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NFLX - Q2 2016 Netflix Inc Earnings Call

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PRESENTATION

David Wells - *Netflix Inc - CFO*

Welcome to the Q2 2016 Netflix earnings call. I'm David Wells, CFO. I'm joined today on the Company side by our CEO, Reed Hastings, and dialing in remotely, our Chief Content Officer, Ted Sarandos. Interviewing us today will be Ben Swinburne from Morgan Stanley, and Scott Devitt from Stifel Nicolaus. And I think, Ben, you have the first question.

Ben Swinburne - *Morgan Stanley - Analyst*

Yes, thank you. Reed, I'm sure we're going to spend a lot of time on the quarter and the long-term outlook, but I wonder if you could just give us a sense, what gives you confidence that the (technical difficulty) shortfall in the quarter was really driven by sort of confusion among members around the price increases or the ungrandfathering versus other factors? For example, content, competition, and any color you might have on voluntary versus non-voluntary churn? Maybe you could help us put some color around what happened versus your expectations?

Reed Hastings - *Netflix Inc - CEO*

I'm getting a lot of echo.

Ben Swinburne - *Morgan Stanley - Analyst*

Yes, I am too.

Reed Hastings - *Netflix Inc - CEO*

That maybe you could mute or something. The -- let's see, you asked the question, why are we confident of this explanation? Well, the obvious explanations other than this are competition, which we're pretty confident is not a factor, because we got this slight uptick in churn in multiple countries the same week. And, of course, that's not a competitive signature, including Canada where many of the other SVOD services don't operate, there's a separate set, Crave and Shomi that operate in Canada. So that's why we're pretty confident it's not competition. And then again, if it was saturation, what we'd be seeing is a hit to gross adds more than we would in terms of churn.

So other possible explanations were that we did something on our service around that week, but we've looked at everything. And the fact that it's coincident with that Google trend data we included really indicates that people don't like price increases, we know that. It's a necessary phase for us to get through. And then with the increased revenue, we're continuing to invest in better and better content. So that's what makes us feel very strong and positive about the long-term, and that this is a short-term phenomenon.

Ben Swinburne - *Morgan Stanley - Analyst*

And David just as a follow-up, when you put the third quarter guidance together, are you assuming that this sort of churn throughout the entire base remains elevated? Or have you seen that initial April churn subside, and really what we're looking at is just the impact from the actual ungrandfathering which you talk about in the letter being in line with expectations?

David Wells - *Netflix Inc - CFO*

Ben, we're assuming that it persists. So we might be wrong on that in terms of it relenting a bit or it gets better. But so far, we've seen it sort of persist through the second quarter and into the early part of the third so we're assuming that persists into Q3, and maybe into Q4 as we continue to ungrandfather. And just a cautionary, the usual customary language. I realize I went straight to your question, but we will be making forward-looking statements in this call, and actual results may vary. With that, we'll go back to our regular questions.

Scott Devitt - *Stifel Nicolaus - Analyst*

Thanks, and this is Scott Devitt. Reed, I was wondering if the effects of the ungrandfathering have any longer term ramifications, in terms of how you think of pricing power on the platform globally?

Reed Hastings - *Netflix Inc - CEO*

Not a ton. We're continuing to improve the content, which is the fundamental driver of value for subscribers, how much they watch, how unique the content is, how exclusive it is. We're going to continue to improve. And again, with new members, we haven't seen any effect. We changed prices to our $8, $10 and $12 last October, and we've had a couple quarters of great growth on the gross add side. So I think this is really around change resistance, whatever the price is for something, people don't like it to go up. But in terms of new members which is most of what drives growth, the new pricing is working great.

Scott Devitt - *Stifel Nicolaus - Analyst*

And in terms of -- for David, in terms of the timing, the links that you provided to Google Trends, I think the uptick started the week of April 3, so is the 3rd through 16th, it predated when you gave earnings last quarter. What was the response? Was it immediate, in terms of the uptick in inquiry volume and interest, or was it somewhat delayed?

David Wells - *Netflix Inc - CFO*

Well, let's keep in mind, Scott, that the -- what we're talking about is a very small change, right? But because of the large base, a small change can result in sort of 300,000 subscribers, which is the miss that we had on domestic resulting, but we did see it. We've learned through -- in the past not to overreact to immediate trend changes. So it was a swing factor when we were discussing Q2, and into Q3 even, and sort of trying to sift through what might affect us in the quarter. We saw a little bit of it, but it was very -- right before we set earnings, and we were on this call at three months ago. And so, we felt that it was a small factor, but it did persist through the quarter, and that's one of -- the major driver of the lower year-on-year growth, and also the lower growth versus expectations.

Ben Swinburne - *Morgan Stanley - Analyst*

And just sticking on the theme for, around churn with another question. David, what are you seeing with the ungrandfathering members, as they face different pricing options? I know you tested a lot over the last couple of months, what are you seeing in terms of their choices? And how does

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that impact your ARPU expectation? And when would the grandfathering process be finished in the US? Is that something in the fourth quarter, any help there would be great?

David Wells - *Netflix Inc - CFO*

Yes, it finishes in the fourth quarter, so it finishes about midway through towards the end of November. And then in terms of their choices, especially around plan mix, or whether they choose the high plan or the low plan, it's as we expected. So we continue to see folks choose the lower plan in some smaller increments, and the higher plan in some increments. So our expectations of ASP growth are still there, about consistent. What we're talking about is the population that it didn't face an immediate grandfathering choice. That's the part that was a bit of a surprise to us, and continues to persist.

Ben Swinburne - *Morgan Stanley - Analyst*

And does any of your data suggest you've seen anything interesting around members that were inactive, or maybe membership sharing as a result of the pricing changes?

David Wells - *Netflix Inc - CFO*

No on both counts, so.

Ben Swinburne - *Morgan Stanley - Analyst*

Okay.

Scott Devitt - *Stifel Nicolaus - Analyst*

And this question may have been addressed in the letter, given that you gave ungrandfathering commentary around international as well, but would be interested if you could just talk through your expectations for existing markets versus new markets, and where you beat and missed?

David Wells - *Netflix Inc - CFO*

Sure, let's see. I would say that we, the trend was across multiple markets. And as we put in the letter, it was in markets that are more highly penetrated, and less highly penetrated. That's why we think it is about the sort of pricing talk that was affected. But in addition to that, we would say that our newer markets have an expectation of multi-year growth. So we know that we've got our work cut out for us, and that we've hit a point where we aren't adding on any new additional markets. But we are going to be seeing periods of accelerated growth and decelerated growth. And we've seen that in the past where some markets sort of pick up and then moderate, and then pick up again. And I think that's what we saw in this quarter and forward. We're indicating that we've got multi-years, just like we have in Latin America. To build that market to where it is has taken us four, five years at this point to get it there.

Scott Devitt - *Stifel Nicolaus - Analyst*

And Reed, you -- sorry (multiple speakers)

Reed Hastings - *Netflix Inc - CEO*

In the new markets in Asia, central Eastern Europe, it's significantly different from early Latin America. It paints a pretty similar picture, at least for these first six months.

Scott Devitt - *Stifel Nicolaus - Analyst*

And Reed, you reiterated the $60 million to $90 million in the US. Would be interested if you could add some color, in terms of where you think the friction points are, if it's content portfolio, competition, those being the two most significant, where you see sources of friction, and what gives you confidence still in that range?

Reed Hastings - *Netflix Inc - CEO*

I don't think there really is any friction. I mean, smart TVs are continuing to sell. Everyone is using internet video and internet television more and more. You see the rise of these virtual MVPDs, all of these things are building out the internet ecosystem.

And I don't see why 10, 20 years from now, why every American household isn't subscribing to Netflix, except for maybe competition. So we've got to stay on our toes on that basis. But think about entertainment and pay television, they're pretty ubiquitous. So in the internet video, that's a pretty big bet that's continuing to pay off. So you put those two forces together, and that's why we feel so good about the long-term in this market.

Ben Swinburne - *Morgan Stanley - Analyst*

I wanted to ask a little bit more about the guidance, David. Last quarter you called out the comp versus Australia, which was I think a bigger one, or a tougher one than we all understood. And you look at third quarter, I think you have Japan, and then fourth, quarter southern Europe, could you maybe put those, at least in relative context versus Q2, so we can think about what those headwinds may or may not look like?

David Wells - *Netflix Inc - CFO*

Sure. I mean, there's always a head wind when we've had a prior launch of a large market, or a market like Australia where we saw strong initial uptake. In terms of that moderating, you've got a lot of pent-up demand that then sort of reverts to a more normal growth pattern over time. That can take several quarters, it can take two quarters. We've seen different experiences by market. So I would say, Japan was a pent-up market in some respects, and then starts to moderate.

So that does factor into the comp. And some of our other markets may be experiencing flat or even down year on growth. It's just a mixture across that. But like I said, we've seen markets that have decelerated, then pick up again and accelerate. So collectively, across the -- all of our basket of investments in markets, we think there is a large long-term opportunity that we're going to optimize against. And we know that we've got work cut out for some of our newer markets that will take time to get there.

Ben Swinburne - *Morgan Stanley - Analyst*

And just wanted to ask you about the Olympics, and where you're factoring that in, or how you're factoring that into your guidance? You mentioned gross additions remain healthy, which at least to me sounds like flat to up, but I'll let you comment if you choose. Are you assuming that impact to gross adds? And if so, is it a US phenomenon, or a global phenomenon in the third quarter?

David Wells - *Netflix Inc - CFO*

It would be global. And so back, you're correctly surmising that gross adds, you can say roughly in line year-on-year. And so with an assumption of a hit from the Olympics which largely affects us in the past on gross adds, or on new subscribers coming in, that's going to affect in terms of a year-over-year trend. We expect that to be a meaningful, a small, but still meaningful impact on the quarter. Negative impact.

Scott Devitt - *Stifel Nicolaus - Analyst*

You haven't announced the X1, the Xfinity deal with Comcast. And was -- without a timeline, was wondering if you could give any clarity in terms of timing? And then more broadly, how you think about MVPD in the US as a driver to subscribers in the way that years ago, getting on to consoles and other devices actually led to an acceleration in growth?

Reed Hastings - *Netflix Inc - CEO*

Sure. We're very excited about the X1 integration. It's scheduled for the second half of this year, so between now and the end of the year. And really, we're focused on getting the integration points very smooth, and the Comcast engineers are doing great work on it. So look for it later this year.

It will help modestly. Again we're more penetrated than we were before, so I don't know that it's as big a breakthrough, because many of those households, Comcast households now have a smart TV or have a Roku, but it will certainly help. And from a user perspective, to just live on the Comcast remote and to be able to stay on that input, as opposed to having to switch inputs is a great thing for them. And then, the integration, I think, you'll be pleased with. So all of those is one more positive force for us coming later this year.

Scott Devitt - *Stifel Nicolaus - Analyst*

And then secondly, maybe for Reed or Ted. The Disney deal is coming soon, with content supposedly launching in September. How much of a factor is that in guidance, how significant do you think that content launches from Disney will be for the business?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Well, remember, keep in mind they're US only, is the output deal. And those films are, I think they're very important for watching and distinguishing Netflix as a different destination for parents, because we'll have all of the Disney movies, all of the Lucas movies, all the Pixar movies. And that, at which distinguishes us separately, but I think it's great high quality watching. But the movies are about 10 months old, so we don't expect them to drive a lot of new subscribers, but we do expect it to drive a lot of customer joy.

Reed Hastings - *Netflix Inc - CEO*

And they come in one at a time, so you don't get the whole load of movies, for example, that are coming on to Starz this summer. Those will stay with [Starz] for the 18 month window. So it will build up over the first 12 to 18 months.

Ben Swinburne - *Morgan Stanley - Analyst*

When we think about the next 12 to 18 months or 24 months for the Company, it would seem that the Olympics as well as the ungrandfathering, are to some extent one-time events. And so, as we think about 2017, I know you guys don't give guidance out that far, but I'm just wondering if it makes sense to assume that churn, the churn impact from this stuff rolls off, and maybe the churn continues to decline the way it has been organically over the last several years across the service, certainly at least if you're successful around original programming. I just want to give you the opportunity to talk about, what the business looks like as you come out of this sort of multiple headwind period here over the next couple of quarters?

Reed Hastings - *Netflix Inc - CEO*

Well, let's see. In the individual market, we would expect it to be as you said, we would expect it to return to its normal patterns and continue to improve. As we expand throughout Asia and Central and Eastern Europe, the overall global may be a different number because those as new territories will be more high churn. But fundamentally, I think your analysis is right, which is there is short-term headwinds for this year. And then, you're looking at the broad growth of internet television, which is continuing to be very positive.

And then that's offset by competitors getting better, but that hasn't seemed to affect us in any of these markets. So I wouldn't anticipate, because all of the online competitors together were competing against linear hours, and there's still so much linear hours to feed at, that there would be any material change competitively around the world.

Ben Swinburne - *Morgan Stanley - Analyst*

Great. And just on the rest of world markets. You mentioned, I think Poland and Turkey in the letter. You also mentioned being economically prudent. Maybe you could spend a minute on how you are thinking about these localization efforts, what that even means? And sort of why the pace is what it is for that part of the business here over the next couple of quarters?

Reed Hastings - *Netflix Inc - CEO*

Yes, it's a small additional investment in any market to localize it, subtitling, and some dubbing across thousands of titles. It's localizing the service, the different apps, and then it's doing local language marketing. And so, we're just taking our time, one by one. The whole advantage of going broad in January was to increase our rate of learning. So we wouldn't have picked out Poland and Turkey, in the absence of any knowledge. But now we can clearly see positive trends, so we're starting with those. And we'll continue to roll out improvements in other markets, again as we see that the content is forming a great match with the society, and continuing to work on that content.

David Wells - *Netflix Inc - CFO*

And just to round out, Ben, Reed, some of the factors, and we could do partner deals in certain countries. We could do local payment options. And so those are the ones that we're referring to, depend on the economic prudence, like the size of the opportunity in those areas.

Scott Devitt - *Stifel Nicolaus - Analyst*

Ted, you've previously given aspirations of mix of 50% original versus acquired content. Could you talk a bit about where you feel you'll be in 2016, and whether 50/50 is still the right mix long-term?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Long-term, I think that's certainly a probable mix, and maybe even a conservative one. But I think in the growth of those original films, series, series for kids, documentaries have proven to be great investments in terms of their efficiency relative to other high profile content that we license, which is encouraging us. I think that it's made our rest of world launch possible, by having content that people want to see, in markets where we haven't yet operated. And it certainly helps in terms of the complexity of global licensing.

So we want to keep pushing it, and we've also been able to manage very high quality, at the same time of doing very high volume. So we put in the letter, but we've had 17 of our original films, specials, and series nominated for Emmy awards, 54 Emmys this year. So we've gotten -- and then add 33 for our kids programming, and we've been able to manage both volume and quality pretty well. So that's what encouraged us to keep pushing.

Scott Devitt - *Stifel Nicolaus - Analyst*

And you'll be at 600 hours of new content in 2016?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Yes, I expect that we'll surpass that pretty comfortably.

Scott Devitt - *Stifel Nicolaus - Analyst*

We've thought about the business longer term, in terms of how much content can you actually put on the service before you no longer need to add content. And the question is, as it relates to originals specifically, is that a fair way to think about it, when trying to think through longer term content obligations?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Yes, definitely. I mean, I think as we, our appetite for licensing off-net decreases, whether our appetite to increase our originals volume. And as long as the customers are happy with the transition, it encourages us to keep being aggressive in that space.

David Wells - *Netflix Inc - CFO*

And Scott, we've been able to expand our contribution margin in the US, and we intend to reduce international losses, which would imply that we're able to grow revenue faster than our content spend internationally. But we'd like to do both. I mean, the advantage of our global distribution platform, to the extent that we can find content that appeals broadly, there's an advantage in scale there in terms of distributing it. So we'd love to continue to expand that content spend, and also to drive some to profit as we go. I think we can do both.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

And I would just add real quick, one of the most positive developments from our original programming has been, today an original show from Netflix can be just as attractive as a show from any network in the United States, when licensing for territories around the world. So it leads you -- what we're doing licensing first window for some titles in some countries, and second window for global, what we're finding is when we launch in our new original series, there's a huge appetite for them around the world.

Reed Hastings - *Netflix Inc - CEO*

And Scott, I think it somewhat depends when you ask how much content is enough, and whether you think of it as trying to attract a 100 million members where we are now, or whether you think of it as trying to attract 1 billion members like Facebook or YouTube are at today on the internet. So it just depends upon the size of your aspirations. And as we accomplish one goal, of course, our aspirations grow. So I think you'll see content continuing to grow essentially forever.

Ben Swinburne - *Morgan Stanley - Analyst*

Reed, just going back to internet TV as a segment and some of the initiatives there, how do you think about, what we think this new Hulu product is going to look like? Which is let's just assume that it's the best of cable, plus a fairly robust on-demand offering. How do you think that impacts your business in the US one way or the other, if they're successful?

Reed Hastings - *Netflix Inc - CEO*

I don't think it will. We haven't seen impact from existing Hulu, if there's a new cable system that's better. Sling TV is in the market today, and our penetration among Sling TV users is quite high. So think of that as cable getting better or MVPD getting better, and Hulu is a potential example of that, if the reports are correct.

Ben Swinburne - *Morgan Stanley - Analyst*

And Ted, when you think about your relationship with the owners of Hulu, particularly Disney who is a critical supplier of yours globally, are you worried that they're going to start making an effort to deliver more content to Hulu versus Netflix? We noticed Disney did a deal for some kids programming during the second quarter, and Fox has already made pretty big shifts towards Hulu from an SVOD perspective. How do you feel about that your relationship with those companies and the contents of this Hulu launch?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Well, the relationships remain very strong, and we continue to do business with every studio, every network in every territory. They're in the business of selling their content to the highest bidder. So it -- so I don't, I'm not concerned that they would sell it for less to Hulu than they would to us, because they have participation problems with the talent that they have to work through. Now they've may get into a position where, if they were really to take that position, and buy everybody out for everything, that would meaningfully change the economics of those network studios. So I'm pretty confident that we're, it will be business as usual with the networks and studios.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

Scott Devitt - *Stifel Nicolaus - Analyst*

Ted, in terms of local originals, understanding every market will be different, can you talk a bit in terms of us trying to understand longer term profitability in the international markets, how you think about local originals as a portion of the mix, if you can take a few examples, or paint a broader brush throughout the international platform?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Well, we're in the very early goings of our international original programming. We've launched Marseille. We've launched original shows in Japan. We've launched in Mexico, and we currently have productions going on in Germany, Spain, Italy, Korea, Japan, France, Brazil, Cambodia. So we are producing around the world original programming. And it really has an outsized impact in those first couple of shows, because I think it does show those local markets that we're investing in their production infrastructure, we're investing in their culture. And then, taking most importantly, taking those shows and distributing them around the world.

So when we release a show like Hibana in Japan, people are watching Hibana all around the world at the exact same time, which makes us a very important part of the entertainment landscape in those countries, and ultimately to those consumers as well.

Scott Devitt - *Stifel Nicolaus - Analyst*

David, you seem to have changed the language in terms of the 40% contribution margin by 2020, and adding possibly earlier as well. I know the trends over the intermediate term past have been trending better. Can you just add some color to that comment?

David Wells - *Netflix Inc - CFO*

Well, I think it's just acknowledging that, like you just articulated we were running ahead on that. So you have to sort of acknowledge reality that we may get there sooner than we sort of initially targeted. I think for us, broadening it back from just the sort of quarterly performance of that progression towards US contribution margin is the right amount to reinvest in the business. We know that we want to drive efficiency, so we want some discipline there between profit and additional investment.

But we also have to figure what's the right amount of reinvestment in the business to maintain competitiveness, both domestically and abroad. And I think the US business -- I've mentioned this in the past, that to the extent we've produced an original for the globe, now that we're in additional markets, we're in more and more markets, the US P&L does receive some of that relief, because there's a smaller share of that allocation going to the US, than there was before.

So some of those -- that was at play. That was in the past, my team reminds me. And nowadays, the profit growth of the US is being driven just by growing revenue faster than content. But I think those two things were at play in the sort of last four to six quarters as we look at the trends. Thanks.

Ben Swinburne - *Morgan Stanley - Analyst*

Ted, just wanted to ask to you comment a little further on the market for acquired programming. I think there's a concern in the marketplace, that it's getting sort of increasingly competitive and expensive. And I'd love to hear how you see the market today, especially versus your expectations or your strategy around avoiding output deals, and really finding stuff that's globally exclusive? And maybe you can comment on the Amazon/PBS deal as well as your own agreement with the CW, the Star Trek announcement today, and also the Chuck Lorre announcement from a few weeks ago?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

You covered a lot of ground there, so let me try to address some of them. As for the CW, the CW is a real anomaly in terms of a network. They happen to produce programming that has a very consistent sensibility, and a very consistent fan base, and that fit really nicely with the big viewing demographic on Netflix. We've had a great relationship with them.

We opted to re-up that relationship, even though it's a domestic only, and an output deal. And we've individually licensed many of those shows for global distribution. And we are thrilled to do that, and not only to re-up our business, but also to move up the availability date of those shows to just eight days after their last episode airs, versus having to wait until just before the new season launches. So the fans of the CW programming are going to love that development.

As far as the PBS Amazon, I'd say we have so aggressively improved and expanded our original kids programming. In fact, we have 35 different original kids programming, kids shows on Netflix now, many more in production in various forms of development. So more and more that programming is leaning to our exclusive global programming, and our original programming, in place of massive loads of content from other sources. So our appetite for that, meaning our appetite for high prices has gone down quite a bit.

And what else did I miss there? (multiple speakers). Yes, Star Trek. So Star Trek is an example of one that seems like an odd ball, because we don't have it in the US. But this is one of those overhangs of regional licensing is that, CBS was not making the US available, and we wanted to make sure we could bring that show to the rest of our subscribers around the world. So we're happy to premier the new Star Trek series all over the world outside of North America.

Ben Swinburne - *Morgan Stanley - Analyst*

Great. And I just want to maybe pick up on the content [pricing] (multiple speakers). Go ahead.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Yes, you'd mentioned also pricing, and I'd mentioned this before and I think it still holds true. You should think about content costs like player personnel costs. At any given season, a super star goes free agent, and that particular player's price goes through the roof, but player personnel costs stay -- remain pretty flat. And that's the case here. Every once in awhile, there's a break out, a very competitive title, and the for that price goes up, but the overall spend, you have it baked into our business model.

Ben Swinburne - *Morgan Stanley - Analyst*

Got it. And just following up on margins. David, if you look at the international markets, which I realize is a portfolio, do you have a good sense for how much local programming you need in a given international market, realizing there's a range, and does that percentage impact the profitability of those markets long-term? In other words, if you need in a market like Germany half the content -- just to make something up -- needs to be German, does that mean that market is structurally lower margin than say, the US market or your broader portfolio? Or is it still too early to figure those things out?

David Wells - *Netflix Inc - CFO*

I think it's still too early. I mean, the dominant aspect that affects profitability in any one given market is the competitiveness, and that can manifest itself in the competitiveness for content bidding. It can manifest itself for competitiveness of the consumer's moment of truth, how much they're viewing, where they're viewing, what are their alternative sources of entertainment? So I would say, that it's way too early. We've been very successful with sort of an 80/20 model today, in very disparate non-english markets in Chile, in Finland, in the Netherlands. And so, we do have markets, early markets like Japan that are tilted a little bit more towards local content. But I don't think the margin characteristics are going to be necessarily determined by the percent of local, as how competitive the market is.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

Scott Devitt - *Stifel Nicolaus - Analyst*

Reed, time spent on the platform is such an important metric. Was wondering if you could update us just on time spent per user, to the extent that there's anything here that's changed in either direction? And then secondly, Sandvine reports [peak] traffic showed a down tick in Netflix, still dominant, but a little bit lower relative to peers, in terms of that domination. You've implemented compression technology during that period. Can you just talk a little bit about how much of an effect that could have had on a metric like that?

Reed Hastings - *Netflix Inc - CEO*

Sure. I think on the Sandvine which covers North America, it might have been like 35% to 33%, something like that. Which would correlate very well with what we think was the increase in coding efficiency. So think of that as a flat result, as opposed to a down result. And then, what was the first question?

Scott Devitt - *Stifel Nicolaus - Analyst*

Just time spent per user, how that's trending? You've given periodic updates on that. I was just wondering if there's anything -- ?

Reed Hastings - *Netflix Inc - CEO*

Sure. Viewing overall is pretty seasonal. So you have to look at it on a year-over-year basis. But on a year-over-year basis, total viewing which is the fact that we sometimes release is up. I forget [exactly] the numbers, but think of it as we were -- I think it was 13 million a quarter ago, and it was maybe 10 million a year ago.

David Wells - *Netflix Inc - CFO*

Yes, Scott, we -- I'm sorry, you did release those numbers at CES in January, so there was a data point there. And I think that's what Reed was referring back to.

Reed Hastings - *Netflix Inc - CEO*

But total viewing is continuing to grow --

Scott Devitt - *Stifel Nicolaus - Analyst*

Okay. And then, secondly -- (multiple speakers)

Reed Hastings - *Netflix Inc - CEO*

On a year-over-year basis.

Scott Devitt - *Stifel Nicolaus - Analyst*

Great. Download functionality, which is a hot topic, some competitors have taken that on. You have historically have suggested, not interested, and it seems like that's changed a little bit more recently. Can you talk about your interest there? And then, also cost implications in terms of contractual obligations?

Reed Hastings - *Netflix Inc - CEO*

Yes, we're open minded about it as we've expanded globally. It's something we've taken more of a look at, given the strength of cellular networks not being as strong in some of the new markets. So that's gotten us to take a look at it. And there's no material cost implications. As you know, some of our competitors in different markets, in Germany, the US and others include a local [caching] capability. So it's a pretty standard part of most deals.

Ben Swinburne - *Morgan Stanley - Analyst*

A question for David, just turning to the financials a bit. Your member growth fell short this quarter, as you guys acknowledged in the letter, but your comments about profitability next year haven't changed, you can expect substantial profits -- or material profits, excuse me, in 2017. Could you talk a little bit about the cash flow burn, cash burn outlook 2016 and 2017, David? And any comment around P&L expense versus cash, now that the top line at least seems to be growing a little bit more slowly than we all expected?

David Wells - *Netflix Inc - CFO*

Well, cash flow despite the perturbations of sort of content coming in and out, and the uncertainty around when that content might time, has been relatively steady at about a [$0.25 million] a quarter. So I would say that there has been no change from my understanding and expectation, that it's about $1 billion, a $1.2 billion in terms of the year, and we expect that again going forward. So free cash flow will improve when we drive more profit, and start organically funding more of our content investment. And in terms of the ratio of content cash to P&L, it's still in that [1.3 to 1.4] range, where it could peak up to [1.4], but it's staying in that [1.3 to 1.4] range.

Ben Swinburne - *Morgan Stanley - Analyst*

Any color on the sequential increase on contractual obligations? I think it was [13.2] at the end of the quarter. How do you think about that number, again given the context of the slowing, or a little bit of a lower top line than you thought?

David Wells - *Netflix Inc - CFO*

Well, content is one of those things where you invest -- you don't invest by quarter, you invest several years or a year. So I think what you're seeing is our investment in rest of world, the rest of world launch, and the growth of additional territories. You're also seeing increased investment in some of our younger territories, where they're growing their content expense at a faster clip than some of our territories that are more highly penetrated, or have been more operating for more years.

But just like Reed was saying that the offline viewing or the downloading rights aren't really a factor, what you're seeing is the growth of additional territories. So that's what's driving the content commitments. And again, I look at this periodically on a per member basis. And it's stayed in that sort of band, and is consistent with sort of prior trends and prior territory launches.

Reed Hastings - *Netflix Inc - CEO*

And you have to remember, Scott, that when we look at it, we've been doing this a long time. We've had these short quarters before. Nine years ago in 2007, we actually went down in subscribers. So this quarter, we're growing, but not as much as we want. But in 2007, we went down from 6.8 million in 6.7 million in this Q2, which is generally a seasonally tight quarter for us. And it didn't feel great going down, but now here we are at over 80 million. So you just got to take a long-term perspective, and internet TV is going to be an enormous market. We're very confident of that, and our competitive position is very strong. So those are the two fundamental things that give us confidence in the long-term, and want us to continue to invest in more content.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

Scott Devitt - *Stifel Nicolaus - Analyst*

Any update David on the chip card transition, to the extent that there's still any [remnant], that you may have seen in the quarter from that?

David Wells - *Netflix Inc - CFO*

It's a small background issue. It was back then, that was sort of became outsized, because we pointed to it as one of the explanatory reasons that we had an [involuntary] churn uptick. But I would say, it continues to be a small background issue.

Scott Devitt - *Stifel Nicolaus - Analyst*

And then for Ted. I don't know if there is a way to think of this that you'd share publicly, but in terms of the product portfolio today and global rights that you have, if you think of it maybe relative to your spend, what portion of the portfolio has global rights associated with it? And then secondly, as it relates to global rights, how are the allocations done between markets?

Ted Sarandos - *Netflix Inc - Chief Content Officer*

So the allocations are done by media market share models, and our -- you should think about our global allocations as, all of our original programming is fully global. Several, but we haven't broken out an exact percentage of our off-net licensees that we do on a global basis. And then, there's individual libraries from each of them, from around the world that we have global rights for, of a lot of content that you may never have heard of, but actually will get healthy niches of watching all over the world as well.

Reed Hastings - *Netflix Inc - CEO*

And Ted is right, some of the content, when we say global, that's global Netflix. Like sometimes, it includes China, and sometimes it doesn't.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

Correct.

Reed Hastings - *Netflix Inc - CEO*

So think of it as global, to where we currently operate.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

And with the exception of our original side, which to date has always included China.

Scott Devitt - *Stifel Nicolaus - Analyst*

Thanks.

Ben Swinburne - *Morgan Stanley - Analyst*

Can you guys talk a little bit about how the Asian market rollouts have gone so far relative to your expectations, and whether you're thinking about maybe different priced tiers, or still sticking to the global price point, as you look at the results there?

Reed Hastings - *Netflix Inc - CEO*

Yes. We thought about it after launch and debated, do we want to try to be a low cost service, like $2 service, or should we try to add content to make it a viable $10 service? And at least for the next few years, we're very much on the latter strategy. So we're going to invest to build a great $10 service. We look at the iPhone success globally. We look at some other high value products, and we want to be an incredible content service at this $10 price point, rather than be a very low, much lower cost or even free service. And so, that's what we're focused on as our current model.

David Wells - *Netflix Inc - CFO*

And Ben, we already do have some price choices in our tiering. So we do use sort of entry level tier as a mechanism for those folks that might be more value-oriented. So we do have some ability there, to separate across price in terms of capturing those subscribers that might be more value-oriented.

Ben Swinburne - *Morgan Stanley - Analyst*

And just sticking with the emerging market theme, but markets you've been in awhile, can you talk about the Latin American market, and whether that continues to be strong? And how you might think something like the second season of Narcos might impact results there?

Reed Hastings - *Netflix Inc - CEO*

Well, Latin America has continued to grow well for us. And what's been fascinating is the growth is pretty steady even in Brazil, where we see a significant recession, and a difficult government situation. So it seems that neither of those factors really effect a value-oriented business like ours. With the second season of Narcos, we're hoping to see great viewing throughout Latin America, throughout the world, but similar to our other originals.

Ted Sarandos - *Netflix Inc - Chief Content Officer*

That second season comes September 2. And it's one of the things that we think is -- get very excited about the prospects of global television. We also have a new series we're filming in Mexico, Ingobernable and a second season of Club de Cuervos in production. So we've got a pretty healthy investment in Latin America. But I think that, where we're at in emerging markets is exactly where we were at in the first few months of the Latin American market, trying to figure out what those people in each of those countries love to watch, and creating a service that is worth every penny of the subscription fees.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

Scott Devitt - *Stifel Nicolaus - Analyst*

Ben and I have both asked questions around cost structure, and other components of the international business, I guess, to try and gain an understanding of longer term profitability, understanding differences in ARPU and content cost by country, and local originals and things of that nature. Is there a reason to think that international in aggregate shouldn't have contribution margins that are similar to US over time?

David Wells - *Netflix Inc - CFO*

Well, I think each market will be different. But when you roll them up, I think structurally we can still get to where we've gotten to in the US. We've demonstrated a Canadian proof point as well. It depends on whether you include them in that international bucket or not. But we do think that we can see across the system sort of a variety.

But if you average across it, we can get to those levels of profitability, at least with the markets that we've seen today. We may penetrate into deeper into markets that have much lower ARPUs, that may have a different characteristic. So then it's a choice of sort of how big of a market do we want to address at that price point? Is that the bigger pie from a revenue or profit perspective, or do we want to experiment down in the price to broaden the market, and go after a bigger market at maybe a lower margin? I think we're too early to tell on that latter case.

Scott Devitt - *Stifel Nicolaus - Analyst*

And then second question again for, David, and apologies if this was answered earlier. But in terms of the ungrandfathering process, so where are you in the US, and then where are you in the international markets that you named, in terms of customers that are going through that process, having seen it at this point?

David Wells - *Netflix Inc - CFO*

Yes. I think in the letter we characterize it, but we're roughly half way through. And that will play out, continue to play out over Q3, and into early Q4.

Scott Devitt - *Stifel Nicolaus - Analyst*

And that's consistent US and those international markets?

David Wells - *Netflix Inc - CFO*

Correct. Now a point worth making here is that our international markets, because they're newer, have more disproportionately, more subscribers that are newer, and already at the higher price points than the US does. That's what makes the US unique in this discussion.

Reed Hastings - *Netflix Inc - CEO*

Let's wrap up with two more questions. Why don't you pick one each?

Ben Swinburne - *Morgan Stanley - Analyst*

I just want to ask about Europe, especially the Continent. You've been in a lot of these markets now for a couple years, but I think that they've been slow. For either or all of you, what do you think you need to do in Continental Europe and Southern Europe to accelerate that growth? And what is -- how much of it is content versus some of the payment stuff, or anything else you might call out that you're working on?

Reed Hastings - *Netflix Inc - CEO*

Well, just to remind you in Spain and Italy, we only launched it last October. France was and Germany was a year or so before that. And we've had really nice success in all of those markets with continued strong growth, following the growth that we've seen for example, in the UK or Canada, which would be the closest proxies in terms of wealthy markets with high pay TV penetration. So big competitive markets, but we've got a solid game plan. We're growing in those markets. Payments are not an issue, so we feel very positive about those markets.

Ben Swinburne - *Morgan Stanley - Analyst*

Thank you.

Scott Devitt - *Stifel Nicolaus - Analyst*

Last one, Reed, [you mentioned payments you've had payments as] a source of friction in some earlier international launch markets. Can you talk about that in the newer markets and what you're doing there to facilitate that?

Reed Hastings - *Netflix Inc - CEO*

Yes, around the world, eCommerce is unequally well developed, so in some markets there's very strong eCommerce payment platforms like the Netherlands. In other markets like Cambodia or Vietnam, it's challenging. So today we only accept international credit cards, so we'll develop, a really -- along with eCommerce in that whole ecosystem, as people want to pay for things online. And that may come through mobile payments like Android and iOS. It will come along with third-party payment systems. But again, the general economy, and people are moving online through mobile, and we're going to be able to take advantage -- or we are taking advantage of that. So in the long term, it's not a big friction point, because everyone is going to want to be able to purchase many things including Netflix.

Scott Devitt - *Stifel Nicolaus - Analyst*

Thank you.

Reed Hastings - *Netflix Inc - CEO*

So thank you, both and thank you to all of our investors. We apologize for the volatility; I know it's not easy on everyone. The big picture is very much intact, and we're very excited about it. And so, we're continuing to execute on growing the business. Thank you very much.

David Wells - *Netflix Inc - CFO*

Thank you.