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Netflix in 2011

Netflix used to be a perfectly good horror movie. Company management swings a chainsaw; investors scream and are cut to bits; audience is titillated. Now it has become one of those avant-garde films your pseudo-intellectual friend recommends: no fun to watch, surreal and confusing . . . . The no-fun-to-watch part is the damage that Netflix's abrupt price increase has had on subscriber numbers. Subscriber growth ground to a halt in the third quarter, after the increase was announced in July. In the current quarter, as the price increase is put into effect, the company expects its physical DVD service to lose 3m—about a fifth—of its subscribers. Streaming video subscribers are expected to be flat to down. Given that Netflix's strategy is designed to encourage growth in streaming, this is far worse news than the hit to DVDs.

— LEX Column: Netflix, *Financial Times*, October 25, 2011[1]

Reed Hastings, founder and CEO of Netflix, was having a rough September. Only a few months earlier, he was on top of the world. Named *Fortune* magazine's businessperson of the year in 2010,[2] Hastings had built the DVD-by-mail company into an enormously popular consumer service. (See **Exhibit 1** for a Netflix income statement.) In July 2011 Netflix announced that it would start charging separately for its streaming video service and its DVD service—and that each service would cost $7.99 a month. The streaming service was formerly a $2 add-on to the basic DVD monthly charge of $7.99 for its entry-level one-DVD-at-a-time plan. Customers who wanted both would now have to pay $15.98 a month. Although most new consumers who wanted only the streaming service would actually see a price reduction, the public outcry over the 60% price increase for the combination drowned out that fact.[3]

Things got worse when Hastings announced that the company would split the DVD-by-mail into a separate business named Qwikster, and that the online streaming business would retain the Netflix name. On September 18, 2011, he announced on his blog:

> It is clear from the feedback over the past two months that many members felt we lacked respect and humility in the way we announced the separation of DVD and streaming, and the price changes. That was certainly not our intent, and I offer my sincere apology. I'll try to explain how this happened.

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> For the past five years, my greatest fear at Netflix has been that we wouldn't make the leap from success in DVDs to success in streaming. Most companies that are great at something—like AOL dialup or Borders bookstores—do not become great at new things people want (streaming for us) because they are afraid to hurt their initial business. Eventually these companies realize their error of not focusing enough on the new thing, and then the company fights desperately and hopelessly to recover. Companies rarely die from moving too fast, and they frequently die from moving too slowly.[4]

Hastings went on to explain that streaming and DVD-by mail were becoming two quite different businesses, with different cost structures and benefits that needed to be marketed differently. In addition, each business needed to be able to grow and operate independently.

Thousands of consumers criticized the plan on Netflix's website, and Netflix stock continued its slide, from $300 earlier in the year to $77 in October.[5] By mid-October, the company reversed course again, abandoning the breakup plan. Asked in a television interview about how it felt to apologize for business mistakes, Hastings was humble:

> Going through marriage counseling 20 years ago was really how I moved to become a better manager and leader . . . This marriage counselor was able to get me to see that I was often lying to myself and my wife . . . and that the value of honesty is that people can take honesty, even if it's not necessarily what they want to hear, if it's really sincere.[6]

The bigger challenge facing Hastings and his team was how to cope with the very different business model for streaming in a company built on the higher margins of DVD-by-mail. How would they manage that transition within a single business, and more importantly, with the company's 20 million customer relationships? That was the question he now had to be honest about.

The U.S. Home Video Rental Market

In the 1990s, the U.S. home video market was a fragmented industry largely populated with "mom-and-pop" retail outlets. Customers rented movies, primarily on VHS cassette, from a retail location for a specified time period, usually between two days and one week, and paid a fee of $3 to $4 for each movie rented.

Blockbuster Inc. became the market leader with the insight that movie rentals were largely impulse decisions. To customers deciding at the last minute that a given night was "movie night," the ability to quickly obtain the newest release was a priority. Statistics showed that new releases represented over 70% of total rentals. Blockbuster's growth strategy revolved around opening new locations, both to expand geographic coverage and to increase penetration and share in existing markets. By 2006, Blockbuster had 5,194 U.S. locations, of which 4,255 were company owned and the balance franchised. Locations were chosen based on customer concentration and proximity to competition, focusing on high-visibility stores in heavily trafficked retail areas. Management often proclaimed that "70% of the U.S. population lives within a 10-minute drive of a Blockbuster."[7] Stores were staffed primarily with part-time employees, averaging 10 staff members per store plus one manager. Occupancy and payroll represented a significant percentage of total costs.

Blockbuster outlets carried about 2,500 different titles per store. A substantial portion of the shelf space in a store was dedicated to hit movies, with the newest releases receiving the most prominent display. Locations typically acquired 100 copies of a new release, and they made up an estimated 75%–80% of demand compared to 20%–25% for catalog releases.[8] Consumers liked to rent new releases during the first three weeks of the studio distribution window.[a] After that, demand fell sharply. The studios protected this window because of the increasing share of revenues that they received from sales (see **Exhibit 2**). As rental demand for a particular title dropped, the stores remarketed used copies to reduce their inventory and generate additional income.

Blockbuster's business model depended on maximizing the days that a movie was out for rent. Stores were reluctant to stock large numbers of lesser-known and independent films, since the demand for these titles was inconsistent. With a relatively narrow selection of mostly familiar movies, customers could generally select a title with a limited amount of advice from the sales staff. Movies not returned to the renting location by the end of the specified rental period were subject to extended viewing fees, or "late fees." In 2004, these fees represented about 10% of revenues. Late fees also improved asset utilization by encouraging a timely return of each rented film, allowing it to be rented by another customer. Late returns led to increased levels of stockouts, costing Blockbuster incremental rental opportunities as well as reduced customer satisfaction.

The unit economics of retail video rental were straightforward. Blockbuster acquired approximately half of its rental inventory under a *purchase model* in which it would pay the studios $15–$18, rent it 9–10 times for $4 per rental, and then resell the DVD for an average of $8 per unit.[b] The other half was acquired under a *revenue share* model in which Blockbuster paid the studio about $5 per copy, rented it 9 times, and resold it for an average of $8, sharing 30% of the revenue with the studios.[9] The mix shifted to 81.8% revenue share by 2006.[10] One analyst estimated that Blockbuster spent $837 million on rental library purchases in 2003. Retail stores cost approximately $300K to set up, and it was estimated that they produced $900K sales per year with an operating profit of $162K.[11]

In 2002 Blockbuster enjoyed record levels of revenue and profitability, riding a wave of consumer DVD-player adoption, which increased from 24% to 37% of U.S. households in just one year. (**Exhibit 3** shows Blockbuster's income statement through 2006.) As consumers sought content for their new players, spending for in-home movie viewing reached $22.3 billion.[12] 2002 represented Blockbuster's fifth consecutive year of same-store sales growth, and the Blockbuster brand achieved nearly 100% recognition with active movie renters. That same year Netflix went public, and some would say that is when Blockbuster's troubles really started to get serious.

Netflix History

Hastings conceived of Netflix in 1997 after he discovered an overdue rental copy of *Apollo 13* in his closet. After paying the $40 late fee, Hastings, a successful entrepreneur who had already founded and sold a software business, began to consider alternative ways to provide a better home movie service. At the time, most movie rentals were VHS videocassettes, but Hastings had heard from a friend about the new DVD technology. DVDs were small and light, enabling inexpensive postal delivery. "I went out, bought a whole bunch of CDs and started mailing them to myself to see how quickly they would come back and what condition they would be in," he explained. "I waited for two days—and they all arrived in perfect condition. All the pieces started to fall into place after that."[13,14]

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[a] Motion picture studios made movies available for exhibition at different times depending on the distribution channel. Specific times were known as "release windows." The first distribution channel after theatrical release was home video on DVD and VHS. This window lasted 45 days, and excluded most other forms of non-theatrical movie distribution, such as pay-per-view, video-on-demand, premium television, basic cable, and network and syndicated television. Thereafter, movies were made available sequentially to television distribution channels.

[b] The company amortized the cost of its in-store rental library over periods ranging from 3 to 12 months, to an estimated residual value ranging from $2 to $5 per unit, depending on the product category.

Netflix's Early Days

Hastings founded Netflix in 1997, and launched the company's first website in early 1998. Netflix targeted early technology adopters who had recently purchased DVD players, offering cross-promotional programs with the manufacturers and sellers of DVD players, thus providing a source of content for customers. Hastings elaborated, "We were targeting people who just bought DVD players. At the time our goal was just to get our coupon in the box. We didn't have too much competition. The market was underserved, and stores didn't carry a wide selection of DVDs at the time."

Netflix's website included a search engine that allowed its customers to sort through its selections by title, actor, director, and genre. Using this search engine, customers built a list, called a "queue," of movies to be received from Netflix. Netflix sent movies to its subscribers based on the order of titles in the queue, with subscribers receiving a new movie as soon as the previous one was returned. The company initially used a pricing model similar to that offered by traditional video stores. Customers chose their films using the company's website, were charged $4 per movie rented plus a $2 shipping and handling charge, and were expected to return films by a specific due date or be charged extended rental fees.

Netflix's early strategy went beyond DVD rentals. While marketing a 2000 IPO, management described the company as the ultimate online destination for movie enthusiasts. Along with the DVD-by-mail service, Netflix was offering its recommendation system to everyone, including nonsubscribers, creating a Web portal rather than simply a subscription service. Hastings described this early strategy: "Our 2000 prospectus was spun towards things that were hot . . . it reflected a tension in our strategy. We would offer price comparisons, theater tickets. That strategic tension didn't resolve itself until the bubble crashed. That summer we realized we weren't going to make it unless we did it on rentals. . . . It was a cash-induced strategic focusing."

This focus was pushed along by the rapid adoption rate of DVD players among U.S. households, which followed the fastest technology adoption curve in history. U.S. household penetration, at 5% in 1999, leapt to 13% by 2000, 37% by 2002, and 65% by 2004, a pace that attracted the attention of channels like Best Buy and Wal-Mart, which discounted them extensively to drive store traffic. DVDs also began replacing VHS cassettes on the shelves of traditional video rental outlets. As DVDs became more widely available both for purchase and for rental, Netflix's value proposition to new DVD-player owners diminished. The company shelved its plans for an IPO and struggled through a large layoff as it began to adjust its business model in an effort to reach profitability. Chief among Hastings's concerns were the general customer dissatisfaction with Netflix's value proposition and the high cost of building a DVD library to support its growing subscriber base.

Feedback from early customers revealed a frustration with Netflix charging rental prices similar to competing retail locations, while providing slower delivery. Neil Hunt, the company's chief product officer, described Netflix's motivation for shifting to its popular no-late-fee subscription model in 1999:

> Pricing had been a discussion point for a long time. Our original model didn't work—we needed to overcome the shipping delay. It just wasn't a high-enough-value product to overcome the delivery waiting time. We spent a lot of money to market to and attract new customers, and they wouldn't be repeat renters. We were spending $100 to $200 to bring in a customer, and they would make one $4 rental. There was no residual value.

Moving to a Prepaid Subscription Service

Hastings believed that moving to a prepaid subscription service could provide better value to Netflix's customers and also turn its longer delivery times into an advantage. The first iteration of the subscription model allowed customers to have four movies in their possession at once and receive up to four new films each month. Hunt explained the effectiveness of the new pricing model: "We turned the disadvantage of delivery time into having a movie at home all the time. The value to Netflix of having our movies in the customers' homes at all times was our key insight."

Netflix soon changed its pricing system again, offering unlimited rentals for the first time. Subscribers could now keep three movies at a time and exchange them as frequently as they liked. Hunt explained the reasons behind this quick change:

> We made the observation that this change would dramatically simplify the program and make it easier to explain the service. It also allowed us to market a more compelling value proposition. The term "unlimited" is great marketing. . . . We had some vigorous debates about this, but in the end it was a leap of faith. The dot-com boom was still in full growth mode, and everyone around us was growing fast. It wasn't the time to do months of testing and analysis. We had to make some bets and not worry about getting it wrong. At that time, the ones who got it right would succeed, and the ones who got it wrong wouldn't be around.

With this change the company added a new group of fans for whom movie rentals were a regular part of their daily entertainment. Many of these customers were turned off by the high cost of paying for each movie rented, yet they still chose to rent from video stores because of limited alternatives. Others were dissatisfied with high late fees, which inhibited their ability to view movies at the times most convenient to them. If "movie night" was not an event but an ordinary form of entertainment, the option to hold movies beyond a two-day rental period was important. For these frequent viewers, Netflix's "all you can eat" model was an attractive alternative to the traditional per-day fee structure.

Subscription costs—the expense of acquiring movies for rent—were still a major burden. Hunt explained the impact that customer demand had on managing the cost of building their film library:

> We began struggling with a new problem. Half of the DVDs we were shipping out were brand new. We realized that we had to fix that. Top new releases received a lot of external marketing support and as a result had strong customer awareness and demand. Of course, those movies were the most expensive to acquire. . . . We couldn't just blindly promote movies that already had external demand generation. We needed to stimulate demand on the older and less-known movies and things already in our catalog. By marketing from the rest of the "tail" we could drive the average price down of building our catalog.

Developing The Proprietary Recommendation System

Netflix initially relied on traditional merchandising to complement its search engine and connect subscribers to the company's library of titles. A small number of employees highlighted different films on the website's home page each week, effectively providing the same recommendations to all subscribers. Hunt explained the consequence of this marketing technique:

> We started with a system that relied heavily on editorial content, but we realized that an editor could only write so many web pages. Five movies would be highlighted on the

> website, then everything that was promoted was instantly rented out. That changed to a different five movies each day of the week, and they were all still instantly rented out. We tried to improve the system to ensure that subscribers weren't referred to movies they had already rented. Eventually, we realized that the promotional value of writing the editorial blurbs was zero.

Realizing the inadequacy of the traditional merchandising system, Netflix engineers developed a proprietary recommendation system to better balance customer demand. Upon establishing a new account for the first time, customers took a short survey to identify their favorite movie genres and rate specific movie titles from one to five. Netflix's proprietary algorithm then used these survey results and the respective ratings of millions of similar customers to recommend films to its subscribers. The recommendations page not only included a list of titles with a ranking of how closely they matched the customer's preferences but also a synopsis of the film, a description of why the film was being recommended, and a collection of reviews from other subscribers. As customers rated each movie they saw, Netflix's software refined its understanding of customers' preferences and more accurately recommended movies that would appeal to each customer.[c]

Key to the success of Netflix's inventory management was a filter placed between the output of the recommendation system and the results shown to the subscriber, screening for those movies that were out of stock. The intent was to avoid frustrating a customer by recommending a title that was not immediately available, but a side benefit was that new releases were rarely on recommendation lists, as they were the most likely films to be in short supply. The system increased the utilization of Netflix's library of films by satisfying customers with movies already acquired and in stock, rather than requiring the purchase of more copies of newer films. Compared to traditional video rental outlets, where new releases would make up over 70% of total rentals, new releases represented less than 30% of Netflix's total rentals in 2006. Hunt explained the power of Netflix's recommendations:

> The recommendation system will pick the best movie for a customer, period. But it has to be something that can ship overnight. High-demand new releases are less visible because they are less frequently in stock. However, the customer benefits from this system. We have recognized improved customer satisfaction by eliminating the "bait and switch" perception. Most revealing about the value of the recommendations is that ratings are three-fourths of a star higher on recommended movies compared to new releases.

While the investment in software engineering was modest, this shift marked a cultural battle within the company with those who remained loyal to the traditional merchandising system. Hastings described his insistence on this change by highlighting another benefit: "A personalized experience is the benefit of the Internet. If you can otherwise do it offline, people won't pay for it online. If our Internet offering was going to be better than stores, we had to find something stores couldn't do well."

Movies were a taste-based product, for which many titles were consumed only once. As such, consumers needed to make a series of purchases without knowing for sure whether they would like the product. Netflix's website resonated with subscribers because they so frequently enjoyed the lesser-known films recommended to them that they might not have otherwise seen. The recommend-

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[c] In 2006 Netflix initiated a competition, the Netflix Prize, which offered $1 million for the best collaborative filtering algorithm to improve its recommendation system. Contestants had to predict viewer preferences in films based on previous ratings but no other consumer information. Netflix provided contestants with a training data set with over 100 million ratings from 480,189 viewers.

ation software established a relationship with customers that was not matched by part-time employees at a retail video store, nor easily replaceable if a customer switched to a competitor's service. Netflix's size and growth rate also enhanced the value of its collaborative filtering system, with its rapid growth in customer-generated ratings. Because it had the largest collection of movie ratings in the world, customers recognized that they were more likely to have their tastes and preferences accurately reflected in recommendations from Netflix's site than any other offered by a competitor.

Building the Movie Library

Even with the increased customer awareness of lower-profile films that Netflix's recommendation system generated, building the company's movie library still represented a major use of cash. As a small player in the video rental market, Netflix had no direct relationships with the major studios. It filled its film library through relationships with a small number of movie distributors, at prices that reflected minimal discounts. Up-front costs forced Netflix to choose carefully when stocking new films and often resulted in fewer than the desired number of copies of a title being acquired. As a result, one of the major sources of customer dissatisfaction was the inability to rent new releases in a timely manner. Netflix took steps to address this by hiring Ted Sarandos as chief content officer to manage content acquisition. Sarandos, who had been with Video City, a major U.S. video rental chain, joined Netflix in May 2000 and led the company's transition to revenue-sharing agreements with the major studios. He recalled:

> We were handicapped with vendors when I first arrived because other Internet vendors at the time had not been successful. As a pure rental business that was 100% subscription-based and 100% Internet-based, we were reinventing the wheel on three dimensions for the studios. However, it is very much a relationship business, working with the studios, and I had worked with those people all of my career, so I managed to bring my relationships with me from my prior company. Within a year, Netflix had negotiated direct revenue-sharing agreements with nearly all the major studios.

Rather than pay an up-front price of $18–$20 per DVD, the studios would reduce their unit up-front price in return for a fee based on the title's total number of rentals for a given period of time. Hastings described this transition with the company's suppliers: "We spent more money, not less, with the studios but got bigger customer satisfaction. It was like paying 20% more and getting two times the number of copies."

The benefit of the new relationships with the studios extended beyond lowering the acquisition costs for new releases. Early on Hastings had recognized the number of customers who were frustrated with the poor selection offered at many video stores, where shelf space was focused on hit movies and new releases. Customers interested in exploring a broader range of movie titles were left unsatisfied by their options. Sarandos explained: "The thing that Reed and I connected on before I even joined Netflix was the promise of a business model that promoted lesser-known movies. Films outside of the top 20 are not distributed widely. If you didn't see a movie within six months of when it was in the theaters, it often disappeared forever."

The use of a national inventory allowed Netflix to satisfy the diverse demands of movie watchers, serving the same number of customers as a local network of Blockbuster retail locations with far fewer copies of a given movie title. Sarandos explained the difference in economics:

> Half the equation of packaged media is allocation—getting the right amount of product in the right locations. This was more of a challenge for products that did not

enjoy broad promotion. The trade radius of a single video store was so small that even a single copy of a lesser-known film had lousy economics. By using a national inventory, we avoid that issue. We never have overstocks on one side of town with understocks on the other side. Using the subscribers' queues provides a great deal of data. By looking into the demand in the near future, we can replicate near-perfect inventory. Overall, we can satisfy demand in an area with about one-third to one-fifth of the inventory needed by a retail chain.

Distribution and Delivery

In the summer of 2001, Netflix operated out of a single distribution center in Sunnyvale, California. While several years of operations had allowed for improvements in this center, the majority of the country was still not able to enjoy next-day delivery of their rented movies. These extended delivery times were a barrier for Netflix in attracting and retaining customers in those regions. Hastings explained: "Post office variability was long on cross-country mail. . . . It essentially meant one-week delivery times. So in the summer of 2001, we realized that regions with overnight delivery were being disproportionately successful. We tested the theory by upgrading Sacramento. The numbers popped quickly."

Netflix's Sunnyvale distribution center could serve the San Francisco Bay Area with overnight delivery. But while outbound mail from Sunnyvale could reach Sacramento overnight, returns often took several days. Netflix tested Sacramento by arranging with the U.S. Postal Service (USPS) to intercept returns at a Sacramento mail-sort center and then truck them to Sunnyvale. This would shorten the turnaround dramatically. "As we added centers in Boston, New York, and D.C., they started performing like the Bay Area," Hastings said.

Armed with this evidence of success, Netflix quickly opened more distribution centers across the country, and subscriber numbers continued to respond to the improved delivery service. The company promised 500,000 subscribers to its investors in its 2002 prospectus, and delivered 700,000 at the time of its May 2002 IPO. The changes in Netflix's pricing and cost structure allowed the company to reach profitability for the first time in the quarter ending June 2003. After establishing the viability of its new business model, Netflix continued to build its subscriber base and upgrade the customer experience by opening new centers. The centers themselves were inexpensive investments: it cost about $60,000 to convert an existing warehouse to Netflix's needs. The company continually added centers to improve on its nationwide coverage and reduce delivery time to its customers. With the number of distribution centers reaching 58 by early 2009, most of Netflix's 10.6 million subscribers could be reached within one delivery day.[15,16] Next-day delivery to more regions of the country allowed it to compete more successfully with retail video stores for new customers drawn by all three of the characteristics Netflix aimed for—convenience, value, and selection.

Netflix considered delivery time to be the key measure of customer satisfaction and continually sought to improve the operations within each of its existing distribution centers. Much of the process of opening return envelopes and filling outgoing mailers with DVDs was still performed manually. However, with careful hiring practices and thorough time and motion studies, Netflix's employees could open and re-stuff an average of 800 DVDs per hour, allowing the entire distribution center network to ship over 1.6 million DVDs per day. (See **Exhibit 4** for photos of the distribution center operations.)

Netflix's relationship with the USPS grew. While the USPS was facing a general decline in first-class mail, Netflix represented its fastest-growing first-class customer. Along with receiving the standard discount for presorting its outbound envelopes by zip code, Netflix worked with the USPS to reduce the time it took to receive a movie return. Rather than deliver returns to the distribution center of origin, the USPS brought the easily recognizable red Netflix envelopes to the closest Netflix distribution center.

Growing Content Acquisition

As the company added subscribers, content acquisition continued to grow in importance for Netflix. Sarandos explained:

> For a technology company like Netflix, we are the group that is most dependent on art. What we do is probably 70% science, 30% art. Our buying staff has to have their finger on the pulse of the market to make their decisions. A high box-office performer won't necessarily be a high video performer, and vice versa. The box office is an indicator, as a proxy for awareness, but not for demand. . . . If rental demand for a title is lower than we forecast, it is a tax on the overall economics of Netflix's model. Even with the benefit of profit sharing, it is a margin eroder. If we underforecast demand, the problem is correctable, but it takes time.

As Netflix built its film library, it grew in importance as a distribution channel for many small and independent film studios. For lower-profile and independent films that did not enjoy the advertising support of major releases, generating customer awareness was a major priority. As Netflix became known as the best source for lesser-known movies, the studios began to look on this partnership with increasing favor. Sarandos explained:

> It wasn't all about fulfilling demand for mainstream videos. We were also providing the studios large markets for their films that they were having trouble reaching. And for the independent films, Netflix can be the dominant channel, representing between 60% and 75% of the earnings for some films. At Netflix, a lesser-known film can really succeed on its merits.
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> *Hotel Rwanda*, the Don Cheadle film about the genocide in Rwanda, is an excellent example. It enjoyed some box-office sales, but generally it was a difficult topic and a difficult film to market, with a low viewership. At Netflix, however, it is our fourth-most-rented film. The rest of the top 10 are movies you would expect, but there is this wonderful independent film right there at number four. More people have seen it at Netflix than at the box office.

In 2006, Netflix evolved from its *de facto* marketing efforts and began acquiring the distribution rights to certain independent films through its Red Envelope Entertainment subsidiary. Sarandos, who led this initiative, explained the shift in strategy:

> Red Envelope Entertainment is 90% about content acquisition. While we do distribute films in other channels, including retail and other video stores, we did this to bring more excellent movies to DVD. Of the 100 films that are featured at a festival such as Sundance, only 10 will make it to DVD. We are looking through the other 90 films for top-tier content to bring to our customers.

By helping to bring high-potential films to market, Netflix hoped to enhance its reputation as the highest-quality source of independent films, an attribute that contributed to its popularity.

Customer Retention

Like many other subscription-based services, customer churn was a critical issue for Netflix. In an average month in 2002, 6.3% of customers canceled their subscriptions. Although that churn rate had been reduced to 3.6% by 2006, it was still a drag on profitability. Because customer acquisition was a major expense, retaining existing customers and reclaiming old ones who had previously unsubscribed were key opportunities.

Originally, customers wishing to unsubscribe had to deal with a salesperson by phone, who attempted to convince the customer to retain his or her account. In 2002, the company changed its approach completely. Customers could unsubscribe online from Netflix as easily as they had been able to join. The only request was that they complete a brief survey explaining why they left. Hastings believed it was more fruitful to encourage departing customers to return later than to try to coerce unwilling customers to stay: "We were on the AOL style of it being really hard to cancel our service. We realized, 'This is stupid. It's a false savings.' We turned it off, enabling the customer to unsubscribe on the website. We had a 30-day burst of churn, but we are convinced that it led to return visitors."

Instead of making Netflix a difficult service to leave, Hastings wanted to make it a service that former customers would return to. Customers appreciated the personalized aspect of Netflix's service, a dimension that the company continued to improve. The proprietary recommendation system grew more accurate in predicting a user's taste as the number of films rated by a subscriber increased. Hastings also emphasized the role of the customer's queue as a major retention tool: "Our explicit strategy is to invest in things that are strategically relevant to customer satisfaction potential. The key invention behind our subscription model is the queue. Our average queue length is 50 movies. It turned out to be an amazing invention. It's our biggest switching cost."

Just as importantly, a customer's profile was maintained if they left Netflix. If the customer were to return, everything was already in place, as if they had never left. Hastings found that growing the business in the face of a high churn rate was easier if many lost customers eventually returned.

Blockbuster Responds

Early public statements by Blockbuster dismissed the notion that its customers would benefit from an online rental business. In May 2002, a spokesperson addressed the online rental market: "Obviously, we pay attention to any way people are getting home entertainment. We always look at all those things. We have not seen a business model that's financially viable long-term in this arena. Online rental services are 'serving a niche market.'"[17]

Three months later, clarifying that Blockbuster did not intend to launch an online business to compete with Netflix, a spokesperson announced, "We don't believe there is enough of a demand for mail order—it's not a sustainable business model."[18] Not until 2003 did Blockbuster's management publicly discuss Netflix by name as a threat to their core business model.

Blockbuster finally responded with the introduction of Blockbuster Online in 2004. The service closely matched Netflix's business model and offered subscribers a far larger selection of movies than was available in stores. Hastings characterized Blockbuster's entry as a "land grab," undercutting Netflix's pricing in an aggressive effort to recover lost market share (see **Exhibit 5**). Blockbuster also tried to improve the performance of its service and distinguish itself from Netflix by integrating its online offering with its traditional store-based business. By using cross-promotions, giving in-store rental coupons to online customers, and stocking online rental requests out of its store inventory, Blockbuster sought to productively use its existing resources and improve value for its customers. In 2006 it introduced Blockbuster Total Access, which allowed customers to exchange DVDs by mail or in a store. By year-end Blockbuster Online had grown to 2.2 million members, although according to the company's annual report, Blockbuster Online still required meaningful advertising support and continued to suffer from "significant" operating losses.[19] In the words of Hastings in 2005, "We're just thankful Blockbuster didn't enter four years ago."[20]

Blockbuster also unveiled its "no late fees" program, effective at all of its stores on January 1, 2005. It felt that its competitors, most importantly Netflix, were differentiating their business offerings from Blockbuster's by the absence of late fees. This change in business strategy came with a cost. In addition to $60 million of marketing and implementation costs, Blockbuster had to forgo about $600 million of revenue annually from late fees. While early signs suggested this program resulted in increased traffic and rental volumes, it did not offset the loss of revenue as its base movie rental revenue grew only 5%. By 2009, *U.S. News & World Report* described Blockbuster as one of 15 companies that might not survive 2009: "The video-rental chain has burned cash while trying to figure out how to maximize fees without alienating customers."[21] Indeed, the company filed for reorganization under Chapter 11 of the U.S. bankruptcy code in 2010. It was ultimately acquired by DISH Network.

Video Over the Internet

During Netflix's rise, industry observers pointed to video-on-demand (VOD) as the "next big thing." VOD was viewed as the marriage of pay-per-view programming combined with Internet downloading of entertainment, including movies and TV shows. The expectation was that viewers would search through a vast library of movies online and then watch a film on their TV set in a full-screen, DVD-quality format. The increasing popularity of content delivery methods such as high-definition pay-per-view and streaming Internet video, as well as the participation of well-funded players in the media industry, suggested that a VOD service fully integrating personal computers and television was not a question of "if" but "when."

VOD Competition

By early 2007, the VOD market had already attracted multiple competitors with approaches that spanned the three delivery channels. Stand-alone online VOD services included Vongo, launched by the Starz subscription cable channel, and CinemaNow, a venture formed by Lionsgate, Microsoft, and Cisco that offered a few thousand titles from major studios. Depending on price, customers were able to rent movies for a limited time, purchase them for viewing on a limited number of devices, or even burn them directly to a DVD.

Other participants relied on a set-top box to bypass the computer and bring films directly to the user's television. Walt Disney offered MovieBeam and included Intel and Cisco as major investors. Customers purchased a set-top box and paid per movie viewed, choosing among a limited but regularly refreshed selection of films. In early 2007, Movie Gallery Inc., the second-largest video rental chain in the U.S, acquired MovieBeam.

Traditional cable and satellite providers also started to offer on-demand delivery. They already had a large share of use of the television set and did not require the user to purchase new equipment. Cable and satellite providers offered an expanded and more flexible pay-per-view system, providing high-definition on-demand programming and a growing number of "free" offerings included as part of the regular monthly fee.

All of these services had two primary limitations to broader appeal: technology and content availability. VOD was perceived as limited until hardware to connect a user's computer to their television was more widely available. With the increasing adoption of big-screen, high-definition TVs, consumers were unwilling to pay equivalent prices for movies that could only be viewed on their computers.

Even more limiting was content availability. Concern about pirated downloads and a lack of urgency to supplant their profitable DVD sales made studios reluctant to offer much content to VOD websites. Hastings described the U.S. rights of physical media and the consequences they had on the studio's cooperation with online video distribution: "U.S. laws enable anyone to buy a DVD and rent it as many times as they want. We can go to Wal-Mart, buy DVDs, and place them in our rental library. We don't need a license from the content owner to do so. Online content doesn't work like that. You have to negotiate the distribution rights with the studios. We're dealing with the same problem as everyone else."

Hunt concurred with his analysis:

> A member of the public can purchase a DVD for $20 at Wal-Mart, but most people are not prepared to pay $20 and watch a movie only once. They want to pay $1 per hour of viewing, not $10, and the physical media rights allow us to rent for that. . . . This does not hold in an electronic media market. Without the rights for an external party to rent their content, studios believe the proper price for their content is $20 per viewing, even for a rental. Therefore, online content is limited to older or less popular films that have a limited sell-through market that we can get more cheaply.

The Transition to Streaming Video at Netflix

We are in a new race, and we are a player [along] with some very large and substantial firms.

— Reed Hastings[22]

Throughout the company's history, Hastings had repeatedly stated that Netflix's purpose was not to provide DVD rentals through the Internet but rather to allow for the best home video viewing for its customers. In a 2003 interview, Hastings said, "Our hope is that we'll eventually be able to download more movies. It's why we named the business Netflix and not DVD-by-Mail." The company signaled its plans to offer VOD services as early as 2001. Hastings's attitude revealed his belief that Netflix could address this growth opportunity early on. Rather than viewing VOD as an option that could appeal only to a niche customer set, he saw the benefits it could provide to the mass market.

The streaming service was launched as an adjunct to the company's core DVD-by-mail offering. The rationale was to take advantage of Netflix's existing strengths, including its brand, its recommendation system, and its large subscription base of online customers. By offering the streaming feature at minimal additional cost as a "View Instantly" option, it could build its market position simply by continuing to grow its existing business. Hastings believed that leveraging Netflix's existing brand and market share was the only way to differentiate his business from the stand-alone sites such as Vongo and MovieLink. Without a clear link between the streaming offering and the traditional DVD rental business, Netflix's offering would have no advantage over those of its start-up competitors.

Netflix saw several keys to success for its streaming service, including content, user personalization, TV attachment, and streaming infrastructure.

Great content When Netflix first launched streaming, competitors like Apple and Amazon had relatively few titles for their services. Streaming content had to be licensed, often via an arduous negotiation. Initially the company struck small deals for niche films. Netflix's first breakthrough streaming deal was with Starz Entertainment in 2008. This brought 2,500 titles from Walt Disney Studios and Sony Pictures—including *Spider-Man 3*, *Ratatouille*, *No Country for Old Men*, and *Superbad*—to its Watch Instantly library.[23]

Streaming content was not subject to the first-sale doctrine, which had enabled the economic model for DVD rentals;[d] rather, a royalty was owed for every use of the work. This not only made the operating expense model different, it also raised the entry cost, Hastings explained:

> We have to license a large set of content for a relatively large amount of dollars just to launch, to be able to have enough content to attract members. Then we have to market hard, then we build the subscriber base . . . But that also means there are barriers to other people doing the same thing. It's a double-edged sword, it's expensive for us to build a big market, but it's also expensive for someone to compete with us.[24]

In 2010, Netflix signed a five-year deal worth nearly $1 billion to stream movies from Paramount, Lionsgate, and MGM. As it became more successful, the licensing costs increased dramatically. Competitors like Apple and Amazon were also very experienced at striking licensing deals, so the question was how the company could sustain differentiation. This led to the idea of developing original content, a technique that cable channels had used effectively to differentiate themselves. Hastings explained:

> I have to say [it was] my colleague Ted Sarandos who really drove that. He's been in the content business his whole life. He said, "Look at HBO, we've got to do this, we can do it better." And I'm like, you know . . . "We mail DVDs, Ted." You know, what do we know? And he said, "Well, you don't know anything, but I know some stuff about this." And I said, "Okay, let's try it." And he picked *House of Cards* as his first thing.[25]

The success of *House of Cards* led Netflix to increase its investments in original content. Hastings quickly changed his tune:

> The originals are going to be just amazing. When season four of "Arrested Development" hits and it's exclusive anywhere in the world on Netflix, that's going to help us build the message that Netflix is one of the entertainment services that everyone wants.[26]

Personalization and user experience The company's goal was to leverage its existing user experience and extend it so that streaming content would play well on whatever device the consumer was using. Members could continue to take advantage of Netflix's considerable investments in its recommendation system to find relevant entertainment.

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[d] The first-sale doctrine limited the rights of a copyright owner under U.S. copyright and trademark law. Under 17 U.S.C. 106(3), the copyright owner had exclusive rights "to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending." However, once a copy of the work was sold, the copyright owner's rights were "exhausted," and the purchaser had the right to resell, rent, give away, or destroy it.

TV attachment and device penetration Netflix recognized that its subscribers enjoyed watching rental DVDs on TV sets, but most streaming services targeted viewing on computers. It mounted an aggressive campaign to create a bridge from the Internet to the TV set, working with Roku to develop the Roku DVP, which was announced in May 2008. This device connected a home Internet router to the composite S-Video or component video inputs on a TV and allowed Netflix programs to be watched on the TV. The company also negotiated a deal with Microsoft to put its service on the Xbox game console system, following the insight that gamers were already connected to both the TV and the Internet. Netflix then embarked on an ambitious campaign to be included in other game console systems and new breeds of Internet-connected TVs from Samsung and others. As mobile devices like the iPad and iPhone became increasingly popular for Internet access, Netflix was quick to make its service available on them as well.

Streaming infrastructure Netflix started out building its own streaming infrastructure. It already had a large IT operation with its member website and DVD distribution operations, but streaming had a wholly different character because of the large amounts of data serving. Scaling promised to be a challenge as the number of streaming customers increased rapidly. In August 2008, the company experienced a database corruption problem. "For a few days we had problems shipping discs to our DVD customers," explained Yuri Izrailevsky, VP of cloud and platform engineering. "At that time we realized that going forward what we really needed was a more fault tolerant system that wouldn't be privy to failures like this."[27] In 2009 Netflix migrated its transcoding[e] applications to Amazon Web Services (AWS), and then in 2010 it migrated the streaming application there as well. This enabled it to launch the Netflix streaming service on the iPhone in 2010. Using cloud infrastructure facilitated rapid scaling and international expansion. Netflix became the largest source of traffic on the Internet, and by early 2011 the company reported a significant milestone. As it stated in its February 2011 10-K:

> In 2010, we passed a significant milestone with the majority of our subscribers viewing more of their TV shows and movies via streaming than by DVD. Going forward, we expect we will be primarily a global streaming business, with the added feature of DVDs-by-mail in the U.S. We believe delivery of entertainment video over the Internet will be a very large global market opportunity, and that our focus on one segment of that market—consumer-paid, commercial-free streaming subscription of TV shows and movies—will enable us to continue to grow rapidly and profitably.[28]

The rapid growth of streaming relative to DVD-by-mail was the genesis for the split that Hastings announced in September 2011. But the customer backlash and subsequent public backtracking presented Hastings with fresh challenges. How could he manage the transition from one business model to another? Did Netflix have the wherewithal to compete against deep-pocketed competitors like Amazon, which was the company's key infrastructure provider for its streaming service?

In January 2005, Wedbush Securities analyst Michael Pachter had called Netflix a "worthless piece of crap."[29] Reflecting on that comment a few years later, Hastings remarked, "I think it is healthy to have smart people make a number of negative arguments about Netflix. It sharpens our thinking."[30] Hastings was going to need plenty of sharp thinking to figure out how to balance the two very different business models going forward.

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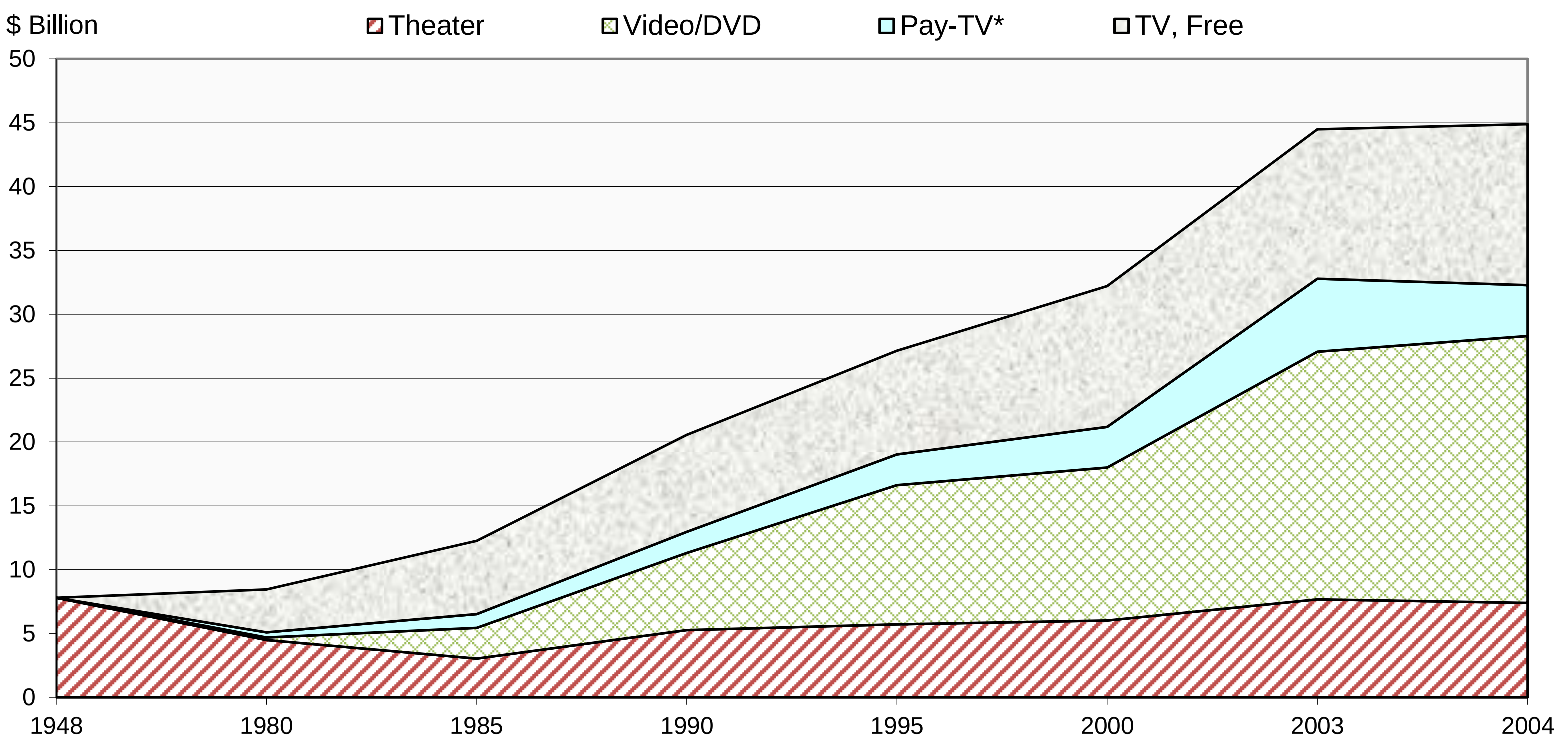
[e] Transcoding was the process of converting one (file movie) format to another. It was often used to alter a movie to play on a different device, such as a tablet or smartphone.

Exhibit 1 Netflix Income Statement

($ millions)	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Revenue	-	1.3	5.0	35.9	75.9	152.8	270.4	500.6	682.2	996.7	1,205.3	1,364.7	1,670.3	2,162.6
Cost Of Goods Sold	-	1.3	7.4	37.4	63.9	98.6	180.4	331.7	465.8	627.0	786.2	910.2	1,079.3	1,357.4
Gross Profit	**-**	**0.0**	**(2.4)**	**(1.5)**	**12.0**	**54.2**	**90.1**	**168.9**	**216.4**	**369.7**	**419.2**	**454.4**	**591.0**	**805.3**
Selling General & Admin Exp.	0.8	6.2	19.0	36.4	29.5	47.3	64.9	122.6	171.9	261.4	270.6	249.4	286.6	358.3
Stock-Based Compensation	-	1.2	-	-	-	-	-	-	-	-	-	-	-	-
R & D Exp.	0.3	3.9	8.6	19.7	19.6	17.6	21.9	29.5	35.4	47.8	71.0	89.9	114.5	163.3
Other Operating Expense/(Income)	-	-	-	-	-	-	(1.2)	(2.6)	(2.0)	(4.8)	(7.2)	(6.3)	-	-
Other Operating Exp., Total	**1.1**	**11.2**	**27.6**	**56.0**	**49.1**	**64.9**	**85.6**	**149.5**	**205.3**	**304.5**	**334.4**	**332.9**	**401.2**	**521.6**
Operating Income	**(1.1)**	**(11.2)**	**(30.0)**	**(57.6)**	**(37.1)**	**(10.7)**	**4.5**	**19.4**	**11.1**	**65.2**	**84.8**	**121.5**	**189.8**	**283.6**
Net Interest Exp.	**0**	**0**	**0.2**	**0.2**	**(1.4)**	**0.4**	**5.3**	**2.4**	**5.8**	**14.8**	**18.5**	**6.7**	**(1.6)**	**(15.9)**
Other Non-Operating Inc. (Exp.)	0.0	0.1	-	-	-	-	(3.3)	-	(0.5)	(0.1)	0	0.1	-	-
EBT Excl. Unusual Items	**(1.1)**	**(11.1)**	**(29.8)**	**(57.4)**	**(38.5)**	**(10.2)**	**6.5**	**21.8**	**16.4**	**79.9**	**103.2**	**128.4**	**188.2**	**267.7**
EBT Incl. Unusual Items	**(1.1)**	**(11.1)**	**(29.8)**	**(57.4)**	**(39.2)**	**(20.9)**	**6.5**	**21.8**	**8.3**	**79.9**	**110.9**	**131.5**	**192.2**	**267.7**
Income Tax Expense	-	-	-	-	-	-	-	0.2	(33.7)	31.1	44.3	48.5	76.3	106.8
Net Income	**(1.1)**	**(11.1)**	**(29.8)**	**(57.4)**	**(39.2)**	**(20.9)**	**6.5**	**21.6**	**42.0**	**48.8**	**66.6**	**83.0**	**115.9**	**160.9**

Source: Adapted by casewriter from Capital IQ, https://www.capitaliq.com/CIQDotNet/Financial/IncomeStatement.aspx?CompanyId=32012&statekey=c009d36820f54b51b68a1de383cdea23.

Exhibit 2 Motion Picture Studio Revenue Share by Release Windows



Source: Adapted by casewriter from "Hollywood-By-The-(Secret)-MPA Numbers," http://edwardjayepstein.com/mpa2004.htm, accessed July 15, 2014.

Exhibit 3 Blockbuster Inc. Income Statement

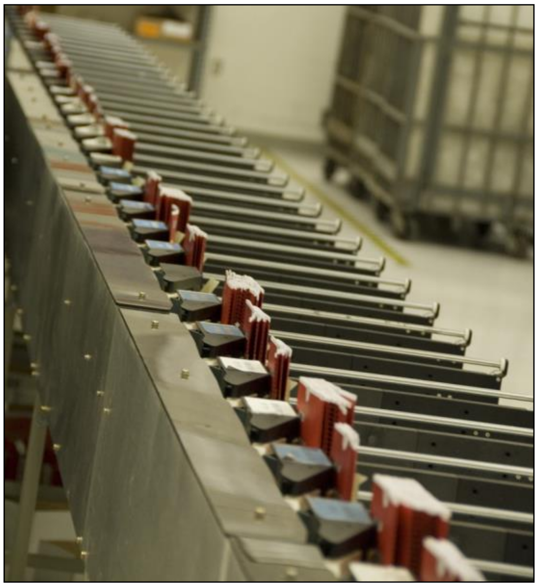
($ millions)	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Revenue	**2,942.1**	**3,313.6**	**3,893.4**	**4,463.5**	**4,960.1**	**5,156.7**	**5,565.9**	**5,911.7**	**5,932.5**	**5,721.8**	**5,522.2**
Cost Of Goods Sold	1,013.7	1,360.5	1,956.4	1,762.5	2,036.0	2,224.8	2,358.7	2,389.8	2,378.7	2,561.0	2,481.0
Gross Profit	**1,928.4**	**1,953.1**	**1,937.0**	**2,701.0**	**2,924.1**	**2,931.9**	**3,207.2**	**3,521.9**	**3,553.8**	**3,160.8**	**3,041.2**
Selling General & Admin Exp.	1,278.9	1,753.2	1,913.3	2,187.0	2,391.0	2,477.4	2,618.7	2,785.3	3,042.5	2,964.9	2,728.9
R & D Exp.	-	-	-	-	-	-	-	-	-	-	-
Depreciation & Amort.	165.5	208.7	212.7	220.5	247.4	244.0	239.1	268.4	247.3	224.3	210.9
Amort. of Goodwill and Intangibles	166.2	168.7	170.2	171.8	180.1	177.1	1.7	-	-	-	-
Other Operating Expense/(Income)	-	-	-	-	-	-	-	-	-	-	-
Other Operating Exp., Total	**1,610.6**	**2,130.6**	**2,296.2**	**2,579.3**	**2,818.5**	**2,898.5**	**2,859.5**	**3,053.7**	**3,289.8**	**3,189.2**	**2,939.8**
Operating Income	**317.8**	**(177.5)**	**(359.2)**	**121.7**	**105.6**	**33.4**	**347.7**	**468.2**	**264.0**	**(28.4)**	**101.4**
Net Interest Exp.	**(18.4)**	**(27.1)**	**(23.7)**	**(116.1)**	**(109.2)**	**(72.1)**	**(45.4)**	**(30.0)**	**(34.5)**	**(94.6)**	**(91.7)**
Income/(Loss) from Affiliates	(4.0)	(18.9)	(1.3)	(2.8)	1.3	0.5	(2.2)	(0.7)	-	-	-
Currency Exchange Gains (Loss)	-	8.0	-	-	-	-	-	-	-	-	4.4
Other Non-Operating Inc. (Exp.)	-	(0.5)	(1.3)	(0.2)	1.7	(1.0)	2.9	(0.4)	1.6	(4.2)	1.0
EBT Excl. Unusual Items	**295.4**	**(216.0)**	**(385.5)**	**2.6**	**(0.6)**	**(39.2)**	**303.0**	**437.1**	**231.1**	**(127.2)**	**15.1**
Restructuring Charges	(50.2)	(45.1)	-	-	-	(225.4)	-	-	-	-	(18.2)
Merger & Related Restruct. Charges	-	-	-	-	-	-	-	-	(2.9)	(12.6)	-
Impairment of Goodwill	-	-	-	-	-	-	-	(1,304.9)	(1,502.7)	(341.9)	(5.1)
Gain (Loss) On Sale Of Invest.	-	(27.1)	(10.5)	-	-	(4.2)	-	-	-	-	-
Gain (Loss) On Sale Of Assets	-	-	-	-	1.7	-	-	-	-	-	-
Asset Writedown	-	-	-	-	(31.6)	-	-	-	-	-	(9.0)
Insurance Settlements	-	-	-	-	-	-	-	-	-	-	4.5
Legal Settlements	-	-	-	-	-	(27.6)	-	-	-	-	-
Other Unusual Items	-	-	-	-	-	-	-	-	-	-	-
EBT Incl. Unusual Items	**245.2**	**(288.2)**	**(396.0)**	**2.6**	**(30.5)**	**(296.4)**	**303.0**	**(867.8)**	**(1,274.5)**	**(481.7)**	**(12.7)**
Income Tax Expense	167.4	30.0	(59.4)	71.8	45.4	(56.1)	107.1	106.5	(20.8)	62.4	(76.4)
Earnings from Cont. Ops.	**77.8**	**(318.2)**	**(336.6)**	**(69.2)**	**(75.9)**	**(240.3)**	**195.9**	**(974.3)**	**(1,253.7)**	**(544.1)**	**63.7**
Earnings of Discontinued Ops.	-	-	-	-	-	-	-	-	4.9	(39.8)	(13.2)
Extraord. Item & Account. Change	-	-	-	-	-	-	(1,817.0)	(4.4)	-	-	-
Net Income to Company	**77.8**	**(318.2)**	**(336.6)**	**(69.2)**	**(75.9)**	**(240.3)**	**(1,621.1)**	**(978.7)**	**(1,248.8)**	**(583.9)**	**50.5**

Source: Adapted by casewriter from Capital IQ.

Note: This data was composed of restated figures from BB Liquidating Inc., the successor to Blockbuster Inc. During the third quarter of 2004, the company recognized non-cash charges of $1.50 billion to impair goodwill in accordance with SFAS No. 142, Goodwill and Other Intangible Assets ("SFAS 142"), related to worse-than-anticipated revenues in its core rental business, which it attributed to increased competition from retail DVD and discounted retail DVD pricing by mass merchants. These trends also indicated that the strength of rental revenues in the fourth quarter had been and would continue to be negatively affected by consumers purchasing DVDs during the holiday season. Additional risks included implementation risks associated with its new online initiatives and risks associated with certain international operations, such as increased competition, two-tiered pricing, and piracy.

Exhibit 4 Netflix Sunnyvale, California, Distribution Center

Automated Sorter for Outbound Envelopes



Movie Archives

"Relabeling" Station

Repackaging DVDs for Resale

Source: Casewriter.

Exhibit 5 Chronology of Netflix and Blockbuster Service Offerings

Date	Netflix	Blockbuster	Notes
4/15/2004	$21.99 per month subscription, three movies out at a time, unlimited rentals.		Netflix raised its price from the previous $19.99 offering.
8/11/2004		$19.99 per month subscription, three movies out at a time, unlimited rentals plus two in-store rental coupons; included free DVD upon sign-up for trial period.	
10/14/2004	$17.99 per month subscription, three movies out at a time, unlimited rentals.		Netflix lowered price in anticipation of market entry by Amazon.
10/18/2004		$17.49 per month, three rentals out at a time.	Blockbuster competitive response to Netflix move.
12/22/2004		$14.99 per month Free DVD eliminated.	

Source: Adapted by casewriter from Anthony DiClemente, "Playing a New Game—A Guide to the Future of Home Video; Initiation of Coverage," Lehman Brothers Global Equity Research, January 18, 2005.

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