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TEACHING NOTE

Netflix, Inc.

Case Overview

The case opens with "The Crown," a Netflix original series, winning the Golden Globe for best television drama. This public recognition leads CEO Reed Hastings to reflect on Netflix's history and current strategic challenges. In less than two decades, Netflix has grown from a DVD-by-mail service into a $55-billion-dollar global company. Along the way, it disrupted established industry players and changed how television is watched. Netflix's success has attracted the attention of aggressive competitors like Amazon, HBO, and Hulu. Netflix must find ways to work with Internet service providers (ISPs) to ensure that subscribers can access that content. As Netflix expands internationally (to 190 countries), it needs to ensure that it invests in the content that will be relevant to its customers. How can Netflix keep subscribers loyal and acquire new ones?

The case outlines the history of Netflix starting with the state of video-on-demand and home Internet technology in the 1990s. Netflix combined the newly developed DVD technology and rapid adoption of home Internet to create a business based on renting movies by mail. This innovation disrupted established brick-and-mortar competitors. The case focuses on how Netflix successfully overtook Blockbuster, entered into video streaming, and integrated backward into content production. Emphasis is placed on how Netflix anticipated and reacted to changes within the video-on-demand industry.

The case goes onto describe Netflix's current competitors, including:

1. Redbox, who continues to pursue the rental of DVDs
2. HBO Now, Hulu, and Sling TV, who were established by companies already operating within the television industry
3. YouTube Red and Amazon Video, who were established by technology-driven companies and have, like Netflix, also begun developing their own content

Netflix's challenges are described in detail towards the end of the case. Netflix is spending $6 billion annually on content. This budget is split between its own original content and licensed material that is often sourced from competitors. As Netflix expands internationally it needs to match its content to a more diverse audience. Netflix must also work with ISPs to ensure that its subscribers can access its service. Netflix's recent experience with Comcast illustrates the contentious nature of these relationships.

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

The case concludes with Hastings posing one final question: How can Netflix ensure its continued success? Like Blockbuster, Netflix grew quickly by disrupting an industry. How can Netflix manage disruption and stay ahead of the competition?

Key Concepts

- Strategy process
  - Planned emergency
- The Long Tail: Selling More of Less
- Innovation and technology strategy
  - Disruptive innovation
- Business model innovation
  - Matching of business model and technology strategy
- Network effects
- Core competencies and imitation by competitors
- Diversification
  - Vertical integration along the value chain
  - Products and services
  - Geography
- International expansion
  - The CAGE Distance Model
  - Liability of foreignness

Suggested Discussion Questions

1. Describe Netflix's strategy process over time. What approach to the strategy process does Netflix follow? What works well with this approach? What are some challenges with this process, especially as Netflix continues to grow fast?

2. **How was Netflix able to disrupt the U.S. home entertainment industry? Describe Netflix's innovation strategy over time. Also, how did Netflix's business change over time? How did its business model innovation support its technology strategy?**

3. **What are Netflix's core competencies? How can they help Netflix to sustain its competitive advantage? How must its core competencies be honed and modified?**

4. **Netflix growth in the United States seems to be maturing. How could Netflix increase demand for its services in the United States? What other services could Netflix offer to drive future growth?**

5. **International expansion appears to be a major growth opportunity for Netflix. What challenges does Netflix face by going beyond the U.S. market? What can Netflix do to address some of the challenges encountered when going internationally? And which international markets should Netflix focus on, and why?**

Suggested Answers

1. Describe Netflix's strategy process over time. What approach to the strategy process does Netflix follow? What works well with this approach? What are some challenges with this process, especially as Netflix continues to grow fast?

With a few notable exceptions, Netflix has followed the planned emergence strategy process throughout its history. Netflix's intended strategy of renting and selling DVDs by mail service was developed by Reed Hastings and Marc Randolph, but they quickly modified it based on autonomous actions, serendipity, and the resource allocation process. See **Exhibit TN-1**.

The Netflix Queue feature, for instance, was inspired by Christina Kish's (head of marketing) frugal reading habits. She used bookstores to browse for books, making a list for later use at the library. Although Kish was not a lower-level employee, this could be considered an example of an autonomous action because of Netflix's small size at the time.

Netflix's serendipitously gained a reputation for having hard-to-find niche and foreign films. Netflix's recommendation engine was designed to steer users to in-stock DVDs to avoid customer disappointment. Stocking large numbers of newly released films would have been expensive so Netflix instead purchased cheaper, older films to fill demand. As the recommendation engine matched users to these films, Netflix found that customers appreciated the lesser known films and viewed at a point of differentiation from competitors fixated on stocking new releases. Netflix was thus able to benefit from demand in the Long Tail.

The Internet enables digitization of information-based goods and services such as music, books, and movies. As a consequence, it acts as an especially disruptive force. Everything that can go digital will—creating some losers and some winners. These observations and their strategic implications have been popularized by Chris Anderson in *The Long Tail: Why the Future of Business is Selling Less of More* (see **Exhibit TN-2**).

The "long tail" phenomenon is that 80 percent of offerings in a category are not big hits. It turns out that 80 percent of sales in a given product category (such as movies, books, and songs) come from blockbusters in the "short head" of the distribution curve, which represents only 20 percent of the offerings in a category. This phenomenon is captured by the *Pareto principle,* also known as the 80-20 rule, which says that roughly 80 percent of effects come from 20 percent of the causes.

The short head represents the mainstream, where all the blockbusters, bestsellers, and hits are to be found. These products tend to appeal to the largest segment of the market with homogenous tastes.

In the physical world of brick-and-mortar retail stores, such limited product selections are often the only choice on display (in Blockbuster video rental stores, for example), because there are significant costs to carrying broader inventory to meet a wider variety of consumer needs.

Netflix benefited by applying the concept of the Long Tail. Netflix collects large amounts of data about users' viewing habits and preferences. This allows them to use an effective resource allocation process when making content investments. Before producing "House of Cards," for example, Netflix checked that there was an audience that liked films with Kevin Spacey and films directed by David Fincher. Netflix has continued following the data with new content, which allows the market to shape their content.

On occasion, Netflix has made mistakes when it relies on top-down strategic initiatives instead of following planned emergence. For example, Hastings' 2011 decision to spinoff DVD by mail subscriptions and form Qwikster was made based on his "obsession with not getting trapped by DVDs." Customers were quick to voice their dissatisfaction about the move (see large drop in share price in **Exhibit 3** in the case), causing Netflix to reverse it.

Netflix's planned emergence strategy process has allowed it to better meet customer expectations and differentiate itself from competitors. As Netflix continues to grow in the U.S. and globally, maintaining this organic and more flexible strategy process may become more difficult as additional layers of management develop and Netflix endeavors to match its service to a more diverse customer base with a wider range of preferences.

2. **How was Netflix able to disrupt the U.S. home entertainment industry? Describe Netflix's innovation strategy over time. Also, how did Netflix's business change over time? How did its business model innovation support its technology strategy?**

Netflix disrupted the U.S. home entertainment industry several times in its short history through value innovation and network effects.

Netflix disrupted video stores by combining developments in video-on-demand and home internet technologies to create a movie rental by mail business. This is an example of value innovation. At the time, customers' only option for renting a movie was visiting a brick-and-mortar store such as Blockbuster. These stores offered instant gratification and focused on having newly released movies in stock. However, customers were faced with late fees if they did not return their rental on time. In 1997, movie stores were stocking VHS tapes. Netflix innovated on value by trading instant gratification for the convenience of home delivery. Niche and foreign films replaced the new releases. The use of DVDs made shipping economical, but also offered higher-quality video. Finally, by using subscription all-you-can-eat pricing, Netflix eliminated the late fees that aggravated customers.

Netflix also disrupted the television industry with value innovation. Netflix's streaming service differentiated itself from cable television by making tradeoffs. By initially focusing on older "rerun TV" and not including local content or sports, Netflix was able to price its subscription service considerably cheaper than cable bundles. Netflix improved the viewing experience by allowing users to watch shows and movies without commercial breaks and on-demand. Netflix also created the phenomenon of "binge watching," making all episodes of a show available at once.

Netflix has been able to leverage network effects in its growth. When it entered the streaming market, it already had a customer base in the DVD rental business. This established network gave it

a foothold when entering into streaming business. As Netflix acquired additional streaming content, it increased the value its subscription service to customers and resulted in more people signing up. With more customers, Netflix could then afford to provide more and higher quality content, which further increased the value of the subscription. This created a created a virtuous cycle that increased the value of a Netflix subscription as more subscribers signed up (see **Exhibit TN-3**).

As the streaming service has grown in popularity, Netflix is now on track of disrupting Hollywood. Netflix entered into streaming with "rerun TV." However, as its subscriber base and content budgets have increased considerably it has been able to move up into higher segments. Netflix was able to disrupt the U.S. home entertainment and movie industries by "riding" the steep technology trajectory (see **Exhibit TN-4**). Netflix was fast to take advantage and employ the latest technology, moving quickly from dial-up modems to streaming over the internet, as broadband has become ubiquitous in the U.S. (see **Exhibit 1** in the case).

Netflix, moreover, has backward integrated into content production and now produces original series with quality rivaling that of films. Since the streaming service is on-demand, Netflix has been able to change the format of high-end productions from movies to series. This allows writers greater storyline development and creative freedom.

3. What are Netflix's core competencies? How can they help Netflix to sustain its competitive advantage? How must its core competencies be honed and modified?

Looking inside the firm allows us to identify core competencies (see **Exhibit TN-5**). Netflix's core competencies include its

- proprietary recommendation engine
- data-driven content investment
- network infrastructure management

Netflix's proprietary recommendation engine allows it to present a personalized experience for each user and anticipate what content that user will enjoy. This system has been carefully refined to make Netflix engaging for users. In that sense, Netflix is a "software company."

By continuously gathering viewing data directly from subscribers, Netflix has a unique advantage over competitors in the film and television industries that rely on market surveys and third parties to assess the success of their content (such as ratings data from Nielsen). This allows Netflix to use its proprietary data to drive investments in both licensed content and Netflix Originals.

Netflix's network infrastructure places the large amounts of data needed to support streaming content closer to customers. This allows them to reduce their reliance on the internet backbone which improves the streaming quality and improves relationships with ISPs. Netflix is now able to predict fairly accurately what consumers will watch at what time and location (see **Exhibit TN-6**).

Netflix's core competencies are difficult and expensive to match creating significant barriers to entry in the streaming video market. Netflix can sustain its competitive advantage by continuing to invest in these competencies. In this sense, Netflix core competencies serve as an important isolating

mechanism, protecting its competitive advantage for the time being. Netflix, however, will have to look for other ways to compete as companies like Amazon gain similar abilities.

4. **Netflix's growth in the United States seems to be maturing. How could Netflix increase demand for its services in the United States? What other services could Netflix offer to drive future growth?**

With Netflix's growth in the U.S. maturing, Netflix may need to diversify its offerings to increase demand for its services or consider additional revenue streams to drive future growth. This could be achieved through related-constrained, related-linked, or unrelated diversification (see **Exhibit TN-7**).

In general, Netflix chooses content that is not time-sensitive and avoids perishable content like sports and news. If Netflix wishes to continue growing streaming domestically and competing against Sling TV and other over-the-top broadcasters, it may need to expand into other categories of content like sports and news. On the other hand, rights to broadcast live sporting events are becoming prohibitively expensive because they are one of the few remaining TV content where viewers cannot skip ads.

Another option is to focus on demographics that it has not reached with its current offerings. Netflix is uniquely positioned to be able to provide content in the language of users' choice. By increasing the amount of content available in multiple languages, Netflix could take market share from foreign-language stations operating in the U.S. These are all examples of related-constrained diversification.

Unlike other media companies such as Disney, Netflix does not look to revenue streams outside of subscription fees (at this point). Netflix may be able to tap into other revenue opportunities such as licensing content-related merchandise, advertising, and product placement. These are examples of related-linked diversification.

Last, Netflix could consider unrelated diversification and invest businesses unrelated to video streaming and content production. This is an unlikely scenario based on Netflix's history, but competitors like Amazon and Google (YouTube) are involved in a wide range of business activities and Netflix could follow suit.

5. **International expansion appears to be a major growth opportunity for Netflix. What challenges does Netflix face by going beyond the U.S. market? What can Netflix do to address some of the challenges encountered when going internationally? And which international markets should Netflix focus on, and why?**

As Netflix expands rapidly outside the U.S., it will encounter new audiences and regulatory environments. Netflix announced in 2016 that it will expand across the globe to 190 countries. That is basically every country in the world, other than North Korea. Yet, one notable exception at this point remains China. Albeit a huge potential market for Netflix, Reed Hasting emphasized in early 2017, that Netflix still remains in the relationship building phase with China.

The new (non-U.S.) audiences will be challenging for Netflix because it has less historic data on their viewing and queue preferences, and there may be several smaller niche audiences globally compared to the U.S. With operations in 190 countries, Netflix will need to provide content that matches

desires of these consumers in languages that they speak. This could make content decisions considerably more difficult going forward. These countries also have different regulatory environments that could affect Netflix's operations and profitability. The case mentions that the European Commission is considering subsidy pots for local content. Netflix will need to find ways to appease these regulators. One way Netflix is doing this already is by producing some content locally in the countries where it operates (see **Exhibit TN-8**).

Netflix should focus first on the countries where it can operate profitably. Netflix's streaming service requires high-speed Internet connections and customers with disposable income to afford the service. This eliminates many countries that have rural and lower-income populations. Translation of existing content and developing relevant local content will be a significant expense that must be supported by subscription fees. Netflix should look at countries and blocks of countries sharing a common language where existing content can be made relevant with translation. Alternatively, Netflix could also consider countries that have large enough populations to support the development or licensing of content relevant to the local population. Finally, Netflix should consider the regulatory environment as many countries may be unwelcoming of a U.S. company or video content. In the 1990s, for example, MTV learned that even music videos did not have a global audience per se, but that viewers preferred local content, or at least local adaptations of content. Netflix needs to address the trade-off between global integration (to drive down cost) and local responsiveness (which increases cost, but also value) (see **Exhibit TN-9**).

Based on these criteria, Canada, Western Europe, Australia, Japan, and India may be good countries to focus on. Netflix has expanded quickly to a vast number of 190 countries. However, this shotgun approach may not be successful in the long-run. Netflix should be able to use its competency in data analytics to determine which countries to focus on in the future.

Additional Resources

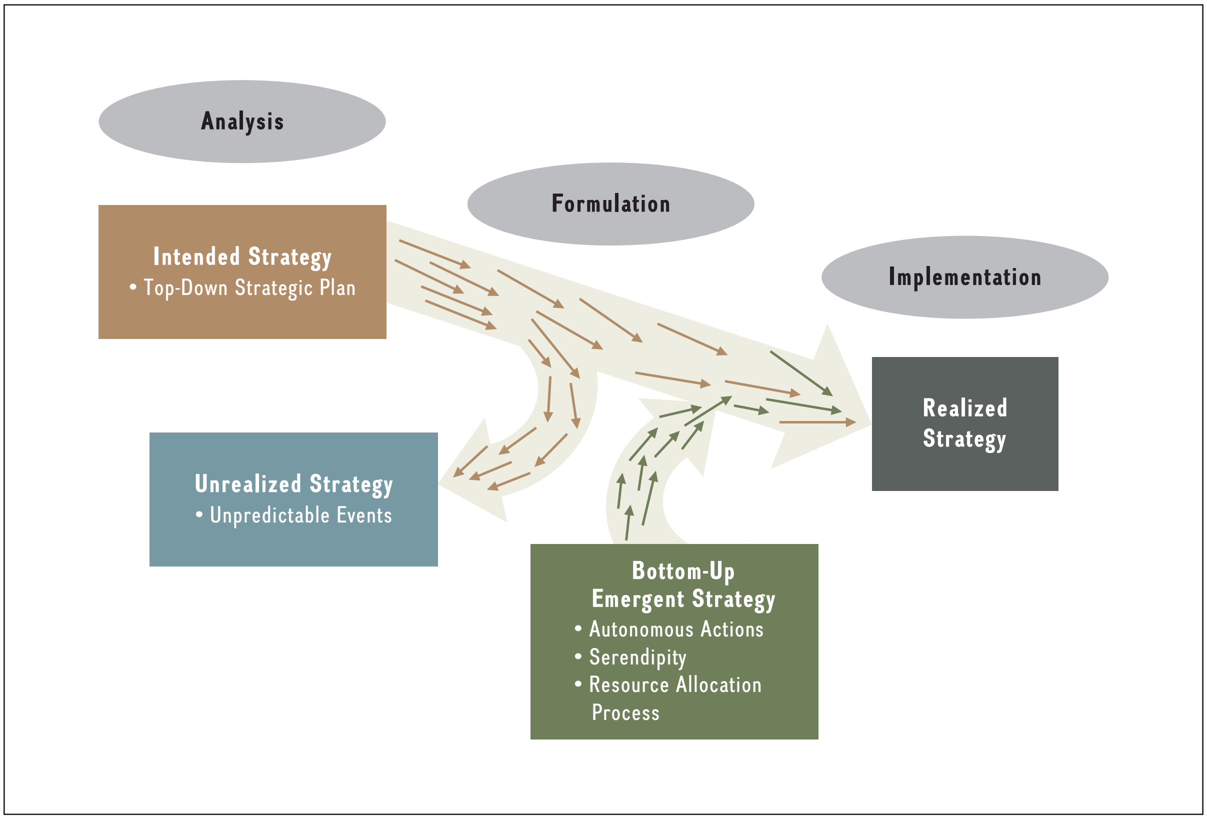
1. Articles

   - "Streaming on screens near you. Can Netflix stay atop the new, broadband-based television ecosystem it helped create?," *The Economist,* August 20, 2016 http://www.economist.com/news/business/21705353-can-netflix-stay-atop-new-broadband-based-television-ecosystem-it-helped-create-streaming
   - King, Andrew A., and Baljir Baatartogtokh. "How Useful Is the Theory of Disruptive Innovation?" *MIT Sloan Management Review,* Fall 2015.

2. Videos

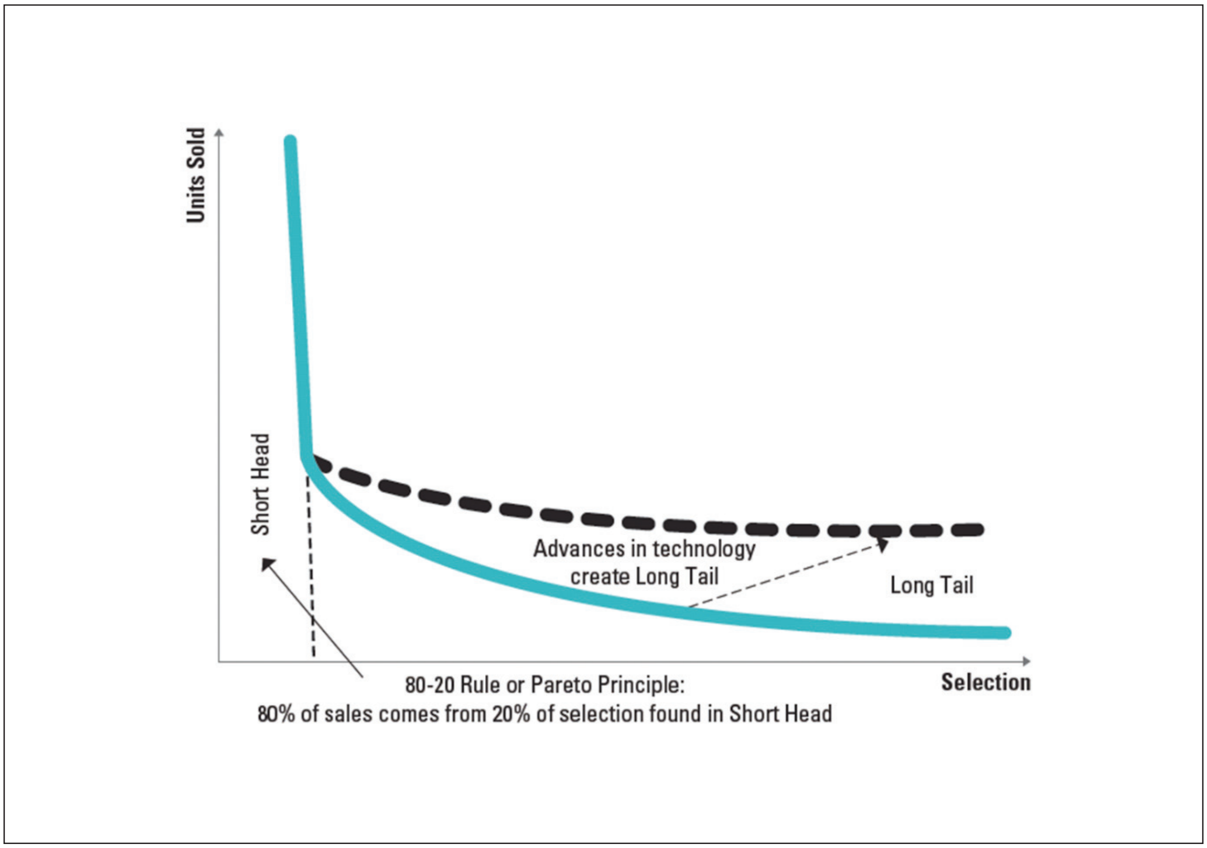
   - "Netflix CEO Reed Hastings talks with WSJ Financial Editor Dennis K. Berman at the 2016 *WSJDlive Conference* in Laguna Beach, CA," *October 26, 2016* https://www.youtube.com/watch?v=pBg3q2vHCLg [25:04 min]

EXHIBIT TN-1 Strategy as Planned Emergence: Realized Strategy as a Combination of Top-Down Intended Strategy and Bottom-Up Emergent Strategy



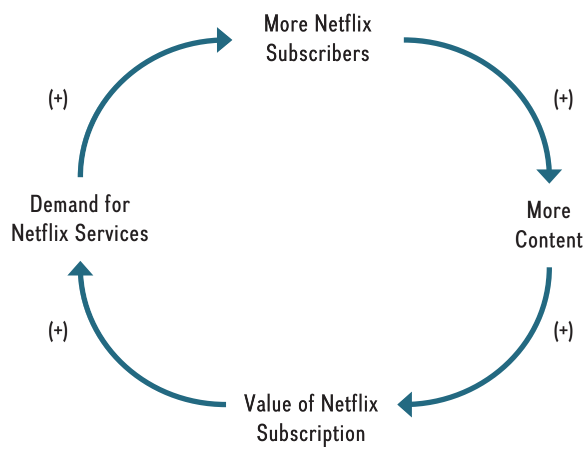
Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.

EXHIBIT TN-2 The Short Head and the Long Tail



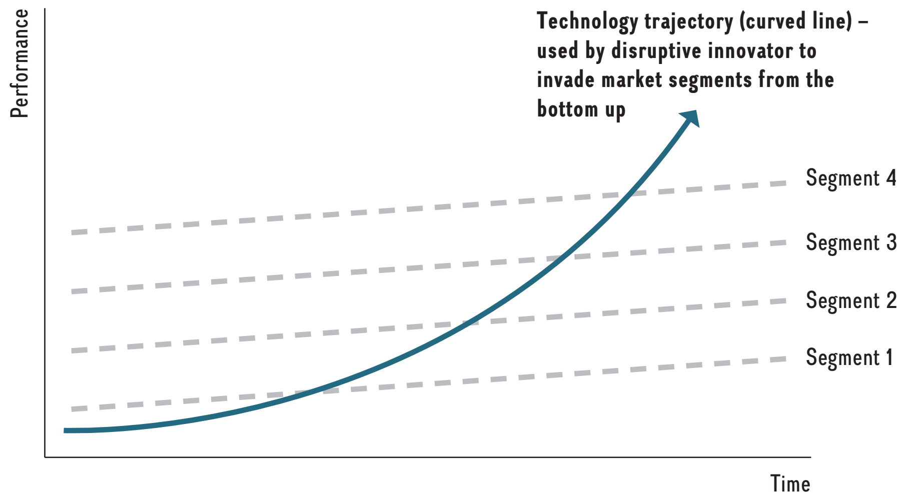
Source: Rothaermel, 1/e.

EXHIBIT TN-3 Netflix Business Model: Leveraging Network Effects to Drive Demand



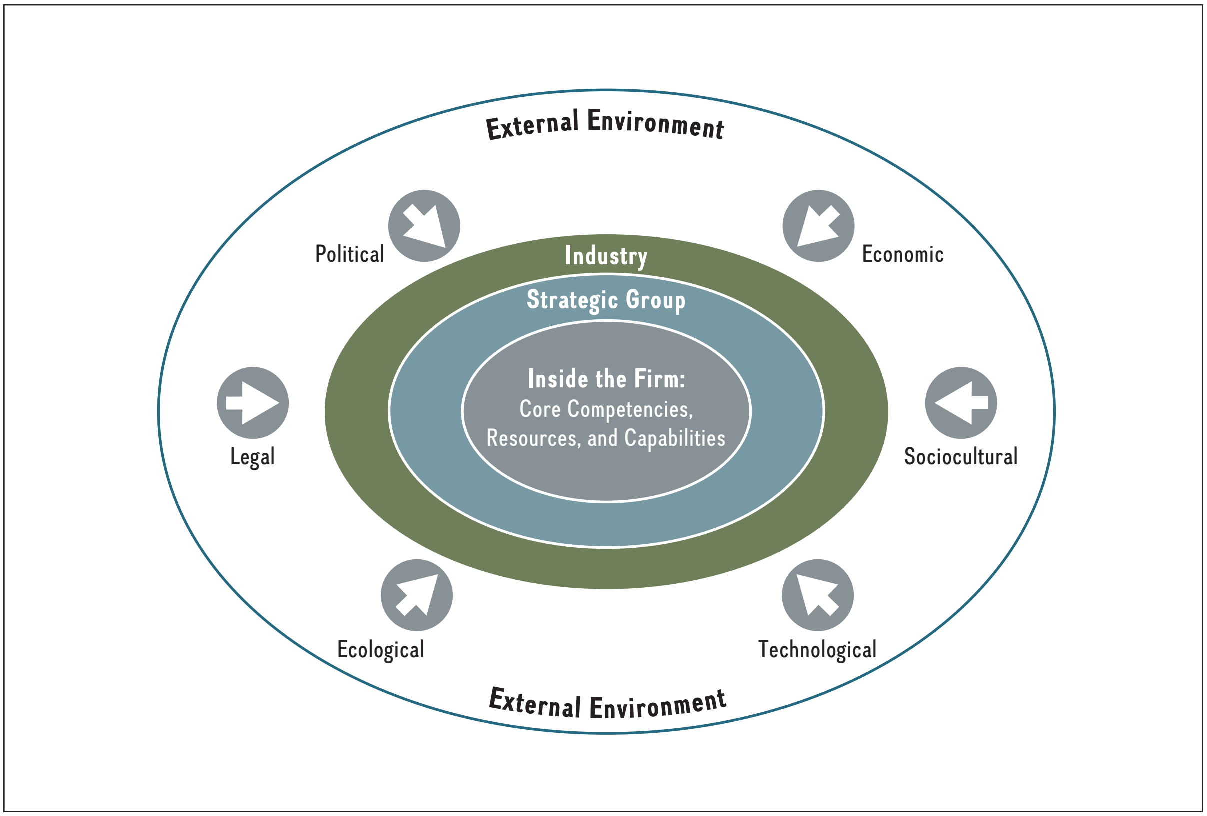
Source: Author's creation.

EXHIBIT TN-4 Disruptive Innovation: Riding the Technology Trajectory to Invade Different Market Segments from the Bottom Up



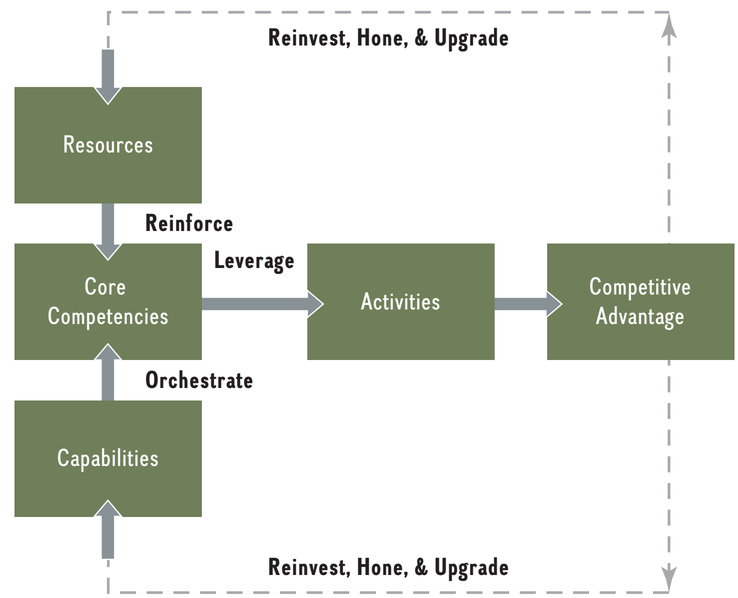
Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.

EXHIBIT TN-5 Inside the Firm: Competitive Advantage Based on Core Competencies, Resources, and Capabilities



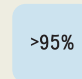
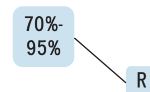
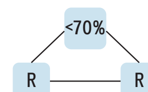
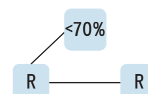
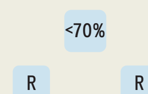
Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.

EXHIBIT TN-6 Linking Core Competencies, Resources, Capabilities, and Activities to Competitive Advantage and Superior Performance



Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.

EXHIBIT TN-7 Four Main Types of Diversification

Revenues from Primary Business	Type of Diversification	Competencies (in products, services, technology or distribution)	Examples	Graphic
>95%	Single Business	Single business leverages its competencies.	Birkenstock Coca-Cola Facebook	
70%–95%	Dominant Business	Dominant and minor businesses share competencies.	Harley-Davidson Nestlé UPS	
	Related Diversification			
	Related-Constrained	Businesses generally share competencies.	ExxonMobil Johnson & Johnson Nike	
<70%	Related-Linked	Some businesses share competencies.	Amazon Disney GE	
	Unrelated Diversification (Conglomerate)	Businesses share few, if any, competencies.	Alphabet Berkshire Hathaway Yamaha	

Note: R = Remainder revenue, generally in other strategic business units (SBUs) within the firm.

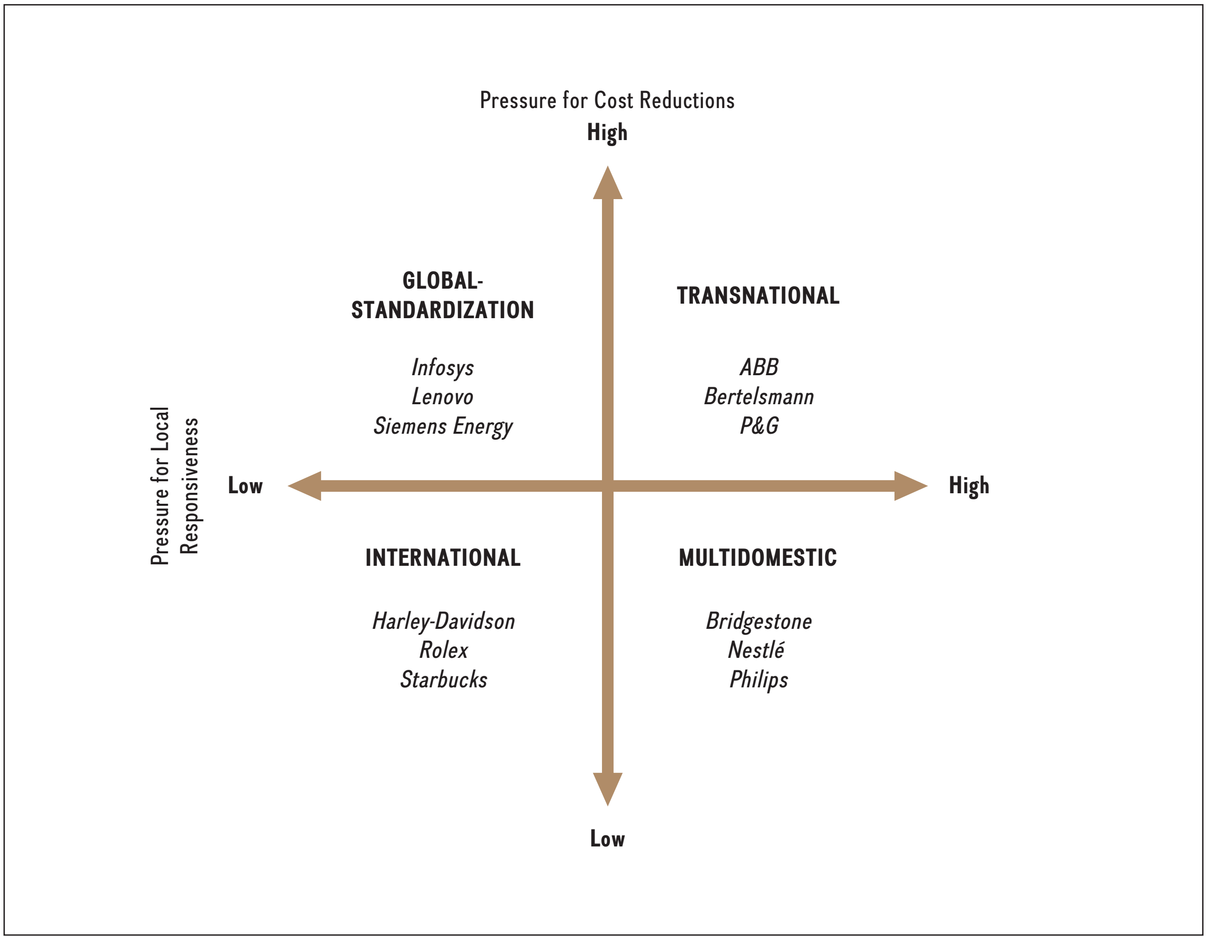
Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.

EXHIBIT TN-8 The CAGE Distance Framework

Distance	C Cultural	A Administrative and Political	G Geographic	E Economic
between two countries increases with...	• Different languages, ethnicities, religions, social norms, and dispositions • Lack of connective ethic or social networks • Lack of trust and mutual respect	• Absence of trading bloc • Absence of shared currency, monetary or political association • Absence of colonial ties • Political hostilities • Weak legal and financial institutions	• Lack of common border, waterway access, adequate transportation, or communication links • Physical remoteness • Different climates and time zones	• Different consumer incomes • Different costs and quality of natural, financial, and human resources • Different information or knowledge
most affects industries or products...	• With high linguistic content (TV) • Related to national and/or religious identity (foods) • Carrying country-specific quality associations (wines)	• That a foreign government views as staples (electricity), as building national reputations (aerospace), or as vital to national security (telecommunications)	• With low value-to-weight ratio (cement) • That are fragile or perishable (glass, meats) • In which communications are vital (financial services)	• For which demand varies by income (cars) • In which labor and other cost differences matter (textiles)

Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.

EXHIBIT TN-9 The Integration-Responsiveness Framework: Global Strategy Positions (and representative MNEs)



Source: Rothaermel, F.T. (2018), Strategic Management, 4th edition. Burr Ridge, IL: McGraw-Hill.