BONUS CASE STUDY: Netflix

Up to the eyeballs in entertainment

Netflix entered the Australian market as a movie and made-for-TV streaming service on 23 March 2015. The subscription video on-demand segment (SVOD) was growing rapidly and highly competitive (Foxtel, an exponent of the linear Pay TV model, has since adjusted pricing and contract policies).

But the Netflix story did not actually start here.

Reed Hastings and Marc Randolph launched Netflix in 1997. According to Reed, the marketing story for how it started goes something like this:

> 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?" Later, on my way to the gym, I realized they had a much better business model. You could pay $30 or $40 a month and work out as little or as much as you wanted.

This story was more a construct to convey their new business model easily, in an elegant and simple anecdote than it was a moment in time. This didn't actually happen, but it's easy to imagine that it did!

Hastings and Randolph met when Hasting's company (Pure Software) acquired Randolph's early stage startup. They enjoyed talking business together, working closely on a few projects, carpooling in from Santa Cruz to Los Gatos.

In a scenario befitting of *Silicon Valley*, Hastings company then merged with another, which was, in turn, then acquired. The result? Hastings was bought out and enjoyed a US$750 million payday. Hastings and Randolph found themselves with little to do and lots of time to plot their next startup.

They explored many options but knew they wanted to sell something over the internet. They were also pretty keen to avoid a business model and product that would be commoditised over time, especially one that might be subject to competition from the likes of Wal-Mart and Amazon.

They saw Amazon 'killing it' in the market with books so they really wanted to do something like that. They toyed with an idea of video rental by post but just couldn't make it work with the logistics of VHS tapes, so tossed that idea in the garbage with a lot of others. Until, that is, a few months later they heard about DVDs, and thought they might just make the video rental thing work…

They bought a used DVD, stuck it in an envelope and posted it to Hastings' house, as an act of 'testing the market' It arrived the next day with no damage done, so they decided their idea had legs.

They launched Netflix to the public in 1998 with a cheque from Hastings for $2.5 million, 30 staff and 925 movie titles.

Now, this is where it gets interesting

One question often asked about crazy successful startups is: 'How did you get your first customers?' Essentially this question is about what the communication model is.

As Jim Cook, Head of Operations, who was on board at the very beginning puts it, Netflix had two key 'secret weapons':

» **They had an established following on Usenet Groups (the precursors to the 90s bulletin boards like Craigslist).**
They did a soft launch of their website on 14 April 1998, with no advertising and no public announcements. They expected a handful of orders each day from 'family and friends', but on day one they received 500 orders as Usenet advocates spread the word in their networks (i.e. through ***Word of Mouth***). Within a month, orders had increased to 100 per day.

» **They provided a promotional offer of 10 free DVDs with every DVD player sold by Panasonic, Sony and Toshiba.**
When consumers opened their DVD, they saw the coupon sitting in the box. In 1997 it was far from certain that DVDs would wipe out VHS so these big-name manufacturers of DVD players didn't need much convincing to include the Netflix offer. The more people using DVDs the better.

Netflix actually ***sold*** and ***rented*** DVDs as well as charged late fees in the beginning. Yes, the DVDs had a due date! The bulk of their revenue in the first year came from DVD sales not rentals. Rentals in fact didn't have great repeat sales.

Randolph and Hastings knew they had an issue. If Amazon or Wal-Mart entered the space, margins would reduce and they wouldn't have a viable business. Moreover, DVD sales were taking up time, resources and management. The idea that the rental business would flourish seemed less and less likely.

So they decided to walk away from DVD sales.

This was a decision that many leaders face at some point: should we choose the high risk, high return strategy or go with the safer, pretty good business path.

These guys were not going to die wondering.

In 1999, they changed their revenue model to UTILISATION by offering an 'unlimited' number of video rentals for a monthly fee.

Netflix listed in 2002 at a market cap of $82.5 million and reached one million subscribers in 2003.

All this makes it sound pretty simple, but it was anything but.

Not as simple as it sounds

Jim Cook spent hundreds of hours in some of the largest regional postal centres watching how the US postal service handled mail. It was imperative that the DVDs went through the mail services as quickly as possible, as cheaply as possible and with as little damage as possible. The game could easily have been won or lost here.

The first challenge was to get their DVD envelope down a flat sorting conveyor as opposed to the fast spinning metal mail sorter drums of death. An envelope of certain dimensions would direct it to the flat mail channel. The flat conveyor could also read barcodes, so barcodes were added to the DVD envelope. The 'red envelope' had to be as cheap to send as possible, had to accommodate a DVD that could be returned, and had to represent the company's brand. The envelope was often the only piece of marketing the customer would see (hence why it was red).

Another part of Netflix's vision was to provide their customers with movies they'd love. Their differentiation model was ***customer focus***.

From the beginning they did a lot of research on their customers. Some of the results surprised them, like the fact that 60% of consumers planned their movie watching.

Netflix also knew that the average video rental customer watched five to seven movies a month. And they realised that customers would not want to come back to a website every time they needed a new one. What a hassle.

So in 1999 they created an online queue. When each DVD was returned, the next one was immediately sent out. This was gold. It made everything easier and faster. They also added customer and critic reviews on their website, optimised DVD images for faster loading, worked hard on great search functionality and relentlessly optimised their Cinematch algorithm, which recommended new titles to customers. (In 2006, Netflix even offered a $1,000,000 prize to the first person who could develop a video algorithm to beat Cinematch. This prize was finally awarded in 2009 to BelKor's Pragmatic Chaos team.)

Xcelerate Netflix

So let's put this all into practice and look closely at the type of Xcelerate framework that Netflix had for the first 10 years (1997 to 2007):

business model	**PHYSICAL: *distribution***
revenue model	1997 to1999 – **TRANSACTION** for DVD sales and rentals
	1999 onwards – **UTILISATION**
communication model	**Channel 5 –** Usenet groups (***Blogs***), the early adopters
	Channel 6 – *Online reviews and ratings*
	Channel 2 – *Advertising*, the coupon in with the new DVD player
	Channel 8 – *Word of Mouth* from very happy customers
differentiation model	***Customer Focus***

When Netflix entered the video rental market, they never really considered that they were taking on Blockbuster. Their sales were dwarfed by the video rental giant; there was no comparison.

In fact, in 2000, Hastings met with Blockbuster management to discuss partnering, even offering to sell the company for $50 million, but Blockbuster declined. In 2004, which ended up being Blockbusters peak year, Hastings said in an analysts briefing that Blockbuster had thrown everything at them but the kitchen sink. The next day Hastings received a large package delivery from Blockbuster. It was a kitchen sink.

In September 2010 Blockbuster filed for bankruptcy. It was a long way down for Blockbuster from its heyday of 60,000 employees, 9000 stores and $5.9 billion in revenue. Blockbuster had been dismissive, at least in the press, of Netflix from the beginning.

Business model Number 2

In 2007 Netflix announced they were launching streaming video (SVoD). This changed their business model to **DIGITAL: *distribution.***

From the beginning critics of Netflix said two things:

1. people won't want to order DVDs by mail
2. even if they did, movies will be delivered digitally in the future.

Critics were wrong on the first count and Netflix is now the leading player in the second category.

To give you a feel for how fast SVoD is growing, the number of households with an SVoD subscription in 2010 was 21 million, in 2015 it was 163 million and by 2020 it is forecast to be 383 million.

Business model Number 3

In 2012 Netflix decided they needed to be less at the mercy of movie studios and committed to two original content projects: *House of Cards* and *Orange is the New Black*. They, in some ways, became a television network.

However, customers could watch what they wanted, whenever they wanted, as many times as they liked.

Now they were content creators their business model changed to **DIGITAL: *creation.***

This was, and still is, a big bet for the company. Generating original content carries most of its costs up front with the benefit down the track. This is quite different to the cost model Netflix negotiated with its content providers – the large movie studios. There were no large upfront costs but they paid a 'royalty' based on a number of subscribers.

This is also a major new skill requirement. Getting great content created that is also right for the audience is no mean feat. Their start in this respect has been very successful. *House of Cards* and *Orange is the New Black* were both big wins. Other shows like *Luke Cage*, *Stranger Things* and *The OA* have also been early successes.

The next evolution is said to be AVoD (advertising video on demand) and is forecast to outgrow SVoD over the next 10 years. It will essentially mean everything is free to the consumer and money is made by the providers from advertising revenues.

Watch this space!

The fight for Aussie eyeballs

Netflix launched its SVoD product in Australia March 2015. In just over a year of operation Netflix had established a clear lead over rivals Stan, a joint venture between Nine Entertainment Co and Fairfax Media, and Presto, previously a joint venture between Seven West Media and Foxtel.*

In the first half of 2016:

- *Netflix had almost five million viewers and 1.9 million subscriptions*
- *Stan had 891,000 viewers and 332,000 subscriptions*
- *Presto had 353,000 viewers and 152,000 subscriptions.*

Foxtel changed its pricing structure in response to Australia's rapid uptake of Netflix, launching lower prices and lower commitment options in the SVoD price range.

Though Netflix still has Amazon to worry about...

**Seven West sold 50% stake to Foxtel in Oct 2016 and will cease operations end January, 2017. Subscribers will transfer to Foxtel who announced changes to their Foxtel Play and other products*