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Netflix, Inc.

It's not Netflix that's making the changes. It's the Internet.

- Reed Hastings, Netflix CEO[1]

At the 2017 Golden Globe awards, Netflix CEO Reed Hastings applauded from his front row seat as he watched screenwriter Peter Morgan approach the podium. Netflix content executives Ted Sarandos and Cindy Holland were seated beside Hastings. Peter Morgan's Netflix-produced original series "The Crown" had just won the award for best television drama. The biographical series about Queen Elizabeth II prevailed over formidable competitors including HBO's "Westworld" and "Game of Thrones." With a budget of 100 million British pounds, "The Crown" was also one of the most expensive dramas ever made.[2] This fact was not lost on Hastings. Standing behind the microphone, Morgan looked out into the audience for the Netflix executives. "Ted, Reed, Cindy–Thank you," he began the acceptance speech.[3]

After returning to his hotel that evening, Hastings reflected on the career that had taken him, a former vacuum cleaner salesman, onto the red carpet. His thoughts quickly wandered back to Netflix's business matters. The annual report would be released in two weeks. With Netflix's stock trading at record highs, investors were looking for numbers to justify Netflix's $55 billion market capitalization. Winning Golden Globes is noteworthy, but Netflix lived as much on Wall Street as it did in Hollywood and Silicon Valley. Netflix had a negative free cash flow of $1.7 billion in 2016.[4] How could Netflix ensure that it was spending money on the right content? Netflix was now operating its streaming service in 190 countries worldwide and needed to cater its licensed and original content to a much more diverse audience than ever before. Also on Hastings' mind was Netflix's sometimes contentious relationship with internet service providers (ISPs). Netflix relied on ISPs to deliver its high-bandwidth content to subscribers. How could Netflix ensure that the ISPs would provide the high-speed connections required to deliver streaming content to its subscribers? Finally, Netflix was facing tougher competitors. Amazon, HBO, and Hulu were investing heavily in streaming content too. As Netflix approached its twentieth year, how could Netflix keep subscribers loyal and acquire new ones?

Professor Frank T. Rothaermel and Research Associate Austin Guenther prepared this case from public sources. Research assistance by Hassan El-Majidi is gratefully acknowledged. This case is developed for the purpose of class discussion. This case is not intended to be used for any kind of endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed, and all errors and omissions, are

A Brief History of Netflix

> I got the idea for Netflix after my company was acquired. I had a big late fee for "Apollo 13." It was six weeks late and I owed the video store $40. I had misplaced the cassette. It was all my fault. I didn't want to tell my wife about it. And I said to myself, "I'm going to compromise the integrity of my marriage over a late fee?" – Reed Hastings, Netflix CEO[5]

Reed Hastings late fee story may include a bit of corporate legend and marketing exaggeration. In an interview, Netflix's other founder and former CEO, Marc Randolph stated that Hastings' late fee story "never happened."[6] Instead, Netflix's DVD rental-by-mail business was a carefully planned enterprise made possible by advances in video-on-demand and home internet technologies.

VIDEO-ON-DEMAND

Through the 1980s most television shows were commissioned and carried by major networks such as ABC, CBS, and NBC. The networks had started in radio and followed the same business model with the arrival of television. Using licenses granted by the Federal Communications Commission (FCC), networks broadcast to viewers free of charge and earned money by selling advertising spots.[7]

With the advent of cable television, themed channels like Nickelodeon, CNN, ESPN, and HBO emerged. Cable companies and channels made money by charging viewers monthly subscription fees and selling advertising. The broadcasters' advertising revenues declined, but they were able to compensate by charging cable companies for carrying their content.[8]

With the introduction of the video cassette recorder (VCR) in the 1980's, viewers gained the ability to watch video content on their own schedule. They could either purchase prerecorded cassettes or make their own tapes from television broadcasts. Instead of being locked into the broadcasters' schedules, viewers could now consume content at their convenience and skip commercials.[9]

Prerecorded cassettes initially retailed for around $50, spurring mom-and-pop retailers to form local video rental clubs. The retailers purchased the tapes and rented them to customers to recover purchase costs and earn a profit.[10] By 1988, video rental revenue was $5.15 billion, surpassing movie box office receipts.[11] In the mid-1990s, the DVD (digital versatile disc) was co-developed by several electronics companies. DVD discs delivered better video quality than VHS tapes and did not require rewinding after viewing.

HOME INTERNET

On December 1, 1996, internet service provider America Online abandoned its pay-by-the-hour billing system. Instead, its seven million customers were offered unlimited internet access for a flat $19.95 monthly fee. Other internet service providers quickly followed suit. The "all you can eat" pricing freed customers from hourly usage fees, but quickly clogged telephone lines with dial-up modem traffic.[12]

In 1997, 37 percent of US households owned a computer, and 18 percent of U.S. adults used the Internet at home.[13] The 56-kilobit dial-up modem was introduced in January 1997, potentially doubling users' connection speeds. Most connections, however, were limited to 40 kilobits per second by telephone line quality.[14] At the turn of the millennium, Internet service providers began offering substantially faster broadband service through digital subscriber lines (DSL) and cable modems. Broadband technology enabled streaming of high-quality video. By 2005, broadband adoption had surpassed dial-up Internet service (**Exhibit 1**).[15]

REED HASTINGS AND MARC RANDOLPH

After high school, Reed Hastings spent a year selling Rainbow vacuum cleaners door-to-door before enrolling in Bowdoin College where he majored in mathematics. He followed college with a Peace Corps assignment teaching math in Swaziland before returning to school again, this time earning a master's degree in computer science from Stanford.

In 1991, Hastings founded Pure Atria Software to commercialize a software debugging program he had written. The company grew quickly under Hastings' leadership and acquired Integrity QA, where Marc Randolph was the Vice President of Marketing. After the acquisition, Hastings and Randolph began working and commuting together.

Marc Randolph began his career fulfilling mail orders for songbooks at the Cherry Lane Music Company. The job allowed him to experiment with different catalog designs and order forms to determine which generated the most sales. He moved on to designing software for managing Cherry Lane's music magazine subscriptions. In 1984, he helped start MacUser magazine which eventually led to his career in software marketing.

In late 1996, Pure Atria's board decided to sell the company to Rational Software for $585 million.[16] Randolph, knowing that his job would likely be cut after the merger was completed, began planning a new venture. Based on his prior experience in direct mail sales, Randolph realized that the recently released DVD format would dramatically change the movie distribution. Unlike VHS tapes, the new DVD discs were thin and easy to mail. In 1997 with funding from Hastings, Randolph began developing a business based on mailing DVDs.[17]

BUILDING SUBSCRIBERS

Netflix's website went live on April 14, 1998. Netflix built an underground following before launch by seeking out technology writers in Internet Usenet groups (an early form of blogging). Netflix offered them the chance to be the first to write about Netflix after it launched in return for beta testing their rental system. This provided Netflix with the opportunity to work out operational issues and granted it immediate access to tech-savvy customers on launch day.[18]

To attract new subscribers with the requisite DVD player, Netflix convinced electronics manufacturers to package a Netflix coupon with new DVD players. The coupon was mutually beneficial. DVDs were still not commonly available, but with the coupon, manufacturers could provide their customers access to a library of hundreds of rental DVDs.[19]

PERSONALIZED WEBSITE

Netflix's website was designed to duplicate the best parts of the video store experience. Netflix's personalized recommendation engine replaced store clerk suggestions. It also pushed customers to older, in-stock movies instead of suggesting new releases. This enabled Netflix to fulfill demand with cheaper inventory and gave Netflix a reputation for having rare niche and foreign films.[20]

> One day we hope to get so good at suggestions that we're able to show you exactly the right film or TV show for your mood when you turn on Netflix. – Reed Hastings, Netflix CEO[21]

Christina Kish, Netflix's head of marketing, was inspired to create the Netflix Queue based on her frugal reading habits. Kish often visited bookstores to find new books, making a list of the titles she liked for later use at the library. Similarly, Netflix's Queue allowed users to designate films that interested them and mark them for later viewing.[22]

BUSINESS MODEL EVOLUTION

Netflix's early business model mirrored that of brick-and-mortar video stores. Netflix customers could browse through DVDs on Netflix's website and have them mailed directly to their homes. DVDs rented for $4 each, plus an additional $2 shipping fee. If the renter wanted to keep the DVD they could purchase it at a discount.[23] Initially, Netflix was also one of the few places where customers could buy DVDs, making sales a primary source of revenue. However, this income stream was under threat as retailers like Amazon and Walmart began stocking DVDs.[24] Randolph and Hastings met with Amazon's Jeff Bezos and agreed to a cross promotion deal with Amazon. Netflix would direct DVD buyers to Amazon in exchange for ad placement on Amazon's website.[25]

In 1999, Netflix began testing different ways to increase rentals and drive customer loyalty. Netflix's Home Rental Library concept sent customers six DVDs at a time for a $20 per month subscription. After returning all the discs, customers could select six more DVDs to rent. Netflix's Serialized Delivery concept continued using Netflix's per disc rental pricing but allowed customers to create a short list of future movie rentals. As soon as the customer returned a DVD, Netflix would send another movie from their list. Customers in the market test groups liked both concepts, so Randolph decided to combine them into a concept called the Marquee Plan. Customers were offered four movies for a $15.99 per month subscription. Hastings labeled the program "near DVD-on-Demand" and positioned it as an alternative to Blockbuster's due dates and late fees.[26] Within six months the program tripled rentals to more than 100,000 per week. Netflix announced a change to the Marquee Program in February 2000 to allow unlimited rentals with up to four DVDs out at a time.[27]

> Imagine watching whatever DVD movies you want, keeping them for as long as you want, and watching as many as you want, all for a flat fee of $19.95 per month...Similar to AOL's transformation of the Internet with its unlimited access plan for a flat fee, Netflix is changing the rules of the movie rental market. – Reed Hastings, Netflix CEO[28]

NETFLIX TAKES ON BLOCKBUSTER

David Cook founded Blockbuster in the mid-1980s. Cook owned a Texas-based software company catering to customers in the oil and gas industry. When the 1980s glut in the oil market began taking a toll on his software business, Cook decided to shift his focus to the video rental market. Using his experience with databases, he created an automated video rental tracking system. He opened the first Blockbuster store in 1985 and used the tracking system to optimize video availability. By 1992, Blockbuster was opening a new store every 24 hours and acquiring rival video store chains domestically and internationally.[29]

To improve the availability of new releases, Blockbuster established revenue sharing agreements with studios. Instead of buying videos outright, Blockbuster negotiated steep discounts for videos and gave studios 40 percent of rental revenue.[30] The DVD was introduced in March 1997, and although it was a consumer success, with nearly 400,000 DVD players sold in the first six months, Blockbuster viewed the format as a threat to its VHS-based business and refused to stock it in stores until late 1998.[31]

By 2000, Blockbuster had grown to 7,700 stores and generated $535 million in earnings on $4.96 billion in revenue.[32, 33] In contrast, Netflix had 300,000 subscribers and was expecting losses of $57 million.[34, 35] Running low on cash, Netflix's Hastings proposed an equity alliance to Blockbuster:

> We offered to sell a forty-nine-percent stake and take the name Blockbuster.com. We'd be their online service – Reed Hastings, Netflix CEO[36]

Blockbuster declined the offer. Blockbuster's management believed that spontaneity drove the video business; it doubted that Netflix's mail-based business would succeed.[37] Furthermore, Blockbuster was already working on a product that would potentially make VHS and DVD rentals obsolete. In partnership with Enron Broadband, Blockbuster was creating a video-on-demand movie streaming system.[38] During a trial launch of the system, customers were able to purchase a $100 device that allowed them to watch rented movies without a trip to a Blockbuster store.[39] However, within months, Blockbuster's attempt to create a video-on-demand service with Enron fell apart. In 2001, Blockbuster took a $450 million charge to replace obsolete VHS inventory with DVDs.[40]

Netflix's continued growth astounded Blockbuster and analysts alike. A report from Kagan Research indicated a maximum of 3.6 million potential users for online rental services, paling in comparison to Blockbuster's 65 million members. One Gartner analyst described Netflix as, "a good niche business."[41] By 2002, however, Netflix was profitable and had launched an initial public offering (**Exhibit 2**).[42]

NETFLIX, MCDONALD'S, AND REDBOX

While Blockbuster continued to ignore Netflix, the online-movie rental business experimented with physical retail locations. Netflix's Marc Randolph and Mitch Lowe wanted to give Netflix users the same instant gratification that Blockbuster customers received when visiting stores by using self-service kiosk machines.[43] Lowe had in fact attempted this idea unsuccessfully years earlier with VHS tape rentals after becoming frustrated with his own video store's employees and overhead expenses.[44] Due to the high cost of the machines, however, Randolph and Lowe decided to test the idea with a Netflix counter operated by a single employee inside a Las Vegas grocery store. This 'Netflix Express' concept tested well. McDonald's contacted Netflix and was interested in using the rental kiosk idea to draw more customers into their restaurants. Despite its promise, Netflix's Reed Hastings shelved the idea. The video business appeared to be heading towards online distribution and the self-service kiosks looked like a step backward. Not ready to give up on the idea, Lowe quit his job at Netflix and went to work for McDonald's Ventures, where he helped create McDonald's Redbox DVD rental kiosk business.[45] Randolph left Netflix in 2003 and was replaced by Hastings as CEO. By 2004, McDonald's had installed Redbox kiosks in all 50 states.[46]

BLOCKBUSTER GOES POSTAL

Blockbuster finally acknowledged Netflix's threat to their business in 2004:

> ...in August 2004 we jumped into the online business in a big way. A few months later we made a dramatic change by eliminating late fees, which had been a major customer irritant. Those moves put Blockbuster back into growth mode...We were planning to spend $200 million to launch Blockbuster Online and another $200 million to eliminate late fees. – John Antioco, Blockbuster CEO[47]

Blockbuster Online launched in August 2004 at $19.99 per month undercutting Netflix's $22 per month rate for new customers. Blockbuster Online subscribers could select DVDs to rent on Blockbuster's website instead of visiting stores. The subscription included unlimited DVD rentals by mail, and customers were allowed to have up to three DVDs out at a time. Two free in-store movie rentals per month were included with the subscription as well.[48] Netflix responded by cutting its three-out subscription price to $17.99.[49] Not to be outdone, Blockbuster then dropped their price to $14.99.[50] Blockbuster advertised the new service heavily with television commercials and in-store coupons. Within four months Blockbuster achieved 750,000 subscribers, a number that had taken Netflix four years to reach.[51] In April 2005, Hastings commented on an investor conference call that Blockbuster had thrown everything at them except the kitchen sink. Blockbuster's management obliged and shipped Hastings a kitchen sink from a hardware store the next day.[52]

In November 2006, Blockbuster announced a hybrid mail and in-store rental model dubbed Blockbuster Total Access. Total Access allowed Blockbuster Online subscribers to exchange their DVDs at store locations as well as by mail. The program also offered subscribers a shorter shipping cycle. If they returned their online rental to a Blockbuster store, it would automatically release the next movie in their queue for shipment.[53]

> Customers shouldn't have to choose between renting online versus in-store, and they should never have to be without a movie. Now thanks to Blockbuster Total Access, they don't have to. – John Antioco, Blockbuster CEO[54]

Blockbuster's success with Total Access crippled Netflix's subscriber growth. Wall Street analyst Michael Pachter declared, "I don't know how Netflix can win this thing. The only way they can get back to growth is if Blockbuster goes away."[55]

LEADERSHIP CHANGES AT BLOCKBUSTER

A compensation dispute between Blockbuster's CEO, John Antioco and billionaire activist shareholder Carl Icahn resulted in Antioco's departure from Blockbuster in July 2007.[56] Jim Keyes, a former chief executive from 7-Eleven replaced Antioco. Keyes was renowned for his data-driven decision making. He extended this practice even to 7-Eleven's doughnut orders, which were adjusted daily based on historic sales data and weather forecasts. When Keyes left 7-Eleven, he had overseen 36 consecutive quarters of revenue growth. His retail success was badly needed at Blockbuster. The chain had closed 9 percent of its stores in 2006 and was planning to close an additional 242 in 2007.[57]

> The opportunity for Blockbuster is to provide true total access whether in the form of physical stores or mail delivery *or* digital distribution. – Jim Keyes, Blockbuster CEO [58]

During a July 2007 corporate retreat, Keyes presented a store-focused strategy. Stores would be transformed into entertainment destinations with prepared foods, retail electronics, and kiosks where customers could load rented movies and games onto flash drives.[59] In April 2008, Keyes made an unsolicited offer to buy Circuit City for $1 billion in an attempt to transform Blockbuster into an electronics retailer. Circuit City's board rejected the offer, doubting Blockbuster's ability to finance such the deal.[60]

> The company announced a big price increase for online customers, cut way back on marketing, and decided to intensify the focus on the store-based business . . . I sold my stock and bought a bunch of Netflix shares . . . – John Antioco, former Blockbuster CEO [61]

STREAMING

In January 2007, Netflix launched an on-demand streaming service. A new Netflix website feature allowed subscribers to watch one thousand titles instantly on their computers.[62] Blockbuster acquired similar capabilities that August by purchasing Movielink, a streaming service backed by Universal, Paramount, Sony Pictures, MGM, and Warner Brothers. The move resulted in an 8 percent gain of Blockbuster's stock price.

In May 2008, Roku, a company incubated at Netflix's headquarters, launched a set-top box that allowed Netflix subscribers to watch streaming content on their televisions. Later that year, Microsoft and Netflix announced that the streaming software would be included in an upgrade to the Xbox 360. Over the next three years Netflix made deals to incorporate their software on over two hundred internet-connected devices.[63]

> Let everybody fight it out, kill each other, and spend lots of money on set-top boxes tethered to big screen TVs. – Jim Keyes, Blockbuster CEO [64]

Acquiring streaming content was a challenge for Netflix. The film industry had long-term contracts in place with the cable subscription channels. In 2008, Netflix struck a deal with Starz to license content Starz had previously acquired. Content providers, however, soon recognized that Netflix offered them not only a good way to generate revenue from old content, but also the ability to generate interest for current shows. For example, by providing past seasons of "Breaking Bad" on Netflix, AMC was able to increase ratings of the current season.[65] Moreover, "Breaking Bad" drew many more viewers on Netflix than when shown originally on AMC. One reason is that Netflix allowed binge watching (of all 62 episodes), without any advertising interruptions.

> The television business is based on managed dissatisfaction. You're watching a great television show you're really wrapped up in? You might get 50 minutes of watching a week and then 18,000 minutes of waiting until the next episode comes along. I'd rather make it all about the joy. – Ted Sarandos, Netflix Chief Content Officer[66]

BLOCKBUSTER KIOSKS

Blockbuster and other traditional video stores were feeling the effects of Redbox's rapid expansion across the U.S. The machines were drawing customers away from brick-and-mortar establishments with more convenient locations and lower prices. "These machines are to the video industry what the Internet was to the music business – disaster," commented Video Buyers Group's Ted Engen.[67] In August 2008, Blockbuster announced a partnership with NCR to develop its own DVD rental kiosks as it continued to close unprofitable stores. "We're actually adding points of service rather than deleting," Keyes stated about the move to kiosks.[68]

THE END FOR BLOCKBUSTER

Blockbuster filed for bankruptcy in September 2010. Dish Network acquired Blockbuster's remaining 1,700 operating stores in 2011 at auction. After the acquisition, Dish continued closing stores and finally pulled the plug on physical locations in 2013.[69] Fittingly, the last movie rented at a Blockbuster was Seth Rogen's apocalyptic comedy "This is the End."[70] Dish operated a Blockbuster branded streaming service until it launched Sling TV in 2015.

> Blockbuster turned out to be the worst investment I ever made. – Carl Icahn[71]

QWIKSTER

While Netflix triumphed over Blockbuster, it was not immune to missteps. In 2011, Netflix announced that it would split DVD and streaming subscriptions with a new entity, Qwikster, handling DVD by mail. For customers subscribing to both services, prices would jump 60 percent. "I was obsessed with not getting trapped by DVDs the way AOL got trapped, the way Kodak did . . . " explained Hastings.[72] Upset over the sudden price increase, 800,000 subscribers abandoned the service causing a massive drop in Netflix's stock price (**Exhibit 3**). Realizing the mistake, Netflix quickly reversed the decision a few weeks later.

> 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. – Reed Hastings, Netflix CEO[73]

ORIGINAL CONTENT

Netflix released its first original series, "House of Cards," in 2013. Netflix commissioned two seasons upfront for $100 million, a bold move that was enabled by Netflix's detailed knowledge of their customers. Directed by David Fincher, the American adaptation of a British political drama by the same name, stars Kevin Spacey and Robin Wright. Netflix's data indicated that the original British production of "House of Cards" was popular with Netflix users, as were director David Fincher's films like "Fight Club" and films starring Kevin Spacey.[74] Ted Sarandos, Netflix's Chief Content Officer remarked, "I didn't use data to make the show, but I used data to determine the potential audience."[75]

> Netflix was the only network that said, 'We believe in you. We've run our data and it tells us that our audience would watch this series. We don't need you to do a pilot. How many [episodes] do you wanna do?' – Kevin Spacey[76]

Netflix followed "House of Cards" with other hits including "Orange is the New Black" and "Stranger Things." By 2016, Netflix had 30 films or shows in production and planned to release 600 hours of original content, doubling its 2015 output.[77]

NETFLIX AND INTERNET SERVICE PROVIDERS

Netflix accounts for 35 percent of peak internet traffic, delivering over 125 million hours of video per day.[78, 79] This heavy network usage has sometimes led to strained relationships with the Internet service providers (ISPs) that carry Netflix's data. To help alleviate traffic on ISP infrastructure, Netflix has moved streaming content storage closer to customers. In 2011, Netflix developed its Open Connect system. Netflix locates Open Connect content servers near or inside ISPs' facilities to make interconnection with the ISPs' infrastructure simpler. Netflix distributes new content to select Open Connect servers during off-peak times. The content is then automatically duplicated onto additional adjacent Open Connect Servers. This provides the ISPs with several local copies of streaming content and considerably reduces Netflix's use of ISP infrastructure.[80]

Throughout 2013 and into 2014, Netflix customers that used Comcast's Internet service experienced noticeably reduced video streaming quality. Comcast publically blamed Netflix for the slow speeds stating, "The only company who decides how Netflix traffic is delivered to us is Netflix. They choose the path the traffic takes to us. They can choose to avoid congestion or inflict it." In the spring of 2014, Netflix agreed to pay Comcast a carriage fee for handling its traffic. The payment resulted in an almost immediate speed increase for the affected Netflix customers. Other ISPs including Time Warner Cable, AT&T, and Verizon negotiated similar payment arrangements with Netflix.[81]

Netflix prevailed over the ISPs in 2015 when the Federal Communications Commission voted to regulate broadband as Title II telecommunications service under the 1934 Communications Act. This "net neutrality" decision eliminated ISPs leverage over Netflix by requiring ISPs to treat all Internet traffic equally. ISPs would no longer be permitted to throttle data or create paid fast lanes.[82]

In the fourth quarter of 2016, Netflix launched offline viewing. The new feature allows users to watch downloaded content on iOS and Android devices where broadband access is limited such as subways, airplanes, and emerging market countries.[83]

Competitors

REDBOX

Redbox rents new-release DVDs, Blu-ray discs, and video games from self-service kiosks located near the entrances of grocery and drug stores. Devised as a way to increase traffic to McDonald's restaurants, Redbox thrived as bricks-and-mortar video stores floundered. Redbox parent company, Outerwall (formerly Coinstar), runs several other kiosk-based businesses including coin counting and electronics recycling. Redbox's success has been attributed to their low rental prices, low cost structure, and providing newer releases than streaming services.[84]

Redbox's meteoric rise flattened in 2014. In a move towards managing for efficiency, Redbox removed 500 of its over 40,000 kiosks. Analyst Steven Frankel commented, "Redbox has definitely reached full maturity. The only question is: how steep is the decline?"[85] Redbox ceased Canadian operations in 2015 to focus on the US market, "where demand for physical media remains strong."[86] In April 2016, Redbox reported that rentals for the quarter had dropped to 137.7 million from 173 million the previous quarter and that quarterly revenues had fallen to $421.5 million from $519.5 million.[87] Apollo Global Management took Outerwall private in September 2016.

HBO NOW

In 1972, Home Box Office (HBO) launched its service in Wilkes-Barre, Pennsylvania.[88] The pay-TV channel split revenues with local cable affiliates to provide them an incentive to promote the service. Three years later, HBO was transmitting to cable affiliates by satellite and had over 275,000 subscribers.[89] In 1976, HBO began financing films in return for distribution rights to satisfy its growing appetite for content at prices it could control.[90] In the 1990s, HBO decided to compete based on quality content resulting in award-winning series such as "The Sopranos." This focus on content has continued with current series like "Game of Thrones" and "Westworld."

HBO entered the streaming market in 2008 with HBO Broadband. Access to the service, however, was limited to HBO cable subscribers.[91] In April 2015, HBO launched HBO Now, a stand-alone streaming service. The move was announced during investor presentation for HBO's parent company, Time Warner. "It is time to remove all barriers to those who want HBO," declared HBO chairman and chief executive Richard Plepler.[92] By February 2016, HBO Now counted over 800,000 subscribers, representing a growing portion of HBO's 50 million U.S. subscribers.[93] HBO budgeted about $2 billion for content in 2015, with about half going towards originals.[94]

> We have a pretty hefty [content] budget, a couple of billion dollars. We're not spending our programming money on library product. We're doing original shows....We've been increasing it, and we'll keep increasing it. – Jeff Bewkes, Time Warner CEO[95]

HULU

In 2007, NBC and Fox teamed up to create Hulu. Hulu's online service allows viewers to stream current and past television shows as well as original content such as "The Awesomes." Initially, Hulu was free and supported by advertising revenue much like broadcast television. In 2010, Hulu introduced Hulu Plus, a paid subscription version of the service offering additional content and fewer commercials. Hulu announced the end of its free service in August 2015. Subscribers can now choose between a $7.99 per month plan with commercials or an $11.99 per month plan without advertisements.

> For the past couple years, we've been focused on building a subscription service that provides the deepest, most personalized content experience possible to our viewers. As we have continued to enhance that offering with new originals, exclusive acquisitions, and movies, the free service became very limited and no longer aligned with the Hulu experience or content strategy. – Ben Smith, Hulu Senior VP[96]

Hulu is now owned by Comcast, Time Warner, 21st Century Fox, and Walt Disney and has plans to launch a live TV service in 2017 with channels from its parent companies. In 2016, Hulu had approximately 12 million subscribers.[97]

AMAZON VIDEO

Amazon entered the video-on-demand business in 2006 with Amazon Unbox. The service allowed both rental and purchase of downloadable movies and television shows. In 2011, Amazon rebranded the service as Instant Video and bundled it as an added perk with its $99 per year Prime membership.[98] In April 2016, Amazon announced that it would begin offering video as a standalone service for $8.99 per month.[99] An estimated 14.5 million of Amazon's 40 million Prime members use Amazon

Video.[100] Amazon spends roughly $3 billion annually on streaming content including deals with HBO and Epix.[101] Amazon released its first original series "Alpha House" in 2013 and has since followed it by many more including the Emmy Award-winning series "Transparent" and "Man in the High Castle."[102]

> When we win a Golden Globe, it helps us sell more shows . . . in a very direct way. Because if you look at Prime members, they buy more on Amazon than non-Prime members, and one of the reasons they do that is once they pay their annual fee, they're looking around to see, 'How can I get more value out of the program?' And so they look across more categories — they shop more. A lot of their behaviors change in ways that are very attractive to us as a business. – Jeff Bezos, Amazon CEO[103]

SLING TV

Dish Network launched Sling TV in January 2015 at the Consumer Electronics Show. Sling TV reaches its audience over the local cable companies, delivering live shows and on-demand content directly to subscribers via the Internet. Sling TV offers three different bundles that include popular channels like ESPN, Disney, AMC, and Comedy Central as well as local content from ABC, NBC, and Fox Stations. The bundles range in price from $20–$40 per month and subscribers are not required to sign long-term contracts. Sling TV is estimated to have 700,000 paying subscribers.[104]

> When we launched, we were focused on "cord nevers." Now, we are a true full cable replacement. – Roger Lynch, Sling TV CEO[105]

YOUTUBE RED

Google's YouTube launched an advertisement-free subscription service dubbed Red in October 2015. The service allows users to save videos for offline viewing and includes access to Google Play Music. Subscribers of the $9.99 per month service will also have access to premium original content not available on the advertising supported side of YouTube. YouTube is pairing some of its most popular video creators with Hollywood talent to create unique content. For example, YouTube star Felix "PewDiePie" Kjellberg has teamed up with the producer of *The Walking Dead* to create the scripted horror show *Scare PewDiePie*.[106]

> To us what is important is we are not doing what everybody else is doing, competing for the same sources of material, the same creative elements. We are looking for people who are proven to work really well on our platform. – Robert Kyncl, YouTube Chief Business Officer[107]

Challenges

RELEVANT CONTENT

In 2017, Netflix plans to spend $6 billion on original and licensed content, up from $5 billion in 2016 (**Exhibit 4**).[108] The majority of this spending goes towards television shows and movies licensed from others.[109] For example, Netflix has global licensing agreements for Fox's "Gotham," AMC's "Breaking

Bad," and ABC's "How to Get Away with Murder." Within the next few years, Netflix aims for half of its content be original.[110] "For a dollar spent and an hour viewed, you get more hours of viewing per dollar spent on original programming versus licensed content," noted Netflix's Ted Sarandos in 2015.[111] As Netflix expands worldwide, it has invested in global originals such as: "The Crown," "Marseille," and "Narcos." Netflix is also making forays into unscripted (reality) television. "Ultimate Beastmaster," a global competition series produced by Sylvester Stallone is scheduled to debut in 2017.[112] Netflix has avoided sports and news content, but is pushing children's programming. About 20 of Netflix's 70 upcoming global originals are intended for children.[113]

As competitors like Amazon and Hulu invest more in content, Sarandos will be competing not only for viewers, but also for talent. "It's a race, but there are going to be many winners," opined Hastings. "If you can build an iPhone app, you start a TV channel. We are going to have to see how that plays out."[114]

INTERNATIONAL GROWTH

Of Netflix's 93.8 million subscribers, 49.4 million (or 53 percent) are in the U.S. (**Exhibit 5**).[115] Netflix announced in January 2016 that it would be radically expanding its services internationally from 60 to 190 countries. Netflix is noticeably absent from China, a market where Hastings commented that Netflix is still, "in the relationship building phase." Netflix is adding services in Arabic, Korean, and Chinese to the 17 languages currently supported. Netflix's original programming will be available in all countries; however, the availability of licensed content varies by country.[116] Netflix's expansion has drawn the attention of a number of government authorities. The European Commission, for example, is considering a European content quota and subsidy pots for national production.[117]

> The big imbalance in Netflix is we're majority US viewing and subscribers. And if you look at YouTube, Facebook, and others, they're about 20 percent US and 80 percent international. – Reed Hastings, Netflix CEO[118]

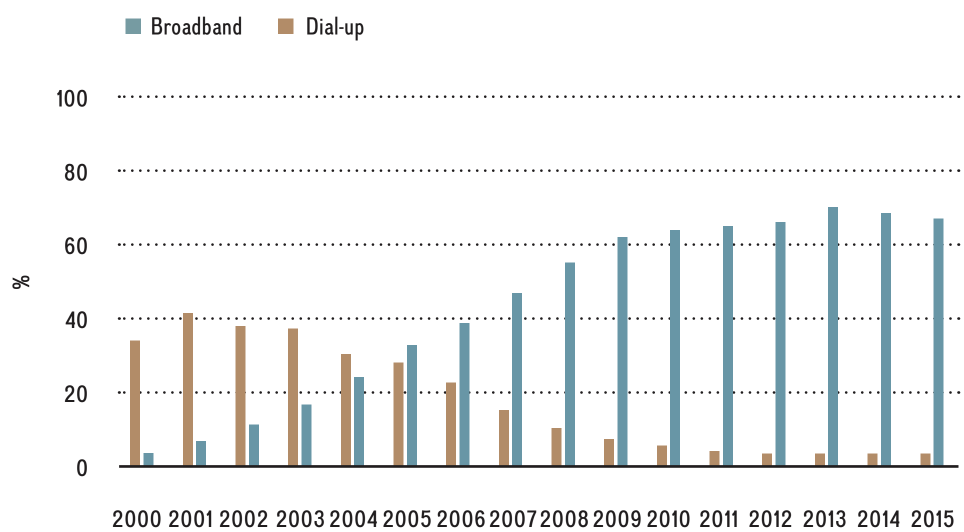
RELATIONSHIPS WITH INTERNET SERVICE PROVIDERS

The Federal Communications Commission's net neutrality decision was a short-lived victory for Netflix. To work around the new rules, ISPs have begun imposing "data caps" on users. Once users exceed their data cap, additional data usage incurs added fees.[119] Another ISP practice concerning to Netflix is "zero-rating," an arrangement where the ISP does not count traffic from preferred data providers towards customers' data caps. Netflix explained their concerns in a September 2016 FCC filing, "Because of a low data cap, an online service [like Netflix] may need to pay an ISP to zero-rate its traffic to enable that ISP's customers to access the online service. Such arrangements create an incentive for ISPs to maintain artificially low caps."[120] In January 2017, net neutrality opponent Ajit Pai was appointed to head the FCC, calling into question the future of Netflix's current relationships with Internet service providers.[121]

Decision Time

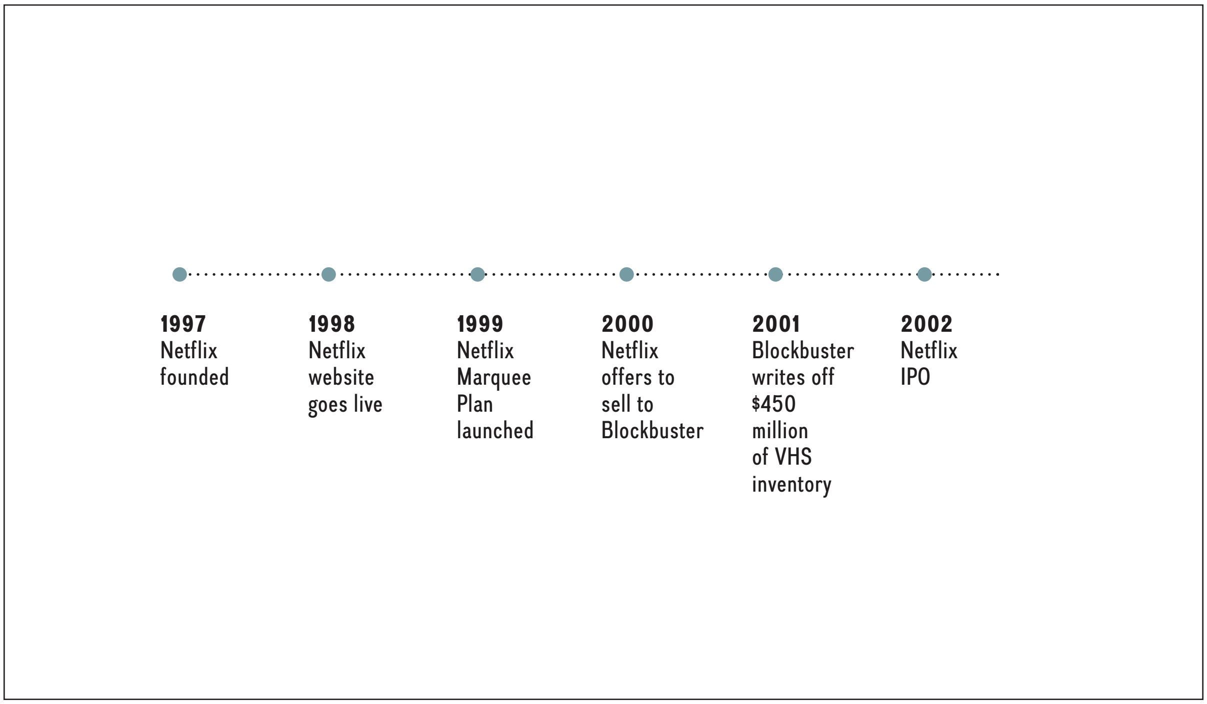
Hastings woke up early the next morning and caught a private jet back to San Francisco. As the jet climbed over the California coastline, Hastings reflected on Netflix's history. Netflix had successfully taken on Blockbuster. Much like Blockbuster, Netflix had grown quickly and become a household name. Hastings hoped that Netflix had learned from the mistakes of Blockbuster and would avoid the same fate. Netflix needed to address the challenges of relevant content, international growth, and the Netflix's relationships with the Internet service providers in the face of rising competition. What could he do to ensure that Netflix's continued success?

EXHIBIT 1 Percent of U.S. Adults with Home Internet Access



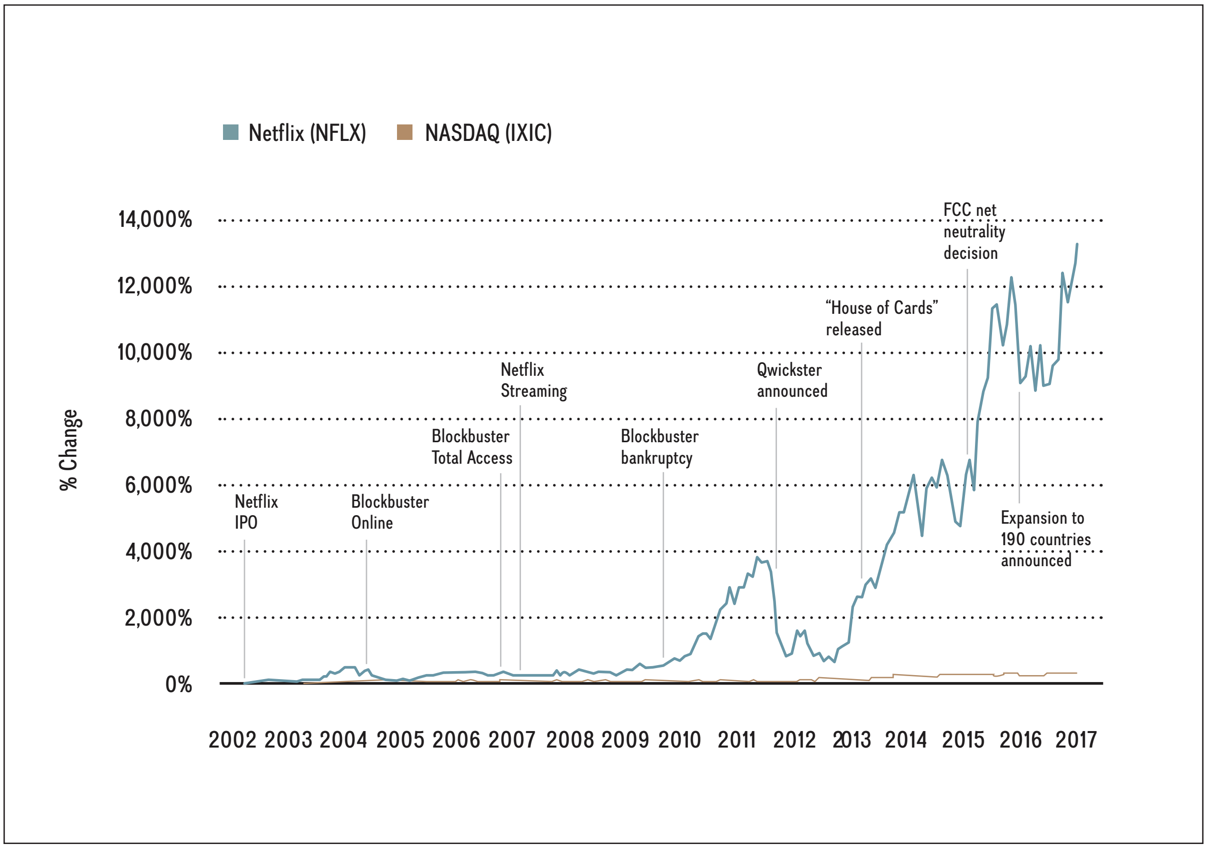
Source: Adapted from "Three Technology Revolutions," http://www.pewinternet.org/three-technology-revolutions/.

EXHIBIT 2 Netflix Pre-IPO timeline



Source: Depiction of publicly available data

EXHIBIT 3 Netflix Key Events and Stock Price vs. NASDAQ 2002–2017



Source: Depiction of publicly available data

EXHIBIT 4 Netflix Key Financial Data 2012–2016

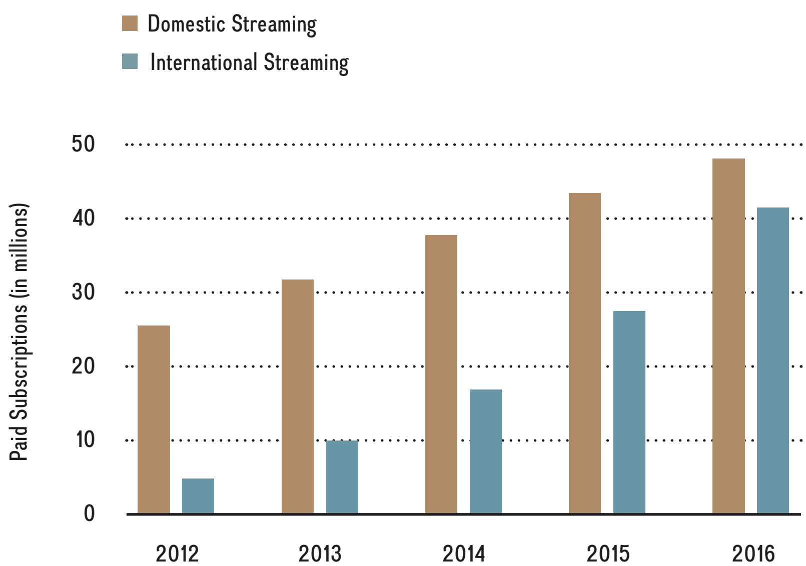
Income Statement (in millions, except per share data)					
Fiscal Year	**2012**	**2013**	**2014**	**2015**	**2016**
Revenues	3,609	4,375	5,505	6,780	8,831
Cost of revenues	2,652	3,117	3,753	4,591	6,030
Gross profit	957	1,257	1,752	2,188	2,801
Marketing	439	470	607	824	991
Technology and development	329	379	472	651	852
General and administrative	139	180	270	407	578
Operating income	50	228	403	306	380
Interest expense	(20)	(29)	(50)	(133)	(150)
Interest and other income (expense)	0	(3)	(3)	(31)	31
Loss on extinguishment of debt	0	(25)	0	0	0
Income before income taxes	30	171	349	142	261
Provision for income taxes	13	59	83	19	74
Net income	17	112	267	123	187
Earnings per share (adjusted for stock splits)	0.04	0.26	0.62	0.28	0.43

Excerpt from Statement of Cash Flows (in millions)					
Fiscal Year	**2012**	**2013**	**2014**	**2015**	**2016**
Free cash flow	(58)	(16)	(127)	(921)	(1,660)

Excerpts from Balance Sheet (in millions)					
Fiscal Year	**2012**	**2013**	**2014**	**2015**	**2016**
Total content assets, net	2,934	3,838	4,939	7,219	11,001
Total content liabilities	2,443	3,122	3,693	4,815	6,527
Total assets	3,962	5,404	7,043	10,203	13,587
Total liabilities	3,217	4,070	5,185	7,979	10,907
Total stockholders' equity	745	1,334	1,858	2,223	2,680

Source: Netflix Annual Reports (various years).

EXHIBIT 5 Paid Netflix Subscriptions (in millions)



Fiscal Year	2012	2013	2014	2015	2016
Domestic DVD	8.05	6.77	5.67	4.79	4.03
Domestic Streaming	25.47	31.71	37.70	43.40	47.91
International Streaming	4.89	9.72	16.78	27.44	41.19

Source: Netflix SEC filings

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