

Q3 2017 Earnings Call

Company Participants

- David B. Wells, Chief Financial Officer
- Gregory K. Peters, Chief Product Officer
- Spencer Wang, Vice President, Finance/Investor Relations & Corporate Development
- Theodore A. Sarandos, Chief Content Officer
- Wilmot Reed Hastings, Chairman, President & Chief Executive Officer

Other Participants

- Doug Mitchelson, Analyst

MANAGEMENT DISCUSSION SECTION

Spencer Wang {BIO 3251222 <GO>}

Good afternoon, and welcome to the Netflix Q3 2017 Earnings Interview. I'm Spencer Wang, Vice President of Investor Relations and Corporate Development. Joining me today are CEO, Reed Hastings; CFO, David Wells; Chief Content Officer, Ted Sarandos; and Chief Product Officer, Greg Peters. Our interviewer this quarter is Doug Mitchelson from UBS. Before we begin, we will be making forward-looking statements and actual results may vary.

With that, let me take you over to Doug for his first question.

Q&A

Q - Doug Mitchelson

Thank you, Spencer. Good afternoon, everybody. I'm going to ask a question for each of you and then we'll start rotating by topic. Reed, for you to start, it was another strong third quarter. Do you feel like we're hitting some sort of inflection point with streaming video? You have your digital peers, soon perhaps competitors pivoting to Hollywood video. We have a slew of SVOD services that will be launching over the next couple of quarters. You have the traditional media companies thinking about diving into direct-to-consumer themselves. Do you see a real sort of inflection point in the marketplace?

A - Wilmot Reed Hastings

Well, Wall Street loves inflection points, so I'd love to say, yes. But no, I think it's pretty much steady growth. I mean we've seen new competitors increase streaming around the world, new devices, new formats, just been a continuous evolution. We started streaming

10 years ago now. We're now completing our 11th year of streaming. So, I'd say overall, more of the same and continued great success for streaming.

Q - Doug Mitchelson

Ted, takeaways for you from the third quarter. What surprised you? What was better? What was worse than expected?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

Well, Doug, I was pleasantly surprised and relieved in our kind of continuing expansion of our original programming verticals, including releasing an adult animated comedy, with Big Mouth, a big feature film like Meyerowitz it's being - getting very well received critically and being watched by a lot - by big numbers all around the world. David Fincher's new series, Mindhunter, and an Italian original, Suburra that was shot in Rome, all in Italian for Italian and European customers, but also for Netflix users around the world. So, it's just kind of a continuing breadth of things that are working well for our subscribers I'm excited about.

Q - Doug Mitchelson

Greg, for you to set the table, any learnings from your time in Asia, specifically the Japan launch, and how that's informing your strategy as you get started in the early days here as Global Product Manager?

A - Gregory K. Peters {BIO 17539678 <GO>}

Sure. I've spent a lot of time there, obviously trying to grow the service, producing and launching new content, and that experience allows me to bring those lessons back to the work that we do in product. So, I'm looking forward to putting more investments in how we support content, how do we invest in technology to improve the efficiency and effectiveness of the work that Ted's team is doing, producing great content at scale.

Also to change the product experience that we have, to do a better job at promoting content that has little built-in awareness, so we can sell those new original series and films more effectively. But then also to continue to evolve the product experience that we have today to be effective at meeting the needs of the next 100 million, 200 million members, so it can be as compelling as it is for the 100 million members we have today.

Q - Doug Mitchelson

And I think we'll talk through some of that as we get deeper in the Q&A. And, Spencer, I'm going to combine the last question between Ted and you on Millarworld, first company acquisition ever. Can you discuss the strategy and how we should measure ROI on that deal?

A - Spencer Wang {BIO 3251222 <GO>}

Sure, Doug. With respect to Millarworld, a couple of things to highlight for you. The first is, I think you can tell from our track record, this is the first acquisition we've done in our

20-year history. So, I think from that, you can take that we have a very strong bias to build over buy.

Secondly, we remain very, very focused, so we're not looking to diversify into new businesses, but rather looking opportunistically at intellectual property and other content assets that can help enhance our content library and also accelerate our growth. So, overall, I think you should expect us to be selective, but opportunistic as it pertains to M&A.

A - Theodore A. Sarandos {BIO 4812832 <GO>}

Yeah, I'd say Mark and Millarworld had incredible concentration of regional projects that we were already kind of circling on the TV side and on the feature side. And so we just we were - it had us look deeper into their track record of original content creation and the roles that they played in creating really iconic films that we think we can continue to build on. So, we're excited about it.

Q - Doug Mitchelson

Do you see a series of other acquisitions that have similar characteristics?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

Well, obviously, we're looking at a lot of things. And when there can be these kind of efficiencies, meaning that much creativity under one roof, we'll definitely want to explore that.

Q - Doug Mitchelson

And so I wanted to switch to the third quarter a little bit more and I think, David, this one might be for you but perhaps Ted as well. It was a relatively content-light quarter, not that a lot of content wasn't released, but when you compare it to the third quarter of last year, it looked a little bit lighter in terms of important original exclusives, yet the results were very strong again. I know in the second quarter, you talked about some uncertainty as to how much was driven by content versus just growth in the overall streaming marketplace. And it seems the third quarter, the answer is really it's the streaming marketplace. Am I reading that right?

A - David B. Wells {BIO 17034721 <GO>}

I think so. I mean, I've been pretty consistent in quarter-after-quarter. The base force that really is the strongest force is the continued adoption of Internet TV and entertainment, and that tends to drive the lion's share of our net additions. When we try to explain the quarter-to-quarter perturbations or some of the lumpiness in our net additions, we tend to use explanations that sort of focus on the incremental, which could be content slate or a particular title that had some notable strength.

But I think, in general, it is the continued adoption of Internet entertainment that is driving our growth, and it's really helped more and more by the increasing strength of our content slate, notably our global originals are helping drive that.

And you saw that show up in the second quarter with all of the growth that we saw on the international line over and above what we thought we might do, but that was continued momentum carried forward from the second quarter as well.

Q - Doug Mitchelson

It's interesting because I think we've been wondering for a while, the last few quarters, you've talked about having some content strength or some titles that we're surprised that perhaps pulled forward growth, whereas maybe you're going to the critical mass, where instead there's a carryover of those strengths from previous quarters, and as you said, it might level off from year to year.

So, do you think we're hitting that critical mass of content? And if so, how do you forecast the fourth quarter, it's a strong content slate year-to-year in our view. And Ted might follow up with that, just to see if he agrees or disagrees. Do you no longer sort of use new big original content like Stranger Things 2 as a driver of your forecast?

A - David B. Wells {BIO 17034721 <GO>}

Well, I think you're pointing out that it's hard, right? As we continue to grow, the large background force again is the adoption of Internet entertainment. But when we try to explain quarter-to-quarter changes, it becomes a little bit harder, and it's hard even from our own team to ascribe certain incremental growth, and we do the best that we can.

But it is of note that this year in particular will be sort of the flattest growth that we've seen from Q1, Q2, Q3. So you've got strengthening content slate and growing content releases - number of releases, paired with a seasonal pattern, paired with very strong adoption globally and growing global adoption of Internet entertainment, and you get to a little bit of a hard pattern to discern.

But we're just pleased that this year's growth, if you back away from the quarters and you look at just the four quarters, this year, we're growing nearly to 22 million global net additions off of up from 19 million, and that was up from prior year. So, in general, the background trend is just increasing growth and increasing adoption.

And then, Ted, over to you for the content comments.

A - Theodore A. Sarandos {BIO 4812832 <GO>}

Yeah, I mean, I think it might be just a reflection of the steady drumbeat of high-quality content that people are watching that are not necessarily all concentrated in the same pockets. There are three different films released this quarter, that if viewing was buying a movie ticket, it would be of sizable successes in Death Note, Naked and To the Bone.

So - and probably very little audience cross over between them. And so that's kind of the benefit I think of the steady output of great new original programming coming nearly every day on Netflix.

Q - Doug Mitchelson

And then, David, last question in this line of questioning. When you think about the fourth quarter guidance, can you just discuss for investors what swing factors you do see in there? Obviously, there might be some price increase churn, you do have some big content like Stranger Things 2 coming. What were the factors that were driving the guidance for the fourth quarter?

A - David B. Wells {BIO 17034721 <GO>}

Sure, I mean, so one primary factor is just the pricings that we had. Again, we had on grandfathering last year. We've got price this year. We have great content coming with Stranger Things 2, Crown 2 and more that Ted will talk about, but some big strong content releases.

And we have just the sort of perturbations that we've seen. Last year was the largest quarter we've ever had, so we're comping off the largest Q4 we've ever had. And this is our best guess, and we've been wrong in the past. But it's our best guess over the next 90 days.

Q - Doug Mitchelson

So, why don't we switch to pricing? So for Reed and for David, can you discuss the pricing strategy broadly? And then I'll have some follow-ups.

A - Wilmot Reed Hastings

Well, price is all relative to value. We're continuing to increase the content offering, and we're seeing that reflected in viewing around the world. So, we try to maintain that feeling that consumers have that we're a great value in terms of the amount of content we have relative to the prices.

And, of course, we maintained our \$7.99 standard def program or €7.99 in the Eurozone at that incredibly low price. So, we've got a great range now, super value oriented in standard def, super premium is great stuff in the 4K. And then definitely I was watching Mindhunter last night on my Dolby Vision 4K TV, and if you haven't tried it yet, you really got to try this HDR TV, it is just unbelievable, how beautiful the picture looks.

Q - Doug Mitchelson

David, anything on your end in terms of sort of why now, anything that this suggest in terms of the pace of content spend, particularly on the cash side? And one more on that, David. It seems at least from what I've seen so far, a lot of the price increases have been really hitting the big and perhaps more mature markets for at least the more developed countries. Is that right? Is that the strategy to take up price in developed countries, because the emerging markets have revenue driven through sub growth?

A - David B. Wells {BIO 17034721 <GO>}

Well, back to what Reed said, I mean it's really about slow and steady. I mean, we've been in no hurry. We're in no hurries. Many investors have sort of criticized us in the past for being under-priced, and I think for us, we want to make sure that we do this commensurate with value, like Reed said.

And as we take up the content library value as we're doing more global originals that people have exclusively and only on Netflix, there's a great association of that value, and we think that we can grow that value and that price slowly and steadily over time.

Q - Doug Mitchelson

(11:43) good to take the spending up for next year, from membership growth and partially from the opportunity.

A - David B. Wells {BIO 17034721 <GO>}

Yeah, I mean, I shouldn't let that go without addressing that there's no timing correlation between our intent to grow content and to grow content spending and the price increases.

I mean, this has been planned for a long time, and so we're sort of growing and slowly growing and planning the business steadily. So we've assumed that we are going to grow ASP slowly over time, and we're taking the content up with that as well.

A - Theodore A. Sarandos {BIO 4812832 <GO>}

I think a great pattern to keep an eye to, Doug, is that, yeah, we're excited that next quarter we're going to release new seasons of established great shows like Stranger Things and The Crown. And most recently, we released new season ones of brand new shows like Atypical, like Big Mouth, like Mindhunter that Reed had mentioned already, and like Ozark that I think consists a steady drumbeat again of the next show you can't live without and the new season of that show that we have to keep going and keep building on.

Q - Doug Mitchelson

And just to make sure we address it in terms of taking up price in developed markets versus undeveloped markets, is that right? Are we just really seeing the price increases in the developed markets so far and it's sort of more of a global strategy?

A - David B. Wells {BIO 17034721 <GO>}

Well, in terms of how you define a developed market, I mean we've raised prices earlier in the year in Brazil, in other parts of Latin America. So, I don't think you can cleanly sort of divide it. It is true that we may not choose to raise price in a market that we're only a year - 18 months old in, specifically around markets that we didn't have a tailored library launch.

We had a - we chose to launch global with sort of an all at once and a global library, and we're specifically increasing the engagement in the library quality in many of these

markets, if not all. But we may choose in those markets that to make the decision that we haven't grown value fast enough. And to be honest, slower track with pricing in those markets.

Q - Doug Mitchelson

The last question on the price increase is, taking the higher tier up \$2. And the question I get asked a lot is, whether password sharing is an issue or how high is it on the priority list for the company? Is the reflection at the higher tiers going up \$2, while the little tiers going up \$1 and the lower tier zero is that you're making password sharing more expensive?

A - David B. Wells {BIO 17034721 <GO>}

Greg, do you want to take that?

A - Gregory K. Peters {BIO 17539678 <GO>}

Sure, I think with regard to the priority, password sharing is an huge issue for us right now, it's on our huge priority to go try and take significant measure to try and stem it.

We think that a broader spend in pricing, better reflects the value that we're delivering in the higher tiers, the 4K, the HDR, the awesomeness that Reed mentioned in Mindhunter, so really you're just seeing us push that spread further apart to try and address that value for us.

Q - Doug Mitchelson

Thank you. So let's switch over to the content access for a little bit, Ted. And before I start asking you about all the competitors trying to win over shows that you might want. Just any update on your content slate, how the development process is scaling. I think we've got a pretty good visibility on the fourth quarter, but do you see a strong first half 2018 coming?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

Yeah, definitely. And we're really excited that we'll wrap up this year with our biggest original film project, yeah, with Bright, which is Will Smith starring with Joel Edgerton and directed by David Ayer. And it's a big-budget event movie that I think people will start seeing the potential for this original movie initiative that it can be done on the enormous scale that we have on the television side.

What I'm also really excited about is we're ramping up our local language original production. So, you're seeing new series in local languages. Just recently in Italy, upcoming in Germany with Dark, and with that incredible success into those markets with those shows. And they could - those shows are continuing to travel outside, which is really exciting for us that those shows we can put more production scale behind them because they're being watched in markets much larger than just the country of origin.

That on top of our kind of steady drumbeat of new original series that is, yes, you are correct, it's becoming a much more competitive marketplace, but we've been really happy with our results in that competitive marketplace.

Q - Doug Mitchelson

Any concerns around access to content, particularly with Hollywood? Of course, the big news since you reported last is Disney going direct-to-consumer and pulling back on the Pay \$1 window with you here in the United States and Canada, but also having the Disney Channel content in there, I think Bob Iger said he's going in hot in terms of his OTT launch in a couple of years on that Disney service. Any concerns that not only the Disney content going away could have an impact on Netflix net value subscribers, but also that other traditional media companies might follow suit?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

So, I think everyone is going to have their own strategies, and it's exciting that everyone is trying to make over-the-top television better and better, and I think that is good for all of us. And we just have to focus on creating content that our members can't live without and get excited about every month. So that's really the - and not get too distracted by the competitive landscape around us.

And whether or not one of our partners decide to produce for us or to compete with us, that's really a choice that they have to make based on their own business. And we're thrilled that more people are doing it because I think it's great for innovation. I think it's great for consumers to have a lot of choice, and that we just have to be the best choice out there. And I think that's not different - the environment isn't a lot different than it is in the television world, where Fox produces for ABC and NBC produces for Fox. And so I think that those choices get made on a case-by-case basis.

I'm not worried about access, Doug, because we have long-term agreements with all these players. The shows that we have are a run of series. So if somebody chooses not to renew a deal here and there, the series that are successful on Netflix ride out as long as they exist in that second window. By interesting way of example, something like Walking Dead, the deal with AMC expired two years ago and Walking Dead continues to be a successful show on Netflix and will as long as the show is being produced.

A - Spencer Wang {BIO 3251222 <GO>}

And just to quantify, Doug, what Ted was saying. Our commitments at the end of the quarter were \$17 billion over the next several years, so that helps sort of put another sort of level of quantification for you on that. And we also have the benefit of our growing library and produced content of which the net book value at the end of quarter was about \$2.5 billion.

A - Theodore A. Sarandos {BIO 4812832 <GO>}

And just one more thing to add would be, included in all these transitions are, we're coproducing content with CBS All Access by way of example with the Star Trek series, the Star Trek Discovery. So, it's a rapidly changing environment, for sure.

A - Wilmot Reed Hastings

And, Doug, Disney is a great brand with great content. But internationally, we have it only in the Netherlands, Australia and Canada. And you saw how big our international growth was in most of the world without the Disney content. So, although it's got an enormously significant brand in terms of its significance relative to growth, you can see that we've done very well in international without it.

A - Theodore A. Sarandos {BIO 4812832 <GO>}

We're able to partner with them when they're ready to.

Q - Doug Mitchelson

I think that it's an interesting dynamic because, increasingly, the license content seems to be going to either Hulu or you have a Disney situation with OTT. So, I think investors are struggling with Netflix as you look farther and farther down the road, the major U.S. media companies might be licensing less and less to Netflix. But you have a strategy of more and more original content. And I'm curious how do you sort of derive the confidence that you were ramping original exclusives on Netflix will offset any loss of licensing content in the future?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

Well, what I'm confident of is that it will not be an erratic shift, because like I said, we have these long-term agreements and those deals kind of run out as we're ramping up. And that has been a pretty smooth transition to-date. I think that in those partnerships that where there's still a lot of value, that I'm sure producers and networks and studios are evaluating is something like Riverdale, where having Riverdale on Netflix in the second window and an enormous audience growth for it in season two.

In fact, 400% audience increase on CW from season one to season two, and the only thing different from that and This Is Us is Riverdale was on Netflix. So, I think people will have to look at that and look at those trade-offs in value and to see when does the partnership become too competitive and make those decisions when the threat of the competition outweighs the value of the partnership.

A - Wilmot Reed Hastings

And, Ted, how big was the increase in This Is Us season to season given that it was on Hulu for back season?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

I don't know. It wasn't nowhere near the 400%. It was up from season one, but not nowhere near 400%.

Q - Doug Mitchelson

I think Jeff Bezos has said that he's looking for the next Game of Thrones. Any sense that perhaps Amazon is shifting programming strategy, and that would have any impact on

Netflix at all?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

So as Richard Plepler looking for the next Game of Thrones.

Q - Doug Mitchelson

So there is Ted Sarandos, there's everybody. I mean there is a lot of disruption going on at Amazon. It is an interesting sort of lesson that you can't just necessarily buy success in Hollywood and you've had some success obviously, and I don't want to belabor the point too much in this form for investors, but I would be interested if you could sort of discuss what you're doing and how it's sustainable in terms of continuing to create high-quality content when others are struggling?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

I think it's an extension of our employee and corporate culture around freedom of responsibility. It attracts the best and brightest. And I think we've created a place where people want to come and create. They've heard from their friends. They've seen it from their peers that they've been able to come into the best work of their lives. And that seems to be quite repeatable. So we keep building on that by giving the resources for our content creator to come and have a great professional experience, and that is something that we keep betting on, where I think other people want to try to replicate heavy handedness of the network model that we've avoided so successfully.

Q - Doug Mitchelson

For Reed and Ted, Wall Street Journal reported, I believe, last week that the Board of Weinstein was considering selling the company or showing down its business. So the situation at Weinstein impact Netflix at all? And if the company was put up for sale, given the sort of massive intellectual property and the studio that resides there, would Netflix be interested?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

Interested in an acquisition?

Q - Doug Mitchelson

Yes.

A - Theodore A. Sarandos {BIO 4812832 <GO>}

There's a lot of smoke to clear from what's happening there. Our business with Weinstein Company is pretty arms distance, and we have a second - output deal on their films, post theatrical and some second window television agreements with them. So it's not material in either way.

A - Wilmot Reed Hastings

It will be extremely unlikely for us to be a bidder for the firm.

Q - Doug Mitchelson

Thank you. Why don't we switch over to Greg? So Greg, on the product side, can you give us what should consumers of Netflix expect in terms of changes over the next the short to midterm, now that you're here?

A - Gregory K. Peters {BIO 17539678 <GO>}

Tons of changes. I think one of the ones that I'm most excited about is, there is a tremendous opportunity I think to morph the product experience, to be more and more effective at explaining to our members what's great about one of the original shows that Ted's team is making, and making that connection with this new novel IP. I think there's a huge opportunity to use all sorts of new forms of assets, video in surprising ways to make those kind of connections.

Q - Doug Mitchelson

And what would you say your priority list is right now?

A - Gregory K. Peters {BIO 17539678 <GO>}

Priority list is supporting Ted and his team in making great content at increasing scale, changing that consumer experience to do a better job at promoting those new series. It's making better use of the marketing that we do too, so we can actually provide technical support to our marketing team to really provide the right message on the right channel at the right time for the right consumers that are targeting and programmatic there as well.

Also, better leveraging our partners, both for new acquisition and engaging our members. And finally, making sure that again that their product continues to be really, really effective at evolving to respond to the new needs of the consumers, the next 100 million, 200 million numbers that we'll have, so we make sure we keep an eye to that shifting global set of used cases and requirements.

A - Wilmot Reed Hastings

And Greg, just add something about Proximus and T-Mobile?

A - Gregory K. Peters {BIO 17539678 <GO>}

Yeah, I mean, one of the things we're super excited about is the work that we're doing on bundling. We started in Europe with Proximus, with SFR Altice, and we've just launched in the United States, T-Mobile here, and we're very, very excited about leveraging our partners to find efficient ways for our members to basically - our new members to be, I should say, to find out about service and sign up and pay very, very effectively.

Q - Doug Mitchelson

And I think to some extent you're touching on mobile access and when investors think about addressing Asia, they nearly think to mobile. Does a company at this point, sort of,

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jump all - Reed, David, if you have any comments, think about mobile as a part of the addressable market, as a part of the TAM, or is the focus still broadband and pay-TV households?

A - Gregory K. Peters {BIO 17539678 <GO>}

I think for sure we do. It's just how much - where we are in the cycle of both learning and addressing that market. And Reed and David comment differently, but we for sure think that's part of the great global opportunity in terms of Internet delivered entertainment.

A - Wilmot Reed Hastings

David Wells can tell you that I'm often complaining when we see internal metrics with number of broadband households is the TAM, because I think about it as number of people. And so, it's very much all people on the planet will get the benefit of the Internet over the next 20 years, and we hope that all of them will get to enjoy Netflix also.

Q - Doug Mitchelson

And so then, Greg, back to you, how are you making the service work better on mobile? Any specifics around how much room there is on encoding and all the fun engineering, things like that?

A - Gregory K. Peters {BIO 17539678 <GO>}

Sure. So, we're definitely focused on making mobile both effective from an user acquisition perspective, so new members, but also from a member engagement perspective. So for those members who don't have a smart TV at home, or maybe want to watch something while they are on the go, we want to make that a great experience.

So as you mentioned, one of the things that we're working very hard on is making sure that the encodes that were using are superefficient, so that we can provide a really, really high-quality video experience with lesser and less bits. I'll just give you an example, one data point as to how low we've gotten this. If you take something like anime, which is super efficient from an encoding perspective, we can now provide an amazing video quality experience on mobile for anime titles at 150 kilobits per second, which is practically unheard of previously. So we're super excited about pushing those numbers down and making that mobile experience as great as we can.

Q - Doug Mitchelson

Since re-brought up T-Mobile, there's a lot of investor questions about the new distribution deal here in the United States with T-Mobile. If you could walk through the deal at all, again a bit of a jump all, but I think perhaps David and Spencer more on your court? And how are you going to measure ROI and the benefits of that relationship?

A - Spencer Wang {BIO 3251222 <GO>}

Sure. So I can jump in and David can fill out. But to sort of pull it back a little bit, Doug, in our partnerships ultimately what we're trying to do is making Netflix easier for customers

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to sign up for and to access and to enjoy. So the T-Mobile partnership is an extension of that. Beyond that, the economic arrangements we generally don't get into, we have some broadly speaking in our BD partnerships, there are marketing components and marketing benefits that we share.

To the extent from a financial reporting perspective, those marketing costs are in our marketing expense line. To the extent that there's a billing relationship and the part of bill is on our behalf, those kind of processing costs are in our cost of revenues alongside our other payment processing expenses.

A - Wilmot Reed Hastings

And, Spencer, if I forgotten to download a film, what's my chance of streaming on airplanes? And what's our progress on that front?

A - Spencer Wang {BIO 3251222 <GO>}

It's getting better, Reed. So we are partnering with airlines and we just recently announced that at the APEX conference at the end of September that we'll be leveraging all the great work that Greg's team has done with those more efficient encodes. And in early 2018, we'll be opening those up to airlines that partner with us, so that we can help them more efficiently use their bandwidth in-flight.

And in that case, we hope that airlines will begin to support and promote in-flight streaming, which we think is a benefit for our mutual customers. It will hopefully delight passengers as they fly and experience Netflix, and we think it's good for our brand and generally more engagement is good for retention for Netflix.

Q - Doug Mitchelson

So what does the company have to do in the markets where it's still early stage, where Netflix penetration is still low? Beyond just localization, and I would be curious if, David, in 2018, you have sort of a percentage of the addressable market that might be localized just to give investors some help on that end. What does Netflix have to do? Is it local programming from Ted? Is it Greg continuing to work on encoding and more efficient bit rates? Is it just wait for the markets to develop?

A - Spencer Wang {BIO 3251222 <GO>}

We're certainly not waiting for anything, Doug. We're aggressively moving on all those fronts of better streaming on the tech side, more relevant content. But again, if you have been an investor in Netflix for a number of years, you remember our launch in Latin America and how we've built out, stayed focused on Mexico and Brazil, and we're doing the same thing in Asia.

So, we know how to run this play. There're specific lessons we have to learn about, which content, how to get that developed that we're working on. But again, the partnership model, we've got that in every nation around the world. So, I think we're making really

good progress. It's just going to take some time to iterate on the content as we did in Latin America five years ago.

Q - Doug Mitchelson

Before I leave the product discussion, I did want to get in one more with Greg on AWS. Are you wedded to that platform? I think Google and Microsoft are trying to make strides.

A - Gregory K. Peters {BIO 17539678 <GO>}

I would just say that AWS has been a great partner for us and we really have enjoyed using their infrastructure.

Q - Doug Mitchelson

Thank you for the enlightenment. David, switching over to you, just on some of the key financial metrics, again just to reaffirm our early discussion. Any change to the outlook across margins, 40% in the not-too-distant future, free cash flow, anything that you'd like to update?

A - David B. Wells {BIO 17034721 <GO>}

Well, I think one thing that's of note is that 40% U.S. contribution margin was our useful target, say, a year to two years ago, as we grew out U.S. profitability and with international losses. You fast forward to that and we sort of approached that target three years early, we were able to turn international profitable, which will stay profitable on a consolidated basis going forward.

So, we've switched to global operating margin and we really are optimizing the business around global operating margin. So, you'll see us shift some spending back and forth, notably marketing. I think I've indicated in the past that U.S. marketing has gone up on an absolute basis. As we see the benefits and we test around some of the more benefits of promoting our original content, I think you'll see that increase again in 2018.

And so we really are focused around growing operating margin. We're 7% this year, well on track and guiding to be on track for that, and continued growth forward, and we'll specify that in January. But we were able to grow from 4% to 7% this past year to give you some indication of that growth.

Q - Doug Mitchelson

Do you have a sense as of now what the 2018 working capital burden might be for building out your original content slate? I mean, I think you've got about \$3 billion or so a year of revenue growth. Ted likes to spend an incremental \$1 billion at least in terms of amortization hitting the income statement it seems each year, and that gives investors \$2 billion to play with, and you obviously have other OpEx. But the big plug that - the big number that we have trouble calculating, of course, is that working capital burden. Do you know at this point what - do you have an insight on that?

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A - David B. Wells {BIO 17034721 <GO>}

Yeah, I mean, we obviously have a much better idea given that we're three months away or two months away, 2.5 months, from next year, I would say, and without sort of backing us into a corner of giving you a specific number for next year, we're going to spend \$7 billion to \$8 billion on a P&L basis on content.

And in the past, the markup, or the working capital ratio markup on content cash to P&L has been somewhere in that 1.4 to 1.5 range. This year it'll be about 1.5. We really do enjoy the benefits of owned productions, and you're seeing us move more and more of our mix - our content mix to owned productions.

So, I think that 1.5 becomes around 1.55 again on average. So there's a lot of lumpiness in these numbers as things tend to shift around from quarter-to-quarter. But we know it's going to be higher. And the \$7 billion to \$8 billion in content spend with a little bit of a markup in the ratio, the offset there is operating profit growth, but you guys run your models, and I think that's giving you enough direction in terms of you getting towards directionally where working capital and free cash flow goes next year.

Q - Doug Mitchelson

And the two dynamics you had in place is approaching about 50% original content by 2020. And to the extent the company grows faster than expected, the content spending might also increase. Are those still in play?

A - David B. Wells {BIO 17034721 <GO>}

They are. And I would just say to socialize that 50% or provide a little bit more context around it, it's becoming increasingly sort of to a Netflix subscriber when they see a Netflix brand on the piece of content, that feels like an original. To us, we have sort of different sub-classifications, whether we own it and made it or we licensed it. At the end of the day to the consumer, what's important is that, it's exclusive and only on Netflix. But I would say that 50% number that we've talked about in the past, that could be higher in the future, as we accelerate more and more content development and as we like the benefits of owned production. But Ted, I don't know if you have something different you would...

A - Theodore A. Sarandos {BIO 4812832 <GO>}

No, I would say that that's accurate and that's the trend, for sure.

Q - Doug Mitchelson

Ted, I think as we're talking about content spending, and it actually makes me wonder what you're going to spend it on. Any update on sort of two categories, one, international, how that's doing in terms of creating more and more local content? How that's scaling? What kind of percentage of budget are we talking about now or in a few years, and then similarly for movies?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

Well, I'd say on the international originals that we enjoy a lot of production efficiencies producing outside of the United States. So we can produce an higher volume and bring kind of higher and higher production standards to those markets. So we've been really thrilled with our ability to do that.

Greg mentioned earlier about anime, just by way of example, we have more than 30 original anime projects in various states of production these days. So, just kind of give you some sense of the scale, and then the series work that we're doing is in the case of Italy, it's not a - just a - Suburra is not just a show you're going to see in Italy. It is a show that looks and feels very much like a Narcos, like a House of Cards, like a big global original, it just happens to be an Italian.

So, we're producing at larger and larger scale, outside the United States, inside of the United States.

And on the movie side, this past quarter we've released eight original films. We plan on about 80 coming up next year. And they range anywhere from the \$1 million Sundance Hit, all the way up to something on a much larger scale like we're seeing on Bright at the end of this year and Irishman that's in production right now with Martin Scorsese, that should be in early 2019.

Q - Doug Mitchelson

And that leads me to wonder about sort of cost of content, because you're scaling up the number of hours and the number of titles, at the same time we keep hearing about inflation certainly for the best content in Hollywood. Any sort of comments on the Shonda Rhimes deals, specifically but more broadly is content cost inflation, something that could become an issue for Netflix at some point?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

Yeah, I'm sorry, if I'm a broken record on this one, Doug, but I get asked this a lot and I feel like I say the same thing a lot, which is I compare a lot to professional sports, where it gets very competitive for the handful of superstars, but overall player personnel costs are pretty predictable. And I think this case it's those big unicorn shows, the price of any one of them might go up in a more competitive market, but general content costs are quite predictable.

So - and we're like - and I think about Shonda Rhimes as you mentioned earlier, is creating a place where she wants to create, where she knows that she could spread her wings a little wider, where she can get outside of the network box a little bit, had a lot more to do with her attractiveness to Netflix than we just had to outbid ABC. And so as we continue to attract world-class talent like that, that will also attract more world-class talents like that.

A - Spencer Wang {BIO 3251222 <GO>}

And Doug, I would say from an investor perspective, hopefully what gives investors confidence is in terms of our ability to manage content cost inflation is, if you look at the

long-term trend in our business, we've grown the content budget, we've grown the content library, made it better, but revenues have grown faster which is what's driven the profit improvement and the margin improvement over the years.

A - Theodore A. Sarandos {BIO 4812832 <GO>}

That's what I was going to say. So, we faced this content cost escalation over the last three years or at least the speculation of it, so what Spencer said.

Q - Doug Mitchelson

The - one thing I find interesting in sort of switching over to sports rights for a moment, well, a question for Reed. So, I think I sort of know what the answer is going to be upfront, but I still want to position the question. So I was hoping you would engage on it. And that is that you just have Facebook bid \$0.5 billion for multiyear digital rights for the IPL in India. Obviously, Amazon is on the air right now with Thursday Night Football here in United States, and I think there is an anticipation by investors that there will be more and more bidding by video platforms on sports rights.

And of course, we all know that Netflix has indicated in the past that it's sort of not rights for you, but this reminds me a little bit of when you were switching from DVDs to streaming, you really sort of waited back not necessarily so much in the weeds, but for the marketplace to evolve to the point where was the right time for you to pursue it. So I am trying to understand just what the trigger points are for Netflix as it looks longer-term at sports content?

A - Wilmot Reed Hastings

Well, we have to see over the next 10 years, Doug, what those trigger points might be hypothetically at some point. In the near term, we have so much going on in the global expansion of movies unscripted, series, documentaries. We're just running at 100 miles an hour, doing our thing around the world. And so, nothing to really talk about this interesting in the near term.

Q - Doug Mitchelson

The other question that we end up asking a lot, but we still want to do it, Amazon is likely to launch some sort of ad product to the first half of next year, and it's not clear if it's a pre-roll, or a post-roll, or banners, or sponsorships, or what have you, my understanding is they are still trying to figure it out. And given that you have emerging markets that perhaps require lower price points than the developed world, any updated thoughts on pursuing advertising at some point?

A - Wilmot Reed Hastings

Often the right strategy for a challenger brand, which is Amazon in the case of streaming video, is to try many things, because they're not sure. Just copying Netflix is not going to typically gets someone very far. The leader's role is to really - as that famous phrase is, to keep the main thing, the main thing. And so our focus is not expanding in new ads at all. Our focus is on doing even better content, getting better partnerships, better mobile

streaming. We just have to have the discipline to keep doing what we're doing at many times the scale. And if we do that, things will work out really well for our global customer base, and thus, for our investors.

A - Spencer Wang {BIO 3251222 <GO>}

And then Doug, I think we have time for one last question.

Q - Doug Mitchelson

Well, it was interesting, because I had two that I was going to go with. So for Reed, I'm going to let you try to divide between the two of them. And one was I was curious I think the investors are really focusing on competition and access to content these days as the market really evolves. And so one was I was sort of curious if you would wrap-up with a sustainable competitive advantages for Netflix. And I think separately, I was going to ask a regulation question, Reed, and that is that when you look at sort of content overseas and local quotas, when you think about what some of your peers are going through around scale issues, is there anything on the regulatory side regarding those two specific issues that Netflix is focused on right now?

A - Wilmot Reed Hastings

Well, Doug, you're very good about staying in character. We've all got our Stranger Things sweaters on because we're celebrating both the amazing content that's coming in 10 days or so, and also targets great promotional strategy. We're learning how to do merchandising. We've got some amazing displays and amazing materials out a target. And Ted, do you want to tell us a little bit about Stranger Things?

A - Theodore A. Sarandos {BIO 4812832 <GO>}

Well, October 27, we'll be releasing the new season of Stranger Things, which gives you answers to the question how are you spending your Halloween? And if you too are getting one of these ugly sweaters from Target to free your next Christmas ugly sweater party. But it really celebrates the spirit of the show in a great way, and we can't wait for the show to come out, which is not only an enormous hit in the United States, but it is equally international across with our membership base. So we are thrilled for Stranger Things coming this month.

A - Wilmot Reed Hastings

And Greg, what are we doing on product to support Stranger Things?

A - Gregory K. Peters {BIO 17539678 <GO>}

We're doing an amazing job of taking up our big parts of the site to basically connect our members with this great show and show off how incredible content it is.

A - Wilmot Reed Hastings

And Doug, to answer your question on scale, I'm sure others are figuring things out. What we're continuing to do is work with Amazon as well as investing in open connect and

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being able to handle all of the growth that we anticipate. And we've had a pretty good track record of that for the last 10 years. So I wouldn't worry about that particularly.

Thank you, everyone, for joining us on the call, and look forward to talking to you more over the quarter.

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