NETFLIX INC
Form 10-Q
April 26, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2013
OR

o 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)

Delaware	77-0467272
(State or other jurisdiction of incorporation or organization)	(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 ý No o
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 ý No o
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 ý		Accelerated filer	o
Non-accelerated filer o	(Do not check if a smaller reporting company)	Smaller reporting company	o

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act). Yes o No ý
As of March 31, 2013, there were 56,143,986 shares of the registrant’s common stock, par value $0.001, outstanding.

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NETFLIX, INC.

Consolidated Statements of Operations
(unaudited)
(in thousands, except per share data)

	Three Months Ended	
	March 31, 2013	March 31, 2012
Revenues	$1,023,961	$869,791
Cost of revenues	726,863	623,933
Marketing	129,175	129,928
Technology and development	91,975	82,801
General and administrative	44,126	35,064
Operating income (loss)	31,822	(1,935)
Other income (expense):		
Interest expense	(6,740)	(4,974)
Interest and other income (expense)	977	(116)
Loss on extinguishment of debt	(25,129)	—
Income (loss) before income taxes	930	(7,025)
Benefit for income taxes	(1,759)	(2,441)
Net income (loss)	$2,689	$(4,584)
Earnings (loss) per share:		
Basic	$0.05	$(0.08)
Diluted	$0.05	$(0.08)
Weighted average common shares outstanding:		
Basic	55,972	55,456
Diluted	60,146	55,456

See accompanying notes to the consolidated financial statements.

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NETFLIX, INC.
Consolidated Statements of Comprehensive Income
(unaudited)
(in thousands)

	Three Months Ended	
	March 31, 2013	March 31, 2012
Net income (loss)	$2,689	$(4,584)
Other comprehensive income (loss):		
Foreign currency translation adjustments	(2,289)	811
Change in unrealized gains on available-for-sale securities, net of tax of $(212) and $38, respectively	(339)	60
Total other comprehensive income (loss)	(2,628)	871
Comprehensive income (loss)	$61	$(3,713)

See accompanying notes to the consolidated financial statements.

NETFLIX, INC.

Consolidated Statements of Cash Flows
(unaudited)
(in thousands)

	Three Months Ended	
	March 31, 2013	March 31, 2012
Cash flows from operating activities:		
Net income (loss)	$2,689	$(4,584)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Additions to streaming content library	(591,941)	(764,893)
Change in streaming content liabilities	9,700	397,553
Amortization of streaming content library	485,740	339,736
Amortization of DVD content library	18,237	20,046
Depreciation and amortization of property, equipment and intangibles	12,051	11,331
Stock-based compensation expense	17,746	19,332
Excess tax benefits from stock-based compensation	(11,615)	(3,755)
Other non-cash items	1,750	(1,519)
Loss on extinguishment of debt	25,129	—
Deferred taxes	(6,748)	(10,843)
Changes in operating assets and liabilities:		
Prepaid content	2,675	2,994
Other current assets	(8,402)	11,741
Accounts payable	17,104	(1,756)
Accrued expenses	(4,132)	1,783
Deferred revenue	9,406	1,806
Other non-current assets and liabilities	8,446	137
Net cash (used in) provided by operating activities	(12,165)	19,109
Cash flows from investing activities:		
Acquisitions of DVD content library	(21,193)	(13,528)
Purchases of property and equipment	(12,203)	(4,766)
Other assets	4,050	1,334
Purchases of short-term investments	(235,623)	(299,467)
Proceeds from sale of short-term investments	81,228	172,335
Proceeds from maturities of short-term investments	4,420	8,275
Net cash used in investing activities	(179,321)	(135,817)
Cash flows from financing activities:		
Proceeds from issuance of common stock	39,146	1,224
Proceeds from issuance of debt	500,000	—
Issuance costs	(9,414)	(388)
Redemption of debt	(219,362)	—
Excess tax benefits from stock-based compensation	11,615	3,755
Principal payments of lease financing obligations	(403)	(559)
Net cash provided by financing activities	321,582	4,032
Effect of exchange rate changes on cash and cash equivalents	(2,336)	615
Net increase (decrease) in cash and cash equivalents	127,760	(112,061)
Cash and cash equivalents, beginning of period	290,291	508,053

Cash and cash equivalents, end of period	$418,051	$395,992

See accompanying notes to the consolidated financial statements.

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NETFLIX, INC.
Consolidated Balance Sheets
(in thousands, except share and par value data)

	As of March 31, 2013 (unaudited)	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$418,051	$290,291
Short-term investments	607,821	457,787
Current content library, net	1,391,505	1,368,162
Prepaid content	57,254	59,929
Other current assets	82,469	64,622
Total current assets	2,557,100	2,240,791
Non-current content library, net	1,576,674	1,506,008
Property and equipment, net	129,319	131,681
Other non-current assets	100,196	89,410
Total assets	$4,363,289	$3,967,890
Liabilities and Stockholders' Equity		
Current liabilities:		
Current content liabilities	$1,355,010	$1,366,847
Accounts payable	102,822	86,468
Accrued expenses	52,004	53,139
Deferred revenue	178,878	169,472
Total current liabilities	1,688,714	1,675,926
Non-current content liabilities	1,083,427	1,076,622
Long-term debt	500,000	200,000
Long-term debt due to related party	200,000	200,000
Other non-current liabilities	78,229	70,669
Total liabilities	3,550,370	3,223,217
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Common stock, $0.001 par value; 160,000,000 shares authorized at March 31, 2013 and December 31, 2012; 56,143,986 and 55,587,167 issued and outstanding at March 31, 2013 and December 31, 2012, respectively	56	56
Additional paid-in capital	369,801	301,616
Accumulated other comprehensive income	291	2,919
Retained earnings	442,771	440,082
Total stockholders' equity	812,919	744,673
Total liabilities and stockholders' equity	$4,363,289	$3,967,890

See accompanying notes to the consolidated financial statements.

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, 2012 filed with the Securities and Exchange Commission (the “SEC”) on January 31, 2013. 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 policy for the streaming content library; the recognition and measurement of income tax assets and liabilities; and the valuation of stock-based compensation. The Company bases its estimates on historical experience and on various other assumptions that the Company believes to be reasonable under the circumstances. Actual results may differ from these 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, 2012. Interim results are not necessarily indicative of the results for a full year.

The Company is organized into three operating segments: Domestic streaming, International streaming and Domestic DVD. The Company’s revenues are derived from monthly membership fees.

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, 2012.

2. Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation in the Consolidated Statements of Operations. Payroll and related expenses of $6.0 million associated with corporate marketing personnel, previously classified in "Marketing" on the Consolidated Statements of Operations, have been reclassified as "General and administrative" for the period ended March 31, 2012. Historically these costs were substantially all recorded in the Domestic streaming segment and impacted segment contribution profit. Management and the Company's chief operating decision maker consider such employee costs to be global corporate costs rather than direct marketing costs and as such are not indicative of any given segment's performance. Accordingly, such costs have been reclassified as "General and administrative" expenses which are not a component of contribution profit. There was no impact to operating income (loss) in any period.

3. Earnings (Loss) Per Share

Basic earnings (loss) per share is computed using the weighted-average number of outstanding shares of common stock during the period. Diluted earnings (loss) 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 shares issuable upon the assumed conversion of the Company’s Senior Convertible Notes and incremental shares issuable upon the assumed exercise of stock options. The computation of earnings (loss) per share is as follows:

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	Three Months Ended March 31, 2013	March 31, 2012
	(in thousands, except per share data)	
Basic earnings (loss) per share:		
Net income (loss)	$ 2,689	$ (4,584)
Shares used in computation:		
Weighted-average common shares outstanding	55,972	55,456
Basic earnings (loss) per share	$ 0.05	$ (0.08)
Diluted earnings (loss) per share:		
Net income (loss)	$ 2,689	$ (4,584)
Senior Convertible Notes interest expense, net of tax	49	—
Numerator for diluted earnings per share	$ 2,738	$ (4,584)
Shares used in computation:		
Weighted-average common shares outstanding	55,972	55,456
Senior Convertible Notes shares	2,331	—
Employee stock options	1,843	—
Weighted-average number of shares	60,146	55,456
Diluted earnings (loss) per share	$ 0.05	$ (0.08)

For the three months ended March 31, 2013 and 2012, 0.4 million and 1.8 million incremental shares issuable upon the assumed exercise of stock options, respectively, are not included in the calculation of diluted earnings (loss) per share, as their inclusion would have been anti-dilutive.

For the three months ended March 31, 2012, 2.3 million shares issuable upon the assumed conversion of the Company's Senior Convertible Notes are not included in the calculation of diluted earnings (loss) per share, as their inclusion would have been anti-dilutive.

4. Short-term Investments

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, the Company’s assets that are measured at fair value on a recurring basis and are categorized using the fair value hierarchy:

	As of March 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Cash	$310,813	$—	$—	$310,813
Level 1 securities:				
Money market funds	7,017	—	—	7,017
Level 2 securities:				
Corporate debt securities	318,573	1,760	(291)	320,042
Government and agency securities classified as cash equivalents	105,823	—	—	105,823
Government and agency securities classified as short-term investments	114,110	179	—	114,289
Asset and mortgage-backed securities	173,219	469	(198)	173,490

Total (1)	$1,029,555	$2,408	$(489)	$1,031,474

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	As of December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Cash	$284,661	$—	$—	$284,661
Level 1 securities:				
Money market funds	10,500	—	—	10,500
Level 2 securities:				
Corporate debt securities	150,322	1,605	(32)	151,895
Government and agency securities	166,643	285	—	166,928
Asset and mortgage-backed securities	138,340	750	(125)	138,965
Total (2)	$750,466	$2,640	$(157)	$752,949

(1) Includes $418.1 million that is included in cash and cash equivalents, $607.8 million included in short-term investments and $5.6 million of restricted cash that is included in other non-current assets related to workers compensation deposits.

(2) Includes $290.3 million that is included in cash and cash equivalents, $457.8 million included in short-term investments and $4.8 million of restricted cash that is included in other non-current assets related to workers compensation deposits.

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. The Company's procedures include controls to ensure that appropriate fair values are recorded, such as comparing prices obtained from multiple independent sources. See Note 6 to the consolidated financial statements for further information regarding the fair value of the Company’s debt instruments.

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 March 31, 2013. There were no material other-than-temporary impairments or credit losses related to available-for-sale securities in the three months ended March 31, 2013 and 2012. In addition, there were no material gross realized gains or losses in the three months ended March 31, 2013 and 2012.
The estimated fair value of short-term investments by contractual maturity as of March 31, 2013 is as follows:

	(in thousands)
Due within one year	$70,895
Due after one year and through 5 years	486,043
Due after 5 years and through 10 years	6,633
Due after 10 years	44,250
Total short-term investments	$607,821

5. Balance Sheet Components

Content Library

Content library consisted of the following:

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	As of March 31, 2013	December 31, 2012
	(in thousands)	
Total content library, gross	$5,376,681	$5,001,524
Accumulated amortization	(2,408,502)	(2,127,354)
Total content library, net	2,968,179	2,874,170
Current content library, net	1,391,505	1,368,162
Non-current content library, net	$1,576,674	$1,506,008

Property and Equipment, Net

Property and equipment and accumulated depreciation consisted of the following:

		As of March 31, 2013	December 31, 2012
		(in thousands)	
Computer equipment	3 years	$88,192	$84,193
Operations and other equipment	5 years	99,402	100,207
Software	3 years	38,740	39,073
Furniture and fixtures	3 years	18,669	18,208
Building	30 years	40,681	40,681
Leasehold improvements	Over life of lease	45,922	45,393
Capital work-in-progress		6,145	8,282
Property and equipment, gross		337,751	336,037
Less: Accumulated depreciation		(208,432)	(204,356)
Property and equipment, net		$129,319	$131,681

6. Long-term Debt

Senior Convertible Notes

As of March 31, 2013, the Company had $200.0 million aggregate principal amount of zero coupon Senior Convertible Notes due on December 1, 2018 (the “Convertible Notes”) outstanding. The Convertible Notes were issued in a private placement offering to TCV VII, L.P., TCV VII(A), L.P. and TCV Member Fund, L.P. A general partner of these funds also serves on the Company’s Board of Directors, and as such, the issuance of the notes is considered a related party transaction. At any time following May 28, 2012, the Company may elect to cause the conversion of the Convertible Notes into shares of the Company’s common stock when specified conditions are satisfied, including that the daily volume weighted average price of the Company’s common stock is equal to or greater than $111.54 for at least 50 trading days during a 65 trading day period prior to the conversion date. The Convertible Notes include, among other terms and conditions, limitations on the Company’s ability to pay cash dividends or to repurchase shares of its common stock, subject to specified exceptions. At March 31, 2013 and December 31, 2012, the Company was in compliance with these covenants.

The Company determined that the embedded conversion option in the Convertible Notes does not require separate accounting treatment as a derivative instrument because it is both indexed to the Company’s own stock and would be classified in Stockholders' equity if freestanding. Additionally, the Convertible Notes do not require or permit any portion of the obligation to be settled in cash and accordingly the liability and equity (conversion option) components are not required to be accounted for separately.

Subsequent to March 31, 2013, after all specified conditions were satisfied, the Company elected to cause the conversion of all outstanding Convertible Notes with an aggregate principal amount of $200.0 million in accordance with the terms of the Indenture governing such notes. Pursuant to this conversion, the Company issued 2.3 million shares of common stock to the holders of the Convertible Notes at a conversion ratio of 11.6553. The fair market value of one share of common stock on the date of conversion was $216.99 per share.

Senior Notes

In February 2013, the Company issued $500.0 million aggregate principal amount of 5.375% Senior Notes due 2021 (the "5.375% Notes"). The 5.375% Notes were issued at par and are senior unsecured obligations of the Company. Interest is payable semi-annually at a rate of 5.375% per annum on February 1 and August 1 of each year, commencing on August 1, 2013. The 5.375% Notes are repayable in whole or

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in part upon the occurrence of a change of control, at the option of the holders, at a purchase price in cash equal to 101% of the principal plus accrued interest. The Company may redeem the 5.375% Notes prior to maturity in whole or in part at an amount equal to the principal amount thereof plus accrued and unpaid interest plus a make-whole payment equivalent to the present value of the remaining interest payments through maturity.
The 5.375% Notes include, among other terms and conditions, limitations on the Company's ability to create, incur or allow certain liens; enter into sale and lease-back transactions; create, assume, incur or guarantee additional indebtedness of the Company's subsidiaries; and consolidate or merge with, or convey, transfer or lease all or substantially all of the Company's and its subsidiaries assets, to another person.
The net proceeds to the Company were $490.6 million. Debt issuance costs of $9.4 million were recorded in "Other non-current assets" on the Consolidated Balance Sheets and are amortized over the term of the notes as "Interest expense" on the Consolidated Statements of Operations.
The Company used $224.5 million of the net proceeds of the 5.375% Notes to redeem the outstanding $200.0 million aggregate principal amount of 8.50% Senior Notes due 2017 (the “8.50% Notes”) and pursuant to the make-whole provision in the Indenture governing the 8.50% Notes, paid a $19.4 million premium and $5.1 million of accrued and unpaid interest. The Company recognized a loss on extinguishment of debt of $25.1 million related to redemption of the 8.50% Notes which included the write off of unamortized debt issuance costs of $4.2 million.
Based on quoted market prices in less active markets (a Level 2 input for this financial instrument), the fair value of the 5.375% Notes as of March 31, 2013 was approximately $496.3 million.

7. Stockholders’ Equity

Subsequent to March 31, 2013, the Company issued 2.3 million shares of common stock in connection with the conversion of the Convertible Notes. See Note 6 to the consolidated financial statements for further details.

Stock Option Plan

In June 2011, the Company adopted the 2011 Stock Plan. The 2011 Stock Plan provides for the grant of incentive stock options to employees and for the grant of non-statutory stock options, stock appreciation rights, restricted stock and restricted stock units to employees, directors and consultants. As of March 31, 2013, 3.8 million shares were reserved for future grants under the 2011 Stock Plan.

A summary of the activities related to the Company’s stock option plans is as follows:

		Options Outstanding			
	Shares Available for Grant	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value (in Thousands)
Balances as of December 31, 2012	4,049,037	4,572,952	$ 71.33		
Granted	(244,054)	244,054	134.56		
Exercised	—	(556,819)	70.30		
Balances as of March 31, 2013	3,804,983	4,260,187	75.09	6.72	$ 502,450
Vested and exercisable at March 31, 2013		4,260,187	75.09	6.72	$ 502,450

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company’s closing stock price on the last trading day of the first quarter of 2013 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on March 31, 2013. This amount changes based on the fair market value of the Company’s common stock. The total intrinsic value of options exercised for the three months ended March 31, 2013 and 2012 was

$50.0 million and $11.7 million, respectively.

Cash received from option exercises for the three months ended March 31, 2013 and 2012 was $39.1 million and $1.2 million, respectively.

Stock-Based Compensation

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Vested stock options granted before June 30, 2004 can be exercised up to three months following termination of employment. Vested stock options granted after June 30, 2004 and before January 1, 2007 can be exercised up to one year following termination of employment. Vested stock options granted on or after January 1, 2007 will remain exercisable for the full ten year contractual term regardless of employment status.

The following table summarizes the assumptions used to value stock option grants using the lattice-binomial model:

	Three Months Ended March 31, 2013		March 31, 2012	
Dividend yield	—	%	—	%
Expected volatility	54	%	65	%
Risk-free interest rate	1.87	%	1.97	%
Suboptimal exercise factor	2.33 - 3.59		2.26 - 3.65	

The Company bifurcates its option grants into two employee groupings (executive and non-executive) based on exercise behavior and considers several factors in determining the estimate of expected term for each group, including the historical option exercise behavior, the terms and vesting periods of the options granted.

The weighted-average fair value of employee stock options granted during the three months ended March 31, 2013 and 2012 was $72.71 and $55.65 per share, respectively.

Stock-based compensation expense related to stock option plans was $17.7 million and $19.3 million for the three months ended March 31, 2013 and 2012, respectively. The total income tax benefit recognized in the income statement related to stock option plans was $6.8 million and $6.7 million for the three months ended March 31, 2013 and 2012, respectively.

8. Accumulated Other Comprehensive Income

The following table summarizes the changes in accumulated balances of other comprehensive income for the three months ended March 31, 2013:

	Foreign currency items	Change in unrealized gains on available for sale securities	Total
	(in thousands)		
Accumulated other comprehensive income (loss), net of tax, as of December 31, 2012	$1,381	$1,538	$2,919
Other comprehensive income before reclassifications			