Netflix: Dynamic Capabilities for Global Success

Teaching Notes

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Case Summary

Netflix successfully reconfigured its asset base from its beginnings as a DVD rental service to produce original content and become the world's largest and premier Internet TV company. In its first era (1997–2006), Netflix established itself as a scalable business characterized by Porter's generic cost leadership strategy creating an activity system which efficiently matched viewer preferences with content. During the second era (2007–2012), Netflix demonstrated novel resources and capabilities through steadily introducing its online streaming model to its DVD subscribers, gradually acclimatizing them to the new era of streaming and using its proprietary customer profiling algorithms. During the third era (2013–present), "Netflix Originals" gained advantage through three of its most important intangible assets: its strong licensing arrangements; its partnerships within the entertainment industry; and its expansive customer database continuously refined by proprietary algorithms. The key challenge facing Netflix management was to evaluate whether the current strategic approach underpinning its growth was sufficient or needed modification to be successful in markets that were very different from its home market, both in the production and consumption of video content. The Dynamic Capabilities Theory (DCT) extends insights about capabilities that are not only valuable, rare and costly to imitate but also dynamically organized to assure the competitiveness of Netflix as a multinational enterprise. In facing the key challenge of sustaining advantage worldwide, Netflix can use its decentralized culture which is designed to capture value produced outside of the traditional boundaries of a firm – this is a dynamic capability which entails attracting the best actors, actresses and entertainers from around the world to offer their creative input for productions that match consumption patterns anticipated by viewer profiles.

Teaching Objectives

- 1.
  The Netflix case offers instructors an opportunity to apply the DCT framework to a well-known global organization which will be familiar to students because many are likely to be customers.
- 2.
  Instructors can use the Netflix case as an example of a large technology firm based in the United States that has successfully faced challenges in internationalization through its decentralized culture and customized offering.
- 3.
  Using questions that target scanning, seizing, or reconfiguring activities, instructors can teach students the distinctions between the DCT framework and the Resource-Based View (RBV).
- 4.
  The contextual factors of the case can be used to force students to scrutinize how shifts in the technological and social environment could be mistaken for the dynamic capabilities of Netflix.

Target Audience

This case addresses core theory and contemporary issues in strategic management, international business, marketing, innovation, and entrepreneurship. Both undergraduate and (post)graduate/Master of Business Administration students will find online streaming and Netflix itself familiar; the teaching approach can be adjusted to cater to either audience. The global context of the web-based business models for online streaming appeals to audiences across the world.

Suggested Teaching Strategy

This Netflix case provides for a discussion that distinguishes dynamic capabilities among other concepts in the RBV and Porter's (1980, 1996) classic competitive strategy. The case authors have intentionally selected three "eras" of success in the story of Netflix to compare and contrast examples of each strategic approach. The key challenge facing Netflix management was to evaluate whether the current strategic approach underpinning its growth was sufficient or needed modification to be successful in markets across the world that were very different from its home market, both in the production and consumption of video content.

The Discussion Questions provide a staged progression as a basis for teaching the case. Question 1 will prompt a general discussion of Netflix's successes and sets the stage for the discussion about the RBV (Hamel, Doz, & Prahalad, 1989; Penrose, 2009; Wernerfelt, 1984) in Question 2 and dynamic capabilities (Teece, 2007; Teece, Pisano, & Shuen, 1997) in Questions 3 and 4.

Suggested Answers to Discussion Questions

1. What were the key factors behind Netflix's success in the first era (1997–2006); second era (2007–2012); and, third era (2013–Present)?

In the first era (1997–2006), the success of Netflix is attributable to two sociological and technological forces: the rapid adoption of DVD players; and household uptake of the Internet in the early 2000s. Netflix demonstrated superior efficiency in capturing the value of these emerging trends by positioning itself as an online DVD rental company that targeted a niche customer segment of early technology adopters. By the end of the first era, new entrants competing for market share made it clear that Netflix could not retain advantage from its original business model – a strategic adjustment was needed.

In the second era (2007–2012), Netflix transitioned to a streaming-only business model, implementing a cumbersome DVD/streaming hybrid business model and ultimately leveraging its proprietary recommendation algorithms to improve its reputation. In addition, Netflix demonstrated a capability to respond quickly to customers when it quickly retracted its decision to spin off its DVD arm.

In the third era (2013–present), Netflix attracted the world's best entertainment artists to co-produce original content for "Netflix Originals" by leveraging its existing partnerships with movie studios and TV networks and its advanced proprietary customer data algorithms. Its multiple Emmy nominations and Golden Globe Awards can be attributed to the company's ability to recombine three of its most important intangible assets: its strong licensing arrangements; its partnerships within the entertainment industry; and its vast customer data algorithms, and its decentralized, creative culture.

2. Use VRIO analysis to identify the capabilities that contributed to Netflix's sustainable competitive advantage.

Students should be encouraged to apply VRIO analysis (Barney, 1991) in Question 2 to understand how the company's main capabilities contributed to the sustainability of its competitive advantage. The question should be answered within the umbrella of the RBV (Hamel et al., 1989; Penrose, 2009; Wernerfelt, 1984). Hamel et al. (1989) used the term "core competence" to define skills and knowledge that are embedded in organizations. Barney (1991) proposed several ways in which resources could be organized for sustainable competitive advantage, arguing that capabilities are embedded in historical and socially complex ways. Netflix competitors include Wal-Mart, Blockbuster, and other video content providers, including those which have typically emerged as partners with national-level Internet service providers such as Comcast.

The Netflix case provides examples of capabilities which illustrate contributions to both temporary and sustainable advantage (see TN Table 1). The company's production of content (Netflix "Originals") and video content quality/variety contribute to the sustainability of the firm's advantage because the capabilities are all valuable, rare, difficult to imitate, and organized.

For example, although online streaming is valuable and organized well by Netflix, competitors can imitate this capability inexpensively by using one of many independent video streaming platforms available. Systems for DVD rentals are decreasing in popularity yet are still valuable to a segment of customers, but that advantage is only temporary because many competitors have imitated the capabilities which support DVD rental.

Teaching Notes Table 1. VRIO analysis applied to Netflix.

Capability	Valuable?	Rare?	Difficult to imitate?	Supported by organization?	Competitive advantage

System for DVD rentals	Yes	No	No	Yes	Temporary
Online streaming of video	Yes	No	No	Yes	Temporary
Content quality/variety	Yes	Yes	Yes	Yes	Sustainable
Production of content (Netflix “Originals”)	Yes	Yes	Yes	Yes	Sustainable

3. How did all three elements of DCT (sensing, seizing, and reconfiguration) underpin the success of “Netflix Originals” and Netflix’s global success?

Question 3 provides an ideal starting point for students to understand Teece’s (2007) dynamic capabilities because “Netflix Originals” exemplify sensing, seizing and reconfiguration very well.

Sensing

Teece (2007) states that, “To identify and shape opportunities, enterprises must constantly scan, search, and explore across technologies and markets, both ‘local’ and ‘distant’”(Teece, 2007, p. 1322). Netflix “sensed” online streaming opportunities as evidenced by Reed Hastings publicly stating in 2000 his intention for Netflix to be a video streaming company. Sensing involves a deep understanding of customer needs such that the probability that an innovation is commercially successful is more likely. Customer understanding came from the company’s data-driven approach to decision-making, based on proprietary algorithms that Netflix developers continually improved. Teece (2007) stresses that the orchestration of capabilities is central to his framework: “…evaluative and inferential skill possessed by an organisation and its management is important” (Teece, 2007, p. 1325). Netflix’s executive team orchestrated both a bottom-up and top-down flow of information sensitive to a host of customer profiles. In addition to being sensitive to individual customer profiles, Netflix also acknowledged the need to customize their user interfaces and content choices to particular cultures and languages.

Seizing

Teece explains that “seizing” involves, “Maintaining and improving technological competences and complementary assets and then, when the opportunity is ripe, investing heavily in the particular technologies and designs most likely to achieve marketplace acceptance”

(Teece, 2007, p. 1326). The key technological competence of the proprietary customer data algorithms was that Netflix continuously enhanced them as more subscribers signed up. In addition, “Netflix Originals” involved complementary assets in the form of long-standing strategic partnerships with movie studios and TV networks. Teece adds that seizing also requires “significant up-front investments” (Teece, 2007, p. 1326), which are exemplified in the agreements to produce two seasons of most series. The firm’s data-driven approach also dictated which “Originals” to shoot, based on subscribers’ preferences – perhaps for the first time in history vertically integrating the consumption of video to the conception of video content in one organization. In a global context, Netflix seized an opportunity to source its “Originals” from non-English locations such as Mexico, France, Italy, Japan and Brazil, and worked with local telecommunications providers to establish Netflix in homes across the world.

A nuanced understanding of Teece’s (2007) explanation of seizing is required because, even though Teece emphasizes swiftly capturing the value of new evolutionary pathways as seizing, Netflix waited a decade before seizing the opportunity to transition to online streaming. Therefore, seizing involves diligent preparation and patience to lay the foundation for future action, rather than attempting to evolve too quickly. Netflix demonstrated this expertise by steadily introducing its online streaming model to its DVD subscribers, to gradually acclimatize them to the new era of streaming. Its strategy was focused less on speed and more on slow adjustments and refining the Netflix business model over time.

Teece emphasizes that: "Long-run success is likely to require achieving necessary internal creative destruction, possibly involving spin-outs and spin-offs to help sustain superior performance" (Teece, 2007, p. 1341). Yet knee-jerk reactions to changes in the external environment proved calamitous for Netflix when it announced spinning off its DVD rental arm into Qwikster. So too much creative destruction can actually have a negative impact as companies seize opportunities. Netflix invented and tested a new business model with "Netflix Originals" and retained its online streaming model while being prudent in phasing out old business models.

Reconfiguring

Reconfiguring refers to the "[c]ontinuous alignment and realignment of specific tangible and intangible assets" (Teece, 2007, p. 1340). Teece also emphasizes the importance of a loosely coupled, decentralized culture; Netflix does indeed possess such a culture, which attracts critical external players with complementary, "co-specialized" assets. The Netflix culture of creative freedom and lack of formal rules intentionally attracted high-profile entertainment artists beyond the boundaries of the firm. In so doing, Netflix captured the value of invaluable expertise and brand power. Netflix's 2016 announcement that consumers worldwide would be able to enjoy TV shows and movies simultaneously was another manifestation of this reconfiguration of assets, signaling a move from a US strategy to a more global vision.

4. Contrast the applicability of Teece's (1997, 2007) dynamic capabilities framework with Porter's (1980, 1996) competitive strategy in explaining Netflix's success.

Question 4 is designed to distinguish dynamic capabilities from Porter's (1985, 1996) competitive strategy in exploiting shifts in the general environment by comparing eras in the success of Netflix that are more aptly explained by a strategic framework. In Netflix's start-up phase from 1997 until the early 2000s, the meteoric rise in the consumption of video content via the Internet was the main trend that Netflix was able to exploit. Trends in video consumption could be characterized as predictable. In this phase, Netflix exemplified Michael Porter's (1980, 1996) classic competitive strategy. Netflix simply identified a small gap in the market, dominated that niche, and then captured enormous value as the niche became a mainstream segment. Of particular importance was the early success of Netflix in capturing the vast majority of the nascent online DVD rental market through harnessing the power of economies of scale. Netflix crafted a scalable business model, grew its subscriber base, acquired DVDs directly from studios at a lower cost, and expanded their shipping centers across the United States, allowing it to deliver to customers at a cheaper average rate. This presence of enormous economies of scale within its initial business model drove down the firm's costs and freed up financial and other organizational resources to bolster its position relative to competitors.

In the current era (2013–present), Porter's concepts are less applicable. "Netflix Originals" was born of existing partnerships with movie studios and TV networks to produce desirable content using proprietary customer data algorithms. Trends in online video consumption are highly unpredictable, so dynamic capabilities would be applicable as Teece argued: "In such [high tech] sectors, the foundations of enterprise success today depend very little on the enterprise's ability to engage in optimization against known constraints, or capturing scale economies in production" (Teece, 2007, p. 1320). Lastly, Teece's (2007) "co-specialized asset" concept explains how "Netflix Originals" captured value produced outside the firm – namely the unique capabilities of artists and movie studios. Porter's concepts are less applicable to firms which compete successfully outside of defined industry-level boundaries.

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