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NFLX - Q4 2015 Netflix Inc Earnings Call

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CORPORATE PARTICIPANTS

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Reed Hastings *Netflix, Inc. - CEO*

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

CONFERENCE CALL PARTICIPANTS

Ben Swinburne *Morgan Stanley - Analyst*

Peter Kafka *Re/code - Analyst*

PRESENTATION

David Wells - *Netflix, Inc. - CFO*

Welcome to the Netflix Q4 2015 earnings call. I'm David Wells, CFO. I'm joined on my right by Reed Hastings, our CEO, and Ted Sarandos, our Chief Content Officer. Interviewing us today will be Peter Kafka from Re/code and Ben Swinburne from Morgan Stanley. Just a reminder, a cautionary statement that we will be making forward-looking statements and actual results may vary. Over to the first interview question.

QUESTIONS AND ANSWERS

Ben Swinburne - *Morgan Stanley - Analyst*

I'll start out. Maybe for Reed and the team, let's -- can you reflect on the fourth-quarter results for us that we're all going through right now? In particular, talk about the international strength. You mentioned you were pleased with the October -- September, October launches, so can we infer that the outperformance versus your expectations maybe came from those areas? Or any color you can give us on the international strength to start us off.

Reed Hastings - *Netflix, Inc. - CEO*

We've got over 50 countries in Q4, so we've had a lot of experience, Ben, at predicting these markets, and then we launched in Japan in early September and Spain, Portugal, and Italy in mid-October. I'd say they've gone very well, as we said in the letter. In terms of the outperformance, it was pretty broad-based, many different contributors around the world to that. What we're seeing basically is that this on demand Internet TV watch whenever and wherever you want, it's very popular wherever you go in the world.

Ben Swinburne - *Morgan Stanley - Analyst*

Just taking that question over to the US for you or also maybe for David, a little bit lighter this quarter than your guidance or budget. Talk to us a little bit about the churn, connects dynamic, and anything you'd want to add around credit card chip sets or any other issues you want to bring up around Q4 performance in the US.

David Wells - *Netflix, Inc. - CFO*

Q4 I would say was pretty close to our projection. We were literally within hours of it. But so we did anticipate that net additions would be lighter year on year. I would say the credit card was a background issue in Q3, continues to be a background issue. But the larger thing is that it's just the next 50 million are a little harder than the first 50 million in terms of growth, and we're doing everything on the content side, on the product side.



We're continuing to improve that service. But you're seeing that the law of large numbers when you grow steady at 5 million, 6 million net additions a year on a larger number, then that percentage growth is smaller year over year, and that's what we predicted and that's what you see in our guide for Q1 as well.

Peter Kafka - *Re/code - Analyst*

Hey, guys, last quarter you said credit card issues were a background issue. This quarter you say that they're a background issue. How long do you anticipate this is going to be a problem for you? Additionally, any sense of why you're the only major consumer Company that's called this out as a problem?

David Wells - *Netflix, Inc. - CFO*

Well, I don't think we're -- Peter, this is David. I don't think we're the only one. I think because we're a recurring merchant, anywhere from 5 to 10 basis points, 15 basis points is sensitive to us. We have optimized. We've spent a lot of time optimizing our recurring billing systems and our approach, and so we're very sensitive to it. Again, it's a small thing. I think we want to focus on the larger things and not the small things. We anticipate that the EMV rollout will continue into 2016, into Q1 and Q2, and we'll always have even globally these issues where there's mass reissues of things and disruptions in the recurring systems that we have.

Peter Kafka - *Re/code - Analyst*

So this may fall under the small thing category, but last quarter you added iOS sign ups. Any impact, surprising one way or another from that?

Reed Hastings - *Netflix, Inc. - CEO*

We've always been able, customers have always been able to sign up on iOS, but they had to do it in the mobile web Safari browser. Now they can do it in app, and it's a positive. It's not transformational, but it's a really nice positive, in particular in new markets as we expand around the world. Where we're less known and less trusted the comfort for customers in terms of using the Apple payment mechanism versus entering their international credit card information is helpful. So think of it as one more in a long list of great payment options that we have.

Ben Swinburne - *Morgan Stanley - Analyst*

Reed, I want to come back to the outlook and the Q1 guidance, in particular, starting with international. You mentioned in the letter the 2016 markets are -- you're playing the long game here, but the guidance is obviously impressive and well above expectations. Are the 2016 launches a big contributor to what you're expecting in Q1 and for the year internationally? Or is this continued momentum building on the existing markets? Any color you can share there?

Reed Hastings - *Netflix, Inc. - CEO*

Yes, it's a lot of both. Obviously, our global guides for over 6 million net additions will be a record for Netflix, and so we're super excited about that. And what's amazing is we're seeing some of our new shows like Making a Murderer not only be huge here in the US, but it's emerging as a big hit around the world for us. You kind of expect Jessica Jones to carry internationally. What's been phenomenal about Ted's team's programming is that these more unusual content titles have also had great draw around the world.



Ben Swinburne - *Morgan Stanley - Analyst*

And let me just ask you about the US, just to pick up on David's comments about the next 50 million. So what are you doing as a management team, maybe to Ted on the content side, what is your research telling you about the people who actually don't have Netflix today? Is there some genre that's not being addressed well enough? Is there a distribution decision you guys need to make to go after that? What are you doing to maybe go after that other opportunity in the US market?

Reed Hastings - *Netflix, Inc. - CEO*

Well, David's a big thinker, so he's thinking about the next 50 million, but I'll stick with the next 5 million. And when we can clearly see the next 5 million, it's -- I've been hearing a lot about it but nothing yet has compelled me to join. And so the big driver is getting people excited about whatever title we have and then making it easy for them to join. Whether it's integrating on the smart TV or integrated into the MVPD set-top or the Apple TV, those are the things that make it easy to fulfill that desire. But the underlying desire is for these new titles, which is why we're so excited about the year coming and the content that Ted's team's put together. Maybe you could talk about some of the big hallmarks we have in the next few months.

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

Just upcoming in this quarter, you're going to see something that we -- as we were pleasantly surprised by how excited the world is over Fuller House. This upcoming, you asked about different kinds of programming for the next 50 million or 5 million, depending on your level of aggression, that you're getting more and more mainstream in some ways with the programming. But as a function of breadth, as a function of doing more for all tastes. So opening that up to include multi-camera sitcoms like The Ranch, like Fuller House. We have also a really great single camera sitcom with Will Arnett called Flaked and the fourth season of House of Cards. You've got all this kind of breadth. Just in a single quarter we're releasing more programming than most networks will in their whole year.

David Wells - *Netflix, Inc. - CFO*

And being pleasantly surprised that shows that are not necessarily all in English are being embraced by US audiences, which is one of those things that has been rolling around in Hollywood for a long time that US folks don't watch subtitles.

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

The continuing success of Narcos in the US, where this primarily Spanish language show that's being watched in enormously mainstream numbers in the US.

Peter Kafka - *Re/code - Analyst*

For Reed and Ted, since last quarter, several of your suppliers, most specifically Time Warner and FOX, have been even more explicit about their desire to pull back in the amount of content they sell to you. Has that caused you to accelerate your original programming or were you already on that same trajectory?

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

We've been on the trajectory to accelerate original programming. I mentioned a couple weeks ago we're going to launch 600 hours of new original programming this year alone. So it is a function of as our budget continues to grow, as our subscriber base grows, we are licensing programming and we're creating programming. As a percentage of our spend, the original spending is growing, but as an absolute, their licensing dollars are continuing to grow as well. And FOX is an important vendor for us, just like they all are. We're also a very important source of revenue for them.

Peter Kafka - *Re/code - Analyst*

If that rhetoric was less intense, if they weren't out there saying, look, we're going to stop selling to SVOD, would you be pulling back on original spending?

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

No, I think we've -- the positives that are come from original spending have been tremendous in terms of our international growth, in terms of really distinguishing and differentiating Netflix from an explosion of SVOD services.

Peter Kafka - *Re/code - Analyst*

And then what do you think about the Marvel relationship? Do you see expanding that one or is that going to stay steady where it is right now?

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

It's a pretty expansive relationship already. We have five different series. Going in, we just announced yesterday that we're going to a second season of Jessica Jones. When you look at those five series with multiple seasons, plus the crossover season of The Defenders, it's a huge commitment and all the way along the way you're going to be introducing new characters who have the potential to spin off and grow that relationship even further. So it's very important for Marvel; it's very important for Disney.

Reed Hastings - *Netflix, Inc. - CEO*

And for us.

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

And for us, absolutely.

Ben Swinburne - *Morgan Stanley - Analyst*

Just Ted, sticking with you on content, why the callout of family programming, emphasis in the letter? Any comment around what you're doing maybe differently there? And now that you have a quarter behind you with some of your movies in the market what did you learn? How does that change your appetite around film?

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

The reason we called it out is to acknowledge that there is a large volume of specifically of kids programming coming out. When normally people think of Netflix original programming, they'd be thinking about our sophisticated dramas and adult comedies more so than our kids programming. But quietly, we've been amassing a very big selection of original kids programming on Netflix, Kidscreen magazine just voted Netflix the number one outlet for kids programming on television, which we're really proud of. And that's going to continue to grow. We're also looking to grow categories like Fuller House, which are programming that are watched together. Parents watching a show that their kids love, that they don't just tolerate but they enjoy too. And it's a real underserved market, and that's why we called that out specifically.



On the movie side, it was a great first swing I think with Ridiculous 6 and Beasts of No Nation. Beasts of No Nation is in the discussion about the Oscars. It didn't quite make it there, but got picked up nominations in almost every other category. The viewing we are thrilled with around the world and have been -- continue to be thrilled with as we've expanded into new territories, both Ridiculous 6 and Beasts of No Nation are watched in huge numbers in all of our new territories. We're really excited by it, and we've got an aggressive slate in 2016 to keep pushing on it.

Ben Swinburne - *Morgan Stanley - Analyst*

Shifting over to the hours data, Reed, that you gave in Las Vegas and then some in the letter, this comes up every quarter, people trying to understand the penetration growth curve in these international markets. So if you look at the European markets where you gave the subscriber number last fall, I think penetration growth's been relatively light so far, certainly versus, say, the UK, which was much stronger. What are you guys doing, maybe you and David, as you think about trying to accelerate the growth in some of these markets that have been tougher out of the gate? And what are the characteristics that we as investors and analysts should look at in these markets to understand the dynamics that drive these growth rates over time?

Reed Hastings - *Netflix, Inc. - CEO*

The first year in the UK was a really tough market. So it's usually successful for us now, but it's not true that it always was. We saw the same thing in Brazil for different reasons. So being light in the beginning doesn't worry us a bit. And what we've seen in market after market like Spain, Italy, France, Germany, is this building momentum as we do more and more local content. We've got this amazing show Marseille coming out in May that I think will really uplift the way our French members think about us and non-members, in particular. So we're really looking forward to that. So it's a natural building cycle. And I think the way you should model it is pretty consistent growth in all of the territories. The variation is pretty modest, again, if you time adjust it from whenever we launch.

Ben Swinburne - *Morgan Stanley - Analyst*

And just on your time spent number, I think we calculated in the fourth quarter anyway about a 12% increase per average sub year over year, which is impressive given you added a lot of new international markets. Anything you can tell us about the highest versus the lowest and whether all markets are still growing? It would appear that the US is still growing, which is impressive. Maybe you could talk about that a little bit.

Reed Hastings - *Netflix, Inc. - CEO*

Well, we're continuing to invest more in content, more in platforms in terms of the performance and the speed and the services growing. So I think it's natural that we're continuing to grow on all those dimensions on the per membership basis as the service matures and the idea. Think about smartphone usage now compared to 10 years ago. Of course, the number of smartphones is up, but the usage and utility is up. I think we've only scratched the surface. Netflix is a tiny percentage of all video viewing today. We have tremendous potential growth ahead of us if we can continue to execute, if we can continue to produce great shows to have this global launch with no snafus. There's a lot of hard execution, but the market potential is really quite large.

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

I would only add that the more content that we're adding, the more likely you're going to land on a show that somebody can't live without. I think that's what you're seeing as we're expanding in not just the volume of content but also the breadth of genres that we're covering in our original shows and our original movies.



Peter Kafka - *Re/code* - Analyst

Reed, when we talked a couple weeks ago, in addition to India you called out Philippines, Saudi Arabia as particularly important markets for you. Anything else you want to emphasize in terms of the 130 plus countries you rolled out a couple weeks ago?

Reed Hastings - *Netflix, Inc.* - CEO

Those are a number of countries that have language match, so Philippines a lot of people speak English. We have English-language content. We have subtitles in Arabic. I know we've translated our service in Arabic, so that's a good match for Saudi Arabia. And then in much of the world, Russia, Poland, central and Eastern Europe, we're still only in English. We have got a ways to go over the next two years. We'll keep adding more languages and make the service more relevant. So we look at it in two categories where we've got language match and where we don't yet. We're seeing both at growth but more substantial growth in those obviously where we have language match. And then beyond language, we have work to do on payments in terms of in each country, there are often local payments or different traditions around payments that we'll start to work on. Think of it as we've really begun on the international or global expansion, rather than it's all sewed up and we're all complete on it.

David Wells - *Netflix, Inc.* - CFO

We've had two weeks, right, so we've been two weeks in terms of that launch.

Peter Kafka - *Re/code* - Analyst

And what are you thinking about as you move into markets where mobile Internet is sort of the dominant way that people get online? Traditionally people are watching you on a connected TV. What happens when they're used to watching or consuming things on a phone?

Reed Hastings - *Netflix, Inc.* - CEO

Same thing, you just watch Netflix on the phone just like you watch YouTube on the phone. A lot of that phone viewing is on Wi-Fi, because of the data charges. And then what you do on the sailor networks is try to have the most efficient video codex you can have, and we're working hard on that. But think of it as it's the same way that people use other Internet video services like YouTube.

Ben Swinburne - *Morgan Stanley* - Analyst

David, I want to come back and maybe talk a little bit on the numbers. Can you update us on your expected cash burn for 2016? And then help us understand the relationship between content on the -- costs on the P&L versus cash as we move through this year and maybe into 2017?

David Wells - *Netflix, Inc.* - CFO

There's no change here. So we'd said before that we're on pace to burn about \$1 billion of cash, mostly on our branded or originals content. That ratio of cash to P&L is about 1.3 to 1.4, and that continues to hold. So you see that it will run up in a peak in certain quarters, if we take delivery of a lot of original content and then runs back down. But I think the 1.3 to 1.4 range of cash to P&L expense will continue to hold. And so far, our expectations of use of cash have been about as expected. You see in the letter that we wrote that we're on pace to use about \$1 billion and maybe a little more this year, but we upsized our debt deal last year, about a year ago. And so in terms of timing, we'd be looking at later this year, maybe early next year before we would need to do any more on the capital side.



Ben Swinburne - *Morgan Stanley - Analyst*

On the US margins, and I realize how you allocate cost between the US and international markets may change over time, but you had a lot more operating leverage last year than perhaps we all thought heading into the year. Yet, you maintain this 2020 guidance of 40% contribution margin. Is that just being conservative or do you expect maybe some change in amortization rate to slow the margin expansion down? What color can you give us about the pace of US margins?

David Wells - *Netflix, Inc. - CFO*

Well, not the latter. I would say there are a couple of points on this. One is that to the extent that we launched rest of world and it was a little earlier than maybe 24 months ago that we would have been fully global or near fully global, I would say the US P&L did receive a little bit of relief, right. But that's a one-time thing and that sort of goes away. The second point is we continue to add content and it's added at an efficient level. We look at the hours viewed and what is generated by the content versus the cost, and we continue to see new additions even in the US and markets that are -- have been in place for four to five years now. We continue to see viewership. And Ted talked a little about engaging new audiences. You'll see us do that. For the foreseeable future, we think we can grow both margin and grow the content spend even in markets in the US.

Peter Kafka - *Re/code - Analyst*

Back to international. I know you guys aren't going to offer any more guidance on when you might go into China. But when and if you do, do you imagine that you're going to have to restrict or alter the catalog based on censorship or other issues with the Chinese market?

Reed Hastings - *Netflix, Inc. - CEO*

Yes, the standards, at least today, they're fluid that the government uses restrict like Game of Thrones reportedly had 10 or 15 minutes from many episodes cut from it. There are issues conforming to those local standards. That's true of all of the Western content that's produced as well as the Chinese content of that market. We'll be on a level playing field with all other services.

Peter Kafka - *Re/code - Analyst*

Same territory, would you have to enter via JV or is there some way you could enter China without doing a JV?

Reed Hastings - *Netflix, Inc. - CEO*

There's all different flavors, if you look at how Disney Life or iTunes or others have done. We're talking to different partners, building the relationships. But again, as I mentioned a few days ago, we have a very long-term look, and this could be many years of discussions or it could happen faster than that. We're going to take our time. The clearest example is really the iPhone, which took many years for Apple to get approval for that, and now it's a very large business for Apple. And so our view is if we're looking out for the business a decade from now, we should just be very patient and continue to build those relationships and listen and learn. So we're in no hurry. Most of our time and effort right now is going in, how do we build the Japanese market? How do we build the Philippines market? How do we build the Saudi Arabian market, markets that are open to us and available right now?

Ben Swinburne - *Morgan Stanley - Analyst*

Want to ask about content spending, maybe for David and Ted to comment on. We presume the relationship between subscriber growth and content spend is not linear going forward. As you guys think about growing the US business, how should we think about the pace of growth in content spending? And Ted, is the 50/50 original acquired ratio still your long-term expectation, or have the relationships with the vertically integrated media companies maybe altered that at all?

David Wells - *Netflix, Inc. - CFO*

Let me take the first part, and then I'll throw it to Ted. It's been -- it is true that once you get to \$4 billion of spend, the rate of growth is going to slow down. So that is definitely true on the US side. But back to my earlier comment, we still think that there's great content to be added to the US service that is efficient, that will continue to increase the competitiveness and attractiveness of the offering in the US. We're going to continue to add to that, to that service. It's at a slower rate of growth, but it continues to grow. And in time, it's not true yet, but in time, we will be adding more of our original branded content than our licensed content. So today we've been adding both. We've been growing originals rather quickly. We'll continue to grow originals quickly, but you're seeing a lot of that added to the US market. And to the extent that we're successful, and Ted, maybe this is a good transition to you, about finding content that works across markets, there will be a blurring of the lines between what is really US content and what is international content and vice versa.

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

I think the art of this is going to be doing something that doesn't feel homogenized for the world, that still feels like great programming for everybody. And then we've had tremendous success so far, like I said with *Narcos*, a primarily Spanish language show, we're working in countries that speak every different language. And *Making a Murderer*, as Reed pointed out, in many parts of the world, these kind of true detective documentaries are incredibly popular in primetime television. So we're pleased to see these continue to be real global genres.

What you asked about, about our suppliers, and I think confrontation is probably overstated. But there's a lot of rhetoric going around right now about how quickly and how aggressively people will license. It's still a very competitive business. I think what happens is that people sell their programming to the highest bidder, and if we are that bidder, we get the programming. If someone else is, they'll get the programming. That's true today and that was true five years ago. So I think what's happening now is we're very pleased with the results of the original spend, and that's what's driving it up, not fear of being cut off on either end.

Ben Swinburne - *Morgan Stanley - Analyst*

And Ted, just on that point, what should we glean from your Dreamworks extension? Obviously, that's a family genre and I think it's kind of an output deal, you could correct me if you're wrong. I know you don't like output deals. On the same time, the CW renewal has not happened. I think that deal's sort of still out there. Is that an example where you could get something done with an independent studio but not with a vertically integrated one?

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

No, the Dreamworks is not an output in the traditional sense, meaning that we agreed to have certain levels of programming, but we worked together in what that programming is going to be and developing those shows along with Dreamworks. We've been thrilled with the results. We took it into more territories and expanded the number of years of programming that will come through that deal, because it's been working great. And I think on the CW deal, it's just in the process of negotiation. It's not behind in any normal process. And as you know, it's a time-honored tradition to negotiate in the press, so you're seeing some of that from them. And right now, I'd say it's just in the process of negotiation. You should also keep in mind that no matter what happens in the CW deal, is the programming that's currently there remains with us through the run of those series. So it's not like we're going to wake up one day without the programming. And we'd like to make that deal work. It's great programming. We have a great relationship with CBS and Warner Brothers on that deal and we'd like to continue it.

Peter Kafka - *Re/code - Analyst*

Reed, you said you didn't think Time Warner should spin out HBO. But if they ignore your advice, does that change your view of the way HBO would act as a global competitor for you? Do you think they have the ability to do things outside of Time Warner they can't do within Time Warner?

Reed Hastings - *Netflix, Inc. - CEO*

HBO's been a great competitor, one we admire for a very long time. You might have seen the recent news that they now are offering HBO Now direct to consumer in multiple new nations. They started just in the Nordics, then some countries in Latin America, now in Spain. They will be a formidable global competitor over time, again, independent of their ownership.

Peter Kafka - *Re/code - Analyst*

And then speaking of competitors, Ted, want to offer a theory about why your competitors at NBC and FOX and other networks spent a lot of time talking about you last week at The Critics Association?

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

It might just be putting up a shiny object to deflect, talk about Netflix instead of what's going on in their own networks these days. But I really couldn't tell you why. NBC was a particular puzzle, both because -- mostly because they used, as an example, a show that they produced for us to try to illustrate what was and wasn't working with some data that didn't feel very true to us.

Peter Kafka - *Re/code - Analyst*

Is the talent --

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

It surprised everybody at NBC too I think.

Reed Hastings - *Netflix, Inc. - CEO*

I think it's just a tactical miss, which is kind of funny in the press.

Peter Kafka - *Re/code - Analyst*

Does the talent or anyone else still ask for numbers or are they happy now or (multiple speakers)?

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

No, if you follow the coverage from the TCA, most of them offered up that they're very happy with the relationship and not to be under the kind of weekly ratings pressure that wouldn't matter much to the success anyway. So they're happy not to focus on it.

Ben Swinburne - *Morgan Stanley - Analyst*

Coming back to David on some of the financials, David, I think you said at CES or at your presentation out in Las Vegas about \$120 million of loss a quarter internationally. Just want to level set and make sure that's the right way we should be thinking about the year. And then on raising more capital, you mentioned in the letter you're looking at lowering your cost of capital which we presume would have been the case. What are you referring to specifically there? Is some of the gyrations in the high yield market causing you to think about raising capital differently than you have in the past?



David Wells - Netflix, Inc. - CFO

So on the first question, you heard me right in terms of \$120 million. Looking ahead, I would say there's two things that might alter that or not materially but plus or minus \$10 million, \$20 million. That would be foreign exchange. We continue to have an environment where we're running deep into some pretty heavy headwinds of foreign exchange. If that continues, that might challenge that \$120 million upward a little, again, \$10 million, \$20 million.

The other thing is just carving out a little bit of room for us. Like I said, we're 14 days, we're two weeks or so into a global launch. We've got lots of markets that we're in early days of setting our level of compelling and competitiveness in our service offering. This year is about investment, and you'll see that. We're focused, we're committed to a global breakeven, but we're also trying to build multi-year businesses in many of these markets. So if we see opportunities, I think there's a little bit of room for us to pursue those later in the year to pour some additional content, marketing, whatever the right mixture of investment is. But it is true. It's about \$120 million. It won't meaningfully depart from that too much, but it could be \$10 million, \$20 million within that.

Reed Hastings - Netflix, Inc. - CEO

And then you should assume the debt instruments are similar to the ones we've used in the past. We've been very happy with those.

David Wells - Netflix, Inc. - CFO

Yes, sorry, Ben. On your last question, nothing's changed there other than our confidence that we'll continue to drive some meaningful profit into 2017, 2018. And to the extent that people are focused on backward-looking financial metrics in terms of creditworthiness, we think that we'll become a better credit risk over time, irrespective of what's happening in the high yield markets. To date, our bonds have traded pretty well.

Ben Swinburne - Morgan Stanley - Analyst

Can I just follow-up, David, on your global breakeven point, I think operating income was down a bit in 2015 versus 2014. But if I look at the 2016 outlook for international losses you just gave us plus some US margin expansion, I think operating income overall should grow a bit off the 2015 base. Maybe I'm thinking about things the wrong way. I just want to --

David Wells - Netflix, Inc. - CFO

No, I think you're doing the right math. But I think that question is a little bit of a modeler in terms of looking at the narrow numbers. That's true in terms of the math. But in general, I would say this year is about our continued international investment. We're not really focused on making sure operating grows. The operating income growth is sort of an outcome of focused on international expansion but also committed to consolidated breakeven.

Ben Swinburne - Morgan Stanley - Analyst

Understood.

Peter Kafka - Re/code - Analyst

You guys said you're releasing people from grandfathering this spring, that means price hikes. David or anyone else, are you thinking about ways you might reach out to folks who are going to see their bill go up by \$1 or \$2 and keeping churn as low as possible?



Reed Hastings - *Netflix, Inc. - CEO*

It's pretty simple. We'll let them know that at a certain date the price change takes effect. So nothing dramatic, pretty straightforward, simple stuff.

Peter Kafka - *Re/code - Analyst*

Great. Reed, while I've got you here, now you've been able to watch what Amazon's been doing with its bundle and Starz and Hulu, any more thought about attaching yourself to any other over-the-top service in some sort of bundle?

Reed Hastings - *Netflix, Inc. - CEO*

We do direct consumer research, and we haven't been able to detect any significant take rate on those. So we'll continue to watch and learn and detect are people on Hulu taking a lot of Showtime or is it pretty much on the margin.

Peter Kafka - *Re/code - Analyst*

But you're not seeing it right now.

Reed Hastings - *Netflix, Inc. - CEO*

We're not seeing it so far.

Peter Kafka - *Re/code - Analyst*

Thanks.

Ben Swinburne - *Morgan Stanley - Analyst*

Let's talk a little bit more about the 2016 launches. Can you guys talk about how the go-to-market strategy is for these markets versus, say, prior international markets? Maybe at a high level operationally when you're thinking about markets like India or parts of Africa, what's different about what you're doing here versus what we've seen before?

Reed Hastings - *Netflix, Inc. - CEO*

It's extremely similar to how we launched Latin America where there's a couple countries that we focused on directly, and there's still some countries that we haven't yet visited four or five years later, but we have a lot of members. So the Internet's a beautiful thing because of its openness. So again, it's very similar to our Latin America launch.

Ben Swinburne - *Morgan Stanley - Analyst*

And anything you're doing on the payment side, since you brought up Latin America, I think that was a challenge initially? I'm sure you've learned a lot. But what can you do proactively in some of these markets to help smooth that for the consumer?

David Wells - *Netflix, Inc. - CFO*

I'll take a that one. So I think we've got a pretty robust payments team. We've invested internally in building that out, getting smart in terms of the payment systems across the world. We're pressing on gift cards and prepaid cards that might open up to the market to those people that don't have access to a credit, debit card. But in rest of world, again it's pretty early days, and I think we'll take the approach that we took in Latin America, which is just to look at our next best opportunities to open up additional pockets of the market. We've done this before, not just in LatAm, but in other places. We'll continue with that play book in the rest of the world.

Our partners are another element of this, right. So Reed mentioned iOS. We'll be looking to draft off of large partners in the group in terms of iOS, Android, and other options. And there's a lot of evolution going on in the payments world. I got misquoted at Citi by saying that we're interested in Bitcoin. But what I said was it would be nice to have in 5 to 10 years a borderless currency like Bitcoin. I think those people that are so excited about it are interested in breaking down those barriers and in using the power of the Internet and the Internet age to reduce the friction of payments that are existing today in some of those banking structures. So we'll be drafting off those long term as well. But in the near term, expect us to continue to just knock down the best opportunities in terms of adding local payment methods, credit, debit cards, drafting off partners as well.

Peter Kafka - *Re/code - Analyst*

Are you guys -- you're participating with T-Mobile in their binge-on program. Are you going to work on Verizon on, I think you're calling it Freebie, I think they announced today?

Reed Hastings - *Netflix, Inc. - CEO*

I don't know enough of the details of Freebie. But generally the great thing what T-Mo is doing is making unlimited video consumption a possibility with freedom from worrying about the data caps. And the quid pro quo from the customer's standpoint on binge-on is that they only get DVD quality on their 4- or 5-inch screen. Which when you look at the DVD quality is actually very, very good. But that's a really unique program that T-Mo's done and it's seeing a great reception amongst our users, and we're seeing viewing going up. And I think T-Mo is seeing some real positive benefits from that. So we hope those kind of programs expand.

Peter Kafka - *Re/code - Analyst*

Reed, can you explain why you're comfortable in participating in programs like that and how that differs from stuff you've complained about at Comcast in the past with their data caps?

Reed Hastings - *Netflix, Inc. - CEO*

Well, it's voluntary on the customer. Any customer of T-Mo's can decide to turn it on or turn it off. That would be a big difference. And then they're not charging any of the providers. It's an open program. Many of our competitors, such as Hulu and HBO are in the program also. But it's an open, no charge program where they're really focused on trying to give the customer some optionality of limited to DVD quality and then you get unlimited viewing, which their customers are choosing in droves.

Peter Kafka - *Re/code - Analyst*

So you don't feel it's a network putting its thumb and saying we favor this kind of programming from this kind of studio or this kind of service.

Reed Hastings - *Netflix, Inc. - CEO*

Correct. That's the big difference. That's right.

Peter Kafka - *Re/code - Analyst*

Thanks.

Ben Swinburne - *Morgan Stanley - Analyst*

Reed, why did you go with the \$7.50, \$8 price point in these international markets, particularly emerging markets where that's a relatively expensive price? Do you reserve the right to go down market over time as well?

Reed Hastings - *Netflix, Inc. - CEO*

Well we're starting out definitely appealing to elites. I mentioned that in Russia and Eastern Europe we're still in English. In Vietnam and Cambodia we're in English. So we're serving elites. You can think of them as a shorthand as iPhone owners. So they've paid \$800 for an iPhone. They're comfortable with entertainment in English. And so for them, \$8, \$10 is a sweet spot price. Certainly in future years as we do more and more in trying to expand into the mass market, we can look at additional pricing options, but we feel good about our pricing and the value for these global originals right now.

Ben Swinburne - *Morgan Stanley - Analyst*

And just on these international markets, there's been a lot of press coverage on the VPN situation and proxies. Maybe you could walk us through what you are doing as a Company that's going to change your policy from prior periods. And could you envision a situation where that might impact your net adds because you have millions of customers in an international market that suddenly went from having a fake US account to having no access.

Reed Hastings - *Netflix, Inc. - CEO*

I don't think we'll see any impact. We've always enforced proxy blocking with a black list. Now we've got an expanded and enhanced black list. So I don't think we're going to see any huge change.

Peter Kafka - *Re/code - Analyst*

Just to be clear, so if you don't think there's going to be any huge change with the VPNs and other proxy work arounds, then why go ahead and do it at all? Is this purely to placate content providers?

Reed Hastings - *Netflix, Inc. - CEO*

You can call it placate or you can call it catering to their desires, which they have legitimate desires. If we license content in Canada, it's not fair for us to be or our customers to be getting that if we've only paid for Canada. So we're trying to pay for it all by shifting to global licenses, and we're working with content providers on that. It's perfectly reasonable what the content owners want, and we know there will be some people affected that are using it today which is why we wanted to be open about it. But it's really a continuation of what we've always done now with this enhanced black list and some other techniques.

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

And remember, all of our originals are fully global. They go live in every country at the same time around the world. Increasingly, we are spending most of our licensing dollars on content that's successful in that way, from small things all the way to big things, like the Oscar-nominated movie *The Big Short*. We'll have the pay TV window around the world so people will be able to watch that movie on Netflix wherever they are.

Reed Hastings - *Netflix, Inc. - CEO*

In the past, you've cited piracy as a major competitor. Any concern that the VPN and proxy work-arounds will push some of your users back to piracy?

Operator

If we see that, there's probably so few of them, it's not a big contributor to overall global piracy. Overall global piracy is a big problem. We're working with all the content owners partially to be a great carrot and also to have the other services like HBO and Amazon be great carrots, and so we can work together on this anti-piracy agenda.

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

Yes, and I think geo filter hacking and piracy are maybe distant cousins at best. I think of geo filter hacking as people hacking to pay versus piracy where people are hacking not to pay.

Ben Swinburne - *Morgan Stanley - Analyst*

Curious if you guys could talk about where you're investing on the technology side. I think your long-term letter talked about over \$700 million in tech and development in 2016. There's some comments in the letter about complexity based in coding. What I'd love to hear beyond the general areas you're spending money is what are you doing to reduce the required speed or bit rate that's needed to stream and enjoy Netflix? I'm particularly thinking about the 2016 maybe mobile first markets.

Reed Hastings - *Netflix, Inc. - CEO*

I think the whole industry is working on these advanced versions of H265 to be able to do very high quality encoding with small bit rates. And so YouTube's made great progress on that. We've made great progress. I think again, people have been working on efficient video encoding for 50 years. It's one of the classic computer science problems, so we're seeing good progress there. We're seeing a lot of progress on our algorithms and being able to rank videos for each person, even better being able to promote to the right person, the right content. Hopefully you've seen some of that in your own experience where the suggestions, that is the billboard at the top of the page, are more often very appropriate and something you're just dying to watch.

Ben Swinburne - *Morgan Stanley - Analyst*

What are the minimum speeds you think someone's going to need in a market like India on fixed line or on mobile to actually stream Netflix?

Reed Hastings - *Netflix, Inc. - CEO*

The minimums are around half a megabit, so that's been consistent in the past. It's a fairly low quality picture. It's around 700 or 800 kilobit to be able to do DVD quality.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

Peter Kafka - *Re/code - Analyst*

You guys have said a few times now that the Making of a Murderer surprised you, its success surprised you. Can you talk a bit about why you had more modest expectations for it, and whether that -- the surprise of that success has gone -- had you sort of rethink your modeling?

Reed Hastings - *Netflix, Inc. - CEO*

Well it surprised me because I know so little about these things. When I met with the film makers and heard about the murderer sequence was interesting, but I thought it would be a specialty thing. I would say Ted and his team aren't that surprised. They always believed in this content.

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

It had a -- there was something very special about it from the beginning. When it came to us, it was seven years in the making already. This came to us over three years ago. And recognized then, even before making original docs, that they had something really special on their hands. The surprise has been to see it perform at the level of some of our scripted series. Even our best documentary series have done very, very well but not performed in such mainstream numbers.

Peter Kafka - *Re/code - Analyst*

Given that surprise, you thought all right, we're going to sort of rethink how we evaluate some of our shows. Or you're just sort of, this is a happy success and you're happy to move on with it?

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

It's on the continuum of expanding our genres anyway. So it's only our second documentary series. We started with Chef's Table, which was a very different show. The next documentary series will probably be very different from Making a Murderer as well. In fact, it starts in a couple of weeks, or this week, I'm sorry, Chelsea Handler's Chelsea Does will be our next documentary series.

Reed Hastings - *Netflix, Inc. - CEO*

We should take one more question and then let everyone go.

Peter Kafka - *Re/code - Analyst*

Real quickly. Ted, I guess for Ted. Your competitors report that you're, in many cases, overspending by a significant amount for original programming as well as repeats. Do you think that gap's going to continue, do you think it's going to increase, or do think eventually fall in line with what they're spending?



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

First I'd like to thank them for endorsing our spending [to talent]. But the truth of it is the only reason we can, in John's own words, have shock and awe spending for a series is because we get shock and awe viewing on that series. Like David said earlier, the efficiency of the content spend has been great, meaning that we're spending a lot on great shows and they get a lot of viewing relative to licensed programming or relative to other programming as well. So we've been excited about it as part of -- and I think it's a competitive marketplace. Overspending is relative. I'd say if a show like *The Get Down*, like *The Crown*, which are relatively expensive shows are successful, it's money well spent the way it was for *House of Cards* and *Orange is the New Black*.

Reed Hastings - *Netflix, Inc. - CEO*

Out of respect for one of our long-time questioners and your colleague Rich Greenfield who had a question about Charter, and was it good if Charter acquires TWC for the Internet industry, the OTT, I'll answer proactively that I think it would be a tremendous positive for the OTT industry because Charter has agreed to a multi-year strong net neutrality policy, something no one else has publicly agreed to. And that that would cover not only the Charter footprint but the Time Warner Cable footprint. And that means that we, Hulu, Amazon and others can compete on an open basis. And so we think it would be a huge step forward for US policy in terms of OTT. Thank you all, Peter, thank you, Ben. We'll talk to you again soon.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

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