

NETFLIX MarketBuster

Summary

In the late 1990s, dotcoms flooded the market from every direction. These dotcoms offered websites that sold a wide variety of products and services. Justballs.com sold any and every type of ball. BuyBreads.com attempted to create a large bakery for the entire nation. DotcomFailures.com was a company completely devoted to chronicling the failures of dotcoms. It was amidst these dotcom failures that Netflix.com emerged in 1998. Netflix functioned as an online video rental store where customers could rent DVDs, however it was one of several websites that offered the same service. What allowed Netflix to survive the dotcom bust and succeed when similar companies failed? It was able to identify a new business model—a MarketBuster—that has changed the way people rent movies and has forced a multibillion dollar industry to change.

The Story

In the 1990s, the video rental industry was dominated by three major players: Blockbuster, Hollywood Entertainment, and Movie Gallery. Each of these companies had a nearly identical business model. People could enter the nearest store to rent movies and video games for a fee. The rental had to be returned by a certain date or else a late fee was assessed.

Initially, Netflix imitated the business model of the existing players in the industry. It allowed customers to rent DVDs for a fee of \$5 per DVD. The only difference was that instead of going to a physical location to pick out and rent a movie, Netflix delivered a DVD to its customers through the mail. Customers were required to return the DVD by a specified date and if they failed to do so, they incurred late fees. Reed Hastings, founder and CEO of Netflix, believed that this business model would succeed because it provided customers the convenience of not having to leave their house to rent a movie. The company felt that it was safer to follow the established business model in the movie rental industry. However, monthly revenues were disappointing and the company failed to grow. According to Hastings, “What gave us the courage to switch was the necessity to switch.”¹

Examining the industry, Hastings saw several opportunities that would allow Netflix to offer customers an alternative way to rent movies.

- *Increasing popularity of DVDs:* When Netflix was first launched in 1998, the DVD was an obscure movie format and not many households owned a DVD player. However, Hastings believed that this new format would expand into a mass market that Netflix could serve by providing people with a new way to rent movies. The success of the company was dependent upon a mass switch from VHS to DVD format since DVDs were significantly cheaper to mail. (A DVD can be mailed with one first-class postage stamp whereas VHS tapes can cost up to \$4)² Hastings’ bet paid off—sales of DVD players started to outpace sales of VHS players. In 2000, 8.5 million DVD players were sold and this figure increased to 12.6 million in 2001 making DVD players the fastest-growing electronic item in history.³ A 2001 research

¹ Lindow, 2001.

² Lewis, 2001, p. 88.

³ Bond, 2002.

report by IDC estimated that by the end of 2005, approximately 70% of all households would own a DVD player.⁴

- *No more late fees*: When Hastings found himself with a \$40 late fee from Blockbuster after failing to return *Apollo 13*, he began to think that there had to be a better way to rent movies. He suspected that there were many others who were fed up with paying late fees and would be interested in a service that did not have due dates. Although late fees were unpopular with customers, they provided as much as 20% of revenues for rental companies like Blockbuster.⁵
- *Convenience*: Netflix's initial business model was built on the assumption that customers value convenience and will embrace services and products that make their lives easier. Why drive to the closest video rental store, stand in line to rent the movie, and drive back to return it when you could receive the rental in the mail? According to market research, the decision to rent a movie was impulsive and one that required little planning and thought. Hastings believed that the decision making process could be altered so that customers would plan ahead in order to benefit from the convenience that Netflix offered.

MarketBusting Moves

Faced with a shift in the industry from the VHS to DVD format and changing customer needs, Netflix engaged in a MarketBusting strategy that included the following moves:

- #1: Reconstruct the consumption chain
- # 27: Exploit your industry's structure for the next life cycle stage
- #3: Make some links in the consumption chain smarter

#1: Reconstruct the consumption chain

Netflix changed its movie rental system to offer a dramatically different experience for the customer. Instead of renting individual movies, Netflix offered customers a membership that allowed them to have up to three DVDs at one time. They could keep these DVDs as long as they wanted. When they were ready for new movies, they simply returned the previously viewed DVDs and received new movies in the mail. Netflix's website listed the extensive selection of DVDs available and customers chose which movies they wanted. As soon as Netflix received a returned DVD, the next movie on a customer's list was mailed to them.

This new system changed the rental process by eliminating the need to wander aimlessly in a store, unable to remember what movies you want to see. Customers could browse through thousands of movies in the comfort of their homes.

27: Exploit your industry's structure for the next life cycle stage

Customers did not pay for each DVD they rented, but were charged a monthly fee to become Netflix members. This provided customers with the ability to rent unlimited DVDs each month. In addition, late fees were eliminated since customers could keep the DVDs as long as they wanted. Netflix prepaid for all postage, so when customers were finished with a movie, they merely returned it to its package and placed it in the mailbox.

In order to attract customers with this new service, Netflix offered a free trial for a month. Ninety percent of those that tried the free trial did not cancel their memberships and continued using the service.⁶

The key to the new system was replenishment. Customers would not have to decide that they want to rent again from Netflix every day, week or month. The only decision they make is

⁴ Evangelista, 2002, p. 5.

⁵ Desjardins, 2005, p. 6.

⁶ *Netflix 2003 Annual Report*

what to rent. Netflix would continually fill customers' needs without relying on them to remake the decision to purchase from it over and over again.

In order to continue to fulfill customers' requests for DVDs, Netflix opened shipping centers that processed the returned DVDs and mailed out the new requests. As the volume of DVDs received and sent increased, many changes were needed to make this system as efficient as possible. The company tried more than 200 different mailing envelopes before it found one that allowed the DVD to be sent safely without costing more than the price of a first-class stamp.⁷ It also had to make adjustments in how employees handled DVDs and inspected them for damages in order to increase efficiency.

#3: Make some links in the consumption chain smarter

Netflix developed proprietary software that uses complex algorithms to recommend movies that each customer would enjoy. Customers rate movies they have viewed so that the software can make recommendations of similar movies or movies in the same genre. Due to this recommendation system, Netflix can offer a serious market for every movie, not just blockbusters. The system recommends all types of movies and often creates awareness for small, independent films. Hollywood loves Netflix because it keeps older titles in motion and gives life to smaller releases.⁸

Netflix also uses the recommendation system to retain customers whose rentals have slowed down or even ceased. It sends customized emails to these customers to notify them about new releases and other movies that they would enjoy based on their previous ratings. Customers have been willing to reward Netflix with continued business because it saves them time, reduces frustration, and offers personalized choice in a previously standardized industry.

The decision to rent a movie had been considered an impulsive one by marketers in the industry. The large, established companies in the industry initially scoffed at Netflix because it sought to change behavior and affect the way people rented movies. Netflix believed that the impulsive decision was when to watch a movie, not when to rent one. Acting upon this assumption, it introduced its unlimited rentals so that customers would always have a movie on-hand when they wanted to watch one. When customers made the impulsive decision to watch a movie, they now could avoid leaving the house, wandering the video store in search of a movie, and waiting in long lines to rent it. The system did require more planning than the traditional process of renting a movie. However, Netflix believed that the convenience of its system was sufficient to cause people to change their behavior.

Key Lessons

Since Netflix introduced its revolutionary movie rental process in 1999, it has seen tremendous growth in its titles, subscribers, and revenues.

	2002	2003	2004
Titles	14,500	18,000	30,000
Subscribers	857,000	1,500,000	2,600,000
Revenues	\$152.8 million	\$272.2 million	\$506.2 million

The company has 23 shipping centers and can provide over 80% of its customers with one day service for DVD delivery.

Netflix learned that it is possible to change consumer behavior, even in established industries, when the new offering is attractive enough and beneficial to the consumer. Instead of altering one link in the consumption chain as it did initially, Netflix altered the chain dramatically to differentiate its service from its competitors.

⁷ Cohen and Sloane, 2003, p. 44.

⁸ Null, 2003, p. 43.

The new business model created by Netflix has been so successful, its competitors have attempted to emulate the service. At the end of 2004, Blockbuster announced that it would no longer charge its customers late fees when movies are returned after their due dates. Blockbuster also introduced an online, unlimited DVD rental through its website. It continues to lower its fees in order to pressure Netflix. Walmart has also launched an imitation of Netflix where customers can rent unlimited DVDs and keep up to two at a time. Amazon.com started an unlimited DVD rental in the UK and has plans to expand into the United States in 2005.

Although competition is increasing, Netflix continues to gain subscribers and has plans to expand into Canada and the UK. Netflix is much smaller than its competitors, but it has established itself as the first company to offer this DVD rental service. Its selection of titles is much larger than that of its competitors. In addition, its recommendation system has not been duplicated by its competitors. Netflix has a customer satisfaction rate of 95% and continues to meet and exceed customers' expectations.⁹ As Netflix continues to serve its customers and develops a deeper understanding of consumer needs, it will gather more knowledge that will help it to innovate further in the future.

⁹ *Netflix 2003 Annual Report*

DRAT Table, Netflix**SOURCE**

External

Powerful Incumbents	Large, established competitors: Blockbuster, Hollywood Entertainment, Walmart, Amazon, Movie Gallery
Opposition from advocacy groups	NA
Risk to key external stakeholders	NA
Inertia	Finding ways to continue to increase the subscriber base by educating customers about the benefits of the Netflix rental system.
Disruption of customer's system or process	Unwillingness of customers to switch their video renting behavior
Changes in standards or regulations required	Increasing popularity of VOD and downloadable movies instead of DVDs

Internal

Internal political maneuvering	As the company grows larger, management issues may arise
Reluctance or resistance by those needed for active implementation	NA
Resource Constraints	As the subscriber base continues to increase, Netflix may need to add additional capacity to ship DVDs (shipping centers, employees, etc)

Platform changes required

Human resource and skills platforms	Managing employees that receive and send DVDs in shipping centers—must make environment comfortable to increase the efficiency of workers.
Logistics platforms	Keep looking for cheaper and faster ways to deliver DVDs
Distributor platforms	NA
IT and database platforms	Continual improvement of recommendations system to increase knowledge of customers' behavior
Technology platforms	Develop the VOD and downloadable movie platform.
Assets, operations, and systems platforms	Increase interaction between shipping centers

Marketbusting Kite

Element	Needed to Support the Marketbusting System
Agenda The key things that the critical people spend time on	<ol style="list-style-type: none"> 1. Increasing subscriber base 2. Offering a better service than its competitors 3. Meeting customer needs 4. Researching new channels to provide movies (ie. VOD) 5. International Expansion
Norms What principles and behaviors are valued?	<ol style="list-style-type: none"> 1. Efficiency 2. Profitability 3. Understanding the customers
News What information and measures are paramount?	<ol style="list-style-type: none"> 1. Subscriber base 2. Number of movie titles 3. Percentage of the market served in less than one day 4. Speed of delivery and of the supply chain
Allocations What gets resourced and how are people rewarded?	Resources go to <ol style="list-style-type: none"> 1. Developing new shipping centers 2. Innovation in determining new ways to provide people with movies Rewards and recognition for successes go to <ol style="list-style-type: none"> 1. Efficient shipping centers
Structure Power, authority, responsibility structure	<ol style="list-style-type: none"> 1. There is communication between the shipping centers to determine which DVD is shipped to which location 2. Employees must unpack and ship a certain number of DVDs per day
History Key routines that have developed and drive activities	<ol style="list-style-type: none"> 1. National Distribution System 2. Customer Movie Rating System 3. Relationships with Hollywood Studios

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