Northern Michigan University

CASE: NETFLIX, INC.

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PERFORMANCE HISTORY

Performance History and Content Spending of Netflix Inc. 2012-2021 (In Thousands of $)

	2021	2020	2019	2018	2017
Revenue	$ 29,697,844	$ 24,996,056	$ 20,156,447	$ 15,794,341	$ 11,692,713
Net Income	$ 5,116,228	$ 2,761,395	$ 1,866,916	$ 1,211,242	$ 558,929
Additions to Streaming Content	$ 17,702,202	$ 11,779,284	$ 13,916,683	$ 13,043,437	$ 9,805,763
Revenue Change YOY	18.81%	24.01%	27.62%	35.08%	32.41%
Profit Margin	17.23%	11.05%	9.26%	7.67%	4.78%
Revenue Dedicated to Adding Content	59.61%	47.12%	69.04%	82.58%	83.86%

Fig. 1.1 shows the performance history of Netflix between the years 2017-2021. The data highlights revenue, net income, and amount spent of adding content to the platform as well as various ratio analyses (Netflix).

	2016	2015	2014	2013	2012
Revenue	$ 8,830,669	$ 6,779,511	$ 5,504,656	$ 4,374,562	$ 3,609,282
Net Income	$ 186,678	$ 122,641	$ 266,799	$ 112,403	$ 17,152
Additions to Streaming Content	$ 8,653,286	$ 5,771,652	$ 3,773,019	$ 3,030,701	$ 2,515,506
Revenue Change YOY	30.26%	23.16%	25.83%	21.20%	12.63%
Profit Margin	2.11%	1.81%	4.85%	2.57%	0.48%
Revenue Dedicated to Adding Content	97.99%	85.13%	68.54%	69.28%	69.70%

Fig 1.2 is a continuation of Figure 1.1 for the years 2012-2016 (Netflix)

Netflix Inc. has experienced significant growth over the past ten years. The company's revenue increased 722% in 2021 when compared to 2012. Revenue consistently increased with an average yearly growth of about 25% since 2012. Net income increased yearly as well, with the highest profit margin occurring in 2021. The years 2019-2021 had the largest profit margin with a relatively enormous margin of 17.23% in 2021, which was well above the 10-year average of (including 2021) 6.18%. The increase in profit margin in 2021 can be attributed to the decrease in the proportion of revenue dedicated streaming content (2015-2018) and a decrease in the proportion dedicated to marketing, technology development, and general & administrative expenses. All of the information provided in Figures 1.1 and 1.2 were found in Netflix's annual Investor Relations Reports.

Total and Additional Paying Netflix Members 2012-2022 (In Thousands Except Percentages)

	2022 (Q1-Q3)	2021	2020	2019	2018	2017
Paid Net Membership Additions	1,241	18,181	36,573	27,831	28,615	21,554
Total Paid Memberships	223,085	221,844	203,663	167,090	139,259	110,644
New Additions Ratio	0.56%	8.20%	17.96%	16.66%	20.55%	19.48%

Fig. 2.1 shows the total, additional, and percentage increase in membership for Netflix for the years 2017-2022 (Netflix).

	2016	2015	2014	2013	2012
Paid Net Membership Additions	13,464	15,482	11,945	9,787	5,773
Total Paid Memberships	89090	75626	60144	48199	38412
New Additions Ratio	15.11%	20.47%	19.86%	20.31%	15.03%

Fig. 2.2 is a continuation of Figure 2.1 for the years 2012-2016 (Netflix).

Netflix has seen a similar growth in terms of paid membership additions over the past ten years, which is to be expected. In 2021, Netflix had grown their paid membership base by 477% since 2011. The lower increase when compared to revenue shows that Netflix is generating more revenue per customer than in previous years. Over the years 2011-2021 the average increase of net membership additions was 17.36%. The year that had the largest growth in terms of paid membership additions was 2018 with an increase of 20.55%.

Netflix experienced growth troubles in the year 2022 with the first two quarters losing over 1 million paying members, but the third quarter made up for the troubles with an addition of about 2.4 million paying members. The loss of paid memberships was reflected in Netflix's stock price dropping nearly 67% from year opening to the end of Q2 2022. All of the information provided in Figures 2.1 and 2.2 were found in NASDAQ's Netflix stock reporting.

CANNIBALIZATION PREDICTIONS

Competition Prices and Proportion of Ad-Supporting Accounts

Company	Price w/ Ads	Price w/o Ads	Discount	Ad Supported Accounts	Multiplier
Hulu	$ 7.99	$ 14.99	47%	70%	1.50
Discovery	$ 4.99	$ 6.99	29%	64%	2.24
Paramount	$ 4.99	$ 9.99	50%	69%	1.38
Peacock	$ 4.99	$ 9.99	50%	71%	1.42
HBO	$ 9.99	$ 14.99	33%	43%	1.29
Netflix	$ 6.99	$ 9.99	30%	?	?

Fig. 3.1 shows the monthly subscription prices of competing streaming platforms ad-free subscription model and the least expensive ad-free subscription to determine the discount offered. The proportion of accounts that utilize the ad-supported model is listed as well, which is used to determine a multiplier of proportion to discount ratio [Multiplier] (Hulu, Discovery+, Paramount+, Netflix, Peacock+, HBO, Peters, Lukovitz).

A major concern (or benefit depending on advertisement revenue) for Netflix is the percentage of current members that will transfer their accounts to the ad-supported plan. By observing the averages of competing streaming platforms it's possible to make a relatively close prediction as to what proportion of cannibalized accounts. Competing streaming platforms have an average of 63% of total paid memberships that are supported with advertisement revenue. When predicting the cannibalization rate the discount provided by the advertisements need to be considered. The multiplier column takes the discount into consideration by taking the proportion of ad supported accounts divided by the discount provided by the ad-supported plan. The average multiplier is 1.56x. The multiplier would suggest that Netflix's discount would generate a total proportion of about 47% of ad-supported accounts.

Netflix is one of two platforms that offer more plans than just the ad-supported versus no advertisements (Hulu offers many different plans as well) . Netflix's basic plan with and without advertisements only offer 720p video quality, and the ad-supported plan has most but not all of the movies and tv shows offered in their basic plan with ads. Some of the missing shows include *House of Cards, New Girl,* and many other popular titles. The user can also pay an additional $4.99-9.99 for 1280p and 4k qualities respectively. The lower quality, discount, and entertainment offerings will drastically decrease the proportion of accounts that will be cannibalized.

First, the average should be taken of the suggested 63% and 47% resulting in a predicted 55%. But, the lower quality video and lack of offerings are likely to greatly reduce the appeal of the plan for customers. Another component that will likely reduce the appeal for customers is the past promises of Netflix which states that they would never allow advertisements on the platform. With all of these hinderances in mind, Netflix will likely have a cannibalization rate of 30-40%.

Predicted Cannibalization Rates and Net Loss in Subscription Revenue

Cannibalization Rate	30%	35%	40%
Total Paid Memberships (2021)	221,844	221,844	221,844
Cannibalized Memberships	66,553	77,645	88,738
Subscription Revenue Generated	$ 5,582,466	$ 6,512,863	$ 7,443,343
Cannibalized Subscription Revenue	$ 9,320,082	$ 10,873,406	$ 12,426,870
Net Loss	$ (3,737,616)	$ (4,360,543)	$ (4,983,526)

Fig 4.1 shows the revenue generated by offering the reduced subscription price and the opportunity cost associated.

Due to Netflix's difficulty gaining new memberships in 2022 the total paid memberships from 2021 will be used to calculate cannibalization. Depending on the low, medium, and high estimates derived from the Figure 3.1, the predicted subscription revenue and cannibalization is calculated. According to Netflix Investor Relations 2021, the average customer pays $11.67 per month.

NEW AD-SUPPORTED MEMBERSHIPS AND REVENUE

Predicting the number of new memberships to Netflix's ad-supported platform will be derived by observing Figures 2.1 and 2.2. The average number of total new memberships over the past five years (2017-2021) is 26,550,800 per year. A very optimistic assumption would be that just over half, or 13,500,000 new memberships, of the five-year average would be generated in 2022 due to the ad-supported plan. The generous assumption will then be broken down into three levels to predict a pessimistic, neutral, and optimistic result.

Scenario 1	
CPM	$ 62.50
Watch Time (Hours)	0.5
# of Ads/Hr	9.00
Ads Per Day	4.5
Revenue/Day/Sub	$ 0.28

Scenario 2	
CPM	$ 62.50
Watch Time (Hours)	1
# of Ads/Hr	9.00
Ads Per Day	9.00
Revenue/Day/Sub	$ 0.56

Fig. 5.1 and 5.2 show the calculations used to determine an estimated daily revenue generated by advertisements based on assumed watch time (Business Insider, Netflix)

The next important estimation is the amount of revenue generated per day per member from advertisements. According to Business Insider and many other sources the cost per mille (CPM) Netflix will charge advertisers will be somewhere between $60 and $65 (AdExchanger, Low), which is well above standard at $30-35 for Connected TV industry. Netflix reports that members will view between 4-5 minutes of advertisements every hour (Netflix). The advertisements may be 15 or 30 seconds long, but for simplicity's sake only the 30 seconds advertisements will be considered (Netflix). In addition, the 15 second advertisements will likely have a lower CPM. The next consideration is the viewing time per customer. According to multiple sources, average pre-quarantine watch times for Netflix was a whopping 2 hours a day (Clark). Taking into consideration the increased prominence of various new streaming platforms the average watch time per customer is likely 30 minutes to an hour a day. The two scenarios result in an incredible $0.28-0.56 in revenue per member each day. The average of the two scenarios ($0.42) will be used in later calculations.

Revenue Generation From Additional Ad-Supporting Members

	Pessimistic	Neutral	Optimistic
Paid New Membership Additions	4,500	9,000	13,500
Subscription Revenue	$ 377,460	$ 754,920	$ 1,132,380
Advertisement Revenue	$ 689,850	$ 1,379,700	$ 2,069,550
Total Additional Annual Revenue	$ 1,067,310	$ 2,134,620	$ 3,201,930

Fig 5.3 shows the revenue generated from subscription costs ($6.99/month) and advertisements based on an assumed pessimistic

Based on a $6.99 subscription price per month and the estimated revenue generated by each member per day ($0.42) the estimated total annual revenue provided by the estimated new membership additions are provided. Ultimately, there's no concrete way to make this prediction as Netflix's ad-supported model is unique when compared to other streaming platforms. Unfortunately for Netflix, the drawbacks of the ad-supported plan are more pronounced compared to other streaming platforms which will likely result in a much more pessimistic outcome. In addition, advertisers may not want to pay the exorbitant CPM prices.

TOTAL ADVERTISEMENT REVENUE

Total Revenue Generated From Advertisements

	Pessimistic	Neutral	Optimistic
Cannibalized Memberships	66,553	77,645	88,738
Paid New Membership Additions	4,500	9,000	13,500
Total Ad-Supported Memberships	71,053	86,645	102,238
Annual Advertisement Revenue	$ 10,892,425	$ 13,282,679	$ 15,673,085

Fig 6.1 combines the revenue generated by advertisements from both cannibalized members and new membership additions.

Combining the pessimistic, neutral, and optimistic predictions from Figures 4.1 and 5.2 the estimated cannibalized and new memberships are combined to find the total ad-supported memberships at the end of 2022. The memberships are then multiplied by the average of the daily advertisement revenue scenarios in Figure 5.1 which is then annualized.

TOTAL ADDITIONAL REVENUE

Total Net Gain in Revenue From Subscription Model

	Pessimistic	Neutral	Optimistic
Annual Advertisement Revenue	$ 10,892,425	$ 13,282,679	$ 15,673,085
Net Cannibalized Subscription Revenue Loss	$ (3,737,616)	$ (4,360,543)	$ (4,983,526)
New Ad-Supported Membership Subscription Revenue	$ 377,460	$ 754,920	$ 1,132,380
Net Gain	$ 7,532,268	$ 9,677,055	$ 11,821,939

Fig 7.1 shows the net gain that Netflix would experience from the new ad-supported subscription model in 2023. The model relies heavily on cannibalization rates and CPM of advertisements (Netflix).

Combining the estimations from Figures 4.1, 5.3, and 6.1 the total net gain from the advertising model is provided. The estimations show an enormous increase in revenue for Netflix with an increase range of 25%-40%. The increase in revenue is mostly attributable to the revenue generated by advertisements for cannibalized members as they would make up the bulk of the audience rather than new subscribers.

The estimations rely heavily on the CPM achieved by Netflix. If Netflix isn't able to convince advertisers to pay the high premium of $62.50 CPM, then the net gain will be much lower. Assuming that Netflix achieves the industry standard CPM of about $32.50 the net gain in revenue would have a range of $5,664,000-8,150,000 or an increase in revenue of about **19-27%.** The actual increase in revenue is likely to be within this range. Nonetheless, Netflix's ad-supported subscription model will very likely increase overall revenue and subscription numbers for Netflix.

ALTERNATIVE STRATEGIES TO INCREASE REVENUE

1. **Increase Monthly Subscription Costs:** An obvious method of increasing overall revenue is by increasing the amount charged per month (which Netflix has repeatedly done). Of course, the increase in pricing is sure to deter current and potential customers from continuing their subscription, so a fine balance of marginal benefit needs to be established. For example, an increase of $0.01 would increase current subscription revenue by $2,218,440.

2. **Increase Quality of Content:** The proportion of revenue dedicated to content additions has decreased over the years and it's beginning to show in content. Personal anecdotal research has determined that the quality of content has been diminishing. According to Statista, Netflix won 44 Emmy's in 2021, but only 26 Emmy's in 2022 (Peters). Even though content spending likely increased. Netflix should focus on

increasing their proportion of revenue dedicated to adding content and content quality to prevent increased competition from stealing current & potential customers.

3. **Increase Embedded Marketing:** Product placement has shown to be a lucrative form or revenue generation with fees ranging from $10k-50k per feature (CBC Radio). Depending on the number of TV episodes and movies launched in a year, the revenue could reach over a hundred million dollars for 2,000 product placements if charging $50k each. Overall though, the increase in revenue would be a small proportion of total revenue.

4. **Promote Merchandise:** Outsourcing of merchandise has been utilized by movies, TV shows, video games, and more for decades with Netflix following suit. What differs for Netflix is that they sell a large proportion of their merchandise Netflix-owned platforms rather than outsourcing everything. The problem is that many people aren't aware of Netflix's offerings. Netflix could promote their merchandise on the home page in a special, short-time banner to increase awareness of their merch. The main concern would be that current customers would find the placement annoying and be further incentivized to join a differing platform, so a short-lived campaign is suggested.

5. **Interactive Subscription Model:** A new model where customers are able to interact with content more by being able to like, dislike, and write reviews about content. The only way a customer could see reviews and ratings would be if they are currently subscribed to the model. Another incentive would be a voting system where subscribers could influence the type of content created by choosing between three or more suggestions offered by Netflix. How much would customers be willing to pay to interact with Netflix? Probably not much more than $1 or $2.

SHOULD NETFLIX CONTINUE WITH ADVERTISING MODEL?

A resounding yes, Netflix should continue with the advertising model. The additional revenue generated through advertisements are much greater than the loss of about $4.68/month on average per member. Depending on CPM, Netflix could experience an increase of 19-40% in revenue without having to greatly increase costs. Another fantastic benefit of the advertisement model is that Netflix can slowly increase the other subscription model prices to incentivize current customers to switch to their ad-supported plan. The main concern with their current model is the choice to only offer the ad-supporting model in 720p and without all of the content available. The two main drawbacks are likely to decrease the number of members that will switch over. The only two suggestions would be to offer 1280p and all content to members of the ad-supporting subscription, as well as slowly increase membership prices of other subscription models to incentive current members to switch models.

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