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# EDITED TRANSCRIPT

NFLX - Q3 2017 Netflix Inc Earnings Call

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OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

## CORPORATE PARTICIPANTS

**David B. Wells** *Netflix, Inc. - CFO*

**Gregory K. Peters** *Netflix, Inc. - Chief Product Officer*

**Reed Hastings** *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

**Spencer Wang** *Netflix, Inc. - VP of IR and Corporate Development*

**Theodore A. Sarandos** *Netflix, Inc. - Chief Content Officer*

## CONFERENCE CALL PARTICIPANTS

**Douglas David Mitchelson** *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

## PRESENTATION

**Spencer Wang** - *Netflix, Inc. - VP of IR and Corporate Development*

Good afternoon, and welcome to the Netflix Q3 2017 Earnings Interview. I'm Spencer Wang, Vice President of Investor Relations and Corporate Development. Joining me today are CEO, Reed Hastings; CFO, David Wells; Chief Content Officer, Ted Sarandos; and Chief Product officer, Greg Peters. Our interviewer this quarter is Doug Mitchelson from UBS.

Before we begin, we will be making forward-looking statements, and actual results may vary. With that, let me kick it over to Doug for his first question.

## QUESTIONS AND ANSWERS

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Thank you, Spencer. Good afternoon, everybody. I'm going to ask a question for each of you, and then we'll start rotating by topic. Reed, for you to start, it was another strong third quarter. Do you feel like we're hitting some sort of inflection point with streaming video? You have your digital peers, soon perhaps competitors, pivoting to Hollywood video. We have a slew of SVOD services that will be launching over the next couple of quarters. You have the traditional media companies thinking about diving into direct-to-consumer themselves. Do you see a real sort of inflection point in the marketplace?

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

Well, Wall Street loves inflection points, so I'd love to say yes. But no, I think it's pretty much steady growth. I mean, we've seen new competitors, increased streaming around the world, new devices, new formats, it's just been a continuous evolution. You know we started streaming 10 years ago now. We're now completing our 11th year of streaming. So I'd say, overall, more of the same and continued great success for streaming.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Ted, takeaways for you from the third quarter. What surprised you? What was better? What was worse than expected?



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

Well, Doug, I was pleasantly surprised and relieved in our kind of continuing expansion of our original programming verticals, including releasing an adult animated comedy, in -- with Big Mouth, a big feature film like Meyerowitz. It's being -- getting very well received critically and being watched by a lot by -- in big numbers all around the world. David Fincher's new series, Mindhunter; and an Italian original, Suburra, that we shot in Rome all in Italian for our Italian and European customers but also for our Netflix users around the world. So it's just kind of a continuing breadth of things that are working well for our subscribers I'm excited about.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Greg, for you to set the table, any learnings from your time in Asia, specifically the Japan launch, and how that's informing your strategy as you get started in the early days here as Global Product Manager?

**Gregory K. Peters** - *Netflix, Inc. - Chief Product Officer*

Sure. I spent a lot of time there, obviously trying to grow the service, producing and launching new content, and that experience allows me to bring those lessons back to the work that we do in product. So I'm looking forward to putting more investment in how we support content, how do we invest in technology to improve the efficiency and effectiveness of the team -- the work that Ted's team is doing, producing great content at scale. Also to change the product experience that we have, to do a better job at promoting content that has little built-in awareness so we can sell those new original series and films more effectively. But then also to continue to evolve the product experience that we have today to be effective at meeting the needs of the next 100 million, 200 million members so it can be as compelling as it is for the 100 million members we have today.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

And I think we'll talk through some of that as we get deeper into the Q&A. And Spencer, I'm going to combine the last question between Ted and you on Millarworld, first company acquisition ever. Can you discuss the strategy and how we should measure ROI on that deal?

**Spencer Wang** - *Netflix, Inc. - VP of IR and Corporate Development*

Sure, Doug. With respect to Millarworld, a couple of things to highlight for you. The first is, I think you can tell from our track record, we -- this is the first acquisition we've done in our 20-year history. So I think, from that, you can take that we have a very strong bias to build over buy. Secondly, we remain very, very focused, so we're not looking to diversify into new businesses but rather looking opportunistically at intellectual property and other content assets that can help enhance our content library and also accelerate our growth. So overall, I think you should expect us to be selective, but opportunistic as it pertains to M&A.

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

Yes. I'd say Mark and Millarworld had incredible concentration of original projects that we were already kind of circling on the TV side and on the feature side. And so we just -- we were -- had us look deeper into their track record of original content creation and the roles that they played in creating really iconic films in -- that we think we can continue to build on, so we're excited about it.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Do you see a series of other acquisitions that have similar characteristics?



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

Well, obviously we're looking at a lot of things, so -- and when there can be these kind of efficiencies, meaning that much creativity under one roof, we'll definitely want to explore that.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

And so I wanted to switch to the third quarter a little bit more. I think, David, this one might be for you but perhaps Ted as well. It was a relatively content-light quarter. Not that a lot of content wasn't released but when you compare it to the third quarter of last year, it looked a little bit lighter in terms of important original exclusives. Yet the results were very strong again. I know, in the second quarter, you talked about some uncertainty as to how much was driven by content versus just growth in the overall streaming marketplace. And it seems the third quarter, the answer is really -- it's the streaming marketplace. Am I reading that right?

**David B. Wells** - *Netflix, Inc. - CFO*

I think so. I mean, I've been pretty consistent in, quarter-after-quarter, the base force that really is the strongest force is the continued adoption of Internet TV and entertainment. And that tends to drive the lion's share of our net additions. When we try to explain the quarter-to-quarter perturbations or some of the lumpiness in our net additions, we tend to use explanations that sort of focus on the incremental, which could be content slate or a particular title that had some notable strength. But I think, in general, it is the continued adoption of Internet entertainment that is driving our growth, and it's really helped more and more by the increasing strength of our content slate. Notably, our global originals are helping drive that. And you saw that show up in the second quarter with all of the growth that we saw on the international line over and above what we thought we might do, but that was continued momentum carried forward from the second quarter as well.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

It's interesting, because I think we've been wondering for a while, the last few quarters, you've talked about having some content strength or some titles that were surprised that perhaps pulled forward growth. Whereas maybe you're getting to the critical mass where instead there's a carryover from strengths in previous quarters. And, as you said, it might level out from year-to-year. So do you think we're hitting that critical mass of content? And if so, how do you forecast the fourth quarter? It's a strong content slate year-to-year in our view. And Ted might follow up with that, just to see if he agrees or disagrees. Do you no longer sort of use new big original content like *Stranger Things 2* as a driver of your forecasts?

**David B. Wells** - *Netflix, Inc. - CFO*

Well, I think it's -- you're pointing out that it's hard, right? As we continue to grow, the large background force, again, is the adoption of Internet entertainment. But when we try to explain quarter-to-quarter changes, it becomes a little bit harder. And it's hard even for our own team to ascribe certain incremental growth, and we do the best that we can. But it is of note that this year in particular will be sort of the flattest growth that we've seen from Q1, Q2, Q3. So you've got strengthening content slate and growing content releases -- number of releases, paired with a seasonal pattern, paired with very strong adoption globally and growing global adoption of Internet entertainment, and you get to a little bit of a hard pattern to discern. But we're just pleased that this year's growth, if you back away from the quarters and you look at just the 4 quarters, this year, we're growing nearly to 22 million global net additions off of -- up from 19 million, and that was up from prior year. So in general, the background trend is just increasing growth and increasing adoption. And then, Ted, over to you for the content comments.

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

Yes, I think -- I mean, I think it might be just a reflection of the steady drumbeat of high-quality content that people are watching that are not necessarily all concentrated in the same pockets. We had 3 different films that -- released this quarter that, if viewing was buying a movie ticket,



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

would be sizable successes in Death Note, Naked and To the Bone. So I mean and probably very little audience crossover between them. And it -- so that's kind of the benefit, I think, of the steady output of great new original programming coming nearly every day on Netflix.

**Douglas David Mitchelson** - UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media

And then, David, last question in this line of questioning. When you think about the fourth quarter guidance, can you just discuss for investors what swing factors you do see in there? Obviously, there might be some price increase churn, you do have some big content like Stranger Things 2 coming. What were the factors that are driving the guidance for the fourth quarter?

**David B. Wells** - Netflix, Inc. - CFO

Sure. I mean, so one primary factor is just the pricings we had. Again, we had un-grandfathering last year. We've got price this year. We have great content coming with Stranger Things 2, Crown 2 and more that Ted will talk about, but some big strong content releases. And we have just the sort of perturbations that we've seen. Last year was the largest quarter we've ever had, so we're comping off the largest Q4 we've ever had. And this is our best guess, and we've been wrong in the past, but it's our best guess of the next 90 days.

**Douglas David Mitchelson** - UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media

So why don't we switch to pricing? So for Reed and for David, can you discuss the pricing strategy broadly? And then I'll have some follow-ups.

**Reed Hastings** - Netflix, Inc. - Founder, Chairman of the Board, CEO & President

Price is all relative to value. We're continuing to increase the content offering, and we're seeing that reflected in viewing around the world. So we try to maintain that feeling that consumers have that we're a great value in terms of the amount of content we have relative to the prices. And of course, we maintained our \$7.99 standard def program or EUR 7.99 in the Eurozone at that incredibly low price. So we've got a great range now, super value-oriented in standard def, super premium is great stuff, and the 4K. And I definitely -- I was watching Mindhunter last night on my Dolby Vision 4K TV, and if you haven't tried it yet, you've really got to try this HDR TV. It is just unbelievable how beautiful the picture looks.

**Douglas David Mitchelson** - UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media

David, anything on your end in terms of sort of why now? Anything that this suggests in terms of the pace of content spend, particularly on the cash side? And one more on that, David. It seems, at least from what I've seen so far, a lot of the price increases have been really hitting the big and perhaps more mature markets or at least the more developed countries. Is that right? Is that the strategy, to take up price in developed countries because the emerging markets are -- have revenue driven through sub growth?

**David B. Wells** - Netflix, Inc. - CFO

Well, I -- back to what Reed said, I mean it's really about slow and steady. I mean, we've been in no hurry. We're in no hurries. Many investors have sort of criticized us in the past for being underpriced, and I think, for us, we want to make sure that we do this commensurate with value, like Reed said. And as we take up the content library value, as we're doing more global originals that people have exclusively and only on Netflix, there's a great association of that value, and we think that we can grow that value and that price slowly and steadily over time.

**Reed Hastings** - Netflix, Inc. - Founder, Chairman of the Board, CEO & President

Doug, we're really going to take the spending up next year. (inaudible) membership growth and partially from the opportunity.

## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**David B. Wells** - Netflix, Inc. - CFO

Yes, I mean, I shouldn't let that go without addressing that there's no timing correlation between our intent to grow content and to grow content spending and the price increases. I mean, this has been planned for a long time, and so we're sort of growing and slowly growing and planning the business steadily. So we've assumed that we're going to grow ASP slowly over time, and we're taking the content up with that as well.

**Theodore A. Sarandos** - Netflix, Inc. - Chief Content Officer

I think a great pattern to keep an eye on, too, Doug, is that, yes, we're excited that next quarter we're going to release new seasons of established great shows like Stranger Things and The Crown, but this -- and most recently, we released new season 1s of brand-new shows like Atypical, like Big Mouth, like Mindhunter that Reed had mentioned already, and like Ozark that I think are a -- it's a steady drumbeat again of the next show you can't live without and the new season of that show that we have to keep going and keep building on.

**Douglas David Mitchelson** - UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media

And just to make sure we address it in terms of taking up price in developed markets versus undeveloped markets, is that right? Or are we just really seeing the price increases in the developed markets so far and it's sort of more of a global strategy?

**David B. Wells** - Netflix, Inc. - CFO

Well, in terms of how you define a developed market, I mean, we've raised price earlier in the year in Brazil, in other parts of Latin America. So I don't think you can cleanly sort of divide it. It is true that we may not choose to raise price in a market that we're only a year -- 18 months old in, specifically around markets that we didn't have a tailored library launch. We had a -- we chose to launch global with sort of an -- all at once in a global library and we're specifically increasing the engagement and the library quality in many of those markets, if not all. But we may choose in those markets that -- to make the decision that we haven't grown value fast enough and, to be on a slower track with pricing in those markets.

**Douglas David Mitchelson** - UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media

The last question on the price increase is taking the higher tier up \$2. And the question I get asked a lot is whether password-sharing is an issue. How high is it on the priority list for the company? Is the reflection that the higher tier's going up \$2, while the middle tier is going up \$1 and the lower tier 0, is that you're making password-sharing more expensive?

**Reed Hastings** - Netflix, Inc. - Founder, Chairman of the Board, CEO & President

Greg, do you want to take that?

**Gregory K. Peters** - Netflix, Inc. - Chief Product Officer

Sure. I think with regard to the priority, password sharing isn't a huge issue for us right now. It's not a huge priority to go try and take significant measure to try and stem it. We think that a broader spread in pricing better reflects the value that we're delivering in the higher tiers, the 4K, the HDR, the awesomeness that Reed mentioned in Mindhunter, so really, you're just seeing us push that spread farther apart to try and address that value [for us].



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

So let's switch over to the content access for a little bit, Ted. And before I start asking about all the competitors trying to win over shows that you might want, just any update on your content slate, how the development process is scaling? I think we've got a pretty good visibility on the fourth quarter, but do you see a strong first half '18 coming?

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

Yes, definitely. And we're really excited. We'll wrap up this year with our biggest original film project yet with Bright, which is Will Smith starring with Joel Edgerton and directed by David Ayer. And it's a big-budget event movie that I think people will start seeing the potential for this original movie initiative that it can be done on the big -- on the enormous scale that we have on the television side. What I'm also really excited about is we're ramping up our local language original production. So you're seeing new series in local languages, just recently in Italy, upcoming in Germany with Dark, and we've had incredible success in those markets with those shows. And they could -- those shows are continuing to travel outside, which is really exciting for us that, those shows, we can put more production scale behind them because they're being watched in markets much larger than just the country of origin. That, on top of our kind of steady drumbeat of new original series that is -- yes, you are correct, it's becoming a much more competitive marketplace, but we've been really happy with our results in that competitive marketplace.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Any concerns around access to content, particularly with Hollywood? Of course, the big news since you reported last is Disney going direct-to-consumer and pulling back on the Pay 1 window with you here in the United States and Canada, but also having the Disney Channel content in there. I think Bob Iger said he's going in hot in terms of his OTT launch in a couple of years on that Disney service. Any concerns that, not only the Disney content going away could have an impact on Netflix and its value to subscribers, but also that other traditional media companies might follow suit?

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

So I think everyone's going to have their own strategies, and it's exciting that everyone is trying to make over-the-top television better and better. I think that is good for all of us. And we just have to focus on creating content that our members can't live without and get excited about every month. So that's really the -- and not get too distracted by the competitive landscape around us. And whether or not one of our partners decide to produce for us or to compete with us, that's really a choice that they have to make based on their own business. And we're thrilled that more people are doing it, because I think it's great for the -- for innovation, I think it's great for consumers to have a lot of choice, and that we just have to be the best choice out there. And I think that's not different -- the environment isn't a lot different than it is in the television world, where Fox produces for ABC and NBC produces for Fox. And so I think that those choices get made on a case-by-case basis. I'm not worried about access, Doug, because we have long-term agreements with all these players. The shows that we have are [run of series]. So if somebody chooses not to renew a deal here and there, the series that are successful on Netflix ride out as long as they exist in that second window. By an interesting way of example, something like Walking Dead. That -- the deal with AMC expired 2 years ago, and Walking Dead continues to be a successful show on Netflix, and will, as long as that show is being produced.

**Spencer Wang** - *Netflix, Inc. - VP of IR and Corporate Development*

And just to quantify, Doug, what Ted was saying. Our commitments at the end of quarter were \$17 billion over the next several years, so that helps sort of put another sort of level of quantification for you on that. And we also have the benefit of our growing library of produced content, of which the net book value at the end of quarter was about \$2.5 billion.



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

And just one more thing to add would be we're -- included in all these transitions are we're coproducing content with CBS All Access, by way of example, with the Star Trek series, Star Trek: Discovery. So it's a rapidly changing environment for sure.

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

And Doug, Disney is a great brand with great content, but internationally, we have it only in The Netherlands, Australia and Canada. And you saw how big our international growth was in most of the world without the Disney content. So although it's got an enormously significant brand in terms of its significance relative to growth, you can see that we've done very well at international without it.

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

We'll have to partner with them when they're ready to.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

I think that it's an interesting dynamic because, increasingly, the license content seems to be going to either Hulu or you have a Disney situation with OTT. So I think investors are struggling with Netflix as you look farther and farther down the road that major U.S. media companies might be licensing less and less to Netflix. But you have a strategy of more and more original content. And I'm curious, how do you sort of derive the confidence that your ramp in original exclusives on Netflix will offset any loss of licensing content in the future?

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

Well, what I'm confident of is that it will not be an erratic shift. Because like I said, we have these long-term agreements, and those deals kind of run out as we're ramping up. And that has been pretty -- a pretty smooth transition to date. I think that the -- in those partnerships that, where there's still a lot of value that I'm sure producers and networks and studios are evaluating, is something like Riverdale. Where having Riverdale on Netflix in the second window meant an enormous audience growth for it in Season 2. In fact, 400% audience increase on CW from Season 1 to Season 2 and the only thing different from that and This Is Us is Riverdale was on Netflix. So I think people will have to look at that and look at those trade-offs in value and to see where -- when does a partnership become too competitive and make those decisions when the threat of the competition outweighs the value of the partnership.

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

And Ted, how big was this increase in This Is Us, season-to-season, given that it was on Hulu for back season?

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

I don't know. It wasn't -- nowhere near the 400%. It was up from season 1 but not -- nowhere near 400%.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

I think Jeff Bezos has said that he's looking for the next Game of Thrones. Any sense that perhaps Amazon is shifting programming strategy, and that would have any impact on Netflix at all?





## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

So is Richard Plepler, looking for the next Game of Thrones.

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

So is Ted Sarandos, so is everybody.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

The -- I mean, there is a lot of disruption going on at Amazon. It is an interesting sort of lesson that you can't just necessarily buy success in Hollywood. And you've had some success obviously, and I don't want to belabor the point too much in this forum for investors, but I would be interested if you could sort of discuss what you're doing and how it's sustainable in terms of continuing to create high-quality content when others are struggling.

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

I think it's an extension of our employee and corporate culture around freedom of responsibility. It attracts the best and brightest, and I think we've created a place where people want to come and create. They've heard from their friends, they've seen it from their peers that they've been able to come and do the best work of their lives. And that is -- seems to be quite repeatable. So we keep building on that by giving the resources for a content creator to come and have a great professional experience. And that is something that we keep betting on where I think other people want to try to replicate the heavy-handedness of the network model that we've avoided so successfully.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

For Reed and Ted, the Wall Street Journal reported, I believe, last week, that the board of Weinstein was considering selling the company or shutting down its business. Does the situation at Weinstein impact Netflix at all? And if the company was put up for sale, given the sort of the massive intellectual property and the studio that resides there, would Netflix be interested?

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

In -- interested in acquisition?

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Yes.

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

There's a lot of smoke to clear from what's happening there. Our business with The Weinstein Company is pretty arm's distance, and we have a second window -- the [output] deal on their films, post theatrical and some second window television agreements with them. So it's not material in either way.

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

It would be extremely unlikely for us to be a bidder for the firm.



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Why don't we switch over to Greg? So Greg, on the product side, can you give us what should consumers of Netflix expect in terms of changes over the next -- the short to midterm, now that you're here?

**Gregory K. Peters** - *Netflix, Inc. - Chief Product Officer*

Tons of changes. I think one of the ones that I'm most excited about is there's a tremendous opportunity, I think, to morph the product experience to be more and more effective at explaining to our members what's great about one of the original shows that Ted's team is making, and making that connection with this new novel IP. I think there's a huge opportunity to use all sorts of new forms of assets, video in surprising ways to make those connections.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

And what would you say your priority list is right now?

**Gregory K. Peters** - *Netflix, Inc. - Chief Product Officer*

Priority list is supporting Ted and his team in making great content, at increasing scale, changing that consumer experience, to do a better job at promoting those new series. It's making better use of the marketing that we do, too, so we can actually provide technical support to our marketing team to really provide the right message on the right channel at the right time for the right consumers that are targeting and programmatic there as well. Also, better leveraging our partners, both for new acquisition and engaging our members. And finally, making sure, again, that the product continues to be really, really effective at evolving to respond to the new needs of the consumers, the next 100 million, 200 million members that we'll have. So we make sure we keep an eye to that shifting global set of use cases and requirements.

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

And just add something about Proximus and T-Mobile.

**Gregory K. Peters** - *Netflix, Inc. - Chief Product Officer*

Yes, I mean, one of the things we're super excited about is the work we're doing on bundling. We started in Europe with Proximus, with SFR/Altice; and we just launched in the United States, T-Mobile here, and we're very, very excited about leveraging our partners to find efficient ways for our members to basically hear -- our new members to be, I should say, to find out about our service and sign up and pay very, very effectively.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

And I think, to some extent, you're touching on mobile access. And when investors think about addressing Asia, they immediately think to mobile. Does the company, at this point -- sort of jump-ball, Reed, David, if you have any comments -- think about mobile as part of the addressable market as part of the TAM? Or is the focus still broadband and pay-TV households?

**David B. Wells** - *Netflix, Inc. - CFO*

I think, for sure we do. It's just how much -- where we are in the cycle of both learning and addressing that market. And Reed and David comment differently, but we for sure think that's part of the great global opportunity in terms of Internet-delivered entertainment.



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

David Wells can tell you that I'm often complaining when we see internal metrics with number of broadband households as the TAM because I think about it as number of people. And so it's very much all people on the planet will get the benefit of the Internet over the next 20 years, and we hope that all of them will get to enjoy Netflix also.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

And so then, Greg, back to you. How are you making the service work better on mobile? Any specifics around how much room there is on encoding and all the fun engineering, things like that?

**Gregory K. Peters** - *Netflix, Inc. - Chief Product Officer*

Sure. So we're definitely focused on making mobile both effective from a user acquisition perspective, so new members, but also from a member engagement perspective. So for those members who don't have a Smart TV at home or maybe want to watch something while they're on the go, we want to make that a great experience. So as you mentioned, one of the things that we're working very hard on is making sure that the encodes that we're using are super-efficient so that we can provide a really, really high-quality video experience, and with lesser and less bits. And just to give you an example, one data point as to how low we've gotten this. If you take something like anime, which is super-efficient from an encoding perspective, we can now provide an amazing quality -- video quality experience on mobile for anime titles at 150 kilobits per second, which is practically unheard of previously. So we're super excited about pushing those numbers down and making that mobile experience as great as we can.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Since Reed brought up T-Mobile, there's a lot of investor questions about the new distribution deal here in the United States with T-Mobile. If you could walk through the deal at all, again, a bit of a jump-ball, but I think perhaps David and Spencer, more in your court. And how are you going to measure ROI and the benefits of that relationship?

**Spencer Wang** - *Netflix, Inc. - VP of IR and Corporate Development*

Sure. So I can jump in and David can fill out. But to sort of pull it back a little bit, Doug, in our partnerships ultimately what we're trying to do is make Netflix easier for customers to sign up for and to access and to enjoy. So the T-Mobile partnership is an extension of that. Beyond that, the economic arrangements we generally don't get into. We have said, broadly speaking, in our BD partnerships, there are marketing components and marketing benefits that we share. To the extent -- from a financial reporting perspective, those marketing costs are in our marketing expense line. To the extent that there's a billing relationship and the partner bills on our behalf, those payment processing costs are in our cost of revenues alongside our other payment processing expenses.

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

And Spencer, if I've forgotten to download a film, what's my chance of streaming on airplanes? And what's our progress on that front?

**Spencer Wang** - *Netflix, Inc. - VP of IR and Corporate Development*

It's getting better, Reed. So we are partnering with airlines, and we just recently announced at the APEX conference at the end of September that we'll be leveraging all the great work that Greg's team has done with those more efficient encodes. And in early 2018, we'll be opening those up to airlines that partner with us, so that we can help them more efficiently use their bandwidth in-flight. And in that case, we hope that airlines will



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

begin to support and promote in-flight streaming, which we think is a benefit for our mutual customers. It will hopefully delight passengers as they fly and experience Netflix, and we think it's good for our brand. And generally, more engagement is good for retention for Netflix.

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**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

So what does the company have to do in the markets where it's still early stage, where Netflix penetration is still low, beyond just localization? And I would be curious if, David, in 2018 you had sort of a percentage of the addressable market that might be localized just to give investors some help on that end. What does Netflix have to do? Is it local programming from Ted? Is it Greg continuing to work on encoding and more efficient bit rates? Is it just waiting for the market to develop?

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**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

We're certainly not waiting for anything, Doug. We're aggressively moving on all those fronts of better streaming on the tech side, more relevant content. But again, if you have been an investor in Netflix for a number of years, you'll remember our launch in Latin America and how we built out, stayed focused on Mexico and Brazil. And we're doing the same thing in Asia. So we know how to run this play. There're specific lessons we have to learn about which content, how to get that developed, that we're working on. But again, the partnership model, we've got that in every nation around the world. So I think we're making really good progress. It's just going to take some time to iterate on the content as we did in Latin America 5 years ago.

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**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Before I leave the product discussion, I did want to get in one more on with Greg on AWS. Are you wedded to that platform? I think Google and Microsoft are trying to make strides.

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**Gregory K. Peters** - *Netflix, Inc. - Chief Product Officer*

I would just say that AWS has been a great partner for us and we really have enjoyed using their infrastructure.

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**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

The -- thank you for the enlightenment. David, switching over to you. Just on some of the key financial metrics, again, just to reaffirm our early discussion. Any change to the outlook across margins, 40% by -- in the not-too-distant future, free cash flow, anything that you would like to update?

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**David B. Wells** - *Netflix, Inc. - CFO*

Well, I think one thing that's of note is the 40% U.S. contribution margin was our youthful target, say, a year to 2 years ago as we grew out U.S. profitability and we had international losses. You fast forward to that, and we sort of approached that target 3 years early. We were able to turn international profitable, which will stay profitable on a consolidated basis going forward. So we've switched to global operating margin, and we really are optimizing the business around global operating margin. So you'll see us shift some spending back and forth, notably marketing. I think I've indicated in the past that U.S. marketing has gone up on an absolute basis as we see the benefits and we test around some of the more benefits of promoting our original content. I think you'll see that increase again in '18. And so we really are focused around growing operating margin. We're 7% this year, well on track and guiding to be on track for that and continued growth forward, and we'll specify that in January. But we were able to grow from 4% to 7% this past year to give you some indication of that growth.



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Do you have a sense as of now what the 2018 working capital burden might be for building out your original content slate? I mean, I think you've got about \$3 billion or so a year of revenue growth. Ted likes to spend an incremental \$1 billion, at least in terms of amortization hitting the income statement it seems each year, and that gives investors \$2 billion to play with. And you obviously have other OpEx, but the big plug -- the big number that we have trouble calculating, of course, is that working capital burden. And do you know, at this point, what -- do you have a line of sight on that?

**David B. Wells** - *Netflix, Inc. - CFO*

Yes. I mean, we obviously have a much better idea, given that we're 3 months away -- or 2 months away, 2.5 from next year. I would say, and without sort of backing us into a corner of giving you a specific number for next year, we're going to spend \$7 billion to \$8 billion on a P&L basis on content. And in the past, the markup, or the working capital ratio markup on content cash to P&L has been somewhere in that 1.4 to 1.5 range. This year, it'll be about 1.5. We really do enjoy the benefits of owned productions, and you'll -- you're seeing us move more and more of our mix, our content mix, to owned productions. So I think that 1.5 becomes around 1.55, again on average. There's a lot of lumpiness in these numbers as things tend to shift around from quarter-to-quarter but we know it's going to be higher. And the \$7 billion to \$8 billion in content spend with a little bit of a markup in the ratio. The offset there is operating profit growth, but you guys run your models, and I think that's given you enough direction in terms of getting towards directionally where working capital and free cash flow goes next year.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

The -- and the 2 dynamics you've had in place is approaching about 50% original content by 2020. And to the extent the company grows faster than expected, the content spending might also increase. Are those still in play?

**David B. Wells** - *Netflix, Inc. - CFO*

They are. And I would just say to socialize that 50% or provide a little bit more context around it, it's becoming increasingly sort of -- to a Netflix subscriber, when they see a Netflix brand on the piece of content, that feels like an original. To us, we have sort of different subclassifications, whether we own it and made it or we licensed it. At the end of the day, to the consumer, what's important is that it's exclusive and only on Netflix. But I would say that 50% number that we've talked about in the past, that could be higher in the future as we accelerate more and more content development and as we like the benefits of owned production. But Ted, I don't know if you'd have something different you would add.

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

No, that -- I would say that, that's accurate and that's the trend, for sure.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

Ted, I think, as we're talking about content spending, it naturally makes me wonder what you're going to spend it on. Any update on sort of 2 categories. One, international; how that's doing in terms of creating more and more local content, how that's scaling, what kind of percentage of budget are we talking about now or in a few years, and then similarly for movies.

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

Well, I'd say, on the international originals, the -- we enjoy a lot of production efficiencies in producing outside of the United States, so we can produce in a higher volume and bring kind of higher and higher production standards to those markets. So we've been really thrilled with our ability to do that. Greg mentioned earlier about anime, just by way of example. We have more than 30 original anime projects in various states of



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

production these days. So I'm just going to give you some sense of the scale. And then the series work that we're doing is, in the case of Italy, is not a -- just a -- Suburra is not just a show that you're going to see in Italy. It is a show that looks and feels very much like a Narcos, like a House of Cards, like a big global original, it just happens to be in Italian. So we're producing at larger and larger scale outside the United States, inside the United States. And on the movie side, we're going to -- we'll -- we've -- this past quarter, we've released 8 original films. We plan on about 80 coming up next year, and they range anywhere from the \$1 million Sundance hit, all the way up to something on a much larger scale like we're seeing on Bright at the end of this year and Irishman, that's in production right now with Martin Scorsese, that should be in early '19.

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**Douglas David Mitchelson** - UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media

And that leads me to wonder about sort of cost of content because you're scaling up the number of hours and the number of titles and, at the same time, we keep hearing about inflation, certainly for the best content in Hollywood. Any sort of comments on the Shonda Rhimes deals specifically, but more broadly, is content cost inflation something that could become an issue for Netflix at some point?

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**Theodore A. Sarandos** - Netflix, Inc. - Chief Content Officer

Yes, I'm sorry if I'm a broken record on this one, Doug, but I get asked this a lot and I feel like I might say the same thing a lot, which is that I compare it a lot to professional sports. Where it gets very competitive for the handful of superstars, but overall player personnel costs are pretty predictable. And I think this case, it's those big unicorn shows. The price of any one of them might go up in a more competitive market. But general content costs are quite predictable. So -- and we're like -- and the thing about Shonda Rhimes, as you mentioned earlier, is creating a place where she wants to create, where she knows that she could spread her wings a little wider, where she can get outside of the network box a little bit, had a lot more to do with her attractiveness to Netflix than we just had to outbid ABC. And I -- so as we continue to attract world-class talent like that, that will also attract more world-class talents like that.

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**Spencer Wang** - Netflix, Inc. - VP of IR and Corporate Development

And Doug, (inaudible) I would say, from an investor perspective, hopefully what gives investors confidence is our -- in terms of our ability to manage content cost inflation is if you look at the long-term trend in our business, we've grown the content budget, we've grown the content library and made it better, but revenues have grown faster, which is what's driven the profit improvement and the margin improvement over the years.

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**David B. Wells** - Netflix, Inc. - CFO

That's what I was going to say. So we faced this content cost escalation over the last 3 years, or at least the speculation of it. So what Spencer said.

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**Douglas David Mitchelson** - UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media

The -- one thing I find interesting, and sort of switching over to sports rights for a moment with a question for Reed. Because I think I sort of know what the answer is going to be up front, but I still want to position the question because I wanted -- I was hoping you would engage on it. And that is that you just had Facebook bid \$0.5 billion for multiyear digital rights for the IPL in India. Obviously, Amazon's on the air right now with Thursday Night Football here in the United States. And I think there's an anticipation by investors that there'll be more and more bidding by video platforms on sports rights. And of course, we all know that Netflix has indicated in the past that it's sort of not right for you, but this reminds me a little bit of when you were switching from DVDs to streaming that you really sort of waited back, not necessarily so much in the weeds, but for the marketplace to evolve to the point where it was the right time for you to pursue it. So I'm trying to understand just what the trigger points are for Netflix as it looks longer term at sports content.



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

Well, we'll have to see over the next 10 years, Doug, what those trigger points might be hypothetically at some point. In the near term, we have so much going on in the global expansion of movies, unscripted, series, documentaries. We're just running 100 miles an hour doing our thing around the world. And so nothing to really talk about that's interesting in the near term.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

The other question that we end up asking a lot but we still want to do it, Amazon is likely to launch some sort of ad product in the first half of next year, and it's not clear if it's a pre-roll or post-roll or banners or sponsorships or what-have-you. My understanding is they're still trying to figure it out. And given that you have emerging markets that perhaps require lower price points than the developed world, any updated thoughts on pursuing advertising at some point?

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

Often, the right strategy for a challenger brand, which is Amazon in the case of streaming video, is to try many things because they're not sure. Just copying Netflix is not going to typically get someone very far. The leader's role is to really -- as that famous phrase is, to keep the main thing the main thing. And so our focus is not expanding in new ads at all. Our focus is on doing even better content, getting better partnerships, better mobile streaming. We just have to have the discipline to keep doing what we're doing at many times the scale. And if we do that, things will work out really well for our global customer base and, thus, for our investors.

**Spencer Wang** - *Netflix, Inc. - VP of IR and Corporate Development*

And then Doug, I think we have time for one last question.

**Douglas David Mitchelson** - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Media*

The -- well, it was interesting because I had 2 that I was going to go with. So for Reed, I'm going to let you try to divide between the 2 of them. And one was, I was curious, I think there's -- investors are really focusing on competition and access to content these days as the market really evolves. And so one was I was sort of curious if you'd wrap up with the sustainable competitive advantages for Netflix. And I think, separately, I was going to ask a regulation question, Reed, and that is that when you look at sort of content overseas and local quotas, when you think about what some of your peers are going through around scale issues, is there anything on the regulatory side regarding those 2 specific issues that Netflix is focused on right now?

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

Well, Doug, you're very good about staying in character. We've all got our Stranger Things sweaters on because we're celebrating both the amazing content that's coming in 10 days or so, and also Target's great promotional strategy. We're learning how to do merchandising. We've got some amazing displays and amazing materials out at Target. And Ted, do you want to tell us a little bit about Stranger Things?

**Theodore A. Sarandos** - *Netflix, Inc. - Chief Content Officer*

Well, October 27, we'll be releasing the new season of Stranger Things, which gives you -- answers the question, how are you spending your Halloween? And if -- you too can get one of these ugly sweaters from Target for your next Christmas ugly sweater party. But it really celebrates the spirit of the show in a great way, and we can't wait for the show to come out, which is not only an enormous hit in the United States, but it is equally international across with our membership base. So we are thrilled for Stranger Things coming this month.



## OCTOBER 16, 2017 / 10:00PM, NFLX - Q3 2017 Netflix Inc Earnings Call

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

And Greg, what are we doing on product to support Stranger Things?

**Gregory K. Peters** - *Netflix, Inc. - Chief Product Officer*

We're doing an amazing job by taking over big parts of the site to basically connect our members with this great show and show off how incredible content it is.

**Reed Hastings** - *Netflix, Inc. - Founder, Chairman of the Board, CEO & President*

And Doug, to answer your question on scale, I'm sure others are figuring things out. What we're continuing to do is work with Amazon as well as investing in Open Connect and being able to handle all of the growth that we anticipate. And we've had a pretty good track record of that for the last 10 years, so I wouldn't worry about that particularly.

Thank you, everyone, for joining us on the call, and look forward to talking to you more over the quarter.

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