



Netflix: DVD vs. Streaming

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* The authors constructed this case solely to provide the basis for class discussion rather than to illustrate either effective or ineffective handling of a managerial situation. All people, places and financial data are fictionalized with the exception of direct quotations from publically available documents.

Abstract

This case study requires students to analyze the issues surrounding the decision of Netflix to split its business into two different parts: Qwikster for its DVD-by-mail business and Netflix for its streaming business. The case offers students a chance to evaluate the strategic choices of top managers, as they respond to rapid changes in technology that impact how consumers access their entertainment content. The case focuses on various aspects of equity valuation using the free cash flow model. Specifically, the case provides students an opportunity to explore the challenges of Netflix analysts when estimating the company's cost of capital, subscriber growth rates, and content acquisition costs in the context of intensifying competition in the on-line streaming market.

Key Words: Corporate Finance, Equity Valuation, Technology, Strategy, Netflix

INTRODUCTION

The Situation

On Monday, September 19, 2011, Rachel Adams, Senior Equity Analyst for Brooks Associates, Inc., a private equity company, was asked to reassess the stock of Netflix by Kenneth Brooks, the firm's Managing Partner. Adams was a junior analyst when she made a buy recommendation for Netflix in 2005. Since then, the firm's \$6 million dollar investment in Netflix increased to over \$77 million, making it one of the best performing stocks under their management. However, it still represented a drop of more than \$70 million in value from its peak position in July 2011, only two months ago. Brooks was concerned that the recent drop had more to do with the shift in the business model of Netflix, rather than the short-term market correction following the recent price hike and huge customer backlash. He was also concerned that a further decline in the stock price of Netflix could seriously damage Brooks' overall portfolio performance this year.

Company Background and Industry Information

Brief History

Founded on August 29, 1997 by Reed Hastings and Marc Randolph, Netflix enjoyed unprecedented growth by primarily providing a subscription-based digital video disc (DVD) movie rental business. Through the Netflix website, consumers were able to browse the extensive list of movies, select films they wanted to watch, and put each movie on their personal queue. Customers would receive DVDs via mail, watch them, and ship them back to receive new DVDs without worrying about late fees.

Netflix typically allowed customers to maintain one to four DVDs in their possession at any given time depending on their subscription package. The love affair consumers had with the Netflix DVD-by-mail business helped push the video rental giant Blockbuster into bankruptcy.⁶ However, by 2007, DVD-by-mail sales started to recede, and Netflix began to deliver movie-streaming services over the Internet.⁶

As of December 31, 2010, Netflix had over 20 million subscribers globally. Subscribers were able to access an unlimited amount of movies and television programs streamed over the Internet to their selected viewing devices including computers, mobile devices, and televisions. Subscribers in the U.S. could also have DVDs delivered to their homes.

Netflix continued to grow and change quickly. Revenues more than doubled in the last five years, growing from \$997 million in 2006 to \$2.16 billion in 2010 (Exhibit 1). Net income grew even faster, from \$49 million in 2006 to \$161 million in 2010. Total assets grew as well, albeit at a slower rate, from \$609 million in 2006 to \$982 million (Exhibit 2).

However, uncertainties regarding rapid changes in technology coupled with the viewership shift from DVDs to streaming caused the price of Netflix stock to fluctuate wildly, going from \$25.03 at the beginning of 2006 to \$298.73 in July 2011 before falling back to \$155.19 in September 2011 (Exhibits 3 & 4).

Furthermore, 2010 was the first year when more subscribers watched movies and television programs through streaming video than through DVDs. Netflix expected the streaming of entertainment video over the Internet to be the main driver for future growth. However, in spite of the solid growth in subscribers and declining acquisition cost per subscriber, Netflix struggled to improve the average monthly revenue and average gross profit per paying customer (Exhibits 5 & 6).

Company Strategy

The main strategy of Netflix (as of September 19, 2011) was to continue the expansion of the video streaming business, both in the United States and globally.¹² The company identified four main goals for future growth. Netflix wanted to (i) continue to improve customer service, (ii) expand content offered via streaming, (iii) expand streaming services to more types of Internet devices, and (iv) continue to meet established targets for operating margins.

Netflix executives expected the DVD business to decline over the next 5 years,⁵ and only remain viable for about 15 more years.¹⁰ Netflix's CEO Hastings was convinced that video streaming was becoming increasingly popular due to its faster speed and lower overhead.¹ According to the International Telecommunications Union, the broadband Internet subscriptions would reach 90 million in 2011 (Exhibit 7). Using broadband connections, Netflix customers could easily order and watch movies instantaneously without the loss of picture quality.⁴

To meet the increasing demand for streaming services, Netflix began investing heavily toward building its streaming content library while reducing its acquisition of DVD content. Overall, its content subscription costs grew from \$532 million in 2006 to \$1,154 million in 2010 (Exhibit 8). Netflix was able to limit the growth in marketing costs including free trials, but other costs, including fulfillment expenses, technology and development expenses, and administrative costs, were increasing in line with sales (Exhibit 9).

Competition

The entertainment video market was extremely competitive and continued to evolve quickly. Barriers to entry had been reduced as the industry moved to streaming video delivery over broadband connections.⁷ Therefore, new companies were able to enter the market without incurring huge startup costs.

Netflix had a large number of competitors, each delivering video content to viewers through varying forms of technology: (i) DVD rental via kiosks/stores, (ii) DVD via mail, (iii) pay-for-play streaming, and (iv) streaming through monthly subscription. The competition in the DVD rental market included Blockbuster, Redbox, Hollywood Movies and many other local businesses. Competitors in the streaming market included Apple (iTunes), Google (YouTube), Hulu (Multiple owners), and Amazon (Prime Instant Videos), plus other multichannel video programming distributors, such as HBO, Cinemax, Direct TV, Time Warner, and Comcast (Exhibit 10).^{7,8,9}

DVD AND STREAMING SERVICES

Strategy

Recognizing the failure of other former 'technology highfliers', including AOL and MySpace, to adapt to rapidly changing industry conditions, Netflix felt the need to move fast, especially since Hollywood studios were demanding significantly higher fees for online rights to movies and TV shows.⁶ Thus, Netflix was forced to seek out more revenue and put more emphasis on building their streaming library.⁸

At a Board meeting in April 2011, Netflix made the key strategic decision to separate their DVD-by-mail and online-streaming businesses from both pricing and product implementation perspectives.⁵ This decision became public on July 12, 2011¹¹ with the new pricing structure taking effect on September 1, 2011.²

The old pricing structure included a \$9.99/month option whereby customers could access movies via either DVD or streaming. The new pricing structure would unbundle these two methods of access. There would be a \$7.99 monthly fee for DVDs and an additional \$7.99 monthly fee for online streaming. Thus, customers who wanted to maintain both outlets would face roughly a 60% price increase, since $\$7.99 \times 2 = \15.98 /month, which is \$5.99 higher than the old combined fee of \$9.99.^{11,12}

The price increase was primarily aimed at improving the financial health of the company amid the declining DVD rental business.¹³ Thus, Netflix was trying to push customers into online delivery, whereby its costs had been historically lower and its profit margins higher.⁶ In conjunction with an investment plan to upgrade its content available over the Internet, Netflix was betting that in the long-run, the number of subscribers would grow or remain relatively stable.^{10,13} They also expected that revenues would grow from the price increase and costs would decline due to the increasing number of subscribers choosing the more cost-effective streaming option.⁸

Rationale

From a delivery cost perspective, streaming was much cheaper to Netflix. DVD warehouses were expensive, as were postal fees to ship and return DVDs.⁸ The cost of new deals to acquire content for streaming had increased from \$64 million in 2009 to over \$400 million in 2010 (Exhibit 8).¹⁰ While the gross profit margin on their DVD business stood at a healthy 37%, the corresponding margin for the streaming business easily exceeded that at 65%.⁶ Initially, Netflix expected 10 million (40%) out of its expected 25 million subscribers in 2011 to be on a streaming-only plan, with 3 million (12%) on a DVD-only plan, and the remaining 12 million (48%) to have a combination DVD/streaming plan.¹³

Response

Some analysts cautioned that a hasty move or refocus toward the streaming-only business could be a mistake.¹² Studios would continue to charge Netflix more for digital licensing deals, especially since competition among streaming content suppliers was increasing rapidly.⁷ The Hollywood studios had leverage on the streaming side, but had no ability to raise prices on the DVD side.¹⁰ Streamed movies were subject to deals the studios struck with TV cable networks like HBO and Showtime and could not be a part of the Netflix catalog until they had run their course on these networks.¹⁰ In contrast, Netflix owned the rights to the DVDs and rented them out earlier, since they were not subject to any timing or broadcast restrictions.¹⁰

The Netflix streaming content consisted mostly of mainstream films, and was relative weaker on smaller, independent films.⁴ It also did not have many newer titles,¹⁰ since these were often blocked for a probationary period so as to not cannibalize the studio's DVD sales or viewership on premium cable TV networks.¹² Customers complained that the streaming service of Netflix did not provide enough watchable content when compared to their DVD library.⁴ Netflix anticipated that increased investment in upgrading their streaming content would ultimately lure more subscribers.^{8,13}

Renegotiations, however, with content providers Sony, Disney, and others turned out to be increasingly challenging.⁵ Netflix previously had a deal with cable network Starz, but talks to renew the deal had broken off due to Starz demanding a price that was 10 times higher than what was agreed upon three years earlier.^{8,9} Thus, Starz would no longer allow Netflix to stream films it licensed from Sony and Disney.⁷ To replace this expiring deal, Netflix sought out a licensing deal with Discovery Communications, which owned programming rights for the Discovery Channel, TLC, and the Science Channel, and was in negotiation for a new deal with DreamWorks studio.⁹

DECISION TO FORM QWIKSTER AND SUBSEQUENT ANALYSIS

In July 2011, Netflix was one of the hottest U.S. stocks, and was widely expected to continue its ascent, especially due to its aggressive plans to expand into international markets (U.K./Ireland and Latin America), and its increased focus on streaming (relative to DVDs-by-mail).³ In fact, one analyst predicted the stock would hit \$1,000 within the next 5 to 7 years.³ By Sunday, September 18, 2011, only 17 days after their new pricing structure had gone into effect, Netflix stock was down 55-60% from its peak price achieved two months earlier.^{6,8} One reason for the decline was that Netflix had underestimated the number of subscribers that would lapse due to the price and administrative changes.^{7,8} As a result, Netflix CEO Reed Hastings issued a public letter (Exhibit 11) that was part-apology (for the price increase, and the manner in which it was communicated to customers), but also part-rationalization (i.e., so as to sway public opinion).⁵ In addition, the letter included the announcement that Netflix was officially separating their DVD business from their streaming business, and renaming the DVD business 'Qwikster'.^{5,10}

Rachel Adams understood the challenge that Netflix was facing. Although she agreed with CEO Reed Hasting's push toward the streaming business, she realized that a thorough analysis of the risks and returns for both its streaming and DVD services was necessary in order to make a strategic decision on Netflix stock within the next two days. Recognizing that she did not have much time, due to the Netflix stock price being so volatile the past few weeks, Adams began collecting data and reading recent industry reports. She also wondered whether Netflix should be viewed as a media company or as a technology company, given the diverse set of firms that it encountered in the marketplace. Feeling a great sense of urgency, Adams decided to begin her analysis by estimating the future subscriber growth and content acquisition costs.

CASE QUESTIONS

The following list of questions covers the majority of issues that Rachel Adams would seek to address in her analysis of Netflix, during the week of September 19, 2011, before she could offer her recommendation regarding Netflix stock.

1. What motivated Netflix to split its business into Qwikster for DVD-via-mail and Netflix for streaming? What is the right mix of investment and strategic focus for Netflix when allocating fixed resources to either the legacy DVD-by-mail business or the relatively more trendy online streaming business?
2. Analyze trends in both the history of Netflix financial performance and growth rates in subscriber counts. Also, evaluate the revenue and expense streams for Netflix, and any interaction between these two measures, in the context of the recent shift in corporate strategy.
3. Assess the impact of key competitors (Amazon, Apple, Google, Zulu, etc.) on the potential success or failure of Netflix, and the changing cost structure of these companies when paying for upgrades in the quality and quantity of content offered online.
4. Discuss whether the overall company-level estimate for 'cost of capital' will vary from the estimates for each of the two business types separately. Then, perform a prospective FCF-based valuation analysis.
5. What other qualitative issues may have a substantial impact on the future viability of Netflix and both the DVD and streaming access models? Also, recommend whether Brooks should buy more, sell, or continue to hold Netflix stock.
6. Discuss how Netflix might improve the processes of both communicating key product changes to consumers, and/or networking with cable TV channels, TV providers, and Hollywood studios.

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Exhibit 1. NetFlix Inc. – Income Statement (in millions of dollars)

	Fiscal Year Ends in December				
	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Sales	996.7	1,205.3	1,371.2	1,670.3	2,162.6
Cost of Sales	469.8	561.2	668.0	821.7	1,018.7
Gross Profit	526.8	644.1	703.1	848.5	1,144.0
SG&A Expenses	306.8	342.2	339.2	403.6	527.7
EBITDA	220.1	301.9	363.9	444.9	616.2
Depreciation	157.1	225.0	242.2	257.5	338.7
EBIT	62.9	77.0	121.7	187.4	277.5
Interest Expense	-	-	2.5	6.5	19.6
Non-operating Expense	15.9	27.5	18.8	11.3	9.8
Special Items	1.5	7.0	(6.5)	-	-
Pretax Income	80.3	111.5	131.5	192.2	267.7
Total Taxes	31.2	44.5	48.5	76.3	106.8
Net Income	49.1	67.0	83.0	115.9	160.9

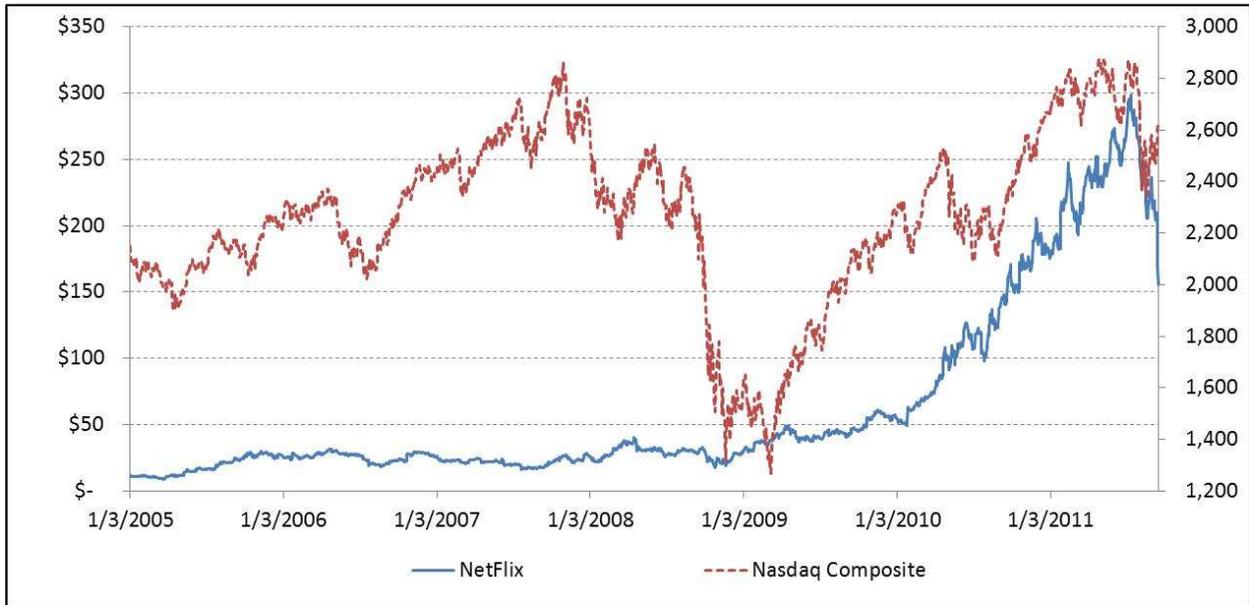
Source: Company Reports.

Exhibit 2. NetFlix Inc.- Balance Sheet (in millions of dollars, except for share values)

	Fiscal Year Ends in December				
	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Cash	400.4	387.4	297.3	320.2	350.4
Current Content Library	-	-	18.7	37.3	181.0
Other Current Assets	10.6	16.0	13.3	23.8	47.4
Total Current Assets	428.4	416.5	361.4	411.0	641.0
Property and Equipment	160.4	209.8	223.5	240.5	309.5
Intangibles	1.0	1.4	1.8	1.6	1.6
Deferred Charges	-	-	-	6.0	5.5
Other Investments	-	-	5.7	-	-
Total Assets	608.8	647.0	617.9	679.7	982.1
Debt - Current Portion	-	-	1.2	1.4	2.1
Accrued Expense	29.9	36.5	31.4	33.4	36.5
Accounts Payable	93.9	104.4	100.3	91.5	222.8
Deferred Revenue	69.7	71.7	83.1	100.1	127.2
Total Current Liabilities	193.4	212.6	216.0	226.4	388.6
Long-term Debt	-	-	38.0	236.6	234.1
Other Non-current Liabilities	-	3.7	16.8	17.7	69.2
Total Liabilities	194.6	216.3	270.8	480.6	691.9
Preferred Stock - Total	-	-	-	-	-
Common Equity	414.2	430.7	347.2	199.1	290.2
Total Stockholders' Equity	414.2	430.7	347.2	199.1	290.2
Shares Outstanding	68.6	64.9	58.9	53.4	52.8
Stock Price - FY Close	25.9	26.6	29.9	55.1	175.7

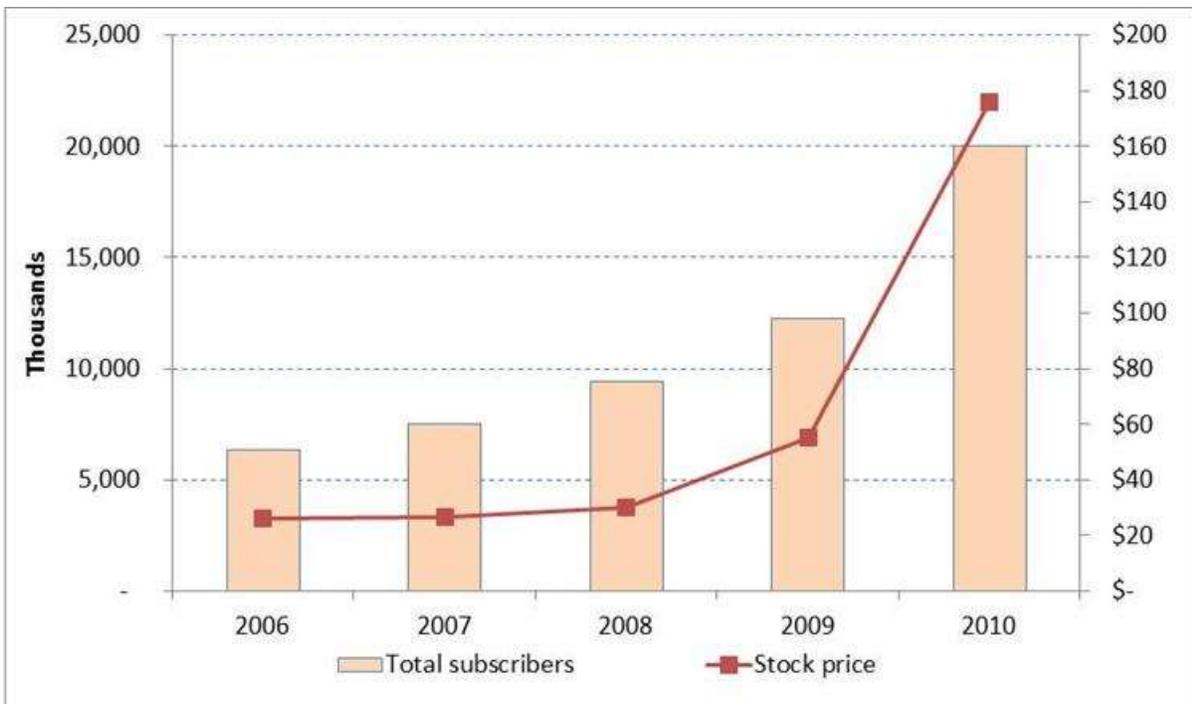
Source: Company Reports.

Exhibit 3. NetFlix Inc. Stock Performance, Jan. 2005 - Sep. 2011



Data Source: Bloomberg

Exhibit 4. NetFlix Inc. Subscriber Growth and Fiscal Year-End Stock Price



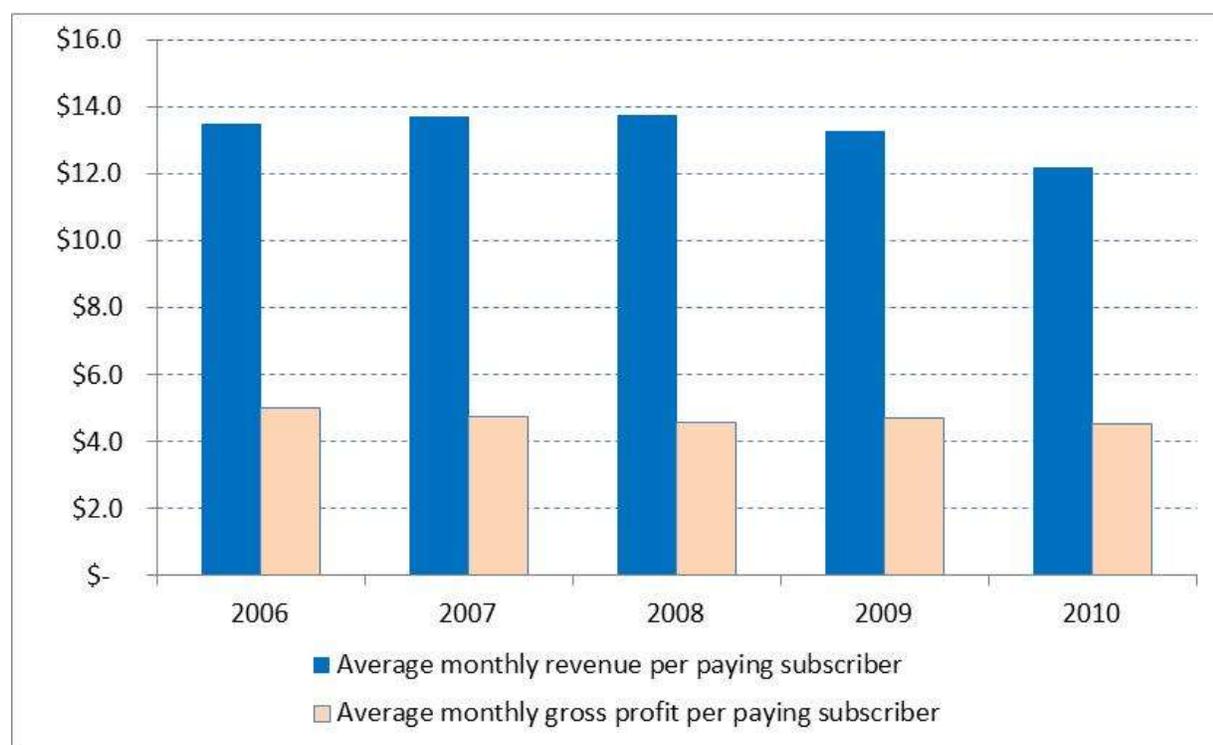
Data Source: Company Reports

Exhibit 5. NetFlix Inc. – Subscriber Data (in thousands, except for subscriber acquisition cost)

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Total subscribers	6,316	7,479	9,390	12,268	20,010
Free subscribers	162	153	226	376	1,742
Paid subscribers	6,154	7,326	9,164	11,892	18,268
Gross subscriber additions	5,250	5,340	6,859	9,332	16,301
Net subscriber additions	2,137	1,163	1,911	2,878	7,742
Acquisition cost per subscriber	\$ 42.94	\$ 40.86	\$ 29.12	\$ 25.48	\$ 18.03

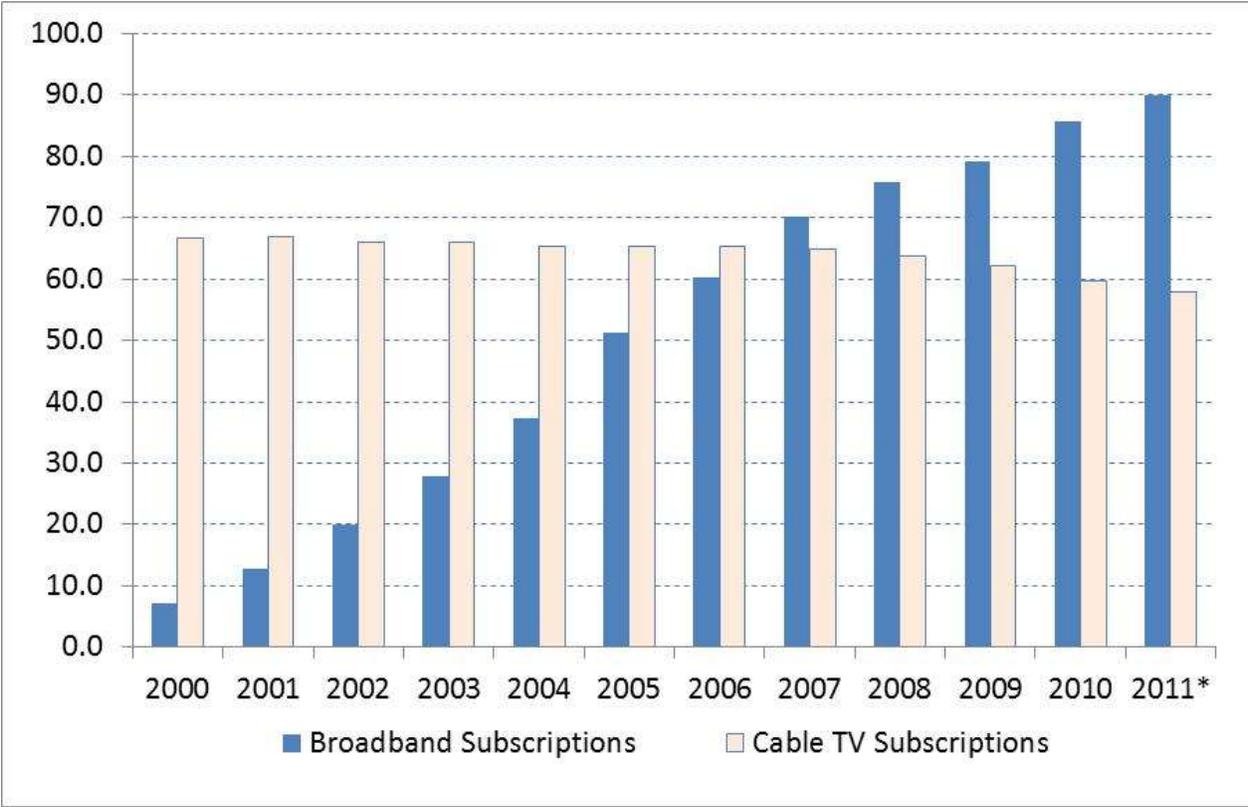
Source: Company Reports

Exhibit 6. NetFlix Inc. – Average Monthly Subscriber Revenue and Gross Profit



Data Source: Company Reports

Exhibit 7. Broadband Internet Subscriptions vs. Cable TV Subscriptions in the U.S. (in millions)



*Expected

Data Source: International Telecommunications Union (Broadband) / National Cable & Telecommunications Association (Cable TV)

Exhibit 8. NetFlix Inc. – Acquisition of Content Library and Capital Expenditures (in millions of dollars)

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Acquisition of streaming content library	-	-	48.3	64.2	406.2
Acquisition of DVD content library	169.5	223.4	162.8	193.0	123.9
Purchases of property and equipment	27.3	44.3	43.8	45.9	33.8
Amortization of content library	141.2	203.4	209.8	219.5	300.6
Depreciation and amortization of PPE	15.9	21.4	32.5	38.0	38.1

Source: Company Reports

Exhibit 9. NetFlix Inc. – Other Operating Data (in millions of dollars)

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Cost of subscription	532.6	664.4	761.1	909.5	1,154.1
Fulfillment expenses	94.4	121.8	149.1	169.8	203.2
Marketing costs including free trials	225.5	218.3	199.7	237.7	293.8
Technology and development expense	48.4	71.4	89.9	114.5	163.3
General and administrative costs	36.2	52.5	49.7	51.3	70.6
Interest expenses	15.9	20.3	2.5	6.5	19.6
Proceeds from sale of DVDs	12.9	21.6	18.4	11.2	12.9
Gain on disposal of DVDs	4.8	7.2	6.3	4.6	6.1

Source: Company Reports

Exhibit 10. NetFlix Inc. – Competitor Data (in millions of dollars)

<u>Company</u>	<u>Time Warner Cable</u>		<u>Dish Network</u>		<u>Coinstar Inc.</u>	
Income Statement	<u>2009</u>	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>	<u>2010</u>
Sales	17,868.0	18,868.0	11,664.2	12,640.7	1,144.8	1,436.4
Cost of Sales	8,555.0	8,941.0	7,022.8	7,386.9	793.4	1,000.9
Gross Profit	9,313.0	9,927.0	4,641.4	5,253.8	351.3	435.5
SG&A	2,830.0	3,057.0	1,953.4	2,103.6	155.1	159.9
EBITDA	6,483.0	6,870.0	2,688.0	3,150.2	196.2	275.6
Depreciation	3,085.0	3,129.0	940.0	984.0	99.8	117.5
EBIT	3,398.0	3,741.0	1,748.0	2,166.3	96.5	158.1
Interest Expense	1,311.0	1,397.0	408.1	471.9	34.3	34.9
Special Items	(127.0)	(52.0)	(361.0)	(225.5)	(13.2)	(14.9)
Pretax Income	1,912.0	2,196.0	1,012.8	1,542.2	48.2	108.9
Total Taxes	820.0	883.0	377.4	557.5	19.0	43.0
Net Income	1,070.0	1,308.0	635.5	984.7	53.6	51.0
Balance Sheet	<u>2009</u>	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>	<u>2010</u>
Cash	1,048.0	3,047.0	2,139.3	2,940.4	192.3	183.4
Receivables	663.0	718.0	779.9	786.1	61.4	26.0
Inventory	0.0	0.0	296.0	487.6	104.4	140.3
Total Current Assets	2,102.0	4,340.0	3,476.0	4,573.4	390.7	488.4
PP&E	13,919.0	13,873.0	3,042.3	3,232.3	400.3	444.7
Intangibles	26,477.0	26,314.0	1,391.4	1,391.4	315.4	277.3
Total Assets	43,694.0	45,822.0	8,295.3	9,632.2	1,222.8	1,282.7
Debt - Current Portion	0.0	0.0	26.5	1,030.9	33.2	197.9
Accounts Payable	478.0	529.0	520.3	400.8	118.9	161.6
Taxes Payable	0.0	0.0	0.0	0.0	20.6	2.3
Total Current Liabilities	2,958.0	3,086.0	3,287.3	4,499.3	374.6	633.3
Total Long Term Debt	22,631.0	23,421.0	6,470.0	5,484.0	429.2	165.4
Deferred LT Taxes	8,957.0	9,637.0	312.8	567.7	0.0	0.0
Total Liabilities	35,005.0	36,605.0	10,387.0	10,765.6	810.4	812.7
Preferred Stock - Total	0.0	0.0	0.0	0.0	0.0	26.9
Common Equity	8,685.0	9,210.0	(2,092.2)	(1,133.9)	412.4	443.1
Total Stockholders' Equity	8,685.0	9,210.0	(2,092.2)	(1,133.9)	412.4	470.0
Shares Outstanding	352.5	348.3	447.2	443.2	31.1	31.8
Stock Price - FY Close	41.39	66.03	20.77	19.66	27.78	56.44

Source: Company Reports

Exhibit 10. NetFlix Inc. – Competitor Data (in millions of dollars), continued

<u>Company</u>	<u>Apple Inc.</u>		<u>Amazon.com</u>		<u>Google</u>	
<u>Income Statement</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>	<u>2010</u>
Sales	42,905.0	65,225.0	24,509.0	34,204.0	23,650.6	29,321.0
Cost of Sales	24,999.0	38,609.0	18,594.0	26,009.0	7,337.9	9,036.0
Gross Profit	17,906.0	26,616.0	5,915.0	8,195.0	16,312.7	20,285.0
SG&A	5,482.0	7,299.0	4,300.0	6,131.0	6,468.0	8,523.0
EBITDA	12,424.0	19,317.0	1,615.0	2,064.0	9,844.7	11,762.0
Depreciation	684.0	932.0	432.0	657.0	1,506.2	1,381.0
EBIT	11,740.0	18,385.0	1,183.0	1,407.0	8,338.5	10,381.0
Interest Expense	0.0	0.0	34.0	39.0	0.0	0.0
Special Items	0.0	0.0	(51.0)	0.0	(26.3)	0.0
Pretax Income	12,066.0	18,540.0	1,155.0	1,504.0	8,381.2	10,796.0
Total Taxes	3,831.0	4,527.0	253.0	352.0	1,860.7	2,291.0
Net Income	8,235.0	14,013.0	902.0	1,152.0	6,520.4	8,505.0
Balance Sheet	2009	2010	2009	2010	2009	2010
Cash	23,464.0	25,620.0	6,366.0	8,762.0	24,484.8	34,975.0
Receivables	5,057.0	9,924.0	836.0	1,324.0	3,201.7	5,002.0
Inventory	455.0	1,051.0	2,171.0	3,202.0	0.0	0.0
Total Current Assets	31,555.0	41,678.0	9,797.0	13,747.0	29,167.0	41,562.0
PP&E	2,954.0	4,768.0	1,290.0	2,414.0	4,844.6	7,759.0
Intangibles	559.0	1,083.0	1,801.0	1,912.0	5,677.5	7,300.0
Total Assets	47,501.0	75,183.0	13,813.0	18,797.0	40,496.8	57,851.0
Debt - Current Portion	0.0	0.0	141.0	224.0	0.0	0.0
Accounts Payable	5,601.0	12,015.0	5,605.0	8,051.0	215.9	483.0
Taxes Payable	430.0	210.0	0.0	0.0	0.0	37.0
Total Current Liabilities	11,506.0	20,722.0	7,364.0	10,372.0	2,747.5	9,996.0
Total Long Term Debt	0.0	0.0	252.0	641.0	0.0	0.0
Deferred LT Taxes	2,216.0	4,300.0	0.0	0.0	0.0	0.0
Total Liabilities	15,861.0	27,392.0	8,556.0	11,933.0	4,492.6	11,610.0
Preferred Stock - Total	0.0	0.0	0.0	0.0	0.0	0.0
Common Equity	31,640.0	47,791.0	5,257.0	6,864.0	36,004.2	46,241.0
Total Stockholders' Equity	31,640.0	47,791.0	5,257.0	6,864.0	36,004.2	46,241.0
Shares Outstanding	899.8	916.0	444.0	451.0	317.8	321.3
Stock Price - FY Close	185.35	283.75	134.52	180.00	619.98	593.97

Source: Company Reports

An Explanation and Some Reflections, Sunday, September 18, 2011

I messed up. I owe everyone an explanation.

It is clear from the feedback over the past two months that many members felt we lacked respect and humility in the way we announced the separation of DVD and streaming, and the price changes. That was certainly not our intent, and I offer my sincere apology. I’ll try to explain how this happened.

For the past five years, my greatest fear at Netflix has been that we wouldn’t make the leap from success in DVDs to success in streaming. Most companies that are great at something – like AOL dialup or Borders bookstores – do not become great at new things people want (streaming for us) because they are afraid to hurt their initial business. Eventually these companies realize their error of not focusing enough on the new thing, and then the company fights desperately and hopelessly to recover. Companies rarely die from moving too fast, and they frequently die from moving too slowly.

When Netflix is evolving rapidly, however, I need to be extra-communicative. This is the key thing I got wrong.

In hindsight, I slid into arrogance based upon past success. We have done very well for a long time by steadily improving our service, without doing much CEO communication. Inside Netflix I say, “Actions speak louder than words,” and we should just keep improving our service.

But now I see that given the huge changes we have been recently making, I should have personally given a full justification to our members of why we are separating DVD and streaming, and charging for both. It wouldn’t have changed the price increase, but it would have been the right thing to do.

So here is what we are doing and why:

Many members love our DVD service, as I do, because nearly every movie ever made is published on DVD, plus lots of TV series. We want to advertise the breadth of our incredible DVD offering so that as many people as possible know it still exists, and it is a great option for those who want the huge and comprehensive selection on DVD. DVD by mail may not last forever, but we want it to last as long as possible.

I also love our streaming service because it is integrated into my TV, and I can watch anytime I want. The benefits of our streaming service are really quite different from the benefits of DVD by mail. We feel we need to focus on rapid improvement as streaming technology and the market evolve, without having to maintain compatibility with our DVD by mail service.

So we realized that streaming and DVD by mail are becoming two quite different businesses, with very different cost structures, different benefits that need to be marketed differently, and we

need to let each grow and operate independently. It's hard for me to write this after over 10 years of mailing DVDs with pride, but we think it is necessary and best: In a few weeks, we will rename our DVD by mail service to "Qwikster". We chose the name Qwikster because it refers to quick delivery. We will keep the name "Netflix" for streaming.

Qwikster will be the same website and DVD service that everyone is used to. It is just a new name, and DVD members will go to qwikster.com to access their DVD queues and choose movies. One improvement we will make at launch is to add a video games upgrade option, similar to our upgrade option for Blu-ray, for those who want to rent Wii, PS3 and Xbox 360 games. Members have been asking for video games for many years, and now that DVD by mail has its own team, we are finally getting it done. Other improvements will follow. Another advantage of separate websites is simplicity for our members. Each website will be focused on just one thing (DVDs or streaming) and will be even easier to use. A negative of the renaming and separation is that the Qwikster.com and Netflix.com websites will not be integrated. So if you subscribe to both services, and if you need to change your credit card or email address, you would need to do it in two places. Similarly, if you rate or review a movie on Qwikster, it doesn't show up on Netflix, and vice-versa.

There are no pricing changes (we're done with that!). Members who subscribe to both services will have two entries on their credit card statements, one for Qwikster and one for Netflix. The total will be the same as the current charges.

Andy Rendich, who has been working on our DVD service for 12 years, and leading it for the last 4 years, will be the CEO of Qwikster. Andy and I made a short welcome video. (You'll probably say we should avoid going into movie making after watching it.) We will let you know in a few weeks when the Qwikster.com website is up and ready. It is merely a renamed version of the Netflix DVD website, but with the addition of video games. You won't have to do anything special if you subscribe to our DVD by mail service.

For me the Netflix red envelope has always been a source of joy. The new envelope is still that distinctive red, but now it will have a Qwikster logo. I know that logo will grow on me over time, but still, it is hard. I imagine it will be the same for many of you. We'll also return to marketing our DVD by mail service, with its amazing selection, now with the Qwikster brand.

Some members will likely feel that we shouldn't split the businesses, and that we shouldn't rename our DVD by mail service. Our view is with this split of the businesses, we will be better at streaming, and we will be better at DVD by mail. It is possible we are moving too fast - it is hard to say. But going forward, Qwikster will continue to run the best DVD by mail service ever, throughout the United States. Netflix will offer the best streaming service for TV shows and movies, hopefully on a global basis. The additional streaming content we have coming in the next few months is substantial, and we are always working to improve our service further.

I want to acknowledge and thank our many members that stuck with us, and to apologize again to those members, both current and former, who felt we treated them thoughtlessly. Both the Qwikster and Netflix teams will work hard to regain your trust. We know it will not be overnight. Actions speak louder than words. But words help people to understand actions.

Respectfully yours, -Reed Hastings, Co-Founder and CEO, Netflix

Source: Netflix US & Canada Blog (<http://blog.netflix.com/2011/09/explanation-and-some-reflections.html>)