BUS 478 D300
CASE SYNOPSIS: NETFLIX
SPR 2013

Group 6:
Sean Hougan
Sadra Sarfraz
Mona Lai
Nicole Manalac
Bonnie Ho

BUS 478
Jerry Sheppard

March 21, 2013

HISTORY

Netflix was founded in 1997 by Marc Randolph and Reed Hastings in Los Gatos, California. In 1998 they began as a rent-by-mail company and today, Netflix is known for pioneering the Internet delivery and streaming of TV shows and movies. The company offered customers an easy process of renting or purchasing DVDs online and provided options that allowed extended rental periods without additional charges. The Netflix subscription service was introduced in 1999, offering customers a choice of four DVD rentals for a monthly fee. However, over the next several years, as Netflix's subscribers and selection increased, it began to provide unlimited DVD rentals for one, low monthly price. In 2000, Netflix introduced CineMatch, a service that gathered information about rental patterns among its customers to group them similarly according to taste. This information gave Netflix insight to customer preferences and as such, could suggest DVD titles to subscribers based on past records and interests ("History of Netflix," n.d.).

Having reached a customer base of approximately 600,000 in May of 2002, Netflix obtained financing with its initial public offering (IPO). It raised $82.5 million, which was used to reduce debt and expand its promotional efforts ("Netflix Company Timeline," n.d.). During this time, Netflix successfully signed revenue sharing agreements with large film distributors and as result, increased its library of movies to give more choices to a growing customer base. In early 2003, Netflix reached 1 million subscribers and by springtime, its stock price was 50% higher than its price at IPO. Come 2007, Netflix launched their movie streaming services to cater to changing consumer preferences. Many film distributors were on board with this idea and it was during this period that Netflix experienced large levels of profit growth through decreased overhead costs from physical inventory and postage savings. At that time, Sandvine reported that Netflix streaming subscribers accounted for as much as 33% percent of Internet traffic (Sandvine, 2012).

Since then, the stock price of Netflix has decreased from its highest point at $299 per share. This can be largely attributed to the fact that customers were unhappy with managements' decision to separate their DVD rental and online streaming services as well as lack of corporate growth strategies.

GENERAL ENVIRONMENT

Demographics*.* Netflix's subscription services are available to many digital consumers because of its affordability. Neither age nor ethnicity significantly impacts the company's marketability as it can simultaneously target several segments of the consumer market due to the diverse selection it offers.

Technological. While consumption of multimedia entertainment continues its growth, there is an increasing demand for better integration of digital media with portable or handheld devices to synchronize with consumers' active lifestyles. Moreover, demand has driven technological advancements that allow for greater network bandwidth to reduce streaming interference and interruptions, as well as high definition images to enhance viewing quality and experience.

Economic. The US is recovering and experiencing growth as the effects of the economic recession are wearing off. Since 2009, annual GDP has grown by 6.2% (US Bureau of Economic Analysis, 2013).

Sociodemographics. The US houses a diverse population with different consumption needs and demands. However, since Netflix offers 24 hour service, it easily caters to various lifestyles.

Legal. US Copyright law may be amended to limit the sale or distribution of DVDs, which may have an adverse impact on Netflix's DVD rentals business and operations (Netflix, 2011, p.8).

CURRENT SITUATION

Netflix is currently the world's leading Internet television network with nearly 33 million global streaming members worldwide (Overview, n.d.). In 2012 alone, it gained 10 million new members globally. Despite large international investments, it generated profits in 40 countries around the world (Netflix: Quarterly Earnings, December 2012.). Netflix has not only been working towards global business expansion, it has also invested in increasing the variety and quantity of its rental selection. A broader title selection helps the company retain and attract more members.

In recent years, Netflix has secured and maintained partnerships with major studios like Walt Disney, Warner Bros. and Paramount. Such licensing deals with movie and television producers, rather than studio Networks, allows Netflix to include a bigger selection of television shows and movies. Netflix has also dealt with government policies like the The Video Privacy Protection Act which prohibited "a video tape service provider" from revealing customer information without the customer's written consent (CNNmoney, 2013). After a year of lobbying, The VPPA was modernized, giving Netflix members freedom to share streamed movies with their friends and vice versa through their Facebook profiles which helps them eliminate marketing costs.

Because acquiring content licenses from producers has become more expensive, Netflix diversified its offerings and started its own production company, Original Series. For example, in early 2012, Netflix released a reboot of a popular British show, "House of Cards" (Netflix: Quarterly Earnings, 2012). This series is different from conventional television shows because it provides all the episodes upon release rather than in fixed intervals over a specific period. After a successful launch, they are planning to release more originally produced shows, as Netflix believes that Internet TV will be the future of television.

The condition of the company's DVD rentals operations further supports the validity of their position on the future of television. Netflix's DVD rentals has gradually seen a decline, with membership at 8.2 million—an effect of $128 million in contribution to 4th quarter earnings of 2012 (Netflix: Quarterly Earnings, 2012). Although DVD rentals are losing popularity, its contribution margin is still at 50%, while domestic streaming's contribution of 18.5% pales in comparison.

Netflix also faces increased competition from companies such as HULU, Google, Apple, Verizon (VZ) and Coinstar (CSTR), Comcast (CMCSA), and Amazon (AMZN), who have cut into the company's core subscription base (Daris, n.d). Its competitors attempt to gain market share by offering lower prices, which will has had an adverse effect on Netflix's business.

INDUSTRY ENVIRONMENT

Threat of New Entrants: There is a medium level of threat for Netflix's subscription service since high capital requirements and distribution channels create barriers to entry. However, it is an attractive market because it appears to be relative easy to adopt streaming services (Zambelli, 2013). The large investments in content acquisition, such as licensing fees and procurement costs, make this market accessible only to those with significant capital. Logistics also proves to be a challenge since exclusive distribution channels are only available to well-established Internet retail companies (Netflix plans debt, 2013).

Power of Suppliers: The power of suppliers is high. Content is the main input source of Netflix's business and owners retain control over the licensed distribution of television shows and movies. The strong strategic alliances in Hollywood, together with the limited number of industry-known and reputable content suppliers, give suppliers strong bargaining power (Tsui, 2012).

Power of Buyers: Buyers have high bargaining power. Netflix's revenue is generated from customer sales so it relies heavily on the demand and loyalty of customers, wherein switching costs are low and nearly non-existent (Company Profile, 2013). Since TV and movies are considered a leisure and entertainment activity, and are amongst a wide array of entertainment types, the chance of switching to other entertainment substitutes is considerable.

Product Substitutes: The threat of substitutes is moderate. There are other alternatives available for viewing TV and movies that may be of higher value because of lower cost or perceived quality and experience, such as pirated multimedia or movie theatres, respectively. In addition, the traditional television set still has a dominant place in society due to familiarity, habitual behaviour, and personal preference making.

Intensity of Rivals: Netflix operates in a highly competitive industry, facing rivals from pay-TV service providers and movie rental companies. Technological advances allow companies to easily imitate Netflix's content delivery structure as demonstrated by Apple TV, Amazon on Demand, and Blockbuster on Demand (Company Profile, 2013). Although Netflix benefits from a first mover advantage in this niche market, it may be forced out of its position because these companies are better positioned due to their financial resources and organizational structure.

COMPETITOR ENVIRONMENT

Netflix faces intense competition from various players in both their domestic and international markets. For the scope of this assignment we will focus on Netflix's domestic market and briefly touch on the key competitive challenges they face in their foreign markets.

In Netflix's domestic market (U.S.), the competitor environment consists of a multitude of players that compete with them for movie and television consumption. Organizations like Blockbuster Inc., Movie Gallery Inc., and Hastings Entertainment that sell and rent DVD products compete with Netflix for their DVD rental services (MarketLine, 2013). Further increasing competition, these companies have been developing ways for customers to access content online, rather than via mail-in DVDs. For example, Blockbuster Inc. has recently launched a service for consumers to stream movies online, on demand. In addition, the company also faces competition from others who operate with a subscription streaming model. These companies include Amazon.com, Redbox, AppleTV, and Hulu.com who provide movie and television services that can be accessed via the Internet through PCs, Internet-connected TVs, and consumer electronic devices including but not limited to the Xbox 360, Playstation, and Wii (MarketLine, 2013).

Netflix also faces intense competition within their international markets in North America, South America, and Europe but face more complex challenges than those present in the U.S. What has been typified with their entry into these markets is a domestic company emerging to compete soon after their arrival. Netflix has been less successful in foreign markets because domestic organizations, who attempt to operate with a similar model to Netflix, are accustomed to the legal framework and viewing habits in their homeland. Furthermore, they have pre-established relationships that enable more competitive bidding for content. For example, followed by their entry into Mexico, AméricaMóvil, an Internet and telecommunications provider launched a similar service that took advantage of the limited broadband width in the country and chose to bundle their streaming services with Internet packages for five dollars a month, which is lower than the price Netflix charges (Maurer, 2012). In addition to this, the company is exposed to risk of increasing piracy worldwide.

Top Competitors

Amazon.com provides an entertainment bundle for "an annual fee of $79 and includes free Super Saver Shipping, free book rentals via its Kindle e-reader, video streaming, and a few other perks" (MacDonald, 2012, p.1). While Amazon's streaming catalogue is tiny in comparison to Netflixs', it is advantageous in offering newer content allowing subscribers to rent or buy digital movies and TV shows for an additional fee (MacDonald, 2012).

Redbox – A recent partnership between Coinstar Inc. and Verizon poses a threat to Netflix's market share with their recent launch of 'Redbox Instant by Verizon' that matches

Netflix's subscription price (Reuters, 2012). This new venture has given them access to movies from Paramount Pictures, Lions Gate Entertainment, and Warner Bros making them an attractive alternative to Netflix (Reuters, 2012, p.1). Like Netflix, subscribers can stream films to certain Internet-connected TVs, phones and tablets.

Apple TV – Apple sells movies and TV shows through the iTunes Store. While they do not compete with Netflix as an unlimited subscription service, they do capture a portion of their market share through one-time movie and television show purchases. There is speculation that Apple will soon attempt to branch into a subscription-based model but this service has yet to be launched (MacDonald, 2012).

Hulu.com – Hulu provides a wide selection of popular prime time television shows by all the major networks in the U.S., and competes with Netflix primarily on their TV series selection. Hulu offers both a free streaming service and a subscription-based service that allows subscribers to view recently aired shows. An advantage that Hulu Plus holds over Netflix is their wide selection, recency, and popularity of the TV series they offer. Furthermore, since Hulu has partnerships with NBC Universal, ABC Television Group, Fox Entertainment Group, and others—they benefit from being able to provide content from these networks at a much lower cost compared to Netflix (MacDonald, 2012). Unlike Netflix, consumers of Hulu do not benefit from commercial free viewing which is how they gain the majority of their revenues (Corty, 2013).

STRATEGIC CHALLENGES

Maintaining Profitability in an Increasingly Competitive Environment

With the most subscribers (72.2 million) of any subscription based entertainment company in the U.S., Netflix has been able to maintain their dominant position in the U.S. market (Corty, 2013). However, with recent advancements from competitors, the environment is becoming increasingly competitive as smaller players capture more and more of their market share (MacDonald, 2012). Furthermore, with the increasing popularity and ease of peer-to-peer file sharing and online streaming sites, Netflix faces further profit losses as a portion of their market opts for a cost-free alternative.

Strengthening Relations with Content Providers

Licensing fees represent a majority of the company's operating costs but are a necessity since large TV and movie libraries attract users. Strengthening relationships with film and production studios can facilitate the process of acquiring licenses and will help enable them to negotiate better prices.

Meeting Diverse and Changing Customer Demands and Preferences

The problem facing Netflix is whether they should continue to operate their DVD mailing business component with its extremely high operational costs, or risk alienating a large portion of its customer base by discontinuing it. Netflix made a move to completely separate the two entities which resulted in a large amount of cancellations and unhappy customers. These customers were dissatisfied with the online streaming service as it does not have a comparable list of titles compared to the DVD rental entity.

Sustainability of Current Market/Leadership Position

A substantial long-term risk is Netflix's subscriber saturation in the U.S. In the past few years, Netflix's subscription base has grown rapidly from 4.2 million in 2005 to 33 million in 2013 (Cortes, 2013). Their ability to continue to attract subscribers will depend on their ability to consistently provide subscribers with a valuable experience of selecting and viewing an increasing selection of favourable TV shows and movies. Analysts are arguing that there are only so many households that value Netflix's service and that are willing to pay the price. Netflix will need to find a way to attract more subscribers in order to overcome their market saturation in the U.S (The Value of Tech, 2011).

REFERENCES

Company Profile Netflix, Inc. (2013, January 4). *MarketLine*. http://web.ebscohost.com.proxy.lib.sfu.ca/bsi/pdfviewer/pdfviewer?sid=c98dfdd5-b589-420d-8ccd-3cfb7e574a77%40sessionmgr4&vid=4&hid=23

Company Timeline. (n.d.). Netflix. Retrieved march 17, 2013, from https://signup.netflix.com/MediaCenter/Timeline

Corty, M. (2013). *Netflix Earnings Stronger than Expected; Long-Term Thesis Intact and Shares Remain Overvalued.* New York: Morningstar.

Daris, M. (2012). Big Problems For This Dwindling Company - Seeking Alpha.*Seeking Alpha - Stock Market News & Financial Analysis* . Retrieved March 18, 2013, from http://seekingalpha.com/article/991171-big-problems-for-this-dwindling-company

MacDonald, S. (2012, August 12). *Netflix Needs to Prepare for War.* Retrieved March 15, 2013, from Seeking Alpha: http://seekingalpha.com/article/838561-netflix-needs-to-prepare-for-war

Maurer, B. (2012, December 4). *Netflix Competitive Battle Heats Up.* Retrieved March 15, 2013, from Seeking Alpha: http://seekingalpha.com/article/1043081-netflix-competitive-battle-heats-up

Netflix: A few Key Strategic Issues. (2011, August 11). *The Value of Tech*. Retrieved March 14, 2013, from valueoftech.blogspot.ca/2011/10/netflix-few-key-strategic-issues.html'

Netflix, Inc. (2011). *Annual report.* Retrieved from http://ir.netflix.com/annuals.cfm

Netflix: Quarterly Earnings. (2012). *Netflix: Overview*. Retrieved March 18, 2013, from http://ir.netflix.com/results.cfm

Netflix May Be A Great Short Because Of Market Saturation - Forbes. (2011).*Information for the World's Business Leaders - Forbes.com*. Retrieved March 18, 2013, from http://www.forbes.com/sites/greatspeculations/2011/01/05/netflix-may-be-a-great-short-because-of-market-saturation/

Netflix plans debt sales to cover licensing costs, original content. (2013, January 29). *Chicago Tribune*. Retrieved from http://articles.chicagotribune.com/2013-01-29/business/chi-netflix-plans-debt-sale-to-cover-licensing-costs-original-content-20130129_1_financial-officer-david-wells-netflix-content

New Netflix Facebook app lets users share viewing history. (2013). *CNNMoney - Business, financial and personal finance news*. Retrieved March 18, 2013, from http://money.cnn.com/2013/03/13/technology/social/netflix-facebook/index.html

Overview. (n.d.). *Netflix* . Retrieved March 12, 2013, from ir.netflix.com/

Reuters. (2012, December 12). Redbox Instant streaming rentals coming this month. *The Chicago Tribune* .

Sandvine. (2012). *Global Internet Phenomena Report: 2H 2012*. Retrieved March 17, 2013, from Sandvine: http://www.sandvine.com/news/global_broadband_trends.asp

U.S. Bureau of Economic Analysis. (2013). *National economic accounts: Gross domestic product.* Retrieved from http://www.bea.gov/

Tsui, C. (2012, November 19) Huayi Brothers, Atom Cinema Honto Productions Form Strategic Alliance Across Taiwan Straits. *The Hollywood Reporter*. Retrieved from http://www.hollywoodreporter.com/news/huayi-brothers-atom-cinema-honto-393240

Zambelli, A. (2013, March 1). A history of media streaming and the future of connected TV. *The Guardian*. Retrieved from http://www.guardian.co.uk/media-network/media-network-blog/2013/mar/01/history-streaming-future-connected-tv