

Netflix

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- Ben Swinburne: Good morning, everybody. I'm Ben Swinburne, Morgan Stanley's Media Analyst. Please note that important disclosures including my personal holdings disclosures and Morgan Stanley disclosures all appear as a handout available in the registration area and on the Morgan Stanley public website. With that out of the way, I want to welcome to the conference Spence Neumann, the CFO of Netflix, back here in-person. He has been the CFO since January of 2019. Prior to that at Activision and prior to that having several senior positions at Walt Disney. Spence, thanks for being here.
- Spence Neumann: Thanks for having me. It is a little surreal to be in-person again, so I'm excited for it. Literally, the last conference I was at we were saying was this one, just as the world was shutting down a couple of years ago.
- Ben Swinburne: Yeah, it's been an eventful 3 years for you at Netflix. We all like to focus and obsess over your quarterly net adds and the volatility in the short term. But maybe, Spence, you could start by stepping back for us and tell us how you and this management team think about the long-term opportunity for Netflix from here.
- Spence Neumann: Sure. For us, I'd say that is what we're focused on is building an amazingly successful long-term business and being the first in entertainment around the globe. That long-term opportunity is unchanged. In fact, we're as excited as ever. Effectively, the business orient is the internet impacting entertainment around the world. And streaming entertainment is the thing. You can see that more and more time is spent streaming consumption of entertainment. Every household around the world is on a path to having connected TVs streaming entertainment to their home. And we believe over time, we should be in all or most of those homes on the planet. Everything we're seeing in terms of how our business continues to grow into those homes is super encouraging even as the world is obviously competing with us in new ways every day.
- Ben Swinburne: In your 3 years at Netflix, you guys added 28 million, then 37 million, then 18 million, so we've seen a lot more volatility than maybe we were used to from the years before. Is there a way to think about what normal is or does such a thing not exist? How do you guys think about that?
- Spence Neumann: Well, the fact that we haven't been together in-person for 2 years, I'd say we're still kind of searching a little bit for what normal is exactly going to look like post-COVID. And

we're still working our way through that. But in terms of what I would say is I think there's probably an overly focused attention on subscriber numbers. What we focus on is as we say, building a great business. We're focused on growing revenue, growing profits, growing cash flow. And that's about driving not just memberships, but in driving engagement, increasing engagement. And obviously, we increase member value pricing occasionally into that value that we create. For us, it's the combination of those things as opposed to a year-to-year or quarter-to-quarter member number. And we believe with high conviction we'll continue to drive double-digit revenue growth, continuing to increase our profit margin as we talked about, and now, not just that path to cash flow breakeven, but now growing positive free cash flow. So those are kind of our primary metrics and doing it in a healthy way while we continue to aggressively invest into our growth.

Ben Swinburne: You and the team have always talked about making incremental improvements and making a lot of them over time to make this business succeed. As you look out over the next several years, what are the things that you guys need to get right to really drive the algorithm that you just laid out for us?

Spence Neumann: Yeah, it's -- I guess sometimes in an audience like this, it doesn't sound that sexy and exciting, but it's true, for us it's very much focusing on the core and getting better every day and getting better faster. It's that velocity of decision making and improvement across the core of our business which is content, it's product, it's kind of discovery and ease of finding and personalization of the service, and then the marketing and communication of it all so that folks love not just watching titles, but watching titles that their friends and families and others are talking about. Having and driving that conversation too. We believe we can continue to get better all the time.

The reality is, the industry has gotten a lot better in the last few years, so it kind of pushes us to get better faster. Again, there's so much we learn each day around new content categories, new parts of the world. We're very focused on improving creative excellence, much more consistency in being great in every part of the world. As they say on the product side and in the marketing side, again, as we do that, we become an increasingly global business, global and local. We're very focused on doing that well. And we're focused on these newer content categories like video games which are small for us today, but hopefully in a decade, they are going to be a very big and important part of our business.

Ben Swinburne: Maybe one more sort of bigger picture question before we dive into some of the regions. I think the company made the decision to suspend service in Russia this week. I don't know if you want to just update us on that thought process and any way to think about the size of that business or anything else?

Spence Neumann: Sure. Well first, it's -- I'd just lead with it's just a horrible tragedy and our hearts go out to all that are impacted in Ukraine and that part of the world and what they're -- just the real human suffering is the most important part. For us, in terms of the implications for our business, we had to make the decision given it's just a complex operating, business operating dynamic right now between increasing sanctions, challenges with payment issues, overlaying what's already a pretty complex regulatory market. It just for us became also just too difficult to we thought operate relative to the opportunity. And then there's obviously the moral and other overlay. We decided to suspend our operations there. We stopped all production, but we also actually suspended the service.

In terms of the size of business, which again, is not the primary factor per se, but it's -- you should view it as not material for us. It's less than 1% of our revenues and we'll manage through it.

Ben Swinburne: Got it. As you know, the market is debating sort of the runway for net adds for you guys given what we've had in terms of volatility over the last couple of quarters and years. You look at markets like the U.S., the business is clearly maturing, but there are markets across APAC and EMEA where the penetration is still pretty low. Where do you think we should be expecting the most growth to come from over time? And do you think it's realistic that net adds can reaccelerate for the company over the long term?

Spence Neumann: Well again, we're focused on healthy growth across a combination of memberships and pricing. And again, we're most focused on increasing that viewer and member satisfaction and engagement and then driving the business metrics from that, those are kind of outcomes. We're focused on growing everywhere around the world. Recently you've seen our member growth, if you focus on adds, over 90% of it has been coming from outside that UCAN region in at least recent quarters. But at the same time, we had the biggest growth in the UCAN market, about 1.2 million paid net adds in Q4 of '21. It was our strongest growth in 3 years in UCAN. Now, we're going through U.S. price increases, so obviously part of our guidance was to see kind of slowdown in member growth in the near term as we roll out these price increases. And that's to be expected. But we want to push growth everywhere.

We're low penetrated in much of APAC. EMEA is a market that is a multiple of the size of UCAN and we're low penetrated there. LatAm, we're a bit more mature, but again, it's still, for us it's still early days in the scheme of things. And we are small relative to every kind of metric we look at, whether it's the hundreds of billions of dollars to spend directly on Direct-to-Consumer entertainment, whether it's the fact that there's over 700 million paid TV households around the world, nearly a billion broadband households. Again, this is ex-China. Our share of TV time, we talk about this a lot, we're less than 10% share of TV time in our most penetrated market in the U.S. On all those metrics, we feel like we're still early days. I think the last time we were here we were on the low end of that. You had asked me, hey, you're in the kind of low end of the range of what we had talked about in the U.S., of the 60 million to 90 million, and now I guess we're in that middle-ish of the range. But it was a little bit of a guess on the range, right? I don't think there's any kind of hard cap at the high end of the range either and we're going to keep pushing forward.

Ben Swinburne: I was going to ask you about UCAN because yeah, you guys have landed the plane nicely in the middle of your range from when I think we gave that 60 million to 90 million a long time ago. But should we look at the U.S. business as a leading indicator to some extent of what this business could look like from a penetration point of view? And do you think you can keep growing the business from a revenue perspective here?

Spence Neumann: I think it would be great if it's a leading indicator. If we can get to that level of penetration around the world, again, by the time we get there, there's probably a billion connected TVs around the world. And you can see our penetration in the U.S., that you kind of do that math, roughly 60% penetrated today. That pretty quickly gets us to a business that's over a half a billion members. And if we can do that where we keep increasing value and drive a reasonable monthly subscription price, that's a pretty large and healthy revenue model. And we think we can drive pretty big profit against it. I would kind of love if it's that. And again, at the end of the day, we're not done growing in the U.S., so when we get there, we're also going to be a bigger business.

Ben Swinburne: Does the fact that the U.S. might be a more competitive, most competitive market tell us anything about the strength of the business when you look at engagement or other stats that maybe we can't see?

Spence Neumann: Well to me, that just reinforces our conviction in the long-term opportunity. I would say the competitive intensity is as strong or stronger in the U.S. as anywhere in the world. To

be clear, competition has always been part of our business. There's always been -- throughout, from the founding of Netflix, there's been big competitors and at least even in our recent history, we've been competing with traditional entertainment. And they're competing with us in new ways. And then there's new work competitors like the YouTube's and TikTok's and video game companies and everything else around the world. Competition is always part of the business, but there's a lot of competition in the U.S. And I think what we've seen is, even as these competitors are competing in new ways, streaming entertainment continue to grow and our business continues to grow. That gets me back to that point of the conviction of like to me that's a forward indicator of future is bright and we just have to keep our head down and keep executing.

Ben Swinburne: Maybe just one question on seasonality if I can. You guys guided to the first quarter and obviously the market reacted to that guidance. But you've been shifting a bit your free trial strategy over the years. Maybe just help us think about why the historical Q1 seasonality might not be the best way to think about 2022.

Spence Neumann: I think there's probably a little bit of that build up, but that was over a course of 3 to 4 years that we were kind of getting out of the free trial business. It wasn't like a big impact in any single quarter. But from where we were, say 2017/2018 in terms of the Q4/Q1 seasonality to where we are 2021/2022, we no longer have those free trials in December that are converting to paid members in January. That does have some impact on seasonality. We also talked about the fact in the Q1 guide that some of our content is more backend weighted. We've got a big film in the Adam Project and our most watched season of TV ever, other than Squid Game, with Bridgerton Season 2 that's happening also late in the quarter. So that factored in a little bit to our guidance. Then frankly, we have a price increase in our biggest market in the world that's rolling through in Q1, so that also has impact on at least our Q1 seasonality this year.

Ben Swinburne: Should we be thinking about anything around the decision to have Stranger Things seasons broken into 2? I think the first half is in Q2, second half in Q3. Is that big enough to sort of move the quarters around?

Spence Neumann: I don't know. I don't know about that. I think it's in general I kind of look at it as what we're trying to do is improve getting back to what we're focused on. On activities between content and product and marketing. On the content side, we're trying to improve our content offering to our members a little bit every day, every year. We tend to talk about, hey, is last year's slate better than this year or is this year's slate better than last year's slate? Yeah. But you should expect that. Is every quarter better than the prior quarter? We hope so. We want to get better all the time. That's one of the things we learn from. And there are certain returning seasons of content where we think that can potentially improve the member experience and give kind of two batches of the content. And we're experimenting all the time and learning and we think that will be something that our members enjoy. But it's not to try to necessarily smooth quarters or anything like that. We're trying to actually have every week and every month and every quarter be great.

Ben Swinburne: Got it. Let's shift to pricing. You mentioned the price increase in the U.S. Including I think the basic tier, which historically you guys have been pretty careful around. Can you talk a little bit about the signals you guys look for and that ultimately led you to the decision to take the pricing that you've taken in the U.S. market this year?

Spence Neumann: Sure. It all starts with we lead with member value. Are we providing more member satisfaction, more member value? Are they enjoying the service? And we look at that in terms of -- there's a number of ways we look at it, but most of what we talk about a lot is purely through engagement and acquisition and retention of those trends when we believe they are kind of trending at a level where we've kind of earned the right to charge a little

bit more. Because again, when we charge a little bit more, it's about increasing that revenue to then reinvest in the service. This is we're trying to drive that positive flywheel of growing revenue, growing profit, reinvesting back into even better content, better product, better discovery and personalization and conversation. That's the flywheel we're driving and those are the metrics we're looking at. As we said on the last call, the business is healthy. In Q4 when we talked about it, engagement up over the prior year and pre-COVID. Retention, or churn levels, lower than prior year and pre-COVID. That was everywhere around the world, so those are the kind of metrics we're looking at.

Ben Swinburne: Is the pricing philosophy or thought process pretty similar around the world when you think about your decision to take rate? Or do you look at different factors including maybe competition differently or where you are in the adoption curve?

Spence Neumann: Well, it's generally the same factors. I mean those are the core factors. At the same time, we don't ignore competition. That would be silly. But at the end of the day, we are pricing for what we believe is the value we provide and what we're rating to and the business we're trying to build. I can't speak to the others. I know it is in your last report on us or I think one of the recent reports you did, that kind of profitability analysis. We're building a profitable business. Last time we were here, I think we were at 13% OI margins and a little over \$2 billion, \$2.5 billion of operating profit. Now we're last year 21% margins over \$6 billion of operating profit. We were up over \$3 billion negative free cash flow last time we were here, breakeven last year, we'll be free cash flow positive this year, so we're looking to build this amazingly successful business. Those other services are going low price, but they're also losing a lot of money. And I don't know what, I can't speak for how they're going to build their business, but we're focused on ours. We lead with value. But we have to look at things specific to the market. You see some countries where we dropped prices in India, we think we were overpriced relative to the market there. Not necessarily relative to competition, but relative to the kind of dynamics in that market with disposable income, discretionary income and income levels.

Ben Swinburne: Makes sense. I have to ask you about advertising. Otherwise, I won't be able to leave this room alive. We had Disney here yesterday. They've obviously introduced the Disney+ ad-supported tier as a way generally to lower the entry points. We're seeing this with lots of services around the world. Any change to how you guys are thinking about advertising or not thinking about advertising as an option for Netflix?

Spence Neumann: I'd love to get like a show of hands of people that like that decision by Disney, but I don't think I'll get it. For us, it's not like we have religion against advertising, to be clear. As I said, what we're focused on is building, optimizing for long-term revenue, big profit goals, and we want to do it in a way that is a great experience for our members. We lean into consumer experience, consumer choice. And what's great for our creators and storytellers. If at some point we determine something, we have the right to kind of play or win in the space and it meets those dimensions, then great. But that's not something that's in our plans right now. We think we have a great model in the subscription business. It scales globally really well. Again, we were about a \$20 billion revenue business 2 years ago when we were here, \$30 billion revenue now. You kind of see how that's pretty -- the growth is healthy across every region of the world. We have a really nice, scalable subscription model. Again, never say never, but it's not in our plans. But other folks are learning from it, so it's hard for us to kind of ignore that others are doing it, but for now, it doesn't make sense for us.

Ben Swinburne: Sure. Okay, let's shift gears to content. Content strategy, content spending and efficiency and product. I feel like for many years it was sort of how much can Netflix spend and how quickly? But now we're at a point where it feels like the spending levels are moderating in terms of growth. Talk a little bit about whether your approach to assessing content efficiency and return on content is changing or shifting at all or how you guys

think about your appetite to continue to grow the content budget over time from here.

Spence Neumann:

Yeah. Well, I think we still have a long way to grow. But again, we have to grow our business in all those metrics you talked about before. We've got to increasingly grow global and get to hopefully a multiple of our current size on a revenue dimension, so our appetite for we want to be that first in entertainment around the world, that's a really big ambition with a much larger content budget than what we're spending today in success. But at the same time, how we think about content efficiency is pretty unchanged. Look at every -- we're managing our business based on what we believe our revenue growth is as we've talked about before. We manage to profit and continuing to grow those profit margins while strategically investing into those highest impact next content dollars. We're trying to get smarter every day about both the absolute impact around engagement levels, acquisition and retention levels of the content that we are putting on the service, both on an absolute basis and relative to something else we can put on the service. We're getting, we hope to get smarter every day on that.

We've been in the business for a longer period of time in some areas of content. English language scripted television, we've been doing originals for about 10 years now. You can imagine that we are further along on that maturity curve of what do we believe are kind of the needs around the world for English language scripted TV so we can get better every day, but we don't necessarily need more. Whereas our original slate in Poland or Germany or others, pick your country, even in Brazil where we've been for a long time, we're still early days frankly in terms of the strength of our slate. Some of that is just getting better. Some of that is more original. Now, the cost structure also is a little bit different in some of these markets and they'll continue to grow and increase. But that helps in terms of that portfolio diversification.

I would say we're moderating in some areas. We're growing faster in others. Like this non-English original content is a higher growth area. Film over the last few years has been a higher growth area for us. Animation is still very early for us in terms of animated films. Some pockets are higher growth, and between the portfolio mix of what I would call Hollywood content and other local originals as well as the kind of relative maturity, allows us to manage the growth rate in content.

Ben Swinburne:

Spence, one of the things that's been sort of a hallmark of your business is the ability to create a show, particularly international show that then travels around the world. I think Ted has talked about 80% of what we all watch is sort of the same stuff, at least in certain geographies. Do you see that sustaining or does that evolve? And does that mean you will eventually need more local programming to really hit the kind of long-term penetration rates you're looking for? How do you think about that impact on the returns the business can generate?

Spence Neumann:

Well, I think we're continuing to learn on that. I think it's generally true, but we're getting smarter all the time as we grow. There are certain markets or countries that we've talked about in the past that stray a little bit from that where they're more kind of local content. Whether it's Japan, Korea, India. The U.S. market, sometimes we forget about the U.S. as being a market itself and how local the things are that we watch. We haven't historically watched a lot of non-English language content in the U.S. We're doing more and hopefully we've been a part of increasing that with things like Lupin and Squid Game and La Casa de Papel and Money Heist.

But some markets are more local. Generally, content for us first starts with having local impact and then can travel regionally and globally. And I think over the course of a long horizon, that 80% may come down a little bit where because of the local mixes, we're trying to be a larger and larger share of TV viewing time in a local market. But that's over a very extended period of time. The good news is, content travels from anywhere to

everywhere and we're increasingly seeing that. It's not just Hollywood content. We've got content like Who Killed Sarah in Mexico travelling around the world. I mentioned Lupin in France. Dark Desire or obviously Squid Game and a lot of the stuff that's coming out of Korea right now. I think more and more as we improve both the content that's coming out of these countries as well as the subbing and dubbing that complements the content, I think we'll see more and more content travelling. But content is always a mix of local and global and regional, so I don't want to hold firm to the 80/20, that mix may come down a bit over time in terms of the global, but I think in a healthy way.

Ben Swinburne: Let me ask you also a similar question on licensed versus self-produced. I think at the end of the year, a little over half of your content, at least on the balance sheet, was self-produced. But licensed programming at least in terms of amortization was up pretty significantly in the fourth quarter. Is there sort of a sweet spot between Netflix self-produced and what you get from other studios that you think makes sense for the business long term? Does it matter to the P&L if you think about it over -- because I think most investors would assume if you own it all, it's probably better than licensing from other studios. But maybe not?

Spence Neumann: We're open to where the best ideas are. There are still studios we're happy to be in business with. There are some that obviously it's more difficult to be in business with. There were some I think specifics on one or two deals in timing of some I think renegotiations or stuff that may have hit in Q4 of last year. But generally, we're continuing to -- branded originals are our future. And then whether they're self-produced or partner managed or licensed from another studio, we're not precious about that. I think you should assume likely that our brand in self-produced will continue to increase just given the natural dynamics of the ecosystem right now. But I don't know, that may change 5 years from now.

Ben Swinburne: And then maybe just lastly on content, I wanted to ask you about Netflix Games. It feels like sort of maybe the biggest TAM expander that you guys have embarked on in a while. Tell us a little bit about what you've learned so far, anything about engagement on the service, any surprises, and what we should expect in that strategy as we look out over the next couple of years.

Spence Neumann: Sure. Again, still super early days. This is something that as I mentioned I think earlier, I hope that it's a big part of our business in a decade. It's not going to be a big part of our business in the next 12 months, but we are very pleased with what we're learning so far. The first year was really about just getting the plumbing right. We went from saying we wanted to get in the games business to launching a games business globally inside of 12 months and having it work on Android and iOS around the world, so that's kind of first thing. Now we're kind of learning into what are the games that our members enjoy? We know our members play, a very significant portion of our members, play games around the world, but now they have to play our games. We're started to get a sense as to what that looks like in terms of retention and hours played and trying to get insights into how they value that versus film and TV content, so it's a learning year. We put 14 games I think on the service. There will be kind of we expect a multiple of that by the end of this year as we continue to roll it out and we'll add new kind of services for those game players. But this is, again, it's a multiyear build. We're encouraged with how we've progressed so far. We're encouraged with the team we built out led by Mike Verdu. You see we're growing both internally and through acquisition with some of the things that we've announced recently, starting with Night School Studio last year, then the announcement of NeXT Games that's not closed, but announced. We'll continue to keep building and keep learning, and hopefully as you say, it becomes not just something that our members, our current members enjoy, hopefully it expands some membership and expands those as a TAM expander. Like right now, we're primarily mobile, so if we have a service that's a part of our content category that's primarily mobile experience, that's

also great for kind of just extension of our addressable market.

Ben Swinburne: Sure. Maybe in the few minutes we have left, Spence, I wanted to ask you about margins and cash flow. First, as you think about -- as we think about 300 basis points as being sort of an average annual margin expansion year for Netflix, help us or remind us the impact from currency this year and why that's obviously something we need to be thinking about. And then talk about your confidence in getting back to that 300 basis points on average as you look out over the next few years. Even if revenue growth maybe is moderating.

Spence Neumann: Yeah. Well, as we said on the last call, we lost about \$1 billion of expected revenue from the kind of middle of '21 until the end of '21. When we were kind of thinking about our margin guidance, that's roughly 2 points of margin.

Ben Swinburne: Due to currency?

Spence Neumann: Yeah, due to currency. That's why we guided to 19% to 20% which if you kind of adjust for currency, that gets you to the high end, puts us right back on that cadence of roughly 3 percentage points per year over any 3-year period. Because we had grown by 5 percentage points the 2 years prior between '21 and '20. From our perspective, other than these short-term swings in FX, we've always said, because we don't hedge, if there's big swings in FX, we don't want to unnecessarily swing the business. We want to grow healthy and invest into our growth. And appropriately either right-size our cost structure or adjust pricing over time with some lead time in between. That's what's reflected in the margins.

Obviously, we're not growing as fast as we'd like. As I said, we want to keep pushing to sustain or reaccelerate our revenue growth. But at that double digit revenue growth pace that we're at today, we're still committed to do that margin guidance of roughly 300 basis points over any 3-year period. And it's now that we're kind of catching back up, so you'll see us push towards that. We're not going to give you a specific date as to when we catch up, but you should see that reflected in our performance going forward.

Ben Swinburne: Are you looking at costs any differently as you think about getting to that margin expansion?

Spence Neumann: Well, we've always managed our cost structure for our margins, so that's not a new thing. I think what you'll see is that we are more focused on all areas of the business. When we're growing the kind of some of the hyper growth that we experienced in the last decade of growing all around the world and developing a Netflix studio around the world, etc., we sacrificed some efficiency for speed and growth. We're always very intentional about prioritizing our content dollars as we mentioned, but there's other parts of the business there's a lot of other spend. While content is roughly 50% of our cost structure, there's another big chunk of our cost structure that's probably not as optimized and so it forces us to prioritize a bit more. And that's good. You all know constraints in budgets can be the mother of invention and innovation and so we lean into it in a positive way. You can see that in terms of things like G&A where we've actually de-leveraged as opposed to finding operating leverage in some areas of the business over the last 3 or 4 years. And so that's just for us just being a little more intentional and prioritized in how we spend.

Ben Swinburne: And then lastly, your free cash flow profile is really starting to inflect we expect, and certainly we estimate is free cash flow is going to ramp substantially. How do you think about the right leverage level? You guys haven't talked in terms of debt to EBITDA, but just how does that evolve as the business matures? Do you see a different capital structure approach than you've had in the past emerging?

- Spence Neumann: It's consistent generally with what we've discussed which is what we've said publicly is that we'll maintain \$10 billion to \$15 billion of growth leverage. We paid down \$700 million of debt in February which puts us now at the high-end, inside the high-end of that range. We'll continue to grow our cash flow. We expect to continue to grow our free cash flow and then use it first and foremost to invest strategically in the business. You've seen we'll do M&A not as a strategy, but as an accelerator, a tactical accelerator to our growth. You've seen M&A across some areas of IP, both film, TV and games as well as content developing capabilities, like some things we've announced like Scanline in the VFX space. We'll continue to do that, and then what's left over, we'll keep minimum cash on the balance sheet, a healthy amount right now is 2 months of revenue, and then beyond that, we'll repurchase our shares opportunistically and we've done that as well with the excess cash. We're not like -- there's not like a debt to EBITDA ratio that we're targeting. We keep an eye on debt to enterprise value, but ultimately, we kind of let that take its course. And you've kind of seen that with the rating agencies and so forth, so that is it in a nutshell. We're trying to be prudent to deal with cash for shareholders.
- Ben Swinburne: Great. It's been a great conversation. We covered everything. Anything you wanted to wrap up with as we look to track your progress going forward?
- Spence Neumann: I don't know. Go watch Drive to Survive, Bridgerton, Adam Project. Go turn on your Netflix. I don't know. Hopefully, we'll see you soon in-person. Good to see you all.
- Ben Swinburne: Thank you, Spence.