Welcome to the Netflix Q4 2016 Earnings Call. I am David Wells, the CFO. Joining me today from the company is Reed Hastings, our CEO and Ted Sarandos, our Chief Content Officer.

Interviewing us on today's call, or interview, is Doug Mitchelson from UBS and Scott Devitt from Stifel Nicolaus. A cautionary note that we will be making forward-looking statements, actual results may vary. Scott, I think you have the first question, so over to Scott.

Question-and-Answer Session

Q - Scott Devitt

Yes, thanks, David. First question for Reed. Just an outstanding quarter, both domestically and internationally, relative to expectation from a subscriber standpoint. And there is so much focus on international given the opportunity there to grow the business, as well as the way you've built out the international business with some more mature markets that you've been in for quite some time. Some newer markets like France and Germany that are starting to kick in, and the 130 that were added at the beginning of 2016. So, I was wondering if you could frame, potentially, the over-performance in the quarter and where you saw strength regionally.

Reed Hastings

You describe it as over-performance in the quarter, but if you look at it on a longer term basis like over the last couple years, it smooths it out. So, we are seeing some lumpiness in the quarters depending on when we launched certain content, but the big picture is remarkably steady and so we have a huge quarter like Q4. This quarter it’s a little bit less and so think of it really as this big adoption of Internet TV. It's in somewhat influenced by the content in the short-term.

And then you asked about the international expansion which has been remarkably steady. Again if you don't look at it by the quarter, but you look at by the year, what was seen Latin America's steady growth, Europe as a whole has been really picking up momentum for us, and Asia, we're just getting started.

Scott Devitt

And then secondly, possibly for David, you got the first quarter U.S. contribution margin above the longer term I think target. Understanding that there is lumpiness in that you're going to continue to invest in their business. Is there any update on that longer term target in terms of the contribution margin for the U.S. market?

David Wells

No, no Scott we did, as you correctly asked me that there's two pieces one is the U.S. contribution margin pops up in the first quarter and we're indicating that that's -- we're going to continue to reinvest.

And then on the international line, we actually broke through into profitability for our consolidated international segment and we will continue to invest -- take that back down through the year.

So, I think that we don't talk about long-term targets other than an operating margin target. We had mentioned before that we would produce meaningful operating profit in 2017 and beyond, so we fleshed that out a little bit for you, the investor now targeting at 7% operating margin for this year and steady growth afterward.

And then we don't think anything structurally is at hand than in terms of our international businesses. It really depends on the competitiveness of each market, but we think we can continue to grow the overall profitability. So, we'll grow operating profit by continuing to grow U.S. margin and also reduce international losses with respect to adding on more investment.

So, I think long-term we'll reduce those losses and grow international margin, but we haven't provided a specific target.

Scott Devitt

Thank you.

Doug Mitchelson

I think on the fourth quarter results, so I'm curious, in the U.S. what content specifically drove the strong performance relative to budgets?

Ted Sarandos

Well, we had a pretty powerful releases in Q4. So, you see particularly shows like Luke Cage, Narcos -- new series of Narcos that travel really well around the world and we know that they are exciting here as consumers of television in America, but it's been fantastic to see how these shows are adopted around the world.

David Wells

Yes, Doug, I would just add to that that we're -- you're now seeing the benefit of Netflix having sort of its third, fourth year of original slates. So, we're now getting -- as Ted mentioned Narcos season two comes out, but we've got new seasons as well. So, you're getting the benefit of shows that might take hold in their second or third season, but some new shows as well, like Stranger Things did for us in the third quarter and continue to be popular through the fourth quarter as well.

Ted Sarandos

And a nice upside surprise us something like Gilmore Girls where you think would be incredibly domestic in its popularity, but we found it to be incredibly internationally popular as well, particularly from performing grade in Europe.

Doug Mitchelson

And this might seem relatively obvious given the comment so far that content is drive to subscriber, but in terms of your ability to measure how content is driving subscribers, and you talked last quarter about including new content into your subscriber growth guidance and you see the strong result this quarter, is it tangible title-by-title, are you making just an overall estimate based on spending or number of release [ph]?

Reed Hastings

Think of it as it’s a cumulative effect. Very few people will join Netflix just because of a single title. But there's a tipping point. We have one more title that has great excitement, you're hearing a lot about and that triggers you to finally sign up for Netflix.

So, it's a cumulative effect of all of these and you can -- you see some frontloading whole forward, but the basic demand creation is increasing as people get more comfortable and more aware of the idea of Internet television where you don't get the commercial interruptions, where you just get to watch when and where you want. So, those are the big drivers.

And then the things that capture the demand are really these big launches that we're doing particular title franchises.

Scott Devitt

Just to feed off Doug's question, there is commentary in the letter regarding content being a driver for subscribers in the second half of 2017. Is that -- just looking at the slate in that period as a driver for their business, or is there something else to that comment?

Ted Sarandos

You should look at, we have multiple seasons of our shows and we see that the audience continues to build cumulatively and therefore the excitement for the upcoming season builds as well.

So, in Q2 of this year, we have new seasons of a lot of our very popular shows, like Orange Is The New Black, Kimmy Schmidt, Bloodline, Sense8, Master of None, and we think that they should have a pretty nice impact on our subscriber growth as well.

David Wells

Yes, and Doug if I -- and Scott if I can knit these comments together, Reed's comments, Ted's comments and your questions, there's a difference between -- so the baseline demand as Reed said is just the transition to Internet TV and the overwhelming convenience of it.

We get -- talking a lot about that sort of quarter, inter-quarter whether we hit above we expected or not based on some of how these shows perform. And if their brand new shows, they don't tend to -- if they are having to punch into the consciousness of the consumer, they don't tend to draw new subscribers in as great of numbers as some of our existing shows. So what we were saying is in the first quarter, we have some great new shows [Indiscernible] that are doing well, but they don't tend to draw numbers like House of Cards did last year in terms of we're lapping House of Cards and for us, it was a surprise of Making a Murderer as well.

So, I think -- what Ted thinks, we have all these great shows coming in the back half of the year and more of them are second season, they tend to draw in more subscribers because they are better-known shows.

Ted Sarandos

Second, third, fourth, and this seasons even.

Scott Devitt

And sorry to be so myopic around the more near-term subs, but one final question on that for me. There was a -- I think a comment, as well, in terms of potentially being a pull-forward in subscribers into Q4 from one as part of the explanation for the 1Q sub guidance. And can you flesh that just a bit and what gives you that type of visibility?

David Wells

Sure. Reed or I could do that, but I'll take a stab at it. I think what we saw in 2016 around our un-grandfathering our price change was a lot of lumpiness in our subscribers in terms of -- we grew strongly in the first quarter, second and third more modestly, and then building into the fourth quarter.

And what we found was we found a lot of rejoins coming back. So, yes, there was a reaction to the price, but we got -- many of those subscribers back. And so I think what we're talking about in the first quarter -- or the fourth quarter we got many of them back that may have come in the first quarter, we may have seen some of those folks in the first quarter. So, we tend to look less at a specific quarter's performance and we look sort of over a six or nine or 12-month period in terms of what is the real trend here, not focusing too much on any specific quarter because they do seem to have bleeds in terms of some folks joining in a quarter that they would've joined the former quarter.

Scott Devitt

Got it. Thank you.

Doug Mitchelson

Two more questions from me on near-term subscribers. First Reed you said that Europe is really picking up and I think when you launch those markets, you indicated we take some time for them to work Latin America now that's happening, but investors are still wondering, something specific that you have done differently or done recently that's drive improvements, particularly in Germany and France?

Reed Hastings

No, there's no specific like pricing, marketing tactic. It's the cumulative effect of show-after-show being end market, just the steady work that we've done and this is what we also saw in Latin American as there was no step function, there was just steady discipline of staying on our game of great shows, great movies, and enjoyment continues to increase. There's slightly incremental more partners that we have, but there's is no real step function. Again it's really the continue buildup of momentum.

Ted Sarandos

Yes, we're seeing as we're adding more and more global shows that it's rising all boats [ph] across the world.

Doug Mitchelson

And I think we talked about acquisition a lot in near-term, when you think about churn management, I think investors are curious both on did X1 integration have any [Indiscernible] in the quarter, did other bundling deals throughout the world -- you certainly have done quite of them, have any influence and as you think about churn trends, is there anything noticeable for investors' assessment and how should we think about that in a flow basis going forward?

Reed Hastings

All the partnership deals we really believe and that's why we're doing more of them, but you can see we had been outperformance in international and in domestic. So, it wasn't just a Comcast story, in which case, it would have been domestic only.

It's fundamentally a story of the broad acceptance of Internet TV and the content. And then on the margin, those partnership deals are good for the customers, good for us and good for the partner.

Scott Devitt

The cable set-top box deals, the -- I think John Malone was quoted recently at Lionsgate Analyst Day as saying that you had approached some operators in terms of being bundled into service, where carriers would cover. And just interested in terms of the accuracy of the statement, is that something you are interested in and what you think the benefit of that would be of such?

Reed Hastings

We wouldn’t want to speculate on future deals. And in general around the world, we've done extremely well focusing on our service as a discrete service, $7.99 a month and incredible content. And so we're just going to keep pounding that drum as we expand around the world and also here in the U.S.

Scott Devitt

And the X1 interface, which is outstanding by the way, we have it at our house, are there -- I assume that there is interest in doing more integrations like that. Is there any reason other than simply being able to cut those deals, technology restriction standpoint with other providers that would limit the ability to do deals with others?

Reed Hastings

Yes, X1s are very advanced set-top, so not all MSOs in the U.S. have such advanced, so they basically can't do Internet apps or can't do Netflix. So, X1 is very strong in that way, so is the dish receiver, so we're able operate on ones that are relatively modern and have other IT apps also.

Doug Mitchelson

Reed, I think you've had advantage just because of the technology investment you've made over time, the scale that you have deployed, any concerns longer term to the extent more and more of your competitors are bundled in on the same aggregating performs like X1 that you could lose a bit of a technology, consumers access your content all through the same interface that they are accessing [Indiscernible]?

Reed Hastings

Well, when the consumer finds in the Comcast UI some Netflix show, they click on that and it opens the Netflix app and then the consumers in the Netflix app, they enjoy the show and then we control after the show, the post-play experience which guides them into another show, another show.

So, we look at it as entry ramp onto our application and we're -- we feel that our application really is the best way to enjoy Netflix content, but that doesn’t mean there shouldn't be easy entry ramp from interfaces like a Comcast user interface because that's very effective for customers.

Doug Mitchelson

And -- so I was circling back to some of the subscriber and I'm curious any learnings now that the global rollover is full year behind you when you look back anything that's far and different than expected and when can we expect the next round of taking some of those skin markets like Poland and Turkey and turning them into market launches?

Reed Hastings

We'll continue with more Poland and Turkey like launches this year with several countries. So, that will just be a steady process we're going through. We'd really like what we saw once we localized Poland and Turkey in terms of increased viewing, increased membership growth. So, we'll just keep on that pattern.

Think of it -- from a near-term subscriber standpoint, it’s a background influence compared to the big established markets in Europe, LatAm and North America. And then of course over time they should be quite substantial. But they are long-term place.

David Wells

And Doug from a financial standpoint, just keep in mind that when we talk about the investments in international, content is the big piece of that. Localization is relatively modest compared to the content.

Scott Devitt

Ted, I think the last time that you spoke publicly this topic; you were doing local language content in 10 different countries. And I was wondering if you could talk about success or challenges of that, and that was tied to original comp.

And then also more broadly, local language in newer markets as well as marketing campaigns, which was identified in 2016 as something that needed to be put in place to get some of the newer markets to begin to progress [Indiscernible]?

Ted Sarandos

Well, so far we've really happy with the success of our local language productions in France and Mexico and Brazil and as I mentioned last time, we've rolled it out to Germany, to Spain, to Italy. We're deep in production. We're entering into a couple of new productions in Asia. What we find is a -- it creates a lot of great excitement for Netflix in the market because it's a really elevated form of television relative to what else is available in the market.

And we love that we're working with local storytellers, local producers to make that content and even more importantly making its available around the world has been a huge differentiator for us.

So when I mentioned earlier about the Gilmore Girls being so popular globally, so it was a little softer anywhere, it might have been in Brazil and about the same time, we're launching a really great little science fiction show called the 3%, a local Portuguese language show that we shot in Brazil. It was enormously popular in Brazil and played to millions of subscribers around the world including the U.S. So, it's been a great way to find new global storytellers and make Netflix feel a lot more local in those countries.

Scott Devitt

And then I think you also quoted as saying that 1,000 hours of content in 2017 seemed to be pretty conservative. Can you speak to that in terms of -- it was local language as a contributor to that, but also as genres and geographies, and what actually is going to be the makeup of those 1,000 hours?

Ted Sarandos

I would like to focus you a little less on the 1,000 hours and more on the quality of those 1,000 hours. About half of the most searched for shows on television around the world this year were Netflix Original shows and that's the kind of thing we're really proud of. A little bit -- even more so than the volume of it all, it's interesting and it's an artifact of a fast growth and commitment that is so many hours, but the rest of this quarter, we still have 42 Original launches to lunch rest of this quarter including shows like Santa Clarita Diet with Drew Barrymore and Timothy Olyphant, a second season of Love, Iron Fist, our latest Marvel series we'll be launching this quarter.

So, I really want to focus you on yes, it’s a lot of volume, but it's also a ton of quality that consumers are falling in love with.

Doug Mitchelson

Shifting over to -- strategies I'm just curious reflecting back on the last year where you had said your price increases flowing through from the Un-grandfathering, Reed, David, did you learn anything about the pricing power of Netflix and can you bid about what investors should expect your pricing strategies in 2017 and beyond please?

Reed Hastings

You should expect us to continue to invest in the consumer experience, making the content incredible and we don't have any plans for any near-term changes. So, I would just continue to look at as a model us as expanding the membership base at these terrific rates.

David Wells

I also think Doug in terms of -- nothing has changed in terms of our long-term view of our ability -- of our belief ability to continue to add great value and slowly, steadily assume that value overtime. So, I don't think anything has changed in that respect.

Doug Mitchelson

I think along the lines of similar things you've been saying Reed, one of the questions that we get from investors is why focus on earnings at all it Netflix? I mean shareholders have clearly rewarded the [Indiscernible] for subscriber growth and revenue growth or leadership position in the market, while Ted is ramping content pretty aggressively, I'm sure he is always asking for more money. Why the philosophy around trying [ph] growth with delivering earnings?

Reed Hastings

Yes, we don't really believe in hockey-stick kind of businesses, like suddenly we'll turn significantly profitable at 200 million members. We think it's much smarter to grow into that bit-by-bit. So, expect us to modestly move up operating income and operating margins as we have from 4% to 7% and continue a slow and growing into that as we grow larger.

We'll keep an eye on the investment levels that are necessary to protect the advantages that we have. So, don't worry about that, but I would say, in general, you grow into the profitability as opposed to postponement forever and then hope that you can change the business model to deliver on the profitability front leader.

David Wells

And the only thing I'd add to that, and Ted probably has his own answer, there's a little bit of scarcity that goes along way in terms of efficiency and I just making sure that we continue to focus on the quality.

Doug Mitchelson

Well said.

Scott Devitt

Ted, how did The Crown do? And did it -- seemed like it would perform well in the U.K. How did it travel throughout -- perform in the U.S. and other regions?

Ted Sarandos

We're incredibly proud of it, both for the reasons you just mentioned which is that it's been incredibly popular globally, there's an enormous interest in the royal family around the world, so in the U.K., it was really celebrated as something that only the BBC could do just a couple of years ago and really loved in the U.K., in the U.S., but also even in countries throughout Asia, throughout Europe obviously where people just love that story, and more importantly, they loved how it was told and we were thrilled that it won at the Golden Globes for Best Drama. It was our first Best Drama Award there and we're excited, we're deep into season two now and excited to tell the rest of the story.

Scott Devitt

Great. Thank you. And Reed, in the test market, you are one quarter away; I think you are going to be approaching 50 million U.S. paying subscribers at the end of the first quarter. There's over 100 million households in the U.S. that subscribe to cable and satellite cable. The price point and the value proposition, it really does not seem like there's any reason why, over time, with broadband speeds, that you should be able to address all households. When you look at the next 50 million in the U.S., where do you incur the friction points that are limiting you right now to getting to those numbers faster?

Reed Hastings

I think it's really this fusion to the society as more and more people use Netflix. We have better and better shows and more of them -- you just get the word of mouth, which is how you grow from nearly 50 million to 60 million and hopefully we keep going.

In terms of getting to a full 1:1 tie ratio with today's cable that includes a lot of sports which we don't have and don't have plans for. So, you want to wait that a little bit. But in terms of the next couple of years, again, I think if you look back four or five years, it's been really pretty steady growth overall and it's following this formula of just improving the value, improving the content, improving the service like adding our offline viewing. It's really creating a big wave of customer joy, the video merchandising that you'll see where you get to choose content by looking at content. So, we're continuing to innovate on multiple fronts to just make it a better experience.

Doug Mitchelson

Two questions from me for David just on some of the financial commentary. In the letter, I think you gave 7% was the guidance for full year 2017. I think would helpful for investors just to understand on the cost category [Indiscernible], what the outlook might be for 2017, so when you look at G&A, and tech and dev, and marketing, if you could give us a sense of what the dynamics for each of those are this year that will be helpful?

David Wells

Sure Doug and we updated our long-term letter a little bit in this respect as well. So, think about 6 billion in content, a billion in tech and dev, somewhere around a billion in G&A to sort of round out the operating profit expense lines and that should get you there.

Doug Mitchelson

That work. And then also notable free cash flow burn $2 billion for this -- that was a bit higher than I believe you suggested a few months ago. So, what's changed?

David Wells

Well, I think what we put in the October letter was that free cash flow might be similar to Q3, it was more than that. We do think it's going to come down this quarter in Q1, but we wanted to give an indication, it's pretty lumpy right now. Even my team has -- we don't really focus on trying to optimize a single quarter, we're looking at sort of across four and eight quarters and we think the run rate is around 500 million right now in terms of the quarter as we continue to expand content.

It's not too different from 2016. I mean we moved up to 1.7 billion in 2016 and so we're indicating that might be around 2 billion this year and we'll go from there. I mean I think what you'll find is we will organically fund more and more of our own content expansion with the growth of our operating profit and so more and more as we transition over the next few years, our debt will be about content expansion, but it also transition to being about optimization of cost to capital.

Scott Devitt

And I think you said at one point in time or possibly it was Reed that -- if content is available, you would be willing to take on more leverage or take on versus first otherwise letting it go because it does fit into the P&L currently.

So, with -- and I'm paraphrasing there, but with -- where you're now in the $2 billion drag, but where content spend see it's beginning to normalize in terms of the outweigh versus the P&L spend. Is there visibility to when the business becomes self-fund based on the current trajectory?

David Wells

We haven't provided that guidance Scott. It really depends on how much we want to continue to expand content and the growth of the business itself. So, we're little bit guarded in terms of providing specific because there's interdependences there.

What I think -- and this back to Doug's question prior is part of the reason that our working capital needs have gone up a little bit is because we're owning more and more of our content and I think that's a good thing for the investor and the shareholder. We control more of the rights, more of the sort of global advantages for being a platform that is increasingly having 90 million and beyond global subscribers will be advantageous for us to own that content.

So, I think the step-up -- the slight step-up from years past -- a couple of years to the 2 billion that we're talking about this year is inclusive of more owned content and increasingly more content categories. I think you get both of those in there.

Scott Devitt

And then secondly as investors begin to look the U.S. market as a template for rest of world as happens with businesses in the Internet when you grow globally, can you just talk about the takes in terms of what could lead to similar margin profile of markets out of U.S. versus higher or lower as the churn?

David Wells

Sure. I'll pitch it to Reed. I'll say something and then Reed can follow-on. But I would say there's competitiveness in those markets. Generally, overall I would say there's nothing fundamental that we can get to margins equal or better in some places of the U.S. So then you think about an average across the globe and it really is about determined somewhat by competitiveness, it's determined by the cost of that content.

But the more we can grow and provide sort of spread the cost of popular content that is engaging to a large portion of the world, the more advantage and scale advantage we see there in terms of being able to do that.

So, I would provide those comments and then see if Reed has anything that he might want to add to that.

Reed Hastings

I think that's perfect David. Our North Star is providing an incredible value to consumer because upon that you can build a very large and very profitable franchise. But it starts with an amazing value for consumers which is a great service and amazing content behind that.

Scott Devitt

Thanks.

Doug Mitchelson

Two questions for Ted. Ted, anything new in terms of ROIs on your investment in content? You look at acquired versus originals, are the lines starting to cross in any way? And as part of that, are you willing to give us an update in hours consumed? Globally, we haven’t had that number from you in a while.

Ted Sarandos

Well, stay tuned for those numbers. We don't have anything to report today, but I'll tell you I think the -- as David had mentioned while it is a bit more cash consumptive, owning our own content and including our original productions has a lot of big scale advantages to the business, probably the most meaningful one is removing the studio markup and overhead on those productions and being able to put more of that on the screen, owning the IP as we expand into multiple seasons, having control over the windows.

And so I lean into both original programming and owned original programming, but we're still very active buyer of second-window content from our studio partners. We are increasingly coproducing some of the programming with networks and studios around the world. We'll take one country and we'll premiere the show globally at the same time which takes off some of that risk and also enhances our partnerships with those networks and studios.

But I do think there's a lot of value in owning the IP and a lot of value in creating new content. But we need to have great programming for our members and sometimes, we don't have that. So, we will have to go out and we're buying it elsewhere to enhance what we are doing.

Doug Mitchelson

I think along those lines, any suggestions as to where the emphasis will be going forward? I think there's still a feeling that this could use more movie content. You made huge investments on the comedy side, which they -- if you want to talk about that. Particular genres that we should expect you to focus ongoing forward?

Ted Sarandos

Well, you could look at those comedy investments as a good example of taking a category that we primarily bought second window from other people just a few years ago and now are producing original programming that takes it from being just something people watch to something people really value Netflix for differentially. The rest of this quarter you're going to see standup shows from Amy Schumer, Dave Chappelle, Trevor Noah, Jim Norton, like some of the top names in comedy.

And as you are -- going out, we've already talked about Chris Rock and Jerry Seinfeld's recent deals. But that's a category we took it from being kind of cheap second window programming to something that really becomes an event and a subscriber acquisition driver for Netflix.

Same thing with unscripted programming with shows that will be launching even this quarter like Ultimate Beastmaster and Abstract, which is a variant on Chef's Table, but about design. And it's all that programming that we used to license in second window that we're finding to be much more valuable to go ahead and produce originally for Netflix.

David Wells

Scott, Doug, I think we got time for maybe one final question from either one of you or one each.

Scott Devitt

I'll go first. The question that I had is -- squeeze in net neutrality edits, it's commented on the letter, but we could just the assumption of the new administration entitled to that neutrality is rolled back, what are the implications for Netflix?

Reed Hastings

I think we addressed that in the letter. I don't have really anything to add to that.

Scott Devitt

Okay.

Doug Mitchelson

I think from my end last question, we're just curious the ultimate vision at this point, we're turning the new calendar year. I think we've had a conversation in the past where you talked about to satisfy consumers you have to give them all the television shows they want for $25. I'm just curious as you talk about the letter, your decade -- next decade is going to be pretty exciting, what's your ultimate vision at this point for the services?

Reed Hastings

You never want to characterize something as an ultimate vision because when you get there, there's always more that you want to do. And so we're taking it year-by-year, we're growing around the world, we're thrilled with our global expansion, ex-China we're really focused on all the different markets, Asia still doing work, in Europe we're building up our content production, muscle, we're able to produce shows now in many countries around the world.

So, think of us just continuing to iterate on the basic cycle of more content, better product that combines as a great service with a great price and hopefully with that, we can attract many more people to join Netflix and then that fuels the whole cycle.

So, we're just going to lather, rinse, repeat again and again for the next couple years and expand that. We have a long way to go. When you think about how many movies and TV shows we don't have. We want to be able to just think about the great range of content that we have and we're very ambitious about what we can do, especially around the world.

So, there's a lot for us to work on. And then just the next six weeks in Brazil, Europe, Asia, we're having a blast just spreading and evangelizing this vision of Internet TV where you get to control what you watch and you get incredible quality content.

And we hope to land this quarter in 99 million subscribers, which will be quite an achievement. And thank you very much all for your support and look forward to talking to again in the quarter.