



## **Netflix Posts Impressive Gains as Hollywood Withers – What's Really Going on Here?**

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Earlier this week, Walt Disney Co. reported a 32% drop in quarterly net income, a decline much worse than analyst expectations and due primarily to a huge decline in DVD sales. Why did this happen? CEO Bob Iger pointed to two factors:

- (1) The impact of consumers scaling back spending on consumer electronics (CE) and DVDs amid “the weakest economy in our lifetime” and
- (2) Fundamental shifts in how consumers want to be entertained (changes some believe will fundamentally alter Disney's entire business structure).

This is what Jeff Zucker, CEO of NBC, calls the “the double trauma of digital revolution and severe recession,” and no one in the business of video is immune to its impact. Unless, that is, you're a company whose business model is counting on the digital revolution while positioned to win in down economic times. Unless, that is, you're Netflix – a company who, unlike others, is boasting strong growth in both revenue and subscribers, as well as early success in a medium where others have languished.

How is Netflix able to pull this off? Why is Netflix doing well in an environment which is defeating more traditional media brands like Disney and Blockbuster, two disparate elements of the same home video chain and both under the weather? What does the success of Netflix portend regarding the future of home video delivery and the nature of video consumption?

Good questions, for sure, but nothing we can discuss at sufficient length in this brief essay. We will, however, offer a few of our many thoughts on the subject.

It is interesting to note that CEO Iger correctly avoided blaming the whole of Disney's troubles on the weak economy, instead pointing to a second culprit: the fact that DVD sales may actually be declining because of fundamental changes in the way consumers go about “consuming” media, video in particular. Really? You

think? While this comes as no shock to those up on [TDG's quantum theory of media](#), it may be the first time a studio executive has publicly acknowledged its truth.<sup>1</sup>

What caused this spin-doctored executive to cease parsing words about the impact of digital video on consumer behavior, breaking with the coached rhetoric for which studio big-wigs have long been known? Because though we can honestly disagree about the pace at which virtual media is changing our consumptive behavior, few would debate that it is having a genuine transformative effect (both on individual consumers and the entire media industry).

Both of the factors to which Iger points are behavioral in nature: the first deals with purchasing behavior negatively impacted by the tanking economy (we're simply not buying as much media as before), and the second with how we go about consuming media (a symptom of much larger shifts in behavioral models indicative of the fact that old models no longer explain how or why consumers act as they do). As TDG has argued, we are in the midst of a shift from mass linear media to relativized or quantum media (with its "audience of one" personalization and enhanced levels of consumer control).

Subsequently, we're seeing heightened discussion in the popular press regarding consumers "cutting the cord" with traditional Pay TV providers in ways similar to those who previously "cut the cord" with their traditional landline phone providers. The value of these long-standing relationships is being challenged to the core – both economically and experientially – by the arrival of web-based alternative video services first to the PC and now to TV. Companies such as Netflix are thus able to bypass the consumer lock long enjoyed by both the Pay TV operator and the local video store and deliver content directly to the consumer. Yes (as Stephen Colbert often says), it takes some balls to think you can pull something like this off. But imagine if you succeed....Then again, forget about imagining it because it's already unfolding right before your eyes.

### **To Boldly Go Where Others Have Gone Before but Failed**

Are the folks at Netflix just fearless, or certified for treatment? If you haven't heard, Netflix is testing whether their current subscribers would pay an extra \$10 to get HBO streamed to their TVs and PCs. A DVD mail-order service as a virtual video network operator? Yep, and why not? Though they may not have been the first to launch a mail-order DVD business or stream video from the web to the TV, they were the first to build a successful mail-order DVD business and they are very likely to be the first to build a successful web-to-TV video streaming service (again, we're not talking downloads here).

So what's in the water at Netflix? Why is it so boldly traversing a business path littered with the corpses of failed start-ups, some of which were supported by the biggest brands in Hollywood and Silicon Valley? Why does Netflix believe it can succeed when so many others have failed?

We have a few ideas.

1. Netflix doesn't require consumers to pay additional service fees to watch streaming video on their PCs or TVs. It simply carved out a portion of the content for which consumers already paid and packaged that in a streaming video service to serve its existing (and growing) subscriber base. Essentially, Netflix just added streaming video as a standard feature of its existing service, with no additional monthly fee. It's a win-win for both Netflix and its subscribers. To give you an idea how well this strategy is working, Microsoft just announced that in the three months since the Netflix/Xbox streaming video service was

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<sup>1</sup> "Disney Loses on Two Fronts," By Dawn C. Chmielewski, *The Los Angeles Times*, February 4, 2009 (<http://www.latimes.com/business/la-fi-disney4-2009feb04,0,908187.story>).

launched, one million Xbox users have already signed up for the Netflix streaming service and are on average watching the video streaming around two hours each week.<sup>2</sup>

2. Netflix doesn't require its web-to-TV streaming customers to spend several hundred dollars for a dedicated proprietary hardware platform simply to view its content.<sup>3</sup> As TDG has long argued, it is critical for both short-term and long-term success that OTT providers avoid having to build and sell proprietary hardware to support a new service. "Go embedded and you'll never go back" has for many years been standard TDG counsel to OTT upstarts, though few paid attention. Instead, the Moviebeams and Akimbos of the world required upfront hardware fees in addition to the costs associated with service subscription or per-viewing fees. These early efforts were the antithesis of the low-risk recipe needed to get consumers to bite on something new. Instead, consumers had to pay before they were asked to pay to play (buy the set-top, buy the service, then play the video). As TDG warned, such efforts were non-starters and would never get off the ground.
3. In lieu of an expensive, proprietary set-top box, Netflix looked to existing consumer electronic platforms currently "on the shelf" and poised for growth (e.g., game consoles, Blu-ray players, HDTVs), then cut a deal to get their "stuff" put in the vendor's platforms. Another win-win – Netflix gets access to (potentially) millions of consumer-facing platforms, and the CE vendor gets a highly differentiated product capable of competing more effectively in highly commoditized markets characterized by razor-thin margins.
4. Netflix had built a strong brand in home video prior to rolling out a streaming video service (and even then it acted incrementally, starting with streaming to the PC, waited for viewership and interest to build, and only then pushed on to the TV). Its original vision was to carve out a slice of Blockbuster's pie using web-based DVD rentals, a simple strategy which Blockbuster completely underestimated. What, Blockbuster asleep at the wheel? I know, big surprise ("Vanity...it's my favorite sin!"). To add insult to injury, Netflix has again trumped Blockbuster, only this time in online video – Netflix is the first (and remains the only) company to offer a subscription-based video streaming service (versus Blockbuster's proprietary set-top/pay-to-play video download service) and the first to bring in third-party CE vendors as partners.

Today, Netflix enjoys almost 10 million users, positive word of mouth, and loyal consumer support – an audience ripe and ready to embrace new (and "free") service enhancements like streaming video. Not that simply having a strong brand is enough to succeed or survive in this emerging space. That's a dangerous delusion (remember Wal-Mart's initial foray into web video distribution?). Netflix is combining its strong consumer-friendly media brand with the right technology, the right user base, and the right business model (subscription streaming with no upfront hardware costs). Without each of these elements in place, the most well-intentioned OTT effort will end in failure. Witness the experience of Vudu, which in my opinion offers the highest quality OTT

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<sup>2</sup> One million Netflix-Xbox activations (both hardware and software in place) with 1.5 billion minutes of viewing time logged means about 1,500 minutes per user or about 25 hours in the 11 weeks since the service was launched. Translation: each Xbox Netflix user averages a little more than two hours of viewing time each week, precisely what TDG predicted in its most recent console video consumption forecast, [Console Vendors and OTT Video Delivery: Let the Games Begin!](#)

<sup>3</sup> Yes, the initial partnership with Roku smacked of a proprietary relationship, but Netflix was quick to dispel that rumor and subsequently launched on other platforms including game consoles (Xbox 360), Blu-ray players (LG and Samsung), and TVs (LG), with many more announcements expected very soon. As well, Roku just announced the addition of Amazon's Unbox video delivery service for rentals and downloads to its platform (a move which actually received a nod of approval from Netflix).

movie service out there – simply to set up, an intuitive, easy-to-use interface, tons of high-quality Hollywood movies, and an expanded “free” section which includes a vast library of video for streaming. Its weaknesses, however, are readily apparent: it requires a new subscriber to invest \$200 or more in a set-top box that can only be used to do one thing, watch video on Vudu; it isn't leveraging an established brand; and it doesn't have an established base of loyal, paying subscribers to support such a play. This isn't just Vudu's limitation, but one which haunts many OTT video start-ups armed with a great idea but no way to sell it.

In the end, the folks at Netflix seem to grasp a key and unwavering truth of the OTT business, one which remains oblivious to many in this business: those who will rise to the top of the early OTT market will position their TV streaming efforts as a logical extension of some solid, media-relevant brand with which consumers have prior experience. Yes, upstarts such as Sky Angel, the OTT Christian broadcasting network, may enjoy limited success in their specific niches, but those who emerge as dominant forces in the broadband TV arena will be extensions of core consumer brands with which we are already familiar. Thus Netflix will be able to build a successful video streaming service precisely because it has a successful DVD rental business from which to launch; a large and loyal audience of subscribers eager for the latest and greatest services; and a brand that communicates value and variety.

### **About The Diffusion Group (TDG):**

TDG is a market planning and research firm dedicated to keeping our clients In Front of the Curve™. Since 2004, TDG has helped more than 250 technology leaders, media companies, and service providers to understand and manage the quantum shifts now impacting how consumers access, navigate, distribute and consume media – whenever and wherever they may be.

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