Netflix: Dynamic Capabilities for Global Success

Case

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Abstract

With over 90 million members in more than 130 countries, Netflix has proven itself to be a leader in the global Internet TV industry. This case study documents the firm's phenomenal rise from uncertain beginnings in DVD rentals to online streaming and original content. It highlights the role of dynamic capabilities in the company's global success, showing how the firm's strategy evolved over three key eras in its history. During the first era Netflix focused on the establishment of a scalable business model in the form of DVD rentals offered to mainstream segments at a competitive price. It developed novel resources and capabilities in its second era with reliable online streaming and 'big data' algorithms that customized a variety of content to customer preferences. However, it was only with the introduction of "Netflix Originals", that the firm exercised dynamic capabilities. What were the dynamic capabilities underlying the firm's growth? Are the strategic approaches that the firm used in the past sufficient to assure sustainable competitive advantage on a global scale?

Case

Learning Outcomes

By the end of the case, students should be able to:

- Understand how dynamic capabilities can play a role in corporate success.
- Distinguish dynamic capabilities from the VRIO concept in the Resource-Based View (RBV).
- Explain how the sensing, seizing and reconfiguring elements of dynamic capabilities contribute to competitive advantage.
- Contrast dynamic capabilities from Porter's classic competitive strategy.
- Describe key implementation issues with the sensing and seizing elements of dynamic capabilities.

The First Era: Founding and Early Days (1997–2006)

Uncertain Beginnings

Netflix was co-founded by Reed Hastings and Marc Randolph on 29 August, 1997 in Scotts Valley, California. The idea was conceived when Hastings, was forced to pay $40 in late fees for a DVD movie he had rented out from Blockbuster Video (Funding Universe, n.d.). From the very beginning, Hastings' vision was to reinvent the way consumers could access and watch the movies they love.

In 1997, Blockbuster Video was the largest competitor in the US DVD rental market, with an enormous retail store footprint across the United States (Noren, 2013). Customers were accustomed to travelling to these brick-and-mortar stores to physically rent out movies, and then return them within the stipulated return period to avoid being charged exorbitant late fees.

Hastings and Randolph recognized an untapped online market opportunity with virtually no competition. In 1998 Netflix began as on online DVD-by-mail business where US customers could purchase DVDs. At that time, the firm had only 30 employees and 925 available DVD titles (Funding Universe, n.d.). Netflix competed with Blockbuster by allowing consumers to order DVDs from the comfort and convenience of their own home, and at a fixed monthly subscription fee.

Later that same year, after emerging e-commerce giant Amazon entered the market, Netflix stopped selling DVDs online. At that point, Netflix chose to focus exclusively on online DVD rental. Within a year, the firm's staff more than tripled to 110 employees, and its available rentals skyrocketed to over 250,000 titles. Despite this shift in focus, revenues remained stagnant, as only 1% of the US. population owned DVD players at that time (Mathew, n.d.).

Betting on DVD and Internet Growth

Netflix introduced their monthly subscription payment model in 1999 at a time when the DVD player ownership rate was negligible, but it accelerated very quickly. As of January 2001, 25% of US households owned DVD players, up from just 5% in January 2000 (Funding Universe, n.d.). "DVD is growing fast, and we'll grow with it," Hastings announced (Netflix, 2003a). In line with the explosion in DVD player sales the number of Netflix subscribers shot up from 292,000 in 2001 to 456,000 in 2002 (Netflix, 2003a). Clearly, the firm's phenomenal growth was fueled by the growing enthusiasm for DVD players; nearly 67% of US households owned a DVD player by 2004 (Netflix, 2003b). During the same period, Internet use was becoming more widespread as US households recognized it as a safe and secure method of shopping. It was rapidly becoming an essential component of people's lives.

Innovative and Scalable Business Model

Netflix provided subscribers with an unlimited DVD rental service for a monthly subscription fee of $19.95, delivering them directly to subscribers' homes through the US Postal Service. Members received their first three DVDs all at once; after they returned one of them in a postage-paid envelope, they automatically received their next movie selection.

Netflix differentiated itself through a proprietary online recommendations engine that helped customers locate new films and TV shows based on consumer ratings. In addition, Netflix originated the movie queue, allowing customers to construct a wish list of movies to watch, which were delivered in preferential order. These two service benefits allowed Netflix to stimulate demand for their entire library, maximizing utilization of each title held in stock. This was a much better approach than that of a typical retail store, which was forced to project how many and which titles their customers would want.

Netflix offerings initially appealed only to a few niche customer segments: "movie buffs who didn't care about new releases, early adopters of DVD players, and online shoppers" (Christensen, Raynor, & McDonald, 2015). The firm's reputation soon blossomed largely through word of mouth communication of its innovative business model of flat-fee unlimited rentals without the hassle of due dates, late fees, shipping fees, or per-title rental fees.

In late 2001, Netflix began developing revenue sharing agreements with premier movie studios and distributors including Universal, DreamWorks and Twentieth Century Fox. This allowed Netflix to access new DVD releases directly and grow its comprehensive selection of titles. In addition, Netflix acquired DVDs at a lower upfront cost than traditional direct purchase agreements, and delivered them to subscribers within a much shorter timeframe. The firm broadly expanded its shipping centers to match the incredible growth of subscribers across the nation, in order to increase DVD delivery speed and drive economies of scale.

Greater affordability, accessibility and availability of movies were instrumental in driving annual Netflix subscriber growth, which exceeded 50% between 1999 and 2004. The firm reached one million subscribers in 2003, and surpassed two million in May 2004 (Netflix, 2005).

Blockbuster Fights Back

In 2000, Blockbuster still commanded almost half of the DVD rental business, as Netflix was still focused on a largely niche segment of tech-savvy early adopters and had only a 5.1% market share (Funding Universe, n.d.). Yet in response to Netflix's growing clout, competition from the large incumbent players – including Blockbuster Video, Hollywood Entertainment, and Wal-Mart – intensified. Wal-Mart and Blockbuster entered the online DVD rental market in the early 2000s. In addition, Blockbuster tested a store-based subscription model for DVDs that posed a major threat given their thousands of retail stores and tens of millions of subscribers across the United States. However, by this time Netflix had earned consistent customer satisfaction rates of 95%. Less than three years later, by the end of 2003, Netflix commanded 95% of the online DVD movie rental market (Netflix, 2004).

In 2005, Blockbuster eliminated its traditional late fee policy and in 2006, it launched its integrated store-based and online program, Total Access (Netflix, 2007a). However, by that stage, it was a case of too little, too late. The focused Netflix business model, capitalization on the surging growth in DVD players and household Internet usage, and loyal subscriber base were currents too strong for Blockbuster to overcome.

The Second Era: Online Streaming (2007–2012)

Slowly Shifting Gears to Streaming

In mid-2000, the prospect for streaming movies and TV shows online became more realistic, as Internet broadband speeds began to increase exponentially. Netflix had been anticipating this trend for over a decade, since the firm's inception back in 1997. In 2000, Hastings had publicly stated his intention for Netflix to be an Internet streaming company: "What Netflix is about is owning a transition stage as rental converts to video-on-demand." He called the company's current business model of fulfilling DVD rentals-by-mail a, "stepping stone to the VOD [video-on-demand] future" (Funding Universe, n.d.).

Hybrid Business Model in 2007

The market for Internet-delivered video consisted of three segments: video-on-demand; subscription; and advertisement-supported. With the tectonic shift toward online consumer viewers and dramatic improvements in broadband quality, the barriers to entry for new competitors were lower than ever before. In January 2007, Netflix announced unlimited streaming of movies and TV episodes on personal computers, and a free addition to their original monthly subscriptions for its 7 million online DVD rental subscribers. Unlimited streaming granted customers instant access to a library of over 1,000 movies and TV episodes (Netflix, 2007b).

Driving Consumer Acceptance of Streaming

To provide an increasingly differentiated and compelling offer for its subscribers, in 2007 and 2008 Netflix commenced large-scale investment in licensing new and exclusive video content from movie studios and TV networks. It leveraged its strong existing relationships with NBC Universal, Warner Bros., and 20th Century Fox, providing them with new revenue streams. As streaming gained traction, Netflix expanded its investment in content, concluding 2008 with over 12,000 movie and TV options, an eight-fold increase since introducing the service two years earlier (Netflix, 2009). Netflix licensed content with an understanding of which content consumers wanted to watch, which resonated with its audience.

Netflix also recognized the opportunity to develop strategic partnerships with leading consumer electronics companies to stream content from the Internet to their devices. By the end of 2008, the firm's engineers had worked alongside several partners, including Samsung and LG, to offer subscribers streaming content through computers, laptops, and gaming systems, among others. Netflix also capitalized on the trend towards Internet-connected TVs and other devices. By year-end 2012, over 700 devices were capable of instantly streaming Netflix content (Netflix, 2009). Its efforts drove rapid consumer acceptance of Internet-delivered entertainment, which was reflected in an almost 100% increase in subscribers from 6.3 million in 2006 to 12.3 million in 2009 (Netflix, 2010a).

Data-Based Subscriber Delight

Proprietary Netflix algorithms were instrumental in consistently drawing millions of new subscribers to their online platform. Since its founding, the firm had amassed detailed data about their subscribers, allowing it to tailor both programming and investment to consumer behavior. Netflix prided itself on being an experiment-oriented culture, using data from real customer usage of their product to ascertain which ideas were best. As their subscriber base expanded, so too did the depth and accuracy of their predictive algorithms.

A key distinguishing factor for Netflix was its recommendation engine – an essential component of Netflix's value proposition. Each of its millions of members enjoyed a personalized member website, enabling them to rate movies they had watched. Netflix collated these ratings into a database of more than 1 billion movie ratings and leveraged its proprietary algorithms and software to recommend movies to the right audience (Netflix, 2006).

Streaming Option and Rebranding Failure

Netflix attained a significant milestone in 2010. The majority of their subscribers watched more of their movies and TV shows via online streaming than by DVD (Netflix, 2010b). In July 2011, Netflix announced DVD-only plans and divided the combined plans for all US subscribers. Subscribers who wanted both streaming content and DVDs-by-mail now had to possess two separate subscription plans (Netflix, 2011a).

In September 2011, Netflix rebranded its separate DVD delivery service as Qwikster, and shifted its primary focus to streaming-only plans. Just one month later, in October 2011, Netflix retracted its planned rebranding due to extremely negative customer reaction, and announced that the streaming and DVD rental services would continue operating on one website under the Netflix brand (Netflix, 2011b). This misstep had a massive cost, with Netflix losing 800,000 subscribers in the fourth quarter of 2011 alone.

“Consumers value the simplicity Netflix has always offered and we respect that,” said Hastings. “There is a difference between moving quickly – which Netflix has done very well for years – and moving too fast, which is what we did in this case” (Netflix, 2011b).

This frank admission of failure by Hastings was emblematic of the Netflix spirit of innovation. They were not afraid to test out “risky” or radical ideas because they believed that innovation involves failure. Netflix entrusted their industry-leading software engineers to test new ideas with customers, and let the data dictate the outcome. Hastings pronounced, “We’re in a creative-inventive market, not a safety-critical market like medicine or nuclear power. You may have heard preventing error is cheaper than fixing it –Yes, in manufacturing or medicine…but not so in creative environments” (Richardson, 2011).

The Third Era: “Originals” and Globalization (2013–Present)

‘Netflix Originals’

As Internet streaming of video content became ubiquitous towards the end of the first decade of the 21st century, Netflix realized that producing engaging content was paramount to attracting and retaining subscribers. A “Netflix Original” is TV or film content that is co-produced, produced, or distributed by Netflix exclusively on their online platform. Netflix began acquiring this type of content for its library in 2011 (Netflix, 2011c). In February 2013, the firm debuted its first “Netflix Original” series – House of Cards, a political drama starring Kevin Spacey, was streamed immediately to over 20 million members around the world (Netflix, 2013a).

Unlike other TV networks, Netflix delivers the fee upfront and immediately orders two seasons of most TV series when it signs a project. With a global subscriber base of over 44 million as of 2013 (Netflix, 2014a), Netflix had the clout to attract the best entertainers in film and television from across the world. In 2014, the company announced it would exclusively host four films starring and produced by iconic comic Adam Sandler (Netflix, 2014b).

In recognition of the cultural phenomenon of family entertainment, in 2013 Netflix debuted “Netflix Original Series for Kids,” which launched immediately to subscribers in over 40 countries around the globe. “Families love Netflix, so creating an original series for kids was a natural for us,” announced Ted Sarandos, Chief Content Officer (Netflix, 2013b).

Investment in its “Originals” was a roaring success. In December 2013, Netflix earned six Golden Globe Award nominations, including four for House of Cards. In July 2014, Netflix received an unprecedented 31 Emmy nominations, proving that its content had really resonated not only with viewers but with those in the television industry as well (Netflix, 2014c).

Leveraging Enormous Subscriber Data

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. It was no accident that Netflix had been extraordinarily successful in picking the right shows for its audience. For over a decade the company had collected very detailed data on its subscribers' preferences through its proprietary algorithms, then leveraged this wealth of data as an accurate predictor of the success of new programming. The data gave them the confidence to bid on and acquire content with deep insights that other, traditional networks did not possess without significant investment and testing of a pilot.

Kevin Spacey chose Netflix to shoot House of Cards because it was the only company that said, "We believe in you. We've run our data, and it tells us our audience would watch this series" (Smith, 2013). Instead of the traditional approach of mandating how the shows were to be made, Netflix gave complete creative license to their executive producers and creative team.

Netflix deepened its consumer understanding and personalized its subscriber offerings through the launch of its "Profiles" feature in August 2013. Chief Product Officer Neil Hunt declared, "Netflix members can create a separate 'profile' for each member of their household, who will each see a uniquely personalized experience based upon their individual watching habits, their personal favorite shows, and favorite genres, all driven by Netflix recommendation technology" (Netflix, 2013b).

In addition, consumers were, for the first time, able to "binge watch" their favorite TV episodes without commercials or waiting for the following weeks' episodes. "Our viewing data shows that the majority of streamers would actually prefer to have a whole season of a show available to watch at their own pace," said Sarandos. "Netflix has pioneered audience choice in programming and has helped free consumers from the limitations of linear television. Our own original series are created for multi-episodic viewing, lining up the content with new norms of viewer control for the first time" (Netflix, 2013c). With this understanding of subscriber preferences, Netflix continued to redefine Internet TV in the 21st century.

The Global Internet TV Network

By 2016, Netflix had gradually broadened its global online streaming service to countries and regions including Canada, Latin America, the UK and Ireland, and Scandinavia. According to Mindshare Chief Executive Officer Christof Baron, the company's internationalization strategy was to, "start with a limited offer which doesn't cost very much money and minimises the risk. Then they collect very detailed data about what people like, and structure programming and investment around consumer behaviour" (Hall, 2014).

Netflix itself acknowledged the need to customize their user interfaces and content choices for particular cultures and languages as they expanded into new markets, to ensure a positive reception with consumers. In addition, Netflix curated its content closely and increasingly licensed content on a global basis so all its members could enjoy the same TV series and movies. It offered non-English "Originals" from locations such as Mexico, France, Italy, Japan and Brazil, and worked with local telecommunications providers to establish Netflix as a fixture in homes across the world (Netflix, 2016a).

In January 2016, Netflix announced that it had made its Internet TV network available to over 130 new countries. "Today you are witnessing the birth of a new global Internet TV network," said Hastings. "With this launch, consumers around the world – from Singapore to St. Petersburg, from San Francisco to Sao Paulo – will be able to enjoy TV shows and movies simultaneously – no more waiting. With the help of the Internet, we are putting power in consumers' hands to watch whenever, wherever and on whatever device. From today onwards, we will listen and we will learn, gradually adding more languages, more content and more ways for people to engage with Netflix" (Netflix, 2016b).

Strategic Approaches to Meeting the Challenges Facing Netflix

The past and future strategic challenges facing Netflix can be seen through three main analytical lenses: (1) Michael Porter's (1980, 1996) competitive strategy; (2) the RBV (Penrose, 2009; Wernerfelt, 1984); and (3) Dynamic Capabilities Theory (DCT) (Teece, 2007, 2014; Teece, Pisano, & Shuen, 1997). Each can provide some sense of the company's past, but you must read more about them to determine which one will be the most helpful in taking Netflix into the future.

The Resource-Based View versus Porter's Competitive Strategy

Theories of strategy employing a RBV (Barney, 1991; Penrose, 2009; Wernerfelt, 1984) emphasize firm-specific capabilities and assets and the presence of certain mechanisms as the underlying keys to organizational success. This approach contrasts with traditional competitive strategy (Porter, 1980, 1996) because both Porter's competitive forces and strategic conflict approaches usually see competitive success originating from "strategizing," in which firms limit competition through tactics such as raising rivals' costs and engaging in exclusionary behavior (Teece et al., 1997). However, excessive strategizing may lead firms to underinvest in core competences and disregard dynamic capabilities, detrimentally affecting firm performance in the long-term (Teece et al., 1997). Such detrimental effects arise from excessive focus on decisions about which markets to enter and how to position the firm in those markets, the selection of markets in which existing resources can best be exploited, ways to deter entry, competitive pricing, and other regular strategic variables.

Penrose (2009) reasoned that a usual course of growth strategy for a firm is to diversify into related lines of business using common fixed resources. Company resources are the foundation for firm renewal and their accumulation directly impacts innovation and firm development. Hence, it is the heterogeneity, rather than the homogeneity, of the productive services available from its resources that contribute to the distinctive character of every firm. Wernerfelt (1984) expanded RBV further by explaining that the optimal growth strategy for a large firm involves striking a balance between the exploitation of existing resources and development of new ones, in order to create resource position barriers (the time and financial cost of imitating resources). Barney (1991) demonstrated that firms must focus on developing valuable, rare, inimitable and non-substitutable resources in order to generate sustained competitive advantage. It is thus the heterogeneity and immobility of a firm's resource endowments that are crucial in determining competitive advantage.

The RBV is often operationalized using "VRIO" analysis:

- V: Valuable capabilities that produce generic value for customers.
- R: Rarity (how rare the capability is among competitors).
- I: Imitability (how costly or otherwise difficult it is to imitate a capability).
- O: Organization (how well a firm is organized to capture the value of a capability over time).

Sustainable advantage is assessed by how well all 4 criteria are met. An advantage is only temporary if there is weakness in any one of these criteria.

The Dynamic Capabilities Theory

The DCT extends RBV by digging deeper to explain why some firms are more capable of renewing their skills and building new competencies in a dynamic external environment (such as why Netflix succeeded where Blockbuster failed). Specifically, DCT seeks to explain the high degree of intra-industry performance variability with firm-specific resources – tangible and intangible assets, including management skills, capabilities, and brand equity (Teece et al., 1997).

The distinguishing element of these dynamic capabilities is that they cannot be easily assembled through markets – they must be nurtured within the firm over time (Teece et al., 1997). The microfoundations of dynamic capabilities are difficult to develop and deploy, and include "distinct skills, processes, procedures, organizational structures, decision rules and disciplines - which undergird enterprise-level sensing, seizing and reconfiguring capacities" (Teece, 2007, p. 1319). Such microfoundations support superior long-term business performance, especially in periods of rapid environmental change.

The DCT explains how a firm adapts to changes in customer and technological opportunities, while also enabling it to develop new products and processes, design and implement viable business models, and even shape the ecosystem it occupies (Teece, 2007). Rather than engaging in optimization against known constraints or pursuing economies of scale in production, an intensely entrepreneurial management style is required to relentlessly hone the evolutionary and entrepreneurial fitness of the firm, especially in periods of rapid environmental change (Teece, 2007).

According to Teece (2007), dynamic capabilities can be broken down into three capacities: (1) sensing and shaping opportunities and threats; (2) seizing opportunities; and (3) reconfiguring to maintain competitiveness.

Sensing

Sensing and shaping opportunities and threats depends on the individual capacities and “analytical systems to learn and to sense, filter, shape and calibrate opportunities.” Netflix gathered extensive data about viewer habits which would later serve filtering algorithms to shape opportunities for the production and consumption of content known as Netflix Originals. Enterprises must constantly scan, search and explore across technologies and markets, both ‘local’ and ‘distant’” (Teece, 2007, pp. 1322 and 1326). More decentralized organizations with greater local autonomy, a deep understanding of customer needs, and strong evaluative and inferential skills are more likely to perceive market and technological developments and embrace innovative collaborators (Teece, 2007).

Seizing

Seizing involves taking advantage of the firm’s structures, procedures, designs and incentives, after first sensing opportunities. Once a new market or technological opportunity is sensed, firms seize opportunities through designing potent business models, which requires analyzing multiple alternatives, possessing a deep understanding of user needs, and thoroughly analyzing the value chain to assess how to best satisfy customers and capture value (Teece, 2007). Having sensed consumption patterns using its proprietary algorithms, Netflix had multiple alternatives to seize opportunities it had identified. Netflix could have sourced video content externally, attempted production itself or selected opportunities that complemented its resources and capabilities. Significant initial investments – like those that Netflix invested in its “Originals” – are required to sustain and enhance technological competences and complementary assets; when the opportunity arises, significant continued investment should be made in the specific technologies and designs most likely to be accepted by consumers.

Reconfiguring

Reconfiguration refers to the, “…continuous alignment and realignment of specific tangible and intangible assets” (Teece, 2007, pp. 1340) as the environment changes over time, including firm growth and changes in the markets and technology. To promote flexibility and responsiveness, firms must endorse a loosely coupled, decentralized culture (Teece, 2007). Tangible assets such as Netflix’s offices and top end computing hardware were valuable but neither rare nor inimitable by competitors such as Blockbuster. Intangible assets such as Netflix’s proprietary algorithms have proven so costly for rivals to imitate that the firm possesses a rare capability. Reconfiguration of these assets was accomplished through Netflix’s organizational culture, which recognized that creative license given to actors such as Kevin Spacey would attract and nurture the talent underpinning quality content. Obviously, Netflix did not “own” entertainers; however, it captured the value of their creative input by reconfiguring its assets to inspire their contribution through a welcoming decentralized culture. By capturing the stream of profits from intangible assets it owns and inspiring valuable inputs from assets it did not own, Netflix continued to reconfigure capabilities that match video production and consumption in markets even in phases of rapid expansion across the world.

Conclusion

Netflix has come a long way from its founding in 1997 as a small US-based online DVD rental company to the world’s leading Internet TV subscription service, with over 90 million subscribers in nearly every country in the world. Central to its success were dynamic capabilities orchestrated by the executive team at Netflix. Specifically, this involved dedicating significant resources and capabilities to successfully innovate and achieve competitive success during all three eras of its existence, in the midst of rapid social and technological changes. 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 in both the production and consumption of video content. Other American behemoths of the Internet era such as Google and eBay have learned that strategies which earned them leadership in the US and European markets have needed to adapt to emerging markets such as China. To sustain its advantage worldwide, Netflix made adjustments and innovations to its business model and strategic approach through exercising dynamic capabilities that were not only valuable, rare and costly to imitate, but also dynamically organized to ensure competitiveness.

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)?
- 2.
  Use VRIO analysis to identify the capabilities that contributed to Netflix's sustainable competitive advantage.
- 3.
  How did all three elements of dynamic capabilities theory (sensing, seizing, and reconfiguration) contribute to the success of "Netflix Originals" and the company's global success?
- 4.
  Contrast the applicability of Teece's (1997, 2007) dynamic capabilities framework with Porter's (1980, 1996) competitive strategy in explaining Netflix's success.

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