TECHNOLOGY | JUNE 23, 2009

Netflix Boss Plots Life After the DVD

By NICK WINGFIELD

LOS GATOS, Calif. -- Netflix Inc. is a standout in the recession. The DVD-rental company added more subscribers than ever during the first three months of the year. Its stock has more than doubled since October.

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Bloomberg News

Reed Hastings, chief executive officer of NetFlix

But Netflix's chief executive officer, Reed Hastings, thinks his core business is doomed. As soon as four years from now, he predicts, the business that generates most of Netflix's revenue today will begin to decline, as DVDs delivered by mail steadily lose ground to movies sent straight over the Internet. So Mr. Hastings, who co-founded the company, is quickly trying to shift Netflix's business -- seeking to make more videos available online and cutting deals with electronics makers so consumers can play those movies on television sets.

His position offers a rare look at how a CEO manages a still-hot business as its time runs out. "Almost no companies succeed at what we're doing," he says.

Companies across the entertainment and technology landscape are struggling with how to profit from Internet video. There's still significant risk that Netflix could falter or lose out to another company that figures out how to do it first. And having picked his battle, the intense former engineer may risk missing other growth opportunities: Mr. Hastings hasn't yet expanded internationally or mounted a direct challenge to kiosks, such as Coinstar Inc.'s Redbox, that let customers pick up $1-a-night DVD rentals.

Mr. Hastings says he is still considering expansion opportunities outside the U.S. and has no plans to open kiosks.

Netflix

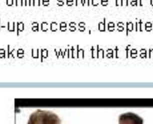
Netflix believes its business of mailing DVDs -- seen here at a now-closed facility in Sunnyvale, Calif. -- will give way to video delivered over the Web.

One of Mr. Hastings's biggest hurdles will be persuading Hollywood studios to give Netflix rights to show more and better movies through its Internet service at a time when many studios are protective of their DVD-sales revenues. Late last year, Sony Corp.'s Sony Pictures threw a hitch into Mr. Hastings's plans when it temporarily blocked access to some of its movies from Netflix's Internet video service in a dispute over whether Netflix had rights to them.

Moreover, Mr. Hastings stumbled in an earlier effort to introduce a set-top box that would bring Internet video service into the living room. Netflix developed the hardware but then abandoned it after Mr. Hastings and other executives got cold feet.

Mr. Hastings, 48 years old, says he is a student of companies tripped up by failing to adapt to technology shifts. To fellow Netflix executives, he has long cited the cautionary tale of America Online, the once-mighty online service that didn't successfully adapt to the broadband Internet era from the days of dial-up access, despite trying to fortify itself by acquiring Time Warner Inc. in 2000. "Every day, I wake up with that fear," says Mr. Hastings.

D7: Netflix's Hastings on The Future of On-Demand Viewing
3:38



What lies ahead for the DVD and movie rental business? WSJ's Sarah McBride speaks with Reed Hastings, Chief Executive Officer of Netflix, about whether the future lies solely in online movie distribution.

His own big break came as a different industry leader failed to keep step. In the late '90s, the home-video business was shifting to DVDs from VHS tapes, offered by rental giants such as Blockbuster Inc. Netflix emerged with warehouses that stocked larger selections of DVDs than Blockbuster's rental outlets could, mailing them around the country in red envelopes. Mr. Hastings charged consumers a flat monthly rate to rent as many DVDs as they liked, eliminating the late fees charged by rental chains.

Blockbuster eventually started its own DVD rent-by-mail service, but scaled it back in late 2007 after consistently losing money on it. A Blockbuster spokesman declined to comment.

Now, amid gathering signs of the DVD's decline, the industry is poised to shift again.

Home-video sales, mostly from DVDs, last year dropped to $14.5 billion from $15.9 billion the previous year, according to Adams Media Research. Movie rentals remained flat over the period, at about $8.2 billion. The number of DVDs Netflix rents every year -- about a half-billion in 2008 -- is still growing, and Mr. Hastings predicts the company will still be shipping discs to consumers 20 years from now.

Movie Mogul

Netflix revenue

Source: the company

But he expects rental figures to begin to dwindle in four to nine years.

Mr. Hastings, a veteran Silicon Valley entrepreneur, says he anticipated the demise of DVDs almost from the time he co-founded the company in 1997. The company's name, coined by Netflix co-founder Marc Randolph, didn't reference discs or mailboxes. From almost the beginning, Netflix invested in software formulas to crunch data about its customers' tastes so it could recommend DVDs to them, a technology Mr. Hastings believed would carry over to an Internet movie service.

In January 2007, Netflix began letting subscribers stream video to their PCs from the company's Web site, allowing users to watch video almost instantly without keeping permanent copies on their hard drives. The service featured only about 1,000 movies and television shows -- about 1% of its DVD selection -- but subscribers could use it for no extra charge.

Now more than 20% of Netflix members regularly use the service. The company says new users attracted by streamed movies have helped push its subscriber total up 25% to 10.3 million at the end of March from a year earlier.

A History of the Moving Image

1832-34: Rotating Drums

Inventors Joseph Plateaus and William George Horner create novelty devices that give viewers the impression of motion. The first moving pictures are simple sequences of drawings.

* * *

1876: Projection

Émile Reynaud invents the praxinoscope, which projects a sequence of moving images onto a screen.

* * *

1894: Kinetoscope

The Kinetoscope, in which viewers peer into a cabinet containing a rapidly moving reel of film, is first demonstrated in New York City. Its invention is largely credited to William Dickson, Thomas Edison's laboratory assistant.

* * *

1923: Television

Rival inventors Vladimir Zworykin and Philo Farnsworth begin work on the electronic television. Eventually the courts decide a patent battle in favor of Mr. Farnsworth, but RCA finds commercial success with Mr. Zworykin's work.

* * *

1975: VHS vs. Betamax

Sony launches Betamax, kicking off a decade-long battle for control of the home video market. Rival JVC launches the incompatible VHS in 1976 and quickly grows to dominate the market. In 1988, Sony concedes the fight and begins producing its own VHS products.

* * *

November 1996: DVDs Hit the Scene

The DVD player goes on sale for the first time, marking the beginning of the end for videocassettes.

* * *

March 2006: Blu-ray vs. HD DVD

Toshiba launches the HD DVD format. Sony follows in June with the launch of its Blu-ray disc. The two rivals continue to confuse consumers until Toshiba shutters its HD DVD business in the first quarter of 2008.

* * *

January 2007: Online Streaming

Netflix offers certain subscribers the ability to stream movies to their computers. Later expansions bring the ability to other platforms, including Microsoft's Xbox Live network.

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March 2008: Hulu Launches

Hulu, a start-up backed by NBC Universal and News Corp., opens to the public with a selection of advertising-supported streaming TV shows and movies.

* * *

November 2008: Blockbuster On Demand

Blockbuster launches its On Demand service that lets viewers with a special set-top box stream movies onto their TV. The company is slated to begin a partnership with TiVo to provide streaming movies in the second half of 2009.

* * *

April 2009: Google and Amazon Join In

New heavyweights enter the online video arena as both Google and Amazon launch offerings for viewers to stream video to their computers.

- Video Sites Duke It Out for Content
- Amazon Will Rent HD Movies, Sell HD TV Shows

The online model has another benefit for Netflix. The company currently pays about 80 cents to post a DVD to a customer's home and back. Its bandwidth costs for streaming a typical two-hour movie: roughly a nickel.

Mr. Hastings's biggest challenge in reorienting Netflix is getting Hollywood to go along for the ride. Netflix's selection of more than 100,000 DVD rental titles is made possible by the "first-sale doctrine" of U.S. copyright law, which permits buyers of DVDs to lend them out without studios' consent.

In Netflix's early days, its buying team would sometimes purchase DVDs at local Wal-Marts or Best Buys if it couldn't get copies through studios, says Ted Sarandos, Netflix's chief content officer.

In contrast, to deliver movies and television shows over the Internet, Netflix has to license them from studios. So far, it has gotten only about 12,000 titles, a hodgepodge of older films such as "Diehard," episodes of popular TV shows including "30 Rock" and a smattering of new releases.

The main reason: Netflix must compete with television subscription services like Time Warner's HBO, Viacom Inc.'s Showtime and others that gain exclusive rights to show studio movies on cable channels or through on-demand systems. These pay channels have bigger audiences than Netflix and a longer history of hashing out complicated licensing agreements to secure movie rights. Their lucrative deals can prevent Netflix from getting Internet rights for movies until years after they're released on DVD.

If Netflix is to expand the titles on its Internet service, it will have to considerably boost its licensing spending, from roughly $100 million last year, according to a person familiar with the matter.

"Netflix has yet to show that it has the resources and profitability to be in the markets where licensing is the business policy," says Warren Lieberfarb, the former head of Time Warner's Warner Bros. home video division, who helped develop the DVD format.

Mr. Hastings says he expects to spend more for Internet movie rights as the popularity of the Internet service grows, while continuing to mail DVDs to customers when they can't stream the same titles over the Internet. Last year he added several thousand titles to Netflix's online library by cutting a deal with Starz Entertainment, the Liberty Media Corp. premium channel that has rights to movies like Walt Disney Co.'s "Wall-E."

Mr. Sarandos, Netflix's point man with the studios, says Hollywood is "clearly conflicted" about the online service's growth because it could help accelerate the decline of DVDs. "They're supportive of our growth since we license content from every single studio in Hollywood," he says. "At the same time, they would like to preserve these business models as long as they can."

Spokespeople for Time Warner's Warner Bros., General Electric Co.'s Universal Pictures and Sony Pictures declined to comment on how Netflix's streaming service affects them.

Mr. Hastings recently got a taste of the fragility of Netflix's relations with studios. In November, Sony Pictures demanded that Netflix block online access to movies like "Superbad" and "Ghostbusters" that it had obtained through its deal with Starz. The dispute concerned whether Netflix had rights to deliver the Sony movies to TV sets through devices like Microsoft Corp.'s Xbox 360 game console. The titles remained available to Netflix subscribers watching them on PCs.

View Full Image

Netflix

A Sony Pictures spokesman declined to comment. A Starz spokesman said: "With Sony, as with all the other studios, we want to make sure we always meet obligations we have in contracts with them."

Mr. Hastings tried once before to bring streaming video to living rooms. He has long believed that Netflix could reach a mass audience only by streaming movies to TVs, not PCs. Over the years, the company toyed with designs for a set-top box that would serve as the link.

After Netflix introduced its streaming service, Mr. Hastings assembled a team that came up with a prototype -- a small, square metallic box that would access the Web through a consumer's broadband connection, let viewers navigate a list of Netflix movies by remote from their couches, and sell for under $100.

But the product's early 2008 public unveiling neared, several senior Netflix executives began to express misgivings about straying into the unfamiliar hardware business. The box would never have mass appeal if it was limited to accessing Netflix's movie services, some argued.

Barry McCarthy, Netflix's chief financial officer, was one of the skeptics. "Are we out of our f-minds?" Mr. McCarthy recalls thinking about the hardware plans. "We don't even know what we don't know about this business." He describes Mr. Hastings's infatuation with the project with two words: "Apple lust."

Mr. Hastings concedes that he "fell in love with building boxes" and that part of the inspiration was watching Apple Inc. use its hardware to sell online content. Apple, too, is seeking to bring Internet video to TV sets through its iTunes Store and a box called Apple TV. "Every entrepreneur is a Steve Jobs wannabe," he says. "I was as guilty of that as anybody."

On Dec. 14, 2007, Mr. Hastings and other senior executives huddled inside one of the movie-titled conference rooms at Netflix's Mediterranean-style headquarters -- called "Paheli," after a Bollywood love story -- to discuss the box. By then, Mr. Hastings had also become concerned that getting into the hardware business would "defocus" the company, according to Anthony Wood, a former Netflix executive in charge of the project at the time.

Ramping Up

Netflix total subscribers

Note: Data are as of the end of each period
Source: the company

The group's conclusion: Netflix would stay out of the hardware business, handing the project to Roku Inc., a privately owned start-up that Mr. Wood had founded. Netflix invested $6 million for a minority stake in Roku and sent about 20 Netflix employees to work there under Mr. Wood. The decision was disappointing for employees across Netflix who were preparing for the product launch.

"It was a big, sudden left turn," Mr. Hastings says.

Mr. Hastings instead began talking to consumer-electronics companies about including software that would allow consumers to access the Netflix streaming service from their devices. The company reached agreements over the next year to get Netflix into Blu-ray high-definition movie players by LG Electronics Inc. and Samsung Co., TiVo Inc. digital video recorders, Microsoft Xbox 360 and big-screen television sets by Vizio Inc.

People involved in the spinoff say it has turned out well for both parties. Roku says it has sold hundreds of thousands of its Netflix set-top boxes. It has also broadened its partnerships with video suppliers beyond Netflix, letting viewers download movies from Internet retailer Amazon.com Inc. as well. Netflix has also benefited, these people say, because it doesn't have an in-house hardware operation that would be a stumbling block in talks with other hardware makers.

Mr. Hastings says he plans to stick to what he knows, software and online services. On the Internet, he is certain to face more powerful competitors than he has in the DVD-rental business, as Netflix competes for consumers with video services from the likes of Apple, Amazon, Google Inc. and Hulu, a joint venture of media companies including News Corp., owner of Dow Jones & Co., which publishes The Wall Street Journal.

"As a capitalist, I'd rather have Blockbuster as my primary competitor than all those Internet companies," Mr. Hastings says.

Write to Nick Wingfield at nick.wingfield@wsj.com

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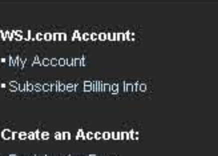

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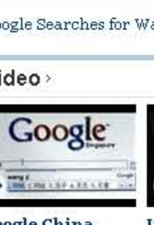

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