

# The Rise of Netflix

By

Richard Trench

# **1. Introduction**

Netflix is the world's largest internet television network offering on-demand TV programming to almost any internet connected screen. Today, Netflix has over 93 million subscribers in more than 190 countries (Netflix, Inc., 2016). This report will examine the rise of Netflix from a DVD rental company, to what it has become today, and discuss what the future may hold in an ever more competitive market for the company.

The report will begin by discussing the history of Netflix from its initial establishment as an online DVD rental company and then plot its rise, and look at how it used technology, in particular the internet in achieving the steady growth that has taken it to the dominant position it holds today. Next, the report will look at Netflix's pricing strategy and examine its success and failures in this regard along with discussing some of Netflix's innovations and how they have added to the company's success.

The next section of the report will look at what the future may hold for Netflix. With competition increasing in recent years, and this trend expected to continue, the report will look at Netflix's current strategy and attempt to determine if this strategy is the correct one, and identify what, if any improvements can be made to this.

## **2. Institutional Background**

### **2.1 A Brief History of Netflix**

Netflix was founded by Reed Hastings and Marc Rudolf, in California in 1997 as an online DVD rental store (CNN, 2014). The two men are still heavily involved in the running of the company with Reed Hastings being the current CEO and majority shareholder (Frank, 2015). Up to the time Netflix was established, the movie rental model was the traditional bricks and mortar type movie store, where customers came to the movie store, browsed through the selection of movies and were charged a per-rental fee to rent movies. The movies had to be returned within a certain timeframe to avoid incurring additional fees. Netflix however attempted to disrupt this well-established model, through only offering its movies online from its website. Initially Netflix kept the traditional pay-per-rental model for its online rentals however, in 1999, they adopted a subscription model where customers paid a monthly subscription fee and could rent an unlimited number of DVDs while holding a no more than a specified number of DVDs at any one time depending on their subscription plan (Mason, 2002). The model proved to be extremely successful and by the time the company went public in 2002, Netflix had over 850,000 subscribers in the US and revenues had reached over US\$150 million (Netflix, 2002). Netflix were the first movers in the online rental model, and by 2003 they controlled around 95% of the market and had almost 1.5 million subscribers. Each subsequent year saw steady growth in terms of subscribers

and revenues and in 2007, Netflix launched its online video streaming service allowing subscribers to watch content on demand on their home computers. By this time, the company were generating revenues of US\$1.2 billion and had over 7.5 million subscribers (Kaufman, S. et al. 2009).

Improvements in internet connectivity speeds helped to accelerate Netflix's rapid growth and by 2010, its internet streaming service had over taken its DVD rental service to become the company's core operation. Netflix's financial report (2010) shows that the more than 20 million subscribers generated revenues of over US\$2.1 billion in that year. In the following years, Netflix expanded its online streaming services internationally and today, the service is available in over 190 countries. Netflix have also over the years increased the range of content available on its service and the company now produce its own content as well as delivering content from other providers. Netflix employ around 4700 people worldwide and generated revenues of almost US\$9 billion in 2016 (Netflix, Inc., 2016)

### **3. The Rise of Netflix**

As can be seen from the brief history of Netflix, the company's rise from 1997 to today has been exponential. We will now examine the main drivers of this growth and discuss how Netflix have used them to their advantage.

#### **3.1 Changing Technology**

Since the company's inception, Netflix have adopted the newest and most modern technologies. Johnson et al. (2014), describe companies like Netflix, that are early adopters of technologies and advancements like this as 'lead users',

When the company began its operations, video cassettes were the main medium used by movie rental companies such as Blockbuster and Movie Gallery. DVDs however, which were in their infancy at the time, were lighter, more durable and cheaper to deliver by post (Mason, 2002). Netflix used this new technology to their advantage choosing them over video cassettes. This decision to adopt a new and emerging technology was a brave move and helped to establish Netflix as a dominant player in the industry.

Around the time Netflix was established, the internet was also new and emerging. Netflix used the internet to challenge the traditional bricks and mortar style movie stores by using the internet for customers to order movies. Establishing their business online, rather than having a network of physical stores helped to give Netflix a competitive over their traditional movie store competitors by greatly reducing costs. Netflix also developed a sophisticated algorithm that has been updated and improved over the years. The algorithm personalises users experience with the company by making

recommendations to customers based on certain criteria such as movies they have previously rented and how they rated them (Hallinan, 2016; Gaglani, 2014).

### **3.2 Operating Online**

Netflix were pioneers of online DVD rentals, challenging the traditional 'bricks and mortar', type walk-in movie rental store (Mason, 2002). They then also pioneered, and became the dominant player in the online movie streaming service (CNN, 2014), so much so that as of 2014, Time Magazine (2014), reported that during peak hours in the US, Netflix accounted for more than one third of internet traffic. This is in sharp contrast to its main competitor, Amazon Video which only accounted for around 2.5% of internet traffic during the same period.

Following a corruption of their data bases in 2008 that resulted in delays and cancellations of their services, Netflix have migrated their operations to cloud based service. While for most users the migration that began in 2008 and took almost seven years will not be noticeable, the migration delivers a more reliable service, more security with billing and better scalability globally for the company (Netflix, 2016).

The decision for Netflix to operate solely online, has indeed proven to be massively successful. When Netflix was established, the main players in the of movie rental market were Blockbuster and Movie Gallery, as well as a plethora of independently owned movie rental stores. These all employed the traditional bricks and mortar model. Netflix radically changed the face of the movie rental market when they entered the market. Senior management in companies like Blockbuster failed to recognise the potential that operating online brought, and while they did make some attempts to capture a share of the online sector, their decisions to remain primarily focused on the walk-in movie store model ultimately lead to their demise (Satell, 2014).

### **3.3 Pricing Strategies**

As previously mentioned, Netflix began with a more traditional pricing strategy of charging customers per rental, which in 1999 they changed to the current subscription based model. The subscription model offers better value for heavy users as they receive unlimited viewing for the monthly subscription fee. Initially the monthly subscription fee allowed subscribers to view content online and avail of the DVD postal service. However, in 2011, CEO Reed Hastings devised a plan to split the online and DVD service. The split meant that for subscribers who wished to avail of both services, their subscription fee would increase by 60%. The move was massively unpopular with subscribers and damaging to Netflix's business. The company's stock fell by 77%, they lost over 800,000 subscribers and the company's reputation was badly damaged (Stewart, 2013).

This incident serves as proof that companies like Netflix need to be acutely aware of the price sensitivities of their customers, and that they will not react well to unjustified price hikes. Extensive market research should always be carried out prior to such a move. This allows for identification of possible issues that may arise, and avoid detrimental incidents like the one described with Netflix. Netflix today however, demonstrate that they are aware of this requirement. In their annual report (2016), they mention that any price increases will be viewed unfavourably by subscribers if price increase are not accompanied by better value.

Today, the company offer a range of pricing tiers, the higher the price, the more options and choice the subscriber receives (Pelts, 2016). In Australia, the basic subscription fee is \$8.99 per month, with the premium offering costing \$14.99 per month. The premium service offers subscribers content in ultra-high definition and the ability to watch content on up to 4 devices. Netflix also offer subscribers one month free in an effort to attract customers to their service (Netflix, Inc., 2016).

Netflix's average price is much lower than their main competitors HBO Now, Dish's Sling TV and Hulu however, Netflix have stated that they intend to increase their pricing in the future as they deliver more value (Pelts, 2016). For now, while their prices are lower than their competitors, it is reasonable to expect that their market domination will prevail.

### **3.4 Netflix's Innovation**

Netflix have used what Johnson et al. (2014), describe as 'process innovation'. This concept essentially is introducing a new technology or process for delivering something that already exists. Netflix did this by radically changing the way that movies were delivered to customers, firstly by adopting DVDs, and secondly by using the internet as the medium for delivery.

Netflix also disrupted the traditional movie rental method, with rentals having to be returned by a certain due date, Netflix's subscription model meant that there were no due dates, this was hugely innovative at the time and played a major part in Netflix achieving market dominance (Allen et al. 2014)

Another innovation that Netflix pioneered is their movie ratings and recommendations system. This involves the use of a sophisticated algorithm that personalises user's experiences and suggests various content based on past viewings and various other factors (Mason, 2002).

Netflix are also at the cutting edge when it comes to research and analysis of what viewers want to watch (Ranshoff, 2010). This advanced research has resulted in Netflix producing acclaimed shows such as House of Cards, 13 Reasons Why and Narcos (Netflix, 2017). Continued investment in this research will help Netflix maintain their dominance and achieve their long-term goal of having 50% of its content produced in house (Forbes, 2016).

## **4. Will Netflix Remain the Dominant Provider?**

This section will examine what the future may hold for Netflix and determine if they can maintain their dominance in the industry.

### **4.1 What is the Netflix Strategy?**

Netflix (2016), have stated that their strategy is to continue to grow their internet streaming service globally and expand their content, focusing on in-house produced content. This year alone, they are expected to increase spending to US\$6 billion on their own productions (Forbes, 2016). According to Jenner (2016), Netflix offers viewers a 'model of individualised viewing practices and self-scheduling on TV'. This strategy of personalising what they deliver to viewers will be key in Netflix's continued success.

### **4.2 How is Netflix Currently Performing?**

Netflix is currently performing extremely well. Its share price has quadrupled in the last 3 years and they company continues to grow its subscriber base and exceed analysts' predictions (Salapa, 2016). According to Salapa (2016), Netflix are also being prudent in focusing more spending and attention on producing its own content rather than acquiring content from third parties. This is helping to keep its cost down, as acquisition of content tends to be more expensive than in-house production.

### **4.3 The Future for Netflix**

Up to 90% of TV viewing is still via the traditional linear TV, which means that it is viewed when it is broadcast (Fontaine, 2013). However, according to an investigation carried out by Kantar Media for Ofcom in the UK (2016), younger viewers are opting more for non-linear, or on-demand viewing. This would suggest that moving forward, the need for on-demand content like that of which Netflix deliver will continue to grow. As the market leader, Netflix are in a strong position to capture much of this growth. However, Fontaine (2013) also discuss how most traditional broadcasters are now also offering on-demand viewing, so competition in the industry is increasing and will no doubt continue to increase. The competitive nature of the industry is indeed eluded to by Netflix (2016), in their annual report.

Netflix will need to continue to innovate and offer new and ever more compelling products and services to their customers to ensure they can maintain their dominance.

Ensuring that they have the most desirable content will be key. Continuing to develop in-house TV shows and movies as well as entering into agreements with other producers of content such as the one they recently entered with Disney, to stream their content will help in this regard (Forbes, 2013).

According to Jalan (2016), the number of US subscribers is approaching saturation and growth, while continuing, is at a much slower rate than previously. With this in mind, Netflix's strategy of growing globally, while focusing on producing content is prudent and will help to consolidate its US base. Analysts forecast that the company can achieve over 100 million subscribers outside of the US by 2022 (Forbes, 2017).

One major challenge that Netflix will face however in its global expansion is that of piracy. In many countries that Netflix has recently launched, online piracy is rife, and indeed in many Asian countries is considered normal. Indeed in Europe, 56% of online viewers stream movies from pirate operators (Salapa, 2016). According to Liao et al. (2013), the best strategy to counter this piracy is to continually offer superior value. As much of the content available through piracy is of inferior quality, for Netflix to focus on delivering the highest quality possible will be crucial.

## 5. Conclusion

This report has set out to examine the rise of Netflix from its inception as an online DVD rental company to the online movie rental company it has become today, operating in more than 190 countries with over 93 million subscribers. The report has illustrated that Netflix have used modern technology, first with the DVD and then the internet to its advantage. While Netflix have made mistakes in the past with their pricing strategies, it is evident that the company have learned from these mistakes and are now focused on delivering the highest quality in return for any price hikes.

Netflix strategy is to grow their business globally and overall, the future seems bright for Netflix. Their recent entry into production of content has played a big part in their success and with increased spending in this regard, should continue to bring more subscribers.

## 6. References

- Allen, G. D. H. F. D., 2014. THE RISE AND FALL OF NETFLIX: WHAT HAPPENED AND WHERE WILL IT GO FROM HERE?. *Journal of the International Academy of Case Studies*, 20(1), pp. 135-143.
- Boardroom Insiders, 2017. *Reed Hastings*. s.l.:s.n.
- CNN, 2014. *A brief history of Netflix*. [Online]  
Available at: <http://edition.cnn.com/2014/07/21/showbiz/gallery/netflix-history/>  
[Accessed 20 May 2017].

Fontaine, G., 2013. Television 2025: Video as a Service. *Communications & Strategies*, Volume 92, pp. 115-118, 123.

Forbes, 2013. *How Big Can Netflix's U.S. Streaming Business Get?*. [Online] Available at: <https://www.forbes.com/sites/greatspeculations/2013/03/07/how-big-can-netflixs-u-s-streaming-business-get/#6ecdea133966> [Accessed 28 May 2017].

Forbes, 2016. *Original Programming Can Be Netflix's Key Competitive Edge In 2017*. [Online] Available at: <https://www.forbes.com/sites/greatspeculations/2016/12/29/can-original-programming-be-netflixs-key-competitive-edge-in-2017/#222944625cc7> [Accessed 28 May 2017].

Forbes, 2017. *Netflix Subscriber Growth Continues Unabated, As Margins Improve*. [Online] Available at: <https://www.forbes.com/sites/greatspeculations/2017/01/19/netflix-subscriber-growth-continues-unabated-as-margins-improve/#30394fe452dd> [Accessed 28 May 2017].

Frank, R., 2015. *Reed Hastings' Netflix stake tops \$1 billion*. [Online] Available at: <http://www.cnn.com/2015/04/16/reed-hastings-netflix-stake-tops-1-billion.html> [Accessed 20 May 2017].

Gagliani, S. H. M., 2014. What Can Medical Education Learn From Facebook and Netflix?. *Annals of Internal Medicine*, 6 May, 160(9), p. 640.

Hallinan, B. S. T., 2016. Recommended for you: The Netflix Prize and the production of algorithmic culture. *New Media & Society*, 18(1), pp. 117-137.

Jalan, R., 2016. *Netflix business strategy and future readiness*. [Online] Available at: <https://www.linkedin.com/pulse/netflix-business-strategy-future-readiness-ram-jalan> [Accessed 28 May 2017].

Jenner, M., 2016. Is this TVIV? On Netflix, TVIII and binge-watching. *New Media & Society*, 18(2), pp. 257-273.

Johnson, G. W. R. S. K. R. P., 2014. *Exploring Strategy*. 10th ed. Harlow: Pearson Education.

Kantar Media, 2016. *Linear vs. non-linear viewing: A qualitative investigation exploring viewers' behaviour and attitudes towards using different TV platforms and services providers*. [Online] Available at: [https://www.ofcom.org.uk/data/assets/pdf\\_file/0029/68816/km\\_report.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0029/68816/km_report.pdf) [Accessed 28 May 2017].

Kaufman, S. Shih, W. Spinola, D., 2009. *Netflix*. s.l.:Harvard Business School.

Liao, Y. W. Y. C., 2013. What drives purchase intention in the context of online content services? The moderating role of ethical self-efficacy for online piracy. *International Journal of Information Management*, 33(1), pp. 199-208.

Mason, S., 2002. Movies on demand: efficiency combines with new technology in Netflix's DVD rental service. *IIE Solutions*, 34(10), p. 25.

Netflix, Inc., 2010. *Netflix 2010 Annual Report*. [Online] Available at: <http://files.shareholder.com/downloads/NFLX/4502113009x0x460274/17454c5b-3088-48c7-957a-b5a83a14cflb/132054ACL.PDF> [Accessed 20 May 2017].

Netflix, Inc., 2016. *2016 Annual Report*, Washington: UNITED STATES SECURITIES AND EXCHANGE COMMISSION.

Netflix, 2002. *2002 Annual Report*, Washington: Securities & Exchange Commission.

Netflix, 2003. *2003 Annual Report*. [Online]  
Available at:  
[http://files.shareholder.com/downloads/NFLX/4502113009x0x16170/8A618AD4-4E4B-433D-8542-6D12F82828A4/2003AR\\_print.pdf](http://files.shareholder.com/downloads/NFLX/4502113009x0x16170/8A618AD4-4E4B-433D-8542-6D12F82828A4/2003AR_print.pdf)  
[Accessed 20 May 2017 ].

Netflix, 2006. *Letter to Shareholders - Netflix 2006 Annual Report*. [Online]  
Available at:  
<http://www.shareholder.com/visitors/DynamicDoc/document.cfm?CompanyID=NFLX&documentID=1684&PIN=917918661&resizeThree=no&Scale=100&Keyword=Type%20Keyword%20Here&Page=3>  
[Accessed 20 May 2017].

Netflix, 2016. *Completing the Netflix Cloud Migration*. [Online]  
Available at: <https://media.netflix.com/en/company-blog/completing-the-netflix-cloud-migration>  
[Accessed 1 June 2017].

Netflix, 2017. *Netflix Announces Initial Public Offering*. [Online]  
Available at: <https://ir.netflix.com/releasedetail.cfm?ReleaseID=81335>  
[Accessed 20 May 2017].

Netflix, 2017. *Netflix Originals*. [Online]  
Available at: <https://www.netflix.com/au/originals>  
[Accessed 28 May 2017].

Netflix, 2017. *Overview*. [Online]  
Available at: <https://ir.netflix.com/index.cfm>  
[Accessed 20 May 2017].

Pelts, S., 2016. *What Is the Netflix Pricing Strategy?*. [Online]  
Available at: <http://marketrealist.com/2016/10/netflix-pricing-strategy/>  
[Accessed 28 May 2017].

Ranshoff, D., 2010. Proteomics Research to Discover Markers: What Can We Learn from Netflix®?. *Clinical Chemistry*, 56(2), pp. 172-176.

Salapa, G., 2016. *Why Netflix's Financials Are Better Than You Think*. [Online]  
Available at: <https://www.forbes.com/sites/valleyvoices/2016/01/25/why-netflixs-financials-are-better-than-you-think/#6b1ef1d258fb>  
[Accessed 30 May 2017].

Satell, G., 2014. *A Look Back At Why Blockbuster Really Failed And Why It Didn't Have To*. [Online]  
Available at: <https://www.forbes.com/sites/gregsatell/2014/09/05/a-look-back-at-why-blockbuster-really-failed-and-why-it-didnt-have-to/#2fa8e72d1d64>  
[Accessed 28 May 2017].

Stewart, J. B., 2013. *Netflix Looks Back on Its Near-Death Spiral*. [Online]  
Available at: <http://www.nytimes.com/2013/04/27/business/netflix-looks-back-on-its-near-death-spiral.html>  
[Accessed 28 May 2017].

Time Magazine, 2014. *Netflix Is Now a Whopping One-Third of Peak Internet Traffic*. [Online]  
Available at: <http://time.com/3597369/netflix-internet-traffic-share/>  
[Accessed 28 May 2017].

