

THE COMPETITIVE ADVANTAGE OF NETFLIX

Most companies over-diversify and very few companies are too focused. Look at Starbucks: They're basically doing the same thing as when they were founded in 1985, but they're doing it on a much grander and more important scale. Businesses that are simple that way, that have a straightforward model and relentlessly focus on the execution, can be very large and very successful because they don't have to invent whole new products and go through the technology transitions. It's one model—improve it, improve it, improve it, get it bigger, improve it, get it bigger, improve it, over and over and over again. That's very exciting because you can make a very big cultural consumer impact.

—Reed Hastings, Founder & CEO of Netflix (2005)¹

INTRODUCTION

In 1997, Reed Hastings searched his house for a misplaced copy of *Apollo 13*, but it wasn't just any copy of the movie—it was a videocassette that he had borrowed from Blockbuster more than six weeks earlier. As the founder of a software company that had sold several months previously for \$750 million, Hastings could have paid the \$40 in fees and thought nothing about it. Instead, he found himself coming up with excuses to tell his wife, realizing, in his own words: “I’m going to compromise the integrity of my marriage over a late fee?”

Later, as Hastings was driving to the gym, the unnecessary dramatics of the situation dawned on him, and he had a solution: “[the gym] had a much better business model. You could pay \$30

¹ Jena McGregor, “2005 Customer First Awards: Private Screening,” *Fast Company Magazine*, December 20, 2007, <https://www.fastcompany.com/customer/2005/customers-netflix.html> (December 16, 2016).

Christy Johnson and Professor Yossi Feinberg prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

or \$40 a month and work out as little or as much as you wanted.”² Years later, cofounder Marc Randolph would claim this was more of a Hastings myth meant to elucidate the value proposition of the company than a true biographical account.

Within ten years of Hastings’ initial concept, Netflix made up more than 29 percent of all traffic on the Internet.³ Netflix emerged as one of the most innovative companies in Silicon Valley, and many academic and business professionals would attempt to understand just what it was that made Netflix so successful in a rapidly evolving world.

From 1997 to 2016, Netflix survived the rise and fall of DVDs, the birth of video streaming, the rise and globalization of streaming, and the escalation of competition between content providers and content creators (see **Exhibit 1**). To understand what made Netflix so consistently successful, it is first crucial to understand the many business models it cycled through in its first 17 years, as well as the company’s evolving competitive advantages.

This case provides an overview of the Netflix culture that played a consistently important role in the company’s success, and then gives a historical look at four distinct eras in Netflix history: (I) pre-IPO, (II) the DVD business, (III) the introduction of streaming, and (IV) content creation.

FREEDOM AND RESPONSIBILITY: THE CULTURE OF NETFLIX

Hastings’ first success was with Pure Software, a company that Netscape cofounder Marc Andreessen would credit with enabling early Netscape engineers to debug their programs.⁴ The year he founded Netflix, Hastings oversaw the sale of Pure Software for \$750 million. When it was sold, there were more than 600 employees and by all traditional means it was an extremely successful venture. But Hastings had not found it easy to be at the helm, noting that “Management was my biggest challenge; every year there were twice as many people and it was trial by fire. I was underprepared for the complexities and personalities.”⁵ And so, from its founding in 1997, the business culture at Netflix was both intentional and important to the company’s ability to innovate.

In 2009, Hastings and Chief Talent Officer Patty McCord—who had been at Pure Software, and then with Netflix since 1997—released a document that Facebook COO Sheryl Sandberg would

² Amy Zipkin, “Out of Africa, Onto the Web,” December 17, 2006, <http://www.nytimes.com/2006/12/17/jobs/17boss.html> (December 26, 2016).

³ See background information at Funding Universe, <http://www.fundinguniverse.com/company-histories/netflix-inc-history/> (December 26, 2016).

⁴ Ken Auletta, “Outside of the Box: Netflix and the Future of Television,” *The New Yorker*, February 3, 2014, <http://www.newyorker.com/magazine/2014/02/03/outside-the-box-2> (December 16, 2016).

⁵ Michael Copeland, “Reed Hastings: Leader of the Pack,” *Fortune Magazine*, November 18, 2010, <http://fortune.com/2010/11/18/reed-hastings-leader-of-the-pack> (November 28, 2016).

later call the “most important document to come out of Silicon Valley.”⁶ The document was an unadorned 124-slide PowerPoint presentation, outlining the culture that Hastings and McCord had built and would continue to build.

Hiring and Firing at Netflix

Above all else, the standards at Netflix were high—and the company gave its employees both freedom and responsibility. Netflix policy was to only hire the best among high performers, and to tell them the blunt truth in one-on-one meetings and reviews so that they could continue to improve and be even higher performers.

To attract this kind of talent Netflix made a rule of paying absolutely top-of-market salaries for employees’ skills. In addition, the company was well known in Silicon Valley for reaching out to employees at other companies that they felt were truly high-performing individuals, actively and constantly recruiting new talent to make Netflix the best it could possibly be.

In the event that an employee did not consistently meet or exceed performance expectations, McCord and Hastings had a clear policy: there would be no probation period, nor time or money invested in further efforts to boost the employee’s performance. Instead, the employee would be given a very significant severance package and would leave—turnover at Netflix meant that things were going right, not wrong. And when the company or team was changing direction, a high-performance employee with skills that no longer matched the work being done would be let go, instead of “repositioned” within the company.

The “Freedom and Responsibility” theme of Netflix culture as it appears in the PowerPoint document outlined the expectation that employees would behave responsibly and make sensible choices aligned with the company’s goals. The clear objective was minimizing the need for policies. The argument justifying this approach was that policies were costly in time and resources and prevented a case-by-case approach when needed. In practice, this meant that internal human resources policies were almost non-existent. The most famous of these examples was the vacation policy: Netflix was the first company to start the trend of “unlimited vacation.” There were no formal expense or travel policies, either.

In the words of McCord, “Adult like behavior means talking openly about issues with your boss, your colleagues, and your subordinates. It meant recognizing that even in companies with reams of HR policies, those policies were frequently skirted as managers and their reports worked out what made sense on a case-by-case basis.” Netflix found that time and money spent on creating and enforcing traditional policies could be avoided if you hired the type of people—“adults,” as Netflix called it—that wouldn’t act selfishly or outside of the best interests of the company.

⁶ “The Woman Behind the Netflix Culture Deck,” FirstRound Review, <http://firstround.com/review/The-woman-behind-the-Netflix-Culture-doc/> (December 1, 2016).

I. NETFLIX PRE-IPO (1997-2001)

Within six months of the epiphany about his video late fees, Reed Hastings founded NetFlix.com, Inc. (the company's pre-IPO name) with a \$2.5 million investment he made out of pocket from the proceeds of the Pure Software sale. Additionally, Hastings recruited Marc Randolph from another computer mail order company as cofounder. By April 1998, Netflix had opened for business with 30 employees and approximately 925 DVD titles to rent out.⁷

DVD Rentals by Mail

Despite Hastings' experience in Netflix's origin story, Netflix initially launched very much along the norms for competitors at the time: on a per-rental basis that included late fees. But the executive team reacted quickly as they failed to gain traction—pulling in less than \$500,000 a month in revenue—and changed to a subscription model. “What gave us the courage to switch,” Hastings said at the time, “was the necessity to switch.”⁸

DVD Subscription Model

The DVD subscription model allowed customers to sign up for a plan that offered an unlimited number of DVD rentals per month with no late fees. A customer would request a DVD and get it by mail. Customers could then keep their DVDs as long as they desired, with the caveat that the next title in the queue would not be mailed until they returned the currently rented one. Netflix priced the plans based on the number of DVDs a customer wanted to rent out at once, with the most popular plan, priced at \$19.95 a month, allowing customers to rent three DVDs at once.⁹ This variable plan offering was the key to traction: by the time Netflix was filing for an IPO in 2001, its monthly revenue had risen to approximately \$6.25 million.

At the time of Netflix's initial launch, DVD players had existed for less than a year and fewer than seven percent of U.S. households had purchased the devices.¹⁰ In addition, fewer than 1,000 total movies were available on DVD.¹¹ This new market did not deter Netflix, which instead seized the opportunity to capture early adopters to the new DVD market, who were frustrated by the inconsistent stock of DVDs at brick-and-mortar video rental stores.

For the online video rental model to be profitable, DVDs were a necessity. Not only were VHS tapes fragile, they were also bulky and therefore expensive to ship. In its first year, Netflix ran mailing tests on more than 200 types of DVD envelopes before settling on the one that offered the best protection—and, just as importantly, could be used by customers to return the same

⁷ “History of Netflix” International Directory of Company Histories, Vol. 58, St. James Press 2004, <http://www.fundinguniverse.com/company-histories/netflix-inc-history/> (November 22, 2016).

⁸ Megan Lindow, “Fee changes helped propel DVD rental company to fast growth,” *Silicon Valley/San Jose Business Journal*, November 23, 2001.

⁹ Ibid.

¹⁰ “DVD Players Overtake VCRs,” CNN Money, December 26, 2006, http://money.cnn.com/2006/12/26/technology/dvd_vcr/ (November 26, 2016).

¹¹ “History of Netflix” International Directory of Company Histories, Vol. 58, St. James Press 2004, <http://www.fundinguniverse.com/company-histories/netflix-inc-history/> (November 22, 2016).

DVD. By 2000, the benefits of Netflix's early adoption of DVD technology would be fully realized: with 8.5 million units sold, DVD players had become the fastest-growing electronic item in history.¹² Still, the \$0.34 postage Netflix paid each way for every DVD rented was one of the largest burdens in the company's costs, especially being a constant variable cost.

Cinematch in the Early Days of Recommendation Algorithms

Enabling the success of the unlimited subscription model were two key features: the Cinematch algorithm that suggested and selected items for a customer's queue; and the inventory management system that integrated with this algorithm.

In 1998, Reed Hastings hired Neil Hunt as chief product officer. Hunt was a software developer and a former researcher in computer vision and image processing from the University of Aberdeen's Schlumberger Palo Alto Research Labs. Unlike the approaches of other competitors at the time, Hunt was completely focused on technologies that would give Netflix the greatest edge—and almost immediately began developing a movie recommendation algorithm for Netflix.¹³ Subscribers could log on and rate movies, and Cinematch would use this data to deliver a list of suggested films as well as a predictive rating for every title in the store.

Despite their modern ubiquity in e-commerce, at the time this type of predictive rating system was something quite innovative. In June 2001, Netflix received a patent for a cutting-edge "computer-implemented method for estimating how a user would rate a movie that the user has not yet rated," utilizing that customer's previous ratings in conjunction with the actual ratings of similar Netflix users who had already rated that movie.¹⁴ But this was the focus of the invention's patent, not the scope: the approach presented in this patent revolutionized recommendations for any type of item, not just movies.¹⁵ At the time, "Suggested for You" was not yet a staple of e-commerce—it was a concept being pioneering, in part, by Netflix.

On a base level, the Cinematch algorithm was a recommendation engine built to ensure customers would rent movies that they enjoyed, as opposed to movies that were simply similar to one they had rented in the past.¹⁶ But the Cinematch algorithm's value to Netflix went far beyond recommendations. By the end of 2001, Netflix had more than 10,000 titles spanning from new release action films to art house films never screened outside of the Sundance Film

¹² Lindow, op. cit.

¹³ "Management Team," Netflix Media Center, <https://media.netflix.com/en/management-team> (November 28, 2016).

¹⁴ "Approach For Estimating User Ratings of Items," Google Patents, November 10, 2009, <https://www.google.com/patents/US7617127> (December 2, 2016).

¹⁵ "Approach for Managing Rental Items Across a Plurality of Distribution Locations," World Intellectual Property Organization, July 14, 2007, <https://patentscope.wipo.int/search/en/detail.jsf?docId=WO2005062887> (December 2, 2016).

¹⁶ "Personalized Movie Recommendor Provides Netflix Visiting With Highly Accurate Recommendations," Netflix Media Center, January 25, 2000, <https://media.netflix.com/en/press-releases/personalized-movie-recommendor-provides-netflix-visitors-with-highly-accurate-film-recommendations-based-on-their-individual-movie-taste-history-migration-1> (November 27, 2016).

Festival. When users were logging onto the site to add movies to their queue that they had heard about outside of Netflix, it tended to be the same new releases that many other users were selecting. By recommending older or lesser-known titles, Netflix could invest less in large quantities of new DVD releases and drive customer tastes towards less-popular titles. Customers were also more willing to “take a chance” and rent a movie that they were unfamiliar with because they were not paying for the individual rental.

If a title was at the top of a customer’s queue and there was not currently a copy available, that movie would be skipped until the title was available—and the next item in the user’s queue would be mailed in the meantime. This was efficient for Netflix, but prompted complaints from many early users who found themselves consistently failing to receive the movies they most wanted to rent. Because the Cinematch algorithm integrated with the company’s inventory management system, it could recommend titles that were or would soon be readily available. As the idea of personalized recommendations caught on, customers with “mainstream” taste in movies were more often requesting titles that they never would have found on the front wall of Blockbuster, and the system of local distribution centers had expanded to offer two- to four-day delivery in much of the country.

Despite this success and the increasing scalability of Netflix’s business model, Blockbuster—with a massively recognizable brand name and more than 5,000 stores in the country stocking popular VHS and DVD titles—was still by far the dominant player in the space.¹⁷ However, in the words of Mike Schuh, who in 1999 invested \$6 million in Netflix with Foundation Capital:

What no one realizes, except maybe Blockbuster, is that Netflix is a complicated software company masquerading as a DVD-rental service. Its film-recommendation software, its merchandising, and the inventory-control systems are sophisticated. It isn’t that they couldn’t be replicated, but they’re hard to do, and it’ll take a lot of money, time, and commitment to get it right as Netflix has.¹⁸

Partnerships: Content Providers & Electronics Manufacturers

By early 2000, Netflix had hired Leslie Kilgore as the chief marketing officer. She had previously held similar positions at influential companies such as Amazon and Pantene.¹⁹ When Kilgore arrived she saw a particular strength that Netflix was not yet exploiting. Company devotees were near evangelical about the service, and subscription data showed that customer turnover was unusually low. By the end of 2001, Kilgore had instituted a free trial which saw almost 90 percent conversion into paying customers. From there on, the company’s marketing

¹⁷ “Blockbuster Inc. IPO,” NASDAQ, August 11, 1999, <http://www.nasdaq.com/markets/ipos/company/blockbuster-inc-10470-5223> (December 5, 2016).

¹⁸ Adam Cohen, “The Great Race: No Startup Has Cashed In More Than Netflix,” CNN Money, December 1, 2002, http://money.cnn.com/magazines/fsb/fsb_archive/2002/12/01/333870/ (December 3, 2016).

¹⁹ Julia Hood, “Corporate Case Study: From Inception to IPO, PR Has Always Delivered for Netflix,” August 12, 2002, <http://www.prweek.com/article/1233867/corporate-case-study-inception-ipo-pr-always-delivered-netflix> (December 2, 2016).

strategy would focus on getting potential customers to use the Netflix product, rather than investing in brand recognition and publicity.

DVD Player Manufacturers

Even as DVD players took hold in American households, the supply of DVD rentals was slow to follow. By the end of 2001 only about 20 percent of video rental store inventory was in DVD format, so brick-and-mortar rental stores were a barrier to adoption for electronics manufacturers looking to profit from the sale of DVD players. Seeing an opportunity, Netflix arranged partnerships with most of the leading electronics manufacturers at the time, including Sony, Panasonic, Toshiba, RCA/Thomson, and Philips.²⁰ DVD players purchased from these vendors came with a flyer explaining Netflix, and a trial offer for one to three months of service.

For a brief period, Netflix supplemented its DVD rental income with a small business unit selling DVDs. As a testament to how seriously Netflix prioritized new customer acquisition, the company agreed to temporarily cease this business in September 2001 in exchange for a partnership with BestBuy wherein BestBuy advertised Netflix's DVD rental business both online and in stores.

Revenue Sharing with Content Providers

In December 2000, Wall Street was scrutinizing the balance sheets of Internet businesses such as Netflix, amid growing concern about a "dot-com bubble."²¹ Netflix forged ahead and signed a deal with Warner Home Video and Columbia Tri-Star that would boost the profitability of its business model. In exchange for a set portion of Netflix's revenues over a certain period of time, these studios would allow Netflix to purchase DVDs of new releases for a discounted price. Soon thereafter, other studios such as DreamWorks and Artisan followed suit and signed similar agreements with Netflix.

The Blockbuster Offer

Despite the rising popularity of both DVDs and Internet-based commerce, Blockbuster remained the unquestioned leader in the video rental space. Though Netflix was definitely no longer an unknown e-commerce player in 2001, Hastings understood where Netflix stood compared to brick-and-mortar stores and any online plays they would begin to make. "As significant as we are," he said in an interview, "we're still tiny compared to our competition. They're about 5,000 percent larger than us."²²

²⁰ "Personalized Movie Recommender Provides Netflix Visitors With Highly Accurate Recommendations," Netflix Media Center, January 25, 2000, <https://media.netflix.com/en/press-releases/personalized-movie-recommender-provides-netflix-visitors-with-highly-accurate-film-recommendations-based-on-their-individual-movie-taste-history-migration-1> (November 27, 2016).

²¹ "Steve Case: The Complete History of the Internet's Boom, Bust, Boom Cycle," *Business Insider*, January 14, 2011, <http://www.businessinsider.com/what-factors-led-to-the-bursting-of-the-internet-bubble-of-the-late-90s-2011-1> (December 26, 2016).

²² Sarah Mason, "Movies on demand: efficiency combines with new technology in Netflix's DVD rental service," IIE Solutions, No. 34, October 2002, <https://www.highbeam.com/doc/1G1-93208214.html> (December 6, 2016).

As market sentiment towards e-commerce began plunging during the dot-com bust in 2000, Reed Hastings, Marc Randolph, and CFO Barry McCarthy got on a plane and flew to Texas to make Blockbuster a bold offer. An IPO was looking unlikely at the time and Hastings knew exactly what Netflix needed to survive: exposure. In exchange for advertisements online and in Blockbuster's brick-and-mortar stores, Blockbuster would acquire a 49 percent stake in Netflix and Netflix would become its online business. In the words of both McCarthy and Hastings, Blockbuster "laughed them and the deal out of the room."²³ According to Blockbuster's internal projections, the online video rental business would only grow to about five percent of the total video rental market—a niche market.

II. THE GROWTH PERIOD OF THE DVD RENTAL BUSINESS (2002-2006)

In the wake of the dot-com bust and subsequent uncertainty, Netflix's growth had been a decent performance for a company that had launched only four years earlier. After having cut a third of its staff in the wake of the market's collapse and successfully going public only on their second try, Netflix could have easily found itself struggling to match its past growth.

In May 2002 after a series of reported false starts, Netflix announced an initial public offering of 5.5 million shares priced at \$15.00 a share. Investors were still wary of the technology markets after the dot-com bubble, but ultimately the strengths of the still-small Netflix won out and the company grossed \$82.5 million.²⁴ By the end of 2002, Netflix's first year as a public company, it had \$150.8 million in revenue and 381 employees—and more than 857,000 unique subscribers (see Exhibit 2).²⁵

Throughout this era, much of the executive leadership remained the same and the company improved far more features than it added. In 2006, four years after its IPO, Netflix had become a household name, hitting \$996 million in revenue, with more than 5.7 million subscribers and 985 employees. The company would go from a net loss of \$38 million in 2002 to \$369 million in net income in 2006 (see Exhibit 3).

Logistics and Process Optimization

Unlike the leadership at Blockbuster and other video rental businesses, the executive team at Netflix did not come from the world of content creation or retail. Both Hastings and Randolph came from the world of technology ventures and this was crucial to the way Netflix approached its logistics and profitability challenges.

²³ Greg Sandoval, "Blockbuster Laughed At Netflix Partnership Offer," C-Net, December 9, 2010, <https://www.cnet.com/news/blockbuster-laughed-at-netflix-partnership-offer/> (December 3, 2016).

²⁴ "Offering of Netflix Brings in \$82.5M," *The New York Times*, May 23, 2002, <http://www.nytimes.com/2002/05/23/business/offering-of-netflix-brings-in-82.5-million.html> (December 14, 2016).

²⁵ Netflix Inc., "Annual 10-K Report" 2002. All revenue, employee, and subscriber numbers in this case are directly sourced from each year's respective 10-K filing.

Compared to the other three eras covered in this case, the 2002 to 2006 years were not typified by new ideas or significant pivots in strategy. Instead Netflix vastly improved its ability to run its core business profitably: renting DVDs online. In Hastings' own words, "Our first phase of business was to prove that customers wanted the service, because it's a new business. Our second phase is making it efficient and profitable with some good industrial engineering work to apply various automation strategies thoughtfully."²⁶ Internally, the four years after Netflix went public was that second phase.

DVD Distribution Centers

When Netflix went public in May 2002, the company was distributing DVDs to customers from three distribution centers. The primary distribution center was in Los Gatos, California, but as of January 2003 the company had opened two regional distribution centers in Boston and Los Angeles. Netflix also began collecting data on any changes in customer satisfaction or referrals.

One of the most common complaints reported by Netflix customers was not about the Netflix service at all; it was about the US Postal Service (USPS). When a customer finished a DVD and put it in the mailbox to return, the next step was waiting for the DVD to arrive back at the distribution center to be "checked in." Then came another wait while USPS delivered the next DVD in the customer's queue. While most subscribers staggered their rental returns to avoid a long wait for the next DVD, Netflix had little control over shipping times, which ranged from two to nine days.

Netflix moved quickly after receiving this data and by June 2002 announced the opening of eight additional distribution centers in cities across the country, including Detroit, Denver, Houston, New York, and Washington, D.C. "We have found that our customers on the West Coast are more likely to promote the service to their friends and family because of the faster service," said Hastings in an interview that month. "Now that the majority of our customers are getting their DVDs more quickly, we believe the faster service will have a positive impact on our continued success."²⁷

Patented Improvements

But it wasn't the sheer scale of the Netflix infrastructure that allowed the company to grow to \$996 million in revenue from 2002 to 2006. Every element of what happened behind the scenes was being improved, optimized, and often patented. In September 2002, Netflix filed a patent for its envelope—the one it used to send and receive DVDs, without adhesive or risk of being held up by USPS due to address panel obfuscation.

In May 2003, Netflix filed a patent for an approach for renting items to customers that let "customers specify what items to rent using item selection criteria separate from deciding when

²⁶ Sarah Mason, op. cit.

²⁷ "Netflix Announces Opening of 10 Regional Distribution Centers," Netflix Investor Relations, June 20, 2002, <https://ir.netflix.com/releasedetail.cfm?ReleaseID=83066> (December 1, 2016).

to receive the specified items.”²⁸ By December 2004, Netflix had filed a patent for “managing rental locations across a plurality of distribution locations,”²⁹ a system that would allow it to take an inventory-free approach to predicting and shipping DVDs to the locations where they believed there would be the most customer demand or, alternately, the least rentals and largest additional storage space.³⁰ These improvements had no small effect—by 2005, Netflix was collectively shipping more than 1 million DVDs by mail per day and had over 35,000 titles available to users.

Growth and Customer Acquisition

Given the nature of Netflix’s subscription model, the company could not just improve its product for existing customers and expect that its revenue would increase—it needed to increase the number of Netflix subscribers. A key component of this growth period was getting potential customers to first understand the rental video subscription “product” and then to try it. From 2002 to 2006, due to the increased marketing efforts coupled with the expansion of e-commerce in general, the number of Netflix subscribers would increase by more than 650 percent.

Customer Segmentation

As Netflix grew in popularity, it began to grow outside of its original core customer demographics—cinophiles and early adopters for whom watching movies was a top priority. These core customers focused heavily on renting movies frequently, and because they were so quick to watch and return films over a one-month period they were also Netflix’s least-profitable customers. Data showed that as Netflix penetrated suburban and rural areas where busy parents and young adults optimistically and consistently overestimated how many movies they would watch a month, profitability increased.

At the time, most of Netflix’s executives had been with the company since its founding. But Netflix also hired a VP of communications from outside—someone who had been head of communications for several successful start-ups after a 15-year stint as VP of communications at Pepsi. So, when Netflix hired Ken Ross as VP of communications, his immediate focus would be on expanding to new and increasingly important customer segments. As one newspaper byline read, “How do you convince NASCAR dads in North Dakota that you don’t have to leave your house to rent a movie?”³¹

²⁸“Approach for Renting Items To Customers,” April 4, 2006, USPTO Patent Full-Text and Image Database, <http://patft.uspto.gov/netacgi/nph-Parser?Sect2=PTO1&Sect2=HITOFF&p=1&u=/netahtml/PTO/search-bool.html&r=1&f=G&l=50&d=PALL&RefSrch=yes&Query=PN/7024381> (December 2, 2016).

²⁹ “Rental Inventory Management,” Justia, July 6, 2007, <http://patents.justia.com/patent/8972290> (November 28, 2016).

³⁰ “Approach For Managing Rental Items Across A Plurality of Distribution Locations,” World Intellectual Property Organization, July 14, 2005, <https://patentscope.wipo.int/search/en/detail.jsf?docId=WO2005062887> (December 3, 2016).

³¹ Michele Marchetti, “Netflix’s Ken Ross Woos Nascar Dads with Concerts and Screenings,” Bizbash, December 17, 2007, http://www.bizbash.com/netflixs_ken_ross_woos_nascar_dads_with_concerts_and_screenings/new-york/story/9033#.WEiCsneZNTY (December 3, 2016).

Influencing Customer Behavior

To Ross, the answer was connecting potential users to an experience in the “real world.” In 2006, the company launched a high-profile “Netflix Rolling Roadshow” that consisted of a series of outdoor screenings of movies in the location where they were set. The company chose famous films for their suburban or rural backgrounds and bumped up the publicity wherever the tour went. When Netflix screened *Field of Dreams* in Iowa, for instance, more than 6,000 fans attended and the Iowa Highway Patrol had to shut down the roads.

The company purposefully pushed forward in growing the DVD customer base. In 2006, Ross proclaimed:

All great consumer brands would tell you that awareness and buzz is a critical objective, but in our case it's a bit different. We're leading a major behavioral change.... People who know Netflix think everyone in the world knows who we are. That is not the case. We still face an awareness gap versus our principal competitor, Blockbuster, which has pretty much ubiquitous awareness. So we have to be a little bit more creative and have to be a little more ingenious, a little more aggressive.³²

III. THE INTRODUCTION OF STREAMING (2007-2011)

By the beginning of 2007, Netflix had reached \$1.2 billion in revenue. The company had 7.5 million subscribers—more than eight times the total five years earlier—and 1,542 employees across the United States. But in May 2008, in the midst of the company's rapid growth and success, CEO Reed Hastings publicly made a prediction: within five years the business that made up 100 percent of Netflix's revenue would peak and begin to decline—for good. DVD rentals, the founder and CEO of a \$1.2 billion DVD rental business declared, would soon become obsolete.³³

When 2011 came to a close, Netflix revenues would more than double to hit \$3.2 billion—\$1.165 billion in net profit—and the company had 24.4 million subscribers and 2,348 employees (see Exhibit 4). But the company did not thrive because Reed Hastings' prediction was wrong; it thrived because his prediction was right—and because he had been preparing the company based on this assumption for years. From 2007 to 2011, Netflix would introduce and then pivot to focusing on its video-on-demand streaming product, permanently altering the expectations of viewers everywhere.

From Limited Streaming to Streaming Only

Hastings first publicly mentioned investing in video-on-demand streaming in 2005, likely long after Netflix developers had started on the project. In his words:

³² Ibid.

³³ Greg Sandoval, “Netflix Chief: DVD Business to Peak in Five Years,” C-Net, May 28, 2008, <https://www.cnet.com/uk/news/netflix-chief-dvd-business-to-peak-in-5-years/> (November 25, 2016).

...movies over the Internet are coming, and at some point it will become big business. We started investing 1 percent to 2 percent of revenue every year in downloading, and I think it's tremendously exciting because it will fundamentally lower our mailing costs. We want to be ready when video-on-demand happens. That's why the company is called Netflix, not DVD-by-Mail.³⁴

Adoption of Streaming

On the heels of Netflix's announcement that it would be rolling out streaming for 1,000 titles, the *New York Times* published an article on this innovative new feature. The first line of the article immediately addressed the prolific reports of Netflix's impending demise: "'We've gotten used to it,' Netflix's chief executive, Reed Hastings, said of the doomsday predictions. But Mr. Hastings also said he understood why questions about his business kept coming up. 'Because DVD is not a hundred-year format, people wonder what will Netflix's second act be.'"³⁵

In 2007, the year streaming was initially rolled out, Netflix invested \$40 million in what it termed "instant viewing."³⁶ When the product rolled out in the first six months of 2007, each Netflix subscriber could enjoy free limited streaming based on the price they paid monthly. Most customers, at \$18 for four rental DVDs a month, would get 18 hours a month of free streaming—while customers paying \$5.99 for just one DVD a month would be limited to six hours. Netflix customers could watch the first 15 minutes of a movie and then decide not to watch the rest, without wasting time and money on renting or buying a movie and waiting for it to download.

As was the case with most Netflix decisions, the company had done clear, extensive testing before launching the streaming product. Nine days after streaming was unveiled, Hastings casually mentioned that, "usage will skew by demographics and age. People under 20 will watch movies all the way through, older people will browse."³⁷ Viewership data was still primarily collected by the Nielsen Company and gathered by household—so no competitor or content provider had data like that. Even Amazon and iTunes, both of whom offered download-based video-on-demand products, only had the ability to track the title's purchase, not the user's interaction with it.

³⁴ Reed Hastings, "How I Did It," *Inc. Magazine*, December 1, 2005, <http://www.inc.com/magazine/20051201/qa-hastings.html> (November 28, 2016).

³⁵ Miguel Helft, "Netflix to Deliver Movies to the PC," *The New York Times*, January 16, 2007, <http://www.nytimes.com/2007/01/16/technology/16netflix.html> (December 1, 2016).

³⁶ Matthew Boyle, "Questions For... Reed Hastings," May 23, 2007, *Fortune Magazine*, http://archive.fortune.com/magazines/fortune/fortune_archive/2007/05/28/100034248/index.htm (November 25, 2016).

³⁷ Quentin Hardy, "Netflix To Stream Live Movies for Free," *Forbes*, January 16, 2007, http://www.forbes.com/2007/01/15/netflix-free-video-streaming-tech-media-cz_qh_0116netflix.html (December 2, 2016).

But even just one year into streaming video to customers' computers, Netflix was pushing forward towards getting its service on televisions without an intermediary provider. Soon after the announcement of the instant viewing feature, Netflix appointed Anthony Wood—the founder of ReplayTV, a venture that had been recently acquired by DirecTV—as VP of Internet television.

Unsatisfied with the experience of Netflix customers streaming titles to small personal computers or the set-top box partnership with LG, Wood developed and debuted the \$100 Netflix Player by Roku in May 2008. This device could not add or remove items from the user's queue but it did allow customers to instantly stream titles to their television, and altogether garnered favorable reviews.

Streaming Only Plans

As streaming began to catch on, Netflix announced in January 2008, less than a year after launch, that subscribers to any of its unlimited rental plans (with prices at the time starting at \$8.99 for one DVD at a time) would now have access unlimited streaming. "Unlimited has always been a very powerful selling point with our subscribers and a large part of what set us apart in the marketplace...during the past year, it became clear that, as with DVDs the idea of streaming unlimited movies and TV episodes on a PC resonated quite strongly," CMO Leslie Kilgore stated in the press release.³⁸

By November 2008, Netflix announced its first-ever streaming-only subscription for \$7.99 a month. In this press release, Hastings noted, "We are now primarily a streaming video company delivering a wide selection of TV shows and films over the Internet,"³⁹ though Netflix's fourth quarter 2008 filing showed only 28 percent of subscribers streamed more than 15 minutes' worth of content.⁴⁰

Technology and Media Companies as Competitors

As Netflix expanded into streaming, its primary competitors shifted significantly. The most obvious shift was away from competing with Blockbuster, Hollywood Video, and other DVD rental stores that were closing more and more often, but had no capabilities to stream video on demand. Now Netflix found itself with two very different types of competitors: cable providers and networks, and the technology companies slowly rolling out video on demand and streaming products.

³⁸ Netflix media announcement, January 14, 2008, <https://media.netflix.com/en/press-releases/netflix-now-offers-subscribers-unlimited-streaming-of-movies-and-tv-shows-on-their-pcs-for-same-monthly-fee-migration-1> (December 26, 2016).

³⁹ Aemon Malone, "Netflix offers subscription plan just for unlimited streaming," Digital Trends, November 22, 2010, <http://www.digitaltrends.com/computing/netflix-raises-offers-subscription-plan-just-for-unlimited-streaming/> (December 26, 2016).

⁴⁰ Robin Wauters, "Nearly Half of Netflix Subscribers Now Watch Streams Online," TechCrunch, January 27, 2010, <https://techcrunch.com/2010/01/27/netflix-q4-2009-earnings/> (December 26, 2016).

Streaming made Netflix a direct competitor of cable networks primarily because of television. Though the company did rent DVDs of full television seasons, these were only available a significantly after the season had aired. By streaming video, Netflix was no longer necessarily constrained by the DVD release date of a television series—which made Netflix a direct threat to the large majority of cable networks who relied on viewers’ addiction to television, not movies. In an article titled “Netflix’s Move Onto the Web Stirs Rivalries,” the *New York Times* publicly noted that for the first time in history U.S. cable subscriptions had fallen over the previous two quarters, prompting companies like Time Warner Cable to offer streaming products.⁴¹

When it came to direct rivals on streaming, Netflix’s primary competitors, increasingly, were large companies with technological backgrounds. In 2007, as Netflix launched limited streaming, options for videos on demand were fairly limited: Apple iTunes sold titles for download and Amazon sold and rented downloads as well.

But by the end of 2011, Amazon had launched free streaming for Amazon Prime members, iTunes had begun offering rental streaming service, HBO launched a video-on-demand product for existing subscribers, and three of the largest content providers in the world had partnered in a joint venture to create Hulu, a free, ad-supported video-on-demand service.

From Inventory Management to Content Acquisition

When Netflix’s business model meant the company’s success hinged on efficient inventory management for customer satisfaction, the company leveraged its technological background to test and improve these verticals. But as Netflix pivoted to focus on streaming, its years of data, algorithms, and optimized processes for DVD distribution centers became less valuable in determining overall customer satisfaction.

Licensing Streaming Content

With the unlimited streaming model, Netflix would no longer be the enemy of instant gratification, nor would postage be the company’s constant burden on their cost model at scale. But with the crumbling of those barriers came the rise of a more ironclad one—streaming content was more difficult to purchase than a stack of DVDs. For Netflix to provide its customers the content they were used to having, it needed to pay huge amounts of money to content providers and operate in an uncertain pricing environment. Though streaming rights in general had become valuable, studios were extremely hesitant to allow high-quality content to be posted online for fear of piracy or a better user experience than cable television could provide. A second major risk came from downstream. While the USPS had offered Netflix a discount on shipping due to the sheer volume of DVDs mailed, Internet service providers were eying the huge flow of video data and lucrative profit margins exploiting their “pipes.”

⁴¹ Tim Arango and David Carr, “Netflix’s Move Onto the Web Stirs Rivalries,” November 24, 2010, *The New York Times*, <http://www.nytimes.com/2010/11/25/business/25netflix.html> (January 5, 2017).

In 2010, Netflix spent more than \$600 million on postage and Chief of Content Ted Sarandos said that in the future he envisioned “moving that entire bucket of spending to Hollywood and out of the post office.”⁴² That same year, Netflix signed a deal to add to its streaming service 1,500 films from Paramount Pictures, Lions Gate Entertainment, and MGM—to the tune of just under \$1 billion over five years. Just two years earlier, a deal with Starz for access to several thousand Disney and SONY movies was only \$30 million.⁴³

By the end of 2010 Netflix made a series of deals that made its intentions to rapidly deprioritize the DVD market abundantly clear, even as the price of streaming rights escalated. For content belonging to Twentieth Century Fox, Universal, Warner Bros., and Sony, Netflix would not rent new DVDs by mail for 28 days after the date that the DVD was released. In exchange, Netflix received expanded streaming rights for titles in these studios’ libraries.⁴⁴ Though it had been less than four years since Netflix had first introduced online streaming, online distribution components were by 2010 ubiquitous in movie deals. Famed producer Harvey Weinstein declared, “It’s because of Netflix.”⁴⁵

Intellectual Property and a Dedication to Innovation

Of the three assets investor Mike Schuh cited as Netflix’s true differentiators in 1999,⁴⁶ only one remained relevant to Netflix’s streaming video subscription product—the film-recommendation software. The exemplary merchandising and inventory control systems that had grown Netflix to a billion-dollar business were simply no longer essential to the future of the company’s success.

Given that Netflix’s competitors were all relatively new and deep-pocketed entrants to the streaming video space, it was crucial that Netflix capitalize on its decade’s worth of data. In September 2009, Netflix applied for a patent for a “method of sharing an item rental account” wherein a secondary user could be attached to one account, with the option to require the primary user to grant the secondary user permission to stream or rent a title.⁴⁷ Not only would this pave the way for the 2011 launch of its “Just for Kids” section, it would keep recommendations and user profiles pristine with individual granularity within the family unit.

In January 2010, Netflix filed for a patent on “insertion points for streaming video autoplay,” a technique that would allow the company to automatically present users with an engaging

⁴² Sue Zeidler, “Update 2- Netflix Strikes New Deal For Warner Bros Titles,” Reuters, January 6, 2010, <http://www.reuters.com/article/warners-netflix-idCNN0620994420100106?rpc=44> (December 3, 2016).

⁴³ Michael Corkery, “Netflix’s Achilles Heel: Content Costs?” *The Wall Street Journal Deal Journal*, August 10, 2010 <http://blogs.wsj.com/deals/2010/08/10/netflixs-achilles-heel-content-costs/> (December 4, 2016).

⁴⁴ Dan Rayburn, “Netflix’s Inventory of Streaming Content Isn’t Growing Fast Enough,” *Business Insider*, October 7, 2010 <http://www.businessinsider.com/netflixs-inventory-of-streaming-content-isnt-growing-fast-enough-2010-10> (December 3, 2016).

⁴⁵ Michael Copeland, “Reed Hastings: Leader of the Pack” *Fortune Magazine*, November 18, 2010, <http://fortune.com/2010/11/18/reed-hastings-leader-of-the-pack> (November 28, 2016).

⁴⁶ Adam Cohen, “The Great Race: No Startup Has Cashed In More Than Netflix,” *CNN Money*, December 1, 2002, http://money.cnn.com/magazines/fsb/fsb_archive/2002/12/01/333870/ (December 3, 2016).

⁴⁷ “Insertion points for streaming video autoplay,” Google Patents, April 1, 2014, <https://www.google.com/patents/US8689269> (December 27, 2016).

preview clip of another title to increase engagement and viewership within the streaming media player. This would prove to be a crucial aspect of Netflix's high engagement hours, especially in serial television shows, where users had seconds to react to attention-grabbing endings before the next episode would begin playing.

Price Hike and Subscription

In July 2011, Netflix announced on the company blog that it planned to “offer new unlimited DVD plans and separate streaming and DVD Plans in the U.S.”; titling the post in a way that made it sound positive for current customers. But the lowest-ever DVD subscription prices boasted in the subtitle was immediately followed up with several sentences trumpeting the growth of the company and the loyalty of their customers. In the body of the text was a short explanation: unlimited streaming would no longer be offered in a bundle with DVD rentals—customers who wanted to continue to subscribe to both would be hit with a rate hike of more than 60 percent, with a total payment of \$15.98 a month, starting on September 1, 2011.

Embodying the entire tone of the announcement, the post quoted a Netflix executive saying, “Netflix members love watching instantly, but we’ve come to recognize there is still a very large continuing demand for DVDs by mail. By better reflecting the underlying costs and offering our lowest prices ever for unlimited DVD, we hope to provide a great value to our current and future DVD-by-mail members”—but with no acknowledgement of the actual price hike itself.⁴⁸ Enormous backlash ensued, and more than 12,000 angry customers left messages on the blog accusing Netflix of greed and poor content quality. Netflix stock dropped from nearly \$300/share the day before the announcement to a meager \$63.85 by November.⁴⁹

Customer Backlash

In the four months following the subscription splits and price hike, Netflix lost more than 800,000 subscribers and the stock price plummeted by approximately 77 percent.⁵⁰ Contributing to the lack of investor confidence was Reed Hastings' ill-advised plan to stop the company's hemorrhaging by spinning the DVD rental subscriptions off into a completely different business. Two months after the initial blog post, he released a YouTube video apologizing for the communication of the price hikes and announcing that the DVD business would be spun off entirely and re-named Qwikster. In the startlingly casual video, Hastings, sitting on a table in the Netflix courtyard, repeatedly assured customers that nothing about the DVD service would change except for, of course, its complete separation from Netflix branding, log-ins, and existing customer queues.

⁴⁸ “Netflix to Offer New Unlimited DVD Plans and Will Separate Streaming and DVD Plans in the U.S.” Netflix Media Center, July 12, 2011, <https://media.netflix.com/en/press-releases/netflix-to-offer-new-unlimited-dvd-plans-and-will-separate-streaming-and-dvd-plans-in-the-us-migration-2> (December 7, 2016).

⁴⁹ Jason Gilbert, “Netflix Price Hike’s One Year Anniversary,” *Huffington Post*, July 12, 2012, http://www.huffingtonpost.com/2012/07/12/netflix-price-hike-anniversary_n_1668382.html (December 2 2016).

⁵⁰ Greg Sandoval, “Netflix’s Lost Year: The inside story of the price-hike train wreck,” C-Net, July 11, 2012, <https://www.cnet.com/news/netflixs-lost-year-the-inside-story-of-the-price-hike-train-wreck/> (November 27, 2016).

Less than a month after the Qwikster spin-off video was released, Hastings wrote another blog post announcing that the plan to make the split was being abandoned. The DVD rental price hike would remain but Netflix called off all of the other changes enacted in the previous five months.

The Executive Exodus

With Netflix's decision to focus on streaming—even at the cost of its DVD rental businesses—Hastings clearly saw a chance to one-up potential disruptors to Netflix. But it was a core tenet of the company's culture to let go of even the most high-performing employees if their knowledge or specialty no longer matched the company's needs. Preceding the decisions first to raise the prices of the subscription service and then to split the DVD rental and streaming businesses, there was a significant shift in the executive team.

As Netflix prepared for the split, Barry McCarthy, the CFO of Netflix since 1999, departed the company to pursue other opportunities. In the words of a Netflix employee in 2011, "...there was turmoil in the company's executive offices. Several of Hastings' most trusted lieutenants were no longer as influential with the CEO. Others had left and their replacements did not yet have the clout to convince Hastings he was being too aggressive."⁵¹

IV. NETFLIX AND CONTENT (2012-2015)

Even after the chaos of 2011—which C-Net went so far as to call Netflix's "lost year"⁵²—the company was making \$3.6 billion in revenue with 33.7 million subscribers and 2,348 employees by the end of 2012. Despite investor uncertainty about the Netflix leadership's ability to balance the fading DVD business and the growing streaming business, this was not the pivot that most immediately threatened the company's survival.

From 2012 to 2015, as content costs rose to astronomical rates and content providers began to see Netflix as a direct competitor, it became more and more necessary for Netflix to expand its profit margins. Despite the enormous overhead and operational changes involved in creating content and expanding abroad, Netflix undertook this second business model pivot because the company had little choice and soon this strategy paid off. By the end of 2015, Netflix hit \$6.78 billion in revenue—\$2.19 billion in net profit—with 44.3 million streaming subscribers and 6.9 million DVD subscribers (see **Exhibit 5**). The company employed 3,700 employees globally.

Net Neutrality and Internet Service Providers

As competition with content providers hit an all-time high, by definition so did competition with Internet service providers—they were often the same companies or at least owned by the same parent company. With so many customers streaming a high volume of high-quality video, Netflix traffic made up very large portion of traffic for major Internet service providers.

⁵¹ Sandoval, "Netflix's Lost Year," op. cit.

⁵² Ibid.

By early 2014, Comcast had decreased the quality of Netflix videos from its usual high-definition quality to a quality comparable to a VHS, hoping they could charge Netflix significant access fees for its traffic.⁵³ Not only were Netflix customers frustrated and confused by the drop in quality, they were calling Netflix customer service en masse, convinced the poor quality was a Netflix service issue or choice. Eventually, Netflix caved to the pressure from Comcast, AT&T, Verizon, and Time Warner Cable and began to pay for direct connections to their networks.⁵⁴ However, in July 2016, U.S. federal courts upheld net neutrality rules—which meant that Internet service providers could no longer deliberately slow down web traffic, a huge win for Netflix.⁵⁵

Investing DVD Profits in a Content World

The critical misstep Hastings made in the pivot to streaming—and his almost single-minded decision to “cannibalize” his own business model before anybody else could—was pulling the rug out from under the old business while it was still profitable. In the past, this willingness to pivot business models had allowed Netflix to persist in its success. But the company’s last pivot had cost the company a nearly disastrous number of subscribers, especially those who perceived the pivot as an abandonment of its DVD subscribers. Starting in the fourth quarter of 2011, Netflix had begun reporting segmented profitability, revenue, and marketing expenses for the DVD rental business so they were separate from the international streaming and domestic streaming segments.

Minimizing Investments, Maximizing Profits

Profit margins for the shrinking DVD rental business were always much higher than from the international or domestic streaming segments. While investments in DVD rental optimization were minimal, the company continued to automate as much of the process as was possible for efficient profit maximization. DVD profit margins increased from 48 percent when Netflix started reporting them separately in 2013 to 50 percent in 2015. Because Netflix entirely ceased investing in marketing for the DVD business, the product would slowly die out when all possible profits or product loyalty had been extracted from the customer segments that preferred to view content on physical discs.

Unlike earlier periods in Netflix history, all of its major competitors from 2011 to 2015 were tied to either content creators or large hegemonic technology companies. Though it had declined significantly from \$1.13 billion in 2012, in 2015 Netflix’s “supplementary” DVD rental segment

⁵³ Zachary Seward, “The inside story of how Netflix came to pay Comcast for Internet traffic,” Quartz, August 27, 2014, <http://qz.com/256586/the-inside-story-of-how-netflix-came-to-pay-comcast-for-internet-traffic/> (December 23, 2016).

⁵⁴ Jon Brodtkin, “Netflix says 99 percent of its links with ISPs are unpaid,” ARS Technica, August 26, 2014, <http://arstechnica.com/information-technology/2014/08/netflix-sends-99-percent-of-its-traffic-over-free-connections-to-isps/> (December 27, 2016).

⁵⁵ Shelby Carpenter, “Court Upholds Net Neutrality – Major Win for Streaming Services,” *Forbes*, June 14, 2016, <http://www.forbes.com/sites/shelbycarpenter/2016/06/14/net-neutrality-fcc-court-video-streaming/#2b4bafb3375c> (December 27, 2016).

still put an additional \$645 million of revenue in the company's pockets. From 2012 to 2015 DVDs contributed a total of approximately \$3.46 billion in revenue—and nearly half of that was pure profit for the company to reinvest.

Streaming Companies as Content Creators

Whether it was a mix of arrogance or simply entrenched thinking, content producers like Hollywood studios and major networks believed that service providers seeking to create content to boost their profit margins could simply never be the same creative force. So content pricing continued to rise, lowering Netflix's profit margins until the company made the decision to test whether they could create successful content for themselves.

In mid-2011, analysts had projected that Netflix's spend on streaming content licensing would jump from 2010's \$180 million to \$1.98 billion in 2012.⁵⁶ That ended up a low-ball estimate; Netflix actually spent \$2.30 billion on licensed content in 2012. Because "pure" content producers believed that they had a monopoly on quality content creation, they also believed that streaming businesses had no choice but to continue to pay their escalating prices.

Producing House of Cards

In 2011, Netflix announced that they had agreed to finance two 13-episode seasons of the David Fincher-produced *House of Cards*—starring Kevin Spacey and Robin Wright—for just upwards of \$100 million. This number made Hollywood gasp and shake their heads, but it was less than five percent of what Netflix spent licensing other content producers' content for that year.

Though other major networks had been bidding for the series and there was a possibility that Netflix would make it ineligible for the major awards, David Fincher and production company MRC ultimately chose Netflix. Because Netflix had signed on to produce two seasons off the bat and planned to release each entire season at one time, David Fincher and his team had the flexibility to produce the show as if it was a long-format movie.

In a move generally reserved for acclaimed film directors but nearly unprecedented for television, Fincher and his crew retained control of the final cut of the show. As the MRC co-chair said of Fincher's artistic control, "It's the largest independent drama production made in the last decade. That combination of size and freedom let them take enormous risks in terms of structure."⁵⁷

Success Benchmarks of House of Cards

The entire first season of *House of Cards* was released in February 2013, to near-unanimous praise. It earned nine Emmy nominations, going on to win three—including "Outstanding

⁵⁶ Julianne Pepitone, "Netflix stock plunges as subscribers quit," CNN Money, September 15, 2011, <http://money.cnn.com/2011/09/15/technology/netflix/> (December 27, 2016).

⁵⁷ Dorothy Pomerantz, "The Producer Behind 'House of Cards' on How Netflix Offered Creative Freedom," *Forbes*, July 18, 2016, <http://www.forbes.com/sites/dorothypomerantz/2013/07/18/the-producer-behind-house-of-cards-on-how-netflix-offered-creative-freedom/print/> (November 27, 2016).

Casting For A Drama Series” and “Outstanding Directing For A Drama Series.” This was a crucial point of legitimacy for an unproven category of content creator, and even further supplemented internal data at Netflix that declared the content creation test a success.

When an interviewer asked Ted Sarandos whether he would spend so much money on *House of Cards* if he had the chance to go back and do it again, he responded, “Yes. If we were to get into original programming and it didn’t work out, I didn’t want it to be because we didn’t try hard enough or we weren’t ambitious enough.”⁵⁸

Continuing Content Creation

In the words of Netflix’s Chief of Content Ted Sarandos, “[Emmy attention] is a valuable symbol of the mainstreaming of Internet television. It puts it on the same playing field with the best of broadcast, cable, and premium television and resets the expectations of the industry and of the consumer.”⁵⁹ After their stunning initial success of *House of Cards*, Netflix would go on to create 36 original television shows by the end of 2015, including the *Orange is the New Black* and *Jessica Jones*. Nine shows of their 2015 lineup were returning from the previous year. In addition, Netflix produced 19 “Netflix Original” movies from 2011 to 2015, 17 of which were documentaries.

CONCLUSION

As 2017 opened, Netflix was in the middle of an extraordinary global expansion. The company had more than 86 million subscribers, nearly half of whom were outside the United States. There were Netflix subscribers in more than 190 countries. A market capitalization of more than \$50 billion and price to earnings ratio near 340 were strong indicators that investors put great trust in the ability of Netflix to grow, adapt, and succeed.⁶⁰

In less than two decades, Netflix leveraged its resources to build, optimize, and take over the market using four different business models. But Netflix was not a product known only in an insular context—the company had become a veritable touchstone of pop culture. It delicately shifted the entire focus of its business from mailing discs to streaming content online (see **Exhibit 1**). And the company had survived the dot-com bubble and a near-catastrophic loss of value—along with massive shifts in both Internet technology and the entertainment industry. In Silicon Valley, ten-person start-ups were building their vacation policies to resemble the Netflix deck released more than half a decade earlier. The executives that built Netflix were now sitting on the boards of Facebook, Microsoft Spotify, HubSpot, and Logitech.⁶¹ And yet, business students, together with companies and analysts across many industries, were still trying to pinpoint what, exactly, made Netflix so successful.

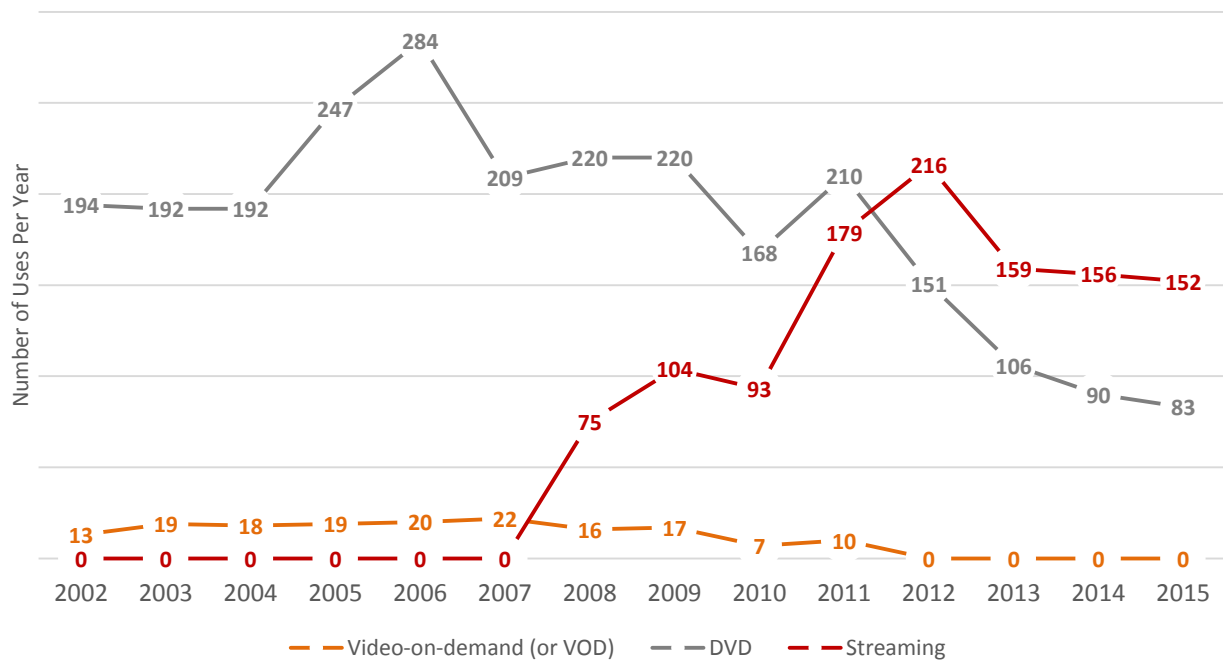
⁵⁸ Lacey Rose, “Netflix’s Ted Sarandos Reveals His Phase 2 for Hollywood,” *The Hollywood Reporter*, May 22, 2013, <http://www.hollywoodreporter.com/news/netflixs-ted-sarandos-reveals-his-526323> (November 25, 2016).

⁵⁹ Ibid.

⁶⁰ Netflix 2016 Q3 Earnings Report.

⁶¹ “Officers and Directors” Netflix Investor Relations, <https://ir.netflix.com/management.cfm> (December 14, 2016).

Exhibit 1
Usage of “DVD,” “VOD,” and “Streaming” in Netflix 10-Ks Over Time



Source: Compiled by Christy Johnson based on data from annual Netflix 10-K filings from 2002-2015. (December 23, 2016).

Exhibit 2
Netflix Statement of Operations
2001–Last Year of “Pre-IPO” Era

	2001	2000	1999	1998
Total revenues				
Cost of revenues:	75,912	35,894	5,006	1,339
Subscription				
Sales	49,088	24,861	4,217	535
	819	-	156	776
Total cost of revenues	49,907	24,861	4,373	1,311
Gross profit				
Operating expenses:	26,005	11,033	633	28
Fulfillment				
Technology and development	13,452	10,247	2,446	763
Marketing	17,734	16,823	7,413	3,857
General and administrative	21,031	25,727	14,070	4,052
Restructuring charges	4,858	6,990	1,993	1,358
Stock-based compensation	671	-	-	-
Total operating expenses	5,686	8,803	4,742	1,151
	63,232	68,590	30,664	11,181
Operating loss				
Other income (expense):	(37,227)	(57,557)	(30,031)	(11,153)
Interest and other income				
Interest and other expense	461	1,845	924	114
Net loss	(1,852)	(1,451)	(738)	(42)
	\$ (38,618)	\$ (57,363)	\$ (29,845)	\$ (11,081)

*in thousands

Source: Netflix Form 10-K Annual Report, 2002.

Exhibit 3
Netflix Statement of Operations
2006 – Last Year of the “Growth Period of the DVD Business” Era

	2006	2005	2004	2003	2002
Revenues					
Cost of revenues:	\$ 996,660	\$ 682,213	\$ 500,611	\$ 270,410	\$ 150,818
Subscription					
	532,621	393,788	273,401	147,736	77,044
Fulfillment expenses					
Total cost of revenues	94,364	71,987	58,311	32,623	20,421
Gross profit	626,985	465,775	331,712	180,359	97,465
Operating expenses:	369,675	216,438	168,899	90,051	53,353
Technology and development					
Marketing	48,379	35,388	29,467	21,863	17,632
General and administrative	225,524	144,562	100,534	51,535	37,423
Gain on disposal of DVDs	36,155	35,486	22,104	13,390	9,867
Total operating expenses	305,261	213,449	149,545	85,579	64,026
Operating income (loss)					
Other income (expense):	64,414	2,989	19,354	4,472	(10,673)
Interest and other income					
Interest and other expense	15,904	5,753	2,592	2,457	1,697
	-	(407)	(170)	(417)	(11,972)
Income (loss) before income taxes					
Provision for (benefit from) income taxes	80,318	8,335	21,776	6,512	(20,948)
Net income (loss)	\$ 49,082	\$ 42,027	\$ 21,595	\$ 6,512	\$ (20,948)

*in thousands

Source: Netflix Form 10-K Annual Report, 2006.

Exhibit 4
Netflix Statement of Operations
2011 – Last Year of the “Introduction to Streaming” Era

	2011	2010	2009
Revenues	\$ 3,204,577	\$ 2,162,625	\$ 1,870,269
Total cost of revenues	2,039,901	1,357,355	1,079,271
Operating income	376,068	283,641	191,939
Operating expenses:			
Technology and development	\$ 259,033	\$ 163,329	\$ 114,542
Marketing	\$ 402,638	\$ 293,839	\$ 237,744
General and administrative	\$ 117,937	\$ 64,461	\$ 46,773
Net income	226,126	160,853	115,860

*in thousands

Source: Netflix Form 10-K Annual Report, 2011.

Exhibit 5
Netflix Statement of Operations
2015 – Last Year of the “Netflix and Content” Era

	Year ended December 31,		
	2015	2014	2013
Revenues	\$ 6,779,511	\$ 5,504,656	\$ 4,374,562
Cost of revenues	4,591,476	3,752,760	3,117,203
Marketing	824,092	607,186	469,942
Technology and development	650,788	472,321	378,769
General and administrative	407,329	269,741	180,301
Operating income	305,826	402,648	228,347
Other income (expense):			
Interest expense	(132,716)	(50,219)	(29,142)
Interest and other income (expense)	(31,225)	(3,060)	(3,002)
Loss on extinguishment of debt	-	-	(25,129)
Income before income taxes	141,885	349,369	171,074
Provision for income taxes	19,244	82,570	58,671
Net income	\$ 122,641	\$ 266,799	\$ 112,403

*In thousands.

Source: Netflix Form 10-K Annual Report, 2015.