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System Focus

# The Video Streaming Wars: Can Disney Catch Netflix?

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*This article is a summary of a presentation from The Governance Institute's 2022 System Forum.*

**At the 2022 System Forum, Mr. Kett led an interactive discussion of a *Harvard Business School* case study about the video streaming war between Disney and Netflix.** Written in January 2020 and updated with the latest data available (third quarter of 2021), the case study is ostensibly about whether Disney can catch Netflix in terms of streaming consumers. The short answer is "no," as the Disney+ subscriber base has plateaued at levels far below that of Netflix. The case study is more about how Netflix completely transformed entertainment by developing a deep understanding of its consumers and constantly improving their experience, taking down companies and entire industries in the process.

## Netflix History in Brief

Founded in 1997, Netflix began by sending out DVDs in the mail to consumers for a fixed monthly fee. Customers could sign up for different levels of service depending on how many movies they wanted at a time. There were no late fees, although customers could not get additional movies beyond their fixed limit until they returned the old ones via pre-paid envelopes that came with the shipment. The company went public in 2002 and by 2007 had delivered over a billion DVDs to customers. That same year, Netflix began offering a streaming service with a limited selection. Streaming proved to be the first step in the company's ability to truly change the entertainment world. In 2008, Netflix began making deals to develop and own original content. Prior to this time, Netflix licensed content from others. By 2013, Netflix released its first original series, *House of Cards*, an American version of a British television series from years earlier. A huge success, the show proved that developing and owning original proprietary content could work. By 2016, Netflix had produced 126 original shows that collectively garnered 147 awards. By 2020, it surpassed 200 million subscribers. Around the same time, Netflix started competing with



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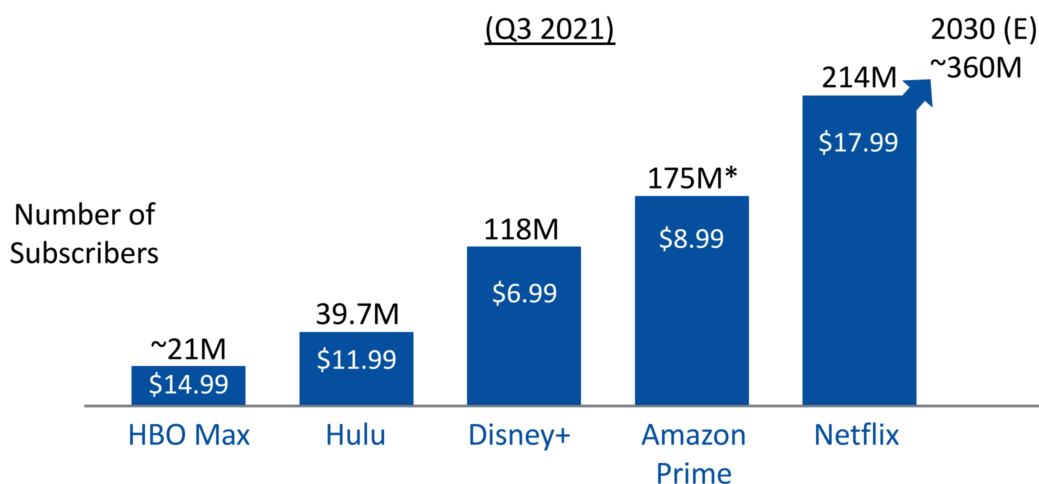
traditional movie studios. In 2021, Netflix released over 80 original movies (more than its initial goal of 71). That same year Warner Brothers released only 17 titles. As shown in **Exhibit 1**, Netflix had 214 million paid subscribers by the third quarter of 2021, with subscribers paying an average of $17.99 each month. The company is expected to have over $33 billion in revenues in 2022 and reach over 360 million subscribers worldwide by 2030. Disney+ will not reach anywhere near that level. Netflix is a very profitable business, although it will spend roughly $20 billion on original content in 2022.

### Exhibit 1: How Many Customers Paying How Much?




## Critical Success Factors for Netflix

Why has Netflix been so successful? How has it "blown up" an ecosystem of entertainment that profitably existed for many decades?

### Factor 1: Bringing the Product to the Customer

At its core, Netflix's success stems from one of the most basic innovations in any industry—bringing the product or service to the consumer. Netflix did that from the very beginning with its mailing of DVDs. This innovation made Netflix much more convenient than its primary competition, Blockbuster video stores. Consumers no longer had to drive to pick up and drop off their movies. They could simply walk to the mailbox. Netflix also eliminated several other inconvenient aspects of the Blockbuster model. First and foremost, there was no risk that a particular movie might be out of stock because someone else was watching it. In other words, the customer got whatever movie(s) he or she wanted. Netflix also eliminated late fees, a major source of frustration for



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consumers. Blockbuster management saw late fees as a revenue source, but consumers saw them as roadblocks that made their experience worse.

Ironically, in 2000, the CEO of cash-strapped Netflix, Reed Hastings, offered then cash-rich Blockbuster the opportunity to purchase a 49 percent stake in Netflix for $50 million. Unable to envision a future where people would not drive to a store to pick out a movie, Blockbuster's leadership rejected the deal on multiple occasions. A decade later, Blockbuster filed for bankruptcy, a victim of its leaders' inability to think like a consumer. With profits at an all-time high, Blockbuster management simply could not see the vulnerability inherent in having a huge fixed-cost base of retail stores in an era where technology was moving toward instant delivery at lower cost to the customer's home.

Netflix was not content with disrupting just the movie rental business. After Netflix launched its limited streaming service, subsequent improvements in streaming speed and television screen size and picture quality combined with Netflix's massive investment in original content and movies, made movie theaters highly vulnerable to disruption. Attendance at theaters had been in a slow, steady decline of roughly 2 percent a year during the decade before COVID. The pandemic massively accelerated this decline. Consumers now realize that they can have a great experience watching a movie from the convenience of their own home for much less money than going to a movie theater.

> "Netflix completely transformed the entire entertainment industry, largely alone."
>
> —*Steve Kett*

Finally, the convenience of in-home streaming has also disrupted traditional television, with viewership down over the last decade in every demographic except for those 65 and older. People are not spending less time in front of their screens, as streaming services more than make up the difference with a 27 percent annual growth rate since 2011.

Ironically, Netflix CEO Reed Hastings' primary motivation in switching from DVDs to streaming was to save money. Mailing costs were quite high and taking a large bite out of company profits. As Internet speeds and bandwidth improved, it became possible to deliver streaming services for less than the



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cost of mailing. The instant gratification that came with streaming was initially an afterthought.

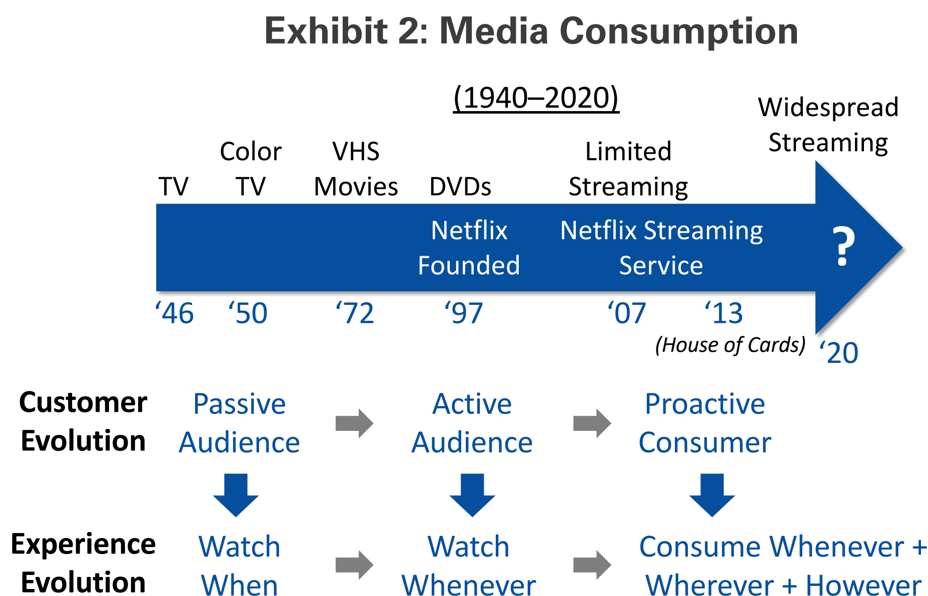
> "Don't underestimate the power of control. People want it. And once you give them a taste of it, they won't go back."
>
> —*Steve Kett*

## Factor 2: Activating and Engaging the "In-Control" Consumer

In addition to being instant and less expensive, streaming services offer the consumer full control of their viewing experiences. Consumers can instantly decide what to watch and when, where, and how to do so. Unlike in a movie theater, they can watch for 30 minutes and then decide to take a 10-minute break or watch the rest another time. They can binge-watch an entire series in one night, no longer having to wait a week for a new episode to be released. Once given this power and control, they will not give it up.

As shown in **Exhibit 2**, media consumption over the past 80 years has been on a path from a passive audience watching media at a time and place defined by someone else to a proactive consumer with full control over what, when, where, and how media are consumed.

### Exhibit 2: Media Consumption



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Proactive, engaged consumers have little appetite for artificial constraints that make their lives more difficult. For example, they are increasingly frustrated with the delays that occur between the release of new movies in theaters and the time they are available through streaming services. They are also getting a taste of what it is like when these windows are reduced or even eliminated. In November 2019, the much-heralded movie *The Irishman* spent 17 days in theaters before becoming available on Netflix. Prior to this time, the typical release window was at least 90 days. The 17-day window was picked for a specific reason—the Movie Picture Association of America requires at least a 17-day theater run in Los Angeles County for a movie to be eligible for an *Oscar*. A year later, release windows were eliminated for the December 2020 launch of *Wonder Woman 1984*. Many movies now release simultaneously in theaters and on streaming services such as HBO Max. As noted, many others now skip theaters all together and make their initial debut on Netflix or another streaming service that owns the content. The reason for this change is simple—while theaters, studios, and actors may like long theater runs because of revenue and profit considerations, consumers do not. They see it as an artificial constraint that serves someone else's interests. These kinds of constraints permeate healthcare and other industries, such as the airlines' hub-and-spoke system. Once consumers get a taste of life without the constraint, they will not go back.

### Factor 3: Receiving Instant Feedback to Allow Personalization and Inform New Content

As shown in **Exhibit 3**, Netflix has created a closed-loop business model where proactive consumers provide immediate feedback on viewing habits and preferences. The company uses this information to build and continually refine sophisticated algorithms that personalize the experience for customers (e.g., through tailored viewing suggestions) and create "recipes" for new content development, giving Netflix a higher success rate with its original shows and movies. (Traditionally, only about 20 percent of new movies recoup their costs; Netflix has a significantly higher success rate.) Interestingly, Netflix has done away with consumer ratings of movies and instead pays close attention to consumer behavior (i.e., what people watch). Netflix algorithms have allowed the company to develop a very diverse set of successful original content, ranging from *The Queen's Gambit* to *Squid Game*. The algorithms create a virtuous cycle, with new content getting better over time as more information is collected.



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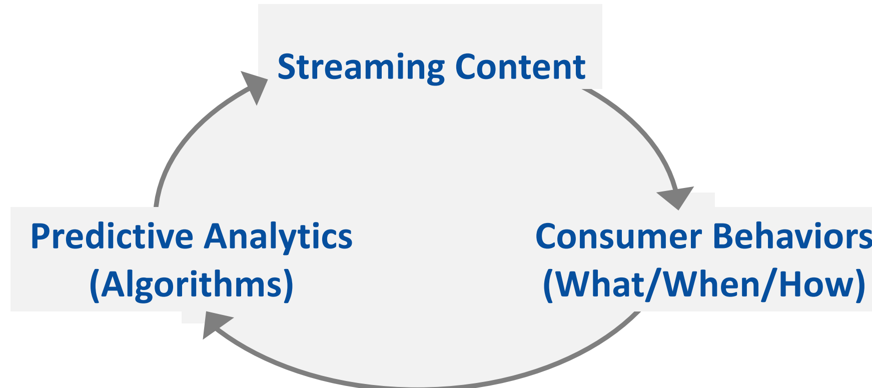
**Exhibit 3: Netflix Is Watching**

*The Power of Closed-Loop Business Models*




## Factor 4: Understanding the Job to Be Done

In his book *Competing Against Luck*, innovation expert Clayton Christensen describes his job-to-be-done (JTBD) methodology, which posits that people buy products and services to complete a job (i.e., to make progress related to a given circumstance in their life). The key to successful product innovation is to understand the job that the product is doing for the consumer. Sometimes that job may not be obvious. In 2016, Mr. Christensen was hired by McDonald's to boost milkshake sales. The company had made tweaks to the product based on customer feedback, but sales remained stagnant. To understand the JTBD for milkshakes, Mr. Christensen hired people to stand in McDonald's locations and closely observe the behavior of those buying them. This research found that over half of all milkshake sales occurred before 8 A.M., typically by men who came in alone, bought only the shake, and drove off with it. Subsequent interviews with these individuals found that they bought the shake to give them something to do on their long, boring drive to work. They wanted to keep the commute interesting. Sometimes they bought other food items to perform the same task, such as bananas, donuts, or bagels, but these generally proved inferior. By contrast, the milkshake fit nicely in the cup holder, did not make a mess, and took a long time to drink and hence lasted for most or all of the trip. Based on this feedback, Christensen's team brainstormed ideas to improve the experience for this customer segment. To make the shakes last longer, they suggested tweaking the formula to make it more viscous and offering thinner straws. To allow customers to get in and out of the store quickly, they suggested setting up a separate self-serve area for the shakes with a credit card swipe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machine. Tested in 100 stores, these relatively simple changes led to a 140 percent increase in sales. The lesson is clear—once one understands the JTBD, the ensuing product innovations become quite straightforward.

> "Customers of businesses with lots of artificial constraints are not really customers, but rather hostages. They'll leave quickly when given the opportunity."
>
> *—Steve Kett*

As **Exhibit 4** illustrates, the JTBDs offered by streaming services tend to be quite different than those offered by a movie theater. That said, Netflix has already begun to encroach on at least one of the JTBDs offered by theaters—allowing a large-group experience. Netflix introduced the ability to have virtual "watch parties" where friends and family in different locations watch the same movie at the same time. This feature has proven quite popular and will endure even after the pandemic ends.

### Exhibit 4: What Jobs Are They Trying to Do?

| Streaming | Theater |
| --- | --- |
| • Enjoy a good movie anytime | • Enjoy a night out |
| • See a TV show when our dinner is done | • Support a historic theater |
| • Watch a TV series for as long as I want (in one sitting) | • Experience the big screen |
| • Watch a movie in shorter segments | • Have a large group experience |

## Key Lessons from the Case

Key lessons from Netflix include the following:

- **Bring the product to the customer**: As noted, one of the first and most basic innovations in any industry is to bring the product or service to the customer rather than making them travel for it. For Netflix, this innovation came from mailing DVDs to subscribers. In healthcare, virtual care and at-home services represent examples of this approach.



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- **Embrace engaged, proactive consumers**: The ability to stream content played a major role in turning Netflix customers from passive audiences into proactive consumers, representing a fundamental shift in the consumer's relationship to the entertainment product.
- **Keep laser-like focus on behaviors and motivations**: Since its founding, Netflix's extraordinary success comes from a laser-like focus on deeply understanding customer behaviors and motivations and continuously improving the customer experience.
- **Use data to tailor products and services**: Netflix gathers detailed data on consumers and their behaviors (i.e., what they watched, when and how they did so), allowing the company to ever more effectively tailor experiences through watch-next suggestions and develop new content better suited to customer preferences.
- **Understand the JTBD (and consider the potential for multiple jobs)**: Even without the benefit of big data, relatively simple research can uncover the JTBD, providing a unique and valuable window into underlying customer motivations and insights into how to develop or change products and services to better serve them. Motivations explain why customers do what they do and give powerful insights into how to design customer experiences to maximize loyalty. While there may be a predominant motivation or job, customers are often trying to complete multiple jobs at the same time. The more a company can help them, the more loyal they will become.
- **Eliminate artificial constraints (even if doing so threatens stakeholders)**: Consumers will abandon businesses that impose artificial constraints as soon as new choices without those constraints become available. Often these choices are enabled by changes or advances in technology. Blockbuster learned this lesson the hard way as consumers flocked to Netflix, which eliminated the need drive to stores or pay late fees. As the Livongo story demonstrates, the same will be true in healthcare. Forcing consumers with diabetes to buy expensive strips to test their glucose levels is a losing proposition when competitors give away the strips and offer wraparound services that make life much easier. Any short-term profits generated from existing constraints (such as rebates on insulin and strips) ultimately pale in comparison to losing the entire line of business.


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- **Beware of "legacy" biases**: History is full of legacy companies that could not recognize the profound threats of new entrants using new technologies. As noted, Kodak could not walk away from its film and chemical business and hence missed out on digital photography. As the Netflix case demonstrates, Blockbuster rejected streaming services and ended up going bankrupt and closing its stores a decade later. American Airlines initially responded to low-cost carrier Southwest not by revamping its entire cost structure, but rather by tweaking the number of olives in its salads. Protecting the existing in-person healthcare infrastructure, such as hospitals and clinics, might prove to be a similarly huge mistake as new technologies bring the potential for so much care to be delivered virtually and/or in the home.
- **Do not hide behind quality arguments**: Legacy companies routinely fight new entrants by accusing them of offering poor quality. They often bring these quality complaints to regulators and legislators in hopes of keeping out the new competition. These arguments ultimately fail. Just as the legacy airlines eventually had to abandon the quality argument and instead compete with low-cost carriers on price, traditional healthcare providers will lose out if they fail to respond to retail clinics, telehealth, and other new entrants that offer just as good quality but greater convenience and lower costs. Some influential individuals, including *New York Times* editor David Remnick, initially used the quality argument to disparage the idea of watching first-rate movies anywhere other than a movie theater. This argument quickly lost out when consumers voted with their feet, abandoning theaters in favor of watching on television sets, laptop computers, iPads, and even smart phones.

> "Don't hide behind the quality argument. Quality is what the customer decides it is. If they want a telehealth visit or to go to a retail clinic, then that's quality for them. Don't be American Airlines, taking olives off salads while someone else is changing the industry."
>
> *—Steve Kett*



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### Questions for Boards to Consider

- How well do we do in tailoring customer experiences?
- How well do we understand our customers' behaviors and motivations? How might better understanding them help us to think differently about the patient experience?
- What artificial constraints do we still impose on consumer choices?
- What have we done to improve the customer experience?
- How well do we understand the JTBDs of our customers? Have we conducted in-depth interviews to better understand them?

*See Consumerism 3.0: Healthcare in a World of Post-COVID Expectations: Insights from the 2022 System Forum to read all the presentation summaries from The Governance Institute's 2022 System Forum.*