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Why Content Isn't King

HOW NETFLIX BECAME AMERICA'S BIGGEST VIDEO SERVICE—MUCH TO THE ASTONISHMENT OF MEDIA EXECUTIVES AND INVESTORS

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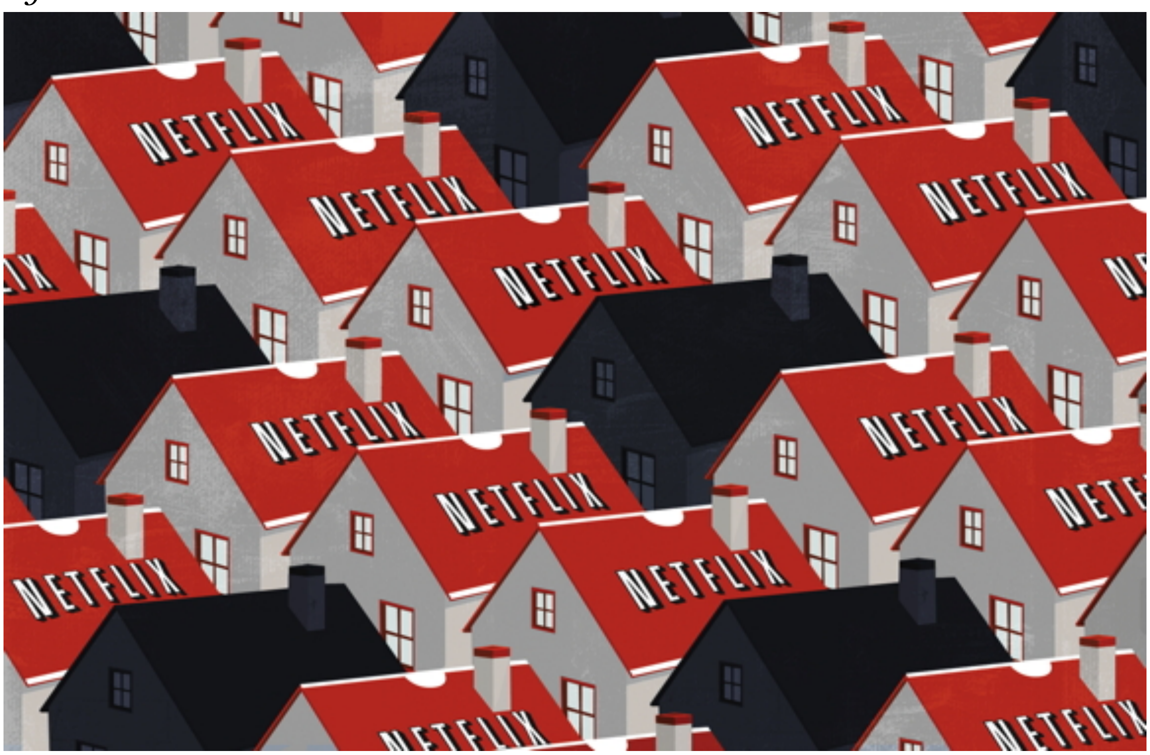

IMAGE CREDIT: TAYLOR CALLERY

NETFLIX FAMOUSLY ENGENDERS fierce loyalty from its ever-growing customer base. This year, it even beat out reigning champion Apple, among 528 other brands, in Brand Keys' annual survey of customer loyalty. In more-rarefied circles, however, the company provokes equally intense but quite different emotional reactions. Among traditional-media executives and investors who like to bet on the fall of high-flying stocks, Netflix's continual share-price appreciation and accelerating subscriber growth have sparked aggravation and even anger. Last December, Time Warner CEO Jeff Bewkes famously likened the relentless march of Netflix to the Albanian army's trying to "take over the world." That same month, in a widely read 7,000-word missive, the respected investor Whitney Tilson provided an exhaustive justification for making a huge bet against Netflix, and then had to cover his short position after the stock reached a new high a couple of months later.

Netflix recently announced that with nearly 23 million U.S. users, it is now the largest video service in the country. Most observers expect the company to have more than 30 million subscribers by the end of the year, generating well over $3 billion in annual revenues. Arguments abound about why Netflix should not be as successful and as highly valued as it is. But the animating force of the perceived Netflix Paradox is disbelief that a company that does what Netflix does can thrive amid the wreckage of the media industry. Netflix is primarily in the business of aggregating entertainment content created by other companies and selling access to it as a subscription service to consumers. In a media culture committed to the proposition that "Content is king," the robust success of a mere redistributor is something incomprehensible and, frankly, a little unnerving, especially while those responsible for the creative lifeblood that flows through its veins struggle for profitability.

In fact, the dirty little secret of the media industry is that content aggregators, not content creators, have long been the overwhelming source of value creation. Well before Netflix was founded in 1997, cable channels that did little more than aggregate old movies, cartoons, or television shows boasted profit margins many times greater than those of the movie studios that had produced the creative content. It is no coincidence that although, say, 90 percent of the public discourse surrounding Comcast's recent $30 billion acquisition of NBC Universal involved the Conan O'Brien drama or the shifting fortunes of Universal Pictures, in reality, 82 percent of the new company's profits come in through the cable channels.

The economic structure of the media business is not fundamentally different from that of business in general. The most-prevalent sources of industrial strength are the mutually reinforcing competitive advantages of scale and customer captivity. Content creation simply does not lend itself to either, while aggregation is amenable to both.

Take scale. Because making a blockbuster movie is expensive, people assume that it is a scale business—that is, the bigger you are, the more cheaply you can produce something. But the defining characteristic of scale is high fixed costs that can be spread most efficiently by the largest player. Moviemaking is not this kind of business. The cost of a blockbuster does not vary based on the size of the studio producing it. Creating hit-driven content in any medium does not require significant fixed costs. Some series-based or other kinds of continuously produced content may have a larger fixed-cost component, but they are the exception, not the rule. Aggregation, on the other hand, by its nature requires a large fixed-cost infrastructure to collect, manage, market, and redistribute content. This is why a cable channel with 20 million subscribers loses money but an identical one with 100 million subscribers might have 50 percent margins.

Customer captivity—the "stickiness" of the company-to-consumer relationship—is similar. If Universal had a successful slate of movies last year, customers aren't more likely to seek out Universal films this year. Again, series or franchise films may be slightly different, but even with that content, the company is much less likely than the talent to be able to reap the benefits of captivity. Just ask the producer at Lionsgate responsible for negotiating with *Mad Men* mastermind Matthew Weiner, or the Sony executive in charge of enticing Tobey Maguire to make *Spider-Man 4*, or whoever at Viacom has the unenviable task of discussing new contract terms with the cast of *Jersey Shore*. Contrast the lack of customer captivity among pure content companies with the leverage cable companies seem to enjoy, by virtue of their loyal viewership, when they threaten to pull their signal from a cable operator.

Time was when the content giants in the movie, music, and book industries could earn superior returns. But their ability to do so had nothing to do with content's being king. It was a function of the scale and captivity inherent in their *aggregation* business: the massive marketing and distribution networks that they rented out to smaller, independent content producers, often at usurious rates. The decline of these enterprises does not reflect any change in the nature of content generation—it was as unattractive a business then as it is now. Instead, their decline reflects the loss of their advantages in aggregation—a loss resulting from a combination of external forces and self-inflicted wounds.

The obvious external force has been advances in technology. One reason that every major book publisher owns huge, half-empty warehouse and distribution facilities is that more books are being delivered electronically. The impact of technology on the music industry is the stuff of legend at this point, but even if companies had discovered a sustainable piracy-free pricing model for digital distribution, the business would still be less attractive than before. Without the fixed-cost requirements associated with producing and distributing CDs and managing racks at Tower Records, the barriers to entry into music-selling are not what they used to be. The detriment of increased competition from newcomers simply outweighs the benefit to established businesses of lower fixed costs.

It would be a mistake to give media managers a pass based on technological developments beyond their control. In industries like media, where a few large players share the same advantages of scale, the key to long-term success is avoiding destructive competition in pricing, costs, and capacity. In the mostly forgotten era of the MCA/Universal chief Lew Wasserman, being a media mogul meant enforcing a culture of informal cooperation, where the bottom line mattered more than one-upping your peers. Wasserman was not literally "the Last Mogul," as multiple biographers have dubbed him, but he may have been the last one who didn't think the defining genius of moguldom was out-bidding all the other moguls for the hottest talent, technology, or property of the moment. While technology has certainly accelerated the challenges of the book industry, the mindless race to build more and better warehouse and distribution facilities ensured chronic industry overcapacity, even before the advent of Amazon or e-book readers. Similarly, a culture that rewards "stealing" established authors from competitors the old-fashioned way—by overpaying—will never earn its shareholders a decent return, regardless of the technological environment.

Netflix's success in streaming video is therefore hardly paradoxical. The company sits squarely in the tradition of the most-successful media businesses: aggregators with strong economies of scale and customer captivity. Netflix used its leading position in its legacy subscription business to quickly develop scale in the streaming business. The company had fewer than 9 million subscribers in 2008, when it began offering video streaming directly to the TV for its existing customers. That move has spurred 10 consecutive quarters of accelerating subscriber growth, and it supported the introduction of a streaming-only service last November. Netflix's ability to spread the fixed costs of content, marketing, and technology across a subscriber base vastly larger than any other competitor's is continually reinforced by superior customer service, a powerful recommendation engine, and a great, habit-forming product.

Even if the Netflix business model is not original, some cultural and structural aspects do distinguish it from most media companies. Culturally, it is a remarkably well-run company that takes pride in both its operating efficiency and its customer focus. CEO Reed Hastings's 128-slide PowerPoint presentation on Netflix corporate culture has been viewed by well over 720,000 people, presumably not all employees. By contrast, media-content companies seem to feel that efficiency necessarily suggests a lack of commitment to artistic integrity. Media-distribution companies, particularly in the cable and telephony markets, have among the worst customer relations in any industry: J. D. Power ranked the cable companies 18th out of 19 industries in service. And most media aggregators, such as cable channels, structurally act as wholesalers, whose customers are not the individual consumers but the cable operators who manage the pipe to the home. Netflix is the rare aggregator that manages the direct customer relationship itself, which allows it both to excel in customer service and to perfect the product by harnessing customer feedback.

These company characteristics are unusual, and yet they hardly constitute a puzzle. But whenever the evidence contradicts conventional media-industry wisdom, the media cognoscenti aggressively resist any reassessment. Better to dismiss any uncomfortable fact as a "paradox" and move on. The media analyst Craig Moffett coined the term "*Dumb Pipe" Paradox* to describe the fact that a shift of consumer habits from cable television to online video streaming could actually help the economics of the cable operators. Moffett correctly pointed out that cable companies would be far better off if they could charge customers based on direct bandwidth usage from video streaming without having to invest in cable boxes. Only in the media industry, however, would it seem a paradox that owning the exclusive broadband pipe into the home at a time of exploding usage makes for a good business. Relying on dumb pipes instead of expensive content or talent is always the smart bet.

Netflix may indeed be overvalued: as the company acknowledges in its candid public filings, it is certain to face more rather than less competition. Retailers like Walmart, various content companies with their Hulu joint venture, distribution companies like Dish Network, and Internet stalwarts like Amazon have either launched or announced a competing subscription product. In each case, the company involved is starting way behind, and in most cases it's had limited experience either managing subscribers or developing compelling aggregated entertainment. Consider Amazon's recent foray: its Amazon Prime product has far fewer subscribers than Netflix (estimates are around 5 million). Furthermore, those subscribers are largely paying for "free" shipping of books and electronics, so they make up a different market from those who are primarily interested in a video-streaming service. Amazon Prime provides much less content and saves a user who's primarily interested in streaming video just over $1 a month from what Netflix charges. As the subscriber base supporting the Netflix marketing machine gets larger, offering consumers a competitive proposition of price and product will only become harder.

Some have pointed to Netflix's recent announcement that it will finance a new original series as an indication that the company knows the jig is up. Content providers will come to their senses and no longer sell Netflix so many of their valuable streaming rights, the argument goes, and that's why Netflix is going into the content business. Netflix has always relied on a deep inventory of long-tail content, sprinkled with some newer material, and a great recommendation engine. The company's willingness to finance a new original series, as part of the tapestry that makes up the Netflix experience, does not make it primarily a content player—any more than the exclusive 101 Network makes DirecTV one. Netflix needs to offer only a very small portion of newer releases to support its overall value proposition; those who would compete with it for exclusive streaming rights do so with far fewer subscribers funding the bid. Netflix will very likely be able to secure more than enough content to keep its customers happy.

Investors and media companies who write off Netflix's success as ephemeral—a function of a one-off content deal that will not be renewed, or of short-term user euphoria, for instance—will be disappointed. Netflix flourishes because of deep-seated competitive advantages fully appreciated and exploited by superior management. Media companies that fail to recognize the true size of the barriers to entry in aggregated streaming video are likely to make matters worse for themselves. Rather than denying the relevance of this new force, they should focus on how to manage it. Investors looking for media companies to bet against would probably do better to focus on those that dismiss Netflix rather than on Netflix itself.