2013 NETFLIX STRATEGIC ANALYSIS

AMS
CONSULTING

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EXECUTIVE SUMMARY

Netflix, Inc. is an American provider of on-demand Internet streaming media available to North and South America, the Caribbean, United Kingdom, Ireland, Sweden, Denmark, Norway, Finland, the Netherlands, and flat rate DVD-by-mail in the United States, where mailed DVDs are sent via Permit Reply Mail.

The company was established in 1997 and is headquartered in Los Gatos, California. It started its subscription-based digital distribution service in 1999,[3] and by 2009 it was offering a collection of 100,000 titles on DVD and had surpassed 10 million subscribers.

On February 25, 2007, Netflix announced its billionth DVD delivery.[4] In April 2011, Netflix announced 23.6 million subscribers in the United States and over 26 million worldwide.[5] By 2011, the total digital revenue for Netflix reached at least $1.5 billion.[6] On October 23, 2012, however, Netflix reported an 88% fall in third-quarter profits.[7] In January 2013, Netflix reported they had added 2 million U.S. customers during the 4th quarter of 2012 with a total of 27.1 million U.S. streaming customers, and 29.4 million total streaming customers. In addition, revenue was up 8% to $945 million for the same period.[8]

As of mid-March 2013, Netflix had 33 million subscribers.[9] That number increased to 36.3 million subscribers (29.2 million in U.S.) in April 2013.[10]

In 2013, Netflix became a "streaming TV network service" that plans to compete with cable television and network television.[10] Netflix also expressed an intention to eventually make television ratings obsolete.[11] On July 18, 2013 Netflix earned the first Primetime Emmy Award nominations for original online only web television at the 65th Primetime Emmy Awards. Three of its web series, *Arrested Development*, *Hemlock Grove*, and *House of Cards*, earned nominations.[12] Among those nominations were Outstanding Drama Series for *House of Cards*, marking it the first web series to earn a Primetime Emmy Award nomination for Outstanding Series (comedy or drama).

Netflix was founded in 1997 in Scotts Valley, California by Marc Randolph[13][14] and Reed Hastings, who previously had worked together at Pure Software along with Mitch Lowe. Randolph was a co-founder of a computer mail order company by the name of MicroWarehouse. Later he was employed by Borland International as vice-president of marketing. Hastings, once a math teacher, had founded Pure Software, which he had recently sold for $700 million. Hastings invested $2.5 million in start up cash for Netflix.[15] The idea of Netflix came to Hastings when he was forced to pay $40 in overdue fines after returning *Apollo 13* well past its due date.[16] The Netflix website was launched on August 29, 1997[17] with only 30 employees and 925 works available for rent and brought a more traditional, online pay-per-rental model (US $4 per rental plus US $2 in postage; late fees applied).[18] Netflix introduced the monthly subscription concept in September 1999,[19] and then dropped the single-rental model in early 2000. Since that time the company has built its reputation on the business model of flat-fee unlimited rentals without due dates, late fees, shipping and handling fees, or per title rental fees.

Netflix was offered to Blockbuster for $50 million in 2000, but the sale was declined.

Netflix initiated an initial public offering (IPO) on May 29, 2002, selling 5.5 million shares of common stock at the price of US $15.00 per share. On June 14, 2002, the company sold an additional 825,000 shares of common stock at the same price. After incurring substantial losses during its first few years, Netflix posted its first profit during fiscal year 2003, earning US $6.5 million profit on revenues of US $272 million.

In 2005, 35,000 different film titles were available, and Netflix shipped 1 million DVDs out every day.[20]

Netflix developed and maintains an extensive personalized video-recommendation system based on ratings and reviews by its customers. On October 1, 2006, Netflix offered a $1,000,000 prize to the first developer of a video-recommendation algorithm that could beat its existing algorithm, Cinematch, at predicting customer ratings by more than 10%.[21]

In February 2007, the company delivered its billionth DVD[22] and began to move away from its original core business model of mailing DVDs by introducing video-on-demand via the Internet. Netflix grew while DVD sales fell from 2006 to 2011.[23][24]

Netflix has played a prominent role in independent film distribution. Through a division called Red Envelope Entertainment, Netflix licensed and distributed independent films such as *Born into Brothels* and *Sherrybaby*. As of late 2006, Red Envelope Entertainment also expanded into producing original content with filmmakers such as John Waters.[25] Netflix closed Red Envelope Entertainment in 2008, in part to avoid competition with its studio partners.[26][27]

Netflix has been one of the most successful dot-com ventures. A *The New York Times* article from September 2002, said that at the time, Netflix mailed about 190,000 discs per day to its 670,000 monthly subscribers.[28] The company's published subscriber count increased from one million in the fourth quarter of 2002 to around 5.6 million at the end of the third quarter of 2006, to 14 million in March 2010. Netflix's growth has been fueled by the fast spread of DVD players in households; as of 2004, nearly two-thirds of U.S. homes had a DVD player. Netflix capitalized on the success of the DVD and its rapid expansion into U.S. homes, integrating the potential of the Internet and e-commerce to provide services and catalogs that brick and mortar retailers could not compete with. Netflix also operates an online affiliate program which has helped it to build online sales for DVD rentals. The company offers unlimited vacation time for salaried workers and allows employees to take any amount of their paychecks in stock options.[29]

By 2010, Netflix's streaming business had grown so quickly that within months the company had shifted from the fastest-growing customer of the United States Postal Service's first-class mail service to the biggest source of Internet traffic in North America in the evening. In November of that year it began offering a standalone streaming service separate from DVD rentals.[30] On September 18, 2011, Netflix announced its intentions to re-brand and re-structure its DVD home media rental service as an independent subsidiary company called Qwikster, totally separating DVD rentals and streaming.[31][32][33]

Andy Rendich, a 12-year veteran of Netflix, would have been the CEO of Qwikster. The new service would carry video games whereas Netflix did not.[34] Then, in October 2011, Netflix announced that it would retain its DVD service under the name Netflix and would not, in fact, create Qwikster for that purpose.[35]

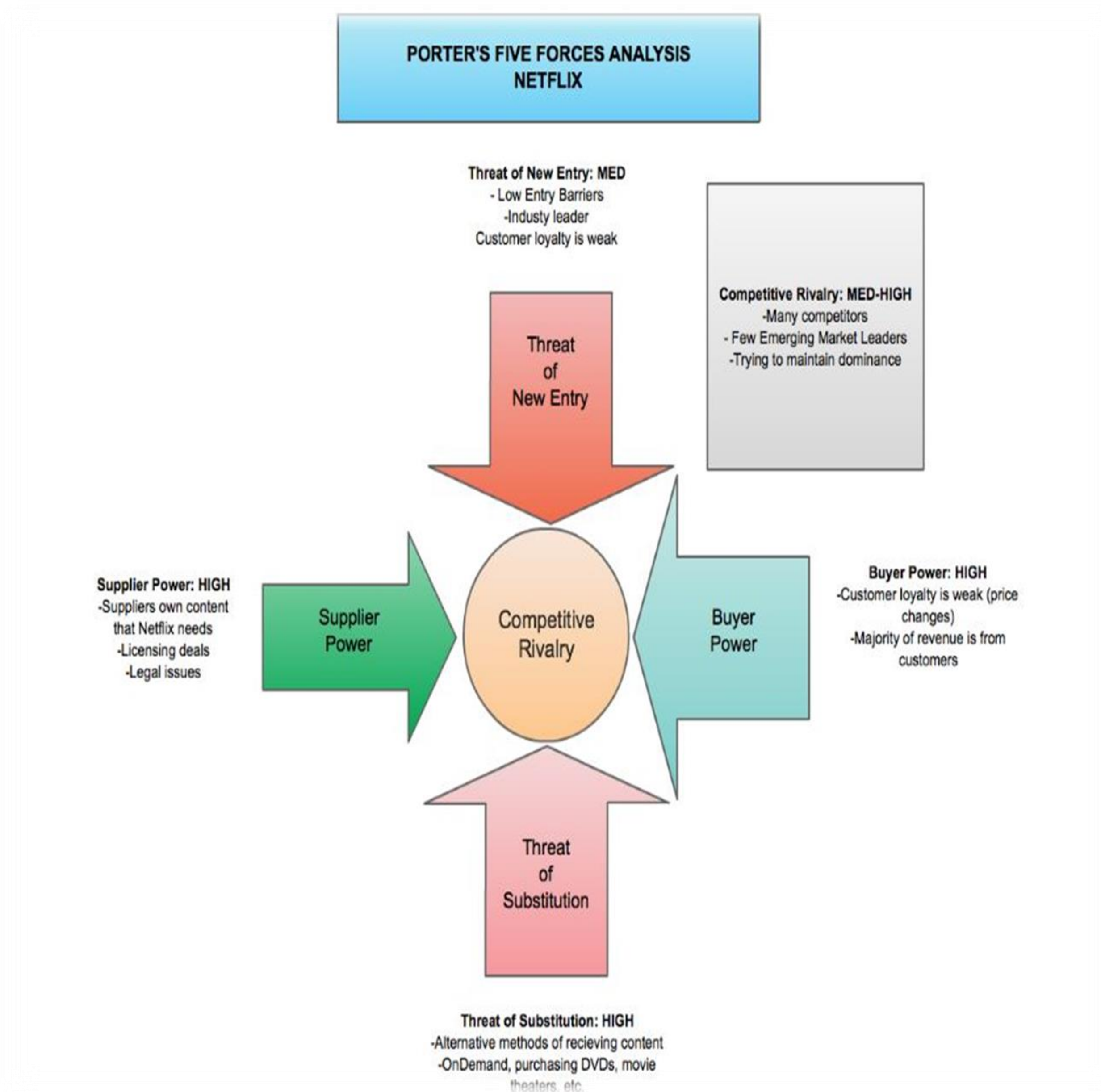
On October 24, 2011, Netflix announced it lost 800,000 US subscribers in the third quarter of 2011 and more subscriber losses were expected in the fourth quarter of 2011. Despite the losses, earnings for Netflix jumped 63 percent for the third quarter of 2011.[36][37]

On January 26, 2012, Netflix said it added 610,000 subscribers in the US by the end of the fourth quarter of 2011. The company announced it had 24.4 million US subscribers for this time period.[38]

In April 2012, Netflix filed with the FEC to form a political action committee (PAC) called FLIXPAC.[39] *Politico* referred to the Los Gatos, California-based PAC as "another political tool with which to aggressively press a pro-intellectual property, anti-video piracy agenda."[39] The hacktivist group Anonymous called for a boycott of Netflix following the news.[40] Netflix spokesperson Joris Evers indicated that the PAC was not set up to support SOPA and PIPA, tweeting that the intent was to "engage on issues like net neutrality, bandwidth caps, UBB and VPPA."[41][42]

On December 24, 2012, at around 1 pm, a number of Amazon Web Services servers crashed affecting numerous services including Netflix "instant streaming". The outage lasted more than 20 hours.[43][44]

In February 2013, Netflix announced it would be hosting its own awards ceremony, *The Flixies*.[45] On March 13, 2013, Netflix announced it's adding a Facebook sharing feature to the Netflix interface, letting subscribers in the U.S. see "Watched by your friends" and “Friends’ Favorites” once they agree to share.[46]


PORTER'S FIVE FORCES ANALYSIS
NETFLIX
Threat of New Entry: MED
- Low Entry Barriers
-Industy leader
Customer loyalty is weak
Competitive Rivalry: MED-HIGH
-Many competitors
- Few Emerging Market Leaders
-Trying to maintain dominance
Threat
of
New Entry
Supplier Power: HIGH
-Suppliers own content
that Netflix needs
-Licensing deals
-Legal issues
Supplier
Power
Competitive
Rivalry
Buyer
Power
Buyer Power: HIGH
-Customer loyalty is weak (price
changes)
-Majority of revenue is from
customers
Threat
of
Substitution
Threat of Substitution: HIGH
-Alternative methods of recieving content
-OnDemand, purchasing DVDs, movie
theaters, etc.

PART 2: SWOT ANALYSIS

"*Netflix has a critical combination of membership, brand awareness, and accessibility that allows them to be competitive with similar but smaller streaming content providers. To cope with the threats they face, Netflix must redirect resources from its delivery services to enhance strengths. Providing ever-expanding streaming content will enable Netflix to serve and attract an even wider base of customers*" (Bauman, Deal, Ishak, & Johnson, 2013).

STRENGTHS

The Netflix brand is a well-known, national name in the US (United States). With more than thirty-eight million customers in 40 countries, its identity is valued greatly among consumers as a quick, easy, and available destination for streaming media. They are the top provider of streaming content in the US, with their service alone accounting for more than thirty percent of US Internet traffic daily. Additionally, the value of the NETFLIX brand name has been on the rise recently after the strong media attention stemming from the success of their first two original series, HOUSE OF CARDS and HEMLOCK GROVE, and the critical acclaim received from their original scripted content has catapulted them into the world of Emmy nominations and other well-known entertainment industry awards.

When it comes to their competitors, they are either less widespread (with fewer customers, such as Hulu) or less massive (in terms of content, like Redbox Instant). Netflix has the largest content library available to audiences, with over sixty thousand titles compared to Amazon's thirty-eight thousand.

Additionally, positive shares currently weigh in their favor as one of their strengths. The stock price of **NFLX** has been volatile in the past, coming a long way from approximately US$50 in October 2012 to the October 2013 price of more than US$306. Combine this with the fact that Netflix continues to increase their slate of critically-acclaimed original programming, and it is likely that their stock will climb further.

WEAKNESSES

Despite the meteoric rise of their stock value, the company is undertaking large amounts of debt to fund the mass licensing packages they use to acquire content from other providers. While this does—in the short run—guarantee their success in terms of numbers when referring to library size, it also enhances their credit risk and runs the danger of impacting further loans. Since they want to continue producing exclusive, original content, they do not want their ability to be provided money impacted (Faruk, 2013).

Additionally, their physical media delivery service has suffered significant losses in the past year. What was once the cornerstone of the Netflix business is now a sideline to their true function: more than two years ago Netflix CEO Reed Hastings predicted that the market for DVD and BluRay discs would decline, and he was correct (Roettgers, 2013). DVDs currently provide more of a contribution margin to their bottom line and in FY2012 Netflix lost more than three million subscribers from that portion of their business.

OPPORTUNITIES

Careful scrutiny of the market reveals three main immediate opportunities for Netflix, all centered on the idea of original content. First, the cord-cutting (watching programming on hand-held devices) trend popular among consumers has created a new demand for internet-based TV. The increased adoption of internet-connected devices for media consumption aids substantially in adding more subscribers as more and more people rely on hand-held devices such as smartphones and tablets.

Netflix's greatest opportunity lies with the continuation and proliferation of ORIGINAL, IN-HOUSE PROGRAMMING. The demand for streaming media already meshes with their ability to provide content digitally, and their own exclusive series can be viewed by consumers anytime, anywhere, at their leisure instead of restricted to broadcast hours or channels. The viewers' tendency is moving towards online, VOD (Video On Demand) content, and Netflix's unique ability to both produce and distribute via the internet is a major opportunity.

This increasing desire for original programming can be seen in Netflix's marketing expenses, which have gone down substantially and in Q4 2012 stood at just 12.4% of their sales (Faruk, 2013). This could be attributed to their original content providing invaluable word-of-mouth campaigns. As a result, Netflix could redirect some of their marketing budget to produce additional original content.

Finally, the idea of original content naturally opens up an avenue into greater international growth. Currently, Netflix has several global markets. While a large majority desire American content, it stands to reason that providing content specifically for larger foreign markets would attract greater subscriber numbers. Netflix is already in the early stages of developing content for Latin America; why not continue the outreach to other cultures? Producing original content gives way to international expansion as Netflix takes on new roles on a global scale.

THREATS

One of the biggest potential threats to Netflix are ISPs (Internet Service Providers), who may discriminate against them if and when network neutrality laws fail to materialize, especially in the US market. In 2012 Marcia Clemmit explained "*ISPs might consider it their financial interest to slow content traffic to [...] competitors [like Netflix] to gain an edge over them.*" Even though Netflix's general counsel David Hyman argues that "*bandwidth is cheap and plentiful and will only grow more so with time, there is no good reason for bandwidth caps and fees to take root,*" the possibility remains that such discriminatory tactics could take place (Dampier, 2012), and why this is one of the three trends worth focusing further on.

Other threats include current Netflix competitors if they reach a point where they can begin to provide more value to consumers; as it stands, "*Amazon has posed the largest threat since 2011 when it began offering streaming as a part of its Amazon Prime service designed to provide free shipping to its subscribers. Although Amazon appears to stay committed to offer this streaming service mainly as a way to attract new customers, its deep pockets and base of loyal customers should have Netflix concerned. In 2012 content growth increased by 70% and Amazon prime had between 3 to 5 million subscribers. Additionally the company plans to attract 5 million additional subscribers by mid 2013*" (Trefis, 2012). In the same report by Trefis, they identified that "*although Comcast's Xfinity service offers less content than its competitor Netflix, it is priced much lower and is more motivated to compete directly with Netflix. Worst of all, Comcast possesses established relationships with media companies that will soon gain the leverage needed to gain access to licensing rights that allow content to mimic its competitor,*" once again establishing the need to respond early and in a friendly manner to ISPs like Comcast in order to mitigate any potential souring of relationships if the net neutrality trend stands unregulated.

Netflix's success was followed by the establishment of numerous other DVD rental companies, both in the United States and abroad. Wal-Mart began an online rental service in October 2002, but left the market in May 2005. However, they returned with their acquisition of the Vudu service in 2010.[166]

Netflix also cited Amazon.com as a potential competitor,[167] which until 2008 offered online video rentals in the UK and Germany—this arm of the business was eventually sold to LoveFilm, but Amazon then bought LoveFilm in 2011.[168] In addition, Amazon now streams movies and TV shows through *Amazon Instant Video*.[169]

Blockbuster Video entered the U.S. online market in August 2004, with a US$19.95 monthly subscription service. This sparked a price war; Netflix had raised its popular three-disc plan from US$19.95 to US$21.99 just prior to Blockbuster's launch, but by October, Netflix reduced this fee to US$17.99. Blockbuster responded with rates as low as US$14.99 for a time, but by August 2005, both companies settled at identical rates.[*citation needed*] On July 22, 2007, Netflix announced that it would drop the prices of its two most popular plans by US$1.00 in an effort to better compete with Blockbuster's online-only offerings.[170] On October 4, 2012, Dish Network announced that it was scrapping plans to make Blockbuster into a Netflix competitor.[171]

Redbox is another competitor that uses a kiosk approach: Rather than mailing DVDs, customers pick up and return DVDs at self-service kiosks located in metropolitan areas. In September 2012, Coinstar, the owners of Redbox announced plans to partner with Verizon to launch *Redbox Instant by Verizon* by late 2012.[172] In early 2013, *Redbox Instant by Verizon* began a limited beta release of their service,[173] which was described by critics as "No Netflix killer"[174] due to "glitches [and] lackluster selection."[175]

Netflix and Blockbuster largely avoid offering pornography, but several "adult video" subscription services were inspired by Netflix, such as SugarDVD and WantedList.[176][177]

Netflix also competes against traditional television with its original online-only web television content. On July 18, 2013 Netflix earned the first Primetime Emmy Award nominations for original online only web television at the 65th Primetime Emmy Awards. Three of its web series, *Arrested Development*, *Hemlock Grove*, and *House of Cards*, earned a combined 14 nominations (9 for *House of Cards*, 3 for *Arrested Development*, and 2 for *Hemlock Grove*).[178] Among the nine *House of Cards* nominations were the Primetime Emmy Award for Outstanding Drama Series, for the first season; the Primetime Emmy Award for Outstanding Lead Actor in a Drama Series, for Kevin Spacey; the Primetime Emmy Award for Outstanding Lead Actress in a Drama Series, for Robin Wright; and the Primetime Emmy Award for Outstanding Directing for a Drama Series, for David Fincher. From *Arrested Development*, Jason Bateman was nominated for the Primetime Emmy Award for Outstanding Lead Actor in a Comedy Series.

On September 22, 2013, Netflix made history with a total of three wins: Fincher's Outstanding Directing for a Drama Series, for the pilot episode "Chapter 1," making "Chapter 1" the first Primetime Emmy-awarded webisode, in addition to the pair of Creative Arts Emmy Awards.[182] However, none of the Emmy awards were considered to be in major categories.[183]

"IN ADDITION, AGGRESSIVE GROWTH IN COMMUNICATION TECHNOLOGY HAS LEAD TO AN INCREASE IN INDIRECT COMPETITORS. THE TWO MAIN INDIRECT COMPETITORS ARE YOUTUBE AND VIDEO PIRACY FILE-SHARING WEBSITES LIKE BITTORRENT AND BEARSHARE. CONSUMERS TURN TO THESE SERVICES BECAUSE VIDEO STREAMING IS AVAILABLE WITHOUT SUBSCRIPTION FEES; AN ATTRACTIVE OPTION IN A STRUGGLING ECONOMY WHERE CONSUMERS CONTINUE TO SEEK CHEAP AND FREE SOURCES OF HOME ENTERTAINMENT" (Thomas, 2012).

Comparatively, Netflix's indirect competitors and piracy represent more of a threat to its profits because they harm all legitimate providers, regardless of market positioning. The following figure outlines Netflix's main competitors:

Direct Competitors	Indirect Competitors
Amazon VOD	YouTube
Hulu	The Pirate Bay
Comcast Xfinity	BitTorrent
DISH Network	Dailymotion
VuDu	
AppleTV	
Redbox	
Voddler	
FilmNight (EU)	
LOVEFiLM (UK)	

NETFLIX VALUATION HIGHLIGHTS

1. U.S. Streaming Subscriptions constitute 57% of the price estimate for Netflix's stock.
2. International Streaming Subscriptions constitute 21% of the price estimate for Netflix's stock.
3. U.S. DVD Subscriptions constitute 16% of the price estimate for Netflix's stock.

POTENTIAL UPSIDE & DOWNSIDE TO NETFLIX STOCK PRICE

Below are key drivers of Netflix's value that present opportunities for upside or downside to the current price estimate for Netflix:

- Netflix's U.S. Streaming Subscribers: Currently we (Trefis, October 2013) forecast Netflix's U.S. streaming subscriber base to increase from around 27 million in 2012 to about 47 million by end of the Trefis forecast period. There could be more than 15% downside to the Trefis price estimate if this figure were to increase to only about 35 million instead of 49 million. This could if the market growth for streaming slows down and competition weighs heavy in the future. On the other hand there could be 20% upside to the Trefis price estimate if Netflix can blow past expectations and capture more than 45% of U.S. households by end of the Trefis forecast period, implying a subscriber base of about 58 million U.S. subscribers.
- Domestic Streaming Contribution Margin: Currently we (Trefis, October 2013) forecast this figure to rise from about 19% in 2012 to close to 31% by the end of our forecast period. However there could be a downside of about 10% to the Trefis price estimate if these cost were to reach a figure of only 25% of total revenues. On the other hand, there could be upside of about 20% if this figure was to increase to 35% instead.

BUSINESS SUMMARY

Netflix offers video rental service in the form of DVDs as well as online streaming to U.S. customers. In international markets including Canada, Latin America, U.K., Ireland and Nordic countries, the company offers only online streaming services. Unlike traditional video rental businesses such as Blockbuster and Redbox, Netflix does not have any store locations and instead delivers DVDs through postal mail in the U.S. and allows its subscribers to view films online.

Netflix's content is available for streaming through variety of devices such as PCs, Macs, video game consoles, tablets and smartphones. The company is consistently working towards striking more content deals in order to improve its online library.

In the case of DVDs, Netflix's customers can choose the videos they want to rent from an online library available on the company's website. Netflix delivers these DVDs/Blu-Rays to its customers as early as the next day (under its *Next Day Delivery* service). These customers can keep the DVD for as long as they want and are not charged any late fee. The company offers different subscription packages based on the number of DVDs its customers can rent at any given point of time.

SOURCES OF VALUE

The majority of Netflix's value is currently hinged on its U.S. Streaming services for the following reasons:

Firstly, the DVD subscribers are expected to decline significantly in the U.S. while streaming subscribers are expected to grow. The home video market is growing in the U.S. and streaming is the best way to tap it given the proliferation of multiple internet-enabled devices. Netflix has seen rapid adoption of its streaming plans in the U.S. Although its growth suffered in 2011 due to price increase, it did fairly well in 2012.

Secondly, the international streaming business is likely to remain a relatively lower value contributor for several years because Netflix will face high content costs as well as local competition and resistance. Moreover, markets such Latin America have lower broadband penetration and per capita income, thereby making any rapid growth in this region difficult for Netflix.

KEY TRENDS

Online Streaming

There is very clear shift of video consumption to the Internet, and Netflix is one of the companies leading this change. The company's DVD subscribers are declining and future growth will come from streaming subscribers. Eventually the company would like to replace all of its physical DVDs with online library.

International Expansion

Netflix entered Canada towards the end of 2010 with its streaming-only service. In 2011, it witnessed good adoption in Canada and consequently expanded to Latin America. In early 2012, Netflix launched its streaming service in the U.K. and Ireland. Following that success, the company also expanded to Nordic countries of Norway, Sweden, Denmark and Finland. While the international market presents a huge potential, it also presents obstacles such as low broadband penetration and speeds, local competition and content licensing complications.

Increasing Competition in Online Streaming

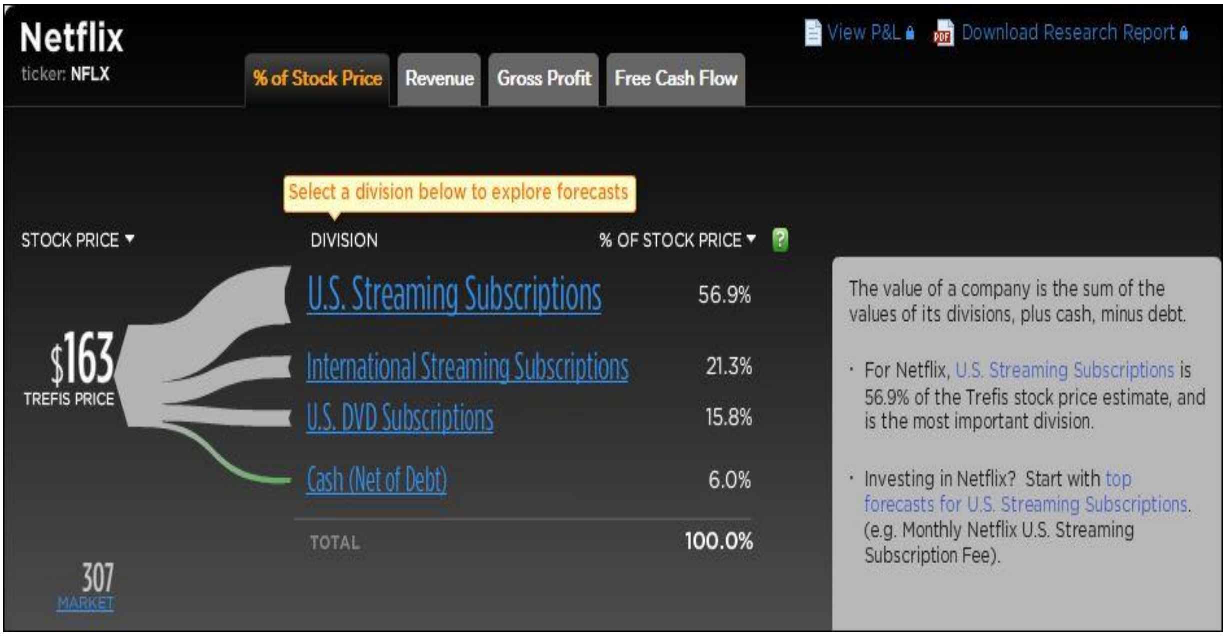
Netflix has been facing increasing competition in online streaming. Along with Amazon and Hulu, Blockbuster and Comcast have also entered this space. Going forward, Verizon and Redbox can post stiff competition as they have partnered to offer a competitive streaming service. The growing competition can not only put pressure on Netflix's subscriber growth, but also increase content costs due to bidding by competitors.

Growing Focus On Original Content

Netflix stated that its content advantage was the biggest driver of its U.S. streaming subscriber growth in Q1 2013. The company has been adding some original and exclusive programming to its streaming library, which seems to be paying off. TV series such as House of Cards, Lilyhammer and Arrested development are drawing lot of audience and attracting customers to sign up. In fact, Netflix has effectively marketed these exclusive shows to maintain its subscriber momentum. While premium networks such as HBO have peaked at around 30+ million subscribers, Netflix sees a much larger opportunity and addressable market size of 60 to 90 million subscribers in the U.S.

Besides some of the exclusive shows that we mentioned before, Netflix also signed a deal with Disney (NYSE:DIS) in 2012, to gain exclusive access to some of its content, once the contract between Starz and Disney expires in 2015. During the first quarter of 2013, Netflix continued to expand its streaming content through deals with Turner Broadcasting, Warner Brothers Television Group, DreamWorks Animation and Hasbro Studios.

Information sources include annual reports, quarterly filings, and quarterly earnings transcripts. Company filings are available from the SEC. (Trefis, October 2013)


Netflix
ticker: NFLX
% of Stock Price
Revenue
Gross Profit
Free Cash Flow
View P&L
Download Research Report
Select a division below to explore forecasts
STOCK PRICE
DIVISION
% OF STOCK PRICE
U.S. Streaming Subscriptions 56.9%
International Streaming Subscriptions 21.3%
U.S. DVD Subscriptions 15.8%
Cash (Net of Debt) 6.0%
TOTAL 100.0%
$163
TREFIS PRICE
307
MARKET
The value of a company is the sum of the values of its divisions, plus cash, minus debt.
For Netflix, U.S. Streaming Subscriptions is 56.9% of the Trefis stock price estimate, and is the most important division.
Investing in Netflix? Start with top forecasts for U.S. Streaming Subscriptions. (e.g. Monthly Netflix U.S. Streaming Subscription Fee).


Netflix
ticker: NFLX
% of Stock Price
Revenue
Gross Profit
Free Cash Flow
View P&L
Download Research Report
Revenue ($)
10 Bil
8.0 Bil
6.0 Bil
4.0 Bil
2.0 Bil
0
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2.2 Bil
3.2 Bil
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4.3 Bil
5.0 Bil
5.6 Bil
6.1 Bil
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7.0 Bil
7.5 Bil
7.8 Bil
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2016
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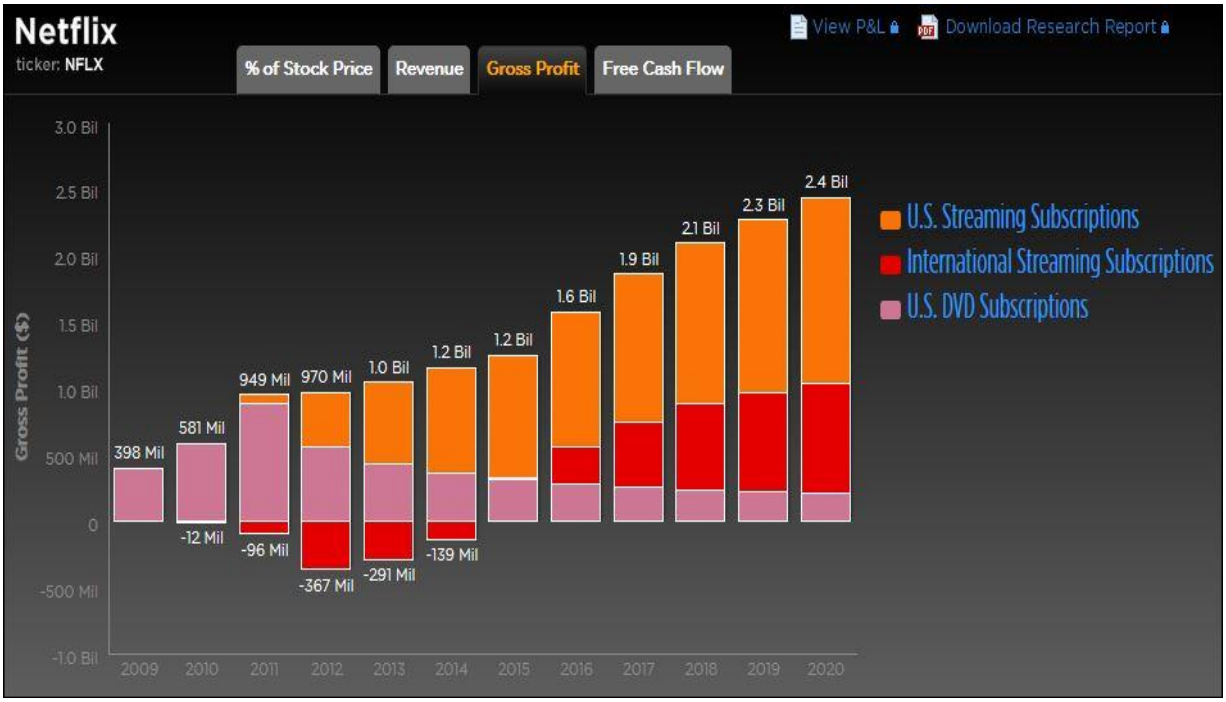
2018
2019
2020
U.S. Streaming Subscriptions
International Streaming Subscriptions
U.S. DVD Subscriptions


Netflix
ticker: NFLX
% of Stock Price
Revenue
Gross Profit
Free Cash Flow
View P&L
Download Research Report
Gross Profit ($)
3.0 Bil
2.5 Bil
2.0 Bil
1.5 Bil
1.0 Bil
500 Mil
0
-500 Mil
-1.0 Bil
398 Mil
581 Mil
949 Mil
970 Mil
1.0 Bil
1.2 Bil
1.2 Bil
1.6 Bil
1.9 Bil
2.1 Bil
2.3 Bil
2.4 Bil
-12 Mil
-96 Mil
-367 Mil
-291 Mil
-139 Mil
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
U.S. Streaming Subscriptions
International Streaming Subscriptions
U.S. DVD Subscriptions


Netflix
ticker: NFLX
% of Stock Price
Revenue
Gross Profit
Free Cash Flow
View P&L
Download Research Report
Free Cash Flow ($)
1.0 Bil
750 Mil
500 Mil
250 Mil
0
-250 Mil
-500 Mil
930 Mil
658 Mil
547 Mil
589 Mil
652 Mil
722 Mil
824 Mil
-198 Mil
-163 Mil
-6.8 Mil
2014
2015
2016
2017
2018
2019
2020
U.S. Streaming Subscriptions
International Streaming Subscriptions
U.S. DVD Subscriptions

Netflix, Inc. (NFLX) - NasdaqGS

305.85 ↑17.42(6.04%) 1:36PM EDT - Nasdaq Real Time Price

Ad

Competitors

Get Competito

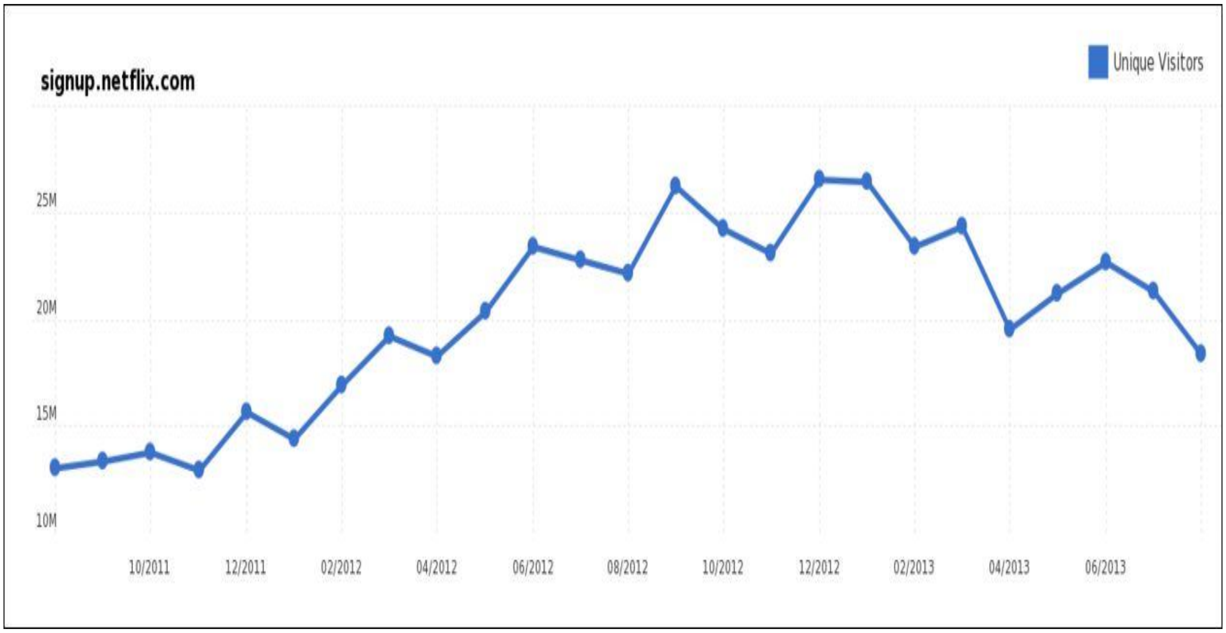
Direct Competitor Comparison

	NFLX	AMZN	PVT1	PVT2	Industry
Market Cap:	18.03B	139.14B	N/A	N/A	N/A
Employees:	2,045	88,400	N/A	N/A	N/A
Qtrly Rev Growth (yoy):	0.20	0.22	N/A	N/A	0.00
Revenue (ttm):	3.94B	66.85B	N/A	N/A	N/A
Gross Margin (ttm):	0.28	0.26	N/A	N/A	0.00
EBITDA (ttm):	171.88M	2.92B	N/A	N/A	N/A
Operating Margin (ttm):	0.03	0.01	N/A	N/A	0.00
Net Income (ttm):	47.73M	-101.00M	N/A	N/A	N/A
EPS (ttm):	0.80	-0.23	N/A	N/A	N/A
P/E (ttm):	380.59	N/A	N/A	N/A	N/A
PEG (5 yr expected):	9.43	9.44	N/A	N/A	N/A
P/S (ttm):	4.31	2.04	N/A	N/A	N/A

AMZN = Amazon.com Inc.
Pvt1 = Blockbuster L.L.C. (privately held)
Pvt2 = Redbox Automated Retail, LLC (privately held)
Industry = Music & Video Stores

Video Rental Companies Ranked By Sales

Company	Symbol	Price	Change	Market Cap	P/E
Blockbuster L.L.C.	Private - View Profile				
Hastings Entertainment Inc.	HAST	2.33	0.00	18.97M	N/A
Netflix, Inc.	NFLX	305.61	0.06	18.03B	380.59
Barnes & Noble, Inc.	BKS	13.70	0.03	816.43M	N/A



This graph captures **only** the sign up domain traffic within netflix.com: the part of the website that **must** be visited if you want to become a subscriber to the service. You can see that sub growth peaked in Q1 this year (2013) and that sub growth is decelerating. This is a **forward** indicator of future subs. Other leading 3rd party traffic measure services validate the same trend (Tumurcuoglu, 2013).

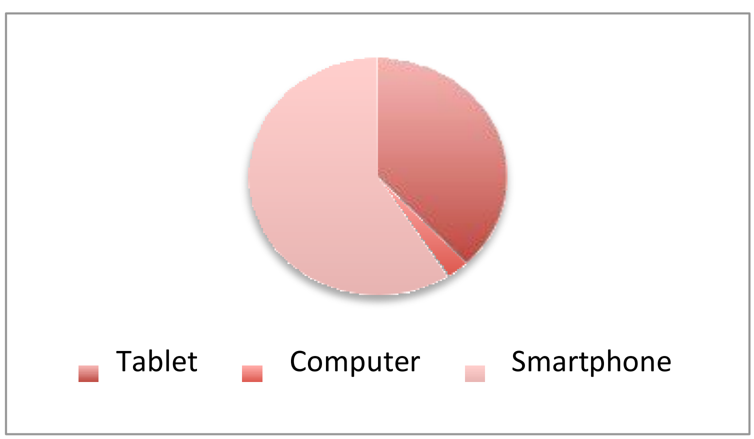
It is important to realize that in today's digital world, change happens both exponentially and erratically. Some of the trends discussed here were barely on anyone's radar five years ago; others have been put before Congress for at least seven years now and still see no sign of future slowdown. As such, I have tried to identify three of the most effectible trends that will affect Netflix, and in turn eliminated those fads with negligible lifespans.

The three emerging trends come from all areas of the business, from new technologies and consumer behavior to regulatory and government issues. The intersection of these general descriptors is where my three trends lie: the idea of the "second screen", network neutrality, and video gaming will all affect the entertainment industry significantly, and in particular Netflix as they navigate the uncharted waters of creating their own content.

SECOND SCREEN ENGAGEMENT

When referring to the "second screen" in the entertainment industry, we refer to the growth of tablets and smartphones as extensions of a consumer's primary watching mechanism. A viewer may be watching a rerun of a television show through their cable subscription while at the same time looking up relevant information about the show on Wikipedia through their smartphones. Alternatively, they can be live---tweeting their thoughts about a sports broadcast as it happens and engage with other fans and viewers around the world simultaneously. This is the world of the second screen: literally, a world in which two screens pervade consumers' lives.

More than 80% of smartphone and table owners report using these devices while watching TV, and at least 25% of them use them multiple times per day. 51% of those who post social media while watching TV do so to connect with others who might also be watching the same program, and 24% of Facebook users report posting about the movie they're watching while in the theater (Ulanoff, 2012).



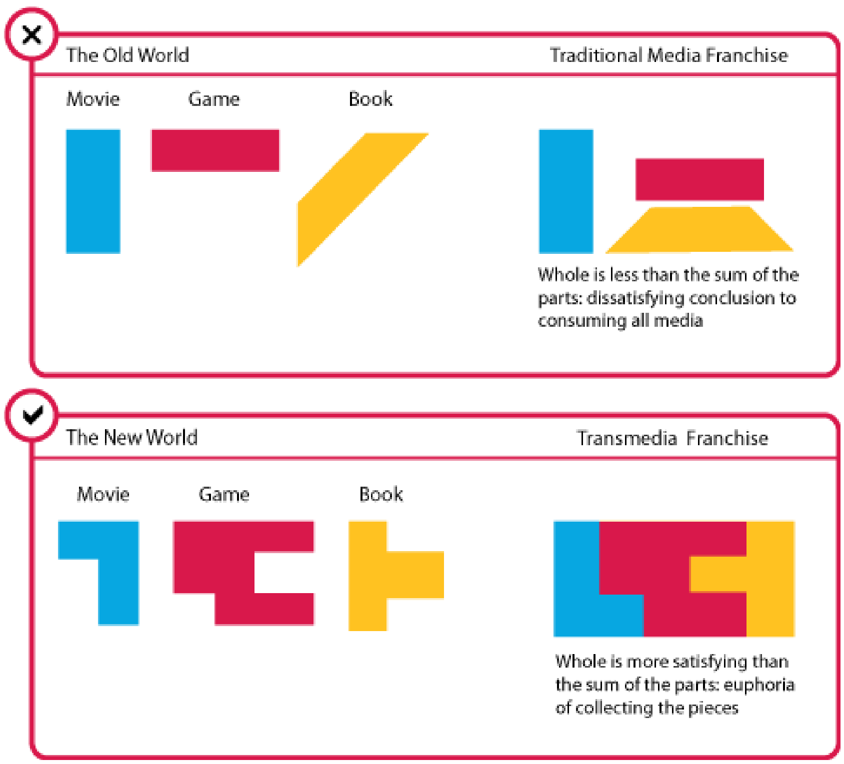
Among digital devices consumers use to watch TV, only 3% of usage actually comes from traditional computers: almost 40% is through tablets and a whopping 59% of all streaming television watched is on a smartphone, truly demonstrating its ubiquity and desire among consumers. Since our apps are by far the largest sector of our our subscribers access our content, the usage of second screens by consumers has a huge impact on Netflix.

NETWORK NEUTRALITY

In 2010, a new set of edicts by the FCC finally settled parts of the almost decade-old argument surrounding net neutrality: wired broadband providers were restricted from Internet traffic discrimination but wireless providers were free to do as they pleased, including limiting or completely removing access to services (Federal Communications Commission, 2010). Unfortunately, this did nothing to resolve the issues when most cable providers (like AT&T) simultaneously operate wireless cells. Ultimately, the controversy surrounding net neutrality is still very much alive.

The argument boils down to the idea that companies who provide Internet access to consumers should have the right to monitor and restrict what traffic and services are run across their own infrastructure. They're laying the cables, building the cell towers, and letting a customer use their equipment to access the Internet, so why shouldn't they be allowed to say what is allowed to use their lines? Internet freedom activists vehemently oppose the issue, citing a base degradation of the founding principles of the Internet, which is to allow the free and open sharing of information. While some governments (like the EU) have codified the idea of "net neutrality"—that is, that ISP companies cannot restrict traffic or access to the open Internet—into law, the US remains recalcitrant in following the rest of the world's lead. Since Netflix is a service accessed by consumers over ISP Internet connections, the result of this debate will have a significant impact on Netflix.

The idea of transmedia relates to cross-platform storytelling. Whereas the old model of storytelling comprises a movie, and then subsequently a novelization of the film and perhaps a game rehashing the plot, the new world of transmedia opens up limitless possibilities that continue a story across platforms, instead of simply duplicating it (Rose, 2011). The image below graphically depicts a comparison of how transmedia franchises can better suit consumers today:



With over three billion hours per week spent globally on video gaming, the idea of continuing stories through alternative media platforms should be highly attractive to Netflix. In 2005, the average American spent 78 hours per month playing video games; in 2012, that number rose to 142 hours per month. Since casual gaming (non-immersive, simple, on-the-go mobile games like *Angry Birds* or *Farmville*, as opposed to traditional first-person shooters or role-playing games like *Halo* or *World of Warcraft*) in particular has been a large part of that increase and consumers already use Netflix apps to obtain Netflix content, it would be very easy and profitable to combine the two and create additional transmedia franchises for Netflix original programming. NBCUniversal has recently tried this by co-building an immersive online video game with their cable series DEFIANCE on Syfy, and they were rewarded with their most-watched scripted series premiere in history (in terms of ratings) and more than seven million hours of playtime on the game since launch (Morabito, 2013).

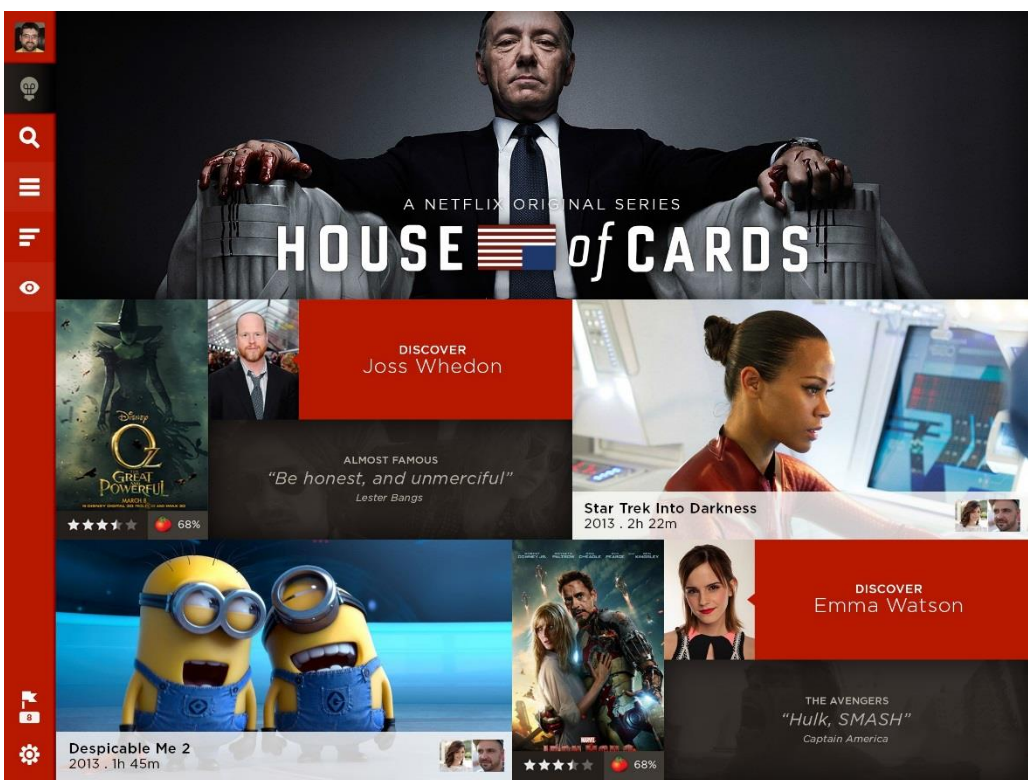
PART 6: RECOMMENDATIONS

Here are a few recommended strategies for Netflix to adopt that would help adapt to their current competitive position and the industry trends I have outlined in this strategic analysis. In some cases, these take the form of new strategic relationships; in others, it will result in Netflix developing new business models and core competencies while reforming others. In total, adapting these prescribed strategies will help Netflix respond in the best way to beneficially utilize the trends at hand.

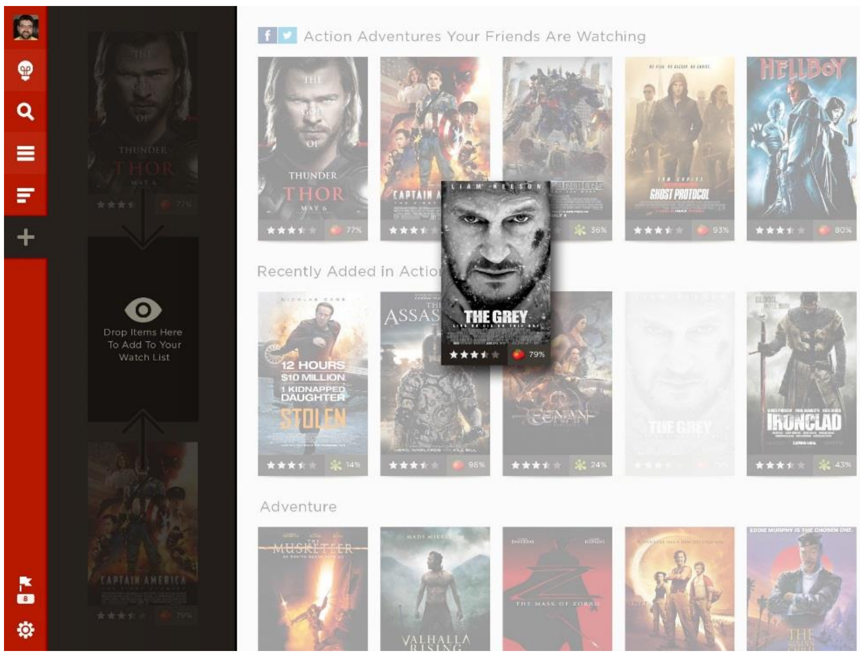
MOBILE APPS

While many consumers have cut the cord and made the switch to Internet-only TV offerings, undoubtedly they've experienced frustrations as well. Current Netflix mobile apps should be overhauled to present a better, more seamless experience for users on tablets, especially when utilizing second screen viewing modes such as AirPlay streaming to a big-screen TV.

From an interface perspective, the programmers at YOUi Labs created a demo of a product they call **FLIPtv**, a natural user interface (NUI) which demonstrates the capabilities of tablets for streaming media content as well as their vision of how second screens can provide new and innovative ways to enjoy content. They took their interface and translated it over to Netflix's tablet app, with impressive results:

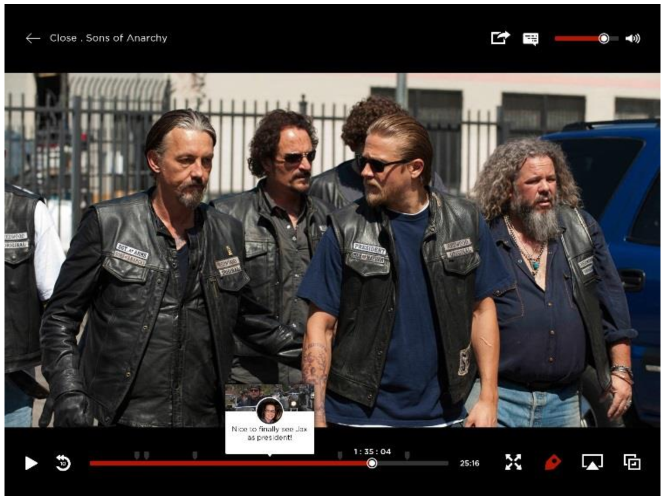


Compared to the current app’s design, this new proposal feels fresh and clean. While retaining the Netflix brand identity, it revitalizes the often used “discover” feature of the service, while providing new opportunities for social integration and community collaboration through such ratings sites as Metacritic and Rotten Tomatoes. Moreover, they propose the login screen change by allowing social credentials as authenticators (much as Netflix already employs on the desktop version; the feature is unfortunately absent in the current Netflix mobile app) as well as minimizing the screen real estate needed for login by adding large, high-resolution tiles of newly-added content to encourage use of the service (The Lab Blog, 2013).

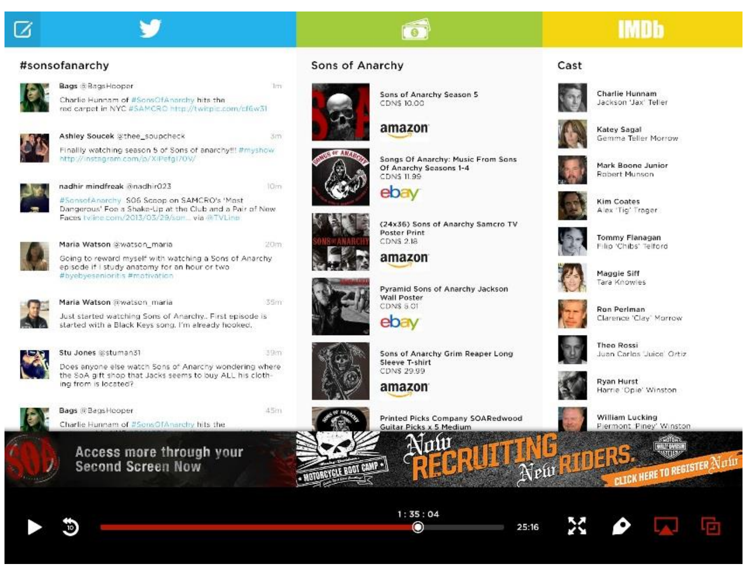


YOUi Labs continue to suggest added-value features like dragging-and-dropping content posters onto dynamic watch lists and queues (see above graphic), skeuomorphic animations, and more detailed friendship connections, including the ability to see what friends on both Facebook and Twitter have watched, their recommendations, and share content with others (The Lab Blog, 2013).

Their most impressive change is when watching shows themselves: the new viewing player includes a tagging feature (see graphic below) that would be instrumental in expanding the social “water cooler” aspects of Netflix content. Viewers can tap the button at any time during a show to tag moments on the timeline relevant with quotes from that scene or make a comment regarding what they saw. Subsequent friends watching the content can see these tags, opening up a dialogue between the partners and encouraging more social conversation through the new Netflix app (The Lab Blog, 2013).



Similarly, many tablets offer an ability to wirelessly stream video content from the table to a larger TV; for example, a viewer's iPad can be signed into the Netflix app and watching ARRESTED DEVELOPMENT when they choose to AirPlay stream the video itself to a big-screen monitor. At this point, the tablet app becomes the prime real estate for second screen content since it is already the one providing the content's timeline; it is completely synced with the show as the viewer is watching, allowing for contextual ads, tweets, shopping, relevant social connections, IMDb and cast/crew information, and more (see below). This creates many more opportunities for second screen engagement, especially with Netflix's own content, and further branding prospects with our licensed content from third parties as well as adding a higher value to them.



Limitless possibilities abound when Netflix considers what can be done once they realize that they *ARE* the second screen: THE app consumers use to consume content. The very fact that content is streamed from Netflix servers to customers' unique accounts opens up many opportunities for taking advantage of this one-on-one time with the viewer. For example, Netflix already permits up to two streams at once per account: if two people are in a long-distance relationship, why not let them both sign in to the same account at the same time and synchronize what they watch together? Couples already hold "Skype dates" where they watch a film "together" when apart, but they're plagued by manually syncing the films and requiring two of the exact same copy. Netflix already has the content; they can easily stream the exact same timeline of a TV show or movie, at the same sync point, in time, to two computers simultaneously. This is just one example of a very easy, inexpensive change that can be implemented at relatively low cost to Netflix but with big value for their subscribers, something that may convince them to want Neflix over current competitors.

In my opinion, Netflix should readjust their mobile apps to present a more integrated, pleasing experience for their subscribers.

FORM STRATEGIC PARTNERSHIPS WITH ISPs & CABLE COMPANIES

As stated earlier, net neutrality threatens the Netflix business because ISPs could easily require either Netflix or the consumer to subsidize the traffic related to media streaming. This is a potentially disruptive trend, so the best way to respond appropriately is to develop strategic partnerships with ISPs.

Netflix needs to make sure large ISPs are on its side if and when the net neutrality debate favors those with the ability to threaten them in the future. It's a simple idea: make friends now with those who can harm them later. The goal is to develop such close working relationships that, when the time comes, they're better able to stem such warring price discrimination.

These partnerships can come in many forms, and admittedly should go through enough administrative oversight and with sufficient input before being formed, but the following are some preliminary ways in which they may come about. AT&T currently has no stake in any media conglomerate, but a large portion of smartphone users stream Netflix content over AT&T's 4G LTE wireless network.

The FCC's last decree on net neutrality gives AT&T (for example) the right to limit or degrade access to Netflix service, which would in turn pull customers away from accessing Netflix over their second screen and mobile devices, which would ultimately turn them off from Netflix subscriptions entirely. To mitigate this threat, Netflix could explore potential relationships with major cell-phone carriers, such as AT&T, Verizon, and T-Mobile by recruiting new subscribers for their services. Through combined advertisements on device apps. By partnering with cell phone carriers, Netflix would provide them a service—additional subscribers—a relationship they would look upon favorably and not want to sour by harming Netflix through tiered pricing and internet access models.

Developing strategic partnerships now with ISPs and cable companies such as Time Warner and Comcast will help Netflix in the long run. It is strategically beneficial for Netflix to avoid the potentially disruptive threat by partnering up now with those who can potentially harm them.

DEVELOP MULTI-PLATFORM PROPERTIES

Video gaming is here to stay, and multi-platform properties like NBCU's DEFIANCE on Syfy are quickly becoming a great way to add value to a traditional franchise series. Netflix has an advantage in being able to deliver content to consumers anytime, on demand, and not being locked into network airtimes, but also the fact that Netflix apps are already downloaded by consumers. Netflix already has the trust of consumers: they already have Netflix apps uploaded on their devices. It would be the logical next step for Netflix to develop proprietary video games and other multi-platform properties for their customer base.

Syfy created a TV show which ties into an online video game, and Netflix already distributes online: their next series could be produced alongside a casual game that viewers can play on their second screen while watching on their main monitor. Alternatively, Netflix could augment their app with a game that would allow viewers to spot clues in a storyline, tag or select them, and collect/achieve prizes in the Netflix game world.

The best way to capitalize on the upward trend of video games and success of multi-platform properties is for Netflix to literally get into the game. Netflix currently has plans for several series in development, and some of those will work best as traditional properties. However, one or two could offer Netflix subscribers much more satisfying conclusions by immersing themselves into the world of their creation; this will offer added value that will make viewers more likely to choose Netflix over competitors who cannot compete with their multi-platform content.

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