

Netflix, Inc. NasdaqGS:NFLX

FQ3 2020 Earnings Call Transcripts

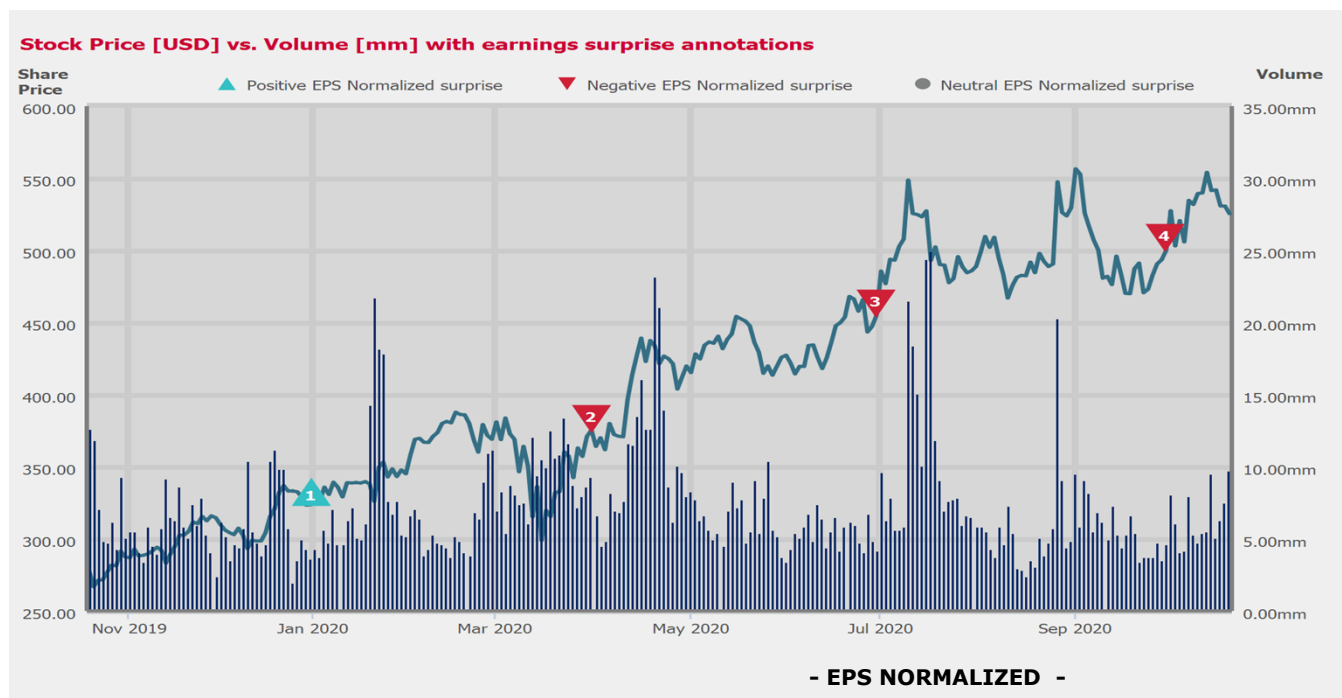
Tuesday, October 20, 2020 10:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2020-			-FQ4 2020-		-FY 2020-	-FY 2021-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	GUIDANCE	CONSENSUS	CONSENSUS
EPS Normalized	2.14	1.74	▼ (18.69 %)	0.94	1.35	6.22	8.88
Revenue (mm)	6380.59	6435.64	▲ 0.86	6588.70	6572.00	24881.95	29324.44

Currency: USD

Consensus as of Oct-19-2020 12:11 PM GMT



	CONSENSUS	ACTUAL	SURPRISE
FQ4 2019	0.52	1.30	▲ 150.00 %
FQ1 2020	1.64	1.57	▼ (4.27 %)
FQ2 2020	1.83	1.59	▼ (13.11 %)
FQ3 2020	2.14	1.74	▼ (18.69 %)

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Call Participants

EXECUTIVES

Gregory K. Peters

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Spencer Adam Neumann

Chief Financial Officer

Theodore A. Sarandos

*Co-CEO, Chief Content Officer &
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Wilmot Reed Hastings

*Co-Founder, Chairman, President
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Presentation

Spencer Wang

Vice President of Finance, Corporate Development & Investor Relations

SP00 good afternoon, and welcome to the Netflix Q3 2020 Earnings Interview. I'm Spencer Wang, VP of IR and Corporate Development. Joining me today are Co-CEO, Reed Hastings; Co-CEO and Chief Content Officer, Ted Sarandos; CFO, Spence Neumann; and COO and Chief Product Officer, Greg Peters. Our interviewer this quarter is Kannan Venkateshwar from Barclays.

As a reminder, we'll be making forward-looking statements, and actual results may vary. With that, let me turn it to you, Kannan, for his first question.

Question and Answer

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Thank you, Spencer, and thanks, everybody, for joining us. Broadly, Spencer, if you could start -- Spence, if we could start with you, given the subscriber numbers, despite you're cautioning us last quarter about growth, all of us can't get -- can't help ourselves from getting enthusiastic every quarter about your subscriber trends. But maybe it would be useful to just contextualize the growth -- the net add number this quarter. Could you help us understand how the gross adds -- gross additions trended from Q2 to Q3? And would you expect gross adds to come down a bit sequentially? And how much of this is an account of chance? So if you could just break down the quarterly sub-numbers a little bit and give us some color, that might be useful.

Spencer Adam Neumann

Chief Financial Officer

Yes, sure, Kannan, thanks. So first, sort of stepping back, if you think about the Q3 subscriber numbers, it was really very much as expected for the quarter. To look at Q3, the biggest impact was really the first half of the year and that giant pull-forward in subscriber additions in the first half of the year with COVID. When we have that much pull-forward, we expected and knew there'd be some level of slowdown, and we tried to project it as best we could. But it's super, super difficult to forecast with perfect precision given all the unknowns and factors. So we actually came pretty close to land within 300,000 members on a member base of roughly 195 million. That's pretty much forecast noise, and there's a number of ins and outs. But the general underlying metrics, as you say, are very healthy.

So retention remains well at very healthy levels, better than we were a year ago. Acquisition remains strong. So you're just seeing some kind of a natural, kind of because of that pull-forward effect, some slowdown. But we don't want to lose sight of the fact that to measure our business, it's really not based on any single quarter of growth fluctuation. It's really about -- it should be measured in multi-quarter and multi-year trends. And so if you look at the past 3 quarters, year-to-date through Q3, we've grown by a little over 28 million members, which is more than we grew all of last year. So super healthy growth, and the underlying both top line and bottom line growth and retention trends in our business are healthy.

Spencer Wang

Vice President of Finance, Corporate Development & Investor Relations

And Kannan, maybe if I could just add, with respect to more context on the subscriber trends. As Spence said, we just really don't overfocus on any 90-day period. And just to give you an example, if the quarter was 48 hours longer, we would have come in slightly above our guidance forecast. So again, as Spence characterized it, I think, really just forecast noise more than anything else.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And it looks like organic ARPU in Lat Am was particularly high. I know you had some price increases earlier in the year as a tax pass-through. I mean did that have any impact on growth because that was one of the regions which seems to have come in a bit lower? And I guess also, if you could contextualize guidance for next year, you did point out that paid net adds will be down next year, first half, at least based on your expectations. So how are you thinking about the impact of pull-forward while modeling next year's numbers? If you could just give us some color around that, it might help us understand it a bit better.

Wilmot Reed Hastings

Co-Founder, Chairman, President & Co-CEO

Greg, maybe you want to take the Lat Am price question, and then I'll take the next year and then pass it over to Spence.

Gregory K. Peters

COO & Chief Product Officer

Yes. Sounds good. And I think, Kannan, it's -- again, it's easy to over-rotate on what we're seeing specifically quarter-to-quarter. And if you look at sort of the 9 months, we see 5 million paid net adds in Lat Am, which is a very healthy growth for us on that period. So I wouldn't overread anything specifically, and it's more, I think, the pull-forward effect. And then over to you, Reed.

Wilmot Reed Hastings

Co-Founder, Chairman, President & Co-CEO

We've been doing high-20s net adds per year for 4 years and this year, on guidance, with 34 million. So we've set all kinds of new records this year. So the pull-forward into next year is relatively modest, in sort of that 5 million or 6 million delta as opposed to the second half of this year, again, where the pull-forward effect from the first half is very strong. So there's probably a little bit of the effect in Q1 from the pull-forward, maybe a little bit less in Q2, but it will wash out. It's not permanent or long term. So I think in terms of modeling it, there's the underlying quality of the service. How many hours do we generate? How much word-of-mouth? And that's improving at some relatively steady rate. And then our growth sort of seesaws around that number depending on the particular conditions going on in that quarter. But year after year, it's fundamentally followed that improvement in the service growth curve. Spence?

Spencer Adam Neumann

Chief Financial Officer

I think you both hit on most of it. I would just emphasize that in the letter, Kannan, we're really talking mostly about the year-over-year comparison for the first half of '21 versus the first half of '20, and that's because of the dynamic that Reed was mentioning. If you look at the first half of this year, again, we grew by 26 million members in the first 2 quarters of 2020. That's more than twice the level of growth we had in 2019. So again, we're just -- we're sort of growing through that big acceleration in our member base. So we shouldn't expect year-over-year first half to be comparable.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it.

Spencer Wang

Vice President of Finance, Corporate Development & Investor Relations

Just try and temper that enthusiasm, Kannan.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

That's fair. So I guess one component which can help us understand this a little bit better, maybe the engagement levels. And obviously, because of the work-from-home environment, there was an engagement lift across the board on streaming services in general. But in some ways, you guys are able to benefit from almost a pure experiment in some ways as different countries reopen at different times, and you're able to see what that does to engagement levels. So as this process plays out around the world, is there any structural lift in engagement you guys have seen in markets that have opened up versus markets that may still not be open? And how much of a tailwind could that be structurally longer term? Or how much of that could become a tough comp next year?

Wilmot Reed Hastings

Co-Founder, Chairman, President & Co-CEO

We do look at some of this, but we try not to get overly focused on the COVID effects because they're very onetime in nature. And by and large now, engagement, churn, all of those metrics are like we would have expected from a year ago. So think of that as a minor background effect. And there was the temporary learning when there's no sports. But it's like, well, it's not really that interesting of finding because it's just

not relevant to the world. Now we're back in a world with partial sports. And it's fine, and we're growing. So again, we compete so broadly. We compete for time against TNF, TikTok and YouTube as well as HBO as well as Fortnite. So really, the limiter for us is what's the quality of our service, how often, how many nights do you say, "Oh my God, I want to go to Netflix and watch the next show."

Kannan Venkateshwar

Barclays Bank PLC, Research Division

And Ted, I guess from -- one of the comments in the release was the goal of shooting 150 productions by year-end.

Theodore A. Sarandos

Co-CEO, Chief Content Officer & Director

Yes.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

So how does that compare to what your initial plans may have been? Because the free cash flow number this quarter is really strong, which tells me that there's probably a lot more content you were initially planning versus what's happening. So if you could just give us some color around the cadence.

Theodore A. Sarandos

Co-CEO, Chief Content Officer & Director

Yes. Like we pointed out, since the COVID shutdowns, we've completed production on over 50 productions, and we expect another 150 before the year is over. So all that ramp up puts us back to nearly fully operational in most parts of the world. Those productions may go a little slower than we had planned. But materially, we are back in business in production in most places of the world, including in North America that have come on slower. So we've got -- so I think we'll be -- we're looking at the '21 slate, everything that we forecast for '21, we expect to hit in '21 with a few minor exceptions and some maybe a little more back-weighted than we had planned for earlier -- last year, but we planned it all coming out.

And I think the thing that we've really been amazed by has been the adaptivity of our production communities to step up to the plate in these new COVID protocols and get the work done in such an incredible way and then so safely. We've had a couple of shutdowns, and I really think that we're in a place right now where we should expect that to happen, that we'll have production shutdown. And the art of it is how quickly and safely can you reopen. And we've been going through that in different parts of the world every day. But right now, I'd say that we're back to near steady state in physical production.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And Greg, from your perspective, when you think about the price increase decision recently, I think there was a price increase in Canada and Australia. Is this based more on some kind of an algorithm around content release slate and subscriber momentum? Or is this based more on the strategic goal of where you want to be with respect to ARPUs over a given time frame? So how should we think about the cadence of price increases going forward given that productions are restarting now?

Gregory K. Peters

COO & Chief Product Officer

Yes. No magic algorithm, but the core model we have is, and what we think really our responsibility and our job is, is to take the money that our members give us every month and invest that as judiciously, as smartly as we can and creating new amazing stories. We've got titles that are coming out across an increasing range of genres, amazing movies like Old Guard and Extraction and more animation like Over the Moon and Willoughbys and Klaus, and so just basically delivering more value is for our members, better product experiences. And if we do that well and we seek to basically every day be better about pretty much every component of how we're investing in that and make that efficiency and that

effectiveness better, we will deliver more value to our members, and we'll occasionally go back and ask those members to pay a little bit more to keep that virtuous cycle of investment and value creation going.

And as we said before, we look at every country independently. So instead of an algorithm, we're just basically assessing, okay, how many new popular titles have we delivered, what are local language originals in that particular country looking like, what's the slate that's coming looking like, what are the fundamental metrics, right, engagement and churn, what do those look like. And then we just -- we do an assessment. And we say do we believe that we're really delivering more value to our members and, if so, do we think it's the right time to go back and ask them to pay a bit more so we can again keep that cycle going. And I think the one other important thing to note here, something, a north star that we hold close to our heart in this whole process, is we think that we are just an incredible entertainment value, and we very much want to remain an incredible value as we continue to improve the service and grow.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

And now that you're in a more normal pricing environment and some of the metrics that you mentioned just now in terms of engagement levels and so on and so on, I mean, when you analyze different markets, is there room for the recent price increases in a couple of markets to expand as we go forward over the next few quarters?

Gregory K. Peters

COO & Chief Product Officer

Yes. I think I won't comment or speculate on any specific changes, but that basic model that we just described, if we continue to do a great job at investing and we feel like there's ample opportunity to deliver more value, and you heard from Ted the sort of the number of original productions that we're doing and increasing even under these conditions that number, and if we do that, then we feel like there is that opportunity to occasionally go back and then ask members where we've delivered that extra value in those countries to pay a little bit more.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And in the U.S., I mean, you've also done away with the free tier recently. And I think U.S. is one of the last markets where you've done this. Is this because most of the new additions in the U.S. are now people who already have been subscribers in the past? I mean could you help us understand the decision to walk away from the free tier in the U.S.?

Gregory K. Peters

COO & Chief Product Officer

Yes. Like most things that we do, we're constantly assessing and testing and trying to understand what's working, what's working best, how do we improve. And we do that with our marketing and promotion tactics as well, one of the most effective ways to introduce Netflix to people in different countries around the world. And based on that testing and that actual performance, we've shifted those tactics, as you noted, in many, many countries, including the United States. But we also seek to innovate and come up with what are new ways that we can use to introduce Netflix to new members. And so an idea that we're excited about, and we'll see how it goes, but we think that giving everyone in a country access to Netflix for free for a weekend could be a great way to expose a bunch of new people to the amazing stories that we have, the service, how the service works, really create an event and hopefully get a bunch of those folks to sign up. So we're going to try that in India, and we'll see how that goes. And that's just an example of the kind of innovation that we seek to do in this space.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

That's interesting. So I guess that dovetails into a question I have for Ted, which is more around some of the shows that have been licensed or reverse-licensed, if I can use that term, to cable networks as

well as services like Pluto. And obviously, some of these are not your productions, they're owned by somebody else. But is this a bigger opportunity in general with your originals? And the opportunity to stream Netflix for free either as an event or even as a starting tier, as a mainstream product with your licensed content or your legacy content, which may not be as productive anymore with your existing base, is that something that you're willing to explore in a bigger way?

Theodore A. Sarandos

Co-CEO, Chief Content Officer & Director

Yes. I think we're always looking at new different ways for people to get a sample of the content that everyone's talking about, including trying the service out here and there in different ways. I think licensing our content to other people are -- mostly, I think it's helpful for us to keep our original content on Netflix so people understand the value proposition of Netflix. And we have seen our ability to grow a show that was on another network or a smaller outlet pretty meaningfully, but we've not necessarily seen it the other way around when we've experimented in the past with things like actually with Narcos, when we licensed it to Univision in the past, trying to get people to try to sample the show. We don't own that show, Gaumont does, and the deal that they did was something that -- it'll be interesting to see how -- if it lifts the awareness and interest in Narcos, but it's on a relatively small platform relative to Netflix.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And Reed, from your perspective, there have been -- and I guess, Ted, this is for you as well, but there have been a bunch of management changes recently or over the course of last year, starting with Spence, of course. But there've been changes in marketing -- in the marketing leadership and recently on the content side. And voluntary churn, like you pointed out in your book, I think, voluntary churn at Netflix is really low compared to other organizations. So it feels a lot more deliberate in some of these choices that you're making. So could you help us think through what drove these changes? And are these changes more or less done? And organizationally, where are you right now?

Theodore A. Sarandos

Co-CEO, Chief Content Officer & Director

Well, I can talk to you on one of the major changes that we're really excited about, which is I was -- restructured the content team to be more like our film team and more like our animation team and have one global organization. And to run that, I tapped Bela Bajaria who's been with Netflix for a long time, has come in to start our unscripted group, brought in that team from scratch, and they developed this incredible unscripted slate that we have today, moved over to our local language original team, hugely successful. These are 2 areas of the business that are going to grow 3 or 4x over the next 3 to 5 years. So I thought that she was really well suited to take on that organization.

And she -- and in that English language scripted series business, she joined us from Paramount -- from Universal Television where she was the President and had brought us such shows as Unbreakable Kimmy Schmidt and Master of None. And she also orchestrated the -- to bring You on as a Netflix Original and delivered that first great season of Witcher. So I think Bela is going to be phenomenal running that group. And then there's some changes after that, that whenever you put new change at the top, there's some downstream effects as well.

Wilmot Reed Hastings

Co-Founder, Chairman, President & Co-CEO

I think, Kannan, to your broader question, yes, we're always trying to broaden our talent as we take on bigger challenges. So Greg took on head of product about 3 or 4 years ago; Spence, CFO, about 1.5 years ago; Spencer, IR, about 8 years ago. And they all have grown into those roles. But it's a normal model. No one gets to keep the job for free. You got to earn it every year, which is intensely challenging, and we all love that part of it.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And Spence, my next question may make you squirm a little bit. But Reed, last month, in an interview, I think you said something that, at least I hadn't realized, was essentially a Keeper Test move which was the change in CFO last year. And you mentioned it was deliberate and you needed an entertainment company CFO, and therefore, it was time for a change. So to make a change at that level, to deliberately seek a CFO more attuned to what an entertainment company looks like, it seems like a face shift in how you think about the company, about what Netflix today is versus maybe a decade ago. Is that the right way to think about -- or interpret that comment?

Wilmot Reed Hastings

Co-Founder, Chairman, President & Co-CEO

Yes, I think so broadly. I mean we've been moving towards being an entertainment company for many years. And our former CFO, David Wells, an extraordinary human being and a great CFO, and we offered him a chance to move to L.A. and to really lean into that, and he demurred. And he had done so well as a generalist and tech CFO. He wanted to stay with that. And then we felt super fortunate to recruit Spence Neumann who's been like the dream CFO for Netflix. So it might -- could not be better and so super fortunate.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

That's great. And one of the things, I guess, which has surprised me over the course of the last year is the way most of you have spoken about the impact of content on growth, right? And I think this started around Q2 of last year when there was a big miss, and one of the reasons attributed was the content slate at that point. And now we increasingly talk about comps versus last year when you have a big show like Stranger Things. I would have expected the opposite, to be honest. I mean when you have 200 million subs and when the content slate is so big, content -- singular pieces of content should, in theory, become smaller parts of overall consumption, but seems like it's starting to have a bigger impact. Could you help us think through the content skew in consumption? Is that skew more or less over time? And why is that seemingly having a bigger effect? Or is that just me reading too much into some of these comments?

Wilmot Reed Hastings

Co-Founder, Chairman, President & Co-CEO

It's just a little bit of math, Kannan. And so let's say there's a 5% variation because of content on the margin. And 5% used to be a small part of the growth, so then you really didn't notice it that much. And now 5% might be half of the annual subscriber growth, so you noticed it much more. I don't think it's particularly changed. We are a little more sensitive to it. Again, on the growth, remember that if you have a theatrical business, you have up-year, down-year, the variation is in revenue. In our case, the revenue is going up and up and up, but there's a little bit of wobble in that direction. So I think that's what's -- I mean I don't think it's particularly more sensitive. Like you say, we've got lots of hits, and we have The Crown coming up and kind of big returning series, we have Witcher coming up. So there's a lot of big things coming.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And so it's fair to say, I guess, that when you have a show like The Crown or The Witcher or Stranger Things coming on, every year that goes by, the impact of these shows to overall growth on a normalized basis, keeps coming down. But on an absolute basis, it still has an impact. So is that basically the way to read some of these comments?

Wilmot Reed Hastings

Co-Founder, Chairman, President & Co-CEO

Correct. And because the growth rate has been steady, let's call that 30 million a year, round numbers, the percentage on the base is a bigger fraction of that, so you feel it more. So from a practical standpoint as investors, it's a bigger deal. But remember, it's variations in the growth. And the stunning thing is just big picture, outside of COVID, how steady the growth has been year after year after year, back to these

underlying growth models like diffusion of word-of-mouth, Netflix is a better way to go, and then you capture a little more of that when you have a big show and then you have a shadow under that. So think of it as like a big general diffused model, and then you're just seeing a little surface variations that are happening.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And then in terms of the total number of titles, if I have this right, I think the total number of shows that you have on Netflix today is actually significantly lower than what you had when Netflix started streaming more than a decade ago. First of all, I don't know if that's true. I mean if that is true, then is that deliberate? And how do you determine optimum volume? I guess that's the broader question? How much is too much?

Theodore A. Sarandos

Co-CEO, Chief Content Officer & Director

It is true that it's less because in the earlier days of Netflix, remember, we were trying to figure out what we could stream. And we were licensing in bulk and volume, just a lot of content just to see what worked well versus today where we're much more deliberate about the programming. And we really don't focus that much on the title count. Remember, in the early days of streaming, everyone was -- that was -- the marketing war was how many titles you had. But it turns out that doesn't -- it isn't that meaningful if people don't watch them. So what we've really done is concentrated on the titles that have a lot of impact and can aggregate big audiences and move the business forward and add a lot of value for our members. So we really don't focus on the title count. But you are correct, it's significantly lower than it was when we first started streaming, I'd say, 10 years ago where we used to license an entire library of 800 films from somebody and nobody watched any of them. So it's really not a chase for how many titles, but are these the titles you can't live without.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And I guess, Ted, in one of your recent interviews, you indicated that the goal was to scale up to 6 animated feature films a year. And if I'm not wrong, I think you guys are already doing more movies than the top 5 Hollywood studios put together. So when you think about that kind of scale to build content, is quality a trade-off? I mean how do you maintain that balance between building scale on originals versus quality?

Theodore A. Sarandos

Co-CEO, Chief Content Officer & Director

I'll tell you the thing that we've been working on and trying and doing, if you think about how many more original series we produce today than we used to and how many more we're producing relative to everybody else in the industry and around the world and yet, last year, we had 160 Emmy nominations for our television slate, which is the most honored single season of television in the history of the Emmys. That kind of quality attracts more quality. We're doing that today in how we're building up our animation slate. Last year, we released 2 feature films that were nominated for the Academy Award for best animated feature. Both were pretty popular. Klaus was extremely popular, also won the BAFTA award for best animated feature and 6 Annie Awards, which is a celebration by -- from animators of the best work of the year. And that kind of quality keeps attracting more quality.

So we're deep into our '21, '22, '23 animation slate, working with some of the greatest animators in the world, like Chris Nee and Jorge Gutierrez and Nora Twomey, Chris Williams, Alex Woo, all making the projects that they've been dying to make and making them at Netflix. So we're really excited about it. We think that there's no quality trade-off for quantity. And we think that there's a big appetite for film and a big appetite for animated features at Netflix.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And Greg, if I could switch to a slightly different topic. Recently, there have been headlines around the Google Play Store changes in payment terms, especially for in-app purchases. And obviously, this has been a broader discussion with the dispute between HBO, Peacock, Roku and so on. And we touched on it last quarter a little bit. But if you could help us think about not just the near-term impact of the Google move but also bigger and longer-term issues, I mean how do you plan to deal with aggregators? Is there -- is this becoming a bigger deal than it used to be in the past? And so how would you expect to cope with some of these issues going forward on the pricing front?

Gregory K. Peters

COO & Chief Product Officer

Sure. On the Google Play Store specifically, I think you -- I won't comment on the details of any given partnership, but you can look at our position on iOS where, for quite some time, we've been signing up new members on those devices through the mobile browser using our own payment method. We're not dependent on the App Store for discovery. We're not dependent on the App Store for payment. And we've seen steady, solid growth through that channel. So it's been quite effective regardless. I think that's relevant to note when you think about sort of that dynamic. And then to your point, look, I mean, the world is shifting to streaming into Internet TV, and a bunch of new players are coming in. And so I think the dynamics between those relationships, aggregators and device manufacturers and new streaming services, are being worked out.

But we have been in this business for quite some time, and we've invested in relationships with device manufacturers and platform owners for over a decade. And we've really, really focused on making this a positive experience for them, adding more value to their devices because we're there, making it great for us because we get to use those devices to access new consumers around the world and making it great for the people to purchase those devices because they have these incredible experiences with Netflix and the amazing stories that we tell on those devices. And I just don't -- I don't see any significant change in that sort of positive model. We're going to keep investing, and we have whole teams who basically just do nothing but make it great for our device manufacturers to take our technology on and deliver then great experiences to the consumers who buy those devices.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And Greg, I think last quarter, one of the things you had mentioned was the promotional impact of Netflix itself, like, instead of spending on marketing, you could use Netflix itself and the scale of Netflix as a promotional tool going forward. And I think the folklore, and I don't know where this data came from but it's quoted all over the place, is that 75% of your viewing comes from the first page in terms of your recommendations. I don't know if that's still -- if that number is true at all. But it would be great to get some context around how much of content consumption is actually driven by the recommendations that you put up on the screen versus other sources potentially.

Gregory K. Peters

COO & Chief Product Officer

Yes. A very significant majority is driven by the recommendations that we present. And so I think, to your point, the model that we're working with is that millions of people, millions of our members, show up every day to our applications, our interfaces, looking for something great to watch. And so we really have a tremendous opportunity to fulfill that interest and fulfill that demand. If we do a good job at -- through the recommendations, the titles that we select, how we present those titles in a compelling way, of giving each of those members something satisfying in that moment, then they're happy, they're fulfilled.

And that means the next night, when they're thinking about like what do they want to watch or how do they want to be entertained, and you think about the wealth of options that are available to them that sort of Reed went through, that if we've done a good job the previous night, they're going to turn to us again, and we have an opportunity to sort of fulfill again and to sort of keep that positive feedback process. And so we're really deeply invested in that. We have hundreds of people who wake up every day and sort

of devote their entire professional existence to making every aspect of that work better and better and better. We know we're going to be doing that for decades to come, which is super exciting.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Yes. And I guess this also means that as you evolve this process, some of the KPIs internally that you measure performance on also changes over time. And I think, Reed, in your book, you've mentioned an interaction with your Chief Marketing Officer at the point, I think this was in 2016, where she pushed back against customer sign-ups being used for measuring performance of the marketing team instead of retention. And I think ultimately, you guys went with retention. But over time, a number of these KPIs seem to have shifted internally. So could you help us understand how you measure performance? To the extent you're comfortable doing this, how do you measure performance for the content team? Has this focus shifted from origination to retention? Is that a bigger part of how you think about the business broadly or even features such as engagement, for example?

Wilmot Reed Hastings

Co-Founder, Chairman, President & Co-CEO

For at least the last 5 years, we've realized there are no gimmicks. There are no techniques. It's fundamentally about member satisfaction. And if we please you on a Wednesday night, you're more likely to come back on a Thursday night. So again, you can juice a given title if you wanted to, but you're going to pay for it downstream because not everybody got the best title for them. Or you can juice sign-ups or you can juice any particular metric, but it's all just very distorting. And the fundamental for us is member joy, which we look at how much of your viewing time do you choose to spend with Netflix, how many repeat days, what's retention, all of those aspects. And so we're really focused on the fundamentals of that pleasing and what does seem to please our members, and that's how we grow.

Now we augment that with a lot of conversation because we want our titles to be the most talked about titles in every nation because when you watch Enola Holmes and then, like, you see this -- all these activations that we're doing in London with Enola Holmes statues, it locks in and it's like something fun to really talk about, and it's a great topspin on a fundamentally great piece of content. But that interplay that we use across product, content, it's how we do budgeting decisions, how much do we want to spend in each area, it's driven fundamentally by our guess on member satisfaction in each country and how that works.

And Ted, you've thought a lot about this, so let me turn it over to you.

Theodore A. Sarandos

Co-CEO, Chief Content Officer & Director

Yes, I would agree with you. I mean I think one of the things, going back to what Greg said, it's not unusual for a Hollywood studio to spend 50%, 70%, sometimes 100% of the production budget of a film and marketing to get people out to the box office and opening weekend. We do a fraction of that for our -- in terms of paid advertising for our films. And yet we're getting 70 million, 80 million, 100 million folks turning out to watch those movies in its first 28 days, which is like a \$1 billion box office in terms of cultural impact. So when I look at that, and I think that's the enormous promise of the scale and the recommendation engine, the value of the recommendation on Netflix, to make sure you have a great experience and come back looking for the next one.

And primarily, what we're trying to do in our marketing is get people to talk about those things that they're watching and got to get it into the conversation, get it into the zeitgeist that the watching -- the heavy lifting of the watching is being handled by the recommendation and the presentations on Netflix on that first page you talked about earlier. So -- but what we can do is do really creative marketing, really clever events to activate the fan base and to excite the fan base so that when they're talking about a movie, they're talking about a Netflix movie. And when they're talking about a TV show, they're talking about a Netflix TV show. And that's the thing that we're building toward every day.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And I guess in terms of the content itself, Ted, I mean there's probably a lot of opportunity right now. Given the shutdown in theatrical and the slow reopenings there, there's a lot of content in the pipeline, and the window between movie releases next year is significantly smaller than what it was last year already. So if this gets pushed out another quarter, potentially a lot of movies will probably come to you or Amazon or somebody else. So how are you thinking about that pipeline of content as you go into next year? Is that a big opportunity in terms of content acquisition?

Theodore A. Sarandos

Co-CEO, Chief Content Officer & Director

It's pretty short-term opportunistic. That said, there will be some things. Reed mentioned Enola Holmes is one that we bought -- that would have gone theatrical. It turned out to be a nice hit for us. And then we just released The Trial of the Chicago 7 that we picked up from Paramount under similar conditions, which is great. You have to remember, we have a very healthy pipeline of films coming out already in the rest of this year and next, in '22. And -- but we're looking at all of them, and we'll be at the table. But I would look at it as a fairly short-term opportunity while the studios refigure how they're going to release films. In different parts of the world, this past week, in Japan, theaters reopened to 100% -- with 100% capacity. So I think they're looking at the impact of that around the world and how long they're going to have to make new plans and what are they going to do with their '21 and '22 films if they are sitting on their '20 films. So I do think there'll be some short-term opportunities. We'll pick up some, not all, but we'll certainly be in the mix.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. And in terms of some of these newer opportunities, is this also potentially a way for new business models to open up? I mean there's also been a lot of experimentation by the likes of Disney on the PVID side as well as releasing some of their movies directly to consumers on streaming. But -- and like music, we've seen a lot more of this as well. So do some of these opportunities during COVID also open up potentially new avenues for monetization from your perspective as well?

Theodore A. Sarandos

Co-CEO, Chief Content Officer & Director

Look, I think what's been happening with -- consumers' desire to see films at home has been growing, and we've been satisfying it. And I think there was kind of a natural migration that was already happening, that this may have accelerated in some dimensions. But I think at some point, theaters are going to reopen and people are going to go back out to the theaters. I hope so. Like I said, I'm a fan of doing it myself. And I do think people kind of crave the social interaction to go out and see a film with an audience sometimes. I don't doubt that that's going to come back in some capacity. So I wouldn't look at this being that radical a change. I just think it would be -- it's probably an accelerated change that was -- may have already been in the works.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it.

Spencer Wang

Vice President of Finance, Corporate Development & Investor Relations

We have time for one more question, Kannan.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. So Spence, I guess, the mandatory free cash flow question that we have to get to, now that you have potentially \$2 billion in free cash flow over the course of this year, and obviously, I mean there's a

lot of lumpiness in this just given the cadence of content production, but broadly, when you think about maybe a 3-year, 4-year kind of horizon, you are getting to a point where cash flow use is going to be more than just about content. How are you thinking about your capital structure? As you get closer to this breakeven point, what's the use of cash once you turn free cash flow positive?

Spencer Adam Neumann

Chief Financial Officer

Yes. Sure. Thanks, Kannan. The free cash flow story is an exciting one for us right now. As you can see, the free cash flow profile is improving. Obviously, this year was a bit short term with not just improving profitability but also the reduction in content spend. But as we look forward to 2021 already, we guided to free cash flow -- negative free cash flow, negative \$1 billion to breakeven, so vastly improved from our peak negative free cash flow in 2019. We're not yet sustainably free cash flow positive or ready to call that, but we're rapidly closing in. And I'd say given the more than \$8 billion of cash on the balance sheet, we are at a point where at least we can probably pretty safely say that we can self-finance our growth without needing to access the capital markets.

But we're still, obviously, based on our guidance, probably a couple of years away at least from sustainably being free cash flow positive. So it's probably a little too early to call our long-term capital allocation approach other than to say that you can trust that we're going to be -- we're going to remain disciplined, and we're going to take an approach that we believe will maximize the long-term value for our shareholders. So more to come on that front.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Got it. Thank you so much. Thanks all for the time today. And hopefully, we'll chat again next quarter.

Wilmot Reed Hastings

Co-Founder, Chairman, President & Co-CEO

The big pictures that you referred to there, next time we get together, we should be over 200 million members, completing a year of 34 million, all-time record free cash flow positive, got an amazing content technology and marketing engine humming, so really looking forward to next year.

Kannan Venkateshwar

Barclays Bank PLC, Research Division

Thank you so much, Reed.

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