TheStreet

Company Name: **Netflix Inc**
Company Ticker: **NFLX**
Sector: **Services**
Industry: **Media**

Event Description: **Q1 2015 Earnings Call**
Market Cap as of Event Date: **28.96B**
Price as of Event Date: **475.46**

Netflix (NFLX) Earnings Report: Q1 2015 Conference Call Transcript

The following Netflix conference call took place on April 15, 2015, 06:00 PM ET. This is a transcript of that earnings call:

Company Participants

- David Wells; Netflix; CFO
- Reed Hastings; Netflix; CEO
- Ted Sarandos; Netflix; Chief Content Officer

Other Participants

- Mark Mahaney; RBC Capital Markets; Analyst
- Michael Nathanson; MoffettNathanson; Analyst

MANAGEMENT DISCUSSION SECTION

David Wells (CFO):

Welcome to the Q1 2015 Netflix earnings call.

I'm David Wells, CFO.

Today I'll be joined on the company side by Reed Hastings, our CEO; and Ted Sarandos, our Chief Content Officer. Interviewing us will be Mark Mahaney from RBC, and Michael Nathanson from MoffettNathanson.

I think Mark has the first question, so over to you, Mark.

QUESTIONS & ANSWERS

Mark Mahaney (Analyst - RBC Capital Markets):

Thanks, David.

First question is for Reed. This was maybe an inflection point quarter, in terms of the domestic streaming sub adds that came in materially ahead of your guidance. They were actually up a little bit year-over-year, which is a bit of a surprise.

In the press release, you talked about both getting more subs in, and retaining them better maybe than you had expected. Could you provide a little bit more color? And is this something you think is happening across the industry, the greater focus on streaming offerings is just helping the leader in the market, or is there something specific that you're doing on both of those ends, the gross sub adds and the churn?

Reed Hastings (CEO):

We've continued to focus on the same things over the last couple years. Improving the content, improving the streaming, improving the user interface, and we've seen the rewards of that in continued growth. I think this quarter in particular, we had some amazing original content, with Unbreakable Kimmy Schmidt, with House of Cards, with Bloodline.

All of that compounded to really push us forward. Certainly what you're seeing is all of Internet TV growing, the attention of the new launches of the competitors is only creating a bigger ecosystem, drawing more and more people in to thinking, hey I've got to check that out, and try this Internet TV thing.

Michael Nathanson (Analyst - MoffettNathanson):

And Reed, for some time, you've talked about a long-term goal of 60 million to 90 million subs. At this pace, sooner or later the financial markets might actually agree with you. Any updated thinking on where we could fall in that range, and when we could get to that?

Reed Hastings (CEO):

I'd say they agree with us already. At a $25 billion to $30 billion market gap, there's a lot of growth priced into it. I think you'd agree. And so, yes, 60 million to 90 million feels great to us. We're continuing to grow.

That's 60 million to 90 million in the U.S. market. Of course, the really big upside beyond that is in international. For most global Internet firms, the U.S. is 20% to 35% of usage and revenue. We're not anywhere close to that yet, but we're continuing to invest in international.

Mark Mahaney (Analyst - RBC Capital Markets):

Reed, in the past quarter we've seen new entrants like HBO Now and Sony Vue come out with pricing. Looks pretty expensive, relative to Netflix . I wonder, do you think you have a pricing umbrella, given where they've launched their products, relative to where you have priced today?

Reed Hastings (CEO):

I think HBO at $15 is a great value. I have traditionally paid more than $15 to my cable company for it. So I think they're doing great work with their premium content.

It does create an obvious underline of just how great the value is of Netflix , with prices ranging from $7.99 to $11.99. But we're really comfortable with that strategy. We're continuing to grow with this strategy, and it is an incredible value. But I think you should really think about it as all the Internet services, HBO Now, and Netflix and Hulu are great values, in comparison to the big bundle.

Michael Nathanson (Analyst - MoffettNathanson):

Okay. And David, for the current quarter, could you talk about the trend on churn? I know you guys don't give out churn numbers, but what was the impact of original content on churn this year, versus a year ago?

David Wells (CFO):

Well, as Reed said, just picking up on those comments, you really do see the improvements in the service, both on the content, the interface, the payments across the globe, really move together. So you see that, with acquisition and churn improving. But we did see improving churn. So we are saying that we saw improving retention through the quarter, and that contributed to that net add performance and growth that we saw in Q1.

Mark Mahaney (Analyst - RBC Capital Markets):

Great. And David, if I could stick on the U.S. business, last quarter you talked about 30%-ish margins. 90 days later, we're already materially above that, and you're telling people to expect this to be -- your business to be above that.

I know there's some stuff in the press release on it, but any more color on why the there's such a pretty material shift in the margins, and to what extent should we just be concerned that you're pushing content costs in the international markets, so really there's not an improvement in the leverage here in the U.S. business?

David Wells (CFO):

It's both, Mark. There's absolutely an improvement driven by the growth. We're growing revenue faster than we're growing our expenses. In terms of the out performance, relative to our target of where we would want to be in terms of U.S. margin growth, it's a couple of things that we had talked about in the letter.

One of them is we're shifting marketing from the U.S. to international. We think it's -- we can grow a little bit faster on international. It's more efficient to do that.

And the second thing is a little bit of just the mechanics of how we allocate content cost by geography. So by going faster internationally, and putting that allocation more towards international, it's going to provide some relief to those global originals, and the global projects that we do have, that are allocated to the US. And we intend to continue to invest in that.

That's also why we put in the letter that our target remains the same, 40% in 2020. So we want to continue to balance the growth of profit with the growth and the competitiveness of our service. We want to reinvest in the service prudently along the way.

Mark Mahaney (Analyst - RBC Capital Markets):

So let me ask a two-part follow-on question of that, one for David and one for Ted. David, cutting back marketing spend in the U.S. in an increasingly competitive market, at some level, that feels a little extra risky than you should be doing. Can you talk to why you're so confident you don't need -- you can cut back on those marketing dollars in the U.S. beyond just one quarter of better-than-expected results?

And then Ted, last quarter in the letter, there was this bolded section, therefore caught my eye, about content spend being more efficient with original content than with licensed content. Do you feel like you've really reached a point that, that's what we're seeing in the business model today, that you're continuing to see more leverage, just on that original content purchase?

Ted Sarandos (Chief Content Officer):

I'll take the last question first there. What we're seeing is the dollars invested in our original programming are more efficient in that for every dollar spent we get more bang for the buck in terms of hours viewed, and hours viewed leads to higher retention, more word of mouth, and more brand halo. So that's why we say that it's turned out to be not just an important strategic investment, but also an efficient one.

David Wells (CFO):

And Mark, on your first question about our relative comfort with moving dollars out of the U.S. and into international, with just one quarter, I would say we've had multiple quarters of strong growth. Marketing dollars have been up. They've been down. I don't think there's a direct connection within one quarter, in terms of the level of marketing spend and the level of growth that we see.

We have migrated over the last two to three years to be more content forward in our marketing, more digital in our marketing, we're getting smarter and more efficient about how we put those dollars to use. And so right now we think there's a greater opportunity with international, and that's what we're doing. We're moving to international spending.

Michael Nathanson (Analyst - MoffettNathanson):

Ted, in the past six months we've seen Viacom and Turner write down the value of acquired syndicated content. Clearly, the value of the content wasn't worth what they were paying. Can you talk a pit about your own usage trends on acquired content, and whether or not you think the long-term trend for what you're acquiring will be declining on a per hour basis?

Ted Sarandos (Chief Content Officer):

Look, as we continue to grow, the thing that's most encouraging is the content we're licensing around the world has got equal and sometimes even disproportionate value to us outside of the US.

We're seeing real global value from licensing shows in multiple territories. And as we're continuing to grow domestically, we're seeing those viewing hours on licensed content, even older licensed content like we saw with Friends last quarter, where the viewing continues to grow. We're still seeing a lot of value from that programming, both our original and our licensed programming from all those sources.

Michael Nathanson (Analyst - MoffettNathanson):

And you expect the price paid going forward will be trending up or down for the acquired?

Ted Sarandos (Chief Content Officer):

It's tough to say. Mostly it's a reflection of how many buyers are in the market. We've got a few other people into the market.

There's some value in having a larger footprint and being able to bring more value to the franchise, for being on Netflix , that we get to realize in our negotiations. But I think most of those prices up and down is driven by the number of competitive buyers in the marketplace.

Michael Nathanson (Analyst - MoffettNathanson):

Let me ask one for David. You mentioned before on the content spend shift between U.S. and international. Can you remind us again how you amortize content between domestic and international markets, how do you decide what the allocation rates are between the two geographies?

David Wells (CFO):

Sure, Michael. In terms of -- well, how we amortize is straight line, for originals, there's accelerated. How we allocate across countries or territories between the operating segment of domestic and international is based on the relative value of that content. So we use the PWC Media survey to help validate what that content would be worth in that market.

And there's pluses and minuses to various types of allocation. We've looked at many types. We think that's the most accurate, in terms of ascribing the relative value of content within each market.

Mark Mahaney (Analyst - RBC Capital Markets):

And David Wells, if we have global content, where does the allocation for Poland show up today?

David Wells (CFO):

Today, the allocation for Poland is going to be spread across, because we haven't yet launched that market. So what's a little bit new for us is, we now have clear line of sight that we are launching the rest of the world, which is new relative to the last six to nine months. So we've shifted a bit, and you're seeing part of that Poland, if we sign a global right for Poland, distributed across our current territories.

A year ago, you would have seen us if it was going to be launched in the next year, park that on the balance sheet, and then start amortizing it once we launched Poland. And if we prospectively signed up for a Poland right, and we just didn't have line of sight to the next year, whether we were going to launch the territory, that would be spread across the existing territories that we were in, which is what we would do today.

Ted Sarandos (Chief Content Officer):

If you back it up a few years, we would have sold off Poland not knowing what to do with it and look for it later.

David Wells (CFO):

That's right.

Mark Mahaney (Analyst - RBC Capital Markets):

Okay. If I could get back to Reed on a question that came up earlier about pricing and maybe tiering power. Reed, your latest thinking, given the momentum in the business and the ability to raise fees or raise ARPU over time, and particularly via tiering, either via service and number of lines or content, your latest thoughts on your pricing and tiering power today?

Reed Hastings (CEO):

Mark, we're super happy right where we are. We've got a great mix of pricing plans and options.

For those that get a new 4K television and are excited about 4K content, we're the leading service in the world for 4K, and that plan is a little more expensive at $11.99. As more 4K TVs are sold, we'll get people to upgrade to the $11.99 plan. In terms of the total pricing structure, we couldn't be happier with the way it creates an incredible value for the consumers, feels fair to them, and it's propelling our growth.

Mark Mahaney (Analyst - RBC Capital Markets):

Okay. Now let me pivot over to the international markets. So we also had -- we had subs upside in the US, we had subs upside internationally. Could you talk about where that came from?

What wasn't mentioned in the letter was Germany and France. Those are obviously major markets. Maybe they're growing in line, or a little less than you thought. What was mentioned is Australia and New Zealand, so any particular color there on which countries are performing in line, better and worse than expectations?

Reed Hastings (CEO):

Sure. That's somewhat of a [recency] by us. We launched France and Germany six or eight months ago, and we talked about it in the immediate aftermath also, that they were successful launches. Now we have added Australia and New Zealand.

In all of these markets, the Internet and Internet television is catching on, and we're leading relative to competitors, and we've got competitors all around the world. In each market, there's a series of competitors. We're feeling very bullish on the long-term in all of these markets.

We've seen when we entered in Latin America three or four years ago that it takes us a year or two to build the brand and get awareness. But think of it as every country in the world, consumers in every country in the world want the benefits of Internet television, choice and selection and price. So absent severe piracy that might be in some of the newer countries, I think we're going to see large commercial success.

David Wells (CFO):

And Mark, this is David. There was no one particular market that drove that. So there were multiple markets that drove that out performance, relative to what we thought, to our forecast.

Michael Nathanson (Analyst - MoffettNathanson):

And in Reed's tweet a couple days ago you mentioned 10 billion hours consumed in the quarter. Could you give us a sense of consumption rates domestically, internationally? Are there any international markets that jump out to be above normal consumers?

Reed Hastings (CEO):

There's variation between countries. Some countries are amazing, and U.S. is one of them. But it's not the biggest. So for competitive reasons, I'm not going to give you precise color, but there's variations.

And what's great about the viewing is, if you look two years ago in this call, we said it was 4 billion hours in the Q1. And over those two years, we've gone from 4 billion to 10 billion hours of viewing. And so you can see along with our membership growth, we're also having engagement growth. Given all the you competitors, improving television, it's really impressive that Netflix is growing not only the subs but engagement also.

Michael Nathanson (Analyst - MoffettNathanson):

Okay. And Ted, you recently mentioned that in China, sounds like you have a go alone strategy. So what is your timing on China's launch and how does that strategy impact your actual launch in China?

Ted Sarandos (Chief Content Officer):

Michael, a bit of that press was lost in translation, a bit. I was explaining to the questioner why we have not taken up partners in the past. But not a reflection of what we want to, or what we're willing to do in China. We're anxious and open to all forms of doing business in China. So that was -- the press was a little bit out of context there.

Mark Mahaney (Analyst - RBC Capital Markets):

Okay. David, last quarter in your script press release, you bolded one of those things was the expansion of all global markets by the end of 2016. Is there an update on that, given what's happened in the first half of the year? Are you accelerating that time line?

David Wells (CFO):

There's no update other than that the expectation for us to launch in 2016 was an acceleration of our earlier stated objective. So no further update.

Mark Mahaney (Analyst - RBC Capital Markets):

And for the June quarter you talked about an increase in the operating loss to $101 million. You've got bigger launches in the back half of the year.

Help us think about when the peak operating loss quarter is in international, and what the size of that -- could that be. If it's $100 million in the June quarter, what's the worst case scenario? Are you willing to run it at a $200 million loss in any one quarter?

David Wells (CFO):

I don't provide specific guidance four or five quarters out for operating loss. But we've said that we're committed to running the business at global break-even, and we have ambitious plans to launch international.

So this quarter you see what you have, you see our guide with the full sort of Australia, New Zealand. You see our guide with additional investments in marketing and some content. We'll have some bigger launches, and we described those as meaningful and significant in the back half of this year. You should expect those losses to trend upward and into 2016, and then to improve from there.

Michael Nathanson (Analyst - MoffettNathanson):

Recently, Reed, you changed your terms and conditions to alert people who use VPNs they could be shut down from usage. We've heard a lot from our clients who are outside the US, that they do use VPNs to watch U.S. content. Why did you change the terms and conditions? And for Ted, are studios asking you about VPN usage? Is that part of the reason?

Reed Hastings (CEO):

With VPN usage that's where someone, to bring up Poland again, where we're not yet operating, has the money to pay for content. They want to access content. They want to pay for that content. Netflix is not yet in Poland, and so they'll use a VPN to come to the U.S. virtually over the Internet, pay for content.

So it's certainly less bad than piracy. It's not something we encourage. It's actually very hard to detect, because VPN gets very good at covering their tracks for all the obvious reasons.

And because we're focused on getting global very quickly, I think we'll see this issue disappear, and it will disappear because we'll be able to meet the demand directly in all the countries. Ted, anything on the studios as our partners?

Ted Sarandos (Chief Content Officer):

Yes, it's one of the many things that we have discussions with studios about on an ongoing basis, and we do continue to work with them, and work with the VPNs. To be honest with you, it's kind of a whack-a-mole to get ahead of the different usage of VPNs. It's become kind of a lifestyle thing for a very small segment of the population.

The real great news is, in the piracy capitals of the world, Netflix is winning. We're pushing down piracy in those markets by getting the access. The best way to really make the VPN issue a completely non-issue is through global licensing that we're continuing to pursue with our partners.

David Wells (CFO):

Hark, to annotate to Ted, the only comments that I would add to Reed's earlier pricing comments were piracy is a governor in terms of our price in high piracy markets outside the US. We wouldn't want to come out with a high price, because there's a lot of piracy. So we have to compete with that. So there is a little bit of governor on our price outside the US.

Michael Nathanson (Analyst - MoffettNathanson):

Okay. And David, one question we get a lot is that your content obligations, they grew in this quarter. Could you talk a bit about your comfort of meeting those obligations, and when do you think you see a peak of your obligations on the balance sheet?

David Wells (CFO):

I am comfortable with the level of content commitments we have, and there's a couple of reasons that I am comfortable with that. One is that the content is working. So we see engagement. We see value for the content, so it makes me more comfortable and confident that we're investing in something that has lasting value.

Two is that we really are scaling, along with the business. So we have grown from $9.5 billion in streaming content commitments in the table to $9.8 billion. That's about a 31% year-over-year growth rate, and our streaming revenue has grown at 31% year-over-year as well.

So that makes me a little bit more comfortable. Now, that includes what we know in terms of licensing commitments. It doesn't include things like Disney output.

So let's take that as an example. That is for future film output at a future box office. So we're unable to know the licensing amount on those films, but we do have to factor that into our forecast, as we have from the very beginning.

So if we look ahead and we factor that in, we think it's an additional $3 billion to $5 billion of content commitments over the next three years, and that's already enticed our forecast, and we've been doing this from the very beginning. So we've gotten a little bit better at making sure that we waterfall deals, and we have the flexibility we need to balance those commitments, and that expense level over time.

Ted Sarandos (Chief Content Officer):

Michael, if I could interrupt for a second. I would also add that you should look at that as a signal of future access to content. Because as we identify the high value content, we seek to lock them up in long-term deals. That does increase our long-term obligation but for things that we want and attract revenue and viewing.

Mark Mahaney (Analyst - RBC Capital Markets):

Ted, could you -- let's stick on that topic on the content, and especially the Disney output that's coming on-board next year, just remind us of some of the details on that? And when you think about the white spaces of Netflix , the content areas that you'd really like to most fill out, how important is Disney as part of that, of those white spaces?

Ted Sarandos (Chief Content Officer):

Our Disney partnership is phenomenal. We have the output deal coming up, but you just, last week we launched our Defender series from Marvel with their first series, Daredevil. It's been a huge success.

Disney's a licensing partner with us around the planet, and we're really excited about the output deal coming on. It's probably one of the few output deals that I'm enthusiastic about, because the Disney content is global. It is tent pole. It's family.

It's a lot of co-viewing among families for the content that gets watched, and it's a great brand to bring comfort to families who subscribe to Netflix . It's a bit of a play between movies and kids programming. I think it's successful for us.

The white space you referred to is with all the excitement about the golden age of television, and all the excitement about our own series, about a third of the viewing hours on Netflix today are still movies. So when we see something like we did early in the year with The Interview, we were able to close that window to 30 days.

We had a phenomenal reaction in the U.S. and Canada to that movie. I want to keep pushing on behalf of the consumers to get those windows narrower and narrower, including premiering original movies on Netflix , which is why we're doing that to fill some of that white space.

Mark Mahaney (Analyst - RBC Capital Markets):

Two-part follow-on on that. Were there direct outputs from that Interview deal whereby you think you can actually do this much more often in the future? And then, Reed, can I swing it back to you afterwards, and ask you about products and major product pipeline for the next 24 months?

I know you mentioned in the letter the enhancement of bringing video playback forward into the browse experience. I'm not sure I actually understand what that means. Could you explain it, and then help us think about how material that could be to the user experience?

Ted Sarandos (Chief Content Officer):

I would say you should look at The Interview as a beautiful one-off. I say beautiful, because bypassing the theaters and premiering on demand, Sony managed to raise about $45 million in revenue from between a modest theatrical and primarily from digital on demand, and then a very strong fee from Netflix for our license, 30 days following that, which took what could have been a financial disaster and turned it into a financial win for the studio. If anything, you want to look at that and say, wow it's a beautiful possibility for a future disruption in release patterns.

Reed Hastings (CEO):

And as Ted said, Mark, we're really sorry on the circumstances for Disney , sorry -- for Sony in the case of The Interview. We certainly wouldn't want to see more of that. But we are focused with our original new movies, trying to push those windows up so early.

You asked about product enhancements. We're doing so much. We tried to sample a little bit in the earnings letter.

The particular improvement that we're talking about there, today when you browse for movies, it's a bunch of stills. And then you say play, you wait a couple seconds, and then it plays the content. What we're learning is how to use real-time video as you browse, so that things are auto starting, making that easier on the display pages, on the detail pages.

So I think you'll be really impressed. But think of it as symbolic of a whole long series of 100 improvements per quarter that we're always working on that in accumulation continue to make our experience better, which pushes up the satisfaction, which helps retention and growth.

Michael Nathanson (Analyst - MoffettNathanson):

Ted and Reed, when you first started building a streaming product, Ted would be in Beverly Hills, giving people checks for content, and all my content companies would say, this is incremental to the pie. We're happy that Netflix is a buyer. In the past nine months, we've seen ratings for cable and broadcast tumble to levels that I never thought was possible.

So I wonder, do you worry that as our industry, traditional media, worries about ratings trends, they become less likely to sell you content, and therefore becomes harder to source really good second or original content? So I wonder how you feel about that.

Ted Sarandos (Chief Content Officer):

I'm not seeing any actual evidence at the table that there's any reluctance to continue to sell. They definitely are trying to juggle terms of their core business versus their license business. That's true, not just of us, but they're also seeding these opportunities for themselves, where you see the networks launching their own on demand services, so I think they really are trying to find the right balance.

Generally I think we are still very healthy for the business in terms of -- both in terms of our licensing dollars, and in terms of the audience generation that we're able to build for the shows on broadcast. It's very encouraging that even with all of the disarray that you spoke about, that FOX can have a phenomenal cultural hit like Empire in the middle of all that. I do think there is obviously plenty of concern about the old way of doing business, but there's lots of action going into how do we do it, going forward, as well.

Reed Hastings (CEO):

And Michael, it's pretty natural, you've got, linear TV has been an amazing 50 year run. Internet TV is starting to grow. Clearly, over the next 20 years, Internet TV's going to replace linear TV, and so I think everyone's scrambling to figure out how do they great apps, how do they -- things like Noggin are fantastic, and that will just keep getting built up.

So it's a transition into figuring out the Internet. And the way people do that is to get involved with us, with our competitors, to try to start to learn what are the new patterns and modalities. Because Internet TV is the way that people will consume video in the future.

Michael Nathanson (Analyst - MoffettNathanson):

Okay. And David, can you just talk a bit about your cash spend versus your P&L spend? I think this quarter was about 30% higher cash spend than P&L. Is that the right way to think about this year and even next year as well?

David Wells (CFO):

Yes, Michael, we've been pretty consistently telling people that prior to the build out of originals, it was 20%, 20% over the expense. Now it's drifting up to 30%. It could drift up to 40% and peak around there in certain quarters, especially if we take delivery of a lot of original product.

But in general, we're building out our content investment, our original content investment. And that is cash intensive, as we put in the letter, and we've been pretty consistent about this. I think what you're going to see now is several persistent quarters, and going forward, of negative free cash flow, while we build this out.

Mark Mahaney (Analyst - RBC Capital Markets):

On that, David, you did this $1.5 billion debt offering in March quarter. Should the expectation on our part be -- the market's part be that you won't need to come back to the markets for the next 1.5 years, or do you want to have the flexibility to, if international launches really do even better than you think, to come back for even more?

David Wells (CFO):

Well, if we're successful in building out the content, and if we want to get to ever increasing mix of original content, meaning that up to 50% of our business is really our own owned content, then we're going to continue to invest in that content, and that will require more and more cash. So I don't think we're saying no, that we're good now, for the future. I don't think we're saying we're definite. But likely, we will need, if we're successful, to go back to the market at some point to continue to build that investment.

Mark Mahaney (Analyst - RBC Capital Markets):

And I want to ask a net neutrality regulatory question to Reed. This actually came from Rich Greenfield. With the FCC laying out this clear oversight of interconnection in that newly filed net neutrality order, do you think if that had been around before, that Netflix would have had to pay for the interconnections? If those rules had been in place, would they have had to pay for interconnections as they have been for whatever, the last year or so?

Reed Hastings (CEO):

It's awfully hard to tell. Going forward, as we think about interconnection, it's a new climate with the FCC's Title II in place. We'll try to figure that out.

We have a number of contracts that are in place already. So there's no immediate actions. But we're very encouraged by the general consumer perspective and political perspective, that broadband access is so important that it is a utility.

It is like power distribution, where it's a natural monopoly in the last mile, there should be one fiber or one cable going to a home with super high speed, and that's the architecture of the future. So everything around it being a utility is great for Internet companies like ourselves, and it's great for consumers.

Michael Nathanson (Analyst - MoffettNathanson):

Reed and Ted, in the past couple weeks we've seen the NFL of all people explore Internet TV when they have announced they'll stream a game over the Internet. We've asked you in the past, but given the changes in the model, do you think you can add sports as a category to Netflix at this point?

Ted Sarandos (Chief Content Officer):

Michael, I think part of our core consumer proposition is on demand. We make viewing certain kinds of content better, because they're on demand. And I don't know that on demand sports is markedly better than live sports.

So that's why we haven't been that excited about it. Why we haven't chased it. There's economic reasons as well. I think in general, that sports is great for live television.

Reed Hastings (CEO):

And the great thing, Michael, about the emergence of sports online is it frees people up to be more a la carte, which gives them more money to be able to spend on Netflix . So if we can anchor the entertainment side for movies and TV shows for every consumer and somebody else, or other set of leagues, anchor the sports part, which is still over the Internet, then the Internet TV proposition is even more powerful for consumers.

Michael Nathanson (Analyst - MoffettNathanson):

Okay. Over the past year, Reed, I've asked you about the Comcast -Time Warner Cable merger. You said we'd love to see deal conditions put on that in order to protect the Internet. You've gone above on beyond with the FCC Title II support.

One of the questions we have at our firm is price regulation Title II. Where do you come on the FCC's ability to regulate pricing? Is that a good or a bad thing for the development of Internet TV?

Reed Hastings (CEO):

We'll have to see. It's very clear that broadband is a necessary utility across the land. I don't think anyone is a fan of price controls.

So our main goal at this point is to get the government to block the Comcast -Time Warner merger. We think, were that merger to come together, and as DSL fades, that company combined would have over 50% of U.S. residential Internet homes. And frankly, that's just too much in one company.

Mark Mahaney (Analyst - RBC Capital Markets):

I wanted to ask a question on marketing to either David or Reed.

You talked about maybe shifting more of your marketing budget online. Any more color beyond that?

There's a lot of different places, ways to spend money online including via Facebook , et cetera. Is there any more color on that, and then why the switch to online? Is there something that's made the off-line marketing channels less efficient for you?

David Wells (CFO):

It depends on the market, Mark. In places where our brand is really well-known, we've noted that we're much more efficient being very targeted with that, and being very specific around content marketing.

Outside the US, in markets where we're building a brand, you should see us -- a mixture of that. So you should see some off-line and some online, in terms of our spend. But every year we get more efficient and more knowledgeable about where that money is best spent.

We're an experimental company. You know that. You have followed us. So you should see us continue to sort of test around the edges of where things are better spent.

Mark Mahaney (Analyst - RBC Capital Markets):

Okay. And then a question on the actual end usage of Netflix . So maybe a broad question for Reed.

When you think about the different use cases in the living room TV, on the go with mobile devices, et cetera, have you seen over the last two or three years a dramatic shift in how people are consuming Netflix content? And particularly as you go into international markets, which may be more mobile-oriented, particularly in Asia, do you think that you've got the -- are you set up the way that you want to be set up on devices in the formats to work that trend, that mobile trend?

Reed Hastings (CEO):

We're feeling really good about our preparation for continuing to expand around the world over the next two years, in terms of devices, in terms of networks, in terms of content. So yes, we have thought through a lot and studied the patterns of consumption, and we're ready to at least begin that journey, by launching around the world. And then what we'll be able to do is learn from there, frankly as we did in Latin America, three or four years ago.

Michael Nathanson (Analyst - MoffettNathanson):

Reed, following on that question, has there been a hand-off on tablets versus smart TVs? A couple years ago we kept thinking smart TVs will be the device that drives Internet TV, but have you seen a difference on consumption by tablets versus smart TVs the past couple years?

Reed Hastings (CEO):

No, we've seen smart TVs just continuing to grow and grow, in usage and sales. Virtually every new TV sold now is a smart TV, at least at the middle and high end, and it's natural for people to use.

Now, do they also watch on tablets? Yes. And on phones.

So really all those categories are experiencing absolute hours growth. But on a percentage basis, smart TV's one of our fastest growing categories.

Michael Nathanson (Analyst - MoffettNathanson):

And David, you called out the impact of foreign exchange in the first quarter. Could you give us a sense of what the year's going to be in exchange? And when do you expect to break out revenues by region so we can get more details on regional international exposure?

David Wells (CFO):

If I knew what was going to happen with foreign exchange, I'd probably quit and then run a hedge fund.

Michael Nathanson (Analyst - MoffettNathanson):

As of today, okay.

David Wells (CFO):

I would say in Q1 most of that below the operating income foreign translation loss was unrealized, right? So we did have a change in our functional currency for our European entity.

So when we first launched into Europe we were very UK-centric. So most of our operating cash flows were in British pounds, which leads you to an accounting decision to functional currency of pounds. Since we've expanded in Europe, and particularly into mainland Europe, with more and more our operating cash flows switch to the euro, so we switched it over. So there's some impact of that in that translation adjustment.

Going forward it really does depend on what happens in terms of the dollar strengthening further into the euro. We're about 25%, in terms of revenues, exposed to foreign currency, and that's growing. If we're successful, that will grow to 50%.

But we also are pretty transparent that we don't hedge, and so we're not really concerned with those accounting translation adjustments. We're pretty transparent to you, as an investor, that we don't hedge. You have the option to go out and hedge if you feel like you're exposed with your Netflix investment, and we're watching in terms of our opportunities for natural hedging.

But with the move to a global license, we may see more and more of those be dollar denominated. So I'll have to update you along the way in terms of our foreign currency exposure.

Reed Hastings (CEO):

Why don't we hit it with one more question, each, and then we'll wrap up.

Mark Mahaney (Analyst - RBC Capital Markets):

David, just check off real quickly, ARPU in both international and in the U.S. market, in international markets assuming currencies stay where they are, does ARPU stabilize where you guided to implicitly in Q2, and where it came out in Q1, and then start moving back up as price increases go into effect, or should we just straight line it?

And then in the U.S. ARPU has been rising. Is any of that caused by tiering of services? Are you getting a lot more people signing up for the $11.99 plans, or is that just the impact of the price increases?

David Wells (CFO):

It's both, Mark. Just to answer your question on both domestic and international, we are seeing ARPU progression, because of people taking the higher tier, and the higher value plans, and we're also seeing the exploration of people sort of coming off, grandfather, rejoining, or joining the service new at the higher price point. Obviously, we have a lot more subscribers in the US.

So you're seeing that ARPU increase disproportionately rise internationally versus the US, just because we're building from a base of much fewer grandfathered subscribers outside the US. So you see both. But your very first question was should we see that progress?

Yes. But we have a large body of U.S. subscribers that come off grandfathering next year. So you can waterfall your churn models, and you would expect that the U.S. what has a much larger base of folks at the older price point.

Michael Nathanson (Analyst - MoffettNathanson):

Reed, over the past 10 years, you have pivoted perfect from selling DVDs to streaming to making your own content to going overseas. So I wonder, when you look at your business plan, what gives you worry? When you look at your challenges ahead, what's the thing that worries you?

Reed Hastings (CEO):

You're nice to say we pivoted perfectly but I think you're forgetting about certain incidents four years ago. But we have succeeded in getting through them. And the key thing is that the company's very agile. We're just a learning machine.

When you think about how Ted has grown our original content muscle, it's just so impressive, how we're continuing to expand international. It's just like we're learning, country by country. We don't get everything right up front, but we fix that.

I think the fundamental is we're just open minded, curious. We're learning. And then frankly, it's that Internet TV is growing around the world at incredible rates. And so we're really propelled by that big macro trend.

To wrap up here, Ted's producing so much content, I thought Ted, maybe you could share a little bit of this quarter's highlights, like Chef's Table and Sense8 and Orange is the New Black and just the amazing things that Netflix is debuting?

Ted Sarandos (Chief Content Officer):

You definitely get a sense of the diversity of the programming that we're going to be offering. If you look at just what's coming up next quarter, with our first original documentary series called Chef's Table, from the director of Jiro Dreams of Sushi. We've got our third series of Orange is the New Black, which is a global sensation that will break in June.

We have our comedy with Lily Tomlin and Jane Fonda called Grace and Frankie, that we're really excited to share with the world. Sense8, I think, will show everybody what a global TV series can really be like, filmed on location in nine cities around the world. Spectacular scale and scope of a theatrical film, directed and created by the Wachowski siblings.

And even original series for kids, with How to Train Your Dragons 2. We're super excited about both the volume and the quality and the diversity of everything we're doing in the original programming next quarter.

Reed Hastings (CEO):

Ted, are all those series globally available on Netflix ?

Ted Sarandos (Chief Content Officer):

Globally available on Netflix .

Reed Hastings (CEO):

I love that.

Thank you so much everyone and in 4K. Thank you so much everyone for your support. We look forward to talking to you over the next quarter.