Q2 2017 Earnings Call

Company Participants

- David B. Wells, Chief Financial Officer
- Reed Hastings, Founder and Chief Executive Officer
- Theodore A. Sarandos, Chief Content Officer

Other Participants

- Doug Mitchelson, Analyst

MANAGEMENT DISCUSSION SECTION

David B. Wells {BIO 17034721 <GO>}

Welcome to the Netflix Q2 2017 earnings call. I am David Wells, CFO. I'm joined today on the company's side by Reed Hastings, our CEO, and Ted Sarandos, our Chief Content Officer. Interviewing us today will be Doug Mitchelson from UBS. We're going to try something a little different and have one interviewer just for a little bit more continuity. Then, I think, Doug will have our first question being our only interviewer.

Before we get started, we will be making forward-looking statements. So, actual results may vary.

Doug, over to you for our first question.

Q&A

Q - Doug Mitchelson

Thank you so much, David. I wanted to start simply by asking if there's anything notable in the quarter. For you, Reed, you talk about Netflix being a learning machine. Anything that you've learned that you want to share with us from the past few months?

A - Reed Hastings {BIO 1971023 <GO>}

Anything notable beyond 5 million net adds in Q2, an all-time record for Q2s, up sequentially from Q1, I mean notable beyond that, I think we're just seeing that the rewards of doing great content focused on the quality of the service are paying off.

Q - Doug Mitchelson

I think I'll roll through some of the quotes that you guys have in the letter this quarter and one of the first ones that caught my eye was due to our amazing content. So, Ted, did you put that word amazing in there? Any update you can give us on thoughts around how content has been in the quarter?

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

Look, I think it was the combination of a lot of great things. 13 Reasons Why started right at the end of the quarter, rolled into some of our biggest content brands, new seasons of House of Cards, Orange Is the New Black, ending the quarter with Okja. So, just I think it was the combination of a lot of different things, kind of a reinforcement that as long as we're programming to a wide variety of taste and keep the quality level high that we can turn some success off of that.

Q - Doug Mitchelson

And, I think, congratulations on all the Emmy nominations to the company and for you specifically, Ted, 91, someone had to count all of those.

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

Thank you. That's definitely a team effort, beyond my own content team, the marketing and PR groups and everyone who kind of makes that happen. It's hard to forget that it is a race. So, it is a big campaign that attaches to that stuff too, but 91 nominations is an all-time record for us and we're thrilled.

Q - Doug Mitchelson

Continuing (02:15) David, for you, you note that our 3Q guidance assumes much of the 2Q momentum will continue. You say you're cognizant of the lessons of the prior quarters where you over-forecasted and there was the lumpiness in net adds. So, should we (02:29) of third quarter includes that you're cognizant of (02:34)?

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

Well, I think, back to your earlier question about what lessons in the last 90 days have held for us and one of them is our business is a little bit tough to predict given the success of content and the popularity of content. We still think the major driver is adoption of Internet television, but on top of that, we're increasingly growing throughout the world. So, we're getting more word-of-mouth in our newer territories and we're seeing great content slates have an effect like they did in the second quarter.

So, I think, you can take that line to mean that our forward guidance assumes continued good trends and continued great trends, but we're a little bit cognizant of other quarters where we've either under or over-forecasted, because some of that demand was pulled forward by a great content slate. In this case, in the second quarter, we had a really strong content slate.

Q - Doug Mitchelson

And continuing on with you, David, you had subs come in ahead of expectations but you talk in the letter about margins being on track for a full year 7%. Does that suggest that the subs and therefore largely revenue are coming in better than expected, you're choosing to invest more and maintain that margin target?

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

Yes. So, we had a 9% margin in the first quarter and we had a lot of content come on in this quarter. So, we got it down to 5%. So, on the first six months, we're running right on our target of 7% and our guide is right on 7%. So, you can take from that that we're going to reinvest and plow back in the business sort of any over-forecasted growth that we have on the top-line.

Q - Doug Mitchelson

And, David, one more for you. You call out ungrandfathering impacting the third quarter. I think you have some price increase (04:16) as impacting 2Q and then grandfathering again in 4Q. Is there any sort of sizing you can give investors around the pricing strategy issues that impacted specifically 2Q, but the year as well, if it's secure (04:29)?

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

Well, I think, last year what we found was because of the PR and the news around the price change in the second quarter, which actually didn't happen or un-grandfathering until the third and fourth quarter, we had a real blended effect through the year. So, it's hard to tease out exactly which quarter we saw effects on both acquisition and retention. We do know that the comping off of last year, we think we will have less noise this year. I think that's pretty clear. So, I would say it was a medium in terms of size and impact on the business from last year.

Q - Doug Mitchelson

Over to Reed. Reed, I'm sure you'd tell me, based on the results you just reported, you did well everywhere, but in particular, it looks like you are presumably getting critical mass. And every country in Europe is different, so I thought I'd sort of try to key in on Germany as an example, particularly I think Germany is one of the tough markets for U.S. companies. Consumers over there don't like to pay for TV; they don't watch as much TV. Obviously, English is not their local language. Amazon was there first as well. So, there's a competitive dynamic. So it looks, based on our tracking, you're actually surpassing Amazon at least in terms of app downloads if not subs. Is that right, are you at the point where you're taking a leadership in Germany? And could you talk a little bit about what you've done right and what you're doing right as far as that market (05:50)?

A - Reed Hastings {BIO 1971023 <GO>}

Doug, Amazon is super successful around the world. If you look at U.S. with Prime, incredibly successful. It just doesn't seem to take away from us. So, I wouldn't characterize it as us versus Amazon in Germany. I would really characterize it as can we have a service that's so great that Germans find it worthwhile paying for? And clearly, we're succeeding at that, making our service better and better.

In particular, there's no advertisements on Netflix and so it's great for kids, it's great for teens and then the great content is so significant in helping those – the growth that you're picking up. But as you suggested, we're really seeing that around the world. Whether it's Brazil or Argentina or Japan, Singapore, Germany, Internet TV is really catching on for us, for YouTube, for others.

Q - Doug Mitchelson

And I guess what I'm trying to get to, Reed, is you launched 2.5 years ago and I think when you launched, drew parallel (06:54) for Latin America and that it would take some time, but you'd figure the markets in Europe out and eventually they would have similar levels of success. Do those parallels still hold and can we look forward to a Europe (07:07) where there's fits and starts in terms of progress or do you really hit the point where you reach escape velocity and you think those markets would be strong markets to unfold?

A - Reed Hastings {BIO 1971023 <GO>}

Well, I think all throughout the west, so Latin America, North America and Europe, we're doing very well. We just got to continue what we're doing, more local productions. We've got some amazing new shows we're producing in Europe and in Latin America.

With Asia, we've got a lot more to learn. We're really expanding a lot in India, Japan. We're figuring it out market by market. But Asia's very unique and very large. So, we see a huge opportunity for us over the next couple of years, all of us spending more time there and investing more.

Q - Doug Mitchelson

Reed, continuing along that line, because Asia's so diverse and we think about Korean, Japan, Thailand, India, they're all very different markets. How do you prioritize your investments in the Asia (08:00) area?

A - Reed Hastings {BIO 1971023 <GO>}

We look at market size, we look at growth of Internet, kind of all the factors that we've always looked at around the world and so then, we're able to prioritize in what we're doing. And we saw some great success, for example, this quarter with Okja. Maybe Ted, you want to describe a little bit of that.

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

Yes. Okja is directed by Bong Joon Ho, who's one of the – is the most celebrated director in Korea and is a huge star and attraction in and of himself, but also the movie itself is one of the most ambitious productions in the history of Korea. His films tend to travel around the world pretty well. Made a ton of noise at the Cannes Film Festival, was the most talked about film of the festival. So, it helped attract new subscribers also, but it also brings a brand halo to Netflix that it's a place for great content worth paying for. And I think we saw some of that benefit throughout Europe and in pockets of Asia where we saw big sign-ups in Korea.

But remember, for most people, they learned about Netflix for the first time when Okja was coming out in Korea. So, relative to the rest of the world, we've got a lot of work to do, but it was a great introduction to Netflix for a lot of the world.

Q - Doug Mitchelson

Well, and sort of carrying that forward, Ted, Reed just mentioned more local content (09:19).

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

Yes. And even more so, Doug, it's – think about local content for global audiences. So, the idea, that's a fantastic story that we make a Korean movie for Korea, but it's even a bigger story that the movie is getting watched by the millions all around the world.

Q - Doug Mitchelson

So, Ted, can you talk a little bit about how you're expanding (09:39) the size of the team, is there a capacity growth, is there a growth in percentage of budget being allocated to...

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

Yes. As Reed mentioned, matching the program into local tastes is really the key and we've seen it in our expansion through Latin America, our expansion into Europe, and as we look to Asia, we have to get better and better at matching those tastes. And those tastes are not as easily aligned with Western tastes. So, we'll invest more time and energy in Asia, putting some people on the ground in Asia that we haven't historically, but well within how we've looked at the size of the teams generally, but locating them more likely outside of the U.S. as we continue to grow for local audiences in Asia and throughout the rest of Europe.

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

And, Doug, just to round out Ted's answer, all those things that you mentioned are involved in that. So, it's growth of the acquisition and development teams. It's also budget. I mean, we already had in place growth and budget in many of these territories. So it's just trying to deploy that more efficiently. And in some cases, it's adding on to the levels of investment. You asked about how we prioritize. Generally, when we see success, we try to add on to that until we reach a point of diminishing returns and so, if we are going to see success in some markets, we may up the content budget in those markets.

Q - Doug Mitchelson

It all makes sense. Reed, over to you, because we're on Asia, if you think about the emerging markets broadly, they're certainly a lot more mobile and I'm curious if you can give us an update on the implications for (11:15) that you have underway as you think about addressing mobile, please.

A - Reed Hastings {BIO 1971023 <GO>}

Absolutely, Doug. I mean, we've had great success on mobile in the developed markets like the U.S. and Europe, and then throughout Latin America and now in Asia. And all of the Netflix service works extremely well on mobile. We're continuing to get better and better at encoding efficiently our films and TV series so that it takes less and less network bandwidth and we are rising in popularity around the world. And that's paralleling the improvements that YouTube and others are doing to make video a natural part of mobile phones. And so that's just a continued evolution.

Q - Doug Mitchelson

Is a mobile Netflix product a different product than we're used to right now?

A - Reed Hastings {BIO 1971023 <GO>}

No, mobile is just a four or five-inch screen for us with a great touch interface and it's very similar to what you see on an iPad to the television. So, think of it as there's just many screens that you can enjoy Netflix on.

Q - Doug Mitchelson

When I think about different kinds of content (12:27-12:32).

A - Reed Hastings {BIO 1971023 <GO>}

I'm afraid, Doug, I can't hear you anymore. There seems to be some AV problem.

Q - Doug Mitchelson

Can you hear me now?

A - Reed Hastings {BIO 1971023 <GO>}

Barely. You'll need to shout.

Q - Doug Mitchelson

So, for Reed or David, as you consider emerging markets again broadly, is there effectively (12:54) the mass market product (12:55) without adding a hugely (12:56) lower price point?

A - Reed Hastings {BIO 1971023 <GO>}

We'll see. We've been very successful getting to beginnings of a mass model product in Latin America, where you've got a lot of fairly developed economies. We'll see in Asia what we can do with that, but for the first couple years, it's focused on more high-end Western-oriented elites and then as we grow into that, we can think about expanding beyond that.

Q - Doug Mitchelson

Ted, back over to you. At the beginning of the year, you talked about having a strong second half content slate. Do you feel that the content slate is settling out for what you thought and there is a strong second half? Any titles that you...

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

Is there any way you can see what the – there's a lot to be really excited about in the second half in terms of our content releases. Starting as early as next week, we have a great show called Ozark, starring Jason Bateman, that we are really excited to launch. And in August, we have the release of Death Note, a great new film that we are going to panel at Comic-Con this week. And also in August, The Defenders, which brings together all of the characters from the Marvel's Defenders, Jessica Jones, Luke Cage, Daredevil and Iron Fist for an incredible season that people are really excited about.

And, of course, throughout the year, we have things that will lead up to Bright at the end of the year, which is a huge film with Will Smith that will only be available on Netflix that we are incredibly excited about.

Q - Doug Mitchelson

Ted, what do you think Reed means when he says he wants you to be able to cancel more shows?

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

Look, I think I mentioned before that in this universe, we look at a lot of things like failure is not such a bad thing. And if you're not failing, maybe you're not trying hard enough. So, when we have a good hit rate and even with the recent cancellations, 93% of our shows have been renewed. So, you want to be introspective and look at that and say, we're being adventurous enough, Daredevil, we are trying new things and I think when you think of things, when you have a very high hit ratio, you definitely want to keep second-guessing yourself even though you do.

Q - Doug Mitchelson

These days, when we think about potential for more and more original shows being produced, therefore likely more and more cancellations over time, any impact on financials that we should think about? And separately and importantly, is the viewing that you're expecting, whether it's licensed content, whether it's original content, whether it's movies that you're putting out, consistent with the amortization schedule that you have in place?

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

Yes. And I think what you raised is a good point, which is the more shows we add, the more likely in absolute numbers that you'll see cancellations of course. But that's only novel on Netflix and it's still novel, because you see on network television about two-thirds of the – about a-third of the content gets cut in the first season versus our content, which is mostly renewed. And it's not because we are less careful about it, it's because we can more efficiently build it and not 100% of the time.

So, we want to launch shows. We love when there is a deep passion fan base for a show. We just needed to be big enough to support the economics of that show, so we don't create opportunity costs for future fans of new shows.

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

And, Doug, just to take a sort of accounting-oriented part of that question, I would say, no, we don't anticipate right now. I mean we look at this constantly. Every quarter we look at the trends. Many of the shows, even if they are not picked up for renewal, they may have a story arc that completes the narrative and so it really is – for us is about the sort of continuity of viewing over the life of the show.

So, even if some of that viewing is concentrated as our amortization methodology reflects, upfront in the sort of first release, the first month of release of that content on the site, it may have sort of steady viewing over the life and if it does, then it's going to be sort of reflective of those trends. If it's really concentrated, then, yes, sure, we would have to reflect that, but many of the non-renewals get wrapped up. Bloodline is an example of something that got wrapped up in a narrative. We're going to do a movie wrap-up on Sense8 and so I think, overall, you'll see us try to wrap the narratives on these.

Q - Doug Mitchelson

And I have some questions on content. I wanted to set up, Reed, with a question for you. In the past we've drawn parallels between Netflix and HBO and that implies Netflix is a TV network, and I think even in the letter this quarter, it talked about that, the TV network phraseology. It seems like you've expanded (17:29) the unscripted movies, original TV. Is Netflix instead more of a Comcast like version of Internet TV or should we think about it as pretty much TV network?

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

I'd think about it more like a super network. We are talking about addressing content desires and needs across the board, as you mentioned, unscripted, but also kids and films. This year at the Emmys just as an example, we have five different series nominated for best comedy or drama. We also have two documentary series nominated for best documentary series, two documentary film that got nominated for best documentary film. We won 10 daytime Emmys for our kids programming. So, we are doing across-the-board programming not programming for one niche, which networks tend to do.

Q - Doug Mitchelson

And then, for Reed, just a question on content (18:19-18:25)? And how do we measure aggregate value to customers buying (18:27) any one piece of content is becoming less and less important as you grow your body of original content?

A - Reed Hastings {BIO 1971023 <GO>}

Well, every piece of content that we do is important and we tried to have that content flourish around the world. But in terms of the overall investment levels, we are continuing to see increased median viewing compared to a year ago, two years ago, three years ago as we were winning a few more of the moments of truth of what do you do to relax? But still, we are such a small player in our viewing compared to linear TV, compared to YouTube, so we have got a long way to go to have more and more content to please more and more members and continue to grow. And what you see us doing as we grow is also improving our margins, so we are getting some efficiency out of that as opposed to spending every dollar in the content, but we are growing the content budget significantly also because of the opportunity that we see.

Q - Doug Mitchelson

Ted, back to you in terms of strategy for how you are producing content. When you think about the fact that Netflix now can self-produce titles, you can license exclusive originals from Hollywood studios, you can license third-party (19:45). Where do you see the greatest return at this point in time and how do you see the others responding to your strategy of self-producing of new shows at this point?

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

The success we've had with our self-produced shows has given us a lot more confidence to expand it. Because we're a global network, those rights are really important in terms of being able to control our destiny and when we can make shows available and what formats to make them available. And beyond that, there's an economic tradeoff, which is, there's a big studio margin that we're able to put on the screen and make better shows when we produce it ourselves.

So a show like Stranger Things, when it becomes a big cultural phenomena, we'd like to be able to control the destiny of those brands as we continue to invest in them. But at the same time, we want to lean on putting the best programming possible on the air, so not being dogmatic about what shows we pick, depending on their business model, but being really careful about picking shows that are great regardless of their business model. But you'll see us do a lot more of self-producing whenever we can.

Q - Doug Mitchelson

And so a last question in this series on content, Ted. We'll probably end up asking this sort of every quarter forever, but any issues on either cost of content or access to the best shows with more and more players? Obviously, Apple hired two (21:06) Sony executives. You had Facebook announce they're buying some original content. Others continue to expand. You're certainly competing very well and the Emmys are sort of proof of the quality of content. But on the margin, do you think (21:18) some projects go to others that (21:21) yourself?

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

Look, I think Internet television is the enormous space and there's going to be lots of competition. And as they come in, if they're going to bid up the cost of the best stuff, which is great, it's great for consumers because more things get made and it's great for creators because there's more buyers at the table. So we expect the content cost to go up on the top premium things, but I think I said I think that's a good result for everybody.

A - Reed Hastings {BIO 1971023 <GO>}

And that, of course, brings in new capacity, like you saw headlines today that Liberty Global and TPG were forming a new television studio to produce shows for all this new market. So, as the prices go up, there's more capacity because there's a very large numbers of writers out there.

Q - Doug Mitchelson

In the letter, it talks pretty explicitly about expanding distribution relationships, whether it's with broadband providers or pay-TV providers or bundling in Netflix service. And, I guess, two questions there. Reed, for you first, what about the reverse? Do you see Netflix as a platform that can bundle other video services and sell that on top of it and make a margin? And second, as part of that, any specifics behind the point (22:34) made in the letter that you expect to significantly expand these efforts?

A - Reed Hastings {BIO 1971023 <GO>}

There are several companies who are selling networks on top of their platform. So, Hulu is doing that, Amazon is doing that. We don't see that as a business direction for us. We're really focused on making our network as great as it possibly can be. And then as you point out, we're now looking at proposals for including Netflix in some services and beginning to learn the bundling part of the business. We're doing a little bit of that in Europe already and it's been quite successful. Thus, we're interested in expanding that.

Q - Doug Mitchelson

And shifting over to David and ASPs, I think in the past you've talked about mid single-digit being a sort of good aspirational point to consider. And when we look at the tiers that you have, it seems like the base tier is relatively premium (23:30) price to the middle tier and the upper tier. One, would you agree with that? And two, are there other ways to differentiate those tiers to create more value and have that be an even bigger part of ASP growth in the future?

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

Doug, I'm not sure I heard the first part of your question on ASP. So just repeat that first part.

Q - Doug Mitchelson

So, for ASPs, I think in the past you've said that mid single-digit growth longer term is the right way for investors to think about Netflix's pricing potential.

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

That's correct. So, if you're just looking for clarity there, yes, that's an easy answer.

Q - Doug Mitchelson

And when we think about the tiers that you currently have in place, the mid-size tier and the higher-priced tier, I feel like they're relatively close in price to the base tier. Is there other ways that you're considering to add value to the higher-price tiers to have tiering up be an increasing part of that ASP growth?

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

Well, I don't think so. I mean, right now, I would say we do see success with people taking the upper tier with just the differentiation of concurrent streams and high definition. So I think we don't think necessarily that we need to add more value. We have the flexibility to add more value in terms of that tier differentiation. But honestly, we think there's progressive growth just from thinking about differentiating those tiers on price point a little more in terms of middle and upper. And then in terms of an expectation of ASP growth, that's reasonable in terms of what you outlined. We are lapping the ungrandfathering of last year, so you are seeing sort of revenue on a year-over-year basis or ASP on a year-over-year basis start to reflect that lapping of a large pool of ungrandfathers coming off.

A - Reed Hastings {BIO 1971023 <GO>}

And, Doug, we're super proud that we've been able to maintain this $8 access point in the U.S. or €8 in Europe, which we've had in place since 2010. So all of this decade, Netflix has been available for $8. And when you think about the content increase over the last seven years, it's phenomenal, and it's still $8 a month at the base level. And we're getting the ASP growth as people optionally select to get HD and Ultra HD, which are amazing new formats that have come on. But again, a key part of the successful strategy is that we're staying very, very affordable for people.

Q - Doug Mitchelson

Yeah, it's interesting because you mentioned sort of the growth in contract and the service, Reed, and you mentioned that the median time spent has been increasing. Are newer customers that are coming on the service this year behaving similar to new customers two years ago or four years ago or...?

A - Reed Hastings {BIO 1971023 <GO>}

Similar and better. I mean, they're watching more.

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

More engaged, yeah.

A - Reed Hastings {BIO 1971023 <GO>}

Yeah, more engaged. Again, that's a combination of the user interface, the algorithms with the personalization and, of course, the content itself. So it's very exciting that we've been able to see even higher engagement with members now compared to last year and the prior years.

Q - Doug Mitchelson

David, I wanted to circle back on churn. You talked about the ungrandfathering churn. I'm just curious if you could sort of help investors understand how churn has evolved over time and do you see meaningful opportunities to improve churn from here and what specifically those opportunities might be?

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

Well, we generally talk about net additions just because of fluidity of somebody coming back on the service, it's hard to parse the two pieces. I've made comments in the past that generally year-over-year churn has improved as we improved the service, as we add more content, as subscribers age up. But more and more as our word of mouth and as we penetrate close to 50% in the U.S. today, those lines are fairly indistinct in terms of who's a rejoin or not and somebody may have been a member of the service 12, 14, 18 months ago.

So I would say in answering the spirit of the question, we continue to improve the quality of the service with more content, with a better interface, all the things that Reed just talked about in terms of driving value to the middle and upper tier to have people choose and electively choose a more robust service. I'd say that continues. And then outside the U.S., as we age, usually the pattern there is to improve the quality of the library. We better match the taste, and that includes both Western content for that local audience and a little bit of local content as well that Ted talked about earlier. So we expect to improve churn outside the U.S. as we get better and better in these markets.

Q - Doug Mitchelson

Sticking with you, David, on the margin side, you've in the last letter and this letter talked about a 7% margin target this year and modest expansion thereafter. Care to help investors out at all in terms of understanding what that pace of margin expansion might be relative to investment opportunities that you have?

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

Well, we're focused on making the 7% this year. We know that we'll clarify that towards October, but we want to balance both growth of the business and reinvestment back in the business, given that we're seeing some great returns on that content, given the growth that we experienced this last quarter with sort of a disciplined growth of profit. We also know that you can't just hockey-stick it in three to five years and expect the business to be in the right place. So I think it's a bit of a balance and right now that 7% with sort of consistent and deliberate growth after that is the right guidance for our investors.

A - Reed Hastings {BIO 1971023 <GO>}

And, Doug, if you remember, last year we were at 4%. So you might be able to apply something there.

Q - Doug Mitchelson

Thank you, Reed. Appreciate that. What would be helpful as well sort of getting the details a little bit on it, David, is can you frame the margin progression in terms of where the leverage comes in the cost structure? Is it the content side, the marketing side, G&A, tech and dev? Where should we see the most leverage in the cost structure over time?

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

Well, to-date, it's really just been about, as we expand globally and people watch a lot of the same content – Ted talked about cost pressures in terms of, as more people piling at the top end of the market on the unit cost of content costs, but we've been able to grow even faster than that. So we're able to expand both our content spending and our margin at the same time because we are growing faster than that content. We expect that to continue forward for the foreseeable future.

We are leveraging marketing. We are spending more on an absolute basis on marketing as we become more and more of a media company. But on a percent of revenue basis, we are leveraging there. G&A and tech and dev has kind of run a little bit in line with revenue as we expand internationally and as we become more of a full-fledged studio and a bigger and at-scale studio. So it's pressure there in terms of adding people. But I do anticipate the ability to leverage some of that down the road.

Q - Doug Mitchelson

The free cash flow burn, and certainly an interesting comment, and you mentioned it last quarter in the letter, you mentioned it this quarter in the letter. I think similar to margins, investors are trying to read between the lines and understand how free cash flow burn might progress over the next few years. First, I think actually for you, Reed, why the comfort level with this level of negative free cash flow? And, David, any sense you can give investors as to does it carry forward at these elevated levels? Does it get better but take a while to get to breakeven? Any help would be appreciated.

A - Reed Hastings {BIO 1971023 <GO>}

Look, when we produce an amazing show like Stranger Things, that's a lot of capital upfront and then you get a payout over many years. And seeing the positive returns on that for the business as a whole is what makes us comfortable that we should continue to invest and integrate to basically self-develop many more properties, as Ted can find the appropriate ones. And then there's comfort with being able to finance it. And, of course, our debt to market cap is incredibly low and conservative. So we've got lots of room there. And I think that combination that it's spent well and we can raise it is what makes us very excited.

The irony is the faster that we grow and the faster we grow the owned originals, the more a draw on free cash flow that will be. So, in some senses, the negative free cash flow will be an indicator of enormous success.

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

And then to annotate your second part of your question, like Reed said, this is a success scenario in the sense of, as we scale and if we are scaling faster, we're going to reinvest part of that back into the content, and that has implications on the cash side. So, for us, as we've seen success with both the popularity of our owned originals, we've expanded into other content verticals. And as we scale faster, as we grow faster globally, that has implications.

That said, we gave you an indication of around $2 billion, this time we've updated that to be between $2 billion and $2.5 billion. So you can think about that as a 10% to 15%. And you put that in line and compare that with our subscriber growth on the top line, you kind of get some indication that we are still being very disciplined about the efficiency of our content cohort investments, and we are looking at how those shows perform over time. But if we have a bigger prize and if we see a bigger prize (33:10) that's going to have some implication on the cash flow side.

Q - Doug Mitchelson

Couple more for Ted and then I think we'll wrap up this meeting. Ted, one question I get a lot is, is the investments in movies. And I think part of it is, with a TV series that it's a brand that goes forward, there's sort of year after year of episodes versus one time for a film and film could be very expensive as well (33:32). And I think in the letter you talked about we believe Internet TV can reinvigorate the film business. So, one, confidence level on your film strategy at this point? And two, any thoughts behind the statement in the letter would be helpful.

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

Well, look, we are doing a lot in the film space for a lot of the same reasons we are doing it in the television space, which is access to great content when consumers want it around the world. So we think it's a good investment. We're trying a lot of different things. Some of them work out great, some of them work out not so great, and we've learned from every single one of them. So we're going to continue to invest in that space because we can bring films to our members when they want them, which is when the world is talking about them, and that's almost impossible to do with a studio partner. So that's why we are pushing down that road. I think that in success, our films will be able to attract subscribers and retain subscribers the way our series have, and that's why we are working so hard at it.

Q - Doug Mitchelson

Another question I get I think is just so noticeable is the investment you made in comedy and we talked a bit about that last quarter, Ted. But is there something behind that strategy in terms of forming close relationships with comedians who also might be actors in TV shows and movies or is it simply ROI (34:50) so keep investing more?

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

Yeah. The category is remarkably efficient even at the premiums that you have to pay to get the superstar talent attached to them because it gets a big audience. They get watched like movies. And just think about it that the main cost of them is the talent themselves versus the cost of production. And it's been also a great way to invest in content partners because as like Chris Rock, by way of example, is getting ready to shoot his special for Netflix, he's right now starring in the next Adam Sandler movie that's being shot right now in New York. So we're really excited about being able to work with great talent like Aziz Ansari, like we did with Chelsea, across the entire platform whenever we can.

Q - Doug Mitchelson

And shifting over to Reed, I noticed in the letter it said over 1 billion hours per week of viewing on the Netflix platform. Is that 1.1 billion or 1.2 billion?

A - Reed Hastings {BIO 1971023 <GO>}

And climbing. That's what we're working on.

Q - Doug Mitchelson

I think I wanted to wrap up with a couple of questions. First, regulatory, Reed, I think you've already expressed your opinion quite clearly on net neutrality. But more broadly, if you look at the regulatory environment globally, particularly in Europe, there appears to be an environment that is a challenge for American companies and certainly Google and Facebook. What's your approach to the regulatory environment given these challenges?

A - Reed Hastings {BIO 1971023 <GO>}

Well, first on net neutrality, the recent effort that we participated in generated over 3 million additional comments to the FCC demanding that the net neutrality rules stay in place, bringing the total to over 8 million comments. So certainly we, other companies, the public have weighed in heavily. We'll see where that goes.

When you look at Europe, we are making big investments in local content, local productions, working well with local content companies. And so I think it'll be a really different dynamic, or we hope so, with Netflix than maybe with other firms because just of the business structure. We are able take some great French and German and other content, Spanish this quarter, and share it around the world and that creates big new markets. So think of us much more as trying to curate some of the world's best content and share it with the world versus the moniker of being a disruptive tech company.

Q - Doug Mitchelson

And the last question from me, we're talking a lot about the shift from linear TV to on-demand viewing. It's something that you talk a lot about, Reed, and you talk about how much leisure time and how many Internet TV services will be successful. And while that's all well and good, I imagine that Netflix wants to continue to be the leader in this category. So just final question is, Reed, how does Netflix sustain and expand its leadership position? Because while the market opportunity might be big, I'm sure you're busy executing every day.

A - Reed Hastings {BIO 1971023 <GO>}

More watching, less sleep.

Q - Doug Mitchelson

And what are you doing and what is Netflix specifically doing to make sure that Netflix leads that more watching, less sleep charge?

A - Reed Hastings {BIO 1971023 <GO>}

Well, again, I'm not sure we are leading it when you look how far ahead YouTube is. Now, you might say, well, it's different content, but it's still very engaging for the audience that's choosing it. But we don't really focus on like who's ahead in certain things. What we focus on is doing our best work. And Ted runs a lot of that with the content. We're doing amazing work in product, making it easy to use, fast, and then finally, all these distribution agreements and marketing we're doing. So we're just improving around the whole company, growing what we have, and we're very excited about what we've accomplished, but what's ahead is also super exciting.

Q - Doug Mitchelson

Thank you, all, very much.

A - Reed Hastings {BIO 1971023 <GO>}

Thank you, Doug.

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

Thanks, Doug.

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

Thanks, Doug.
