Welcome to the Netflix Q3 2015 earnings call. I am David Wells, CFO. Joining me today from the company is Reed Hastings, our CEO; and Ted Sarandos, our Chief Content Officer.

Interviewing us today will be Peter Kafka of Re/code; and Mark Mahaney of RBC.

Now, today we will be making forward-looking statements, so actual results may vary.

I think I am turning it over to you Mark for our first question.

Question-and-Answer Session

Q - Mark Mahaney

Thanks, David. First question has to do with domestic streaming market for Netflix. Sub numbers for the second September quarter in a row came in light, you talked about involuntary churn. Could you give a little bit more color around the source of that sub add weakness? Is this a temporary problem and then just delay concerns that it could be due to greater increased competitive pressure or due to pushback against some of the recently disclosed price increases?

David Wells

Sure, I could take this one Mark. I would say that in terms of additions they were pretty strong through the quarter in terms of flat year-over-year. In net additions they were down year-over-year, and that we explained and attributed to our involuntary churn or payments-related churn. We think partially that was due to the transition to the chip cards, which is still ongoing. And we've reflected that trend going forward into Q4 in our guidance.

We don't think though that it really affects our addressable market size of 60 million to 90 million. I would say last year we had a little bit of concern at the same time, when we over-forecasted Q3 and we ended up in Q4 delivering up to 6 million subscribers for that year. We've done about 5 million to 6 million for the last four years.

So I would say our thesis on the addressable market isn't really changed, isn't changed. And in terms of the involuntary churn, we've been improving that. It's better year-on-year, but it has impacted at our levels even on a small basis, 10 basis points, 20 basis points.

Reed Hastings

So next Q3, Mark, you could be sure that we're definitely going to have low guidance in July. So we think it's just the summer part.

Mark Mahaney

And then, Reed, you've added 6 million net subs for the last four years in the U.S., at some point you can't sustain that, your level. As you look forward to next year and what kind of keeps you in that 5 million to 6 million range, so just address issues like your confidence that the marketplace will accept the price increases. Is it that we should expect a greater amount of original content coming up to help keep that sub add level that 5 million to 6 million. Just address how the consistency of that growth going forward?

Reed Hastings

When we look at the last couple of years, where we've been -- last four years, we've been about 6 million net adds in the U.S., and then accelerating number of new members internationally. But restricting the comments to the U.S., it's fundamentally that internet TV is better than linear TV. The consumers can watch when they want, on what type of device they want, and the content has just got better and better.

So the fundamental confidence about the large scale is because on-demand is a better experience than linear, and the entire market is going to move from linear to on-demand internet television over the next 10 to 20 years. In terms of the specific, when we look at the shows that we have coming out next year, that gives us a lot of confidence. We have the Disney pay-one deal coming in the U.S. in the third quarter. Third, fourth quarter next year?

Theodore Sarandos

Fourth of next year.

Reed Hastings

Fourth quarter next year. And so we got just a tremendous content coming in. I am sure there is a lot of competitors, but there always have been. I mean we've competed against cable and satellite, and we've competed against YouTube and all kinds of pay-per-view and DVD. So there is a lot of ways to consume entertainment. And despite all of those, Netflix keeps growing, because we keep improving. So that's why we feel good about next year, both domestic and especially international.

David Wells

And then just a narrow point, Mark, on the pricing. I mean, we changed the price in the U.S. last Q2. Q3 came in less than expected, but then we delivered in Q4, and then substantially Q1, Q2 of this year with a higher price. So I don't think you can ascribe that to a price for the U.S. in terms of growth.

Peter Kafka

Hey, guys, I want to ask an international question. But first, can you just go back and explain a little more about the involuntary churn and what it was with the credit cards that caused people to be unable to pay? I've got the same account number, what happens when my card type changes, it prevents me from paying. And what didn't you see that happened in Q3?

David Wells

Peter, this is David. It's not consistently the case that people don't have the same account number and some issuers are going to replace that number when they issue that. And for us as a recurring merchant, where we really want to reduce the friction of renewal and reduce the friction of having any sort of interaction where we have to update your payment method and present an opportunity not to do that, it just means that there is more noise introduced into that. And we think it's a contributor.

Like I said, it's likely multifactor. There may be other things going on here, but certainly the transition to the chip cards is not helping, and that has to be a factor in it. And we're only partially the way through, so the U.S. issuers are going to continue that in Q4. They were supposed to be done in October, and they're not. They're about a-third of the way through. So we'll continue to see that in the U.S., as we go along.

Reed Hastings

And gross additions were above forecast, right?

David Wells

Correct.

Reed Hastings

That's why we're attributing it to the misforecast, which is quite modest, because this is the most accurate forecast we've ever had on an overall basis to this slight change, relative to our forecast in the involuntary churn.

Peter Kafka

And you said the international numbers came in where you expected, but you didn't provide any color on sort of which territories are doing better or worse than others. Are there surprises by territory that something do particularly well or particularly underperform?

Reed Hastings

They're all doing really well, but some are bigger than others. But for competitive reasons, we don't give per country color. So we are continuing to learn in every market and improving every market. Every market is growing. But some are doing better than others, which you would expect, and that's up to us to manage to get the total portfolio to be as fast growing as they are.

Mark Mahaney

It's Mark again. So Reed let me ask you one question and then Ted a question to you. Reed, I know in the last earnings call, I think, you cautioned people not to get too robust in the Japan launch. And then also argued there or made the comment that Brazil was like a rocket ship. So at least could you just update maybe a little commentary on those two markets? Our survey work indicated that Brazil was in fact a rocket ship, is that continuing? And then Japan, should we continue to be mellow in terms of modest in terms of the ramp up there?

Reed Hastings

It's clearly, clearly undisciplined, my no commentary on countries. So if I said it was a rocket ship that has continued. Brazil what we're seeing is this with a tough economy, a value-based product like Netflix, that's very inexpensive is really appreciated. And so even though there's tight economic times currently, that has not held back our growth. And we were definitely pleased with the content and with the offering that we had. And maybe Ted you can talk a little bit about the Japanese content offering.

Theodore Sarandos

Yes. I'd say, even back to Brazil, I mean one of the great upsides, and this was our Global Original series Narcos. The star of Narcos and the Director and Creator of Narcos are both Brazilian superstars. So Brazil has received Narcos particularly well as it's been well-received around the world.

In Japan, I think what's been really great too is the local acceptance of our Global Originals. So we're seeing them perform as a percentage of watching, about the same, as they are in other territories, which again defies conventional wisdom that Japan is primarily a local territory.

And we hedged a little bit too and had some local Netflix original content in Japan, including a show called Terrace House is doing particularly well too. So I think it's been a great success in being able to make shows for the globe and extend to places as diverse as Brazil and Japan.

Reed Hastings

And Narcos is really just such an incredible story, because it's two-thirds in Spanish, and that was a huge success for us around the world, including France and Norway. And so it really speaks a lot to our ability to connect the world to do amazing shows around the world that are great stories for everyone.

Theodore Sarandos

And great stories travel.

Mark Mahaney

Ted on the original content launches, as you're thinking about next year, can you help us think about whether the original content launches as a whole are going to be as impactful, less impactful or more or so than what we're seeing in 2015?

Theodore Sarandos

Well, I can tell you that I would say as impactful. I don't know if that'd be more or less. But certainly as we continue to expand into second, third and four seasons of our original shows, what you see there is the franchise value grows dramatically. So as this initiative is aging, the desire to see the new seasons builds up more and more excitement.

And we're not waiting for next year for that, we have an amazing launch scheduled for Q4. In the Marvel Defender series, we're bringing out the second show, Jessica Jones in Q4 as an example, which I think is going to spark a lot more interest in the entire Daredevil run, and the next one is coming up after that.

Reed Hastings

When we talked about the $5 billion content budget for next year, you said for sure, it was going to have more impact.

Peter Kafka

On license content, there's a lot of chatter about some of the studios, networks pulling back for stuff they're licensing to you folks. You guys addressed that in your shareholder letter. You said some content providers may choose to license to you, some may not. Have you seen evidence that people are actively steering content away from Netflix in particular?

Theodore Sarandos

The media business is absolutely influx. As Reed said, you've had this growing move away from linear and towards on-demand, both watching and spending. So the future of how the networks and studios deal with Netflix, and Hulu, and Amazon Prime Instant Video, is certainly going to determine their future.

So there is a lot of caution. And you see how volatile the market can be just with a turn of a phrase last quarter. So I think what's happening is, is that you're hearing a lot of chatter, but you see in our earnings letter, we detailed some major global television deals we've signed across the board with our suppliers.

You should keep in mind that those particular deals are big rocks to move with our suppliers. Buying and selling global television is a brand new behavior to the industry. So whatever you're seeing is more chatter, but roughly business as usual. But of course, some caution, caution that's been around since we've been licensing streaming content.

Reed Hastings

Peter, the caution it's SVOD wide. So when you think about new content on Hulu, I mean Hulu is even more of our cord-cutter's dream than Netflix is, because it's got the network shows day after. So you really want to read it. A lot of the concern is about SVOD generally, which is to be understood.

Peter Kafka

But Hulu is owned by three of the major networks, James Murdoch at Fox said he'll be working with you differently. A show like Empire, the biggest show last year is going to Hulu and not to Netflix. Are you seeing any of the Hulu studios in particular steer content away from you and towards Hulu?

Theodore Sarandos

Remember we're buying show by show. So what happens is happening on the show level not the supplier level. As Reed said it's particularly puzzling that considering that it's much more disruptive to give commercial free options the day after broadcast and it is the year after broadcast.

David Wells

It doesn't address the strategic issue that is supposedly causing the anger with a backlash or the choice not --

Theodore Sarandos

For accelerating cord cutting in that case.

Reed Hastings

And the thing to tease out here is, let's say, the Empire creators, they get paid based upon how the show monetizes. So the studio is under an obligation to monetize that as fully as they can. So Hulu can outbid us, as they did on Empire, and that's fair game. But they can't win it at half the bid, because then the participants don't get paid the right amount.

Theodore Sarandos

And I think participants are well in tune with that as well.

Mark Mahaney

It's Mark. Let me ask two questions. One on the Epix deal and one on some of the background to the price increase you just announced. On the Epix deal maybe, Ted, could you comment on this. So the decision to not renew it, could you just kind of explain that? Was that due to the economics that you thought were going to be part of the deal really didn't come through for you? The cost per viewing hour is too high? Was it that there's a broader movement at Netflix away from feature films? Were there too many restrictions on a renewal? Just kind of explain to us why that deal didn't get renewed?

Theodore Sarandos

So some of our core initiatives around our content are around exclusivity, and accelerating windows and giving consumer access to content earlier and earlier, so the pay TV window has been particularly out of step with consumer desire to watch content when they wanted. And exclusivity, obviously, when we entered into our agreement with Epix, we were kind of de facto exclusive, and since then they dramatically expanded their cable distribution, which is great for them.

They did a deal with Amazon. They were about to do a deal with Hulu when our deal was coming up for renewal. So what we said was that if we were going to do a non-exclusive deal for Epix, that would put the content on Netflix several months after pay television and they are completely non-exclusive. It wasn't a very strategic investment and therefore it would be very small relative to what we had been paying. And so we agreed that were -- our strategic initiative and theirs were diverging, and we just went our separate ways.

We do a great deal of business with Lions Gate. We're continuing to expand our business Paramount and MGM around the world, so this isn't a studio problem, it's just really was the Epix product was less and less in tune with what we're doing at Netflix around exclusivity and windows acceleration.

Reed Hastings

And while the movies on Epix are quite good, we found that there is more awareness on the original side and what we're hoping for over this next two year as we launch, so really incredible movies that are highly original and premier on Netflix as well as in the movie theater simultaneously that we can do better putting the money into those kind of spectacles that we create more consumer desire and awareness through that vehicle than through this additional pay-one licensing.

Theodore Sarandos

And I think that some of the economics match the success of original program, original series programming, which is for the cost of production. You have full exclusivity and global rights in perpetuity versus a very narrow window a year after it's released in the theater in one territory. So a $1 billion of output spending versus a $1 billion in for original spending and they turn out to the right strategy.

Mark Mahaney

And then, a follow-up question on the price increase. So this is the second dollar price increase, I think, in about a 15 month, 18 month timeframe. How do you think about pricing going forwards? Is this now the Netflix norm about once a year $1 price increase? I think long-term you believe you've got a lot of ARPU power. Is there any change in thinking about whether that's due to tiering as opposed to just straight up price increases?

Reed Hastings

So Mark, Netflix is $7.99 for our standard -def offering. It was $7.99 last year, it was $7.99 two years ago, three years ago, so yes it is due to the tiering. And what we're trying to do is spread out the tiers, so that now we've got the $7.99 standard-def, but $9.99 high-definition, and $11.99 ultra-high definition. So think of it is related to putting in a good tiering mechanism as opposed to anything else, and really Netflix is highly available. And standard-def is DVD quality, its not bad quality at all. So that $7.99 for DVD quality, unlimited streaming video, it's an incredible value.

Mark Mahaney

So a follow-up on that, does that mean that we should expect those three price points to stay the same for the next three to five years. Do you have the tiering that you want right now?

Reed Hastings

We're not making any prognostications about the future on the pricing, but it is related to the value. And the more that we have incredible value, the more that we have amazing originals, then over time we're going to be able to ask consumers for more to be able to invest more. And that's been the rhythm we've been on as we did the tearing and introduced that, if you look at how much broader and bigger our content is now than two years ago, I think we fairly delivered on that promise.

David Hyman

And I think, it's worth saying that consumers have acknowledged that I think, that with the combination of grandfathering and the content additions that we've been able to make in the terms of the reactions, I think people are acknowledging that there is real value being delivered through the service.

Peter Kafka

On the original content side, for a couple of years you guys have been making your own shows and you've never acknowledged that any show was less than successful. You never had to take a write-down. As you start spending more on original content and as you make bigger individual bets on things like movies, at what point do you think you will be able to tell or investor should be able to expect to hear from your performance of individual shows, movies or any other kind of content that -- ?

Theodore Sarandos

So Peter, you should keep in mind, that as our slate of original programming grows, the diversity, the size, the scope, the scale of those shows is different. So when we say a show is successful, it's because relative to the investment it's successful, relative to how else we would have spent that money on licensing something else, does this creation, did it attract the audience that it was built for.

So the range of budgets is very broad. The range of audiences we expect to bring to it are very broad. So that's why we've been right in so far in terms of predicting the size of the audience for these shows. Not that they don't all reach 30 million subscribers.

Peter Kafka

You haven't made any mistakes in your projections and your original content to date for the last two years.

Theodore Sarandos

Well, we've not had content write-down, so to your point. So basically we're saying is that we're investing according to the size of the show. And when we've been wrong, there's been more upside than we had forecasted. So we had got into our original programming, very conservative in terms of our modeling, relative to licensing, and have found that it's been much more impactful.

Reed Hastings

Peter, probably the best way to externally tell, is do we take on additional seasons of a show. So some shows have been so successful that we're moving on to season fours. One show had a lot of growth, it was great for what it was. The season three was the final season. And so you can say, well, therefore that was less successful, and that's true.

But so far, we haven't had any show that's performed so weakly in season one that we haven't taken it to season two. I'm sure there will be such a show eventually, but that's probably the best indicator that you or an investor could use, and it didn't really work for us. Yes, we didn't do more of it.

Theodore Sarandos

And in that case you'd say it was relative to an eight season show, it was less successful, but in its own economics were was quite successful.

Reed Hastings

Yes. Go ahead.

Peter Kafka

Recently Amazon just moved to block the sales of Apple and Google streaming devices with their competitive products. Given your dependence on Amazon's AWS, are you rethinking that relationship? Can you rethink that relationship?

Reed Hastings

AWS has been a great supplier to us. They demonstrated again and again strong market leadership, strong attentiveness to our account. We could not be happier with AWS. And they've always kept that separate from Amazon retail. So with Amazon retail, we've had up and down issues for a couple of years, we couldn't buy ads on IMDB, things like that, and that never spilled over to AWS.

Now, we have a really good relationship with Amazon retail also. But the important point to your question is they manage those separately, and we're very committed to AWS and are comfortable with that commitment.

Mark Mahaney

Let me switchback over to international markets. I think the overall sub numbers came in higher than expected and the guidance was a little bit higher than the Street at least expected. But the mix of free subs was a little bit higher than I think most people had expected. Do you have a decent read as to whether those free subs are converting like you've seen in other markets, any particular reason that there is extra risk here, because those subs may not convert as well?

Reed Hastings

No, you should see those consistent.

David Wells

Yes, there is no change in trend there, Mark.

Mark Mahaney

And then in a fourth quarter, I think your international revenue forecast implies like a trailing off in ARPU or pretty sharp sequential drop in ARPU, is there a particular reason behind that? Are you at specific price points in some of the newer markets that you're launching?

David Wells

No. It's the strong dollar, Mark. So there is a bit of a headwind there because of the strong dollar.

Peter Kafka

On the content side, HBO one of your big competitor is moving into news. A lot of that supposedly aimed at millennials, theoretically your customers as well. Is that something you guys would contemplate at all? And then some more question for sports. You guys have repeatedly said you're not interested in sports. Are you willing to serve conceded that maybe you would be a little interested at some point down the road?

Theodore Sarandos

Well, look on the news side, I think we definitely are being more adventurous in terms of the genres that we're going into. We're getting ready to launch Chelsea Handler's talk show early next year, that's our first move into talk. Kind of aimed at the same kind of thing, we have a weekly talk show, where most of our things have been very long shelf-like movies and television series. So I think it's a very kind of similar migration or certainly exploration. And in sports, I think we're in the same place. There is a lot of irrational bidders for sports. We're not anxious to become another one.

Peter Kafka

So to translate that sounds like you're saying you're not likely to move into sports, but news you're already interested in and may increase that appetite.

Theodore Sarandos

Yes, we're interested in being able to improve the viewing experience whatever kind of content people are watching. So I think in sports, sports on-demand is not as exciting as sports live, where I think everything else that we're doing that kind of freeze the viewers from the linear schedule in ways that they enjoy and more enjoy the programming, then we could bring some value to that.

David Wells

So Ted you're leaving the lead there for innovation, right. You're giving yourself a little bit room for innovating.

Theodore Sarandos

Yes, exactly.

Reed Hastings

Well, let's be clear on that room. What's the likelihood that we compete directly with VICE in the next two years?

Theodore Sarandos

Probably high.

Reed Hastings

There you go.

Peter Kafka

All, Amazon, Roku, Google, I'm missing somebody, Apple, all introduced new streaming boxes in last few weeks. Are you seeing more usages and more growth from sort of dumb TVs with smart boxes or you're seeing more usage and growth from connect TVs that have the stuff baked in?

Reed Hastings

They're both growing. They compete with each other. So those categories are growing. It's only really the game consoles that are not growing as fast for secular reasons, the early on. They were the only high-connected devices attached to the TV. And now, they are facing competition in share from smart TVs and from these attached devices.

Mark Mahaney

David, a balance sheet question for you. I think in the letter, you talk about looking to raise additional capital next year. Do you think the next year will be the last year in which you'll need to do that, as you think about the plans for the next three to five years? And then any additional color on what kind of capital or how you would raise that capital next year?

David Wells

Well, it's largely unknown, right. I mean you're asking me three or four years out. But I would say, given our plans to expand content and given the fact that we're on pace to use about $1 billion this year and no indications that that would shrink next year, we wanted to give some headway or some inside into the fact that we may be back in the market next year.

We've done that on a regular sort of cadence of about once a year. So there is no change from that. But there is still some uncertainty in terms of the pipeline, how much we would need exactly next year. But I would say, safe indications are that we will be back in the market in the next 12 to 18 months.

Reed Hastings

And then a success scenario, where Ted is able to invest the originals as well in the future as he has in the past. We would hope to be back, because we want to be funding these incredible creative productions around the world. So in a success scenario, we would do a bunch more over the next five, 10 years.

Mark Mahaney

And in terms of contribution margins maybe again David for you, I think you reiterated your goal of getting to 40% contribution margins in U.S. by 2020. Are those European countries and some of that in Canada, some of that earlier countries that you launched in. Could you just talk about what the contribution margin has been like in those markets? Has it been similar to what you did in the U.S. over the last three years?

David Wells

Well, similar to the comment of Reed, we don't give a specific, Mark, in commentary for competitive reasons. But we have said and I'll reiterate that there is nothing structural that means we can't get equal or better margins outside the U.S. that we've seen in the U.S. And we gave you a data point on Canada that that had reached U.S. margin. About 18 months ago, we gave you a point on that. So there is no reason that we couldn't do better. Largely it's determined competitively within that country or that region in terms of how well we do on the profit side.

Peter Kafka

Recently you guys agreed to sell subscriptions to Apple phone users via iOS in app purchases. For years you didn't do that. Are you paying the same 30% tax that everyone else pays, when someone gets an app subscription through Apple? And then why make that change now after years of not doing that?

Reed Hastings

It's a great opportunity to expand. So historically, we've only been on the Apple TV and that on the iPhone. And we don't comment specifically on the business terms. So I can't directly answer your question. But we're really excited about the potential, especially as we go global over the next year-and-a-half to be able to serve all of the iPhone customers around the world. So some higher motivation on our side to get access to that incredible iPhone customer base around the world.

Peter Kafka

If that does generate a lot of new subscriptions, will we see the impact of that on you financials? Will those come in significantly lower monthly revenue numbers?

Reed Hastings

No, the revenue is the same. You would see an increase in COGS to deal with the fees to Apple. That's where it would show up. But it's essentially the gross revenue the 7.99 or 9.99 that shows for us.

Peter Kafka

Curious what you guys think of new streaming offerings from Verizon and Comcast both, what you think of them as actual content? And what you think of the notion and broadband providers that you need to work with, now competing with subscription or streaming services?

Reed Hastings

We're really big and everybody has got to get into streaming. It's been our main message for several years, that what is known as channels is going to become apps. And that all of these providers need to have great apps on a phone, on a tablet, on a TV, so it's completely consistent with all of that.

And what we see is if we have great content, then consumers watch our service and enjoy it and tell their friends about it. And it kind of doesn't matter that there is also a great sports game on or there is also a shows on Verizon or on Comcast. So part of the reason that we may seem a little blasé is that it really hasn't affected us. What has affected us is when we have great show like Narcos that just takes the world by storm. So that's what we're focused on, how do we have more incredible shows.

Peter Kafka

Do you think that the products of Verizon and Comcast just launched are great products?

Reed Hastings

It's early in the market. They are great companies. They will work on that. But I'm not going to critique them. They're all, they are in, they are trying, and that's a great thing. Of course, you seen Sony Vue, you've seen the Dish sling product. So people are really innovative, which is great for consumers. And not every product, when it first comes out is great, and they'll continue to work on them.

David Wells

And there are certainly better iterations than their prior versions. So they are getting better.

Theodore Sarandos

Our first streaming offering was pretty ugly.

Mark Mahaney

Ted, we got a couple of series of emails about whether Star Wars is going to be available, all the films on the Netflix next year, what's the answer?

Theodore Sarandos

They're all subject to negotiations. It's up to Disney, how they want to manage access to those assets before, during or after the release of Star Wars 7. So it's certainly an ongoing discussion.

Reed Hastings

And assuming Star Wars launches theatrically this year, then it would not come to Netflix as part of the [multiple speakers].

Theodore Sarandos

No, it would be the last title on the Starz, in the Disney output going to Starz.

Reed Hastings

So it wouldn't come to Netflix.

Theodore Sarandos

Yes, correct.

Mark Mahaney

And then there was a new user interface launched on the site about four months ago, and hoped that that would be kind of improved user retention satisfaction levels four months in, any takeaways?

Reed Hastings

Super happy with it, and we're generating new improvements already, improvements there, improvements on mobile, improvements on the TV. So thinking a product group is just an amazing learning organization. It's always pushing the balance and its steady improvement on all of those fronts, Mark. And it's the aggregate of that, which has us at so many viewing hours and so much customer satisfaction that we've been working at all of these improvements over the last seven years on streaming.

David Wells

And that's been very flattered in terms of being imitated across the world.

Peter Kafka

You guys changed your amortization schedule for your license content, just like you had for originals, you said it's because you're seeing more viewing in the first month. What does that mean are people -- does that mean people are less interested in the stuff than you thought overtime or they're more interested than you thought. Originally what does that tell us about viewing behavior?

David Wells

Presumably, Peter you're referring to that amortization change or the change in accounting estimate. And no, it doesn't. You can't conclude that nor should you conclude that from the change. What we're saying is there is more viewing in the first month not necessarily less viewing over the lifetime, it just moved up a little bit. And it could be that we view that at so much good content over the last few years that it's become -- you have to make a good choice, right. You've got 20 good choices, you're choosing.

So it could be that the merchandising system is concentrating a little bit of that when something comes in. Regardless, we try to be accurate in our accounting, and we follow the trends regularly on a quarterly basis. And this past quarter, we noted some content that was trending up, so we accelerated the amortization on that. We wanted to be upfront, even though it's relatively small based, if you look at it in comparison to the overall U.S. content spend it's relatively small.

Reed Hastings

Peter, let me give you a little example, it will help on this one. Suppose we pay $1 million dollars for a title for a four year license, and we think it's going to go 1 million hours of viewing. But the title is just incredibly popular, and instead it does 10 million hours. But many of those hours are in the first month as supposed to spread over the four years. Well, then we would accelerate the amortization of that million dollars, even though the whole thing is doing much better than we ever thought. Its relative proportion overtime is more upfront. So that's why we would front load that million dollars.

Peter Kafka

And generally what's happening, are these things over performing or is there a mix where they sometimes are performing less well than you thought?

Reed Hastings

It's not about the total performance that gets us to change the amortization, it's the relative performance overtime. And so if it performs a lot in the beginning, relative to how it does at the end. That's what gets us to accelerate.

So your earlier question about write-downs is what's missing. You're not quite getting that, let's see, if a title under performed our estimate, but was very back-loaded, then the right accounting would be to shift it out further as oppose to pull it up. And so you're thinking of it in a write-up and write-down sense, and that's not actually how it works. The schedule is based upon how it does overtime relative to the license period. Did that example help?

Peter Kafka

No, no, but in both cases you're saying look, we have these things for so long that it always worked out. That is why I was asking about the write-down part. You've never once reached a point where you missed entirely and you found something that no one wants over any more time.

David Wells

Let me take that, Peter, because I think there has been a couple of questions on that. We certainly license things that perform less well than we expected sometimes, right. There is a portfolio of content that we're licensing. We don't always get it right. But in the case if something that doesn't perform as well as we expected, we're not a producer that has ultimate revenues like a production studio that has to write that down based on a lower expectation of revenue.

We have something available on our service in broadcaster accounting. And in broadcasters, if we're deriving revenue over the life of that license period over the service, it doesn't result in a write-down. It just maybe an opportunity cost that we can license something better down the road.

Theodore Sarandos

Well, and a good recent real world example is Longmire. We just released the original fourth season of Longmire. So season one, two, and three, which we've licensed for several years on Netflix, they were at the kind of tail end of their life, actually exploded when Longmire season four launched.

So it's very unique to the behavior, like nothing actually performs like everything else. So we are trying to do is make sure the amort matches the viewing patterns.

David Wells

And it's a good lead in to remind everyone that these are dynamic, right. That's why we look at it every quarter, because things change. We see when something gets released like Longmire or we release the third season, then the first season of that particular title may see a bump. So it's something that we're constantly looking at.

Reed Hastings

And where it's ambiguous, we would tend to want to amortize it more quickly. That's advantages to us.

Theodore Sarandos

Right.

Reed Hastings

But it has to be justified by the actual viewing patterns.

Mark Mahaney

On global rights deals, Ted, just a big picture, as you see yourself, is the company able to negotiate more and more of these content deals on a global rights basis?

Theodore Sarandos

Yes, it's definitely been the drive of myself and my team all year, trying to move the sellers into a more of a global mode. Remember, they are mostly situated as regional sellers of content, sometimes the rights are fragmented in their ownership. But in the cases of the deals we did this past quarter, they were controlled by one entity and typically solved by multiple regions and we corralled the deals into the corporate offices, and were able to license the world on those titles. Titles that we think will have great global appeal.

So I think the growth, the opportunities, the challenges of Netflix are all global, so that its having a lot of regional discussions around the world isn't that efficient. And it turns out that tastes are rather global too. So it's actually really well lined up.

Mark Mahaney

And then Ted or Reed, when you think about the mix in international markets of local versus global content, any general change in your thinking on what the optimum mix is, and you find it that you're constantly toggling with depending on the market that you're in?

Theodore Sarandos

It's interesting, like you said every time we launch in a new market, we know more in that first 24 hours of viewing, than we did from a year of research. And in terms of the move, I think, we went in expecting Japan to be much more local than it turned out to be. It's more local than other territories, but not as local as conventional wisdom would have had.

And it actually moves with a global desire for some of these large shows, so that the local tastes are usually determined by what you have access to. And if we're growing the access to great content around the world, people are moving or migrating to that kind of viewing. So that's why we're able to do local language originals, our own global originals and then licensed content, not just from Hollywood to the world, but from the world to the rest of the world.

Peter Kafka

Another international question. Can you guys give us any update on China, either in terms of what you're thinking about in terms of timing or what your approach is going to be to a really regulated market there when you do show up?

Reed Hastings

We can tell you, well, we're still learning a lot. So nothing really specific our helpful, except that we're still in early stages.

Peter Kafka

And lot of you guys mentioned getting in new Pay TV Window for a specific movie, The Big Short. Are you negotiating those deals now on one-off deals for individual movies or you're doing these for whole slates?

Theodore Sarandos

There were conversations directly with producers. So a lot of times, well, if you can get to the rights before they get fragmented, that's when you could do those deals. So they tend to be more curated title-by-title in that way.

Mark Mahaney

Reed, I think I'll just ask one last question directly to you. When you think about the biggest challenges that you think Netflix faces over the next several years, three to five years, what do you think they are? What do you focus most of your time on?

Reed Hastings

Well, I would say the biggest challenge is, our being the service that people want, really feeling out more movies and more TV shows. We're working so hard to have these great original productions, and if we could have 10 more Oranges and 5 more Narcos, I know I'm putting a lot of pressure, that would be really transformative.

Especially, I'll bring up the Narcos, we've got an example, because it was filmed in Bogota, Columbia. The main company doing it, it was a French company. So it's a very international production; Brazilian cast. And we have an incredible production Marseille, which I'll give a little plug for, that's in filming now. And I think it will be a really great crossover around the world kind of crime, drama, family, politics.

And the more we do these around the world, obviously, that's great in a local market in terms of establishing our bona fides and reputation with customers. But it's also great, because there is something new, something fresh. And as long as we're continuing to push the bounds on things, like original movies or international productions, then the consumers are really embracing.

Mark Mahaney

David, help us think through and it's I guess one of same things I am sensing very strongly is just increasing appetite enthusiasm for original content. From a P&L perspective, that $5 billion next year in content spend, theoretically if that was 25% original content versus 15% or 10%, the impact of that on margins, as you mix shift more and more towards original content, is that accretive to margins?

David Wells

Well, the good news for me as a forecaster is it does take Ted a little bit of time to actually produce these shows. So anyway, we get a little bit of lead time in terms of some visibility into the production. So our targets at 40% U.S. margin already encapsulate this shift towards originals overtime.

I think we made some earlier comments about a long-term shift that could be upwards of 50% of originals, and we still anticipate being able to meet our margin targets and also shift towards originals. It's going to bring more amortization in, but we think we can do both.

Reed Hastings

And I'll use the word expansion. So think of it as our license content is growing, but our original content is growing faster. There is a mix shift, but I don't want that to get misunderstood as a reduction in license spending.

David Wells

We are still spending on licensed content.

Theodore Sarandos

And remember, between original films, original cartoons, animated shows for kids, our original scripted series, we're releasing more original titles in Q4 than we released in entire second year of original programming. So it is accelerating rather quickly and you're seeing it.

Peter Kafka

Reed, you said for a while now, the future of TV is apps, and now Tim Cook is saying the same thing, it's now the conventional wisdom. Do you think individual viewers or consumers want to pick and choose their own apps, their own shows, serving in a la carte world or do you think there's a role for someone who sort of bundle all the stuff back together.

Reed Hastings

Well, that will be a really interesting question over the next couple of years. We're going to work really hard to expand our movies and TV shows so quickly in such a compelling way, that lots of the viewing for movies and TV shows is through Netflix, which is sort of what makes us want to focus so much on that area.

But I could imagine future bundles emerging. Once there is a whole bunch of apps, and as you go through this industry change now, next probably three, five, 10 years, where there is a lot of discrete offerings, everybody is improving their brand value.

And then you get to a maturing phase of the market, and then there is some consolidation, which could be acquisitions, it could be other things or it could be bundles. But the next couple years, when you have this new phase of the market, I think everyone is just racing to make a great app like Netflix, like HBO Now, those things.

We should hit your last question here, because we're running out of time.

Peter Kafka

This will be it. It's a small one. You're seeing some folks sort of rebundle already, right. Hulu is showing Showtime together. Would you be comfortable having Netflix bundle with another service?

Reed Hastings

We don't see a lot of take rate from our consumer side on the Hulu Showtime. We think we're better focused on just establishing the Netflix brand. Again, at this phase in the market, we think the real key is focus.

At some future time the bundling may be appropriate. Of course, we'll keep an eye and watch the Hulu Showtime take rate to see, to confirm that there is very little traction of that. So we'll be open minded. But our instinct is focused on making Netflix the passion brand in this space.

End of Q&A

Theodore Sarandos

And before we sign off, we should remind everybody that Friday, tomorrow, is the premier of Beasts of No Nation on Netflix and in selected theaters around the country.