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NFLX - Q3 2013 Netflix, Inc. Earnings Conference Call

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CORPORATE PARTICIPANTS

Erin Kasenbach *Netflix Inc - Director of IR*

Reed Hastings *Netflix Inc - CEO*

David Wells *Netflix Inc - CFO*

Ted Sarandos *Netflix Inc - Chief Content Officer*

CONFERENCE CALL PARTICIPANTS

Rich Greenfield *BTIG Research - Analyst*

Doug Anmuth *JPMorgan - Analyst*

PRESENTATION

Erin Kasenbach - *Netflix Inc - Director of IR*

Good afternoon. I'm Erin Kasenbach, Director of Investor Relations at Netflix. I'd like to welcome you all to our third-quarter 2013 earnings interview. During today's discussion, we may make forward-looking statements, and our actual results may vary from those statements.

With me today is Reed Hastings, our CEO; David Wells, CFO; Ted Sarandos, Chief Content Officer; and helping to facilitate our discussion is Rich Greenfield of BTIG Research, and Doug Anmuth at JPMorgan. Let me now turn it over to Rich for our first question.

Rich Greenfield - *BTIG Research - Analyst*

Thanks, Erin, and thanks, everyone from Netflix for being here. We are going to switch questions tonight between me and Doug.

First question though, really, for Reed, is when you look at the investor statement, your stock is up a lot year-to-date. And you actually make a comment about the fact that there's a little bit of a sense of euphoria like there was in 2003. Normally, you have always said that you leave it for Wall Street to determine what happens to your stock. Why did you make the comment this time about your stock and specifically about euphoria?

Reed Hastings - *Netflix Inc - CEO*

Well, Rich, every time I read a story about Netflix is the highest appreciating stock on the S&P 500, it worries me because that was the exact headline that we used to see in 2003. You can definitely -- we have a sense of momentum investors driving the stock price more than we might normally. There's not a lot we can do about it but I wanted to honestly reflect upon that.

Go ahead, Doug.

Doug Anmuth - *JPMorgan - Analyst*

Great. So our next question we're going to ask a couple about 3Q in particular.

So, Reed, can you help us understand what kind of impact you think Orange is the New Black had on subscribers in 3Q? You pointed out pretty early obviously in the letter and maybe if you could compare it to some of the initial impact that you've seen from other originals this year?



Reed Hastings - Netflix Inc - CEO

Well Orange was a great success for us, but we don't have a way of separating out is that why we did well? We are at the top half of our US guidance or how material it was. It was also our overall content improvement. It was the general brand improvement. And then remember we have a soft comp from last year. So being up year-over-year is not as tough this quarter or in Q3. So it definitely helped. We're thrilled about it, but there's no clean analysis. And we're not particularly -- we're trying to do more great content like Orange. But we don't need to know is it 2% or 5% or 10% of our sub growth.

Rich Greenfield - BTIG Research - Analyst

And from the standpoint of the Chromecast, you announced an offer during the quarter where Google, I believe, was funding some of the subscriber acquisitions for Netflix. Was it immaterial? You didn't really make a lot of comment about it in a press release. Just curious how significant that was and how do we think about those type of offers going forward?

Reed Hastings - Netflix Inc - CEO

Well, we'd like to see more of those types of offers. They work particularly well for consumer electronics companies selling smart TVs and other things. But it's pretty small today. And it was not material on the Chromecast because most of those 3 months went to existing subscribers. If you think about the kind of person who orders a Chromecast in the first 3 days, they're pretty into technology and gear, and most of those people were already Netflix subscribers, so it was a nice way to get a jumpstart for Chromecast. Chromecast, we're very about it excited about in the long term, but it was not in this instance material to membership growth.

Doug Anmuth - JPMorgan - Analyst

Just a quick follow-up on Chromecast, can you help us understand how the economics work there?

Reed Hastings - Netflix Inc - CEO

David, what have we said so far?

David Wells - Netflix Inc - CFO

Yes, Doug, it's no different than other devices. So we don't talk about the very specifics of all our deals, but it's no different than the economics of other devices that we've had out there.

Rich Greenfield - BTIG Research - Analyst

In the statement, you make a comment about Latin America, that you had a significant number of what you would call low-quality promotions in the market. It looks like, if we're doing the math right, that it added somewhere around a few hundred to 400,000. If you compare the growth in total members versus the paid members, you lose a few hundred thousand plus subscribers. Just wondering, why did you do the low-quality promotions? What was going on there? Give us some background?

David Wells - Netflix Inc - CFO

This is David. I'll probably take that one, Rich. It's not that we did low-quality promotions. It's that we are continuing to optimize and hone our payments in Latin America. It's something that we have been challenged with since we were first in the market. And we optimize how much we're validating upfront in terms of methods of payment, both on direct debit, debit card, and on credit card. And you can make choices to let in a number

of subscribers that you think might be a high percentage of fraud, in which case you've got a lot of people in the free trial state that aren't going to become paid subscribers. You crank down on that and you run the risk of blocking a few people that are going to be paid subscribers. So you're always optimizing between the two.

So our statements were more about the continual optimization and the fact that in September we had a fair number of folks -- I'd say less than 20% -- in our Latin American free trials that were in a state where we didn't think they were going to matriculate to a paid subscriber.

Doug Anmuth - *JPMorgan - Analyst*

Just one more related to 3Q, in particular, for you, David. Can you help us understand the breakdown in amortization costs and the library between domestic and international?

David Wells - *Netflix Inc - CFO*

Sure. You've got some of that in our cost-of-revenue break out and our financial statements, but if you're referring to the change in the amortization, the \$27 million in additional amortization, \$20 million was domestic and \$7 million was international.

Rich Greenfield - *BTIG Research - Analyst*

Moving onto Q4, when you think about Q4, you're looking for a notable improvement in Q4 profitability, internationally, in terms of streaming. You didn't really give much background in terms of what was driving that. It's that purely a subscriber growth and no new market launches or is there more to why international profitability is starting to really improve?

Reed Hastings - *Netflix Inc - CEO*

You've got the right synopsis of it, Rich. Which is, it's about growing the revenue and we don't have a new launch country. So on the natural, on a sequential basis, you would see it steadily improve, absent additional launches.

David Wells - *Netflix Inc - CFO*

The only thing I'd add to that, Reed -- this is David -- is that with more and more markets, if you've got a small improvement in each one of those additional markets, it's just the nature of having multiple markets that when you stack them all together, you see a total that actually improves sequentially. It's a little bit of easy math there, but it is part of that picture.

Doug Anmuth - *JPMorgan - Analyst*

Reed, just a question on 4Q and the outlook in particular. You talked about in 3Q having the easier comp from the summer Olympics. Why not expect 4Q US streaming net adds to be about the 4Q 2012 levels, given the way content has improved over the past year?

Reed Hastings - *Netflix Inc - CEO*

Well, that's where I started our internal forecast discussions, too, because we've had three quarters where we've been above past year. And so it makes sense that we would all think that. But it really does turn out that there -- in Q1 we were ahead of year ago because of subscriber redefinition we did the prior quarter. In Q2, with the launch of Arrested, which is the only franchise that already had a big market up front. And then Q3 we have the soft comp. So that's why we will be quite pleased with a steady year-over-year for Q4. And that's the underlying belief system. And that's what we're tracking to also in the first 3 weeks of the quarter.

Rich Greenfield - BTIG Research - Analyst

And when you look at -- if we move on category-wise to domestic streaming -- when you think about your comments about the margin improvement, I think on the last few calls you've talked about 100 basis points -- or you shifted 100 basis points to 400 basis points year-over-year for each quarter. And you said that that was really contingent upon your ability to continue to grow subscribers domestically at the same rate that you have been.

When you look at that -- and you seem pretty confident in your ability to keep that going, going forward. Should we take that to mean that you think that you can continue to add 7 million-ish subscribers in 2014 and beyond, or does margin improvement have to slow as you move into 2014 and 2015?

Reed Hastings - Netflix Inc - CEO

Well, on this calendar year, it's about 6 million domestic net additions, not 7 million. But if we are able to continue 6 million next year, then we believe we can keep the margin continuing to grow. So that's what that says, is that we really need that 6 million next year consistent with this year and then the margin can continue to grow the 400 basis points quarter-over-prior-year-quarter. Does that answer your question?

Rich Greenfield - BTIG Research - Analyst

Yes.

David Wells - Netflix Inc - CFO

Rich, this is David. I would add to that, that we're also growing content expense. So the growth that we're talking about allows us to expand margin and also grow our content expense.

Doug Anmuth - JPMorgan - Analyst

When you think about domestic streaming and, for Reed in particular, you've talked about 60 million to 90 million US subscribers potentially at some point. Do you think about either the quality of content or the technology as being the bigger inhibitor toward reaching this goal over time?

Reed Hastings - Netflix Inc - CEO

We have that same debate internally and the metaphor I use is that it's like a plane with two big engines and you want both engines working as fast as you can. You don't really know which one is contributing what, but we want to have the most incredible technology that we can in terms of on-demand personalization and that makes a fundamental difference. And we want to have the most incredible content that we have, both licensed and original. And if we can do both of those really well for the next couple years, that is very optimistic for us and would lead to a big growth.

The third one that we're getting better and better at is our advertising. As you can see, we put in some links in the script, and you can get the feel and sense of the improvement in our ability to market our content and really develop that connection. And why don't I flip it to Ted for a second, on what you see, Ted, as the content growth improvement? Because I think Doug is talking about that?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Thanks, Reed. And Doug, and I think the content continues to improve. And as David pointed out, in the current forecast, it includes room to continue to invest. What we've seen is, is that some of the original content has got a particular halo effect on the brand that creates a stickiness that we're liking the signs of, for sure. And that's why we are continuing to invest in that space.

So it's like one of those things where evolving Netflix from being a place where I can see a lot of my favorite shows to the place I can see the shows that I love is a big investment that we're moving toward. So it's all dependent on having the great delivery technology that keeps that in the background for consumers when they just want to know how Netflix works. That's where you lose them so we just want to know that you just push play and it works.

Rich Greenfield - *BTIG Research - Analyst*

So you launched personal profiles in the quarter. That's something that has been talked about for a long time, getting to more of an individualized basis. Did it have a notable impact? Are you seeing most consumers set up personal profiles or is it still something where it's an education process? And just attached to that, you haven't updated in I think six months now, actual usage of Netflix from a global standpoint. I think in Q1 you said 4 billion plus hours were streamed after House of Cards aired. Any update you can give us on those numbers?

Reed Hastings - *Netflix Inc - CEO*

Sure, Rich. We did about 5 billion hours in the last quarter. It's continuing to grow.

On profiles, we're seeing continued growth in the adoption. It's mostly targeted at new members signing up. Most existing members have a way that they use Netflix that they are used to and a few highly motivated of those will set up a profile. But most of it comes in the initial set-up screens. And that is targeted largely at families, where you want to set up a profile for one of your kids or all of your kids and keep the kids' viewing separate from the parents'. So there is a little more use of profiles than that. You can use them in various ways but that's the initial big focus. And profiles have been great. Yes, it's been talked about a long time, and we're really excited to actually have it out and in use.

Doug Anmuth - *JPMorgan - Analyst*

A question for David. Can you talk to us more about how you expect streaming margins to scale over time and do you believe you can get to the current margin levels of paid TV cable networks?

David Wells - *Netflix Inc - CFO*

Sure, Doug. What we've said in our long-term letter and previous questions we get in, is we don't really have a long-term margin target. We think as long as we're able to continue to grow at the rates we've seen this year, next year we can continue to expand and invest in content and grow margins. With continued scale and growth, our margins should continue to grow but we don't have a long-term target.

Rich Greenfield - *BTIG Research - Analyst*

When the studios -- if we're going to move over topic-wise over to your actual original programming strategy -- was just thinking, when content is commissioned, you end up with people watching a whole number of episodes at once. It really is up to the consumer to choose how they want to watch and what they want to watch. The average broadcast show is actually -- people try it and generally get only a couple of episodes in before they end up usually giving up and it's a very rare show where people end up watching an entire season of content.

For Netflix, when you say that your content is quote-unquote successful, and I think all of you have talked to a five for five batting average, does that assume that the average consumer is watching all of the episodes or your average Netflix subscriber who starts House of Cards has actually watched the whole series or are they only watching, say, six or seven of the shows? How do we think about that?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Rich, we have a remarkable complete rate, and that's one of the metrics we talk about when we talk about success. Because it's a pretty safe bet that if somebody watches all 13 episodes of a show in a pretty short time span that they love that content, so it's a good leading indicator for us that we're doing okay with them.

I know, to your point, where there is traditionally a pretty high bail out rate after the third or fourth week of a new show. And what we see is a pretty steady growth as people both binge right out of the gate, and then settle into a more comfortable viewing pattern. So we do have a favorable complete rate to anything that I've seen on television when I've tracked the ratings.

Doug Anmuth - *JPMorgan - Analyst*

Just as a follow-up on originals, Ted, you've said in the past that each subsequent show has been better or had more viewing than the one preceding it in terms of originals. Can you just talk to--?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

(Multiple speakers) in the first week. That's what that comment was that in the first seven days of each of the new shows.

Doug Anmuth - *JPMorgan - Analyst*

Okay. Can you tell us how audiences are building for some of the earlier originals? For example, like House of Cards?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

In what -- I'm sorry -- in what patterns of the building?

Doug Anmuth - *JPMorgan - Analyst*

Well just in terms of how the show continues to build audience even after the initial run?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

They are continuing to build. We have this burst of excitement at the beginning usually tied to the marketing that we're doing and also the positive press spin that's going on around the new shows in their first couple of days. But unlike other shows that tend to lose audience week over week over week, we cumulatively gain audience as we go along.

So in House of Cards, we had another unique bump when the show was nominated for the Emmy Awards. We saw a measurable bump in both users and hours watched, as people discovered the show for the first time and -- or returned to the show after having tried it at the beginning. So we're seeing -- they are certainly not dead after the first couple of days or first couple of weeks of the show and they're continuing to find new audience. The way we do for licensed content, too. The way we saw lots of audience build around Breaking Bad early seasons as the last season came on the air and was receiving a lot of press attention. So no different than that.



Rich Greenfield - BTIG Research - Analyst

And--

Reed Hastings - Netflix Inc - CEO

Doug, one of the things that we'll see for the first time next year is what we're able to do with season 2 with these shows. So when we have season 2 of House of Cards, we're going to be doing a lot to get people into season 1 in the beginning and to really complete that. So we think we'll get a big boost in season 1 viewing as we're remarketing the brand House of Cards and really engaging in the excitement around season 2.

Rich Greenfield - BTIG Research - Analyst

You recently announced that -- I think Ted announced, actually, when he was speaking -- that you're increasing your investment in originals. You had before said that it was going to be under 10% and now you seem comfortable with a number larger than 10% of overall programming, eventually, over the next couple of years being original programming.

Curious, I assume embedded within that is not only the season 2s of all the shows we just mentioned, but also the new Damages writers show that you just announced with Sony? And then just curious, you also had a show, I believe, from the Wachowskis is called Sense8 or Sense8 --?

Ted Sarandos - Netflix Inc - Chief Content Officer

Yes. We announced that a few months ago. Right.

Rich Greenfield - BTIG Research - Analyst

That's also a 2014 to show? Because that wasn't in your press release? And I'm just wondering, what is actually in your expectations for 2014 original programming and why the change in the level of spending?

Ted Sarandos - Netflix Inc - Chief Content Officer

Well, it's a -- remember that we're trying to optimize for high-quality shows. So they take a long time to discover; they take a little bit longer to build; and the delivery time becomes a little more elastic. So we announced last year we expected Sense8 to land in the end of 2014 and we still do. It's subject to move a little bit, I imagine. We do expect the KZK show to deliver in 2014, as well. I know we have some other announcements coming along the way.

To your earlier part of your question, we said it's a doubling of where we're at today. That includes some of these shows -- some shows that we've yet to announce. And including some of these shows that have yet to launch, like the first wave of the DreamWorks animation deal, the season 2s, and all the content.

So we're trying to move as quickly as we can. And we think that it's not that we're going to -- comfortable with a number bigger than 10%. We're comfortable with the number that we are currently sitting at and where we are currently looking to grow to, and we're going to keep reviewing it. HBO, as an example, is about 40% of their spend is on original programming. So there's a big gap from where we are to where we could be.

David Wells - Netflix Inc - CFO

Rich, this is David. Just at the risk of repeating a little bit about -- of what Ted just said, to reconcile some of those comments, it's our intention, as we've said, to double it. The expense will still be sub-10% likely next year. It just takes a long time, in terms of the lead time, to get the shows out and with the commitment to quality, to get those out.

But the doubling of expense over time is certainly there. We've talked 10%, 20%, 25%. We don't know what the right number is but we know that it's going to grow over time and with the success we've seen to date, we are going to continue to expand it.

Doug Anmuth - JPMorgan - Analyst

Just along those lines, would you ever want to own content outright? How do you think about ramping up your own production capabilities to control a series completely? What would have to happen for you to shift the model more in that direction?

Ted Sarandos - Netflix Inc - Chief Content Officer

So we would like to control the territories and the windows that we need. And we could either achieve that through owning it outright or by negotiating with third-party producers to end up in the same place and I'm a little indifferent between the two.

In our early goings, we were protective and trying to hedge our bets as we stepped into content and certainly didn't want to build a big infrastructure around ownership -- something we'd be much more comfortable doing today. And particular considering the complexity of new territories as we open them up.

Rich Greenfield - BTIG Research - Analyst

When a company fails in the original production business, all of your peers, Ted, they end up taking an immediate write down of the content. They really have to expense it right away. Given your model, where it's all part of the subscription process, how does one determine whether a show would have to be written off and given the long life of being able to be on the Netflix quote-unquote shelf, will we ultimately see write-downs from Netflix? Because obviously everything you make won't be in the five-for-five batting average range?

David Wells - Netflix Inc - CFO

Yes. I'll probably take this one, Ted. Rich, likely you won't see many write-downs in the sense that we've already got a shorter amortization period than the license period. But if we feel like the hours viewed are not going to be generated from a particular title or a piece of content, we would look across that category, we would look at the title and say, are we materially off of it and then we would have to make a judgment.

But generally, we're already shorter than the license period. So there's some conservatism there. And then we would look at our projections to see how far apart we are. But generally it's about those hours coming in spread over the life of the term, which is less about whether you have a piece of content that you think is going to be viewed a half than something you expected before and it's more about the pattern of those hours.

Ted Sarandos - Netflix Inc - Chief Content Officer

How quickly the viewing happens, right?



David Wells - Netflix Inc - CFO

Right. And so there's an opportunity cost, though, if we do have a show that is performing significantly less than we expected, that will obviously crowd out other investments that we could be making and other content that we could be making.

Doug Anmuth - JPMorgan - Analyst

This one for Ted. You've obviously already broken new ground in terms of releasing all the episodes of a particular season at the same time. How do you think about the breaking further convention and perhaps releasing a second season or a next season of a show sooner than that traditional 12-month Hollywood cycle?

Ted Sarandos - Netflix Inc - Chief Content Officer

Yes, we're very excited about trying to do that in terms of when we go into a show. Particularly, if we're having to -- if we've committed to multiple seasons upfront, then we would accelerate the production schedule. But again, we don't want to lose track of quality, so we want to leave time for the writing to be as best as it can be. And also for the talent to rest in between seasons, but ideally we'd like to reduce those cycle times between seasons beyond -- tighter than the one year we're seeing today.

We went to a second season of Orange is the New Black early, because we had seen all 13 episodes, we were highly confident in the forecast models, and the quality of the show, and it enabled us to move into production sooner and close the window between season 1 and season 2. So you see it in that show already.

Rich Greenfield - BTIG Research - Analyst

If we look to content beyond the TV series that you're creating and think more broadly, I asked you at the end of the last conference call about movies, and it seems like over the last few months, more and more of people in the movie industry keep expecting you to do something in the movie business.

Curious what's stopping you? It seems like you seemed to have quite an interest in breaking into the movie business. If you did it, what would it look like? Documentary? [100 million] type? Are we talking Avengers? What do you want to do and why would you want to be in the movie business?

Ted Sarandos - Netflix Inc - Chief Content Officer

Well, we're looking at all those things you just described and we are actively looking right now at a few documentary projects that will premiere on Netflix versus more traditional windows. And on the movie side, I would keep my mind wide open to what those films would be and what they would look like.

And really the driver of it is, like we were able to break convention on television by offering all episodes at once, something that consumers have really loved, we'd like to do more of that in the movie space, in that today we're held to the traditional pay television model, meaning the movies are not coming to Netflix until they hit pay television, almost a year after they are in theaters. Even though that window is moving, I don't know that it's moving aggressively enough for people who really do have experience more in a demand or more on-demand lifestyle around their content. So I think that the more we could be aggressive with windowing by taking more control over the content earlier in the process, that would be good for our members.



Doug Anmuth - JPMorgan - Analyst

There is increasing talk about the NFL looking to sell certain digital rights to other providers. Can you talk about your appetite for live event and sports content and how you might be able to use that potentially as a loss leader for sub acquisition? Is it possible you could even make the economics on that content itself work out?

Ted Sarandos - Netflix Inc - Chief Content Officer

I'd say we're in the same place we were, Doug. We're still not interested in sports. What we bring to the table is a lot of improvement because of all the attributes of on demand. And I don't think that brings much to sports viewing, which is primarily a linear experience.

Rich Greenfield - BTIG Research - Analyst

A topic that I think is near and dear to everybody right now in terms of Netflix is your MVPD ISP relationships and how that plays out and Doug and I have a number of questions on that topic. First off, John Malone was in New York for the Liberty analyst day, obviously, representing in part, Charter. And he basically said that riding on the pipes of the ISPs for free is quote simply unsustainable. Was hoping for a big picture response from Reed?

Reed Hastings - Netflix Inc - CEO

Yes. When you look at broadband collecting \$40 to \$60 a month for offering broadband and not having to pay content costs, I could say, well, that's unsustainable, they have to pay some of the content costs. But in fact, the argument works both ways. And we think it will work out in the long-term best if there's neutrality and that if we bring the bits, there's an interchange, and that there's no charging at the interchange. And this is the architecture that's allowed the growth of the global Internet, which is not taxing each other. So we're very optimistic that that will continue.

There are people who, say, own cable companies or own content companies, who aspire on the other side to collect but I don't think it's going to happen. It's definitely still emerging and growing. And in general with our Open Connect, which is free to all ISPs, we are seeing a great adoption. It's nearly every single ISP outside of the US and its many of the smaller ones inside the US so we're definitely making some real progress there and I think it will leave room for great consumer services from broadband companies and from content companies.

Doug Anmuth - JPMorgan - Analyst

Just along those lines, can you help us understand how the recent deals are structured with Virgin Media and Com Hem? In the past, I believe you primarily paid on devices and subscriber acquisition on more of a per sub basis. Are we seeing any more of a shift toward recurring economics with these kind of deals going forward?

Reed Hastings - Netflix Inc - CEO

Yes, Doug. As you would suspect, I can't get into the individual terms. And what I would say is that we're really set to try to help Virgin expand their footprint. They're doing a leading-edge job with their MVPD. And what we hope to do is be able to use that quality of experience that they're generating to help them grow share because of course then other MVPDs will want to do that also.

Rich Greenfield - BTIG Research - Analyst

When you look at the US, what are the biggest challenges? Google Fiber has you on their box. They actually in some ways sell their box to the consumer. Others are leasing the boxes. Is it possible for you to be on a Comcast leased set top box or does it have to be on a box like a Roku or Apple TV? Can you just walk us through what are the biggest hurdles to replicating this in the US?



Reed Hastings - Netflix Inc - CEO

No, I'm sure we could be on a Comcast box. So the real question is, we have to figure out deal terms that make sense for both sides. And it's been an ongoing discussion with many of the MVPDs, not limited to Comcast. But I have an X1, the Comcast box, at home. It's got an [apps] and I listen to Pandora on it. And I think, of course, well, I'd like to be able to watch Netflix and that would keep me on the Comcast X1, which is a great product. So I'm really hopeful that we can do that with both Comcast and other people in the industry.

Rich Greenfield - BTIG Research - Analyst

But David was speaking at a conference just a couple of weeks ago and said that some of your programming deals make that very challenging. Could you elaborate?

Reed Hastings - Netflix Inc - CEO

Sure. I don't think at this point it would be a problem to be on a Comcast box and presumably others. So historically there definitely were some concerns but I think we're through that at this point.

Doug Anmuth - JPMorgan - Analyst

Just following up on that, does the CDN you've built play into the implications for getting wholesale deals done?

Reed Hastings - Netflix Inc - CEO

A little bit because we want to do is have a great experience on these boxes. And the ISPs that directly interconnect with our Open Connect CDN get a better experience, higher video quality, less re-buffering. And so with Virgin we're integrated all the way through and it creates a better experience. And that's really what everybody wants is a better experience.

Rich Greenfield - BTIG Research - Analyst

Could you talk about your ISP penetration rates? Do you see a notable difference in terms of cable operators versus telco fiber versus DSL? Are there real differences at this point? Are people looking towards the highest quality charts that you roll out each month in terms of who's the best?

Reed Hastings - Netflix Inc - CEO

Well, I would say a few consumers look but I can't say that people move in droves from one to another just based on our comparison. But what we really see is that ISPs -- especially cable and fiber -- want to invest in the next-generation architecture to be able to offer 100 megabits, a gigabit, and you're seeing this because these are very highly profitable businesses if you can get them to scale.

And there's no point for a consumer getting 100 megabit pipe or a gigabit pipe if it doesn't get to places like Netflix and YouTube quickly. So it's both the on ramp -- that's the speed that's rated -- and it's how well interconnected it is. And that's why we developed this free Open Connect program to be able to supply those highest possible speeds.



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Doug Anmuth - JPMorgan - Analyst

Just shifting gears to talk about international streaming a little bit, how should we think about the relative degrees of profitability in the international markets? How many perhaps are currently profitable? And how do you think about general time frame to reach break even?

Reed Hastings - Netflix Inc - CEO

Go ahead, David.

David Wells - Netflix Inc - CFO

Either one of us can answer that but, Doug, we've said for competitive reasons that we don't provide additional color on the markets. You can take the information that you do have, which is the progression of the overall international loss getting better each quarter, and our statements that we're growing net additions or members in each one of those markets. So both of them give you an indication of improving pictures in each one of our markets.

Rich Greenfield - BTIG Research - Analyst

When you look at the top 10 broadband markets, Netflix right now, if you look at total household subscribers in millions, Netflix is only in 3 of the top 10, the US, the UK, and Brazil; that leaves 7 very large broadband markets that you have not attacked yet. The markets that you've actually entered most recently, leaving off Latin America, are actually relatively smaller in terms of total broadband subscribers. When do you go for the big ones? What's holding you back from getting into some of those very large broadband markets?

Reed Hastings - Netflix Inc - CEO

Well, it's definitely something we're looking at, Rich. We definitely have been being a little bit more cautious since the price change 2 years ago. And our thinner base in the US, now we're gaining momentum there. We expanded in the Nordics a year ago. Netherlands recently. And so when we look forward to next year, we'll definitely be looking at some larger expansions in terms of the size of broadband markets.

Doug Anmuth - JPMorgan - Analyst

Just following up there, you highlighted the initial response in the Nordics and the Netherlands. Can you talk a little bit more about the experience you've had there so far, the characteristics in those markets that have made them potentially off to a faster start than some of the other markets that you're seen?

Reed Hastings - Netflix Inc - CEO

Well, really we've had great and consistent success across all of the markets except for the payments issue that we underestimated in Latin America. We've been straightforward about that. We're making progress on that. And over time, Latin America will be an enormous success for us. It's already growing rapidly. The number of broadband households in Latin America will exceed the US over the next 5 years. So it's really a huge -- and broadband households is subscribers households who have enough money to pay for broadband. So that's even up the count. And Latin America will be huge in that category and huge for us.

But other than the payments issue, we've had a very consistent reception across all of the markets of -- people want on demand. And everybody loves -- not everybody but in every market, there are lots of people that love Hollywood content. And then we're continuing to augment that with lots of local content.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

It's worth pointing out, too, Reed, that House of Cards and Orange is the New Black, particularly, but also Hemlock Grove and all the original shows, have been remarkably popular in every territory we operate in, even on much lesser marketing spend. So we've been thrilled that we've been able to find some real international scale with our original programs, as well.

Rich Greenfield - *BTIG Research - Analyst*

And Ted, while my Brazilian is not great -- or Portuguese is not great -- it does seem like from reading some of the local papers that you have done a little bit of local programming in Brazil. Wondering if you can talk to us about that, how significant spend-wise and is this the start of much larger local programming strategy overseas?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Rich, it's pretty much a scale problem, right? So you have to have enough people there to program for them specifically or to produce for them specifically. I'd say what we're doing in Portuguese local language content in Brazil is very much at the experimental stage. And we think, given the indicators that we're seeing in Latin America, that it's very feasible that we can make the economics work for local production in some of these territories.

Doug Anmuth - *JPMorgan - Analyst*

Just one more on the international markets, do you ultimately believe that most of these markets can look like the US in terms of penetration and usage, assuming the technology, the broadband capability is ultimately on a comparable level? Or do you think that there is something else unique about the US just in terms of penetration or usage goals that would make this market different?

Reed Hastings - *Netflix Inc - CEO*

No. I don't think there's anything fundamental that's different about the US. If you look at YouTube usage, it's about 80% international. If you look at Skype revenue before they were acquired, it's about 83% international.

So given the relative size of the economies, the US, which is 5% of the population, generates more revenue than its population count in the world. But it should be around 20%/80% in the long term. Maybe 30%/70% since we started so US-centric and DVD-centric but those are the numbers that the other large Internet firms have.

Rich Greenfield - *BTIG Research - Analyst*

If we shift over to competition, we have new management now at Hulu, new cash infusion of \$700 million at Hulu. Amazon supposedly -- it seems like worst kept secret -- is rolling out some form of a set top box. Wondering when you look at 2014, are you expecting a more aggressive domestic competitive landscape than we've seen throughout 2013?

Reed Hastings - *Netflix Inc - CEO*

Not particularly. There are certain markets like the UK that are very competitive with BSkyB and NOW TV. There are other markets -- well, all of the markets really are pretty competitive. And remember it's that we just don't compete against say other \$8 to \$10 video services. We compete broadly against cable and satellite; we compete against video games; we compete against just browsing time, killing time on the web. And so it's because we compete so broadly that we haven't seen any material effect as more direct competitors have risen and fallen in the last 2 or 3 years.



There's a lot of competition for content. But then if you think of our originals, there we compete with about 40 different cable networks that are producing originals. So if you're a writer and you have a great idea, you are bidding it out broadly to see who will buy bite at the best price.

Doug Anmuth - JPMorgan - Analyst

Just one more on the competitive front, Reed. If we look at Google searches for Netflix, it looks like they vastly exceed those for LOVEFiLM right now in the UK. What you think is driving the success that you're having there relative to LOVE given that they were earlier to the market?

Reed Hastings - Netflix Inc - CEO

It's a really tough thing doing a hybrid play with DVD. People associate you with DVD. And the branding of LOVEFiLM Instant is impossible to deliver on. It's the conundrum that we figured out when we were doing both. And so LOVEFiLM to people meant DVD and super-broad selection and LOVEFiLM Instant, which is the brand, means all that but now streaming and for a series of rights issues, no company can deliver on that.

And so Redbox Instant has the same problem. The brand fundamentally is not correct because they can't deliver on that promise, as exciting as it sounds to consumers. So that's a big tension. Now Amazon is having a lot of success on the pay-per-view side and on streaming inside of Prime. And so those are really the areas of focus for them. And they're very successful in those areas.

Rich Greenfield - BTIG Research - Analyst

Playing, though, exactly on what you just said, Reed, and shifting over to your DVD business, Netflix really has become synonymous with streaming on a global basis. Is your DVD business at this point strategic? Are there other ways to best create value out of that business for Netflix?

Reed Hastings - Netflix Inc - CEO

I think the best way is within Netflix and it's running as a stand-alone group that's doing great work. We've got over 7 million people that are very excited to have the breadth of selection, including all the HBO and Showtime series, on DVD. So it's just got a super selection. But we don't market it a lot partially because of that brand confusion problem. So it's really -- it will shrink a little bit every year. But I think the best way to monetize it is going to be to keep it as it is.

Doug Anmuth - JPMorgan - Analyst

Reed, you've long talked about users preferring to watch Netflix content on their large-screen TVs. Google, the other night, said that 40% of YouTube usage was now coming to via mobile. How much of Netflix's total viewing comes from mobile devices currently? And how much of a driver do you think mobile ubiquity is just in driving new subscribers and then also reducing churn?

Reed Hastings - Netflix Inc - CEO

Well, there's mobile on cellular networks and that's fairly small for us. I think it's a combination of the long-form content and the data caps that are on those plans. And then there's mobile within the home where it's on Wi-Fi and it's the device you watch in bed, you watch curled up on the couch. And that's been quite large for us. So it's really depends on the subcategory. But fundamentally, where Netflix works best is with an Internet screen that's got on Wi-Fi rather than on cellular networks.



Rich Greenfield - BTIG Research - Analyst

And when you think about those devices, could you give us any color on is tablets now -- if you think about in-home viewing -- is tablets now a meaningful percentage and do you see differences between what -- are people using it more on iOS than on Android? We've heard from some people -- Allen from Michinima, the other day, indicated that most of their viewing actually occurs on tablets on iOS devices. Are you seeing similar type patterns where there really is a skew?

Reed Hastings - Netflix Inc - CEO

Well, we don't give out individual breakdowns either on devices or on OSs. But in general, the competition between the Android family and the iOS family and the Windows family is creating a great bounty for consumers because of the low prices and attractive usage patterns and then Netflix, YouTube, and others benefit from all of those usage patterns. So tablets are growing, mobile phones are growing, but frankly so are smart TVs growing very rapidly for us.

Doug Anmuth - JPMorgan - Analyst

Can you talk about what kind of lift you expect to see in 4Q from the new gaming consoles? And is this as material now as it was in the early days of streaming when you were just beginning to get distribution?

Reed Hastings - Netflix Inc - CEO

Doug, I think we'll see very little lift from that because the people who buy the PS4 and Xbox One are the people who already have the PS3 and the Xbox 360. They are the hard-core fans who want to get the coolest, latest thing to play more games. So the first wave does not expand the market for us or for them. So it's really a question of do those companies over time pioneer a model where instead of 60 million or 80 million as a lifetime they get to 200 million or 300 million units? So through some combination of price and utility, and then it becomes expansive. But that's a couple years down the road.

Rich Greenfield - BTIG Research - Analyst

When you look at the overall viewing that you have, you've talked about three-quarters of it coming from your recommendation engine. Just curious, when you look at that recommendation engine going forward, can it still get a lot better? In your press release, you talked about -- or actually, the update to your long-term view, you actually detailed that you're increasing your spending on technology up to \$400 million from \$350 million was in the prior long-term view. Is that to make things like the recommendation engine better? What are you trying to do in terms of make the product better? What's not good right now in terms of the offering?

Reed Hastings - Netflix Inc - CEO

The recommendations are getting better and better, which is a combination of the data that we can collect, and then how much CPU and intelligence we can put in terms of processing that.

And so it's got a long way to go. If you think about where we'll be in 5 or 10 years, how much better will Google Search be? How much better will Netflix recommendations -- how much better will Amazon be? All of the different businesses are getting better at processing these large amounts of data to synthesize better and better recommendations. And so I'm very optimistic about it over the next couple years getting to where there's a half-dozen recommendations that we offer that are cherry-picked and that a large percentage of the time one of those half-dozen are exactly what you're looking for.



Doug Anmuth - JPMorgan - Analyst

A question for David, just on the balance sheet. What are your thoughts on the strength of the balance sheet currently? And if you had access to more capital, how would you potentially look to deploy this in terms of either TV production, moving into movies perhaps more directly, or expanding international quicker?

David Wells - Netflix Inc - CFO

Well, Doug, we haven't used any cash this year. We started the year with the February raise -- we were about \$1 billion now we're about \$1.1 billion. The two primary things that continue to be a use of cash are our international investments in the sense that we run negative on those, and they're at a loss on a consolidated basis, and our content spending and that's predominantly originals and output-style deals. And we'll continue to assess these but we're pretty comfortable where we are right now. Obviously, the market conditions are attractive at a number of different places but we still continue to assess it and be pretty comfortable with where we stand.

Rich Greenfield - BTIG Research - Analyst

Just to follow-up, though. Last quarter, I think you made a comment that there might be a need to tap the markets to move faster. Is that something that you think about? Given where your stock is, given where the debt markets are, why aren't you trying to move even faster right now than you are in terms of international expansion? Debt is cheap and your equity is at all-time record highs. Just why not faster is really the open question?

David Wells - Netflix Inc - CFO

Well, Reed and I can take a piece of this together. But I would say that we don't feel capital constrained right now in terms of our pace of expansion. If we did, we would go out and tap the markets. But Reed, if you've got a follow-up for that, too?

Reed Hastings - Netflix Inc - CEO

No, I'd say the same thing, which is we think we're going at a great clip. We wanted to get back to solid profitability, be able to fund our international work. And if we went much faster on international, we would drive the global P&L negative, which is not something we've been comfortable with. So on a practical basis, we're more P&L constrained on international.

On originals, Ted knows he's got cash if he needs to use it to be able to get the right talent and the right projects. And so there's no particular constraint there, so the only reason frankly that we haven't raised more money is we don't see the need right now. So then we just balance what's a good security blanket and we think we're pretty comfortable but you could certainly make an argument we should, given all the conditions you said, take it up a little bit. But it will be pretty immaterial if we did something.

Doug Anmuth - JPMorgan - Analyst

Just following up on that note, in the past you've talked about running the overall business on a breakeven basis. But of course we see in the domestic streaming business, the 400 basis points of year-over-year margin expansion and being reasonable, obviously, in terms of how you're expanding into international markets. How do we think about that statement of running breakeven going forward?

Reed Hastings - Netflix Inc - CEO

Well, we generally say running profitable now. Keeping the business profitable. So that's how we've evolved that statement.



Rich Greenfield - BTIG Research - Analyst

When you think about Aero, they've defied the logic of the broadcasters in seeming to prove themselves legal to date in the courts. While I know that you look at yourselves as a cable network or digital cable network, much like HBO, the combination of an offering of \$8 a month for a DVR with a bunch of broadcast television stations, as well as deep catalog and great original programming from Netflix, does seem like a pretty potent combination for a good chunk -- maybe not tens of millions but certainly millions of consumers. Is an alliance or some form of greater working arrangement a possibility for you as you look forward?

Reed Hastings - Netflix Inc - CEO

Well Aero is both opportunity and threat. To some degree, it's some opportunity that more people get used to on-demand and love that. It's also a threat because the natural course for them as they get to a couple million subscribers is first to license other cable networks, trying to build a better package, and then ultimately become a competitor for Netflix.

Now they're one competitor of many competitors, as I talked about, so we don't spend any particular time on Aero. Think of it as the entertainment time pool for money and time is very large so no one competitor really has seemed to be able to affect us either positively or negatively. So I would really doubt that we notice anything specific about Aero's growth upon Netflix, either positive or negative in the next couple years.

Doug Anmuth - JPMorgan - Analyst

Just a question on cord cutting, Reed. Can you just talk about your current views in terms of where we are with cord cutting in the US? What you think the trends are there? And if you have any idea in terms of how much of a driver this is for Netflix?

Reed Hastings - Netflix Inc - CEO

Well, the trends have been quite clear. The data is that there zero cord cutting. We are at 100 million on a year-over-year basis and Q2 goes down a little bit every year as students move but it's the same as Q2 last year. So right now there's zero cord cutting. The question is, will that last -- and that really depends on does cable continue to get better? Cable is taking share from satellite. Fiber is growing a little bit, too. So there's some important and interesting secular moves in that.

But in general, consumers are getting a lot of content on cable. And that's doing well for them. And our market has not been the cord cutter market. If you think about it domestically, we've grown from 0 to 31 million and there's been no decline in MVPD households. So it's really seems pretty strong. The consumers see us as complementary to MVPD rather than a replacement for it.

Rich Greenfield - BTIG Research - Analyst

From an HBO standpoint, you passed them now in the US. I know that certainly the media blogosphere seems very excited about that statistic. But it seems like in the shareholder letter, that you seem more focused on a much bigger, long-term opportunity, which is the international subscribers of HBO at 114 million. And obviously, with your international business where it is to now, you've got a long way to go, but it also sounds like you have some big plans for international market launches in the next to 12 to 24 months. Is it years away, meaning 5-plus years away to be bigger than HBO globally? Or could you actually get that even faster than that, given the pace of broadband adoption on a global basis?

Reed Hastings - Netflix Inc - CEO

I think it will probably take longer than that because they're continuing to grow. The thing about us is as we grow, HBO is really focusing on doing incredible work. They will probably do some of the best shows they ever do in the next 5 years. They are expanding more aggressively in international. So I think what we'll see is they grow some; we hopefully grow a lot. And I don't know when we'll catch them. It's going to be a long time. At 114

million, they've been at it since 1972 -- so that's 40 years. And we've been at it on a streaming sense only 7 years. So I'm really happy with our progress-to-date, but we do have a long way to go to catch up to them.

Doug Anmuth - JPMorgan - Analyst

A question for Ted, just on originals and other content. Can you just talk more about -- obviously since you've had the originals over the last 6 to 9 months or so, this particular wave, how much that's opened up the door for writers and producers to come to you directly? Where you are on inbounds and how that's changed the environment for you?

Ted Sarandos - Netflix Inc - Chief Content Officer

Both the success of the shows in terms of the launching and certainly the success at the Emmy Awards was helpful. But mostly content creators are really attracted to the notion of creative control and being able to come here and make the show that they intended to make without a lot of creative interference.

So we get a lot of inbound traffic. I would guess that on most major projects, we are the first if not the second stop for these content creators. Because they're mostly, incredibly enthused about the idea of how we make and release the content and how we support it once it's live. So far, it's been incredibly door-opening, which was the intent of doing high-profile shows like House of Cards right out of the gate.

Rich Greenfield - BTIG Research - Analyst

A housekeeping question for David on the amortization change that you made. You talk about that \$27 million number. What was the offset? Because you are obviously ramping your marketing spend that Reed talked about, you're continuing to ramp your technology spend. You, I assume, didn't know heading into last quarter when you gave guidance that you were going to have the step-up in accelerated amortization both in Q3 as well as in Q4. Where's the offset? Is it just purely on a subscriber growth number that you're making it up? Or how do we make up that delta?

David Wells - Netflix Inc - CFO

Sure. You're correct that we didn't know heading into guidance. \$20 million of it is domestic. And about half of that, we were -- made up in terms of outperformance with subscribers, revenue, lower content, and some marketing expenses that got pushed. The other half, we were able to adjust marketing spend and so you'll see some of it gets shifted into Q4, some of the discretionary items. We were able to shift some of the other money around, so we made up the difference that way.

Doug Anmuth - JPMorgan - Analyst

Question just on the DVD front. Can you talk about where you are now in terms of distribution centers compared to where you were at the peak? And other things that you've done in terms of improving efficiency there?

David Wells - Netflix Inc - CFO

Sure, I'll probably take this one, Doug. We're about 39 centers and I think we peaked out at about 48, maybe around 50. So probably about 20% less. But we still continue to reach a great percentage of the US in 1-day service, because even if we drop a distribution center, we'll add a shuttle, which still gets the mail to that local postal center. So it's not a one-to-one relationship when we close a distribution center, that folks in that area get 2-day service. It has a large part to do with the US postal system and what's happening there. So when they close distribution centers there's only so much we can do in terms of moving things around. But we're still pleased with how much of the US we get in 1-day service.



Rich Greenfield - BTIG Research - Analyst

Shifting over to Open Connect -- Reed, you mentioned it before -- but when we had this video hangout the last time, I believe you were requiring Open Connect in order for people to have access to your highest quality content. It seems like you've dropped that mandate in order to get higher quality content out into the market. Can you discuss that change in strategy?

Reed Hastings - Netflix Inc - CEO

Yes. We realized with 4K coming, we want to be one of the big suppliers of 4K content next year. That we wanted not to complicate that as to which networks it was available on and not, and if we were going to have 4K available everywhere, we should have Super HD also available, so it's really driven from the impending next year 4K expansion.

Doug Anmuth - JPMorgan - Analyst

David, just a follow-up on the amortization. So you pulled forward the \$27 million in 3Q. Could you talk just a little bit about over the next few quarters, how we should think about that impact?

David Wells - Netflix Inc - CFO

What we said was we're not coming off our targets. So the impact is absorbed, basically, right now. So you shouldn't think of there being any impact. Obviously, there's some hit to the international side and so that's part of the losses on the international. But overall, I'll just remind folks, that it's still less than 10% of our overall content expense. So even though there's this change, the majority of that was catch-up amortization related to titles that were released prior to Q3.

Rich Greenfield - BTIG Research - Analyst

But when you see a show like Walking Dead, versus, let's just say, House of Cards, you're seeing a dramatically different profile in terms of viewership, in terms of people are watching House of Cards basically within a few month window, whereas something like Walking Dead, every night, the most-watched episode is still the first episode of season 1. And so you're seeing that defined trend change or do you think that once you launch season 2 of House of Cards, that's going to actually change back to more of the Walking Dead-like model and changing the amortization policy may have been too early to adjust, if that makes sense?

Reed Hastings - Netflix Inc - CEO

It's possible, Rich, that will be true, but we have to do what we can based upon the estimates that we have. And the difference is not so much on what happens to the tail. Remember with Walking Dead, we don't get it on same day as the new episode comes out. We get it following season. And so you're tapping into a much more stable part of the demand curve in society. Whereas when we release House of Cards we create a fervor around it as the new episode of the new show.

And so think of it as when -- with content that debuts on Netflix -- there's a surge of viewing in the first couple months that's quite strong -- and then we allocate the cost on that basis. Whereas when we get prior season from anybody else, then it's not the amount of promotion going on about that show is less for the prior season, and so it's a relatively stable demand. And that's the fundamental difference in the linear versus accelerated.



Doug Anmuth - JPMorgan - Analyst

Just a question regarding social, and Facebook, in particular. Any update just in terms of social sharing and how that's driving engagement currently?

Reed Hastings - Netflix Inc - CEO

Well, we're continuing to work on it. We've got some big tests that are in flight now, trying to find the right balance -- the right consumer model that people are excited about. But so far, no big news to talk about.

Rich Greenfield - BTIG Research - Analyst

We've gotten several questions from investors asking about Carl Icahn and what your relationship with him is now and if you have any sense of just how Carl thinks about what you've done in a fairly short time of his investment?

Reed Hastings - Netflix Inc - CEO

Well he says he likes people that make him money and so he's happy with me for now. And I'd have to refer you to him in terms of how he feels about the investment.

Doug Anmuth - JPMorgan - Analyst

Just a question on pricing, Reed. You make it pretty clear in the letter that the \$7.99 price point is working well in terms of members and contribution margin growth. How do you think about that potential to change further out?

Reed Hastings - Netflix Inc - CEO

Well, we're always looking at ideas and thinking about it but we're not on the edge of doing something. The \$7.99 is working for us very well. We'll continue to monitor the trends. We've got many markets around the world so we're able to potentially look at some different avenues. We did do a price increase in Brazil that was necessary relative to inflation. It's something can look at if we have to. But right now, the \$7.99 is working great for us.

Rich Greenfield - BTIG Research - Analyst

And when you look at international markets, we've got a couple of questions that both point to this in terms of what are you looking for now? Obviously you chose to go into some relatively smaller markets. But what are the key things now as you go forward that you're looking for in terms of which markets to launch? And will we see groups of markets like Scandinavia and Latin America, or should we expect more targeted individual countries going forward?

Reed Hastings - Netflix Inc - CEO

Ted, do you want to take that one?

Ted Sarandos - Netflix Inc - Chief Content Officer

How were looking at? We're looking mostly at markets that have all those characteristics that we would look for from the beginning. Really active online consumers. Sophisticated payment structures that we can tap into -- so well established eCommerce behavior. And a good healthy appetite

for Western content. I think our program has been, like I said, so far has been really successful everywhere we go. So we're looking for markets where that programming will travel incredibly well. And continue on that path.

Reed Hastings - *Netflix Inc - CEO*

Great. You guys almost set here?

Rich Greenfield - *BTIG Research - Analyst*

We have one more -- well, at least I have one more question. I'll let Doug ask one more, as well. But the one question that everyone wants to know from Ted, and this is very important.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Yes (laughter).

Rich Greenfield - *BTIG Research - Analyst*

Just Ted

Ted Sarandos - *Netflix Inc - Chief Content Officer*

It will be up -- it has a DVD cycle that we need to honor with Sony, who puts that through, so I don't have the date in front of me but it will be up in a few months.

Rich Greenfield - *BTIG Research - Analyst*

Before the end of the year or probably after the end of the year?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

After the end of the year.

Doug Anmuth - *JPMorgan - Analyst*

All right. Great. I think we're good from my end, guys.

Rich Greenfield - *BTIG Research - Analyst*

Thanks.

Reed Hastings - *Netflix Inc - CEO*

Okay. Great. Thanks, guys.



Doug Anmuth - *JPMorgan - Analyst*

Thank you.

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