JPMorgan Global Technology, Media and Telecom Conference

Company Participants

- David Wells, CFO

Other Participants

- Unidentified Participant, Analyst, Unknown

Presentation

Unidentified Participant

All right, we're going to go ahead and get started. I know the room is still filling in a little bit. But thank you all for being here today. And it is our pleasure to have with us David Wells, CFO of Netflix.

So Netflix, the world's leading Internet subscription service. In the US more than 29 million streaming subscriptions; more than 7 million internationally; and also about 8 million DVD subscriptions in the US.

David has been CFO since December of 2010. Prior to that he headed up FP&A and was also the director of operations planning. He has been with the Company since 2004. So welcome, David.

David Wells {BIO 17034721 <GO>}

Thank you.

Unidentified Participant

All right. So let's talk Domestic streaming. You announced pricing changes were coming up on -- two years ago, basically. How are you feeling about the brand here and your relationship with customers at this point? Do you feel like you have repaired a good amount of the damage that was sort of done at that point?

David Wells {BIO 17034721 <GO>}

Yes, I think what we said was it would probably be about a three-year period of general recovery. And I think that still holds, with the first-year holding the balance of the largest part of that recovery. And I think that is still true.

We continue to see improvements both sequentially and year-over-year in our likelihood to recommend, which is the equivalent of our Net Promoter Score. It is a like measure. And we continue to see that reflective in improvements in our net additions via retention.

So I would say we still feel like there is still more recovery to be had. Most of it has been there. But we still have some more recovery we could do.

And we are still mindful that any sort of negative pricing things could set that fire off again. So we're a little bit mindful of that still.

Unidentified Participant

Okay. All right. How do you think about balancing the growth of streaming revenue versus margins going forward? Are you managing the business toward a certain long-term margin target over time? Can you be at HBO-like margins, in your view?

David Wells {BIO 17034721 <GO>}

Well we are not to managing to a long-term margin target per se right now. What we have is a commitment and a target of a 100 basis point expansion, or average of 100 basis points a quarter; and we feel pretty good about the ability to expand both margin and content spend and gross subscribers -- all three of those things. So we feel pretty good about the level of marketing spend, about content spend. And product spend.

Because it is not just about the content spend; it is about those other two things as well. We routinely evaluate the level of spend in all three of those areas. And we feel like there is a good discipline and cadence to gradual margin expansion as long as we are able to continue to grow our content library at the same time.

So in general, the business feels good, healthy. There is some good discipline to it. But we are always evaluating on the margin whether there is an opportunity and whether we should temporarily park that commitment or not; and so far we are able to continue to do that.

Unidentified Participant

Okay. These are numbers you obviously don't report anymore. But maybe you can just help us think a little bit more broadly about how churn has trended over the last year. You have said there is a direct correlation between time spent on Netflix and then also, of course, the propensity to churn.

Your viewing hours per user continue to grow. Yet it is unclear how much the rate of churn has come down. Can you talk through this dynamic a little bit?

David Wells {BIO 17034721 <GO>}

Sure. Our general focus is on net additions because there is a lot of noise in the turnaround, rejoins. In general, retention has improved year-over-year; and that is reflective in our -- really the perception and reality of the content library and the quality of that content library.

So you will hear me and I think you will probably ask -- are likely to ask me about originals. That is part of the overall --

Unidentified Participant

Originals?

David Wells {BIO 17034721 <GO>}

Yes, exactly. That is part of the overall content library perception. So are big deals that we have done in the past. In Q4 in Disney we announced that we added some Disney catalog to the site. All of this contributes to the overall content perception. And that is manifested in both acquisition and retention and in net additions.

Unidentified Participant

So what do more recently acquired subscribers, their composition and retention characteristics look like compared to people who have been in the base for a little bit longer at this point? You have obviously seen a shift years ago, DVD to streaming. What does that change look like now?

David Wells {BIO 17034721 <GO>}

Well it is still true that subscribers who first come into the service retain at slightly lower rates than subscribers who have been with us a while. So there is still a retention curve improvement as subscribers age with us.

It is also true that subscribers who view more retain better than subscribers who view less. So both of those things are true.

I think what you observe is that as a member or a consumer comes into the service, they are evaluating how much value they receive from the service and over time they settle into a pattern where they feel like they get very good value from the service. And those who don't turn out. And that is what creates that pattern, that relationship.

Unidentified Participant

Okay. You've talked about implementing the family plan for additional streams, for streams greater than two basically. But at the same time you've talked about the sharing of passwords really not being an issue in your mind.

How do you reconcile those two? And what is the opportunity with more of the family plan?

David Wells {BIO 17034721 <GO>}

Well we introduced the 4-streaming plan. And it is a very, very small percentage of the base -- we said less than 2% that this would appeal to. And that is based on observations of people actually running into the cap of two simultaneous streams and also calls to our customer service center.

So it is a very small percentage of the base. It solves a problem for very large families and households.

And with respect and relative to password sharing, honestly, if password sharing were a bigger problem, the 4-stream actually might exacerbate that because then -- now you are allowing even more people to share one common plan. So if we felt like that was a huge problem, it would have factored into the calculus of releasing a 4-stream plan.

I don't -- our observation and our view is that password sharing is not quite as large as has been out there, floated out there.

Unidentified Participant

Okay. We talked earlier about brand recovery and where you are. But at the same time you are providing a lot of value for $8 a month. So I think we understand that pricing is consistent for the near future.

What would give you the confidence at some point in time to think more that the service has some pricing power without negatively impacting the brand and user sentiment?

David Wells {BIO 17034721 <GO>}

Well as you pointed out, it is sort of time away from the July 2011 event. It is also relative to competition. So even though folks can feel like in a vacuum that the price point feels like there is room, it is relative to what the available consumer alternatives are and the competitive environment as well.

But we feel pretty good about the $8 price point. We are able to continue to grow subscribers, we are able to expand content. And we are able to continue to focus on product improvements at the $8 price point.

And I am assuming that question was focused on the US. Outside the US we did do a small increase in Brazil. So we have raised price in Brazil. But other than that, that has been flat.

Unidentified Participant

Okay. All right, let's talk more about content. Can you help us understand the returns, how you think about them in terms of viewing hours per dollar spend across non-exclusive content, exclusive content. And then also originals?

David Wells {BIO 17034721 <GO>}

Sure. We have talked in the past about cost per hour. So if you take the cost of a particular piece of content and divide it by the number of hours viewed, that gives you a relative measure that you can compare it to other pieces of content or other content deals. And that is a particularly sort of objective way to look across the content library.

You have to account for different types of content. So obviously, exclusive content is going to be more expensive than non-exclusive content and therefore might be more valuable. You can argue that it is more valuable to the consumer and to the subscriber -- and we do.

So what you see in our content spend and our offering is a portfolio that addresses -- we have some non-exclusive, some exclusive, some original content that falls into that exclusive and new content. So there is a portfolio. And we are always looking to push towards more optimal spending and experiment within those classes.

But in general I would say cost per hour is still a good relative metric. But we also look to and acknowledge that having movie Pay 1 feature content is important. That tends to cost more. But it is very important to the subscriber.

So I don't think you would expect us to shift all the way towards, say, 95% television, 5% movies. There will be a balanced portfolio in our approach even going forward.

Unidentified Participant

Okay. How has your philosophy on content spending changed in terms of quantity versus quality? We now see that you are being more selective in a way. And we certainly see this perhaps in your Viacom discussions as well.

David Wells {BIO 17034721 <GO>}

Sure. We have migrated and evolved more towards being curated, which is a little bit choosier. And I would say that is part of a natural evolution. You could say that most folks would have predicted that we'd get there.

It is also -- there is a couple of big forces that contribute to that evolution. One is the competitive environment, certainly in terms of moving the market towards exclusive deals. That is part of that calculus.

I would also say just our own experience and the willingness of the content suppliers to be more comfortable, now that there is a couple of bidders, with Amazon and us. And there is more track record and experience of non-cannibalization of their existing streams.

So early on, let's say three to four years ago, when we were looking to build the streaming offering, there was a lot of hand-wringing -- and understandably, on their part -- in terms of how much cannibalization would this engender. Is this a good thing?

So there was more experimentation and more bulk deals done, because in general some of that bulk didn't really have another monetization alternative. So now you are seeing that become a force as well.

Unidentified Participant

Okay. You talked about House of Cards driving some modest impact, let's say, on net adds in 1Q. Probably helping retention more than actual gross adds. How are you thinking about things for Arrested Development here in 2Q and 3Q?

David Wells {BIO 17034721 <GO>}

Sure. I think I would say we are consistent in the expected case is that it will take multiple titles for there to be a real impact on both -- on our net additions even through acquisition and through retention.

I would say Arrested fits in an interesting category because it's got a very, very loyal fan base established. So there is an acknowledgement on our part that it might have an impact in Q2; and that we otherwise would have felt like we had lower year-over-year net additions for Q2 based on a seasonal pattern. But Arrested is a wild card.

So I would say in general we are excited about it. It comes out in 10 days. It has got some really funny stuff in it, if you are a fan. But it is a bit of a wild card.

Unidentified Participant

Okay. I got an e-mail the other day from Amazon and they are actively promoting House of Cards DVD coming out in June. How does this make you guys feel? You license original content for a period of time but you don't own the rights to it. Should you, going forward?

David Wells {BIO 17034721 <GO>}

We own the online distribution rights. We didn't -- MRC, which developed House of Cards for us, we still feel really good about the length of that engagement. I have heard reports out there. And I can assure you that the license period is longer than being discussed and it extends if there is another season.

The DVD rights were not owned by us. And they are monetized by MRC. Obviously we would ordinarily not want that to be on a competitive service.

But when we entered the originals business it was a conscious decision not to enter with full ownership. There was much more risk, much more cost associated with that, because you have to compensate the producer for those other monetization channels. And this is an outcome of that.

I would say for the cost of the DVD library you can be on Netflix for four-plus months. So we will see how engaging it is in terms of how many folks buy it.

Unidentified Participant

Could you see Netflix over time going down the path more into owning content, being more involved in the creative process?

David Wells {BIO 17034721 <GO>}

Well involvement? I think you should separate involvement in the creative process from the ownership of the intellectual property, because they can be very distinct. But it is definitely possible for us to experiment with more full ownership models in terms of also owning the other distribution mechanisms for a piece of content.

Unidentified Participant

Okay. We have heard Netflix talk about potentially doing 20 originals in a year. I think this year you're in the seven, eight kind of range.

What does it take to get there? What kind of time frame is that? Is it realistic?

David Wells {BIO 17034721 <GO>}

Well it is certainly realistic in a longer time frame. A year is probably not realistic unless we see a lot of good, quality projects. And the lead time to develop those, a year would be very aggressive.

So I think in general we are pleased with the current productions we have had and will continue to experiment within genre, within type of content. And if it makes sense you would expect us to expand that; and a doubling over two or three years is possible. A doubling over a year is pretty aggressive.

Unidentified Participant

Okay. I have a lot more questions. But given just that we have such a crowded room, if you guys do, please head toward the mics. We may have one that can be passed around as well. You can also raise your hand and we will just repeat the question. So I will just give you some time for that.

You have talked about negotiating global content contracts potentially at some point. What is the path to doing that? What kind of scale do you need to have for that to really make sense?

David Wells {BIO 17034721 <GO>}

Well we have already negotiated global content agreements on some originals as well as independent films. But if you are talking about global deals on Pay 1 features and on major television, I would say we are still a ways away.

The content owners sell by market. So in order for them to be amenable to a deal like that we would have to be at least equal in terms of compensating them for a by-market model. So it would take a little bit more scale in terms of being in more territories to get to that flip-over point.

Questions And Answers

Q - Unidentified Participant

Okay. A question from the iPad app. What are the competitive differences between Netflix and STARZ that allowed Netflix to outbid STARZ for the Disney content?

A - David Wells {BIO 17034721 <GO>}

Well terms of competitive differences we're in a very different business model. STARZ is distributed as a Pay 1 or as a pay television option through cable; and Netflix is a stand-alone consumer offering.

I would say we have a larger subscriber base, just based on the reported numbers from Kagan as written. So we have an ability to monetize content over a larger subscriber base would be the main difference.

Q - Unidentified Participant

Okay. Any questions from the audience? Go ahead.

(inaudible; microphone inaccessible)

A - David Wells {BIO 17034721 <GO>}

So the question is -- would we ever consider live programming?

I don't think so. When you are talking about live you're generally talk about sports and concerts. ESPN does a very good job on sports and others. And there's many people trying to nibble around the regional sports network edges of that. It would be tough for us to do a better job of that.

Q - Unidentified Participant

(inaudible; microphone inaccessible)

A - David Wells {BIO 17034721 <GO>}

So the question was -- there was an article written about ESPN thinking about subsidizing data plans.

I am sure they are going to -- they will try a lot of things. I don't know if Netflix has a particular point of view on that one. But there will be a lot of evolution and experiments with linear television trying to evolve and migrate in a more on-demand world.

Q - Unidentified Participant

Is it something you guys would ever consider? You're potentially using a lot of bandwidth. I realize most of it is going to come over WiFi.

A - David Wells {BIO 17034721 <GO>}

In general, Netflix is a fairly low price point. I don't think that we are really driving a ton of data cap hitting.

You see a little bit of that in Canada, more so in some of the restrictive elements of the Eastern side of Canada. And we responded to that by lowering the default bit rate. And it seems like consumers are pretty comfortable with that in terms of that approach.

I would say the general trend would be more towards faster and faster broadband. More for your dollar, more for more dollars potentially for the ISPs.

And I am all for it. When you travel abroad and you get speeds outside the US, you feel a little hokey about being a US person running at a slower broadband rate, when we should have the capability to run faster.

Q - Unidentified Participant

Just sticking with mobile, what are the changes -- I feel like Reed always downplays this a little bit; I don't know why. I tend to think it is maybe a bigger part of the story, or at least it could be going forward. But the changes in consumption patterns toward mobile devices?

A - David Wells {BIO 17034721 <GO>}

I think the shift towards mobile is evident of just the on-demand nature. And the freedom and flexibility that on-demand offers. What we have seen is definitely a rise in tablet and mobile, tablet within the mobile category.

But generally it is tied to the home WiFi. Folks are still using the home base. They may be upstairs, they may be on a den couch or something. And just the kids might have an iPad and wandering around with it.

So I would expect that flexibility and freedom to continue to grow. But it is not a dominant behavior in the sense that folks that really want to sit down to a prime-time experience generally try to do so on the big screen. And we continue to see that.

Q - Unidentified Participant

Okay.

(inaudible; microphone inaccessible)

A - David Wells {BIO 17034721 <GO>}

So the question is, how many subs do we think that we can eventually get to in the United States?

We still think that the valid addressable market is somewhere in the 60 million to 90 million household range. That is based on around about 100 million pay television households. And the fact that we are a stand-alone direct-to-consumer offering and an $8 price point.

We feel like that is well within the purview of what can happen. And we feel like we are well positioned to get a good share of that.

Q - Unidentified Participant

(inaudible; microphone inaccessible)

A - David Wells {BIO 17034721 <GO>}

Sure. So there's two questions. One is -- what is our competitive advantage in terms of the delivery of entertainment, the cost of delivery? And the second question being -- are we comfortable with our relationship and partnership with Amazon. And Amazon Web services particularly?

So to the first question, first part of that question, I would say there is not a huge advantage in the delivery cost. So the premise of the question I probably would disagree with, in the sense that there is not a huge disadvantage or advantage.

There's many companies that can deliver via television, via satellite, via the Internet. The advantage in the Internet delivery is flexibility and the freedom of choice. It is not necessarily in the cost of that delivery.

To the second question, we are very comfortable with our partnership with Amazon. They continue to be very much a leader in the cloud computing space. And I think we have a very symbiotic relationship with using their service, developing tools to use cloud architecture and cloud computing.

We get that community and that engineering community very excited about prizes and development and open-source software and tools. Amazon retail continues to use AWS. And it would be very, very harmful competitively for their AWS service for them to ever do anything anti-competitive with Netflix, since we are one of the largest champions of their service in addition to being a customer.

Q - Unidentified Participant

I might be off here. But I think I saw this morning or maybe last night that you were pulling some access from your API, in terms of providing people the ability to see what content will be removed from the site. Is that accurate?

A - David Wells {BIO 17034721 <GO>}

Yes. That is fairly accurate in terms of -- we have made a shift in the openness of those APIs.

Q - Unidentified Participant

Okay. So what is the -- obviously you had a lot of noise over the last couple weeks as some -- the bulk of content moved off. What is the thought process behind that?

A - David Wells {BIO 17034721 <GO>}

Well it is generally about making sure that we control the excitement and discovery of the experience of the content. So we feel like we have done a good job of grandfathering those folks that have built other things, as well as just transitioning away from it.

Q - Unidentified Participant

Okay. Just going back to originals a little bit, how do you feel like the momentum, the vibe, has changed in terms of Hollywood producers, directors, just wanting to work with Netflix, given the initial success that you have seen with House of Cards and the buzz around other shows?

A - David Wells {BIO 17034721 <GO>}

Sure. I mentioned earlier in the session that three, four years ago there was a lot of hand-wringing over just doing any deal with us. And I would say given -- based on the mutual success of those deals where it really didn't harm their business and it helped their bottom line, there was expansion of the opportunity and looking to expand deals; and I would say we are still very much in that mode. So that has been helpful. And that has been a different dynamic.

In terms of originals, what originals adds into that is the excitement of really potentially a new Golden Age of television. The flexibility and freedom that an on-demand world allows a writing team to think about a narrative and a story arc that doesn't necessarily have to conform to pre-existing structures and frameworks is very exciting to writing teams. It is very freeing.

The concept that you can deliver 13 episodes at once -- you could deliver three episodes at once, you could deliver six episodes at once -- gives you a lot more flexibility in terms of how to craft that story arc. And I think there was a lot of consternation about whether talent would embrace this or not. I don't think we are seeing that.

I think if anything, there is an interest and a novelty around what this really could do. And again I don't think it is hyperbolic to describe a new Golden Age of television.

Q - Unidentified Participant

What does the curve look like in terms of how your users are consuming original content? In terms of once a week, the typical linear model on one side, versus complete binge viewing and watching House of Cards in a day or a weekend.

A - David Wells {BIO 17034721 <GO>}

Well I think it is a little bit generous to talk about our stable of original content in the sense that we have two things. And we are releasing Arrested in a bit. So you're being generous. I appreciate that.

Q - Unidentified Participant

So House of Cards and Hemlock Grove?

A - David Wells {BIO 17034721 <GO>}

And Lilyhammer.

Q - Unidentified Participant

And Lilyhammer.

A - David Wells {BIO 17034721 <GO>}

So three things, plus Arrested coming. By the end of the year we will have a more robust offering. And I think you should expect us to experiment with things like a tab for original content so people can really highlight what is differentiated and new and different on Netflix.

But in terms of how the behavior -- it really is different for different groups of people. There are some people that binge-view the entire 13 episodes. In fact, it is a little bit of an office pool as to how fast the first, what we call round-tripper will be on any given title. On Hemlock Grove, it was literally they had five minutes for bathroom breaks, in terms of being able to watch the show when it was released and when it was finished.

So that is not the typical behavior. The typical behavior is much more measured, as the folks in the room probably would weigh in. That you don't really have that much time to do that. So you kind of collect your times. Some people do two and three at once; some measure them out one at once. It is all over the map.

Q - Unidentified Participant

Other questions in the audience?

(inaudible; microphone inaccessible)

A - David Wells {BIO 17034721 <GO>}

The question is -- would we consider selling advertising?

We did experiment with that a bit long ago in our past. We did experiment with advertising on the site. We felt like it was not conducive to the brand that we have today. So I don't think you would expect that.

Outside the US, there is the potential for different business models to work within different countries; so you never say never. But ultimately today I think we are pretty comfortable with the fact that we don't advertise on the site. And it has become ingrained in our brand.

Q - Unidentified Participant

So let's talk international a little bit. UK seems to be off to a really good start. But at the same time it is also your most competitive market. Is there anything that you are doing differently here in terms of running the business? And what else do you attribute the strong start out of the gate?

A - David Wells {BIO 17034721 <GO>}

Well I think the LatAm has good growth too. So I wouldn't characterize these two markets as one good, one bad. I would say they each have their unique positives --

Q - Unidentified Participant

I didn't characterize LatAm as bad.

A - David Wells {BIO 17034721 <GO>}

They each have their unique positives and negatives. I would say what is different in the UK, we see much more head-to-head consumer advertising. You know -- join LOVEFiLM for X pounds versus Netflix. So there is much more head-to-head.

Sky when they entered also did some very upfront, competitive advertising. So much more propensity to sort of woo customers; much more competitive advertising climate.

But other than that I would say it is the same formula that we enacted in the US, Canada, LatAm, which is ever improve the content offering, improve the product, focus on delivering what is very valuable to the consumer.

Q - Unidentified Participant

But it sounds like in the UK you would say that is perhaps an example of where the competitive advertising, just the fact you have a lot of players there, is actually just increasing awareness of the overall capabilities and driving more people toward (multiple speakers)?

A - David Wells {BIO 17034721 <GO>}

That is the positive or the flipside of that competitive advertising, is it drives the category. So there is much less emphasis on teaching people how streaming can give them the freedom, can give them control. And there is more emphasis on what we have to offer in our content library and what we have to offer in our feature set.

Versus in Latin America, say, there is much more about teaching people that this product actually works. It won't buffer on you. You can see your show. You have a lot of choice. There is just a different element to the advertising.

Q - Unidentified Participant

So what are the dynamics really in LatAm? Maybe at least initially maybe there was a bit of a slower start; but then at the same time you talked about raising prices in Brazil. I guess, what are the hurdles to driving even bigger adoption here?

A - David Wells {BIO 17034721 <GO>}

Well I would say the biggest hurdle was also somewhat underestimated by us in entering the market. And that was the development of e-Commerce trust. And when I say that, that is the classic -- how comfortable am I entering a credit card or a debit card into a website to pay for something?

Netflix is in both the plus and minus position of being a pioneer in many of these markets, in terms of we are not necessarily the first e-Commerce player in the market -- there has been lots of online travel, plane tickets. So forth. But we are one of the first recurring e-Commerce players at a low price point.

So when you think about an $8 or equivalent price point recurring, we are sort of pressing forward on debit card models and on direct debit models where there really isn't another corollary. So we are forming a category.

But we are very pleased with the progress. It continues to develop and grow at great rates in terms of both broadband and also the development of general e-Commerce. But I would say that is a particular idiosyncratic challenge in Latin America.

We also are seeing a little bit of competition develop. Clarovideo, which was Telmex or America Movil, launched in Mexico and they launched in Brazil as well. It is not exactly an equivalent competitive product; it has a much thinner content offering.

But it is at a lower price point and allows them to create a little bit more consumer noise in terms of advertising a MXN69 product versus a MXN99 product. So again, while consumers aren't knowledgeable about the content offerings of both services, they have to experiment and that creates a little bit of noise.

Q - Unidentified Participant

Okay. Let's talk about your partners -- well, your lack of partnerships basically with cable companies and telcos. Why don't you partner with them in order to gain broader distribution? And maybe you could talk about that a little bit from the US perspective and then also internationally. And if there is perhaps a better opportunity internationally.

A - David Wells {BIO 17034721 <GO>}

Well in terms of in the US we are already are partnering with some of the smaller cable operators with our Open Connect program. That is not a direct reseller or a package deal relationship. But we are certainly partnering with them. We continue to roll that program out and to be open to partnership.

I would say to the extent that the cable companies view us as a direct competitor or a competitor, they are less willing to partner both on the Open Connect program and also on any other reseller arrangement. But we are certainly open to partnerships.

I think it probably, outside of Open Connect in the US, matters less because we are a well-known brand and we are not necessarily building a brand. And it is fairly easy to pay for our service with a credit card or a debit card in the US.

Outside the US, there is more benefit to existing payment methods set up with a cable operator. So there's some advantages there, as well as general brand building. So there is a bigger benefit to us in terms of partnering outside the US than there is inside the US. But we are certainly open to either one.

Q - Unidentified Participant

Okay. Two content questions, maybe if you can provide a little bit more color in terms of Viacom, how you are thinking about this, what the goal is here.

Then secondly what happens to Epix later this summer?

A - David Wells {BIO 17034721 <GO>}

So on both of them I will probably disappoint you by saying we don't comment on the specifics. So I wouldn't have much to say on either one of those.

Viacom, we are an interested seller, they are -- or an interested buyer, they are an interested seller; and it is an active negotiation.

Q - Unidentified Participant

Okay. All right, great. I think in the interest of time we are going to leave it there. Thank you, all. Thank you, David.

A - David Wells {BIO 17034721 <GO>}

Thanks.