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# EDITED TRANSCRIPT

NFLX - Q2 2014 Netflix Inc Earnings Call

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## CORPORATE PARTICIPANTS

**David Wells** *Netflix, Inc. - CFO*

**Reed Hastings** *Netflix, Inc. - CEO*

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

## CONFERENCE CALL PARTICIPANTS

**Douglas Anmuth** *JPMorgan - Analyst*

**Michael Nathanson** *MoffettNathanson LLC - Analyst*

## PRESENTATION

**David Wells** - *Netflix, Inc. - CFO*

Welcome to the Netflix Q2 2014 earnings interview. I'm David Wells, CFO. I'm joined today on the Company side by Reed Hastings, our CEO, and Ted Sarandos, our Chief Content Officer. Interviewing us today will once again be Doug Anmuth from JPMorgan, and joining us today for the first time will be Michael Nathanson, from MoffettNathanson, who receives the baton from Rich Greenfield.

We will be making forward-looking statements today. Actual results may vary. Our first question comes from Doug, so I'll turn it over to Doug.

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## QUESTIONS AND ANSWERS

**Douglas Anmuth** - *JPMorgan - Analyst*

Great, thanks, David. Welcome, everybody, and thank you to Netflix for having Michael and me host today's conference call. So our first question, just on international strength, Reed, if you could talk about what drove the international strength in subscribers in Q2? You called out a couple things in particular, in terms of the Virgin deal, in terms of a set top box integration, and then also smart TV viewing in Latin America, so was hoping you could add a little bit more color on those, as well.

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**Reed Hastings** - *Netflix, Inc. - CEO*

You bet, Doug. I mean, what we've seen really is just tremendous adoption of On Demand viewing. Consumers around the world, whether it's Argentina, Brazil, Finland, the UK, it's been really quite consistent, so there's some accelerators that we talked about with the smart TV.

But there's probably no better symbol of how strong this On Demand phenomenon than to tell you that during the World Cup, we were concerned that we would see a drop off around the world, particularly in Brazil, and that we didn't want to over-read it, if we saw a drop off in net adds and growth. And what was incredible is just how straight our line of net additions were in Brazil during the World Cup, and that's nothing, I don't think, that we're specifically doing. It's really this growing demand for control, and for the consumer to be able to click and watch what they want. And so that's why we're stepping up on the international expansion, is because we really see that this is an enormous moment in history as On Demand Internet services are coming to the fore around the world.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay, David, can I ask you one on incremental margins? If you look at your margins in the first half of the year, you've grown your margins incrementally 45%, dropping down from revenues to margin, to profits. Why don't you think margins can continue growing at the 400 basis point range that you saw, and why did you identify different levels, the 100, 200, 400 basis point level of improvement? What controls those potential margin levels?



**David Wells** - *Netflix, Inc. - CFO*

Well, Michael, I don't know if I agree with your premise. I don't think we said that margins will stop growing, or will shift to 200. What we said is, when we get to 30%, we want to give ourselves a little bit of leeway to reevaluate.

There's a number of things that we'll weigh and balance, and that is the competitive set, what we want to spend on content, how we want to grow that, how our average subscription price is growing with the recent price changes, it's still very early on those, so there's a number of things that will balance out, and we want to give ourselves the leeway to back off a little bit, if we think that's the right trade-off to make, in terms of spending more on content. It doesn't mean that we will. It just means that we're trying to create a little bit of room for ourselves, especially with all of those unknowns, as we get closer to next year.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Okay, thanks. And Reed, in the letter, you talked about the price changes having a minimal impact on growth overall, but can you just provide a little bit more color? Do you think, in terms of the nuances, did it impact churn, or help reduce churn in any way during the quarter? And what's your view on the way the price change could impact going forward?

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**Reed Hastings** - *Netflix, Inc. - CEO*

I think we've seen, really, the impact of the price change go through already, so it's pretty nominal, both in terms of acquisition, which in principle becomes a little bit harder, because of the roughly \$1 higher prices, or in retention, which could be a hair better from the grandfathered subs. But it's only \$1 difference, so I really think that it's background noise, which is what we want it to be. We want to think of what we do, as we're steadily improving the content and the growth and the word of mouth, and that when we make a small change in price, and handle it appropriately, it really makes no noticeable effect in the business, so that's why we're thrilled with that outcome.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay. David, I wondered if looking at your guidance for Q3, would you have gotten to breakeven internationally in the third quarter, if it wasn't for the new market launches? And should we think about the growth rate and costs in the third quarter sustainable into the fourth quarter internationally?

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**David Wells** - *Netflix, Inc. - CFO*

So in terms of our international guide, I think that you can see that most of that is our new markets. So yes, we would be pretty close to breakeven, if not at breakeven, for Q3 in our existing markets, and then the second part of your question was again, could you repeat that?

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Well if you look at that inflation in Q3 from let's say breakeven to where you're guiding to, should we assume that continues to the fourth quarter? It seems like a logical assumption, that there won't be a lot of change.

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**David Wells** - *Netflix, Inc. - CFO*

I see what you mean. Well, just a reminder that our launches that we're saying are in the back half of the third quarter, so they are not a full quarter of content spending. So you're going to get that full quarter of content spending for the first time in Q4. So our typical pattern has been to grow content spend from the launch quarter. In marketing, it balloons a little bit in that first quarter of growth as we launch a brand new brand in those markets and then it tends to settle down into a run rate, and that should give you some trending on our international cost.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Thanks.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Great, and Ted, just perhaps one more question just related to Q2, and then we'll move on. Can you comment on Orange Is the New Black? You talked about in the letter how it became the most watched show in every country during Q2. Are there any other updates that you can provide around usage metrics, and then maybe talk about what you saw in Orange in Q2 perhaps versus the second season of House of Cards a quarter earlier?

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

Well, I think it continued the positive trajectory that we saw from House of Cards, meaning that the excitement from a second season is amplified from something like a show that people don't really know a lot about yet, or in the case of House of Cards, before we even launched that, nobody knew what a Netflix original series was going to be like. So here you had a large pool of people around the world anxious for that second season to hit. You saw it in the social media buzz, that was really phenomenal for that launch, and it gives us a lot of confidence for the outlying seasons for Orange Is the New Black, and our other original series as well.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

I have one for Ted and for Reed together. So last week, Fox announced interest in acquiring Time-Warner, two companies you know a lot about. If a merger were to occur, how do you think that could affect your negotiating leverage to get acquired and original programming, and is this a deal that you would block, Reed, given the scale of the TV and film output from both companies?

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

Michael, I'd say that Fox and Warner are both pretty powerful companies today, particularly in the area of original production for television and film, so I don't know how that changes much, in terms of them coming together. Wouldn't want to make a lot of speculation about what's driving it. Probably has a lot more to do with cable negotiations in sports than consolidating power in production. It's very difficult to corner the market on creativity or ideas, so I don't see that how it would affect things too dramatically in these early days.

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**Reed Hastings** - *Netflix, Inc. - CEO*

And Michael, I don't have any speculation for you on what we would do. There's not even a deal between those companies, so we'll take it as it comes. But as Ted said, the more that we're working directly with producers, the less vulnerable we are to aggregation in the big content suppliers.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay, thanks.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Just following up there in terms of content, and on studio related, do you feel like you have the need to own your own studio production capabilities, to protect yourself from some of the risks potentially associated with fewer production houses to buy from? Would you create your own studio from scratch perhaps, or would it make sense to be acquisitive in this area?

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

I think a lot of it is tactical in terms of how you go about the production cost. Do you want to own the infrastructure versus hire it or rent it, and you'd make those decisions as you go. There's probably some advantages to either model, and we'll keep exploring them as we own more and more of our production, as we go forward. But think about it as the difference between renting sound stage time, or owning the stage itself. It really depends on the volume of production you're planning to ramp up.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay, Reed, can I shift you to the net neutrality debate, which I know you've shared a lot with already. But in your opinion, what is the right regulatory approach for the US, and should the FCC regulate the broadband industry as entitled to service? So I want to know if you could affect change of regulatory view, how would you do it?

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**Reed Hastings** - *Netflix, Inc. - CEO*

Well I think the most practical thing would be for the FCC to make it a merger condition policy, of strong net neutrality, including no-fee interconnect, so that's our main focuses around the merger acquisitions. In terms of the broad policy framework, it's tough in the US, because there doesn't seem to be much chance that Congress will pass a new law, and so then you've got imperfect instruments in Title II and Section 706. So the fundamental, though, is really for the FCC has the power in merger conditions, and clearly going to be a lot of mergers to be able to institute strong net neutrality, so we think that's the most pragmatic approach.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay, thanks.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Just following up there, Reed, last week in your comment letter to the FCC, you said that the Internet is at a crossroads and there's a risk of going down the path toward cable TV. Can you talk about what you meant there in a little bit more detail, and then why you think the other road is better for the industry?

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**Reed Hastings** - *Netflix, Inc. - CEO*

Sure. In the cable industry, there's been constant conflict between the networks and the cable distributors, leading to blackouts and brownouts, trying to figure out pricing. And we would hate to see ISPs brownout or blackout certain Internet sites while they tried to extract payments. That just ruins the consumer experiences idea, that when you sign up for the Internet you can get everywhere.

So, it's finding an industry structure that works for everybody, that allows there to be great investment in super high speed broadband, but also a stable, understood, interconnect structure that makes it able so the consumers can get all of the services they want. And those doing content services like ourselves and Hulu and others can innovate, without the fear of being taxed. So that's why we're so big on the no-fee interconnect.



**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Reed, it's Michael. Following up on that as the media analyst here, I would say if you look at the power of retrans is the content owner that has the power over the dumb pipe. When I look at where we are going as a Company, you're making more investments in original content, exclusive content. You are the content owner. So why do you think you won't be able to, why don't you think you don't have the power to force the pipes into putting you on whatever you want, because you are the content to what I'm subscribing to?

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**Reed Hastings** - *Netflix, Inc. - CEO*

Sure, there's a lot of ways to think about it. We do get asked in the cable business, so for example, HBO is our peer in the cable business. They actually charge the distributor rather than pay the distributor, and so the question comes up, should we over time be charging ISPs for the privilege of carrying our data to their customers, and charging for that?

And again, I don't think so. I think the Internet really has this different much more open architecture than classic cable, where we meet in the middle, we bring the bits to where they want, we don't charge them, they don't charge us. Both sides innovate, it's very open structure, and I think then you get more competitors for Netflix frankly, but what you get is this open vibrant system that the Internet has been so famous for, and that's really the tradition that we grew up in, and that we're trying to see carry forward, and I'm optimistic about it, frankly.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay, thanks.

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**Douglas Anmuth** - *JPMorgan - Analyst*

And Reed, actually for David let me switch gears a little bit, but sticking with net neutrality. If the condition in the case arises where we don't have strong net neutrality going forward, how do investors get assurances that the business is protected, in terms of cost, perhaps interconnection costs over time? And really thinking about it both on a short-term basis, and then over the long term.

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**David Wells** - *Netflix, Inc. - CFO*

Well on a short-term basis, I think there's great assurances in the sense that we've been able to sign these immediate interconnect deals, and still able to achieve our margin targets, and our guidance implies those costs are embedded. So I do think it's about a long term cost, and we'll see where we go from here in terms of the years.

I think for Netflix, content is our largest cost. It dwarfs all of the other costs, so I think it's really about profit margin at that point, in terms of how much margin goes to a delivery cost, versus other costs in our business. We would rather spend it on content.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Reed, this should be our last one after net neutrality. You referenced the Virgin relationship in the UK as being helpful. Can you give us any more specifics on the rates of growth you get, when you become closer to the distributor or the MSO? Is there anything you can talk about, maybe growth rates in the UK, pre- and post- the Virgin relationship?

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**Reed Hastings** - *Netflix, Inc. - CEO*

Well we've only been live on Virgin for about six months, so what we can say is the initial reaction has been positive. It's not transformative to ballpark it, I don't think, for either of us but it's great for consumers on input, number one, that's their default input, to be able to use Netflix on the device, the Virgin set top that they use most of the time. So I would say it's an incremental positive. When you look, there's so many new smart TVs coming, that have Netflix built in. There's going to be lots of ways to access Netflix -- Chromecast, Apple TV, smart TV, MVPD set-top, so it's a nice positive, but it's not transformative.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay, thanks.

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**Douglas Anmuth** - *JPMorgan - Analyst*

David, a question just around free cash flow. As you're ramping up originals here fairly aggressively, and you obviously mention a number of titles that are in production, and as that ramps up into 2015, can you just help us understand how we should think about the impact in terms of working capital around originals, and how we should think about that future trajectory of free cash flow versus EPS going forward? Thanks.

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**David Wells** - *Netflix, Inc. - CFO*

Sure. It's no different than we've said before, which is the two main things that are pressuring cash use. Our content expansion, predominantly our produced content, as well as our international expansion. So Doug, I don't think anything has changed.

I will say that we've been able to bump along at flat to slightly up, in terms of free cash flow. If we expand more aggressively internationally obviously that will pressure a little bit, and as we continue to expand original content and produced content that will expand. So investors should expect to see a little bit of a dip in Q4 and Q1, and it will be tied to that expansion of content, and in the future, it really depends on how fast we expand internationally.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Ted, following on that answer, how does the content offerings differ, domestically and internationally? How does the local language factor play in? Do you have to source more locally than we probably would expect in France and Germany versus Canada and the UK? So any update on your strategies on sourcing content internationally?

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

Well Michael, what's been really great is how much the content travels. So in all of the international territories, and France and Germany don't appear to be that much different, it's somewhere between 10% and 20% local, and mostly the rest will be international product. Mostly Hollywood product that people want to see around the world. So we do have a heavy focus on accessing the local content that matters, and establishing local relationships with the local producers in every market. We imagine when we get out to some more exotic parts of the world, that may skew a little more local, but to date it's been well within that 20% local range.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Thanks.

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**Douglas Anmuth** - *JPMorgan - Analyst*

So a question on international expansion, perhaps for Reed. So if we think about the six markets that are coming here over the next few months, it feels like there are some specific nuances to some of them, perhaps Germany, which is more of a debit card than a credit card market for example, France, which has some protections around its own local content. Can you talk about some of those nuances, and how they are likely to impact your business?

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**Reed Hastings** - *Netflix, Inc. - CEO*

Well, I think, Doug, in every market around the world there are nuances. Just to give you an example, in Brazil, there's a tremendous payment complexity, plus the leadership of TV Globo. In Canada, there's the CRTC. In the UK, the BBC is quite unique in its role in society.

So think of us as adapting to the local conditions in each case. As you point out, in Germany, there's a number of aspects that are unique, as well as in France. And we're going to see this as we continue to expand beyond France and Germany and other countries, that there's unique conditions in every market. And our challenge and excitement around the Company is becoming a great global Company where we really understand the nuance of each of these markets, and do a great job for consumers around the world.

So there are some challenges there, there's no question. I'm sure we will stub our toes on some things, and learn and pick up the pieces, like with payments in the beginning of Lat Am three years ago. But we've got a lot of confidence about being able to figure out the issues once we get started. So that's why our view is we should get in the market, we should figure things out, and then we'll figure out those issues again around payments or other things in Germany and in France.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Following on the answer to France for Reed, there's a government policy in France called cultural exception, and you're familiar with it, where you have to fund a certain number of local productions, and pay also taxes to an authority. So how do you get around that issue, where in France, I know is very protectionist about the content that can be shown there?

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**Reed Hastings** - *Netflix, Inc. - CEO*

Well, we aren't really trying to get around anything. We want to invest in French society and in French content, and we want to give an avenue for French content to get out around the world. There's some amazing French storytellers, there's a great French movie business, TV shows are growing. We're looking to do some investments in France with production that we can do, we joke about it being House of Cards, being House of Versailles. That's not literally the kind of thing it would be, but something like that, where it's a big French production, but it's not just for France, it's for the whole world. We're actively licensing, again, French content.

Think of what we're trying to do as connecting the world, as some of the world's best content brought to the world's citizens, and that's really motivating for Ted, for me, for all of the people at Netflix. And so, we definitely got to work with French society, and with the assumptions and beliefs that they have. And we want to be loved in France by French consumers, because we understand French content, because we give it a bigger home, and because we bring them some variety like US television shows, things that historically have been under-distributed. Ted, do you want to add to that?

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

Yes, I would just say for all of that protectionism and all of the cultural favors, that The Mentalist is the most popular television show in France, so the tastes don't run that far off when you get down to the consumer. But I'm really excited to have France look at us as somebody who brings opportunity to the market, not there to harm the market in any way, and that we will employ French production employees, and create great content in France.



But as Reed said, for around the world, and we currently even have -- Gaumont is a French Company that produces Hemlock Grove for us now, and is about to go into production with Narcos. A lot of our animation projects are co-productions with French production companies, so this is not new ground for us, we're really excited about it.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Ted, just following up there, can you give us an update on certain content that you have as originals in the US and other parts of the world, but that you don't currently own on a first run basis in Germany and France? I believe such as House of Cards, and your thoughts just on how material that is to the service?

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

Well, Doug, because we're expanding our originals so rapidly, I don't think it's necessarily detrimental. We would love to have had House of Cards in the first window in France and Germany, but its been very successful for others there. But Orange Is the New Black we will be launching for the first time in those territories, and all of our going forward series will also be there. And we're backfilling by having some other first-run content like From Dusk Till Dawn and other series, that will premier in France and Germany for the first time on Netflix as well.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Ted, do you have to change the way you source content? Would it be more efficient for the Company to buy all rights and all media going forward? So how do you think about that and what is your impact to the business model by doing that?

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

The more we expand, the more you reach those tipping points where the economics make sense to buy out the rest of the world, for different projects. When we first got in, remember, we were taking a pretty big bet on House of Cards right off the bat, so we were hedging it a bit, by leaving some of those other territories on the table. And as we've gotten more and more international, and more and more original, we're picking up those territories today.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay, thanks.

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**Douglas Anmuth** - *JPMorgan - Analyst*

David, a question just about the overall addressable market internationally, and I think you go into a little bit of detail in the letter, but you mentioned 700 million broadband households, I believe, globally. We know the 90 million or so in the US, and adding -- expanding international here to 180 million. How are you thinking basically about the rest of the TAM, and the ability for that to grow here over time?

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**David Wells** - *Netflix, Inc. - CFO*

Well yes, those numbers, the 730 million is Kagan's number. There's another number that's 800 million that's Price Waterhouse's, so around that range of 700 million to 800 million are today's broadband households. And all of those territories, mainly outside the US and most of the developed markets in Europe, are growing at a much faster pace. So those numbers are going to grow and grow. For us, we look at China is about a quarter of that 730 million. We're addressing a large swath of Europe, and we would look to further that in Europe later if we're successful. And so we like what we see.



As Reed said earlier, we really do see widespread adoption and enjoyment of Netflix as a product. The On Demand aspects, the great content that's produced in any market, and the exciting aspects of us as a global distribution platform, and being able to bring great content to markets in the US, to markets in Europe and Asia, we like the prospects of our opportunities there.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Reed, David just mentioned China as a large source of potential broadband households. How do you get into China, and what's your thinking about potential timing of a China expansion?

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**Reed Hastings** - *Netflix, Inc. - CEO*

Well, I'll let David address that.

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**David Wells** - *Netflix, Inc. - CFO*

I think it's early. It's fair to tennis match that right back at me, Michael, but I think it's pretty early. I think my reason that I would say it's a quarter is it's conspicuously large, and it's conspicuously a growing and very strong economy. So look for the future, in terms of an answer from us, in China.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay, thanks.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Great, just shifting gears into the US streaming business. As you approach 40 million streaming subs in the US toward the end of this year, and you're looking toward that lower end of 60 million to 90 million that you talk about, how do you think the mix of net adds changes between gross adds and churn going forward, and does lower churn really become an even stronger driver of the business?

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**David Wells** - *Netflix, Inc. - CFO*

Doug, if that's addressed to me, I think that obviously, we do think that we've got growth in both, so it would be growth in reducing churn, or improving our retention, and in bringing more and more people into the market. I mean, our originals have the potential, as we produce more and more content, to bring more people into Netflix, and bring new types of subscribers into Netflix. So I think over time that mix will shift more and more to people who are coming back, and people who are staying longer, just as we penetrate deeper into the US. But we still think we've got some room to grow on both sides.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Ted, when you think about your US programming mix, what do you think the optimal mix of expenses would be between originals, acquired TV and acquired film? And what's the right balance of spending across those three buckets?

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

Over time, Michael, I'd love if you could think about it much more fluidly than that, because we have a lot of programming like Breaking Bad, that in the UK, it's a Netflix original show, and in other territories it's a license. And we move pretty fluidly in and out of that, so baked into our margin

guidance is our content spend, and we want to move a lot of it to originals, mostly because we have found that it's given us new brand strength as those shows have been successful. And if they continue to prove to be successful we want to move down that path further.

But there's a lot of times where we will premier the sequel to Breaking Bad, Better Call Saul, we're going to premier that everywhere outside of North America on Netflix, so that's kind of an original show and kind of not for us, in terms of how we treat it. So we're really, if you want to think about it as total content expense, and we want to get the content the consumers love, and right now we're having success in that area, and we want to keep pushing down that path. So there's no optimal mix in that way.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Ted, can you walk us through what the release schedule looks like for originals just through the rest of 2014 and then into 2015? And I realize it's tough maybe to choose between your kids here, but what new shows are you particularly excited about?

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

Well, we've listed out all of the premier dates that are coming up. The ones coming up in August, where we have BoJack Horseman, which is our first foray into adult animated comedy. It has Will Arnett and Aaron Paul voicing it. It's very funny, and it's again, it's a new broadening of what we're doing on originals, that's pretty exciting. And then we have the fourth season of The Killing also coming out in a couple weeks, that we're also excited about, in August.

The one that's very ambitious and on a large scale, and we've been really thrilled with how it's been coming in, is Marco Polo that we're filming in Malaysia right now. It's a very large scale show, we filmed it in Venice, in Malaysia, in Kazakhstan. It's like we're trying to do things that would be very difficult to do on conventional television. Marco Polo is a very ambitious project coming together really beautifully, and we're excited about that for Q4.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Reed, and Ted, I wonder, from when you first started, you basically built a service on library acquired content. You've evolved to exclusives and originals. I wonder, when you look at usage trends today, how important are the library archive shows that you maybe bought in the first rounds of negotiations with studios, versus the things you're buying now? So if you talk a bit about behavior usage trends among your consumers, as you've gotten longer into the process?

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

Well the great thing about this time we're in right now, Michael, is the content is so great, and there's so much of it being produced, you could barely watch it all in your lifetime. So the library becomes important, because most people have never seen it, so it's new to them. We're producing and bringing out original programming at about as fast a pace as we can, and maintaining the quality that we've been able to, so we're going to continue pushing down that path, and originals is going to be an important component of that, all the time.

We'll also, I think, we'll always be a very valuable off net buyer for networks, because so much of that content has never been seen by the public. So we're excited that we'll continue to play in that space, where we're pretty popular at May screenings, so we commit when they are showing those projects, for us to potentially be a first window partner for those shows outside of the US. And because we are not wed to, we're only going



to put on the shows that we produce, that gives us the opportunity to put a lot of content in front of consumers that they love, regardless of the business model.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Ted, I just wanted to follow-up on a point that you said earlier, just around contracts. And I guess I'm curious how the initial kind of contracts around House of Cards and Orange may differ from what you're signing for new original series now, and is it fair to think that you are getting all of the international or global rights basically for these new originals that are coming out?

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

The key for us, Doug, is that we're trying to make sure we can control the exploitation in those territories, particularly the ones that we're heading to, so you can either get to that by owning the show outright, or by negotiating the control of those rights up front, with the content owners, and have them as partners. And I'm open to either one of those, that give us those controls, so that when we open in new markets, we can launch those titles with us, if they're coming up at a time that makes sense, given that we put so much branding power behind those shows, leading up to their launch.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Reed, can I ask you about international competition? You really enjoyed a first mover advantage in your first markets you went into, but now you see a lot of European markets where there's two or three services outside of the UK, let's say in Germany and France, trying to do what you're doing. How do you think you'll be able to differentiate yourself and competition levels in some of those markets were someone like a Sky, Sky Deutschland, is already trying to achieve the same type of service?

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**Reed Hastings** - *Netflix, Inc. - CEO*

Well it's a bit revisionist history, Michael because to say we were first mover, because if you think about the UK, LOVEFiLM had been there for seven years, developed a 2 million subscriber base, bought by Amazon, infused with streaming content, was a tremendous significant competitor to us 2.5 years ago when we launched. And what we did is we focused on television content, they focused on movies, we focused on incredible streaming performance so you never got buffering, working with all of the integrators. And fundamentally it's a focus thing, which is, it's everything for us, whereas this was a project for someone within a larger Company. And then now, 2.5 years later, of course LOVEFiLM has folded up as a brand, so we're tremendously excited about the opportunity to continue to move forward.

We've also had Sky, from the beginning in the UK, be a very aggressive competitor. Lots of different aspects of their service, but what it's turned out, is that we can grow very substantially in the UK, and Sky is untouched. Similar to here in the US, how we're growing rapidly, but MVPD as a total is untouched.

So I think the big MVPDs are recognizing that Netflix, it's one more network, it's like YouTube, it doesn't change our outcomes in any material way, and we have again great focus, global R&D. So those are the things that we look forward to, but in the end of the day there may well be room for several of these services in a market, with different types of content, they each have exclusive content.

If you think historically in the US, like HBO and Showtime, they are not really competing against each other except for content, they are competing to get part of someone's entertainment budget, and in the same way we're like that in a new market, so we don't need to beat some new competitor. We just need to create an incredible service that all of the citizens in each country that we serve, want to be part of Netflix.



**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Okay.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Great. Ted, can you talk more about your plans for Chelsea Handler's new show coming up, and does this signal more of a move into live streaming, and now that you're moving more into late night talk, is there more of a strategy potentially around sports content over the long term?

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

I think Chelsea is going to be a great representative of the programming on Netflix, because her show is a lot about the entertainment world, movies and television and pop culture, and we think that it will be a great addition to Netflix in 2016. We just filmed her first comedy special in Chicago, and she's going to do four more in 2015, and the show itself, you should think about it as the way that people are not watching scripted programming the way they used to, they are also not watching these late night talk shows the way they used to, meaning they are not watching them at 11:30. They are watching them days, weeks, sometimes months later, online, or on stacked episodes on DVR.

So what we're hoping to do with Chelsea and her team is create a show that's built closer to the way people are going to watch it, the way we had done with serialized dramas, where we took out the commercial breaks and the cliffhangers, and really produced it for the way people watch. And we've got a lot of time between now and then to work through all of the format details, and Chelsea is incredibly excited, and we're really excited about her brand, and we think it's going to be great for us. And in terms of your other question, I think about it as more of a continuum, that this is not that instantly-perishable content by any stretch, but it's, to your point, it's more perishable than a movie. But the economics level that out for us.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

David and Reed, I have a question on international margins. Do you think that international margins in their end state will look like US margins, or is anything structurally different about your international business or scale, versus the US activities?

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**David Wells** - *Netflix, Inc. - CFO*

This is David. I'll take that one. No, there isn't. We've gotten this question before. There's nothing really different about our international businesses, that we can't achieve US-like margins or better in some of our markets. It really is about the competition in those markets. And in terms of what consumer alternatives are there, and how much we're able to charge and the value that we deliver to those consumers. But there's nothing structurally challenging about those markets, that we can't achieve equal or better.

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**Douglas Anmuth** - *JPMorgan - Analyst*

David, just a question on the balance sheet. Can you help us understand how you think about the right amount of cash to have on the balance sheet, just given international expansion and then current free cash flow generation? And as part of that, we see the streaming content obligations move from \$7.1 billion to \$7.7 billion, which I think is one of the more significant moves that we've seen in recent quarters. And just how we should interpret that?

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**David Wells** - *Netflix, Inc. - CFO*

Well the content obligations are a little bit lumpy, depending upon what we do on produced content. So I would look at it over a year-on-year basis rather than a sequential basis, but you're right. They've gone up some. They will continue to go up, as we expand and grow our produced content line, and to some extent, our international expansions as well.

As we sign up for multi-year deals those obligations roll on to the table as well, so the right amount of cash, cash is not an inoculator in terms of a prolonged competitive battle. It does help in terms of short-term, it does help the business in terms of making producers and others feel good about our balance sheet position. I would say in general, I was a bit worried earlier on, say two or three years ago, when we were going through 2011, that we were a little thin, and I thought we would be burning it faster than we actually did.

So for awhile there, I was a bit of a Chicken Little in terms of saying, telling investors, we're going to start burning, we're going to start burning, and we really didn't. We grew it a little bit. We stayed flat for a while.

So I think I'm pretty solid on telling folks, look, in Q4 and Q1 we're going to start using cash a little bit more as we expand internationally, and as we grow our content spend, and in the future, it will really depend on our international, on the pace of our international expansion. So I think I feel good about the level we're at now, and it will really depend on our future plans.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Ted, just recently this week I think you announced a Pay 1 deal in Canada for Disney, and I know you've done a couple Pay 1 deals elsewhere. Where do you think the potential is really to break the Pay 1 window outside the US, is that somewhere we could see more deals like that going forward?

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

I made a distinction before around Disney, relative to the other studios, in that for us, that Disney output deal represents a pretty big chunk of kids' viewing in general. So I think of it more like a kids programming move, that also has a lot of movie components, and some really great movie components with the Marvel films and certainly the upcoming Star Wars movies.

What's really interesting about the Canadian deal is that Disney has now moved that deal in the US and Canada to one supplier, which has not been the historic norm, and we're also going to line up the window, so our Canadian subscribers can be seeing in the movies at the exact same time as the US subscribers. And we do have other Pay 1 deals around the world, including Warner Brothers in the Nordics, as an example, and a few others. But for us, it's getting access to films, trying to continue to narrow that window, so we can get them to consumers sooner and sooner, to deliver on the expectation that the Internet has set up for what I want, when I want, where I want.

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**Reed Hastings** - *Netflix, Inc. - CEO*

Doug and Michael, why don't we do one question each for you, and then we'll wrap it up.

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**Douglas Anmuth** - *JPMorgan - Analyst*

Okay, great. So I wanted to go back to something we touched on earlier, and I guess it's primarily for David. Just trying to understand better, and hope you can drill down more on the 30%, why that's the right level to go to and then reassess the domestic streaming margins, and help us understand better how you think about these tradeoffs that you mentioned in the letter, the 400, 200, and then 100 basis points of margin improvement on an annual basis?



**David Wells** - *Netflix, Inc. - CFO*

Well Doug, there's nothing magical about the 30% number. It's a convenient level for us to reassess, and we think we'll get there next year. So there's nothing magical about that one 30% number, and then in terms of whether we -- how we think about the next target, whether we leave it at 400 basis point year-on-year growth, or whether it goes to 200 or 100. It's really about, do we think that we can continue to expand our market and solidify our competitive position with investments in content, or do we think that we can continue to grow content at a moderate, a slightly less aggressive pace, and put more to margin.

As we grow, what we've explained in terms of that margin that we're getting bigger and bigger, it just gets harder to deliver 400 basis points of growth on a higher and higher margin. It's just the math behind it. So it may not be the right thing to do, to continue to press forward, as aggressively on content or on profit growth, versus other things that we could spend the money on, with content being the largest one.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

I would say, just following on that, is there anything that you know today on the content cost side, like the Disney deal in June 2017, that makes you say that? Have you looked at your -- is there something that you're looking forward to, and saying, that is a hurdle that could change it?

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**David Wells** - *Netflix, Inc. - CFO*

No, Michael. This is more about perspective opportunity spend on the content line. We forward plan our business, we forward plan our content spending, knowing fully well that Disney deal has been done over a year. And then we have projections, Disney could have 20 releases at \$400 million plus box office, but that's not likely to happen.

So I think what we've done is taken a bunch of different median scenarios and said look, we've got that planned out. It's really about what else can we do with it, can we do more experiments in Ted's world in the produced content? Can we license more content, is that the right decision versus profit growth? And making a very smart decision as business owners long term about the competitiveness, and setting ourselves up competitively for the long term.

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**Michael Nathanson** - *MoffettNathanson LLC - Analyst*

Thank you.

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**Reed Hastings** - *Netflix, Inc. - CEO*

Thank you, to everyone for joining us for the call, and we look forward in October to be able to report to you on our initial success with our French and German launches. Thank you very much.

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**David Wells** - *Netflix, Inc. - CFO*

Thanks.



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