael Pachter at Wedbush, could you please explain the new pricing plan for Blu-ray access with a simple answer? Is the price increase going to be implemented for all subscribers, requiring those who prefer to pass on the Blu-ray opportunity to opt out? There is some confusion as to whether the pricing is opt in.

In other words subscribers who choose Blu-ray will be charged, but those who did not affirmatively choose Blu-ray will be not charged or opt out as described above?

Reed Hastings ***Netflix - President and CEO***

It's opt in. So if you want Blu-ray, you go through an additional sign up as a member saying I would like Blu-ray and we say it's an extra $1.00 and you say yes or no.

The only case where it was opt out, which is what generated the confusion, was Blu-ray used to be a free option. And of those who had prior signed up for Blu-ray, they have an opt out of the Blu-ray status if they don't want the charge. And that is what generated the confusion.

But for the general subscriber, going forward 8.6 million, it's opt in.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Andy Hargreaves of Pacific Crest, was there a limit or what was the linearity of churn? Did more people leave late in the quarter?

Reed Hastings ***Netflix - President and CEO***

No material change from -- there's normal seasonal patterns that we see. But there was no significant pattern, for example, related to the economy that we saw during the quarter.

Deborah Crawford ***Netflix - VP of Investor Relations***

And a similar question, also from Andy Hargreaves, the linearity of gross additions. Was it front-end loaded or consistent?

Reed Hastings ***Netflix - President and CEO***

As we announced in our prerelease of the numbers, in August -- presumably due to the Olympics and to our shipping outage -- net additions were light which is mostly steady churn. So it's really lights in gross additions.

We think from the distraction of the Olympics and then September was relatively more strong. So it doesn't tie into the overall retail thesis of things getting worse and worse. And I think the Olympics was a special effect for us in terms of consuming viewing hours, thus obscuring the underlying economy.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Doug (inaudible) at Barclays Capital, you've typically said you grow earnings in the middle of the pack of Internet companies. But given the macro environment and even exchange, that tax growth rate will seemingly come down over the next 12 to 18 months.

Is it reasonable to think you are still in the middle of backpack in 2009 or do you think you can outperform?

Barry McCarthy ***Netflix - CFO and PAO***

Hard to know. As Reed pointed out in his comments, the nature of the subscription business is that it's positioned well, to weather the store of an economic downturn as compared with revenue stream that's essentially non-recurring.

So we have a lot of optimism about our ability to sustain near-term profits. And it's hard to imagine that there would be a significant sharp downward departure from the overall trend line in earnings growth and that remains to be seen what happens to new subscriber growth on a go forward in reaction to the economic environment. But as I said in my comments, overall, we are pretty optimistic.

So we will provide guidance for '09 on a January call. I haven't specifically answered your question, but I'm trying to indicate at least of our frame of mind as we are thinking about prospects for '09.

Deborah Crawford ***Netflix - VP of Investor Relations***

Also from Doug at Barclays, what are you optimizing more for in tough environments between subscriber growth and earnings growth? Same balance as before? And what does that mean for subscriber acquisition costs going forward. You've spent more this quarter, but you've generally pulled back.

Reed Hastings ***Netflix - President and CEO***

I would say our balance between earnings growth and subscriber revenue growth and our thinking on that has not changed materially. If the economy changes materially over the next couple quarters, it might have to be something we would look at.

But assuming that it's no worse than today than, as Barry said, the power of the subscription model then that gives us stability through these otherwise turbulent areas.

Deborah Crawford ***Netflix - VP of Investor Relations***

From [Mark McHaney] at Citigroup, how can Netflix be confident that soft subscriber additions are due to economy and not due to alternative or competition or maturation of the market? Do you have any customer surveys to prove this point?

Reed Hastings ***Netflix - President and CEO***

I'm not sure a customer survey would really prove it to you, surveys being as general as they can. It's definitely something that we think about which is, is it really economy or is it something else? We try to really tease apart the various competitive alternative hypotheses. And at this point it strongly points towards economy from a range of sources, but it is something that we keep an open mind about.

Barry McCarthy ***Netflix - CFO and PAO***

I wonder (inaudible) perspective. You know there's this saying goes something like this -- what you see is a function of where you sit. And where we sit right now, having underperformed the low end of our guidance expectations for the quarter and lowered our expectations for Q4, it looks like the business is dramatically slowing. It feels like we are underperforming.

On the other hand if we were to step back to say, January of 2008 when our year-end subscriber guidance was 8.4 million to 8.9 million, we realize that, gee, at the end of the third quarter of the year we had more subscribers than we were expecting to have at year-end. And in January of this year we weren't taking questions about whether or not the market would saturate it.

So on a what you see is kind of a function of where you sit, I realize that it feels like the economy is slowing, slowing, slowing; and it raises some concerns about future growth prospects for the business. But as little as nine months ago, been ecstatic about finishing the third quarter with more subs than we were forecasting to finish the year with.

So let's don't push the panic button. Have a little perspective on where we are. Overall the business is doing pretty well.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Larry Witt at Morningstar, if Starz is free to distribute the content they buy from studios in any form they want, when does the studios prefer to deal with Netflix directly?

Reed Hastings ***Netflix - President and CEO***

You know, Starz -- we are not privy to what their contracts are with the studios. And the studios would prefer to get a lot of money for their content. If Starz pays them a lot of money, for -- for example -- Internet distribution rights, there's no inherent reason why the studios want to deal with us.

So in the current deal, Starz has those rights. They paid for those rights. And it makes sense all around to build that market.

We, in addition to the Starz deal, have lots of other content in the Starz deal. It's about 2500 titles in total. And we have over 10,000 other titles that are direct with the studios.

So we are flexible. And we will work in both ways.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Ingrassia at Roth, what indications do you have, if any, that mainstream consumers are willing to pay a premium for the streaming option or for Blu-ray?

Reed Hastings ***Netflix - President and CEO***

On Blu-ray, we are charging a premium and we expect to have about 0.5 million subscribers of the 8.6 million. So we have that indication.

In streaming we don't have any hard indication yet, because we don't have a surcharge on it. Generally, people are willing to pay for what they're active users of and don't want to pay for what they're not using. So the focus for now in the first stage of this is getting the usage up, which is really driven by the content expansion and the platform expansion.

If we are successful on those as we have been in expanding from 2000 titles a year and a half ago to 8,000 to 12,000 titles now to continuing our platform expansion, then I think we are really creating consumer value, which will be able to be monetized.

Deborah Crawford ***Netflix - VP of Investor Relations***

Also from Rich, what happened to the deferred tax asset? Why did this line more than double sequentially?

Reed Hastings ***Netflix - President and CEO***

I will have to take that off line. I will get back to you. If it's off the top of my head, I'm not sure.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Dan Ernst at Hudson Square, Blu-ray. Any reduction in Blu-ray usage after the price cut? What did your outlook for Blu-ray titles selection currently rather spend less than 1000 titles?

Reed Hastings ***Netflix - President and CEO***

While Blu-ray is [sitting] on a total titles count, on a weighted basis it is pretty strong because there's Blu-ray for all of the new releases at this point. So you know we are optimistic player prices are falling, they are starting to get some volume.

It's the same cycle that we really have seen on DVD. And I think what we will see is like a progressive scan, was a feature that was only in high-end DVD players and then became a feature in low-end DVD players. And after that was upscaling with H DMI out. That was a feature on high-end DVD players and then migrated to the middle of the market and into the basic models.

To think of Blu-ray partially as a player is just a new better, upscaling player and as prices come down, people who even are just DVD watchers are going to get a Blu-ray player because the prices are low and it upscales the DVD very nicely. So we are really pretty optimistic as prices come down on Blu-ray players replacing DVD players.

Deborah Crawford ***Netflix - VP of Investor Relations***

Also from Dan Ernst -- digital content acquisition. Title selection numbers moving up, but still there are very few of the Netflix 100 as a point of reference that have the digital options. What is the outlook for adding more popular titles and what are the key obstacles to adding more titles?

Reed Hastings ***Netflix - President and CEO***

The key obstacles are really money. The titles are available but expensive. And what we have to do is grow the ecosystem of embedded players that connect to the TV so that we can monetize the content expenses.

So what we see is we have steady increase in the number of players and devices. They can access the Netflix content, steadily increasing adoption on the laptop viewing and on both Intel Mac and the PC.

And along with that, we will growth the title count. As I mentioned earlier, in the last 18 months we've grown it from 2,000 titles to over 12,000. So we know there's a long way to go. It's going to take many years. But we think we are doing -- making great progress on that and we will continue to do so.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Barton Crockett at JPMorgan, how much cash do you believe you need to maintain on the balance sheet to be comfortable in this economic environment?

Barry McCarthy ***Netflix - CFO and PAO***

Well we have a point of view about that. And I think we will keep it to our sales in order to have maximum amount of flexibility.

Reed Hastings ***Netflix - President and CEO***

And we've been cash flow positive every year for the past six or seven years, including during our big battles with Blockbusters. So -- .

Reed Hastings ***Netflix - President and CEO***

As long as we have been public.

Barry McCarthy ***Netflix - CFO and PAO***

As long as we've been public. So consuming cash is quite unlikely.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Lloyd Walmsley at Thomas Weisel Partners, can you please discuss trends and content acquisition with regard to both digital and [physical] content? Specifically your DVD CapEx growth of 5% this quarter is much lower than ending subscriber growth of 23%.

Is the shift you mentioned to more catalog shipments sustainable going forward or more of a quarterly specific trend? As we look to 2009, if we expect a digital product to draw strong subscriber growth and digital content consumption in 2009, should we assume that there is some pressure on growth margin offsetting the revenue gains of subscriber growth?

Barry McCarthy ***Netflix - CFO and PAO***

I think there are two -- I heard two of what I think are two questions. So correct me as I go. One relates to content purchasing which we had already addressed and then the mix between and the implications of revshare for CapEx.

And as Reed pointed out, it changes from time to time depending on which of our studio partners has a hot hand. And at the moment we have a large studio partners and revshare deals just got a hot hand.

And then I think the second part of the question relates to DVD spend -- I'm sorry, ED spending, whether or not increased spending on ED over time will create [large end] growth margin pressure on the business. And the answer is in two parts.

One, as Reed had said previously, we are in investment mode in ED world from a content perspective into 2010. And, secondly, at some point investments we are making in improving our (inaudible) service, we expect to earn the return on, either in the form of lower return or lower SAC because of higher organic growth or both or none of the above. In a failure scenario -- obviously we are planning for success.

So we will talk more about a margin impact on '09 in January when we give '09 guidance. But suffice it to say at least with respect to say the Starz content and the dramatic growth in the library during this calendar year, we had baked those increases into our guidance for the current calendar year. And we've remained on plan from a spending and margin perspective.

Reed Hastings ***Netflix - President and CEO***

And one part of that question was, if record [I] catalog shipments in Q3 sustainable and the answer is partially yes. As our Website gets better at matching people with movies, that tends to shift people to catalog.

And substantially not in that it is seasonal, Q3 is the lightest season for new releases. Q4 and Q1 that we are going into are much heavier and this Q3, because of the Olympics, studios really avoided putting out a big new releases during that time period. So it was linked leaner in that and that is advantageous to us on catalog.

Barry McCarthy ***Netflix - CFO and PAO***

And the catalog mix this third quarter was the same as it was in third quarter a year ago.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Andy Hargreaves of Pacific Crest, are you concerned about the emerging conflicts between your service and CE devices and retailers who sell DVDs?

Reed Hastings ***Netflix - President and CEO***

Like retailers who sell DVDs like Best Buy, Wal-Mart -- not particularly. I think they know that the consumer has a lot of options on cable and over the Internet. And we are partnering with them to try to figure out how to sell more devices in a kind of a -- a win-win model, especially pushing Blu-ray.

So don't see a lot of conflicts coming on that path.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Ken Smith at [Munder], what is the Bay Area household penetration and the rest of the country household penetration?

Barry McCarthy ***Netflix - CFO and PAO***

The Bay Area penetration at the end of the third quarter was 18.8% up from 18.5% last quarter. So a 30 basis point improvement. The rest of the country finished at 7.4%, up from 7.2% in the second quarter. So for rest of country that was a 20 basis point increase, same as it was a year ago Q2 to Q3. And a year ago Q2 to Q3 we saw a 40 basis point increase versus a 30 basis point increase this year.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Youssef Squali of Jefferies, your year end subscriber guidance is now lower than what you gave out a couple of weeks ago. Is that an indication of a slower than expected October so far?

Reed Hastings ***Netflix - President and CEO***

Yes, a little bit.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Lloyd Walmsley at Thomas Weisel Partners, your cost of subscription revenue was down 4% Q over Q, while fulfillment expense was up 4%. Was there's something related to the usage added that increased the fulfillment cost on a onetime basis? Or is there something structural that will impact fulfillment expense going forward?

Reed Hastings ***Netflix - President and CEO***

There was no big structural change during the quarter. So if there's a little (inaudible) there, it might be the outage, but there is nothing structural going on.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Doug (inaudible) at Barclays capital, if the macroenvironment were to further deteriorate in 2009, would you [save] digital content spending versus what you're currently contemplating for the purpose of delivering EPS?

Reed Hastings ***Netflix - President and CEO***

That would definitely be on the table. It depends on what that climate looks like; what the revenue growth and earnings growth look like. But if we are in an extraordinary situation like that, then there are no sacred cows and we would look at each element.

Keeping subscribers and earnings growing has always been very important to us. You know we have had a great track record on a year-over-year basis, keeping that going, and we want to push through this recession with that record intact.

Deborah Crawford ***Netflix - VP of Investor Relations***

Also from Doug at Barclays, do you still anticipate one more digital device this year?

Reed Hastings ***Netflix - President and CEO***

Yes.

Deborah Crawford ***Netflix - VP of Investor Relations***

From Scott Devitt at Stifel Nicolaus, can you speak to the exclusivity of digital distribution agreements, specifically the Roku and Xbox distribution deals? Do partners have the ability to offer their distribution to other content providers? Would you ever have interest in controlling or owning this distribution?

Reed Hastings ***Netflix - President and CEO***

The terms generally are, Netflix is not exclusive so they can put other video services on those platforms. Xbox already has a very successful video on demand service under the Xbox Live Marketplace brand. And Roku has announced plans to open up a platform and to have their platform have multiple service providers, which will help with their sales and help addressable households for us.

So we are supportive of that. It's a pretty wide-open heterogeneous world and we are embracing that.

Deborah Crawford ***Netflix - VP of Investor Relations***

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

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Q4 2008 Netflix Earnings Conference Call

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Reed Hastings *Netflix - President, CEO, and Co-founder*
Barry McCarthy *Netflix - CFO and PAO*

CONFERENCE CALL PARTICIPANTS

Jim Friedland *Cowen and Company - Analyst*
Youssef Squali *Jefferies & Company - Analyst*
Mark Mahaney *Citi - Analyst*
Doug Anmuth *Barclays Capital - Analyst*
Heath Terry *FBR Capital Market - Analyst*
Charles Wolf *Needham & Company - Analyst*
Tony Wible *Janney Montgomery Scott - Analyst*
Andy Hargreaves *Pacific Crest Securities - Analyst*

PRESENTATION

Operator

Good day, everyone, and welcome to the Netflix fourth quarter 2008 earnings conference. As a reminder, today's call is being recorded.

For opening remarks and introductions, I would like to turn the conference over to Ms. 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 fourth quarter 2008 earnings call. Before turning the call over to Reed Hastings, the Company's Co-founder and CEO, I will 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 10-K, filed with the Commission on February 28, 2008.

We released earnings for the fourth quarter at approximately 1:05 PM 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 5 PM Pacific time today.

Finally, as we noted in the press release we issued earlier today, 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'd like to the call over to Reed.

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

Thanks, Deborah, and welcome everyone to the call. Our goal is to grow subscribers and earnings every year, while expanding into Internet-delivered video.

We made great progress against this goal in 2008. Despite the recession, we grew our subscriber base from 8.7 million to 9.4 million subscribers in Q4. As you can see from our Q1 guidance, we expect this strong growth to continue in the first quarter.

Paralleling our strong subscriber growth was strong earnings growth, with EPS at $0.38 for the quarter, up 65% from a year ago; at $1.32 for the full year, up 36% from 2007. The strength of our business allowed us to increase EPS at these rates while, at the same time, substantially increasing our investment levels in Internet-delivered video.

In hindsight, in Q4, we under-forecast our subscriber growth, primarily because we underestimated the positive impact of the introduction of the multifunction CE devices from LG Electronics, Samsung, Microsoft and TiVo that promote Netflix streaming.

The second smaller factor in our outperformance was better-than-expected responses to our marketing. The precise impact of the recession is unclear, but it's very clear that streaming is energizing our growth.

While our streaming excess is exciting and we will spend some time on that later on this call, we continue to invest in improving our DVD by mail experience. There is a lot of top and bottom line growth left in online DVD rental.

We expect our DVD and Blu-ray shipments to continue to grow in 2009 as they did in 2008, as we improve our service levels and this general e-commerce acceptance helps us growth despite flatness in the overall DVD and Blu-ray rental. We think our annual disk shipments will continue to grow every year for many years. And even in the highly penetrated San Francisco Bay area, our shipments are continuing to grow.

In terms of Blu-ray specifically, about 700,000 of our subscribers were renting Blu-ray from Netflix at the end of Q4 and adoption is growing nicely. If Blu-ray player prices continue to fall as expected, driven by next generation chip designs, then wide adoption becomes increasingly likely and with it extended life of disk-based viewing.

Our growing scale gives us many operational advantages. We are now up to nearly 60 distribution centers across America and can provide delivery to over 97% of our subscribers in about one business day.

This quarter, we will be attempting weekend shipping in parts of the country which will provide even faster service, both for those new subscribers who sign up over the weekend and for those subscribers returning movies at the end of the week.

The payoff of this relentless, operational focus is the competitive advantage of continuing high levels of customer satisfaction. We once again came in on top of [4C] results ranking of customer satisfaction for e-commerce, tied this time at number one with Amazon.

Our success in DVD by mail is driving our earnings growth as well as fueling our Internet delivery. We are working hard to ensure that our success in DVD by mail continues.

Turning to streaming, in Q4, we substantially increased our investment in streaming content. And we plan to substantially increase our spending on streaming content in 2009.

We have a basic plan at $4.99 per month that offers some streaming of some content and we have premium unlimited plans starting at $8.99. One of our content investments is to include Stars Play in all of our premium plans. Stars Play includes the major films of Sony and Disney.

Most of our streaming spend -- most of our streaming content spending however is directly with TV networks and studios. We now have over 12,000 movie and TV choices up from [2000, two] years ago and we plan to spend as much money as we can with the studios licensing as much content as we can. And we are already one of the studio's largest Internet revenue sources.

Our spending is limited away by what content is available at reasonable prices. And what we can afford in total, given our earnings goals.

Our existing subscribers are watching instantly in ever greater numbers. And in just the last month, millions of our subscribers got more value from their Netflix subscription by streaming.

The more subscribers watch online from Netflix, the more likely we think they are to remain subscribers and to watch slightly fewer DVDs in a month. Since we don't have a control group of random subscribers who are not enable for [instant] watching, we can tell you exactly how large these positive effects on churn and disk usage are, but we believe they exist.

Increased streaming content not only helps us with our current subs, but also helps us with CE partnerships. One of the main reasons LG

Electronics, Samsung, Microsoft, TIVO, and others want to offer Netflix streaming to their customers is instant access to compelling content with a promise of even more content to come.

This helps them differentiate their products against non-Netflix-ready devices and adds value to the customer. The LG Electronics and Samsung Blu-ray players in particular had a very high connect rate during the fourth quarter. That is, a high percentage of purchasers are subscribing to Netflix.

Xbox and TIVO had a lower percentage, but larger total numbers, due to their software update to their substantial install basis. While we don't pay or charge anything to have our software included in devices, we do pay our partners to generate new Netflix subscribers.

In other words, some of our marketing dollars are going to our CE partners to help create demand for new Netflix subscribers. And that is included in our subscriber acquisition cost. Nearly all the CE-generated subscribers also rent DVDs from Netflix, which really reinforces the importance of the DVD streaming combination subscription. For the long period, the DVD is relevant to consumers.

If our CE partners can make more money from promoting us than promoting other services because of our broader relevance then we will be able to maintain a preferred placement over time. We continue to gain new and deeper partnerships with CE manufacturers. At CES a few weeks ago, Samsung and LG announced the expansion of Netflix into a wider range of their Blu-ray models in 2009. And to have the Netflix application included directly in some of the LG broadband-connected televisions.

Similarly, we announced our first partnership with Visio to have the Netflix application included in their televisions. We are in discussions with nearly every major CE company and, one by one, we hope to be able to broadly cover the Blu-ray category and the Internet TV category over the next few years.

In terms of having our Netflix application included in additional video game consoles, we currently have an exclusive deal with Microsoft Xbox. We have been very busy expanding our CE device partnerships, but we also added support for Apple Computers and improved our PC-based player. We see the laptop as a significant long-term viewing platform, not as an intermediate step towards something else, and are investing accordingly and continuing to improve our laptop-based player.

Our first CE partner, Roku, recently announced that their devices -- including the installed base of Netflix players -- would be updated to include the Amazon pay-per-view service. We are fully in support of this and let me explain why.

There are three primary economic models for streaming. Add supported such as Hulu and You Tube, pay-per-view such as Amazon and Apple, and subscription such as Netflix. The downside of our CE partners adding the Amazon pay-per-view service is more competition for Netflix, but the competition is pretty indirect because most of the pay-per-view business is in big new releases that we don't offer on streaming subscription.

The upside is that Amazon will also be promoting the streaming CE devices, which provides us more households to stream our service to. Similarly, CE companies are adding the add supported services to their devices. The combination of all of these models will accelerate adoption of video streaming.

At some point, the ad supported companies or the pay-per-view company may decide to also provide subscription like Netflix. The Netflix competitive advantages are that we combine streaming with DVD rental, and that our large subscriber base helps us support more content, and that we are significantly subsidized streaming content for the next few years.

Our intent is to focus exclusively on our subscription model as it is large -- as it is a large enough opportunity for us and we are more likely to prevail by focusing on subscription. Consumers who subscribe to Netflix also go to movie theaters, buy DVDs, subscribe to cable, use pay-per-view services, watch YouTube and Hulu, and even read DVDs from local stores.

No firm or model owns an entertainment customer and we think there is room for us to create a large subscriber base while other firms also succeed with their model.

All in all, we are making solid progress in our online video efforts. We are still in investment mode for Internet delivery, but we can see how between the CE partner promotion and the possibly reduced disk usage, we should be able to keep increasing our content investment while, at the same time, growing earnings in accordance with our desires.

In terms of competition, the market for entertainment video remains intense. DVR-based television continues to grow. Free ad-supported Internet video services are growing. Kiosk-based $1.00 DVD rentals continue to grow. VOD from both cable and the Internet companies is growing, and video stores are only shrinking slowly.

Despite this intense marketplace activity, our consumer proposition is working well. And we continue to significantly expand our subscriber base.

I will close where I started. We had a strong fourth quarter capping off a solid year. We had good growth in our core DVD offering and growing momentum in our instant watching. We currently expect to hit 10 million subscribers this quarter, which is a wonderful, hugely symbolic milestone of which we are proud.

And now, I'll turn it over to Barry.

Barry McCarthy ***Netflix - CFO and PAO***

Good afternoon and thank you for joining today's call. Q4 performance will be the focus of my remarks. I'll also comment on our Q1 and full year 2009 guidance and update you on our stock buyback authorization and repurchase activity.

Sub growth, revenue, SAC, churn, gross margin, net income, EPS, free cash flow. All these metrics were better than we expected in Q4 especially free cash flow of $51 million, which was more free cash flow than we had produced in all of 2007 -- a new record.

I will provide more detail on the quarter in a moment, but first I want to acknowledge that our October forecast of slowing growth turned out to be wrong. As Reed indicated our CE partnerships and our expanding library of licensed content has a positive impact on our growth in Q4.

We have been heavily investing in Internet delivery for several years. And Q4 was the first time we saw the benefits in terms of significantly faster sub growth, lower SAC, more profit, and greater enterprise value.

So let's look at the drivers of Q4 performance in more detail. Subscriber growth accelerated during the quarter. And we finished 2008 up 26% on a year-over-year basis. It was our fourth consecutive quarter of 20 plus percent net sub growth -- remarkable, considering we cut marketing spending on a year-over-year basis by 8%.

The acceleration in sub growth was accompanied by near-record low SAC of $26.67. In addition to the multi platform growth I just talked about, near-record low SAC was driven by stronger growth across paid acquisition channels and word-of-mouth combined.

As the quarter unfolded, it became clear from the underlying performance of the business that we could drive faster growth with increased marketing spending of $8 million and still meet street expectations for Q4 earnings. This increased spending helped drive the performance on netting subscribers and we continue to see strong momentum in our business quarter to date.

Gross margin improved 140 basis points year-over-year to 35.2%, despite the 2008 postal rate increase and the growing expense of licensing Internet-delivered content. With great engineering talent, we continue to improve our Website's ability to merchandise longtail content, which was an important contributor to margin expansion.

The sequential improvement in margins of 100 basis points resulted from the expected seasonal decline in DVD usage in Q4. Two additional observations about gross margin.

One, we are seeing early signs of less DVD usage with some subscribers, who are also watching instantly as compared to subscribers who only receive DVDs. Time will tell whether the substitution effect is an attribute of early adopters were a mainstream behavior.

Over the long term, if this substitution effect becomes a mainstream behavior and other things being equal, Netflix profit margins would expand as postage and packaging expense is replaced by streaming expense. This margin expense would be offset somewhat by higher content cost, which would accelerate revenue growth for our studio partners, a win-win proposition for us and for them.

My second observation is that one of the primary determinants of gross margin for the foreseeable future will be the overall level of investment spending in online content. The level of spending will be paced by our success with streaming and our determination to continue to deliver strong earnings growth.

As I mentioned in my opening remarks, free cash flow of $51 million was remarkably strong and established a new high watermark for the business. The largest sequential growth drivers were a $19 million increase in deferred revenue from the sale of gift subscriptions, followed by a working capital increase of $11 million, and higher net income excluding non-cash items such as depreciation and amortization expense of $6 million, offset by a $15 million increase in content spending.

Some of these seasonal factors and timing differences, like the growth in deferred revenues in AP, will reverse themselves in Q1 which brings me to the subject of guidance. Our Q1 guidance reflects the strong momentum we see in the business today. The full year guidance assumes a continuing difficult economic climate. From our perspective, subscriber growth in the back half of the year is subject to greater uncertainty than in prior years, both because of the economic climate and because the increased complexity around Internet streaming. You have only to look at our forecasting miss in Q4 to see an example of this.

So while our full-year forecast of decelerating net sub growth represents our best and possibly somewhat conservative thinking, we acknowledge that the full year could be much better than we forecast like it was in Q4 or it could be somewhat worse.

Given the rapid growth in the popularity of our stream content as more and more Netflix subscribers are able to consume that content on their TVs, we expect the popularity of our $8.99 subscription plan to continue to grow and SAC to continue to remain below $30.

Our guidance assumes a $0.02 postal rate increase in May of this year. In the event postal rate increase by less than we forecast, we would likely reinvest some of the savings in growing the business faster. With or without this added investment, we will grow on a percentage basis our investment in the Internet delivery of movies and TV content significantly faster than the year-over-year percentage growth in revenue.

Over time, we expect this incremental investment to generate faster subscriber growth and potentially lower churn and lower disk usage, as well as more profit and more enterprise value.

As is customary in Q1, we expect to see a sequential decline in gross margin related to seasonal patterns of disk usage. By way of rebut a reminder, disk usage tends to pick up in Q1, down in Q2 and Q3, and Q4 is lower still. Gross margins tend to move inversely with disk usage.

At a high level, I would say our core financial objective for 2009 is to grow net income by at least 12%, even as we significantly increase our investment in Internet streaming. And if we began to outperform our net income forecast, our secondary objective is to reinvest some of the additional profit in even more spending on Internet streaming and/or subscriber acquisition expense to derive future profit growth.

And, finally, I would like to provide an update on our stock buyback program. During Q4, we repurchased $10 million or 499,000 shares at an average cost of $20. The balance of the unused authorization, about $50 million, expired on December 31st of last year. For the full year 2008, we purchased a total of 7.3 million shares, offset by stock option grants and ESP issuance of 1.1 million shares, for a net decrease in outstanding shares of 6.2 million.

Under previous authorizations, we have repurchased a total of 12.1 million shares at a total cost of $300 million, and an average cost of

$24.85, reducing our year-end fully diluted share count by 17%.

Today I am pleased to announce the Netflix Board has authorized a new share repurchase program for 2009. Based on the Board's authorization, we anticipate a repurchase program of up to $175 million. Future repurchases would be made in accordance with this authorization.

In closing and in summary, Q4 results were better than we expected -- actually much better -- and we continue to see strong momentum in the business today. We are excited by the early indications that our investment in the Internet delivery of movie and TV content is beginning to bear fruit; and we look forward to talking with you about the performance of the business again next quarter.

So now it is time to answer your questions and as a reminder we would like you to email your questions to Deb Crawford at dcrawford -- with a C -- @netflix.com as you did last quarter. Deb will read the questions out loud. Reed and I will do our best to answer them.

So, Deborah, over to you.

QUESTIONS AND ANSWERS

Operator

Once again if you would like to ask a question please email to dcrawford@netflix.com. Ms. Crawford, I will turn the conference back over to you with the first question.

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

Thank you. The first question is from Michael Olson at Piper. What can we expect for the trajectory of Watch Instantly content acquisition? First part of that question.

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

As Barry said, we are going to increase the spending faster than revenue growth. If you are looking for title count, we are trying not to get measured by that because sometimes a single set of big titles makes a bigger difference than 1,000 small titles.

So there's some correlation with title count and it will continue to rise, but what we want to do is have more and more relative content for our subscribers. And we have made good progress on that to date.

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

Second question also from Michael Olson -- the revenue and subscriber guidance in Q1 in 2009 is higher than we anticipated. But EPS guidance is essentially in line.

Can you talk about what expectations are offsetting higher revenue? Is it Watch Instantly or marketing spend?

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

Well, difficult for us to respond to changes in our forecast as compared with your expectations since, obviously, we are on slightly different pages. I'd remind you that as the business grows faster, we also incur marketing expenses associated with the growth in those subscribers and then over the life of those subscribers, we capture value in terms of lifetime profit and enterprise value.

So it may simply be a timing difference.

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

From Jim Friedland at Cowen. Are the cuts in G&A from the shutdown of Red Envelope and the recent downsizing of Watch Instantly customer service now behind the Company?

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

Red Envelope. Yes. We're not sure what the other --.

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

He said downsizing of Watch Instantly customer service.

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

I think that might be a reference to, we've had in our customer support group, people who had to debug low-level PC issues because our software had low-level PC bugs. We did a new release of our PC watching client which is substantially free of those errors.

And so we were able to release a number of those technical specialists to customer support. So I think that is what that's in reference to. Which is, there wasn't work for them to do that was technical in nature.

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

The next question is from Rich Ingrassia at Roth. Do you think you are still pulling the majority of your new subscribers from the pool of current or former Blockbuster members? If not, from where then?

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

I don't know that we've ever pulled the majority of our subscribers from current or past Blockbuster subscribers. I don't perceive a material change in our -- where subscribers come from. A lot of them, they are multiuse customers. They do pay-per-view, they buy, they rent, they are involved in media.

So there's no big shift there that we've perceived about where subscribers come from.

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

Doug Anmuth at Barclays Capital. Can you talk about the reclassification in the cash flows statement, etc., for streaming content?

Barry McCarthy ***Netflix - CFO and PAO***

Sure. I've gotten several questions about this. With the evolution of our acquisition of streaming content, we determined in consultation with our orders that the streaming content should be classified in accordance with FAS 63, which is new; and the portion of the streaming content that is expected to be amortized on a straight line basis over the next 12 months is classified in the current content library. The acquisition of streaming content is classified as operating activities in the cash flow, different from DVD. But there's no impact on the income statement or free cash flow.

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

Srinivas Anantha at Oppenheimer & Co. I know that the streaming service is currently complementary to the normal suspension service. But in the future do you plan to launch a dedicated streaming service?

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

There's definitely a possibility. There is nothing that prevents us from offering dedicated. Our view on it is, the bulk of the market is interested in the big new releases and in the subscription and we're able through the DVD combination to provide that.

So it is definitely a possibility for the future. But we don't think there's a big market there for dedicated streaming -- or streaming only, given the content availability situation, which is roughly 100,000 titles on DVD and about 12,000 on streaming.

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

The next question is from Colin Sebastian at Lazard. Do you have any plans to expand Internet delivery from streaming videos into the rental or purchase of digital download?

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

That's not an area as I went through my comments about pay-per-view and when whether pay-per-view or streaming or download, it's essentially the same thing. That is really about our brand. Our brand is really about a monthly entertainment subscription and that's what we're focused on. So we don't have any plans to be involved in those markets where Amazon, Apple, Blockbuster, a few others play.

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

Matthew Hart at VanKampen. Would you ever look to acquire Blockbuster's mail business?

Barry McCarthy ***Netflix - CFO and PAO***

Never say never, but I think those days were big two, three years ago and most people were focused on now is expanding in the streaming direction.

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

Second question also from Matthew Hart. What are some of the key technological hurdles preventing broader adoption of streaming?

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

I don't know if they are really broad technological hurdles but the broad hurdles are just having people get used to it. First stage is having people watch Internet video on their PC -- their laptop, from You Tube, from Hulu, from CNN, from Netflix. Second stage is through Internet-baked devices -- game consoles, Blu-ray, TV.

And then what you'll see is more and more content providers follow ABC, CBS, etc., and provide the streaming on the Web. So the ecosystem is building very nicely; Internet video is on a significant rise and that's bringing in advertisers, subscription, pay-per-view and all the content providers.

So I think we'll see very significant growth in online video over the next five years, and we intend to participate in that.

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

From Daniel Ernst at Hudson Square. While I realize it is a small base today, if you look at the base of streaming customers using one of the hardware solutions -- Roku, LG, Samsung, Xbox, TIVO -- what percentage of those subscribers are new to Netflix? In other words, can you give a sense of the subscriber contribution from those devices?

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

I'm going to hold off on providing any detail on that for competitive reasons.

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

Second question from Daniel Ernst. Despite an increase in subscribers and some new releases like Wall-E and Dark Knight, as well as a larger base of Blu-ray available films, your DVD library acquisition spend was down both sequentially and year over year. Can you discuss content acquisition spend trends?

Barry McCarthy ***Netflix - CFO and PAO***

Yes, the thing that's confusing there is the difference between rev share and purchase. So you are looking at the purchase (inaudible) the balance sheet.

And that only tells a percentage of the picture and then, some years depending on what rev share deals we have and how hot the studios are that we have the rev share deals with, you'll see that acquisition line move around. So it's not a very useful indicator for you.

We are continuing to invest and provide complete DVD availability and we have every Blu-ray that's out, too, from the major studios. We are very committed to that business and it's on par, I would say, with the last couple of years in terms of where the trends have been.

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

Tony Wible. Janney Montgomery Scott. Are you seeing or do you expect to see any benefit from reduced ad rates for online and/or television?

(Technical Difficulties)

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

Helps the rest of our marketing work and similarly the more that we spend on marketing, it reinforces all those things with our CE partners and gets people who want Netflix service then, to buy those devices. So they both reinforce each other in very positive ways.

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

Michael Olson, Piper Jaffray. I have a hard time thinking of a reason why a CE partner would not want you incorporate Watch instantly. Can you talk about any reasons why any potential CE partners have pushed back on Watch Instantly integration?

Also how many additional CE partners can we expect in the next couple of quarters?

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

That's a good insight that there is really no reason not to include the Netflix offering. So it has purely been technology which has, some chip platforms are more able to handle the streaming of DRM and some take a little longer in the porting activity.

Some companies perceive it as a high priority to get Netflix in and they will allocate the team early. Other companies haven't yet seen it as a high priority. But in all cases, it is not a negative. It is purely around the amount of work that it takes to get in; and the good news is we are getting better and better as we do more and more of these platforms of making it easier to put in.

So I think you can expect a broader range of partners over the year. But again, you don't quite want to think about it as -- or strictly not think about it as a number of partners. You want to think of it as kind of a percentage of devices that are sold.

That is, a few big partners make a bigger difference than a whole lot of smaller ones. So I think our efforts are focused in the right way.

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

Heath Terry at Friedman Billings Ramsey. Does the success of your streaming service renew your interest in expanding internationally? Is there an important first mover advantage that you would consider in evaluating that decision?

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

Only slightly does it renew the interest. You know we would be on the international doing streaming only there and I don't know if there is enough content and a large enough ecosystem to do that. In terms of first mover damage, I'm sure there are. We would love to be the first mover in those categories. I'm not 100% sure we will be.

But for now, we are focused on growing in this very large opportunity in the US and adding, spending more on content and continuing to grow earnings and subscribers in the US.

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

Derek Brown at Cantor Fitzgerald. You have mentioned in the past that we should measure, at least in part, your success in the digital realm by the number of Netflix-enabled devices in the market by year-end 2009. Could you provide us with the aggregate number of Netflix-enabled devices at year-end 2008 and a target for 2009?

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

We haven't released specific numbers on how many devices. I think what you've seen in our investments is that we -- our strategy is working. That is, we are getting in devices and it is manifesting itself positively in the P&L and the more that it manifests itself positively in the P&L, we will be able to ask you to judge us purely by the P&L which is easier for everyone than the indirect of how many partners.

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

Operator, that's about it. We would now like to open the call for a few final questions. Just in case anyone has an additional question, clarification or I missed your question. Thank you.

Operator

(Operator Instructions). Jim Friedland. Cowen and Company.

Jim Friedland ***Cowen and Company - Analyst***

Just a few housekeeping questions. One, San Francisco Bay Area, penetration in Q4; two is buyback -- is the buyback included in the guidance? And three, which would you be using for an effective tax rate in '09? Thanks.

Barry McCarthy ***Netflix - CFO and PAO***

Inverse order, 41%; no comment; and 19.4%, Bay Area penetration, 8.1% penetration; rest of country versus 18.8% in Q3 and 7.4, [respectably].

Jim Friedland ***Cowen and Company - Analyst***

Okay, great. Thanks.

Operator

Youssef Squali. Jefferies & Company.

Youssef Squali ***Jefferies & Company - Analyst***

Thank you very much. Barry, just a quick clarification. I think you said to -- your answer to a question that was those before that you have not seen any benefit from a lower ad rate in Q4.

I'm just trying to reconcile that. Anything or everything that we're hearing from ad players out there, online ad players is that at least on the CP inside and, particularly, on nonpremium inventory, where you guys seem to spend a lot of money, we've seen double-digit declines year on year.

And, given the fact that you are one of the top 20 online advertisers out there, how can you not see a benefit?

Barry McCarthy ***Netflix - CFO and PAO***

You know, I put the question to our Chief Marketing Officer in almost exactly the same tone. And she reminded me that we already buy at low rates in mostly in the remnant market. So what must be happening is that the trickle down effect hasn't yet hit the remnant space which is already incredibly discounted.

Youssef Squali ***Jefferies & Company - Analyst***

Okay to. Thanks.

Operator

Mark Mahaney with Citi.

Mark Mahaney ***Citi - Analyst***

Just a quick question on the free trial subs. I know it is a small number, it did seem to tick up a little bit outside of historical norms. Any read into that? Do you view that as significant at all?

Barry McCarthy ***Netflix - CFO and PAO***

That would be the strong momentum through the end of the quarter. The seasonal growth is very back-end loaded in Q4 and tends to be very front-end loaded at least historically in Q1. So if you are carrying faster growth into the end of the quarter than you have historically, you'd see a higher proportion of free trials.

Mark Mahaney ***Citi - Analyst***

Thank you Barry.

Operator

Doug Anmuth. Barclays.

Doug Anmuth ***Barclays Capital - Analyst***

Couple of questions. First one is just given the overall decline in DVD sales which we saw last year, is there any change to your overall, long-term view that your DVD by mail business peaks between 2013 and 2018? And then, secondly, you commented on the digital spend as being greater than the revenue growth, most likely in 2009.

How would you characterize the increase in digital spend '09 over '08 versus '08 over '07? Thanks.

Barry McCarthy ***Netflix - CFO and PAO***

We've done a good job of not commenting actually on how much we've been spending and people tell me you've done a pretty good job of estimating how much we spent. So we grew it a lot last year and we are going to grow it very fast in the upcoming year.

As we said in -- during our prepared remarks, as much as the P&L will afford us the opportunity to grow it constrained by our target growth in EPS in at least 12% and paced by the success we are seeing in the marketplace.

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

And then, you asked about DVD length. Nothing has changed our view that our shipments and rentals will continue to grow and peak some time in 2013 to 2018 as best we can tell.

Doug Anmuth ***Barclays Capital - Analyst***

If I could just follow up with one more. Barry, do you think that you are being equally conservative in your outlook for '09 as you have been in January of other years? Or is there it reasonable to think you are being even a little bit more conservative just given the overall macro environment?

Barry McCarthy ***Netflix - CFO and PAO***

I think we clearly are uncertain about what the second half of the year will bring. I would say. And on balance I think it would perhaps have tipped the scale slightly more towards conservatism than optimism because the cost of missing is enormous as compared with the upside of [beating].

And as the year progresses, we will have greater visibility into how it unfolds. I would like to remind everyone that most of the sub growth historically has come in Q2 and Q4, and with very little sub growth in Q2 and a slight acceleration in Q3. So we may not have a whole lot of visibility until late in about the second half of the year until late in the third quarter.

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

Of course, Barry meant they are Q1 and Q4 are the top growth. You said Q2 (multiple speakers).

Barry McCarthy ***Netflix - CFO and PAO***

Excuse me. Yes. Q1 and Q4 with not much in Q2 and a slight acceleration in Q3.

Operator

Heath Terry, FBR Capital Market.

Heath Terry ***FBR Capital Market - Analyst***

You mentioned that as you start to see a substitution effect there should be a net impact from the decline in packaging and shipping costs. Can you give us an idea if there is any impact one way or the other on the content front?

I guess, put more simply, is the revenue share agreement that you have for online different in any meaningful way from the cost of serving disks or the revenue share agreements that you have for your DVD business?

Barry McCarthy ***Netflix - CFO and PAO***

Your question presumes that content is purchased mostly like the -- rights are acquired mostly on a rev share basis in [ED], and there is a combination of fixed and variable just like there is in DVD.

And I would say that the license rights, the variable portion of the license rights, simply because of the nature of the rights that we are acquiring are uniquely different than they are in DVD.

Heath Terry ***FBR Capital Market - Analyst***

Okay. Thanks.

Operator

Charles Wolf. Needham & Company.

Charles Wolf ***Needham & Company - Analyst***

Do you think your business has actually been helped by the recession in the sense that people are not going to theatres as much and instead substituting Netflix for that experience?

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

There is no way for us to tell. We are very thankful that would done so well, but whether that is because of the recession or despite it, there's no strong evidence to either side.

Charles Wolf ***Needham & Company - Analyst***

Okay. Thank you.

Barry McCarthy ***Netflix - CFO and PAO***

I think your answer ran to grow subscriber additions which is the context in which Reed answered it. I think we probably share the view that in terms of the turn rate that we have seen it, we are seeing an uptick, a slight headwind related to the recession. So holding all other things constant, in the absence of a recession we would expect to see a lower churn rate and faster net sub growth.

Charles Wolf ***Needham & Company - Analyst***

Okay. Thanks Barry.

Operator

Tony Wible. Janney Montgomery.

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

Barry, a while ago you talked about this vintage churn concept and I was hoping you could just updates and let us know how that base pool of customers is churning, relatively speaking. And should we still anticipate that they grow to be a larger portion of the sub base for the overall churn to kind of trend down?

Barry McCarthy ***Netflix - CFO and PAO***

I think you are referring to the base of subscribers we spoke about at the analyst day that has been with us for at least 12 months. And I think they were at the time of the analyst day roughly 56% of the pay. And a larger percentage (inaudible) -- I don't know what it is. And I confess I haven't looked at the turn rate for the subscribers who have been with us 12 plus months, but I don't have any reason to think that it has changed in a significant way then.

It's been very stable for many years. And I imagine it is now as well.

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

Okay. Any update on the number of turns that you are seeing on each individual disk or any change in the breakage rates that you've seen in the most recent quarter or quarters?

Barry McCarthy ***Netflix - CFO and PAO***

No. I mentioned that seasonally we saw disk usage decline. I've seen some sellside speculation that with cocooning, usage rates would go up. I don't think there is any evidence that that is happening. So the quarter came in about as we expected. Did that answer your question?

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

And on the breakage side, are you seeing -- I guess that's what I was more looking at. Are you seeing any envelopes missing or just how long the disks are lasting?

Barry McCarthy ***Netflix - CFO and PAO***

No real change. I mean, we make a tiny bit of progress most quarters for the prior quarter. A lot of hard work, but there's no material -- nothing going on.

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

And Blu-ray versus standard -- I know a way back you were a little bit -- we didn't know how well Blu-ray's durability would hold up. It's been comparable to DVD?

Barry McCarthy ***Netflix - CFO and PAO***

It is much stronger than DVD when -- relative to its format introduction. So when DVD came out, we had a tough situation. And it took us a couple of years to get ahead of. We are much smarter now so we are farther down that curve than we were in DVD at this point in the life.

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

Great. Thank you.

Operator

Andy Hargreaves, Pacific Crest Securities.

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

Does the expectation for online content acquisition costs to go up quite a bit and (inaudible) any expectations for loosening rights on premium content?

Barry McCarthy ***Netflix - CFO and PAO***

No. We are not expecting any change in studio windowing or anything dramatic in that way.

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

So it's a volume issue, not price?

Barry McCarthy ***Netflix - CFO and PAO***

Yes. I mean, there is a lot of content out there from TV networks and some content from studios and it's just out. You know we are -- so there's plenty to buy as we give our buying group money. So it is really just how much can we afford to invest, given our desire to continue to grow total subscriber base, i.e., invest in marketing and grow our earnings.

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

And am I hearing you right? That, basically, the margin compression that's embedded into guidance is almost exclusively more content acquisition?

Barry McCarthy ***Netflix - CFO and PAO***

Well, there's a little bit of postal rate, but, yes, that would be other one.

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

Thank you.

Operator

That does conclude today's question and answer session. At this time I would like to turn the conference over to Mr. Reed Hastings for any additional or closing comments.

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

Thank you, everyone, for joining us this afternoon. To recap and close, the business performed very strongly in Q4 and it looks great quarter to date. We are really beginning to see the payoff from our investment in Internet-delivered video. And I look forward to updating you on our continued progress 90 days from now. Thank you very much.

Operator

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