CASE 6

Netflix's Business Model and Strategy in Renting Movies and TV Episodes

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In May 2010, Netflix's strategy was producing impressive strategic and financial results. During the past five years, Netflix had emerged as the world's largest subscription service for sending DVDs by mail and streaming movies and TV episodes over the Internet. It had attracted 15 million subscribers as of July 2010, up from 4.2 million at year-end 2007 and 1.6 million at year-end 2004. Netflix was shipping about 2 million DVDs on average daily to subscribers, and some 61 percent of the company's subscribers were now watching movies and TV episodes streamed from Netflix over the Internet, up from 48 percent at year-end 2009 and 38 percent in the first quarter of 2009.

Netflix's revenues grew from $500 million in 2004 to $1.2 billion in 2007 to $1.7 billion in 2009 and were expected to surpass $2.1 billion in 2010. In the second quarter of 2010, revenues were $519.8 million, representing 27 percent year-over-year growth from $408.5 million in the second quarter of 2009 and 5 percent sequential growth from $493.7 million in the first quarter of 2010. The company's net income had increased from $21.6 million in 2004 to $115.8 million in 2009, equal to a compound annual growth rate of nearly 40 percent; top management expected net income for full-year 2010 to be in the range of $141 to $156 million. Netflix's stock price closed at an all-time high of $170.83 on September 29, 2010, up from closing prices of $55.09 on December 31, 2009, and $29.87 on January 2, 2009.

Meanwhile, Netflix's traditional video store competitors were experiencing sharp declines in sales and heavy losses. Blockbuster and Movie Gallery, both of which operated thousands of video stores where customers could rent DVDs, were facing financial disaster. During 2009, Blockbuster's worldwide revenues from rentals of movies and video games declined by nearly $530 million to $2.5 billion; many analysts believed that the downward trend in Blockbuster's rental revenues, which began in 2003 when its rental revenues were $4.5 billion, would be hard to reverse. In September 2010, Blockbuster filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code, owing to declining revenues, net losses of $569 million in 2009 and $385 million in 2008, and the burden of its $963 million debt (including capital lease obligations). Since 2002, Blockbuster had only been profitable one year (earning $39 million) and had lost a total of $3.8 billion. Prior to its bankruptcy filing, Blockbuster was planning to close 500 to 545 of its 5,220 company-owned stores worldwide, after closing or selling 586 stores in 2009 and 1,459 stores in 2005–2008.

Movie Gallery filed for Chapter 11 bankruptcy in February 2010, less than two years after emerging from bankruptcy in the spring of 2008 under new owners. Movie Gallery's troubles began after the company took on too much debt to acquire Hollywood Entertainment Corporation in 2005 for more than $800 million. At the time of its second bankruptcy filing, Movie Gallery had $600 million in debt and was plagued with declining sales and losses. As part of its strategic moves to emerge from its February 2010 bankruptcy filing, Movie Gallery had begun closing 760 of its Movie Gallery, Hollywood Video, and Game

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