CASE 20
Netflix

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Well, let's separate the market into two phases. One is the phase of DVD, which peaks in five to 10 years and lasts for 20 to 30 years. Then there is the phase of Internet delivery, which peaks 20 or 30 years from now and lasts for 100 years.[1]

Reed Hastings
Founder and CEO of Netflix, February 2005

Introduction

In late April 2010, Reed Hastings, Founder and CEO of Netflix, announced that his company had exceeded expectations by achieving outstanding first quarter results. The company, which Hastings co-founded in 1997, had grown its subscriber base by 35 percent in the course of one year (Q1-2009 to Q1-2010) to nearly 14 million subscribers. Within the same period, revenue grew by 25 percent to $493.7 million and net income by 44 percent to $32.3 million.[2] By all accounts, the company had come out of the "great recession" in fine form and the market rewarded Netflix as measured by an increase of almost 300 percent in the value of a share of its stock to an all-time high of $119.50 by the time of the earnings announcement.[3]

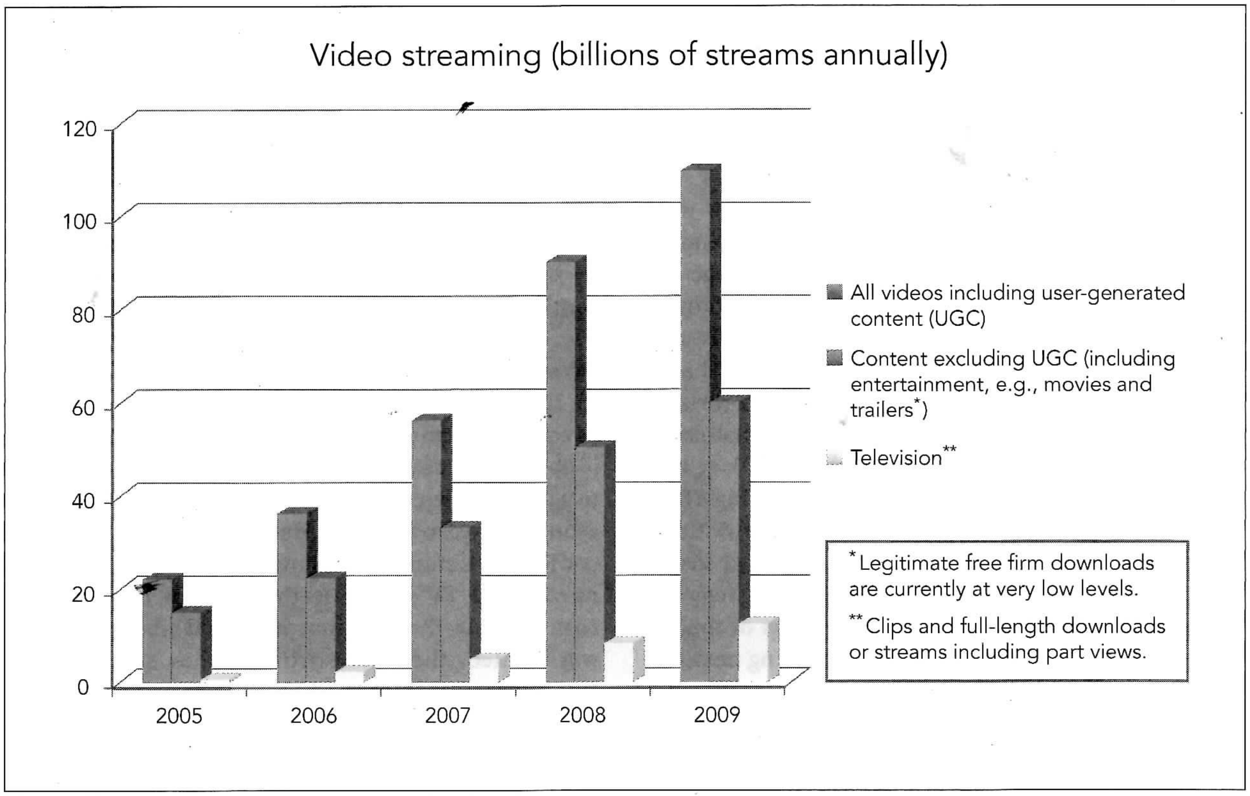
However, in spite of the outstanding results, there was still cause for concern at the publicly traded company's Los Gatos, California headquarters. The subscription DVD rental company had just heard that its delivery partner, the US Postal Service (USPS), was considering stopping Saturday delivery as a way to hopefully staunch its financial losses.[4] With this change and the certitude of continued USPS postage rate increases, Netflix knew it could soon be forced to either raise prices or disappoint customers with slower DVD delivery—and neither was appealing.

Additionally, because of the proliferation of video content available via Internet-connected consumer electronic devices, the Netflix subscriber consumption model was changing. According to Netflix, 55 percent of its subscribers streamed their movies and TV episodes rather than waiting for DVDs in the mail during Q1-2010.[5] This indicated that the subscriber consumption model was fully engaged in a significant change; unfortunately, this also meant that a new breed of competitor—such as Amazon VOD (video on demand), Hulu, and Apple TV—were entering the fray alongside Netflix's historical competitors, Blockbuster and Redbox.

On the supplier side of the business, the major Hollywood studios and content providers were lining up to protect their most valuable revenue stream—DVD sales. In an effort to maximize those sales, Warner Brothers negotiated an agreement with Netflix in January 2010 that required Netflix to delay its rental of new releases until 28 days after the DVDs on-sale date in exchange for lower rates on the DVDs Netflix purchased for its rental stock. However, because 75 percent of DVD sales occur within the first four weeks of availability, many saw Warner Brothers as the key winner in this deal as the more customers that felt compelled to purchase the DVD in lieu of waiting 28 days, the fewer customers there would be in the potential rental pool later.[6] If other studios followed Warner's model, consumers could become disenchanted with the late availability of content in the Netflix library and seek other sources.

Netflix knew that, in the face of increased competition and free video available on the Internet, it must somehow maintain the relevance of the firm's brand in the minds of consumers. Consumers in this market are loyal to content and sensitive to price, meaning that if Netflix failed to continue providing timely and reasonably priced new releases via mail order and streaming service, due to the relatively low barriers of entry in the streaming arena, someone else would (Exhibit 1 provides a visual illustration of video-streaming trends).

Exhibit 1 Video-Streaming Trend



Source: Future source estimates from selected Web analytics (Accustream, Nielsen, Comscore, INS/The Conference Board).

Company History

Reed Hastings and Marc Randolph, proven veteran "new technology" entrepreneurs, founded Netflix in 1997 in Scotts Valley, California, together with Mitch Lowe.[i,7] Hastings came up with the idea for a rent-by-mail video business after he was forced to pay a $40 late fee for an overdue in-store copy of *Apollo 13*. Investing $2.5 million from the sale of his former company—Pure Atria Software—Netflix was born.[8]

Early Phase & IPO

Netflix launched its Web site on April 14, 1998, and thus positioned itself to take advantage of the new DVD technology that Hastings and Randolph believed would eventually replace VHS as the preferred playback format. In the early years, there were only a few companies—such as Magic Disc, DVD Express, and Reel.com—competing in the rent-by-mail DVD industry. To promote its brand, Netflix provided a free rental coupon to consumers that purchased Toshiba, Sony, and Pioneer DVD players or select Hewlett-Packard PCs and Apple computers. Also in 1998, with a deal widely publicized in the media, Netflix boosted its brand recognition by selling Bill Clinton's grand jury testimony in the Monica Lewinsky scandal for two cents plus shipping. To preempt the rise of a formidable competitor while in its nascency, Netflix called an early truce with Amazon and ended that firm's foray into DVD sales after agreeing to forward customers interested in purchasing DVDs to Amazon in exchange for Amazon promoting Netflix for rentals on its heavily trafficked Web site.

To the delight of consumers perpetually disappointed to find new releases out of stock at their local bricks-and-mortar video rental stores, Netflix's Web site guaranteed that all DVD titles would be in stock and delivered quickly and directly to customers' doorsteps via the USPS. Initially, Netflix offered a 7-day pay-per-rental model at a cost of $4 per DVD plus $2 postage with applicable late fees. In September 1999, Netflix introduced its monthly subscription plan—the Marquee Program—charging $15.95 per month and allowing four (later cut to three) DVD rentals per shipment, unlimited non-concurrent shipments, with no due dates or late fees. With 97 percent of business driven through the Marquee Program within four months of its offering, Netflix dropped its per rental fee model in early 2000. "The new program was

[i] Mitch Lowe, who helped found Netflix and bring it to IPO, is now president of Redbox Automated Retail, LLC, one of Netflix's main competitors today.

possible because the company had achieved economies of scale, with 10,000 orders processed each day by its own proprietary software system," said Hastings.[9] In July 1999, Hastings secured $30 million in financing to help build and market the Netflix brand to consumers and maintain its rapid dominance of the rent-by-mail DVD industry.

Netflix signed revenue sharing agreements with movie studios including Warner Home Video, Columbia Tri-Star, DreamWorks, and Artisan in exchange for lower prices on bulk DVD purchases. In addition to stocking the more mainstream selections, Netflix also found great success renting lesser-known and hard-to-find independent and foreign films. In February 2002, Netflix reached its goal of 500,000 customers and completed its initial public offering (IPO), selling 5.5 million shares of common stock and raising $82.5 million in equity. Despite the unprofitable revenue stream of Netflix's early years, the firm enjoyed steady growth in its customer base and opened 10 regional distribution centers in different metro areas of the US to increase the number of customers receiving next-day DVD deliveries.

Aggressive Growth and Earning a Profit

By 2002, Netflix had signed revenue sharing agreements with an unprecedented 50 film distributors. Growing consumer demand for DVD rentals brought competition from firms such as Blockbuster and Walmart, with both starting their own online DVD rental services and Walmart undercutting Netflix's subscription price by more than a dollar. As a result, Netflix's cancellation rate began to climb and its stock price dropped by 50 percent. Rather than lowering its price, in response, Netflix opened a dozen additional distribution centers around the US, thus improving its service for thousands of customers. Conceding the win, Walmart ended its DVD rental services and entered instead into a promotional deal with Netflix in 2005.[10] Blockbuster, on the other hand, engaged in a monthly subscription price war with Netflix, eventually settling on a price structure identical to Netflix only to be undercut when Netflix lowered the prices of its two most popular subscription plans by one dollar.[11] Despite the competition, Netflix managed to double its subscriber base and reach one million subscribers by February 2003. In addition, Netflix reported its first profitable quarter by June of the same year. After achieving its first profit, Netflix continued to grow and fend off an increasing number of competitors.[12] As a value-added service and to give the firm an edge in competing with new entrants, Netflix developed, patented, and maintained an extensive personalized video recommendation system based on user rentals, ratings, and reviews.

In addition to the challenges of direct competition from other firms, on a separate front, Netflix faced ongoing legal issues. For example, in 2005, Netflix opted to settle a class action suit alleging the firm did not "provide unlimited DVD rentals and one day delivery as promised in its marketing materials," by giving the plaintiffs a free one-month upgrade in their service.[13] Despite the increased competition and incessant legal issues during this period, Netflix continued to increase its customer base and not only turn a profit, but continue to.

Dawn of the Digital Age

In 2000, Netflix shifted its goal from DVD rentals to streaming video with Hastings stating, "What Netflix is about is owning a transition stage as rental converts to video on demand."[14] Foreseeing that "DVD is not a hundred-year format," Hastings introduced online content streaming that allowed subscribers to watch movies and TV shows on their PCs at no additional cost. Despite the fact that its initial library of titles was limited, they came from studios such as NBC Universal, Sony Pictures, 20th Century Fox, Paramount Pictures, and Warner Brothers and thus comprised a respectable opening library of titles.[15] By 2009, Netflix's streaming library had grown eightfold, offered titles in HD 720-progressive format, and compatibility to include PCs, Macs, TVs, Blu-Ray players, TiVo, Roku, Microsoft Xbox 360, and Sony's Playstation 3.[16,17] Further improvements to the firm's proprietary movie recommendation software, Saturday shipping, and automated distribution centers allowed Netflix to acquire one million new subscribers in Q4-2009 alone. In early 2010, Netflix further increased its compatibility by offering its streaming services via Apple's iPad and Nintendo's Wii.[18,19] Netflix's early start in the subscription DVD rental industry, strong distribution capabilities, and loyal customers keep it the industry leader and make it an e-commerce success story in an ever-changing business landscape.[20]

Remember When VHS and Betamax Were Awesome?

According to Dave Hoffman, content planning and analysis manager at Netflix, "Our business model went from dead, to streaming is cool but all the money is made on DVDs, to wow, we're actually delivering great content and people are paying for it instead of going to Blockbuster." These sentiments describe the general landscape of the digital video-streaming marketplace as competition continues to intensify.

Technology plays a major factor in the new media world as barriers to entry in the digital world are limited to non-existent. This technological transformation coupled with increased consumer demand for digital content delivery has forced companies like Blockbuster to shut down bricks-and-mortar locations and develop platforms that mimic Netflix and allow customers to order online and/or stream content.[21] The Diffusion Group, a market research company, projects revenue from Internet video to TV to grow from $1 billion in 2009 to $5.7 billion in 2014. Companies like Netflix will reap enhanced consumer loyalty from devices such as Blu-Ray players and video game consoles equipped to stream content. As a partial result of streaming deals with several consumer electronics device manufacturers, Netflix saw its subscriber base increase by 35 percent from Q1-2009 to Q1-2010. The key for any player in this marketplace is to win the digital fight and the major advantages a company can develop are being first to market, having the best content, and scaling benefits. Technological threats include illegal downloads and Internet hackers. The growth Netflix has experienced since its inception has obviously attracted hackers to manipulate the company. For example, Netflix tracks how long a user streams each downloaded video; nevertheless, a hacker admitted to getting around this so Netflix would not know he was able to watch more than a few minutes of a film.[22]

Demographic trends such as increased world population (6.1 billion in 2000 to 7.2 billion in 2015[23]) present opportunities to Netflix as it currently only operates in the US. In 2009, there were 384 million Internet users in China[24] and 81 million Internet users in India.[25] Expanding into these countries and others across the globe has the potential to give Netflix a competitive advantage, especially since ailing Blockbuster plans to focus on its North American market and will potentially pull out of 17 countries worldwide. Netflix could tap into these markets; however, the firm must consider the costs to expand (i.e., distribution centers if it chooses to mail DVDs, a new department at corporate HQ for the international segment, etc.), prepare for barriers to entry across borders, as well as learn the nuances of negotiating agreements with foreign film studios.

With little governmental regulation over delivery of streaming content, the biggest legal barrier for Netflix is gaining rights from movie studios to obtain first-run content sooner. In their attempt to avoid cannibalization and maximize DVD sales, currently, Warner Brothers, 20th Century Fox, and Universal Studios[26] have a 28-day delay on Netflix obtaining newly released DVDs. Premium subscriptions (and the increased revenue they generate) are the key to a content provider being first-to-market with original content; however, from the studios' perspective, doing so will require remuneration for their loss of DVD sales. Whether content suppliers and content providers can reach this type of agreement has yet to be seen.

An Open Casting Call

When Netflix diversified its DVD-by-mail distribution model to include streaming content over the Internet, it became the first to offer subscribers two delivery options for one low monthly price.[27] While the market for Internet delivered video content is still in its formative stages[28] and competition is expected to build, the overall market for in-home entertainment video is very competitive, largely because consumers can subscribe to multiple providers simultaneously or shift their spending from one provider to another with ease.[29] As an example, consumers can subscribe to cable, rent a DVD from Redbox, buy a DVD from Walmart, download a movie from Apple iTunes, view a television program on Hulu.com, and subscribe to Netflix all within the same period (Exhibit 2 provides a side-by-side comparison of DVD rental company products and services). Currently, Netflix is the main provider in the subscription segment, but the firm faces competition from Blockbuster and Redbox in this space.[30]

Blockbuster Inc.

Blockbuster's objective is to remain the world's largest video rental chain. Blockbuster operates more than 6,500 company-owned or franchised stores in 17 countries with 62 percent of those stores located in the US. Annually, the chain as a whole rents more than 1 billion videos, DVDs, and video games. In addition to in-store rentals and purchases—and putting it in direct competition with Netflix and, to some degree, Redbox—customers can watch a rented or purchased instant download via "Blockbuster Online."

Recently, Blockbuster has closed hundreds of stores and has plans to divest its foreign operations to focus on its North American business in its effort to move toward a digital future and stay afloat. At present, Blockbuster carries $1 billion in debt and is accelerating its store-closing schedule: shutting down 20 percent of its stores and reducing the footprint of 250 stores by the end of 2010. To assist in transitioning from a store-based distribution system to a multi-channel approach involving mail, vending, and digital download options, in January 2009, Blockbuster created an executive position to lead its digital entertainment division. In addition, Blockbuster has partnered with Samsung Electronics America to allow owners of Samsung's next generation of high-definition TVs to rent Blockbuster DVDs with the press of a button using their high-speed Internet connection. Blockbuster also provides VOD service through alliances with TiVo and is following Redbox's

Exhibit 2 Comparison of Online DVD Rental Services

	Netflix	Blockbuster Online	iTunes	Green Cine	DVD Avenue	Cinema Now	Cafe DVD
Lowest Monthly Price	$7.99	$9.99	$3.99	$9.95	$9.99	$3.99	$14.95
Cost of Instant Viewing per Month							
One Movie	$7.99	$8.99	$3.99	N/A	N/A	$3.99	N/A
10 Movies	$7.99	$39.99	$39.99	N/A	N/A	$39.99	N/A
50 Movies	$7.99	$199.50	$199.50	N/A	N/A	$199.50	N/A
100 Movies	$7.99	$399.00	$399.00	N/A	N/A	$399.00	N/A
Membership Features							
By mail	✔	✔	✔	✔	✔		✔
Watch instantly (stream)	✔	✔	✔				
Free Trial	✔	✔					
Unlimited per month DVD rental or TV	✔	✔	✔	✔	✔	✔	
No due dates and free two-way shipping	✔	✔		✔			
No late fees	✔	✔	✔	✔	✔		
Library	100,000	95,000		30,000	25,000		60,000
Avg delivery time (in days)	Mail 1–2/ Instant	Mail 1–2/ Instant	Instant only	Mail only 1–4	Mail only 1–2	Instant only	Mail only 1–4
Accessibility							
Watch with TV	✔	✔	✔	✔	✔	✔	✔
Access/watch with PC	✔	✔	✔	✔	✔	✔	✔
Access by mail	✔	✔		✔			✔
Instant access on Wii	✔						
Instant access on PS3 or Xbox 360	✔					✔	
Instant access on iPad, iPhone, or iPod Touch			✔				
Instant access on Roku	✔						
Access with Internet TV	✔						
In-Store Exchanges		✔					

Source: Adapted from http://dvd-rental-review.toptenreviews.com

lead with Blockbuster Express branded DVD kiosks for video rentals in supermarkets, convenience stores, and other retail locations in a deal with ATM manufacturer, NCR. This partnership got a boost in late 2009 when NCR acquired DVDPlay, a West Coast based kiosk DVD rental company with about 1,500 kiosks already in place. The NCR purchase boosted the number of installed kiosks to about 3,800 by the end of 2009 with Blockbuster/NCR planning to install an additional 6,200, or 10,000 total, kiosks. In 2007, Blockbuster acquired Movielink, an online movie-downloading company owned by major Hollywood studios, to explore alternative distribution channels[31,32] and in 2009, Blockbuster announced a partnership with digital media firm, Sonic Solutions. The two companies have been working together to offer VOD for PCs, cell phones, TVs connected to the Internet, and other electronic devices and plan to have streaming and progressive download options available when the service launches.

Redbox Automated Retail, LLC (Redbox)

Redbox, founded in 2003, is owned by Coinstar and its President, Mitch Lowe, was formerly Netflix's VP of business development. Redbox offers an alternative in an industry dominated by Netflix and Blockbuster: it places automated red kiosks at selected McDonald's, supermarkets, and convenience stores where any customer with a credit or debit card can rent movies for $1 per day. For added convenience, customers can reserve movies online, then pick the movie up at the selected kiosk, and return movies to any Redbox machine—all without a membership. Each kiosk holds more than 700 discs with 200 titles and the fast-growing company owns and operates 22,000 kiosks nationwide—a number projected to more than double by 2012.[33,34]

The latest recession spurred an increased use of Redbox, which recently generated four million card swipes in one month. In July 2009, Netflix rightly declared that Redbox and its convenient kiosks would be its number one competitor by the end of the year. Redbox's $1 rentals have been disruptive not only to its DVD rental rivals, but to Hollywood as well. Studios are torn between supplying Redbox with cheap wholesale discs and trying to starve it by keeping the selections late and/or limited in the hopes of preserving their more lucrative DVD sales to consumers. So far, 20th Century Fox and Universal Pictures are in favor of not distributing newer titles to Redbox; however, in July 2009, Sony Pictures signed a five-year supply deal with the company. In August 2009, Redbox filed suit against 20th Century Fox after it requested that Redbox delay renting DVDs of its films until 30 days after their public release date. Redbox then filed similar suits against Universal (and its 45-day wait) and Warner Home Video (with a 28-day delay).[35,36,37]

Everyone Else

In the long run, Netflix's stiffest challenge will be the growing demand for digital movie rentals provided by Internet and cable companies. These providers are subdivided into the VOD segment (including Apple's iTunes, Amazon.com, and CinemaNow), the ad-supported segment (Hulu.com, Google's YouTube, and the newly introduced Google TV), and the subscription segment (Blockbuster Online).[38]

Other indirect competitors include video package providers with pay-per-view and VOD content. For example, cable providers such as Time Warner and Comcast; direct satellite providers such as DIRECTV and Echostar; and telecommunications providers such as AT&T and Verizon. Entertainment video stores selling DVDs such as Best Buy, Walmart, and Amazon.com also compete against Netflix indirectly.[39]

An as yet entirely new dimension to the market that Netflix may have to deal with is the possibility of content providers taking on the responsibility of the digital distribution of their own content. Potential entrants to this market range from the actual studios that create and own the rights to the content, to illegal digital distributors. Within this range and, again, because of the low barriers to entry, are a multitude of content provider permutations. Suppliers with significant capital at their disposal could afford to assume complete control over the timing of the physical and digital distribution of their content in an attempt to maximize their profit. This supplier power would mean that, as a middleman distributor, Netflix could experience a compromised revenue stream and be unable to maintain pace with the cost of licensing content.[40] Sony or Disney, for instance, could generate and distribute their own content exclusively through their own streaming service. At the same time, the content would most likely be available to savvy consumers via the Internet for free. To maintain an advantage, Netflix must ensure high streaming quality and easy access so initial consumer experiences are successful. Additionally, Netflix must generate early brand identity in the streaming video content delivery method by leveraging its DVD rental subscriptions and "giving away" its video-streaming library.[41]

Content Providers

Netflix operates in a challenging industry due to the fact that content suppliers—television and movie studios—wield significant influence: a fact that renders Netflix untouchable in one respect and vulnerable in another. The line of demarcation that separates Netflix's defenses and vulnerabilities is the video content delivery method. Netflix constantly assesses its position in the industry from both the DVD rental perspective as well as the streaming video perspective. That said, the DVD rental method will deteriorate significantly over the next two decades and shift to streaming video. This change will transfer the upper hand to content suppliers because the relatively low barriers to entry into the streaming video market will create countless distributors from which suppliers may choose.[42]

Because Netflix dominates the DVD rental segment, this is where it leverages its distribution expertise to generate significant revenue for the firm and the movie studios. Aside from the fact that the rental of a physical DVD will soon be a thing of the past, at this point, the threat of competition on this side of the industry is low due to the relatively high barriers to entry. These barriers include the establishment of multiple physical distribution centers to ensure quick delivery, considerable capital to acquire enough reasonably priced DVDs to ensure demand for new releases is met, and favorable bulk postage rates. Netflix utilizes the sheer size of its subscriber/customer base to create economies of scale that are difficult to imitate, yielding a potentially sustainable competitive advantage for the firm.[43]

As for the streaming video segment however, a number of factors leave Netflix exposed to potential competitive disadvantages. For example, because the studios that supply content currently generate a significant portion of their revenue from DVD sales, they will continue to be reluctant to allow immediate streaming rights to any provider and will demand increasingly higher licensing fees.[44] This reluctance to provide streaming rights coupled with the proliferation of illegal video pirating and downloads occurring while movies are still in theatres means studios will continue to leverage the early demand for their products to garner the maximum licensing fees.[45] This will impact Netflix's bottom line as the firm bids against other streaming video providers and acquisition fees begin to trend up as a result.[46]

As demand for streaming video content accelerates, DVD rental demand will diminish. As previously mentioned, because consumers are loyal to content and not to particular distributors, Netflix may be hard pressed to convince consumers to view content from its service as opposed to one of the other many new choices available now and expected to appear.[47] The low barriers to entry into the market have the potential to fuel an explosive growth of content distributors all vying to satisfy the convenience and instant gratification cravings of consumers. For a distributor to provide desirable content in terms of price and quality as demanded by consumers, it must first negotiate content licensing with suppliers—suppliers with a wide array of streaming distribution options. With forecasts estimating that "Internet video alone will account for 57 percent of all consumer Internet traffic in 2014" and strong demand for their content, movie studios in particular will enjoy a strong position in all negotiations.[48]

Who Decides?

With both physical and streaming video demand forecast to increase significantly, consumers will gravitate to simple-to-use services that provide the content they seek. Today, Netflix definitely provides value to its customers by quickly delivering DVDs to their mailboxes. This convenience cannot be underestimated, particularly because the most valuable resources of consumers today—time and money—are expected to remain constrained. For Netflix's long-term survival, its transition to streaming content satisfies both of these consumer value propositions. However, while Netflix's early insertion into the streaming market will pay dividends in terms of embedding its brand in consumer consciousness, with the continued proliferation of electronic devices with Internet video capabilities and the anticipated expansion of content distributors, in the end, consumers' choices among competitors will determine the winners among those competing in these markets. With low switching costs, consumers will leverage the Internet's inherent capabilities to find the video they seek at precisely the moment they want to view it. Wisely, even Netflix itself makes it easy for consumers to switch their subscription plans or suspend their service at any time via its Web site. An example of this is the recent trend of customers signing up for the lowest priced unlimited DVD-by-mail subscription plan with unlimited streaming video availability and content. This trend is interesting because it signals a toggle in consumers' awareness of Netflix's streaming video capabilities—an awareness that will, ultimately, impact Netflix's bottom line.

Another impact on the bottom line is the price Netflix will eventually have to pay to license and distribute content. Netflix's position as a middleman distributor is useful for the DVD rental portion of its business because, at present, suppliers rely on Netflix to generate a portion of their revenue. However, this doesn't mean the supplier doesn't have any power because, as demand for video increases, Netflix must continue to provide the latest and most popular releases in a timely manner and studios can charge a premium for Netflix to be able to do so.

Yet another pivotal facet of the Netflix rental distribution model is the firm's reliance on the USPS and broadband Internet providers. The USPS continues to raise postage rates in an attempt to combat revenue losses caused by a decrease in overall volume as a result of the growth of electronic mail, digital downloading, and e-commerce. In addition to the ongoing cost increases of the USPS are the eventual charges that consumers will have to pay for the volume of content they download via their broadband Internet connections.[49] This increased cost to the consumer will most likely result in consumers demanding lower subscription fees from providers such as Netflix. Without some concession, the consumer would likely seek less expensive or even free providers of video content via the Internet, an outcome that could wring out a majority of Netflix's profits.

Although Netflix does not face a significant threat from substitute forms of visual entertainment such as reading, live entertainment, or visiting a museum, the firm must recognize an industry-wide lack of brand loyalty and the real threat of consumers switching to substitute content providers that offer a compelling enough quality and cost combination. For example, switching costs are relatively non-existent because customers pay for their subscriptions on a month-to-month basis and can suspend, alter, and reinstate their subscriptions at will.[50] Although the demand for video is increasing, there is a physical limit to the amount of time the average consumer can realistically view video, currently estimated at an average of five hours a day. To gain market share, Netflix has partnered with hardware providers to make it easy for consumers to connect and subscribe to its service.[51]

Recently, this convenience appears to have helped grow Netflix subscriptions to more than 13 million.[52] The main driver of this is the connection convenience provided by Netflix's partnerships with gaming console manufacturers that allow the Wi-Fi enabled devices to stream Netflix to the consumer's TV via the console. This is a significant transformation of the living room to a center of on demand entertainment enabled by the ability to connect the TV to the Internet. This transformation will be further spurred by the introduction of Internet-enabled TVs.[53]

Behind the Scenes

Netflix has positioned itself as a cost leader with a variety of products and services. The company's Q1-2010 earnings report illustrates this point:

Our core strategy is to grow a large subscription business consisting of streaming and DVD-by-mail content. By combining streaming and DVD as part of the Netflix subscription, we are able to offer subscribers a uniquely compelling selection of movies for one low monthly price. We believe this creates a competitive advantage as compared to a streaming only subscription service.[54]

From the cost perspective, Netflix appeals to price sensitive consumers who are not willing to pay more to either purchase a DVD or view content "à la carte" as with VOD or download. As a result of the company's substantial monthly subscriber revenue, Netflix is able to differentiate itself from other content providers with of its extensive catalogue, proprietary recommendation system, outstanding customer service, and near constant innovation.

How Netflix Works

Netflix subscribers are able to select, receive, and watch/stream content in an unlimited "all you can eat" manner for as little as $8.99 per month.[55] The process starts when Netflix subscribers interface with a simple Web-portal that allows them to build a 'queue,' or list, of DVDs and digital streaming content they wish to view in the future. Building a queue can be done by browsing a diverse set of pre-selected category lists such as 'New Releases' and 'Critics Picks' or by viewing the customized 'Movies You'll ♥' link to access titles matched to the user via an algorithm based on their past viewing history.[56] After the subscriber has created a queue, Netflix then either sends a DVD to them via the USPS in the company's signature red mailing envelope or, if preferred and offered, makes it available for immediate download via a broadband Internet connection. In the case of DVDs, the subscriber is able to keep the title as long as they wish without a late fee before returning it using the postage pre-paid, red envelope provided by Netflix.

Delivering DVDs to Subscribers

A large part of Netflix's large-scale, quick growth is due to its innovative logistics system that allows it to deliver DVDs by mail to "more than 97 percent of customers in one business day."[57] To do this, Netflix operates 58 warehouses across the country and ships over two million discs from its inventory six days a week. With the exception of Sunday morning, each day at a Netflix warehouse begins at 3:00 am when a truck leaves to pick up boxes of returned DVDs from the post office. When the truck returns, the boxes are unloaded and employees "rip open each envelope, toss it, pull the disc from its sleeve, check that the title matches the sleeve, inspect the disc for cracks or scratches, inspect the sleeve for stains or marks, clean the disc with a quick circular motion on a towel pulled tight across a square block of wood, insert the disc into its sleeve, and file the disc." Netflix expects line workers to perform this task "a minimum of 650 times per hour." Inspected DVDs are then checked back into inventory by a machine that scans sleeve barcodes, at a rate of up to 30,000 DVDs per hour. Following this step, workers run the entire warehouse inventory through a similar scanning and sorting station to separate out the DVDs scheduled to ship to subscribers that day. They then send the separated DVDs to a stuffing machine that seals the discs into envelopes and prints delivery labels with a laser.[58] In recent years, Netflix has moved to automate 60 percent of its processes and the resulting efficiency improvements have led to a 17 percent lower cost per shipment. For example, at one time, only 600 DVDs could be inserted into mailers per hour: this rate is now more than 4,000 DVDs per hour.[59]

The entire process is finished by 5:00 pm, when the delivery truck departs for the post office. Netflix is extremely tight lipped about its quality targets for DVD delivery, but failure rates are thought to be "far less than a quarter of one percent."[60] If true, Netflix has achieved a six-sigma level process in distribution of DVDs.

Streaming Content to Subscribers

With the emergence of higher capacity broadband Internet connections, advances in audio- and video-streaming technology, and the development of compression/decompression (codec) software, in 2007, Netflix released its "View Instantly" offering allowing subscribers to stream data to their home PC.[61] In streaming, the codecs "discard unnecessary data, lower the overall [screen] resolution and take other steps to make the file smaller"[62] so it may be more quickly and easily transmitted to the user. Additionally, "playing the streaming file discards the data as you watch. A full copy of the file never exists on your computer, so you can't save it for later."[63]

Netflix is now pursuing several alternative methods for delivering streaming content.[64] Subscribers are currently able to stream content from Netflix using "Microsoft's Xbox 360, Sony's PS3 game consoles, and Nintendo's Wii console; Blu-ray disc players from Samsung, LG, and Insignia; Internet TVs from LG, Sony, and VIZIO; the Roku digital video player and TiVo digital video recorders; and Apple's iPad tablet."[65] By embedding its streaming technology on a wide variety of devices, Netflix has the advantage of not requiring consumers to purchase a dedicated set-top box to stream content.[66]

Because each of these devices require a unique set of codecs and a complex "always-on" infrastructure, in recent months Netflix has chosen Amazon Web Services (AWS) "to run a variety of mission-critical, customer-facing and backend applications."[67] By stepping into Amazon's cloud computing infrastructure, Netflix hopes to "utilize vast numbers of servers to transcode and store TV episodes and movies into new formats quickly, and AWS pay-as-you-go pricing ensures that Netflix pays only for resources used."[68] As a result of this set of technological innovations, in Q1-2010, more than 55 percent of Netflix subscribers streamed at least 15 minutes of content from the site.[69]

Marketing and Sales

To attract new subscribers, Netflix uses a variety of on and offline advertising including Web-based banner ads, paid Web-based search listings, print advertising, and direct mail promotions.[70] To encourage potential new subscribers, Netflix offers a no-obligation first month of free service; additionally, the firm has a convenient tool on its Web site that allows current subscribers to invite their friends to join. As streaming has gained momentum, Netflix has even given current subscribers a 10 percent discount in the first month after they stream content using a device such as Nintendo's Wii.[71]

Customer Service and Company Culture

According to independent researcher Foresee Results, since 2005, Netflix has placed first in 90 percent of polls measuring e-commerce customer satisfaction. Other indices, such as the American Customer Satisfaction Index (ACSI), also rank Netflix first as compared to other e-retail Web sites.[72] Under his tenure, Hastings has ensured that Netflix isn't considered mediocre, as was the case at his first start-up company, Pure Software. Says Hastings of that experience, "We went from being a heat-filled, everybody-wants-to-be-here place to a dronish, when-does-the-day-end sausage factory. We got more bureaucratic as we grew."[73] Upon starting Netflix, recruiting, rewarding, and retaining the best talent has been Hastings answer to this. He expects extremely high performance with the average employee doing the job of three to four people and he rewards them for it by providing extremely attractive compensation packages, choice in how they are paid (cash vs. stock ratio), and unlimited vacation time. With this culture, there is nowhere to hide and average performers are provided with a generous severance package as an incentive to walk away. Hastings ensures the company hires the most talented from its pool of candidates by telling recruiters, "Money is no object."[74] In 2006, he successfully applied this strategy to capitalize on intellectual resources external to Netflix by holding a contest with a $1 million prize open to the worldwide public that challenged individuals or teams to come up with an at least 10 percent more accurate algorithm to predict consumer movie preferences. Netflix received 44,014 valid submissions from 5,169 individuals and teams with, ultimately, two teams achieving the 10 percent improvement goal sought by Hastings.[75] In 2009, Hastings awarded the $1 million prize to the first team to submit and, despite subsequent litigation alleging violation of privacy laws, its success has prompted Hastings to explore similar contest ideas with $1 million prizes.[76]

At the Box Office

According to the firm's 2010 annual report, Netflix's revenue, which is substantially derived from monthly subscription fees, increased in 2009 by $305.7 million compared to 2008 and another $492.4 in 2010 compared to 2009 (see Exhibit 3A for Netflix revenue for these periods). This increase is attributed to increased consumer awareness of the compelling value of streaming video and DVD-by-mail for one low price as well as the other benefits Netflix offers. This subscriber growth, which has been highly correlated with Netflix's earnings growth trend over the past 11 years, appears to be sustainable even with higher customer attrition as the firm is able to offset those losses with new customer acquisitions or reactivations. However, revenue per subscriber declined primarily due to the growing popularity of Netflix's lower priced plans and reduced marketing spending[77] (Exhibit 3B shows financial data per subscriber). This financial outcome could be by design as the company has been using its margins to develop its digital streaming platform: a strategy that results in limited near-term incremental monetization opportunity, such as not declaring or paying any cash dividends presently or in the foreseeable future (see Exhibit 3C).[78]

Netflix's main source of liquidity has been cash from operations. In 2009, however, long-term debt financing was added as part of its source of liquidity as it issued a $200 million aggregate principal amount of senior notes that are due in November 2017. This resulted in Netflix posting much higher debt ratios relative to the industry

Exhibit 3A Netflix: Consolidated Statements of Operations (in thousands, except per share data)

	Year ended December 31		
	2010	2009	2008
Revenues	$2,162,625	$1,670,269	$1,364,661
Cost of revenues:			
Subscription	1,154,109	909,461	761,133
Fulfillment expenses	203,246	169,810	149,101
Total cost of revenues	1,357,355	1,079,271	910,234
Gross profit	805,270	590,998	454,427
Operating expenses:			
Technology and development	163,329	114,542	89,873
Marketing	293,839	237,744	199,713
General and administrative	70,555	51,333	49,662
Gain on disposal of DVDs	(6,094)	(4,560)	(6,327)
Total operating expenses	521,629	399,059	332,921
Operating income	283,641	191,939	121,506
Other income (expense):			
Interest expense	(19,629)	(6,475)	(2,458)
Interest and other income	3,684	6,728	12,452
Income before income taxes	267,696	192,192	131,500
Provision for income taxes	106,843	76,332	48,474
Net income	$ 160,853	$ 115,860	$ 83,026
Net income per share:			
Basic	$ 3.06	$ 2.05	$ 1.36
Diluted	$ 2.96	$ 1.98	$ 1.32
Weighted-average common shares outstanding:			
Basic	52,529	56,560	60,961
Diluted	54,304	58,416	62,836

Source: Netflix 10-K filing for year ended December 31, 2010. SEC.gov.

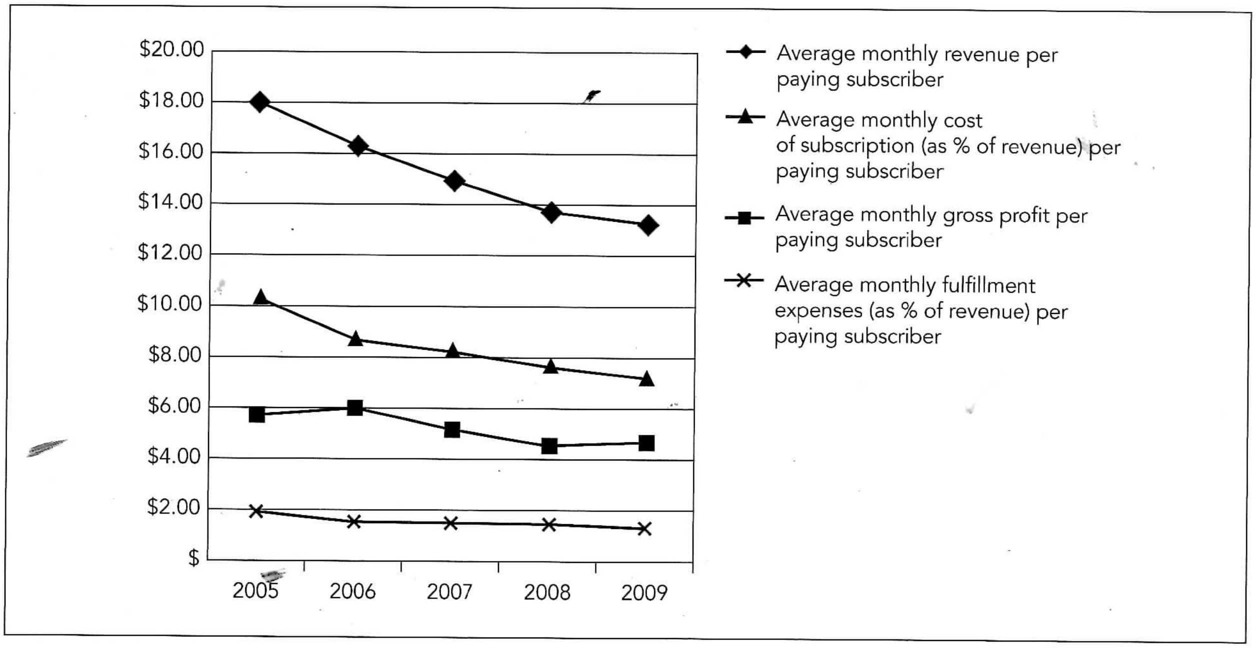
median. Nevertheless, its profitability and operation ratios outperformed the industry revealing Netflix's strong position (Exhibit 3D shows financial ratios as compared to the industry). Additionally, with higher cash balance growth rates, Netflix's primary use of cash has involved financing its stock repurchase program, delivery expenses, content acquisitions, as well as capital expenditures related to information technology and automated equipment for operations, marketing, and fulfillment, thereby leading to an increased assets growth rate and a significantly decreased liability growth rate over the past three years. Judging from Netflix's resource investments/allocations and its financial ratios against overall industry performance, Netflix is transitioning well into a hybrid model while becoming a better funded company than its competitors (Exhibits 4A, 4B, 4C, and 4D provide financial data in comparison to Netflix competitors).

Key Strategic Leaders

Reed Hastings—Founder, Chairman, and CEO

Reed Hastings received a BA in mathematics from Bowdoin College in 1983 and a master's in computer science from Stanford University in 1988. Hastings founded Pure Software in 1991 at the age of 31. In 1997, Pure Atria Software was acquired by Rational Software for $700 million and Hastings began to work on his new idea—Netflix.[79,80] He launched the subscription service for Netflix in 1999 that grew to one million subscribers in less than four years. Ten years after its founding, Netflix had a total of 12.3 million subscribers. Due to Hastings's vision and tremendous success, he was added to *TIME* magazine's "*TIME* 100" list that included the most influential global citizens in 2005. In 2007, he was appointed to Microsoft's Board of Directors and later that year was inducted to the Video Business Hall of Fame.[81]

Exhibit 3B Netflix: Annual Revenue by Subscriber



Data	Year ended December 31				
	2005	2006	2007	2008	2009
Revenues ($ thousands)	682,213	996,660	1,205,340	1,364,661	1,670,269
Gross Profit ($ thousands)	217,663	369,675	419,172	454,427	590,998
Other Data:					
Average number of paying subscribers	3,169	5,083	6718	8,268	10,464

(Percentages)	Year ended December 31				
	2005	2006	2007	2008	2009
Revenues	100.0%	100.0%	100.0%	100.0%	$682,213
Cost of Revenues:					
Subscription	57.7%	53.4%	55.1%	55.8%	54.4%
Fulfillment Expenses	10.6%	9.5%	10.1%	10.9%	10.2%
Total Cost of Revenues	68.3%	62.9%	65.2%	66.7%	64.6%

(Calculations)	Year ended December 31				
	2005	2006	2007	2008	2009
Average monthly revenue per paying subscriber	$17.94	$16.34	$14.95	$13.75	$13.30
Average monthly gross profit per paying subscriber	$5.72	$6.06	$5.20	$4.58	$4.71
Average monthly cost of subscription (as % of revenue) per paying subscriber	$10.35	$8.73	$8.24	$7.67	$7.24
Average monthly fulfillment expenses (as % of revenue) per paying subscriber	$1.90	$1.55	$1.51	$1.50	$1.36

Source: Raw data retrieved from Netflix 10-K filings for years ending 2005 to 2009. SEC.gov.

Exhibit 3C Netflix: Consolidated Statements of Cash Flows (in thousands)

	Year Ended December 31, 2009	2008	2007
Cash flows from operating activities:			
Net income	$ 115,860	$ 83,026	$ 66,608
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation of property, equipment and intangibles	38,044	32,454	22,219
Amortization of content library	219,490	209,757	203,415
Amortization of discounts and premiums on investments	607	625	24
Amortization of debt issuance costs	1,124	—	—
Stock-based compensation expense	12,618	12,264	11,976
Excess tax benefits from stock-based compensation	(12,683)	(5,220)	(26,248)
Loss (gain) on disposal of property and equipment	254	101	142
Gain on sale of short-term investments	(1,509)	(3,130)	(687)
Gain on disposal of DVDs	(7,637)	(13,350)	(14,637)
Gain on sale of investment in business	(1,783)	—	—
Deferred taxes	6,328	(5,905)	(893)
Changes in operating assets and liabilities:			
Prepaid expenses and other current assets	(11,001)	(4,181)	(3,893)
Content library	(64,217)	(48,290)	(34,821)
Accounts payable	(2,256)	7,111	16,555
Accrued expenses	13,169	(1,824)	32,809
Deferred revenue	16,970	11,462	1,987
Other assets and liabilities	1,685	9,137	2,868
Net cash provided by operating activities	325,063	284,037	277,424
Cash flows from investing activities:			
Purchases of short-term investments	(228,000)	(256,959)	(405,340)
Proceeds from sale of short-term investments	166,706	304,163	200,832
Proceeds from maturities of short-term investments	35,673	3,170	—
Purchases of property and equipment	(45,932)	(43,790)	(44,256)
Acquisition of intangible asset	(200)	(1,062)	(550)
Acquisitions of content library	(193,044)	(162,849)	(208,647)
Proceeds from sale of DVDs	11,164	18,368	21,640
Investment in business	—	(6,000)	—
Proceeds from sale of investment in business	7,483	—	—
Other assets	71	(1)	297
Net cash used in investing activities	(246,079)	(144,960)	(436,024)
Cash flows from financing activities:			
Principal payments of lease financing obligations	(1,158)	(823)	(390)
Proceeds from issuance of common stock	35,274	18,872	9,609
Excess tax benefits from stock-based compensation	12,683	5,220	26,248
Borrowings on line of credit, net of issuance costs	18,978	—	—
Payments on line of credit	(20,000)	—	—
Proceeds from issuance of debt, net of issuance costs	193,917	—	—
Repurchases of common stock	(324,335)	(199,904)	(99,858)
Net cash used by financing activities	(84,641)	(176,635)	(64,391)
Net decrease in cash and cash equivalents	(5,657)	(37,558)	(222,991)
Cash and cash equivalents, beginning of year	139,881	177,439	400,430
Cash and cash equivalents, end of year	$134,224	$139,881	$177,439
Supplemental disclosure:			
Income taxes paid	$ 58,770	$ 40,494	$ 15,775
Interest paid	3,878	2,458	1,188

Source: Netflix 10-K filing for year ended December 31, 2010. SEC.gov.

Exhibit 3D Selected Financial Data: Financial Ratios

	Company	Industry Median
Profitability		
Gross profit margin	36.31%	24.42%
Net profit margin	7.11%	2.14%
Return on equity	51.00%	14.00%
Return on assets	19.70%	5.90%
Operations		
Inventory turnover	20.3	9.8
Days cost of goods sold in inventory	18.0	37.0
Asset Turnover	2.8	2.7
Financial		
Current ratio	1.82	1.36
Quick ratio	1.4	0.9
Leverage ratio*	3.41	2.71
Total debt/equity*	1.00	0.12
Interest coverage	20.43	46.85
Per Share Data ($)		
Revenue per share*	31.09	37.8
Cash flow per share	5.88	3.65
Working capital per share	3.53	3.4
Long-term debt per share*	4.53	0.51

*Ratio worse than industry performance.
Source: Data for exhibit retrieved from Morningstar, Inc.

Exhibit 4A Blockbuster: Statement of Operations

	Year Ended Jan 2, 2011
Revenues:	
Rental revenues	$1,816.0
Merchandise sales	296.4
Other revenues	44.1
	2,156.5
Cost of sales:	
Cost of rental revenues	655.9
Cost of merchandise sold	228.9
	884.8
Gross profit	1,271.7
Operating expenses:	
General and administrative	1,233.1
Advertising	50.6
Depreciation and intangible amortization	85.0
Impairment of long-lived assets	22.2
	1,390.9
Operating income (loss)	(119.2)
Interest (expense) income, net	(93.5)
Other items, net	(3.1)

(Continued)

Revenues:	
Income (loss) before reorganization items and income taxes	(215.8)
Reorganization items, net	(9.7)
Provision for income taxes	(2.2)
Equity in income (loss) of non-debtor subsidiaries, net of tax	(20.9)
Income (loss) from continuing operations	(248.6)
Income (loss) from discontinued operations, net of tax	(19.4)
Net income (loss)	$ (268.0)

Source: Blockbuster 10-K filing for year ended January 2, 2011. SEC.gov.

Exhibit 4B Amazon: Consolidated Statements of Operations (in millions, except per share data)

	Year Ended December 31		
	2010	2009	2008
Net sales	$34,204	$24,509	$19,166
Operating expenses			
Cost of sales	26,561	18,978	14,896
Fulfillment	2,898	2,052	1,658
Marketing	1,029	680	482
Technology and content	1,734	1,240	1,033
General and administrative	470	328	279
Other operating expense (income), net	106	102	(24)
Total operating expenses	32,798	23,380	18,324
Income from operations	1,406	1,129	842
Interest income	51	37	83
Interest expense	(39)	(34)	(71)
Other income (expense), net	79	29	47
Total non-operating income (expense)	91	32	59
Income before income taxes	1,497	1,161	901
Provision for income taxes	(352)	(253)	(247)

Source: Amazon 10-K filing for year ended December 31, 2010. SEC.gov.

Exhibit 4C Walmart: Percentage of Segment Net Sales

	January 31,	
STRATEGIC MERCHANDISE UNITS	2011	2010
Grocery	54%	53%
Entertainment	12%	13%
Hardlines	11%	11%
Health and wellness	11%	10%
Apparel	7%	8%
Home	5%	5%
Total	100%	100%

Source: Walmart 10-K filing for year ended January 31, 2011. SEC.gov.

Exhibit 4D Walmart: Consolidated Results of Operations

	Fiscal Years Ended January 31		
	2011	2010	2009
Net sales[1]	$418,952	$405,132	$401,087
Percentage change from comparable period	3.4%	1.0%	7.3%
Total U.S. calendar comparable store and club sales	–0.6%	–0.8%	3.5%
Gross profit margin as a percentage of sales	24.7%	24.9%	24.2%
Operating income[1]	$ 25,542	$ 24,002	$ 22,767
Operating income as a percentage of net sales	6.1%	5.9%	5.7%
Income from continuing operations[1]	$ 15,959	$ 14,962	$ 13,734
Unit counts	8,970	8,459	7,909
Retail square feet[2]	984,949	952,237	918,044

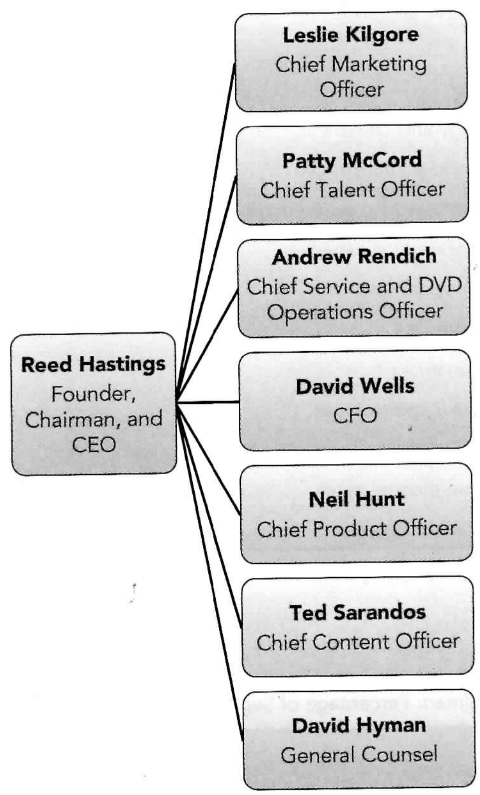
[1]Dollar amounts in millions.

[2]Amounts in thousands.

Source: Walmart 10-K filing for year ended January 31, 2011. SEC.gov.

In March 2010, Hastings was recognized by *Barron's* when he was placed on its annual "30 Most Respected CEOs" list. His ability to consistently defy odds and position Netflix as the leader in the DVD rental and video-streaming business while competitors such as Blockbuster close the doors of their bricks-and-mortar establishments is what qualifies Hastings to stand among the likes of Steve Jobs of Apple, Larry Ellison of Oracle, and Warren Buffett of Berkshire Hathaway.[82] Hastings prefers to use a functional structure with specialized functions such as marketing, operations, talent, and content to support implementation of the firm's strategy (Exhibit 5 shows the executive level of the Netflix organization chart).

Exhibit 5 Netflix Organizational Chart



Source: Information taken August 2011 from http://ir.netflix.com/management.cfm.

Andrew Rendich—Chief Service and DVD Operations Officer

Andrew Rendich holds computer science and computer engineering degrees from the Rochester Institute of Technology and Alfred State and had over eight years experience in software development and engineering management before joining Netflix in 1999. Before his promotion to VP of operations in 2007, Rendich was VP of systems development where he played a key role in furthering the automation of Netflix's DVD delivery service: work that ultimately reduced errors and lowered costs. Daily DVD shipments have multiplied from a few thousand to more than two million under Rendich's leadership. As chief service and operations officer, Rendich is in charge of Netflix's relationship with the USPS and thus, pivotal to one of the key challenges Netflix faces today: USPS's possible elimination of Saturday delivery service.[83]

Ted Sarandos—Chief Content Officer

Ted Sarandos has more than 25 years of experience in the home entertainment industry. He managed a retail video chain from 1983 until 1988 and was the director of sales and operations for video distributor ETD. Just prior to joining Netflix in 2000, he served as VP of product and merchandising for Video City where he negotiated the industry's first DVD revenue sharing agreement. With the recent agreement between Warner Brothers and Netflix, Sarandos's prior experience has been and will continue to be instrumental to Netflix's success in this sector. As chief content officer, Sarandos oversees 75 employees in the Beverly Hills office and manages Netflix's relationships with studios, producers, and the like in his pursuit of content acquisitions. Sarandos has grown Netflix's DVD library from 2,000 to 100,000 titles and helped launch the video-streaming business with over 17,000 TV shows and movies available for download.[84] In 2008, he helped cut a deal with STARZ to stream Disney and Sony films, a move that put him under the scrutiny of Hollywood studios as he works to position Netflix for the future.

How to Set a Sail to Catch the Wind

After the Q1-2010 financial results announcement, Hastings stated,

It is clear that our performance, and the overall appeal of the Netflix service, is being driven by subscribers watching instantly. On that score, we reached a milestone in the quarter as more than half of all members—55 percent and growing—enjoyed movies and TV episodes streamed from Netflix over the Internet.[85]

As Netflix positions itself for the future, the relevance of streaming video is apparent. With a streaming video content library of only 17,000 titles[86] (compared to over 100,000 DVD titles), will Sarandos be able to successfully convince movie studios that Netflix is the best medium for their streaming content? Will Hastings and Sarandos be able to complete a deal with the studios that allows Netflix to retain its low-cost subscription model? Also, how will the 28-day delay negotiated between Netflix and Warner Brothers, 20th Century Fox, and Universal affect Netflix subscriptions; will subscribers jump ship and go elsewhere to watch their movies sooner; will Netflix lose subscribers to competitors such as Hulu and Vudu? How will Netflix prevent subscriber defection and retain its current customer base? Will Netflix be able to maintain its foundation of successful innovation and maintain its competitive advantages?

Streaming video is likely to assuage the desire for instant gratification that mail delivery does not, but what about subscribers who have not made the shift to streaming video? How will Rendich overcome the obstacle of possible elimination of Saturday mail delivery? Can Netflix offer customers an alternative such as the kiosk model currently implemented by Redbox and Blockbuster Express? How will Netflix maintain profits in the face of increased competition and costs? Also, as Blockbuster continues to decline, would a move into the international arena be wise considering Netflix has yet to tap into that market? If Netflix grows internationally, will illegal downloads become a bigger issue with Netflix opening the floodgates to more subscribers across the globe? Without question, these are key issues that Hastings and his executive team will need to address in the coming years if Netflix is to remain a viable and strong competitor in the DVD rental and video-streaming business.

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