

The Disruptor's Dilemma

Will Dragon

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What to make of Netflix, the popular video-streaming and DVD-by-mail service provider? What began as an unpopular 60% price hike earlier this summer quickly spiraled into a catastrophic public relations and shareholder confidence crisis. But, before we implicate Netflix as a market leader that failed to understand what its customers wanted, let's take a closer look at the role industry dynamics played in this saga.

Netflix CEO Reed Hastings reacted to customer backlash to the firm's price increase with an awkward and hastily generated mea culpa, which he emailed to subscribers on September 18th. In that message, Hastings also announced that the firm was splitting its services into two operationally distinct entities, renaming the DVD-by-mail business Quickster while keeping the Netflix brand for the streaming service. This sent Netflix's already embattled stock price into a steeper nose dive, further eroding the firm's value; its share price is down nearly 70 percent in the past three months.

By early October, Hastings had already reversed his decision to bifurcate the firm. Unfortunately for Netflix's investors, Hastings' recant hasn't been enough to soothe worried markets nor stem the tide of subscriber defections. Netflix recently announced that it had lost more than 800,000 subscribers over the summer.

Netflix's missteps aside, though, it's worth remembering how Netflix came to be and the circumstances behind its ascendancy. In the late 90's Hastings and his partner understood the frailty of Blockbuster Video's business model. The high fixed costs associated with bricks and mortar as well as the outsized payments the firm was making to Hollywood studios had consigned the firm to near unprofitability for almost a decade. Netflix simply did away with the high operating costs associated with Blockbuster's business model. The irony of the current situation, of course, is that Netflix has emboldened competitors, including Blockbuster, a firm that Netflix was instrumental in bringing to the brink of bankruptcy.

But the real story here is not the opportunities presented to Blockbuster and other competitors by Netflix's missteps. The real story is that Hastings once again has his eye to the future and is trying desperately to avoid

becoming the next Blockbuster. The future of video is in direct-to-TV streaming, not DVDs in red envelopes. Viewed in this light, Netflix's erratic behavior is somewhat more understandable.

The company's actions were not those of an industry leader that lacks a fundamental understanding of the competitive environment. Rather, the company's actions more closely mimic those of an organization that is acutely aware of the precariousness of its own position. While Hastings is guilty of mismanaging the public image of Netflix, he is not guilty of misunderstanding the dynamics of a complex, adolescent, and evolving industry. What Hastings understands -- and what many pundits have lost sight of -- is that the struggle to identify the business model that will succeed in the online video market has not yet been resolved.

Netflix may have an advantage in the internet video market right now, but only time will tell if Netflix's business model will survive the uncertainty ahead. That is what Netflix is focused on, positioning the streaming video side of its business for success. Netflix's error was underestimating the importance of the DVD business to its long time subscribers -- even if that business is a stop-gap to the future.

And so for now the dance between Netflix, Blockbuster, Hollywood, and other competitors continues. And while Netflix and Hastings are certainly down right now, it would be foolish for others to consider them out. It goes to show you that the dynamics of an industry are often just as important as the competitive environment. How industries are configured can play a significant role in determining, not only the rules of the game, but also their winners and losers -- and that is the disruptor's dilemma.

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