

Netflix Long Term View

“Look at the bigger picture”

-- Francis Underwood, *House of Cards*.

Summary

Over the coming decades and across the world, Internet TV will replace linear TV.

Apps will replace channels, remote controls will disappear, and screens will proliferate.

As Internet TV grows from millions to billions, Netflix, HBO, and ESPN are leading the way.

Linear TV is popular and ripe for replacement

People love TV content, and we watch over a billion hours a day of linear TV.

But people don't love the linear TV experience where channels¹ present programs at particular times on non-portable screens with complicated remote controls. Consumers click through a grid to choose something to watch. DVRs and VOD add an on-demand layer at the cost of storage and increased complexity. Finding good things to watch isn't easy or enjoyable. While hugely popular, the linear TV channel model is ripe for replacement.

The evolution to Internet TV apps is already starting

In addition to Netflix, most of the world's leading linear TV networks are moving into Internet TV. The WatchESPN app runs on many Internet platforms and is specifically designed to showcase sports. ESPN will keep improving their app to try to stay ahead of MLB.tv, which is another terrific Internet TV sports app. The HBO GO app makes HBO's films and series much more accessible than on HBO's linear channel. The BBC iPlayer app in the UK provides a rich and popular on-demand interface for a wide range of BBC programming. The other major linear networks are not far behind.

¹ From a business terminology standpoint, HBO and ESPN are cable TV networks, and Netflix is an Internet TV network. From a consumer terminology standpoint, however, we are a service and an app, while ESPN and HBO are channels, and WatchESPN and HBO GO are apps.

While Internet TV is only a very small percent of video viewing today, we think it will grow every year because:

- 1 The Internet will get faster, more reliable and more available;
- 2 Smart TV sales will increase and eventually every TV will have Wifi and apps;
- 3 Smart TV adapters (Roku, AppleTV, etc.) will get less expensive and better;
- 4 Tablet and smartphone viewing will increase;
- 5 Tablets and smartphones will be used as touch interfaces for Internet TV;
- 6 Internet TV apps will rapidly improve through competition and frequent updates;
- 7 Streaming 4k video will happen long before linear TV supports 4k video;
- 8 Internet video advertising will be personalized and relevant;
- 9 TV Everywhere will provide a smooth economic transition for existing networks;
- 10 New entrants like Netflix are innovating rapidly.

Eventually, as linear TV is viewed less, the spectrum it now uses on cable and fiber will be reallocated to expanding data transmission. Satellite TV subscribers will be fewer, and mostly be in places where high-speed Internet (cable or fiber) is not available. The importance of high-speed Internet will increase.

This transformation is occurring at different speeds in different nations. In the UK, for example, the BBC is already [starting to program](#) more for its iPlayer app than for its linear channels, given the large and growing viewing on the iPlayer.

For most existing networks, this economic transition will occur through TV Everywhere. If a consumer continues to subscribe to linear TV from a multi-channel video program distributor (MVPD), they get a password to use the Internet apps for the networks they subscribe to on linear. The more networks successfully keep their prime-time programming behind this authentication wall, the less “cord cutting” will occur. The same consumer who today finds it worthwhile to pay for a linear TV package will likely pay for a “linear plus apps” package.

Existing networks, such as ESPN and HBO, that offer amazing apps will get more viewing than in the past, and be more valuable. Existing networks that fail to develop first-class apps will lose viewing and revenue.

In addition to the linear networks building apps, some large MVPDs will do their own multi-channel app for viewing all of the networks they carry. Examples are Xfinity, Sky Go, and Horizon. These will win viewing also, by offering a great Internet on-demand experience on multiple screens. So far, the individual network apps (HBO GO, etc) are ahead of the MVPD apps because consumers relate to the network brands, and the apps are tailored to the specific content type. The competition for Internet TV viewing, however, is just beginning.

Internet TV apps will improve just like the mobile phone

Twenty years ago, the mobile phone was quite large, expensive, limited to voice communication, suffered static and was trivial to eavesdrop on. It was hard then to imagine that by now, there would be 6 billion active mobile phones in the world, central to so many of our lives. We see a parallel in the rise and intertwined improvement of Internet TV apps, broadband, and devices over the next 20 years.

Internet-native new entrants

In addition to creating opportunity for linear networks, the emergence of Internet TV also enables new apps like Netflix, YouTube, MLB.tv, and iTunes to build large-scale direct-to-consumer services that are independent of the traditional MVPD bundle.

Netflix competes for entertainment time with traditional networks, but the scope of such time is quite large. Consumer time devoted to web browsing and video games, for instance, has expanded hugely over the last two decades without a corresponding diminution of TV viewing. Another example is that when AMC produces great shows, it does not noticeably shrink the audience for HBO. As our service has become very popular, there has been no discernible decline in domestic MVPD viewing, according to Nielsen.

Netflix singular focus

Simplicity is at our core.

We are commercial-free unlimited-viewing subscription TV. We don't have pay-per-view and we don't have advertisements. Those are fine business models that other brands do well. We choose to be the best at our model, and to have our brand stand for commercial-free, unlimited viewing, low flat monthly fee.

We don't and can't compete on breadth with Comcast, Sky, Amazon, Apple, Microsoft, Sony, or Google. For us to be hugely successful we have to be a focused passion brand. Starbucks, not 7-Eleven. Southwest, not United. HBO, not Dish.

We are not a generic "video" company that streams all types of video such as news, user-generated, sports, music video, or reality. We are movies and TV shows².

We are counter-positioned against the hassles, complexity, and frustration that embodies most MVPD relationships with their customers. We strive to be extremely straightforward and simple.

² Within TV shows, we are primarily long-lived TV shows that are enjoyable 5 years after they are produced (in contrast to great topical real-time shows like Jon Stewart or competitive reality shows like the Voice).

There is no better embodiment of this than our no-hassle online cancellation. Members can leave when they want and come back when they want.

We are about the freedom of on-demand and the fun of indulgent viewing. We are about the flexibility of any screen anywhere any time. We are about fantastic content that is increasingly only available on Netflix.

We spend over \$450M per year on global marketing to attract people to try Netflix, and to reinforce with our members why Netflix is worthy. Our extensive content is key, as is the ability for members to have control over their viewing experience.

Winning more moments of truth

Our North Star is to win more of our members' "moments of truth". Those decision moments are, say, on Thursday 7:15 pm or Monday 2:40 am when our member wants to relax, enjoy a shared experience with friends and family, or is just bored. They could play a video game, surf the web, read a magazine, channel surf their MVPD/DVR system, buy a pay-per-view movie, put on a DVD, turn on Hulu or Amazon Prime, *or they could tap on Netflix*. We want our members to choose Netflix in these moments of truth.

We win those moments of truth when members expect, based on their prior experience with us, that Netflix will be pleasurable, compared to all those other options. The pleasure comes from our simple experience for choosing, control over when to start/pause/resume the video, and from content that suits their taste and their mood.

When we deliver enjoyment, members watch more Netflix, continue their membership, and evangelize Netflix to their friends.

Improving our service

We are currently spending about \$350M per year on a wide range of efforts to improve our service and app, and we are constantly getting better.

One area is our core services: our streaming delivery, sign-up, billing and customer service, across more than 1000 devices being used in more than 40 countries. Here we strive for operational excellence to avoid any problems. Members want Netflix to just work -- flawlessly. On this front, we're well ahead, but we have plenty of room to improve. We continue to invest heavily to ensure that our service is always available, our streaming has a minimum of buffering, and has great audio-video quality.

Another area of focus is personalized merchandising, which drives what content we feature on a given member's initial screen. Google search is an example of a ranking system, where results

are automatically computed to show Google's estimate of the most relevant answer to the query. For Netflix, the user's home page is the personalized ranking of what we think will be most relevant for that specific user at any given time. By analyzing terabytes of data from every recent click, view, re-view, early abandon, page views and other data, we are able to generate a personalized homepage filled with the content most likely to please. Our aim is to keep inventing and tuning algorithms to generate higher satisfaction, viewing, and retention, for whatever the level of content we can afford in that territory.

All of our algorithm work, like with Google search ranking, is proven or disproven by A/B testing. Only algorithms that lead to an improved experience get rolled out to everyone.

There are a hundred other areas we also are improving, like how smoothly our scrolling works on an iPad, or how well our kids area works on a PS3. Most of this work is guided by A/B testing as well.

The core metrics we use to evaluate A/B testing are signups rates, viewing, and retention. While our app is much better than it was 5 years ago, it is nothing compared to what it will be 5 years from now.

Content people love

We're now investing over \$2b per year in content licensing and the creation of original shows.

People's tastes are very broad, even in a single market. The Internet allows us to offer a wide selection, and to have our user-interface quickly learn each individual's tastes. Those members who love action blockbusters, Korean soaps, anime, sci-fi, Sundance films, zombie shows, or kid's cartoons will find that Netflix fills their homepage with relevant and interesting similar titles.

This allows us to provide most members an incredible array of content to enjoy. When we have a new big film or a new season of a great and popular show, those titles will only account for a very small percentage of viewing. There is so much to watch that even the highest-demand titles don't materially swing viewing.

As we've gained experience, we've realized that the 20th documentary about the financial crisis will mostly just take away viewing from the other 19 such docs, and instead of trying to have everything, we should strive to have the best in each category. As such, we are actively curating our service rather than carrying as many titles as we can.

Our licensing is all time-based, so that we might pay, for example, \$200,000 for a 4 year exclusive subscription video-on-demand (SVOD) license for a given title. At the time of renewal, we evaluate how much the title has been viewed as well as member rating feedback to determine how much we are willing to pay. How many similar titles we have is also a consideration.

In each market, we license content from multiple suppliers, mirroring the fragmentation of the content industry. Movie content owners appreciate that we're a new bidder at the table. Typically our bids are for exclusive access to the SVOD rights, and are against various cable and broadcast networks, as well on online competitors. For serialized TV shows the effect is even more pronounced because it wasn't easy for cable and broadcast networks to syndicate serialized storytelling to others, and we've pushed the price up considerably. As a rule, content owners always want another bidder, and never want one bidder to become too strong.

The vast majority of our spending is on movies and prior-season TV shows from other networks. Recently, however, we've been expanding into Original content, which premieres exclusively on Netflix.

Original content beginnings

Over the years, we've successfully developed the art of estimating how much our members will watch a given show or movie based upon how it has performed to date in other, earlier channels (theatrical for movie; broadcast and cable first-run for TV) and on how comparable titles have performed on Netflix. This generally enables us to avoid overpaying for content, relative to member enjoyment.

With Originals, we are now extending that concept to estimate the attractiveness of projects that are brought to us by professional producers. There is more judgment required in this process, and more variability due to the art in the production process, but because of the data we have on our members' viewing habits and our experience in licensing a broad range of content, we think we can do as good or better job than our linear TV peers in choosing projects and setting budgets.

Once we've decided to do a project, production is typically done by one of our partners, like Lionsgate or 21st Century Fox, with our oversight. We believe we are managing this aspect as well as our industry peers do through operational excellence and good hiring.

We believe we have a strong advantage over our linear competitors when it comes to launching a show. They have to attract an audience for Sunday at 8pm, say. We can be much more flexible. Because we are not allocating scarce prime-time slots like linear TV does, a show that is taking a long time to find its audience is one we can keep nurturing. This allows us to prudently commit to a whole season, rather than just a pilot episode. In addition, we are able to provide a platform for more creative storytelling (varying run times per episode based on storyline, no need for week to week recaps, no fixed notion of what constitutes a "season"). We believe this makes it easier to attract talent.

By personalizing promotion of the right content to the right member, we have a large opportunity to promote our Originals and one that's effectively unlimited in duration. Several months after

the premiere of *House of Cards*, huge numbers of members are just starting the series each week. The improved economics from whole-season, and improved storytelling that comes from giving creators more scope, are big advantages.

We will learn as we go, and expand our Original content slate as we get more insight and confidence. For 2013 and the next few years, we expect it to be less than 10% of our content spending.

The one material difference worth noting is Originals production is cash-intensive and, depending upon the terms, that means for us that cash is front loaded relative to the P&L. As we expand Originals, they will consume cash. Since we are otherwise using domestic profits to fund international markets, we will raise capital as needed to fund the growth of Originals.

International

The market for movies and TV series is national or, in some cases, regional. We work within that distribution architecture, licensing our content for each market at prevailing prices.

Our advantage internationally is our global tech spending for an improving app and service, our process knowledge, our data from related markets, and our globally-known brand. Our disadvantages are not knowing each specific culture as well as a local competitor. In any given market, once we have achieved the scale to pay for a big content library, we are likely to have a very long term profit stream.

Each market has a mix of local and global content tastes. We assess them from a variety of information sources before we enter a market, and then after launch we learn more about what is most popular and what is not. As we renew deals, the content mix gets better and better.

When we enter a market, we have to win the bidding for a big set of content, and then market ourselves effectively to start the membership growth. It is a daunting and expensive process, but we believe any future competitor will have the same or larger challenges.

Our strategy is to expand as quickly as possible while staying profitable on a global basis, as long as there are compelling markets to expand into, and we are continuing to see growth in our current markets.

We launched Canada in September 2010, and it is already profitable for us, and still growing nicely. We launched Latin America in September 2011, UK and Ireland in January 2012, and four Nordic nations in October 2012. We are growing membership in all of these markets, and we will launch our next market in the 2nd half of 2013.

Economic power comes from market-specific scale. We would be stronger being the leader in a few markets than one of the herd in many markets. Of course, our ambition is to be the leader in many markets, but that will take us some time.

Competition

We compete very broadly for a share of members' time and spending. Over the coming years, most other forms of entertainment will improve. Consumers will choose and consume from multiple options. Generally, cable and Internet networks have mostly exclusive content against each other. Piracy and pay-per-view are the only two competitors that can have a nearly full set of content.

We call competitors for entertainment time and spending that do not bid against us for content (such as video game providers, sports networks and piracy) "competitors-for-time". We call the narrower set of firms that do bid against us for content "competitors-for-content".

The network that we think likely to be our biggest long-term competitor-for-content is HBO. They recently won, for example, long-term exclusive domestic movie output deals with Universal and Fox. They bid against us on many Original projects. They are not currently a bidder against us for prior-season television from other networks. They have global reach and strengthening technology capacity.

Behind HBO would come Amazon/Lovefilm/Prime, Hulu, Now TV, and many cable and broadcast networks in various territories. Amazon in particular is spending heavily and commissioning its own original programming, presumably because they see the same exciting big picture for Internet TV that we do. Many consumers will subscribe to multiple services if they each have unique compelling content³. Success relative to these competitors-for-content would be us having substantially larger revenue and therefore sustainable increasing content, tech and marketing spending, leading to further growth, and a virtuous cycle.

While we are passing HBO in domestic members in 2013, it will be several years before we are peers with them in terms of Original programming, Emmy awards, and international members. It wouldn't be surprising to us if HBO does their best work and achieves their highest growth over the next decade, spurred on by the Netflix competition and the Internet TV opportunity.

ISP relationships

We have productive relationships with most Internet Service Providers, or ISPs, given our joint interest in making broadband important and useful to people. Broadband is hugely profitable

³ This is quite different from the XM versus Sirius battle where any one car is only going to have one of these options, or the competition between, say, Dish and Directv and cable. Our competition is like that between Showtime and HBO.

for ISPs, partially because unlike MVPDs, they don't pay content costs, and because there are fewer competitors for high-speed Internet (just telco and cable) than MVPD (which has cable, free over-the-air, two satellite firms, and some telco).

The more successful Netflix is, the more important we are to the ISPs' subscribers, and the more important it is for Netflix and the ISPs to work closely together on the network interconnection points so the ISP subscribers actually experience the benefits of their high-speed Internet. To this end, Netflix's Open Connect network allows ISPs to directly interconnect with Netflix.

At times we have worried about the strategic motivations of ISPs that are also MVPDs, but the absence of cord-cutting has mitigated this concern. In the USA, MVPDs have remained stable at 100 million subscribers while Netflix has grown to about 30 million members. The stability of the MVPD subscriber base, despite Netflix large membership, suggests that most members consider Netflix complementary to, rather than a substitute for, MVPD video. MVPDs are keeping their subscribers through TV Everywhere authentication. Internet video services like Netflix, MLB.tv, iTunes and YouTube are not currently a material strategic problem for companies that are both an ISP and an MVPD.

Netflix margin structure and growth

Our domestic margin structure is mostly set top down. For any given future period, we estimate the revenue, and decide what we want to spend, and how much margin we want in that period. Competitive pressures in bidding for content would tend to make us have slightly less content than we would otherwise, rather than overspending. The same is true for paid media and our marketing budget. The output variable, if you will, is membership growth that those spending choices influence. Obviously, we have some limits to our spending flexibility and our true discretionary top-down process is only practical when the revenue is reasonably predictable.

The margin structure we have chosen is to grow content plus marketing slightly slower than we grow revenue, and we've been targeting in the USA about 100 basis points of contribution margin improvement per quarter. While we continue to grow rapidly, we are likely to be able to continue this margin expansion.

The primary forces propelling our growth are our own service, content and marketing improvements, and the improvement of Internet networks and devices. The primary forces impeding our growth are saturation and the broad set of competitors-for-time all improving their offerings.

We are pleased that our domestic net adds are currently tracking to about last year's level, indicating that the growth forces are still strong. We introduced our pure streaming plan at \$7.99 in 2010, we've been adding more content to it ever since, and we are very happy with the membership growth at this \$7.99 price point.

From a high-level, HBO-linear is our closest comparison, and they have about 30 million domestic members. We have more content, more viewing, a broader brand proposition, are on-demand, on all devices, and are less expensive, so we estimate that we can be 2 to 3 times larger than current linear-HBO, or 60-90 million domestic members. This factors in that as we grow, our content and service can continue to get better.

Our international segment is just beginning and is in investment mode, although our first expansion market, Canada, is already generating contribution profits.

Longevity & defensibility of profit stream

One of the reasons we are investing in international expansion so heavily is we believe that once a subscription video service has achieved profitability and scale in a market (20% to 30% of households), it is very likely to be able to sustain that profit stream for many decades. At that percentage of households, our advantages in content acquisition and member acquisition are considerable.

Broadcast networks were huge and growing franchises for decades, until cable viewing started to replace over-the-air viewing. It will likely take something “beyond streaming” for a scale player in subscription streaming like Netflix to see its profits choked off. So our view is our profit streams will likely grow for multi-decades, since whatever is eventually “beyond streaming” is very far away.

Conclusion

If we could look decades into the future at the ways that people access entertainment, we would no doubt see a very different image than we see today - mind-blowing video quality, a proliferation of screens, yet-unimagined natural user interface, and an unbelievable range of choice.

But if we were to turn instead and look at the person watching that screen, we believe we would observe a number of similarities across generations. We'd see someone who is getting a moment to escape into a story - to simply relax and enjoy one of life's real pleasures with their friends and family.

People love TV shows & movies. We love being the best possible place to enjoy them. Ours is an amazing opportunity to grow, innovate and lead for several decades. We know we will have great competition along the way, and we embrace the challenge.

"We have clearance, Clarence."

"Roger, Roger."

- Airplane, 1980

This document contains certain forward-looking statements within the meaning of the federal securities laws, including statements regarding our outlook concerning the development of Internet TV and the decline of linear TV; the scope, timing and players involved in this transformation to Internet TV; our approach to being an Internet TV network or "app", including improvements to our service features and content licensing, development and financing; our international expansion, the impact of competition; our relationship with ISPs; our margin structure; and, sustainability of profits. The forward-looking statements in this document are subject to risks and uncertainties that could cause actual results and events to differ, including, without limitation: our ability to attract new members and retain existing members; our ability to compete effectively; maintenance and expansion of device platforms for instant streaming; fluctuations in consumer usage of our service; competition; and, widespread consumer adoption of different modes of viewing in-home filmed entertainment. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in our filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 1, 2013. We undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this document.

[Last updated 25 April 2013]