How Netflix Nearly Lost Its Footing During the Recession and What It Did to Recover

Both a movie studio and entertainment platform, Netflix has nearly 140 million subscribers and is the dominant player in the streaming services industry. But few remember that at the height of the recession, it came close to flaming out.

In general, recessions are good for the entertainment business. The Great Depression ushered in Hollywood's "Golden Age," as movies were an escape and a way to have an inexpensive night out.

Despite this, in 2011, Netflix almost melted down. It lost 800,000 customers almost overnight, and the company's stock price cratered by 80%. Its customers, still reeling from the effects of the 2008 financial crisis, were counting every penny. This wasn't the time for the company to lose their hard earned trust—but that's what Netflix did.

To calm investor fears, Netflix's stock price needed to stabilize. The road back required a gutsy and well thought out strategy with financial strength at its heart.

Anyone in finance can learn from Netflix's story, a story of taking a long-term view of risk while managing customer dissatisfaction. It's also an object lesson in how to not just stay afloat during a recession, but to use the learnings from one to drive a company forward.

The vision behind Netflix

Netflix made a name for itself in 1997 as pioneer of the DVD mail-order business, ultimately helping drive competitors like Blockbuster and Hollywood Video out of business. It was also a first mover in streaming video, taking a chance on its future success in a market now valued at over $22B and growing by leaps and bounds.

People liked the convenience of ordering DVDs by mail and streaming video at home. And with economical subscription bundles and no late fees, Netflix offered good value when consumers were more price conscious than ever. Between 2006 and 2011, its subscriber numbers ballooned 290%, from 6.3 million to 24.6 million.

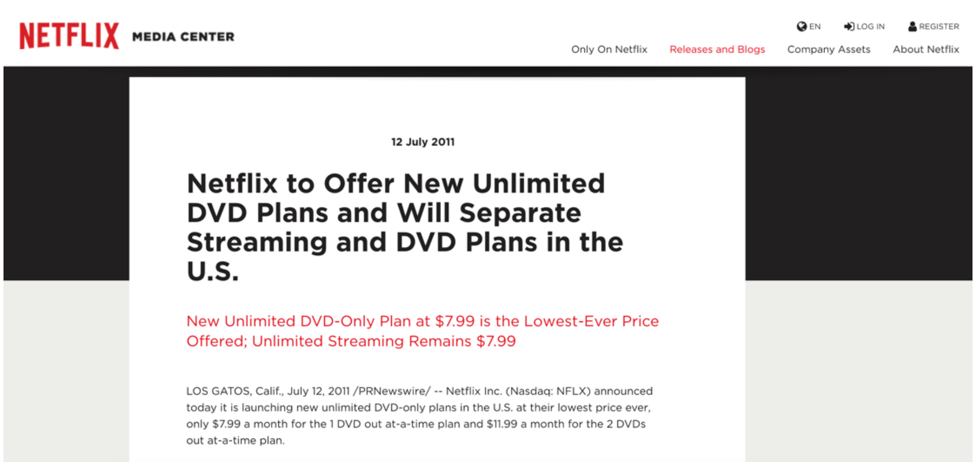
However, for Netflix CEO Reed Hastings and his co-founder Marc Randolph, DVD rentals were just the start.

They always envisioned the company as a streaming-only video service. "One of the biggest challenges that we had was … we had to come up with a premise for the company that was delivery agnostic," said Randolph in a 2014 interview. "But if we were to come out and say, 'This is all about downloading or streaming,' and we said that in 1997 and '98, that would have been … disastrous."

In short, their vision was clear to them, but not to others. This set the stage for confusion down the road. As Hastings later confessed, communication wasn't his strong point. He believed that "actions speak louder than words," an attitude that led to a near catastrophe in 2011.

The recession-era misstep that almost sank Netflix

In July 2011, the company pushed forward with an initiative that made sense in light of its aspirations as a streaming company. First, they announced that Netflix was splitting its plans into two parts: streaming video and DVD rentals.


NETFLIX MEDIA CENTER

EN LOG IN REGISTER

Only On Netflix Releases and Blogs Company Assets About Netflix

12 July 2011

Netflix to Offer New Unlimited DVD Plans and Will Separate Streaming and DVD Plans in the U.S.

New Unlimited DVD-Only Plan at $7.99 is the Lowest-Ever Price Offered; Unlimited Streaming Remains $7.99

LOS GATOS, Calif., July 12, 2011 /PRNewswire/ -- Netflix Inc. (Nasdaq: NFLX) announced today it is launching new unlimited DVD-only plans in the U.S. at their lowest price ever, only $7.99 a month for the 1 DVD out at-a-time plan and $11.99 a month for the 2 DVDs out at-a-time plan.

(Logo: http://photos.prnewswire.com/prnh/20101014/SF81638LOGO)

Those who wanted both streaming and DVDs had to pay 60% more per month. Previously they'd been able to bundle both for just $2 more. Any other time, this might've gone through with mild grumbling. But this wasn't any time. This was a painful, protracted recession.

The company attempted to spin it as offering subscribers choice. The could have "a streaming-only plan, a DVD-only plan or the option to subscribe to both."

"Netflix members love watching instantly, but we've come to recognize there is still a very large continuing demand for DVDs by mail," said Andy Rendich, Netflix Chief Service and Operations Officer. "By better reflecting the underlying costs and offering our lowest prices ever for unlimited DVD, we hope to provide a great value to our current and future DVD-by-mail members."

But members weren't buying it. In fact, most saw it as a cash grab, especially since on paper Netflix looked so healthy. Few understood the immense expenditures that were being laid out to keep Netflix on the cutting edge of streaming, including$30M a year to allow Netflix streaming subscribers to access 2,500 movies, TV shows, and concerts from cable channel Starz.

Three months later, Netflix put out an announcement made the situation exponentially worse. The company was now was splitting into two parts. Again, this all made sense in light of Hastings' vision, but it didn't take into account the headaches it created for customers.

There were to be two different sign ins and two different accounts. User preferences wouldn't cross over. This meant subscribers were losing one of Netflix's best features: personalized suggestions. The DVD rental side was to be rebranded Qwikster, a name that was widely mocked and compared with Web 1.0 era startups that went belly up, such as Friendster, Napster, and Dogster. For many who were hoping the company would walk back the pricing decision, this was the last straw.

"Reed, thanks for reminding me that I should go somewhere else for my DVD rentals. It was an insult enough that you raised the price on me last month, right in the middle of the biggest recession since the Great Depression, but now instead of a sincere apology, all we get is excuses and a flimsy new name," wrote one of the over 10,000 who commented on the company blog.

Customers bailed out almost immediately following the announcement. Netflix's stock price tanked, from $300 a share in mid-July to $78 in late October, and sinking further from there. Analysts described it as a "nuclear winter" for Netflix, with many predicting the company's demise. They also questioned Hastings' leadership.

It would require a skillful strategy to pull the company back from the edge. Much depended on the finance team, led by former CFO David Wells, who Hastings later credited with "managing the company's finances during a period of 'dramatic growth.'"

(Source: CNN Money) Netflix's stock price plummeted in October 2011 following a price hike and an announcement that the company would split up its offerings and rename the DVD rental side.

The company needed to turn the situation around—and fast. Much of this fell on the finance team. They were well aware that the company would have to navigate the change from Netflix as a DVD rental site to Netflix as a streaming video destination, all the while winning back the trust of its subscribers.

As Wells and the rest of the finance team knew, the company's key metric was subscribers. Win there, and the rest followed.

This required that they consider the key factors that would make the journey possible. First, the company needed to show it was listening to its customers. Second, they had to reduce risk by moving fast into streaming video ahead of the competition. Third, they needed to turn the company into a creative force in its own right.

The finance team no doubt knew that with this strategy there would be short-term losses. DVDs had been a profitable business line that had sustained the company since its inception in 1997. Sidelining it would make a serious dent. And finally, the company needed a way to make Netflix a viable alternative to its competitors, including the heavyweights of the industry like HBO.

Diminish risk

From a financial perspective, the team saw that removing the legacy part of the business would be the best strategy in the long-term. But it was a delicate balancing act to convince subscribers to move towards streaming. Here's what had to happen:

- The viewing public had to see Netflix in positive terms once again
- Streaming subscriptions had to increase
- DVD subscribers had to be shifted into a separate business area

Hastings understood the extent of his blunder, scrapped Qwikster, and issued a humble apology, emphasizing that he was listening to his customers: "I messed up … In hindsight, I slid into arrogance based upon past success," he wrote on the company blog.

From there the company pushed forward with essentially the same plan: Customers still had to pay separately for streaming and DVD rental plans. Between Q3 and Q4 2011, DVD-by-mail subscriptions dropped 20%, from $13.93M to $11.17M. Meanwhile, streaming-only subscriptions increased slightly, netting just $52M on $476M in sales in Q4.

For a public company in the spotlight for a bad decision, Netflix was not reassuring investors. But the company wasn't going to backtrack.

As Hastings explained on the company blog, if the company didn't take financial hits now, they would have to accept even greater losses in the future. Being bold was the less risky approach.

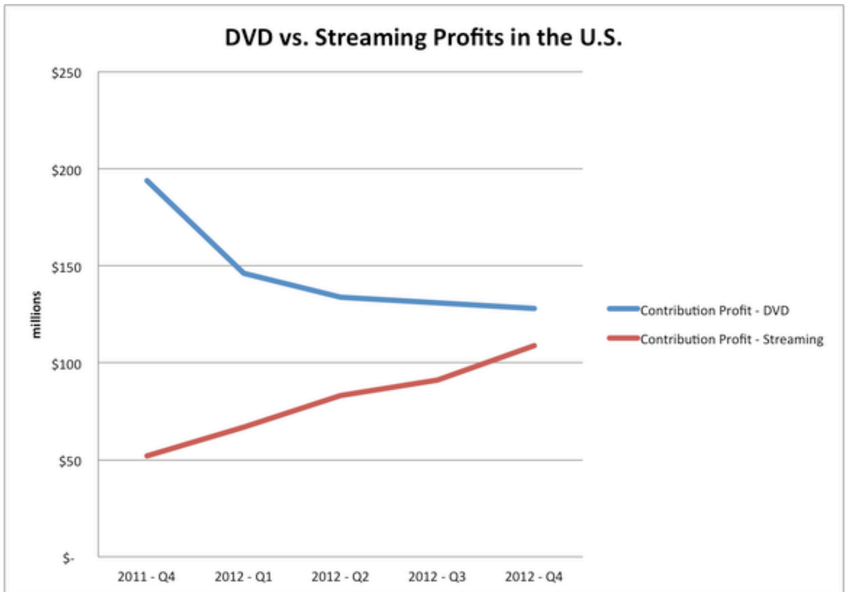
"For the past five years, my greatest fear at Netflix has been that we wouldn't make the leap from success in DVDs to success in streaming. Most companies that are great at something – like AOL dialup or Borders bookstores – do not become great at new things people want (streaming for us) because they are afraid to hurt their initial business. Eventually these companies realize their error of not focusing enough on the new thing, and then the company fights desperately and hopelessly to recover. Companies rarely die from moving too fast, and they frequently die from moving too slowly."

When the uproar died down, the last of the plan was put in place. The DVD side of the business was separated out in 2012, though given a less 1990s name: DVD.com. This cemented the most important element of the financial strategy, which was to remove DVDs from the company's core offerings. It was also a subtle push to get more streaming customers on board.

Customers, faced with the choice between DVDs and streaming, chose the latter. By the end of 2012, the company's streaming subscriber numbers surged, adding nearly 10 million globally. Meanwhile its losses continued on the DVD side, with around 400,000 dropping out.

No doubt, the CFO and finance team understood where the market was heading. These losses were no longer a bad sign: in fact, they were a good one. This meant that their plan was taking shape.

Their calculations proved out. Not only did streaming continue to increase, but the company's profits from streaming began to overtake DVDs. This meant its stock price rebounded as analysts and investors realized that the company was on the right track after all. There was no more talk of a "nuclear winter." By October 2013, the stock price reached an all-time high of almost $400 a share.



(Source: Motley Fool) Netflix's once fat profits from DVDs fell while streaming surged ahead and soon overtook them.

Spend on R&D

The team knew that to get out ahead of the competition, it had to be a technology leader. It was one of the to use an algorithm to determine user preferences. Then, Netflix began its moonshot into streaming. This meant:

- Netflix was a first mover among its peers in the streaming video area
- The finance team proved it was willing to think long-term and support large investments in untried technology
- CFO David Wells and his team acted in service of their goal of growing subscribers

In 2007, the company put $40M into developing a video streaming system called Watch Now. This may not seem like a lot for the Netflix of today, but at the time this investment accounted for almost 60% of the year's profits.

Not only that, but the technology was in its infancy. Watch Now could only run on Windows Internet Explorer, and users had to download an applet to use it. There were also bandwidth problems, as the internet didn't yet support the speed needed for a seamless video-watching experience.

Despite all this, it meant Netflix perfected the technology ahead of the competition. The company was also growing its user base while its competitors sat on the sidelines waiting for streaming to be ready for prime time.

By 2012, all looked rosy. This early bet had proved correct. But in fact, Netflix was about to become a victim of its own success.

Spend on content

The team knew as early as 2011 that to keep its place at the top of the streaming food chain, Netflix would have to create content of its own. This meant:

- Placing large bets to ensure top quality entertainment
- Pioneer new ways of delivering content to audiences that would feed their appetite
- Reinvent the Netflix brand as a TV and movie studio

Just as the ship seemed to be righting itself, another disaster struck. The partnership with Starz, forged in 2008, abruptly ended in 2012. The reason — Netflix was no longer a struggling bit player that could distribute the channel's offerings on the cheap. Now, it was a competitor. Starz was owned by Liberty Media, a large cable operator with a number of channels under its control. Netflix posed a direct threat.

Thousands of movies and TV shows disappeared from Netflix virtually overnight. Customers weren't happy. Meanwhile, the cost and complexity of acquiring titles from Hollywood was becoming unsustainable.

The company once again had to make a choice. The team had learned that the safest route was to reduce risk by moving faster than the competition. They had to reinvent Netflix as a studio in its own right. And they couldn't afford to back into it. They'd have to go big.

With Netflix Originals, the company pushed forward a bold plan to beat Hollywood at its own game. They would bring in big Hollywood talent and spend millions making shows and movies that were the same caliber as those coming out of the big studios.

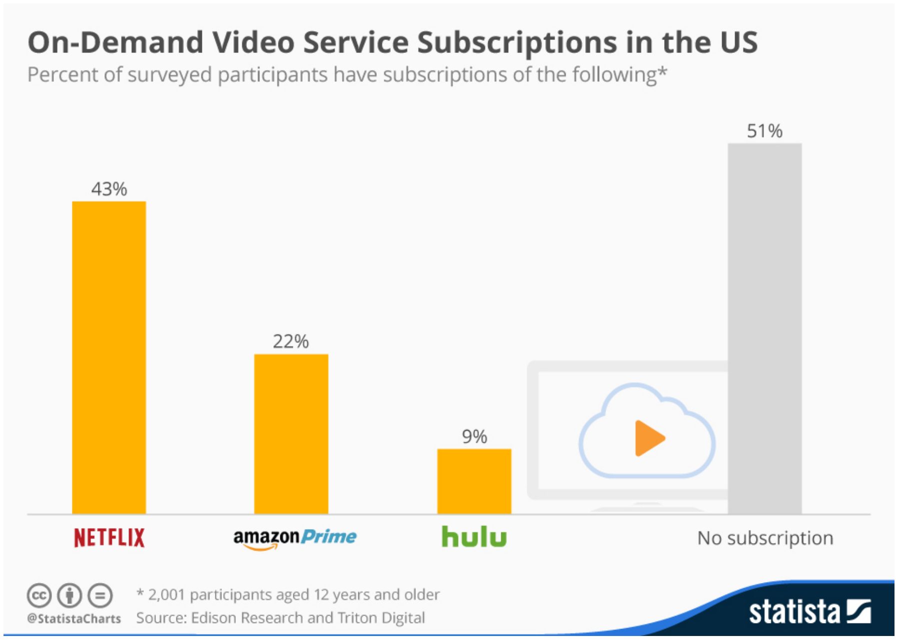
Wells was a key part of this. As he later told audiences at a 2017 Goldman Sachs conference, "I don't think we have any regrets of the level of content investment we've made to date." Rather, he said the amount the company spent would continue to increase as long as "the company can continue to add to its more than 100 million subscribers around the world."

In other words, Wells knew that growing subscribers was the goal that mattered most, and if that meant making big investments in creating content, then he was ready to do so.

The next decision proved that the company's focus on technology was about to pay off. Netflix chose as its debut program a U.S. remake of a British political drama, "House of Cards." The company spared no expense bringing in top talent to make it, which included director David Fincher ("Fight Club," "The Social Network") and actor Kevin Spacey. Netflix spent $100M on the series.

Major networks had passed on the idea because it didn't seem to have wide appeal. Once again, the team's investments in R&D were paying off. Their smart financial decision to develop a user data tracking algorithm showed that viewers enjoyed the original show. Not only that, but they often chose political dramas over other genres, and they liked movies starring Spacey and directed by Fincher.

Armed with this data, Netflix signed on to make two seasons of "House of Cards," and then released the first season all at once in February 2013. It was a hit. Its stock price rose 97% in the first quarter of 2013 alone. By the end of 2013, Netflix had more than 44 million subscribers and invented a new phenomenon called "binge-watching." Netflix's competitors are still scrambling to catch up.



(Source: Statista 2016) Netflix's dominance of streaming video picked up steam as competitors scrambled to catch up.

"House of Cards" set a new standard for streaming video programming. The show drew legions of loyal fans. It was the first online-only series to receive major nominations at the Primetime Emmys, and won a 2013 Outstanding Director award for David Fincher. Lead actress Robin Wright, who portrayed Claire Underwood, was the first to win a Golden Globe for an online-only series.

As the accolades piled up, Netflix blew out its production side. Its next hit "Orange is the New Black," debuted in July 2013. This was followed by many more binge worthy shows including "Stranger Things," "Black Mirror," and "The Crown."

Amazon, meanwhile, had Amazon Studios, but it had taken a more cautious approach. It made small budget shows, and distributed them through multiple external studios. It wasn't until the release of "Transparent" in 2015 that Amazon had created a series of the same caliber. And it didn't consolidate its offerings into one destination, Prime Video, until 2017.

Staying the course

The Netflix story teaches us a great deal about how to successfully navigate tricky waters during a recession. The company had to move fast in order to reduce the risk of being outpaced by the competition. This meant expecting and even welcoming losses in the core business.

It also shows how finance teams touch every aspect of a company. When subscribers were angered by the changes the company made, it was on the CFO to a great extent to drive the initiative forward while facing down a loss of confidence by investors and customers.

Wells and his team also had to be willing to invest first in R&D and later in entertainment. These expenditures were not for the faint hearted. They were risky bets in untried areas with no guarantee of success.

Ultimately, the story shows that keeping the ultimate goal in mind can clear the way for good decision making. Though there were setbacks, it was the combination of the CEO's vision and the tactical success on the financial front that turned Netflix into the success it is today.