NETFLIX INC
Form S-1/A
April 16, 2002

AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON APRIL 16, 2002

REGISTRATION NO. 333-83878

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

AMENDMENT NO. 2

TO
FORM S-1
REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

NETFLIX, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	7841	77-0467272
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(PRIMARY STANDARD INDUSTRIAL CLASSIFICATION CODE NUMBER)	(I.R.S. EMPLOYER IDENTIFICATION NUMBER)

970 UNIVERSITY AVENUE
LOS GATOS, CA 95032
(408) 399-3700
(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF REGISTRANT'S PRINCIPAL EXECUTIVE OFFICES)

W. BARRY MCCARTHY, JR.
CHIEF FINANCIAL OFFICER
970 UNIVERSITY AVENUE
LOS GATOS, CA 95032
(408) 399-3700
(NAME, ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF AGENT FOR SERVICE)

COPIES TO:

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APPROXIMATE DATE OF COMMENCEMENT OF PROPOSED SALE TO THE PUBLIC: As soon as practicable after the effective date of this Registration Statement.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. [_]

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [_]

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [_]

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. [_]

If delivery of the prospectus is expected to be made pursuant to rule 434, please check the following box. [_]

TITLE OF EACH CLASS OF SECURITIES TO BE REGISTERED	PROPOSED MAXIMUM AGGREGATE OFFERING PRICE(1)	AMOUNT OF REGISTRATION F
Common Stock $0.001 par value........................	$115,000,000	$10,580

(1) Estimated solely for the purpose of calculating the amount of the registration fee pursuant to Rule 457(o) under the Securities Act of 1933.
(2) Amount previously paid.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL HEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933 OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(A), MAY DETERMINE.

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THE INFORMATION IN THIS PROSPECTUS IS NOT COMPLETE AND MAY BE CHANGED. WE MAY NOT SELL THESE SECURITIES UNTIL THE REGISTRATION STATEMENT FILED WITH THE SECURITIES AND EXCHANGE COMMISSION IS EFFECTIVE. THIS PROSPECTUS IS NOT AN OFFER TO SELL THESE SECURITIES AND IS NOT SOLICITING AN OFFER TO BUY THESE SECURITIES IN ANY STATE WHERE THE OFFER OR SALE IS NOT PERMITTED.

SUBJECT TO COMPLETION
PRELIMINARY PROSPECTUS DATED , 2002

PROSPECTUS

SHARES

[LOGO] NETFLIX, INC.

COMMON STOCK

This is Netflix, Inc.'s initial public offering of common stock. We are selling all of the shares.

We expect the public offering price to be between $ and $ per share. Currently, no public market exists for the shares. After pricing of the offering, we expect that the shares will be quoted on the Nasdaq National Market under the symbol "NFLX."

INVESTING IN OUR COMMON STOCK INVOLVES RISKS THAT ARE DESCRIBED IN THE "RISK FACTORS" SECTION BEGINNING ON PAGE 5 OF THIS PROSPECTUS.

	PER SHARE	TOTAL
Public offering price..........................	$	$
Underwriting discount..........................	$	$
Proceeds, before expenses, to Netflix, Inc.......	$	$

The underwriters may also purchase up to an additional shares from us at the public offering price, less the underwriting discount, within 30 days from the date of this prospectus to cover over-allotments.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The shares will be ready for delivery on or about , 2002.

MERRILL LYNCH & CO.

THOMAS WEISEL PARTNERS LLC

U.S. BANCORP PIPER JAFFRAY

The date of this prospectus is , 2002.

[INSIDE FRONT COVER]

TABLE OF CONTENTS

You should rely only on the information contained in this prospectus. We have not, and the underwriters have not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus is accurate only as of the date on the front cover of this prospectus or other date stated in this prospectus. Our business, financial condition, results of operations and prospects may have changed since that date.

Netflix, Netflix.com, CineMatch and Mr. DVD are our trademarks. Each trademark, trade name or service mark of any other company appearing in this prospectus belongs to its holder.

SUMMARY

THIS SUMMARY HIGHLIGHTS INFORMATION CONTAINED ELSEWHERE IN THIS PROSPECTUS. YOU SHOULD READ THE ENTIRE PROSPECTUS CAREFULLY, INCLUDING "RISK FACTORS" AND OUR FINANCIAL STATEMENTS AND THE NOTES TO THOSE FINANCIAL STATEMENTS APPEARING ELSEWHERE IN THIS PROSPECTUS BEFORE YOU DECIDE TO INVEST IN OUR COMMON STOCK.

OUR COMPANY

We are the largest online entertainment subscription service in the United States providing more than 600,000 subscribers access to a comprehensive library of more than 11,500 movie, television and other filmed entertainment titles. Our standard subscription plan allows subscribers to have three titles out at the same time with no due dates, late fees or shipping charges for $19.95 per month. Subscribers can view as many titles as they want in a month. Subscribers select titles at our Web site (WWW.NETFLIX.COM) aided by our proprietary CineMatch technology, receive them on DVD by first-class mail and return them to us at their convenience using our prepaid mailers. Once a title has been returned, we mail the next available title in a subscriber's queue. In 2001, our total revenues were $75.9 million and our net loss was $38.6 million. For the three months ended March 31, 2002, our total revenues were $30.5 million and our net loss was $3.6 million.

In 2001, domestic consumers spent more than $32 billion on in-home filmed entertainment, representing approximately 80% of total filmed entertainment expenditures, according to Adams Media Research. Consumer video rentals and purchases comprised the largest portion of in-home filmed entertainment, representing $23 billion, or 73% of the market in 2001, according to Adams Media Research.

The home video segment of the in-home filmed entertainment market is undergoing a rapid technology transition away from VHS to DVD. The DVD player is the fastest selling consumer electronics device in history, according to DVD Entertainment Group. In September 2001, standalone set-top DVD player shipments outpaced VCR shipments for the first time in history, and this trend continued throughout the remainder of 2001. At the end of 2001, approximately 25 million U.S. households had a standalone set-top DVD player, representing an increase of 97% in 2001. Adams Media Research estimates that the number of U.S. households with a DVD player will grow to 67 million in 2006, representing approximately 60% of U.S. television households in 2006.

Our subscription service has grown rapidly since its launch in September 1999. We believe our growth has been driven primarily by our unrivalled selection, consistently high levels of customer satisfaction, rapid customer adoption of DVD players and our increasingly effective marketing strategy. We primarily use pay-for-performance marketing programs and free trial offers to acquire new subscribers. In the San Francisco Bay area, where the U.S. Postal Service can make one- or two-day deliveries from our San Jose distribution center, approximately 2.8% of all households subscribe to Netflix.

Our proprietary CineMatch technology enables us to create a customized store for each subscriber and to generate personalized recommendations which effectively merchandize our comprehensive library of titles. We provide more than 18 million personal recommendations daily. In March 2002, more than 11,000 of our more than 11,500 titles were selected by our subscribers.

We currently provide titles on DVD only. We are focused on rapidly growing our subscriber base and revenues and utilizing our proprietary technology to minimize operating costs. Our technology is extensively employed to manage and integrate our business, including our Web site interface, order processing, fulfillment operations and customer service. We believe our technology also allows us to maximize our library utilization and to run our fulfillment operations in a flexible manner with minimal capital requirements.

Our scalable infrastructure and online interface eliminate the need for expensive retail outlets and allow us to service our large and expanding subscriber base from one primary distribution center and a series of low-cost regional distribution centers. We utilize proprietary technology developed in-house to manage the shipping and receiving of a total of 5.3 million DVDs per month. Our software automates the process of tracking and routing titles to and from each of our distribution centers and allocates order responsibilities among them. We plan to operate low-cost regional distribution centers throughout the United States to reduce delivery times and increase library utilization.

We were incorporated in Delaware in August 1997 and changed our name from NetFlix.com, Inc. to Netflix, Inc. in March 2002. Our executive offices are located at 970 University Avenue, Los Gatos, California 95032, and our telephone number at that address is (408) 399-3700. Our Web site is located at http://www.netflix.com. The information contained in our Web site does not constitute a part of this prospectus.

THE OFFERING

Common stock offered by Netflix........	shares
Common stock to be outstanding after the offering........................	shares
Use of proceeds.......................	We estimate that our net proceeds from this offering will be approximately $ million. We intend to use the net proceeds for: . repayment of approximately $13.9 million of indebtedness under our subordinated promissory notes,

including accrued interest as of March 31, 2002; and

. general corporate purposes, including working capital.

Risk factors..........................	See "Risk Factors" and other information included in this prospectus for a discussion of factors you should carefully consider before deciding to invest in shares of our common stock.
Proposed Nasdaq National Market symbol.	NFLX

Unless we indicate otherwise, all information in this prospectus: (1) assumes no exercise of the over-allotment option granted to the underwriters; (2) assumes the conversion into common stock of each outstanding share of our preferred stock, which will occur automatically upon the completion of this offering; (3) is based upon 45,197,271 shares outstanding as of March 31, 2002, including shares to be issued to certain studios immediately prior to this offering based on our capitalization as of March 31, 2002; (4) gives effect to a proposed for reverse stock split to be effected prior to the completion of this offering; and (5) excludes:

- 12,861,856 shares of common stock issuable upon the exercise of stock options outstanding as of March 31, 2002, with a weighted average exercise price of $1.00 per share and 3,400,595 shares of common stock available for future option grants under our 1997 Stock Plan and 2002 Stock Plan, as of March 31, 2002;
- 21,053,931 shares of common stock issuable upon exercise of warrants with a weighted average exercise price of $1.07 per share; and
- 1,750,000 shares of common stock reserved for issuance under our 2002 Employee Stock Purchase Plan.

3

SUMMARY FINANCIAL AND OTHER DATA

The summary financial data below should be read together with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and the related notes included elsewhere in this prospectus.

	YEAR ENDED DECEMBER 31,			THREE MONTHS ENDED MARCH 31,	
	1999	2000	2001	2001	2002

	(IN THOUSANDS EXCEPT PER SHARE DATA)				
STATEMENT OF OPERATIONS DATA:					
Total revenues	$ 5,006	$ 35,894	$ 75,912	$ 17,057	$30,527
Gross profit (loss)	633	11,033	26,005	(1,120)	15,369
Operating loss	(30,031)	(57,557)	(37,227)	(20,417)	(3,151
Net loss	(29,845)	(57,363)	(38,618)	(20,598)	(3,605
Net loss per share:					
Basic and diluted	$ (7.13)	$ (13.52)	$ (7.05)	$ (4.09)	$ (0.59
Pro forma--basic and diluted/(1)/			$ (0.91)		$ (0.08
Supplemental pro forma/(2)/					
Number of shares used in computing per shares amounts:					
Basic and diluted	4,183	4,243	5,479	5,039	6,141
Pro forma--basic and diluted/(1)/			42,296		44,503
Supplemental pro forma/(2)/					

	AS OF MARCH 31, 2002		
	ACTUAL	PRO FORMA/(1)/	PRO FORMA AS ADJUSTED/(3)/
	(IN THOUSANDS)		
BALANCE SHEET DATA:			
Cash and cash equivalents	$ 15,671	$15,671	$
Working capital (deficit)	(9,547)	(9,547)	
Total assets	44,306	44,306	
Long-term debt, less current portion	4,117	4,117	
Redeemable convertible preferred stock	101,830	--	
Stockholders' equity (deficit)	(91,306)	10,524	

	YEAR ENDED DECEMBER 31,			THREE MONTHS ENDED MARCH 31,	
	1999	2000	2001	2001	2002
	(IN THOUSANDS EXCEPT PER SHARE DATA)				
OTHER DATA:					
EBITDA/(4)/ (unaudited)	$(21,223)	$(28,179)	$ (1,716)	$(3,600)	$ 3,583
Number of subscribers (unaudited)	107	292	456	303	603
Net cash provided by (used in):					
Operating activities	$(16,529)	$(22,706)	$ 4,847	$(2,805)	$ 6,505
Investing activities	(19,742)	(24,972)	(12,670)	(4,087)	(5,798)
Financing activities	49,408	48,375	9,059	(927)	(1,167)

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(1) The pro forma balance sheet data, pro forma net loss per share--basic and diluted, and pro forma number of shares--basic and diluted give effect to the conversion of all outstanding shares of our preferred stock, including the Series F Non-Voting Preferred Stock to be issued to studios immediately prior to this offering, into shares of common stock automatically upon completion of this offering.

(2) The supplemental pro forma net loss per share--basic and diluted gives effect to the repayment of our subordinated promissory notes with the proceeds from the offering for the shares solely sold to repay these subordinated promissory notes.

(3) The pro forma as adjusted column gives effect to the sale of shares of common stock offered by us at an assumed initial public offering price of $ per share and the application of the net proceeds from the offering, after deducting underwriting discounts and commissions and estimated offering expenses, including repayment of our subordinated promissory notes.

(4) EBITDA consists of operating loss before depreciation, amortization, non-cash charges for equity instruments granted to non-employees and stock-based compensation. EBITDA provides an alternative measure of cash flow from operations. You should not consider EBITDA as a substitute for operating loss, as an indicator of our operating performance or as an alternative to cash flows from operating activities as a measure of liquidity. We may calculate EBITDA differently from other companies.

4

RISK FACTORS

YOU SHOULD CAREFULLY CONSIDER THE RISKS DESCRIBED BELOW BEFORE BUYING SHARES IN THIS OFFERING. IF ANY OF THE FOLLOWING RISKS ACTUALLY OCCUR, OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS COULD BE HARMED. IN THAT CASE, THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE, AND YOU COULD LOSE ALL OR PART OF YOUR INVESTMENT.

RISKS RELATED TO OUR BUSINESS

WE HAVE A LIMITED OPERATING HISTORY AND HISTORY OF NET LOSSES, AND WE ANTICIPATE THAT WE WILL EXPERIENCE NET LOSSES FOR THE FORESEEABLE FUTURE.

You should consider our business and prospects in light of the risks, expenses and difficulties encountered by companies in their early stage of development. We have experienced significant net losses since our inception and, given the significant operating and capital expenditures associated with our business plan, anticipate continuing net losses for the foreseeable future. If we do achieve profitability, we cannot be certain that we will be able to sustain or increase such profitability. We incurred net losses of $38.6 million for the year ended 2001. As of March 31, 2002, we had total stockholders' deficit of $91.3 million. Only recently, beginning in 2001, have we generated positive cash flow from operations, and we cannot be certain that we will be able to sustain or increase such positive cash flow from operations from period to period in the future. To achieve and sustain profitability, we must accomplish numerous objectives, including substantially increasing the number of paying subscribers to our service. We cannot assure you that we will be able to achieve these objectives.

IF OUR EFFORTS TO ATTRACT SUBSCRIBERS ARE NOT SUCCESSFUL, OUR REVENUES WILL BE AFFECTED ADVERSELY.

We must continue to attract and retain subscribers. To succeed, we must continue to attract a large number of subscribers who have traditionally used video retailers, video rental outlets, pay cable channels, such as HBO and Showtime, and pay-per-view and video-on-demand, or VOD, for in-home filmed entertainment. Our ability to attract and retain subscribers will depend in part on our ability to consistently provide our subscribers a high quality experience for selecting, viewing, receiving and returning titles, including providing accurate recommendations through our CineMatch technology. If consumers do not perceive our service offering to be of high quality, or if we introduce new services that are not favorably received by them, we may not be able to attract or retain subscribers. In addition, many of our new subscribers originate from word-of-mouth advertising and referrals from existing subscribers. If our efforts to satisfy our existing subscribers are not successful, we may not be able to attract new subscribers, and as a result, our revenue will be affected adversely.

WE RELY HEAVILY ON OUR PROPRIETARY TECHNOLOGY TO PROCESS DELIVERIES AND RETURNS OF OUR DVDS AND TO MANAGE OTHER ASPECTS OF OUR OPERATIONS, AND THE FAILURE OF THIS TECHNOLOGY TO OPERATE EFFECTIVELY COULD ADVERSELY AFFECT OUR BUSINESS.

We use complex proprietary software to process deliveries and returns of our DVDs and to manage other aspects of our operations. Our proprietary technology is intended to allow our primary distribution center in San Jose, California and our recently opened regional distribution centers to be operated on an integrated basis. We have only recently begun shipping DVDs from our regional distribution centers, and we are continuing to modify the software used to manage the delivery and return process for these regional distribution centers as our utilization of these facilities increases and as we open and operate additional distribution centers. If we are unable to maintain and enhance our technology to manage the processing of DVDs among our distribution centers in a timely and efficient manner, our ability to retain existing subscribers and to add new subscribers may be impaired.

IF WE ARE NOT ABLE TO MANAGE OUR GROWTH, OUR BUSINESS COULD BE AFFECTED ADVERSELY.

We have expanded rapidly since we launched our Web site in April 1998. We anticipate that further expansion of our operations will be required to address any significant growth in our subscriber base and to take

advantage of favorable market opportunities. Any future expansion will likely place significant demands on our managerial, operational, administrative and financial resources. If we are not able to respond effectively to new or increased demands that arise because of our growth, or, if in responding, our management is materially distracted from our current operations, our business may be affected adversely. In addition, if we do not have sufficient breadth and depth of the titles necessary to satisfy increased demand arising from growth in our subscriber base, our subscriber satisfaction may be affected adversely.

The increased utilization of our regional distribution centers is intended to decrease the delivery and return times for DVDs. We anticipate that subscribers will exchange more titles as a result of the reduced time that DVDs spend in transit, our shipping and delivery costs and revenue sharing expenses will increase, which would adversely affect our operating results if not offset by increased subscriber retention and other mitigating factors.

We have no experience offering our subscription service outside the United States. If we offer our service outside the United States, we will need to focus substantial resources to handling operations in a foreign environment, including addressing issues related to foreign labor markets and the regulatory environments. As a result, our managerial, operational, administrative and financial resources may be strained. Any international expansion may not achieve the subscription acquisition or operating results anticipated by us at the time we determine to expand our operations internationally.

IF WE EXPERIENCE EXCESSIVE RATES OF SUBSCRIBER CHURN, OUR REVENUES AND BUSINESS WILL BE HARMED.

We must minimize the rate of loss of existing subscribers while adding new subscribers. For the 12 months ended March 31, 2002, an average of approximately 8% of our total subscribers cancelled their subscriptions each month. Subscribers cancel their subscription to our service for many reasons, including a perception that they do not use the service sufficiently, delivery takes too long, the service is a poor value and customer service issues are not satisfactorily resolved. We must continually add new subscribers both to replace subscribers who cancel and to continue to grow our business beyond our current subscriber base. If too many of our subscribers cancel our service, or if we are unable to attract new subscribers in numbers sufficient to grow our business, our operating results will be adversely affected. Further, if excessive numbers of subscribers cancel our service, we may be required to incur significantly higher marketing expenditures than we currently anticipate to replace these subscribers with new subscribers.

OUR OPERATING RESULTS ARE EXPECTED TO BE DIFFICULT TO PREDICT BASED ON A NUMBER

OF FACTORS THAT ALSO WILL AFFECT OUR LONG-TERM PERFORMANCE.

We expect our operating results to fluctuate significantly in the future based on a variety of factors, many of which are outside our control and difficult to predict. As a result, period-to-period comparisons of our operating results may not be a good indicator of our future or long-term performance. The following factors may affect us from period-to-period and may affect our long-term performance:

- our ability to manage our fulfillment processes to handle significant increases in the number of subscribers and subscriber selections;
- our ability to improve or maintain gross margins in our business;
- changes by our competitors to their product and service offerings;
- price competition;
- our ability to maintain an adequate breadth and depth of titles;
- our ability to manage our inventory levels;
- changes in promotional support offered by studios;
- our ability to maintain, upgrade and develop our Web site, our internal computer systems and our fulfillment processes and utilize efficiently our distribution centers;

- fluctuations in consumer spending on DVD players, DVDs and related products;
- fluctuations in the use of the Internet for the purchase of consumer goods and services such as those offered by us;

- technical difficulties, system downtime or Internet disruptions;
- our ability to attract new and qualified personnel in a timely and effective manner and retain existing personnel;
- the amount and timing of operating costs and capital expenditures relating to expansion of our business, operations and infrastructure;
- our ability to effectively manage the development of new business segments and markets;
- our ability to maintain and develop new and existing marketing relationships;
- our ability to successfully manage the integration of operations and technology resulting from acquisitions;
- governmental regulation and taxation policies; and
- general economic conditions and economic conditions specific to the Internet, online commerce and the movie industry.

In addition to these factors, our operating results may fluctuate based upon seasonal fluctuations in DVD player sales and in the use of the Internet. During our limited operating history, we have experienced greater additions of new subscribers during late fall and the winter months, and these seasonal fluctuations may continue in future periods.

IF OUR EFFORTS TO BUILD STRONG BRAND IDENTITY, AND IMPROVE SUBSCRIBER SATISFACTION AND LOYALTY ARE NOT SUCCESSFUL, WE MAY NOT BE ABLE TO ATTRACT OR RETAIN SUBSCRIBERS, AND OUR OPERATING RESULTS WILL BE AFFECTED ADVERSELY.

The Netflix brand is only four years old, and we must continue to build strong brand identity. To succeed, we must continue to attract and retain a large number of owners of DVD players who have traditionally relied on store-based rental outlets and persuade them to subscribe to our service through our Web site. We may be required to incur significantly higher advertising and promotional expenditures than we currently anticipate to attract large numbers of new subscribers. We believe that the importance of brand loyalty will increase with a proliferation of DVD subscription services and other means of distributing titles, such as VOD. If our branding efforts are not successful, our operating results and our ability to attract and retain subscribers will be affected adversely.

In addition, DVD players have become available for purchase for under $100. Purchasers of DVD players at low price levels may be less inclined than earlier purchasers of DVD players to try our subscription service or may not be willing to commit to a monthly subscription fee. If we are unable to attract similar interest from new purchasers of DVD players as we have from purchasers of DVD players to date, our revenues may be affected adversely.

IF WE EXPERIENCE DELIVERY PROBLEMS OR IF OUR SUBSCRIBERS OR POTENTIAL SUBSCRIBERS LOSE CONFIDENCE IN THE U.S. MAIL SYSTEM, WE COULD LOSE SUBSCRIBERS, WHICH COULD ADVERSELY AFFECT OUR OPERATING RESULTS.

We rely exclusively on the U.S. Postal Service to deliver DVDs from our distribution centers and for subscribers to return DVDs to us. We are subject to risks associated with using the public mail system to meet our shipping needs, including delays caused by bioterrorism, potential labor activism and inclement weather. For example, in the fall of 2001 terrorists used the U.S. Postal Service to deliver envelopes containing Anthrax, following which mail deliveries around the United States experienced significant delays. Our DVDs also are

subject to risks of breakage during delivery and handling by the U.S. Postal Service. Our failure to timely deliver DVDs to our subscribers could cause them to become dissatisfied and cancel our service, which could adversely affect our operating results.

INCREASES IN THE COST OF DELIVERING DVDS COULD ADVERSELY AFFECT OUR GROSS PROFIT AND MARKETING EXPENSES.

Increases in postage delivery rates will adversely affect our gross profit if we elect not to raise our subscription rates to offset the increase. The U.S. Postal Service has announced that it will increase the rate for first-class postage from $0.34 to $0.37 in June 2002. In addition, the U.S. Postal Service has announced long-term plans to reduce its costs and make its service more efficient. If the U.S. Postal Service curtails its services, such as by the discontinuation of Saturday delivery service, our ability to timely deliver DVDs could diminish, and our subscriber satisfaction could be affected adversely.

Currently, most filmed entertainment is packaged on a single lightweight DVD. Our delivery process is designed to accommodate the delivery of one DVD to fulfill a selection. Because of the lightweight nature of a DVD, we generally mail one envelope containing a title using standard first-class postage, however, studios occasionally provide additional content on a second DVD, or may package a title on two DVDs. If packaging of filmed entertainment on multiple DVDs were to become more prevalent, or if the weight of DVDs were to increase, our costs of delivery and fulfillment processing would increase. In addition, we expense shipping costs of free trial programs to new subscribers as marketing expense. Therefore, if the cost of delivering titles were to increase, our marketing expense would be adversely affected.

IF WE ARE UNABLE TO EFFECTIVELY UTILIZE OUR CINEMATCH TECHNOLOGY, OUR BUSINESS MAY SUFFER.

Based on proprietary algorithms, our CineMatch technology enables us to predict and recommend titles and effectively merchandize our library to our subscribers. We believe that in order for CineMatch to function most effectively, it must access a large database of user ratings. We cannot assure you that the proprietary algorithms in our CineMatch technology will continue to function effectively to predict and recommend titles, or that we will continue to be successful in enticing subscribers to rate enough titles for our database to effectively predict and recommend new or existing titles.

If CineMatch does not enable us to predict and recommend titles that our subscribers will enjoy our personal movie recommendation service will be less useful, in which event:

- our subscriber satisfaction may decrease, subscribers may perceive our service to be of lower value and our ability to attract and retain subscribers may be affected adversely;

- our ability to effectively merchandise and utilize our library will be affected adversely; and

- our subscribers may default to choosing titles from among new releases or other titles that cost us more to provide, and our margins may be affected adversely.

IF WE DO NOT CORRECTLY ANTICIPATE OUR SHORT AND LONG-TERM NEEDS FOR TITLES THAT WE ACQUIRE PURSUANT TO REVENUE SHARING AGREEMENTS, OUR SUBSCRIBER SATISFACTION AND RESULTS OF OPERATIONS MAY BE AFFECTED ADVERSELY.

Under our revenue sharing agreements, we generally pre-order titles prior to their release on DVD based on our anticipated needs. If we anticipate inaccurately and we acquire insufficient copy depth for specific titles, it is generally impracticable for us to acquire additional copy depth for such titles while such titles are subject to revenue sharing. If we do not acquire sufficient copies of titles, we may not satisfy subscriber demand and our subscriber satisfaction and results of operations could be affected adversely.

Conversely, if we attempt to mitigate this risk and acquire more copies than needed to satisfy our subscriber demand, then our inventory utilization would become less effective and our gross margins would be affected adversely.

IF OUR SUBSCRIBERS SELECT TITLES THAT ARE MORE EXPENSIVE FOR US TO ACQUIRE AND DELIVER ON A MORE FREQUENT BASIS, OUR EXPENSES WOULD INCREASE.

Certain titles cost us more to acquire or result in greater revenue sharing expenses depending on the source from whom they are acquired and the terms on which they are acquired. If subscribers select these more costly titles more often on a proportional basis compared to all titles selected, our revenue sharing and other DVD acquisition expenses could increase, and our gross margins could be adversely affected.

IF WE ARE UNABLE TO OFFSET INCREASED DEMAND FOR TITLES WITH INCREASED SUBSCRIBER RETENTION OR OPERATING MARGINS, OUR OPERATING RESULTS MAY BE AFFECTED ADVERSELY.

Subscribers to our service can view as many titles as they want every month and, depending on the service plan, may have out between two and eight titles at a time. With our use of regional distribution centers, there will be a reduction in the transit time of DVDs. As a result, we anticipate that our subscribers will exchange more titles per month which will increase our operating costs. If our subscriber retention does not increase or our operating margins do not improve to an extent necessary to offset the effect of increased operating costs, our operating results will be adversely affected.

In addition, subscriber demand for titles may increase for a variety of other reasons beyond our control, including promotion by studios and seasonal variations in movie watching. Our subscriber growth and retention may be affected adversely if we attempt to increase our monthly subscription fees to offset any increased costs of acquiring or delivering titles.

IF WE ARE UNABLE TO COMPETE EFFECTIVELY, OUR BUSINESS WILL BE AFFECTED ADVERSELY.

The market for in-home filmed entertainment is intensely competitive and subject to rapid change. Many consumers maintain simultaneous relationships with multiple in-home filmed entertainment providers and can easily shift spending from one provider to another. For example, consumers may subscribe to

HBO, rent a DVD from Blockbuster, buy a DVD from Wal-Mart and subscribe to Netflix, or some combination thereof, all in the same month. Competitors may be able to launch new businesses at relatively low cost. DVDs represent only one of many existing and potential new technologies for viewing filmed entertainment. In addition, the growth in adoption of DVD technology is not mutually exclusive from the growth of other technologies. If we are unable to successfully compete with current and new competitors and technologies, we may not be able to achieve adequate market share, increase our revenues, or achieve and maintain profitability. Our principal competitors include, or could include:

- video rental outlets, such as Blockbuster Video and Hollywood Entertainment;
- movie retail stores, such as Best Buy, Wal-Mart and Amazon.com;
- subscription entertainment services, such as HBO and Showtime;
- pay-per-view and video-on-demand services;
- online DVD sites, such as dvdovernight and Rentmydvd.com;
- Internet movie providers, such as Movielink, backed by Columbia TriStar, Warner Bros. and a few other studios, Movies.com, backed by Walt Disney and Twentieth Century Fox, CinemaNow.com, backed by Blockbuster and Microsoft, and Movie Flix;
- cable providers, such as AOL Time Warner and Comcast; and
- direct broadcast satellite providers, such as DirectTV and Echostar.

Many of our competitors have longer operating histories, larger customer bases, greater brand recognition and significantly greater financial, marketing and other resources than we do. Some of our

competitors have adopted, and may continue to adopt, aggressive pricing policies and devote substantially more resources to marketing and Web site and systems development than we do. Increased competition may result in reduced operating margins, loss of market share and reduced revenues. In addition, our competitors may form strategic alliances with studios and distributors that could affect adversely our ability to obtain filmed entertainment on favorable terms.

IF CONSUMER ADOPTION OF DVD PLAYERS SLOWS, OUR BUSINESS COULD BE ADVERSELY AFFECTED.

The rapid adoption of DVD players has been fueled by strong retail support, strong studio support and falling DVD player prices. If retailers or studios reduce their support of the DVD format, or if manufacturers raise prices, continued DVD adoption by consumers could slow. If new or existing technologies, such as D-VHS, were to become more popular at the expense of the adoption or use of DVD technology, consumers may delay or avoid purchasing a DVD player. Our subscriber growth will be substantially influenced by future consumer adoption of DVD players, and if such adoption slows, our subscriber growth may also slow.

WE DEPEND ON STUDIOS TO RELEASE TITLES ON DVD FOR AN EXCLUSIVE TIME PERIOD FOLLOWING THEATRICAL RELEASE.

Our ability to attract and retain subscribers is related to our ability to offer new releases of filmed entertainment on DVD prior to their release to other distribution channels. Except for theatrical release, DVD and VHS currently enjoy a significant competitive advantage over other distribution channels, such as pay-per-view and VOD, because of the early timing of the distribution window for DVD and VHS. The window for DVD and VHS rental and retail sales is generally exclusive against other forms of non-theatrical movie distribution, such as pay-per-view, premium television, basic cable and network and syndicated television. The length of the exclusive window for movie rental and retail sales varies, typically ranging from 30 to 90 days.

Our business could suffer increased competition if:

- the window for rental were no longer the first following the theatrical release; or

- the length of this window were shortened.

The order, length and exclusivity of each window for each distribution channel is determined solely by the studio releasing the title, and we cannot assure you that the studios will not change their policies in the future in a manner that would be adverse to our business and results of operations.

In addition, any conditions that adversely affect the movie industry, including constraints on capital, financial difficulties, regulatory requirements and strikes, work stoppages or other disruptions involving writers, actors or other essential personnel, could affect adversely the availability of new titles, consumer demand for filmed entertainment and our business.

IF WE ARE UNABLE TO RENEGOTIATE OUR REVENUE SHARING AGREEMENTS WHEN THEY EXPIRE ON TERMS FAVORABLE TO US, OR IF THE COST TO US OF PURCHASING TITLES ON A WHOLESALE BASIS INCREASES, OUR GROSS MARGINS MAY BE AFFECTED ADVERSELY.

Since 2000, we have entered into over 50 revenue sharing arrangements with studios and distributors. In 2001, we acquired approximately 80% of our titles through revenue sharing agreements with studios and distributors, including our agreements with Columbia TriStar Home Entertainment and Warner Home Video. These revenue sharing agreements generally have terms of up to five years. The length of time we share revenue on each title ends after a fixed period. As our revenue sharing agreements expire, we may be required to negotiate new terms that could be disadvantageous to us.

Titles that we do not acquire under a revenue sharing agreement are purchased on a wholesale basis from studios or other distributors. If the price of titles that we purchase wholesale increases, our gross margin will be affected adversely.

IF THE SALES PRICE OF DVDS TO RETAIL CONSUMERS DECREASES, OUR ABILITY TO

ATTRACT NEW SUBSCRIBERS MAY BE AFFECTED ADVERSELY.

The cost of manufacturing DVDs is substantially less than the price for which new DVDs are generally sold in the retail market. Thus, we believe that studios and other resellers of DVDs have significant flexibility in pricing DVDs for retail sale. If the retail price of DVDs were to become significantly lower, consumers may choose to purchase DVDs rather than subscribe to our service.

IF DISPOSABLE DVDS ARE DEVELOPED, ADOPTED AND SUPPORTED AS A METHOD OF CONTENT DELIVERY BY THE STUDIOS, OUR BUSINESS COULD BE ADVERSELY AFFECTED.

We are currently aware that certain entities are attempting to develop disposable DVDs. As currently contemplated, disposable DVDs would allow a consumer to view a DVD for an unlimited number of times during a given time period, following which the DVD becomes unplayable by a chemical reaction, and is then disposable. If disposable DVDs become a viable alternative method of content delivery supported by the studios, our business could be adversely affected.

IF WE FAIL TO MAINTAIN OR ADEQUATELY REPLACE OUR OUTSIDE SOURCES OF NEW SUBSCRIBERS OR ARE UNABLE TO CONTINUE TO MARKET OUR SERVICE IN THE MANNER CURRENTLY CONDUCTED, OUR SUBSCRIBER LEVELS MAY BE AFFECTED ADVERSELY AND OUR MARKETING EXPENSES MAY INCREASE.

We obtain a large portion of our new subscribers through incentive-based online marketing programs. We engage third parties to solicit new subscribers through the use of banner ads, pop-under and pop-over placements, direct links and e-mails. We also have an active affiliate program by which third parties register with us and obtain particular advertisements from us for use on their Web sites or through other online marketing forums. In addition, we have engaged in various offline incentive-based marketing programs. For example, we obtain subscribers through solicitations placed inside the packaging of stand alone DVD players through arrangements we have with DVD player manufacturers, including ApexDigital, JVC Corporation of America, Panasonic Consumer Electronics Company, Philips Consumer Electronics, RCA, Samsung, Sanyo-Fisher, Sharp, Sony Electronics and Toshiba. We have recently explored other incentive-based advertising channels including newspaper and television advertising. These third parties may not continue to participate in our marketing programs if the programs do not provide sufficient value for their participation, our competitors offer better terms or the market for incentive-based advertising decreases. If we are unable to maintain or replace these sources of subscribers, our subscriber levels may be affected adversely and our cost of marketing may increase.

We also may not be able to continue to support the marketing of our service in the manner currently marketed if such activities are adverse to our business. Laws or regulations may be enacted which prohibit use of mass emails or similar marketing activities. Even if no relevant law or regulation is enacted, we may discontinue use or support of certain activities if we become concerned that subscribers or potential subscribers deem them intrusive or they otherwise adversely affect our goodwill and brand. For example, we recently terminated our relationship with certain third party online e-mail brokers who were unwilling or unable to comply with our standards for solicitation which include among other things that all recipients have "opted-in" to receive the solicitation. If these marketing activities are curtailed, our ability to attract new subscribers may be affected adversely.

In addition, while the DVD player manufacturers with whom we have promotional relationships are required to include our promotional materials with every DVD player they sell, we cannot effectively control what portion of DVD players sold by them actually include the promotional materials. If these DVD player manufacturers do not fully comply with the terms of our promotional relationships, our ability to attract new subscribers may be affected adversely.

FOLLOWING THE OFFERING, WE MAY NEED ADDITIONAL CAPITAL, AND WE CANNOT BE SURE THAT ADDITIONAL FINANCING WILL BE AVAILABLE.

Historically, we have funded our operating losses and capital expenditures through proceeds from private equity and debt financings and equipment leases. Although we currently anticipate that the proceeds of

this offering, together with our available funds and cash flow from operations, will be sufficient to meet our cash needs for the foreseeable future, we may require additional financing. Our ability to obtain financing will depend, among other things, on our development efforts, business plans, operating performance and condition of the capital markets at the time we seek financing. We cannot assure you that additional financing will be available to us on favorable terms when required, or at all. If we raise additional funds through the issuance of equity, equity-linked or debt securities, those securities may have rights, preferences or privileges senior to the rights of our common stock, and our stockholders may experience dilution.

ANY SIGNIFICANT DISRUPTION IN SERVICE ON OUR WEB SITE OR IN OUR COMPUTER SYSTEMS COULD RESULT IN A LOSS OF SUBSCRIBERS.

Subscribers and potential subscribers access our service through our Web site, where the title selection process is integrated with our delivery processing systems and software. Our reputation and ability to attract, retain and serve our subscribers is dependent upon the reliable performance of our Web site, network infrastructure and fulfillment processes. Interruptions in these systems could make our Web site unavailable and hinder our ability to fulfill selections. Much of our software is proprietary, and we rely on the expertise of members of our engineering and software development teams for the continued performance of our software and computer systems. Service interruptions or the unavailability of our Web site could diminish the overall attractiveness of our subscription service to existing and potential subscribers.

Our servers are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions, which could lead to interruptions and delays in our service and operations and loss, misuse or theft of data. Our Web site periodically experiences directed attacks intended to cause a disruption in service. Any attempts by hackers to disrupt our Web site service or our internal systems, if successful, could harm our business, be expensive to remedy and damage our reputation. Our general business disruption insurance does not cover expenses related to direct attacks on our Web site or internal systems. Efforts to prevent hackers from entering our computer systems are expensive to implement and may limit the functionality of our services. Any significant disruption to our Web site or internal computer systems could result in a loss of subscribers and adversely affect our business and results of operations.

Our communications hardware and the computer hardware used to operate our Web site are hosted at the facilities of a third party provider. Hardware for our delivery systems is maintained in our distribution centers. Fires, floods, earthquakes, power losses, telecommunications failures, break-ins and similar events could damage these systems and hardware or cause them to fail completely. Problems faced by our third party Web hosting provider, with the telecommunications network providers with whom it contracts or with the systems by which it allocates capacity among its subscribers, including us, could impact adversely the experience of our subscribers. Any of these problems could result in a loss of subscribers.

OUR EXECUTIVE OFFICES AND PRIMARY DISTRIBUTION CENTER ARE LOCATED IN THE SAN FRANCISCO BAY AREA. IN THE EVENT OF AN EARTHQUAKE, OTHER NATURAL OR MAN-MADE DISASTER OR POWER LOSS, OUR OPERATIONS WOULD BE AFFECTED ADVERSELY.

Our executive offices and primary distribution center are located in the San Francisco Bay area. Our business and operations could be materially adversely affected in the event of electrical blackouts, fires, floods, earthquakes, power losses, telecommunications failures, break-ins or similar events. We may not be able to effectively shift our fulfillment and delivery operations due to disruptions in service in the San Francisco Bay area or any other facility. Because the San Francisco Bay area is located in an earthquake-sensitive area, we are particularly susceptible to the risk of damage to, or total destruction of, our primary distribution center and the surrounding transportation infrastructure. We are not insured against any losses or expenses that arise from a disruption to our business due to earthquakes. Further, the State of California has experienced deficiencies in its power supply over the last year, resulting in occasional rolling black-outs. If rolling blackouts or other disruptions in power occur, our business and operations would be disrupted, and our business would be affected adversely.

THE LOSS OF ONE OR MORE OF OUR KEY PERSONNEL, OR OUR FAILURE TO ATTRACT, ASSIMILATE AND RETAIN OTHER HIGHLY QUALIFIED PERSONNEL IN THE FUTURE, COULD SERIOUSLY HARM OUR EXISTING BUSINESS AND NEW SERVICE DEVELOPMENTS.

We depend on the continued services and performance of our key personnel, including Reed Hastings, our Chief Executive Officer, President and Chairman of the Board, W. Barry McCarthy, Jr., our Chief Financial Officer and Secretary, Thomas R. Dillon, our Vice President of Operations, Leslie J. Kilgore, our Vice President of Marketing, and Neil Hunt, our Vice President of E-Commerce. In addition, much of our key technology and systems are custom made for our business by our personnel so that the loss of our key technology personnel could disrupt the operation of our title selection and fulfillment systems and have an adverse effect on our ability to grow and expand our systems.

PRIVACY CONCERNS COULD LIMIT OUR ABILITY TO LEVERAGE OUR SUBSCRIBER DATA.

In the ordinary course of business, and in particular, in connection with providing our personal movie recommendation service, we collect and utilize data supplied by our subscribers. We currently face certain legal obligations regarding the manner in which we treat such information. Other businesses have been criticized by privacy groups and governmental bodies for attempts to link personal identities and other information to data collected on the Internet regarding users' browsing and other habits. Increased regulation of data utilization practices, including self-regulation, as well as increased enforcement of existing laws could have an adverse effect on our business.

OUR REPUTATION AND RELATIONSHIPS WITH SUBSCRIBERS WOULD BE HARMED IF OUR BILLING DATA WERE TO BE ACCESSED BY UNAUTHORIZED PERSONS.

To secure transmission of confidential information obtained by us for billing purposes, including subscribers' credit card data, we rely on licensed encryption and authentication technology. In conjunction with the credit card companies, we take measures to protect against unauthorized intrusion into our subscribers' credit card and other data. If, despite these measures, we experienced any unauthorized intrusion into our subscribers' data, current and potential subscribers may become unwilling to provide the information to us necessary for them to become subscribers, and our business could be affected adversely. Similarly, if a well-publicized breach of the consumer data security of any other major consumer Web site were to occur, there could be a general public loss of confidence in the use of the Internet for commerce transactions, which could adversely affect our business.

In addition, because we obtain subscribers' billing information on our Web site, we do not obtain signatures from subscribers in connection with the use of credit cards by them. Under current credit card practices, to the extent we do not obtain cardholders' signatures, we are liable for fraudulent credit card transactions, even where the associated financial institution approves payment of the orders. We do not currently carry insurance against the risk of fraudulent credit card transactions. A failure to adequately control fraudulent credit card transactions would harm our business and results of operations.

OUR RELATIONSHIP WITH SUBSCRIBERS AND CREDIT CARD COMPANIES COULD BE HARMED IF OUR BILLING SOFTWARE FAILS.

We have in the past experienced problems with our subscriber billing software, causing us to overbill subscribers. Although we have and will continue to credit the accounts of the subscribers we overbill, problems with our billing software may have an adverse effect on our subscriber satisfaction and may cause one or more of the major credit companies to disallow our continued use of their payment products. In addition, if our billing software fails and we fail to bill subscribers our cash flow and results of operations will be affected adversely.

IF OUR TRADEMARKS AND OTHER PROPRIETARY RIGHTS ARE NOT ADEQUATELY PROTECTED TO PREVENT USE OR APPROPRIATION BY OUR COMPETITORS, THE VALUE OF OUR BRAND AND OTHER INTANGIBLE ASSETS MAY BE DIMINISHED, AND OUR BUSINESS MAY BE ADVERSELY AFFECTED.

We rely and expect to continue to rely on a combination of confidentiality and license agreements with our employees, consultants and third parties with whom we have relationships, as well as trademark, copyright,

patent and trade secret protection laws, to protect our proprietary rights. We have filed trademark applications in the United States for the Netflix, Netflix.com, CineMatch and Mr. DVD names, and have filed a U.S. patent application for aspects of our technology. We intend to file an amended trademark application for the Netflix design logo responsive to a denial of our initial application for the Netflix design logo. From time to time we expect to file additional trademark and patent applications. Nevertheless, these applications may not be approved, third parties may challenge any patents issued to or held by us, third parties may knowingly or unknowingly infringe our patents, trademarks and other proprietary rights, and we may not be able to prevent infringement without substantial expense to us. If the protection of our proprietary rights is inadequate to prevent use or appropriation by third parties, the value of our brand and other intangible assets may be diminished, competitors may be able to more effectively mimic our service and methods of operations, the perception of our business and service to subscribers and potential subscribers may become confused in the marketplace and our ability to attract subscribers may be adversely affected.

INTELLECTUAL PROPERTY CLAIMS AGAINST US COULD BE COSTLY AND RESULT IN THE LOSS OF SIGNIFICANT RIGHTS RELATED TO, AMONG OTHER THINGS, OUR WEB SITE, CINEMATCH TECHNOLOGY AND TITLE SELECTION PROCESSES.

Trademark, patent and other intellectual property rights are becoming increasingly important to us and other Internet companies. If there is a successful claim of patent infringement against us and we are unable to develop non-infringing technology or license the infringed or similar technology on a timely basis, our business

and competitive position may be affected adversely. Many companies are devoting significant resources to developing patents that could potentially affect many aspects of our business. There are numerous patents that broadly claim means and methods of conducting business on the Internet. We may be accused of infringing certain of these patents. In addition, other parties may assert infringement or unfair competition claims against us that could relate to any aspect of our technology, business processes or other intellectual property. We have not exhaustively searched patents relative to our technology. We cannot predict whether third parties will assert claims of infringement against us, the subject matter of any of these claims or whether these assertions or prosecutions will adversely affect our business. If we are forced to defend ourselves against any of these claims, whether they are with or without merit or are determined in our favor, we may face costly litigation, diversion of technical and management personnel, inability to use our current Web site or CineMatch technology or product shipment delays. As a result of a dispute, we may have to develop non-infringing technology or enter into royalty or licensing agreements. These royalty or licensing agreements, if required, may be unavailable on terms acceptable to us, or at all.

IF WE ARE UNABLE TO PROTECT OUR DOMAIN NAMES, OUR REPUTATION AND BRAND COULD BE AFFECTED ADVERSELY.

We currently hold various domain names relating to our brand, including Netflix.com. Failure to protect our domain names could affect adversely our reputation and brand, and make it more difficult for users to find our Web site and our service. The acquisition and maintenance of domain names generally are regulated by governmental agencies and their designees. The regulation of domain names in the United States may change in the near future. Governing bodies may establish additional top-level domains, appoint additional domain name registrars or modify the requirements for holding domain names. As a result, we may be unable to acquire or maintain relevant domain names. Furthermore, the relationship between regulations governing domain names and laws protecting trademarks and similar proprietary rights is unclear. We may be unable to prevent third parties from acquiring domain names that are similar to, infringe upon or otherwise decrease the value of our trademarks and other proprietary rights.

BECAUSE OUR BUSINESS IS ACCESSED OVER THE INTERNET, IF THE INTERNET INFRASTRUCTURE IS NOT DEVELOPED OR MAINTAINED, WE WILL LOSE SUBSCRIBERS.

The Internet may not become a viable commercial marketplace for many potential subscribers due to inadequate development of network infrastructure and enabling technologies that address consumer concerns about:

- network performance;

- security;
- reliability;
- speed of access;
- ease of use; and
- bandwidth availability.

The Internet has experienced a variety of outages and delays as a result of damage to portions of its infrastructure, and it could face outages and delays in the future. These outages and delays could frustrate public use of the Internet, including use of our Web site offerings. In addition, the Internet could lose its viability due to delays in the development or adoption of new standards and protocols to handle increased levels of activity or due to governmental regulation.

IF WE BECOME SUBJECT TO LIABILITY FOR THE INTERNET CONTENT THAT WE PUBLISH OR UPLOAD FROM OUR USERS, OUR RESULTS OF OPERATIONS WOULD BE AFFECTED ADVERSELY.

As a publisher of online content, we face potential liability for negligence, copyright, patent or trademark infringement or other claims based on the nature and content of materials that we publish or distribute. We also may face potential liability for content uploaded from our users in connection with our community-related content or movie reviews. If we become liable, then our business may suffer. Litigation to defend these claims could be costly and harm our results of operations. We cannot assure you that we are adequately insured to cover claims of these types or to indemnify us for all liability that may be imposed on us.

WE MAY NEED TO CHANGE THE MANNER IN WHICH WE CONDUCT OUR BUSINESS, OR INCUR GREATER OPERATING EXPENSES, IF GOVERNMENT REGULATION OF THE INTERNET OR OTHER AREAS OF OUR BUSINESS CHANGES OR IF CONSUMER ATTITUDES TOWARD USE OF THE INTERNET CHANGE.

The adoption or modification of laws or regulations relating to the Internet or other areas of our business could limit or otherwise adversely affect the manner in which we currently conduct our business. In addition, the growth and development of the market for online commerce may lead to more stringent consumer protection laws, which may impose additional burdens on us. If we are required to comply with new regulations or legislation or new interpretations of existing regulations or legislation, this compliance could cause us to incur additional expenses or alter our business model.

The manner in which Internet and other legislation may be interpreted and enforced cannot be precisely determined and may subject either us or our customers to potential liability, which in turn could have an adverse effect on our business, results of operations and financial condition. The adoption of any laws or regulations that adversely affect the popularity or growth in use of the Internet could decrease the demand for our subscription service and increase our cost of doing business.

In addition, if consumer attitudes toward use of the Internet change, consumers may become unwilling to select their entertainment online or otherwise provide us with information necessary for them to become subscribers. Further, we may not be able to effectively market our services online to users of the Internet. If we are unable to interact with consumers because of changes in their attitude toward use of the Internet, our subscriber acquisition and retention and operating results may be affected adversely.

RISKS RELATED TO THIS OFFERING

OUR OFFICERS AND DIRECTORS AND THEIR AFFILIATES WILL EXERCISE SIGNIFICANT CONTROL OVER NETFLIX.

After the completion of this offering, our executive officers and directors, their immediate family members and affiliated venture capital funds will beneficially own, in the aggregate, approximately % of

our outstanding common stock. In addition, Jay Hoag, one of our directors, will beneficially own approximately % of our outstanding common stock, Reed Hastings, our president, chief executive officer, and chairman of our board of directors will beneficially own approximately % of our outstanding common stock and Michael Schuh, one of our directors, will beneficially own approximately % of our outstanding common stock. These stockholders may have individual interests that are different from yours and will be able to exercise significant control over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us.

PROVISIONS IN OUR CHARTER DOCUMENTS AND UNDER DELAWARE LAW COULD DISCOURAGE A TAKEOVER THAT STOCKHOLDERS MAY CONSIDER FAVORABLE.

Following this offering, our charter documents may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable because they:

- authorize our board of directors, without stockholder approval, to issue up to 10,000,000 shares of undesignated preferred stock;
- provide for a classified board of directors;
- prohibit our stockholders from acting by written consent;
- establish advance notice requirements for proposing matters to be approved by stockholders at stockholder meetings; and
- prohibit stockholders from calling a special meeting of stockholders.

As a Delaware corporation, we are also subject to certain Delaware anti-takeover provisions. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction. Our board of directors could rely on Delaware law to prevent or delay an acquisition of us. For a description of our capital stock, see "Description of Capital Stock."

OUR STOCK PRICE COULD BE VOLATILE AND COULD DECLINE FOLLOWING THIS OFFERING.

Prior to this offering, there has been no public market for shares of our common stock. An active market may not develop following completion of this offering, or if developed, may not be maintained.

The market prices of the securities of Internet and technology-related companies have been extremely volatile. The price at which our common stock will trade after this offering could be extremely volatile and may fluctuate substantially due to the following factors, some of which are beyond our control:

- variations in our operating results;
- variations between our actual operating results and the expectations of securities analysts, investors and the financial community;
- announcements of developments affecting our business, systems or expansion plans by us or others;

- market volatility in general; and

- the operating results of our competitors.

As a result of these and other factors, investors in our common stock may not be able to resell their shares at or above the initial offering price.

16

In the past, securities class action litigation often has been instituted against companies following periods of volatility in the market price of their securities. This type of litigation, if directed at us, could result in substantial costs and a diversion of management's attention and resources.

WE WILL RECORD SUBSTANTIAL EXPENSES RELATED TO OUR ISSUANCE OF STOCK OPTIONS THAT MAY HAVE A MATERIAL NEGATIVE IMPACT ON OUR OPERATING RESULTS FOR THE FORESEEABLE FUTURE.

We are required to recognize, as a reduction of stockholders' equity, deferred compensation equal to the difference between the deemed fair market value of our common stock for financial reporting purposes and the exercise price of these options at the date of grant. This deferred compensation is amortized over the vesting period of the applicable options, generally three to four years, using the graded vesting method. At December 31, 2001, approximately $5.7 million of deferred compensation related to employee stock options remained unamortized. The resulting amortization expense will have a material negative impact on our operating results in future periods. In addition, in August and September 2001 we repriced options to purchase an aggregate of 2,741,386 shares of our common stock to $1.00 per share. We cannot predict the amount of compensation expense that we will have to recognize on a quarterly basis for these repriced options, and it could materially negatively impact our operating results for future periods. See further disclosure of variable award accounting on pages 27 and 28 under "Management's Discussion and Analysis of Financial Condition and Results of Operations--Operating Expenses--Stock-Based Compensation."

FUTURE SALES OF OUR COMMON STOCK, INCLUDING THE SHARES PURCHASED IN THIS OFFERING, MAY DEPRESS OUR STOCK PRICE.

Sales of substantial amounts of our common stock in the public market following this offering by our existing stockholders or upon the exercise of outstanding options or warrants to purchase shares of our common stock may adversely affect the market price of our common stock. Such sales could create public perception of difficulties or problems with our business. As a result, these sales might make it more difficult for us to sell securities in the future at a time and price that we deem necessary or appropriate.

Upon completion of this offering, we will have outstanding   shares of common stock, assuming no exercise of the underwriters' over-allotment option and no exercise of outstanding options and warrants after March 31, 2002. Holders of   of our currently outstanding shares and warrants and options to acquire shares have entered into lock-up agreements with the underwriters of this offering. With limited exceptions, these lock-up agreements prohibit a stockholder from selling, contracting to sell or otherwise disposing of any common stock or any securities that are convertible into or exercisable for common stock for 180 days from the date of this prospectus, although Merrill Lynch may, in its sole discretion and at any time without notice, release all or any portion of the securities subject to these lock-up agreements. As a result of these lock-up agreements, notwithstanding possible earlier eligibility for sale under the provisions of Rule 144, 144(k) or 701, none of these shares may be sold until 181 days after the date of this prospectus.

Of the outstanding shares subject to lock-up agreements:

- of these shares will be tradable without restriction pursuant to Rule 144(k) 181 days after the date of this prospectus; and

- of these shares will be tradable, subject to the limitations imposed by Rule 144 181 days after the date of this prospectus.

FINANCIAL FORECASTING BY US AND FINANCIAL ANALYSTS WHO MAY PUBLISH ESTIMATES OF OUR FINANCIAL RESULTS WILL BE DIFFICULT BECAUSE OF OUR LIMITED OPERATING HISTORY, AND OUR ACTUAL RESULTS MAY DIFFER FROM FORECASTS.

As a result of our recent growth and our limited operating history, it is difficult to accurately forecast our revenues, gross profit, operating expenses, number of paying subscribers, number of DVDs shipped per day and other financial and operating data. The inability by us or the financial community to accurately forecast our operating results could cause our net losses in a given quarter to be greater than expected, which could cause a

decline in the trading price of our common stock. We have a limited amount of meaningful historical financial data upon which to base planned operating expenses. We base our current and forecasted expense levels and DVD acquisitions on our operating plans and estimates of future revenues, which are dependent on the growth of our subscriber base and the demand for titles by our subscribers. As a result, we may be unable to make accurate financial forecasts or to adjust our spending in a timely manner to compensate for any unexpected shortfalls in revenues. We believe that these difficulties in forecasting are even greater for financial analysts that may publish their own estimates of our financial results.

OUR MANAGEMENT MAY NOT USE THE PROCEEDS OF THIS OFFERING EFFECTIVELY.

Our management has broad discretion over the use of proceeds of this offering. In addition, our management has not designated a specific use for a substantial portion of the proceeds of this offering. Accordingly, it is possible that our management may allocate the proceeds in ways that do not improve our operating results. In addition, these proceeds may not be invested to yield a favorable rate of return.

WE HAVE NO INTENTION TO PAY CASH DIVIDENDS ON OUR COMMON STOCK FOR THE FORESEEABLE FUTURE, AND OUR LEASE FINANCING AGREEMENTS PROHIBIT US FROM DOING SO.

We currently expect to retain future earnings, if any, to finance the growth and development of our business and do not anticipate paying any cash dividends for the foreseeable future. Further, lease financing agreements to which we are a party and pursuant to which we have outstanding indebtedness, prohibit us from paying any dividends. Therefore, you will not receive any return on an investment in our common stock unless you sell your common stock for a price greater than which you paid for it.

FORWARD-LOOKING STATEMENTS

You should not place undue reliance on forward-looking statements in this prospectus. This prospectus contains forward-looking statements that involve risks and uncertainties. These statements relate to our future plans, objectives, expectations and intentions. We use words such as "anticipates," "believes," "plans," "expects," "future," "intends" and similar expressions to identify such forward-looking statements. Forward- looking statements include statements regarding our business strategy, future operating performance, the size of the market for our services and our prospects. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this prospectus. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us described in "Risk Factors" starting on page 5 and elsewhere in this prospectus. We caution you not to rely on these statements without also considering the risks and uncertainties associated with these statements and our business that are addressed in this prospectus.

This prospectus contains various estimates related to the Internet, e-commerce and the filmed entertainment industry. These estimates have been included in studies published or produced by market research and other firms including Adams Media Research, DVD Entertainment Group and the National Cable Television Association. These estimates have been produced by industry analysts based on trends to date, their knowledge of technologies and markets, and customer research, but these are forecasts only and are subject to inherent uncertainty.

USE OF PROCEEDS

The net proceeds to us from the sale of shares being offered by us at an assumed initial public offering price of $ per share, after deducting estimated underwriting discounts and commissions and estimated offering expenses, are estimated to be approximately $ million, or approximately $ million if the underwriters' over-allotment option is exercised in full.

The principal purposes of this offering are to create a public market for our common stock, to facilitate our future access to the public capital markets and to provide us with flexibility in the future, including to acquire additional businesses, products or technologies either with the net proceeds from this offering or through the publicly traded common stock we create through this offering, although we have no present intention to acquire any such businesses, products or technologies at this time. We intend to use a portion of the net proceeds of this offering to repay all outstanding indebtedness under our subordinated promissory notes, which was approximately $13.9 million as of March 31, 2002, including accrued interest and for general corporate purposes, including working capital. Our subordinated promissory notes, issued in July 2001, accrue interest at a stated rate of 10% per year compounded annually and mature upon the earlier of July 10, 2011 and the completion of this offering. The proceeds we received from the issuance of our subordinated promissory notes have been used for working capital, capital expenditures and general corporate purposes.

We have not allocated a specific amount of our net proceeds from this offering to any particular purpose, other than repayment of indebtedness under our subordinated promissory notes. The net proceeds that we actually expend for general corporate purposes may vary significantly depending on a number of factors, including future revenue growth, if any, and our cash flows. As a result, we will retain broad discretion over the allocation of the net proceeds from this offering. Pending use of the net proceeds from this offering, we intend to invest the net proceeds in short-term, investment-grade securities.

DIVIDEND POLICY

We have never declared or paid any cash dividends on our capital stock. We currently expect to retain future earnings, if any, to finance the growth and development of our business and do not anticipate paying any cash dividends in the foreseeable future. Our existing lease financing agreements prohibit us from paying any dividends.

CAPITALIZATION

The following table sets forth our cash, cash equivalents and capitalization as of March 31, 2002:

- on an actual basis;
- on a pro forma basis assuming the conversion of all shares of our preferred stock into shares of common stock automatically upon completion of this offering and the filing of our amended and

restated certificate of incorporation upon completion of this offering, including shares to be issued to certain studios immediately prior to this offering; and

. on a pro forma as adjusted basis to reflect the sale of shares of our common stock at an assumed initial public offering price of $ per share, less the underwriting discounts and commissions and estimated offering expenses, and the application of the net proceeds from this offering.

This information should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and our financial statements and notes to those statements appearing elsewhere in this prospectus.

	AS
	ACTUAL
Cash and cash equivalents	$ 15,671
Subordinated promissory notes, net of unamortized discount of $10.8 million	$ 3,158
Capital lease obligations, net of current portion	959
Total long-term debt	4,117
Redeemable convertible preferred stock and warrants:	
Series B, C, D, E and E-1 Convertible Preferred Stock: 26,925,014 shares authorized; 20,316,909 shares issued and outstanding (actual); no shares issued or outstanding	101,479
Convertible preferred stock warrants	351
Total redeemable convertible preferred stock and warrants	101,830
Stockholders' equity (deficit):	
Preferred stock, $0.001 par value: 10,000,000 shares authorized (pro forma and pro forma as adjusted); no shares issued and outstanding	--
Series A Convertible Preferred Stock, $0.001 par value: 5,000,000 shares authorized; 4,444,545 shares issued and outstanding (actual); no shares issued or outstanding (pro forma and pro forma as adjusted)	4
Series F Convertible Preferred Stock, $0.001 par value: 3,500,000 shares authorized; 1,712,954 outstanding (actual); no shares issued and outstanding (pro forma and pro forma as adjusted)	2
Common stock, $0.001 par value: 100,000,000 shares authorized (actual); 150,000,000 shares authorized (pro forma and pro forma as adjusted); 6,575,750 shares issued and outstanding (actual); 45,197,271 shares issued and outstanding (pro forma) and shares issued and outstanding (pro forma as adjusted)	7
Additional paid-in capital	62,105
Deferred stock-based compensation	(12,553
Accumulated deficit	(140,871
Total stockholders' equity (deficit)	$ (91,306
Total capitalization	$ 14,641

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DILUTION

If you invest in our stock, your interest will be diluted to the extent of the difference between the public offering price per share of our common stock and the pro forma net tangible book value per share of our common stock after this offering.

The pro forma net tangible book value of our common stock on March 31, 2002 was $ million or $ per share of common stock. Pro forma net tangible book value per share represents the amount of our total tangible assets less total liabilities, divided by the number of shares of common stock outstanding, after giving effect to the automatic conversion of our preferred stock into common stock upon the completion of this offering at an assumed initial public offering price of $ per share. Dilution in net tangible book value per share represents the difference between the amount per share paid by purchasers of shares of our common stock in this offering and the net tangible book value per share of our common stock immediately afterwards. After giving effect to our sale of million shares of common stock offered by this prospectus at an assumed initial public offering price of $ per share and after deducting the underwriting discounts, commissions and estimated offering expenses payable by us, and the application of a portion of the net proceeds to repay all outstanding indebtedness under our subordinated promissory notes, our pro forma net tangible book value would have been $ million, or approximately $ per share. This represents an immediate increase in pro forma net tangible book value of $ per share to existing stockholders and an immediate dilution in pro forma net tangible book value of $ per share to new investors. The following table illustrates the per share dilution:

Estimated public offering price per share		$
Pro forma net tangible book value per share as of March 31, 2002	$	
Increase per share attributable to new investors		
Pro forma net tangible book value per share after this offering		
Dilution in pro forma net tangible book value per share to new investors		$

This table excludes all options and warrants that will remain outstanding upon completion of this offering. See Notes 4, 6 and 7 to Notes to Financial Statements. The exercise of outstanding options and warrants having an exercise price less than the offering price would increase the dilutive effect to new investors.

The following table sets forth on a pro forma basis, as of March 31, 2002, the differences between the number of shares of common stock purchased from us, the total price and average price per share paid by existing stockholders and by the new investors, before deducting expenses payable by us, using the estimated public offering price of $ per share.

	SHARES PURCHASED		TOTAL CONSIDERATION		AVERAGE PRICE PER
	NUMBER	PERCENTAGE	AMOUNT	PERCENTAGE	SHARE
Existing stockholders.................		%	$	%	$
New investors.........................					
Total..............................		100.0%	$	100.0%	

If the underwriter's over-allotment option is exercised in full, the number of shares held by new public investors will be increased to or approximately % of the total number of shares of our common stock outstanding after this offering.

SELECTED FINANCIAL AND OTHER DATA

The following selected financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," and are qualified by reference to our financial statements and notes thereto appearing elsewhere in this prospectus. The audited statement of operations data set forth below for the years ended December 31, 1999, 2000 and 2001 and the audited balance sheet data as of December 31, 2000 and 2001 are derived from, and are qualified by reference to, the financial statements of Netflix included elsewhere in this prospectus. The statement of operations data for the years ended December 31, 1998 and for the period from August 29, 1997 (inception) to December 31, 1997 and the balance sheet data as of December 31, 1997, 1998 and 1999 are derived from, and are qualified by reference to, the financial statements of Netflix not included elsewhere in this prospectus. The statement of operations data for the three months ended March 31, 2001 and 2002 and the balance sheet data as of March 31, 2002, are derived from, and qualified by reference to, the unaudited financial statements of Netflix included elsewhere in this prospectus and include all adjustments necessary for a fair presentation on the same basis as the annual financial statements. The historical results are not necessarily indicative of results to be expected for any future period.

	PERIOD FROM AUGUST 29, 1997 (INCEPTION) TO DECEMBER 31, 1997	YEAR ENDED DECEMBE		
		1998	1999	2000
		(IN THOUSANDS, EXCEPT PE		

STATEMENT OF OPERATIONS DATA:				
Revenues:				
Subscription	$ --	$ 585	$ 4,854	$ 35,8
Sales	--	754	152	
Total revenues	--	1,339	5,006	35,8
Cost of revenues:				
Subscription	--	535	4,217	24,8
Sales	--	776	156	
Total cost of revenues	--	1,311	4,373	24,8
Gross profit	--	28	633	11,0
Operating expenses:				
Fulfillment*	--	763	2,446	10,2
Technology and development*	100	3,857	7,413	16,8
Marketing*	103	4,052	14,070	25,7
General and administrative*	158	1,358	1,993	6,9
Restructuring charges	--	--	--	
Stock-based compensation*	--	1,151	4,742	8,8
Total operating expenses	361	11,181	30,664	68,5
Operating loss	(361)	(11,153)	(30,031)	(57,5
Interest and other income (expense), net	2	72	186	1
Net loss	$(359)	$(11,081)	$(29,845)	$(57,3
Basic and diluted net loss per share	$ --	$ (12.27)	$ (7.13)	$ (13.
Weighted average shares outstanding used in computing net loss per share	--	903	4,183	4,2
* Amortization of stock-based compensation not included in expense line-item:				
Fulfillment	$ --	$ 105	$ 624	$ 2,2
Technology and development	--	223	1,141	2,8
Marketing	--	253	351	1,8
General and administrative	--	570	2,626	1,7
	$ --	$ 1,151	$ 4,742	$ 8,8

	AS OF DECEMBER 31,				
	1997	1998	1999	2000	2001
			(IN THOUSANDS)		
BALANCE SHEET DATA:					
Cash and cash equivalents	$1,582	$ 1,061	$ 14,198	$ 14,895	$ 16,1

Working capital (deficit)	1,360	(4,704)	11,028	(1,655)	(6,6
Total assets	1,901	4,849	34,773	52,488	41,6
Capital lease obligations, less current portion	--	172	811	2,024	1,0
Notes payable, less current portion	--	--	3,959	1,843	
Subordinated notes payable	--	--	--	--	2,7
Redeemable convertible preferred stock	--	6,321	51,819	101,830	101,8
Stockholders' equity (deficit)	1,636	(8,044)	(32,028)	(73,267)	(90,5

	PERIOD FROM AUGUST 29, 1997 (INCEPTION) TO DECEMBER 31,	YEAR ENDED DECEMBER		
	1997	1998	1999	2000
		(IN THOUSANDS, EXCEPT PE		
OTHER DATA:				
EBITDA/(1)/ (unaudited)	$ (356)	$(9,575)	$(21,223)	$(28,17
Number of subscribers (unaudited)	--	--	107	29
Net cash provided by (used in):				
Operating activities	$ (261)	$(5,408)	$(16,529)	$(22,70
Investing activities	(152)	(2,363)	(19,742)	(24,97
Financing activities	(1,995)	(7,250)	49,408	48,37

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(1) EBITDA consists of operating loss before depreciation, amortization, non-cash charges for equity instruments granted to non-employees and stock-based compensation. EBITDA provides an alternative measure of cash flow from operations. You should not consider EBITDA as a substitute for operating loss, as an indicator of our operating performance or as an alternative to cash flows from operating activities as a measure of liquidity. We may calculate EBITDA differently from other companies.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THE FOLLOWING DISCUSSION OF OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS SHOULD BE READ IN CONJUNCTION WITH OUR FINANCIAL STATEMENTS AND RELATED NOTES. THIS DISCUSSION CONTAINS FORWARD-LOOKING STATEMENTS WHICH INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS COULD DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THESE FORWARD-LOOKING STATEMENTS FOR MANY REASONS, INCLUDING THE RISKS FACED BY US DESCRIBED IN "RISK FACTORS" STARTING ON PAGE 5 AND ELSEWHERE IN THIS PROSPECTUS.

OVERVIEW

We are the largest online entertainment subscription service in the United States providing more than 600,000 subscribers access to a comprehensive library of more than 11,500 movie, television and other filmed entertainment titles. Our standard subscription plan allows subscribers to have three titles out at the same time with no due dates, late fees or shipping charges for $19.95 per month. Subscribers can view as many titles as they want in a month. Subscribers select titles at our Web site (WWW.NETFLIX.COM) aided by our proprietary CineMatch technology, receive them on DVD by first-class mail and return them to us at their convenience using our prepaid mailers. Once a title has been returned, we mail the next available title in a subscriber's queue.

We were organized as a Delaware corporation in August 1997. We have incurred significant losses since our inception. As of March 31, 2002, we had a total stockholders' deficit of $91.3 million. We expect that we will continue to incur substantial losses for the foreseeable future. We also expect to incur significant marketing, technology and development, general and administrative and stock-based compensation expenses. As a result, we will need to significantly increase our operating margins to achieve profitability and may never achieve profitability.

CRITICAL ACCOUNTING POLICIES

We believe our change to the estimated life over which we amortize the costs of acquiring titles for our library and the selection of a method of amortization for the costs we incur to acquire titles for our library are critical accounting policies because they involve some of the more significant judgments and estimates used in the preparation of our financial statements.

CHANGE IN ESTIMATED LIFE OF THE COST OF OUR LIBRARY

In late 2000 and early 2001, we entered into a series of revenue sharing agreements with studios which substantially changed our business model for acquiring DVDs and satisfying subscriber demand for titles. These revenue sharing agreements enable us to acquire DVDs at a lower upfront cost than traditional buying arrangements. We share a percentage of the net revenues generated by the use of each particular title with these studios over a fixed period of time, generally 12 months. Before the change in our business model, we typically acquired fewer copies of a particular title and utilized each copy over a longer period of time. The implementation of these revenue sharing agreements improved our ability to acquire larger quantities of newly released titles and satisfy a substantial portion of subscriber demand for such titles over a shorter period of time. On January 1, 2001, we revised the amortization policy for the cost of our library from an accelerated method using a three year life to the same accelerated method of amortization using a one year life.

The change in life has been accounted for as a change in accounting estimate and is accounted for on a prospective basis from January 1, 2001. Had the DVDs acquired prior to January 1, 2001 been amortized using a three-year life, amortization expense for 2001 would have been $4.7 million lower than the amount recorded in our financial statements, representing a $0.86 per share impact on loss per common share in 2001.

SELECTION OF A METHOD OF AMORTIZATION OF UPFRONT COSTS OF OUR LIBRARY

Under our revenue sharing agreements, we remit an upfront payment to acquire titles from the studios. This payment includes a contractually specified initial fixed license fee that is capitalized. Some payments also include a contractually specified prepayment of future revenue sharing obligations that is classified as prepaid revenue sharing expense and is applied against future revenue sharing obligations. A nominal amount is also capitalized upon acquisition of a particular title for the cost of the estimated number of DVDs we expect to purchase at the end of the title term. This cost is amortized with the cost of the initial license fee on an accelerated basis over one year. We believe the use of an accelerated method is appropriate because we normally experience heavy initial demand for a title, which subsides once initial demand has been satisfied.

REVENUES

We derive substantially all of our revenues from monthly subscription fees. From the launch of our Web site in April 1998 through January 1999, we generated revenues primarily from individual DVD rentals and sales to customers. In March 1999, we stopped selling new DVDs. From February 1999 through October 1999, we generated revenues primarily from individual DVD rentals to customers. In September 1999, we launched our subscription service, and through February 2000, for a fixed monthly subscription fee of $15.95, subscribers could have up to four titles per month with no due dates or late fees, and for $3.98, could order an additional title. In February 2000, we modified our standard subscription service to provide subscribers access to an unlimited number of titles for $19.95 per month, with a maximum of four titles out at any time. Existing subscribers were switched to our new service, some at $15.95 per month and the rest at $19.95 per month. In October 2000, we again modified our standard subscription service to provide subscribers access to an unlimited number of titles for a fixed monthly fee, with a maximum of three titles out at the same time. There is no minimum subscription period and subscribers can cancel our service at any time.

We had an insignificant amount of DVD sales in 1999 and no DVD sales in 2000. Beginning in late 2000, as part of the change in our business model, we began acquiring larger quantities of particular titles through our revenue sharing agreements. As a result, once initial demand for a particular title has been satisfied, we may hold a number of titles in excess of the quantities needed to satisfy ongoing subscriber demand. Several studios allow us to sell the DVDs acquired from them at the end of the revenue sharing term. Before we sell a particular title, we compare the number of copies we hold to estimated future demand to determine the number of copies we can sell without jeopardizing our ability to satisfy future subscriber demand. From time to time, we expect to make bulk sales of our used DVDs to resellers.

We recognize subscription revenues ratably during each subscriber's monthly subscription period. We record refunds to subscribers as a reduction of revenues or deferred revenues, as appropriate. We recognize revenues from the sale of used DVDs to resellers when the DVDs are shipped to the reseller. Historically, revenues from DVD rentals and shipping revenues also were recognized when the product was shipped to the customer.

In addition to our standard service, we also offer a lower priced plan in which subscribers can keep two titles at the same time for $13.95 per month, as well as higher priced plans offering four, five and eight titles out at the same time for $24.95, $29.95 and $39.95 per month, respectively. As of March 31, 2002, approximately 90% of our paying subscribers paid $19.95 or more per month.

COST OF REVENUES

COST OF SUBSCRIPTION REVENUES

We acquire titles for our library using traditional buying methods and revenue sharing agreements. Traditional buying methods normally result in higher upfront costs when compared to titles obtained through revenue sharing agreements. Cost of subscription revenues consists of revenue sharing costs, amortization of our

library, amortization of intangible assets related to equity instruments issued to certain studios and postage and packaging costs related to shipping titles to paying subscribers.

REVENUE SHARING COSTS. Our revenue sharing agreements generally commit us to pay an initial upfront fee for each DVD acquired. Under certain of our revenue sharing agreements, we pay an additional minimum revenue sharing fee for each DVD shipped to a subscriber. Other than the initial upfront payment for DVD's acquired, we are not obligated to pay any minimum revenue sharing fee on DVDs that are not shipped. We characterize these payments to the studios as revenue sharing costs. As of December 31, 2001, we had revenue sharing agreements with over 40 studios that expire at various dates beginning in 2002.

AMORTIZATION OF THE COST OF DVDS. Prior to January 1, 2001, we amortized our cost of DVDs using an accelerated method over an estimated life of three years and assumed no salvage value. On January 1, 2001, we revised the estimated life to one year and assumed a salvage value of $2.00 for the DVDs that we believe we will eventually sell.

AMORTIZATION OF INTANGIBLE ASSETS RELATED TO EQUITY ISSUED TO STUDIOS. In 2000, in connection with signing revenue sharing agreements with Columbia TriStar Home Entertainment, Dreamworks International Distribution and Warner Home Video, we agreed to issue each of these studios an amount of our Series F Non-Voting Preferred Stock equal to 1.204% of our fully diluted equity securities outstanding. In 2001, in connection with signing revenue sharing agreements with Twentieth Century Fox Home Entertainment and Universal Studios Home Video, we agreed to issue to each of the two studios an amount of our Series F Non-Voting Preferred Stock equal to 1.204% of our fully diluted equity securities outstanding. As of December 31, 2001, the aggregate of Series F Non-Voting Preferred Stock granted to these five studios equaled 6.02% of our fully diluted equity securities outstanding. Prior to this offering, these studios are entitled to receive additional grants of Series F Non-Voting Preferred Stock to maintain their equity interests at 1.204% of our fully diluted equity securities outstanding. Consequently, when we grant options or issue stock, we also are obligated to issue additional shares of Series F

Non-Voting Preferred Stock to these studios to maintain their equity ownership interest at 6.02% in the aggregate. Our Series F Non-Voting Preferred Stock automatically converts into our common stock upon the closing of this offering. We recognize our obligation to grant these equity interests at fair value as an intangible asset and we increase additional paid-in capital on our balance sheet. We then amortize the intangible asset on a straight-line basis to cost of subscription revenues over the term of each revenue sharing agreement with each studio. The term for the three agreements entered into in 2000 is five years and the term for the two agreements entered into 2001 is three years. Each time there is a dilution event prior to this offering, we will determine the value of our obligation to issue additional equity interests. The determined value is added to the intangible asset and amortized to cost of subscription revenues over the remaining term of the applicable revenue sharing agreement.

POSTAGE AND PACKAGING. Postage and packaging costs consist of the postage costs to mail titles to and from our paying subscribers, each of which is currently $0.34 but will increase to $0.37 on June 30, 2002, and the packaging costs for the mailers.

COST OF SALES REVENUES

Cost of revenues for DVD sales includes the salvage value for used DVDs sold and, historically, cost of merchandise sold to customers.

OPERATING EXPENSES

FULFILLMENT

Fulfillment expense represents those expenses incurred in operating and staffing our distribution and customer service centers, including costs attributable to receiving, inspecting and warehousing our library.

Fulfillment also includes credit card fees and other collection related expenses. Through December 2001, we maintained only one distribution center in San Jose, California. We are currently shipping DVDs to subscribers from eight regional distribution centers, at various levels of capacity. We plan to open a limited number of additional regional distribution centers in 2002. As we open and operate new regional distribution centers, we expect that our fulfillment costs will increase.

TECHNOLOGY AND DEVELOPMENT

Technology and development expense consists of payroll and related expenses we incur related to testing, maintaining and modifying our Web site, CineMatch technology, telecommunications systems and infrastructure and other internal-use software systems. Technology and development expense also includes depreciation of the computer hardware we use to run our Web site and store our data. We continuously research and test a variety of potential improvements to our internal hardware and software systems in an effort to improve our productivity and enhance our subscribers' experience. We expect to continue to invest in technology and improvements in our Web site and internal-use software and, as a result, we expect our technology and development expense will continue to increase. We believe certain costs we have incurred on several improvement projects have ongoing benefit. Consequently, we capitalized technology and development related expenses of $0.3 million in 1999, $1.3 million in 2000 and $1.2 million in 2001. The capitalized amounts are amortized on a straight-line basis over the estimated period of benefit of each improvement, ranging from one to two years.

MARKETING

Marketing expense consists of marketing expenditures and other promotional activities, including revenue sharing costs, postage and packaging costs and library amortization costs related to free trial periods. In the second half of 2001, we implemented several new subscriber acquisition activities which provide incentives in the form of pay-for-performance payments for each new subscriber provided to us. We anticipate that our marketing expense will increase in future periods as a result of the overall growth in our subscriber base, free trial offers and pay-for-performance arrangements.

GENERAL AND ADMINISTRATIVE

General and administrative expense consists of payroll and related expenses for executive, finance, content acquisition and administrative personnel, as well as recruiting, professional fees and other general corporate expenses.

STOCK-BASED COMPENSATION

Stock-based compensation for equity instruments issued to employees represents the aggregate difference, at the grant date, between the respective exercise price of stock options or stock grants and the deemed fair market value of the underlying stock. Stock-based compensation is generally amortized over the vesting period of the underlying options or grants based on an accelerated amortization method.

In 2001, we offered our employees and directors the right to exchange certain stock options. We exchanged employee options to purchase 2.7 million shares of common stock with varying exercise prices in exchange for options to purchase 2.7 million shares of common stock with an exercise price of $1.00. The stock option exchange resulted in variable award accounting treatment for all of the exchanged options. Variable award accounting will continue until all options subject to variable accounting are exercised, cancelled or expire. Variable accounting treatment will result in unpredictable and potentially significant charges or credits to our operating expenses from fluctuations in the market price of our common stock.

For each hypothetical one-dollar increase or decrease in the fair value of our common stock, we will record deferred compensation in an amount equal to the number of shares underlying the variable awards multiplied by the one-dollar change. However, to the extent these variable awards are not fully vested, our stock compensation expense will be less than the amount we record as deferred compensation. For example, if at December 31, 2001 the fair value of our common stock had increased or decreased by $1.00, our deferred stock-based compensation would change by approximately $2.7 million and our stock-based compensation expense would be affected by approximately $0.4 million. Once these variable awards become fully vested, our stock based compensation will be affected on a dollar for dollar basis and a change in our stock price will directly impact the amount we record as stock-based compensation in an amount equal to the number of shares underlying the variable awards outstanding multiplied by the change in the fair value of our common stock. For example, assuming all 2.7 million variable awards are fully vested and outstanding and assuming an increase (decrease) in the fair value of our common stock of $1.00 in a quarter, our stock-based compensation expense (credit) related to the variable awards for that quarter would be $2.7 million. As of March 31, 2002, most of these variable awards were not fully vested and had a variety of final vesting dates over the next three years.

RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2001 COMPARED TO THREE MONTHS ENDED MARCH 31, 2002

REVENUES

SUBSCRIPTION REVENUES. Our subscription revenues increased from $17.1 million for the three months ended March 31, 2001 to $30.1 million for the three months ended March 31, 2002, representing a 76% increase. This increase was driven primarily by a 78% increase in the average number of subscribers between 2001 and 2002. We believe the increase in the number of subscribers was caused by our unrivalled selection of titles, consistently high levels of subscriber satisfaction, the rapid consumer adoption of DVD players and our increasingly effective marketing programs.

SALES REVENUES. Our sales revenues increased from $0.0 for the three months ended March 31, 2001 to $0.5 million for the three months ended March 31, 2002. This increase was due to our sale of used DVDs to resellers. We did not sell any titles during the three months ended March 31, 2001.

COST OF REVENUES AND GROSS PROFIT

COST OF SUBSCRIPTION REVENUES. Cost of subscription revenues decreased from $18.2 million for the three months ended March 31, 2001 to $14.9 million for the three months ended March 31, 2002, representing an 18% decrease. This decrease was attributable primarily to the net effect of the following:

- REVENUE SHARING COSTS. Our revenue sharing costs increased from $2.4 million for the three months ended March 31, 2001 to $6.2 million for the three months ended March 31, 2002, representing a 157% increase. As a percentage of subscription revenues, our revenue sharing costs increased from 14% in the three months ended March 31, 2001 to 20% in the three months ended March 31, 2002. This increase was due primarily to a substantial increase in the percentage of titles subject to revenue sharing agreements mailed to our subscribers.

- DVD AMORTIZATION COSTS. Our DVD amortization costs decreased from $11.1 million for the three months ended March 31, 2001 to $2.7 million for the three months ended March 31, 2002, representing a 76% decrease. The decrease was attributable to an increase in amortization in the three months ended March 31, 2001 which was caused by the change in the estimated life of our DVD library from three years to one year. In addition, the decrease was also caused by a decrease in acquisitions of DVD library from $23.9 million in 2000 compared to $8.9 million in 2001.

- AMORTIZATION OF INTANGIBLE ASSETS RELATED TO EQUITY ISSUED TO STUDIOS. We recorded intangible assets of $0.9 million for the three months ended March 31, 2001 and $0.8 million for the three months ended March 31, 2002 related to our issuance of Series F Non-Voting Preferred Stock to studios. We recorded related amortization of these intangible assets of $0.4 million for the three

months ended March 31, 2001 and $0.6 million for the three months ended March 31, 2002. The increase in amortization of intangible assets was attributed to increases in intangible assets caused by our obligation to issue additional shares of Series F Non-Voting Preferred Stock to these studios upon dilution.

- POSTAGE AND PACKAGING COSTS. Our postage and packaging costs increased from $4.3 million for the three months ended March 31, 2001 to $5.4 million for the three months ended March 31, 2002, representing a 26% increase. This increase was attributable primarily to an increase in the number of DVDs mailed to our subscribers. As a percentage of subscription revenues, our postage and packaging costs decreased from 25% for the three months ended March 31, 2001 to 18% for the three months ended March 31, 2002 primarily due to a decrease in the postage per title as a result of packaging improvements.

COST OF SALES REVENUES. Cost of sales revenues increased from $0.0 for the three months ended March 31, 2001 to $0.3 million for the three months ended March 31, 2002. This increase was attributable to our decision to sell used DVDs to resellers.

GROSS PROFIT. Our gross profit increased from a $1.1 million loss for the three months ended March 31, 2001 to $15.4 million profit for the three months ended March 31, 2002. Our gross profit increased primarily as a result of the growth in our subscription revenues and a decrease in our direct costs of providing those subscription services.

OPERATING EXPENSES

FULFILLMENT. Fulfillment expenses increased from $3.6 million for the