NETFLIX INC
Form 10-Q
May 07, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2007

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)

Delaware	**77-0467272**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**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 x NO ¨.

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act) Yes ¨ No x

As of April 30, 2007, there were 68,259,793 shares of the registrant s common stock, par value $0.001, outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

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Netflix, Inc.

Condensed Consolidated Statements of Operations

(unaudited)

(in thousands, except per share data)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007
Revenues	$ 224,126	$ 305,320
Cost of revenues:		
Subscription	126,220	165,189
Fulfillment expenses*	22,045	29,783
Total cost of revenues	148,265	194,972
Gross profit	75,861	110,348
Operating expenses:		
Technology and development *	11,206	15,715
Marketing *	52,968	72,138
General and administrative *	8,292	12,188
Gain on disposal of DVDs	(1,387)	(908)
Total operating expenses	71,079	99,133
Operating income	4,782	11,215
Other income:		
Interest and other income	2,452	5,350
Income before income taxes	7,234	16,565
Income taxes	2,830	6,701
Net income	$ 4,404	$ 9,864
Net income per share:		
Basic	$ 0.08	$ 0.14
Diluted	$ 0.07	$ 0.14
Weighted average common shares outstanding:		
Basic	55,213	68,693
Diluted	66,456	70,672
*** Stock-based compensation included in expense line items:**		
Fulfillment expenses	$ 260	$ 146
Technology and development	965	757
Marketing	554	531
General and administrative	1,531	1,369

See accompanying notes to condensed consolidated financial statements.

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Netflix, Inc.

Condensed Consolidated Balance Sheets

(unaudited)

(in thousands, except share and par value data)

	As of December 31, 2006	As of March 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 400,430	$ 218,458
Short-term investments		169,525
Prepaid expenses	4,742	5,567
Prepaid revenue sharing expenses	9,456	10,432
Deferred tax assets	3,155	3,191
Other current assets	10,635	19,100
Total current assets	428,418	426,273
Content library, net	104,908	114,137
Property and equipment, net	55,503	64,452
Deferred tax assets	15,600	15,819
Other assets	4,350	4,429
Total assets	$ 608,779	$ 625,110
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 93,864	$ 93,959
Accrued expenses	29,905	33,528
Deferred revenue	69,678	64,234
Total current liabilities	193,447	191,721
Deferred rent	1,121	1,185
Total liabilities	194,568	192,906
Commitments and contingencies		
Stockholders equity:		
Common stock, $0.001 par value; 160,000,000 shares authorized at December 31, 2006 and March 31, 2007; 68,612,463 and 68,761,943 issued and outstanding at December 31, 2006 and March 31, 2007, respectively	69	69
Additional paid-in capital	454,731	462,376
Accumulated other comprehensive income		484
Accumulated deficit	(40,589)	(30,725)
Total stockholders equity	414,211	432,204
Total liabilities and stockholders equity	$ 608,779	$ 625,110

See accompanying notes to condensed consolidated financial statements.

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Netflix, Inc.

Condensed Consolidated Statements of Cash Flows

(unaudited)

(in thousands)

	Three Months Ended	
	March 31, 2006	March 31, 2007
Cash flows from operating activities:		
Net income	$ 4,404	$ 9,864
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of property and equipment	3,609	4,601
Amortization of content library	27,281	49,442
Amortization of intangible assets	12	24
Amortization of discounts and premiums on investments		(82)
Stock-based compensation expense	3,310	2,803
Excess tax benefits from stock-based compensation	(690)	(4,076)
Gain on disposal of property and equipment	(23)	
Gain on sale of short-term investments		(147)
Gain on disposal of DVDs	(2,049)	(2,597)
Deferred taxes	2,058	(255)
Changes in operating assets and liabilities:		
Prepaid expenses and other current assets	2,304	(10,266)
Accounts payable	2,873	11,399
Accrued expenses	3,439	7,699
Deferred revenue	(608)	(5,444)
Deferred rent	70	64
Net cash provided by operating activities	45,990	63,029
Cash flows from investing activities:		
Purchases of short-term investments		(264,234)
Proceeds from sale of short-term investments		95,422
Purchases of property and equipment	(6,686)	(18,013)
Acquisitions of content library	(29,842)	(68,541)
Proceeds from sale of DVDs	2,481	5,626
Proceeds from disposal of property and equipment	23	
Other assets	(291)	(103)
Net cash used in investing activities	(34,315)	(249,843)
Cash flows from financing activities:		
Proceeds from issuance of common stock	3,144	766
Excess tax benefits from stock-based compensation	690	4,076
Net cash provided by financing activities	3,834	4,842
Net increase (decrease) in cash and cash equivalents	15,509	(181,972)
Cash and cash equivalents, beginning of period	212,256	400,430

Cash and cash equivalents, end of period	$ 227,765	$ 218,458

See accompanying notes to condensed consolidated financial statements.

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Netflix, Inc.

Notes to Condensed Consolidated Financial Statements

1. Basis of Presentation and Summary of Significant Accounting Policies

The accompanying condensed consolidated interim financial statements of Netflix, Inc. and its wholly owned subsidiary (the Company) have been prepared in conformity with accounting principles generally accepted in the United States 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, 2006. The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. Examples include the estimate of useful lives and residual value of its content library; the valuation of stock-based compensation; and the recognition and measurement of income tax assets and liabilities. 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, 2006 filed with the Securities and Exchange Commission (the SEC) on February 28, 2007. Interim results are not necessarily indicative of the results for a full year.

Fair Value of Financial Instruments

The fair value of the Company s cash and cash equivalents, accounts payable and accrued expenses approximates their carrying value due to their short maturities.

Cash Equivalents and Short-term Investments

The Company classifies cash equivalents and short-term investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The Company considers investments in instruments purchased with an original maturity of 90 days or less to be cash equivalents. The Company classifies short-term investments as available-for-sale which consists of marketable securities with original maturities in excess of 90 days. Short-term investments are reported at fair value with unrealized gains and losses included in accumulated other comprehensive income within stockholders equity in the condensed consolidated balance sheet. The amortization of premiums and discounts on the investments, realized gains and losses, and declines in value judged to be other-than-temporary on available-for-sale securities are included in interest and other income in the condensed consolidated statement of operations. The Company uses the specific identification method to determine cost in calculating realized gains and losses upon sale of short-term investments.

Restricted Cash

As of March 31, 2006 and 2007, other assets included restricted cash of $750 thousand and $1.5 million, respectively, related to workers compensation insurance deposits. In addition, as of March 31, 2007, other current assets included $2.2 million set aside for plaintiffs attorneys fees and expenses in the *Chavez vs. Netflix, Inc.* lawsuit.

Amortization of Content Library

The Company amortizes its DVDs, less estimated salvage value, on a sum-of-the-months accelerated basis over their estimated useful lives. The useful life of the new-release DVDs and back-catalog DVDs is estimated to be 1 year and 3 years, respectively. In estimating the useful life of its DVDs, the Company takes into account library utilization as well as an estimate for lost or damaged DVDs. The Company amortizes license fees on internet-based content on a straight-line basis over the term of the license agreement. See Note 3 to the condensed consolidated financial statements for further discussion.

Amortization of Intangible Assets

Intangible assets are carried at cost less accumulated amortization. The Company amortizes the intangible assets with finite lives using the straight-line method over the estimated economic lives of the assets, ranging from approximately 10 to 14 years. In the first quarter of 2007, the Company wrote off fully amortized intangible assets of $11.9 million.

Netflix, Inc.

Notes to Condensed Consolidated Financial Statements

Property and Equipment

Property and equipment are carried at cost less accumulated depreciation. Depreciation is calculated using the straight-line method over the shorter of the estimated useful lives of the respective assets, generally up to 5 years, or the lease term for leasehold improvements, if applicable.

Impairment of Long-Lived Assets

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, long-lived assets such as property and equipment and intangible assets subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of asset groups to be held and used is measured by a comparison of the carrying amount of an asset group to estimated undiscounted future cash flows expected to be generated by the asset group. If the carrying amount of an asset group exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of an asset group exceeds fair value of the asset group.

Capitalized Software Costs

The Company capitalizes costs related to developing or obtaining internal-use software. Capitalization of costs begins after the conceptual formulation stage has been completed. Capitalized software costs are included in property and equipment, net and are amortized over the estimated useful life of the software, which is generally one year.

Revenue Recognition

Subscription revenues are recognized ratably over each subscriber s monthly subscription period. Refunds to subscribers are recorded as a reduction of revenues. Revenues from sales of advertising are recognized upon completion of the campaign. Revenues are presented net of the taxes that are collected from customers and remitted to governmental authorities. Deferred revenue consists of subscription revenues billed to subscribers that have not been recognized. Deferred revenue also includes gift subscriptions that have not been redeemed.

Cost of Revenues

Subscription. Cost of subscription consists of postage and packaging expenses, amortization of the content library and revenue sharing expenses related to shipping titles and the delivery of internet-based content to paying subscribers. Revenue sharing expenses are recorded when either a) DVDs are shipped to subscribers or b) internet-based content is viewed by subscribers.

The terms of some revenue sharing agreements with studios obligate the Company to make minimum revenue sharing payments for certain titles. The Company amortizes minimum revenue sharing prepayments (or accretes an amount payable to studios if the payment is due in arrears) as revenue sharing obligations are incurred. A provision for estimated shortfall, if any, on minimum revenue sharing payments is made in the period in which the shortfall becomes probable and can be reasonably estimated. Additionally, the terms of some revenue sharing agreements with studios provide for rebates based on achieving specified performance levels. The Company accrues for these rebates as earned based on historical title performance and estimates of demand for the titles over the remainder of the title term. Actual rebates may vary which could result in an increase or reduction in the estimated amounts previously accrued.

Fulfillment expenses. Fulfillment expenses represent those costs incurred in operating and staffing the Company s fulfillment and customer service centers, including costs attributable to receiving, inspecting and warehousing the Company s content library. Fulfillment expenses also include credit card fees.

Technology and Development

Technology and development expenses consist of payroll and related expenses incurred in testing, maintaining and modifying the Company s Web Site, its recommendation service, developing solutions for the internet-based delivery of content to subscribers, telecommunications systems and infrastructure and other internal-use software systems. Technology and development expenses also include depreciation on computer hardware and capitalized software.

Marketing

Marketing expenses consist of payroll and related expenses and advertising expenses. Advertising expenses include marketing program expenditures and other promotional activities, including revenue sharing expenses, postage and packaging expenses and content amortization related to free trial periods. Advertising costs are expensed as incurred except for advertising production costs, which are expensed the first time the advertising is run.

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Notes to Condensed Consolidated Financial Statements

The Company and its vendors participate in a variety of cooperative advertising programs and other promotional programs in which the vendors provide the Company with cash consideration in exchange for marketing and advertising of the vendor s products. If the consideration received represents reimbursement of specific incremental and identifiable costs incurred to promote the vendor s product, it is recorded as an offset to the associated marketing expense incurred. Any reimbursement greater than the specific incremental and identifiable costs incurred is recognized as a reduction of cost of revenues when recognized in the Company s statements of operations.

Income Taxes

The Company accounts for income taxes using the asset and liability method. Deferred income taxes are recognized by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The measurement of deferred tax assets is reduced, if necessary, by a valuation allowance for any tax benefits for which future realization is uncertain.

Comprehensive Income

The Company reports comprehensive income or loss in accordance with the provisions of SFAS No. 130, *Reporting Comprehensive Income*, which establishes standards for reporting comprehensive income and its components in the financial statements. Other comprehensive income consists of unrealized gains and losses on available-for-sale securities. Tax effects of other comprehensive income are not material for any period presented. See Note 4 to the condensed consolidated financial statements for further discussion.

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 primarily of incremental shares issuable upon the assumed exercise of stock options, warrants to purchase common stock and shares currently purchasable pursuant to our employee stock purchase plan using the treasury stock method. The computation of net income per share is as follows:

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007
	(in thousands)	
Basic earnings per share:		
Net income	$ 4,404	$ 9,864
Shares used in computation:		
Weighted-average ordinary shares outstanding	55,213	68,693
Basic earnings per share	$ 0.08	$ 0.14
Diluted earnings per share:		
Net income	$ 4,404	$ 9,864
Shares used in computation:		
Weighted-average ordinary shares outstanding	55,213	68,693
Warrants	8,393	
Employee stock options	2,850	