Netflix in 2012: Can It Recover from Its Strategy Missteps?

CASE 11

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Throughout 2010 and the first six months of 2011, Netflix was on a roll. Movie enthusiasts were flocking to become Netflix subscribers in unprecedented numbers, and shareholders were exceptionally pleased with Netflix's skyrocketing stock price. During those 18 months from January 1, 2010 through June 30, 2011, the number of domestic Netflix subscribers doubled from 12.3 million to 24.6 million, quarterly revenues climbed from $445 million to $770 million, and quarterly operating income climbed from $53 million to $125 million. Netflix's swift growth in the U.S. and its promising potential for expanding internationally pushed the company's stock price to an all-time high of $304.79 on July 13, 2011, up from a close of $55.19 on December 31, 2009. Already solidly entrenched as the biggest and best-known Internet subscription service for watching TV shows and movies, the only question in mid-2011 seemed to be how big and pervasive Netflix's service might one day become in the larger world market for renting movies and TV episodes.

Then, over the next four months, Netflix announced a series of strategy changes and new initiatives that tarnished the company's reputation and sent the company's stock price into a tailspin:

- In mid-July 2011, Netflix announced a new pricing plan that effectively raised the monthly subscription price by 60 percent for customers who were paying $9.99 per month for the ability to (1) receive an unlimited number of DVDs each month (delivered and returned by mail with one title out at a time), and (2) watch an unlimited number of movies and TV episodes streamed over the Internet. The new arrangement called for a total separation of unlimited DVDs and unlimited streaming to better reflect the different costs associated with the two delivery methods and to give members a choice: a DVD-only plan, a streaming-only plan, or the option to subscribe to both. The monthly subscription price for the unlimited streaming plan was set at $7.99 a month. The monthly subscription price for DVDs only—one out at a time—was also set at $7.99 a month. If customers wanted both unlimited streaming and unlimited DVDs, they had to sign up for both plans and pay a total of $15.98 a month ($7.99 + $7.99)—Netflix said it was discontinuing all plans that included both streaming and DVDs by mail. For new Netflix members, the changes were effective immediately. For existing members, the new pricing started for charges on or after September 1, 2011.

Customer reaction was decidedly negative. Unhappy subscribers posted thousands of comments on Netflix's site and Facebook page. Over the next eight weeks, Netflix's stock price dropped steadily to around $210–$220 per share, partly because of rumors that perhaps as many as 600,000 Netflix customers had canceled their subscriptions.

The stock price slide was exacerbated by media reports that Starz, a premium movie channel offered by many multichannel TV providers, had broken off talks with Netflix regarding renewal of the contract whereby Starz supplied Netflix with certain Starz-controlled movies and TV shows that Netflix could then provide either on DVDs or via streaming to its subscribers. The substance of the breakdown in negotiations centered on the much higher price that Starz was asking Netflix to pay to renew its rights to distribute Starz content to Netflix subscribers—Starz was rumored to have

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demanded as much as $300 million annually to renew its license with Netflix, versus the $30 million annually that Netflix had been paying.[1] (Netflix's licensing agreement with Starz later expired in March 2012, and the content was removed from its library of offerings to subscribers.)

- On September 18, 2011, in an attempt at damage control, Netflix CEO Reed Hastings in a post on the Netflix blog at **http://blog.netflix.com/** apologetically said that the basis for the new pricing had been poorly communicated and personally took the blame for the miscue. He elaborated on the rationale behind the new pricing plans and then, in something of a bombshell, went on to reveal that Netflix was separating its DVD-by-mail subscription service and its unlimited streaming subscription service into two businesses operating at different websites. Hastings said the DVD-by-mail service would be renamed Qwikster, with its own website (**www.qwikster.com**) and its own billing. Current Netflix subscribers who wanted DVDs by mail would have to go to **www.qwikster.com** and sign up for the plan. He indicated that the Qwikster website would be operational in a matter of weeks—see Exhibit 1 for the full text of the post by Hastings.

EXHIBIT 1 Reed Hastings's Blog Posting, September 18, 2011

An Explanation and Some Reflections

I messed up. I owe everyone an explanation.

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

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

When Netflix is evolving rapidly, however, I need to be extra-communicative. This is the key thing I got wrong.

In hindsight, I slid into arrogance based upon past success. We have done very well for a long time by steadily improving our service, without doing much CEO communication. Inside Netflix I say, "Actions speak louder than words," and we should just keep improving our service.

But now I see that given the huge changes we have been recently making, I should have personally given a full justification to our members of why we are separating DVD and streaming, and charging for both. It wouldn't have changed the price increase, but it would have been the right thing to do.

So here is what we are doing and why:

Many members love our DVD service, as I do, because nearly every movie ever made is published on DVD, plus lots of TV series. We want to advertise the breadth of our incredible DVD offering so that as many people as possible know it still exists, and it is a great option for those who want the huge and comprehensive selection on DVD. DVD by mail may not last forever, but we want it to last as long as possible.

I also love our streaming service because it is integrated into my TV, and I can watch anytime I want. The benefits of our streaming service are really quite different from the benefits of DVD by mail. We feel we need to focus on rapid improvement as streaming technology and the market evolve, without having to maintain compatibility with our DVD by mail service.

So we realized that streaming and DVD by mail are becoming two quite different businesses, with very different cost structures, different benefits that need to be marketed differently, and we need to let each grow and operate independently. It's hard for me to write this after over 10 years of mailing DVDs with pride, but we think it is necessary and best: In a few weeks, we will rename our DVD by mail service to "Qwikster."

We chose the name Qwikster because it refers to quick delivery. We will keep the name "Netflix" for streaming.

(*Continued*)

EXHIBIT 1 (*Concluded*)

Qwikster will be the same website and DVD service that everyone is used to. It is just a new name, and DVD members will go to qwikster.com to access their DVD queues and choose movies. One improvement we will make at launch is to add a video games upgrade option, similar to our upgrade option for Blu-ray, for those who want to rent Wii, PS3 and Xbox 360 games. Members have been asking for video games for many years, and now that DVD by mail has its own team, we are finally getting it done. Other improvements will follow. Another advantage of separate websites is simplicity for our members. Each website will be focused on just one thing (DVDs or streaming) and will be even easier to use. A negative of the renaming and separation is that the Qwikster.com and Netflix.com websites will not be integrated. So if you subscribe to both services, and if you need to change your credit card or email address, you would need to do it in two places. Similarly, if you rate or review a movie on Qwikster, it doesn't show up on Netflix, and vice-versa.

There are no pricing changes (we're done with that!). Members who subscribe to both services will have two entries on their credit card statements, one for Qwikster and one for Netflix. The total will be the same as the current charges.

Andy Rendich, who has been working on our DVD service for 12 years, and leading it for the last 4 years, will be the CEO of Qwikster. Andy and I made a short welcome video. (You'll probably say we should avoid going into movie making after watching it.) We will let you know in a few weeks when the Qwikster.com website is up and ready. It is merely a renamed version of the Netflix DVD website, but with the addition of video games. You won't have to do anything special if you subscribe to our DVD by mail service.

For me the Netflix red envelope has always been a source of joy. The new envelope is still that distinctive red, but now it will have a Qwikster logo. I know that logo will grow on me over time, but still, it is hard. I imagine it will be the same for many of you. We'll also return to marketing our DVD by mail service, with its amazing selection, now with the Qwikster brand.

Some members will likely feel that we shouldn't split the businesses, and that we shouldn't rename our DVD by mail service. Our view is with this split of the businesses, we will be better at streaming, and we will be better at DVD by mail. It is possible we are moving too fast – it is hard to say. But going forward, Qwikster will continue to run the best DVD by mail service ever, throughout the United States. Netflix will offer the best streaming service for TV shows and movies, hopefully on a global basis. The additional streaming content we have coming in the next few months is substantial, and we are always working to improve our service further.

I want to acknowledge and thank our many members that stuck with us, and to apologize again to those members, both current and former, who felt we treated them thoughtlessly.

Both the Qwikster and Netflix teams will work hard to regain your trust. We know it will not be overnight. Actions speak louder than words. But words help people to understand actions.

Respectfully yours,

Reed Hastings, Co-Founder and CEO, Netflix

Source: Posting at Netflix Blog, http://blog.netflix.com/, September 18, 2011, accessed March 6, 2012.

Hastings's announcement about Netflix's strategy to split the DVDs-by-mail business from the Internet streaming business and to create Qwikster sparked a second furor from already disgruntled subscribers and further adverse investor reaction (the stock price plunged from around $208 per share to about $115 per share over the next three weeks). Netflix's strategy to split the DVDs-by-mail business from the Internet streaming business drew harsh criticism from Wall Street analysts and business commentators; virtually all knowledgeable industry observers expressed amazement that Netflix executives would even contemplate such a move.

- On October 10, 2011, three weeks after Hastings disclosed the plan to divide Netflix into two standalone businesses, Netflix sent personal e-mails to all U.S. subscribers stating that it was scrapping its Qwikster proposal and that U.S. members would continue to use one website, one account, and one password for their movie and TV watching enjoyment under the Netflix brand. Simultaneously, Netflix issued a press release and posted statements on the Netflix blog at **http://blog.netflix.com/** saying it was abandoning the Qwikster strategy. In the blog, Reed Hastings said, "It is clear that for many of our members two websites would make things more difficult. So we are going to keep Netflix as one place to go for streaming and DVDs."
- On October 24, 2011, Netflix announced that in early 2012 it would begin offering unlimited TV

shows and movies instantly streamed over the Internet to some 26 million households in the United Kingdom and Ireland—20 million of these households had high-speed broadband Internet service and thus could stream movies to their TVs, computers, or other devices. This move represented the third strategic initiative to expand Netflix's international reach. Netflix began streaming to members in Canada in 2010, and in September 2011 it initiated streaming services to 43 countries in Latin America and the Caribbean; there were four times as many households with high-speed broadband service in these 43 countries as there were in Canada. In all three cases, Netflix estimated that it would take about two years after the initial launch to attract sufficient subscribers to generate a positive "contribution profit"—Netflix defined "contribution profit (loss)" as revenues less cost of revenues and marketing expenses; cost of revenues included subscription costs and order fulfillment costs.

In announcing the company's entry into Latin America and the Caribbean, Netflix said it was establishing a single low monthly price of 99 pesos for subscribers in Mexico and a price of US$7.99 for customers in the 42 countries in Central America, South America, and the Caribbean. In Brazil, Netflix content was available in Portuguese; in eight other South American countries and all of the Central America countries, Netflix content was made available in Spanish; in the Caribbean, Netflix was available in English and Spanish. As part of its September entry into Latin America and the Caribbean, Netflix had entered into regional license agreements to obtain movies and TV shows in Spanish and Portuguese from a large variety of major motion picture and television studios, including Walt Disney Studios, Paramount Studios, Sony Pictures Television, NBCUniversal International Television, CBS Television, MGM, Lionsgate, Summit, Relativity, BBC Worldwide, TV Bandeirantes, Televisa, Telemundo, TV Azteca, TV Globo, Caracol, Telefe, and RCTV.

Also, on October 24, Netflix announced that the number of domestic subscribers dropped by a net of 810,000 during the third quarter of 2011, thus resulting in operating profits, a net income, and earnings per share that were below Wall Street estimates and investor expectations. Internationally, the company said it had reached 1 million subscribers in Canada and that member counts in Latin America and the Caribbean should exceed 500,000 by year-end 2011. However, Netflix's contribution losses from international operations jumped from $9.3 million in the second quarter of 2011 to $23.3 million in the third quarter of 2011, owing to increased expenses associated with the startup of operations in Latin America and the Caribbean.

On the day following the release of Netflix's third quarter financial results, the company's stock price dropped from $118.84 to close at $77.37.

- On November 21, 2011, Netflix announced that it had raised $400 million in new capital by (1) selling 2.86 million shares of common stock to certain mutual funds and accounts managed by T. Rowe Price Associates for $70 per share (which generated proceeds of $200 million) and (2) selling a $200 million aggregate principal amount of Zero Coupon Convertible Senior Notes due December 1, 2018 to a private party. Any time after six months, Netflix had the option of converting the Zero Coupon Notes into shares of Netflix common stock at an initial conversion rate of 11.6533 shares of common stock per $1,000 principal amount, subject to the satisfaction of certain conditions. Netflix executives said that the company did not intend to spend any of the newly raised capital. Rather, the company intended to use the capital as a safety net since the company's cash on hand and future cash flows from operations would likely be squeezed in upcoming quarters by the ongoing need to:
  - Make cash payments for additions to its library of titles available for streaming.
  - Absorb the expected contribution losses from international operations over the next five to seven quarters.

In the weeks following the announcement of the $400 million in new financing, Netflix's stock price dropped to as low as $62.37 and traded in the range of $65 to $71 for most all of December 2011.

Financial statement data for Netflix for 2000–2011 are shown in Exhibits 2 and 3.

INDUSTRY ENVIRONMENT

Since 2000, the introduction of new technologies and electronics products had rapidly multiplied consumer opportunities to view movies. It was commonplace

EXHIBIT 2 Netflix's Consolidated Statements of Operations, 2000–2011 (in millions, except per share data)

	2000	2005	2007	2009	2010	2011
Revenues	$ 35.9	$682.2	$1,205.3	$1,670.3	$2,162.6	$3,205.6
Cost of revenues:						
Subscription costs	24.9	393.8	664.4	909.5	1,154.1	1,789.6
Fulfillment expenses	10.2	72.0	121.3	169.8	203.2	250.3
Total cost of revenues	35.1	465.8	786.2	1,079.3	1,357.4	2,039.9
Gross profit	0.8	216.4	419.2	591.0	805.3	1,164.7
Operating expenses						
Technology and development	16.8	35.4	71.0	114.5	163.3	259.0
Marketing	25.7	144.6	218.2	237.7	293.8	402.6
General and administrative	7.0	35.5	52.4	51.3	64.5	117.9
Other	9.7	(2.0)	(14.2)	(4.6)	—	9.0
Total operating expenses	59.2	213.4	327.4	399.1	521.6	788.8
Operating income	(58.4)	3.0	91.8	191.9	283.6	376.1
Interest and other income (expense)	(0.2)	5.3	20.1	0.3	(15.9)	(16.5)
Income before income taxes	—	8.3	110.9	192.2	267.7	359.5
Provision for (benefit from) income taxes	—	(33.7)	44.3	76.3	106.8	133.4
Net income	$ (58.5)	$ 42.0	$ 66.7	$ 115.9	$ 160.8	$ 226.1
Net income per share:						
Basic	$(20.61)	$0.79	$0.99	$2.05	$3.06	$4.28
Diluted	(20.61)	0.64	0.97	1.98	2.96	4.16
Weighted average common shares outstanding:						
Basic	2.8	53.5	67.1	56.6	52.5	52.8
Diluted	2.8	65.5	68.9	58.4	54.3	54.4

Note: Totals may not add due to rounding.

Source: Company 10-K reports for 2003, 2006, and 2009.

EXHIBIT 3 Selected Balance Sheet and Cash Flow Data for Netflix, 2000–2011 (in millions of $)

	2000	2005	2007	2009	2010	2011
Selected Balance Sheet Data:						
Cash and cash equivalents	$ 14.9	$212.3	$177.4	$134.2	$194.5	$ 508.1
Short-term investments	—	—	207.7	186.0	155.9	290.0
Current assets	n.a.	243.7	432.4	416.5	637.2	1,830.9
Net investment in content library	n.a.	57.0	128.4	146.1	362.0	1,966.6
Total assets	52.5	364.7	679.0	679.7	982.1	3,069.2
Current liabilities	n.a.	137.6	208.9	226.4	388.6	1,225.1
Working capital*	(1.7)	106.1	223.5	190.1	248.6	605.8
Stockholders' equity	(73.3)	226.3	429.8	199.1	290.2	642.8
Cash Flow Data:						
Net cash provided by operating activities	$(22.7)	$157.5	$277.4	$325.1	$276.4	$ 317.7
Net cash used in investing activities	(25.0)	(133.2)	(436.0)	(246.1)	(116.1)	(265.8)
Net cash provided by (used in) financing activities	48.4	13.3	(64.4)	(84.6)	(100.0)	261.6

* Defined as current assets minus current liabilities.

Sources: Company 10-K reports for 2003, 2005, 2007, 2008, 2009, and 2011.

in 2012 for movies to be viewed at theaters, on airline flights, in hotels, from the rear seats of motor vehicles equipped with video consoles, in homes, or most anywhere on a laptop PC or handheld device like an Apple iPhone, iPad, or iPod touch. Home viewing was possible on PCs, televisions connected to a digital video disc (DVD) player, and video game consoles. As of 2012, more than 90 percent of U.S. households had DVD players connected to their TVs, enabling them to play movie DVDs. Households with big-screen high-definition TVs and a Blu-ray player could rent a Blu-ray DVD and enjoy a significantly higher picture quality. In recent years, millions of households had upgraded to high-speed or broadband Internet service and purchased Blu-ray DVD devices, video game consoles, and/or televisions with built-in connectivity to the Internet, enabling them to view content streamed over the Internet. However, heading into 2012, it was clear that the 134 million U.S. households with high-speed Internet service and Internet-connected Blu-ray players, video game consoles, TVs, computers, tablets, and/or smartphones were rapidly shifting from renting physical DVDs to watching movies and TV episodes streamed over the Internet.

Increasing numbers of devices had recently appeared in electronics stores (or become available from cable, satellite, and fiber-optic TV providers) that enabled TVs to be connected to the Internet and receive streamed content from online providers with no hassle. These devices made it simple for households to order streamed movies with just a few clicks instead of traveling to a video rental store or waiting for a disk to be delivered through the mail. In 2012, more than 700 different devices were capable of streaming content from Netflix.

Consumers could obtain or view movie DVDs and TV episodes through a wide variety of distribution channels and providers. The options included:

- Watching movies on assorted cable channels included in the TV and entertainment packages provided by traditional cable providers (such as Time Warner, Comcast, Cox, and Charter), direct broadcast satellite providers (such as DIRECTV and DISH Network), or fiber-optics providers (like AT&T and Verizon that had installed thousands of miles of fiber-optic cable that enabled them to simultaneously provide TV packages, telephone, and Internet services to customers).
- Subscribing to any of several movie-only channels (such as HBO, Showtime, and Starz) through a cable, satellite, or fiber-optics provider.
- Using a TV remote to order movies instantly streamed directly to a TV on a pay-per-view basis (generally referred to as "video-on-demand" or VOD). Cable, satellite, and fiber-optic providers of multichannel TV packages were promoting their VOD services and making more movie titles available to their customers. In 2011, roughly 40 million U.S. households (15 percent) spent about $1.3 billion on VOD movie rentals.[2]
- Purchasing DVDs from such retailers as Walmart, Target, Best Buy, Toys "R" Us, and Amazon.com. DVD sales, however, had declined for the past three years, partially a reflection of growing consumer preferences to rent rather than purchase DVDs of movies and TV episodes.
- Renting DVDs from Blockbuster and other local retail stores or from standalone rental kiosks like Redbox and Blockbuster Express. Physical-disc rentals at traditional brick-and-mortar locations had been trending downward for five to eight years, but the downward spiral accelerated in 2010–2011. Blockbuster's share of physical disc rentals dropped from 23 percent in 2010 to 17 percent in 2011.[3] The chief beneficiary of declining rentals at brick-and-mortar movie rental locations was Redbox. Since 2007, when Redbox first began deploying its distinctive red vending machine kiosks, Redbox's share of physical-disc DVD and Blu-ray movie rentals in the U.S. had mushroomed to 37 percent as of 2011 (up from 25 percent in 2010).
- Renting DVDs online from Netflix, Blockbuster, and several other subscription services that either mailed DVDs directly to subscribers' homes or streamed the content to subscribers via broadband Internet connections. In 2011, Netflix had about a 30 percent share of the physical DVD rental market and about a 56 percent share of streaming rentals.[4]
- Utilizing the rental or download services of such providers as Apple's iTunes store, Amazon Instant Video, Hulu.com, VUDU.com, Best Buy Cinema Now, Sony PlayStation Network, and Google's YouTube.
- Most recently, a new class of user interface apps had become available that enabled subscribers to the services of multichannel TV providers (like cable or satellite operators) to watch certain TV shows, movies, and other programs at their convenience rather than at scheduled broadcast times. This service—called TV Everywhere—gave subscribers the

option to watch programs on Internet-connected TVs and computers, iPads, iPhones, Android phones, and other devices. HBO's TV Everywhere application—called HBO GO—enabled HBO subscribers to have anytime, anywhere access to all HBO shows, hit movies, and other programs through participating multichannel TV providers. In 2012, most multichannel TV providers and the owners of most channels carried on cable and satellite networks were exploring TV Everywhere options and packages for interested viewers.

- Pirating files of movies and other content from Internet sources via the use of illegal file-sharing software. Piracy was widely thought to be a contributing factor to declining sales of movie DVDs. In 2011–2012, movie studios were becoming increasingly concerned that digital piracy could become a tidal wave.[5] Much of Netflix's streaming library was rumored to be available through online piracy.

In recent years, movie studios had released filmed entertainment content for distribution to movie DVD retailers and to companies renting movie DVDs about 17 weeks after a film first began showing in theaters. After about three months in theaters, movie studios usually released first-run films to pay-per-view and video-on-demand (VOD) providers (prior to the last several years, the release window had been about six months). However, in October 2011, a Kevin Spacey film was released in theaters and through both Netflix and Time Warner Cable on the same day; the movie grossed $3.5 million at theaters and the studio realized more than $5 million each from Netflix and Time Warner Cable.[6] Premium TV channels like HBO, Starz, Cinemax, and Showtime were next in the distribution window, typically getting access to premium films one year after initial theater showings. Movie studios released films for viewing to basic cable and network TV some two to three years after theatrical release. TV episodes were often made available for Internet viewing shortly after the original air date.

Recently, however, some movie studios had experimented with shortened release periods, including making new release titles available to video-on-demand providers or for online purchase on the same date DVDs could be sold by retailers. Other movie studios had implemented or announced their intention to implement policies preventing movie rental providers from renting movie DVDs until 30 to 60 days following the date DVD titles could be sold by retailers. For example, in January 2012, Warner Home Entertainment increased the availability date for rental DVDs top kiosks and subscription-by-mail services to 58 days. Movie studios and TV networks were expected to continue to experiment with the timing of the releases to various distribution channels and providers, in an ongoing effort to discover how best to maximize revenues.

Market Trends in Home Viewing of Movies

The wave of the future in the market for renting movies and TV content was unquestionably in streaming movies and TV shows to Internet-connected TVs, computers, and mobile devices. Streaming had the advantage of allowing household members to order and instantly watch the movies and TV programs they wanted to see. Renting a streamed movie could be done either by utilizing the services of Netflix, Blockbuster Online, Amazon Instant Video, Apple's iTunes, and other streaming video providers or by using a TV remote to place orders with a cable, satellite, or fiber-optics provider to instantly watch a movie from a list of several hundred selections that changed periodically. With a few exceptions, rental prices for pay-per-view and VOD movies ranged from $1 to $6, but the rental price for popular recently released movies was usually $3.99 to $5.99. During 2011, several movie studios had experimented with charging up to $30 for films released to pay-per-view and VOD providers for showing after eight weeks in theaters, but disappointingly small viewer response to such high-priced rentals quickly put an end to this strategy.[7] In 2012, many in-home movie viewers saw unlimited Internet streaming from subscription services as a better value than pay-per-view—the rental costs for two pay-per-view movies usually exceeded the $7.99 monthly price for unlimited streaming currently being charged by Netflix.

Several strategic initiatives to promote increased use of streaming video were underway in 2012.

- The owners of Hulu—Providence Equity Partners, The Walt Disney Company (owner of the ABC network), News Corp. (the parent of Fox Broadcasting and Fox Entertainment) and Comcast (the owner of NBCUniversal)—had for several years offered a free online video service at **www.hulu.com** where

viewers could watch a selection of hit TV shows and movies from the libraries of ABC, NBC, Fox Broadcasting, Walt Disney Studios, Universal Studios, Fox Entertainment, and a few others; the revenues to support the free Hulu site came from advertisers whose commercials were inserted into all of the free programs. But in mid-2011, three years after creating the Hulu site, the owners became reluctant to continue giving their content away for free and began an effort to sell the venture. In October 2011, the sales process was abandoned; Google, the DISH Network, Amazon, and Yahoo were rumored to have contemplated or made offers to acquire Hulu. Shortly thereafter, Hulu began actively promoting an advertising-supported unlimited streaming service called Hulu Plus where, for $7.99 per month, subscribers could watch a much larger selection of premium movies and primetime TV shows interspersed with commercials.

- Time Warner Cable, Comcast, Charter, DISH Network, DIRECTV, HBO, Showtime, and others were in the early stages of promoting their TV Everywhere concept and program offerings that enabled customers to watch certain TV shows free at any time on any Internet-connected device (including computers and such mobile devices as iPads and smartphones) as long as they were paying subscribers. For example, DIRECTV had created a device called Nomad to help subscribers watch their recorded programs anywhere; Nomad allowed subscribers to synchronize their smartphone, laptop, or tablet with recorded content on their DVRs and watch the recorded programs anywhere, anytime. DISH Network had introduced a "Sling Adapter" that—in conjunction with an Internet-connected DVR and a free DISH remote access app downloaded onto a mobile device—enabled customers to watch TV programs at their convenience on any Internet-connected device. However, for TV Everywhere to reach its full potential, each cable, satellite, and fiber-optic multichannel TV provider had to negotiate agreements for online rights to each channel's programming. As of early 2012, just a few multichannel TV providers had secured online rights to as many as 15 channels, but this was expected to be temporary.
- Google and Apple were rolling out new versions of their Google TV and Apple TV products to try to win traction with consumers. Google had partnered with LG, Vizio, and Samsung to introduce TVs equipped with Google TV and was rapidly expanding its library of apps optimized for Google TV, all in an attempt to facilitate easy consumer discovery of content that was available for streaming to TVs and/or Android devices. In addition, Google had invested in a new subsidiary called Google Fiber that was actively exploring plans to enter the Internet service and/or TV provider marketplaces by offering a one-gigabit-per-second Internet service coupled with an on-demand TV service that enabled customers to watch what they wanted when they wanted without ever having to record anything. In March 2012, Google filed applications with the Missouri Public Service Commission and the Kansas Corporation Commission for approval to offer a video service to subscribers in the Kansas City area—the proposal called for Google to use national and regional programming collection points to send IPTV (a television-over-Internet technology) across its private fiber-optic network (Google Fiber) to subscribers in Kansas City. It remained to be seen whether Google could secure broadcast rights from the owners of various TV channels and Hollywood movie studios to lure customers; however, Google's YouTube was spending hundreds of millions of dollars funding new TV channels that were scheduled to be available online and could be a part of Google's TV package. Time Warner Cable was the dominant TV provider in Kansas City, while Direct TV, DISH Network, and AT&T's U-verse had smaller customer bases.

Apple TV was a tiny box that enabled users to play high-definition content from iTunes, Netflix, YouTube, and live sports events (professional baseball, hockey, and basketball) on TVs, or to stream content to TVs from an iPad, iPhone, or iPod touch, or to stream music and photos from computers to TVs. In March 2012, Netflix and Apple implemented an agreement whereby Apple TV users could sign up for Netflix services directly through their Apple TV device, using their iTunes account.

IHS Screen Digest Research had forecast that streaming content would exceed 3.4 billion views in 2012.[8] It also expected that movie viewing online in 2012 would exceed combined viewing on DVDs and Blu-ray devices for the first time.[9]

Competitive Intensity

The movie rental business was intensely competitive in 2012. Local brick-and-mortar stores that rented DVD discs were in the throes of a death spiral, as a growing number of their customers switched either

to obtaining their DVDs at Redbox vending kiosks or utilizing Internet streaming services of one kind or another. Blockbuster, once a movie rental powerhouse with over $4.5 billion in annual rental revenues and more than 9,000 company-owned and franchised stores in a host of countries, was a shadow of its former self in 2012. After losing over $4 billion during the 2002–2010 period, closing thousands of store locations, and launching several unsuccessful strategic attempts to rejuvenate revenues and return to profitability, Blockbuster filed for Chapter 11 bankruptcy protection in September 2010. Following a bankruptcy court auction, DISH Network emerged in April 2011 as the owner of Blockbuster's operations in the United States and certain foreign countries for a winning bid valued at $321 million. From the acquisition date of April 26, 2011 through December 31, 2011, Blockbuster operations contributed $975 million in revenue and $4 million in net income to DISH Network's consolidated results of operations. Going into 2012, Blockbuster was operating some 1,500 retail stores in the United States, but DISH Network management had announced that it expected to close over 500 domestic Blockbuster stores during the first half of 2012 as a result of weak store-level financial performance and that additional stores might also need to be closed. For the time being, Blockbuster was offering movies and video games for sale and rental through its retail stores, the blockbuster.com website (via a DVDs-by-mail subscription service), and pay-per-view VOD service. In addition, DISH Network subscribers could access Blockbuster@Home to obtain movies, video games, and TV shows through Internet streaming, mail and in-store exchanges, and online downloads.

Movie Gallery, once the second-largest movie rental chain, filed for Chapter 11 bankruptcy protection in February 2010 and, shortly thereafter, opted to liquidate its entire movie rental business and close 1,871 Movie Gallery, 545 Hollywood Video, and 250 Game Crazy store locations. Within months, Movie Gallery ceased to exist.

The big winner in renting DVD discs was Redbox. Redbox had entered the movie rental business in 2007 with a vending machine–based strategy whereby Redbox self-service DVD kiosks were placed in leading supermarkets, drug stores, mass merchants like Walmart, convenience stores, and fast-food restaurants (McDonald's). Customers could rent new-release movie DVDs for $1 per day (the price was raised to $1.20 per day in fall 2011). Retailers with Redbox kiosks were paid a percentage of the rental revenues. Going into 2012, Redbox had deployed 35,400 of its vending machine kiosks in 29,300 locations in every state of the United States and in Puerto Rico. In February 2012, Redbox agreed to acquire about 9,000 Blockbuster-branded DVD kiosks operated by NCR Corp. Redbox and Netflix (with its DVDs-by-mail subscription option) were positioned to dominate the physical DVD rental segment for the foreseeable future.

The main battle in the movie rental marketplace was in the VOD and Internet streaming segments where several classes of competitors employing a variety of strategies were maneuvering to win the viewing time of consumers, capture enough revenue to be profitable, and become one of the market leaders. Competitors offering pay-per-view and VOD rentals were popular options for households and individuals that rented movies occasionally (once or at most twice per month), since the rental costs tended to be less than either the monthly subscription prices for unlimited streaming or the monthly fees to access premium movie channels like HBO, Starz, Cinemax, and Showtime. However, competitors offering unlimited Internet streaming plans tended to be the most economical and convenient choice for individuals and households that watched an average of three or more titles per month and for individuals that wanted to be able to watch movies or TV shows on mobile devices.

Netflix was the clear leader in Internet streaming in 2012, with over 23 million streaming subscribers that watched an average of 30 hours of video monthly and some 60,000 titles that could be viewed on an Internet-connected device.[10] But Netflix had numerous ambitious rivals that saw huge revenue and profit opportunities in using online technology to provide movies, TV programming, and other entertainment content to all types of Internet-connected devices on an anywhere, anytime basis.

Netflix's two most important subscription-based instant streaming rivals included:

- *Hulu Plus*—The subscription fee for Hulu Plus was $7.99 per month for unlimited streaming, and new subscribers got a one-week free trial. All Hulu Plus content included advertisements as a means of helping keep the monthly subscription price low. The Hulu Plus library of offerings included all current season episodes of popular TV shows, over 15,000 back season episodes of 380 + TV shows, and over 425 movies, many in high-definition.
- *Amazon Prime Instant Video*—This service entailed becoming an Amazon Prime member for a fee of $79 per year (after a one-month free trial). All Amazon Prime members were entitled to free two-day

shipping on *all Amazon orders*, unlimited commercial-free streaming of 17,000 movies and TV programs, one free Kindle book rental each month, and assorted other perks. In March 2012, there were an estimated 3.5 to 5 million Amazon Prime members. New Amazon Prime members were entitled to a one-month free trial. While Amazon had originally created its Amazon Prime membership program as a means of providing unlimited two-day shipping to customers that frequently ordered merchandise from Amazon and liked to receive their orders quickly, in 2012 it was clear that Amazon was also endeavoring to brand Amazon Prime as a standalone streaming service at a subscription price below that of Netflix. In addition, Amazon competed with Netflix's DVDs-by-mail subscription service and with VOD and pay-per-view providers via its Amazon Instant Video offering, which enabled any visitor to the Amazon website to place an online order to instantly watch on a pay-per-view basis any of the 42,000 movies or TV shows in Amazon's rental library.

In February 2010, Walmart announced its intention to distribute movies over the Internet and had acquired VUDU, a leading provider of digital technologies that enabled online delivery of entertainment content. In 2012, VUDU was the largest home entertainment retailer in the United States with the capability to stream about 20,000 movie titles (including some 4,000 HD titles with Dolby Surround Sound) to Internet-connected TVs, Blu-ray players, computers, iPads and other tablets, and video game consoles (Xbox 360 and PlayStation 3). Movies were available the same day they were released on DVD or Blu-ray discs and could be purchased or rented without a subscription; the rental fee was $2 per night for two nights. First-time users were eligible for free VUDU movie credits that could be used for a one-month trial period. In April 2012, Walmart initiated an exclusive in-store disc-to-digital service powered by VUDU technology which enabled people to bring their DVD and Blu-ray collections from partnering movie studios (Paramount, Sony, Fox, Universal, and Warner Bros.) to a Walmart Photo Center and have digital copies of the DVDs placed in a personal VUDU account. Then, VUDU account holders could log on to VUDU.com and view their movies any time, any place on more than 300 different Internet-connected devices.

The growing rush among multichannel TV providers to offer subscribers attractive TV Everywhere packages signaled a widespread belief that using Internet streaming to enable subscribers to watch certain TV shows or movies free at any time on any Internet-connected device was the best long-term solution for competing effectively with Netflix's Internet streaming service. In 2012, most every major network broadcaster, multichannel TV provider, and premium movie channel was investing in Internet apps for all types of Internet-connected TVs, laptops, video game consoles, tablets, and smartphones and otherwise positioning themselves to offer attractive TV Everywhere packages. HBO with its HBO GO offering (**www.hbogo.com**) and Showtime with its Showtime Anytime offering (**www.showtimeanytime.com**) were both trying to gain more viewing hours with their subscribers. Pricing for TV Everywhere offerings was simple—users just entered an authentication code verifying their subscription status at the appropriate website. Subscribers then clicked on whichever offering interested them to initiate instant streaming to their device.

According to market research done by The NPD Group, 15 percent of U.S. consumers aged 13 and older used pay-TV VOD services from their multichannel cable, satellite, and fiber-optic providers in the 12 months ending August 2011; this translated into 40 million users and rental revenues of $1.1 billion.[11] However, there were four million fewer VOD users who paid additional fees to watch movies from these same providers in August 2011 compared to August 2010. This was attributed to the growing number of attractive VOD offerings from rival online VOD providers such as iTunes, Amazon Instant Video, VUDU, and others that instantly streamed rentals over the Internet. The NPD Group estimated that Internet streaming accounted for one out of every six VOD rentals in 2011 and that the share of Internet-streamed VOD rentals was likely to continue to grow, chiefly because many consumers saw the prices of Internet-streamed rentals as a better value and believed such providers had more movie-title selections.[12]

NETFLIX'S BUSINESS MODEL AND STRATEGY

Since launching the company's online movie rental service in 1999, Reed Hastings, founder and CEO of Netflix, had been the chief architect of Netflix's subscription-based business model and strategy that had transformed Netflix into the world's largest online entertainment subscription service and revolutionized

the way that many people rented movies and previously broadcast TV shows. Hastings's goals for Netflix were simple: Build the world's best Internet movie service, keep improving Netflix's offerings and services faster than rivals, attract growing numbers of subscribers every year, and grow long-term earnings per share. Hastings was a strong believer in moving early and fast to initiate strategic changes that would help Netflix outcompete rivals, strengthen its brand image and reputation, and fortify its position as industry leader.

Netflix's Subscription-Based Business Model

Netflix employed a subscription-based business model. Members could choose from a variety of subscription plans whose prices and terms had varied over the years. Originally, all of the subscription plans were based on obtaining and returning DVDs by mail, with monthly prices dependent on the number of titles out at a time. But as more and more households began to have high-speed Internet connections, Netflix began bundling unlimited streaming with each of its DVD-by-mail subscription options, with the long-term intent of encouraging subscribers to switch to watching instantly streamed movies rather than using DVD discs delivered and returned by mail. The DVDs-by-mail part of the business had order fulfillment costs and postage costs that were bypassed when members opted for instant streaming.

The DVD-by-Mail Option Subscribers who opted to receive movie and TV episode DVDs by mail went to Netflix's website, selected one or more movies from its DVD library of over 120,000 titles, and received the movie DVDs by first-class mail generally within one business day—more than 97 percent of Netflix's subscribers lived within one-day delivery of the company's 50 distribution centers (plus 50 other shipping points) located throughout the United States. During the 2004–2010 period, Netflix had aggressively added more distribution centers and shipping points in order to provide members with one-business-day delivery on DVD orders. Subscribers could keep a DVD for as long as they wished, with no due dates, no late fees, no shipping fees, and no pay-per-view fees. Subscribers returned DVDs via the U.S. Postal Service in a prepaid return envelope that came with each movie order. The address on the return envelope was always the closest distribution center/shipping point so that returned DVDs could quickly be returned to inventory and used to fill incoming orders from subscribers.

Exhibit 4 shows Netflix's various subscription plan options during 2010–2012. The most popular DVD-by-mail plans were those with one, two, or three titles out at a time.

The Streaming Option Netflix launched its Internet streaming service in January 2007, with instant-watching capability for 2,000 titles on personal computers. Very quickly, Netflix invested aggressively to enable its software to instantly stream content to a growing number of "Netflix-ready" devices, including Sony's PlayStation 3 consoles, Microsoft's Xbox 360, Nintendo's Wii, Internet-connected Blu-ray players and TVs, TiVo DVRs, and special Netflix players made by Roku and several other electronics manufacturers. At the same time, it began licensing increasing amounts of digital content that could be instantly streamed to subscribers. Initially, Netflix took a "metered" approach to streaming, in essence offering an hour per month of instant watching on a PC for every dollar of a subscriber's monthly subscription plan. For example, subscribers on the $16.99 per month plan, which provides unlimited DVD rentals with three discs out at a time, received 17 hours a month of movies and TV episodes watched instantly on their PCs while those on the $4.99 limited plan were entitled to 5 hours of instant streaming. In January 2009, Netflix switched to an unlimited streaming option on all of its monthly subscription plans for unlimited DVD rentals; the limited plan continued to have a monthly streaming limit. Netflix had about 6,000 movie titles available for streaming as of January 2009 and about 20,000 titles in mid-2010.

Then in July 2011, Netflix announced that effective September 1, 2011 it would no longer offer a single subscription plan including both DVD-by-mail and streaming in the United States. Domestic subscribers who wished to receive DVDs-by-mail and also watch streamed content had to elect both a DVD-by-mail subscription plan and a streaming subscription plan. By December 31, 2011, Netflix had a total of 21.7 million domestic streaming subscribers (including 1.52 million who were in their free-trial period) and 11.2 million domestic DVD-by-mail subscribers (including 210,000 who were in their free-trial period); almost 6.6 million Netflix members had both a streaming subscription and a DVD-by-mail subscription.

All new Netflix subscribers received a free one-month trial. At the end of the free trial period,

EXHIBIT 4 Netflix's Subscription Plans, 2010–2012

Subscription Plan Choices	Monthly Subscription Price		
	June 2010	Nov. 22, 2010 through June 2011	September 2011 through 2012
Unlimited DVD Plans:			
1 title out at a time	$8.99 plus unlimited streaming	$9.99 plus unlimited streaming	$7.99
2 titles out at a time	$13.99 plus unlimited streaming	$14.99 plus unlimited streaming	$11.99
3 titles out at a time	$16.99 plus unlimited streaming	$19.99 plus unlimited streaming	$15.99
4 titles out at a time	$23.99 plus unlimited streaming	$27.99 plus unlimited streaming	$21.99
5 to 8 titles out at a time	$29.99–$47.99 plus unlimited streaming	$34.99–$53.99 plus unlimited streaming	$27.99–$43.99
Unlimited streaming (no DVDs)	Not available	$7.99	$7.99
Unlimited streaming plus DVDs			
Unlimited streaming plus 1 DVD title out at a time	—	—	$15.98
Unlimited streaming plus 2 DVD titles out at a time	—	—	$19.98
Unlimited streaming with 3–8 DVDs			$23.98–$51.98
Limited plan:			
• 1 DVD title out at a time	$4.99	$4.99	$4.99
• A maximum of 2 DVD rentals per month			
• 2 hours of video streaming to a PC or Apple Mac per month (this plan did not allow members to stream movies to TVs via a Netflix-ready device)			
• Limited streaming selection			

Source: Company records and postings at **www.netflix.com**.

members automatically began paying the monthly fee, unless they canceled their subscription. All paying subscribers were billed monthly in advance. Payments were made by credit card or debit card. Subscribers could cancel at any time.

Exhibit 5 shows trends in Netflix's subscriber growth in the United States. Exhibit 6 shows quarterly trends in Netflix subscriptions and profitability by market segment.

New subscribers were drawn to try Netflix's online movie rental service because of (1) the wide selection, (2) the extensive information Netflix provided about each movie in its rental library (including critic reviews, member reviews, online trailers, and subscriber ratings), (3) the ease with which they could find and order movies, (4) Netflix's policies of no late fees and no due dates on DVD rentals (which eliminated the hassle of getting DVDs back to local rental stores by the designated due date), (5) the convenience of being provided a postage-paid return envelope for mailing DVDs back to Netflix, and (6) the convenience of ordering and instantly watching movies streamed to their TVs or computers with no additional pay-per-view charge.

Management believed that Netflix's subscriber base consisted of three types of customers: those who liked the convenience of home delivery and/or instant streaming, bargain hunters who were enthused about being able to watch many movies for an economical monthly price, and movie buffs who wanted the ability to choose from a very wide selection of films and TV shows.

EXHIBIT 5 Domestic Subscriber Data for Netflix, 2000–2011

	2000	2005	2007	2009	2010	Jan. 1 – June 30, 2011	July 1 – Dec. 31, 2011
Total subscribers at beginning of period	107,000	2,610,000	6,316,000	9,390,000	12,268,000	19,501,000	24,594,000
Gross subscriber additions during period	515,000	3,729,000	5,340,000	9,322,000	15,648,000	11,614,000	9,930,000
Subscriber cancellations during the period	330,000	2,160,000	4,177,000	6,444,000	8,415,000	6,521,000	10,129,000
Total subscribers at end of period	292,000	4,179,000	7,479,000	12,268,000	19,501,000	24,594,000	24,395,000
Net subscriber additions during the period	185,000	1,569,000	1,163,000	2,878,000	7,233,000	5,093,000	(199,000)
Free trial subscribers at end of period	n.a.	153,000	153,000	376,000	1,566,000	1,331,000	1,537,000
Subscriber acquisition cost	$49.96	$38.78	$40.86	$25.48	$18.21	$14.70	$15.41
Average monthly revenue per paying subscriber	n.a.	$17.94	$14.95	$13.30	$12.20	$11.49	$12.35

n.a. = not available.

Sources: Netflix's 10-K Reports, 2010, 2009, 2005, and 2003 and Netflix Quarterly Report for the period ending June 30, 2011, posted in the investors relations section at **www.netflix.com**, accessed March 16, 2012.

EXHIBIT 6 Quarterly Trends in Netflix Subscriptions and Profitability, by Market Segment, Quarter 3, 2011 through Quarter 1, 2012 (in 000s)

	Three Months Ended		
	September 30, 2011	December 31, 2011	March 31, 2012
Domestic Streaming			
Free subscriptions at end of period	937	1,518	1,388
Paid subscriptions at end of period	20,511	20,153	22,022
Total subscriptions at end of period	21,448	21,671	23,410
Revenue	n.a.	$476,334	$ 506,645
Cost of revenues and marketing expenses	n.a.	424,224	440,157
Contribution profit		$ 52,110	$ 66,508
International Streaming			
Free subscriptions at end of period	491	411	646
Paid subscriptions at end of period	989	1,447	2,409
Total subscriptions at end of period	1,480	1,858	3,065
Revenue	$ 22,687	$ 28,988	$ 43,425
Cost of revenues and marketing expenses	46,005	88,731	146,108
Contribution profit	$ (23,318)	$ (59,743)	$(102,683)
Domestic DVDs-by-Mail			
Free subscriptions at end of period	115	126	131
Paid subscriptions at end of period	13,813	11,039	9,958
Total subscriptions at end of period	13,928	11,039	10,089
Revenue		$370,253	$ 319,701
Cost of revenues and marketing expenses		176,488	173,568
Contribution profit		$193,765	$ 146,133

(*Continued*)

EXHIBIT 6 (*Concluded*)

	Three Months Ended		
	September 30, 2011	December 31, 2011	March 31, 2012
Consolidated Operations			
Free unique subscribers at end of period*	1,437	1,948	2,056
Paid unique subscribers at end of period*	23,832	24,305	27,083
Total unique subscribers at end of period*	25,269	26,253	29,139
Revenue	$821,839	$875,575	$ 869,791
Cost of revenues and marketing expenses	625,725	689,443	759,833
Contribution profit	196,114	186,132	109,958
Other operating expenses	99,272	124,260	111,893
Operating income	96,842	61,872	(1,935)
Other income (expense)	(3,219)	(5,037)	(5,090)
Provision for income taxes	31,163	21,616	(2,441)
Net income	$ 62,460	$ 35,219	$ (4,584)

Note: Netflix defined "contribution profit (loss)" as revenues less cost of revenues and marketing expenses. Cost of revenue includes expenses related to the acquisition and licensing of content (streaming content license agreements, DVD direct purchases and DVD revenue sharing agreements with studios, distributors and other content suppliers), as well as content delivery costs related to providing streaming content and shipping DVDs to subscribers (which includes the postage costs to mail DVDs to and from our paying subscribers, the packaging and label costs for the mailers, all costs associated with streaming content over the Internet, the costs of operating and staffing shipping centers and customer service centers, DVD inventory management expenses, and credit card fees).

*Since some Netflix members in the United States subscribed to both streaming and DVD-by-mail plans, they were counted as a single unique subscriber to avoid double counting the same subscriber.

n.a. = not applicable. During July and August of the third quarter of 2011, Netflix's domestic streaming content and DVD-by-mail operations were combined. Subscribers in the United States were able to receive both streaming content and DVDs under a single hybrid plan. Accordingly, revenues were generated and marketing expenses were incurred in connection with the subscription offerings as a whole. Therefore, the company did not allocate revenues or marketing expenses for the domestic streaming and domestic DVD segments prior to the fourth quarter of 2011.

Source: Netflix records posted in the Financial Statements portion of the investor relations section at www.netflix.com, accessed March 19, 2012.

Netflix's Strategy

Netflix had a multipronged strategy to build an ever-growing subscriber base that included:

- Providing subscribers with a comprehensive selection of DVD titles.
- Acquiring new content by building and maintaining mutually beneficial relationships with entertainment video providers.
- Making it easy for subscribers to identify movies and TV shows they were likely to enjoy and to put them in a queue for either instant streaming or delivery by mail.
- Giving subscribers a choice of watching streaming content or receiving quickly delivered DVDs by mail.
- Spending aggressively on marketing to attract subscribers and build widespread awareness of the Netflix brand and service.
- Promoting rapid transition of U.S. subscribers to streaming delivery rather than mail delivery.
- Expanding internationally.

A Comprehensive Library of Movies and TV Episodes Since its early days, Netflix's strategy had been to offer subscribers a large and diverse selection of DVD titles. It had been aggressive in seeking out attractive new titles to add to its offerings. Because of this, its library of offerings had grown from some 55,000 titles in 2005 to about 120,000 titles in 2012, although the number of titles available for streaming was only about 30,000 as mid-2012 approached. The lineup included everything from the latest available Hollywood releases to releases several decades old to movie classics to independent films to hard-to-locate documentaries to TV shows and how-to videos, as well as a growing collection of cartoons and movies for children 12 and under. Netflix's DVD

library far outdistanced the selection available in local brick-and-mortar movie rental stores and the 200 to 400 titles available in Redbox vending machines, but it was on a par with the number of titles available at Amazon. In mid-2012, Netflix's streaming library contained more titles than any other streaming service.

New Content Acquisition Over the years, Netflix had spent considerable time and energy establishing strong ties with various entertainment video providers and leveraging these ties to both expand its content library and gain access to new releases as early as possible—the time frame that Netflix gained access to films after their theatrical release was an important item of negotiation for Netflix (in 2011, Netflix was able to negotiate access to certain films produced by Lionsgate within one year of their initial theatrical release for showing to members in the UK and Ireland). Also, in 2011, Netflix had successfully negotiated *exclusive* rights to show a number of titles produced by several studios.

In August 2011, Netflix introduced a new "Just for Kids" section on its website that contained a large selection of kid-friendly movies and TV shows. In March 2012, all of the Just for Kids selections became available for streaming on PlayStation 3 game consoles. As of early March 2012, over 1 billion hours of Just for Kids programming had been streamed to Netflix members.

New content was acquired from movie studios and distributors through direct purchases, revenue-sharing agreements, and licensing agreements to stream content. Netflix acquired many of its new-release movie DVDs from studios for a low upfront fee in exchange for a commitment for a defined period of time either to share a percentage of subscription revenues or to pay a fee based on content utilization. After the revenue-sharing period expired for a title, Netflix generally had the option of returning the title to the studio, purchasing the title, or destroying its copies of the title. On occasion, Netflix also purchased DVDs for a fixed fee per disc from various studios, distributors, and other suppliers. Netflix had about 140,000 titles in its DVD library as of April 2012.

In the case of movie titles and TV episodes that were delivered to subscribers via the Internet for instant viewing, Netflix generally paid a fee to license the content for a defined period of time, with the total fees spread out over the term of the license agreement (so as to match up content payments with the stream of subscription revenues coming in for that content). Following the expiration of the license term, Netflix either removed the content from its library of streamed offerings or negotiated an extension or renewal of the license agreement. Netflix greatly accelerated its acquisition of new streaming content in 2010 and 2011, increasing its streaming library to around 60,000 titles, up from about 17,000 titles in 2009. Netflix's payments to movie studios for streaming rights in 2010–2011 exceeded its payments for DVD distribution rights—see Exhibit 7. In 2010–2011, Netflix's rapidly growing subscriber base gave movie studios and the network broadcasters of popular TV shows considerably more bargaining power to negotiate higher prices for the new content that Netflix sought to acquire for its content library. Netflix management was fully aware of its weakening bargaining position in new content acquisition, and the higher prices it was having to pay to secure streaming rights largely accounted for why the company's contribution profits from streaming were lower than from DVD rentals—see Exhibit 6. However, Netflix executives expected that long-term growth in the number of streaming subscribers would enable the company to earn attractive profits on its streaming business, despite the increased costs of acquiring attractive new content.

Netflix had incurred obligations to pay $3.91 billion for streaming content as of December 31, 2011, up from $1.12 billion as of December 31, 2010. Some of these obligations did not appear on the company's year-end 2011 balance sheet because they did not meet content library asset recognition criteria (either the fee was not known or reasonably determinable for a specific title or the fee was known but the title was not yet available for streaming to subscribers). Certain of Netflix's new licensing agreements also had variable terms and included renewal provisions that were solely at the option of the content provider. The expected timing of Netflix's streaming content payments was as follows:[13]

Less than one year	$ 797.6 mil
Due after 1 year and through 3 years	2,384.4
Due after 3 years and through 5 years	650.5
Due after 5 years	74.7
Total streaming obligations	$3,907.2 mil

EXHIBIT 7 Netflix's Quarterly Expenditures for Additions to Content Library, 2009–2011

	Expenditures for Additions to DVD Library (in 000s)	Expenditures for Additions to Streaming Content Library (in 000s)	Total Expenditures for New Content (in 000s)
2009			
Quarter 1	$ 46,499	$ 22,091	$ 68,590
Quarter 2	43,224	9,343	52,567
Quarter 3	46,273	9,998	56,271
Quarter 4	57,048	22,785	79,833
Annual Total	$193,044	$ 64,217	$ 257,261
2010			
Quarter 1	$ 36,902	$ 50,475	$ 87,377
Quarter 2	24,191	66,157	90,348
Quarter 3	29,900	115,149	145,049
Quarter 4	32,908	174,429	207,337
Annual Total	$123,901	$ 406,210	$ 530,111
2011			
Quarter 1	$ 22,119	$ 192,307	$ 214,426
Quarter 2	19,065	612,595	631,660
Quarter 3	20,826	539,285	560,111
Quarter 4	23,144	976,545	999,689
Annual Total	$ 85,154	$2,320,732	$2,405,886

Source: Company cash flow data, posted in the investor relations section at www.netflix.com, accessed March 16, 2012.

Netflix's Convenient and Easy-to-Use Movie Selection Software Netflix had developed proprietary software technology that allowed members to easily scan a movie's length, appropriateness for various types of audiences (G, PG, or R), primary cast members, genre, and an average of the ratings submitted by other subscribers (based on 1 to 5 stars). With one click, members could watch a short preview if they wished. Most importantly perhaps was a personalized 1- to 5-star recommendation for each title that was based on a subscribers' own ratings of movies previously viewed, movies that the member had placed on a list for future streamed viewing and/or mail delivery), and the overall or average rating of all subscribers.

Subscribers often began their search for movie titles by viewing a list of several hundred personalized movie title "recommendations" that Netflix's software automatically generated for each member. Each member's list of recommended movies was the product of Netflix-created algorithms that organized the company's entire library of titles into clusters of similar movies and then sorted the movies in each cluster from most liked to least liked based on over 3 billion ratings provided by subscribers. In 2010–2011, Netflix added new movie ratings from subscribers to its database at a rate of about 20 million per week. Those subscribers who rated similar movies in similar clusters were categorized as like-minded viewers. When a subscriber was online and browsing through the movie selections, the software was programmed to check the clusters the subscriber had rented/viewed in the past, determine which movies the customer had yet to rent/view in that cluster, and recommended only those movies in the cluster that had been highly rated by viewers. Viewer ratings determined which available titles were displayed to a subscriber and in what order. When streaming members came upon a title they wanted to view, that title could, with a single click, be put on their "instant queue"—a list for future viewing. A member's instant queue was immediately viewable with one click whenever the member went to Netflix's website. With one additional click, any title on a member's instant queue could be activated for immediate

viewing. In spring 2011, a number of the world's leading consumer electronics companies began placing a Netflix button on their remotes for operating newly purchased TVs, Blu-ray disc players, and other devices that had built-in Internet connections—the button provided Netflix subscribers with a one-click connection to their instant queue. Clicking on a remote with a Netflix button resulted in all of the titles in a subscriber's instant queue appearing on the TV screen within a few seconds; streaming was instantly initiated by clicking on whichever title the subscriber wished to watch. In the case of members with DVD-by-mail subscriptions, members browsing the title library on Netflix's website could with one click place a title on their list (or queue) to receive it by mail. DVD subscribers specified the order in which titles in their personal queue were to be mailed out and could alter the lists or the mailing order at any time. It was also possible to reserve a copy of upcoming releases. Netflix management saw the movie recommendation tool as a quick and personalized means of helping subscribers identify titles they were likely to enjoy.

Netflix management believed that over 50 percent of the titles selected by subscribers came from the recommendations generated by its proprietary software. The software algorithms were thought to be particularly effective in promoting selections of smaller, high-quality films to subscribers who otherwise might not have discovered them in the company's massive and ever-changing collection. On average, about 85 percent of the titles in Netflix's content library were rented each quarter, an indication of the effectiveness of the company's recommendation software in steering subscribers to movies of interest and achieving broader utilization of the company's entire library of titles.

A Choice of Mail Delivery vs. Streaming

Up until 2007–2008 when streaming technology had advanced to the point that made providing video-on-demand a viable option, Netflix concentrated its efforts on speeding the time it took to deliver subscriber orders via mail delivery. The strategy was to establish a nationwide network of distribution centers and shipping points with the capability to deliver DVDs ordered by subscribers within one business day. To achieve quick delivery and return capability, Netflix created sophisticated software to track the location of each DVD title in inventory and determine the fastest way of getting the DVD orders to subscribers. When a subscriber placed an order for a specific DVD, the system first looked for that DVD at the shipping center closest to the customer. If that center didn't have the DVD in stock, the system then checked for availability at the next closest center. The search continued until the DVD was found, at which point the regional distribution center with the ordered DVD in its inventory was provided with the information needed to initiate the order fulfillment and shipping process. If the DVD was unavailable anywhere in the system, it was wait-listed. The software system then moved to the customer's next choice and the process started all over. And no matter where the DVD was sent from, the system knew to print the return label on the prepaid envelope to send the DVDs to the shipping center closest to the customer to reduce return mail times and permit more efficient use of Netflix's DVD inventory. No subscriber orders were shipped on holidays or weekends.

By early 2007, Netflix had 50 regional distribution centers and another 50 shipping points scattered across the U.S., giving it a one-business-day delivery capability for 95 percent of its subscribers and, in most cases, also enabling one-day return times. As of 2010, additional improvements in Netflix's distribution and shipping network had resulted in a one-business-day delivery capability for 98 percent of Netflix's subscribers.

In 2007, when entertainment studios became more willing to allow Internet delivery of their content (since recent technological advances prevented streamed movies from being pirated), Netflix moved quickly to better compete with the growing numbers of video-on-demand providers by adding the feature of unlimited streaming to its regular monthly subscription plans. The market for Internet delivery of media content consisted of three segments: the rental of Internet delivered content, the download-to-own segment, and the advertising-supported online delivery segment (mainly, YouTube and Hulu). Netflix's objective was to be the clear leader in the rental segment via its instant watching feature.

Giving subscribers the option of watching DVDs delivered by mail or instantly watching movies streamed to subscribers' computers or TVs had considerable strategic appeal to Netflix in two respects. One, giving subscribers the option to order and instantly watch streamed content put Netflix in a position to compete head to head with the growing numbers of video-on-demand providers. Second, providing streamed content to subscribers had the attraction of

being cheaper than (1) incurring the postage expenses on DVD orders and returns, (2) having to obtain and manage an ever-larger inventory of DVDs, and (3) covering the labor costs of additional distribution center personnel to fill a growing volume of DVD orders and handle increased numbers of returned DVDs. But streaming content to subscribers was not cost-free; it required server capacity, software to authenticate orders from subscribers, and a system of computers containing copies of the content files placed at various points in a network so as to maximize bandwidth and allow subscribers to access a copy of the file on a server near the subscriber. Having subscribers accessing a central server ran the risk of an Internet transmission bottleneck. Netflix also utilized third-party content delivery networks to help it efficiently stream movies and TV episodes in high volume to Netflix subscribers over the Internet. According to one report, Netflix incurred a cost of about 5 cents to stream a movie to a subscriber compared to costs of about $1 in roundtrip mailing and labor fees for a DVD.[14]

Netflix executives believed that the strategy of combining streaming and DVDs-by-mail into a single monthly subscription price during the 2007 to September 2011 period enabled Netflix not only to offer members an attractively large selection of movies for one low monthly price but also to enjoy a competitive advantage vis-à-vis rivals as compared to providing a postal-delivery-only or Internet-delivery-only subscription service. Furthermore, Netflix management believed the company's combination postal-delivery/streaming service delivered compelling customer value and customer satisfaction by eliminating the hassle involved in making trips to local movie rental stores to choose and return rented DVDs.

In March 2012, six months after instituting separate plans for streaming and DVDs-by-mail, Netflix instituted as yet unannounced and somewhat subtle changes at its website. A support page appeared at **www.netflix.com** that sent people registering for a free trial subscription to "dvd.netflix.com" if they wanted to sign up for a DVD-by-mail-only account.[15] In addition, Netflix began redirecting DVD-by-mail customers to a separate web page when they tried to rate movies on Netflix's main site, and DVD-by-mail-only subscribers that searched for movie titles were only shown titles that were also available for streaming rather than the heretofore full library of DVD titles.[16] Furthermore, ratings and recommendations by DVD and streaming customers were separated.

Marketing and Advertising Netflix used multiple marketing channels to attract subscribers, including online advertising (paid search listings, banner ads, text on popular sites such as AOL and Yahoo, and permission-based e-mails), radio stations, regional and national television, direct mail, and print ads. The costs of free monthly trials were treated as a marketing expense. It also participated in a variety of cooperative advertising programs with studios through which Netflix received cash consideration in return for featuring a studio's movies in its advertising. In recent years, Netflix had worked closely with the makers of Netflix-ready electronics devices to expand the number of devices on which subscribers could view Netflix-streamed content; these expenses were all considered marketing expenses and sometimes took the form of payments to various consumer electronics partners for their efforts to produce and distribute these devices.

Management had boosted marketing expenditures of all kinds (including paid advertising) from $25.7 million in 2000 (16.8 percent of revenues) to $142.0 million in 2005 (20.8 percent of revenues) to $218.2 million in 2007 (18.1 percent of revenues). When the recession hit in late 2007 and 2008, management trimmed 2008 marketing expenditures to $199.7 million (14.6 percent of revenues) as a cost containment measure, but in 2009 marketing expenditures resumed their upward trend, climbing to $237.7 million (14.2 percent of revenues). Marketing expenses rose even more dramatically to $298.8 million in 2010 and to $402.6 million in 2011 owing to:

- Increased adverting efforts, particularly in the newly entered countries of Canada, Latin America, the United Kingdom, and Ireland.
- Increased costs of free trial subscriptions.
- Increased payments to the company's consumer electronics partners.

Advertising campaigns of one type or another were underway more or less continuously, with the lure of one-month free trials usually being the prominent ad feature. Advertising expenses totaled approximately $205.9 million in 2009, $181.4 million in 2008, and $207.9 million in 2007—ad expenses for 2011 and 2010 were not publicly reported.

Transitioning to Internet Delivery of Content Netflix's core strategy in 2012 was to grow its streaming subscription business domestically and globally. Since launching streaming to

Internet-connected devices in 2007, the company had continuously improved the streaming experience of subscribers in three major ways:

- Expanding the size of its streaming content library, currently about 60,000 titles.
- Working with consumer electronics partners to increase the number of Internet-connected devices that could be used to view Netflix-streamed content.
- Improving the ease with which subscribers could navigate Netflix's website to locate and select content they wanted to watch.

The result had been rapidly growing consumer acceptance of, and interest in, the delivery of TV shows and movies directly over the Internet. Netflix subscribers watched over 2 billion hours of streaming video in the fourth quarter of 2011, an average of approximately 30 hours per member per month (which equated to a cost of $0.27 per hour of viewing, given the current $7.99 subscription price).[17] During this same period, the company realized a contribution profit of $52.1 million on its domestic streaming business segment (see Exhibit 6).

Going forward, Netflix executives expected that the number of members with DVD-by-mail subscriptions would decline, as subscribers migrated from DVD-by-mail plans to Internet streaming plans and as subscribers with both DVD-by-mail and streaming subscriptions opted for streaming-only subscriptions. An ever-smaller fraction of new subscribers was expected to opt for the DVD-by-mail plan. Management saw no need to proactively encourage or try to accelerate the decline in domestic DVD-by-mail subscriptions beyond the actions already taken—rather the strategy was to simply let subscribers choose whichever plan or plans they wished, since the company had ample ability to provide a satisfying experience to both DVD and streaming subscribers. Netflix management projected that the number of domestic DVD subscribers would decline from just over 11.0 million at the end of 2011 to about 9.5 million at the end of March 2012, with smaller sequential declines in future quarters. Early indications were that the number of Netflix streaming subscribers in the United States would rise by about 1.7 million in the first quarter of 2012.

In the near term, the falloff in revenues from declining domestic DVD subscriptions was projected to be offset by revenue gains from ongoing growth in the numbers of domestic streaming subscribers. Domestic DVD contribution margins were expected to remain healthy despite shrinking volume, due to the lower postage costs and order fulfillment costs associated with declines in the number of DVD discs being ordered by DVD-by-mail subscribers.

In March 2012, there were reports that Netflix was in exploratory discussions with multichannel TV providers about offering its streaming content as an add-on option alongside such premium movie channels as HBO, Showtime, and Starz.[18] One benefit from such a strategic approach was said to be the likelihood that customers who purchased Netflix through a multichannel TV provider would be more likely to remain a subscriber. Anywhere from 30 to 70 percent of Netflix's subscribers canceled their subscriptions each year (see Exhibit 3)—the percentage of existing subscribers that canceled their subscriptions was referred to as the "churn rate." For Netflix to grow its subscriber base in upcoming years, it had to overcome its churn rate by attracting enough new subscribers to more than offset subscriber cancellations. The appeal of offering Netflix through multichannel TV providers was that pay-television channels had a customer churn rate of only 20 to 25 percent. At an investor event in San Francisco in late February 2012, Reed Hastings said that partnering with cable companies to offer Netflix streaming as an add-on option was a natural progression for the company.[19]

International Expansion Strategy

Making Netflix's streaming service available to growing numbers of households and individuals outside the United States was a central element of Netflix's long-term strategy to grow revenues and profits. Netflix executives were fully aware that international expansion would temporarily depress overall company profitability since it took roughly two years to build a sufficiently large subscriber base in newly entered country markets to have sufficient revenues to cover all the associated costs. The biggest cost to enter new countries was the expense of obtaining licenses from movie studios and the owners of TV shows to stream their content to subscribers in these countries. The second biggest cost was related to the incremental advertising and marketing expenses needed to attract new subscribers and grow subscription revenues fast enough to achieve profitability within the targeted two-year time frame.

In 2011, Netflix's international streaming segment (Canada and Latin America) reported a contribution

loss of $103.1 million. Top management had projected that the added international expenses of expanding service to the UK and Ireland in January 2012 would result in total international contribution losses for Canada, Latin America, United Kingdom, and Ireland of between $108 million and $118 million in Quarter 1 of 2012.

Netflix planned to continue to invest in expanding its streaming content libraries in Latin America, the United Kingdom, and Ireland throughout 2012 and beyond, just as it had done since launching its service in Canada. According to CEO Reed Hastings and CFO David Wells, a bigger content library:[20]

> improves the consumer experience, builds strong word of mouth and positive brand awareness, and drives additional acquisition [of new subscribers], all elements of a strong foundation for long-term success.

Nonetheless, Netflix's entry into Latin America presented unique challenges not encountered in the other international markets. The concept of on-demand streaming video (outside of piracy and YouTube) was not something most Latin American households were familiar with, which required Netflix to do more work in driving consumer understanding and acceptance of the company's streaming service. Moreover, in Latin America, a smaller fraction of households had fewer Internet-connected TVs, Bluray players, and other devices that readily connected to Netflix's service. Plus, in many locations there was an underdeveloped Internet infrastructure, relatively low credit card usage among households and individuals, and consumer payment challenges for ecommerce. Many Latin American banks turned down all ecommerce debit card transactions due to fraud risk.

NETFLIX'S PERFORMANCE PROSPECTS IN 2012

Management's latest forecast for 2012 called for modest quarterly losses throughout 2012 and a loss for the whole year, due entirely to the sizable contribution losses in the international segment. However, continued growth in the number of domestic streaming subscribers was expected to produce contribution margins of 10–12 percent during 2012, comfortably above the company's long-term domestic streaming target of 8 percent, and in line with the 10.9 percent domestic streaming contribution margin in the fourth quarter of 2011. Netflix management said that until the company returned to global profitability, it did not intend to launch additional international expansion.

Highlights of Netflix's Performance in Quarter 1 of 2012

For the first three months of 2012, Netflix reported revenues of $869.8 million (21.0 percent higher than the revenues of $718.6 million in the first quarter of 2011) and a net loss of $4.6 million (versus net income of $60.2 million in the first quarter of 2011). The net loss for the quarter stemmed from contribution losses of $102.7 million in the international streaming segment; however, Netflix added 1 million more paying international subscribers during Quarter 1 and had another 600,000 international subscribers enrolled in free trials. International streaming revenues were $43.4 million in the first quarter, versus revenues of $29.0 million for the fourth quarter of 2011 and $12.3 million for the first quarter of 2011.

In the United States, the total number of streaming subscribers (including free-trial subscribers) rose from 21.7 million at the end of the fourth quarter of 2011 to 23.4 million at the end of the first quarter of 2012. Total paying subscribers jumped by 1.85 million during the quarter (from 20.15 million as of December 31, 2011 to 22.0 million as of March 31, 2012). Not surprisingly, the number of domestic DVD subscribers dropped by almost 1.1 million during the quarter to a total of 10.1 million as of March 31. Nonetheless, the customer count exceeded management's expectations, and contribution profits from this segment were $146.1 million—seven million of the DVD subscribers were also streaming subscribers. Viewing per member was at a record high level during the quarter.

Reed Hastings indicated that Netflix would likely add a net of 7 million domestic streaming subscribers during 2012 (about the same number added in 2010) and end the year with approximately 27.2 million domestic streaming customers. He also said that:

- It would take longer than eight quarters after initial entry for the company's operations in Latin America, the UK, and Ireland to reach sustained profitability, owing to ongoing investments in content improvements and somewhat slower-than-expected growth in membership.
- The company expected to return to global profitability in the second quarter of 2012 because of increasing contribution profits in domestic streaming, slow erosion of contribution profits in

the domestic DVD segment, and narrowing contribution losses in the international streaming segment. Netflix had positive free cash flow of $2 million during the first three months of 2012.

- Given the strong response to the launch of the company's service in the UK, the company planned to enter another European market in Q4 of 2012. Quickly investing the growing profits from the company's domestic business in additional global expansion had two key advantages: (1) entering foreign markets ahead of other streaming rivals made it easier for Netflix to build a profitable subscriber base and (2) having growing numbers of subscribers in a growing number of countries enabled Netflix to more quickly reach the global scale needed to license global content rights economically.

Initial investor reaction to all this was decidedly negative. In the week following the April announcement of Netflix's first-quarter results, full-year expectations, and future plans, Netflix's stock price—which had climbed to $129 per share in mid-February before falling back to the $105–$110 range in mid-April—dropped about $25 per share and then over the next 10 days slid further, trading as low as $72.49.

ENDNOTES

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