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NFLX - Q3 2014 Netflix Inc Earnings Call

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PRESENTATION

David Wells - *Netflix, Inc. - CFO*

Welcome to the Netflix Q3 2014 earnings call. I am David Wells, CFO. Joining me today on the Company side is Reed Hastings, our CEO, and Ted Sarandos, our Chief Content Officer. Interviewing us on our results today will be Michael Nathanson from MoffettNathanson. And for his last time, Doug Anmuth from JPMorgan. Jug will be -- Doug will be handing the baton over to Mark Mahaney from RBC next quarter.

I think Michael, you have our first question, so I'll turn it over the to Michael.

Michael Nathanson - *MoffettNathanson - Analyst*

The first question will be to Reed. I think the obvious question to ask is given the missing subscribers this quarter in the US and the slightly slower growth next quarter in the US, what gives you confidence that you're still on the middle part of the growth curve on the S-curve, especially given the fact that you have a grandfather price increase a couple years down the road? So anything on that.

Reed Hastings - *Netflix, Inc. - CEO*

Sure, Michael. We added 3 million net subscribers in Q3, so about a 1 million a month. And then in Q4, we're forecasting 4 million. If you look just at the domestic side, however, that's about 1 million, and about 2 million in Q4. And we're hoping for big numbers. We're always working hard on that.

But when you ask what's the confidence that we're on the middle part, we really have to feel our way along quarter by quarter as we improve the content. And if you think about the general society all moving to Internet TV, like HBO's announcement today, there's a lot of feeling of just everyone is going there. Not exactly sure the rate of transfer, but Internet TV is going to be everything in couple years.

Michael Nathanson - *MoffettNathanson - Analyst*

And Reed, just to follow up on that, why is 60 million to 90 million still the right number in the US, given what we saw here in 3Q and what you're looking at for the fourth quarter?

Reed Hastings - *Netflix, Inc. - CEO*

Well, everything that we're seeing is completely consistent with the whole society, not only the US, but around the world, is moving to Internet video and Internet television. And so, I think it's completely consistent with what we're seeing. We're seeing -- we saw Starz a week ago announce



that they're doing an Internet video service. We saw HBO. Perhaps there will be other providers over the coming weeks. So think of all the big networks are moving to Internet video, and it's just becoming a very large opportunity.

Michael Nathanson - *MoffettNathanson - Analyst*

David, given that revenues came in line, subscribers came in lighter in the US, was there a mix shift amongst your pricing tiers in the third quarter?

David Wells - *Netflix, Inc. - CFO*

Not really. Before I jump into the question, I realize that I didn't provide the Safe Harbor statement. So we will be making forward-looking statements during this interview, and actual results may vary. There's your proof that this is not a scripted interview.

Michael, back to your question. In terms of really the revenue number, we sort of missed on the total subscriber line, and there is a bit of a delay between the folks getting a 30-day free trial and the revenue coming in. So that would explain most of it. There's a little bit of a mix shift in terms of ASP being slightly higher than we forecasted. But most of it was just because of the revenue having a little bit of a lag.

Michael Nathanson - *MoffettNathanson - Analyst*

Reed, can you talk about the strength of subscribers in the new Western European markets in 3Q, how they performed early on versus your expectations? And then also, how much do you know here about conversion rates as they're just coming off of their one-month free trials and how is that impacting your guidance for 4Q?

Reed Hastings - *Netflix, Inc. - CEO*

Well, we had a very successful launch. We've done numerous launches now, starting in Canada four years ago, so we're getting better and better at it. We've got some of the fastest integration with MVPD set tops that we've ever seen in the world.

In the US, we still don't really have anything material. In the UK, it took us a year and-a-half to get Virgin, and we were able to announce Orange and Deutsche Telekom, and these are all going live shortly or just turned live or going live over the next couple months. So really a great successful launch that portends well for us, and that's built into the guidance.

So we're feeling just incredible about international. When you think that from starting four years ago in Canada through to the Netherlands, so almost 40 countries as a whole are now profitable, just an average of two or three years after starting. It's a great success, and that's why we're continuing to invest so rapidly in international.

Michael Nathanson - *MoffettNathanson - Analyst*

Okay. I have a two-parter for Reed and Ted on HBO GO. Today, the big news out of the Time-Warner Investor Day was the announcement of an over-the-top service to be launched next year in the US.

The two questions would be for Reed, what do you think the impact on competition will be as they start really pushing that product? And for Ted, the take-away was they might start sourcing some of Time Warner's -- putting Time Warner's content into HBO on kids and maybe on movies and TV shows. So talk about those two things.

Reed Hastings - *Netflix, Inc. - CEO*

Sure. Absolutely. On the consumer side, it's one more channel. So already consumers subscribed to us and Hulu and Amazon and they do pay-per-view and they do DVD and they do cable. So there's so many great sources of entertainment. And consumers subscribe to many of these.

So there's not much of a change in the direct competitive landscape. We and HBO have completely different content. So I don't think it will be a significant impact at the consumer level. As we bid for content, that's more significant, and I'll turn that over to Ted.

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

Yes, I'd say similarly that HBO is another buyer in the market, if they do choose to start licensing from -- even from their sister companies. And different companies have different views of how they look to vertically integrate. But in this case, I think they have an established revenue model for that content, with buyers like Netflix and others that they will have to competitively bid in the market for.

Doug Anmuth - *JPMorgan - Analyst*

Reed, just following up on HBO GO and the competitive dynamic there, do you have a view on how it could be priced and distributed when it ultimately comes out?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

In Nordics, they've competed with us since launch two years now with HBO Nordics. And there, they chose to price on top of our pricing. Now, that pricing is higher because VAT and cost of living, so it's not definitely indicative. But they've been quite aggressive in the Nordics and we've stayed well ahead.

Michael Nathanson - *MoffettNathanson - Analyst*

It looks like this quarter -- I'll throw to David -- that the guidance you provided on free stubs in international markets missed our expectations and your expectations. What is going on there? How could free trial subs miss expectations?

David Wells - *Netflix, Inc. - CFO*

Well, there's a number of ways. We just didn't grow as much as we thought we were going to, in terms of bringing folks in. So across a number of markets, we were lighter, versus our forecast, than we expected. And you collect all of those markets together, and you get to a point where you missed on the total number, but you made it on the paid number.

Reed Hastings - *Netflix, Inc. - CEO*

And when David talks about missing, remember that what we're providing is our internal forecast, and we expect to miss pretty frequently. That's the midpoint, essentially, and so we'll be a little above that, a little below that every quarter.

Doug Anmuth - *JPMorgan - Analyst*

And David, you called out in the letter, basically, that the increase in pricing may have had some impact in 3Q, and perhaps a greater impact than you saw in the second quarter, perhaps because Orange Is the New Black offset that. Beside pricing, is there anything else that you can point to in the US, in particular?

David Wells - *Netflix, Inc. - CFO*

Any given quarter, there's a number of swing factors involved. We said that was our leading indicator or leading factor in the quarter. The Home Depot breach certainly brought down some of our -- put a number of people on payment hold. But we felt like if we provided three or four more swing factors, it felt a little bit like an excuse, so we didn't do that, but there were certainly other factors at play.

We had a strong comp last year with releasing Orange in July versus in Q2 of this year, and we talked a little bit about that. We certainly saw some effects from the Home Depot breach. And then, there's two or three more of those that we could talk about, but they're minor compared to what we think is the major one.

Doug Anmuth - *JPMorgan - Analyst*

Reed, we get a lot of questions about France versus Germany as markets. Can you -- I know it's early days, can you share some information as what you're seeing on initial take-up rates or excitement around -- in France and Germany for Netflix?

Reed Hastings - *Netflix, Inc. - CEO*

Absolutely. France and Germany are unique markets and so is Brazil a unique market and so is Norway. Now, we're over 45 of these unique markets and every market we've been able to figure out, over time, what's the right mix of content. And think of basic consumer behavior, as they want control, they want Internet video, because they get to watch on any screen. They get to watch any time they want. They get to binge watch. Those are very universal values.

And so we're gaining increasing confidence that Netflix is highly relevant around the world, and that's why we're just looking forward to continuing to expand next year.

Doug Anmuth - *JPMorgan - Analyst*

And just following up, Reed, and perhaps Ted here, as we talk about the international business, what percentage of content in new international markets is local? How do you know what the right level is here? And do you feel like you have enough currently in France and Germany?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

Doug, I'll jump in there. It's similarly placed as the other markets have been, around 15% to 20% local, with another -- with the 80%, 85% being either Hollywood or other international content. One of our first indicators that we are getting the mix right is how many hours of viewing people are participating in. And in France and Germany, the viewing hours are quite healthy relative to all of our other launches. So we're -- the consumers are finding the things they want.

The tricky thing is figuring out is the local content something that people want in the long term. Because when we first go to a new market, I think people are mostly excited about those things that they didn't have access to before.

So Orange Is the New Black was by far the most watched show in both France and Germany, and in fact all of the markets that we launched. So it tells you that with all the differences in taste, that they all rallied around that show.

I do think too that we're offering those markets unprecedented choice, not just in programming, but also in choice of language where you can watch the show either in native language with subtitles or dubbed in local language, which is something that's not been available to consumers in those markets before.

Michael Nathanson - *MoffettNathanson - Analyst*

David, in the press release today or the letter to shareholders, you mention that Canada's now at the same margin as the US after four years. How different are the penetration rates between those markets? I know you don't get into the actual rates, but how different are acceptance rates there? And is that the threshold for profitability, in terms of US-level profitability around the world.

David Wells - *Netflix, Inc. - CFO*

You're right, we don't get into specifics, but the penetration, the rate of growth in any given market can be different. So the rate of growth between Canada, between Europe and between Latin America can be very different.

But just reiterating, in terms of the financial performance and the return on investment, in 2012, we spent nearly \$400 million in terms of contribution loss on international. And what we were telling you today is that is now a positive number. So in little less than two years, we've made great progress.

We think the international is a very good investment. So some markets are going to take longer than others. The content may be priced lower in those markets, so the economics are very different market to market.

Doug Anmuth - *JPMorgan - Analyst*

David, you mentioned in the letter a little bit about the changes in the VAT in Europe that go into effect in 2015. Can you talk here about how those new rules will impact Netflix in Europe and how much profit is at risk here? Can you just perhaps quantify things beyond just talking qualitatively about it?

David Wells - *Netflix, Inc. - CFO*

Sure, so Luxembourg had an arrangement with the EU where if you were headquartered there, you could charge a 15% Luxembourg VAT rate. The VAT rates, they vary from Switzerland at 8% on the low end to the Nordic countries at 25% at the high end.

For us, we're talking about an internal cost change to Netflix, because we're not going to pass that along to the consumer, of about 5% on average of European revenue. So some of those rates are going from 15% to 25%. Some of them are going from 15% to 19% and so forth. But a weighted average that you can ballpark is 5% of European rev.

Michael Nathanson - *MoffettNathanson - Analyst*

David or Reed, can you give us an update on 2015 international expansion plans? You've called out you're going to keep opening up new markets. How should investors think about the speed of those openings and investments in 2015?

Reed Hastings - *Netflix, Inc. - CEO*

We're still sorting that out, Michael. Trying to figure out which markets are most attractive, and we'll have some announcements to make over the next year. If you look at our long-term strategy, we've been extremely consistent over the past three years, saying that we're going of to take all of our profits and put them into international expansion, because we see it as such a big opportunity.

So think of that as the base case, if we can move quickly enough, then we can deploy all of those profits in highly productive ways.

David Wells - *Netflix, Inc. - CFO*

I would say to give you some sense of the magnitude, we peaked out of international loss at \$105 million. We guided in Q4 to number that's slightly lower than that. In terms of the potential down the road, we certainly could see that level of investment.

Doug Anmuth - *JPMorgan - Analyst*

Thank you. So following up on that, Reed and perhaps David as well, Reed, you were quoted about a month ago as saying that it would take three to five years for a single country to get to breakeven, and then also that it could take Europe 5 to 10 years overall to be breakeven. And then also that you want to be fully global including China.

Can you help us sort these out? And in particular, do you still believe that international contribution margins can be comparable to US margins in a more mature state?

Reed Hastings - *Netflix, Inc. - CEO*

Yes, we're making great progress on international. We gave you the proof point on Canada, having gotten there. We're continuing to make progress in all those markets towards having a similar contribution -- to contribution profit to the US and contribution margin. So feeling great about that.

Three to five years is what we've seen in our experience. We'll see if future markets are slower or faster. There's some variation.

And then the overall Europe picture is because we keep adding new markets. So that's why that's a longer time frame, because it's a cascade from the very beginning.

Doug Anmuth - *JPMorgan - Analyst*

And just to clarify on that, you still think that that's the right kind of time frame for Europe overall, cascading from the beginning?

Reed Hastings - *Netflix, Inc. - CEO*

Yes, there's nothing that's changed.

Michael Nathanson - *MoffettNathanson - Analyst*

Okay. Ted, as you start buying rights like Gotham worldwide, you start seeing some markets like Australia acknowledge that you have the rights to Gotham in those markets. How do you balance the need to basically buy global rights with a desire to be more measured as you expand internationally?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

The one thing that's been really encouraging, Michael, is that the -- a lot of our content choices have proven to be extremely global, starting with all of our original series that Orange Is the New Black and House of Cards have been huge successes in not just in Australia but in China, I mean, all over the world. So these buys bode well, I think, for future expansion in all territories.

And right now I believe we've hit a financial tipping point where we can move forward on buying up more territories than we're currently operating in, versus playing catch up, which we had been doing, licensing the territory or creating an original series and then several years later, having to go back and either renegotiate for that series or not have it, like we don't have House of Cards in some of our current expansion territories.



Doug Anmuth - *JPMorgan - Analyst*

David, just on international expansion, what do you think the best way is for the street to think about and model your future international markets? So meaning, if we don't know the exact markets in any given year, what is a reasonable expectation for the number of new broadband households that you'd like to address over the next few years? Obviously, there's big implications here for both subs and of course for the bottom line. And do you expect these international launches to continue to be more heavy in 3Q and 4Q or more evenly spread out through the year?

David Wells - *Netflix, Inc. - CFO*

I've given you some indication of at least the financial magnitude. I don't think we have an addressable broadband household target in mind when we think about the next wave of international expansion. There's a number of execution elements that come into play, how many we think we can do successfully well at the same time or consecutively. And certainly, we're getting closer and closer, as Ted talked about, to a global right.

So in terms of the incremental cost associated with an international launch, we certainly are reflective in some of our produced content today of having a global right or close to a global right. So I would say it's our intent to continue to roll out international. You've got some indication of magnitude on the financial side, and we intend to continue to pursue it, because it's been a great investment so far.

Michael Nathanson - *MoffettNathanson - Analyst*

David, based on some of our analysis, I think other people feel the same way, it looks like you can add in new markets between 300 and 500 basis points of penetration in the first couple years. Is that consistent with your own data which you have and we've not been able to dig into?

David Wells - *Netflix, Inc. - CFO*

We don't provide that level of detail and specificity.

Reed Hastings - *Netflix, Inc. - CEO*

The one thing, David, that we've said in -- as we do in the launch markets is that it took in the US seven years to get to about one-third of broadband households. And that in the developed markets, so not as much LATAM, but for Western Europe that we're targeting those kind of numbers, getting to one-third of households over seven years. So that would be consistent with the trajectory that you just outlined, Michael.

Doug Anmuth - *JPMorgan - Analyst*

Let's shift over a little bit more toward content. So Ted, a couple big announcements recently, certainly Crouching Tiger, Hidden Dragon and also the Adam Sandler deal. I'll just hit on the latter. But can you talk more about how data influenced the decision to do the four-movie deal with Adam Sandler? Can you talk about his global appeal as well, and do you think there are other actors or actresses that could have similar appeal for Netflix going forward?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

Sure, Doug. The Adam Sandler decision was driven by following market after market, seeing Adam's films from his deepest catalog to his newest releases, performing -- outperforming -- not only outperforming their box office, but performing wonderfully in every territory, defying conventional wisdom that American comedy doesn't travel.

And more importantly, he really performed well in the box office in our key markets like Brazil, like Germany, like the UK. And his last movie was 60% international. So Adam is not only a proven 20-year star, meaning he has a movie that performs well in the box office every summer for 20 years, he is a real global superstar. And we see that in the data, and the more international we get, the more access we have to those data points versus relying on conventional wisdom of generic thinking, like American comedians don't travel so well.

So we're really proud of the deal, and we think that our subscribers are going to love having access to those movies immediately through this new deal.

Michael Nathanson - *MoffettNathanson - Analyst*

Ted, you mentioned, or the letter mentioned today that it's more efficient for you to buy movies this way than buying in your PayOne window. Could you talk more about that, because it seems to me that if you are a successful film producer, you want to use the windows to monetize all your consumer touch points? Why is it more efficient to do it this way versus PayOne?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

There's a couple ways to think about it, Michael; the main one is access to content that people want to watch. I think this long, protracted window model was fine before OnDemand was possible, but consumers now expect to see content sooner and have access to content in earlier windows in the formats that they want to watch.

In this case, we're talking about Netflix and the current pay model doesn't deliver movies to us til about 10 months to a year after theatrical. And in some cases, nine years after theatrical if it's sitting behind someone else's deal.

If you look at a successful film, and you roll up all the licensing fees in each territory, it is possible that there's an economic tradeoff that you are paying less to produce the film than you are to license it. And this model, to your point, about do you want to exploit all those other windows. For us, this is programming cost, not an individual P&L on each film.

Reed Hastings - *Netflix, Inc. - CEO*

And the broad point here is especially with the Adam Sandler multi-movie deal, it's establishing a sense in the subscribers of I'm thrilled with Netflix because I'm into Adam Sandler, I watch this, and now the next movie and the next movie comes. Think of it -- with us playing with this idea of episodic and serialized, but now in the movie form. And seeing what kind of great brand allegiances we can create for Adam's fans; that's not everybody, but they're very identifiable. I think it's a very creative approach that Ted's pioneered here.

Doug Anmuth - *JPMorgan - Analyst*

And on that note with the Adam Sandler deals, Ted, can you just talk to us about how you'd actually measure the success of these kind of partnerships, given that you don't have the traditional barometer of the box office to track here?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

I would think about it the same way we look at the successes around original series of any of our licensed series. Relative to what you're paying, do you get this kind of three legs of success with the viewing, the brand halo, and the net subscriber additions based on access to the content?

I think that particularly in this one is, we try to be as consumer-friendly as we can, and I think the model here is telling us is that consumers want access to those films sooner, and that we could build and model that's economically feasible to do it. But if the measure -- you should think about measuring success the same we do series -- do people get excited about Netflix because of it? I think, as Reed pointed out, I'm as excited about



this as I have been since we talked about House of Cards a couple years ago, about the potential impact on the brand and the subscriber enthusiasm around it.

Michael Nathanson - *MoffettNathanson - Analyst*

Ted, in the UK, we found some data that suggests that younger households are consuming a lot more Netflix than older households, penetration rates are higher. You mentioned in the letter that you had I think 75 series, kids series with over 2 million views. Can you talk a little about what does that mean? Is that over a week? Is that over --What duration is that and is that globally?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

Those are active titles, titles that are currently being watched and that's a domestic number. We wanted to point that out, because relative to other outlets for kids' programming, that's a pretty big number for those -- particularly in that kind of volume. But those are domestic, and you can think about the international and domestic split roughly similar to our subscriber base.

Michael Nathanson - *MoffettNathanson - Analyst*

Within what time frame? Is it on a monthly basis? Is it cumed over time?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

They're currently active titles, and they're cumed for active titles.

Michael Nathanson - *MoffettNathanson - Analyst*

Thanks.

Doug Anmuth - *JPMorgan - Analyst*

Ted, on Crouching Tiger, Hidden Dragon, some of the major theater chains here have responded pretty negatively early on in terms of the day-in-day IMAX release and Netflix streaming plans. What happens to the economics of your film strategy if some of those major chains prevent IMAX from exhibiting the film?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

Very little economically. I think that the key to it is we would like to give the consumers the choice to see a big film on a big screen. Crouching Tiger, Hidden Dragon is not a direct-to-video, low-budget sequel. It's a big film, and it would be fantastic to have the opportunity be able to see it on the IMAX screens at the same time. And IMAX has made arrangements with us for that to happen.

I think it's, as expected, the theater chains reacted negatively publicly. But I think the real story will unfold on August 28th when the film opens when we see if it's on those screens or not.



Michael Nathanson - *MoffettNathanson - Analyst*

Reed, in the past quarter, it looks like in Canada, a local tribunal, the CRTC, was asking for some data regarding Netflix, that you guys were not willing because of privacy to share. Are you worried that governments and regulators will start asking for even more disclosure and try to enforce more traditional regulatory pressures upon your business?

Reed Hastings - *Netflix, Inc. - CEO*

It's super important that Netflix maintain a reputation with consumers for protecting privacy against a wide range of players. So you'll see us be a really staunch ally of the consumer.

Will there be conflict with certain government agencies? There may over time. We're not seeking to have a fight. We're going to try to work well with everyone. And certainly, as an example, in France, I think we really turned around what could have been a difficult situation into one that was quite positive. We're getting better and better at those government-relation skills where we don't have to have a battle.

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

Probably worth mentioning, Michael, in Canada, producing Netflix content, particularly in the animated space, we're one of the largest employers in Canada for animation executives. I think something on the magnitude of \$140 million a year being poured into the Canadian economy producing animation for Netflix. It's pretty impressive.

Doug Anmuth - *JPMorgan - Analyst*

David, can you talk about how the amortization of these newer movie deals are going to be recognized on the financial statements? And then, in particular, can you go into some more detail, I know you talk about it in the letter some, but just the dynamics around free cash flow and EPS as both a function of some of the heavier content investments and then also the international expansion as well?

David Wells - *Netflix, Inc. - CFO*

Sure. So I'll take the amortization question. In terms of how the movies will be amortized, they will be accelerated, like our large original series are. And until we have more data to challenge that, whether it should be faster or slower, we'll take that assumption that they will be accelerated.

And then, your second question was on free cash flow relative to net incomes. We put the graph in there to illustrate the separation that happened in Q3. We've been saying this for quite some time in terms of the pressures on cash being the expansion of content, including produced content as well as the international expansion, because it forces the loss lower.

So I would say it's still consistent when we talked about a 1.2 to 1.3 ratio of cash outlaid to content P&L expense is still consistent. And if we spend \$3 billion globally on content and growing, even taking the 1.2 or the 20% ratio, that's \$600 million of cash laid out for content, over and above the P&L expense.

So we expect these trends be persistent, and I think that we -- we have \$1.7 billion in cash. I think we're okay for the next few quarters. But we continually look at this. And if we continue to expand both content and international, as we expect to do, then you should continue to see some pressure on the cash, on the free cash flow.



Michael Nathanson - *MoffettNathanson - Analyst*

Ted, can you talk a bit about off-network syndication? In the past quarter, you were able to license both Gotham and Black List a year after they aired on network television. Can you talk a bit about what's changed in the model and what's the cost of those types of purchases versus maybe library content?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

Yes, and there's other variants on the model, like in January, you'll see Better Call Saul, the Breaking Bad prequel that we will be licensing in all of our other territories, and a year after in the US and Canada and then in the first run in every other territory we operate in. We're super excited about that one too.

I look at it about, as all these models are changing pretty rapidly, there's multiple buyers in the markets. So I think at any one piece of content, the bidding can get pretty intense, but overall, the content costs are pretty consistent on all these new models. And I think operating in 50 different countries and being willing to operate in multiple windows gives us a real advantage in the market, so we're excited about that.

Doug Anmuth - *JPMorgan - Analyst*

And Ted, there have been some comments in the press recently and I think coming from the agencies essentially, that really the foundation for the agencies in selling to its streaming service, back ends of course are typically their foundation, but selling to a streaming service with a perpetual deal, they wouldn't necessarily know where that back end would come from if there may not be a second sale. Does that create a problem for you in buying content rights across all markets, and do you see any pushback there?

Ted Sarandos - *Netflix, Inc. - Chief Content Officer*

No, Doug, just like every time you press into a new market and a new window and a new paradigm, you've got to figure out how to make it work in the old world too. I think these problems were contemplated back when HBO started doing original series before they had a DVD business, before they knew if they were going to syndicate. I think those are all navigatable and have been navigated in the past, and we're navigating them as well.

Michael Nathanson - *MoffettNathanson - Analyst*

Reed, a question on internet net neutrality. One of the things we struggle with, looking at broadband investment is if the interconnect fee is capped or protected or kept zero, how do investors in broadband plant recoup their investment if they can't charge interconnections? How does the Comcast investor or the product investor think about returns on their investment if they can't charge for interconnection?

Reed Hastings - *Netflix, Inc. - CEO*

The simple version is they collect revenue on the Internet from their customers and that pays for the network, and we don't ask them to pay for our content, and we don't think they should ask us to pay for their network. So that's the basis of the no-fee interconnect.

Doug Anmuth - *JPMorgan - Analyst*

David, I think US marketing spend was down about 5% year over year and more than 200 basis points as a percentage of revenue. Why spend fewer dollars in 3Q if the growth was slowing down and you were coming in below forecast? And could this have hindered sub growth, and how should we think about that marketing dollar trend going forward?

David Wells - *Netflix, Inc. - CFO*

I think back six, eight years ago, there was a much more direct connection between our marketing spend and our net additions, in terms of bidding on bounties for people to sign up via click-through on an online ad. I don't think that's true anymore. So I don't think that whether our marketing spend is up 10% or down 10%, there's an immediate direct connection felt on our net addition growth.

So when we look at our marketing spend, we look at a number of factors. We look at what content, what opportunities we have to spend against that in the quarter. We look at what our margin targets are. There's number of things that go into that. But I wouldn't say that that was a large influence on the year-on-year decline in growth that we saw in the US.

Michael Nathanson - *MoffettNathanson - Analyst*

Reed, over the past weekend, our home, which uses FiOS, had trouble getting onto Netflix, which is a good problem to have. I wonder what does your research tell you about satisfaction levels when there's a buffering or connectivity issue, and how does that get solved?

Reed Hastings - *Netflix, Inc. - CEO*

I'm surprised that you got an issue. Verizon's done a lot of investment over the past three months to get the average speeds up. And what's remarkable is how quickly they've been able to expand the interconnect, so that the average speeds for Verizon are now some of the highest in the United States, still not as high as many of the speeds in Europe, but some of the highest in the US.

So it should be very rare, and I'll have to follow up with you, and we can take a look at the logs for your home, if you're comfortable with that. We'll see what was going on. Maybe one of the kids was doing some illegal downloading.

Michael Nathanson - *MoffettNathanson - Analyst*

It's my problem. Reed, just in thinking about the US versus international markets, can you compare and contrast some of the challenges with peering, with interconnection and net neutrality. Especially in markets internationally where we may be seeing some consolidation, do you see any elevated challenges in some of those new markets you might wish to go into in 2015 and beyond?

Reed Hastings - *Netflix, Inc. - CEO*

Outside the US, there's much more of a common regiment of settlement-free interconnect. The whole charging for interconnect is really an artifact of size. So Comcast is the biggest, so they get to charge the most and then it goes down from there. It's straight power dynamics, as opposed to costs or anything like that. So it's a much friendlier climate outside the US for settlement-free interconnect.

Doug Anmuth - *JPMorgan - Analyst*

David, can you update us on foreign exchange? I know it's still early days and you guys are growing internationally, but is your cost base denominated for the most part in US dollars, and is the revenue base dominated internationally? Has currency affected you guys this year?

David Wells - *Netflix, Inc. - CFO*

It's a mix, but it's actually very quite small, it's under \$1 million of P&L effect. On valuing the balance sheet items, there's a little bit more of an effect especially against the British pound. I would say there's a mixture across it. So there's some natural hedging that, but right now it's actually quite small in terms of an overall influence on our EPS and on our P&L.

Doug Anmuth - *JPMorgan - Analyst*

Reed, or perhaps David, can you review the economics just around how the through the middle set-top box relationships work? And perhaps talk a little bit about how some of these newer dynamics or relationships in Western Europe may be relative to earlier deals and some of the smaller stuff, for example, that you've had in the US?

Reed Hastings - *Netflix, Inc. - CEO*

I think we'll both tell you the same thing, that we can't tell you much about those deals. That we're comfortable with the economics. We've done lots of deals in the US, first with X-Box, then with PlayStation, Apple TV, et cetera. So we've been doing these kinds of deals for a long time.

Michael Nathanson - *MoffettNathanson - Analyst*

Reed, as HBO starts building out in the US, you've had experience in the Nordic region where they competed with you. Could you share a bit what you've learned within the Nordics, and what does it mean for overall television consumption in that market?

Reed Hastings - *Netflix, Inc. - CEO*

Each market's unique, so I think they've had some teething problems initially two years ago that they probably would not have in the US. I think they've been licensing broadly. They just licensed a number of STARZ titles, so they're willing to license beyond their core platform.

They've done pretty well and we've done very well. And what we've talked to when we've talked to subscribers there is they're really -- if they're into content, they subscribe to both services. I really think we're going to see this really fun couple years where the two of us compete for the best content, the most Emmys, the subscriber growth and many, many people will subscribe to both services. We're looking forward to that.

We're just excited that HBO's really in the game with the Internet. They're the leader in their field. They're well ahead of their peer group. They're ahead of the broadcast networks in this dimension, so it's exciting to see.

Doug Anmuth - *JPMorgan - Analyst*

David, you updated the US margin outlook to the 200 basis points of expansion per year and getting up to 40% over five years, of course after you hit 30% early next year. How do you get comfortable that you can still invest what you need to in content in the US and also do that 40% longer-term margin?

David Wells - *Netflix, Inc. - CFO*

I think Ted would tell you that he'd take everything that we can give him. But I think that even with the shift to the 200, it still allows for some pretty significant expansions of both licensed and produced content. So we feel pretty comfortable about the room for continued growth of the quality of the content. And I think it provides a little bit of discipline in terms of making sure that we spend that marginal dollar well. So I'd say that we're pretty comfortable on both senses.

Doug Anmuth - *JPMorgan - Analyst*

Any chance you want to share more on what sub number that 40% implies five years down the line?

David Wells - *Netflix, Inc. - CFO*

It implies continued growth.

Reed Hastings - *Netflix, Inc. - CEO*

Michael and Doug, we should do one more question each and then we should wrap it up.

Michael Nathanson - *MoffettNathanson - Analyst*

Okay. Thanks, Reed. I have one for Ted. I believe one of your content deals early on had a put option for a Company to actually put shows to you. I wondered what do you think will happen to those types -- to that agreement longer term, and should we expect some more -- a big bundle of shows put to you in the next one or two years?

Stephen Ju - *Credit Suisse - Analyst*

All those deals, especially the early deals are very organic. They've all been in various stages of renegotiation and extension and redefining. So there's nothing looming that's troubling in that way. Remember, they were mostly designed at the beginning to gain access to the content, not to try to avoid getting the content. There's nothing out there that we're nervous about or concerned about in our existing deals about a put that could be looming out there.

Doug Anmuth - *JPMorgan - Analyst*

Reed, a question that we frequently get still is on pricing. We obviously saw the small, what we thought was a small pricing change in 2Q, but perhaps at a bigger impact in the third quarter. Does that mean really as we look out over the next couple years that you may not do anything in terms of pricing, or do you still think that you'd look to experiment and potentially do things around tiering?

Reed Hastings - *Netflix, Inc. - CEO*

We'll definitely be listening closely to our members, and then as we add more and more great original content, and I think we're more valuable to consumers. So we're seeing an adjustment period that's this quarter. We're learning how to do that.

But over the long time, consumer pay for value, and it's up to us to front load that value, and, boy, the slate of content that Ted has for next year, it's really exciting and kicks off with Marco Polo in early December. With that, let me thank everybody for joining us on this call and look forward to catching up with all of you over the quarter. And special thanks to Doug for his year of service. So we'll continue.

David Wells - *Netflix, Inc. - CFO*

Thank you.



QUESTIONS AND ANSWERS

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