

TEACHING NOTE 9: NETFLIX, Inc.

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Case synopsis

The case describes Netflix remarkable journey, it explains the development of the business model from Netflix' initially value proposition, to duplicate the best parts of the video store experience, to mailing rented DVD's to consumers and eventually to on-demand streaming service as we know it today. To enable Netflix subscribers to watch streaming content on their televisions and later also on their smart devices, Netflix made deals to incorporate their software on over two hundred internet-connected devices. Netflix accounts for 35 percent of peak internet traffic, delivering over 125 million hours of video per day. This heavy network usage has sometimes led to strained relationships with the Internet service providers (ISPs) that carry Netflix's data. To stay relevant and to leapfrog their increasingly challenging competitors like Redbox, HBO Now, Hulu, Amazon Video, Sling TV and YouTube Red. Netflix developed their own content to distinctive themselves and planned to spend \$6 billion on original and licensed content in 2017, up from \$5 billion in 2016. The majority of this spending goes towards television shows and movies licensed from others. Netflix had successfully taken on Blockbuster, who at the time didn't believe in the future value of Netflix when they were still viable and had the opportunity to join forces with Netflix. Much like Blockbuster in the past, Netflix had grown quickly and become a household name.

Teaching Objectives

If used in conjunction with Chapter 9, the Netflix case can be used to meet the following teaching objectives:

- *Understanding the characteristics of strategic innovation:* Strategic innovation, i.e. renewing the firm's business model to create or sustain a competitive advantage, aims to achieve a long-term corporate life. Strategic innovation or renewal is based on change of one or more strategic characteristics, namely: Strategic Reasoning, Strategic Visioning, Strategic Alignment and Strategic Venturing. All these characteristics are touched upon in the Netflix case and their identification helps to gain better insight on the influence of these changes on the innovativeness of the organization.
- *Comprehending business model renewal:* A business model consists of three elements: the product offering, which is to be a superior mix of attributes (e.g. price, reliability, specifications); the value chain, the value adding way to supply the superior product offering; and the resource base that is necessary to perform the value adding activities. The Netflix case shows the evolution of its value proposition from mirroring the traditional brick-and-mortar video stores into the on-demand streaming service as we know it today.
- *Understanding the paradox of exploitation and exploration:* This paradox leads to the question whether the company should renew itself by improving the current organization or by radically rejuvenation the organization through disrupting technologies and processes. Netflix is a case in which they do both.

Teaching Guideline

Students can learn about business model renewal from Netflix, their ability to change their value proposition and their perspective on strategic innovation. Although strategists cannot predict the future, they know that it will differ from today. Netflix not only reacted to changes, they also initiated changes by innovation activities, effectively creating an environmental misfit for competitors, like Blockbuster. Also, students can learn that it can take bold moves to leapfrog intense competition, and that this can be done with less risk if you know your customers behavior in more detail and if you are able to utilize customer insights. Netflix released its first original series, “House of Cards,” in 2013 for instance, and commissioned two seasons upfront for \$100 million, a bold move that was enabled by Netflix’s detailed knowledge of their customers.

Netflix also faced challenges with Internet Service providers for example, the case shows how to manage external partners in order to strengthen the company’s competitive position with exploitation, Netflix developed its Open Connect system for instance to make interconnection with the ISP’s infrastructure simpler and located their servers near or inside ISPs’ facilities.

Case Questions

1. *Describe the strategic innovation processes Netflix has underwent*
2. *Describe how Netflix overcomes the inhibitors of strategic innovation*
3. *Describe how Netflix engages simultaneously in Outside-In and Inside-Out renewal*
4. *Explain the dominating Netflix perspective on strategic innovation*

Case Analysis

1. *Describe the strategic innovation processes Netflix has underwent*

There are four constituting elements of strategic innovation: creating, entrepreneuring, changing and investing processes.

Strategic innovation as a creating process is about creative thinking within a ‘bounded context’, Netflix has shown lots of creativity to reach to where they are today, one illuminating example of this creativity showed off when they felt that their DVD income stream was under pressure when retailers like Amazon and Walmart began stocking DVD’s. Netflix response was to have a meeting with Amazon’s Jeff Bezos and make a cross promotion deal with Amazon instead of competing with them.

Strategic innovation as an entrepreneurial process is about the driving force of entrepreneurial activity in order to find growth opportunities. Obviously, Netflix demonstrated their entrepreneurial activity by unlocking the online streaming possibilities for their services as the vehicle for growth in which they succeeded without a doubt.

Strategic innovation as a change process is about changing the organizational system (how people have been configured and relate to one another) which also needs to be adjusted in line with business model changes. Little has been said in the case about the change process although there is one related example, in 2011 Netflix splitted the DVD and streaming subscriptions with a new entity, Qwikster, handling DVD by mail. This reconfiguration led to a price increase for some customers, a misstep, Netflix quickly reversed the decision a few weeks later.

Strategic innovation as an investing process is about a positive return on invested resources. Investments in strategic innovation competes with other investment categories. International growth is one strategic investment Netflix is pursuing. Of Netflix’s 93.8 million subscribers, 49.4 million (or 53 percent) are in the US. Netflix announced in January 2016 that it would be radically expanding its services internationally from 60 to 190 countries.

2. *Describe how Netflix overcomes the inhibitors of strategic innovation.*

Strategic renewal is hard to accomplish, mainly as a result of the following inhibitors:

- *Innovation results.* When established companies consider innovation options, past experiences influence how alternatives are valued and evaluated. They become reluctant to explore alternatives that have been tried before, in favor of ways and means that have brought executives success in the past. Netflix overcomes this inhibitor by really listening to their customers, if their customers seem to agree with the course of action, they move forward, this was the case when their customers did not seem to agree with Netflix' course of action, they undo their decisions.
- *Inertia and bias.* Building up inertia and bias over time prohibits organizations from appreciating the potential of innovation outside the dominant organizational logic and managers' cognitive maps. Netflix hammers on the avoiding the mistakes that have been made by similar companies, Blockbuster and AOL for instance which eventually became obsolete. With those experiences in mind they keep pushing forward to improve their services to not end up like them. Also the competitive landscape became quite large over time, causing the need for them to stay on top of their game.
- *Feedback.* When innovation results are satisfying to senior management, employees are no longer pushed to explore other possibilities. Netflix way to overcome this hurdle lies in its international expansion drift. By continuously growing and exploring new geographical markets and related challenges, feedback continually comes from different people with different cognitive maps with possible solutions to issues relevant in different contexts.

3. *Describe how Netflix engages simultaneously in outside-in and inside-out renewal*

Outside-in renewal, is about the perspective of the market – in other words, from the outside in, that drives strategy. With an outside-in mindset, top management's strategy dialogue starts with the market.

Inside-out strategic thinking, on the other hand ultimately relies on gaining maximum returns from existing assets – in other words, increasing efficiency.

Obviously Netflix does both, they have an outside-in mindset, looking closely to what the market demands of them, what alternatives the market has to offer and how the market responds to their actions. They also listen to the market if they have made a decision what turns out to be a bad decision.

From the inside-out perspective, Netflix has been very successful with scaling up their services to more subscribers, in more countries with higher quality content, continuously updating their systems, infrastructure and content.

4. *Explain the dominating Netflix perspective on strategic innovation*

There are two perspectives on strategic innovation. On the one hand side is the strategic improvement perspective, proponents of this perspective advocate that companies should focus on improving their business model. On the other hand side is the radical rejuvenation perspective, according to this perspective companies should focus on breakthrough innovations that change the rules of the competitive game rather than becoming better at playing by the current rules.

Netflix dominating perspective is the strategic improvement perspective, this has more or less to do with the fact that the services of Netflix are pretty much straightforward, driven by technology and thus scalable and fulfilling a great need wherefor they can built upon their current business model.

What happened after the case?

Netflix's global growth is a big factor in the company's success. By 2017 it was operating in over 190 countries, and today close to 73 million of its some 130 million subscribers are outside the U.S. In the second quarter of 2018, its international streaming revenues exceeded domestic streaming revenues for the first time. This is a remarkable achievement for a company that was only in the U.S. before 2010, and in only 50 countries by 2015. Netflix's success can be attributed to two strategic moves — a three-stage expansion process into new markets and the ways it worked with those markets — which other companies looking to expand globally can use too. Netflix did not try to enter all markets at once. Rather, it carefully selected its initial adjacent markets in terms of geography and psychic distance, or perceived differences between markets. For example, its earliest international expansion, in 2010, was to Canada, which is geographically close to and shares many similarities with the United States. Netflix was thus able to develop its internationalization capabilities in locations where the challenges of “foreignness” were less acute. In doing so, the company learned how to expand and enhance its core capabilities beyond its home market. (adapted from HBR, How Netflix Expanded to 190 Countries in 7 Years, by Louis Brennan)