# FINAL TRANSCRIPT

**Thomson StreetEvents℠**

## NFLX - Q3 2011 Netflix Inc Earnings Conference Call

**Event Date/Time: Oct. 24. 2011 / 10:00PM GMT**



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## CORPORATE PARTICIPANTS

**Ellie Mertz**
*Netflix Inc - VP*

**Reed Hastings**
*Netflix Inc - CEO*

**David Wells**
*Netflix Inc - CFO*

## CONFERENCE CALL PARTICIPANTS

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

## PRESENTATION

**Operator**

Good day, everyone, and welcome to the Netflix third quarter 2011 earnings Q&A session. Today's call is been 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.

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**Ellie Mertz** - *Netflix Inc - VP*

Thank you and good afternoon. Welcome to the Netflix third quarter 2011 earnings Q&A session. I'm joined here by Reed Hastings, CEO; and David Wells, CFO.

We announced our financial results for the third quarter at approximately 1.05 PM 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 www.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 10K 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 PM Pacific time today. Now, let's move directly to questions. Similar to previous quarters, we have organized the questions by topic as we receive them via e-mail this afternoon. We'll start with questions about the domestic business.

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?

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**Reed Hastings** - *Netflix Inc - CEO*

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 change the plan or cancel. 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 three to four weeks ago. So that's what gives us confidence that it's this wave passing through.

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**Ellie Mertz** - *Netflix Inc - VP*

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?

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**Reed Hastings** - *Netflix Inc - CEO*

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 is 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.

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**Ellie Mertz** - *Netflix Inc - VP*

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

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**Reed Hastings** - *Netflix Inc - CEO*

As we addressed in the letter, we think the future is brightest by focusing on streaming. We could in principle, offer a discount for hybrid; but if we were going to use discounting dollars, we would not want to be trying to incent more DVDs and subsidizing DVD, 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 are really quite comfortable in our growth with the two $7.99 programs.

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**Ellie Mertz** - *Netflix Inc - VP*

Do you need to ramp spending to win back sentiment to drive the 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?

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**Reed Hastings** - *Netflix Inc - CEO*

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 have 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. And it's really exciting that we're able to fill up that content as we documented in its effect in our letter.

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**Ellie Mertz** - *Netflix Inc - VP*

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

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**David Wells** - *Netflix Inc - CFO*

This is David Wells the CFO. So in terms of our subscriber guidance, what we said in the letter was we would be up slightly from the 23.8 million unique subscribers we ended 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.

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**Ellie Mertz** - *Netflix Inc - VP*

Will trend peak in Q4?

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**Reed Hastings** - *Netflix Inc - CEO*

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 of the business or net additions.

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**David Wells** - *Netflix Inc - CFO*

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 in Q4? Reed's already answered that question in terms of the weekly trends that we see and the retention rates.

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**Ellie Mertz** - *Netflix Inc - VP*

Could you provide more detail around your domestic streaming contribution margin? 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?

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**David Wells** - *Netflix Inc - CFO*

I think in the long run, the long-term margin structure for streaming will be ultimately determined by the competitive space and how money competitors we have. In the short run, we have 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 will be able to grow in pace along with that of investment addition. We think we will be able to take up contribution margin at the same time.

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**Ellie Mertz** - *Netflix Inc - VP*

Related question, how will US content cost double in 2012 and contribution margin be up 100 basis points every quarter?

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**David Wells** - *Netflix Inc - CFO*

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

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**Reed Hastings** - *Netflix Inc - CEO*

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

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**Ellie Mertz** - *Netflix Inc - VP*

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 found on our investor letter, Q3 SAC of about 1525 was actually comparable to the prior quarter, In Q2, we reported a very similar SAC of 1509 and it was actually down this quarter about 24% from year ago. So to date we haven't seen any of the negative publicity effect our subscriber acquisition costs.

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**Reed Hastings** - *Netflix Inc - CEO*

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

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**Ellie Mertz** - *Netflix Inc - VP*

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 brands like Qwikster?

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**Reed Hastings** - *Netflix Inc - CEO*

In hindsight, it's 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 two 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 are going to stick with DVD as part of the Netflix brand. And going forward, we will 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 are going to be pushing and promoting streaming.

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**Ellie Mertz** - *Netflix Inc - VP*

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 target for US streaming, international streaming, and DVD?

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**Reed Hastings** - *Netflix Inc - CEO*

I think David answered part of that about the long-term margin, and DVD is partially high margin because of the US for-sale doctrine. Where we can buy the DVD, pay for it once, and than rent it as long as we want. So 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 many years for DVD. And as we said in the letter, we don't anticipate further investments in equipment and property plant and equipment for DVD. So we think that we can manage that downward.

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**Ellie Mertz** - *Netflix Inc - VP*

This is a similar related question. Given that DVD by mail is a mature, some would call it buggy-whip business category for renting recent films, do you anticipate a steady decline in that business or do 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?

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**Reed Hastings** - *Netflix Inc - CEO*

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

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**Ellie Mertz** - *Netflix Inc - VP*

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 catalogue 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?

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**Reed Hastings** - *Netflix Inc - CEO*

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

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**David Wells** - *Netflix Inc - CFO*

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 to the extent that subscribers also use their local video store, Redbox, and other services, they continue to do that.

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**Ellie Mertz** - *Netflix Inc - VP*

I'll move to questions about content. Has exclusive 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?

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**Reed Hastings** - *Netflix Inc - CEO*

Well, as mentioned back in our April investor letter, the industry is mostly an exclusive licensing industry. And we will end up doing more and more exclusive over time. And that has been witnessed in what we have 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.

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**Ellie Mertz** - *Netflix Inc - VP*

Is original content the key to reenergizing gross additions?

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**Reed Hastings** - *Netflix Inc - CEO*

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 OnDemand incredible streaming that we have and that's what's really propelled our growth over the last several years.

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**Ellie Mertz** - *Netflix Inc - VP*

Specific question about Epix. The folks at Epix say that there is a window starting August 10, 2012 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?

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**Reed Hastings** - *Netflix Inc - CEO*

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

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**Ellie Mertz** - *Netflix Inc - VP*

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?

I can take this one. Potentially 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 change of control limitations, which would cancel the agreements if you were ever acquired?

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**Reed Hastings** - *Netflix Inc - CEO*

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

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**Ellie Mertz** - *Netflix Inc - VP*

Are you okay being rerun television?



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**Reed Hastings** - *Netflix Inc - CEO*

I think as I said over the 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 seasons of Mad Men, Breaking Bad, etc; and that that creates a great customer experience especially for episodic content. And going back on series that you might not have seen all the episodes that you can get into. And so complete prior season plus a huge selection of movies is a great combination service.

**Ellie Mertz** - *Netflix Inc - VP*

In advance of the release of the full 10Q, do you have an updated figure for total off balance sheet streaming content commitments?

**David Wells** - *Netflix Inc - CFO*

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 are writing up another $1.1 billion in future commitments that don't meet the criteria for library recognition.

**Ellie Mertz** - *Netflix Inc - VP*

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

**Reed Hastings** - *Netflix Inc - CEO*

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 round numbers, think of them as they're each about half.

**Ellie Mertz** - *Netflix Inc - VP*

When you say that you will be spending nearly double what you spend for the content this year in 2012, will that be all new cash outlay or will that include the multi-year contracts you have already entered into and currently hold either on or off the balance sheet?

**David Wells** - *Netflix Inc - CFO*

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

**Reed Hastings** - *Netflix Inc - CEO*

And the increase referred to there is PNL view.



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**Ellie Mertz** - *Netflix Inc - VP*

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 which is Amazon, Hulu, Dish, Google, and Apple?

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**Reed Hastings** - *Netflix Inc - CEO*

Let's see. Relative to pay television, it's not a zero-sum game. 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 from multiple providers. That being said, when budgets are tight, there is 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 OnDemand experience to which you can create a much better user experience by being pure OnDemand. We are highly personalized so it's much easier to discover lots of content you might not know exists that's unique for each individual. And then, of course, a 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 three.

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 couple of years; and it's completely predictable that there will be many new entrants and so we're focussed on how do we extend our lead and our benefits, again, focussed on streaming.

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**Ellie Mertz** - *Netflix Inc - VP*

What, if any, impact 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?

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**Reed Hastings** - *Netflix Inc - CEO*

From neither one have we seen any impact.

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**Ellie Mertz** - *Netflix Inc - VP*

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

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**Reed Hastings** - *Netflix Inc - CEO*

Well, we are going to put a pause on our international expansion post UK and Ireland until we 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 are 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.

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**Ellie Mertz** - *Netflix Inc - VP*

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

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**Reed Hastings** - *Netflix Inc - CEO*

Well, Sky Movies does have the six major studios, but there is a wide range of other movie content available from the non-six majors, and then there's a tremendous amount of television that's available also. And Sky Movies is expensive, it's GBP16 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.

To answer the question of why the UK and Ireland is 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 for-on-demand from BBC iPlayer, Sky Go, all the different providers. It's a very fertile market in that way, and our big advantage is really knowing the streaming technology well, the stream marketing, and we feel great about entering with all of our CE partners.

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**Ellie Mertz** - *Netflix Inc - VP*

On international, you're now investing in multiple markets when your core domestic market is experiencing growing pains. With UK 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?

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**Reed Hastings** - *Netflix Inc - CEO*

In the US, we are very confident of our success in streaming. Our content is in the best shape it's ever been, and it's really an incredible selection of content and that is showing up for us in viewing hours and all of the key metrics. In Canada, we are being very successful, so we are excited about that. And now we are going to be focusing on the UK. And LoveFilm, which is owned by Amazon is a well-run firm, they'll be a great competitor, they will be one of a dozen competitors for over the top including as I mentioned BBC iPlayer, for-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.

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**David Wells** - *Netflix Inc - CFO*

I would also add that LoveFilm was the first mover in DVD by mail in the UK. It's not clear to me that there is a first mover in the streaming. They do have some offering and they're increasing that offering, but if we launch in Q1, then it's not clear that they're the first mover in streaming.

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**Ellie Mertz** - *Netflix Inc - VP*

Will you quantify the magnitude of consolidated losses that you are likely to occur -- incur in the first part of 2012 as you launch in the UK and Ireland?

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**David Wells** - *Netflix Inc - CFO*

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

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**Ellie Mertz** - *Netflix Inc - VP*

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

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**Reed Hastings** - *Netflix Inc - CEO*

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

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**Ellie Mertz** - *Netflix Inc - VP*

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

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**Reed Hastings** - *Netflix Inc - CEO*

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

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**David Wells** - *Netflix Inc - CFO*

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 does well.

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**Ellie Mertz** - *Netflix Inc - VP*

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?

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**Reed Hastings** - *Netflix Inc - CEO*

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

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**Ellie Mertz** - *Netflix Inc - VP*

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 for their devices. Can you give us an update on these partnerships? Would these devices be shipping in time for the 2011 winter holiday season?

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**Reed Hastings** - *Netflix Inc - CEO*

I don't know specifically on specific brands; but 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.



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**Ellie Mertz** - *Netflix Inc - VP*

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

I can take us 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 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 had a benefit in Q3 that we won't have in future quarters.

**David Wells** - *Netflix Inc - CFO*

Just a clarification, you said 37% for the full-year, correct?

**Ellie Mertz** - *Netflix Inc - VP*

Yes.

How long will you wait for regulatory clarity in the US related to the Facebook issue?

**Reed Hastings** - *Netflix Inc - CEO*

Well, there's a bill in the Congress now, HR2471, which clarifies that a consumer does have the right to give permission for their video data to be shared and predicting what the US Congress is going to do 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 will figure out our next best steps at that point.

**Ellie Mertz** - *Netflix Inc - VP*

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

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Our first question comes from Youssef Squali from Jefferies & Co. Your line is open.

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

Thank you very much. Good afternoon, everybody. Reed, just a couple -- 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 cash cow, are there any synergies that still exist between that and the streaming business, and if there's any value to actually keeping it under the same umbrella? Thanks.



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**Reed Hastings** - *Netflix Inc - CEO*

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 will keep it and run it steadily, and keep the service. So that would be the plan going forward.

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**Operator**

Thank you. (Operator Instructions) Our next question comes from --

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**Reed Hastings** - *Netflix Inc - CEO*

That's okay, guys. Our job as we see it is to try to anticipate your questions and answer as many of them proactively in our investor letter as possible. I will take the absence of telephone questions that at least in that dimension, we are doing a good job. 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 everyday here at Netflix is spent doing. With that, thank you all very much.

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**Operator**

Ladies and gentlemen, thanks for participating in today's program. This concludes the program. You may all disconnect.

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