Netflix: Past, Present, and Future Innovation

Entrepreneurship & Innovation Strategy: Section #2

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Introduction

Netflix is an interesting company because it sits in an ever-changing ecosystem populated by old and new economy players. On one side, you have movie and TV studios that produce feature-length movies and serialized TV shows that are, in many ways, identical to the movies and TV shows that were produced when the medium was invented. On the other side, you have a rapidly-evolving set of computer-enabled devices and data transmission systems that allow consumers to access the studios media content in virtually any location with a power source and a fast Wifi connection. As a distributor, Netflix has been forced to evolve with these changes, and changes in content consumption methods have had a major impact on the home entertainment ecosystem and the profitability and power of the players involved.

The paper is organized into three sections. The first section investigates the circumstances and decisions that helped Netflix launch successfully in 1998. The second section looks at Netflix’s approach to and experience in the internet video streaming business. These sections were selected because they offer rich case studies on entering and managing an evolving ecosystem. The final section considers the future of the Company and the steps that they can take to increase value capture in the future.

Phase I: Building the DVD-By-Mail Business

Netflix’s corporate creation myth starts with, allegedly, a story about CEO Reed Hastings paying a $40 late fee to a Santa Cruz video store after renting popular movie Apollo 13. The real story is much simpler: Hasting’s co-founder Marc Randolph looked at the migration of commerce from offline to online and felt like there was a way to make a business renting movies through the web. Randolph, who worked with Hastings at software maker Pure Atria, was fascinated by data-driven marketing like direct mail and saw the internet as conduit to get more marketing data faster. When Randolph tells the creation story, he argues that the real “Eureka” moment was when he and Hastings realized that they could mail CDs through the US Postal Service without damaging the disks. This paved the way for the DVD rental-by-mail business that put Netflix on the map. Randolph began serious work on Netflix in the summer of 1997 after Pure Atria was sold. At the time, the video rental market was dominated by Blockbuster and a handful of other players who were focused entirely on renting VHS titles. In the following years, Netflix would make a series of smart – and lucky – decisions that allowed them to become the dominant company in the video rental industry. The first critical move was partnering with DVD player manufacturers to drive consumer interest in the new media format. By forming these partnerships, Netflix reduced the adoption chain risk that the manufacturers were facing, and it provided Netflix with great visibility. The second critical move was how Netflix approached the studios and positioned their service as a market enhancing proposition to the studios. Finally, by luck and some good fortune, Netflix entered the market when the ecosystem was ready for them and their risks were limited to internal execution risk.
Adoption of DVDs

While their business plan called for renting DVDs by mail, the success of the DVD player was far from a sure thing in mid-1997. At the time the format was brand new – only 110,000 machines would sell in the first six months of 1997 – and the technology faced an uphill battle to unseat the much larger VHS tape technology. As late as 2002, retailers like Circuit City were criticized for dropping their inventory of VHS tapes, even though the dollar volume of DVD sales had finally exceeded that of VHS sales that very same year. Part of the reason for the technology’s slow adoption was the cost; most machines cost over $1,000 in 1997. Studios were also slow to convert to DVD, which meant that content libraries were very limited.

While Netflix would have struggled to find any customers in 1997, it did realize that the Company’s success would depend on the success of the entire DVD market. One of the Company’s key early decisions was to partner with DVD manufacturers. Netflix gave the manufacturers coupons to include in the boxes that contained the manufacturers’ DVD players. The coupons entitled customers to ten free rentals from Netflix. Netflix’s first target was Sony. While Sony rebuffed the Company initially, Netflix found willing partners in Toshiba, and, eventually, Sony. Netflix also extended these partnerships to include computer makers Apple and Hewlett-Packard, who had started to manufacture computers that included built-in DVD players. These promotions were critical drivers of early traffic to the Netflix site. The Company was able to secure these deals because Netflix’s small but growing library of titles limited the adoption chain risk that manufacturers faced in selling DVDs. At the time, the home video market was dominated by the rental providers, and their nearly ubiquitous stores ensured easy access to a wide range of titles. Blockbuster and peer Hollywood Video saw the DVD as a costly threat to their VHS-centered model, and they refused to stock the format on the shelves in their stores. By providing a centralized source of titles, Netflix offered consumers an alternative source of content, which made the purchase decision easier.

Partnership with Content Creators

The second critical decision that Netflix made was in its content acquisition strategy. At the time of Netflix’s launch, the movie studios were growing increasingly frustrated by the size and power of dominant rental chain, Blockbuster. In home entertainment, studios made the bulk of their profits from selling DVDs to electronics stores, who ultimately sold them to end consumers. The growth in rental

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2 Desjardins, Doug. “DVD boom has many asking, is it time to retire VHS?”, *DSN Retailing Today*. July 8, 2002.
stores reduced the incidence of VHS purchases, however, as consumers were able to access content at much lower prices. This ate into the profits of the movie studios.

Late 1990s Home Entertainment Ecosystem

![Diagram showing the Home Entertainment Ecosystem with Movie Studios, Hardware Suppliers, Electronics Retailers, Consumers, and Rental Stores]

Netflix entered the industry at a time when frustrations with Blockbuster and its peers were high and the studios were working hard to find additional profit streams. At the time of Netflix's launch, the Company was so small that it struggled to attract much attention from the studios and could not secure special purchasing deals. Instead, Netflix realized that anything they could do to promote DVD adoption would help to grow their business. Netflix used this approach to convince the studios to work with the Company on promotions for the new technology. It was an easy sell for the Company, and a great way for the young business to make connections with the studios. Gina Keating, author of the book "Netflixed," writes:

"The studios’ home entertainment divisions had long detested the hard bargains Blockbuster drove on inventory...Helping NFLX spread awareness of the DVD format through joint promotions represented a small risk for the potentially great reward of shifting home entertainment lucrative DVD sales."³

While the studios focused on short-term profits, Netflix looked at the long-term growth of the market as a key driver for their business. The studios saw profits from the growth in DVD without realizing that they had invited the equivalent of a second Blockbuster into their mix. Netflix wasn’t changing the industry ecosystem all that much; it was just redirecting viewership from VHS to DVD and stealing share from the offline retailers. Critically, however, Netflix presented their business as an innovation that would enhance the overall market the studios faced because it was simply a channel through which the studios could distribute additional product. Blockbuster would be the long term loser as Netflix disrupted Blockbuster’s connection with customers and build a major lead in technology that their rival would never be able to beat.

How Key Players Classified Netflix’s Innovation

<table>
<thead>
<tr>
<th>Disrupt</th>
<th>Architectural Innovation: Blockbuster was slow to match Netflix’s online offering and lost connections with some customers as a result; Netflix’s technology advantage accelerated Blockbuster’s bankruptcy</th>
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<td>Conserve</td>
<td>Incremental Innovation: Movie Studios maintained their connection to customers through the box office and increased revenue from new DVD technology</td>
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<td>Modular Innovation:</td>
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Timing the Adoption Chain Risk

While Randolph and Hastings had been incubating the idea of Netflix in their minds for months, the Company officially got to work building out their website in October of 1997. Over the next six months, the team would assemble all the pieces necessary for the site to open, including customer search and inventory management tools. While these systems pale in comparison to what the Company offers today, the site had enough infrastructure for what the Company thought would be a modest launch.

Available materials on the history of Netflix suggests that the Company hadn’t put too much thought into when they would launch their business, but, in hindsight, they came along at just the right point in time in the adoption curve. Netflix biographer Gina Keating writes:

“By launch day DVD players were selling far faster than videocassette recorders...it had taken VHS two years to get in to half as many households...price of players were falling fast to an average of $580 in April 1998 from $1,100 a year earlier. Initially wary, movie studios finally accepted the new format and were releasing DVD titles at a clip of one hundred per month.”

Netflix’s entry in to the DVD market came just as DVD players were beginning to “cross the chasm”. DVD players were no longer reserved for wealthy cinephiles, and improving technology and title availability started to bring down the costs of owning a DVD player (and switching away from a VHS player). At the same time, internet usage and access was exploding (doubling in 1996 and 1997), paving the way for a decade of rapid growth. As a result of their good fortune, Netflix only had to focus on execution risks inherent in their business, and they did not have to worry about co-innovation risks or adoption of the technologies that enabled their service to work. For the next decade this business model stayed largely the same with a focus on subscriber growth, logistics and content acquisition. Netflix would create a new business model a decade later when it launched its streaming service.

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4 Keating, Kindle mark 688.
Phase II: Stepping Into Streaming

Beginning in 2007 Netflix slowly began rolling out its content to subscribers through a video streaming offering. The innovation was completing the vision its founder had when creating the Company as illustrated in his famous quote: “Eventually in the very long term, it's unlikely that we'll be on plastic media. So, we've always known that, that's why we named the Company Netflix and not DVDs by Mail.”

The timing of the move coincided with an increase in broadband penetration and the rollout of high speed 3G wireless networks combined with the emergence of high quality graphic streaming capabilities on laptops and other media devices such as video game consoles. This move to streaming was well regarded by subscribers, technology enthusiasts, and Wall Street analysts alike. Most everyone agreed that just as CDs had gone the way of the dodo with the emergence of MP3s, so too would the DVD disappear with the rise of internet video streaming.

Netflix’s established DVD-by-mail business was a critical assets in making the leap into the video streaming market. Ten years of experience had given the company time to develop one of the most sophisticated recommendations engines that existed on the internet, and its marketing team had refined their pages continuously to optimize the user experience. Success in streaming, however, was far from a slam dunk and plenty of other players had failed when trying to enter this market before Netflix. Like its entry in to the DVD-by-mail business, Netflix was thoughtful in its approach to entering the streaming market and constructing an ecosystem that would allow the streaming business model to thrive.

Ecosystem Carryover

Netflix was not the first provider of movies available on demand through the internet. Netflix biographer Keating described her first impressions of the move into streaming,

“Steve Swasey [Netflix Vice President of Corporate Communication] had been warning me and the others – as Hastings had been warning investors – not to expect much in the way of title selection. I couldn’t help thinking of the myriad download services I had seen come and go over the previous three years, mainly because there was nothing on them that anyone wanted to watch. They seemed little more than an inconvenient form of pay per view.”

What set Netflix apart from other entrants was its ability to roll out the streaming service with much less risk and higher initial profitability compared to earlier video streaming entrants. When Netflix first introduced the service it was simply adding another portal for subscribers to consume content. Netflix introduced streaming at no additional cost to subscribers, simply adding a “Watch Instantly” option for a limited number of titles on available on the Company’s website. This was a value adding convenience to subscribers who now could consume their content instantaneously compared to waiting for the DVD to ship in the mail.

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5 http://abcnews.go.com/Business/netflix-ceo-reed-hastings-company-sincere-regret-customers/story?id=14608865
6 Keating, Kindle Note 2957
Initially, subscribers were limited to watching only one hour of streaming content per dollar they spent on their monthly subscription package (for example, a $16.99 plan would entitle a viewer to 17 hours of streaming content in a given month.) However, by early 2008, Netflix lifted this limit, allowing unlimited streaming content to nearly all subscribers. This move was likely a reaction to Apple’s entry to the movie rental industry, but given Netflix’s existing DVD subscriber base and the high acquisition cost dynamics of streaming content (estimated at approximately 80%) many also viewed it as a way to solidify Netflix’s market leadership in streaming. Furthermore, in 2008 Netflix transitioned from a computer-based video streaming service to a living room offering through the introduction of the Netflix application on Xbox 360. Over time, Netflix would increase its living room penetration by adding Netflix apps to TVs, game consoles, and set-top boxes. Device makers were enthusiastic to incorporate Netflix software, but the Company also incubated set-top box company Roku to have control over at least one access portal.

Given that higher licensing agreements for streaming content significantly increased the fixed costs compared to DVD by Mail. Under the DVD rental-only cost structure, variable costs represented about 89% of total costs, primarily including the cost to purchase DVDs from studios, fulfillment expenses, and marketing expenses. In 2009, the estimated total costs of the DVD rental business represented 89.6% of revenues. Under a model of streaming-only content, variable costs were limited only to marketing, with fixed costs representing 84% of the total cost structure, while total costs were estimated to be 3% lower than DVDs at 86.8%.

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8 Aggarwal, Sandeep and Velikov, Stan; “Online DVD Rental + Streaming, A Potent Combination;” Collins Stewart, November 19, 2009
The company’s position within the DVD rental eco-system was viewed as a key advantage, significantly increasing the barriers to entry. Netflix was able to use its dominant position in DVD rentals to subsidize the substantial costs associated with introducing streaming and spread streaming’s high fixed costs across millions of paying subscribers. Analysts at Collins Stewart explain Netflix’s competitive advantage from ecosystem carryover writing in a 2009 report,

“In a subscription-only world Netflix will be the only company, in our view, that can spread its very high fixed content cost to tens of millions of subscribers immediately and benefit from scale. In our view, other competitors trying to offer movies via streaming under a fixed subscription plan (vs pay-per-view) seems highly unlikely because of not having tens of millions of subscribers to justify high fixed content”.

### Streaming Ecosystem Map

![Streaming Ecosystem Map](image)

### Lack of First Mover Advantage

Analyst’s expectations that Netflix streaming’s high fixed costs combined with existing large subscriber base would create a barrier to entry and first mover advantage prohibiting competitors from successfully entering the market turned out to be false. Between 2010 and 2012, numerous competitors with existing subscriber networks entered the video streaming market. Furthermore, Netflix entered international markets despite the lack of a first mover advantage in streaming or an ecosystem carryover from a DVD by Mail business. To evaluate why analyst predictions to not hold true, lets compare the internet streaming distribution market with cable TV distribution.

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9 Aggarwal, Sandeep and Velikov, Stan; “Online DVD Rental + Streaming, A Potent Combination;” Collins Stewart, November 19, 2009
Cable TV providers have sustained a highly profitable and defensible market position for decades. This stems back decades starting with the government incentivizing private investment in the highly capital intensive roll out of laying cable networks underground through the establishment of regional cable monopolies. As rollouts were completed, these monopolies consolidated in order to gain scale and spread its fixed costs across a larger subscriber base. For decades cable distributors faced limited competition as new entrants would not invest in laying cable networks without a guaranteed subscriber base, resulting in cable operators having significant leverage in negotiating distribution contracts with content providers, in this case, TV channels. It was not until a self-inflicted wound did cable companies invite completion.

In the early 2000s cable companies ventured into the phone service in order to offer “triple play” communications to consumers. Seeking to defend their core businesses, telecom providers such as Verizon and AT&T have responded by laying cable networks and competing with the cable incumbent operators. This increased competition has increased the power of TV convert providers who now can leverage the two distribution networks against each other, often resulting in temporary station blackouts which anger consumers.

The difference in first mover advantage sustainability between TV cable distributors and Netflix as an internet video distributor lies in the nature of the fixed costs. It is not simply enough to have a high fixed costs structure, but the fixed costs structure must be on entry into the market place. For TV operators, the fixed costs were born in laying the cable in order to be able to distribute cable. For internet video distributors, this is analogous to the creation of streaming software and a user interface. While not a trivial investment, it is not an overly large deterrent to enter such a vast and growing market.

The fixed costs within the internet streaming market lay with the acquisition of content rather than its distribution. Therefore, when contracts expire the first mover only has an advantage if they can allocate their fixed costs across the largest subscriber base. However, successful new video streaming entrants are competing with two different models. The first model leverages an existing subscriber base in an adjacent market to increase the likelihood of success in the video streaming content, similar to how the telecom operators entered cable distribution. The best example of this strategy is Amazon, who is leverage its existing internet customer base and driving streaming adoption by subsidizing the service by
offering free shipping on all Amazon purchased products to those who subscribe to the streaming service. The second model is from the content creators themselves. Services such as HBO GO and Hulu (a joint venture by Disney, Fox and NBC Universal) have lower risk given their reduced content acquisition costs and are just newfound distribution channels for their valuable content.

Further underscoring the notion that no such first mover advantage exists in video streaming is Netflix’s own international expansion. Over the past two years Netflix has rolled out its streaming offering in 43 countries without any DVD by Mail ecosystem carryover and despite the existence of incumbent video streaming distributors. In fact in the UK, Netflix successfully entered and has accumulated approximately 1 million subscribers since January 2012 despite the existence of an incumbent both a local DVD by Mail provider and an incumbent video streaming offering having already secured exclusive local content. If Netflix believed it would be able to successfully expand internationally, then it should not have been widely assumed that competition would not be able to compete domestically.

**Power Shift Leading to Adoption Chain Risk**

Similar to the shift of power to content creators in the cable TV distribution market due to the emergence of the telecom providers, the power has shifted in the internet streaming market as well. Upon launch Netflix benefitted greatly from a first mover advantage in both DVD by mail and streaming movie delivery, essentially inventing both markets. Adding to this was the fact that the content providers were not yet sure what they had with streaming video, and seemingly took an experimental approach to this new distribution channel. As such, content creators subsidized Netflix in order to establish legitimacy within the internet video streaming market. However, as the legitimacy of streaming video was firmly established and with the newfound competition from streaming rivals seeking to develop a content library, the power shifted from Netflix to the content creators who were well positioned to capture the value.

In the early days of streaming, studios such as Starz viewed this revenue as 100% accretive to their bottom line. In 2008, Starz was excited to enter the online streaming market and signed a 5 year, $30 million dollar contract adding 2,500 titles to Netflix’s movie library. The deal provided Netflix with exclusive distribution rights to its movie content for the first two years of the contract. However, by February 2012 Starz announced that it would not be renewing its contract with Netflix. Some estimated that Starz could fetch up to $200 million per year while other rumors indicated that contract talks broke down due to Starz insistence that Netflix implement a tiered pricing plan specifically for Starz content. Comments by Starz CEO illustrate how the power had shifted to the hands of the content creator:

> This decision is a result of our strategy to protect the premium nature of our brand by preserving the appropriate pricing and packaging of our exclusive and highly valuable content. With our current studio rights and growing original programming presence, the network is in an excellent position to evaluate new opportunities and expand its overall business.  

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12. [http://www.huffingtonpost.com/2012/02/27/netflix-starz-play_n_1304611.html](http://www.huffingtonpost.com/2012/02/27/netflix-starz-play_n_1304611.html)
On the other hand, TV shows have a greater incentive to subscriber to Netflix streaming services compared to movies. For movies, the benefit from streaming is solely the increased in revenue and therefore the content library goes to the highest bidder. However for existing TV shows, streaming offers a quick and convenient way for customers to catch up on prior seasons and enter into the viewing base for future seasons leading to increased advertising revenue. Therefore, Netflix's value proposition as having the largest subscriber base is highly attractive to distribute existing TV shows and the Company’s streaming platform has largely its content library to reflect this.

**Attempt to Increase Revenues and Erosion of Profitability**

While Netflix’s dominant position in the DVD ecosystem positioned it well to expand into streaming video, the increasing fixed costs of streaming content began to increase at a rate faster than Netflix was able to grow its subscription base. As a result, between 2009 and 2011 gross profit per subscriber decreased roughly 8%, from $48.17 to $44.36, a trend that was expected to continue going forward.\(^{13}\)

To combat its shrinking margins, and with a streaming library of sufficient size, Netflix attempted to decouple the DVD ecosystem from that of the streaming content.

In July 2011 the Company announced in a blog post that the Company would be de-bundling the streaming service from the DVD service, representing a 60% price increase for customers that wanted both services.\(^{14}\) Shortly thereafter, to more completely separate the two businesses, Reed Hastings announced that the DVD business would be broken off into an entirely independent business to be named Qwikster, while the streaming business would remain under Netflix. Subscribers of both services would see two separate bills and they would have two completely separate accounts. However, the strength of the combined DVD and streaming ecosystem and associated network effects proved stronger than Netflix anticipated. As a result, customer backlash was swift and strong. Not only were customers opposed to the price increases, they also detested the idea of having two separate accounts, two separate usernames and passwords, and most importantly, two separate sets of recommendations and two separate queues.\(^ {15}\) Regardless of whether or not subscribers viewed content through DVD or streaming, they wanted all their viewing behavior fed into the same recommendation engine, and they only wanted to manage one account with one movie queue.

On October 10, 2011, less than a month after Reed Hastings had announced the separation of the two businesses, he announced a retraction of the decision. The DVD and streaming services would remain debundled with the price increases still in place, but Qwikster was dead and the two businesses would remain as one under the Netflix name.\(^ {16}\) By the end of third quarter 2011 Netflix had lost an estimated 800,000 subscribers primarily, but subscriber growth resumed in the fourth quarter as the Company got

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\(^{13}\) Netflix 2011 10-K pp. 24, 49  
\(^{15}\) Albanesius, Chloe, “Netflix Ditches Qwikster: What You Need to Know”, PCMag.com, 10/11/11, [http://www.pcmag.com/article2/0,2817,2394446,00.asp](http://www.pcmag.com/article2/0,2817,2394446,00.asp)  
\(^{16}\) DVDs will be staying at netflix.com; [http://blog.netflix.com/2011/10/dvds-will-be-staying-at-netflixcom.html](http://blog.netflix.com/2011/10/dvds-will-be-staying-at-netflixcom.html)
back on track.\textsuperscript{17} This represented the first ever quarter of subscriber losses for Netflix, and worrisome event given that the Company’s model has shifting to allocated a high fixed base across a large customer base and given the increased competition for streaming services.

With increased competition leading to higher content acquisition costs, and with the drop in subscribers from the de-bundling announcement resulting in Netflix’s content investments being allocated across a lower than expected user base, Netflix’s operating profitability has taken a dive. Operating margins in 2012 are forecasted at just break even compared to 13% in 2010.\textsuperscript{18} While some bounce is forecasted as the Company continues to grow subscribers, many of the changes to the business model are structural and will continue to put pressure on Netflix’s profitability.


\textsuperscript{18} Macquarie Equity Research Report, Netflix Virtuous Cycle Turning Vicious, 17 Sept 2012
Phase III: How Netflix Can Capture Value and Regain Profitability

With the absence of a meaningful first mover advantage in the streaming market leading to the entrance of competitors and the erosion of profit margin, Netflix is once again forced to evolve its business model and differentiate itself in order to capture value. The following section will evaluate three different potential initiatives and the accompanying risks as Netflix strives to add additional value in the market place in order to regain profitability; original content creation to create an exclusive value proposition, device proliferation and international expansion to grow its subscription base, and tiered streaming subscription plans to increase revenue per subscriber.

Original Content Creation

Netflix value proposition has always been providing consumers with access to a vast supply of content in with better convenience. In the DVD-by-Mail era, Netflix provided the consumer with an unrivaled inventory catalog of movie and TV show content while eliminating the consumers’ burden on traveling back and forth to the local rental store. In video streaming, Netflix took convenience even further by proving immediate viewing availability through downloading. However, these two fundamental pillars to Netflix’s business have dissolved. With increased competition within the video streaming market, Netflix’s provides neither greater access to content nor greater convenience. Rivals offerings, such as Amazon Prime, have a larger and more up to date selection compared to Netflix streaming, with Amazon’s Instant Video providing instant streaming access to its vast library.19

<table>
<thead>
<tr>
<th>Supplier</th>
<th>Amazon Prime (Streaming)</th>
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<th>Watch Instantly (Streaming)</th>
<th>DVD by Mail</th>
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<td>Day after TV Show Airs</td>
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<tr>
<td><strong>Movie Content Window</strong></td>
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<td>Same day as DVD release</td>
<td>28 days after DVD release, smaller collection than DVD</td>
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<td>DVD and Blu-ray</td>
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19 Jefferies Equity Research Report, Growth Story Offset by Rising Costs and Competition, 4 Sept 2012
Given Amazon’s already existing breadth and the high prices charged by content creators for distribution exclusivity, Netflix recognized that in order to profitably dominate internet content distribution the Company would need to re-differentiate itself by creating its own content. Netflix is betting that by creating its own content the Company will be viewed as adding more value than simply distributing third party content over the web and thus will be positioned for value capture within the vast internet video distribution market. This transition begins on February 1, 2013 with House of Cards, a Netflix Original TV show starring Kevin Costner, being released exclusively through Netflix.20 While this strategy may seem like a rapid departure from Netflix’s core distribution business model, is not unprecedented. In fact, it parallels HBO’s domination of premium TV content distribution over the past 40 years.

Founded in 1972 as a subsidiary of Time Inc., HBO bought the rights to transmit recent films via cable TV. As cable infrastructure continued to improve HBO increased subscribers from 50,000 in 1974 to 1.5 million in 1978 and achieved profitability. With the increased recognition, HBO signed contracts with the major movie studios and households were subscribing for cable just for HBO.21

HBO’s success quickly found competition as Viacom started Showtime as a direct rival. In 1978 Viacom struck a deal with Teleprompter, the largest cable systems operator in the United States, which resulted in Teleprompter’s customers receiving Showtime instead of HBO. With HBO and Showtime offering similar content, Time Inc. sought to defend HBO’s market position by acquiring American Television & Communication Corp., the second largest cable operator in the US. Recognizing the need to differentiate itself from Showtime fully penetrate the cable market, HBO began investing in preproduction financing of movies in exchange for exclusive distribution rights. This strategy proved successful and by 1982 HBO had 9.8 million viewers, nearly 3x as many as Showtime, the closest competitor. This scale allowed it to pay more and secure better content. For instance, in HBO paid $1.4 million for the hit movie Raging Bull while Showtime paid $1 million, but HBO’s larger subscriber base resulted in this fixed costs being allocated to only $0.15 per subscriber compared to $0.30 for Showtime.22

For the next decade HBO and Showtime engaged in fierce competition as the channels sought to differentiate themselves by paying higher prices for exclusive rights. Furthermore, the rise of advertising supported cable stations and the growth of movie rentals threatened the Pay TV business model. In the early 1990s, HBO’s response was again to differentiate with exclusive content by diving into production of exclusive content and by 1997 received 90 Emmy nominations, more than any of the broadcast networks. HBO has continued to invest in original content including doubling its investment in the past four years and has producing hits such as The Sopranos, Curb Your Enthusiasm, Sex and the City and Game of Thrones. This success prompted HBO’s co-president Richard Plepler to say; “Original

programming is the centerpiece of our brand and what our subscribers continue to cite as a main reason why they want HBO.\(^\text{23}\)

As evidenced by the above quote, the creation of original content also serves to reduce the power of suppliers, in this case, third party content creators. Given Netflix’s current position, this is extremely valuable. If Netflix can transition its customer base from subscribing due to its convenient access to third party content to subscribing specifically to watch Netflix’s content then Netflix will have more leverage in negotiations which should drive down content acquisition costs or reduce the damage of losing access to a studio’s library.

HBO’s successful evolution from transmitting third-party hit movies to original content development has tremendously influenced Netflix’s strategy to develop original content in order to dominate the internet video market. In fact, Netflix has essentially outlined its path to content creation by echoing HBO’s strategy. On a recent quarterly conference call Netflix CEO Reed Hastings communicated that original programming will constitute a “modest” part of its budget with the long term high water mark being HBOs current spending of 33%-40% on original production with the remainder being spent on third party content. The below comments further indicated the shift in Netflix strategy towards content creation and the long term benefits its hopes to achieve in both subscription growth and profitability:

> “HBO gets around $7 or $8 per sub from the MSOs. We hope that we can have a much larger subscriber base than them. And that will allow us to spend even more on content to have an even better service. Then you’ve got obviously the on-demand aspect of Netflix and all of the work that we do to make it personalized and even more useful. So we should be able to, in the long term, have an even better margin position than HBO. But it really depends on a relative scale. So if we’re twice as large as the nearest competitor, it would tend to lead to large margins. If it is neck and neck of us and HBO in terms of subscriber size then there would be tighter margins for both of us.”\(^\text{24}\)

As of today, Netflix has announced the production of four original TV shows and documentaries to be released in 2013, including the revival of favorite Arrested Development, a highly downloading cult TV show on Netflix’s streaming offering. However, such a strategy does not come cheaply as evidenced by Netflix paying $100 million to produce 26 episodes of House of Cards (2 seasons), outbidding rivals HBO and AMC.\(^\text{25}\) Executed correctly, the strategy will create desirable original content leading to increased revenues through gained subscribers or higher subscription prices charged to subscribers.

**Device Proliferation and International Expansion**

As Reed Hastings noted above, Netflix push to beat HBO depends primarily on its ability to win the subscription battle. Today, HBO has a family of channels transmitting to over 28 million US subscribers and an additional 37 million international subscribers in 170 countries primarily through on-demand


\(^{24}\) Netflix Q4 2011 Earnings Conference Call Transcript

\(^{25}\) Macquarie Equity Research Report, Netflix Virtuous Cycle Turning Vicious, 17 Sept 2012
While matching such a high footprint in order to compete on content development and acquisition will prove challenging, Netflix existing ecosystem combined with a growth strategy based on device proliferation and international expansion poses a significant threat to HBO.

In only 5 years since its launch, Netflix’s US streaming offering has accumulated a subscriber base of 24 million, almost matching HBO’s base. Netflix has accumulated such a strong base largely by partnering with new and existing media devices which could connect Netflix’s streaming services to the living room. Starting in 2008 with the Xbox 360 and later followed by the PlayStation 3 and Nintendo Wii, Netflix has penetrated approximately 50 million US homes through video game consoles. Adding in other media devices such as DVD players and Apple TV, equity research analysts estimate that Netflix streaming can connect in approximately 50% of US households. It is worth noting that Netflix’s device diversification strategy has allowed the Company to achieve a highly successful roll out without undertaking a leadership role in the innovation and assuming significant co-innovation risk.

Looking into the future, Netflix should benefit from further market penetration. Earlier this year Samsung released a new line up of “Smart TVs” with built in Google TV software and other TV manufacturers are following suit. Over the next several years, Netflix should be able to penetrate nearly 100% of US living rooms without the need of a complementary device. This penetration should propel Netflix past HBO as the largest Pay-TV subscriber base, allowing it to better scale investments in content development and acquisition. Furthermore, as Netflix further embeds itself in the living room through TVs, consumers may view Netflix internet streaming as just another channel rather than an additional service including the revival of adding a Netflix button on the remote control, increasing the likelihood of consumer adoption.

Table 1: Netflix Streaming Service International Rollout Data

<table>
<thead>
<tr>
<th>Service Launch Date</th>
<th>Population (MM)</th>
<th>Netflix Streaming Subs (MM) 2Q’12</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>Oct-08</td>
<td>311</td>
</tr>
<tr>
<td>Canada</td>
<td>Sep-10</td>
<td>34</td>
</tr>
<tr>
<td>Latin America &amp; The Caribbean</td>
<td>Sep-11</td>
<td>500 - 600</td>
</tr>
<tr>
<td>UK &amp; Ireland</td>
<td>Jan-12</td>
<td>67</td>
</tr>
<tr>
<td>Scandinavia</td>
<td>4Q 2012</td>
<td>25</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>937 - 1,037</strong></td>
<td><strong>27.8</strong></td>
</tr>
</tbody>
</table>

Source: Company, Jefferies

While Netflix is well on its way to success in the US market, the Company has only recently began entering international territories with most of its country entries less than 1 year old. International penetration also poses significantly greater challenges given Netflix’s lack of first mover streaming advantage, no ecosystem carryover from DVD by Mail business, high content acquisition costs and questionable demand for streaming services given propensity for pirating. Despite these obstacles,

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26 HBO Websites
27 Macquarie Equity Research Report, Netflix Virtuous Cycle Turning Vicious, 17 Sept 2012
Netflix has accumulated approximately 4 million international subscribers to its streaming services. While subscriber growth should continue to be robust, developing unique and exclusive content will help Netflix differentiate itself and should accelerate consumer adoption.

**Tiered Streaming Subscription Plans**

While increasing the number of subscribers will lead to increasing revenue and scale, Netflix should also focus on increasing its average rate per user ("ARPU") once it develops a substantial library of exclusive content. Increasing ARPU has been something Netflix has struggled with over the past 5 years as the Company has transitioned from its DVD by Mail offering to the Streaming platform.

Charging customers different amounts based on various consumptions levels, or tiered subscriptions plans, would enable Netflix to increase its ARPU for premium subscribers. However, the Company has a checkered past when implementing such a strategy.

Netflix has successfully used a tier data subscription approach to differentiate users by level of consumption within its DVD by Mail business. Users who consume frequently pay a premium to have up to 3 DVDs rented at a given time while the basic level of subscription only allows for 1 DVD rental at a time. As Netflix began offering its Streaming service, premium users began substituting their extra DVD rentals in exchange for consuming free streaming content leading to a decrease in ARPU. For this reason, along with higher content costs and shaping the vision for the future, Netflix’s announced in September 2011 the split of its DVD by Mail and Streaming services. The split accompanied a 60% price increase for those consumers who continued to subscribe to both services. The announcement spurred an outcry amongst subscribers and over 800,000 subscribers were lost in the quarter following the announcement.

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29 Jefferies Equity Research Report, Growth Story Offset by Rising Costs and Competition, 4 Sept 2012  
30 Macquarie Equity Research Report, Netflix Virtuous Cycle Turning Vicious, 17 Sept 2012  
These two different pricing strategies provide the blueprint for how Netflix can capture increased subscription fees in the future. In the DVD by Mail example, those consuming the basic plan still had access to the complete Netflix library but were slightly limited in total consumption capability. In the second example however, consumers already accustomed to both the convenience of streaming and the vast DVD by Mail library were forced to choose between the two or pay substantially higher prices, leading to the revolt. For Netflix to increase its streaming prices in the future, the Company must accompany these prices with increased service offerings such as Netflix’s original content.

Consumers have well established the viability of Netflix $7.99 streaming plan consisting of its vast library of recent TV shows and a dated movie catalog. This plan should serve as the basic Netflix TV subscription plan. A more advanced TV plan costing $9.99 would offer access provided in the basic TV plan plus access to all Netflix original TV shows. Lastly, as the Company increases both its subscriber base and ARPU on the success of its original programming, Netflix could further establish a $14.99 plan with the addition of recent releases from one or more major movie studios.\(^\text{32}\)

| Fig 16  Theoretical Netflix tiered pricing plan |
|-----------------|------------------|------------------|
| Old catalog TV shows (MacGyver) | X                | X                |
| Past seasons of current hits (The Office) | X                | X                | X                |
| Exclusive syndicated shows (Mad Men) | X                | X                |
| Some catalog movies | X                | X                |
| Netflix original TV shows (Lillyhammer) | X                | X                |
| One major studio output deal | X                |

Source: Macquarie Capital (USA), Sep. 2012

Most importantly, what do all these plans have in common? They are all cheaper than subscribing to HBO. HBO customers are currently charged $16 per month\(^\text{33}\) from there cable operators and receive access only to HBO original content and to select movies. HBO itself only receives approximately half of this charge. Even the premium Netflix packaged discussed above, which would include access Netflix original TV shows, a vast library of currently popular TV shows and a partnership with a major movie studio, would still cost less than HBO despite delivering more. And best of all, Netflix model of being both the content creator and the distributor would enable to Company to capture 100% of the consumers’ spend and place it at a considerable advantage compared to is peers.

With the potential to substantially increase both its subscriber base and ARPU and achieve even greater success than HBO, it is no wonder why Reed Hastings is betting the future of Netflix on the streaming of Netflix original content.

**Potential Risks**

Netflix’s transition to original content is certainly not a riskless endeavor. The largest risk facing the Company is simply the execution risk associated with developing original content given that this is a wide departure from the Company’s existing business model. To overcome this risk, Netflix must

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\(^{32}\) Macquarie Equity Research Report, Netflix Virtuous Cycle Turning Vicious, 17 Sept 2012

allocate sufficient financial and labor resources aligned with its new strategy. However, in using a wider lens, Netflix faces two future potential adoption chain risks within its ecosystem.

Netflix’s streaming offering is reliant upon the bandwidth of local cable providers. Looking forward, Netflix faces the risk of internet companies introducing a data cap or tiered broadband pricing the same way some cell providers have done for their data plans. For example, AT&T instituted a 150 GB cap for DSL subscribers and a 250 GB cap for U-Verse subscribers. Netflix is currently lobbying against caps, though the outcome at this stage is unclear.

Both the data cap and tiered broadband pricing pose a serious risk to Netflix, as its core value proposition currently is predicated on the $7.99/month unlimited model, but the end price for users would rise if a consumer were to break through data caps set by their broadband supplier. This threat could cripple Netflix as a September 2012 study by internet security firm Sandvine showed that Netflix streaming accounts for 33% of all US prime time web viewings based on internet traffic, more than 18x rivals Amazon, HBO Go and Hulu. This may benefit cable providers with rival streaming services such as Comcast which subsidizes its Xfinity streaming service by excluding it from its data consumption cap. Time Warner Cable could potentially decide to do the same with HBO Go.

To protect its streaming platform, Netflix must find a way to profitably insulate its subscribers from such fees. Currently, Netflix has given users the ability to dial down the quality of streaming video. Whereas historically users did not have options for streaming quality, they are now able to choose a range of options from “Good quality” (up to 0.3 GB per hour) up to “Best quality” (up to 2.5 GB per hour for HD). However, decreasing quality is unlikely to be the best long term alternative. Another alternative may be to subsidize the consumer by offering to pay data overages. Given the existing thin margins this seems unlikely. Another possibility is to partner with a major internet player such as Facebook. Facebook has helped international users avoid mobile data charges in the UK, France, Australia and other countries through a subsidized slimmed down mobile site with Facebook paying any data overages in exchange for the increased website traffic. This strategy is currently prohibited in the US although a bill is currently being considered by the US Congress and Hulu has a law suit application in Federal Court.

If both subsidies and finding a partner do not work, Netflix’s best option may be to sell the Company. Activist investor Carl Icahn has recently taken a stake in the Company and many believe he is seeking to sell Netflix to major internet content distributors such as Amazon, Apple or Facebook. However, a sale to a cable distributor similar to how HBO being owned by Time Warner may make more sense and allow the buyer to achieve distribution synergies. One specific distributor, Verizon, may be attracted to such a model given its ability to distribute Netflix’s content nationally both in living rooms through Fios and over its wireless mobile network.

35 Macquarie Equity Research Report, Netflix Virtuous Cycle Turning Vicious, 17 Sept 2012
36 http://support.netflix.com/en/node/87#gsc.tab=0
Another adoption chain risk potentially facing Netflix is its reliance on Google and Apple TV to fully penetrate the living room. While these companies may appreciate their relationship with Netflix now in order gain legitimacy for “smart TVs,” these companies also compete with Netflix in the rental of movies and television shows through Google’s You Tube channel (which has now signed every major studio except for Fox) and Apple’s iTunes. This reason precisely illustrates the importance for Netflix to successfully develop exclusive original content and create a secure demand for its streaming platform.

Conclusion

In summary, Netflix’s history has been one of tremendous success, innovation and now power struggle. First, the Company partnered with both DVD manufacturers and movie studios to bolster the market of DVDs and enable Netflix to dominate the movie rental market previously dominated by Blockbuster. Second, Netflix seamlessly carried over its existing large subscriber base and became the first Company to successfully penetrate the internet video streaming market. While this transition was once thought of as a story of highly defensible first mover advantage, in actuality the legitimacy of internet streaming invited a host of different ecosystem player to enter as direct rivals. This increased competition shifted power from Netflix to content creators, increasing the cost of content acquisition and eroding the Company’s profitability. Now, Netflix is redefining itself in order to differentiate and capture value by focusing on developing its own original content. This strategy combined with increased household device penetration and international expansion should secure Netflix’s place as an essential component of the living room and enable the Company to return to profitability and possible to increase prices. However, Netflix should keep its lens wide open and identify the possible adoption chain risks associated with broadband usage and access point channels and use creative strategic decision making to mitigate these risks.

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