Good day, everyone, and welcome to the Netflix Third Quarter 2011 Earnings Q&A session. Today's call is being recorded. At this time, for opening remarks and introductions, I would like to turn the call over to Ms. Ellie Mertz, VP of Finance and Investor Relations. Please go ahead.

Ellie Mertz

Thank you and good afternoon. Welcome to the Netflix Third Quarter 2011 Earnings Q&A session. I am joined here by Reed Hastings, CEO; and David Wells, CFO.

We announced our financial results for the third quarter at approximately 1:25 p.m, Pacific Time today. The shareholder letter and the Q3 financial results and the webcast of this Q&A session are all available at the company's Investor Relations website at ir.netflix.com. As is our standard practice, we will begin the call with questions received via e-mail. Please e-mail your questions to ir@netflix.com. In the time remaining after e-mail Q&A, we will also open up the lines to take live, follow-up questions. The dial-in number is within our investor letter, but let me repeat it now. Please call (760) 666-3613 if you would like to get in the call queue.

We may make forward-looking statements during this call regarding the company's future performance. Actual results may differ materially from these statements due to risks and uncertainties related to the business. A detailed discussion of such risks and uncertainties is contained in our filings with the Securities and Exchange Commission, including our annual report on Form 10-K filed with the commission on February 18, 2011. A rebroadcast of this Q&A session will be available at the Netflix website after 6 p.m. Pacific Time today.

Now let's move directly to questions. Similar to previous quarters, we have organized the questions by topic as we received them via e-mail this afternoon. We'll start with questions about the domestic business.

Question-and-Answer Session

Ellie Mertz

Given the sub losses in October, why are you so confident that November will be flat and December will have positive net adds for streaming? What does the churn look like week-to-week in October?

Reed Hastings

Now, what we've seen is a second wave of cancellations from the price increase. The first wave was in July upon announcement, and the second wave has been in September and October, as people become more aware of the price increase, and then either changed the plan or canceled. And that wave has been declining very steadily over the past couple of weeks. And so we have substantially less weekly cancels now than we did just 3 to 4 weeks ago. So that's what gives us confidence that it's -- this wave passing through.

Ellie Mertz

Why do you specifically believe your December month domestic net adds will be strongly positive? Do you plan a major marketing campaign to help make this happen?

Reed Hastings

Our marketing has been very successful for the last several years, and we don't plan on any substantial change to it. It's a great set of campaigns that work very well at attracting streaming subscribers. And in Q4, particularly in December, there's more focus on a set of devices, video game consoles that get sold, iPads that get sold, a wide range of devices. And so our expectations are modeled from prior year's performance.

Ellie Mertz

Why not reintroduce a combined streaming DVD plan offering at a discount for taking both?

Reed Hastings

Well, as we addressed in the letter, we think the future is brightest by focusing on streaming. We could, in principle, offer discounts for hybrid, but if we were going to use discounting dollars, we wouldn't want to trying to incent more DVD use and subsidizing DVDs, we'd want to be discounting streaming, and focus on getting even more market share. As it turns out, we think that $7.99 streaming is such a great price, that mostly we should focus on continuing to fill out the content. And so we're really quite comfortable in our growth with the 2 $7.99 programs.

Ellie Mertz

Do you mean to ramp spending to win back sentiment, to drive a virtuous cycle, even if it means lower margins for the next 12 to 18 months? Has your programming spend targets for 2012 changed due to the change in subscriber trends? If so, what type of content are you giving up?

Reed Hastings

Well, as we said in the letter, the focus for us is in building back our reputation and brand strength. But that's not through grand gestures, signing some crazy content deal or doing something else. It's the same set of steps that we've been using year after year for the past 10 years in terms of building our brand, which is a steady focus on execution, improving our service quarter-after-quarter. And in terms of our programming content, we do have built into our plan substantial increases in the content investment over this year and over the prior year. It's really exciting that we're able to fill out that content as we documented in its effect in our letter.

Ellie Mertz

Can you please provide apples-to-apples comparisons for your subscriber guidance? What does it imply on a unique subscriber basis? And how many hybrid subscribers are you assuming for Q4?

David Wells

This is David Wells, the CFO. So in terms of our subscriber guidance, what we said in the letter is we will be up slightly from the 23.8 million unique subscribers we needed Q3 with. So that tells you sort of where we are from a unique subscriber basis.

I will say that from a hybrid subscriber basis, we expect streaming only subscribers to grow substantially, DVD only subscribers to be up somewhat, and for those subscribers taking both services to be down. And I think all the pieces are there in the letter and the guidance.

Ellie Mertz

Would churn peak in Q4?

Reed Hastings

Really, we focus on net adds and growing the business. And we make it very easy for customers to exit or cancel Netflix and then come back. So we really don't focus on churn. We focus on total growth with the business or net additions.

David Wells

And I think if they were meaning to ask the question of, will the number of people leaving the service related to the price changes, peak end Q4, Reed’s already answered that question in terms of the weekly trends that we see, and retention rates.

Ellie Mertz

Can you provide more detail about around your domestic streaming contribution margins? 8% seems unusually low, given that you already have 21 million streaming subscribers, and should therefore have significant scale. Is there a subscriber level at which you believe your streaming contribution margin will meet or exceed your DVD contribution margin?

David Wells

I think in the long-run, the long-term margin structure for streaming will be ultimately determined by the competitive space, and how many competitors we have. In the short run, we've been aggressively adding streaming content at the same rate of subscriber growth, and we continue to anticipate investing in that in 2012. But we do have the confidence that we'll be able to grow in pace along with that rate of investment addition. So we think we'll be able to take up contribution margin at the same time.

Ellie Mertz

Related question. How will U.S. content cost double in 2012, and contribution margin be up 100 basis points over the quarter?

David Wells

I think I just answered that question, but we would anticipate that the growth of streaming subscribers to outpace the content addition.

Reed Hastings

Well, in the other part is that in Q4 of this year, we've taken the content cost way up. So it's not doubling the Q4 levels going forward, it's on a year-over-year basis.

Ellie Mertz

What is the impact of the overall bad publicity on your cost per addition in each of the streaming and DVD-by-mail categories? Is the adverse impact more so on the streaming side, or the DVD-by-mail segment?

I can take this one. As you saw in our investor letter, Q3 SAC of about $15.25 was actually comparable to the prior quarter. In Q2 we reported a very similar SAC of $15.09, and it was actually down this quarter about $0.24, 24% from a year ago. So to date, we haven't seen any of the negative publicity affect our subscriber acquisition cost.

Reed Hastings

I think what we would imply is that our SAC might be even lower had we not had a brand hit.

Ellie Mertz

So moving on to questions specifically about the DVD business. I understand the ripping of the Band-Aid off approach, excuse me. I understand the ripping the Band-Aid off approach you used with your pricing changes. But what possible rationale could one use to justify the idea of paying to develop and build an entirely separate brand like Qwikster?

Reed Hastings

Well, in hindsight, it is hard to justify. I will tell you that the brand properties of DVD and streaming are quite different. DVD is complete, but it's got the by-mail aspect, which is quite slow. Streaming is instant and the selection is less. And so having separate brands representing really the different audiences that care about those 2 services can, in theory, make sense. However, in practice, post the price increase, Qwikster became the symbol of Netflix not listening. And we quickly changed course on that, and we're going to stick with DVD as part of the Netflix brand. And going forward, we'll be very aggressive on promoting streaming Netflix and the benefits, and anyone who wants to also subscribe to DVD will be very welcome, but we're going to be pushing and promoting streaming.

Ellie Mertz

What are your assumptions for growth for the domestic DVD business? Are the DVD trends company specific? Or is there a larger industry trend or change in consumer behavior? I noticed that DVD margins are currently much higher than streaming. What are your long-term contribution margin targets for U.S. streaming, international streaming and DVD?

Reed Hastings

I think David answered part of that on the long-term margin. And DVD is partially high margin because of the U.S. First Sale Doctrine, where we can buy the DVD, pay for it once, and then rent it as long as we want. So it's an unusually -- it's an unusual situation limited to DVD.

And then in terms of DVD subscriber counts and base, this quarter, there's a big downdraft, as evidenced in our guidance, and then it will be a slow decline over the next well, many years, for DVD. And as we've said in the letter, we don't anticipate further investments and equipment and property brand equipment for DVD. So we think that we can manage that downward.

Ellie Mertz

So this is a similar, related question. Given that DVD-by-mail is a mature, someone called it buggy whipped, business category for renting recent films, do you anticipate a steady decline in that business? Or do you believe there is a stabilized level of subscribers that the business is likely to support? In other words, what is the minimum subscriber level required to sustain a reasonably profitable cash cow business in that segment? And how viable do you believe it is?

Reed Hastings

It will probably be something like AOL dial-up from 2002 through to today, where it’s a steady decline ever year a little bit, but there's a long-term residual market. And there's very little fixed cost in the business. So that's not a material cutoff of its efficiency, it's almost all variable cost. The postage, the labor, all of those aspects.

Ellie Mertz

Final question on the DVD business. Historically, Netflix DVD business was so successful because it could effectively monetize the back catalogue, with a rental mix of only 30% new release and 70% back catalog compared to Blockbuster at effectively 90% new release and 10% back catalogue. How has the streaming service affected this mix for hybrid customers? And how much impact on profitability is there as DVD rentals shift towards new releases?

Reed Hastings

There's been no substantial shift in the DVD mix over the last couple of years. And so DVD is still primarily a catalogue rental business, where people like the incredible depth and breadth of the catalog, over a 100,000 titles.

David Wells

And I would also add to that, that we've said before that Netflix is not the only service that our subscribers use to source their entertainment. And so to the extent that subscribers also use their local video store, Redbox and other services, they continue to do that.

Ellie Mertz

Let's move to questions about content. Have expensive content become more important? What is your bias in terms of paying either higher fees for pure exclusivity, or paying lower rights fees and letting something like Epix become non-exclusive?

Reed Hastings

Well, as we mentioned back, I think, in our April investor letter, the industry is mostly an exclusive licensing industry, and we'll end up doing more and more exclusive over time, and that has been witnessed in what we've seen to date. So we do expect to continue to expand exclusive licensing arrangements. And then on Epix specifically, I don't have a comment.

Ellie Mertz

Is original content the key to reenergizing gross additions?

Reed Hastings

Well gross additions are up over a year ago. And, of course, we always want them to be up even more. And original content may play a part in that over time. We've got some smaller, innovative, original content with Lillehammer, and some larger high-profile content next fall. And those are nice augmentations to the strategy. But the core of our strategy is to create a great customer experience with the content we have, using the personalization, the on-demand incredible streaming that we have, and that's what's really propelled our growth over the last several years.

Ellie Mertz

Specific question about Epix. The folks at Epix say that there is a window starting August 10, allowing Epix the option of either renegotiating new terms on your current deal or leaving the terms as is. Therefore, can you confirm that this is indeed the case?

David Wells

We don't talk about specifics on the deals that we had. I will say that, that date sounds early.

Ellie Mertz

To what extent are your streaming content deals, which usually encompass multiple years on variable cost terms, i.e. tied to subscriber numbers, to better assure maintenance of your operating margin targets?

So I can take this one. So essentially, all of our streaming content licenses are on a fixed fee basis, and we amortize them straight-line over the length of the license agreement.

Next question. Do your content deals include broad changes in control limitations, which would cancel the agreements, if you were ever acquired?

David Wells

Again, we don't usually talk about specifics, but no, there isn't a limitation.

Ellie Mertz

Are you okay with being rerun television?

Deborah T. Crawford

While I think as I said over last couple of months, it's not how I would characterize it, but it's not fundamentally inaccurate to say that we have incredible complete prior season, like the last couple of seasons of "Mad Men" and "Breaking Bad" et cetera, and that, that creates a great customer experience, especially for episodic content. And going back on series, you might not have seen all the episodes or couldn’t get into. And so complete prior season, plus a huge selection of movies, is a great combination service.

Ellie Mertz

In advance of the release of the full 10-Q. Give an updated figure for total off-balance-sheet streaming content commitments.

David Wells

Sure. Streaming content commitments in the table will read $3.5 billion, up from $2.3 billion and that number is inclusive of what's already in the library, so essentially, we're writing up another $1.1 billion in the future commitments that don't meet the criteria for library recognition.

Ellie Mertz

What's the split between movie streaming and TV streaming in the U.S. market? Does that differ in Canada?

Reed Hastings

TV, as a percentage of hours, is ahead of movies at this point, in most places in the world for us. But it can vary sometimes on the programming mix. But you know round numbers, think of them as they’re each about half.

Ellie Mertz

When you say that you'll be spending nearly double what you've spent for the content this year in 2012, would that be all new cash outlay, or would that include the multiyear contracts fields you've already in entered into, and currently hold, either on or off the balance sheet?

David Wells

It will include the deals that we've already announced and included, and some new deals, so it’s a mixture of both. But it does include the new deals, I mean, the existing deals.

Reed Hastings

And the increase referred to there is P&L view.

David Wells

Sure.

Ellie Mertz

So moving to some questions about competition. What is your competitive advantage competing against the traditional pay channels? What about against all the presumed new entrants that everyone seems to be so spooked about, such as Amazon, Hulu, Dish, Google and Apple?

Reed Hastings

Well let’s see. Relative to pay television, it's not a 0 some gain. So many people, including me, subscribe to HBO because it's got incredible content in addition to Netflix. So think of it as multiple channels, and people will consume in -- from multiple providers. That being said, when budgets are tight, there's a hierarchy of which ones do you use most. And we definitely want to win those. And so our competitive differentiation there is that we're a pure on-demand experience, to which we can create a much better user experience by being pure on-demand, we're highly personalized, so it's much easier to discover lots of content we might not know exist that's unique for each individual. And then, of course, how more enormously great value at $7.99 unlimited and unbundled from the traditional cable system, it creates an incredible value. So those are the primary 3.

And then in terms of the many new competitors, that's exactly what happens in a big new opportunity. I think everybody sees that Internet video is going to be an enormous market over the next couple of years, and it's completely predictable that there will be many new entrants. And so we're focused on how do we extend our lead and our benefits, again, focused on streaming.

Ellie Mertz

What, if any impacts, have you seen from Dish Network's effort to build out its Blockbuster Movie Pass streaming option? Same question for Amazon Prime free video offering.

Reed Hastings

From neither one have we seen any impact.

Ellie Mertz

Moving to questions about international. How long will the international expansion be halted?

Reed Hastings

Well, we're going to put a pause on our international expansion post the U.K. and Ireland 'till get back to global profitability. So that depends on how fast we can grow our global subscriber base, which will be some number of quarters. And we're eager to get back to continuing the international expansion because we see it as such a large opportunity. But we need to take a few quarters to get our subscriber base back to the appropriate size.

Ellie Mertz

Why did you choose the U.K. and Ireland as your next market, even though it's expensive on a relative basis, and are already fairly competitive? Hasn't Sky locked up most of the content rights already? What is your point of differentiation there?

Reed Hastings

Well, Sky Movies does have the fixed major studios, but there is a wide range of other movie content available from the non-fixed majors, and then there's a tremendous amount of television that's available also. And Sky Movies is expensive at GBP 16, or about $25 a month and it's only taken now by less than 5 million citizens or households. So there's a big opportunity for those who don't have Sky Movies. And then for those who do have Sky Movies for using our TV content selection to attract those subscribers.

So the answer to the question of why the U.K. and Ireland, it's because we see a very attractive market, with great, over-the-top penetration. Many consumers are very comfortable with online video, and use it frequently from 4 on Demand, from BBC iPlayer, Sky Go, all the different providers. So it's a very fertile market in that way. And our big advantage is really knowing streaming technology well, streaming marketing, and we feel great about entering with all of our CE partners.

Ellie Mertz

On international, you're now investing in multiple markets, when your core domestic market is experiencing growing pains. With U.K. and Ireland, you're entering into a market where LOVEFiLM was the first mover. Can you discuss how you think about the trade-off between establishing a foothold in international markets, while attempting to grow domestically through broadening the content library?

David Wells

Well, in the U.S., we're very confident of our success in streaming. Our content is in the best shape it's ever been. It's really an incredible selection of content, and that's showing up for us in viewing hours and all the kind of key metrics. In Canada, we're very successful, so we're excited about that. And now, we're going to be focusing on the U.K. And LOVEFiLM, which is owned by Amazon, is a well-run firm, they'll be a great competitor, they'll be one of a dozen competitors for over-the-top, including, as I mentioned, the BBC iPlayer, 4 on Demand, Sky Go and others. So it's -- we look forward to entering in the market and establishing what a great value Netflix is.

Reed Hastings

I would also add that LOVEFiLm was the first mover in DVD-by-mail in the U.K, it's not clear to me that they're there the first mover in streaming. They do have some offering and they're increasing that offering. But if we launch in Q1, that it's not clear that they're the first mover in streaming.

Ellie Mertz

Will you quantify the magnitude of consolidated losses that you are likely to incur in the first part of 2012, as you launch in U.K. and Ireland?

Reed Hastings

Well, what we've said in Q4, we guided to contribution profit midpoint of $65 million loss. If you put that together with our statements that Canada is roughly breakeven, then you can assume that most of that is Latin American loss, plus some expenses related to prepping for the U.K. And I would say that the first quarter loss for the U.K. is, in rough numbers, akin to the Latin American loss.

Ellie Mertz

In posted your guidance, are you saying that Netflix will be unprofitable on a global basis over all of 2012? In other words, were losses over the next few quarters be larger than any profits that could come in 3Q or 4Q of 2012?

Reed Hastings

What we said is, that in the first few quarters, we're putting a pause on international until they get back to global profitability, and we haven't guided to the later half of 2012.

Ellie Mertz

Are any differences in terms of the types of content that are working in Latin America versus the U.S. and Canada? What types of shows and films are proving the most popular there?

Reed Hastings

We're very early in on Latin America, about 45 days since we launched. So we're just starting to learn those lessons, and to figure out how to constantly improve our service, as we did when we launched Canada, and then 6 months after we started Canada. So we'll learn more every quarter on that.

David Wells

An easy anecdote on that one is telenovelas work well in Latin America, and they don't work in Canada. But I don't think that's telling you anything other than what Reed said.

Ellie Mertz

Can you provide any more detail on your Latin American rollout? Which specific countries in Latin America have been the biggest contributors to your international subscriber growth?

Reed Hastings

Well, as you would expect, Mexico and Brazil are the 2 largest broadband streaming markets, and those are our 2 largest markets.

Ellie Mertz

Moving on to a question about CE devices. In January at the CES conference, you announced that Best Buy, Memorex, Panasonic, Samsung, Sharp and others would add Netflix buttons to their remote controls to their devices. Can you give us an update on these partnerships? Will these devices they should be in time for the 2011 winter holiday season?

Reed Hastings

I don't know specifically on specific brands, but on it as a whole, I would say the Netflix button program has been going great and there will be lots of devices in the market in Q4 in preparation for Christmas.

Ellie Mertz

Some other miscellaneous questions. What is the company's guidance for its future tax rate?

I can take this one. We guide to roughly 30% effective tax rate for the full year, and probably slightly higher, something around 38% for Q4, likely trending to say, 39% in the following year. If you look at the Q3 effective tax rate, it was quite low at approximately 33%, and that was due to the expiration of some statutory limitations on some past audits. So we have to treat benefit in Q3 that we won't have in future quarters.

David Wells

And just a clarification, Ellie, you said 37% for the full year, correct? Okay.

Ellie Mertz

Yes. How long will you wait for regulatory clarity in the U.S. related to the Facebook issue?

Reed Hastings

Well, there's a bill in Congress now, H.R. 2471, which clarifies that a consumer does have the right to get permission for their video data that we shared, and that predicting what the U.S. Congress is going to is not something we're going to engage in. If it passes, that's great, and fantastic for consumers everywhere. If it doesn't, we'll figure out our next best steps at that point.

Ellie Mertz

Great. So at this time, I'd like to turn it over to the operator and begin taking live, call-in questions.

Operator

[Operator Instructions] Our first question comes from Youssef Squali from Jefferies & Company.

Youssef H. Squali - Jefferies & Company, Inc., Research Division

Reed, just a couple of questions, or really one question going back to the DVD business. Clearly, it's -- as it starts atrophying, I'm just trying to understand what is the value of that business to you now, outside of just being a cash cow? Are there any synergies that still exist between that and the streaming business? And if there is any value to actually keep it under the same umbrella?

Reed Hastings

Youssef, at this point, it's a source of profits funding our international expansion, and it's a source of satisfaction to the more than 10 million members who subscribe to our DVD service, whether they also subscribe to streaming or not. And so we'll keep it and run it steadily, and keep the service levels great for it. So that would be the plan going forth.

Operator

[Operator Instructions] Our next question comes from... [Operator Instructions]

Reed Hastings

Well, that's okay you guys. Our job as we see, it is try to anticipate your questions and answer as many of them proactively in our investor letter as possible. I'll take the absence of telephone questions that, at least in that dimension, we're doing a good job. And we want to thank everyone for their support. We know it's been an extremely challenging time to be a shareholder over the last couple of months.

And I want to tell everyone that we are extremely focused on growing our streaming business on a global basis, and believe it's a tremendous opportunity to create a very valuable and important and respected firm, and that's what every day here at Netflix is spent doing.

So with that, thank you all very much.