Netflix braces for growth slowdown, stock plunges

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In this Nov. 22, 2010 photo, a movie selected from among Netflix's "Watch Instantly" titles begins to download on a home computer screen in New York. Netflix Inc., reports quarterly financial results Monday, July, 25, 2011, after the market close.(AP Photo/James H. Collins, file)

Netflix Inc. is bracing for a backlash to its recently announced price hikes that could result in its slowest subscriber growth in more than three years.

The company's sobering forecast Monday overshadowed its second-quarter earnings that easily topped Wall Street's expectations.

Netflix's shares plummeted by more than 10 percent, largely because the company expects its results for the current quarter ending in September to miss the targets set by industry analysts.

The shortfall stems from an anticipated slowdown in Netflix's subscriber growth amid changes to its online video and DVD rental service that will raise prices by as much as 60 percent. It's most radical change in the company's pricing since it began renting DVDs through the mail 12 years ago.

Instead of offering packages that combine DVD rentals and Internet-delivered video for a single price, Netflix informed subscribers two weeks ago that it would sell the two entertainment options as separate plans.

The change means customers will have to pay substantially more if they want to get both DVDs and Internet video from Netflix. For instance, a bundled plan that had been priced at $10 per month will now cost $16 per month, beginning Sept. 1, for existing customers. The prices of other popular bundled plans will rise by 20 percent to 33 percent.

Netflix expects many customers to pick between the DVD or streaming plan to avoid getting hit with a higher bill if they subscribe to both plans. The company said it anticipates other subscribers irked by the rate changes will stop being customers entirely.

Management didn't estimate how many subscribers will cancel, but a large customer exodus appears to be factored into the company's forecast for the current quarter.

Netflix expects to add as few as 190,000 subscribers or as many as 1.29 million subscribers in the current quarter. Either figure will be a falloff from the 1.9 million subscribers added in the April-June period, which propelled Netflix's total customers to nearly 25.6 million. In last year's third quarter, Netflix added nearly 2 million subscribers.

If the growth falls on the lower end of management's estimates, it would represent the lowest number of subscribers that Netflix has picked up during a three-month stretch since the second quarter of 2008 when it added 168,000 customers. Back then, Netflix only operated in the U.S. It now has 1 million Canadian customers who subscribe to the Internet streaming service. The company plans to expand into Latin America later this year.

"We are feeling great about the decision, as tough as it is," Netflix CEO Reed Hastings told analysts about the new pricing plan in a Monday conference call.

Hastings is counting on the squall stirred up by the pricing changes to blow over quickly. By the final quarter, he thinks Netflix's subscriber growth will return to the rapid pace of the past two years. To do that, Netflix will have to add more than 3 million subscribers during the final three months of the year.

Some of the numbers that Netflix released helped explain why the company felt compelled to change its rental plans, even though it knew the new prices would alienate many of its most loyal customers.

The company is paying increasingly higher bills for the rights to stream Internet video. It's happening while Netflix must also cover the costs of mailing DVDs to millions of U.S. households that still want to watch movies on discs because movie studios insist on keeping the most-recent theatrical releases on that format.

Netflix spent nearly $613 million on streaming rights in the second quarter, a more than nine-fold increase from the same time last year. The company, which is based in Los Gatos, has signed long-term contracts committing it to pay $2.44 billion for streaming rights.

Meanwhile, more than 15 million of Netflix's subscribers were still renting DVDs through the mail, although they aren't asking for as many discs each month as they once did.

Even before the rate changes, most of Netflix's new subscribers have been signing up for a streaming-only plan that the company rolled out last year. About 75 percent, or 1.3 million, of the customers added in the second quarter opted for the streaming-only option.

The company expects 12 million subscribers, or less than half of its customers, to be paying for both the DVD and streaming options at the end of September.

Netflix earned $68.2 million, or $1.26 per share, in the most recent quarter. That marked a 57 percent increase from $43.5 million, or 80 cents per share, at the same time last year.

Revenue climbed 52 percent from the same time last year to $789 million.

The earnings per share were well above the average estimate among analysts surveyed by FactSet. The revenue fell about $2 million below analyst forecasts.

Investors though were more concerned about management's third-quarter forecast. That calls for Netflix's earnings per share to range from 72 cents to $1.07 per share on revenue of $800 million to $829 million. Analysts had projected earnings of $1.11 per share on $845 million in revenue.

Netflix shares plunged $28.53 to $253 in Monday's extended trading. The stock had closed at $281.53, leaving it with a 60 percent gain so far this year.

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