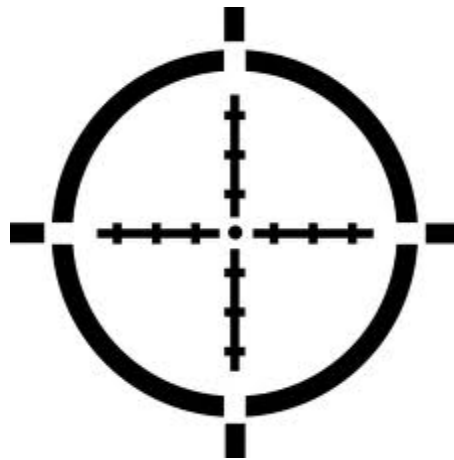


Netflix, Inc.

Client Report

Danger Zone Consulting



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Executive Summary

Netflix is a provider of on-demand internet streaming media available to viewers in North and South America, the Caribbean, and parts of Europe. Netflix occupies a unique place in the media industry, aggregating, distributing, and recently creating its own content. Users use an online platform to stream TV shows and movies directly on TVs, computers, and mobile devices when and where they choose. Subscribers pay US \$7.99 per month. Its disruptive business model has proven popular among younger users, whose lives are increasingly spent on their personal computers and mobile devices. The company also provides standard definition DVDs and Blu-ray discs to its subscribers in the United States, although this constitutes a small portion of their business. Netflix was founded in 1997 and is headquartered in Los Gatos, California.

Netflix's financials reflect a strong, profitable company in a booming industry. Netflix has proved its staying power in the industry and can be considered the market leader in the online streaming media entertainment industry. As of April 14th 2014, Netflix trades at \$326.71 and has a market cap of \$19.54 billion. The company's IPO in 2002 saw shares sell for \$15, which shows how much Netflix has grown and the optimism and faith of investors and analysts in the company and its management. Netflix has a lot of cash on hand and healthy cash flows to support its expansion. The only concern is the high P/E valuation, which is typical of tech companies.

A 5 Forces Analysis shows that the main dangers to Netflix's business model are the threat of substitute products, and the bargaining power of suppliers and consumers. The intensity of existing competition and the threat of new entrants are low because of Netflix's unique position in the industry as the first of these online media-streaming companies to create, aggregate and distribute content. The entertainment industry is also large enough that the existing companies have room to explore and innovate. The capital requirements are high, which prevent new entrants from gaining a foothold against the big players. The threat of substitute products is high because there are an increasing number of competitors such as Amazon Prime and Hulu and the costs of switching are low. The bargaining power of suppliers is high as Netflix's core business model (~90%) still relies on negotiating distribution rights with TV and

movie studios, as well as negotiating bandwidth provision with companies such as Comcast, which can control the amount of bandwidth applications like Netflix use. The bargaining power of consumers is also high, since loyalties are low and switching costs are low.

A SWOT analysis reveals that Netflix's core business model is solid, but there are several weaknesses and threats that it needs to be aware of moving forward. Netflix's core business model, online media streaming, is proven, and the trend towards online and mobile entertainment looks set to continue. The company is also financially stable with strong management. The weaknesses are a continued dependency on content creators and an outdated catalog of movies and TV shows. Domestic and international regulatory threats could also derail its progress along with the ongoing fight for net neutrality. Lastly, one of the biggest threats is the illegal downloads industry, or torrents, which are popular among younger users. Several opportunities for international expansion as well as increased vertical and horizontal integration present themselves, which leads to our strategic recommendations.

Our strategic recommendations focus on strengthening the core business, increasing the number of subscribers and targeted global expansion. Netflix must focus on vertical and horizontal integration, which means creating more original content under the Netflix name and bundling with other home entertainment systems in a bid to attract more subscribers. The company should also update their catalog to make sure it contains the latest movies and TV shows as a common complaint about Netflix is its dated catalog. Lastly, we feel that the European Union (EU) and India might be two good places to expand internationally, as these countries have the infrastructure, economic and political climate to support the introduction of Netflix.

Company History and General Information

Netflix is a provider of on-demand internet streaming media available to viewers in North and South America, the Caribbean, and parts of Europe. Netflix occupies a unique place in the media industry, aggregating, distributing, and recently creating its own content through an online platform that lets viewer choose when and where they want to watch television shows or movies. Subscribers pay US \$7.99 per month. Its disruptive business model has proven popular among younger users, whose lives are increasingly spent on their personal computers.

Netflix began as an online DVD mail order company, allowing customers to select DVD titles online and receive them via Permit Reply Mail. Netflix has since moved on to providing on-demand Internet streaming entertainment across a wide variety of genres, though it still maintains its DVD rental business.

Netflix, Inc. was established in 1997 by founders Marc Randolph and Reed Hastings (present CEO) who had previously worked together, and its headquarters are at Los Gatos, California. The Netflix website was launched on August 29th 1997 with only 30 employees and 925 titles available for rent, with a per-title rental cost model. It moved to a monthly subscription concept in 1999, building its reputation on the business model of flat-fee unlimited rentals without due dates, late fees, shipping and handling fees, or per-title rental fees.

Netflix had its IPO on May 29th 2002, selling 5.5 million shares of common stock at US \$15 per share. On June 14th 2002, Netflix sold another 825,000 shares at the same price. Netflix posted its first profit during 2003, earning \$6.5 million profit on revenues of \$272 million.

By 2005, 35,000 film titles were available and Netflix shipped close to 1 million DVDs every day. It had developed an extensive personalized video-recommendation system based on reviews and ratings by customers, and currently uses the same algorithm in predicting customers' preferences.

In February 2007, the company delivered its billionth DVD and began to move towards Video-on-Demand via internet streaming, which it saw as the future of media and entertainment. DVD

sales fell from 2006 to 2011. By 2010, Netflix's streaming business had grown to the extent that the company shifted from being the fastest-growing customer of the USPS's first-class mail service to the biggest source of internet traffic in North America in the evening.

On September 18th, 2011 Netflix revealed plans to split off their DVD-rental section and rename it Qwikster, where users would have to use a separate website to access Qwikster. This received a negative reaction from many customers, and Reed Hastings quickly announced the cancellation of the planned Qwikster service on October 10th.

Netflix has exclusive pay-TV deals with major and mini-major movie studios. Select titles from Relativity Media, DreamWorks Animation, Open Road Films, FilmDistrict, The Weinstein Company and Walt Disney Studios Motion Pictures are only available through Netflix. Other studios providing content on Netflix under license include Disney-ABC Television Group, DreamWorks Classics, Kino International, Warner Bros. Television, 20th Television, Hasbro Studios, Saban Brands and CBS Television Distribution.

In 2013, Netflix was the first company to acquire and release original content for its subscription streaming service with the political drama *House of Cards*, which debuted in February 2013. This was a landmark event because all 13 episodes of the drama were released at the same time, reinforcing the notion that the average American TV viewer was inclined to "binge-watch" episodes, as opposed to the traditional weekly release of a single episode. Currently, Netflix has ten original series in its library, with Emmy and Academy Awards nominations and wins for many of its series.

As of 2014, Netflix reported 33.1 million US subscribers, and around 44 million globally.

Financial Analysis

Overview

Selected Valuation Metrics	Netflix, Inc.
Market Capitalization	19.54B
Trailing P/E	176.50
Forward P/E (Dec 31, 2015)	43.91
Price/Book	14.96
Current Ratio	1.42
Debt/Equity	39.79
EPS	1.85
Beta	2.02
EBITDA	276.72M
ROE	10.82%
ROA	3.04%
Profit Margin	2.57%

As of April 14th 2014

Netflix's financials reflect a strong, profitable company in a booming industry. Netflix has proved its staying power in the industry and can be considered the market leader in the online streaming media entertainment industry. As of April 14th 2014, Netflix trades at \$326.71 and has a market cap of \$19.54 billion. The company's IPO in 2002 saw shares sell for \$15, which shows how much Netflix has grown since and the optimism and faith of investors and analysts in the company and its management. Netflix has a lot of cash on hand and healthy cash flows to support its expansion. The only concern is the high P/E valuation, which is typical of tech companies.

Netflix has experienced another strong year and continued an upward trend in financial growth. The company has continued to see revenues rise at remarkable rates over the past 5 years, at an average growth rate of nearly 32% per year. This potentially unsustainable growth can be attributed to the expansion of the Netflix streaming user base. Over the same time period, Netflix has seen its user subscriptions increase from 12.3 million to over 44 million members. Most of this increase has been domestic, but Netflix now reaches approximately 10 million members internationally.

Fifteen years ago there was no such thing as online TV. The online streaming industry is young and Netflix is its trailblazer. In terms of competitors, Amazon's subdivision Amazon Prime provides the same streaming service of shows and movies. However, any financial comparison between Netflix and Amazon Prime would prove challenging, as separating Amazon Prime from Amazon in the financials is difficult. In reality, Netflix's biggest competitor are illegal streaming sites that allow users to download media content for free. Overall, analyzing Netflix's financials alone provides enough evidence for Netflix's financial health.

Revenue and Profitability

	Year ended December 31,		
	2013	2012	2011
	(in thousands, except per share data)		
Revenues	\$ 4,374,562	\$ 3,609,282	\$ 3,204,577
Cost of revenues	3,083,256	2,625,866	2,039,901
Operating income	228,347	49,992	376,068
Net income	112,403	17,152	226,126
Earnings per share:			
Basic	\$ 1.93	\$ 0.31	\$ 4.28
Diluted	\$ 1.85	\$ 0.29	\$ 4.16
Weighted-average common shares outstanding:			
Basic	58,198	55,521	52,847
Diluted	60,761	58,904	54,369

Source: Netflix Annual Report, 2013

Netflix finished strong, posting net gains of earnings in both Q4 and the fiscal year of 2013. By seeing an increase in online subscriptions of nearly 4 million members, Netflix continued its growth and posted fourth quarter earnings of nearly \$1.175 billion; an increase from the \$1.105 billion mark seen in the third quarter of 2013. Both of these values are substantially higher than their previous counterpart, where Netflix brought in \$905 million and \$954 million in the third and fourth quarters of 2012, respectively. The past two years of financials show Netflix's revenues to be increasing at a stable rate with the potential for continued short-term and long-term growth.

With a total user base hovering around 44 million, Netflix saw its yearly revenue stream increase by nearly 22%, soaring from \$3.6 billion in 2012 to nearly \$4.4 billion in 2013. Additionally, operating and net income saw huge jumps between 2012 and 2013; operating income increased

from \$49 million to \$228 million while net income rose from \$17 million to nearly \$112 million. While these increases appear to be unsustainable, they must be noted as a sign of the popularity of online streaming and the direction of the media-entertainment industry towards the internet as a viewing medium. As a more general comparison, in 2012 Netflix saw an increase of \$400 million in total revenue from 2011, but nearly a \$300 million and \$200 million loss in operating and net income, respectively. These inconsistencies are explained through Netflix's expenses. Netflix committed to expanding their product by starting to produce their own TV shows as well as attempting to further develop their international presence. Endeavors like these caused Netflix's costs to be abnormally high, as these projects have high initial costs.

For fiscal 2013, Netflix managed solid returns with a 10.82% and 3.04% return on equity and assets, respectively. Both of these numbers are strong by themselves, but are below industry averages. The CATV industry average for return on equity is an astounding 45.7%. These numbers can be misleading however as the CATV industry includes companies such as Comcast, Time Warner, and DirecTV, which are all cable providers and have large revenue streams from channel and sports contracts, thereby making any comparison with Netflix unfair. This issue is exacerbated when comparing Netflix's modest 2.57% profit margin to the industry average of 11.0%. Historically, Netflix hovers around a 9% profit margin. The company appears to be heading back to these strong levels as Netflix has seen its profit margin steadily increasing over the past 2 years.

Balance Sheet Analysis

	As of December 31,		
	2013	2012	2011
	(in thousands)		
Cash, cash equivalents and short-term investments	\$ 1,200,405	\$ 748,078	\$ 797,811
Total content library, net	3,797,492	2,874,170	1,966,643
Working capital	904,560	564,865	605,802
Total assets	5,412,563	3,967,890	3,069,196
Long-term debt	500,000	200,000	200,000
Long-term debt due to related party	—	200,000	200,000
Non-current content liabilities	1,345,590	1,076,622	739,628
Total stockholders' equity	1,333,561	744,673	642,810

Source: Netflix Annual Report, 2013

Over the past year, Netflix has seen a substantial increase in total assets. Netflix ended 2012 with \$3.967 billion in total assets and managed to increase that value to \$5.41 billion at the end of 2013. Most of this increase resulted from a \$500 million increase in non-current content library assets. Still, Netflix saw nearly a \$1 billion dollar increase in total current assets, most of which came from significant increases in cash as well as content ownership.

Liabilities increased by nearly \$800 million to a total of \$4.075 billion in total current liabilities. The large growth in content ownership not only accounted for the asset increase but also for around \$450 million of the liability increase. In addition to content ownership, Netflix also added \$500 million in long-term debt and plans on accumulating \$400 million more in the first quarter of FY2014, mostly for use in acquiring and creating more content. Netflix raised \$600 million in stockholder equity predominantly from common stock equity increases.

Cash and Liquidity

As is characteristic of most tech companies, Netflix has an abundance of cash on hand. Netflix currently operates with \$1.2 billion in cash, which equates to \$20.7 cash per share. In the past year, Netflix received nearly \$98 million in cash from operating activities. Combining these cash figures with a low debt value of \$530 million, Netflix currently operates with \$2.43 billion in levered free cash. By constantly being pressured to expand to a competitive advantage, having such an abundance of levered free cash is key. This enables Netflix to monetarily pursue ideas at will without any concern of lingering debt or liquidity issues. Netflix's current ratio of assets to liabilities sits at 1.42. Once again, this value suggests that Netflix is healthy and able to financially handle any issues that may arise.

	Year Ended December 31,		
	2013	2012 (1)	2011
	(in thousands)		
Net cash provided by operating activities	\$ 97,831	\$ 21,586	\$ 317,712
Free cash flow (2)	(16,300)	(58,151)	186,550

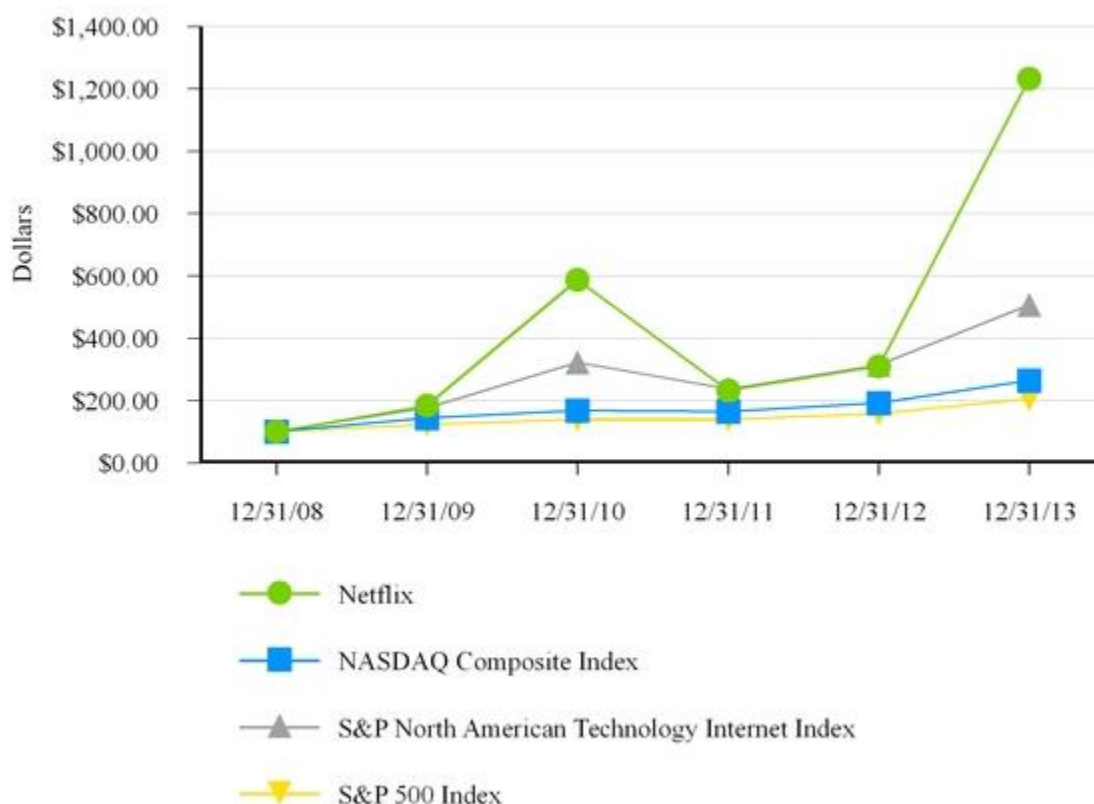
Source: Netflix Annual Report, 2013

Net cash provided by operating activities was \$97.8 million in FY2013. In FY2012, net cash from operating actives was a lowly \$21.5 million. The largest contributor to this substantial

increase was an increase in net income. Net income in FY2013 was \$95 million more than FY2012. Once again, the high startup costs of original productions caused Netflix to have a less than stellar FY2012, but the company is by no means in a weak position financially. Netflix also added nearly \$120 million in cash flows from the issuance of common stock. After recognizing only \$4 million in proceeds from common stock in FY2012, Netflix received \$124 million from issuing common stock in FY2013, a significant increase.

Netflix is strapped with cash. After expending significant amounts of cash into original content production in 2012, Netflix reaped its benefits and returned to its normal profitable self in 2013. From a cash perspective, in 2012 Netflix saw a net decrease in cash of nearly \$217 million, but regained all that was lost in 2013 with \$314 million increase in cash and cash equivalents.

Stock Performance and Valuation



Source: Netflix Annual Report, 2013

Investors have to be pleased with Netflix's stocks performance over the past few years. Since October of 2012, Netflix has seen its stock price increase by nearly 517%, significantly outperforming the NASDAQ, S&P 500, and the S&P North American Technology Indexes. This indicates that Netflix has cornered a large portion of the market, taken advantage of its position as the trailblazer in this industry and continued to inspire confidence in investors and analysts alike. Shares closed at \$326.71 per share on April 11th, 2014 on the NYSE, giving it a market cap of \$19.54 billion.

Recently, Netflix has seen its stock price plummet nearly \$100 per share in the past month. While the company has not released any new figures, most investors speculate that the rumor of a potential Apple and Comcast partnership has taken its toll on Netflix's stock. Apple currently has a product known as Apple TV, which actually has Netflix embedded in the program. Apple TV is meant to replace cable and provide users with all the various streaming offerings (e.g. Netflix, HuluPlus, HBO Go) in one location. However, the rumor of a potential partnership between Apple and Comcast would result in AppleTV offering a streaming program directly from Comcast's cable network. By doing so, AppleTV would avoid all buffering issues and poor quality that Netflix has to deal with during periods of heavy traffic. The potential mega-partnership of Comcast and Apple has caused investors to shy away from Netflix, causing the stock price to drop significantly over the past month.

While Netflix's stock price may be falling, there is no reason to believe this will become a permanent trend. Netflix currently has a trailing price-to-earnings ratio of 176.50, suggesting that investors still believe there is substantial room for growth; the forward P/E of 43.91 may be more realistic and represent Netflix as being more stable. Netflix trumps the industry average for price to earnings, with the Industry average currently residing at 22.60. Thus, even if Netflix were to see its P/E ratio decline, they would still dominate the Industry average P/E. While the comparison highlights Netflix's magnitude, comparing the P/E of Netflix to companies such as DirecTV and Comcast is not always insightful as Netflix is a tech company, which causes financial values to generally be geared toward growth potential and thus overvalued. Regardless, investors appear to believe in Netflix and its opportunity for growth with such high P/E ratios.

The company also sits on a price-to-book ratio of 14.96, meaning that the stock price reflects 15 times more value than Netflix's tangible assets. This high price-to-book ratio is very characteristic of tech companies as most of tech companies' assets lie in content and other web-based programs that are not tangible and have no monetary valuations alone. The tech company standard is also seen in Netflix's beta value of 2.02. Almost all tech companies have betas greater than 1 as these tech-based companies often have significant room for growth, but also have the greatest risk attached to them. Thus, neither Netflix's price-to-book nor beta value are out of place as they are a tech company with most of their value tied up in online content and other intangible assets.

Overall, Netflix is a financial stable company with potential for significant growth. Revenue streams have been steadily increasing over the past few years and looks to continue as Netflix continues to innovate and find new ways to attract new members to its already large user-base.

Five Forces Analysis

Force	Strategic Significance
Intensity of Existing Competition	Low
Threat of New Entrants	Low/Moderate
Threat of Substitute Products	High
Bargaining Power of Suppliers	High
Bargaining Power of Consumers	High/Moderate

Intensity of Existing Competition

Netflix has shifted its focus away from DVD rentals to become primarily a provider of on-demand Internet streaming media. The company does not have many direct competitors, as its business model is so broad and incorporates all levels of the media distribution chain: creation, aggregation, and distribution. Netflix's main competitors in the online media industry include Amazon Prime, Hulu, HBO Go and VZ-CSTR although none of these companies have operations that line up exactly with Netflix's. Players in the market compete mainly among prices, quality of content, and ease of use. Netflix has recently begun providing original content to distinguish itself from competitors, and some of these series have gained national recognition. The online media streaming industry is growing quickly as technology advances and companies will continue to try to offer the best and most recent content to consumers. Because the industry is growing quickly, there is plenty of room for all players to grow in the industry without intense competition.

Threat of New Entrants

The threat of new entrants is low, and should not pose a danger to Netflix's online streaming services, mainly because there are large barriers to entry. High capital costs are required in order to obtain content and a strong distribution network, which prevent smaller companies from entering the industry. Companies trying to enter the market need to be able to offer a variety of high quality content online at fast download speeds, and this level of infrastructure is costly. However, larger companies, such as Apple and Google, have expressed modest interest in entering related markets, and these companies do have the capital requirements to threaten Netflix. Netflix does have a first-mover advantage, and is one of the best-known brands in the

industry. The company will have to continue to innovate as technology improves to maintain its position as market leader. Netflix has strong, forward-looking leadership, which will try to maintain its competitive advantage.

Threat of Substitute Products

Physical DVD rental and sales companies do not pose much of a threat to Netflix, as consumers prefer the low costs and instant gratification that come with online streaming. However, one very dangerous threat to Netflix is illegal pirating. There exist websites that allow customers to access most media content for free, although these sites are technically illegal. However, there is very little risk for customers who download content from these sites. The downside to illegal streaming is that it can be somewhat complicated and is not nearly as intuitive as Netflix's service. However, there is a significant segment of Netflix's potential market base that would rather illegally pirate content than pay the low membership fee. It is possible that government agencies might choose to enforce these anti-pirating laws more strictly, and substitute products would then no longer concern Netflix. In fact, it may be in Netflix's best interest to lobby for tighter enforcement of these laws because as it stands, illegal pirating poses one of the largest threats to Netflix's business model.

Competition could also increase as networks and content providers improve their own Internet presence and create their own content distribution applications as they try to cut out Netflix altogether. Every major network is trying to improve their Internet applications on tablets, smart TVs, phones, game consoles, and laptops, just like Netflix has already done. They would like to cut out the middle aggregators such as Netflix and improve their own accessibility in order to take a larger share of the profits. Netflix provides value in that it aggregates so many content providers at a single source. However, if content providers can provide their own means of Internet streaming, then they might begin restricting the content they sell to Netflix. Netflix's success depends on providing current, varied, and popular content to consumers, so if it is forced toward the end of the content life cycle, it might have to rely more on its original content, which is not its core business and constitutes very little of its revenue.

Bargaining Power of Suppliers

There are relatively few quality media content providers and thus few substitutes that Netflix could deal with. In this respect, the bargaining power of suppliers is relatively high. Netflix has recently started developing its own content with its Netflix Originals, which have gained some traction amongst viewers and received acclaim from the entertainment industry. However, most of Netflix's revenue is derived from its core product, aggregating and distributing media content. Netflix needs to maintain its breadth and variety of products, which makes the company dependent on its providers. Though Netflix's subscriber base is growing, which gives it some leverage in negotiating terms, it is still at the mercy of these media providers for much of its business. For example, Netflix recently lost its contract with Viacom International, one of the leading content providers for popular children's shows, which upset many parents who used Netflix as a single source for their children's television. In fact, Netflix lost this contract to its rival Amazon Instant Prime. These content providers have extremely differentiated products, which often do not have close substitutes. Therefore it is critical that Netflix maintains good relations with its content providers, who would be happy to sell elsewhere. As a result, a large portion of the industry profitability will go to the suppliers.

Additionally, Internet Service Providers (ISPs) have bargaining power over Netflix, in that they control Netflix's bandwidth and streaming speeds. Strong bandwidth is essential for Netflix's operations, as customers demand fast and uninterrupted streaming services. Currently, ISPs can force large companies like Netflix to pay a premium by threatening to reduce their bandwidth. There has been a recent movement towards net neutrality, which argues that ISPs should view all web traffic as equal and should not extract fees from large companies like Netflix that depend on high bandwidth and can pay a premium. The US still has not enacted net neutrality laws, which means that Netflix has to pay US ISPs a premium for its high-quality bandwidth. Netflix's recent deal with Comcast was over bandwidth issues. In Europe though, net neutrality is more strictly enforced which has lowered Netflix's costs. At the same time, net neutrality also diminishes some of Netflix's competitive advantage and levels the playing field for all website companies. Although Netflix paid a premium for high bandwidth, the premium also prohibited some

companies from competing with them. It remains to be seen whether net neutrality movements will help or hurt Netflix in the long run.

As mentioned previously, every major network and content providers is trying to improve their own Internet accessibility so that they can distribute content directly to consumers as well.

Although Netflix does provide value by aggregating content, suppliers may begin to restrict the content they sell to Netflix if they believe they can distribute the content just as effectively and gain a share of the profits.

Bargaining Power of Consumers

Customers in the Internet media streaming industry do have significant bargaining power because switching costs are so low, and customers are willing to change services quickly. Netflix currently charges a monthly membership fee of \$7.99, which is extremely affordable. However, because customers are not locked into contracts for long periods of time, they are very price sensitive and will choose other distributors. One strategy that Netflix has employed to limit customer bargaining power has been its original content creation. Netflix Original Series has received much attention and acclaim, and most importantly cannot be found on other large distributors. While most of content can be found on illegal pirating websites for free, many customers still would rather pay the low monthly membership fee and enjoy Netflix's ease of use than risk pirating shows illegally.

SWOT Analysis

Strengths	Weaknesses
<ul style="list-style-type: none"> • Proven Business Model • Financially Stable • Popularity Among Younger Generation • Strong Management 	<ul style="list-style-type: none"> • Dependency on Content Creators • Inconsistent, Outdated Catalog
Opportunities	Threats
<ul style="list-style-type: none"> • Targeted International Expansion • Increased Vertical and Horizontal Expansion 	<ul style="list-style-type: none"> • Domestic and International Regulatory Threats • Bandwidth Regulation • Illegal Downloads Industry

Strengths

Netflix has a proven business model in a rapidly-growing industry that makes it a market leader in online media content distribution. Netflix stands alone in this regard, especially given that it had a first-mover advantage in this industry. At \$7.99 per month for unlimited content viewing on an unlimited number of devices, existing subscribers are unlikely to shift to a competitor while new users will be drawn to Netflix on the basis of its low cost (the average movie ticket cost \$8.38 in 2013¹). Netflix provides one of the largest catalogs of movies and television shows online, and its 33.1 million subscribers prove that its core business model remains stable. This large subscriber base gives it leverage in negotiating deals with movie and television studios.

Netflix's strong financial health gives it the versatility to pursue opportunities in virtually any aspect of the entertainment provider industry. Its latest ventures, original TV programming, were all paid with the \$1.2 billion in cash reserves that the company has. Its healthy cash flow also ensures that the company is in no danger financially, and as long as its strategy remains competitive, the company has the cash to experiment and innovate.

In the last decade, users have increasingly spent more and more of their lives on their personal computer, tablets, and mobile devices. Especially among the younger generation, staying

¹ Source: National Association of Theater Owners

“connected” all the time is important in our daily lives, and more often than not people will have more than one electronic device turned on at any given time. Online streaming of media content occupies a vital role in how the younger generation spends their free time, and the ability to watch entertainment videos on the go is becoming very important in this era. Netflix thus fulfills this role for many people, and the future of the entertainment industry looks more and more likely to be online.

Netflix’s strong management is a big strength, and its business decisions have proved this. Reed Hastings was the first to recognize the potential of online entertainment streaming and capitalized on it. Netflix recovered well from their Qwikster debacle in 2011, proving that the management team was listening to their users. The decision to produce original content was also a landmark for what is primarily a media aggregation and distribution service. In addition, releasing all episodes of a single season at the same time was again a first for any media platform, and showed that management understood the current viewer’s preferences for “binge-watching” television shows. This decision paid off, as the popularity and success of television series like *House of Cards* has given Netflix even more cachet in the industry.

Weaknesses

As Netflix remains primarily a content aggregator and distributor, it remains beholden to the movie and television studios in terms of the content it can distribute. Thus, even though its subscriber base can be used as leverage, it is still subject to the mercy and whims of these studios. Its move to produce original content was a smart diversifying move, but may have angered studios who may have begun to see Netflix as a competitor and not a distribution partner. Retaliatory moves may not have been taken, but should Netflix continue to produce more and more of its own content, its core business model may suffer, especially since Netflix will require a lot more content to rival the size of television and movie studios.

Netflix’s catalog has come to be seen by some as outdated and inconsistent. Its ‘recent releases’ are generally months old and it lacks many Academy Award winning films and well as more recent films. On its homepage, there isn’t even a “new releases”. Furthermore, the catalog is known to change frequently and without notice. For example, the TV series *Absolutely*

Fabulous, which was previously available, is now no longer offered. Lastly, some users have mentioned that competitors' user interfaces are easier to use.

Opportunities

Targeted international expansion will allow Netflix to ride the online-entertainment industry wave that is hitting the globe. If Netflix is able to get around barriers in politics, culture, and language, they can increase their subscriber base exponentially. Its current expansion into Latin America has led to huge spending in advertisements that have increased subscribers, but is still hampered by a lack of knowledge about the region. A large portion of the population do not have credit cards, which is the primary mode of payment for subscribers. A lack of high-speed internet connections in the region is another disincentive for the population to subscribe. Lastly, the foreign movie catalog on Netflix is relatively small, with English-movie translations and subtitles still underdeveloped.

Continued vertical integration may be the key to attracting more subscribers and grabbing more market share in the home entertainment industry. Vertical integration means combining the content creation, aggregating and distribution aspects of media-entertainment business. Netflix has its core businesses in aggregation and distribution, but creating more original content has two advantages: Firstly, the current popularity of Netflix Originals legitimizes its position in the media content field, and makes it more visible and more established as a big player in the burgeoning online media entertainment industry. Secondly, creating more content would attract more subscribers, since Netflix Originals are only available through Netflix.

Horizontal Integration would entail trying to partner with as many home and mobile entertainment platforms as possible, bundling with video game platforms, Smart TVs, living room PCs as well as tablets and mobile phones. Increasingly, home entertainment systems are becoming all-in-one solutions and mobile phones and tablets are never far from users. As Netflix is not a physical system the way Roku or Apple TV is, they would have less trouble in bundling their application with these systems. This would allow Netflix to establish itself as essential in any home or mobile entertainment system, which should boost subscription. Additionally, it

could be catering to a different segment of the market, such as the gaming community, which would be a form of diversification.

Threats

Regulatory threats may threaten Netflix's expansion and curb its growth. Net neutrality states that Internet Service Providers must not discriminate or charge differentially by user, content, site, platform and application, type of attached equipment and modes of communication. The war over net neutrality is not moving in Netflix's favor, as a U.S Court of Appeals struck down the FCC's network neutrality rules for cable service providers in January. Netflix issued a letter to shareholders, explaining that domestic Internet Service Providers can now legally impede the video streams that members request from Netflix, disrupting the stream and degrading the entertainment experience². Netflix also struck a deal with Comcast to ensure Netflix subscribers would continue to enjoy fast speed and smooth access. The terms of the deal were thought to be in the region of a few million dollars, which may not dent the financials of Netflix, but does set some precedence in the way that Internet Service Providers can control bandwidth, which is problematic for Netflix's future.

International expansion exposes Netflix to the increasingly complicated regulation surrounding online media streaming. Although breaking into countries like China and India would be major opportunities for Netflix to bolster its subscriber base, the regulations and politics in these countries are opaque, complicated, and frequently thought to be corrupt. This makes it difficult for Netflix to expand overseas unless it dedicates more time and money the endeavor.

The illegal downloads industry is still thriving, and file-sharing networks called torrents are very popular amongst users who wish to download media content (movies, TV shows, music) without paying for it. Content that appears on torrent websites are attractive because of its cost (or lack thereof), its speed, and its comprehensive and constantly updated library. Television shows and movies that have just been broadcasted can often be seen on torrent websites the same day. Although regulation has gotten stricter with regards to torrenting, there remains no concrete

² Source: Netflix Investor Relations, *Long Term View*, Stable URL: <http://ir.netflix.com/long-term-view.cfm>

evidence of users being arrested or fined in large numbers, which means that most users do not feel the threat of legal action enough to deter them from using torrenting websites. At present, there are still many torrent sites and the user base remains very large. Torrent users who do not wish to pay for viewing content will not subscribe to Netflix, especially since the library of content on torrent websites is much more comprehensive.

Strategic Recommendations

Our strategic recommendations focus on strengthening the core business, increasing the number of subscribers, and targeted global expansion. These are not mutually exclusive, and can be separated into the following actions:

- More Vertical Integration
- More Horizontal Integration
- Updating Catalog
- Targeted Global Expansion

More Vertical Integration

More content creation is a move towards greater vertical integration. In the entertainment industry, there is a 3 step process: creation, aggregation, and distribution. Most players in this industry occupy one or two roles within this process. Netflix is the first company that has taken steps to occupy all three roles. In creating original content, Netflix has signaled its intent to become one of the big players, especially as online media consumes a larger portion of market share and viewers' habits continue to change.

Netflix has the financial stability and health to hire the right screenwriters, producers, directors, and actors, as proven by the Emmy-winning *House of Cards*. The popularity of that series has given Netflix the credibility and visibility it needs to establish itself as a content creator. Continued acclaim for other Netflix originals will increase the number of subscribers since Netflix has the only right to distribute these originals. The downside of this strategy is the possibility that movie and TV studios may begin to see Netflix as a competitor, and may choose retaliatory actions such as refusing to grant licensing rights to Netflix. This has not happened so far, and if Netflix's subscriber base increases to the extent that it constitutes a large part of the US entertainment viewing market this should not be a problem³.

³ As per the 2013 Annual Report, Netflix reports that it intends to "substantially increase investment in original content", although it will still constitute less than 10% of overall expense on content.

Two additional notes related to content creation:

1. An interesting paradigm might result in which Netflix originals have enough sway that other distributors might want to pay for the rights to these series, which may form another source of revenue, although this may detract from the goal of increasing subscription to Netflix. This is a future concern, but bears some consideration.
2. Releasing all episodes of the series at once also reveals an astute insight into the changing mindset of viewers. Viewers are more inclined to “binge-watch” TV shows nowadays, but it remains to be seen if this mode of content distribution can turn into a revenue stream. We do recommend that Netflix continues to do this with all future original content as it creates an increased psychological demand-supply cycle, and causes viewers to spend more time watching TV shows online in general, which is a business advantage, particularly for Netflix.

More Horizontal Integration

Bundling Netflix with other home entertainment systems would constitute horizontal integration and strategic marketing. As home entertainment becomes more and more all-inclusive, Netflix needs to ensure that it is available on all these platforms. Smart TVs, computers that can double as TV screens, game consoles that can perform computer functions; home entertainment is consolidating in the living room, simplifying users’ lives while also becoming more competitive. By negotiating deals with all these manufacturers, Netflix can ensure that it becomes the primary source of online streaming media, while increasing visibility and taking advantage of untapped markets like gamers. Netflix can perhaps offer a free month’s trial for buyers of these systems as a way of attracting new subscribers. As it is mainly an application, it would be easier for it to be added onto these systems than other online media streaming systems like Apple TV.

Focusing on bundling with mobile entertainment systems is also crucial to increased horizontal integration. One of Netflix’s crucial qualities is the ability to stream on up to two devices simultaneously under a single username or password⁴. It’s availability on-the-go is also

⁴ At present, Netflix has plans for a new family plan which would cost \$11.99 per month and let subscribers stream on as many as four devices simultaneously.

invaluable to commuters. By bundling with mobile phone or tablet manufacturers as one of the pre-installed applications and perhaps offering a free month's trial, this could be a big incentive for mobile device users.

Updating Catalog

It is imperative that Netflix updates its catalog of media, as this is one of the major complaints for current users. The biggest complaints are that recent films and Academy Award films (both nominated and won) are not available, and that even content that used to be available is for some reason now unavailable. Netflix has garnered a big enough following that it can and should leverage better licensing deals with studios. Being known for an incomprehensive catalog will deter potential subscribers and alienate present ones. Additionally, improving its catalog of foreign films and improving the closed captioning on its English catalog of films is important as well, since global expansion is one of its goals. Again, this is important in trying to attract foreign subscribers who are not just interested in English language films. Netflix's financial health should allow it to achieve this goal easily.

On a related note, Netflix might want to consider attempting to negotiate concurrent releases with movie studios. The growing trend towards staying at home instead of going to the movies can be attributed to applications like Netflix, with their accessibility to a large catalog of films whilst allowing users to remain in the comfort of their own home. Perhaps this can be taken advantage of, with Netflix charging users a premium for movies that are playing in theaters. This is more of a long term goal, when Netflix's catalog has been sufficiently updated and its subscriber base rivals the number of movie-goers on any given weekend. As the future of entertainment shifts online though, this would be the next logical step.

Targeted Global Expansion

Most of Netflix's subscribers are in the United States. However, economies of scale and globalization have led to the ubiquity of home and mobile entertainment devices in developing and developed countries all over the world. This constitutes a huge opportunity for Netflix, since online media entertainment has proliferated in the last five years. However, the global expansion

must be carefully planned or wasteful expenses may result, as in the case of Latin America, where large advertising expenses have yet to translate into large increases in subscription. The main flaws observed in the Latin American expansion were a lack of infrastructure, the lack of an attractive catalog, and low barriers to entry. Following this example, we can perhaps devise some conditions that would prove useful in selecting countries for targeted expansion.

Firstly, the country must have the infrastructure in place to support large bandwidth transfers and modes of payment. The country must have a high technology usage and adoption rate, with the population owning more than one device preferably. This ensures that the population would be familiar with Netflix or at least the concept of online streaming, and would be intrigued by the novelty or availability of Netflix. A high technology usage rate would also mean that most households have access to a quick internet that supports the bandwidth for streaming online videos. Secondly, financial infrastructure is important, as the problem with Latin American expansion was that most people could not pay subscription fees since they did not own credit cards. As such, Netflix must target countries that are developed enough to have the national or global financial institutions to support payment to online websites.

Secondly, we have already touched on the importance of updating its catalog. Perhaps here the key point is the targeted updates of foreign films – Only when Netflix has narrowed down its list of countries to expand into should catalog enrichment occur to include the right kinds of films and subtitles.

Lastly, low barriers to entry is key. Countries like China may have a sizable population to add to Netflix's subscriber base, but the opaqueness of its regulations and politics make it a complex market to enter, possibly not worth the 1.2 billion potential subscribers (its feud with Google should serve as warning enough). Netflix should base its expansion on countries that would welcome a hallmark of technological advancement, with transparent regulations and easy entry.

With these factors in mind, we have two recommendations. Our initial recommendation is countries in the European Union. Although its financial stability is questionable at the moment, Europe remains an advanced and liberal society, technologically and financially advanced and

well regulated by the European Union. This would be an easy market to enter, and should be part of Netflix's short-term expansion strategy. Additionally, considering its current poor financial state, the E.U. would welcome any investment. Our second recommendation is India. Although the barriers to entry are complicated by the politics of the country, the country has always been a great advocate for technology and its benefits. Most of its large population remains backward, but India also produces the most number of graduates in the technology and engineering fields in the world. It is this segment of the population that will be attracted to Netflix and its possibilities, and this segment is a large market worth exploring.