

Can Netflix Play David to the Goliaths Entering the DVD Online Rental Space?

A JOURNAL OF STRATEGY & BUSINESS TRANSFORMATION

Susan Verghese

With over 464 million homes predicted to have DVD players by the end of 2009 (compared to 435 million with VCRs), and with US consumer expenditure on electronic media and entertainment on the rise (from \$100 billion in 2002 to over \$120 billion by 2010), the DVD rental industry appears to be a promising market.¹

Within this space, Netflix, a 1999 start-up, developed a unique value proposition that has enabled it to become the world's largest online DVD movie rental service. That position is now being threatened by large competitors, like Blockbuster and Walmart, which are also jumping on the bandwagon with similar propositions, trying to ensure their own share in the growing revenues that the industry is providing.

Netflix's position in threatened

Netflix was started in 1999 as an online movie rental service. Its unique service of providing an expansive selection of DVDs, an easier way to choose movies, fast and free shipping, and "no late fees/ due dates" secured it a customer base of over 2 million members, to whom it offered access to over 25,000 movie titles.

With more than \$270 million in revenue in 2003, Netflix CEO Reed Hastings's 5-year plan projecting company earnings of about \$1 billion, and the acquisition of more than 5 million customers, seemed attainable. What he could not foresee was the emergence of giants like Blockbuster, a \$6 billion company, or WalMart, a \$256 billion company, who would enter the US market space with competing services and prices earlier this year, or Amazon, a \$5.3 billion company, entering the UK market this month.²

Company	DVD selection	Fees per month	Free trial	DVDs at time
Blockbuster (online)	>30,000	\$14.99	2 week	3
Netflix	>25,000	\$17.99	2 week	3
DVD Avenue	>9,000	\$14.95 to \$44.95	-	2 to 8
Walmart	16,000	\$15.54	30 day	2

Can Netflix Play David to the Goliaths Entering the DVD Online Rental Space?

A JOURNAL OF STRATEGY & BUSINESS TRANSFORMATION

Susan Verghese

An overall comparison of the services offered by the main competitors in the industry is listed above:

All of the top players, moreover, offered many of the same features and benefits, including: free shipping (and return), no late fees/ due-dates, optional cancellation of services at any time, and free trials.

Blockbuster's Smoking Gun

Blockbuster's foray into the US DVD online rental market place was particularly aggressive. In addition to the common promotions offered by its competitors, it also gave its members 2 free in-store rentals per month.

Moreover, for the 2004 holiday season, Blockbuster initiated three aggressive competitive strategies:

- Price cuts for its services that aimed directly at curtailing sales of its main rival, Netflix
- Elimination of late fees--a core feature of the Netflix proposition—which was announced soon after Amazon's introduction of its rival DVD online service in the UK and scheduled for rollout in January 2005
- Its intent to make a hostile bid, in January 2005, for Hollywood Entertainment (the number 2 video store chain)³ by purchasing all of the outstanding shares of that company

Protecting its own turf: Netflix

Netflix retaliated to Blockbuster's price cuts by initiating its own version of a price war: it decreased its monthly subscription cost from \$21.99 to \$17.99.

Netflix's price reduction, however, led to a sharp sell-off of its shares the day the cut was announced⁴. This was followed by a rebounding of its shares, with the announcement of Blockbuster's hostile bid for Hollywood Entertainment. As a result of its price reduction, Netflix experienced a 73% increase in subscribers-- to 2.6 million in 2004, from 1.5 million in 2003; a historically low level of subscribers attrition during the year; and an expectation of at least 4 million subscribers in 2005.⁵

To further strengthen its own position, Netflix also introduced a recommendation engine, CineMatch, and a Netflix *Friends* feature, where members

Can Netflix Play David to the Goliaths Entering the DVD Online Rental Space?

A JOURNAL OF STRATEGY & BUSINESS TRANSFORMATION

Susan Verghese

could discuss movies, while influencing others to use the online site.

Its strategies for 2005 include:

- An expansion of its services to Canada and the UK. Its UK expansion strategy was initially planned for 2004, but was shelved upon the announcement of Amazon's entry into the UK market.
- A partnership with TiVo that will include the development of a service allowing customers of both companies to access DVD-quality movies through broadband Internet connections.⁶

At present, Netflix feels confident it can temper Blockbuster and other competitors. According to Netflix's Chief Executive Reed Hastings, "The more Blockbuster promotes online rental, the more they are driving consumers to try Netflix." Hastings also warned that Blockbuster's price cut would hurt business at its stores, which offer a subscription service for \$24.99 a month.

Netflix feels that its own "single-minded focus on the online DVD-rental market" will help it combat future price cuts initiated by companies like Blockbuster that have additional businesses competing for their attention. Analysts, however, are skeptical of that stance, noting that Netflix has already sacrificed much of its gross margin for additional subscribers, and that the outlook for margins in the coming years doesn't look any better.

The Future

So, Netflix is not out of murky waters yet.

With the impending entry of Amazon in the US DVD online rental market; and with pricing and subscription growth remaining essential to its revenues, Netflix may have to resort to another price war in the coming years to maintain its position in the industry.

Equally important, it will also have to find new ways to tackle the potential expansion of services offered by pay-per view and premium cable channels, new technologies that may evolve, and potential new competitors like Yahoo⁷, which could enter the market space to augment its own domestic US offerings.

References

Can Netflix Play David to the Goliaths Entering the DVD Online Rental Space?

A JOURNAL OF STRATEGY & BUSINESS TRANSFORMATION

Susan Verghese

1. Informa Media
2. Hoovers online, "Big Competition Checks Out Netflix" (WSJ, December 29, 2004)
3. "Technology Stocks Rise after Post- Holiday Dip" (WSJ online, December 28, 2004)
4. " Blockbuster cuts online rental fee" (WSJ, December 23, 2004)
5. Netflix won't match Blockbuster's price cut, CEO says" (Dow Jones News-wires, December 22, 2004)
6. "I want a movie! Now!" (Newsweek, September 13, 2004)
"Big Buy for Yahoo Isn't Likely" (WSJ, December 15, 2004)