

Strategic Report for Netflix, Inc.



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Executive Summary

Following a year of continued growth and profitability, CEO Reed Hastings contracted Oasis Consulting to strategically advise Netflix, Inc. Although Netflix's innovative business model has led to the company's success, Netflix faces a transitional home entertainment industry, in which volatile consumer preferences and intense competition prove a major threat to Netflix's long-term viability. Oasis Consulting assigned the project to their Entertainment Division, whose lead consultant, Hillary Carroll, has compiled a strategic report with the assistance of her two colleagues, Alex Menenberg and Ian Kwok. The team researched Netflix's brief history, business model, industry landscape, competitors, and financials to provide Netflix with a thorough strategic analysis, which includes a competitive analysis, SWOT analysis, financial analysis, and concludes with strategic recommendations for Netflix, Inc. The following briefly introduces the key issues Netflix faces and summarizes Oasis' findings and strategic recommendations:

Netflix, Inc. is the largest online movie rental service provider, with a subscription base of over 10 million and an inventory of 100,000 DVD and Blu ray titles. Along with offering a breadth of titles, Netflix also provides movie ratings, reviews, and a recommendation service customized to each subscriber's preferences. In addition to its traditional DVD-by-mail service, Netflix has recently expanded to include digital streaming of over 12,000 titles instantly to subscribers' computers and television sets.

Netflix acquires distribution rights for its media content through the outright purchase of video titles and through profit sharing agreements with studios, networks, and distributors. Netflix has also entered into joint ventures with a handful of electronics companies to develop television devices that are compatible with Netflix's streaming video content.

Upon first glance, it appears as though Netflix operates in a relatively uncompetitive video rental industry dominated by a handful of large firms including Blockbuster and Movie Gallery. Since Netflix's primary competitor, Blockbuster faces a grim financial outlook and possible bankruptcy, the probability of Netflix gaining greater market share seems inevitable. However, this forecast is deceiving because the traditional video rental industry landscape

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has shifted and now competes directly with digitally distributed visual entertainment. A large number of small, innovative, internet based firms, like Hulu and Boxee, have penetrated the digital visual entertainment market and now prove to be Netflix's greatest threats.

Although traditional "brick-and-mortar" video rental outlets will continue to dominate the video rental industry in the near future, the industry has begun to shift from physical video formats like the DVD and Blu ray to digital content streamed over the internet and on to home television sets. This transition will likely make physical DVDs obsolete in the distant future. It is impossible to determine what technologies or innovations will define digital distribution markets, but there are a number of firms already vying for market control. Therefore, Netflix faces numerous competitors that are difficult to detect because they do not have significant market share as of now, but may have a strategic edge on Netflix in the long run.

This transitional market landscape proves a challenge to Netflix because not only must they remain competitive with "brick-and mortar" competitors in the DVD dominated market of today, but they must also position themselves to remain competitive in future digital distribution markets. In light of this challenging industry landscape, Oasis has focused on providing business strategies that will enable Netflix to maintain short-term and long-term profitability.

In the short-term, Netflix's profitability depends entirely on subscription fees. Therefore, the company must strive to increase their subscription base through marketing, competitive pricing, customer service, and breadth of titles. Simultaneously, Netflix must maintain their current subscription base by reducing churn, the percent of subscribers that cancel their Netflix subscriptions each year. Netflix must also remain cognizant of and adapt to emerging industry innovations and technologies, which could undercut Netflix's current business model.

In the long-term, Netflix needs to position itself as the firm that will bridge the transition from physical DVD content to digital content distribution. Currently, Oasis believes that Netflix is the company best suited to fill this roll but we have provided strategies that will

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ensure Netflix maintains their competitive advantage over new market entrants. These strategies include increasing investments in expanding streaming title selection, investing in more refined streaming technology, and most importantly establishing profit sharing relationships with studios and networks for exclusive control of content. The final recommendation will be especially important because both networks and studios will be major forces in directing the trajectory of the home entertainment industry in the near and distant future.

Company Overview

History

In 1997, Reed Hastings founded Netflix and by 1998 the company began full operations renting and selling DVDs by mail. It quickly became apparent that the demand for DVD-by-mail rentals outweighed demand for buying DVDs and Netflix decided to discontinue DVDs sales and instead focus their business model on rentals. In 1999, Netflix made another strategic move by phasing out single DVD rentals and introducing a multi-tiered subscription-rental model that allowed customers to pay based on their demand for DVD consumption. This pricing experiment proved successful and by 2000 Netflix had completely abandoned single DVD rentals. Around this time Netflix supplemented its promising business model by launching its CineMatch application, which generates customized rental selections for subscribers based on his or her previous rentals and movie rankings.

By 2002, Netflix's unique service gained enough momentum to pass the 500,000-subscriber mark and complete an IPO, which allowed Netflix to pay down debt and open more distribution and shipping centers to reduce time lags between DVD shipments. Throughout the early 2000s, Netflix continued to increase both its subscription base and inventory of DVD titles. By 2003 Netflix's subscribers had tripled to 1.5 million and had acquired rights to over 15,000 titles. However, Netflix's obvious success quickly captured the attention of in-home video entertainment competitors Blockbuster and Wal-Mart. Both companies soon released online, DVD-by-mail products that mimicked Netflix's business model. However,

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Netflix reacted to the new online DVD rental entrants by increasing expenditures on advertising, technology, and customer service. Although both new entrants tried to undercut Netflix's prices, neither was able to maintain profits, which forced Wal-Mart to exit the DVD rental business by 2005 and caused Blockbuster to alter their strategy, focus on profitability, and raise prices in 2007. Ultimately, Netflix emerged the winner in DVD-by-mail rentals and maintains a 75% majority market share.

Netflix's recent history has been characterized by continued growth and investment in internet-streaming technologies and services. Beginning in early 2007, Netflix launched its internet-streaming video service. Through a handful of strategic partnerships and agreements, Netflix continues to position itself for the imminent transition from physical to digital home media consumption. In 2008, Netflix partnered with Samsung, LG Electronics, Microsoft, and Roku to develop Netflix compatible devices that instantly stream movies to a home television sets. Between 2008 and 2009, Netflix also negotiated agreements with networks, CBS, Disney, Starz Entertainment, and most recently MTV, to acquire rights for streaming their TV and movie content. Today, Netflix includes a growing subscription base of over 10 million and inventory of 100,000 titles.¹

Business Model

Netflix is the largest online movie rental service provider and offers a library of over 100,000 DVD titles, 12,000 of which can be streamed instantly online, to its ten million subscribers. Netflix's DVD titles include movies, television, and other filmed entertainment products. Along with an extensive collection of titles, the Netflix service also includes access to movie ratings, reviews, and personalized movie recommendations.

Netflix ships DVDs to customers through first class mail and rentals are then returned in pre-paid envelopes. The entire transaction is free of cost to the customer. To ensure timely deliveries and returns, Netflix has established an extensive distribution network of shipping centers across the United States. Recently, Netflix has expanded its business to include digital distribution through online and in-home instant streaming of DVD content. Netflix acquires distribution rights for its DVD content through the outright purchasing of titles and through profit sharing agreements with various studios, distributors, and networks.²

Overall, Netflix has been successful in developing an internet movie service. They maintain their majority market share and profitability by focusing on an e-commerce business model that increases revenue by strategically growing their subscription base. Netflix maintains this subscription base growth through substantial marketing investments, offering a large selection of titles, providing a unique movie recommendation service, and incorporating technological developments, like Blu-ray and instant streaming, into their business model.

Competitive Analysis

Overview

To ensure Netflix's viability and profitability it is essential to strategically assess the complex landscape of the home entertainment market and then use this information to gain a competitive advantage over rival firms. To begin an industry analysis, we must first attempt to define Netflix's industry. However, defining the in-home entertainment industry presents challenges because movies, television programs, and other "entertainment videos" are distributed to viewers through a broad spectrum of channels. A handful of the available distribution channels currently include DVD rental and retail outlets, DVD rental and retail websites, cable, premium television, pay-per-view, Video on Demand (VOD), and Internet delivery.³ To further complicate defining the industry, a number of firms offer more than one of these distribution channels, including Netflix, which operates both a video rental website and offers internet streaming.

Nevertheless, Netflix is officially classified as being in the "Video tape rental" industry, coded SIC 7841. Within this industry, Netflix's closest competitor is Blockbuster, followed by Movie Gallery and Redbox.⁴ Blockbuster leads the market in in-store rentals with more than 7,000 stores worldwide and \$5.3 billion in revenue for the fiscal year 2008.⁵ However, Netflix dominates by-mail rentals with 75% market share and \$1.4 billion in revenue for 2008. Although "brick-and-mortar" firms constitute Netflix's traditionally defined competitors, an evolving home entertainment market must now include digitally distributed visual media. Therefore, Netflix has been forced to compete against savvy young internet

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sites, which stream television and movie content and quickly adapt to evolving consumer preferences and technologies. Examples of these “minimal market share but substantial innovative threat” firms include Hulu, Boxee, and Vudu. Along with young innovative firms, Netflix also faces competition from established e-commerce firms, like Amazon and Apple, who are using their established Internet presence to respond to digitally distributed entertainment demands.

Porter’s Five Forces

Force	Strategic Significance
Internal Rivalry	Low
Entry & Exit	Moderate/Low
Substitutes & Complements	High
Supplier Power	High
Buyer Power	Moderate

Internal Rivalry

Looking strictly at the video rental industry, Netflix faces minimal internal rivalry because the industry is dominated by only a handful of firms, namely Blockbuster. Although Netflix faces little internal rivalry in its immediate industry, the company faces an intensely competitive broader market. Since home entertainment covers a broad spectrum of technologies and channels of distribution, Netflix is in direct competition with firms in a number of other industries including cable networks, who air movies on television, satellite companies’ VOD services, and websites like Hulu, which provide video content through online streaming. Furthermore, as people transition from consumption of physical DVDs to digitally distributed media, these competitors, who can be grouped as digital distributors, will become Netflix’s greatest threat. However, in the near future, Netflix’s greatest rivals will continue to be traditional “brick-and-mortar” rental stores, like Blockbuster, and will remain a minimal threat to Netflix’s business.

Entry and Exit

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Entry into the in-home video entertainment industry is unregulated but constrained by the costs of acquiring distribution rights from Studios. However, as delivery of video and television content becomes increasingly distributed through the internet, entry costs to launch a business similar to Netflix's will decrease because capital costs are relatively lower than "brick and mortar" firms. Nevertheless, in an industry as competitive as video entertainment the viability of a new firm may not be very likely unless that firm can produce an innovative or superior format for media viewing. A firm that could create and popularize a new technology for in-home entertainment viewing could enter the industry and quickly gain significant market share.

Exit costs in the video rental industry depend on the structure of the firm. As an online DVD rental service, Netflix has minimal investments in capital because they rent office space and distribution centers, do not own any physical stores, and could sell their inventory of DVDs in a liquidation sale relatively easily. However, a business like Blockbuster has much higher exit costs because Blockbuster has extensive investments in real-estate.

Substitutes & Complements

The threat of substitutes to Netflix's business model is the highest of the five forces because Netflix competes with a handful of entertainment viewing formats that are relatively interchangeable including VOD, pay-per-view, online streaming etc... Many people simultaneously subscribe to a combination of these services, and since they are close substitutes and there are minimal switching costs, small fluctuations in prices can cause consumers to abandon one viewing format and quickly replace it with another. The greatest substitute threat, which Netflix has begun to address, is the replacement of the physical DVD viewing format with digital viewing formats. In the next 10 to 20 years, it is projected that media consumption will shift away entirely from the DVD to digital streaming and the company that can provide digital media at the lowest price, with the best content, and greatest ease of use may be in the position to dominate the entire market. Therefore, looking forward, Netflix must position itself above rival firms by incorporating its greatest threat and closest substitute, digital streaming, into its business model and then bridge the transition from physical to digital media consumption.

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As Netflix transitions into providing streaming content to personal computers and televisions, complements to their business have become products that are compatible with Netflix video streaming. For example, Xbox 360 recently added Netflix streaming capabilities to their gaming console. As a result, a few hundred thousand of new Netflix subscribers last year were also individuals, who had just purchased Netflix compatible Xbox 360s.⁶ The bundling of Netflix streaming software with televisions, gaming consoles, DVD or Blu ray players etc... increases Netflix subscribers and therefore profits. To capitalize on these profitable complements to their streaming service, it is advantageous for Netflix to enter into joint ventures with companies that produce electronics.

Supplier Power

Netflix acquires its video content through direct purchases, revenue sharing agreements, and licensing agreements. These agreements, which allow Netflix to rent DVDs and stream video content, are primarily obtained from studios, networks, and distributors. Therefore, Netflix's suppliers, e.g. studios, networks, and distributors, control the prices that Netflix must pay for its video content. The First Sale Doctrine, a copyright law stipulating that once a copyright owner sells a copy of their work they relinquish control of the work and the purchaser may redistribute the work as they wish, provides protection for Netflix with regards to redistributing DVD titles. However, the First Sale Doctrine does not apply to streaming content. Therefore, Netflix is especially vulnerable to supplier power during streaming distribution cost negotiations. The studios and distributors who license streaming content are in full control of the terms and conditions with Netflix and may rescind the availability of the content at will. As the DVD format becomes increasingly obsolete and streaming video content grows in popularity, Netflix become more susceptible to the power of their suppliers.

Another aspect of the in-home video entertainment industry, which substantially affects the Netflix business model, is the window of time between theatrical releases and in-home video releases. Studios have complete control over dictating the length of these windows. Currently DVD format releases are given priority over VOD or internet-delivery, because studios earn substantially greater profits from DVD sales. Since studios control the length of these release windows they also control who has the advantage of being the first to provide

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in-home access to new releases, especially blockbusters. By entering into profit sharing agreements with their suppliers, Netflix may be able to curb supplier power by aligning their profit interests with those of their suppliers.

Buyer Power

As previously discussed, the in-home video entertainment industry is intensely competitive because customers subscribe to multiple providers simultaneously and it is virtually costless for them to compare prices between providers. Therefore, Netflix's buyers have a moderate level of power because if Netflix's prices become comparatively more expensive than alternative video providers like hulu.com or VOD, their customers merely have to cancel their Netflix subscription, which is paid on a month-by-month basis. Due to the industry landscape that Netflix faces, they must be conscious of their competitors' prices and make every effort to keep subscription costs low. Technological developments in video consumption are continually changing, which results in volatile buyer preferences. Therefore, Netflix must maintain a current business model and adapt to industry development like video streaming to maintain their subscription base.

SWOT**Strengths**

- Market Power
 - Netflix has captured 75% of the online DVD rental market and as an industry leader has become a household brand.
- Economies of Scale in Business Model
 - Netflix's online interface and flexible infrastructure allows them to maintain low operating costs while increasing their subscription base. Therefore, as subscribers increase, profits rise and marginal operating costs decrease.
- Value in Customer Services
 - Netflix offers a customized DVD recommendation service based on ratings and a subscriber's previously viewed films. These recommendations paired with Netflix's extensive DVD inventory enable customers to explore video

content far beyond mainstream feature films. The service is patented and unique to Netflix.

- Large DVD Inventory
 - Over 100,000 titles and 72 million discs, which include new releases, television shows, and obscure films. Greater selection than any other home video retailer
- Effective Pricing Scheme
 - Netflix gains revenue through a multi-tiered subscription fee structure that allows Netflix to capture greater profits through price discrimination

Weaknesses

- Churn, Subscriber Acquisition Costs (SAC), and Average Revenue per User (ARPU)
 - Netflix's service is subscription based, which means that the company's continued growth is dependant upon maintaining low churn rate, low SAC, and high ARPU. These three factors can be difficult to control due to the lack of switching costs in the video entertainment industry.
- Lack of Global Diversification
 - Although present across the U.S, Netflix has not expanded outside the country, which makes it entirely dependant on one market. Globalizing could benefit the business by providing more stability and increasing growth prospects

Opportunities

- Digital Distribution
 - As digital distribution of video content becomes an increasingly popular viewing format, Netflix strategically positioned to serve as a bridge during the slow transition from physical DVD formats to digital streaming. Netflix is better positioned for this role than other firms because they already have an E-Commerce business model and a brand name.
- Partnerships and Profit Sharing Schemes

- Partnerships with companies like Microsoft (e.g. Netflix compatible Xbox 360) allow Netflix to expand their subscription base and Netflix compatible streaming devices. Profit sharing schemes with studios allow Netflix to acquire exclusive distribution rights. Both new partnerships and profit sharing schemes should be sought to increase Netflix's subscription base, profits, and establish themselves as the frontrunner in providing digital home entertainment.
- Subscription Growth Potential
 - The video rental industry grosses over \$8 billion a year (See Figure 7) and Netflix only taps into \$1.4 billion of this growing market. Furthermore, the U.S has over 100 million households, half of which have broadband connections, and Netflix's subscription base only includes about 10 million customers.

Threats

- Studio Power
 - The major entertainment studios in Hollywood control film release windows and distribution rights, which are two primary determinants for Netflix's acquisition costs and profits. Therefore, if the studios decide to decrease the 4-6 week gap between DVD releases and VOD releases, Netflix would lose a major strategic advantage.
- Intensely Competitive Market
 - The home video industry covers a broad range of viewing platforms, services, prices, and technologies. There are a number of unique competitors that could potentially provide home video cheaper than Netflix. Since most viewers subscribe to a handful of these competitors, and few have switching or "sticky" fees, if a new competitor emerges with greater streaming capacity and lower prices, Netflix's business model could be severely jeopardized.
- Unpredictable Video Rental Industry
 - The industry is continually evolving due to technological and formatting innovations. Products, prices, and consumer preferences are subject to quick

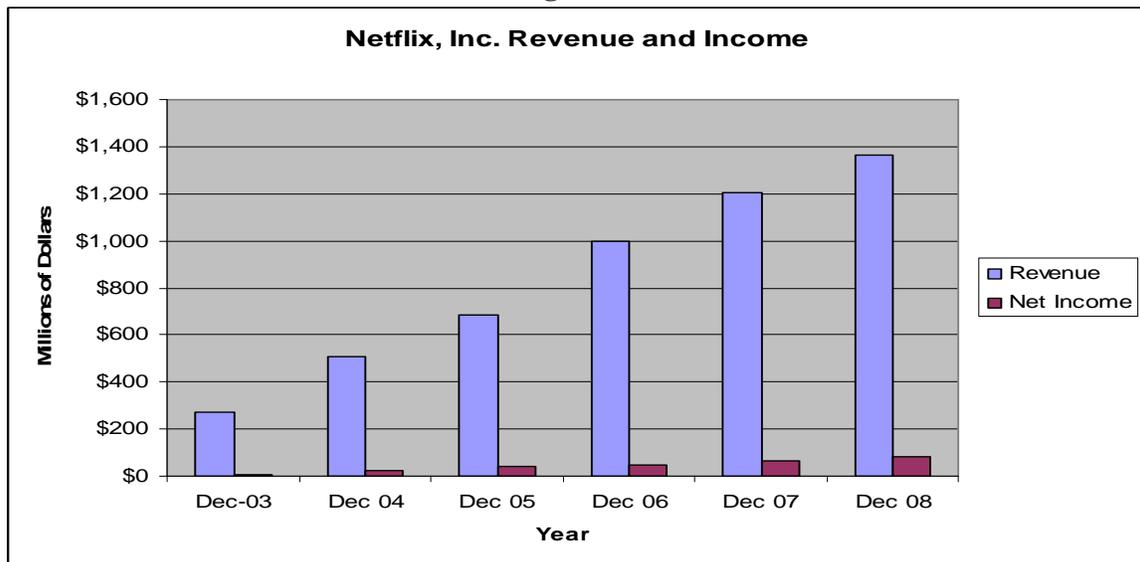
change, creating highly erratic and unpredictable markets in which new entrants are always a threat and a malleable business model is essential to succeed

Financial Analysis

Overview

Although most firms are experiencing financial losses due to a grim economic climate, Netflix has maintained robust profits. The company’s continued growth suggests that Netflix may be insulated from recessions due to its business model, which offers a form of “escapism” by providing relatively cheap video entertainment. Netflix’s success is evident in a handful of key financials. In 2008, Netflix earned revenue of about \$1.4 billion, a growth of 12% from 2007. Net income for 2008 was about \$83 million. Netflix has experienced growth in revenue and EPS since the company went public in 2002 (See Figure 1). Netflix is also predicted to grow more than 14% a year for the next five years which, given the financial forecast, is an impressive feat.

Figure 1



As a subscription-based company, Netflix’s income comes almost exclusively from subscription fees. In the immediate future, Netflix can continue outperforming analyst expectations and maintain an edge over competitors by increasing profitability through

subscription based growth, reducing churn, and pricing competitively. By analyzing key ratios from Netflix’s financial statements, information pertaining to the company’s liquidity, leverage, and profitability give insight regarding Netflix’s financial health compared to industry averages and provide context for later strategic recommendations. Following an overview of financial statement highlights, an analysis of Netflix’s historical and current stock prices depict market sentiments about Netflix’s growth potential and the perceived value of the company.

Financial Statement Analysis

Analyzing Netflix’s 2008 financials, the Oasis Entertainment Division focused on key ratios pertinent to strategic recommendations presented later in the report. These ratios measure crucial aspects of Netflix’s business including liquidity, leverage, and profitability.

Figure 2

Key Financial Ratios			
	Netflix	Blockbuster	Industry
Current Ratio	1.67	1.00	0.70
Quick Ratio	--	0.4	0.9
Leverage Ratio	0.06	0.44	0.33
Total Debt/Equity	0.11	4.40	0.45
Interest Coverage	54.50	--	3.38

Liquidity ratios provide information about a company’s ability to satisfy short-term obligations. Specifically, the Current Ratio measures a company’s ability to pay obligations within the next 12 months and can be calculated by dividing current assets by current liabilities. Looking at Figure 2, it is evident that Netflix outperforms both its industry and greatest competitor, Blockbuster. Netflix’s high liquidity is evident in the company’s substantial amount of available cash; the company has Cash and Short Term Investments equaling about 300 million. Netflix’s greater than one Current Ratio also indicates that its assets outweigh current liabilities and that Netflix is, at present, a financially sound company.

Analyzing Netflix's historical balance sheets and leverage ratios reveal that Netflix operates out of its current, on hand cash, and has had few borrowings. Netflix paid off its start-up debt by 2003, after a 2002 IPO, and since then has acquired no short-term or long-term debt until this past fiscal year, 2008. As of year end 2008 Netflix had taken on 1.1 million in short-term debt and 38 million in long-term debt. However, in looking at Netflix's Debt/Equity ratio compared to Blockbuster and the overall industry it is apparent that Netflix's leverage is well below the industry average. In developing a handful of strategic recommendations presented in full at the end of this report, Oasis recommends that Netflix substantially increase its leverage by undertaking more debt and reinvesting borrowed money in streaming technological research and development or profit sharing schemes with studios.

Figure 3

Profitability Ratios			
	Netflix	Blockbuster	Industry
Gross Profit Margin	33.30%	51.50%	36.00%
Pre-Tax Profit Margin	9.60%	(6.60%)	(7.60%)
Net Profit Margin	6.10%	(7.10%)	(11.50%)
Return on Equity	21.3%	(86.0%)	10.8%
Return on Assets	13.1%	(15.3%)	(13.0%)
Return on Invested Capital	19.8%	(27.4%)	2.9%

Profitability ratios (See Figure 3) reflect a company's ability to use assets and manage expenses in obtaining decent rates of return. In Netflix's business model assets primarily include subscribers' subscription fees and expenses include DVD shipping costs, Subscriber-acquisition costs (e.g. marketing), and amortization of DVDs. Netflix outperforms the industry and Blockbuster across every profitability ratio except for Gross Profit Margins. Subtracting the Cost of Goods Sold from Revenue and then dividing that quantity by Revenue generates a Gross Profit Margin. Since Netflix attributes the cost of packaging and

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mailing of DVDs to “Cost of Goods Sold” and other rental stores do not carry that cost, Netflix’s Gross Profit Margins are artificially low and therefore not as good a profitability indicator as Net Profit Margins in comparing Netflix to industry averages. However, from Netflix’s Net Profit Margin it is evident that Netflix is profitable especially compared to the industry average and Blockbuster, both of whom are unprofitable. Additional indicators of profitability include returns on assets, equity, and investments. In each of these areas Netflix continues to outperform the industry and competitors.

Figure 4 depicts a historical chart of Netflix’s profit margins and shows that although Gross Margins have been erratic, Net Profit Margins and Operating Margins have followed increasing growth trends. Netflix’s Operating Margins are particularly interesting because they have increased at a faster and steadier rate than Net Profit Margins. This steady increase reveals Netflix’s profitable operating margin, and is used to pay fixed costs, like interest on debt. In light of this analysis, a strategic recommendation further on suggests Netflix take on more debt because profitable operating margins enable efficient financing of interest on the debt.

Figure 4



From the financial ratios discussed above, it is evident that Netflix is in excellent financial condition and has outperformed the industry and its main competitor, Blockbuster, in

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almost every financial segment. Looking at Figure 1, Netflix’s out performance of competitors and continued growth in revenue and income indicate healthy economic growth and continually improving financial performances. Netflix’s strong financials, specifically its abundant cash, very low debt to equity, and profitable operating margins, suggest that Netflix is in a good position to take on significantly more debt to leverage digital distribution positioning strategies without financially jeopardizing its current business operations.

Stock Price Analysis

Figure 5

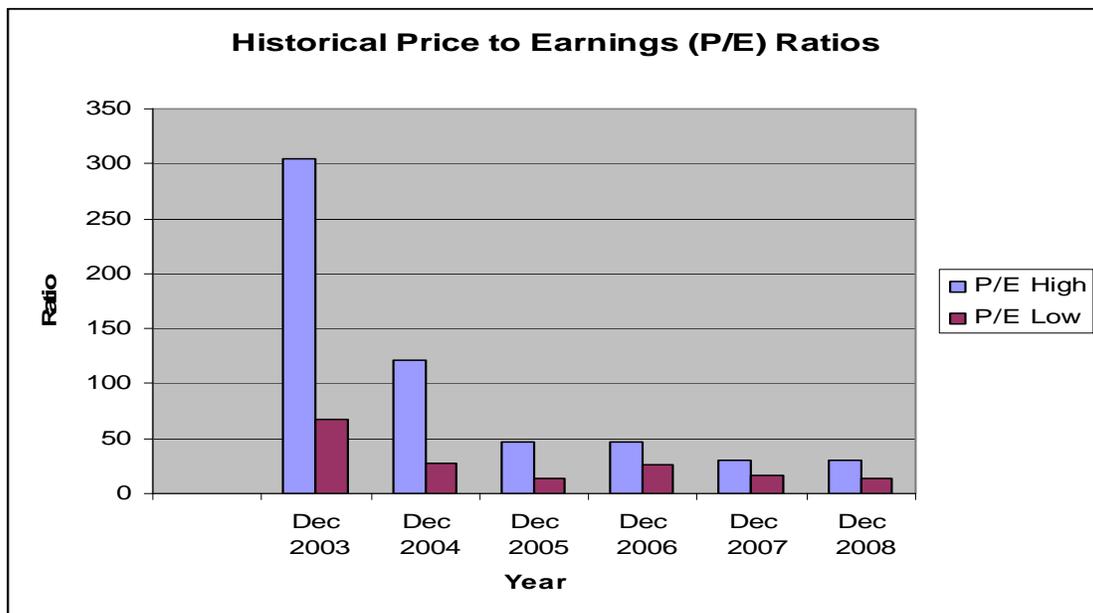


Source: <http://www.reuters.com/finance/stocks/chart?symbol=NFLX.O>

Netflix’s stock is fairly volatile and has historically been impacted by its competitors’ actions. In 2004 Netflix’s stock price dipped significantly in conjunction with Blockbuster launching its own Web-based subscription service. A following dramatic drop in stock prices occurred in mid 2006 and can most likely be attributed to Blockbuster launching TotalAccess, a DVD-by-mail service, which undercut Netflix’s prices. Although Netflix’s stock price has been historically volatile, the fourth quarter of 2008 and the first quarter of 2009 have seen Netflix’s stock steadily climbing from a low of \$18.95 at the end of October to \$48.83 in mid April. This jump in price is especially significant when taking into account the grim financial environment, the poor performance of Netflix’s primary competitor, Blockbuster, and a decrease in consumers’ discretionary spending (See Figure 5). Recently heightened media

attention over which video entertainment company will “win and take all” in an emerging digital distribution market coinciding with Netflix’s dramatic increase in stock value may be an indication that investors predict Netflix a probable contender. However, the most likely reason for Netflix’s recent strong stock performance is that Netflix was one of the few companies with very strong fourth quarter earnings and growth reports. The fourth quarter financial performance reflects the likelihood that the economic recession has made Netflix a relatively cheaper replacement for other expensive entertainment options like movie theater tickets.

Figure 6



Since Netflix’s stock price is volatile, analyzing the company’s historical and current P/E ratios provides a clearer understanding of the markets’ expectations for Netflix’s earnings and sustainability of those earnings’ growth. Looking at Figure 6 it is evident that Netflix’s P/E ratio dropped substantially after 2003, which occurred because expected shareholder return drops substantially throughout a products lifecycle. Therefore, after Netflix’s 2002 IPO, growth prospects for the company were very high and as these prospects were realized the P/E ratio leveled off. However, Netflix’s P/E ratio leveled off very quickly to 30 in 2007 and 31 in 2008. Although Netflix’s P/E ratio is greater than the industry average of about 22 the relatively stable P/E ratio over the past few years may indicate that the Netflix’s value is not as high as current stock prices indicate.

Netflix benefits from a solid e-commerce business model backed by a decade of growth and increasing revenue. The key issues facing Netflix are not inherent to the company but rather a product of a rapidly evolving and unpredictable home entertainment industry. Netflix is still a young firm and if they hope to establish a lasting presence in the video entertainment industry, they must make a handful of strategic moves to maintain their market share in the near and distant future.

Strategic Recommendations

Overview

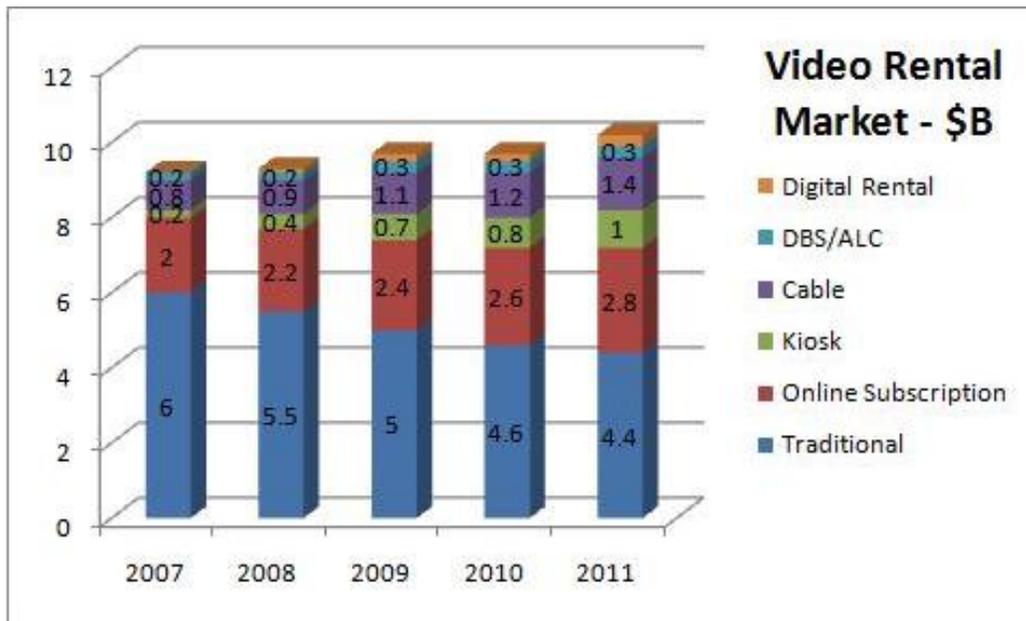
The Oasis Entertainment Division has isolated Netflix's primary challenge as being its market environment, which continually evolves due to technological and media format innovations. Products, prices, and consumer preferences are subject to quick change, creating highly erratic and unpredictable markets in which new entrants are always a threat and forward thinking business strategies are essential to viability. As of now, the video entertainment market appears to be transitioning from its current formats, physical DVD and Blu ray technology, to digitally distributed content. Although the physical video rental market (traditional rentals, online subscriptions, and kiosk video rentals) remains robust with over \$8 million in sales, a figure predicted to remain stable for the next five years (See Figure 7), the market as a whole continues to grow and physical video rentals' share of the growing market is decreasing. In contrast, digital rentals share of the market is increasing. Although digital content will not gain significant market share during the next five years, projections indicate that adoption of digitally distributed media will overtake physical formats within the next 15 to 20 years.⁷

Due to distinct short-term and long-term landscapes in the home entertainment industry, firms like Blockbuster, who currently dominate the market, may not survive the next couple of decades. On the other hand, it remains unclear which firm will emerge as the new digital distribution industry leader. However, given that the transition between physical and digital formats will occur gradually, Netflix is at an advantage to assume the position because it has a large selection of physical DVDs in addition to an e-commerce business, the combination

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of both would allow the company to adapt quickly to digital distribution developments, while also maintaining profitability in the short-term. However, if Netflix hopes to ascertain itself as an eventual market leader in digital video distribution it must adopt both short and long run strategic positions. Given Netflix’s evolving market environment, Oasis has outlined strategic recommendations which will enable the company to maintain its current profitability and growth in the short-term and solidify a dominant market position in digital distribution in the long-term.

Figure 7



Source: <http://www.fmsdevelopment.com/wp/?p=127>

Short-Term Recommendations

In the short-term, Netflix must focus on profitability and expanding its subscription base. Profitability can be increased by reducing churn, lowering subscriber-acquisition costs (SAC), and increasing average revenue per paying subscriber (ARPU). Expanding Netflix’s subscription base is also essential to revenue growth and building brand loyalty. This subscription based growth can be accomplished with competitive pricing and added product value through customer service.

Netflix earns revenue through subscription-fees. Therefore, as a subscription-based business, Netflix’s earnings growth depends on maintaining low subscriber acquisition costs,

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increasing profits per subscriber, and retaining already acquired customers. However, accomplishing these goals can be difficult due to a highly competitive video entertainment market and minimal switching costs between firms. For example, subscriber-acquisition costs are mainly attributed to marketing and in 2006 Netflix was forced to contend with new DVD-by-mail entrant, Blockbuster, and spent 23% of its Gross Income Margin on marketing costs to reacquire customers that left because of Blockbuster's lower prices. This caused SAC to jump to an average of \$45. However, by 2008 Blockbuster was no longer a threat, marketing declined to 15% of Netflix's Gross Margin, and SAC decreased to a little over \$25. In other words, because the components affecting subscription-fee based earnings are highly dependant on market conditions and competitors, it can be difficult to control them. Oasis, however, has found opportunities to affect costs associated with churn.

Netflix reduced churn rates from about 7% in 2001 to about 4% today. Still, 4% is a relatively high number and needs to be lowered. Maintaining low churn rates creates greater earnings because older customers tend to rent fewer DVDs a month. The DVD usage of a one-year subscriber is 20% less than a new subscriber and the usage rate continues to decrease for progressively older customers.⁸ Netflix earns an average of \$13.75 in revenue from each customer a month. If the average one-year old subscriber rents 4 movies a month and the new subscriber rents 6, and Netflix pays \$1 per DVD in shipping, processing, and amortization costs, then the older subscriber costs Netflix \$4, while the new subscriber costs Netflix \$6. At the end of the month Netflix gains a profit of \$9.75 from the older subscriber, but only \$7.75 from the new subscriber. If you include SAC, which the new subscriber also incurs, the older subscriber is obviously more valuable to earnings.

To reduce subscriber churn and retain more profitable older subscribers, Netflix must create incentives for customers to stay with Netflix longer or deterrents against canceling subscriptions. Deterrents, such as early cancellation fees or binding contracts, may scare indecisive customers away from even trying Netflix. Therefore, Oasis has focused on strategies with time based incentives. Since Netflix recoups its roughly \$27 subscriber-acquisition costs at about month seven, we are recommending that Netflix provide a benefit for subscribers who reach the seven month milestone. For example Netflix could reward seven month long subscribers by initiating access to free streaming content, an extra DVD

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rental, a fee discount etc... These incentives could be applied to one-year, two-year, and three-year milestones as well.

In the short-term Netflix must also strive to maintain subscription based growth to increase revenue growth and establish brand loyalty. Netflix currently has over 10 million subscribers and revenues of \$1.4 billion. Looking at the video rental market as a whole, which makes about \$8 billion (See Figure 7), Netflix's revenue share seems unimpressive. Nevertheless, this means that Netflix has vast market penetration potential, especially because the video entertainment market continues to expand, while "brick-and-mortar" rental stores are losing market share, and digital distribution is increasing in popularity. Furthermore, considering there are about 100 million households in the U.S. and about half of them have broadband connections, Netflix's current 10 million subscribers puts the company nowhere near a market saturation of 50 million, and households with broadband will continue to increase in the near future. Therefore, there are ample opportunities for Netflix to grow out their subscription base through marketing efforts, competitive pricing, and value added services. The value added by Netflix's customized video recommendation service is a major distinction between Netflix and its competitors because it enables customers to fully tap into the potential of Netflix's extensive DVD inventory. Therefore, Oasis recommends that Netflix focus their marketing efforts on this aspect of their business model to acquire new customers and increase market penetration and profits.

Long-Term Recommendations

Netflix's business model is well suited for the transition from physical DVD and Blu ray formats to digital video entertainment distribution. Netflix has a financially successful DVD-by-mail business, which will most likely remain profitable as long as the DVD format is in use (10-20 years). Netflix also has a website interface, which subscribers are accustomed to, and which easily functions as an online video streaming arena and streams content to home television sets. Additionally, Netflix's growing subscription base will extend Netflix's brand recognition, loyalty, and network. Although Netflix's business model is better positioned to withstand the imminent video rental market transition than "brick and mortar" firms like Blockbuster, Netflix still has a handful of weaknesses that must be addressed to position itself as a viable long-term digital distribution market power. Netflix's long-term weaknesses

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include mediocre streaming technology, and susceptibility to Studios' omnipresent control over digital content release windows, licensing costs, distribution rights, and breadth of available streaming titles. Netflix's viability and growth potential in the distant future depend upon immediate strategic responses to these long-term threats. To ensure Netflix's success in positioning itself for future profitability, Oasis has outlined a few long-term strategic recommendations.

First, the major determinant in which firm will capture digital distribution market share is the company that can produce the fastest, easiest-to-use, and highest picture quality streaming technology. The firm that develops this streaming technology will obtain a significant competitive advantage over rivals. As of now, Netflix's digital streaming quality is inferior to physical viewing formats. Users of Netflix's online streaming video often complain that it is slow, unreliable, and pixelated. Therefore, if Netflix seeks to position itself as a leader in streaming digital content, they must invest in research and development to improve digital streaming technology or Netflix should acquire a smaller tech firm that focuses on developing higher quality online video streaming. Looking at Netflix's operating expenses, Technology and Development expenditures have grown to about \$90 million in FY 2008, but this value pales in comparison to the \$200 million spent on marketing. Although marketing is crucial to growing a larger subscription base, allocating more cash to technological research could ultimately lead to higher future returns as the video rental industry transitions to digital distribution.

Second and most importantly, Netflix will face a change in cost structure as video entertainment transitions into digital distribution. This shift in costs will result from the higher acquisition prices of digital media as compared to physical DVD content. Studios determine the cost of streaming content and as Studios' greatest revenue source, DVD sales, becomes obsolete, they will experiment with various pricing schemes, distribution methods, and joint venture opportunities to try and recoup lost profits. To maintain low content acquisition costs, and increase content selection Netflix must establish extensive relationships with the Studios. Studios will ultimately determine the future of the digital distribution industry and if Netflix hopes to maintain profitability and market share in the long-term it must align the Studios' profit interests with its own. To accomplish this

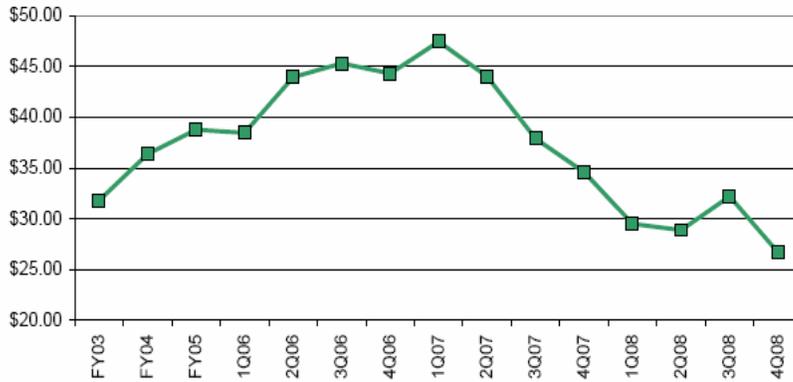
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alignment of interests between Studios and Netflix, Oasis Entertainment Division has a couple of recommendations. The first recommendation is for Netflix to vertically integrate with a studio. Vertical integration would reduce costs for both the Studio and Netflix by cutting out the transaction costs associated with negotiating licensing and distribution terms for streaming content. Aligning interests with a Studio would also enable the Studio to determine release windows that would benefit Netflix over other video entertainment competitors, like VOD, or pay-per-view. Vertical integration would also give Netflix access to an entire library of exclusive film content and priority over new releases. This would be especially beneficial to Netflix because their current streaming selection lacks diversity, depth and quality. A vertical integration would also benefit Studios in that they could replace obsolete DVD distribution channels with a brand name digital distributor that legally distributes content and already has a multi million subscription base. The studio would also be integrated with a firm that has robust, healthy financials. Given that a vertical integration negotiation between a Studio and Netflix may be deemed anti-competitive, a back up recommendation is for Netflix to use its leveraging potential by taken on debt and continuing to aggressively negotiate profit sharing schemes with Studios, Networks, and Distributors.

In sum, Netflix, Inc. is a firm with a competitive business model, healthy financials, and a growing subscription base. These descriptive characteristics allude to a firm in a content state that should be left unaltered. However, Netflix's market environment has reached a critical juncture and if Netflix adopts the above outlined recommendations it could leverage its successful nascent business model into an industry standard for digital entertainment.

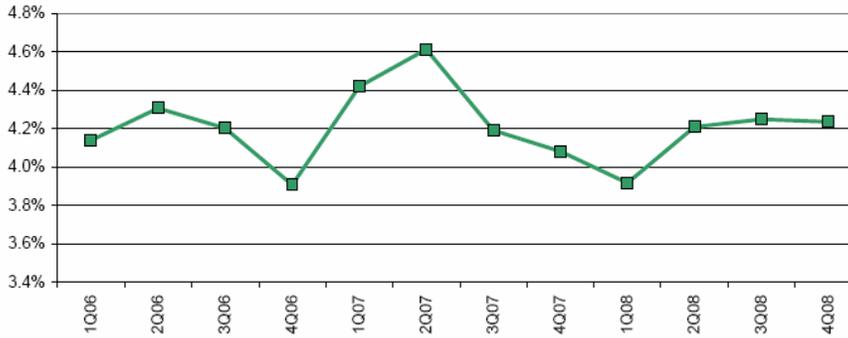
Appendix

Historical Subscriber-Acquisition Costs



Sources: Company reports and William Blair & Company, L.L.C. estimates

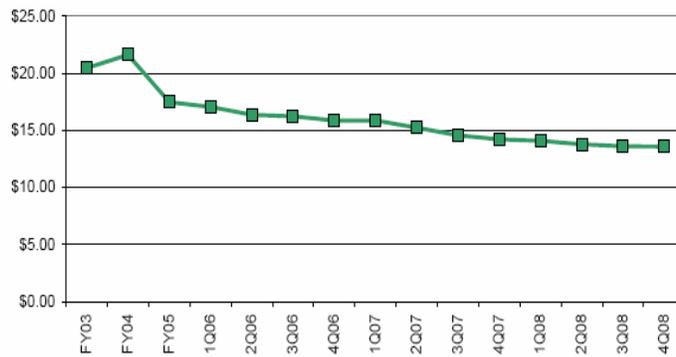
**Netflix, Inc.
Historical Churn Rate Percentage***



*The churn rate provided above is cancellations in a period as a percentage of beginning subscribers + gross add

Sources: Company reports and William Blair & Company, L.L.C. estimates

**Netflix, Inc.
Average Revenue Per Paying Subscriber**



Source: Company reports

End Notes

¹ Netflix, Inc. FY 2008 10-K

² <http://premium.hoovers.com/subscribe/co/factsheet.xhtml?ID=rffkhtkssjckrj>

³ Netflix, Inc. FY 2008 10-K

⁴ <http://premium.hoovers.com/subscribe/co/factsheet.xhtml?ID=rffkhtkssjckrj>

⁵ <http://premium.hoovers.com/subscribe/co/factsheet.xhtml?ID=ffffrtrxxfcksxkct>

⁶ <http://www.businessinsider.com/2009/2/netflix-1-million-subscribers-streaming-via-xbox-360>

⁷ <http://www.fmsdevelopment.com/wp/?p=127>

⁸ <http://banker.thomsonib.com/ta/?ExpressCode=claremontuniv>

⁹ Netflix, Inc. FY 2008 10-K