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NFLX - Q3 2016 Netflix Inc Earnings Call

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CORPORATE PARTICIPANTS

David Wells *Netflix, Inc. - CFO*

Reed Hastings *Netflix, Inc. - CEO*

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

CONFERENCE CALL PARTICIPANTS

Ben Swinburne *Morgan Stanley - Analyst*

Scott Devitt *Stifel Nicolaus - Analyst*

PRESENTATION

QUESTIONS AND ANSWERS

David Wells - *Netflix, Inc. - CFO*

Welcome to the Netflix Q3 2016 earnings call. I'm David Wells, CFO, and joining me on the Company side today is Reed Hastings, our CEO; and Ted Sarandos, our Chief Content Officer. Interviewing us will be Scott Devitt from Stifel, sorry, Scott Devitt from Stifel and Ben Swinburne from Morgan Stanley. Ben in his fourth interview before he passes the baton.

Before we get started, we will be making forward-looking statements. Actual results may vary. Ben, I think you have the first question. Over to you.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you very much. Reed, maybe we could start by focusing in on the international strength this quarter. Typically, I think you and your colleagues have downplayed the impact of originals, but in the letter you really called out the benefit of -- on acquisitions from your original content. I think you noted Stranger Things and Narcos.

Can you just shed some light on that? Why do you think those are having such an impact on gross adds today? And any particular color on markets that might surprise us about where those originals were really driving the business?

Reed Hastings - *Netflix, Inc. - CEO*

Sure. If you look over the whole year, we've generated 12 million net adds this year; last year we generated 12 million net adds, so there's been remarkable steadiness over -- measured over the three-quarter period. But if you look at any single quarter, we're high, we're low, and I think what's happening is that when we have some big originals, it definitely grows the business. But some of that is a pull forward from the natural underlying growth rate.

So if, in hindsight, if we look back in Q1, we over interpreted that, in Q2, then we overinterpreted a low. But it's actually quite steady over the midterm, which is basically a fundamental organic growth of this on-demand internet television. So think of it as it can affect the quarter a lot. It affects the year only a little, that is as the total programming is better.

Ben Swinburne - *Morgan Stanley - Analyst*

And you mentioned that the churn, I think, globally was roughly in line with your expectations as you move through the quarter. If we just think about the longer term, particularly, next year, there's probably logic to say that your net adds could improve next year overall, given you're not



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going to have this elevated churn. How do you think about the impact of churn as we move into 2017, and do you have any expectations for price increases at this point?

Reed Hastings - *Netflix, Inc. - CEO*

Well, we definitely want to increase net adds. But when I look over the last three or four years at how steady they've been, how hard they've been to move up, and similarly, that they've been very steady, we're only probably going to be able to make a little progress on increasing year-over-year net adds next year. So we're fundamentally in this growth cycle that's to do with the Internet, smart TV, people getting used to on demand, all of those aspects. So we're continuing to make progress.

I wouldn't hook it to the micro-variables about this churn or that churn or this show. It's much more of a deep force that's changing the market as more and more people are getting used to Internet television.

David Wells - *Netflix, Inc. - CFO*

Ben, if I might add, it's probably useful to talk about US and international a little bit differently. The US is a much older market in terms of our ability to improve that product and have more time. We've settled into a rate of churn that's lower than some of our international markets. They get there over time, but I would say just in terms of that conversation, we think that there's room left to improve the US as that ungrandfathering effect fades out over time. But outside the US, we'll definitely have more opportunity to improve churn over time as we improve those products outside the US.

Ben Swinburne - *Morgan Stanley - Analyst*

And not to do my Lester Holt impression, but Reed, to make you answer the question, do you have any expectation for price increases at this point that you could talk about?

Reed Hastings - *Netflix, Inc. - CEO*

No, we have no plans on price increases outside of an inflation adjustments that we do in Brazil on an annual, which is the law there.

Ben Swinburne - *Morgan Stanley - Analyst*

Okay, thank you.

Scott Devitt - *Stifel Nicolaus - Analyst*

Then to just follow-up on another part of Ben's question which was international overperformance, which markets actually overperformed to the extent that you can identify specific markets or even that it was some of the older markets that were overperforming relative to new or otherwise?

Reed Hastings - *Netflix, Inc. - CEO*

For competitive reasons, we're really not going to break out per-country markets and results. I would say we're having broad success around international. We're continuing to make those investments. We've got a lot of room to go to improve the service. We mentioned in the letter that we've only just now localized Poland and Turkey. That brings us up to 22 languages; YouTube is at 50, so we've got a long way to go in that localization effort.

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Ted Sarandos - Netflix, Inc. - Chief Content Officer

I'd just add real quick that one of the really encouraging points was our big series that we had going on in the quarter, Luke Cage, Stranger Things, The Get Down, Narcos, of course, the great thing is they performed proportionately well globally. So the content is traveling in a way that we'd hoped.

David Wells - Netflix, Inc. - CFO

Scott and Ben, I would say it wasn't any one market. Right? I think it's okay to talk about the fact it was a very broad-based performance across multiple international markets, so very broad.

Scott Devitt - Stifel Nicolaus - Analyst

And then secondly, the quarterly volatility in the stock and the performance relative to your visibility three months out domestically, internationally, it certainly does seem to accelerate the [grain] process for folks like me that watch the business on a quarterly basis. And was just wondering to the extent that, Reed, you just mentioned that the visibility into the business and the linearity and progression of subscriber growth on an annual basis seems to be more predictable. Is there any thought in terms of providing annual guidance as it relates to subscriber growth instead of quarterly guidance?

Reed Hastings - Netflix, Inc. - CEO

Not particularly, I think we can all see that it's time for me to apologize for the volatility again. This time it's in a good direction. But I think more and more investors are able to look at the multi-year picture and they see the patterns emerging, and so then it will be less and less about our guidance.

I think the main thing about one-year guidance is we probably don't have any more insight than investors do. Whereas in the current quarter when we're two or three weeks into it, we do have a little bit of an advantage, so that's why we do the current quarter guidance.

Ben Swinburne - Morgan Stanley - Analyst

Let me ask you, Reed or David, about the X1 integration. Brian demoed it recently at a conference, it looks quite elegant. Do you expect this to be a meaningful contributor in the fourth quarter when we look at your domestic net adds? And maybe stepping back, Reed, do you think these partnerships play a larger role over time in driving your business than they have maybe historically?

Reed Hastings - Netflix, Inc. - CEO

Yes, we sure hope so. It's rolling out this quarter, it's a really nice integration. Comcast users tend to be pretty advanced, high-income households, so many of them already have Netflix. But having it integrated into X1 will make it easier to use. That increases the word of mouth, and all of these MVPD integrations, they help just like being integrated in smart televisions. So think of it as the more devices we're in, the easier it is to use, but there's no step function here, because again, most of those homes probably have Netflix already.

Ben Swinburne - Morgan Stanley - Analyst

And do you have any concerns at all that the consumer who accesses it through the X1 is not as deep in the Netflix universe from an experience perspective as they might be using it in the smart TV or an app because they're navigating through the Xfinity guide? How did you get comfortable that that wasn't going to be a negative, net negative or maybe you felt like it was offset by other positives?



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Reed Hastings - Netflix, Inc. - CEO

Well, there's definitely concerns like that, and on the same side, an MVPD has concerns that by putting on Netflix, they will build more Netflix awareness and we have concerns that the UI. But ultimately where we get together is let's try to learn together what the customer really wants. And if we're thoughtful with each other and we're focused on the customer together, we're both going to be able to prosper.

And then on the X1 specifically when you click on, say it's in the guide to the show, it brings you into the Netflix user interface for showing you the show. And then the post-play kicks in where you've got the different follow-up shows that you could watch on Netflix.

David Wells - Netflix, Inc. - CFO

And Scott and Ben, we have other partners that we've launched with, Virgin and others, that we've gotten an early preview in terms of how the consumer interacts with the application. And as long as we're able to continue to improve the attractiveness and the compellingness of the content and the experience of Netflix, we feel like we're -- it's a good partnership.

Reed Hastings - Netflix, Inc. - CEO

And the X1 is the most powerful CPU box we've ever seen in the MVPD space, and so the percentage of streams that are HD and the UI is really spectacular. It's the best that we've ever seen.

Ben Swinburne - Morgan Stanley - Analyst

Great.

Scott Devitt - Stifel Nicolaus - Analyst

Reed, you mentioned no plans for pricing increase in the near term. Now that you've gone through the ungrandfathering, which has created a level of consistency in pricing across the customer base, I'm wondering how you think about pricing increases in the future. It seems like with where the product is priced in the US and internationally today, that there's still quite a bit of room. And just wondering philosophically how you think about acting on that over time.

Reed Hastings - Netflix, Inc. - CEO

Well look, we've had great couple years at these price points and there's a lot of competition entering the market. What we're focused on is just how do we increase value to the consumer by having more spectacular shows so that people watch more of Netflix. And over time that will take care of itself, but we don't want to get overconfident just because we've had a good couple years here.

David Wells - Netflix, Inc. - CFO

There's a small technical carve out in Reed's answer in terms of we do have some territories of the world, countries of the world changing their VAT or their GST laws. And to the extent that we feel like that's a territory- or country-level response and we can pass that to the consumer, we may do that. It's just we have a lot of different price points across the world at this point. So that's just a technical addition to Reed's answer.



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Scott Devitt - *Stifel Nicolaus - Analyst*

And then, David, back to you. In terms of the commentary about material profits, we're now closing in on 2017. You added some language in the shareholder letter about material process again in 2017 and continuing to grow from there. Could you add any numbers to that in terms of what material profits actually means, how we should think about that next year and in coming years?

David Wells - *Netflix, Inc. - CFO*

Well we added is some numbers in Q3 and in our guide for Q4, so you're starting to see that operating margin grow and the operating profit. We're growing both revenue and operating margin. So you're starting to see that grow already, but it will grow more and more materially next year and forward.

So I think as we are able to reduce our international losses, we don't have another set of territories that we're launching next year. And as we're able to grow both margin and revenue in the US, you're seeing that lift out. But we'll have more specifics to say in Q1 in terms of providing some more guidance on that.

Ben Swinburne - *Morgan Stanley - Analyst*

David, let me just pick up on that since we're talking about the financial outlook. It looks like this year I think you guys are guiding to about \$1.5 billion of free cash burn, which is higher than we were before. Maybe you could talk about what's driving that variance?

And then as you look to next year, \$6 billion of content amortization is a 20% growth rate year on year versus 50 this year. So we're seeing content costs grow slow, yet if you look at content obligations which are up \$1 billion sequentially, or your free-cash-flow guidance, which I think was -- it used to be similar next year to this year, the gap seems to be widening between amort and cash. Maybe you could just talk about what's driving that, if I have that right.

David Wells - *Netflix, Inc. - CFO*

Yes, a little bit right, I would correct a few points in there, but I would say our former guidance for free cash flow was around a negative \$1 billion, \$1.2 billion, and now we're saying \$1.5 billion for this year. It's a little, it's uncertain next year what that number might be, but I'd be surprised if it grows on a quarterly basis.

So I would say as we're able to raise operating income, we'll be able to fund more of that organically. So we should be able to take more of that inside in terms of and reduce our free cash flow. But I want to give some wiggle room for the scale of the business. If we're successful and if we grow faster than we expect, we could expand our content even more than what we consider we would do today. So there's a little bit of matching that to the scale growth of the business, how successful we are, how big the business we are growing internationally.

And I would say in terms of the commitment number, that number is up to 14.2 from the 13s before, and that has a lot to do with the expansion of our originals, our licensed originals, and our international. So we launched the rest of world in January of this year. We continue to add content to all of our international markets as well, so you're seeing that grow. I would expect that to somewhat moderate in the 18-24 month period as we go forward. We don't have another international launch to layer on to that, but we are expanding the business, so you've got two forces there counteracting each other. But in terms of our -- go ahead.

Reed Hastings - *Netflix, Inc. - CEO*

Ted, maybe you can go through a little bit when we do the self-produced content like Stranger Things, all of the advantages to it for the business, despite the increased use of cash?



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Ted Sarandos - Netflix, Inc. - Chief Content Officer

Yes, absolutely. I think when we see something like Stranger Things come across, there's the simple one, which is it doesn't come with the studio markup that's attached to it that is just purely expenses not on screen, and the other is much more flexibility in terms of the rights that we have and the rights and how we exploit and how we continue to maintain exclusivity where we're not seeing the content against our wishes go into other markets in the syndication and DVD and others. And we're able to produce it at a very high quality and also much more efficiently. So to the extent that we can do that, while it does require more cash upfront to fund the development process versus a studio who would take that on, we find it's a great tradeoff for cash.

David Wells - Netflix, Inc. - CFO

And to reconcile back to, just to reconcile back to your question, some of that was already reflected in our forecasting and in our guidance. But I would say as we get better and we exercise that muscle of our own production, more of that is reflected in our pipeline. So you're seeing that number, that \$1.2 billion number float up to \$1.5 billion.

Ben Swinburne - Morgan Stanley - Analyst

And Ted, there was a comment in the letter where you were talking about your recent acquisitions like Quantico, and designated survivor where you talked about ensuring early financing, so I'm just trying to connect David's point and Ted's point. Are you talking about providing early financing to studio partners in exchange for better windowing globally? Is that what that comment is related to, and then maybe that's impacting the free-cash-flow timing?

Ted Sarandos - Netflix, Inc. - Chief Content Officer

Nothing that's been done to date; it's basically just setting the table. There's a bunch of other different ways that you get involved as a production partner with our studio partners versus a second-window buyer. And some of that would include securing financing rather than having the studios continue to pursue deficit finance models.

Ben Swinburne - Morgan Stanley - Analyst

Got it.

Scott Devitt - Stifel Nicolaus - Analyst

600 hours of original content in 2016 is going to 1,000 hours in 2017. I think, David, you recently said at a conference that you're about one-third to a half of the way to the 50/50 split between original and third-party content. Where would that 1,000 hours put you in 2017?

David Wells - Netflix, Inc. - CFO

Well, it's a combination of Ted and I, so I'll pass it to Ted in a second, but I would say we don't have a target. My comment about 50% was more grounding people towards the earlier comments that we made about 20% or 30%. So I'd say we like what we see in terms of the engagement on our originals, so we're continuing to expand them and so we're going to keep growing them. We don't have a magic target, though, that we're trying to hit. It's more about continued expansion and that mix of our content being more of originals and less of licensing but we're still expanding both, licensing content is still expanding. Ted, if you want to add to that.



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

Well said. I would just say, to your point, the license business, while as a percentage of business will shrink. As an absolute number, it will continue to grow for the next couple of years. And there isn't a magic target, to David's point. What we want to do is have really great, compelling, and differentiated programming for our members. And we get there through original programming when we do it successfully, so we just want to keep steering the business that way.

Scott Devitt - *Stifel Nicolaus - Analyst*

Do you have any targets for the original content that is produced by your own studio in terms of the ratio that is ultimately produced by your own studio versus licensed originals?

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

No, similarly what we're trying not to do is get trapped in the business model to making creative choices. Meaning that sometimes someone else owns the IP and you want to do what's right by the viewer by giving them great things to watch, and the only way to do that is to do that through a third-party license deal.

Our financial preference, of course, is to produce it through our studios. And when that opportunity will continue to present itself, we're going to increasingly do that as well. But we're not locking into a formula of how much of the programming has to be self-produced versus third-party license.

David Wells - *Netflix, Inc. - CFO*

Exactly.

Ben Swinburne - *Morgan Stanley - Analyst*

Ted, I just want to stick with you here for a minute on the content side. Stranger Things and The Get Down are interesting content examples over the summer that got a lot of attention. I believe The Get Down was quite expensive. Didn't seem to get the same size audience as Stranger Things, which I believe was less expensive and attractive economics.

Why, when you look at The Get Down, is that a good investment for you given the ticket size? And I think you renewed it for a second season. What is that doing for your business that maybe we might be missing or the popular press is missing?

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

Well, what's still to come is the second half of the first season, so that's still coming up. We're excited about how it got started. Yes, it's an expensive piece of television, mostly because it's very large-scale, cinematic. The reason why Baz Luhrmann's films work around the world is that kind of attractiveness. So we're still seeing how it's going to unfold for the first season.

And all the shows land at a different level of noise in the press, and probably depending on what circles you run in, whether or not your friends are talking about it. But we've been really very excited about how the show has been performing, particularly in the quarter where we had four shows that turned out to be big event programs for us.



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Ben Swinburne - *Morgan Stanley - Analyst*

You've commented before that output deals and pay-one deals from a timing perspective are suboptimal, but at the same time, you said really nice things about Disney's product over the years and how they work on your platform. How is the pay-one deal performing versus expectations? You happy with it? I believe it's a relatively short-term deal. Is it something you think you'd like to do more of over time with Disney?

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

Look, I think that we expected it to be a very popular content and it's turning out to be. So Zootopia was the first really high profile film to come through. And it's performing in huge numbers, because it's great kids viewing beyond being great movie viewing.

And the Disney brand, different than any other studio, can deliver that kind of tent-pole kids programming that the family loves. And as long as it continues to perform at those levels, we look to expand it with Disney, but I don't think any other studio really can match that output and match those economics, and therefore, deliver that viewing. So we're going to still look for -- look opportunistically at films that are available for that window, but really continue to put energy behind our original film initiative as well.

Reed Hastings - *Netflix, Inc. - CEO*

In some countries, we have the Disney movie output, Australia, Canada, US. But in other countries like in the UK, we lost the bidding to Sky about two years ago. So it really varies by market. We're one of the bidders, and we hope to, over time, be one of the biggest bidders so they choose us, but it really does vary by market.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

Scott Devitt - *Stifel Nicolaus - Analyst*

Reed, it's been speculated in the media that downloading offline viewing may become available on Netflix by the end of 2016. Can you provide any insights or clarity on that speculation?

Reed Hastings - *Netflix, Inc. - CEO*

Yes, what we've said this year is we're open to it, it's something we're looking at but we have nothing more specific to offer.

Scott Devitt - *Stifel Nicolaus - Analyst*

And then secondly, password sharing in the US, you have plans in place that limit that. Just interested still in the enforcement of password sharing in the US in terms of limiting that currently and in the future. And then similarly, with VPN networks within the international business, your views of that in terms of accessing content outside of countries that have certain geographic rights.

Reed Hastings - *Netflix, Inc. - CEO*

Well, I think we've been very successful at finding technological ways of inhibiting the cross-border VPNs, which is roughly, like I'd mentioned, we didn't win the bidding for the Disney movies in the UK, so it's clearly not fair to allow our UK subscribers to watch the Disney movies from Canada or to the US. And so we found, with the help of the studios, some more technology that enforced their rights.



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And we try to get global rights for everything, like How to Get Away with Murder from ABC, because then it's available to everyone, which is clearly what consumers want. In terms of -- what was the other question you had?

Scott Devitt - *Stifel Nicolaus - Analyst*

Password sharing?

Reed Hastings - *Netflix, Inc. - CEO*

No plans on making any changes there. Password sharing is something you have to learn to live with, because there's so much legitimate password sharing like, you know, you sharing with your spouse, with your kids, so there's no bright line and we're doing fine as is.

Ben Swinburne - *Morgan Stanley - Analyst*

Reed, just sticking with the theme of Disney, Bob Iger made some interesting comments a couple weeks ago, talking about how his bountiful list of brands, ABC, Pixar, Marvel, may not be enough in the future and that distribution -- figuring out distribution was important to him. Do you have any reaction to that? Does it seem to be aimed at over the top, and he does have a relationship with Hulu, which is a potential -- a competitor and maybe a bigger competitor over time. But do you have any reaction to those comments?

Reed Hastings - *Netflix, Inc. - CEO*

No, they have a great strategy. They've got Hulu, they've got the Major League Baseball initiative, where they bought some of that. And then, of course, they've got Disney Life, which they operate in a number of countries. So it makes a ton of sense for them to be growing in the OTT side and to figure that out, as it does for us to do content. And I think you'll see more -- you saw CBS All Access in the last two years really become a big focus for CBS, so it's just continuation of that theme.

Ben Swinburne - *Morgan Stanley - Analyst*

Ted, just somewhat related here, I realize this is hypothetical, but access to content, it's a big debate for Netflix. And I'm curious if you thought being part of a larger media Company would inhibit your ability to acquire content from others in the industry or competitors to that kind of a Company?

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

Like I said in previous quarters, this kind of frenemy model has existed for decades in television, where competing studios produce for one other constantly. And it's really the question I think that our suppliers will have to make when they're making decisions around their expansion over the top is, can they make better returns selling to Netflix or building their own thing? And that's both a long-term and short-term question and currently, hypothetical.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

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Scott Devitt - *Stifel Nicolaus - Analyst*

Reed, just following up on competitor comments, Jeff Bezos recently made a comment that possibly Amazon Video could be the fourth pillar of Amazon's business. And I was just wondering how you think about, you have such an extensive lead in this global buildout, how you think about Amazon long term as a competitor and Mr. Bezos' comments there?

Reed Hastings - *Netflix, Inc. - CEO*

Well, we think about it as share of screen time, and when people are doing other things with their screens, be they mobile or television screens, they're not doing Netflix. So Snapchat, YouTube, Facebook video, all of that takes a lot of hours, probably much more so than Amazon.

But there are so many competitors out there for screen time and we win today such a small percentage of total screen time that moves by specific competitors are unlikely to have a material effect. What affects us is can we continue to win affection? And that's through doing all of this incredible content, through expanding globally, having all those rights be global eventually. So those are the things we're focused on.

Scott Devitt - *Stifel Nicolaus - Analyst*

David, you commented in the letter about going to market for acquiring more debt in coming weeks. You also mentioned at a conference recently that you thought the business was under-levered. You mentioned a 5%, I think, debt-to-cap ratio. How do you think about debt longer term in terms of what that looks like and how you think about it, is it net debt to EBITDA or otherwise?

David Wells - *Netflix, Inc. - CFO*

Yes, my comments at the Goldman Sachs conference, about a 20% debt rate or a long-term optimization of cost of capital. I don't think we're talking about by the end of the year getting to a 20% leverage ratio. So just to talk about a shorter term or a medium term, we would be looking to raise as needed in terms of funding our content expansion. So we've been pretty clear along the year that we would go to market sometime this year to add a modest amount of debt to the balance sheet, and then do that on a recurring basis, as needed, to fund our content expansion.

So over time, though, we anticipate that we could get and would optimize our cost of capital up to a 20% leverage ratio. And we're talking about a debt-to-market cap at that point. But I think we would be closer to a EBITDA basis as well, because the business is going to be growing in operating income and EBITDA.

Ben Swinburne - *Morgan Stanley - Analyst*

David, you guys recently localized your first batch of rest-of-world markets. I believe it was Poland and Turkey, and it sounds like that's been successful in driving growth in those markets. The obvious question would be why not move faster on localization? You've got a lot of recent rest-of-world launches. Is that a cost-benefit analysis or human bandwidth throttle? What is keeping you from moving quicker and what's the right pace for us to think about in 2017?

David Wells - *Netflix, Inc. - CFO*

Dammit, move faster. I think it's a quality aspect, right? In terms of we want to make sure we have an eye towards quality as well. We had a couple of rough blog entries about some of our localization and subtitling in some markets, so we pay attention to those.

So we're moving as quickly as we can, being methodical and thoughtful about those opportunities to localize. And yes, we are pleased with both Poland and Turkey in terms of those impacts. It makes sense people want to consume in their language. And so it's not going to make sense to

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localize in a super small territory, but for the larger territories, it's going to make sense. And even for the medium-size territories, we'll get there eventually; I think it's just a matter of sequencing.

Ben Swinburne - *Morgan Stanley - Analyst*

And just to come back to maybe more of the short term, you had talked earlier this year about Australia and New Zealand being a difficult comp, I believe in Q2. You've called out in the letter Q4 comp of Spain, Portugal, Italy. Is there any way to put that fourth-quarter comp and the second-quarter comp in some context, just thinking of order of magnitude?

David Wells - *Netflix, Inc. - CFO*

Again, back to Reed's earlier comments about for competitive reasons, we don't talk specifics about our markets, I probably wouldn't. But I would say that there is a harvesting of demand initially when we launch in a market. It's that first launch quarter that we tend to have higher net additions, and then that moderates over time into a run rate that's a little bit more normalized.

We have the same thing going on that we highlighted in Q1 where we have rest of world in the first quarter of this year was a large number. And when I look at Wall Street's estimates for Q1, they're higher. I think they're not taking that into account. So we wanted to call that out so that folks had the benefit of anticipating that.

Ben Swinburne - *Morgan Stanley - Analyst*

Any other Wall Street estimates you'd like to call out?

David Wells - *Netflix, Inc. - CFO*

Just the growing operating income and just the fact that I think Q1 was a little high relative to our expectations.

Ben Swinburne - *Morgan Stanley - Analyst*

Got you. Thank you.

Scott Devitt - *Stifel Nicolaus - Analyst*

Ted, as you look at localized content and new markets, how easy or difficult is it to find the talent in those markets to produce the content? How successful have you been there?

And along that same topic, how do you think about some of these newer markets in terms of how much of that content ultimately will need to be localized to create that S-curve inflection in some of the markets that were launched in 2016?

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

In terms of successes to date, Club de Cuervos, our first Mexican original, was quite successful, and we're getting ready to bring out the second season. Marseille for our French customers, not only successful in France but successful throughout Europe, and got a significant amount of watching in the United States subtitled and dubbed in English. And so we're continuing to push.



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It's not degrees of difficulty; it's just a matter of understanding the production community and the local taste and whose work and making great films in those markets in some cases and are anxious to make the migration to television that they've been seeing happening in the US. And so it's difficult in terms of not being on the ground there usually. But I think we're making tradeoffs in terms of the Company culture to travel our folks into territory, get to know the folks in the markets, work with the best and brightest filmmakers and television creators and bring their shows to the global market through Netflix.

And in terms of localizing for taste, in many parts of the world, US content or English-speaking content localized into local languages has been incredibly successful. In some places where the tastes run much more local, like Japan, like India, certainly we'll take more of a local approach in terms of licensing and producing more local language content there as well. But I think over time that the taste will fall into line with the desire to see the big, spectacular shows that people are talking about around the world, no matter where you are.

Reed Hastings - *Netflix, Inc. - CEO*

And Ted, maybe you could give them some color on Dark, [Sboda], Cable Girls, in terms of being content that may spread beyond their home market?

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

Yes, absolutely. What we try to do, we're producing, to Reed's point, we're producing a show right now that just went into production literally today called Dark in Germany. It's with quite a successful filmmaker whose films have traveled around the world. We've been in the business of buying those films from those filmmakers and making them travel around the world for years, so I think that will continue with the move into multi-episodic series as well.

So we get that scale advantage of being able to take a German show that the German audiences will be very excited about and that we know that that will expand throughout Europe, and that we've been really great at finding audiences, even in the US in subtitles and dubs, which has been a really a niche business for most people but very mainstream numbers for us.

Scott Devitt - *Stifel Nicolaus - Analyst*

Going back to David's comment about the difficult first-quarter comp internationally. You had 130 markets that launched at the beginning of 2016, so it's obvious what the comp issue is. But also in your business, you have that initial wave, but then you have things like localized content, awareness, and other factors that actually drive, as an example, in the Latin American market, an inflection that happened two to three years after the initial launch. So as we look at 1Q 2017 and then think about the 130 new Markets, how do we think about that initial bump relative to the potential of these new markets actually beginning to really kick in throughout the year in 2017?

David Wells - *Netflix, Inc. - CFO*

Well as you say, they do -- one is going positive in terms of growth of growth, and one is negative in terms of initial launch. And what I was trying to call out without actually providing our Q1 guide until January was back in January of this year, I tried to moderate the estimates or the expectations coming out of our global launch. We had a very successful launch in Q1; we had a lot of demand associated with that launch that started moderating into Q2, and I think people saw the success of Q1 and really raised their numbers in Q2.

And I'm trying to get a little bit ahead of that in the sense that we had a very successful launch in Q1 of this year that is going to be very difficult to replicate. Some of that was pent-up demand, and we're not going to be able to do that. That's not saying that we're -- many of our other markets are growing in terms of the growth. It's just right now in terms of what we see, that large launch is going to overwhelm some of the growth of the other markets.



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So we still like what we're seeing in these markets. We're growing year on year in some, some moderate. We've had very different -- a wide variety of results across markets. We've had markets that slow down and then accelerating growth. And so if you abstract back, I think the general trend is the world is embracing Internet television and we're riding on a very strong tailwind of technological change, and that is definitely intact.

Scott Devitt - *Stifel Nicolaus - Analyst*

Thank you.

Ben Swinburne - *Morgan Stanley - Analyst*

David, any color on how the 2014 markets are ramping or at least France and Germany in particular. I think there's been some concern in the marketplace that France isn't going well. I think you closed an office there. And in Germany, Amazon seems to be doing quite well. So if you can just talk about how the model may or may not be working well in those 2014 markets?

David Wells - *Netflix, Inc. - CFO*

Let me disconnect one thing there in terms of we did choose to consolidate some of our French staff into our Amsterdam staff, but that had nothing to do with the market, whether the market was growing or not. That had everything to do with the synergy of communication and how the teams are working together.

And then in terms of the other markets, again, we don't say much specifically about our markets for competitive reasons. But you would have to take my earlier comment about the fact that we saw very broad out-performance relative to expectations in this quarter or in Q3 that would be inclusive of those markets. So I think we're pleased with how things are going.

Ben Swinburne - *Morgan Stanley - Analyst*

Great. Shifting gears back to you, Ted. You hired, I hope I'm pronouncing this right, Bela Bajaria from NBC recently, and one of her mandates is unscripted. So I'm just wondering, is unscripted going from something that you have a couple of bets in to something more strategic for you? When you think about 600 hours to 1,000, how much is unscripted driving growth? Is it a material part of the plan for next year and why?

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

It's not a material part for next year, but I imagine it could be a -- it will be growing over the next several years. It's been -- it's an area of viewing that people around the world enjoy. The content travels well, it's efficient to produce.

The current sources of second-window, unscripted programming are under a great deal of pressure from the cable operators, not to sell their content off of their own universe because many of the episodes seem to be interchangeable. So being able to have a good, steady flow of high-quality unscripted programming is something we want to focus on, because I think we could do it well and efficiently and maybe elevated in a way that it will travel even more than it does today.

Ben Swinburne - *Morgan Stanley - Analyst*

And just if I could follow-up quickly on unscripted, it would seem to be not obvious for the on-demand bingeing consumption model. But maybe you've had some experience so far with some of your talk stuff or your comedies that maybe suggests it is. What can you tell us about that?



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

There's certainly some benefits from the scale off of those shows. But our ability to produce -- remember, we have a lot of data and a lot of content that gets watched. And what travels and what doesn't, what gets repeated and what doesn't, and it gives us a higher degree of confidence today than we had a couple years ago in our ability or even desire to produce it in the space.

But it is a segment of programming. We keep opening up new segments of programming the way we did with talk shows last year, the way we will in the first quarter with Ultimate Beastmaster, our first competition show. So we're pressing into some new areas of the business all the time to bring new, unique, elevated and differentiated programming to our members.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

Scott Devitt - *Stifel Nicolaus - Analyst*

Reed, investors get caught up a lot in the 60 million to 90 million household number in the US, and as an indicator or predictor for success in international markets over time. If you can do it in the US you can do it internationally, and if you can't you can't. You're running a little north of 4 million subscribers in 2016 from 5 million in 2015. How do you think about that business in terms of the trajectory in over, say the next one, three, five years in terms of how many subs that you can put on the business in the US on an annual basis?

Reed Hastings - *Netflix, Inc. - CEO*

We have to take it year by year; it depends on how well we execute. Do we have more Stranger Things, where it breaks through and everyone feels like they've got to get in, Luke Cage, Get Down, Narcos. We have a show coming up, The Crown, that's some of the most impressive television I have ever seen. And so I think November 4, when you ask yourself about 60 million to 90 million, when you watch that show, it's going to seem quite achievable. But it all hangs on how well we execute and we're just going to work really hard on that front.

Scott Devitt - *Stifel Nicolaus - Analyst*

Following along those lines, in terms of the relevance of content to drive subscribers, given that that's why subscribers watch the shows on Netflix, on a P&L basis anyway, the growth in content spend has begun to very much leverage relative to the growth in the digital revenue stream. And I'm just wondering, as we look at that in 2017, over 2016 and then 2018, 2019, and 2020, is that something that we can expect to continue into the future? Or is there a point in time at some level of spend at which you think you've built a complete enough portfolio that that leverage actually significantly accelerates?

Reed Hastings - *Netflix, Inc. - CEO*

No, we'll keep investing in growing the content spend, even domestically, for quite a long time. We see an ability to continue to please consumers with a wide range of content. And so, I think if you're trying to model the business long term, you should think of content and hours viewed and brand love, all as continuing up in the US and internationally for a long time. Let me take two more questions, one from each of you.

Ben Swinburne - *Morgan Stanley - Analyst*

Great. I know we beat ungrandfathering to death last quarter, but if I can come back one more time before I sign off. David, you had talked last quarter about elevated churn, even among members that were not seeing a price increase. And I think this quarter, you talked about churn being



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generally in line with expectations. I just wanted to see if you had any color on that piece. Did the ungrandfathering noise continue to elevate churn?

And then I'll just ask my follow-up. On the fourth quarter, I just want to confirm the only ungrandfathering we have left is the \$1 cohort. Is that accurate?

David Wells - *Netflix, Inc. - CFO*

So it's accurate on the last one. We have some older-generation devices that are difficult to message as well. So I think that defines the last few cohorts of people left. And then back to your primary question in terms of what did we see in the quarter relative to our expectations and relative to prior quarters and actuals? I would say, I mentioned earlier in the interview that we still see some effect from the ungrandfathering. So there is a bit of an overhang from the price change; it's starting to fade and we expect that to continue to fade. But we do think there's opportunity to improve that going forward in terms of next year.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

Scott Devitt - *Stifel Nicolaus - Analyst*

Reed, last one, an open-ended question. You've talked a lot historically about the opportunities in Internet TV and have been very right in terms of the direction that the industry has gone. With where your business is now, I was wondering if you can just share some updated views in terms of the way you think the industry progresses over the next 5, 10, 20 years in terms of what wins and what loses?

Reed Hastings - *Netflix, Inc. - CEO*

We generally think of the growth of Internet TV like the growth of the mobile phone, that is fixed-line telephony was an amazing invention, 100 years of development and brought incredible benefits to society and the same thing is true with linear TV; it's been an amazing innovation. But the age of linear is starting to fade and is going to be replaced by Internet. And those firms like the BBC or, CBS that's doing All Access, that invest heavily, I think will move into the future on Internet consumption.

I think you'll see Internet growth generally more broadband, fiber-optic to every village and town, those general trend lines. The growth, both of YouTube-type advertising-supported services, Facebook video, Snapchat. So you're just going to see these new scenarios everywhere. And eventually, movies and TV shows will be global, ubiquitous, some amazing budgets. So I think you have to think big about the future.

We're closing in on 100 million members, but I remind everyone at Netflix that Facebook and YouTube have 1 billion daily actives. And so in many parts, we're just so small compared to those other Internet video firms and we have a lot of catch up to do. And that's again, investing in our content and making it globally interesting and compelling, which we're working on. So there's a lot out there, but we just have to take it year by year and it's tremendous fun inventing the future.

Scott Devitt - *Stifel Nicolaus - Analyst*

Thank you.

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Thank you, gentlemen.

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