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NFLX - Q3 2015 Netflix Inc Earnings Call

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PRESENTATION

David Wells - *Netflix Inc - CFO*

Welcome to the Netflix Q3 2015 earnings call. I'm David Wells, CFO. Joining me today from the Company is Reed Hastings, our CEO, and Ted Sarandos, our Chief Content Officer. Interviewing us today will be Peter Kafka of Re/code, and Mark Mahaney of RBC.

Now today, we'll be making forward-looking statements, so actual results may vary. I think I am turning it over to you, Mark, for our first question.

Mark Mahaney - *RBC Capital Markets - Analyst*

Great, thanks, David. First question has to do with the domestic streaming market for Netflix. Sub numbers for the second September quarter in a row came in light. You've talked about involuntary churn. Could you give a little bit more color around the source of that sub add weakness? Is this a temporary problem? And then just delay concerns that it could be due to a greater increase competitive pressure, or due to kick back, push back against some of the recently disclosed price increases?

David Wells - *Netflix Inc - CFO*

Sure, I can take this one, Mark. I would say that in terms of additions, they were pretty strong through the quarter. In terms of flat being flat year-over-year. In net additions, they were down year-over-year. And that we explained and attributed to our involuntary churn or payments related churn. We think partially that was due to the transition to the chip cards, which is still ongoing, and we've reflected that trend going forward into Q4 in our guidance.

We don't think, though, that it really affects our addressable market size of 60 million to 90 million. I would say last year, we had a little bit of concern at the same time when we over-forecasted Q3, and we ended up in Q4 delivering up to 6 million subscribers for that year. We've done about 5 million to 6 million for the last four years. So I would say our thesis on the addressable market isn't changed. And in terms of the involuntary churn, we've been improving that. It's better year on year, but it is impacted at our levels even on a small basis, 10, 20 basis points.

Reed Hastings - *Netflix Inc - CEO*

So next Q3, Mark, you could be sure that we're definitely going to have low guidance in July. So we think it's just the summer part.

Mark Mahaney - *RBC Capital Markets - Analyst*

Okay. And then, Reed, if you've added 6 million subs, net subs, for the last four years in the US, at some point, you can't you sustain that. Your level as you look forward to next year and what keeps you in that 5 million to 6 million range.



So just address the issues like your confidence that you can get -- that the marketplace will accept the price increases. Is it that we should expect a greater amount of original content coming out to help keep that sub add level at that 5 million to 6 million? Just address the consistency of that growth going forwards.

Reed Hastings - *Netflix Inc - CEO*

When we look at the last couple years, where we've been -- last four years, we've been about 6 million net adds in the US, and then an accelerating number of new members internationally. But restricting the comments to US, it's fundamentally that internet TV is better than linear TV. The consumers can watch when they want, on what type of device they want, and the content has just gotten better and better. So the fundamental confidence about the large scale is because on demand is a better experience than linear. And the entire market is going to move from linear to on demand, internet television, over the next 10 to 20 years.

In terms of the specific, when we look at the shows that we have coming out next year, that gives us a lot of confidence.

We have the Disney Pay 1 deal coming in the US in the third quarter. Third, fourth quarter of next year.

David Wells - *Netflix Inc - CFO*

Fourth of next year.

Reed Hastings - *Netflix Inc - CEO*

Fourth quarter of next year. So we got just a tremendous content coming in. And sure, there's a lot of competitors, but there always have been. We've competed against cable and satellite, and we've competed against YouTube and all kinds of pay-per-view and DVD. So there's a lot of ways to consume entertainment. And despite all of those, Netflix keeps growing because we keep improving. So that's why we feel good about next year, both domestic and especially international.

David Wells - *Netflix Inc - CFO*

And then just a narrow point, Mark, on the pricing. We changed the price in the US last Q2. Q3 came in less than expected, but then we delivered in Q4 and then subsequently Q1, Q2 of this year with a higher price. So I don't think you can ascribe that to a price for the US in terms of growth.

Peter Kafka - *Re/code - Analyst*

I want to ask an international question, but first can you just go back and explain a little bit more about the involuntary churn? And what it was with the credit cards that caused people to be unable to pay? I've got the same account number. What happens when my card type changes, it prevents me from paying? And what didn't you see that happened in Q3?

David Wells - *Netflix Inc - CFO*

Peter, this is David. It's not consistently the case that people don't have the same account number. Some issuers are going to replace that number when they issue that. And for us, as a recurring merchant, where we really want to reduce the friction of renewal and reduce the friction of having any sort of interaction where you have to update your payment method and present an opportunity not to do that. It just means that there's more noise introduced into that, and we think it's a contributor.

Like I said, it's likely multi-factor. There may be other things going on here, but certainly the transition to the chip cards is not helping and that has to be a factor in it. And we're only partially the way through, so the US issuers are going to continue that in Q4. They were supposed to be done in October. They're not, they're about a third of the way through. So we'll continue to see that in the US as we go along.

Peter Kafka - *Re/code* - Analyst

And gross additions were above forecast, right?

David Wells - *Netflix Inc* - CFO

Correct.

Reed Hastings - *Netflix Inc* - CEO

The original forecast? That's why we're attributing it to the mis-forecast, which is quite modest. Because this is the most accurate forecast we've ever had on an overall basis to this slight change relative to our forecast in the involuntary churn.

Peter Kafka - *Re/code* - Analyst

As you as you said, the international numbers came in where you expected. But you didn't provide any color on which territories are doing better or worse than others. Are there surprises by territory? Did something do particularly well or particularly under perform?

Reed Hastings - *Netflix Inc* - CEO

They're all doing really well, but some are bigger than others. But for competitive reasons, we don't give per country color. So we're continuing to learn in every market and improving in every market. Every market is growing. But some are doing better than others, which you would expect and that's up to us to manage to get the total portfolio to be as fast growing as they are.

Mark Mahaney - *RBC Capital Markets* - Analyst

It's Mark again. So, Reed, let me ask you one question, and then, Ted, a question to you. Reed, I know on the last earnings call, I think you cautioned people not to get too robust in the Japan launch. And then also argued or made the comment that Brazil was like a rocket ship.

So at least could you just update maybe a little commentary on those two markets? Our survey work indicated that Brazil was in fact a rocket ship. Is that continuing? And then Japan, should we continue to be mellow or modest in terms of the ramp-up there?

Reed Hastings - *Netflix Inc* - CEO

It's clearly undisciplined in my no commentary on countries. So if I said it was a rocket ship, that has continued. Brazil, what we're seeing is this with a tough economy, a value-based product like Netflix that's very inexpensive, is really appreciated. And so even though there's tight economic times currently, that has not held back our growth. And we were definitely pleased with the content and with the offering that we have. And maybe, Ted, you can talk a little about the Japanese content offering.



Ted Sarandos - *Netflix Inc - Chief Content Officer*

Yes, I'd say even back to Brazil, one of the great upsides in this was our global original series, Narcos, the star of Narcos and the director and creator of Narcos are both Brazilian superstars. So Brazil has received Narcos particularly well, as it's been well received around the world.

In Japan, I think what's been really great too is that is the local acceptance of our global originals. So we're seeing them perform as a percentage of watching about the same as they are in other territories. Which again defies conventional wisdom that Japan is primarily a local territory. We hedged a little bit too and had some local Netflix original content in Japan, including a show called Terrace House that's doing particularly well too. So it's been I think been a great success in being able to make shows for the globe, and extend to places as diverse as Brazil and Japan.

Reed Hastings - *Netflix Inc - CEO*

And Narcos is really just such an incredible story, because it's two-thirds in Spanish and yet was a huge success for us around the world including France and Norway. And so it really speaks a lot to our ability to connect the world, to do amazing shows around the world, that are great stories for everyone.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

And great stories travel.

Mark Mahaney - *RBC Capital Markets - Analyst*

Ted, on the original content launches as you're thinking about next year. Can you help us think about whether the original content launches as a whole are going to be as impactful, less impactful or more so than what we're seeing in 2015?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

I can tell you that I would say as impactful. I don't know if they'll be more or less. But certainly as, as we continue to expand into second, third and fourth seasons of our original shows. What you see there is the franchise value grows dramatically. So as this initiative is aging, the desire to see the new seasons builds up more and more excitement.

And we're not waiting for next year for that. We have an amazing launch schedule for Q4. In the Marvel Defender series, we're bringing out the second show, Jessica Jones in Q4 as an example. Which I think is going to spark a lot more interest in the entire Daredevil run and the next ones coming up after that.

Reed Hastings - *Netflix Inc - CEO*

Now when we talked about the \$5 billion content budget for next year, you said for sure it was going to have more impact.

Peter Kafka - *Re/code - Analyst*

On licensed content, and there's a lot of chatter about some of the studio's networks pulling back from stuff they're licensing to you folks. You guys addressed that in your shareholder letter. You said some content providers may choose to license to you, some may not. Have you seen evidence that people are actively steering content away from Netflix in particular?



Ted Sarandos - *Netflix Inc - Chief Content Officer*

I think the media business is absolutely in flux. As Reed said, you've had this growing move of away from linear and towards on demand, both watching and spending. So the future of how the networks and studios deal with Netflix and Hulu and Amazon Prime instant video is certainly going to determine their future.

So there's a lot of caution, and you see how volatile the market can be just with the turn of a phrase last quarter. So I think what's happening is, is that you're hearing a lot of chatter. But you see in our earnings letter, we detail some major global television deals we've signed across the board with our suppliers. You should keep in mind that those particular deals are big rocks to move with our suppliers. Buying and selling global television is a brand-new behavior to the industry.

So what we're seeing is more chatter, but roughly business as usual. But of course some caution, caution that's been around since we've been licensing streaming content.

Reed Hastings - *Netflix Inc - CEO*

And in general, Peter, the caution it's SVOD wide. So when you think about new content on Hulu, Hulu is even more of a cord cutter's dream than Netflix is because it's got the new network shows the day after. So you really want to read, it's a lot of the concern is about SVOD generally which is to be understood.

Peter Kafka - *Re/code - Analyst*

But Hulu is owned by three of the major networks. James Murdoch at Fox said he'll be working with you differently, a show like Empire, the biggest show last year, is going to Hulu, not to Netflix. Are you seeing any of the Hulu studios in particular steer content away from you and towards Hulu?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Remember, we're buying show by show. So it affects -- so what happens is happening on the show level, not the supplier level. As Reed said, it's particularly puzzling that, considering that it's much more disruptive to give commercial free options the day after broadcast than it is the year after broadcast.

Mark Mahaney - *RBC Capital Markets - Analyst*

It doesn't address the strategic issue that is supposedly causing the anger or the backlash or the choice not to --

Ted Sarandos - *Netflix Inc - Chief Content Officer*

We're accelerating cord cutting in that case.

Reed Hastings - *Netflix Inc - CEO*

The thing to tease out here is let's say the Empire creators, they get paid based upon how the show monetizes. So the studio's under an obligation to monetize that as fully as they can. So Hulu can outbid us as they did on Empire, and that's fair game. But they can't win it at half the bid, because then the participants don't get paid the right amount.



Ted Sarandos - *Netflix Inc - Chief Content Officer*

I think the participants are well in tune with that as well.

Mark Mahaney - *RBC Capital Markets - Analyst*

It's Mark. Let me ask two questions, one on the Epix deal, and one on some background to the price increase you just announced. On the Epix deal, maybe, Ted, could you comment on this? So the decision to not renew it, could you just kind of explain that? Was that due to the economics that you thought were going to be part of the deal, really didn't come through for you, the cost per viewing hour was too high? Was it that there's a broader movement at Netflix away from feature films? We're there too many restrictions on the renewal? Explain to us why that deal didn't get renewed.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

So some of our core initiatives around our content are around exclusivity, and accelerating windows and giving consumers access to content earlier and earlier. The pay TV window has been particularly out of step with consumer desire to watch content when they want it. And exclusivity obviously when we entered into our agreement with Epix, we were de facto exclusive. And since then, they dramatically expanded their cable distribution, which is great for them. They did a deal with Amazon. They were about to do a deal with Hulu when our deal was coming up for renewal.

What we said was, that if we were going to do a non-exclusive deal for Epix that would put the content on Netflix several months after pay television and completely non-exclusive, it wasn't a very strategic investment, and therefore, would be very small relative to what we had been paying. We agreed that our strategic initiative and theirs were diverging, and we just went our separate ways.

We do a great deal of business with Lionsgate. We're continuing to expand our business with Paramount and MGM around the world. So this isn't a studio problem. It just really was the Epix product was less and less in tune with what we're doing at Netflix around exclusivity and windows acceleration.

Reed Hastings - *Netflix Inc - CEO*

And while the movies on Epix are quite good, we found that there's more awareness on the original side. And what we're hoping for over this next two years as we launch some really incredible movies that are highly original and premiere on Netflix as well as in the movie theater simultaneously, that we can do better putting the money into those kind of spectacles, that we create more consumer desire and awareness through that vehicle than through this additional Pay 1 licensing.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

And I think some of the economics match the success of original series programming. Which is, for the cost of production, you have full exclusivity and global rights in perpetuity versus very a narrow window a year after it's released in the theater in one territory. So \$1 billion of output spending versus \$1 billion in original spending may turn out to be the right strategy.

Mark Mahaney - *RBC Capital Markets - Analyst*

Okay. And then a follow-up question on the price increase. So this is the second dollar price increase I think they about in a 15 month, 18 month time frame. How do you think about pricing going forwards?

Is this now the Netflix norm about once a year \$1 price increase? I think long-term, you believe you've got a lot of ARPU power. Is there any change in thinking about whether that's due to tiering as opposed to just straight out price increases?



Reed Hastings - *Netflix Inc - CEO*

So, Mark, Netflix is \$7.99 for our standard def offering. It was \$7.99 last year. It was \$7.99 two years ago, three years ago. So, yes, it is due to the tiering. And what we're trying to do is spread out the tiers, so that now we've got the \$7.99 standard def, the \$9.99 high definition and the \$11.99 ultra high definition.

So think of it as related to putting in a good tiering mechanism as opposed to anything else. And really, Netflix is highly available and standard def is DVD quality, it's not bad quality at all. So that \$7.99 for DVD quality unlimited streaming video, it's an incredible value.

Mark Mahaney - *RBC Capital Markets - Analyst*

So to follow up on that. Does that mean that we should expect those three price points to stay the same for the next three to five years? Do you have the tiering that you want right now?

Reed Hastings - *Netflix Inc - CEO*

We're not making any prognostications about the future on the pricing. But it is related to the value. And the more that we have incredible value, the more that we have amazing originals.

Then over time, we're going to be able to ask consumers for more to be able to invest more. And that's been the rhythm we've been on as we did the tiering and introduced that. If you look at how much broader and bigger our content is now than two years ago, I think we've really delivered on that promise.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

I think it's worth saying that consumers have acknowledged that I think. With the combination of grandfathering and the content additions that we've been able to make in terms of the reactions, I think people are acknowledging that there's real value being delivered through the service.

Mark Mahaney - *RBC Capital Markets - Analyst*

On the original content side, for a couple years, you guys have been making your own shows. And you've never acknowledged that any show was less than successful. You never had to take a write-down. As you start spending more on original content and as you make bigger individual bets on things like movies, at what point do you think you'll be able to tell or investors should be able to expect to hear from you about the performance of individual shows, movies or any other kind of content?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Peter, you should keep in mind that as our slate of original programming grows, the diversity, the size, the scope, the scale of those shows is different. So when we say a show is successful, it's because relative to the investment, it's successful. Relative to how else we would have spent that money on licensing something else, does this creation, did it attract the audience that it was built for?

So the range of budgets is very broad. The range of audiences that we expect to bring to it are very broad. So that's why we've been right so far in terms of predicting the size of the audience for these shows. Not that they will reach 30 million subscribers.



Mark Mahaney - RBC Capital Markets - Analyst

So you haven't made any mistakes in your projections on your original content to date for the last two years?

Ted Sarandos - Netflix Inc - Chief Content Officer

We've not had content write-downs, to your point. So basically what we're saying is that we're investing according to the size of the show. And when we've been wrong, there's been some more upside than we had forecasted. So we had gone into our original programming very conservative in terms of our modeling relative to licensing. And have found that it's been much more impactful.

Reed Hastings - Netflix Inc - CEO

Peter, probably the best way to externally tell is do we take on additional seasons of a show. So some shows have been so successful that we're moving on to season fours. One show, Hemlock Grove, is great for what it was. But season three was the final season. And so you could say well, therefore, that was less successful, and that's true.

But so far we haven't had any show that's performed so weakly in season one that we haven't taken it to season two. I'm sure there will be such a show eventually. But that's probably the best indicator that you or an investor could use on it didn't really work for us is we didn't do more of it.

Ted Sarandos - Netflix Inc - Chief Content Officer

And in that case, you'd say it was relative to an eight season show it was less successful. But in its own economics, were quite successful.

Peter Kafka - Re/code - Analyst

Recently Amazon just moved to block the sales of Apple and Google streaming devices, their competitive products. Given your dependence on Amazon's AWS, are you rethinking that relationship? Can you rethink that relationship?

Reed Hastings - Netflix Inc - CEO

AWS has been a great supplier to us. They've demonstrated again and again strong market leadership, strong attentiveness to our account. We could not be happier with AWS, and they've always kept that separate from Amazon retail.

So with Amazon retail, we've had up and down issues for a couple years. We couldn't buy ads on IMDB, things like that, and that never spilled over to AWS. Now we have a really good relationship with Amazon retail also. But the important point to your question is they manage those separately, and we're very committed to AWS and are comfortable with that commitment.

Mark Mahaney - RBC Capital Markets - Analyst

Let me switch back over to the international markets. I think the overall sub numbers came in higher than expected, and the guidance was a little bit higher than the street at least expected. But the mix of free subs was a little bit higher than I think most people had expected.

Do you have a decent read as to whether those free subs are converting like you've seen in other markets? Any particular reason that there's extra risk here because those subs may not convert as well?

Reed Hastings - *Netflix Inc - CEO*

No, you should see those consistent.

David Wells - *Netflix Inc - CFO*

Yes, there's no change in trend there, Mark.

Mark Mahaney - *RBC Capital Markets - Analyst*

And then in the fourth quarter, I think your international revenue forecast implies like a trailing off an ARPU or a pretty sharp sequential drop in ARPU. Is there any particular reason behind that? (Multiple speakers) price points in some of the newer markets that you're launching?

David Wells - *Netflix Inc - CFO*

No, it's the strong dollar, Mark. So there's a bit of a headwind there because of the strong dollar.

Peter Kafka - *Re/code - Analyst*

Okay. On the content side, HBO one of your big competitors, is moving into news. A lot of that's supposedly aimed at the millennials, theoretically your customers as well. Is that something you guys would contemplate at all?

And then similar question for sports. You guys have repeatedly said you're not interested in sports. Are you willing to concede that maybe you would be a little interested at some point down the road?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

On the news side, we definitely are being more adventurous in terms of the genres that we're going into. We're getting ready to launch Chelsea Handler's talk show early next year. That's our first move into talk. Kind of aimed at the same kind of thing, more of a weekly talk show. Where most of our things have been very long shelf life movies and television series. So I think it's a very similar migration or certainly exploration.

And in sports, I think we're in the same place. Which is, there's a lot of irrational bidders for sports. We're not anxious to become another one.

Mark Mahaney - *RBC Capital Markets - Analyst*

So to translate that, it sounds like you're saying you're not likely to move into sports, but news you're already interested and may increase that appetite.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

We're interested in being able to improve the viewing experience. Whatever kind of content people are watching. So I think in sports, sports on demand is not as exciting as sports live. Where I think everything else that we're doing that frees the viewers from the linear schedule in ways that they enjoy and more enjoy the programming, that we could bring some value to that.

Mark Mahaney - *RBC Capital Markets - Analyst*

So, Ted, you're leaving the lead there for innovation, right, you're giving yourself a little bit of room for innovating.

Peter Kafka - *Re/code - Analyst*

Well, let's be clear on that room. What's the likelihood that we compete directly with Vice in the next two years?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Probably high.

Peter Kafka - *Re/code - Analyst*

Okay. There you go. Amazon, Roku, Google, I'm missing somebody, Apple all introduced new boxes, the new streaming boxes in the last few weeks. Are you seeing more usage and more growth from dumb TVs with smart boxes, or are you seeing more usage and growth from connected tvs that have the stuff baked in?

Reed Hastings - *Netflix Inc - CEO*

They're both growing. They compete with each other. So those categories are growing. It's only really the game consoles that are not growing as fast for secular reasons. Early on, they were the only high connected devices attached to the TV. And now they're facing competition and share from smart TVs and from these attached devices.

Peter Kafka - *Re/code - Analyst*

Thanks.

Mark Mahaney - *RBC Capital Markets - Analyst*

David, a balance sheet question for you. I think in the letter, you talk about likely to raise -- looking to raise additional capital next year.

Do you think this will -- that next year will be the last year in which you'll need to do that as you think about the plans for the next three to five years? And then any additional color on what kind of capital or how you would raise that capital next year?

David Wells - *Netflix Inc - CFO*

Well it's largely unknown. You're asking me three or four years out.

But I would say, given our plans to expand content and given the fact that we're on pace to use about \$1 billion this year and no indications that that would shrink next year. We wanted to give some headway or some insight into the fact that we may be back in the market next year. We've done debt on a regular cadence of about once a year. So there's no change from that.

But there's still some uncertainty in terms of the pipeline, how much we would need exactly next year. But I'd say safe indications are that we would be back in the market in the next 12 to 18 months.



Reed Hastings - *Netflix Inc - CEO*

And then success in [REO] where Ted is able to invest the originals as well in the future, as he has in the past. We would hope to be back because we want to be funding these incredible creative productions around the world. So in a success scenario, we would do a bunch more over the next 5, 10 years.

Mark Mahaney - *RBC Capital Markets - Analyst*

In terms of contribution margins, maybe again, David, for you. I think you reiterated your goal of getting to 40% contribution margins in the US by 2020. Are those European countries and some of the -- and Canada, some of the earlier countries that you launched in, could you just talk about what the contribution margin has been like in those markets? Has it been similar to what you did in the US over the last three years?

David Wells - *Netflix Inc - CFO*

Similar to the comment that Reed, we don't give specific market commentary for competitive reasons. But we have said, and I'll reiterate, that there's nothing structural that means we can't get to equal or better margins outside the US that we've seen in the US.

And we gave you a data point on Canada that that had reached US margin, about 18 months ago we gave you a point on that. So there's no reason that we couldn't do better. Largely, it's determined competitively within that country or that region in terms of how well we'll do on the profit side.

Peter Kafka - *Re/code - Analyst*

Recently you guys agreed to sell subscriptions to Apple phone users via iOS in-app purchases. For years you didn't do that. Are you paying the same 30% tax that everyone else pays when someone gets an in-app subscription through Apple, and why make that change now after years of not doing that?

Reed Hastings - *Netflix Inc - CEO*

It's a great opportunity to expand. So historically, we've only been on the Apple TV and not on the iPhone. And we don't comment specifically on the business terms, so I can't directly answer your question. But we're really excited about the potential, especially as we go global over the next year and a half to be able to serve all of the iPhone customers around the world. So some higher motivation on our side to get access to that incredible iPhone customer base around the world.

Peter Kafka - *Re/code - Analyst*

Is there a way we're going to see -- and if that does generate a lot of new subscriptions, will we see the impact of that on your financials? Will those come in at significantly lower monthly revenue numbers?

Reed Hastings - *Netflix Inc - CEO*

No, the revenue is the same. You would see an increase in COGS to do with the fees to Apple. That's where it would show up. But it's essentially the gross revenue, the \$7.99 or \$9.99 that shows for us.

Peter Kafka - *Re/code - Analyst*

Got it. Curious what you guys think of the new streaming offerings from Verizon and Comcast? Both what you think of them as actual content, and what you think of the notion of broadband providers that you need to work with now competing with you with subscription or streaming services.

Reed Hastings - *Netflix Inc - CEO*

We're really big on every body has got to get into streaming. It's been our main message for several years that what is known as channels is going to become apps, and that all of these providers need to have great apps, on a phone, on a tablet, on a TV. So it's completely consistent with all of that. And what we see is, if we have great content, then consumers watch our service and enjoy it and tell their friends about it. And it kind of doesn't matter that there's also a great sports game on, or there's also shows on Verizon or on Comcast.

So part of the reason that we may seem a little blase is that it really hasn't affected us. What has affected us is when we have a great show like Narcos that just takes the world by storm. So that's what we're focused on, how do we have more incredible shows.

Peter Kafka - *Re/code - Analyst*

Do you think the products that Verizon and Comcast just launched are great products?

Reed Hastings - *Netflix Inc - CEO*

It's early in the market. They're great companies. They will work on that. But I'm not going to critique them. They're in. They're trying, and that's a great thing. Of course you've seen Sony Vue, you've seen the Dish Sling product. So people are really innovating which is great for consumers. And not every product when it first comes out is great, and they'll all continue to work on them.

David Wells - *Netflix Inc - CFO*

And they're certainly better iterations than their prior versions. So they are getting better.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Our first streaming offering was pretty ugly.

Mark Mahaney - *RBC Capital Markets - Analyst*

Ted, we've got a couple of series of e-mails about whether Star Wars is going to be available, all the films on Netflix next year. What's the answer?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

They're all subject to negotiations. So it's up to Disney how they want to manage access to those assets before, during or after the release of Star Wars VII. So it's certainly an ongoing discussion.

Reed Hastings - *Netflix Inc - CEO*

And assuming Star Wars launches theatrically this year, then it would not come to Netflix as part of the -- (multiple speakers)

Ted Sarandos - *Netflix Inc - Chief Content Officer*

No. It would be the last title in the Disney output going to Starz.

Reed Hastings - *Netflix Inc - CEO*

So it wouldn't come to Netflix.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Correct.

Mark Mahaney - *RBC Capital Markets - Analyst*

Okay. And then there was a new user interface launched on the site about four months ago. In the hope that that would kind of improve user retention, satisfaction levels. Four months in, any takeaways?

Reed Hastings - *Netflix Inc - CEO*

Super happy with it. And we've generating new improvements already, improvements there, improvements on mobile, improvements on the TV. So think of the product group as an amazing learning organization. It's always pushing the bounds, and it's steady improvement on all of those fronts, Mark. And it's the aggregate of which that has us at so many viewing hours and so much customer satisfaction that we've been working at all of these improvements over the last seven years on streaming.

David Wells - *Netflix Inc - CFO*

And it's been very flattered in terms of being imitated across the world.

Peter Kafka - *Re/code - Analyst*

You guys changed your amortization schedule for your licensed content just like you had for your originals. You said that's because you're seeing more viewing in the first month. What does that mean? Are people -- there's less -- people are less interested in the stuff than you thought over time, or they're more interested than you thought originally? What does that tell us about viewing behavior?

David Wells - *Netflix Inc - CFO*

Presumably, Peter, you're referring to the amortization change or the change in accounting estimate. And no, it doesn't. You can't conclude that nor should you conclude that from the change. What we're saying is, there's more viewing in the first month, not necessarily less viewing over the lifetime. It's just moved up a little bit. And it could be that we have added so much good content over the last few years, that it's become -- you have to make a good choice. You've got 20 good choices you're choosing. So it could be that the merchandising system is concentrating a little bit of that when something comes in.

Regardless, we try to be accurate in our accounting, and we follow the trends regularly on a quarterly basis. And this past quarter, we noted some content that was trending up. So we accelerated the amortization on that. We wanted to be up front, even though it's relatively small based. If you look at it in comparison to the overall US content spend, it's relatively small.

Reed Hastings - *Netflix Inc - CEO*

Let me give you a little example that will help on this one. Suppose we pay \$1 million for a title for a four year license, and we think it's going to do a million hours of viewing. But the title is just incredibly popular, and instead it does 10 million hours. But many of those hours are in the first month, as opposed to spread over the four years. Well then we would accelerate the amortization of that \$1 million. Even though the whole thing is doing much better than we ever thought. It's relative proportion over time is more up front. So that's why we would front load that \$1 million. So the title -- (multiple speakers).

Mark Mahaney - *RBC Capital Markets - Analyst*

Is that generally what's happening that these things are over performing? Or is there a mix, where they sometimes are performing less well than you thought?

Reed Hastings - *Netflix Inc - CEO*

It's not about the total performance that gets us to change the amortization. It's the relative performance over time. So if it performs a lot in the beginning, relative to how it does at the end, that's what gets us to accelerate.

So your earlier question about write-downs is what's missing. You're not quite getting that -- let's see, if a title under performed our estimate but was very back loaded, then the right accounting would be to shift it out further as opposed to pull it up. And so you're thinking of it in a write-up and write-down sense, and that's not actually how it works. The schedule is based upon how it does over time relative to the license period. Did that example help?

Mark Mahaney - *RBC Capital Markets - Analyst*

But in both cases, you're saying, look, we have these things for so long, that it always works out. That was why I was asking about the write-down part. You've never once reached a point where you've missed entirely and you found something that no one wants over any amount of time.

David Wells - *Netflix Inc - CFO*

Let me take that, Peter, because I think there's been a couple questions on that. We certainly license things that perform less well than we expected sometimes. There's a portfolio of content that we're licensing, we don't always get it right. But in the case of something that doesn't perform as well as we expected, we're not a producer that has ultimate revenues, like a production studio that has to write that down based on a lower expectation of revenue.

We have something available on our service in broadcaster accounting. And in broadcasters, if we're deriving revenue over the life of that license period over the service, it doesn't result in a write-down. It just may be an opportunity cost that we can't license something better down the road.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

And a good recent real world example is Longmire. We just released the original fourth season of Longmire. So season one, two and three, which we've licensed for several years on Netflix, they were at the tail end of their life, actually exploded when Longmire season four launched. So it's very unique to the behavior. Nothing actually performs like everything else. So what we are trying to do is make sure that the [amort] matches the viewing patterns.

David Wells - *Netflix Inc - CFO*

And it's a good lead in to remind everyone that these are dynamic. That's why we look at it every quarter. Because things change. We see when something gets released like Longmire or we release a third season, then the first season of that particular title may see a bump. So it's something that we're constantly looking at.

Reed Hastings - *Netflix Inc - CEO*

And where it's ambiguous, we would tend to want to amortize it more quickly. That's advantageous to us. But it has to be justified by the actual viewing patterns.

Mark Mahaney - *RBC Capital Markets - Analyst*

On global rights deals, Ted, just big picture, do you see yourself -- is the Company able to negotiate more and more of these content deals on a global rights basis?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Yes, it's definitely been the drive of myself and my team all year trying to get these -- trying to move the sellers into a more of a global mode. Remember they're mostly situated as regional sellers of content. Sometimes the rights are fragmented in their ownership. But in the cases of the deals we did this past quarter, they were controlled by one entity. And typically sold by multiple regions, and we corralled the deals into the corporate offices, and were able to license the world on those titles. Titles that we think will have great global appeal.

So I think the growth, the opportunities, the challenges of Netflix are all global. So that having a lot of regional discussions around the world isn't that efficient, and it turns out that tastes are rather global too. So it's actually really well lined up.

Mark Mahaney - *RBC Capital Markets - Analyst*

Ted or Reed, when you think about the mix in international markets of local versus global content, any general change in your thinking on what the optimal mix is? And do you find that you're constantly toggling depending on the market that you're in?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

It's interesting, like I said, every time we launch in a new market, we know more in that first 24 hours of viewing than we did from a year of research. And in terms of the move, I think we went in expecting Japan to be much more local than it turned out to be. It's more local than other territories, but not as local as conventional wisdom would have had. And it actually moves with the global desire for some of these large shows. So that the tastes, local tastes, are usually determined by what you have access to.

And if we're growing the access to great content around the world, people are moving -- are migrating to that kind of viewing. So that's why we're able to do local language originals, our own global originals and then licensed content. Not just from Hollywood to the world, but from the world to the rest of the world.

Peter Kafka - *Re/code - Analyst*

Another international question. Can you guys give us any update on China? Either in the sense of what you're thinking about in terms of timing, or what your approach is going to be to a really regulated market there when you do show up?

Ted Sarandos - Netflix Inc - Chief Content Officer

We can tell you we're still learning a lot, so nothing really specific or helpful except that we're still in the early stages.

Peter Kafka - Re/code - Analyst

And in your letter, you guys mentioned getting a new pay TV window for a specific movie, The Big Short. Are you negotiating those deals now on one-off deals for individual movies, or are you doing these for whole slates?

Ted Sarandos - Netflix Inc - Chief Content Officer

There were conversations directly with producers. So a lot of times -- if you can get to the rights before they get fragmented, that's when you can do those deals. So they tend to be more curated title by title in that way.

Mark Mahaney - RBC Capital Markets - Analyst

Reed, I think I'll just ask one last question directly to you. When you think about the biggest challenges that you think Netflix faces over the next several years, three to five years, what do you think they are? What do you focus most of your time on?

Reed Hastings - Netflix Inc - CEO

Well I would say the biggest challenges are being the service that people want, really filling out more movies and more TV shows. We're working so hard to have these great original productions. And if we could have 10 more Oranges and 5 more Narcos, I know I'm putting a lot of pressure on Ted, but that would be really transformative. Especially, I'll bring up the Narcos. We've got an example because it was filmed in Bogota, Colombia. The main company doing it was a French Company, so it's a very international production.

Ted Sarandos - Netflix Inc - Chief Content Officer

Brazilian cast.

Reed Hastings - Netflix Inc - CEO

Brazilian cast. And we have a incredible production, Marseille, which I'll give a little plug for. That's in filming now. And I think it will be a really great crossover around the world, kind of crime drama, family, politics. And the more we do these around the world, obviously, that's great in the local market in terms of establishing our bone fides and reputation with customers.

But it's also great because it's something new, it's something fresh. And as long as we're continuing to push the bounds on things like our original movies, our international productions, then the consumers are really embracing.

Mark Mahaney - RBC Capital Markets - Analyst

I'll follow up. David, help us think through -- I guess one of the things I'm sensing very strongly is just increasing appetite, enthusiasm for original content. From a P&L perspective, that \$5 billion next year in content spend. Theoretically, if that was 25% original content versus 15% or 10%, the impact of that on margins as you mix shift more and more towards original content, is that accretive to margins?



David Wells - *Netflix Inc - CFO*

Well the good news for me as a forecaster, is it does take Ted a little bit of time to actually produce these shows. We get a little bit of lead time in terms of some visibility into the production. So our targets at 40% US margin already encapsulate this shift towards originals over time.

I think Reed made some earlier comments about a long-term shift that could be upwards of 50% of originals. And we still anticipate being able to meet our margin targets, and also shift towards originals. Which are -- it's going to bring more amortization in, but we think we can do both.

Reed Hastings - *Netflix Inc - CEO*

And I'll use the word expansion. So think of it as our licensed content is growing, but our original content is growing faster. So there is a mix shift, but I don't want that to get misunderstood as a reduction in licensed spending.

David Wells - *Netflix Inc - CFO*

We're still expanding spending on licensed content.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

And remember, between original films, original cartoons, animated shows for kids, our original scripted series, we're releasing more original titles in Q4 than we released in our entire second year of original programming. So it is accelerating rather quickly, and you're seeing it.

Peter Kafka - *Re/code - Analyst*

Reed, you've said for a while now the future of TV is apps, and now Tim Cook is saying the same thing. It's now the conventional wisdom. Do you think individual viewers, consumers, want to pick and choose their own apps, their own shows, in a la carte world? Or do you think there's a role for someone to bundle all this stuff back together?

Reed Hastings - *Netflix Inc - CEO*

Well that will be a really interesting question over the next couple years. We're going to work really hard to expand our movies and TV shows so quickly, in such a compelling way that lots of the viewing for movies and TV shows is through Netflix. Which is sort of what makes us want to focus so much on that area.

But I could imagine future bundles emerging, once there's a whole bunch of apps. And as you go through this industry change now, next probably 3, 5, 10 years, where there's a lot of discrete offerings, everybody's improving their brand value. And then you get to a maturing phase of the market, and then there's some consolidation which could be acquisitions, it could be other things or it could be bundles. But the next couple years, when you have this new phase of the market, I think everyone's just racing to make a great app like Netflix, like HBO NOW, those things.

This is the last question here because we're running out of time.

Peter Kafka - *Re/code - Analyst*

This will be it, it's a small one. You're seeing some folks rebundle already, right, Hulu is [sewing] Showtime together. Would you be comfortable having Netflix bundled with another service?

Reed Hastings - *Netflix Inc - CEO*

We don't see a lot of take rate from our consumer set on the Hulu, Showtime. We think we're better focused on just establishing the Netflix brand. Again, at this phase in the market, we think the real key is focus.

At some future time, the bundling may be appropriate. And of course we'll keep an eye and watch the Hulu Showtime take rate to see -- to confirm that there's very little traction of that. So we'll be open minded, but our instinct is, focus on making Netflix the passion brand in this space.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

And before we sign off, we should remind everybody that Friday, tomorrow is the premiere of *Beast of No Nation* on Netflix, and in selected theaters around the country.

Reed Hastings - *Netflix Inc - CEO*

Awesome movie. I hope you guys all watch. Thank you, guys.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Thank you.

David Wells - *Netflix Inc - CFO*

Thank you.

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