

NETFLIX INC
Form 10-Q
October 27, 2011
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2011

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number: 000-49802

Netflix, Inc.

(Exact name of Registrant as specified in its charter)

Edgar Filing: NETFLIX INC - Form 10-Q

Delaware
(State or other jurisdiction of
incorporation or organization)

77-0467272
(I.R.S. Employer
Identification Number)

100 Winchester Circle, Los Gatos, California 95032
(Address and zip code of principal executive offices)

(408) 540-3700
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act). Yes No

As of September 30, 2011, there were 52,504,091 shares of the registrant's common stock, par value \$0.001, outstanding.

Table of Contents

Table of Contents

	Page
<u>Part I. Financial Information</u>	
Item 1.	
Consolidated Financial Statements	
<u>Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2011 and 2010</u>	2
<u>Consolidated Balance Sheets as of September 30, 2011 and December 31, 2010</u>	3
<u>Consolidated Statements of Cash Flows for the Three and Nine Months Ended September 30, 2011 and 2010</u>	4
<u>Notes to Consolidated Financial Statements</u>	5
Item 2.	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
Item 3.	
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	28
Item 4.	
<u>Controls and Procedures</u>	28
<u>Part II. Other Information</u>	
Item 1.	
<u>Legal Proceedings</u>	30
Item 1A.	
<u>Risk Factors</u>	30
Item 2.	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	30
Item 6.	
<u>Exhibits</u>	31
<u>Signatures</u>	32
<u>Exhibit Index</u>	33

Table of Contents**NETFLIX, INC.****Consolidated Statements of Operations****(unaudited)****(in thousands, except per share data)**

	Three Months Ended		Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2011	2010	2011	2010
Revenues	\$ 821,839	\$ 553,219	\$ 2,329,002	\$ 1,566,703
Cost of revenues:				
Subscription	471,823	292,406	1,277,018	817,353
Fulfillment expenses	64,794	52,063	187,728	149,212
Total cost of revenues	536,617	344,469	1,464,746	966,565
Gross profit	285,222	208,750	864,256	600,138
Operating expenses:				
Technology and development	69,480	42,108	178,250	117,370
Marketing	89,108	81,238	288,350	230,990
General and administrative	29,792	15,903	83,460	46,590
Total operating expenses	188,380	139,249	550,060	394,950
Operating income	96,842	69,501	314,196	205,188
Other income (expense):				
Interest expense	(4,915)	(4,945)	(15,083)	(14,797)
Interest and other income	1,696	853	3,574	2,746
Income before income taxes	93,623	65,409	302,687	193,137
Provision for income taxes	31,163	27,442	111,780	79,379
Net income	\$ 62,460	\$ 37,967	\$ 190,907	\$ 113,758
Net income per share:				
Basic	\$ 1.19	\$ 0.73	\$ 3.63	\$ 2.17
Diluted	\$ 1.16	\$ 0.70	\$ 3.53	\$ 2.09
Weighted average common shares outstanding:				
Basic	52,569	52,142	52,599	52,510
Diluted	53,870	53,931	54,008	54,341

See accompanying notes to the consolidated financial statements.

Table of Contents**NETFLIX, INC.****Consolidated Balance Sheets****(unaudited)****(in thousands, except share and par value data)**

	September 30, 2011	As of December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	\$ 159,199	\$ 194,499
Short-term investments	206,573	155,888
Current content library, net	705,398	181,006
Prepaid content	77,146	62,217
Other current assets	41,797	43,621
Total current assets	1,190,113	637,231
Content library, net	570,210	180,973
Property and equipment, net	143,993	128,570
Deferred tax assets	28,743	17,467
Other non-current assets	28,499	17,826
Total assets	\$ 1,961,558	\$ 982,067
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 750,107	\$ 222,824
Accrued expenses	54,671	36,489
Current portion of lease financing obligations	2,259	2,083
Deferred revenue	160,929	127,183
Total current liabilities	967,966	388,579
Long-term debt	200,000	200,000
Lease financing obligations, excluding current portion	32,400	34,123
Other non-current liabilities	372,840	69,201
Total liabilities	1,573,206	691,903
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Common stock, \$0.001 par value; 160,000,000 shares authorized at September 30, 2011 and December 31, 2010; 52,504,091 and 52,781,949 issued and outstanding at September 30, 2011 and December 31, 2010, respectively	53	53
Additional paid-in capital		51,622
Accumulated other comprehensive income, net	588	750
Retained earnings	387,711	237,739
Total stockholders' equity	388,352	290,164
Total liabilities and stockholders' equity	\$ 1,961,558	\$ 982,067

See accompanying notes to the consolidated financial statements.

Table of Contents

NETFLIX, INC.

Consolidated Statements of Cash Flows

(unaudited)

(in thousands)

	Three Months Ended		Nine Months Ended	
	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
Cash flows from operating activities:				
Net income	\$ 62,460	\$ 37,967	\$ 190,907	\$ 113,758
Adjustments to reconcile net income to net cash provided by operating activities:				
Additions to streaming content library	(539,285)	(115,149)	(1,344,187)	(231,781)
Change in streaming content liabilities	314,720	58,638	816,620	88,197
Amortization of streaming content library	187,446	44,568	417,849	93,091
Amortization of DVD content library	23,000	32,578	73,990	111,490
Depreciation and amortization of property, equipment and intangibles	11,913	8,678	31,921	28,846
Stock-based compensation expense	15,705	7,296	43,505	19,726
Excess tax benefits from stock-based compensation	(11,761)	(16,093)	(45,283)	(34,699)
Other non-cash items	(1,745)	(1,754)	(3,472)	(7,814)
Deferred taxes	(5,281)	3,194	(14,190)	(2,961)
Changes in operating assets and liabilities:				
Prepaid content	(17,335)	(25,485)	(14,928)	(32,581)
Other current assets	(8,578)	(3,374)	4,935	(12,037)
Other accounts payable	(5,422)	(10,914)	4,948	1,246
Accrued expenses	20,920	18,003	61,531	39,666
Deferred revenue	13,992	1,567	33,746	2,889
Other non-current assets and liabilities	(11,218)	2,507	(5,646)	2,648
Net cash provided by operating activities	49,531	42,227	252,246	179,684
Cash flows from investing activities:				
Acquisition of DVD content library	(20,826)	(29,900)	(62,010)	(90,993)
Purchases of short-term investments	(7,673)	(15,379)	(100,536)	(73,169)
Proceeds from sale of short-term investments	37	42,238	31,508	105,063
Proceeds from maturities of short-term investments	1,805	1,995	18,440	10,318
Purchases of property and equipment	(14,080)	(7,342)	(39,026)	(19,406)
Other assets	(844)	2,782	1,419	10,289
Net cash used in investing activities	(41,581)	(5,606)	(150,205)	(57,898)
Cash flows from financing activities:				
Principal payments of lease financing obligations	(526)	(470)	(1,547)	(1,296)
Proceeds from issuance of common stock	4,409	10,927	18,589	33,954
Excess tax benefits from stock-based compensation	11,761	16,093	45,283	34,699
Repurchases of common stock	(39,602)	(57,390)	(199,666)	(210,259)
Net cash used in financing activities	(23,958)	(30,840)	(137,341)	(142,902)
Net increase (decrease) in cash and cash equivalents	(16,008)	5,781	(35,300)	(21,116)
Cash and cash equivalents, beginning of period	175,207	107,327	194,499	134,224

Edgar Filing: NETFLIX INC - Form 10-Q

Cash and cash equivalents, end of period	\$ 159,199	\$ 113,108	\$ 159,199	\$ 113,108
--	------------	------------	------------	------------

See accompanying notes to the consolidated financial statements.

Table of Contents**NETFLIX, INC.****Notes to Consolidated Financial Statements****(unaudited)****1. Basis of Presentation and Summary of Significant Accounting Policies**

The accompanying consolidated interim financial statements of Netflix, Inc. and its wholly owned subsidiaries (the Company) have been prepared in conformity with accounting principles generally accepted in the United States (U.S.) and are consistent in all material respects with those applied in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission (the SEC) on February 18, 2011. The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant items subject to such estimates and assumptions include the amortization methodology of the Company's content library, the valuation of stock-based compensation and the recognition and measurement of income tax assets and liabilities. The Company bases its estimates on historical experience and on various other assumptions that the Company believes to be reasonable under the circumstances. The actual results experienced by the Company may differ from management's estimates.

The interim financial information is unaudited, but reflects all normal recurring adjustments that are, in the opinion of management, necessary to fairly present the information set forth herein. The interim financial statements should be read in conjunction with the audited financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010. Interim results are not necessarily indicative of the results for a full year.

The Company is organized into two operating segments: Domestic (the United States) and International. See Note 10 for further information about the Company's operating segments.

Certain prior period amounts have been reclassified to conform to current period presentation. These reclassifications did not impact total assets, total liabilities, stockholders' equity, results of operations or cash flows.

There have been no material changes in the Company's significant accounting policies as compared to the significant accounting policies described in the Company's Annual Report on Form 10-K for the year ended December 31, 2010.

2. Net Income Per Share

Basic net income per share is computed using the weighted-average number of outstanding shares of common stock during the period. Diluted net income per share is computed using the weighted-average number of outstanding shares of common stock and, when dilutive, potential common shares outstanding during the period. Potential common shares consist of incremental shares issuable upon the assumed exercise of stock options, and for 2010, shares that were purchasable pursuant to the Company's employee stock purchase plan (ESPP) using the treasury stock method. The Company's ESPP was suspended in 2011 and there were no offerings in 2011. The computation of net income per share is as follows:

	Three months ended		Nine months ended	
	September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
	(in thousands, except per share data)			
Basic earnings per share:				
Net income	\$ 62,460	\$ 37,967	\$ 190,907	\$ 113,758
Shares used in computation:				
Weighted-average common shares outstanding	52,569	52,142	52,599	52,510
Basic earnings per share	\$ 1.19	\$ 0.73	\$ 3.63	\$ 2.17

Diluted earnings per share:

Edgar Filing: NETFLIX INC - Form 10-Q

Net income	\$ 62,460	\$ 37,967	\$ 190,907	\$ 113,758
Shares used in computation:				
Weighted-average common shares outstanding	52,569	52,142	52,599	52,510
Employee stock options and employee stock purchase plan shares	1,301	1,789	1,409	1,831
Weighted-average number of shares	53,870	53,931	54,008	54,341
Diluted earnings per share	\$ 1.16	\$ 0.70	\$ 3.53	\$ 2.09

Table of Contents

Employee stock options with exercise prices greater than the average market price of the common stock during the period were excluded from the diluted calculation as their inclusion would have been anti-dilutive. The number of options excluded for the three and nine months ended September 30, 2011 were 188,609 and 75,823, respectively. The number of options excluded for the three and nine months ended September 30, 2010 was immaterial.

3. Short-Term Investments and Fair Value Measurement

The Company's investment policy is consistent with the definition of available-for-sale securities. The Company does not buy and hold securities principally for the purpose of selling them in the near future. The Company's policy is focused on the preservation of capital, liquidity and return. From time to time, the Company may sell certain securities but the objectives are generally not to generate profits on short-term differences in price. The following table summarizes, by major security type, our assets that are measured at fair value on a recurring basis and are categorized using the fair value hierarchy:

	Amortized Cost	September 30, 2011		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
		(in thousands)		
Cash	\$ 157,229	\$	\$	\$ 157,229
Level 1 securities (1):				
Money market funds	6,532			6,532
Level 2 securities (3):				
Corporate debt securities	116,569	743	(171)	117,141
Government and agency securities	87,663	740		88,403
Asset and mortgage-backed securities	970	59		1,029
	\$ 368,963	\$ 1,542	\$ (171)	\$ 370,334
Less: Long-term restricted cash (1)				(4,562)
Total cash, cash equivalents and short-term investments				\$ 365,772

	Amortized Cost	December 31, 2010		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
		(in thousands)		
Cash	\$ 194,146	\$	\$	\$ 194,146
Level 1 securities (2):				
Money market funds	4,914			4,914
Level 2 securities (3):				
Corporate debt securities	109,745	1,043	(101)	110,687
Government and agency securities	42,062	331	(101)	42,292
Asset and mortgage-backed securities	2,881	168	(140)	2,909
	\$ 353,748	\$ 1,542	\$ (342)	354,948
Less: Long-term restricted cash (2)				(4,561)
Total cash, cash equivalents and short-term investments				\$ 350,387

Edgar Filing: NETFLIX INC - Form 10-Q

- (1) Includes \$2.0 million that is included in cash and cash equivalents and \$4.6 million of long-term restricted cash that is included in other non-current assets related to workers compensation deposits.
- (2) Includes \$0.4 million that is included in cash and cash equivalents and \$4.6 million of long-term restricted cash that is included in other non-current assets related to workers compensation deposits.
- (3) Included in short-term investments.

Fair value is a market-based measurement that should be determined based on the assumptions that market participants would use in pricing an asset or liability. The hierarchy level assigned to each security in the Company's available-for-sale portfolio and cash equivalents is based on its assessment of the transparency and reliability of the inputs used in the valuation of such instrument at the measurement date. The fair value of available-for-sale securities and cash equivalents included in the Level 1 category is based on quoted prices that are readily and regularly available in an active market. The fair value of available-for-sale securities included in the Level 2 category is based on observable inputs, such as quoted prices for similar assets at the measurement date; quoted prices in markets that are not active; or other inputs that are observable, either directly or indirectly. These values were obtained from an independent pricing service and were evaluated using pricing models that vary by asset class and may incorporate available trade, bid and other market information and price quotes from well-established independent pricing vendors and broker-dealers. Our procedures include controls to ensure that appropriate fair values are recorded such as comparing prices obtained from multiple independent sources. See Note 4 for further information regarding the fair value of the Company's 8.50% senior notes.

Table of Contents

Because the Company does not intend to sell the investments that are in an unrealized loss position and it is not likely that the Company will be required to sell any investments before recovery of their amortized cost basis, the Company does not consider those investments with an unrealized loss to be other-than-temporarily impaired at September 30, 2011. There were no material other-than-temporary impairments or credit losses related to available-for-sale securities in the three or nine months ended September 30, 2011 and 2010. In addition, there were no material gross realized gains or losses in the three or nine months ended September 30, 2011 and 2010.

The estimated fair value of short-term investments by contractual maturity as of September 30, 2011 is as follows:

	(in thousands)
Due within one year	\$ 96,056
Due after one year and through 5 years	109,488
Due after 5 years and through 10 years	
Due after 10 years	1,029
Total short-term investments	\$ 206,573

4. Long-term Debt

As of September 30, 2011, the Company had \$200.0 million of long-term debt outstanding. The debt consists of \$200.0 million aggregate principal amount of 8.50% senior notes due November 15, 2017 (the "Notes"). Interest on the Notes is payable semi-annually at a rate of 8.50% per annum on May 15 and November 15 of each year, commencing on May 15, 2010.

The Notes include, among other terms and conditions, limitations on the Company's ability to create, incur, assume or be liable for indebtedness (other than specified types of permitted indebtedness); dispose of assets outside the ordinary course (subject to specified exceptions); acquire, merge or consolidate with or into another person or entity (other than specified types of permitted acquisitions); create, incur or allow any lien on any of its property or assign any right to receive income (except for specified permitted liens); make investments (other than specified types of investments); or pay dividends, make distributions, or purchase or redeem the Company's equity interests (each subject to specified exceptions). At September 30, 2011 and December 31, 2010, the Company was in compliance with these covenants.

Based on quoted market prices, the fair value of the Notes as of September 30, 2011 and December 31, 2010 was approximately \$216.5 million and \$225.0 million, respectively.

5. Balance Sheet Components**Content Library, Net**

Content library and accumulated amortization are as follows:

	September 30, 2011	As of December 31, 2010
	(in thousands)	
Streaming content library, gross	\$ 1,629,096	\$ 441,637
DVD content library, gross	604,139	627,392
Content library, gross	2,233,235	1,069,029
Less: accumulated amortization	(957,627)	(707,050)
Total content library, net	1,275,608	361,979
Less: Current content library, net	705,398	181,006

Edgar Filing: NETFLIX INC - Form 10-Q

Content library, net	\$ 570,210	\$ 180,973
----------------------	------------	------------

Table of Contents*Property and Equipment, Net*

Property and equipment and accumulated depreciation are as follows:

		September 30, 2011	As of December 31, 2010
		(in thousands)	
Computer equipment	3 years	\$ 68,907	\$ 60,289
Operations and other equipment	5 years	100,262	