Netflix (NFLX) has been one **POWERHOUSE** of a stock with incredible performance, up approximately 3700% since 2012 vs the S&P 500 up 113% and five leading Media companies up nearly 200% on average (Jan 2012-Jun 2013).

Examining a few charts showing the fundamental momentum of the service makes it easy to see the reason for investors' enthusiasm for Netflix stock relative to the incumbents:

Netflix has grown Subscribers and Revenue significantly and sustainably over the past decade, with an acceleration over the past 5 years...

*Source: Kleiner Perkins Internet Trends 2017 Report*

It's done this by offering an over-the-top (of the Internet or OTT) streaming video subscription service, using the **CLASSIC DISRUPTOR PLAYBOOK TO AN OVER-SERVED MARKET**, that is significantly cheaper
and more customer friendly than existing incumbent services in the US...

Source: Kleiner Perkins Internet Trends 2017 Report

Drawing significant consumer attention away from the traditional Media networks and demonstrating strengthening customer engagement (audience viewership in total and per subscriber)...

Source: Matthew Ball and REDEF

Boiling down these data leads to the conclusion that Netflix users spend about 10% of what their Pay TV spend would be on a Netflix subscription but spend 40-50% of their TV viewing time there, for a 75-80% cost advantage per hour of viewing.

Making matters worse, the trend among younger generations points to an accelerated decline in relevance of the traditional television media industry in the US...

Source: Matthew Ball and REDEF

Source: Matthew Ball and REDEF
Traditional Pay TV service is literally dying off unless it can change this trend. Few could have predicted such change and performance prospectively 5 years ago, but we think it is generally indicative of the underlying value that Netflix has accrued in creating the first global scale media company by leveraging the inherent advantages stemming from internet distribution, global scale, and direct customer to content relationships.

Over the phenomenal period of returns and fundamental business performance, controversy has surrounded the company due to what had initially seemed like a limited and low-quality catalog, undifferentiable business model (reselling licensed content over the Internet), unsustainable/unscaleable niche (media companies would stop licensing and kill it when it got too big), and its cumulative cash burn that continues at increasing levels even still. We were among them until we delved into the fundamental industry dynamics playing out a couple of years ago that led us to change our minds. We’ll address these issues in our discussion.
We discussed the **Disruption of Traditional Media** by mass consumer adoption of the Internet in our previous post, while specific to the phenomenal rise of Netflix's value, we had observed in our post on **Stock Prices and Business Value** that:

"the huge winner was the company whose starting position was highly in doubt as a mediocre, cheap service (really kind of an afterthought on what to watch and how much you paid as a subscriber) and has over the space of only 5 years built itself into a leadership position of a global scale media company, with nearly 100 million subscribers worldwide, and one that is seen as the biggest threat to the traditional trillion-dollar global media industry.

While as fundamental investors, we at Ensemble Capital always seek out companies with strong moat characteristics trading below our estimate of their intrinsic values, the actual performance of companies we or anyone chooses to invest in will in the long run reflect business performance... a change in market perception of a business as one with no-moat to one with a good moat, as the case of Netflix demonstrates, is a very very valuable thing when it comes to ascribing business value."

The global scale of Internet enabled technology companies has been a powerful value creator, as demonstrated by the most significant moat-bearing businesses to benefit from it over the past 5 years in the chart above, i.e. Apple (AAPL), Amazon (AMZN), Facebook (FB), Google (GOOGL), Microsoft (MSFT), and Salesforce.com (CRM), which combined averaged a 400% return. Yet as referenced in the quote above, the combination of an emergent moat (from no moat) and global scale is a super powerful value generator driving Netflix's 3700% return over the same time period. We believe Netflix has emerged as a global scale company with an increasingly strengthening moat.
We will discuss how Netflix built itself from the small "ALBANIAN ARMY" on the fringes of the media world into the leading Global Scale Media company by leveraging Internet distribution and direct customer relationships as core competitive advantages in an industry that bullied its customers (via excessive price increases, over-bundling, poor customer service, artificial choice constraints, and arguably declining service quality) because of its privileged oligopolistic position.

This post will cap our three part discussion (see Part 1 and Part 2 here) on how the Internet and connected devices have disintermediated the moat advantages of traditional media and distribution companies and created new opportunities at an even greater, global scale by disaggregating physical distribution from the media business while democratizing and lowering direct distribution costs to reaching consumers. We discussed some aspects of Netflix’s business in the disruption piece but flesh it out some more with the benefit of another year of experience observing the industry.
HOW DID NETFLIX DO IT?

The most important determinant for Netflix's success is its culture and its focus on the customer experience. That culture has underpinned the path of its history as it navigated opportunities and challenges, leading to the development of its capabilities that have successfully enabled it to cumulatively catapult itself into the position it sits in today. As the de facto founder of the OTT enabled Global Scale media business, it has created the playbook and shaped key characteristics of the market requirements though innovation. As with most sustained fast-growing businesses, Netflix's business model has an effective “flywheel” in place that summarizes its growth strategy.

Underpinning this model is the interplay between subscribers, who generate revenue used to invest in the customer acquisition and experience, and content, which is the product being consumed – the more subscribers Netflix attracts, the more content it can buy/license, which in turn drives greater subscribers. It's important not to overlook the other important components of the strategy around the core because they are the elements that sustain and enhance both the competitive advantage and growth runway for Netflix.

**Culture is the Ultimate Cause for Netflix's Long-Term Success**
The founding of Netflix was based around the idea of conveniently buying and renting DVDs by mail but quickly evolved into a subscription service given its early customers' passion for films. The success of that model over the entire store-based video rental market and later the realization of the greater vision to becoming a global INTERNET TV platform can only be credited to the company's CULTURE, with roots in its entrepreneurial history and a strong focus on constantly improving its value proposition for its customers. This culture has served as its operating system, as it does in every company, and one that has evolved over time to adapt to new challenges and opportunities.

Being a technology company founded by software entrepreneurs has been a foundational aspect of Netflix's culture, with a recognition of what was technologically feasible at any particular point in time, how capabilities would evolve (requiring large upfront investments to leverage them), the entrepreneur's originality to rethink how the service should be delivered to take advantage of this, and the acumen to recognize which of these underlying capabilities would need to be built in house to create what has become a vertically integrated service and a new platform for media delivery.

However, simply being a technology company looking to disrupt the media industry would not have been a sufficient basis for Netflix's success -- it's how Netflix approached the evolution of its service, with the customer experience at the center of its focus and its culture in service of how to best execute against that goal that's made it so successful.

Contrast that with traditional media companies, which appear to have been more focused on leveraging lucrative business models to sustain promises made to shareholders on financial targets and capital return instead of focusing on the customer experience first and how to improve that in light of new technological capabilities (media creation and distribution has always had an important technology component to it) and evolving customer expectations. Or we can compare it with technology companies, with both Apple's APPROACH and Google's having thus far failed to successfully transform the traditional Pay-TV customer experience despite their perennially larger resources and technological capabilities relative to Netflix.

There were important lessons co-founder and CEO Reed Hastings and his team brought from their experiences at previous companies but also learned and institutionalized as they Fought To Survive through the Dotcom bubble crash in 2000 and competitive challenges since from much larger competitors when it came to defining the culture as it has evolved (described by former Chief Talent Officer Patty McCord in her book POWERFUL, SUMMARIZED HERE). That culture emphasizes self-empowerment, independence, and accountability, a high level of responsibility, performance, experimentation and iteration, learning using both data and judgement, and an opportunity to grow as the company's vision did.

As a result, the management at Netflix has been very honest and clear with itself and employees about the changing strategies and core capabilities necessary to develop over time to win in the long-term as its vision and opportunity expanded, while making the tough decisions and executing admirably (despite setbacks) in the medium term to achieve its goal of becoming the leading global Internet TV platform in the long-term.

Importantly, the guiding star has been the focus on constantly improving the customer experience, value offering, and its own competitive position (in that order) which has meant reinventing itself a couple of times. In part, this was necessitated by being an Internet service with low switching costs (facilitating low sign-up friction), where retaining customers has utmost priority for growth and sustainability. To retain customers successfully amidst the constant pace of innovation and competition from other very engaging free and paid services, often backed by much larger companies in the media and technology
industries, has required the reorientation of the company and a reinvention of its business model even if its go-to-market strategy and fundamental value proposition to customers has been consistent. Making customers happy has come with a lot of short-term pain for shareholders and employees, however.

A dramatic example of this was when Netflix pivoted from its position as a profitable, growing mailed DVD service, after a hard-won battle against the much larger incumbent, Blockbuster Video, into a money losing video streaming service in 2011. The company went from reporting nearly $400MM in operating profit in 2011 to just $50MM in 2012 and has been cashflow negative ever since as it has invested more than its earned in its content catalog, the core “product” being offered by its service. Investors and management recognized that the Internet was ultimately going to be the long-term solution for media distribution, but when the time came for management to make the decision to "go all in" on streaming and create the future, the impact of its financial model was significant... and very negative.

However, management was focused on ultimately being on the right side of technological change and the customer experience (even if consumers hadn't realized it yet!) despite the impact it would have on profitability and its stock price in the short run both for fear of being disrupted by another and in pursuit of the much larger global opportunity it presented.

Amazon’s CEO Jeff Bezos exhorted in his 2016 ANNUAL LETTER:

"Embrace External Trends. The outside world can push you into Day 2 [stasis and decline] if you won’t or can’t embrace powerful trends quickly. If you fight them, you’re probably fighting the future. Embrace them and you have a tailwind. These big trends are not that hard to spot (they get talked and written about a lot), but they can be strangely hard for large organizations to embrace."

"There are many advantages to a customer-centric approach, but here’s the big one: customers are always beautifully, wonderfully dissatisfied, even when they report being happy and business is great. Even when they don’t yet know it, customers want something better, and your desire to delight customers will drive you to invent on their behalf."
Though Bezos articulated these principles, Netflix has practiced this for all its history. In fact, it’s not strange at all why the big external trends are hard to embrace for large organizations -- it typically involves a change to their traditional way of doing business with a negative impact in the near term on profitability and that is usually too hard for incumbent organizations and their investors to stomach in the short term, even if it’s in service of a greater long-term value (the whole “bird in hand” aphorism, which works until it doesn’t!).

The result of Netflix’s decision to bet on video streaming was a 75% decline in its stock price, a hurt compounded only by the fact that it had to raise $400MM at the lows to fund the needed content investments to drive the streaming strategy forward.

However, two years later, Netflix stock fully recovered its losses reaching a new high as it executed on its streaming subscription strategy and the market began to recognize the value of the business it was building as well as the future larger global opportunity it was growing into because of the new connected mobile devices (smartphones and tablets) phenomenon taking the world by storm. It was the right bet to have made for the long term.

In contrast, a company like Time Warner (not to mention its peers) was unable to culturally make the necessary investments and changes to its strategy and shareholder capital return commitments with enough urgency, even as it saw the threat from Netflix’s Albanian Army growing, when it launched its DTC HBO NOW OTT streaming service on April 7, 2015.

HBO is a premium content network, one of the few that can monetize itself as a standalone branded differentiated subscription service as it had been doing for decades as a "channel". In fact, it was a key driver of cable Pay-TV adoption early in its history and had a brand that could be leveraged globally. Unfortunately, HBO NOW’s launch was a timid, hesitant entry by the incumbent organization into OTT distribution due both to HBO’s existing multi-year contractual obligations with partners globally and management's unwillingness to be aggressive with its investment in growing the service right out of the gate.

If it was clear to us that getting to Global Scale as fast as possible was the key to long term health, it should have been clear to Time Warner’s management. It therefore should have retained content rights from its Time Warner Studios and aggressively sought out more from third parties to scale the standalone HBO service’s catalog (making it more valuable with broader appeal), spent more heavily on marketing and customer acquisition to drive subscriber and revenue growth, and priced the service more competitively to juice that growth effort upfront. Instead it stuck with the standard $14.99 per month pricing (67% higher the Netflix) it retailed with its Pay-TV distribution partners in order not to compete with them (despite their lower effective retail average price with promotions).

More broadly, Time Warner’s management CONCEDED to many of the important elements that the incumbent Pay TV industry had to adapt to in order to be competitive with Netflix, like enabling access to current shows anytime and on any device, being able to access entire seasons of broadcasted shows, reducing advertising loads on content, and delivering better content suited to targeted audiences. But enabling convenience for the consumer meant reworking distribution agreements with partners or charging distributors more to “capture” the added value of accessing the entire season of current shows available on demand to grow profit margins, while the right thing to have done was to recognize their future business was at risk and it was the consumer who needed to accrete more value for what they were already paying to stay. To do what we saw as needed, its profits would have fallen dramatically and its buyback program would have fallen well short of market expectations while its distribution partners may have retaliated with more aggressive efforts to reach subscribers directly.
Consequently, HBO Now grew to 800K subscribers in its first partial year in 2015, added 1.2MM in 2016, and 3MM in 2017 while Netflix grew subscribers 17MM, 19MM, and 24MM, respectively, a 12x higher growth rate. In the meantime, HBO's content budget grew to $2.3B in 2017 from $2B in 2015 while Netflix's comparable content spend on its P&L grew from 3.4B to 6.2B, a 9x higher growth rate. Net-net, Netflix grew both its content budget (value provided to customers) and its subscribers (response of market to value provided) at about a 10x rate than HBO Now over the last 3 years. As a result, Netflix successfully carried the momentum of building its business from the not so distant days of 2013 when its publicly stated goal “WAS TO BECOME HBO FASTER THAN HBO BECAME US”, growing an order of magnitude faster than HBO could.

Despite its hesitance to aggressively go "all in" with its HBO OTT service, business and FX headwinds in the latter half of 2015 forced management to pull back earnings expectations and make changes to its business plan throughout the company causing the stock to fall from the mid 80's to the low 60's level.

The pain of a 25% drop in its stock price was too much for management to bear. As 2016 played out, instead of recommitting to sufficient investments to reposition in pursuit of a changing industry landscape and larger global opportunity by pouring any upside into driving content acquisition and growth initiatives, it began to again "reward" shareholders with EARNINGS BEATS, HIGHER DIVIDENDS, AND BUYBACKS (instead of doubling down into more aggressively investing in its OTT strategy) ultimately acquiescing to a sale of the company to AT&T in October 2016, an admission of the limits of the company's culture of financial optimization of a staid business model vs one of resilience and value maximization.

Netflix's ability to stick out the pain of its stock decline while focusing on the right investments for the future to maximize its long-term value is a testament to its resilient culture.

Further, Netflix's culture and customer focus has also enabled it to successfully reinvent industry standard behaviors that are symptomatic of the oligopolistic power of the incumbents that disadvantaged customers, thereby ingratiating Netflix with its
customers. For example, while Pay-TV service often tries to lock in customers via annual contracts and proprietary hardware, Netflix only offers flexibility for the customer to cancel on a monthly basis with no proprietary hardware buys to entrench lock in, relying instead on earning its customers' "love" and loyalty to stick with every month them by delighting them with continuously increasing value.

Whereas traditional Pay-TV operators are looking “crack-down” on password sharing as the music industry had unsuccessfully tried it in the early 2000’s, Netflix has adopted a more relaxed practice among its subscribers’ practice of sharing passwords. In fact, Netflix has (quietly) turned password sharing into a fundamental advantage for itself by letting it proliferate as a viral marketing and adoption growth strategy, a concept that most analysts covering the company for years still don’t grasp and regularly ask when it will put a stop to the behavior and recapture the revenue "leakage".

What needs to be understood is that given the fixed cost structure of licensing and producing content, it behooves Netflix to have its service adopted and habituated across the largest swath of users as possible, even the supposed freeloaders. Instead of disenfranchising its customers with the threat of cracking down on a behavior that antagonizes its customers and potential customers, it has designed its service’s pricing based on the number of simultaneous streams viewed, effectively offering a discount for larger simultaneous streaming bundles that paying subscribers are free to share.

To wit, Netflix has priced its service by the number of simultaneous streams accessible at $7.99 per month for one stream, $10.99 for two ($5.50 per stream), and $13.99 for four streams ($3.50 per stream). The brilliance of this offering strategy is that it makes Netflix indifferent to its customers sharing passwords and, in fact, benefits from incremental user adoption/habituation when they share unutilized (already paid for) streams with new to Netflix or price sensitive friends, family members, roommates, neighbors, strangers or whomever! In fact, Netflix makes this super easy by allowing the creation of many separate profiles that track individual's content viewing and offer personalized recommendations for each separately under the same subscription plan.

This sort of "bundled" pricing discount also makes the service very affordable to potential users in areas of the developing world where a $10-14 per month subscription would be unaffordable but by sharing a 2 or 4-stream bundle among friends, makes a $3-5 per user much more affordable for access to high quality content. As we saw with the impact of Apple launching iTunes during an era when the music business suffered from rampant piracy, when consumers have an affordable and convenient option to purchase content, they generally adopt it enthusiastically.

In one last anecdote on culture, Netflix used its legal CEASE AND DESIST to an IP infringement around its surprise hit series "Stranger Things" as a humorous marketing opportunity, further playing off to its image as a "no-jerk" company in contrast to the tone the broader media industry tends to take with such matters. The free marketing this generates and the goodwill this builds with customers compounds as a result. No wonder the younger generations of customers have been deciding they JUST DON’T WANT TO DEAL WITH TRADITIONAL PAY_TV ANYMORE!

**Global Scale Capabilities**

Netflix's culture and customer centrism has driven the investment in building capabilities that have driven its success against the traditional Pay-TV companies that we believe are necessary to successfully drive Global Scale in the Internet age:

1. its focus on subscribers, attracting, delighting, and retaining them with its convenient and easy to use service and growing content catalog,
2. made possible by an array of skills developed around technology, marketing, payments, and content sourcing

3. driving greater overall engagement with its catalog of content,

4. driving the scale to make it the best place to find content relevant to the subgroups of subscribers at a scale that could not economically be personalized for in the past.

Greater engagement drives higher subscriber growth and revenue, which allows Netflix to invest even more into content and capabilities to improve the engagement and value of its service to more subscribers, ultimately driving increasing value for the company and its shareholders.

1. Subscribers are everything.

Netflix’s strategy centers around loving its customers and delighting them with its service. At its heart, Netflix’s business model starts with its subscribers -- the more subscribers it can sign up and retain, the more subscription revenue it can generate and the more it can invest in its content catalog. The larger and better quality the catalog of content and the easier it is to find and watch shows in the catalog, the more attractive and engaging it is to new and existing subscribers, thereby increasing its subscriber and revenue growth, the core engine of value accretion for Netflix.

The more compelling Netflix’s service is (both content and convenience), the stronger and more relevant its moat. On the other hand, the more pressure the traditional incumbent media companies feel on both their topline growth and content costs as their consumers engage more with Netflix, the lower their ability to reinvest in their content moats and the weaker their moats get while their lateness to streaming renders their moats less relevant because their content is less convenient/desirable to engage with. It’s the classic definition of a "virtuous" cycle for Netflix, similar to the competitive dynamic it created with its former video rental arch rival, Blockbuster Video, which died of the "vicious" cycle it experienced on the losing end of engagement.

However, given how easy it is for customers to choose and switch among Internet based services and the variety of free options consumers have, such as YouTube, pirated content on Tor services, Facebook, etc., Netflix must delight its customers to earn their engagement while continuously "upping" its content and services offering to stay ahead of the competition. Another way to phrase this is that Netflix must constantly increase the value it provides its customers because it does not have a customer "lock in" strategy, it has a “winning the customer's attention” strategy, or what it calls its “moments of truth”.

“We compete for a share of members' time and spending for relaxation and stimulation, against linear networks, pay-per-view content, DVD watching, other internet networks, video gaming, web browsing, magazine reading, video piracy, and much more. Over the coming years, most of these forms of entertainment will improve.

If you think of your own behavior any evening or weekend in the last month when you did not watch Netflix, you will understand how broad and vigorous our competition is.

We strive to win more of our members' "moments of truth". Those decision points are, say, at 7:15 pm when a member wants to relax, enjoy a shared experience with friends and family, or is bored. The member could choose Netflix, or a multitude of other options.”

Source: Netflix

Two important results of this has been the ability to raise its prices 3 times in the past 4 years without materially impacting its long-term growth rate, demonstrating just how much consumer surplus it
provides the customer relative to the value it captures via pricing, while also bringing down its churn rate over time, demonstrating increasing customer satisfaction with its service. The large value gap also means that Netflix has additional pricing power in the future it can take to improve its margins.

Contrast this to the widely renowned disdain consumers generally have for their interactions with incumbent service providers and the perception that their prices are always going up without sufficient added value because they have **LIMITED CHOICE** among the cable and telephone oligopolists in their local markets. It becomes clear that there is a fairly strong motivation for customers to part with the tyranny of their traditional service providers.

By delighting consumers with their service offering, Netflix lets its customers **TAKE THE POWER BACK** from the abusive, generally arrogant and powerful incumbents. The fact that the increasing numbers of consumers in the US without Pay-TV service are so called "cord-nevers" reflects these, generally younger consumers, whose preference has been **not to even engage** with the traditional incumbents because they have options like Netflix and YouTube that their parents didn’t. Though a bit dated, the NPS survey below illustrates what we’re all anecdotally aware of to be true still today that is an underlying problem for the traditional incumbent distributors, and therefore the bulk of existing revenue streams of the incumbent media companies that they are married to.

![NPS Survey](image)

**Source: Pacific Crest Securities**

Raising prices while lowering churn and maintaining a rapid growth rate without customer lock-in within a competitive landscape is a strong testament to the increasing value and relevance Netflix’s service provides to its customers. This is a much stronger and more sustainable moat signature than a similar power drawn from the resentful customers without choice or with lock in strategies, signaling the ability to continue driving greater value over time. Notably, Apple (100%+ return on invested capital at a very large scale) is the best exemplar of how valuable winning the consumer’s heart can be over the long term, with which Netflix shares many characteristics including a huge overlap with its customer base.

2. **Critical Skills are Key Differentiators to Realize Global Scale**

Due to its history as an Internet service over the last two decades, Netflix has invested in building and honing the key skills necessary to scale as a direct global media platform.

**TECHNOLOGY development capability** deliver video over the internet globally across different connected networks and devices in a secure and personalized way is an important one that Netflix has consistently been at the forefront of and developed in-house.

Convenience has been at the core of the service offering since the start of the company when it delivered DVDs by mail. As Internet access technology has evolved over time, Netflix has enhanced the convenience of its service by leveraging these from broadband speeds that made streaming video over the Internet possible to the variety of connected devices used to access the service, to the proliferation of infrastructure services used from wireline to wireless. With 4G mobile service and its declining cost, Netflix is on track to be ubiquitously accessible by its customers almost anytime, anywhere. Just because the service is available does not mean it’s easy - the variety of devices consumers use over varying connection speeds, wireline or wireless, at different locations globally means that the streaming
video experience can have a lot of variability from quality to buffering speeds to jitter. The ability to appropriately encode and source each stream across those differing set of variables is critical towards the quality of the experience, which Netflix has developed in-house and presents a time and investment barrier for others to replicate.

In another analog to Apple, just as the iPhone has been subsidized as a marketing tool to win over new subscribers by American wireless carriers in the past, T-Mobile is using free Netflix service for its subscribers to get them to upgrade to Unlimited 4G service, a testament to Netflix’s universal appeal as a killer application for the T-Mobile’s connectivity service. Finally, individual viewing habits can be tracked over the Internet, which allows Netflix to personalize content for every logged in subscriber, creating a personal “bundle” of content recommendations, a capability that should improve over time and is entirely unavailable to traditional one-way television technology. This capability also works in reverse, with data from viewer habits forming what content to produce or license and at what price.

Furthermore, while the service has been popular in the US for many years, accounting for a third of bandwidth usage at peak evening periods, in order to scale its service globally to tens and hundreds of millions of subscribers, Netflix had to invest in developing its own global CONTENT DELIVERY NETWORK (CDNs) to prevent TAKING DOWN THE ENTIRE INTERNET. This statement is obviously not literally true, but it would certainly have broken the business models of many Internet Service Providers (ISPs) serving Netflix’s end users and would have resulted in its growth hitting a wall due to customer access.

Netflix’s strong technology skills have allowed it to both scale its service globally while preserving the business models of ISPs as partners needed to access its customers and provide a great viewing experience across differing networks and devices. Despite the single sentence description, underlying the statement were a series of difficult problems the Netflix’s engineers had to tackle over a period of years. By proactively investing in the technical ability to scale its service globally, Netflix transformed a potential headwind to its success (ISP cost economics as a barrier) into a tailwind of end consumer demand that it could partner with ISPs to ultimately satisfy in a way that benefited all three parties - Netflix, the ISPs, and the end consumers. In contrast, the incumbent media industry has yet to demonstrate the ability to LEVERAGE TECHNOLOGICAL CAPABILITIES to compete effectively with their service delivery.

Finally, and importantly, one of the big promises of an Internet based video service is the large selection of content it can make available to every user, but the selection value isn't optimized unless you can help individuals discover what they'd be interested in. Netflix has worked on personalization technology for over a decade so that every piece of content that it buys or licenses (at a fixed cost and time period) can be leveraged across as many users who would be interested in viewing it as possible (at zero marginal cost) driving engagement and ROI. On this point, the NETFLIX PRIZE contest in 2006 was one effort to crowdsource algorithmic enhancements with the goal being just a 10% improvement to Netflix’s internal
set, and even that proved to be a very challenging goal worth a substantial million dollar prize that drew many of the world's brightest intellects both for the challenge of beating the best algorithms Netflix could come up with but also to access the invaluable anonymized subscriber data set to work with (an early big data problem available to tackle). Such a seemingly small engagement increment can be worth much more when applied over billions of dollars of content investment.

Marketing capabilities are critical in effectively acquiring and retaining subscribers to drive scale. Netflix connects with consumers directly via the Internet, which means it has to have a cost efficient and effective online and offline marketing strategy to reach new subscribers – something it learned how to do when it initially built up its DVD business.

As an illustrative example of the importance of this capability, was the earlier mentioned launch of HBO NOW in April 2015, which managed to sign up only 5MM net new subscribers in its first 3 years through 2017 vs Netflix's 60MM. Netflix's ability to grow faster than an OTT service launched by one of the leading global brands with large capital and content resources (Time Warner) demonstrates how much faster its scale is distancing competitors, making it harder to catch up in the race to get to global scale. Though we believe there will be a handful of global scale media companies (Disney and Amazon are leading candidates but also Facebook and Google's YouTube), this growth advantage at scale that Netflix exhibits underpins our confidence that Netflix will be a leader among them.

Payment capabilities or rather, the lack thereof, are an important part of the friction Netflix has dealt with in many international markets. The lack of electronic payment infrastructures to pay for the service has driven Netflix to build the skills and partnerships necessary, on a market by market basis, to tap into alternative payment structures. Though not often discussed, it is a critical skill to effectively scale globally because being able to collect its monthly subscriber revenue, used to pay for ongoing content commitments, is at the heart of Netflix's or any other global media company's lifeblood. One reason that traditional media companies were regionally oriented was exactly this challenge, in our opinion, instead of choosing to partner with local distributors at highly discounted rates, accepting much lower "market" prices in international markets while Netflix's control of payment allows it to be more capable of directly discovering the market price in real time, market by market. Its early launch in Latin America in 2011 was effectively an investment by the company to gain important learnings on how to effectively get paid for its service in countries without developed electronic payment systems.

Source: Company reports

3. Content is the Product

that Netflix is ultimately delivering to its customers, with which it must drive engagement to realize its service's value for all stakeholders. Although Netflix launched its service by solely licensing third party content, over time it has had to develop to ability to source and produce original content for its service as its scale and scope grew. While the bear story had always been that either Netflix's content catalog was undifferentiated or that the third party incumbent media companies would cease licensing their content when its scale grew to be threatening, we believe STARZ' REFUSAL TO RENEW ITS CONTENT LICENSE with Netflix in 2011 made it clear that in-house content capabilities would be required over time.

This would allow Netflix to competitively source content either internally or externally using the billions of dollars “streaming” in every year from subscribers, giving it both the option to go directly to content producers but also better ensure the viability of its third-party licensing partnerships through coopetition instead risking being left in the lurch by
media owners based solely on dependence (discussed further below).

While it was able to access content just as any other distributor was able to early on, as its success grew and as more incumbents began to notice its success and momentum, the risk of losing access to third party content grew. After recouping the cost of owned media during their first run window, Netflix's licensing payments were lucrative high margin incremental revenue for traditional media companies syndicating owned content, making it hard for them to walk away from Netflix despite the threat of disruption looming in the future. However, due to the threat of someday losing access to the third-party content (as the case was with Starz in 2012 and will be with Disney's owned content beginning in 2019), Netflix took on the development and licensing its own original content. Amazingly and to everyone's surprise, its first forays into originally produced content were award winning hits, a phenomenon that continues to this day.

Producing its own content has the added scalability benefits of retaining global rights (vs traditional staggered period regional rights licensing traditionally practiced) and leveraging its proprietary treasure trove of viewer data to select and price content its subscriber subgroups would find attractive. That capability contrasts with traditional media companies' reliance on appealing to broad audiences (ratings) along the lowest common denominator of interest because they lack detailed audience viewing data and the supply limitations of an appointment based, linear TV viewing technology. Though this was a good economic model in the past, the ability to create more targeted, higher value (potentially lower cost under-monetized niche) content for smaller groups of audiences (with visibility down to the individual user) and let them access the content whenever, wherever obviates traditional television's supply limitations while increasing engagement based on successful personalization. In the chart below, note that Netflix has organically grown to become the most engaged network on a per subscriber basis, and will only be surpassed by the merger of two incumbents, Disney and Fox, in a deal that has yet to close.

Furthermore, as it’s rolled out its service globally, Netflix has also created the capability to source content globally (sometimes required by regulation in certain locales) and redistributing it to subscribers in foreign geographies that would never have sought it out for lack of awareness. This data driven targeting/marketing capability uniquely provides Netflix's the capability to drive viewer demand for its content investments across a global audience (increasing scale of demand) while increasing both the pool of its content supply (lowering overall cost) while better pricing the value of each piece of content pays.
As a result, the global data-driven capability gives Netflix a huge advantage over incumbents in driving higher ROI on its content portfolio while increasing subscriber engagement. Which means it makes sense to invest a lot more in its content portfolio than it would have for traditional media companies. The more content it can profitably license or produce, the more attractive the service to both new and existing subscribers, which drives user engagement, greater revenue, and future content budget. This value enhancing virtuous cycle has driven Netflix to continue investing all its cash generated from operations, and more via debt raises, because it's been working effectively at generating continued subscriber growth. Making the controversial strategy even more rational is the fact that the capital markets have offered the long-term debt at LOW COST. So long as that remains the case and subscriber growth and engagement warrant it, we believe this is the optimal value creating strategy because it accelerates Netflix’s content moat scale, making it harder for all but a handful of competitors to catch up to its growing global scale.

4. **Scale is ultimately the economic moat** and we believe that Netflix passed that tipping point a couple of years ago. It allows Netflix to present a compelling offer to new subscribers and retain existing subscribers. It allows it to compete effectively for the content it feels is most compelling for its subscribers and its economic model. Ironically, it also enhances Netflix’s ability to source content from most sub-scale media incumbents when exclusivity is not a priority.

Scale allows Netflix to pay the most for any particular piece of content that it feels is compelling to own exclusive global rights to, while costing it the least on a unit (per hour per sub) basis given its global subscriber size and massive engagement. Subscale incumbents, i.e. everyone except a handful like Disney+Fox (DIS, FOXA), Comcast (CMCSA), and Time Warner (TWX), have no choice but to continue licensing content to Netflix or one of the handful of other Global players that will emerge. If they do not cooperate, there is the threat that Netflix could go directly to the talent behind sought after content with its available, uncommitted budget as recent high profile deals with SHONDA RHIMES, RYAN MURPHY, Will Smith, Adam Sandler, Seth Rogan, and others have demonstrated, and cut out smaller media companies entirely from the most engaging known content producers. On the other side of the content

---

**Exhibit 1: Estimated FY18 content spending for digital and traditional media companies (shaded indicates companies after prospective M&A transactions; $91bn excludes double-counting of merging entities)**

---

[Source: RBC Capital Markets]
budget equation are the content creators who would love to get paid more, with more creative freedom, and potentially get distribution to a much larger global audience. It vaults Netflix into one of the premier content producers that content creators want to partner with.

The "godfather of cable" John Malone, one of the most strategic leaders in Media and was literally one of the architects of cable television service business in the US, has even admitted that it’s too late for incumbents to catch up to Netflix because of its scale and that the Media business' scale is now measured on a Global level.

"DAVID FABER: And-- you know, I’m curious, given your experience, having been one of the founders of that world to a certain extent 40-some-odd years ago, this ecosystem, are we at a point that’s sort of unlike anything you’ve seen in the past?

JOHN MALONE: Well, I would say the biggest change is the globalization, which was really empowered by the standardization of the internet. I mean, we never used to have a global footprint and global standards against which you could create software, hardware services... So I’d say in my—in my career, that’s the biggest change, is the denominator is up by at least a factor of ten to one in terms of scale. And what that does is it makes scale even more important in a media business where scale always was important... it’s all about, you know-- can Netflix get enough scale that nobody really can challenge them? Can they figure out how to use that scale?

DAVID FABER: You had been arguing for years that the cable companies should have banded together, figured out a Netflix-like service. It’s too late now?

JOHN MALONE: It’s way too late... So, you know, his scale, the ability to create content to scale. I mean, if you think about it, three years ago, HBO was the biggest, most powerful thing in the-- in the-- premium entertainment category. They spent I think two and-- $2 billion to $2.5 billion on content. They're now dwarfed.

DAVID FABER: Netflix will spend $8 billion next year.

JOHN MALONE: and beside that, HBO is essentially only a domestic distributor. So they don't have the global platform under them. And, while they can syndicate or sell their content to foreign distributors, it-- it-- it is not nearly as strong a business model as being able to know the customer, deliver the stuff directly, and control the pricing at which your product is delivered. So-- and having all the information about the consumer and their habits-- which in Reed's case, he's not using for advertising at this point, but he certainly can use that to optimize his programming. So I-- I think he's done a brilliant job of-- of building that business.

JOHN MALONE: Scale is-- is very, very powerful when you’re producing something that has a high fixed and very low variable cost. So when you get to a point where your marginal cost is $0, profitability is enormous as you scale up." [emphasis added]

Source: CNBC

The irony is that Starz, which Malone had a controlling stake in before merging it with Lionsgate Films (LGF), was the first to have cheaply license its content to Netflix, giving it the "starter" content it needed to begin building its streaming offering in 2007.
The last point Malone makes is a critical one to understand when it comes to Netflix’s choices made in recent years, where management has chosen to invest at higher than sustainable rates to drive growth and scale in content and customer acquisition. Given the fixed cost nature of content and the scale necessary to break away from the traditional competition in getting to global scale, we believe management is following the right strategy in building the business to capture a large portion of the global subscriber opportunity as quickly as it can, including borrowing in the capital markets at a reasonable rate.

Note that among the large (as yet unmerged) companies, Netflix has the fastest growing content budget, demonstrating the compounding power of its subscriber scale on revenue and content spending budget.

With its fast-growing global business, Netflix is poised to be the largest global non-sports content buyer.

Source: Company Reports and Ensemble Capital Management
In fact, when ranked by subscribers, Netflix is now the 2nd largest paid video service provider globally! And given the scaling advantages of an internet delivered OTT service, we believe, likely to grow to become the largest provider over the next 5-10 years.

We believe the scale of the global opportunity is to capture about half of all smartphone users (excluding China where partnerships/licensing with local companies are likely to be the more limited form of entry), which we estimate to be about 1B high end users (the iPhone+high end Android user) and about 2B mid-tier users (primarily Android) for a total of 2-3B of the 5B total users estimated by 2020. By our estimates, Netflix’s opportunity is a $100-200B revenue per year opportunity ahead.

The tests of a moat are both the ability to sustainably create value for customers and capture a fair portion of it for shareholder returns. While Netflix’s profitability has been low for the past few years and free cashflow negative, we believe that has been the cost of scaling the business quickly during a window of opportunity that Netflix correctly identified and executed on.
This thesis has been validated by two distinct observations:

The first is the underpricing of its service relative to the value it provides, leaving quite a bit of consumer surplus on the table that has underpinned its very fast subscriber adoption for years. We observe their consumer surplus by tracking consumer engagement and quality of the content being offered presented earlier as well as the amount of content investment per monthly dollar of ARPU and the hourly cost of viewing content on Netflix relative to other content networks shown below.
Clearly subscribers have been getting a great deal for a highly engaging and desirable service with Netflix’s priced at $10-11 per month ARPU (maybe half that if shared). Netflix has been playing a long term strategic game on pricing, deliberately underpricing in order to grow its subscribers rapidly (low cost of trial/entry, great value to signing up and staying for habit creation, “Netflix and Chill”), while over-investing to scale its content moat before better financed incumbents and new entrants had an opportunity to do so.

The second observation is that Netflix has been able to successfully raise prices three times since 2014 without significantly impacting its longer-term growth trajectory demonstrating to us that there exists a significant consumer surplus that motivates new subscribers to continue signing up at such a rapid pace.

We can see the demonstration of our thesis in the increasing proportion of value Netflix is capturing in its maturing US market, which is poised to grow in the mid- to low-single digit percent over the next decade from 53MM subscribers, where its gross margin has increased to 46% in 2017 from 29% in 2012 and contribution margin to 37% from 17% as "household" penetration closes in on 50%. The contribution margin is comprised of the profit after accounting for the directly attributable costs to the US business segment like content costs and marketing costs but not the unattributable corporate costs like G&A and R&D, which together accounted for 16% of total revenues.

Its less mature, fast growing International business segment, which grew paid subscribers 40% to 59MM subscribers in 2017 and is poised to keep growing rapidly, earned a gross margin of 19% and contribution margin of 4.5%, but we expect this to improve over the next decade to near US levels as growth matures. Clearly it makes sense to invest aggressively in content and marketing to continue driving the international growth given its very low penetration of 58MM paying subscriber "households" relative to the available market we estimate to be 2-3B potential users (translating to about 1B subscriber "households", which happens to equate to the number of global Pay-TV subscribers).

While Netflix has achieved a scaling tipping point in the US on content spend, it has yet to do so in International even though we believe it has the subscriber growth momentum to do so (one reason for Amazon’s AGGRESSIVE INTERNATIONAL PRICING to try and stymy Netflix’s scale momentum).

Source: GlobalWebIndex
In concluding, we believe that Netflix has accumulated the competencies necessary to succeed in the new Internet-enabled global media landscape. A core part of this has been its cultural ability to reinvent and invest in the capabilities necessary to bring its long-term vision of INTERNET TELEVISION to the world and one that continues to serve the company as a core strength. The changes that the Internet wrought to the Media industry are just now being felt as Pay TV subscribers in the US fall to new lows while younger segments of the population demand increasing convenience, choice, and value to sign up. As OTT penetration increases in the Europe and other parts of the world, not only will Pay TV feel the competitive pressure but more importantly, a larger opportunity will build due to the broader distribution of that all-purpose device, the Internet connected smartphone, which brings accessibility and scale efficiency of high quality video entertainment to a much larger swath of the world at a much lower price that traditional, wireline connected Pay-TV service (accelerated by “password-sharing”!).

Clearly, we're at the front end of the shape the industry will take over the next decade. We believe analyzing the core competencies and success factors behind Netflix's rapid rise leveraging the new technology indicate to us that moats will exist if companies are able to accumulate the set of skills necessary for the new media world and scale quickly enough. However, we believe that most incumbents will not be successful in doing so if they haven't developed most of those capabilities at this point because newer platform players like Amazon, Facebook, and Google have and they are moving fast to pursue the global media opportunity. We think that it will be a handful of winners that take most of the market while there will be room for numerous niche high value, highly targeted content providers as well. Among them, we believe Netflix has already made the leap across the scale threshold and will be one of the few winners in this trillion-dollar global industry.

For the traditional US Pay-TV service, its increasingly clear we're watching the FINAL CONTDOWN heading into a dramatic transformation of the industry!

Source: recode
Source: Company reports, MoffettNathanson estimates and analysis

Source: MoffettNathanson
DISCLOSURES

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities listed above. The performance information shown above has been calculated using a representative client account managed by the firm in our core equity strategy. This chart reflects the full list of securities in the core equity strategy for the quarter ended 3-31-2018. Information on the methodology used to calculate the performance information is available upon request. The performance shown in this chart will not equal Ensemble’s composite performance due to, among other things, the deduction of fees and expenses from the composite performance and the timing of transactions in Ensemble’s clients’ accounts.

ADDITIONAL IMPORTANT DISCLOSURES

Ensemble Capital is an SEC registered investment adviser; however, this does not imply any level of skill or training and no inference of such should be made. The opinions expressed herein are as of the date of publication and are provided for informational purposes only. Content will not be updated after publication and should not be considered current after the publication date. We provide historical content for transparency purposes only. All opinions are subject to change without notice and due to changes in the market or economic conditions may not necessarily come to pass. Nothing contained herein should be construed as a comprehensive statement of the matters discussed, considered investment, financial, legal, or tax advice, or a recommendation to buy or sell any securities, and no investment decision should be made based solely on any information provided herein. Ensemble Capital does not become a fiduciary to any reader or other person or entity by the person’s use of or access to the material. The reader assumes the responsibility of evaluating the merits and risks associated with the use of any information or other content and for any decisions based on such content.
Netflix and the Rise of Global Media
Arif Karim, CFA
June 26, 2018

All investments in securities carry risks, including the risk of losing one’s entire investment. Investing in stocks, bonds, exchange traded funds, mutual funds, and money market funds involve risk of loss. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable or suitable for a particular investor's financial situation or risk tolerance. Some securities rely on leverage which accentuates gains & losses. Foreign investing involves greater volatility and political, economic and currency risks and differences in accounting methods. Future investments will be made under different economic and market conditions than those that prevailed during past periods. Past performance of an individual security is no guarantee of future results. Past performance of Ensemble Capital client investment accounts is no guarantee of future results. In addition, there is no guarantee that the investment objectives of Ensemble Capital’s core equity strategy will be met. Asset allocation and portfolio diversification cannot ensure or guarantee better performance and cannot eliminate the risk of investment losses.

As a result of client-specific circumstances, individual clients may hold positions that are not part of Ensemble Capital’s core equity strategy. Ensemble is a fully discretionary adviser and may exit a portfolio position at any time without notice, in its own discretion. Ensemble Capital employees and related persons may hold positions or other interests in the securities mentioned herein. Employees and related persons trade for their own accounts on the basis of their personal investment goals and financial circumstances.

Some of the information provided herein has been obtained from third party sources that we believe to be reliable, but it is not guaranteed. This content may contain forward-looking statements using terminology such as "may", "will", "expect", "intend", "anticipate", "estimate", "believe", "continue", "potential" or other similar terms. Although we make such statements based on assumptions that we believe to be reasonable, there can be no assurance that actual results will not differ materially from those expressed in the forward-looking statements. Such statements involve risks, uncertainties and assumptions and should not be construed as any kind of guarantee.