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9-607-138
REV: APRIL 27, 2009

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Netflix

Late one afternoon in January 2007, Reed Hastings had just concluded a meeting with his senior management team in the King Kong board room at Netflix's corporate headquarters in Los Gatos, California. Hastings, the founder and CEO of the company, which pioneered online DVD rentals, was preparing to unveil Netflix's highly anticipated entrance into the online video market. Many industry observers believed that the ability of customers to order movies through their computers for instant viewing, commonly referred to as video-on-demand (VOD), would quickly impact the large user base for Netflix's core business.

Hastings looked across the third floor of the office building and the conference rooms named for some of his staff's favorite films. A love of movies clearly ran deep among Netflix employees, and he was confident that one way or another, his team would maintain the company's position as a leader in the home video market. But, as he reflected upon the years of investment and discussions surrounding the new feature that Netflix would be offering its customers, he could not help but think of the merits of the paths not chosen.

As the management team filed out of the board room around him, Hastings returned his thoughts to the present. While he believed that the DVD rental market would remain healthy for years into the future, he knew that this announcement would impact not just the market's perception of his company but its ability to sustain its position as a giant in the media industry. With new resolve, Hastings returned to his desk to review his forthcoming announcement one more time.

Company Background

Netflix, an online subscription-based DVD rental service, was first conceived by Hastings after he discovered an overdue rental copy of *Apollo 13* in his closet. After paying the $40 late fee, Hastings, a successful entrepreneur who had already founded and sold a software business, began to consider alternative ways to provide a home movie service that would better satisfy customers. The business that emerged from Hastings' frustration was a rental company that used the U.S. Postal Service to deliver DVDs to its subscribers. By year-end 2006, subscribers could use Netflix's website to choose from among over 70,000 different titles held on over 55 million DVDs. Through its 44 distribution centers across the country, Netflix could deliver to more than 90% of its 6.6 million subscribers within a single business day. Netflix's flagship subscription plan offered unlimited monthly rentals,

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Senior Lecturers Willy Shih and Stephen Kaufman and David Spinola (MBA 2007) prepared this case. HBS cases are developed solely as the basis for class discussion. Certain details have been disguised. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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allowing customers to hold up to three movies in their possession at any one time for a monthly fee of $17.99. For the year ending December 31, 2006, Netflix had achieved revenues of nearly $1 billion, generating free cash flow of $64 million. (See **Exhibit 1** for Netflix financials.)

The History of Home Video Rental

When Netflix was founded in 1997, the home video market was a fragmented industry largely populated with "mom-and-pop" retail outlets. Customers rented movies, primarily on VHS cassette, from a retail location for a specified time period, usually between two days and one week, and paid a fee of $3 to $4 for each movie rented. The market leader was rental giant Blockbuster Inc. Blockbuster's success was based on the insight that movie rentals were largely impulse decisions. To customers deciding at the last minute that a given night was "movie night," the ability to quickly obtain the newest release was a priority. Statistics showed that new releases represented over 70% of total rentals.

Much of Blockbuster's growth strategy revolved around opening new locations, both to expand geographic coverage and to increase penetration and share in existing markets. In 2006, Blockbuster had 5,194 U.S. locations, of which 4,255 were company owned, with the balance franchised. Locations were chosen based upon a careful review of local data, including customer concentration and proximity to competition, focusing on highly visible stores in high-traffic areas. Management commonly proclaimed that "70% of the U.S. population lives within a 10 minute drive of a Blockbuster,"[1] highlighting how its retail network offered unmatched convenience to impulse movie renters. Stores were staffed primarily with part-time employees, averaging 10 staff members per store plus one manager. Occupancy and payroll represented a significant percentage of total costs.

The nationwide network of Blockbuster outlets carried a similar selection of movies, offering about 2,500 different titles per store. Shelf space in each store was mostly dedicated to hit movies, with the newest releases receiving the most prominent positioning. Locations acquired multiple copies of popular and high-profile movies, at a cost of about $18 per film or DVD, in anticipation of high customer demand at the release date. Blockbuster's financial success depended on maximizing the days that any individual movie was out for rent. Stores were reluctant to stock large numbers of lesser-known and independent films, since the demand for these titles was inconsistent. With a relatively narrow selection of mostly familiar movies, customers could generally select a title with a limited amount of advice from the sales staff. In time, each Blockbuster retail outlet would begin to sell previewed copies of its new releases at a discount, generating incremental return on its investment and clearing shelf space for the next wave of new movies.

Traditionally, any movies not returned to the same location from which they were rented by the end of the specified rental period were subject to extended viewing fees, or "late fees." In 2004, these fees represented over $600 million for Blockbuster, or about 10% of revenues. In addition to the revenue benefit, late fees served a critical asset utilization function for Blockbuster. They encouraged a timely return of each rented film, allowing it to be rented by another customer. In their absence, delayed returns could lead to increased levels of stockouts, costing Blockbuster incremental rental opportunities as well as reducing customer satisfaction.

When Netflix went public in 2002, Blockbuster was enjoying record levels of revenue and profitability amidst a period of industry expansion. According to research reports cited in

[1] Pete Barlas, "Blockbuster Borrows from Netflix' Playbook, but Stays Offline Monthly DVD Rental Program Subscribers," *Investor's Business Daily*, August 12, 2002.

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Blockbuster's 2002 public filings, DVD players were present in 37% of U.S. television households, up from 24% the prior year. The increase in the popularity of the DVD format had helped to grow industry movie rental revenues from $8.5 billion to $8.7 billion. The year 2002 also represented Blockbuster's fifth consecutive year of same-store sales growth, and the Blockbuster brand achieved nearly 100% recognition with active movie renters.

Netflix History

Netflix was founded in 1997 during the emergent days of Internet retailing, when online competitors to traditional "brick-and-mortar" retail stores were gaining prominence. Rather than attempt to attract customers to a retail location, Netflix offered home delivery of DVDs through the mail.

When its original website was launched in early 1998, most available movies for rent in video stores used the VHS cassette format. In contrast, Netflix concentrated efforts on early-technology adopters who had recently purchased DVD players. Its marketing strategy was to develop cross-promotional programs with the manufacturers and sellers of DVD players, providing a source of content for customers. Hastings elaborated on Netflix's goals in its early days: "We were targeting people who just bought DVD players. At the time our goal was just to get our coupon in the box. We didn't have too much competition. The market was underserved, and stores didn't carry a wide selection of DVDs at the time."

Netflix's website included a search engine that allowed its customers to easily sort through its selections by title, actor, director, and genre. Using this search engine, customers built a list of movies, called a queue, to be received from Netflix. Netflix sent movies to its subscribers based on the order of titles on the list, with subscribers receiving a new movie from their queue upon the return of a currently outstanding film.

Rather than replicate the model of video rental chains and lease retail locations, Netflix depended on the U.S. Postal Service to deliver DVDs to its subscribers. DVDs are small and light, enabling inexpensive delivery and easy receipt by nearly every potential U.S. customer. Hastings related how he determined that the delivery performance offered by the USPS was satisfactory: "I went out, bought a whole bunch of CDs and started mailing them to myself to see how quickly they would come back and what condition they would be in. I waited for two days—and they all arrived in perfect condition. All the pieces started to fall into place after that."[2]

Netflix initially used a pricing model similar to that offered by traditional video stores. Customers chose their film using the company's website, were charged $4 per movie rented plus a $2 shipping and handling charge, and were expected to return films by a specific due date or be charged extended rental fees.

Hastings and his team used the models of the most successful Internet retailers of the time to identify characteristics they thought might appeal to customers: (1) value, (2) convenience, and (3) selection. Hastings referred to value customers as "eBay customers," those to whom Internet shopping was an opportunity to target a great deal. Convenience and selection, in contrast, attracted the "Amazon customers," those who used online shopping as an alternative to traveling to retail outlets and choosing among limited in-stock offerings.

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[2] Aline Van Duyn, "DVD Rentals pass their screen test," *Financial Times*, October 4, 2005, p. 15.

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

This focus was forced in part by the rapid adoption rate of DVD players among U.S. households, which became the fastest technology adoption in history. U.S. household penetration, at 5% in 1999, leapt to 13% by 2000, a level that attracted the attention of other channels. DVDs started being sold at large retailers such as Best Buy and Wal-Mart and began replacing VHS cassettes on the shelves of traditional video rental outlets. As this transition occurred, the convenience advantage that Netflix offered to DVD viewers suffered in comparison to the video stores. The company shelved its plans for an IPO and struggled through a large layoff as it began to adjust its business model in an effort to reach profitability. Chief among Hastings' concerns were the general customer dissatisfaction with Netflix's value proposition and the high cost of building a DVD library to support the growing subscriber base.

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

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

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

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

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

With this change in pricing, the company added a new group of fans for whom movie rentals were a regular part of their daily entertainment. Many of these high-volume customers were turned

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off by the high cost of paying for each movie being rented yet still chose to rent from video stores because of limited alternatives. Others were dissatisfied with how large late fees inhibited their ability to view movies at the times most convenient to them. If "movie night" was not an event but an ordinary form of entertainment, the option to hold movies beyond a two-day rental period was important. For these frequent viewers, Netflix's "all you can eat" model was an attractive alternative to the traditional per-day fee structure.

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

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

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

> We started with a system that relied heavily on editorial content, but we realized that an editor could only write so many Web pages. Five movies would be highlighted on the website, then everything that was promoted was instantly rented out. That changed to a different five movies each day of the week, and they were all still instantly rented out. We tried to improve the system to ensure that subscribers weren't referred to movies they had already rented. Eventually, we realized that the promotional value of writing the editorial blurbs was zero.

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

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

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

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

Movies are a taste-based product, for which many titles are consumed only once. As such, consumers must make a series of purchases without knowing for sure if they will like the product. Netflix's website resonated with subscribers because they so frequently enjoyed the less well-known films recommended to them that they might not otherwise have seen. This software established a relationship with customers that was not matched by part-time employees at a retail video store, nor easily replaceable upon switching to a competitor's service. Netflix's size and growth rate also generated a positive "network effect" from its large customer-generated rating system. Because it had the largest collection of movie ratings in the world, customers recognized that they were more likely to have their tastes and preferences accurately reflected in recommendations from Netflix's site than any other offered by a competitor.

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

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

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

The benefit of the new relationships with the studios extended beyond lowering the acquisition costs for high-demand releases. Hastings recognized early on the number of customers who were

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

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

> Half the equation of packaged media is allocation—getting the right amount of product in the right locations. This was more of a challenge for products that did not enjoy broad promotion. The trade radius of a single video store was so small that even a single copy of a lesser-known film had lousy economics. By using a national inventory, we avoid that issue. We never have overstocks on one side of town with understocks on the other side. Using the subscribers' queues provides a great deal of data. By looking into the demand in the near future, we can replicate near-perfect inventory. Overall, we can satisfy demand in an area with about one-third to one-fifth of the inventory needed by a retail chain.

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

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

Armed with this evidence of success, Netflix quickly opened more distribution centers across the country, and subscriber numbers continued to respond to the improved delivery service. The company promised 500,000 subscribers to its investors in its 2002 prospectus and delivered 700,000 at the time of the May 2002 IPO. These changes in Netflix's pricing and cost structure allowed the company to reach profitability for the first time in the quarter ending June 2003. After establishing the viability of this business model, Netflix continued to build its subscriber base and upgrade the customer experience by opening new centers (see **Exhibit 2** for Netflix's operating statistics). The centers themselves were inexpensive investments; it cost about $60,000 to convert an existing warehouse to Netflix's needs. The company continually added centers to improve upon its nationwide coverage and reduce delivery time to its customers. With the number reaching 44 by early 2007, over 90% of subscribers could be reached within one delivery day. The improved ability for Netflix to provide next-day delivery to more regions of the country allowed it to compete more successfully with retail video stores for new customers drawn by all three of the targeted characteristics of convenience, value, and selection.

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Netflix considered delivery time to be the key measure of customer satisfaction and continually sought to improve the operations within each of its existing distribution centers. Much of the process of opening return envelopes and filling outgoing mailers with DVDs was still performed manually. However, with careful hiring practices and thorough time and motion studies, Netflix's employees could open and restuff an average of 800 DVDs per hour, allowing the entire distribution center network to ship over 1.6 million DVDs per day. (See **Exhibit 3** for photos of the distribution center operations.)

Netflix's relationship with the USPS grew. While the USPS was facing a general decline in first-class mail, Netflix represented its fastest-growing first-class customer. Along with receiving the standard discount for presorting of its outbound envelopes by zip code, Netflix worked with the USPS to reduce the time it took to receive a movie return. Rather than deliver returns to the distribution center of origin, the USPS brought the easily recognizable red Netflix envelopes to the closest Netflix distribution center. And recently, Netflix began using multiple "truck routes," supporting each distribution center to expedite returns. This shortened turnaround time for new movies and improved the overall customer experience.

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

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

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

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

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

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

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make it to DVD. We are looking through the other 90 films for top-tier content to bring to our customers.

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

As it was for many subscription-based services, customer churn was a critical issue for Netflix. In an average month in 2006, 3.6% of customers would cancel their subscription. In 2002, that churn rate was even higher, at 6.3%. Since customer acquisition was a major expense, retaining existing customers and reclaiming old ones who had previously unsubscribed was a key opportunity.

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

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

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

Blockbuster Responds

Early public statements by Blockbuster dismissed the notion that its customers would benefit from an online rental business. In May 2002, a spokesperson addressed the online rental market: "Obviously, we pay attention to any way people are getting home entertainment. We always look at all those things. We have not seen a business model that's financially viable long-term in this arena. Online rental services are 'serving a niche market.'"[3]

Three months later, clarifying that Blockbuster did not intend to launch an online business to compete with Netflix, a spokesperson announced, "We don't believe there is enough of a demand for mail order—it's not a sustainable business model."[4] Furthermore, the 2002 annual report made only a cursory mention of the threat posed by online rental websites, with no mention at all in the "Risks"

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[3] Brian McClimans, "Frustration leads to new Internet, mail DVD service," *Associated Press Newswires*, May 18, 2002.

[4] Pete Barlas, "Blockbuster Borrows from Netflix' Playbook, but Stays Offline Monthly DVD Rental Program Subscribers," *Investor's Business Daily*, August 12, 2002.

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section. Not until 2003 did Blockbuster's management publicly discuss Netflix by name as a threat to their core business model.

Blockbuster did not formally respond to Netflix until the introduction of Blockbuster Online in 2004. The offering first appeared in the company's disclosures in 2003, which included a tersely worded intent to launch an online subscription service during 2004. This service, closely matching Netflix's business model, offered subscribers a far greater selection of movies than was available in stores. When Blockbuster finally did enter the marketplace, it did so with what Hastings described as a "land grab" mentality, undercutting Netflix's pricing in an aggressive effort to recover lost market share. Blockbuster also tried to improve the performance of its service and distinguish itself from Netflix by integrating its online offering with its traditional store-based business. By using cross-promotions, giving in-store rental coupons to online customers, and stocking online rental requests out of its store inventory, Blockbuster attempted to find ways to productively utilize its existing resources and improve performance for its customers. While by the end of 2006 Blockbuster Online had grown to 2.2 million members, the 2006 annual report reported that Blockbuster Online still required meaningful advertising support and continued to suffer from "significant" operating losses. In the words of Hastings in 2005: "We're just thankful Blockbuster didn't enter four years ago."[5]

Blockbuster also unveiled its "no late fees" program, effective at all of its stores on January 1, 2005. Blockbuster felt that its competitors, most importantly Netflix, were differentiating their business offering from Blockbuster's due to the absence of late fees in their service offerings. This change in business strategy was not without a cost. In addition to the $60 million of marketing and implementation costs of the program, Blockbuster chose to forgo about $600 million of revenue by eliminating late fees. While early signs suggested this program resulted in increased traffic and rental volumes, it did not offset the loss of revenue as base movie rental revenue grew only 5%.

Video-on-Demand

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

Online Video Alternatives

Netflix had been following the development of VOD since the company's inception, and Hastings sorted the available forms of Internet video into three groups. The first was advertising-supported video. Comparable to standard network television, newspapers, and magazines, this would include content that would be interrupted by regular advertising. Due to the gap between potential advertising revenue and content acquisition costs, this channel would have difficulty supporting new-release feature-length films. More common content was expected to be user-generated video, television-style programming, and older films. Online participants in this space in early 2007

[5] Gary Rivlin, "Does the Kid Stay in the Picture?" *The New York Times*, February 22, 2005.

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included YouTube and various network websites that contained streaming video (such as ABC.com and CBS.com).

The second channel would offer digital file ownership. This approach was similar to purchasing the latest bestseller at a bookstore or a DVD from a traditional retailer and would focus on feature-length films. Sites would let customers permanently download a film to a limited number of devices, similar to the purchase of music files on popular sites such as Apple's iTunes. Revenue would not be generated through advertising but through the actual sale of content, at prices comparable to the retail price of DVDs.

The final channel was the online video rental and pay TV. This channel was characterized by limited rights and finite durations common to traditional rentals. Like digital file ownership, this channel would offer primarily feature-length films with limited advertising support. Revenue would be generated through low-priced (around $3) temporary downloads. This was the segment of the market in which Netflix expected to participate.

VOD Competition

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

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

Blockbuster announced in early 2007 that it was in talks to acquire MovieLink, a venture between several major studios (including MGM, Paramount, Sony, Warner Brothers, and Universal) that offered a pay-per-view downloading service, with a library of about 1,500 films.

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

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

Even more limiting was content availability. Concern about pirated downloads and a lack of urgency to supplant their profitable DVD sales made studios reluctant to offer much content to VOD websites. Hastings described the U.S. rights of physical media and the consequences they had on the studio's cooperation with online video distribution: "U.S. laws enable anyone to buy a DVD and rent it as many times as they want. We can go to Wal-Mart, buy DVDs, and place them in our rental

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library. We don't need a license from the content owner to do so. Online content doesn't work like that. You have to negotiate the distribution rights with the studios. We're dealing with the same problem as everyone else."

Hunt concurred with his analysis:

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

Online Video at Netflix

Most industry observers believed that the emergence of a viable VOD technology posed a threat to Netflix's online DVD rental business. With a fully developed VOD offering, customers would no longer have to choose between selection and impulse rentals. Those who found online DVD rentals and traditional video stores to be inconvenient would now be able to watch their selection immediately, without waiting for it to arrive via the mail or even leaving their home. While the timing of mass adoption of VOD was unclear, it appeared that the long-term success of Netflix would require some consideration of this new delivery method.

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

Early development of an online video feature was also a matter of preparedness. The company had been dedicating cash for investment to VOD for several years, including $10 million in 2006 and plans for an additional $40 million in 2007, even as it grew its core online rental business. Hastings recognized that the resolution of the two large impediments to widespread adoption of VOD, the connectivity between a user's computer and television and the current limitations in available content, were, to a large degree, beyond the scope of Netflix's core focus, which was movie recommendations and delivery. Given the pace of technology improvement, it was critical that Netflix have a functional VOD offering in place when those issues were resolved.

Another challenge was lack of an obvious customer base for any online viewing feature. Hastings and his team searched for a group that could serve as their "beachhead," becoming early adopters for this streaming video offering. But no niche group of viewers emerged around a particular genre to drive early demand for Netflix's online viewing offering.

Through this investment and development process, Hastings and his team had reviewed three alternatives for Netflix's online video feature. The first was a licensing arrangement through which the company would offer its proprietary recommendation system to cable providers seeking to enhance their VOD offering. Management recognized that Netflix's greatest asset was the

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personalized user experience created by the ratings and recommendations system. Perhaps there was an opportunity to license the strongest part of its business model and effectively outsource delivery to the cable companies, much as was done with the USPS. Cable subscribers could, for an additional fee, use the Netflix website and benefit from its familiar recommendation system, ordering movies for instant viewing on their television. This would also bypass the technology challenge of connecting a user's computer with their television, and a VOD feature that did not rely on downloading could mitigate concerns over piracy and accelerate premium-content acquisition. While this might eventually cannibalize the core business, Netflix would be replacing one stream of positive cash flows with another. Despite these benefits, Hastings was still uncomfortable partnering with a competitor. With the fast pace of technology improvements, what was the likelihood that a satisfactory connection between a user's computer and television would emerge shortly after settling on this sort of agreement?

A second option was to integrate a streaming online video feature into their core offering. The rationale here was to take advantage of Netflix's existing strengths, including its brand, its recommendation system, and its large market share of online customers. By offering the streaming feature at no additional cost to the existing online DVD rental business, Netflix could increase its penetration of the young VOD market simply by continuing to grow its existing business. Hastings believed that leveraging Netflix's existing brand and market share was the only way to differentiate his business from the stand-alone sites such as Vongo and MovieLink. Without a clear link between the streaming offering and the traditional DVD rental business, Netflix's VOD offering would have no advantage over those of its start-up competitors. Still, Hastings was concerned with what was effectively giving away this new feature for no additional revenue. While online delivery meant no shipping costs and no additional employees needed to handle extra volume in a distribution center, there were still-content acquisition costs for online video, along with a material amount of programming support needed. Part of Netflix's early success had been to reach for positive cash flows before growing wildly. Hastings wondered if this was a step in the wrong direction.

Finally, he considered the merits of building a stand-alone online video business, similar to what was being offered by Vongo or MovieLink. Hastings was somewhat concerned with distracting his core team from his stated goal of growing Netflix's core business to 20 million subscribers. He was worried that asking these same employees to pursue an online video initiative would create some confusion about the future of the company. One solution would be to create a separate profit center and an entirely different service through which customers would pay exclusively for online video access. While Hastings acknowledged that the market for this service would be small in early 2007, he believed that there would eventually be resolution for the issues of content and connectivity, allowing this market to mushroom. When this happened, he was confident that the Netflix brand name and customer awareness would give it a distinct advantage over many newer entrants.

The announcement was just days away.

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Exhibit 1 Netflix Financial Statements

(Dollars in Thousands)	1998	1999	2000	2001	2002	2003	2004	2005	2006
Income Statement									
Sales									
Subscription	585	4,854	35,894	74,255	150,818	270,410	500,611	682,213	996,660
Cost of Revenues									
Subscription	535	4,217	24,861	49,088	77,044	147,736	273,401	393,788	532,621
Fulfillment	763	2,446	10,247	13,452	19,366	31,274	56,609	70,762	93,439
Total	**1,298**	**6,663**	**35,108**	**62,540**	**96,410**	**179,010**	**330,010**	**464,550**	**626,060**
Gross Profit	**(713)**	**(1,809)**	**786**	**11,715**	**54,408**	**91,400**	**170,601**	**217,663**	**370,600**
Operating Expenses									
Tech and Development	3,857	7,413	16,823	17,734	14,625	17,884	22,906	30,942	44,771
Marketing	4,052	14,070	25,727	21,031	35,783	49,949	98,027	141,997	223,386
G&A	1,358	1,993	6,990	4,658	6,737	9,585	16,287	29,395	30,130
Restructuring	0	0	0	671	0	0	0	0	0
Stock-based comp	1,151	4,742	8,803	5,686	8,832	10,719	16,587	14,327	12,696
Gain on disposal of DVDs	22	4	0	(838)	(896)	(1,209)	(2,560)	(1,987)	(4,797)
Total Operating Expenses	**10,440**	**28,218**	**58,343**	**49,780**	**65,081**	**86,928**	**151,247**	**214,674**	**306,186**
Operating Income	**(11,153)**	**(30,027)**	**(57,557)**	**(38,065)**	**(10,673)**	**4,472**	**19,354**	**2,989**	**64,414**
Interest and other income	72	924	1,645	461	1,697	2,457	2,592	5,753	15,904
Interest Expense	0	(738)	(1,451)	(1,852)	(11,972)	(417)	(170)	(407)	0
Pre-Tax Income	**(11,081)**	**(29,841)**	**(57,363)**	**(39,456)**	**(20,948)**	**6,512**	**21,776**	**8,335**	**80,318**
Taxes	0	0	0	0	0	0	181	(33,692)	31,236
Net Income	**(11,081)**	**(29,841)**	**(57,363)**	**(39,456)**	**(20,948)**	**6,512**	**21,595**	**42,027**	**49,082**
Cash Flow Summary									
Cash flows from Operations	(5,408)	(16,529)	(22,706)	4,847	40,114	89,792	145,269	157,507	247,862
Acquisition costs of DVD Library	(2,186.0)	(9,866)	(23,895)	(8,851)	(24,070)	(55,620)	(100,087)	(111,446)	(169,528)
Purchase of Property, Plant and Equipment	(103.0)	(3,295)	(6,210)	(3,233)	(2,751)	(8,872)	(15,720)	(27,653)	(27,333)
Proceeds from sales of DVDs	0.0	0	0	0	1,988	1,833	5,617	5,781	12,886
Free Cash Flow	**(7,697)**	**(29,690)**	**(52,811)**	**(7,237)**	**15,281**	**27,133**	**35,079**	**24,189**	**63,887**

Source: Netflix 2006 10-K, March 16, 2007, Netflix S1, March 6, 2002.

Exhibit 2 Netflix Subscriber Growth

	1999	2000	2001	2002	2003	2004	2005	2006
Total Subscribers (000)	107	292	456	857	1,487	2,610	4,179	6,316

Source: Netflix 2006 10-K, March 16, 2007, Netflix S1, March 6, 2002

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Exhibit 3 Sunnyvale Distribution Center

Automated Sorter for Outbound Envelopes

Movie Archives

"Relabeling" Station

Repackaging DVDs for Resale

Source: Casewriter.

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