

Q3 2020 Earnings Call

Company Participants

- Gregory Peters, Chief Operating Officer & Chief Product Officer
- Reed Hastings, Co-Founder, Chairman, President & Co-Chief Executive Officer
- Spencer Neumann, Chief Financial Officer
- Spencer Wang, Vice President- Finance and Investor Relations
- Theodore Sarandos, Co-Chief Executive Officer & Chief Content Officer

Other Participants

- Kannan Venkateshwar, Analyst

Presentation

Spencer Wang {BIO 3251222 <GO>}

Good afternoon and welcome to the Netflix Q3 2020 Earnings Interview. I'm Spencer Wang, VP of IR and Corporate Development. Joining me today are Co-CEO Reed Hastings; Co-CEO and Chief Content Officer, Ted Sarandos; CFO, Spencer Neumann; and COO and Chief Product Officer, Greg Peters. Our interviewer this quarter is Kannan Venkateshwar from Barclays. As a reminder, we'll be making forward-looking statements and actual results may vary.

With that, let me turn it to Kannan for his first question.

Questions And Answers

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Spencer Neumann {BIO 3006410 <GO>}

Yeah. Sure, Kannan. Thanks. So, first sort of stepping back, if you think about the Q3 subscriber numbers, it was really very much as expected for the quarter. To look at Q3,

FINAL

the biggest impact was really the first half of the year, and a giant pull forward in subscriber additions in the first half of the year with COVID. When we have that much pull forward, we expected and knew there'd be some level of slowdown and we tried to project it as best we could. But it's super difficult to forecast with perfect precision given all the unknowns and factors. So we actually came pretty close to land within 300,000 members on a member base of roughly 195 million. That's pretty much forecast noise and there is a number of ins and outs. But the general underlying metrics, as you say, are very healthy, so retention remains well at very healthy levels better than where we were a year ago, acquisition remains strong. So you're just seeing some kind of a natural kind of -- because of that pull-forward effect some slowdown, but don't want to lose sight of the fact that to measure our business is really not based on any single quarter of growth fluctuation. It's really about it should be measured in multi-quarter and multi-year trends. And so if you look at the past three quarters, year-to-date through Q3, we've grown by little over 28 million members, which is more than we grew all of last year. So super healthy growth and the underlying both top line and bottom line growth and retention trends in our business were healthy.

A - Reed Hastings {BIO 1971023 <GO>}

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

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Reed Hastings {BIO 1971023 <GO>}

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

A - Gregory Peters {BIO 17539678 <GO>}

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

A - Reed Hastings {BIO 1971023 <GO>}

FINAL

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

A - Spencer Neumann {BIO 3006410 <GO>}

I think you -- I think you both hit on most of it. I would just emphasize that in the letter Kannan we're really talking mostly about the year-over-year comparison for the first half of '21 versus the first half of '20 and that's because of the dynamic that Reed was mentioning, if you look at the first half of this year, again, we grew by 26 million members in the first two quarters of 2020, that's more than twice the level of growth we had in 2019.

So again, we're just, we're sort of growing through that big acceleration in our member base. So we shouldn't expect year-over-year first half to be comparable.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

Got it.

A - Reed Hastings {BIO 1971023 <GO>}

Just try and temper that enthusiasm Kannan (Multiple Speakers).

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Reed Hastings {BIO 1971023 <GO>}

You know, we do look at some of this, but we try not to get overly focused on COVID effects because they're very one-time in nature, and by and large now engagement churn, all of those metrics are like we would have expected from a year ago. So think of that as a minor background effect and there was the temporary learning when there is no sports,

but it's like, well, it's not really that interesting a finding as it's just not relevant to the world, now we're back in a world with partial sports and it's behind and we're growing.

So again, you know, we compete so broadly, we compete for time against Tik-Tok and YouTube as well as HBO as well as Fortnite. So really the limiter for us is, what's the quality of our service, how often -- how many nights, you say, my God, I want to go to Netflix and watch the next show?

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Theodore Sarandos {BIO 4812832 <GO>}

Yeah.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Theodore Sarandos {BIO 4812832 <GO>}

Yeah, like we pointed out, since the COVID shutdowns, we've completed production on over 50 productions, and we expect another 150 before the year is over. So all that -- that ramp-up puts us back to nearly fully operational in most parts of the world. Those productions may go a little slower than we had planned, but materially we are back -- we're back in business of production in most places of world, including in North America that have come on slower. So we've got -- so I think when we're looking at the '20 -- the '21 slate, everything that we forecast for '21, we expect to hit in '21 with a few minor exceptions. And some maybe a little more back weighted than we had planned for early last year, but we plan on it all coming out and I think the thing that we've really been amazed by has been the adaptivity of our production communities to step up to the plate in these new COVID protocols and get the work done in such an incredible way and then so safely. We've had a couple of shutdowns and I really think that we're in a place right now where we should expect that to happen, that we'll have production shutdown and the art of it is how quickly and safely can you reopen? And we've been going through that in different parts of the world every day. But right now, I'd say that we're back to near steady state in physical production.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

Got it. And Greg, from your perspective, when you think about the price increase decision recently, I think there was a price increase in Canada and Australia. Is this based more on some kind of an algorithm around content release slate and subscriber momentum or is this based more on the strategic goal of where you want to be with respect to ARPUs over

FINAL

Bloomberg Transcript

a given timeframe? So how should we think about the cadence of price increases going forward given that productions have been starting now?

A - Gregory Peters {BIO 17539678 <GO>}

Yeah, no magic algorithm, but the core model we have is, and we think really our responsibility and our job is, is to take the money that our members give us every month and invest that as judiciously and as smartly as we can in creating new amazing stories. We've got titles that are coming at a price in increasing range of genres, amazing movies like Old Guard and Extraction and more animation like Over the Moon, Willoughby's, and Klaus. And so just basically delivering more value for our members' better product experiences. And if we do that well and we seek to basically every day be better about pretty much every component of how we're investing that and make that efficiency and that effectiveness better, we will deliver more value to our members and will occasionally go back and ask those members to pay a little bit more to keep that virtuous cycle of investment and value creation going.

And as we said before, we look at every country independently. So when said of any algorithm, we're just basically assessing, okay, how many new popular titles have we delivered? What our local language originals in that particular country looking like? What's the slate that's coming looking like? What is the fundamental metrics, right, engagement and churn, what do those look like? And then we just, we do an assessment. When we say -- we believe that we're really delivering more value to our members. And if so, do we think it's the right time to go back and ask them to pay a bit more, so we can again keep that cycle going.

And I think the one other important thing to note here, it's something Northstar that we hold close to our heart in this whole process is we think that we are just an incredible entertainment value. And we very much want to remain an incredible value as we continue to improve the service and grow.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Gregory Peters {BIO 17539678 <GO>}

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

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Gregory Peters {BIO 17539678 <GO>}

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

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

That's interesting. So I guess that dovetails into a question I had for Ted which is more around some of the shows that have been licensed or reverse licensed if I can use that term to cable networks as well as services like Pluto and obviously some of these are not your productions, they are owned by somebody else. But is this a bigger opportunity in general with your originals, and the opportunity to stream Netflix for free either as an event or even as a starting tier as a mainstream product with your licensed content -- or your legacy content, which may not be as productive anymore with your existing base, is that something that you're willing to explore in a bigger way?

A - Theodore Sarandos {BIO 4812832 <GO>}

Yeah. I think we're -- we're always looking at new different ways for people to get a sample of the content that everyone is talking about including trying to service out here and there in different ways. I think licensing our content to other people, mostly, I think it's helpful for us to keep our original content on Netflix. So people understand the value proposition of Netflix.

And we have seen our ability to grow a show that was on other network or a smaller outlet, pretty meaningfully. We've not necessarily seen it the other way around when we've experimented in the past with things like actually with Narcos, when we licensed it to Univision in the past and try to -- get people to try to sample the show.. We don't own that show Gaumont and the deal that they did was something that it'll be interesting to see how if it lifts the awareness and interest in Narcos but it's on to relatively small platform relative to Netflix.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Theodore Sarandos {BIO 4812832 <GO>}

Well, I can talk to you on one of the major changes that we're really excited about, which is I was restructuring the content team to be more like our film team and more like our animation team and have one global organization. And to run that, I tapped Bela Bajaria who has been with Netflix for a long time, has come in to start our unscripted group, brought in that team from scratch and they developed this incredible scripted outlet slate that we have today, moved over to our local language original team, hugely successful. These are two areas of the business that are going to grow three times or four times over the next three years to five years. So I thought that she was really well suited to take on that organization. And she entered in that English language scripted series business. She joined us from Universal Television, where she was the President and had brought us such shows as Unbreakable Kimmy Schmidt and Master of None and she also orchestrated to bring You on as a Netflix original and delivered that first great season of Witcher. So I think Bela is going to be phenomenal running that group. And then there were some changes after that, that whenever you put new change at the top, there are some downstream effects as well.

A - Reed Hastings {BIO 1971023 <GO>}

And Kannan, to your broader questions, yes, we're always trying to broaden our talent as we take on bigger challenges. So, Greg took on Head of Product about three or four years ago, Spence CFO about a year-and-a-half ago, Spencer, IR, about eight years ago, and they all have grown into those roles. But it's a normal model. No one gets to keep the job for free, you've got to earn it every year, which is intensely challenging and we all love that part of it.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Reed Hastings {BIO 1971023 <GO>}

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

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

That's great.

A - Spencer Neumann {BIO 3006410 <GO>}

I thought I was going to do keeper test right here --

A - Theodore Sarandos {BIO 4812832 <GO>}

(Multiple Speakers) I would have been in Netflix --

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

And one of the things I guess which has surprised me over the course of the last year is the way most of you have spoken about the impact of content on growth, right. And I think that started around Q2 of last year, when there was a big miss. And one of the reasons attributed was the content slate at that point and now we increasingly talk about comps versus last year, when you have a big show, like Stranger Things. I would have expected the opposite to be honest, when you have 200 million subs and when the content slate is so big, content -- singular pieces of content should in theory become smaller parts of overall consumption. But it seems like it's starting to have a bigger impact.

Could you help us think through the content skew in consumption? Is that skew more or less over time, and why is that seemingly having a bigger effect, but is that just me reading too much into some of these comments?

A - Reed Hastings {BIO 1971023 <GO>}

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

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Reed Hastings {BIO 1971023 <GO>}

Correct, and because the growth rate has been steady, let's call that 30 million a year in round numbers, percentage on the base is a bigger fraction of that. So you see a bit more. Yeah, from a practical standpoint as investors. It's a bigger deal. But remember it's variations in the growth and the stunning thing is just a big picture outside of COVID how steady the growth has been year after year after year back to this underlying growth model is like diffusion of word of mouth, Netflix is a better way to go. And then you capture a little more of that when you have a big show. And then you have a shadow under that. So I think of it as like a big general diffused model and then you're just seeing a little surface variations that are happening.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Reed Hastings {BIO 1971023 <GO>}

It is true that they're less because in the earlier days of Netflix remember, we were trying to figure out what we can stream and we were licensing in bulk and volume just a lot of content, just to see what worked well versus today where we're much more deliberate about the programming and we really don't focus that much on the title count. Remember in the early days of streaming, if one was -- that was the marketing war was how many titles you had, but it turns out that doesn't, isn't that meaningful if people don't watch them.

So what we've really done is concentrated on the titles that have a lot of impact and can aggregate big audiences and move the business forward and add a lot of value for our members. So we really don't focus on the title count, but you are correct, it's significantly lower than it was when we first started streaming, I'd say, 10 years ago where we used to license an entire library of 800 films from somebody and nobody watched any of them.

So it's really not a chase for how many titles, but, are these the titles you can't live without?

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Theodore Sarandos {BIO 4812832 <GO>}

I'll tell you the thing that we've been working on and train and doing, if you think about how many more original series, we produce today than we used to and how many more we're producing relative to everybody else in the industry and around the world and yet last year we had 160 Emmy nominations for our television slate, which is the most honored single season of television in the history of the Emmy's. That kind of quality attracts more quality.

We are doing that today in how we're building up our animation slate. Last year, we released two feature films that were nominated for the Academy Award for best-animated feature, both were pretty popular, Klaus was extremely popular, also won the BAFTA Award for best animated feature and six Annie Awards, which is a celebration by -- from animators of the best work of the year and that kind of quality keeps attracting more quality.

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

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Gregory Peters {BIO 17539678 <GO>}

Sure. On the Google Play Store specifically, I think you -- I won't comment on the details of any given partnership, but you can look at our position on iOS where for quite some time we've been signing up new members on those devices through the mobile browser using our own payment method. We're not dependent on the App Store for discovery, we're not dependent on the App Store for payment and we've seen steady solid growth through that channel. So it's been quite effective regardless. I think that's relevant to note, when you think about sort of that dynamic.

And then to your point, look, I mean, the world is shifting to streaming into Internet TV and a bunch of new players are coming in, and so I think the dynamics between those relationships, aggregators, device manufacturers and new streaming services are being worked out, but we have been in this business for quite some time and we've invested in relationships with device manufacturers and platform owners for over a decade, and we

really, really focused on making this a positive experience for them adding more value to their devices because where they're making it great for us because we get to use those devices to access new consumers around the world and making great for the people to purchase those devices because they have these incredible experiences with Netflix and the amazing stories that we tell on those devices.

And I just don't -- I don't see any significant change in that sort of positive model, we're investing, here we have full teams who basically just do nothing but make it great for our device manufacturers to take our technology on and deliver then great experiences to the consumers who buy those devices.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Gregory Peters {BIO 17539678 <GO>}

Yeah, a very significant majority is driven by the recommendations that we present. And so, I think to your point, the model that we are working with is that millions of people -- millions of our members show up every day to our applications, our interfaces looking for something great to watch. And so we really have a tremendous opportunity to fulfill that interest and fulfill that demand. If we do a good job at -- through the recommendations, the titles that we select, how we present those titles in a compelling way of giving each of those members something satisfying in that moment, then they are happy, they're fulfilled. And that means the next night when they're thinking about, like what do they want to watch or how do they want to be entertained and you think about the wealth of options that are available to them, that sort of Reed went through. But if we've done a good job the previous night, they're going to turn to us again and we have an opportunity to sort of fulfill again and to sort of keep that positive feedback process. And so we're really deeply invested in that. We have hundreds of people who wake up every day and sort of do both their entire professional existence to making every aspect of that work better and better and better. We know we're going to be doing that for decades to come but super exciting

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

Yeah. And I guess, this also means that as you evolve this process, some of the KPIs internally that you measure performance on also changes over time. And I think, Reed, in your book, you've mentioned an interaction with your Chief Marketing Officer at the point, I think this was in 2016 where she pushed back against customer sign-ups being used for measuring performance of the marketing team instead of retention. And I think, ultimately, you guys went with retention. But over time, a number of these KPIs seem to have shifted internally. So could you help us understand how you measure performance

to the extent you're comfortable doing this? How do you measure performance for the content team? Has this focus shifted from origination to retention? Is that a bigger part of how you think about the business broadly, odd-even features such as engagement, for example?

A - Gregory Peters {BIO 17539678 <GO>}

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

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

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

A - Theodore Sarandos {BIO 4812832 <GO>}

Yeah, I would agree with you. I mean, I think one of the things going back to what Greg said, it's not unusual for a Hollywood studio to spend 50%, 70%, sometimes 100% of the production budget of a film in marketing to get people out to the box office on opening weekend.

Now, we do a fraction of that for our advertisers -- in terms of paid advertising for our films and yet, we're getting 70, 80, 100 million folks turning out to watch those movies in its first 28 days, which is like a \$1 billion box office in terms of cultural impact. So, when I look at that and I think that's the enormous promise of the scale and the recommendation engine, the value of the recommendation on Netflix to make sure you have a great experience and come back looking for the next one.

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

Netflix movie. And when they are talking about a TV show, they're talking about a Netflix TV show and that's sort of thing that we're building toward every day.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Theodore Sarandos {BIO 4812832 <GO>}

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

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Theodore Sarandos {BIO 4812832 <GO>}

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

A - Spencer Wang {BIO 3251222 <GO>}

We have time for one more question, Kannan.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

Got it. So, Spence, I guess the mandatory free cash flow question that we have to get to. Now that you have potentially \$2 billion in free cash flow over the course of this year and obviously, I mean there's a lot of lumpiness in this just given the cadence of content production. But broadly, when you think about maybe a three year, four year kind of a horizon, you are getting to a point where cash flow use is going to be more than just about content. How you're thinking about your capital structure? As you get closer to this breakeven point, what's the use of cash once you've done free cash flow positive?

A - Spencer Wang {BIO 3251222 <GO>}

Yeah. Sure. Well, thanks, Kannan. The free cash flow story is an exciting one for us right now. As you can see, the free cash flow profile is improving. Obviously, this year was a bit short term with not just improving profitability, but also the reduction in content spend as we look forward to 2021 already. We guided to free cash flow -- negative free cash flow of negative \$1 billion to breakeven, so vastly improved from our peak negative free cash flow in 2019. We're not yet sustainably free cash flow positive, ready to call that. But we're rapidly closing in. And so given the more than \$8 billion of cash on the balance sheet, we are at a point where at least you probably pretty safely say that we can self finance our growth without needing to access the capital markets. But we're still -- we are still obviously based on our guidance, probably a couple years away at least from sustainably being free cash flow positive. So it's probably a little too early to call our long-term capital allocation approach, other than to say that you can trust that we're going to be -- we're going to remain disciplined and we're going to take an approach that we believe will maximize the long-term value for our shareholder and so more to come on that front.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

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

A - Reed Hastings {BIO 1971023 <GO>}

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

So really looking forward to next year.

Q - Kannan Venkateshwar {BIO 15351027 <GO>}

Thank you so much, Reed.

This transcript may not be 100 percent accurate and may contain misspellings and other inaccuracies. This transcript is provided "as is", without express or implied warranties of

any kind. Bloomberg retains all rights to this transcript and provides it solely for your personal, non-commercial use. Bloomberg, its suppliers and third-party agents shall have no liability for errors in this transcript or for lost profits, losses, or direct, indirect, incidental, consequential, special or punitive damages in connection with the furnishing, performance or use of such transcript. Neither the information nor any opinion expressed in this transcript constitutes a solicitation of the purchase or sale of securities or commodities. Any opinion expressed in the transcript does not necessarily reflect the views of Bloomberg LP. © COPYRIGHT 2021, BLOOMBERG LP. All rights reserved. Any reproduction, redistribution or retransmission is expressly prohibited.

FINAL

Bloomberg Transcript