How Netflix's Value-Adding Business Model Impacted the Economy

An in-depth look at the emergence of Netflix

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INTRODUCTION

Since the boom of the internet, the race to become a completely digital society has begun. This has led to the emergence of new services and industries. Because of the internet, many internet-based services and applications have sprung up. Many companies have made the switch to cloud computing. Most noteworthy, and the first to the market, was Netflix. Netflix is known for their internet-based streaming service used for watching television on any mobile device, such as tablets, laptops, and smartphones. Because of Netflix's success in the streaming business other competitive companies have emerged, such as Hulu, Amazon TV, HBO and YouTube. Essentially, any device that can connect to the internet, can use Netflix's service or other competing services. According to Nielsen data, over the last 10 years, the internet has grown to become a fundamental part of our society. 274.2 million Americans were hooked up to the Internet in 2011 (more than double the number with access in 2000) and spent 81 billion minutes on social networks and blogs (Nielsen). There are 165.9 million people who watch video on the computer. As stated in Nielsen, 28% of users choose to watch online video on a smartphone rather than watching online video on other handheld devices, which is 11%. (Nielsen). The expansion into streaming services has been linked to the emergence of newer technology that provided for a higher level of bandwidth and thus a better user experience. In that regard, the advanced innovation and increased subscription rates provided for better returns in terms of economics for those companies in the streaming media business such as Netflix. From a broader perspective, the evolution of digitization such as Netflix has had direct impact on macroeconomics, including employment, emergence of new innovative businesses, and traditional media businesses within the economy.

NETFLIX REPRESENTS A CLASSICAL SERVICE MODEL
As an Adaptation from the Distribution of Use Value Model

Netflix represents the typical service business model, in the video-on-demand industry where users of the service and payers are the same entity. Netflix was the pioneer who used this business model to offer entertainment content using video streaming technology in exchange for a subscription fee depending on the number of users. The following diagram displays how this classical service model works in terms of Netflix.

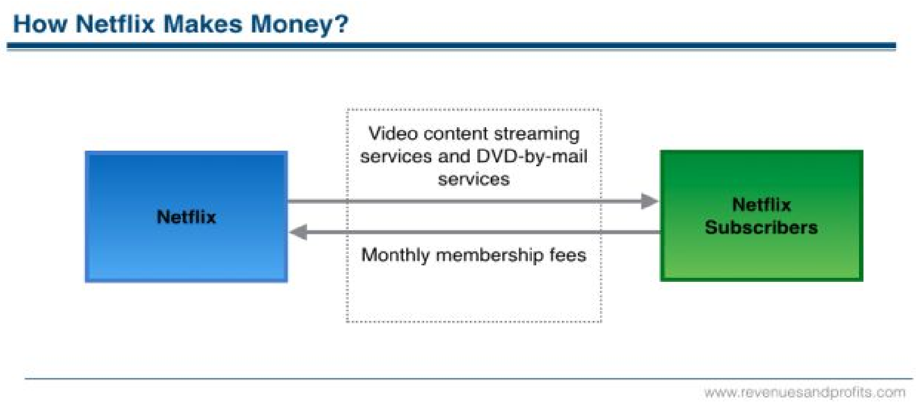

Figure 1: The Classical Service Business Model for Netflix
(Miglani, Jitender)

This model seems to be an adaptation of the Distribution of Use Value Model because it focuses on the tertiary sector of the economy; the services sector. The diagram below showcases the Distribution of Use Value Model and demonstrates how Netflix is a value-adding company.

The original business model of Netflix was a service system through mail-order DVD completely based on a subscription model, where customers pay a certain amount per month. However, this model had its limitations and in order to expand its business and grow they switched to a streaming service model. This change provided Netflix with increased growth and economic value with lower costs that would ultimately drive increased profits.

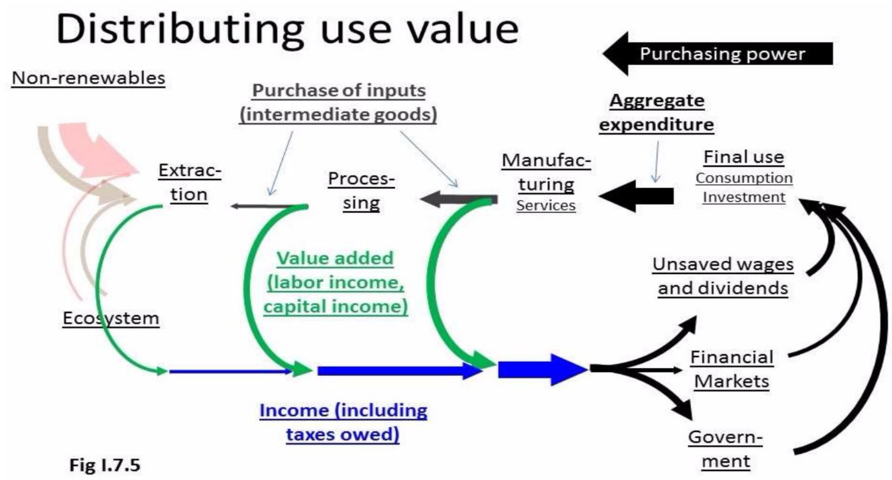

Figure 2: The Distribution of Use Value Model
(Seeley)

In terms of content delivery, which is the section where value is delivered to the consumer; Netflix uses a multitude of methods to provide content to the end user. Netflix licenses content from various broadcast networks, cable network providers, but also directly from movie and film and television studios. In addition, Netflix develops its own original content e.g. House of Cards. The way Netflix integrates technology enables a wider range of devices that are able to stream media and thus provides the user with expanded access to its services. The rating algorithm CineMatch, which recommends customers movies matched to their tastes, makes for a distinct personalized experience and service.

Netflix captures its value through the use of its subscription model, of which the company charges a set subscription fee per month for an unlimited access to TV shows and movies streamed over the internet to their Smart TVs and mobile devices. Currently, Netflix does not use price discrimination for its customers. Netflix is against including advertisements to its content and instead, the company plans to slightly increase its fees over time to generate higher revenues, so that it can continue to protect its original ad-free value proposition.

NETFLIX REVENUE SHOWS THE ECONOMIC VALUE OF STREAMING

Netflix has three revenue generating segments starting 2012 (see Figure 3 below): "Domestic streaming, which refers to the content streaming business in the U.S.; International streaming, which refers to the streaming business from countries outside the U.S.; and Domestic DVD, which refers to the DVD-by-mail services business in the U.S." (Miglani, Jtender).

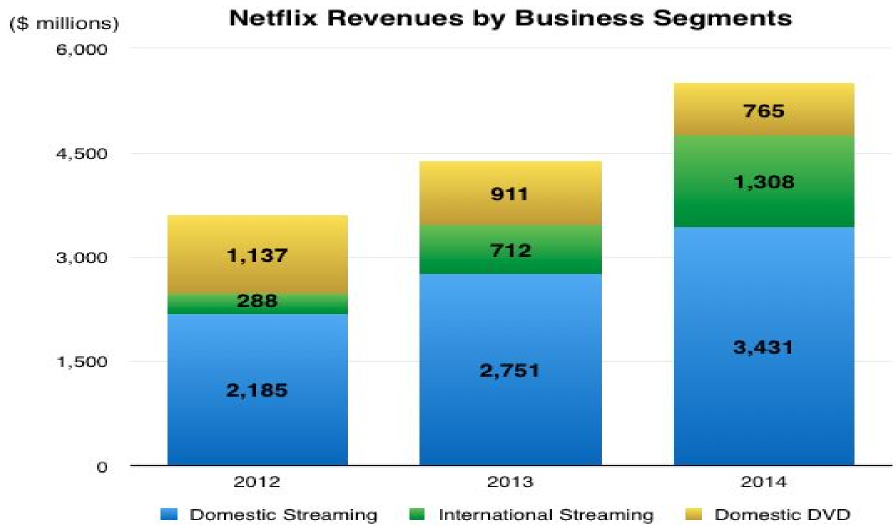

Figure 3: Netflix Revenues by Business Segments
(Miglani, Jitender)

In 2012, Netflix generated $2.473 billion in total revenue from its streaming service and $1.137 billion in revenue from its DVD rental business (Figure 3). Netflix's DVD rental business represented 32% of its total revenue for 2012, while the streaming business represented 68% of its total revenue for the same year (see Table 1 below). However in 2014, Netflix generated $3.463 billion in revenue from streaming business and $991 million in revenue from their DVD rental business (Figure 3). Netflix's DVD rental business represented 14% of its total revenue in 2014, while its streaming business represented 86% of its total revenue for the same year (Table

1). The revenue breakdown for 2015, shows that the majority of Netflix revenue was generated by its streaming service (92%) versus that of its DVD rental business (18%; Table 1).

Table 1. Percent Revenue Generated per Business Segment*

Segments	2012	2013	2014	2015
DVD	32%	21%	14%	8%
Streaming	68%	79%	86%	92%
TOTAL	100%	100%	100%	100%

**Percentages calculated based on data from (How Netflix Makes Money) and (Netflix 2015 Revenues).*

The overall revenue trend demonstrates that more and more consumers are seeing the use-value of the streaming service and have switched into this subscription plan from Netflix's DVD rental plans.

A comparison of Netflix's Profit Margins (i.e. gross, operating and net margins) for 2012 through 2014 shows an interesting economic trend in terms of Netflix managing its business model to drive increased profits and thus towards an economic/competitive advantage with respect to obtaining and delivering its content (see Figure 4).

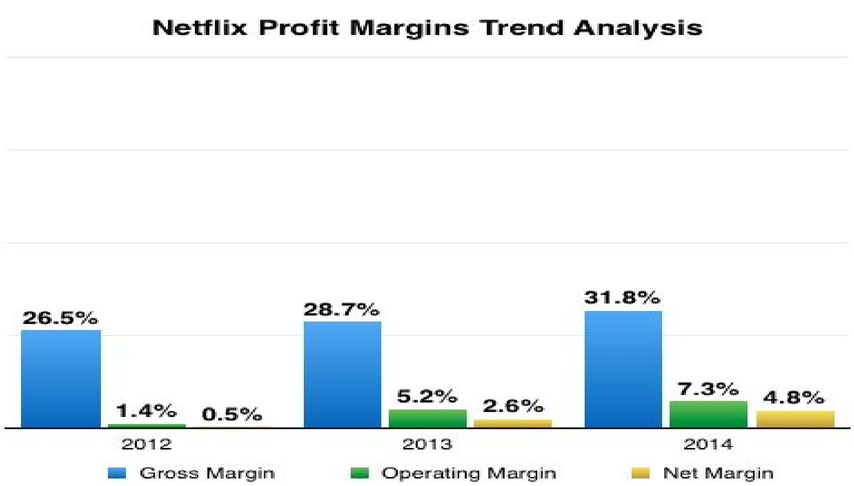

Figure 4: Netflix Profit Margins Trend Analysis
(Miglani, Jitender)

As shown above in Figure 4, Netflix consistently and successfully increased its Gross, Operating and Net Margins from 2012 to 2014. Of particular importance, Netflix's Net Margin of 0.5% in 2012 had increased to a Net Margin to 4.8% in 2014 indicating that its strategic plan to revert its customer base to a streaming service from a DVD rental plan is economically attractive in terms of its profitability. This positive profitability trend can be attributed by the enhanced popularity and acceptance by consumers and the use of streaming media to internet connected devices, which provided Netflix with a competitive advantage over its non-digitized competitors, in particular Blockbuster.

NETFLIX'S IMPACT ON THE ECONOMY

Employment

Before the advent of the Internet and digitized content, Blockbuster was the leading provider of rental media. However, since the company filed for bankruptcy in 2010 and was later acquired by Dish Network, unemployment in the Video Tape and Disc Rental Industry skyrocketed. "Blockbuster was the dominant firm in the industry and employed nearly 60,000 employees at more than 9,000 stores at its peak in 2004. But in the last decade, employment in the video/disk rental industry has collapsed from 153,000 jobs in 2005 to fewer than 11,000 in May of this year – that's a 93% decrease in a decade" (Perry, Mark; see Figure 5). The Figure below illustrates how Netflix, as an innovator, has almost driven the video tape/disc rental business, along with one time behemoth companies like Blockbuster, into extinction. "That could arguably be the largest percentage of employment decline in any U.S. industry over the last decade" (Perry, Mark). In a free market economy, "the ultimate winners of innovative destruction are the consumers, who reap the benefits of intense, disruptive, cut-throat market competition in the form of a constantly-evolving, never-ending bonanza of innovative consumer products that get better, faster, and cheaper all the time" (Perry, Mark).

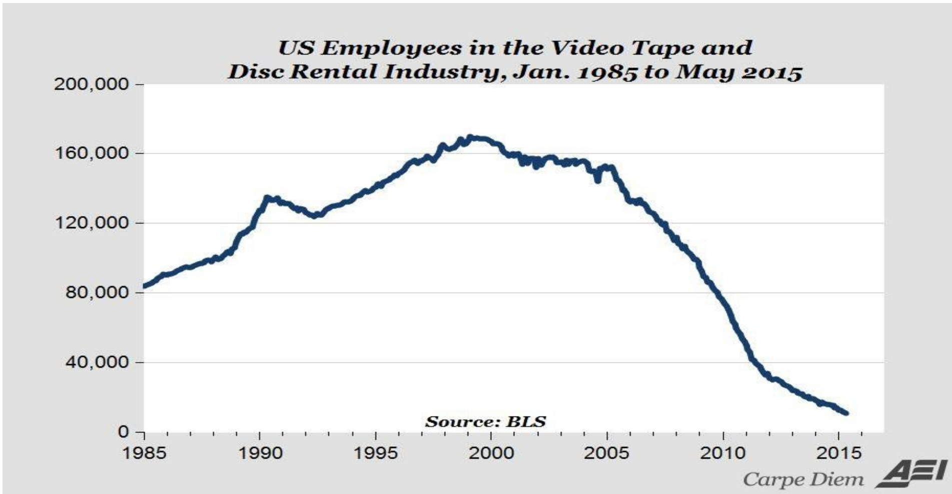

Figure 5: US Employment in Video Tape and Disc Rental Industry
(Perry, Mark)

The Emergence of New Innovative Companies Utilizing Netflix's Business Model

Since Netflix was successful in delivering digital media to consumers, other innovative companies have emerged using a similar business model. "Netflix's initial model of sharing products by mail has attracted a wave of startups and big retailers hoping to be the Netflix of toys (Spark Box Toys), books (Booksfree), fashion (CoutureSqd, Le Tote, Rent the Runway), designer jewelry (RocksBox) and more" (Wang, Ucilia). "Some of these companies charge a membership fee, just like Netflix, while others offer pay-per-use online rentals. All are part of the sharing economy: they make money by sharing the same products instead of by selling more products. The sharing economy also includes Airbnb, which rents private rooms, apartments and homes; and Zipcar, which charges a monthly fee to members who share cars instead of owning them" (Wang, Ucilia). It's also important to highlight that because of Netflix's success, these innovative startups have been creating more jobs and lowering unemployment.

The Netflix Effect on Traditional Media Businesses

According to Mark Perry, the “Netflix effect”, or the fear of streaming, is “challenging cable networks, traditional network TV channels, and pay-TV services” (Perry, Mark). Many investors of the pay-TV industry have grown concerned about the changing nature of video viewing as signs that consumers are fast ditching pay-TV for streaming video. As shown below in Figure 6, Netflix’s Year-to-Date Returns have increased significantly, while other traditional media companies, like Disney, CBS, Time-Warner, and FOX have dropped.

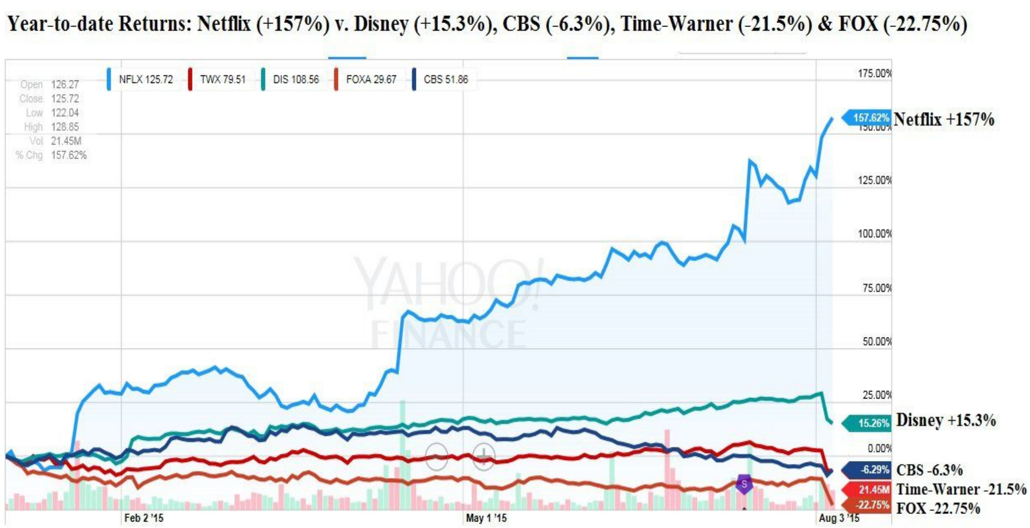

Figure 6: Year-to-date Returns of Leading Traditional Media Companies
(Perry Mark)

Nearly half (46%) of U.S. homes have access to a streaming service as of July, according to Nielsen data. That figure rises to 62% for homes with people age 18 to 34, underscoring the allure of on-demand video especially among Millennials.

Media research firm SNL Kagan estimates the share of cord-cutting households, households that have cut back on their pay-TV services, had reached 9.7% during the first quarter of 2015. The number of homes getting TV shows and movies from Internet services rather than pay-TV providers has more than doubled from last year. However, the "Netflix effect" hasn't just affected payed TV services and cable networks, it has also affected Theaters like IMAX, AMC, Cinemark, and others. With home entertainment equipment constantly getting cheaper, many moviegoers are deciding not to go to the movies which has become more expensive and instead obtain their share of entertainment from streaming services like Netflix which is a much more cost effective entertainment to consumers.

CONCLUSION

Netflix revolutionized the distribution of entertainment industry by introducing a new way of receiving entertainment, initially by a mail-order-DVD plan then via a more cost effective and profitable streaming service. Because of this shift in innovation by Netflix and competitive forces within the economy, companies such as BlockBuster and others brick and mortar DVD rental businesses have gone out of business, and closed their doors which has significantly impacted the U.S. employment within this industry. The success of Netflix's value-adding business model has helped to spur the emergence of new and innovative companies and has impacted positively on the employment in the economy.

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