Netflix: The Streaming Challenge

“We are now a streaming company, which also offers DVD-by-mail.”
Reed Hastings, CEO Netflix, Reuters, October 21, 2010

“Once you put it on Netflix, you really can’t sell it anywhere else.”

On a cold day in January 2012 Jan Simon arrived back in Barcelona to continue his MBA at a leading business school. He had just spent the holidays with his parents, family and friends in Seattle, enjoying great food and some good movies during the long, relaxing evenings. On the way back to Europe he thought about the company that had become an entertainment cornerstone in his parents’ home: Netflix. What would be the future of the company with the red envelopes? Would it survive its move from the world of sending DVDs by mail to streaming movies over the Internet? Would its international expansion be successful? Should he invest in the company?

The Company

Netflix was founded by Reed Hastings and Marc Randolph in 1997 in Scotts Valley, California (see Exhibit 1 for company timeline; see Exhibit 2, 3, 4, 5, 6 and 7 for financials). In April 1998 the company launched its website, followed by the launch of its unlimited rentals subscription service in 1999. In 2000 the company launched its personalized movie recommendation system, followed by its IPO on May 22, 2002 (raising approximately $85 million). In 2006 the company launched the Netflix Prize, a competition to develop recommendation software that would improve by at least 10% its own recommendation engine (it took a team of several PhDs three years to win

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2 That same year also saw the introduction of the DVD and revenue sharing in video rental.

This case was prepared by Professor Marc Sachon as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. April 2012.

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the prize in 2009). In 2007 Netflix introduced streaming of television shows and movies followed in 2008 by partnerships with consumer electronics companies to stream content to blu-ray DVD players and game consoles, as well as other devices. By the end of 2010 Netflix had 20 million members. In September of that year it began its international expansion by offering streaming in Canada, followed in 2011 with the entry into Latin America and the Caribbean and in 2012 into the United Kingdom.

The idea to start the company stemmed from an experience Reed Hastings had when he forgot to return a movie he had rented from a major video rental chain. On returning the “Apollo 13” movie, he was charged with a $60 late return fee: “I realized immediately that it was a poor customer experience. It was also suboptimal for the companies – the retailers and vendors.”

Partly as a result of this experience, Reed and his cofounder, Marc, developed the idea of online DVD rentals. Initially Netflix offered individual online DVD rentals and delivered the DVDs by standard mail, using a pay-per-rent system like Blockbuster, the world’s largest video rental chain at the time. During its first year Netflix even charged late fees. Market share remained insignificant and the company decided to change its business model; it implemented a subscription-based model, until then unheard of in the entertainment industry. From then on, subscribers would pay a flat fee and could keep a DVD for as long as they pleased. The flat fee included viewing and shipping, so subscribers had nothing else to worry about. When the subscription model was introduced in 1999, membership started to grow: by January 2000, the company had 85,000 subscribers; 300,000 by January 2001; 750,000 by November 2002; reaching the one million mark by February 2003, faster than any company before it. Growth didn’t stop there and by the end of 2011 Netflix had more than 26 million subscribers.

The IT industry took note and on March 26, 2007 Reed Hastings joined the board of directors of Microsoft and in 2010 Fortune magazine elected him the “2010 Business Person of the Year” – ahead of Steve Jobs (Apple), Mark Zuckerberg (Facebook) and Alan Mulally (Ford). That same year Reed Hastings announced that “for all practical purposes we are now a streaming company that also offers DVD-by-mail…. We’ll spend more on streaming content than DVD content.” By fall of 2010, 66% of its users were streaming content online. This also meant, however, that the future business outlook for Netflix was not as clear as it had been during the previous decade; with the growth of streaming, the power structures in the movie rental business were shifting again.

**The Early Years: DVD Rentals**

Under the 1999 DVD rental model, subscribers paid a rate of $19.95 per month and could rent as many movies as they wanted, watch them as often as they wanted and return them at their leisure without any late fee (approximately 93% of customers chose this option) – as long as they never had more than three Netflix DVDs in their possession (for a subscription rate of

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6 Fortune, December 2010.
$29.95 this number would be five DVDs and at $39.95 a customer could stock as many as eight DVDs). The average Netflix subscriber rented five DVDs per month. The subscription rate was lowered to $17.99 by 2005.

To rent a movie, a subscriber accessed the Netflix website and chose a DVD title from its catalog – the largest DVD rental catalog in the world (see Exhibit 8 for an illustration of Netflix’s DVD rental process). Next, the subscriber was informed about delivery lead time: less than two days, two to five days or longer than five days. Based on this information they could then choose to rent the selected DVD or not. The selected title was then added to a queue of other DVDs that had been selected at an earlier date, the subscriber’s “wish list.” For some subscribers this list could be 400 films long. Subscribers could modify their queue at any time on the Web and were encouraged to rate any movies they had seen. These data would be processed by Netflix’s proprietary algorithm-based technology called Cinematch. The result would be a list of suggestions aimed at increasing the movie experience of the subscriber, all based on his or her previous rentals and feedback on the viewing experience. The software “learned” what the subscriber liked. It was a cornerstone of Netflix demand management and one of the first successful, large-scale applications of customer analytics.

Cinematch could generate thousands, even millions of recommendations per second, contained more than a billion ratings for more than 100,000 movie titles and processed hundreds of thousands of simultaneous visitors at peak times. During their movie selection process on the website, customers could run all sorts of classifications of movies, by actors, directors, years, genres etc. The results were impressive; even as early as 2002, some 70% of the movies customers rented on Netflix’s website were recommended to them by Cinematch and Netflix generated 80% of rental activity from 2,000 titles, decreasing demand for new releases where margins were thinner (the average video store generated 80% of its revenues from 200 titles). Similarly, only 30% of Netflix rentals were new releases while this number was at 80% for Blockbuster.

In 2005, Netflix revised its terms of use, stating: “In determining priority for shipping and inventory allocation, we give priority to those members who receive the fewest DVDs through our service.” This modification effectively introduced “throttling” into its business model; heavy users were identified by an algorithm and their service was slowed down, effectively reducing the number of DVDs shipped to a client. One heavy user (18 to 22 DVDs per month) saw the number of DVDs drop to 13 per month (see Exhibit 9).

By 2008, more than 95% of Netflix members received their DVDs with next day delivery, shipped to them in the familiar red Netflix envelope (see Exhibit 10 for an example of the Netflix envelope; see Exhibit 11 for next day delivery evolution). Netflix’s envelopes were

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designed so that the same envelope could be used for shipping a DVD to a customer and then returning it to a Netflix distribution center after having watched the movie.

More on the DVD packaging process:

Subscribers would drop the red Netflix envelope in a mailbox from where it would be shipped to the nearest regional Netflix distribution center. After viewing a DVD, subscribers had the opportunity to rate the movie with one to five stars. This information was stored and processed by Cinematch to generate movie suggestions for subscribers. In 2010, some 60% of Netflix users rated movies and the average user rated some 200 titles – but 1% of users had rated more than 5,000 titles and the top 0.01% had rated more than 20,000 titles!13

For its in- and outbound logistics, Netflix had signed a risk-sharing partnership with the United States Postal Service (USPS). Netflix spent approximately 25% of its revenues on postal expenses in 2010. USPS shipped DVDs to and from customers, first-class U.S. postal service, while an e-mail was sent to the subscriber informing him or her about the shipment.14 Once the envelope was received at the DC, Netflix then identified the next DVD on the wish list and checked for its availability at the regional distribution center. Titles that were not available there were moved through time zones until one of the nearby distribution centers could fill the demand. The DVD wish list was worked off from top to bottom. If one of the DVDs selected for shipment was not available at any of the Netflix DCs, the subsequent DVD would be shipped instead, postponing the shipment of the unavailable DVD until it became available again. Blockbusters were assigned on a first-come-first-served basis. Many subscribers updated their queue every couple of days to always have their currently most preferred movie at the top. At the same time some subscribers were unhappy with the long wait for newly released movies; a wait of several weeks was not uncommon for hot new releases.

DVD Operations

Originally, Netflix operated from a distribution center in Los Gatos, California, gradually extending its service to cover all the United States. By 2010 all metropolitan areas enjoyed a service level of receiving their DVDs within two days or less. Subscribers were served from 58 distribution centers located across the country, in proximity to one of the more than 280 processing and distribution centers of the USPS. Netflix chose the locations based on the availability of USPS centers and population distribution. All of the distribution centers were served from a national fulfillment center opened in 2009 and located in Grove City, Ohio.

Originally, processing of DVDs in the Netflix distribution centers was done manually. The only automated task was that of sealing the envelopes before mailing them. Netflix employees would pick up DVD shipments from the USPS office in the morning and then process each of the thousands of inbound DVDs: remove from envelope, inspect, scan bar code and store temporarily. During lunch break a computer system matched the scanned DVDs with wish lists

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of regional subscribers. During the afternoon, workers at the DC processed outbound DVDs: they scanned them, the system then printed two labels (one for sending to the subscriber, another for the return shipment) and then they inserted each DVD into its red envelope, which would be placed in a postal carton. A staff of about 20 workers could handle up to 50,000 receipts and shipments each day. Each evening all outgoing DVDs would be taken to the USPS center for distribution. Netflix distribution centers typically had less than 1% of inbound DVDs on hand at the end of a day. These DVDs were sent to the central distribution center for storage at the end of the week.\footnote{Behind the scenes at a Netflix distribution center: USA Today. 2009.\textit{USA Today visits Netflix, Jefferson Graham}. (Online). Last accessed April 2016. Available from: \url{https://youtu.be/400OBYOc5Bo}.

Netflix ordered outbound envelopes by ZIP code, reducing work for USPS. In return, it got a slightly lower rate than first-class postage (which was $0.42 in 2008, $0.44 in 2009 and $0.45 in 2012). By 2008, Netflix had automated the DVD sorting process in order to increase quality and efficiency; more than 60% of the process was automated, increasing efficiency by 44%, decreasing costs per shipment by 17% while increasing overall quality of service (see Exhibit 12 for an example of a sorting machine).\footnote{Netflix ordered outbound envelopes by ZIP code, reducing work for USPS. In return, it got a slightly lower rate than first-class postage (which was $0.42 in 2008, $0.44 in 2009 and $0.45 in 2012). By 2008, Netflix had automated the DVD sorting process in order to increase quality and efficiency; more than 60% of the process was automated, increasing efficiency by 44%, decreasing costs per shipment by 17% while increasing overall quality of service (see Exhibit 12 for an example of a sorting machine).}

\section*{Streaming}

By 2006 Netflix realized that the time was ripe to take the next step and make the company’s name a reality: Netflix, i.e., distribute movies via the Internet, as Reed Hastings had envisioned when he cofounded the company. In January 2007, one year after Apple and Amazon announced movie-downloading services (respectively), Netflix introduced streaming of movies. For a typical DVD subscription plan of $17.99 per month subscribers would get an additional 18 hours of streaming to their PC (Amazon offered online movie rentals for $3 to $4 a movie).

Streaming was chosen over download, as it avoided conflict with the movie studios; with streaming, movies could not be stored on the PC, making pirating more difficult. Furthermore, customers got instant gratification as they would not have to wait for the download to be completed. Netflix offered an initial catalog of about 1,000 movie titles and television shows. Users were required to download a special piece of software (it would only run on recent versions of Windows and its Internet Explorer) and have an Internet connection of at least 1Mbps to watch films in VHS quality (3Mbps for DVD quality). Netflix estimated that the launch of streaming would cost the company $40 million in 2007.

Not everybody was convinced that Netflix would be able to compete with companies like Apple in online streaming and so some financial analysts, like J.P. Morgan Securities, downgraded Netflix’s stock.\footnote{Not everybody was convinced that Netflix would be able to compete with companies like Apple in online streaming and so some financial analysts, like J.P. Morgan Securities, downgraded Netflix’s stock.} The company wasn’t concerned however; its stock kept increasing, as did its subscriber base. By 2008 Netflix offered 12,000 movie titles and TV shows via streaming. Unlike the DVD...
service, however, these titles did not include new releases, but were catalog titles. In 2011 Netflix separated the unlimited DVD-by-mail and unlimited streaming plans and customers could opt for streaming only subscriptions: all-you-can-watch for less than $8 per month.

*Reed Hasting’s opinion on online distribution:*


At the time Netflix had 10 million streaming-only subscribers, three million DVD-only subscribers and 12 million DVD and streaming subscribers. Some 25% of its subscribers were streaming via Nintendo Wii, 13% via Sony PS3 and 12% via Microsoft’s Xbox360. By 2012, Netflix had expanded its service availability to everything from PCs, video game consoles, smartphones and tablets. The list of new devices able to use Netflix’s streaming service was growing constantly.

*Netflix prepares for the end of DVD.*


In building its streaming business, Netflix had to expend increased efforts in order to secure deals with content providers. In October 2008 Netflix signed a contract with Starz, a premium movie and original programming entertainment service provider operating in the United States, giving Netflix access to approximately 2,500 Disney and Sony movies for an annual fee of $30 million (Starz was taking advantage of a loophole in its contract with the studios). In September 2011 talks between Netflix and Starz to renew the contract were broken off. In August 2010, Netflix signed a five-year deal with Epix (Paramount, Lionsgate and MGM) to gain access to its movies, original programming and library. Epix would make new movies available to Netflix 90 days after their premiere on Epix.

In September 2011 Netflix announced a pay-TV deal with DreamWorks Animation (“Kung Fu Panda,” “Antz,” etc.), giving Netflix the right to start streaming content in 2013 for an unspecified number of years. Netflix signed similar deals with other content providers (Disney in December 2011), albeit at their mercy; video windows were back and movie studios and distributors were able to cherry-pick what content to sell to Netflix and what to other companies. A look at Netflix’s cash flow statement revealed that content acquisition cost was increasing considerably.

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Streaming brought several unique challenges with it; while DVDs required distribution centers, streaming required data centers. Netflix stored the entire viewing history of its subscribers, including the position at which they had stopped watching a movie stream, so that they could return to the same position at a later point. Furthermore, all viewing-related data was fed to Cinematch for customer analytics. Originally the company operated a single data center, but in 2010 it began moving its data to Amazon Web Services (“the cloud”). Another issue of growing concern was bandwidth; download caps in the United States did not exist or were at 250GB per month or higher in 2010/2011. This supported the viral spread of streaming services such as the one offered by Netflix. In spring 2011, Netflix accounted for 25% of North American Internet traffic – by fall of 2011 that number had increased to 29%. In Canada, Netflix had limited the resolution of its streaming content in order to free up bandwidth. Netflix also teamed up with companies such as eyeIO to develop new compression algorithms that reduced bandwidth needs. At the same time, as Netflix became available on more and more devices, the demand for bandwidth continued to increase.

The expansion into online content streaming seemed to be a logical step for Netflix. But it in this case a completely different legal framework took hold: in the case of purchasing a DVD, the first-sale doctrine applied, which was established by the U.S. Supreme Court in 1908. It meant that the purchase of a VHS or DVD settled any claims of the copyright holder (i.e., movie studio) and gave rental companies the right to rent out the movie as often as it wanted. The first-sale doctrine, however did not apply to streaming. Instead, streaming content was regulated by the Federal Communication Commission (FCC) and received the same treatment as TV and radio shows; Netflix would have to pay the copyright owner each time they wanted to use its content. So instead of paying once for a DVD and then renting it out multiple times, Netflix now had to negotiate with the studios each time it wanted to stream any of their content. This made content acquisition much more difficult for Netflix and thus its streaming library was much smaller than the DVD library.

The Netflix Value Chain

Netflix’s value chain started with the movie studios, followed by the movie distributors (in the United States many distributors were owned by the studios), the recommendation engine (Cinematch), the logistics service provider (USPS), the national distribution center, regional distribution centers and the subscribers.

Content acquisition depended on delivery form. The legal framework for DVDs and streaming differed notably, giving much more power to the movie studios in the latter case. For DVDs, Netflix primarily purchased new releases and depreciated the costs at 12 months accelerated. For streaming, Netflix was more selective. Hastings stated: “So, we don’t particularly look for new

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21 In Europe a different legal framework applied: the “Rental Right Directive” gave the copyright holder an exclusive right to authorize or prohibit the rental, lease or lending of cinematic work; in effect, rental companies had to compensate the copyright owner for each rental.
releases vs. old or anime vs. drama. We really look at what our subscribers are watching and try to get more of that,” and, “We have virtually no new releases in streaming.”

Netflix could obtain DVDs by buying them or under a revenue sharing agreement. The company even bought pre-viewed DVDs to reduce content acquisition costs (generally, the larger a title was, the better the used purchase would work). In the case of revenue sharing, the movie studio could define special contractual requirements – e.g., establishing minimum and maximum inventory levels, revenue sharing percentages, bundling of titles, etc. Ever since the turn of the century, movie studios had reduced the video window and increasingly pushed the retail sale of DVDs as it contributed greatly to their profitability. This reduced their hold on rental companies. When, for a given title, a movie studio extended the video rental window (period during which a movie would not be available for rental, see Exhibit 13 for data on video windows) or gave exclusivity to other companies (e.g., in 2007 Blockbuster signed an exclusivity deal with The Weinstein Company) Netflix would buy the DVDs from the retail channel.

In 2011, Walmart was the largest DVD retailer in North America, representing 40% of all DVDs sold. While this procedure increased processing costs for Netflix (DVDs sometimes arrived in retail-style jewel cases), it allowed Netflix to circumvent some of the studios’ strategic decisions.

Revenue sharing was introduced by Blockbuster in 1997 to align the interests of movie studios and rental outlets (i.e., companies that rent and sell DVDs, e.g., Blockbuster); instead of paying $15 to $30 per DVD, retailers would pay a low up-front fee of $1 to $5 per DVD (depending on the box-office performance of the title) and then share the rental revenue stream with the studios. Blockbuster typically paid about 40% of the DVD rental charge of $3 to $5 to the studios. Revenue sharing agreements expired after a year, at which point the rentailer had to decide to buy the VHS/DVDs or return them to the studios. Up-front fees and revenue splits varied across broad box-office categories; studios appropriated higher revenue percentages for box-office hits and for some titles with little demand revenue, sharing would not even be considered.

Studios often imposed upper and lower limits for copies under the revenue sharing agreement – which could lead to suboptimal economic performance when compared to situations without inventory limits. These inventory levels could vary across products within each of the box-office categories as well as across store sizes. A key part of the revenue sharing model was the emergence of an independent and trustworthy third party: Rentrak, a company specializing in monitoring POS and usage data. Movie studios and rentail companies used Rentrak to collect and analyze usage data to calculate the revenue split. Concurrent with the increasing use of revenue sharing in the industry, a polarization of movie rental titles was taking place; while in 1997 new releases represented 40% of all rented titles, by 2001 this number had grown to

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22 Reed Hastings, final transcript Netflix earnings conference call, 3Q2009, Thomson Reuters.
23 Idem.
24 Revenue sharing had been used in the motion picture industry ever since the 1920s; during opening week cinemas had to pay as much as 70% of their revenue to movie studios (this percentage would fall in subsequent weeks).
59% in the United States. By 2009 Blockbuster was making 80% of its revenues from new releases.

The movie studios loved DVDs. With the arrival of DVDs in 1997, revenue streams for the movie studios grew to unknown proportions; in 1999 global retail sales of DVDs generated $1.5 billion, but by 2006 this number had grown to $23.6 billion. Industry experts estimated that 80% of studios’ profitability was derived from selling DVDs. By 2007, however, numbers were changing; DVD sales were starting to decline (see Exhibit 14 and Exhibit 15), while movie rentals (streaming and/or DVD) kept steady. In trying to prolong the life of the rich DVD revenue streams, movie studios started to push new technologies (blu-ray and its sibling 3D), but by 2012 it seemed that the DVD bonanza was over. Movie studios also took issue with the first-sale doctrine that excluded them from the revenue streams generated in the video rental business. Several industry observers considered the possibility that the first-sale doctrine might fall – with significant implications for Netflix.

Cinematch was proprietary software that Netflix had developed to solve one of the challenges of the Long Tail: matching supply and demand in an environment of product proliferation (by 2011, Netflix offered more than 100,000 different DVD titles) and markets of one, i.e., making sure that each subscriber received movie recommendations that met his or her movie watching preferences to a high degree. This ability to make personalized movie recommendations was crucial to Netflix’s success, as approximately two-thirds of the DVDs it shipped were from the tail of the demand distribution. To be able to do so, Netflix tracked some key personalization metrics, including: percent of customers for which profit margin is known; customer satisfaction relative to expectation for cost, delivery, quality and overall service; percent delivered by company commit time; standard deviation of order cycle time and revenue per supply chain management employee per year.

*Netflix’s effect on the video rental market:*


Netflix’s national fulfillment center (central DC) in Ohio originally had a head count of some 120 people. It served as a middleman between the film studios and Netflix’s other distribution centers. On a typical day in 2010, the Ohio center would receive 150,000 to 200,000 DVDs (representing between one and 300 titles) from movie studios and replicators. It operated a machine that could identify labels up to about 30,000 paper disc sleeves per hour. The center shipped DVDs via 300 FedEx packages every day and could store up to five million discs of the 89 million Netflix had in circulation in 2009. Each new distribution center improved

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30 Reed Hastings, final transcript Netflix earnings conference call, 3Q2009, Thomson Reuters.
service, but also added head count by about 20 persons, increasing administrative and related costs by approximately $50,000 per year and person.

**Competition**

*Blockbuster*

Blockbuster, founded in 1985 in Dallas, Texas, played a key role in building the movie rental industry into a key revenue generator for the motion picture industry.

*BlockBuster advertising (1994)*


Originally, the company acquired VHS tapes for an up-front cost of approximately $65 per copy. Until 1997 the typical rental fee was $3 for three days. Shelf life of a VHS tape was typically 12 weeks, after which used VHS tapes were sold as “pre-viewed” movies for approximately $10 per tape. After introducing revenue sharing in 1997, Blockbuster significantly increased copy depth for new-release movies (e.g., “Titanic”); where this number had traditionally been between one and four copies per title, starting in 1997 it was not unusual to see 50 copies at the local Blockbuster store. In its heyday Blockbuster operated more than 4,000 outlets in the United States, generating $6 billion in annual revenue in 2004 (Netflix reported revenues of $0.5 billion for the same year). But even as early as 2003, some industry experts stated that Blockbuster’s business model was outdated when compared with Netflix. In 2005, Netflix forced Blockbuster to drop its late fees, which up to then had generated as much as 25% of its revenue stream.

*DVD rental fees:*


By September 2010 the company was losing $1.1 billion and filed for bankruptcy. It was valued at $24 million at the time, down from $8.4 billion in 1994. On April 6, 2011, Dish Network Corp. acquired Blockbuster in an auction by paying $320 million. Many industry observers wondered why.

*Redbox*

Redbox was founded in 2002, with McDonalds as one of its initial shareholders. In 2003 Mitch Lowe, who had been with Netflix from the company’s inception, joined Redbox to become its COO in 2005 and president in 2009. The company operated automated rental kiosks at which customers could rent DVDs at $1 per night (many kiosks also offered video games for rental at $2 per day). By 2012 the company operated more than 29,000 kiosks in the United States. Featuring “up to 200 titles and 630 discs, Redbox is a fully automated video rental store contained in 12 square feet of retail space. With more than 68% of the U.S. population living
within a five-minute drive of a Redbox kiosk, Redbox is where America rents movies and games.”

To return a DVD or game, the customer would drop it off at any kiosk.

Originally, Redbox was set up so that if a customer had not returned his or her DVD after 15 days it would pass into his or her property. In October 2008, however, Universal Studios took Redbox to court and required the company to accept a 45-day video window during which it could not rent or sell new releases, to limit the number of Universal DVDs that it could stock and to ultimately destroy all pre-viewed Universal DVDs so that they could not be sold at low prices to consumers.

By 2010 Redbox had reached agreements with the leading movie studios, agreeing to their rental windows of 28 days or more. By summer 2011 the company had a database of 30.5 million unique customer e-mail IDs. In February 2012, Redbox and Verizon Networks agreed to launch a streaming video service. Verizon would hold a 65% ownership and Redbox a 35% ownership. The new company would offer new releases and video games via its more than 20,000 kiosks and use streaming for library content. Redbox also announced that it would increase its rates to $1.20 per night to offset rising operations costs of its kiosk business. Scott Di Valerio, CFO of Coinstar (parent company of Redbox), stated: “Streaming is great – it’s really exciting, but we think there is a bright future in physical.”

Reed Hastings’s opinion on Redbox:

Content Streaming Competitors

The content streaming business was populated with several serious competitors: Amazon (Amazon Video on Demand); Apple (iTunes); Comcast (cable, NBC Universal, part ownership of Hulu); Google (YouTube), Hulu (shareholders Disney and News Corp., and others); Redbox and Time Warner (cable, HBO, etc.).

Reed Hastings’s opinion on the future of DVDs (in 2009):

By 2012 the Motion Picture Association of America (MPAA) listed 35 legitimate business ventures on its website that offered online content distribution services. The studios played the different distribution models against each other. Some providers, like iTunes, distributed a large selection of (historical) box-office hits under a pay-per-view model (charging $4.99 per movie

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33 Redbox company website, March 2012.
34 Redbox Automated Retail vs. Universal Studios Home Entertainment, 2008.
36 Verizon Networks had sales of $106 billion in 2010 and an extensive IP network infrastructure with 30 million customers and 109 million wireless customers.
in 2010). Others, like Netflix, only had access to long-tail titles, as it wasn’t willing to pay what content providers demanded for their more successful movies and TV shows. In 2012 it was not clear which of the competing models of online movie distribution would prevail.

International Expansion

Netflix started eying its international expansion into Japan and Europe in 2002/2003. It wanted to capitalize on the growing acceptance of the DVD platform in home entertainment. It took several more years, however, to expand outside North America; in 2011 Netflix entered several countries in Latin America and the Caribbean, followed by the UK and Ireland in 2012. In doing so, it offered streaming, not DVDs.

Moving outside North America in general and into Europe in particular brought some unique challenges. Europe hosted a plethora of languages – some countries even had several different languages, each with its own grammar and vocabulary (e.g., Spain and Switzerland). Many countries had state-owned television stations which aired high-quality programs and even feature-length movies – without intermissions for advertising. Furthermore, pay-TV companies, such as the powerful Canal Plus group, had a very large subscription base in many markets. Postage rates were significantly higher in Europe than in the United States, complicating the idea of DVD rentals.

Finally, due to a different legal framework, studios were able to dictate differential sale and rental purchasing terms and some studios even used sales-only windows in Europe, i.e., DVDs were not released for rental until the retail window had closed. The same applied to streaming.

Netflix Outlook

In 2011, Netflix looked into integrating its online service with Facebook – to allow Facebook users to share information about their viewing habits. Federal laws prohibited this project from going forward in the United States, but they did not apply in other countries. In September 2011, Netflix wanted to spin off its DVD rental business into Qwikster, a new company – and focus exclusively on streaming. In doing so, the company changed its subscription plans, effectively raising customers’ monthly charge by 60%. Consumers reacted strongly and new subscriber acquisition rates dropped by 30%, forcing Reed Hastings to send an e-mail to subscribers, apologizing for the decision and cancelling it.

Reed Hastings explains how Netflix will focus on video streaming:

Industry experts estimated that this cost Netflix some 600,000 subscribers. Also in 2011, Reed Hastings sent a letter to the chairman of the Committee on Energy and Commerce to voice

concerns about a proposal to utilize the Congressional Review Act to vacate the FCC’s Open Internet Order – i.e., to introduce usage-based costing of bandwidth:

Moves by wired ISPs to shift consumers to pay-per-gigabyte models instead of the current unlimited-up-to-a-large-cap approach, threatens to stifle the Internet. We hope this doesn’t happen, and will do what we can to promote the unlimited-up-to-a-large-cap model.... Moreover, at $1 per gigabyte over wired networks, it would be grossly overpriced.40

By February 2012 Netflix had entered yet another area of business by launching its first original series, Lilyhammer, albeit to mixed reviews.

Kevin Spacey talks about House of Cards’ fourth season on Netflix:

Jan wondered what had made Netflix so successful in the past – and to what degree the reasons for success still applied in a world of streaming media....

40 Reed Hastings, April 6, 2011 (part of electronic filing by Goldberg, Godles, Wiener & Wright to M.H. Dortch, secretary of Federal Communications, May 11, 2011).
Exhibit 1
Netflix Timeline

1997 – Reed Hastings and fellow software executive Marc Randolph cofounded Netflix to offer online movie rentals.

1999 – Netflix launches the subscription service, offering unlimited rentals for one low monthly subscription.

2000 – Netflix launches the personalized movie recommendation system that uses Netflix members’ ratings to accurately predict choices for all Netflix members.

May 22, 2002 – Netflix makes its initial public offering (IPO) of 5,500,000 shares at $15.00 per share on Nasdaq under the ticker “NFLX.” Total Netflix members at the time: 600,000.

2002 – Netflix ends the year with 857,000 members, up 88% from 2001.

2003 – Netflix ends the year with 1,487,000 members, up 74% from 2002.

2004 – Netflix ends the year with 2,610,000 members, up 76% from 2003.

2005 – Netflix ends the year with 4.2 million members, up 60% from 2004.

2006 – Netflix launches the Netflix Prize, promising $1 million to the first person or team who can achieve certain accuracy goals in recommending movies based on personal preferences. The company releases 100 million anonymous movie ratings ranging from one to five stars, the largest such data set ever released.

2006 – Netflix ends the year with 6.3 million members, up 51% over 2005.

2007 – Netflix introduces streaming, which allows members to instantly watch television shows and movies on their personal computers.

2007 – Netflix ends the year with 7.5 million members, up 18% over 2006.

2008 – Netflix partners with consumer electronics companies to stream on the Xbox 360, Blu-ray disc players, TV set-top boxes and the Apple Macintosh computer.

2008 – Netflix ends the year with 9.4 million members, up 26% over 2007.

2009 – Netflix partners with consumer electronics companies to stream on the PS3, Internet connected televisions and other Internet connected devices.

2009 – Netflix awards the $1 million Netflix Prize to the “BellKor’s Pragmatic Chaos” team of seven researchers from four countries; over three years the contest has attracted more than 40,000 teams from 186 countries.

2009 – Netflix ends the year with 12.3 million members, up 31% over 2008.

2010 – Netflix is available on the Apple iPad, iPhone and iPod Touch, the Nintendo Wii and other Internet connected devices.

2010 – Netflix launches in Canada.

2010 – Netflix ends the year with 20 million members, up 63% from 2009.

2011 – Netflix launches throughout Latin America and the Caribbean.

2012 – Netflix launches in the United Kingdom and Ireland.

Exhibit 2

Netflix Statement of Operations (in US $ Thousands, Except per Share Data)
Consolidated Statements of Operations (Year Ending December 31)

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<th></th>
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<th></th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>REVENUES</td>
<td>3,204,577</td>
<td>2,162,625</td>
<td>1,670,269</td>
<td>1,364,661</td>
<td>1,205,340</td>
<td>996,660</td>
<td>682,213</td>
<td>500,611</td>
<td>270,410</td>
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<td>Cost of revenues:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Subscription</td>
<td>1,789,596</td>
<td>1,154,109</td>
<td>909,461</td>
<td>761,133</td>
<td>664,407</td>
<td>532,621</td>
<td>393,788</td>
<td>273,401</td>
<td>147,736</td>
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<td>Fulfillment expenses</td>
<td>250,305</td>
<td>203,246</td>
<td>169,810</td>
<td>149,101</td>
<td>121,761</td>
<td>94,364</td>
<td>71,987</td>
<td>56,609</td>
<td>31,274</td>
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<td>Total cost of revenues</td>
<td>2,039,901</td>
<td>1,357,355</td>
<td>1,079,271</td>
<td>910,234</td>
<td>786,168</td>
<td>626,985</td>
<td>465,775</td>
<td>330,010</td>
<td>179,010</td>
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<td>GROSS PROFIT</td>
<td>1,164,676</td>
<td>805,270</td>
<td>590,998</td>
<td>454,427</td>
<td>419,172</td>
<td>369,675</td>
<td>216,438</td>
<td>170,601</td>
<td>91,400</td>
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<td>Operating expenses:</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Marketing</td>
<td>402,638</td>
<td>293,839</td>
<td>237,744</td>
<td>199,713</td>
<td>181,522</td>
<td>148,891</td>
<td>116,833</td>
<td>90,991</td>
<td>54,991</td>
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<tr>
<td>Technology and development</td>
<td>259,033</td>
<td>163,329</td>
<td>114,542</td>
<td>89,873</td>
<td>70,979</td>
<td>47,831</td>
<td>35,388</td>
<td>22,906</td>
<td>17,884</td>
</tr>
<tr>
<td>General and administrative</td>
<td>117,937</td>
<td>70,555</td>
<td>51,333</td>
<td>49,662</td>
<td>47,831</td>
<td>47,831</td>
<td>35,388</td>
<td>22,906</td>
<td>17,884</td>
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<tr>
<td>Gain on disposal of DVDs</td>
<td>9,000</td>
<td>-6,094</td>
<td>-4,560</td>
<td>-3,272</td>
<td>-1,966</td>
<td>-1,479</td>
<td>-1,987</td>
<td>-2,560</td>
<td>-1,209</td>
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<td>Gain on legal settlement</td>
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<td>-7,000</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>788,608</td>
<td>521,629</td>
<td>399,059</td>
<td>332,921</td>
<td>327,399</td>
<td>304,457</td>
<td>213,449</td>
<td>151,247</td>
<td>86,928</td>
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<td>OPERATING INCOME</td>
<td>376,068</td>
<td>283,641</td>
<td>201,939</td>
<td>121,506</td>
<td>91,773</td>
<td>65,218</td>
<td>2,989</td>
<td>19,354</td>
<td>4,472</td>
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<td>Other income (expense):</td>
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<td></td>
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<td></td>
<td></td>
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<td>-20,025</td>
<td>-19,629</td>
<td>-6,475</td>
<td>-2,458</td>
<td>-1,188</td>
<td>-1,210</td>
<td>-407</td>
<td>-170</td>
<td>-417</td>
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<td>3,684</td>
<td>6,728</td>
<td>12,452</td>
<td>20,340</td>
<td>15,904</td>
<td>5,536</td>
<td>2,592</td>
<td>2,457</td>
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<td>267,696</td>
<td>192,192</td>
<td>131,500</td>
<td>110,925</td>
<td>79,912</td>
<td>8,335</td>
<td>21,776</td>
<td>6,512</td>
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<td>Provision for income taxes</td>
<td>133,396</td>
<td>106,843</td>
<td>76,332</td>
<td>48,474</td>
<td>44,317</td>
<td>31,073</td>
<td>33,692</td>
<td>181</td>
<td>0</td>
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<td>NET INCOME</td>
<td>226,126</td>
<td>160,853</td>
<td>115,860</td>
<td>83,026</td>
<td>66,608</td>
<td>48,539</td>
<td>42,027</td>
<td>21,595</td>
<td>6,512</td>
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<td>Net income per share:</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Basic</td>
<td>$4.28</td>
<td>$3.06</td>
<td>$2.05</td>
<td>$1.36</td>
<td>$0.99</td>
<td>$0.78</td>
<td>$0.79</td>
<td>$0.42</td>
<td>$0.14</td>
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<tr>
<td>Diluted</td>
<td>$4.16</td>
<td>$2.96</td>
<td>$1.98</td>
<td>$1.32</td>
<td>$0.97</td>
<td>$0.71</td>
<td>$0.64</td>
<td>$0.33</td>
<td>$0.10</td>
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<td>Weighted-average common shares outstanding:</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic</td>
<td>52,847</td>
<td>52,529</td>
<td>56,560</td>
<td>60,961</td>
<td>67,076</td>
<td>62,577</td>
<td>53,528</td>
<td>51,988</td>
<td>47,786</td>
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<tr>
<td>Diluted</td>
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<td>54,304</td>
<td>58,416</td>
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<td>68,902</td>
<td>69,075</td>
<td>65,518</td>
<td>64,713</td>
<td>62,884</td>
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</tbody>
</table>

### Exhibit 3

**Netflix Balance Sheet (as of December 31) (in US $ Thousands)**

<table>
<thead>
<tr>
<th>Year</th>
<th>ASSETS</th>
<th>LIABILITIES AND STOCKHOLDER'S (DEFICIT) EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current Assets</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ASSETS</td>
<td>LIABILITIES</td>
</tr>
<tr>
<td></td>
<td>Cash and cash equivalents</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>16,131</td>
<td>111,416</td>
</tr>
<tr>
<td>2010</td>
<td>59,814</td>
<td>101,830</td>
</tr>
<tr>
<td>2009</td>
<td>89,894</td>
<td>89,356</td>
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<tr>
<td>2008</td>
<td>174,461</td>
<td>112,708</td>
</tr>
<tr>
<td>2007</td>
<td>212,256</td>
<td>112,708</td>
</tr>
<tr>
<td>2006</td>
<td>400,430</td>
<td>112,708</td>
</tr>
<tr>
<td>2005</td>
<td>177,439</td>
<td>112,708</td>
</tr>
<tr>
<td>2004</td>
<td>139,881</td>
<td>112,708</td>
</tr>
<tr>
<td>2003</td>
<td>134,224</td>
<td>112,708</td>
</tr>
<tr>
<td>2002</td>
<td>194,499</td>
<td>112,708</td>
</tr>
<tr>
<td>2001</td>
<td>508,053</td>
<td>112,708</td>
</tr>
</tbody>
</table>

# Exhibit 4


<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash flows from operating activities:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>226,126</td>
<td>160,853</td>
<td>115,860</td>
</tr>
</tbody>
</table>

Adjustments to reconcile net income to net cash provided by operating activities:

- Acquisitions / Additions to streaming content library | -2,320,732 | -406,210 | -64,217 |
- Change in streaming content liabilities | 1,460,400  | 167,836  | -4,014  |
- Amortization of streaming content library | 699,128  | 158,100  | 48,192  |
- Amortization of DVD content library | 96,744  | 142,496  | 171,298  |
- Depreciation and amortization of property, equipment and intangibles | 43,747  | 38,099  | 38,044  |
- Stock-based compensation expense | 61,582  | 27,996  | 12,618  |
- Excess tax benefits from stock-based compensation | -45,784  | -62,214  | -12,683  |
- Other non-cash items | -4,050  | -9,128  | -7,161  |
- Deferred taxes | -18,597  | -962  | 6,328  |
- Gain on sale of business | -  | -  | -1,783  |

Changes in operating assets and liabilities:

- Prepaid content | 6,211  | -35,476  | -5,643  |
- Other current assets | -4,775  | -18,027  | -5,358  |
- Other accounts payable | 24,314  | 18,098  | 1,537  |
- Accrued expenses | 68,902  | 67,209  | 13,169  |
- Deferred revenue | 21,613  | 27,086  | 16,970  |
- Other non-current assets and liabilities | 2,883  | 645  | 1,906  |

**Net Cash Provided by Operating Activities** | 317,712  | 276,401  | 325,063  |

Cash flows from investing activities:

- Acquisition of DVD content library | -85,154  | -123,901  | -193,044  |
- Purchases of short-term investments | -223,750  | -107,362  | -228,000  |
- Proceeds from sale of short-term investments | 50,993  | 120,857  | 166,706  |
- Proceeds from maturities of short-term investments | 38,105  | 15,818  | 35,673  |
- Purchases of property and equipment | -49,682  | -33,837  | -45,932  |
- Proceeds from sale of business | -  | -  | 7,483  |
- Other assets | 3,674  | 12,344  | 11,035  |

**Net Cash Used in Investing Activities** | -265,814  | -116,081  | -246,079  |

Cash flows from financing activities:

- Principal payments of lease financing obligations | -2,083  | -1,776  | -1,158  |
- Proceeds from issuance of common stock upon exercise of options | 19,614  | 49,776  | 35,274  |
- Proceeds from public offering of common stock, net of issuance costs | 199,947  | -  | -  |
- Excess tax benefits from stock-based compensation | 45,784  | 62,214  | 12,683  |
- Borrowings on line of credit, net of issuance costs | -  | -  | 18,978  |
- Payments on line of credit | -  | -  | -20,000  |
- Repurchases of common stock | 198,060  | -  | 193,917  |
- Net cash provided by (used in) financing activities | 261,656  | -100,045  | -84,641  |
- Net increase (decrease) in cash and cash equivalents | 313,554  | 60,275  | -5,657  |
- Cash and cash equivalents, beginning of year | 194,499  | 134,224  | 139,881  |

**Cash and Cash Equivalents, End of Year** | $508,053 | $194,499 | $134,224 |

Supplemental disclosure:

- Income taxes paid | $79,069  | $56,218  | $58,770  |
- Interest paid | 19,395  | 20,101  | 3,878  |

Exhibit 5

Netflix Stock Performance

Source: Google Finance.
## Exhibit 6

### Netflix 2012 Financial KPI

Netflix operates a fast-growing DVD rental and video streaming service available in the United States, Canada, and eventually Central and South America. Netflix delivers digital content to PCs, Internet-connected TVs, and consumer electronic devices including but not limited to the Xbox 360, PlayStation, and Wii. In July 2011, the company changed its $10 per month price for 1 DVD at a time plus streaming. This combination now costs $16 per month, with streaming or 1 DVD at a time priced at $6 per month.

### Growth Rates

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue %</th>
<th>Operating Income %</th>
<th>Earnings/Share %</th>
<th>Dividends %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>48.2</td>
<td>32.9</td>
<td>26.8</td>
<td>43.4</td>
</tr>
<tr>
<td>2013</td>
<td>40.5</td>
<td>46.6</td>
<td>24.8</td>
<td>42.4</td>
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</table>

### Profitability Analysis

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<tr>
<th>Current</th>
<th>Yr Ago</th>
<th>Avg</th>
<th>Ind</th>
<th>Met</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Equity</td>
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<td>9.9</td>
<td>6.9</td>
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<tr>
<td>Return on Assets</td>
<td>11.4</td>
<td>11.4</td>
<td>11.4</td>
<td>11.4</td>
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<tr>
<td>Fixed Asset Turn</td>
<td>2.17</td>
<td>2.17</td>
<td>2.17</td>
<td>2.17</td>
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<tr>
<td>Inventory Turn</td>
<td>3.7</td>
<td>3.7</td>
<td>3.7</td>
<td>3.7</td>
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<tr>
<td>Revenue/Employee USD K1048.8</td>
<td>667.9</td>
<td>1048.8</td>
<td>667.9</td>
<td>1048.8</td>
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<tr>
<td>Gross Margin %</td>
<td>38.3</td>
<td>31.4</td>
<td>31.4</td>
<td>31.4</td>
</tr>
<tr>
<td>Operating Margin %</td>
<td>11.7</td>
<td>10.6</td>
<td>10.6</td>
<td>10.6</td>
</tr>
<tr>
<td>Net Margin %</td>
<td>8.8</td>
<td>8.8</td>
<td>8.8</td>
<td>8.8</td>
</tr>
<tr>
<td>Free Cash Flow/Rev %</td>
<td>5.3</td>
<td>5.3</td>
<td>5.3</td>
<td>5.3</td>
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<tr>
<td>R&amp;D/Rev %</td>
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<td>6.1</td>
<td>6.1</td>
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### Financial Position

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<th>13-14 USD Mil</th>
<th>13-14 USD Mil</th>
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<td>Cash</td>
<td>195</td>
<td>508</td>
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<tr>
<td>Inventories</td>
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<td>Receivables</td>
<td>641</td>
<td>1831</td>
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<td>Current Assets</td>
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<td>136</td>
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<td>Fixed Assets</td>
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<td>136</td>
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<td>Intangibles</td>
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<td>1574</td>
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<td>Total Assets</td>
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<td>3669</td>
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<td>1013</td>
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<td>Short-Term Debt</td>
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<td>Long-Term Debt</td>
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<td>Total Liabilities</td>
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<td>2426</td>
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<tr>
<td>Total Equity</td>
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<td>643</td>
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### Valuation Analysis

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<th>Met</th>
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</thead>
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<td>30.8</td>
<td>14.8</td>
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<td>Forward P/E</td>
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<td>13.4</td>
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<td>Price/Cash Flow</td>
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<td>11.9</td>
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<tr>
<td>Price/Cash Flow Rev</td>
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<td>28.9</td>
<td>18.5</td>
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<td>Dividend Yield %</td>
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<td>0.3</td>
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<td>Price/Sales</td>
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<td>PEG Ratio</td>
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### Stock Performance

<table>
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<th>Year</th>
<th>Total Return %</th>
<th>Dividend Yield %</th>
<th>Market Cap USD Mil</th>
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<td>70.9</td>
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<tr>
<td>2013</td>
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<td>2014</td>
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<tr>
<td>2015</td>
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<tr>
<td>2016</td>
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### Financials

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<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
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<tbody>
<tr>
<td>Revenue USD Mil</td>
<td>49.5</td>
<td>54.5</td>
<td>54.5</td>
<td>54.5</td>
</tr>
<tr>
<td>Gross Margin %</td>
<td>34.8</td>
<td>34.8</td>
<td>34.8</td>
<td>34.8</td>
</tr>
<tr>
<td>Operating Income USD Mil</td>
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<td>12.3</td>
<td>12.3</td>
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<tr>
<td>Earnings/Share USD Mil</td>
<td>4.9</td>
<td>4.9</td>
<td>4.9</td>
<td>4.9</td>
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</table>

### Key Industry Peers

<table>
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<tr>
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<th>2012</th>
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<th>2015</th>
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</thead>
<tbody>
<tr>
<td>Revenue USD Mil</td>
<td>27.1</td>
<td>27.1</td>
<td>27.1</td>
<td>27.1</td>
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<tr>
<td>Earnings/Share USD Mil</td>
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<td>4.9</td>
<td>4.9</td>
<td>4.9</td>
</tr>
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### Major Fund Holders

<table>
<thead>
<tr>
<th>Description</th>
<th>% of Shares</th>
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</table>

Source: Morningstar Equity Research, February 2012.
Exhibit 7

Evolution of Netflix Quarterly Results

Exhibit 8
The Netflix DVD Rental Process

Source: Own elaboration.
Exhibit 9
The Concept of Throttling

Monitoring the mail  A “throttle slows down the movie in the mail – and maintains profits.

Members choose three DVDs per order.*
Mailing costs the company 78¢ per envelope.
After each return, next movie in cue is shipped.
More than nine rentals per month alerts system.
A “throttle” is applied to your account – which delays shipping and re-queues your order.

SOURCE: Netflix.  * $17.99 per month is most popular option.


Exhibit 10
Netflix Envelope

DVD and protective sleeve
Inner envelope (pocket for DVD on right)
Envelope upon arrival at customer

Source: Pictures taken by the case-writer.
Exhibit 11
Next-Day Delivery Over Time

% of Netflix Subscribers Serviced In 1 Business Day


Exhibit 12
DVD Sorting Machine

Exhibit 13
Home-Video-Generated Revenue Streams

U.S. Packaged Home-Video Consumer
Spending – Historical & Projected ($ Billions)

Source: Crossan R. Andersen, president & CEO, 2010 Entertainment Merchants Association.
Exhibit 14
U.S. Home-Video Revenue Stream Split

Exhibit 15
Video Rental Window