Netflix: Disrupting Blockbuster

Lauren Fraser – Kyle Khasigian – Amanda Lynch – Frank Madden – Hans Reichstetter – Catherine Sharp

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Executive Summary

Netflix’s meteoric rise to leadership in the online rental space can largely be traced to its unlikely marriage of both old and new. On the one side, Netflix timed its entry in 1997 to coincide with the emergence of DVD technology, while utilizing an innovative customer interface made possible by the explosion in consumer access to the internet. Meanwhile, the company’s distribution strategy was fundamentally tied to something far more mundane: the U.S. Postal Service. With its mail-order model, the company developed a capital-friendly and scalable distribution model that both increased inventory efficiency and added value for customers through increased selection. Netflix further differentiated itself by employing a monthly pricing model and focusing on lesser-known titles, playing to two major holes in the traditional retail model: the frustration of late fees and limited selection of older films.

Overall, Netflix’s strategy allowed it to quickly establish a foothold in the market while also mitigating Blockbuster’s ability to respond. Netflix’s radical approach ran contrary to both Blockbuster’s retail model and pricing scheme, and the company’s value proposition fundamentally challenges many of the key customer preference assumptions underlying the Blockbuster model. Not surprisingly, this made the industry giant highly averse to matching Netflix’s offering. Yet as Blockbuster hesitated, Netflix’s value proposition only strengthened, further entrenching the company’s position as the leader in the nascent online rental segment. The inconvenience of DVDs by mail was less than Blockbuster anticipated, and Netflix’s queuing and recommendation systems added value for both customers and the company while increasing switching costs.

Though this paper focuses on Netflix’s innovative approach to disrupting the movie rental market, we conclude with an examination of the challenges that lie ahead for Netflix. Most notably, the company faces an imminent threat in the form of video on-demand, which if executed properly could provide the immediate content delivery that the mail-order model lacks. To its credit, Netflix has proactively sought out ways to leverage VoD services for its existing subscribers and its partnership agreements with device manufacturers provide a multi-platform approach to solving the VoD puzzle. However, content providers will likely be able to capture more of the value from streaming content, while the overall value of delivering content in this market also remains uncertain.
**Video Rental Market**

The video rental market began in earnest in the mid-80s, paralleling the explosion in VHS player sales. By the time Netflix started in 1997, the video rental market was dominated by Blockbuster, which since its founding in 1985 had grown to a commanding 40% share of the market.¹ The remaining market was split by a few other national players and hundreds of local mom-and-pop rental shops. The basic formula for these businesses was to hold a physical inventory of movies at individual retail stores, with a large selection of new releases and a more limited selection of old movies. Blockbuster’s holdings were about 70% new releases and 30% other films.²

Overall, Blockbuster catered to impulse movie renters, who would enter the store and seek out their movie of choice. Movie rental fees ranged from $3 to 4 and late returns added additional fees. Blockbuster’s success was tied in part to its large geographic distribution of over 5,000 locations in key areas with high customer concentration in highly-visible, high-traffic placements. Though individual stores were limited in their choice of inventory, Blockbuster’s late fee policy allowed stores to maintain high video turnover and thus control inventory levels. The late fees were also profitable. In 2004, late fees accounted for over 10% of Blockbuster’s revenue.³ The company also successfully expanded into video sales, including sales of used DVDs following initial release, and its stores also sold high-margin items such as candy, soda and popcorn.

Though “movie night” competed with many other activities for consumers’ entertainment dollars, there were few direct substitutes for renting at local video stores. Movies could be purchased, but this was expensive and often customers were unsure how many times they would actually want to watch the movie. Movies on TV typically had commercials and were aired at inconvenient times, while premium movie channels cost $10-20 per month and still suffered from limited selection and viewing convenience. Different movies could be watched in the theater, but this also represented a greater expense, less choice and specific location. As a result,

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if a customer wanted to watch a specific movie inexpensively, at their convenience and at home, a movie rental shop was the only choice.

Customers rented videos for a variety of reasons, but most were simply for entertainment. Some planned specific movie watching events and others rented films they wanted to see in hopes of making time for viewing. While the Blockbuster model worked well for impulse renters, requiring customers to watch their rentals within a short time period proved less practical for those who knew what they wanted to watch but did not know when they would have time to do it.

It was this problem with late fees that encouraged Reed Hastings to create Netflix. He wanted the flexibility to watch a movie at his leisure and not incur a fee for the holding period. He identified a gap in the market in that a movie rental company could offer more value, more convenience and more selection and availability. The Netflix business model capitalized on a number of market trends. Hastings relied on the introduction and adoption of DVDs, the increasing use of the internet, and the organizational structure of the United States Postal Service when developing his innovation.

By 1997, major manufacturers began shipping DVD players in the U.S. and studios began selling titles in that format, providing significant advantages over VHS cassettes. These included higher quality, increased storage capacity, and the ability to quickly skip to selected scenes. In 1999 only 5% of households had DVD players but by 2002 this number had increased to 37%. However, most importantly for Hastings, DVDs were small and difficult to damage. Hastings conceived of a plan in which Netflix would mail DVDs to customers so they would not have to travel to the store to get the movie. DVDs made this process easy and cheap – the discs could be shipped by normal USPS delivery. The company worked closely with the USPS to ensure DVD delivery was prompt and improved Netflix’s customer experience. But while the convenience of home delivery would be of less use to customers who did not mind driving to the video store, the company also would have significant advantages in terms of inventory. By using a centralized rather than local distribution model, Netflix could smooth out local fluctuations in demand and

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carry a significantly broader selection of films. Also, as discussed later, Netflix developed a queue functionality on their website that enabled it to reliably predict future demand. Compared to the 2,500 titles held at most video stores, Netflix boasted 15,000 titles by 2003 and over 70,000 titles by 2006, all while carrying 1/3 to 1/5 the inventory of its retail competitors.

The internet proved to be another critical technology enabler in Netflix’s overall viability. More and more people were going online and using the internet to make purchases and find services that were cheaper, more available and more convenient. Hastings recognized the power of the internet to reach the national population, provide search services and gather customer information. All of these elements together – the opportunity to improve upon value and convenience in the current video rental industry, the introduction of the DVD and the growth of e-commerce on the internet – created an environment in which Netflix could provide a unique offering.

**Strategy Overview**

Though Netflix is best known for its monthly subscription service, its initial pricing model in 1997 closely resembled that of the traditional retail model. Early subscribers were charged $4 per rental and $2 for shipping plus late fees, relatively high charges reflecting both the costs of DVDs at the time as well as a lack of scale in the company’s own operations. Early on, the company differentiated itself along two primary fronts: target market and distribution. For customers, the primary axis of innovation was that of distribution. By relying on the USPS, Netflix made the trip to the video store unnecessary, appealing to the burgeoning group of internet-savvy buyers who were already transacting regularly through Amazon and eBay. Still, operating from only a single California distribution center meant delivery to East Coast customers could take nearly a week, undercutting Netflix’s convenience.

Netflix reached a turning point in 1999 when it switched to its now-famous monthly subscription service, which charged $19.99 per month for unlimited rentals of three DVDs at a time. The model both simplified and differentiated Netflix’s offering, appealing to high-volume users who knew what they wanted but preferred the flexibility of returning videos at their own convenience.

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At the same time, Netflix refined its web interface, which included both a patented movie queuing wish list as well as recommendation system. Aside from the clear value it provides to customers, the system also allows Netflix invaluable insight into customer preferences and creates what Hastings refers to as “our biggest switching cost.” The company’s growth has also allowed continuous expansion of its distribution network, which now includes over 50 distribution centers that allows one-day delivery to over 90% of the country.

Yet even as Netflix has proven the mail-order doubters wrong, the company is acknowledging that the days of physically delivering movies could be numbered. In the past year, the company has made significant investments in relationships with device manufacturers, with the goal of gaining streaming video access to as many homes as possible. Currently, the company offers 17,000 movies and TV shows through its streaming “Watch Now” service, which is bundled with most of its existing subscription packages. Rather than betting on one technology, Netflix streaming video is viewable through PCs as well as Xbox 360, PS3 and certain set-top boxes, TiVos, and Blu-Ray players.

**Judo Strategy: Exploiting Blockbuster’s Meal Ticket**

To topple a dominant incumbent such as Blockbuster, Netflix has relied on a number of elements of Yoffie and Cusumano’s “Judo Strategy,” reflected in the company’s savvy exploitation of Blockbuster’s own success, new technologies and niche markets. Notably, Netflix bypassed the need for a national retail network with its mail order model, and then further diverged from industry precedent with its monthly subscription model.

Rather than try to steal market share directly from its entrenched opponents, Netflix also began by focusing its efforts on customers who were not being adequately served by the Blockbuster model. That included tech-savvy buyers embracing DVD technology as well as movie watchers interested in harder-to-find films that were largely ignored by retail chains focusing on new releases. At each turn, Blockbuster’s existing business model provided an opening for Netflix to exploit, while simultaneously making it difficult for Blockbuster to respond. Moving forward, Netflix’s aggressive move to create partnerships in the video on demand space reflects its willingness to move beyond the model that helped build its initial success.

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Riding the DVD Wave

In many ways, the advent of DVD technology provided the initial opening for Netflix to exploit. Blockbuster and other established chains already held huge inventories of VHS tapes, meaning that they would be slower to move towards adopting a new standard and would have a more complicated optimization task as they sought to balance inventories of new and old technologies. Existing retailers were also slowed by the tastes of their legacy customers—even if Blockbuster wanted to move to DVD as quickly as possible, it risked losing market share if it left behind those customers hesitant to pay hundreds of dollars for a new DVD player. As a result, Blockbuster’s broad appeal made it a greater challenge to keep everyone happy.

For Netflix, building an inventory from scratch meant that DVD was the obvious way to go, both strategically as well as practically. The size of DVDs—especially in comparison to boxier cassettes—meant first class mail was an affordable solution to the distribution question. Meanwhile, Blockbuster’s network of over 5,000 retail stores meant that the company would also be hesitant to embrace a model that made so much of its capital base unnecessary. Perhaps not surprisingly, Blockbuster continued to dismiss the mail-order model even as Netflix began to steal an ever larger share of the market it once dominated. In doing so, the company ignored customers’ distaste for late fees and the degree to which they pre-planned their movie watching. Moreover, Netflix’s proprietary queuing and recommendation system provided users with significantly better advice than a video store geek could ever hope to provide, while also allowing Netflix to promote older and lesser-known titles that were less expensive to procure. Thus, Netflix could simultaneously create higher value for customers while increasing its own operating efficiency.

Death of the Late Fee

Netflix’s 1999 decision to eliminate late fees and move to a monthly subscription model was also a calculated risk that Blockbuster was ill-suited to match. By late 2004, nearly 20% of Blockbuster’s $5 billion in annual revenue came from late fees, a staggering figure and a pillar of the company’s retail model. Not only did late fees provide significant incremental revenue without incremental cost, but they also served as a tool to keep inventory more predictable. As a

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result, Blockbuster’s decision in late 2004 to add a one week grace period—a half-hearted attempt to match Netflix’s “no late fee” system—was an unmistakable concession to the Netflix model. Though Blockbuster claimed that increased rental income would help offset the lost late fee income⁹, the move was mostly a desperate attempt to stop the bleeding at the hands of Netflix, which had grown to 9% of the DVD rental market in 2004 and doubled to 18% by 2008¹⁰. Ironically, the late fee issue also highlighted the differing incentives faced by the two companies. While Blockbuster had always viewed late returns as a major hurdle to avoiding stock-outs, Netflix’s monthly subscription model meant the company actually preferred customers who took a long time to return movies, since Netflix would not have to ship another movie until the late one was returned.

**Netflix Ecosystem: Solving the Movies-by-Mail Puzzle**

Netflix’s innovation ecosystem was relatively simple at its outset, relying on DVD adoption in a broad sense while utilizing major DVD player manufacturers for marketing and the USPS for distribution. Overall, Netflix’s strategy minimized interdependence risk by allying itself with major players who had already placed significant bets on DVD technology and were unlikely to directly compete in the rental space. Just as importantly, physical use laws in the United States meant that the company *did not* need a formal relationship with the content-providing studio owners, enabling increased value capture.

**DVD Technology**

Fittingly, the company’s 1997 launch came six months after the first shipments of DVD players in the U.S., with Netflix’s DVD-only service representing a calculated bet that the new technology would quickly gain traction and overtake VHS as the standard in home video. While the company’s upside was inextricably tied to the adoption curve of DVDs, Netflix was able to use its DVD focus as a differentiating factor among early adopters while scaling its own operations to mirror the adoption of this enabling technology.

Needless to say, Netflix’s bet paid off. Though DVDs’ arrival to market was initially slowed by rival manufacturers’ competing standards and studio concerns over another new format,

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customers quickly embraced the technology, as 23 million players were shipped in 1998 alone\(^\text{11}\). Within six years, DVD rentals had overtaken VHS rentals and 50 million Americans had purchased DVD players, four years faster than VHS took to reach the same figure\(^\text{12}\).

Netflix’s early marketing efforts focused on partnering with major DVD player manufacturers to place a “10 free rentals” coupon in the packaging of the players themselves. This piggyback approach allowed Netflix to reach exactly the customers who might be interested in their service: those who had just bought a new DVD player and were looking for things to do with it. Best of all, the strategy cost Netflix almost nothing. Remembering the failures of Betamax and LaserDisc, Panasonic, Toshiba and Sony saw Netflix’s potential to accelerate DVD adoption and included Netflix coupons at no charge\(^\text{13}\).

*Distribution*

Also crucial was Netflix’s distribution strategy. Though mailing DVDs went counter to the retail model that dominated the industry, Netflix chose a rather well-known partner to help execute its unorthodox strategy: the USPS. First established a year before the signing of the Declaration of Independence, the Postal Service had all the resources necessary to ship each Netflix DVD anywhere in the country for the cost of first class mail. Initially, Netflix’s challenge was in adapting its packaging and process to integrate into the USPS system, and as time went on Netflix’s huge scale proved both a blessing and a curse. In 2007, the USPS threatened significant rate increases on Netflix’s envelopes, which could jam automated sorters and thus required manual sorting\(^\text{14}\). Yet Netflix has also been the USPS’ fastest growing customer for first class mail\(^\text{15}\), spending over $600 million annually on postage\(^\text{16}\). The USPS recently was


\(^{15}\) Shih 9

sued by game rental service GameFly for providing preferential service through Netflix-only mailbox slots\(^{17}\).

Overall, having the USPS as a partner has likely aided Netflix’s ability to capture value. Though the USPS cannot officially provide preferential service to Netflix, the partners have worked together to streamline the distribution process, which has allowed Netflix to completely forego the retail store investments required to follow the Blockbuster model. Instead, Netflix has gradually built a national distribution center network, with the cost of converting a warehouse into a distribution center of just $60,000\(^{18}\). Moreover, the USPS’ ability to capture more of Netflix’s added value is inherently limited by its inability to charge discriminatory prices on different customers.

*Content*

On the content side, Netflix benefited greatly from the fact that it *did not* need special relationships with studios to rent out their DVDs. From an innovation standpoint, the company was initially reliant on studios releasing titles in DVD format, and the company’s value proposition was inherently magnified as studios’ complete libraries began to be released in the new format. This was especially important for Netflix, whose strategy emphasized older and lesser-known films rather than costlier new releases. However, the quick adoption of the DVD format quickly mitigated much of this risk, and Netflix’s centralized model meant that even early on it could offer customers thousands of titles that individual video stores did not have the shelf space or budget to carry.

Studios have also been limited in their ability to capture Netflix’s added value, though this will be changing as VoD becomes a bigger part of Netflix’s business model. The First Sale Doctrine allows anyone to sell or rent DVDs that they have purchased, and in Netflix’s early days this even meant buying retail from Wal-Mart or Best Buy when studios would not license films\(^{19}\). However, the company over time has moved to revenue sharing agreements with most major

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\(^{18}\) Shih 7

studios, allowing Netflix to pay less up front for hot new releases while providing customers increased access to in-demand titles\textsuperscript{20}.

Over time, Netflix also began to exploit its ability to drive revenues for independent and lesser-known films. Because of the company’s ability to link its millions of users to films they might not otherwise hear about, Netflix accounts for 60-75\% of the market for many smaller films. This encouraged the company to establish its own subsidiary aimed at acquiring distribution rights for independent films\textsuperscript{21}. While superficially stretching Netflix’s core competency, the move makes more sense given the value Netflix derives from having cheap, well-reviewed films in its catalog.

**Challenging Norms: Restructuring the Traditional Value Chain**

Much of Blockbuster’s success hinged upon the insight that “movie night” was often a last-minute decision. To this end, the company’s strategy focused on increasing the number of retail locations to maximize its reach and enable easy access to the majority of the population. Given that each retail outlet was constrained by limited shelf space to a maximum offering of about 2,500 different titles per store, the chain focused primarily on new releases, which represented over 70\% of total rentals\textsuperscript{22}. Blockbuster acquired movies at the cost of about $18 per film, and realized revenues from rental fees (charged on a per-video basis), late fees, and sales of used videos.

Netflix aimed to radically alter this structure by defining its own value proposition that played off its unique business model and departing from the traditional retail push model. By doing so, the company realized significant bottom line advantages against its brick-and-mortar rivals.

**Creating a Unique Value Proposition**

The delivery delay inherent in the Netflix model prevented the company from competing on the idea of “last-minute movie night,” but it did present an opportunity to have a movie in the customer’s home at all times. This insight enabled Netflix to turn a potential disadvantage into a key benefit. By dropping its initial per-movie pricing scheme and switching to a subscription-

\textsuperscript{20} Shih 6
\textsuperscript{21} Shih 8
\textsuperscript{22} Shih 2
Based model, Netflix provided its subscribers with a constant stream of content. In order to direct the flow of titles, Netflix asked customers to create a movie queue, which would be delivered in sequence (depending on availability), with a maximum of three at one time (the company subsequently added higher-volume subscriptions). By doing so, Netflix was able to maintain an inventory that very closely matched its immediate needs. This enabled the company to reduce its risk of overstocking or understocking, and meant that demand could be met with about one-third to one-fifth the inventory needed by a retail location.  

*Turning Push into Pull*

Netflix’s increased ability to forecast its demand enabled it to expand its offerings far beyond that of a traditional retailer. Rental chains typically hedged against inventory risk by limiting their offers to popular titles and new releases. As a result, customers interested in lesser-known films were left empty-handed. With no shelf-space constraints, and an enormous aggregated supply base offered by its network of distribution centers, Netflix could better afford to stock titles for which demand was uncertain.

Netflix complemented its unique queue feature with a movie recommendation system, which surveyed new subscribers to gather data on movie preferences. Customers were recommended movies based upon their reported preferences, and then rated each movie they saw, which served to further refine the system’s recommendations. Because the system employed a filter which prevented out-of-stock titles from appearing in a customer’s recommendations, less popular titles were often recommended and viewed by customers. Netflix’s recommendation system allowed it to have a significant effect on the demand environment, essentially creating demand for titles that would otherwise have seen only limited circulation.

*Exploiting Technology Maturity to Become a Best Mover*

When Netflix was introduced, in 1997, the market for VHS tapes was saturated, with limited innovation possibilities and a dominant player garnering a large percentage of rental volume via a country-wide network of retail location. Netflix recognized the emerging DVD technology as the “next big thing” and latched onto the format, forgoing the market for VHS rentals entirely.

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and positioning itself as an alternative to rental chains, which were only beginning to embrace the technology.

Netflix quickly acquired brand recognition and technical expertise in the online DVD rental space. Its success as a first mover can be attributed to both luck and to skill. By engaging in cross-promotional activity with DVD makers, the company targeted early adopters of DVD technology and quickly built up its library as its subscriber base grew. The next several years saw household penetration of the DVD format increase dramatically – up to 24% in 2001 and 37% in 2002. Throughout this period, Netflix remained uncontested in its market, and set the standard for pricing with its “all you can rent” model. With Blockbuster and other rental chains, constrained by their massive inventories of VHS cassettes, new technology adoption by this traditional channel was bound to be delayed. Though rental chains were beginning to invest in DVD inventories, pricing and delivery were firmly entrenched: Blockbuster continued to operate strictly from its retail locations, and enforce its policy of late fees for overdue rentals. Netflix was able to acquire a subscriber base of over one million before the video rental giant even acknowledged the threat in 2003.

Instrumental in cementing its first mover advantage was Netflix’s personalized recommendation system. As the subscriber base grew, so too did Netflix’s catalog of customer ratings. As customers provided ratings for movie titles, the recommendation system became more accurate, as recommendations could be provided based on the likes and dislikes of those with similar preferences. As this personalized aspect of Netflix’s service was not easily replicable by a company starting an online model from scratch, it represented a significant switching cost to Netflix’s customers. Furthermore, because it provided added value to the customer, there was no sense of being “locked in” to the Netflix offering.

**Competitive Response from Blockbuster**

By the time Netflix was founded in 1997, Blockbuster had emerged as the dominant player in the video rental market. Before Blockbuster entered, the video rental business was largely fragmented with “mom-and-pop” stores that served local towns with a limited selection of rental options and a largely unappealing retail experience. Since its IPO in 1986, the company had

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achieved success worldwide with a business model that focused on providing a reliable selection of new release hits, in addition to lesser-known titles, to customers in most US markets as well as select international markets. Instead of the few hundred titles available in a typical “mom-and-pop” store, Blockbuster was able to offer customers 2,500 titles through its big-box stores.\textsuperscript{26} In addition to a significantly larger product selection, Blockbuster focused on customer service in its modern, comfortable retail space in order to lure customers away from their local rental stores. Flexible store hours and proximity to its customers made Blockbuster a reliable and convenient option for the last-minute movie watchers they targeted. Once its brand was well-established, Blockbuster’s strategy involved a growth plan of opening retail outlets in new markets while expanding within existing ones. By 2000, Blockbuster operated about 6,500 stores and held a commanding 27 percent market share in the media rental business.\textsuperscript{27}

\textit{Blockbuster’s Initial Response to Netflix}

With its massive retail presence and high brand awareness among customers, Blockbuster had become the behemoth in the video rental business. The growth had not come without a cost, though, and throughout the mid-1990s the company struggled to make its store operations profitable and suffered from management turnover.\textsuperscript{28} By the late 1990s and early 2000s, Blockbuster had turned around its operations, resulting in consistent same store sales growth and record profitability by 2002. By 2003, it began to focus more on higher-margin DVD and other in-store sales, resulting in greater profitability at the expense of revenue growth.\textsuperscript{29} It was also during this period of turmoil, that Netflix entered the market with its innovative online rental platform.

Blockbuster’s core strength lay in its brick-and-mortar retailing capabilities. It knew how to deliver a better \textit{in-store} buying experience for its customers. Throughout the tech boom of the late 1990s, it had adopted a wait-and-see strategy in regards to new online distribution models. While it began to recognize the emerging online market in 2002, Blockbuster dismissed it as unproven.\textsuperscript{30} If we analyze this decision from Blockbuster’s perspective at the time, it becomes

\textsuperscript{26} Shih 2
\textsuperscript{27} http://www.fundinguniverse.com/company-histories/Blockbuster-Inc-Company-History.html
\textsuperscript{28} Ibid
\textsuperscript{30} Shih 9
clear why they favored the brick-and-mortar business. First, the business world had just experienced the tech boom and subsequent crash; many high-flying internet business plans had come and gone in the matter of a few years. Blockbuster was perhaps reluctant to throw itself into an online market perceived to be risky and unviable. Second, the company was the dominant market player that had saturated the US and over 25 countries with its 6,500 stores on the belief that movie-watching was essentially a spur-of-the-moment decision for consumers. Due to the nature of the distribution platform, online rental companies could never deliver the speed required to accommodate these last-minute decisions. Finally, the company likely realized that there was significant value in the Blockbuster brand. If the internet model did materialize and prove viable for the long-term, a well-recognized brand name like Blockbuster could quickly move in to dominate young, unestablished startups like Netflix. Blockbuster’s history in the retail market proved that first mover advantage could easily be overturned, and it therefore chose to be a late-mover in the online market as necessary.

**Lack of Customer Understanding**

Fundamentally, Blockbuster miscalculated the nature of its customers’ buying decisions. It had assumed that most customers rented movies as a *last-minute decision*. Perhaps this was indeed the case before the arrival of Netflix. From the customer’s perspective, there were essentially three options for watching movies at home: 1) watch a movie from one’s own limited and expensive catalog (almost certainly a movie the customer had already seen), 2) take their chances with a limited selection of movies aired on TV or pay-per-view, or 3) rent a movie from a store with a large selection at a low price. The existence of late fees in Blockbuster’s model further entrenched the economic incentive for a customer to behave this way, since renting a movie many days prior to watching it resulted in a steep increase in costs. Given these options, customers’ behaviors were constrained by the fact that they had no options available to pre-plan their movie watching. Many were forced into the last-minute model. Blockbuster’s key failure in understanding their customers’ behavior was a lack of recognition that those behaviors were dictated by the current state of the market, but not necessarily indicative of their behavior when the constraints were lifted. Customers clearly wanted convenient access to tens of thousands of titles, and they were willing to trade off the convenience of immediate viewing for this level of access.
**Blockbuster Forced into Action**

By 2004, Netflix had proven that its market niche was real and its business model was sustainable. Its subscriber growth rates exceeded 50% for five straight years, and it ended the year with 2.6 million subscribers serving up $22 million in profit. It was clear that Netflix’s subscription base was hurting Blockbuster’s retail sales, and it was time to take action.

Blockbuster responded by announcing that it would open its own online retail store in 2004. Blockbuster largely duplicated Netflix’s model, but it offered a couple differentiating features that it believed would prevail in the long-term. First, it offered free in-store rentals in addition to online rentals for essentially the same price as Netflix (and later lowered their prices below Netflix’s). Second, it integrated the online component into its retail business by allowing returns at its physical retail locations. As discussed earlier, Blockbuster also abandoned its late fee policy.

Blockbuster’s move into the online market was reasonably successful, as viewed through the lens of customer acquisition. By 2007, it had managed to sign up 3.1 million subscribers, likely taking a chunk out of Netflix’s 7.5 million customers and retaining a number of customers who might later have abandoned the in-store model for the online model.\(^\text{31}\) Financially, the picture was significantly less rosy for Blockbuster. The cost of marketing their new online store, integrating it with the in-store model, and undercutting Netflix’s subscription model took its toll in 2005, and the company still has yet to make the venture as financially successful as Netflix’s.

**First Mover vs. Best Mover**

Blockbuster witnessed the tech boom and bust, and it decided to stick to its traditional in-store model as opposed to entering the online foray. It clearly did not believe there would be a great deal of first mover advantage in this market. After all, the company had strong historical relationships with the supply chain, a well-entrenched domestic and international footprint, and wide brand recognition among consumers. Netflix had already done the legwork as the first mover, and Blockbuster would not have to establish itself or prove the business to be viable before moving online. It took the position of being the best mover by offering more product for

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the same price and leveraging its stores for additional customer convenience. So how has Netflix still managed to prevail over Blockbuster?

Netflix has been able to take advantage of two conditions that allow for First Mover Advantage to exist. First, it had market preemption. It offered a simple product (DVDs by mail) in an efficiently-sized opportunity. Since it was early into the online video rental market, it helped shape market demand, and the addressable market grew around their online model. There were no other serious competitors, so Netflix had full control of the market. Netflix’s distribution model allowed it to reach nearly all people nationwide, so there was not much market left unserved. Therefore, it could satisfy the full market demand by itself, making it efficiently sized. Second, Netflix’s model took advantage of network externalities. By allowing customers to state their preferences, Netflix could target customers with certain films that were both available and likely suited to the customers’ tastes. A vast database was built up over time, allowing Netflix to continually optimize its recommendations. It also developed a degree of switching costs by allowing customers to build a queue of movies to be delivered in the future. An average customer’s queue length was 50 movies long.\(^{32}\) Unless a competitor offered a significantly more valuable product, a customer would not likely abandon the queue of movies he had taken the time to accumulate.

Blockbuster had miscalculated the fact that it could be a better mover in this market. DVD rental is a very simple product, and both companies had access to essentially the same libraries and could deliver the same level of speed and convenience through their online marketplaces. Blockbuster’s big mistake was its belief that its combined in-store/online offering was a true differentiator. The fact is that the customers that moved online did not do so temporarily, they did so permanently. Most had probably become accustomed to the delayed delivery model instead of the last-minute decision model. In-store rentals became irrelevant to that segment, so Blockbuster’s strategy for acquiring Netflix’s customers by offering in-store integration was rendered ineffective. Blockbuster’s brand name was not enough to win back customers, especially since Netflix’s offering was so well-executed and perceived highly by its early adopters.

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Finally, Blockbuster’s approach for value creation in the online market still relies heavily on its success with the in-store model. Due to the company’s need to close underperforming stores, whatever value Blockbuster created with its combined in-store/online package has been eroding ever since. Since Netflix started gaining significant traction, Blockbuster has been steadily winding down its physical footprint, including a recent announcement that it would close 22% of its stores.\(^{33}\) Needless to say, when the company makes its in-store option one of the sole differentiators of its online service, a nearby store needs to exist in order for a customer to take advantage of the option. With each store closure, that option becomes less and less valuable and makes it more difficult for the company to become a best mover capable of converting customers to its platform. On the other hand, it would be rather uneconomical to keep an unprofitable store open just to give a boost to its online model, so closure became necessary.

**Netflix’s Future: Streaming Strategy**

Netflix has emerged unscathed from its battle with Blockbuster for the by-mail market, mainly because Blockbuster was fighting on foreign turf. In recent years, however, a new battle has emerged among companies on the internet. On one side are incumbent video rental providers like Netflix and Blockbuster, and on the other side are the up-and-coming streaming video content providers. Netflix CEO Reed Hastings unequivocally notes that “the company’s success hinges on its ability to transition to online video from DVDs.” As disruptive as Netflix was to brick-and-mortar businesses like Blockbuster and Hollywood Video, streaming video has the opportunity to redefine the industry for the second time in the past 15 years.

After a failed attempt at creating the Netflix Player, a branded set-top box later spun off to create Roku, the company determined that the most opportune solution to delivering streaming video to customers was through current devices already used in households. As with other broad shifts in the traditional media landscape, this would require the reformation of an industry ecosystem, except this time the content owners would hold significantly more power. To gain access to customers in alternative hardware channels, Netflix signed an agreement in 2008 with Microsoft to stream video through its Xbox 360 device for an additional fee of $40 per year. To follow suit, Sony in 2009 and Nintendo in 2010 will offer Netflix video streaming from their devices.

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free of charge to existing users. Hastings’ decision to dramatically alter Netflix’s operations strategy has helped the company to remain at the forefront of content delivery. Today, customers can stream Netflix content from their gaming systems, LG and Samsung Blu-ray players, and through their TiVos and new flatscreen TVs. Hastings sees this multi-platform strategy as the key to Netflix infiltrating homes and maintaining its position: “By the end of 2009, nearly 10 million Netflix-equipped gadgets will be hanging on the walls and sitting in entertainment centers.”

The words “ambitious” and “visionary” have been used to describe Netflix’s entrance into the media industry, but it has been the company’s ability to effectively decode consumer trends and timely enter markets prior to competition that continue to drive its success. Services like Pandora and Hulu have proven the feasibility of streaming content and drawn an increasing number of consumers to use the internet as a replacement for traditional media. While Netflix always foresaw the internet to be the future of its business (“There was a reason he called the company Netflix and not, say, DVDs by Mail”), it has only been in the last few years that the technology has caught up with customer demands for at-home convenience, broad selection and immediate delivery. As part of its 2009 Q3 results, “Hastings said 42 percent of Netflix subscribers streamed at least 15 minutes of one TV episode or movie during the third quarter. This is up from 22 percent (of a smaller base) who streamed as much during the same period last year.” Additionally, the company is launching a streaming-only option internationally in the near future. When it introduced its by-mail model in the late 1990s, Hastings effectively captured the segment of the rental market that valued convenience and selection over the ability to have a last-minute viewing experience. Streaming video has the potential to provide all three value drivers to consumers and destroy Netflix’s advantage. The main difference between Blockbuster’s earlier response to the internet model and Netflix’s current response to streaming video lies in Netflix’s unwillingness to hesitate. Being a late mover ultimately doomed Blockbuster’s foray into DVDs by-mail, and Netflix refuses to follow suit.

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As it did when it took on Blockbuster with its mail-order DVD business, Netflix is directly challenging strong incumbents, both the cable companies and content providers, with its streaming offering. The stakes are massive—for cable companies, television subscriptions still account for about 60 percent of revenue, with a third of cable revenues accounting for at least half of revenues at content providers such as Disney and Discovery. Even public stations like NBC and ABC will be hurt by a streaming option because of their reliance on advertising and viewership. For example, “Fox crams 18 commercials into every Sunday night airing of The Simpsons, earning 54 cents per viewer. But, according to research firm Sanford C. Bernstein, Fox airs just three commercials for the same show on Hulu—a site it co-owns with NBC Universal and Disney—earning a measly 18 cents per viewer.”

For Netflix’s streaming option, advertising revenue from content will not only be less, but the portion that content providers will actually receive is yet to be seen. In other words, the value of the overall pie is highly uncertain.

Streaming is an even bigger problem for Hollywood studios and other content providers, who rely on post-theater revenues to generate the majority of each movie’s profit, which is particularly true for new releases. Movie value lifecycles start with theaters and progress from Pay-Per-View and DVD to Pay-TV networks until finally being released to other outlets. Along each stage, studios receive a significant sum to limit the number of eyes that have access to the content. By allowing the movie to be included in the Netflix library, the studios greatly reduce the value to each link in the chain. Currently, Netflix has been able to find a loophole in the system by licensing content directly from Pay-Per-View stations, such as Starz, who have exclusive rights as part of their agreement with the studios. However, the loophole could soon be closed, shifting the power back to the content providers. Renegotiation of current PPV contract terms puts Netflix at risk of losing premium new releases in the future, thus removing a key reason new subscribers sign up.

In an attempt to combat this outcome, Netflix is aggressively looking for scale through a virtuous cycle. By attracting new subscribers with its current agreements, Netflix is capable of paying more for premium content, which in turn attracts more subscribers. Nevertheless, the power is held by the studios, who can easily charge exorbitant prices for new releases and price Netflix

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completely out of the market. Similarly, cable companies could block Netflix’s access to content, or seek to offer their own Netflix-like services\(^\text{38}\).

The attractiveness of the streaming market is also encouraging more powerful competitors. We mentioned earlier that Hulu and Roku, if they can develop their own content library, are potential competitors. But no company is a bigger threat to Netflix than Apple. While Apple does not currently provide owned or licensed content, the opportunity to combine its Apple TV and iTunes platforms with the brand equity of Apple would create a formidable foe for Netflix. As mentioned in class, iTunes is not currently a major profit center for Apple, but there is nothing keeping Apple from developing a subscription-based streaming option to compete with Netflix. Apple has the industry connections and the content to quickly catch up and pass Netflix if it ever decides to do so. Despite this threat, Netflix is looking into creating an iPhone Application that will compete directly with purchased iTunes content, which may force Apple to actively protect its business.

Netflix has never been afraid of a challenge and has quietly been successful despite numerous pundits voicing competitive concerns, thriving on “the strength of its unique algorithms and its relentless focus on getting customers content they didn’t even know they wanted\(^\text{39}\).” And Netflix has no plans to change this focus. The company recognizes the existence of a Technology S-Curve, and that innovation gains, as perceived by customers, will take place earlier in the product life cycle and will help result in the technology’s widespread adoption. As a result, Netflix recently distributed one million dollars to a team that created a new algorithm that increased the accuracy of the Netflix recommendation system by 10%. Netflix’s recommendation system not only helps its subscribers find their favorite movies, but it has helped the company find hidden gems within its content portfolio, increasing the company’s value to consumers. While Netflix was an early mover in streaming content, it also recognizes that the best mover will be the most likely to prevail, and therefore it has focused its efforts on optimizing the customer’s online experience.

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\(^{39}\) Roth, Daniel. “Netflix Everywhere: Sorry Cable, You’re History.” *Wired Magazine*. September 21, 2009
The future holds the potential for both promise and failure for Netflix. Streaming content is proving to be the solution for consumers, but includes increased conflict with empowered content providers as well as the cable companies and possibly Apple. However, Netflix has proven itself resilient as it looks to strengthen its content portfolio and distribution network to further grow its power in the digital media supply chain.