# Netflix: Streaming into the future

**Will Netflix be able to turn the movie rental business upside down in the streaming environment, the same as it did more than a decade ago with DVDs?**

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The idea for Netflix was born in the mid-1990s, when company cofounder Reed Hastings forgot to return a movie rental and was fined more than $40 by the rental company.

"I realized immediately that it was a poor customer experience," he recalls. "It was also suboptimal for the companies — the retailers and studios alike."

The experience inspired Hastings and business partner Marc Randolph to launch Netflix in 1997.

The business idea was to offer a selection of DVDs that could be ordered online and delivered directly to customers' homes and later returned via standard U.S. mail.

But that original business model can only take you so far.

In his case study, "Netflix: The Streaming Challenge," IESE Prof. Marc Sachon considers the challenges and opportunities that Netflix faces in maintaining its position as a leading movie rental company in an age of streaming over the Internet.

## Phenomenal growth

Netflix was the first entertainment company to establish a successful flat-fee model. For $19.95, subscribers could select DVDs from a catalog of available titles and keep them for as long as they wanted.

Traditional movie rental chains could not beat such a convenient service. This allowed Netflix to break all previous records of growth in online subscriptions.

It also led many industry experts to realize that the traditional movie rental business had no future, as it was burdened with significantly higher fixed and variable costs.

Netflix did not operate any stores, but dispatched DVDs from its 50 distribution centers distributed across the United States.

By 2010, subscribers in U.S. metropolitan areas could choose from an online catalog of more than 100,000 titles and receive their pick within 24 hours, on average.

Having such a large online catalog enabled Netflix — and, by extension, Hollywood — to make money where nobody had done before: in the so-called "long tail" of the distribution chain among the less popular, non-blockbuster items.

In this, Netflix's recommendation system was crucial. By aggregating and crunching subscriber data, Netflix could automatically generate further movie suggestions that closely mirrored a user's preferences.

This provided for an unmatched customer experience in an environment of product proliferation.

In putting this system together, Netflix was pioneering the sort of customer analytics that have become the cornerstones of other Internet companies like Facebook.

Note: See earlier case study by Marc Sachon,"[Netflix: Online Rental of DVDs, From Clicks to Bricks & Flix](#)."

## Change of scenery

In 2007 Netflix introduced its first version of streaming. Netflix chose live streaming over downloading as it made pirating more difficult, while at the same time provided more instant gratification to customers.

By 2010 Netflix was distributing more movie content via the Web than via DVDs. Indeed, by 2011, more than a quarter of all North American Internet traffic was being generated by Netflix.

Online movie distribution generally falls into two categories: "Head" companies, such as

Apple, distribute a selection of box-office hits under a pay-per-view model. Netflix, meanwhile, leverages its recommendation engine to offer a wide selection of movies at the "tail" of the distribution chain.

In 2012, it was not yet clear how the power struggle in this chain would evolve.

The power players of Hollywood traditionally supported the online initiatives of companies like Amazon and Apple to distribute a limited number of hit titles via their platforms.

But Hollywood also realizes that pushing too hard at the "head" could result in a loss of the value generated at the "tail" of the distribution chain via Netflix's business model.

Even though Amazon and Apple are establishing themselves as key players in this field, only Netflix has the multimillion subscriber base across so many different platforms, Android included.

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