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

Ellie Mertz

Thank you, and good afternoon. Welcome to the Netflix 2011 Earnings Q&A Session. We now start our financial results for the first quarter at approximately 1:05 p.m. Pacific Time today. The shareholder letter and the Q1 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, this call will consist solely of Q&A, and we're going to conduct the Q&A via e-mail. Please email your questions to ir@netflix.com.

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 6:00 p.m. Pacific Time today.

Now let's move directly to questions. We've organized the questions by topic design, and we'll start with content questions. Here we go.

Question-and-Answer Session

Ellie Mertz

As you acquire digital content rights, what level of competition are you seeing during the negotiation?

Reed Hastings

There's a substantial level of competition, as you would expect, not only amongst the online players but against cable networks and sometimes in partnership with cable networks in the window sharing. So content owners want to get the best price for their content as you would expect, and they're pretty sophisticated about making sure that they've got all the possible offers on the table.

Ellie Mertz

Related question, how much risk is there that Amazon will outbid for Netflix for digital rights to Starz content?

Reed Hastings

I'm not sure that Amazon specifically is a different risk. I would say, in general, Starz, like any other content provider wants to get the most money for their content. The Starz deal is non-exclusive today so it could be across a range of providers, it could be a single. But I don't think I'd particularly single out Amazon as a risk factor relative to, say, Hulu Plus or Dish or anybody else.

Ellie Mertz

In the past, Reed has commented about shutting down Red Envelope and Netflix's lack of interest in producing content or licensing previously unreleased content, but they've bet on creativity and was outside of Netflix's circle of confidence. How can you reconcile these previous remarks with the recent move to invest in the House of Cards series?

Reed Hastings

Well, there is a slight shift there, which is we're willing to try a little bit more riskier work than we've done with a little bit of our budget, and then we're going to see how it goes. So sort of how we approach international, when we tried Canada first before getting too committed. And our theory is that with serialized content, we may be able to build an audience very effectively because if you -- with on-demand, you can get back to the first episode as momentum around the series builds. I don't know if it's anything we'd bet the farm on, but we're certainly willing to try it with a small percent of the budget in House of Cards and then 2 or 3 other smaller ones that we would look for. And if we're successful with it, then we would expand our circle of confidence a little bit more, a little bit more. So we'll take it step-by-step and year-by-year.

David Wells

To add to that, this is David. In the House of Cards deal, it was a prepackaged deal that came to us. We weren't looking for -- out there looking for creative talent or directors or a script. It's a small nuance, but it was an important one for us and the fact that we weren't having to manage the larger part of the creative process.

Ellie Mertz

An additional question on House of Cards. Are you seeking to buy domestic or global rights to House of Cards? Is your intent to keep House of Cards exclusive to Netflix? Or actually presenting the series on Netflix, will you look to sell subsequent lengths to other cable or broadcast networks or online services?

Reed Hastings

Well, House of Cards doesn't start until the fall of next year so it'll be a couple years out before we are faced with those decisions, and we've licensed it for multiple territories.

Ellie Mertz

Okay. Press speculation puts your spend on Mad Men at nearly $1 million per episode, which seems to be lower than recent syndication deals for procedurals, but higher than deals for some other low profile, serialized series. Why did you just decide to pay for exclusivity? And should we think of your Mad Men deal as typical of some other TV deals you may be doing going forward or was it the unique case?

Reed Hastings

We don't comment on the specific deal terms of any of our deals.

Ellie Mertz

Can you share any data that supports your view that putting a previous season on Netflix grows audience for a current season of the show? Wouldn't Netflix also diminish sales of prior season DVDs?

Reed Hastings

Well, what we've seen as an example with Spartacus is we've seen something even more aggressive, which is we have current season with Spartacus, that's a Starz original, which has been very successful. And now, it's one of the highest rated shows on cable despite the fact or maybe because of the fact that it's also on Netflix. And so I think, in general, it's opened our eyes to the fact that more and more awareness of a given show sometimes creates more viewing on both cable and our MVPD [multichannel video programming distributor] and on Netflix.

Ellie Mertz

Given the size of your subscriber base, is it getting easier to negotiate content deals or is there still a level of animosity with some content owners that must be worked through?

Reed Hastings

I don't think there's any animosity. It's only a question of is our check big enough. And so as we get a larger subscriber base, that becomes easier to write bigger checks. And it's very respectful, I would say, across the board.

Ellie Mertz

Moving to the topic of international. In terms of international expansion and content acquisition in non-U.S. markets, what type of expenditures do you anticipate making for locally relevant content, and how might deals with foreign outlets differ from domestic deals?

Reed Hastings

Well, we’re not sure of how much local content will be important for Netflix. With Canada, we've got a fair amount of Canadian content and it's quite successful for us. And our new territories will also license some local content, and then we'll feel our way along as we see what's our subscribers are viewing and what they enjoy.

David Wells

I'd say there's an opportunity here outside the U.S. in some markets. And with respect to some local content, there might not be a secondary market or a third or fourth sort of channel for the content owner. So to the extent that we might be the only syndicated buyer in the market, it's going to work well for us in terms of the economics.

Ellie Mertz

Will new geographies take priority over the U.S. as you build out content? Or should we continue to expect the U.S. to see the bulk of the spending?

Reed Hastings

I think you should think about them as separate. We'll run the U.S. around 14% operating margin and spend on content in accordance with that. And in international, you'll spend as we see appropriate to launch the service, where we’ve, obviously, got spending ahead of revenue. And then as rapidly as possible, within 8 quarters in our target model get each territory to be positive operating margin. In Canada, we've been very successful and we intend to be at breakeven on a operating contribution basis within 4 quarters of launch which is in Q3 and really quite extraordinary. That's probably too high a bar for every international territory, but 8 quarters feels good.

Ellie Mertz

On the topic of Canada, can you provide a little color on how the ISP bandwidth cap in Canada have impacted consumer behavior? What percentage of your Canadian customers are using the new "managed video quality tool" in watching lower quality video? Also do you believe ISPs in the U.S. or other countries are thinking of capping bandwidth in a similar strict fashion?

Reed Hastings

We don't have any indication that in the U.S. low, call it, below 100 gigabytes data caps are going to become a significant offering. In Canada, it's switched to default so every virtually everybody is on our low data usage, slightly lower video quality plan. And it is helping both directly in terms of the usage and indirectly in terms of the general fear of usage charges, so it's a mitigator. I'm not sure I would call it a solution. It helps. I think, the right solution, over time, is that Canadians enjoy great untapped Internet like the rest of the developed world.

Ellie Mertz

Related question, how do usage patterns in Canada perform relative to your expectation given the various cap rates? What drove the more modest subscriber growth performance relative to your expectations?

Reed Hastings

I think on what drove the overshoot on the forecast is just we don't have any seasonal data. So the growth was very consistent throughout the quarter, and we're really happy with it. And it's a pretty small percentage, but we just don't have multiple years of year-on-year data. In terms of the caps, they play a role, but they played a role from inception. The caps are not something that were new this quarter. The caps have been in effect for a year or more in Canada.

David Wells

Just to add to that, we achieved 8% of broadband household penetration in Canada in 7 months. It took us 6 years in the U.S. to get there. Just so that you don't feel like we're sort of trying to makes ourselves feel better on the forecasting is we're happy about the business. We think we’ve got a great business going in Canada and we're excited about going forward.

Ellie Mertz

Another related question. The shareholder letter mentioned the seasonality curve in Canada. Can you elaborate on this comment? Is your initial sense that the markets similar to other colder regions, where subscriber growth is more tepid in the warm months?

Reed Hastings

We'll know in 1.5 year from now after we've gone through the initial seasonality is massed by the launch. And so you really can't get a clean read until at least a year from now about the beginnings of the seasonality effect.

Ellie Mertz

Is it reasonable to assume that Netflix could enter as many as two international markets or more per year starting in 2012?

Reed Hastings

If we continue to see the kind of success that we've seen in Canada, if we think it would be very smart for us to move at least that fast, yes.

Ellie Mertz

You noted a high probability of success in our second international market, driving early content commitments for a third market What are the data points that you focus us on to define success prior to launching in a market?

Reed Hastings

The reason that we feel a high degree of confidence is how well Canada has done, how well our licensing has gone for content in our second international market, and our qualitative focus group work on the reactions in that market for our service. So those are all very healthy indicators that we'll enjoy success.

David Wells

And those qualitative factors have a lot to do with how much that content is going to cost us relative to where we think we could price it and the consumers' willingness to pay based on their other entertainment alternatives. And we've grown more, I think, confident over the last year given where we think those economics are going to work out.

Ellie Mertz

Moving to the topic of subscribers and subscriber metrics. Do you think we get tiered pricing for multiuser households from Netflix by year end? In that case, how big an addressable market is it?

Reed Hastings

Well, what we’ve said before was that the individual subscriber market is that 2 to 3 or few year, I think is how we characterized it in the last Investor Letter. And we haven't changed our point of view. This is a gradual evolution. It's not going to be an immediate 90- or 180-day thing for Netflix. And I think pricing is certainly part of that evolution, changes to the interface are part of that evolution, changes to how we -- if and when we enforce concurrent stream limits, either per device or by account. So there's lots of things for us to figure out and tease out. We wouldn't want to alienate the subscriber or the consumer as we go through those. And I think that we'll evolve to those over the next couple of years.

Ellie Mertz

Can you share any details on Facebook integration that you are working on? What will be the primary objective of the same? Enhance your recommendation engine or drive engagement or acquire subscribers?

Reed Hastings

It's better for us to share those details when we launch that. So I'll defer that.

Ellie Mertz

Are you starting to see DVD subscribers trade down from multi-op subscription?

Reed Hastings

I don't think so. In fact, what we've said before is that basically downward migration and upward migration are canceling each other, and that's what we continue to see. With respect to the price change, we saw behavior that was more linked to the immediate announcement than to the credit card change. Meaning when a subscriber actually got the change to the price on their bill, there wasn't as much activity as when they were notified of the change.

Ellie Mertz

So related to the price increase. Was the price increase a contributor to the increase in churn or was it more of a normal seasonal pattern?

Reed Hastings

Normal seasonal pattern. It's also a factor of the tremendous growth we saw in Q1. If you followed our company for a long time, you'll note that when we grow quickly, our churn goes up because the retention rates of early subscriber are lower than those subscribers that have been around for 12 or more months. And we continue to see that.

Ellie Mertz

Another question on churn. Can you comment some on the churn rates for streaming-only customers in the U.S.? And is it above or below the average? Do you expect a decline over time as customers are maybe testing out this service today?

Reed Hastings

What we said is streaming only has a higher churn rate. It's easier to get in of and out of so it's the same as we said last quarter.

David Wells

Yes and we've said before that the streaming-only plan actually crossed over the DVD only. So that is retention for streaming-only subscribers is actually a higher rate than DVD-only subscribers. It's going to be slightly lower than hybrid, but it's better.

Ellie Mertz

And the final question on churn. It still seems like the overall churn rate for the company is still high relative to other MVPD companies, and causes you to respend SAC [subscriber acquisition cost] dollars on customers that have already been Netflix subscribers in the past? If your customer satisfaction is very high on your streaming products, shouldn't your churn materially decline over the next 18 months in the United States?

Reed Hastings

Well, given how stable churn has been the last 2 years, I'd be hard put to think why it should suddenly decline in the next 18 months. And the question refers to us like other MVPD, and MVPD is a much different service. It's premises-based. It's more expensive, and it's more considered an essential service so it's really just quite different in all those dimensions. We have a low subscriber acquisition cost, and we have higher churn. And people do test out the service, come back, go out, go in. And that's fine because our overall growth, our net adds are continuing to increase.

Ellie Mertz

Moving to the topic of SAC. Why did the domestic SAC rise so much quarter-over-quarter? Which should be the right base level going forward, Q4's 10 87? Or Q1's 14 38?

David Wells

There's no such thing as a right base for going forward, but what we've said in the last quarter's Investor Letter and we reiterate it in this Investor Letter is that we identified the fact that we would have additional money. We would love to spend it on streaming content. Because of the complexity of those contracts, there's more lead time acquired and therefore, we put the money into marketing. So the higher SACs sequentially from Q4 to Q1 is a somewhat of an artifact of additional marketing dollars we spent up to the efficient point in Q1. And we'll continue to make that trade-off going forward. Now what we've said in the Investor Letter, just to remind folks, is that we're going to weigh streaming cost. We plan to do that. We're going to continue to do that, and so you should see marketing as a percentage of revenue somewhat mollified relative to Q1.

Ellie Mertz

As subscribers have grown to streaming, how's the demographics of the Netflix subscriber changed? Is the demographic in Canada comparable to the U.S.?

Reed Hastings

Yes, there is no material difference, in fact.

Ellie Mertz

Can you get U.S. in SF [San Francisco] Bay Area household penetration?

David Wells

We've done question this before and what I'll respond by saying that the penetration in the U.S. is 21%. You can calculate that for yourself by looking at the 22.8 million U.S. subscribers and taking it over roughly 110 million households. The reason that people ask us this is we've given out Bay Area before because when we launched the DVD service back in 1999, we started in the Bay Area. And we had thought at that time that the Bay Area would be a good proxy for the rest of the country. We've come and evolved that notion to believe that that's not necessarily the case especially with a streaming product that we've launched nationally. So in terms of penetration, it's 21% U.S.

Ellie Mertz

Your Letter to Shareholders mentioned that you expect DVD shipments to decline slightly year-over-year. In the past, Netflix has announced various milestones in DVD shipments such as 1 billion that were in 2007 and 2 billion April 2009 just shipped. When did Netflix ship the 3 billion discs? Are there other notable DVD milestones?

Reed Hastings

Our focus is really on streaming at this point. So I don't anticipate that we would have or will make those kind of announcements.

Ellie Mertz

Moving to the topic of competition. Can you speak to the competitive landscape sans peers [ph] and how serious it is today versus, say, a year ago, especially with Amazon's free video streaming offering and with Dish streaming HBO content and Starz channels for free?

Reed Hastings

Well, a big market attracts a lot of competition. I think, it's pretty clear to everyone that online video is a big opportunity. There'll be a number of substantial competitors. If Dish launches something into the Blockbuster brand, that'll be the newest entrant. Clearly, Hulu Plus and Amazon may or may not have been having a success but they haven't held us back at all, at what you'd expect to the growing market because in Q1, domestically, our net adds were up over 90%. So we feel great about that.

Ellie Mertz

You mentioned Dish as a competitor. Could you elaborate? Blockbuster is currently a VOD product, white labeling Sonic technology. Do you expect that to change?

Reed Hastings

We really don't know what Dish is up to, but presumably they paid a couple hundred million for Blockbuster not for its technology but for its brand. It's a well-known brand. And they would do that, it would be consistent to do that if they had plans to launch a service with a fair amount of content and a fair amount of marketing such that it would make sense to pay $300 million to be able to use the Blockbuster brand.

Ellie Mertz

One more question on competition. How do you look at HBO and HBO GO as a competitive product as it prepares to expand across the many platforms Netflix currently occupies?

Reed Hastings

Well, HBO GO is an implementation of TV Everywhere. A consumer can't subscribe to HBO GO directly. And so it really doesn't compete today. I would say our overall effort that TV Everywhere is making is how to improve MVPD. And one aspect of that is HBO Online. But for example, in the Comcast implementation, you don't use HBO GO as the user interface. You use the Xfinity user interface. And so, I think, you'll see different implementations and the only -- the competitive threat to take out of that for us is TV Everywhere.

Ellie Mertz

Moving on to questions about the financials. In response to a question posed last quarter regarding the significant increase in AP, the company indicated that "largely payments, are at a short timing at the end of the quarter that could reverse itself in Q1." Can the company indicate why did this not reverse in Q1 and instead AP increased further?

David Wells

So I was just responding to you the sequential increase in AP last quarter. I answered it somewhat narrowly in saying that the two contrasts that drove that AP increase were going to reverse themselves out in Q2, and they did. On top of that, in addition to that, we signed a bunch of new content deals that we discussed in the Investor Letter. And to the extent that those deals were within a year with identified titles, it drove the AP up. So let me answer this in a general sense. Cash payments for content increased $130 million year-over-year versus $110 million year-over-year increase in the expense associated with that content. So to the extent that we'd talked about close matching of our payment terms with our expense, we are continuing to execute on that. We ran a little bit ahead in Q1. In terms of the sequential increase, the cash out the door for content was roughly in line with the expense increase. So I think you should see the accounts payable and the associated long-term accrued payable line increase with our continued investment in streaming content. I don't think you'll see it increase at quite the same rate, say, going forward as you saw in the last couple of quarters, but it will go up.

Ellie Mertz

Can you explain the large sequential and year-over-year drop in acquisitions for the DVD content library?

David Wells

I'm sorry, repeat that one more time.

Reed Hastings

I can handle it. There's a mix there when you do a rev share title. Most of the expense, essentially all of it, does not go through that line. So that can be a shift towards rev share from purchasing DVDs.

Ellie Mertz

On the streaming side, are storage and incoming costs typically fixed or variable? And are they significant relative to content delivery cost?

Reed Hastings

They are not significant.

David Wells

No, not significant.

Deborah Crawford

What drove the G&A increase in the quarter, and what are your expectations going forward?

David Wells

So mostly headcount. There were some increase related to stock comp expense due to employees taking more equity compensation versus cash competition, but mostly a headcount increase.

Ellie Mertz

Why is fulfillment cost still growing? Do you expect it to slow as DVD shipments decline?

David Wells

Fulfillment cost as a percent of revenue is actually declining. Fulfillment, the absolute fulfillment cost is growing because we shipped more in the quarter. We have more subscribers that have more credit card expense associated with them with their revenue. But as a percent of revenue, it's actually been declining over last 6 quarters or so.

Ellie Mertz

Next question. If you are a growth company, why are you dividending cash out to shareholders rather than reinvesting it back into the business?

Reed Hastings

We're generating cash flow when we anticipate continuing to generate cash flow.

David Wells

And I think we're doing both. I think we're trying to draw a fine distinction between being a pure company that invests everything we possibly have into growth and also returning some to shareholders. So I think it's consistent with the strategy that we've had for quite some time of trying to draw both, to do both; be a growth company and also make sure that we're not setting up a false promise to return earnings down the road.

Ellie Mertz

Turning to a handful of miscellaneous questions. When will we start seeing Netflix streaming on Android devices? Will future versions of Androids solve the DRM [digital rights management] issues that prevent making Netflix widely available on the platform?

Reed Hastings

We're working hard on Android. Don't have any news at this call. It's a big priority for us, and stay tuned.

Ellie Mertz

Device partitions have been a significant component of building out the footprint of streaming subs domestically, and it seems like it could be used as a valuable tool in building out the international footprint. To what extent will your U.S. device partnerships be applicable internationally? Or what will it take build out a similar ecosystem of devices?

Reed Hastings

We very much expect to work with our CE partners around the world. And certainly in Canada, we've already done that with specific Canadian implementations across all of our major CE partners. And there's now many,

many devices in the Canadian market. And that's a good blueprint for what we'll be doing going forward.

Deborah Crawford

In the press release, you say TV shows and feature films are consumed in equal volumes. Is that true domestically and in Canada?

Reed Hastings

It's approximately true in both, yes.

Ellie Mertz

Moving to a marketing question. [indiscernible] is likely to be a very lucrative upfront process for both broadcast and cable networks come this May and June? Do you see it paying what is rumored to possibly be as high as low teens price hikes for the network add inventory for marketing purposes? Or do you just bypass network television spending and gear your marketing spend more towards lower CPN alternative such as outdoor or radio?

Reed Hastings

We always try to market most efficiently we can. And sometimes if one channel, say, outdoor or online or print or network to increasing costs, it would get less of our total dollars. So it's a big broad mix of which the 2 primary components for us are online and television, not necessarily network but cable offering.

Ellie Mertz

Great. Okay, so that's the last question for today. We’d like to thank everyone for your time, and we look forward to speaking with you again next quarter.