



Aalto University
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The motivations for Netflix to vertically integrate its business model

Why Netflix began the production of Netflix Originals

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Abstract

Technological advancements of the internet and internet connected devices resulted in the convergence of media, telecommunications, and informatics. This caused a disruption in the US entertainment industry and allowed the aggregation of content to bypass traditional channels to customers. It also provided an opportunity for new entrants to enter the entertainment industry in the form of over-the-top (OTT) services, such as Netflix in 2007. However, Netflix did not remain as a pure content aggregator over the internet. Instead Netflix vertically integrated its business model by producing exclusive content, Netflix originals, in 2012. Since then, Netflix has continuously increased their investments into Netflix originals, which is a marked departure from its previous business model. Hence, the objective of this thesis, a literature review, is to identify the advantages and motivations of Netflix to produce content and vertically integrate their business model.

Netflix's motivators and advantages were divided into two categories, the ecosystem motivators and the new digital advantages of OTT services. To understand the ecosystem motivators, the ecosystem and its changes, due to Netflix's business model changes, are first overviewed and analysed. The thesis primarily studies the ecosystem of the major players of the US entertainment industry ecosystem, due to its relative significance. The main trends in the industry that were discerned, was the increasingly vertically integrated entertainment industry as a whole and the increasing of the content scarcity strategy. Since the thesis is attempting to identify insights regarding Netflix, an analysis of the top five risk factors from Netflix's annual reports during 2007-2018 is conducted. This is complimented with traditional competitive motivations for vertical integration (i.e. platformization, vertical integration advantages, horizontal integration, content scarcity and differentiation) in order to find the ecosystem motivators for Netflix.

Netflix's inherent digital advantages, as an OTT service, are subsequently reviewed. The capabilities identified are the new data capabilities of OTT services, the long tail content diversity strategy opportunity, and the international scalability of digital services. The thesis concludes by drawing upon the ecosystem motivators and digital capabilities to determine; why Netflix vertically integrated their business model prior to the rest of the industry.

Keywords Netflix, OTT service, entertainment industry, vertical integration

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1 Introduction

The television and film entertainment industry is experiencing a disruption by Netflix and other over-the-top (OTT) services (Evens 2012). Another similar disruption is occurring in the music industry, streaming music with Spotify (Fox et al. 2010). This transitional phase has many implications for industry incumbents, which have begun adapting to the arrival of OTT services (Fudurić et al. 2018). For OTT services are challenging the existing power structures in the TV/film entertainment industry (e.g. cord-cutting where customers discontinue cable services in favour of OTT services) and creating conflicts of interest in the industry value chain (Ballon & Evens 2014).

On the 24th of May 2018, Netflix briefly surpassed Disney and all other pure media companies globally in market capitalization (Sonenshine 2018). Furthermore, Netflix is currently the world's leading internet delivered television company with 148 million subscribers in over 190 countries, in 2018 Q4 (Netflix 2019a). This is an impressive feat from a recently relatively internationally unknown DVD-rental firm and shows the impact of the OTT service disruption.

Netflix was founded in 1997 and originally operated as an offline movie rental business. In 1999, Netflix changed their business model for the first time, to one that offered a monthly subscription service for unlimited DVD rentals. This model remained until 2008, when Netflix took advantage of the ongoing technological convergence occurring on media, and digitalized their business model by starting an OTT service, a subscription video-on-demand (SVOD) streaming service using licensed content. (Radosinská 2017) In 2010, Netflix started their international expansion by expanding to Canada. In 2012 Netflix changed their business model yet again, by producing or co-producing their own exclusive content also known as Netflix originals. Currently, in 2019, Netflix has spread throughout the entire world, and have since then even won multiple Emmy and Academy (Oscar) awards and with their own content.

In 2012, Netflix's original content totalled to 8 hours, whereas, in 2017 they released 1257 hours of exclusive content, as seen in Figure 1. In 2018, Goldman Sachs estimated that Netflix spent approximately between \$12 and \$13 billion on original content and by 2022 Netflix is expected to spend annually \$22.5bn on content (Economist 2018). To put it in perspective, it would be close to the current total of content spending by all other entertainment industry players in the US (Economist 2018). Additionally, Netflix is

currently planning to open their own studio in New York, which will cost up to 100\$ million in investments (Spangler 2019a). Hence, Netflix's significant investment into their own content and content production is a major departure from their previous business model of aggregating licensed content.

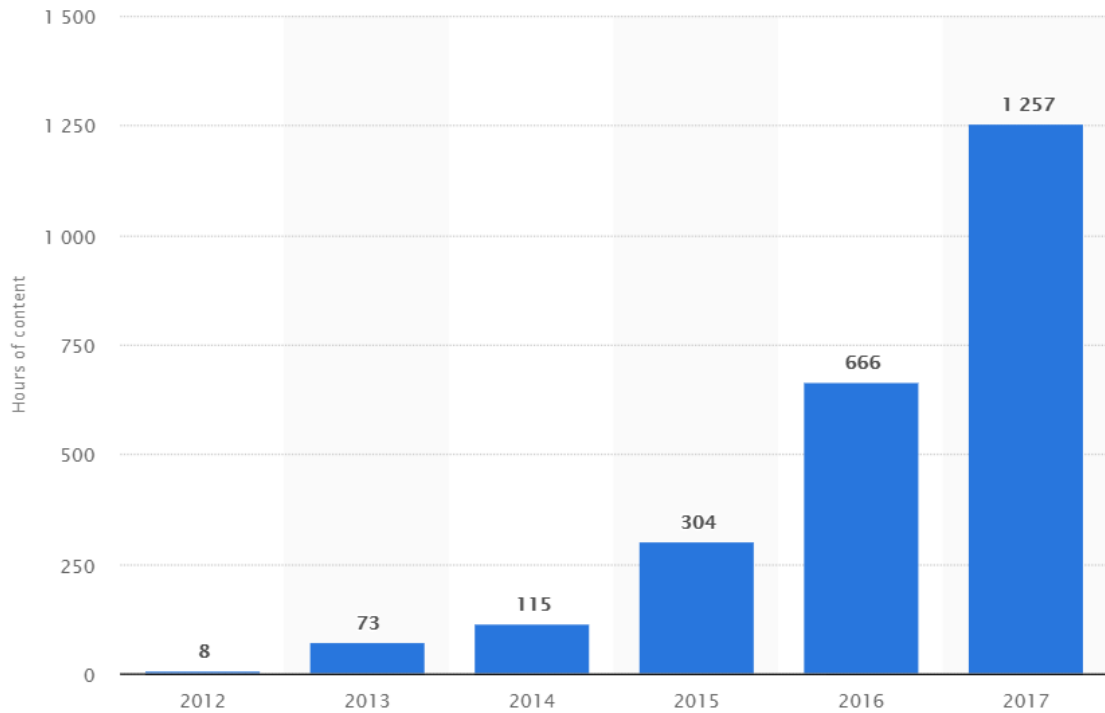


Figure 1. The number of hours of original content produced by Netflix worldwide from 2012 to 2017 (in hours) (source: IHS Markit 2018)

1.1 Research objectives and research questions

The rapid rise of Netflix, and their business model adaptations have seen interesting developments on the television entertainment industry. The current OTT service market is a relatively new development (e.g. Netflix entered the OTT market in 2007), and hence research in OTT services and their effects on the entertainment industry and vice versa is fairly limited (Kim et al. 2017). Thus, the objective of this thesis is to further the research on OTT services and to find the potential motivations of Netflix's business model change. Netflix's transformation from a pure digital content distributor of licensed content into additionally investing into their own exclusive content, is an interesting and topical topic.

The thesis will answer the following research questions:

RQ1: How has the US entertainment industry changed during and after Netflix's business model changes?

RQ2: What are the US entertainment ecosystem motivators for Netflix's business model changes?

RQ3: What are the digitalization motivators for Netflix's business model changes?

1.2 Scope of research

This thesis will primarily focus on the US entertainment industry and its effects on Netflix's motivations to transform its business model to a vertically integrated model. Furthermore, the thesis focuses on the primarily on the US perspective due to the entertainment industry being the most relevant there, for the major players in the industry are US based players. However, Netflix's international importance will be considered briefly in the thesis, to add perspective to Netflix's choices. Since the OTT industry is an information and service industry, the second main perspective the thesis considers is the digital motivators for Netflix. Hence non-industry specific motivators and non-digital specific motivators will be disregarded.

Additionally, only the main players of the US ecosystem industry will be analysed, and other OTT industry players which have a significant business model differences such as Youtube (e.g. their content is mainly user originated) will be left out of the scope of this thesis.

1.3 Methodology

This thesis is conducted as a literature review of articles that have relevance to the OTT services or Netflix, which have ecosystem or business strategy aspects involved. Since the industry is rapidly changing (e.g. Disney's acquisition of Fox assets, and news of several upcoming OTT services occurred during the formulation of this thesis), a significant portion of the articles are chosen on the basis of recency and some news articles have been used for OTT service change-related information. The scholarly articles were primarily (~95%) discovered using the Scopus database and the remaining (~5%) of the articles were discovered using google scholar. Additionally, most of the graphs used were found using Statista.

1.4 Structure of the research

Chapter 2 explains the relevant US entertainment industry's players. Chapter 3 examines the changes of the US entertainment industry ecosystem. Chapter 4 overviews the advantages of Netflix's business model changes. Finally, Chapter 5 will present conclusions based on the thesis.

2 Entertainment industry ecosystem definitions

The US entertainment industry ecosystem, from creating the content to the screens customers use, can be divided in many ways into many different sectors. For example, in Figure 2 Evens (2012) models it with content suppliers, network managers, OTT distributors (cloud), and the media device providers. In Figure 3 Ballon & Evens (2014) model it with producers (i.e. content suppliers), broadcasters (i.e. rights/license holders and distribution over-the-air), distributors (i.e. further/more distribution), OTT players and the audience. Since the entertainment industry has numerous companies, this thesis will focus on the ecosystem of the main players in the US in order to simplify the model.

	Content	Network	Cloud	Device
Key resources	Content rights	Network capacity	Find, play and share	User experience
	Brand name	Customer base	Global reach	Customer data
Main risk	Piracy	Bit pipe	Throttling	Alliances
Companies	Disney, Fox, BBC, Mediaset, HBO	Cablevision, AT&T, BSKyB, BT, Orange	Google, Netflix, Facebook, Yahoo	Samsung, Apple, Sony, Microsoft

Figure 2. Companies, key resources and risk in the broadband television ecosystem (source: Evens 2012)

Thus, in this thesis broadcasters and content producers will be in parts combined and the broadcaster distribution over-the-air will not be a significant part of the ecosystem. Distribution will be known as network and the differentiation of the network types will not be significant; audience and device will be interchangeable. Due to the device players not being significant enough, they will fall beyond the scope of thesis.

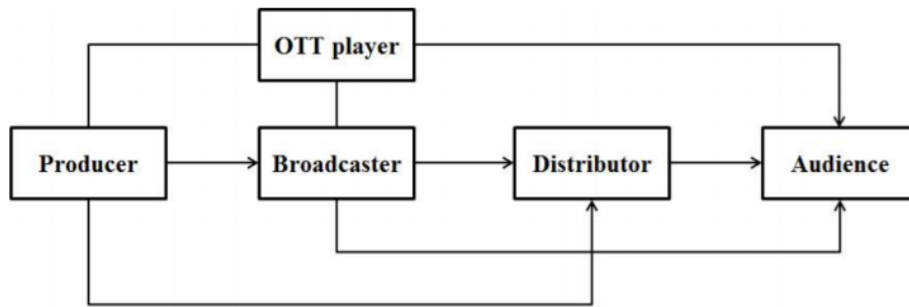


Figure 3. The Audiovisual value chain (source: Ballon & Evens 2014)

To understand the current television entertainment industry and its changes, it is clearest by first overviewing the ecosystem of the industry players. The television and film entertainment industry is a complex industry (Evens 2012), and is known with many terms in the literature, for example the audiovisual industry or the entertainment media industry. In this thesis, the term entertainment industry will mainly be used.

The rest of this chapter will explain industry and other relevant terminology in the following subchapters.

2.1 OTT Services

Over-the-top (OTT) services are internet-delivered television content distributor companies, although the definition details may vary according to interpretation (Radosinská 2017; Kim et al. 2017). OTT services in the entertainment industry are also known as subscription video-on-demand (SVoD) or video streaming services. This thesis will use OTT service for standardisation.

Prior to fast broadband speed and devices being capable of streaming high enough quality, television content was distributed by cable, broadcasting (over-the-air) or by satellite (Kim et al. 2017). The interpretation from FCC (The US Federal Communications Commission) specifies, that OTT services offer video content through an internet or other Internet Protocol based transmission path, which is not also provided by the OTT service (Kim et al. 2017). Hence, OTT services are television content distributors, which do not own any transmission infrastructure, such as the cable or satellite companies. However, network companies have now expanded to OTT services recently, making this definition susceptible. Nevertheless, the OTT players are a significant addition to the entertainment industry ecosystem, for “*The global OTT*

market has grown significantly from \$4.2 billion in 2010 to \$21 billion in 2014 and is expected to reach \$51.1 billion by 2020” (Kim et al. 2017).

The current main US OTT services include, Netflix, Hulu, Amazon, Youtube and HBO Go (Fluent 2017). However, these distributors vary by showing primarily professionally generated content or user created content, and whether they are subscription based or also include a freemium model of revenue (Kim et al. 2016). Additionally, Hulu and HBO Go are owned by industry incumbents. Due to the scope of this thesis we will only be considering mainly professionally generated content services, hence Youtube will be left out.

2.2 Network

The network sector consists of telecommunications, cable and satellite companies. Prior to the recent industry changes, these companies operated by providing further transmission opportunities for the broadcaster sector.

Telecommunications companies, who maintain the broadband internet connection, transmit IPTV from broadcasters. IPTV is TV/film aired through telecommunication connections, whereas prior it was aired through copper cable networks. Some definitions use IPTV for OTT services, however, others use it primarily for broadcasted content. Currently, the disruption entertainment industry disruption has increased the use of IPTV (broadband TV) due to the increased internet connected devices used by end users. Hence, the over-the-air transmission broadcasters used to transmit their content are losing relevance. (Evens 2012) Additionally, the increased use of IPTV has cannibalized the use of copper cable networks and satellite infrastructure, regarding the network companies.

Since OTT services use a broadband network for their services, the network companies also have a special relationship in regards to OTT services (Evens 2012). For example, in the article by Stocker et al. (2017) it is mentioned that Netflix is responsible for approximately one third of the peak Internet traffic on US fixed networks. Hence, abiding by net neutrality principles (i.e. network companies treating all internet communications and speed equally) can have important implications for the ecosystem, however, this falls beyond the scope of the thesis.

The main US entertainment players from the network sector are Comcast (cable) and AT&T (telecommunications).

2.3 Broadcasters and Content Producers

The main function of broadcasters prior to OTT service introduction, was acting as an intermediary role as license holders to content and distributing the content over-the-air or further distributing it with network companies (Evens 2012). Although, in the context of this thesis, the main broadcasters are also historically major content creation companies and the relevance of independent content producers is minimal. Independent content producers (studios) still exist, their function is to create content and license these to distributors, which were in the past the broadcasters.

The current main US entertainment players, which are broadcasters and content producers are Disney and National Amusements.

2.4 Other relevant definitions

In this thesis **Netflix originals** are Netflix's own exclusive content. Currently, Netflix originals are created by other production companies, which is produced or sometimes co-produced by Netflix. Nevertheless, there is some content that Netflix promotes as original content, which is actually content exclusive in a particular market (Wayne 2017). For example, in the US the Norwegian show Nobel is promoted as a Netflix original even though it was produced for the Norwegian Broadcasting Corporation (NRK) (Wayne 2017). Netflix has also begun investing in their own studios, thus, Netflix will soon fully produce and create their own content (Aguiar & Waldfogel 2018; Spangler 2019a). It has previously produced content in a studio it created called the Red Envelope Entertainment during 2006-2008, although, it was not a significant investment.

Vertical integration is the expansion of the company's operations upstream or downstream the value chain beyond their initial operations (Kenton 2018). For example, in the value chain of a groceries where a company's initial operation is a grocery shop, the company can vertically integrate by expanding their operations into producing groceries. In this thesis, this is akin to Netflix expanding into Netflix originals. **Horizontal integration**, on the other hand, is to further expand in their current operations (Kenton 2019). For example, a grocery shop buying another grocery shop. This is similar to Disney acquiring another content producing company's assets, such as the acquisition of 21st century Fox assets.

3 The disruption in depth and ecosystem changes

This chapter will first focus on the US ecosystem changes, due to the US market's significance in the entertainment industry (Canacine 2019; MPAA 2019). In order to keep the thesis compact, the changes will be focused on the most significant entertainment companies. Nevertheless, the implications of Netflix's expansion abroad are important, hence the foreign entertainment industry ecosystems will be briefly overviewed.

3.1 The disruption

The technological convergence disrupted the decades stable television industry, which previously had relied on their transmission infrastructure, and distribution deals with other satellite, cable operator or broadcasting companies. The disruption was caused, by the technological advancements of the internet and internet connected devices, which further caused the convergence of media, telecommunications, and informatics. This allowed the aggregation of content through the Internet and has allowed content to bypass traditional channels to customers, hence providing an opening for new entrants to the market. Traditional network channels such as satellite and (TV) cable infrastructure were able to be replaced with internet broadband (telecommunications) channels, hence weakening the importance of cable and satellite. Even though network companies still owned the telecommunications channels, due to net neutrality principles OTT services can bypass the network companies' position in regards to customers. (Evens 2012; Daidj & Egert 2017)

Netflix managed to secure a market position in the US, before being prevented by the local incumbents, yet their expansion strategy did not stop there. The company expanded their territory to Latin America, most of Europe and a couple Oceanic/Asian countries, and to worldwide availability in, 2011, 2012-2015, and 2016, respectively (Radosinská 2017). As mentioned in the introduction and shown in Figure 1 and 4, this global expansion has been accompanied with investments in Netflix's own exclusive content and content production, hence a vertical expansion of their business model. Netflix aired their first exclusive content in 2012, which totalled in 8 hours of content, whereas, in 2017 they released 1257 hours of exclusive content.

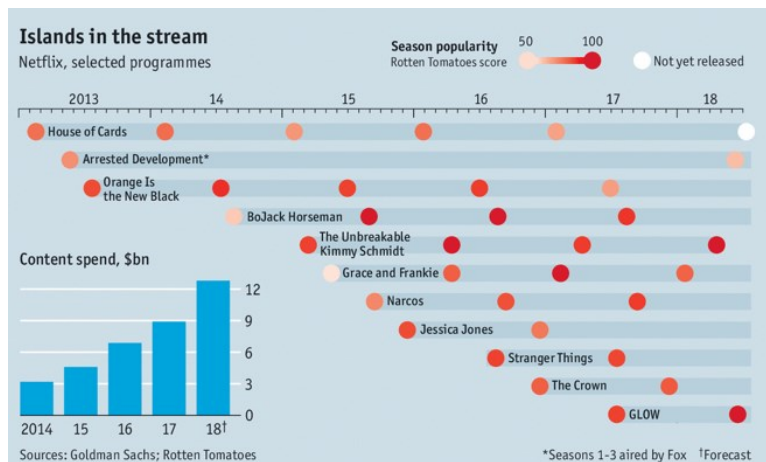


Figure 4. Content spending by Netflix and a visualization of the amount of popular shows increasing (source: Economist 2018)

In the beginning of the OTT service disruption of the entertainment industry, OTT services were more differentiated from traditional services by being the sole users of internet streamed video (Radosinská 2017). Nevertheless, due to the unique capabilities (e.g. VOD, scalability) of OTT services, the OTT market is continually growing and predicted to grow over 100 % between 2014-2020 (Kim et al. 2017). The disruption possibilities (i.e. by bypassing network companies) of OTT and the success of Netflix and investments into their own content, has caused other entertainment industry players to have expanded out of their sector into OTT and content creation (Kim et al. 2017).

3.2 US ecosystem changes

In 2017, the US television entertainment industry was dominated by six conglomerates: Comcast, 21st Century Fox, Disney, Viacom, Time Warner, and CBS (Wayne 2017). Although, since then the industry has seen some changes, such as the acquisition of a major portion of Fox entertainment assets (21st century Fox assets) and the acquisition of Time Warner by AT&T. Wayne (2017) also did not mention that both Viacom and CBS are subsidiaries of National amusements. Furthermore, in 2017 the main programming expenditures show Amazon as a significant player (Redcode 2018; Wayne 2017). Amazon is also the second most subscribed OTT service, due to being the only other significant internationally operating OTT service (eMarketer 2019). Hence, I will illustrate the vertical (and horizontal) integration changes in my ecosystem analysis by Netflix, National Amusements, AT&T, Comcast, Disney, and Amazon.

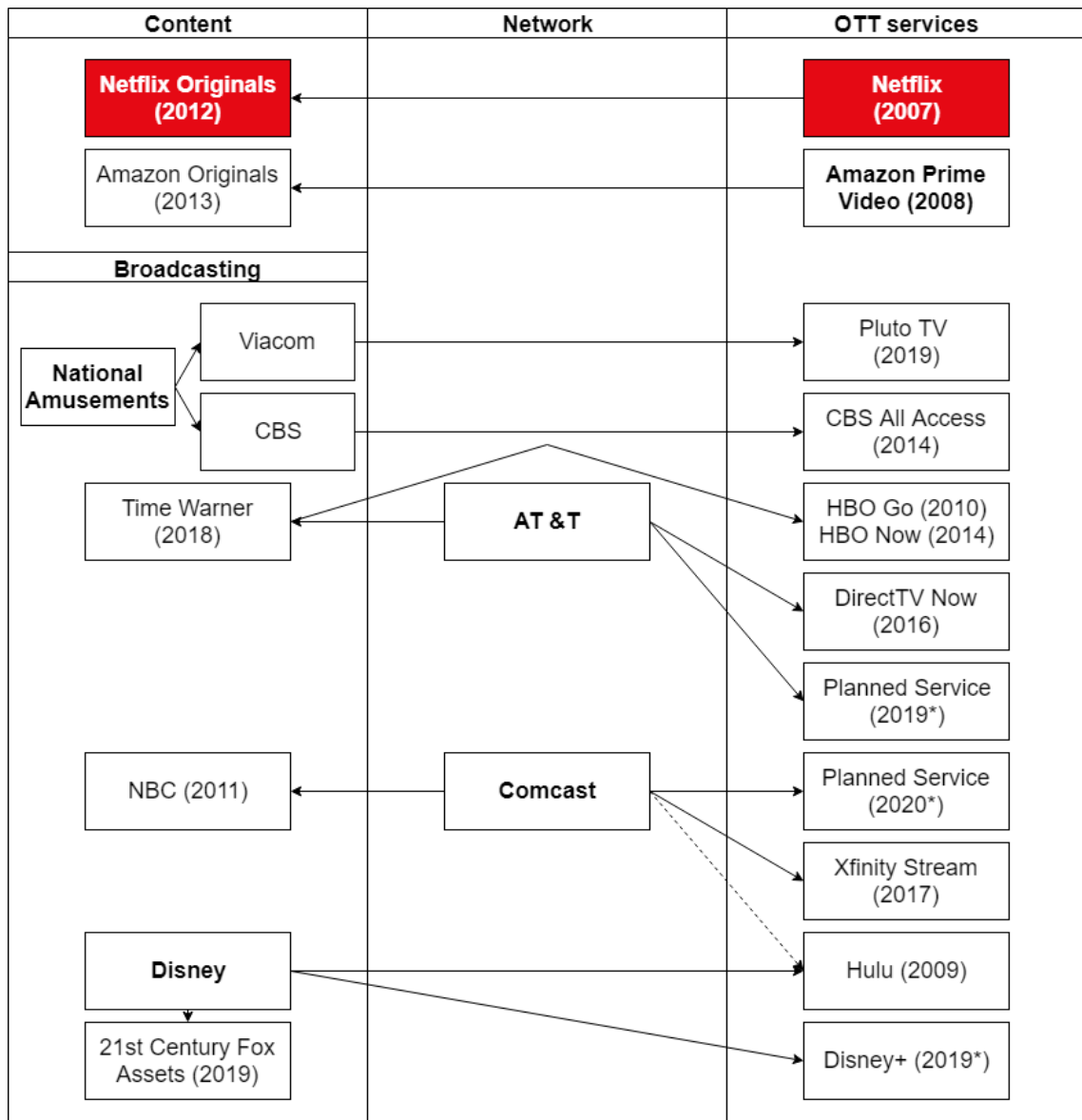


Figure 5. The US entertainment industry’s major player relevant vertical integration changes (i.e. US entertainment ecosystem changes analysis). (*) indicates a planned upcoming service. Comcast’s dotted line means a partial ownership (30 %) of Hulu (sources: Netflix 2007; Netflix 2012; Chartier 2008; Perez 2012; Zacks 2019; Goldsmith 2019; Colvin 2019; Alexander 2019; Shapiro 2019; Sieffert 2012; Trefis 2018; Lynch 2019; Sanson & Steirer 2019; Spangler 2019b; Pettersson & Shaw 2019)

From Figure 5, it can clearly be inferred that Netflix’s and other OTT services introduction to the entertainment industry along with Netflix’s own vertical expansion strategy, has prompted vertical integration strategies from other players in the industry. Additionally, numerous other literature sources claim that Netflix’s business model

changes have prompted action by the incumbent players of the industry. According to the Economist (2018), Netflix’s vertical integration served as a call to arms to its competitors, such as AT&T’s acquisition of Time Warner and HBO Now. Furthermore, not only did the vertical integration spur similar actions from others, the Economist (2018) suggested that if Disney acquires the Fox deal (Disney acquired the 21st Century Fox Assets in 2019), it is due to horizontal integration efforts by Disney to acquire even more content. The Fox deal was ongoing at the time the article was written by the Economist (2018).

“The first thought on everyone’s mind is how do we compete with Netflix?” said Chris Silbermann, the managing director of ICM, which is an agency that represents people (i.e. Jerry Seinfeld), who have signed significant deals with Netflix (Economist 2018). Therefore, it is clear that Netflix has caused significant industry changes in the industry incumbents.

According to Ballon & Evens (2014), the value chain of the entertainment industry was originally simple: content producers created content, broadcasters held the licences/rights of the content, networks were in charge of the main distribution of the content, and finally the content arrived at the audience via the television/device. In this thesis the original value chain in Figure 6 is modelled according to the value chain in the article by Ballon & Evens (2014), with the addition of over-the-air distribution channel and the exclusion of OTT players.

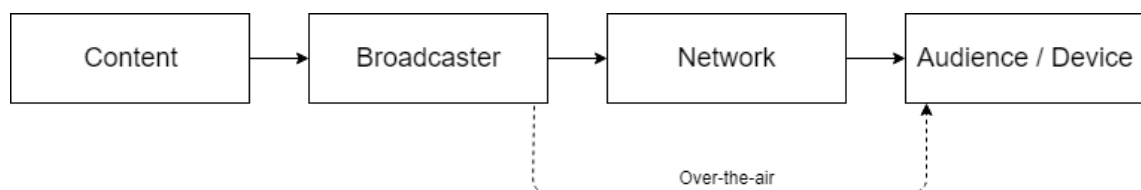


Figure 6. The original value chain of the entertainment industry modelled after Ballon & Evens (2014) and Evens (2012).

Figure 7 shows the industry with the introduction of OTT players. Since this thesis will focus on the major players of the industry, the major broadcasters were already vertically integrated with content by the time of OTT service disruption (2007). The line in between the OTT players and broadcasters signifies the prior more easily licensed content OTT players originally based their business model on. Figure 7 also visualises how OTT players were able to bypass the Network.

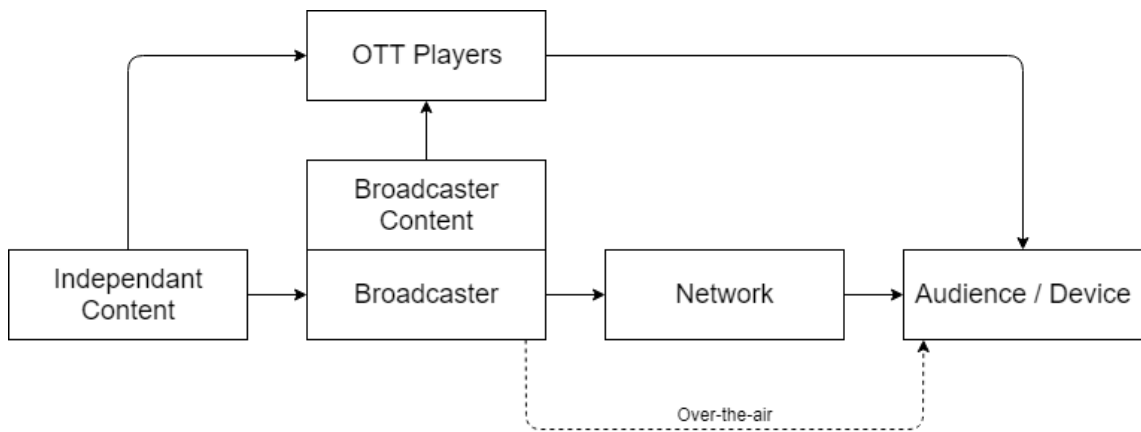


Figure 7. The value chain of the industry before the competitive changes of the incumbents, adapted from Figures 4 & 5

Figure 8 shows the current state of the entertainment industry after the expansion of OTT players into their own exclusive products. Broadcaster companies have vertically expanded to OTT services, and Network Companies have expanded to content creation and OTT services. The dotted lines from the other major player's content sections, signifies the less contentious relationship OTT services had regarding licensed content with the broadcaster and network companies. The broadband connection OTT players require from networks now has a dotted line signifying the increased importance of the Network control over broadband, due to net neutrality principles weakening.

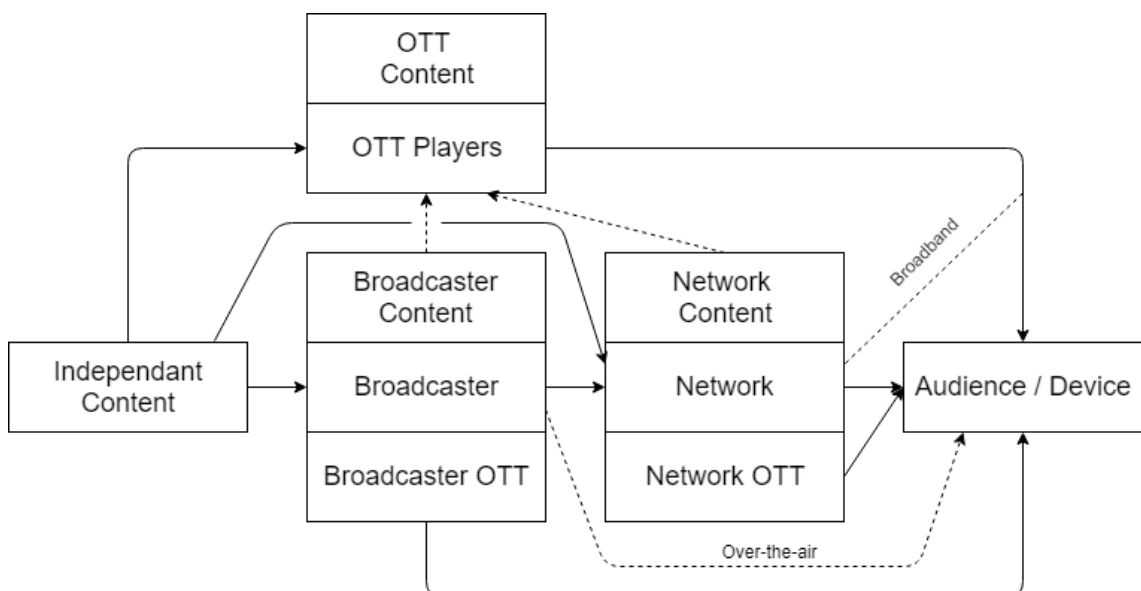


Figure 8. The current value chain of the industry adapted from Figures 4 & 5

Figure 9 shows an example value chain using current players. Currently major players such as Disney and AT&T owned Time Warner still share content with Netflix, however, Disney is phasing out their products from Netflix’s selection in favour of its own OTT services and other major players may follow suite (Franck 2019; Rodriguez 2019). This is illustrated in Figure 10 as the trend seems to be in favour of increased exclusivity of content between the main players. Nevertheless, independent content producers will continue to license their products to any distribution player.

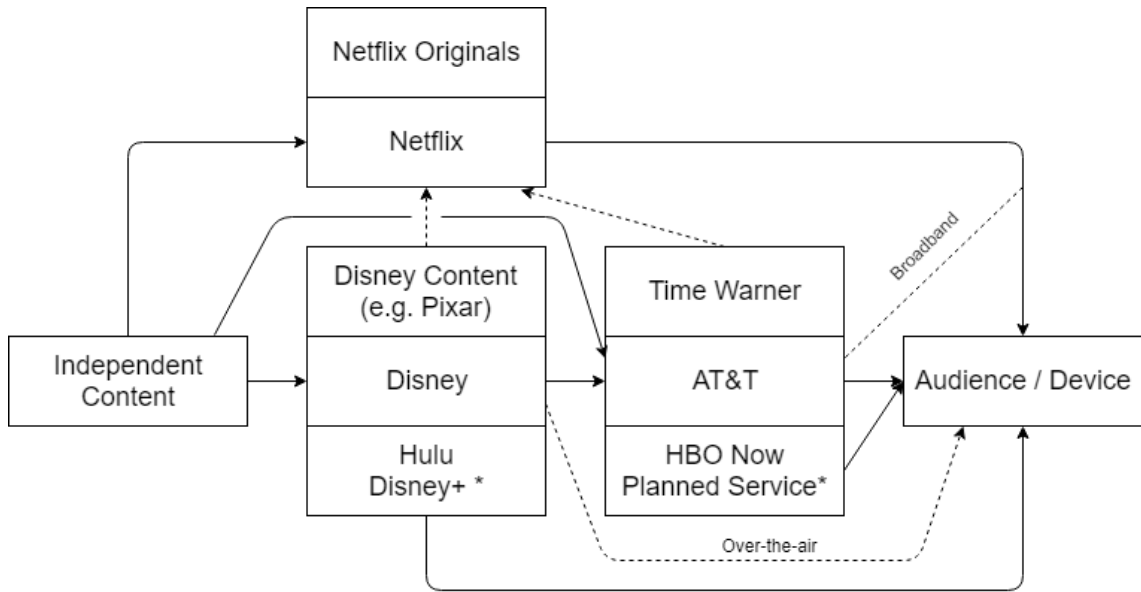


Figure 9. Example value chain of the industry

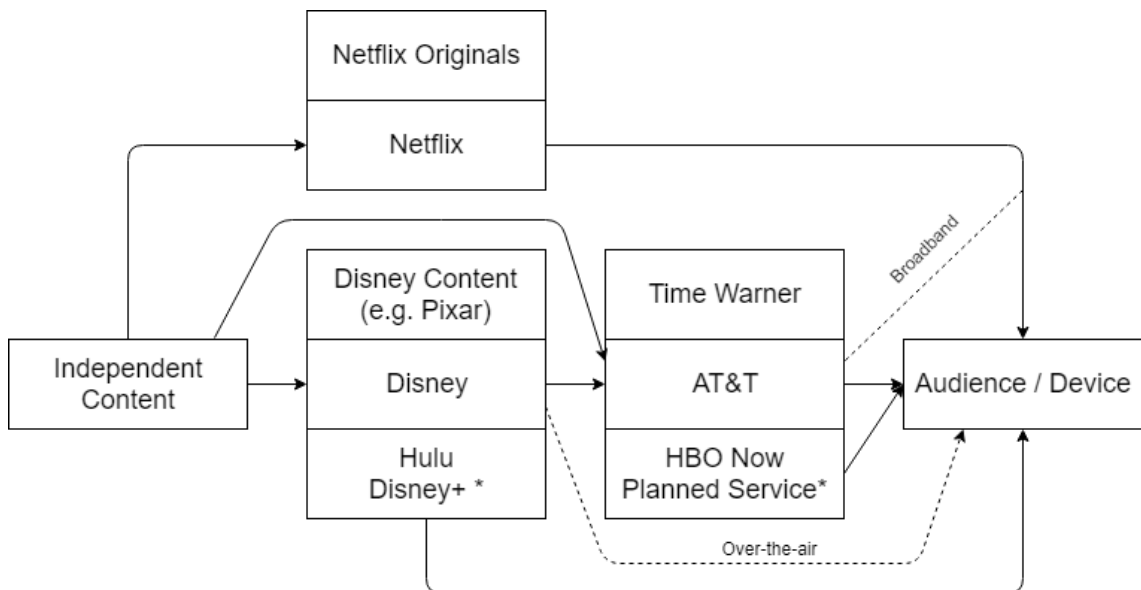


Figure 10. Future ecosystem example

3.3 International ecosystem changes

Despite the US being Netflix’s primary single country market, the international market is larger as seen in Figure 11. Hence, it is relevant to examine the ecosystem changes elsewhere to provide perspective if the US ecosystem changes are applicable elsewhere. This subchapter will analyse Australia and France, along with comments from other countries.

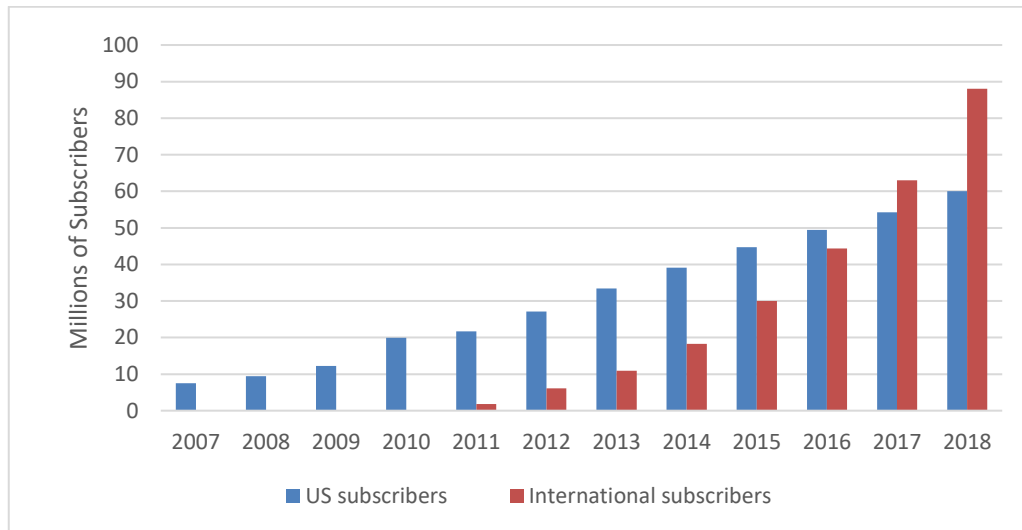


Figure 11. Netflix US and International (non-US) subscriber count (sources: Netflix 2019a; Netflix 2019b; Coldewey 2011; Dunn 2017)

The Australian entertainment industry ecosystem is currently undergoing similar entertainment industry ecosystem changes than the US. Singtel Optus, the second largest telecommunications (network) company, has consolidated content by acquiring exclusive rights to several sports entertainment contents (EPL, UEFA and FIFA), and has invested in TV/film content (National Geographic). This is their most significant content expansion since 2002. Telstra, the largest network company, has also increased their content acquisition (i.e. they have also increased sports content ownership) although not as aggressively as Singtel Optus, for they have a previous (since the mid-1990s) part-ownership in Australia’s only pay television company, Foxtel. The content Foxtel owns currently is not exclusive content, yet they have recently also expanded into the OTT service market. Telstra and Optus both own their own OTT services. Furthermore, smaller network companies have vertically strategically partnered with the local (Australian) OTT service, Fetch TV which owns exclusive to Australia content. (Meese 2019)

Historically, Australia's network (ISP) provider market has been competitive, and Australia has had a slow uptake of subscription television (Meese 2019). Hence, according to Meese (2019) the motivations for Australian network companies to acquire (more) content comes from the trends identified in the US and Europe.

In France, OTT services began entering the market since 2005 and by the end of 2000s it had the highest number of competing services in Europe. Netflix joined this market in 2014, by that time their main competitors were the broadcaster Canal+ and the network operator Orange. Both Canal+ and Orange were content producers prior, and similar to Disney and Comcast in the US. Canal+ had launched a streaming service, Canalplay, in 2011, which it then evolved into a SVoD service similar to Netflix in 2013. Orange expanded its premium channel (OCS) into OTT service in 2016, and Daidj & Egert (2017) mention that Orange has had an aggressive strategy in OTT services market since the end of 2000s. Hence, similar trends to the US ecosystem trends are also noticeable in France.

According to Daidj & Egert (2017), content acquisition by non-content players in the entertainment industry is part of a global trend. This is also agreed upon by Meese (2019) and additionally Evens (2012) states examples of similar trends (e.g. in Britain).

4 Advantages and motivators for vertical expansion

Netflix's move into original content production has had a significant impact on the US entertainment industry ecosystem, as well as internationally. Reed Hastings, the co-founder and CEO of Netflix said in 2016, "*We knew there was no long-term business in being a rerun (i.e. solely a licensed content aggregator) company, just as we knew there was no long-term business in being a DVD-rental company*" (Wayne 2017). The article by Daidj & Egert (2017) mentions that Netflix's success, compared to its early competitor Blockbuster, is explained particularly by their business model evolution.

In this chapter, the thesis will infer motivators for Netflix to produce exclusive content: first by analysing ecosystem motivators and complimenting traditional competitive advantages, and second by analysing motivators emerged from the new entertainment industry capabilities of OTT services, due to the digital nature of the service.

4.1 Ecosystem motivators and traditional competitive elements

As shown in the previous chapters, the changes in the entertainment industry are happening at a rapid pace. The common phenomenon between the major players seems to be the further vertical integration or expansion of their companies, as seen in Figure 5. The further vertical integration of the industry has many implications and may illuminate the reason why Netflix is investing so heavily in their own content. This section (4.1) will examine the Porter's 5 forces, platformization, vertical integration, horizontal integration, content scarcity and differentiation aspects of the industry changes, in other words the ecosystem motivators and traditional competitive elements.

4.1.1 Risk factor analysis for Netflix

In this section (4.1.1) I will analyse the top five risks factors in Netflix's annual reports during 2007-2018, using Porter's five forces. First, I will shortly explain Porter's five forces, second I will identify the main trends in the top 5 risk factors, and finally these trends will be analysed. Furthermore, the thesis objective is to find the advantages and motivators for Netflix's business model changes, hence, analysing Netflix's annual reports can illuminate these from Netflix's perspective.

This analysis is based on Porter's five forces, due to it being a well-known framework to study competition in an industry or market. Additionally, the vertical integration aspect is being analysed, hence, a framework that analyses the OTT service and its suppliers is apt.

Competition in the industry: The more companies with an equivalent service or product, the less the power a company has. Suppliers and buyers seek out the competition with better prices or deals.

Power of the customers: The number of buyers or customers influences the ability of the customers to drive down prices.

Power of the suppliers: The number of suppliers with key or unique inputs and how much it would cost for a company to switch suppliers. The fewer suppliers, the more power the suppliers have and the higher the prices.

Potential of new entrants into an industry: The lower the barriers of entry (i.e. the less money and time used to enter the industry) the easier it is for new companies to enter the industry and increase competition or weaken prior companies' positions.

Threat of Substitutes: If a service or product has no close substitute then the companies can increase prices, whereas, if there are close substitutes customers may forgo the target company's equivalent service or product.

(Chappelow 2019)

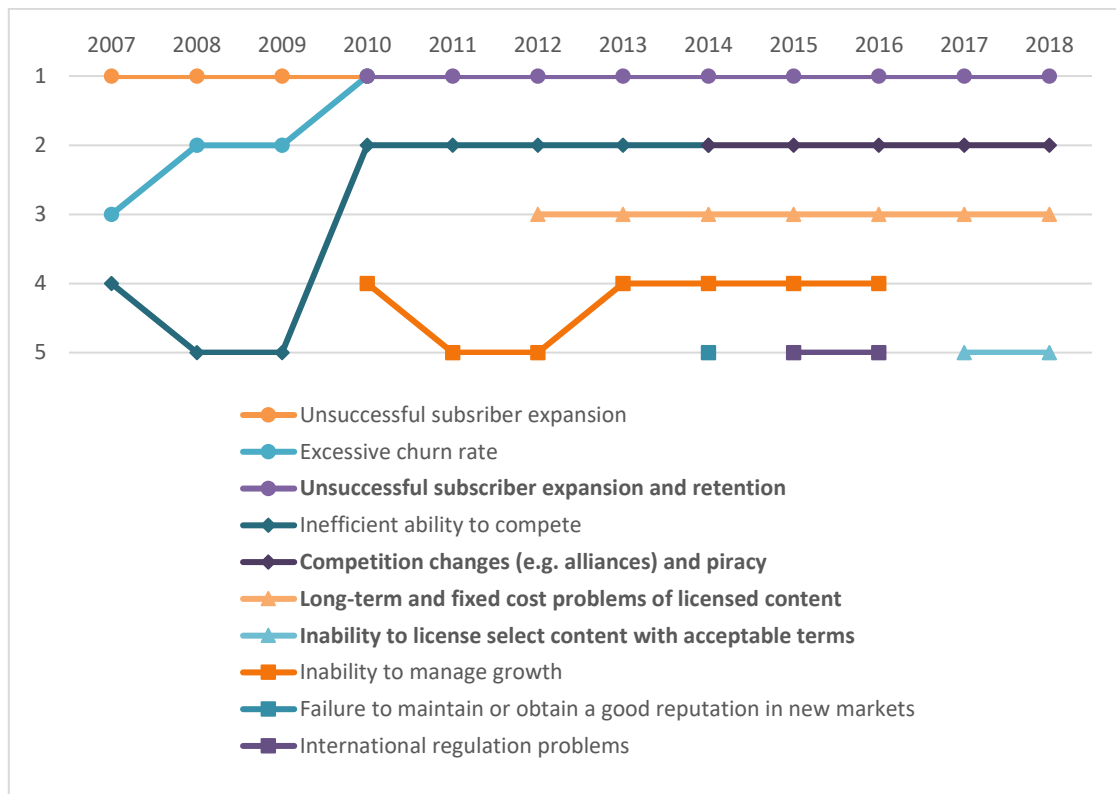


Figure 12. Netflix's top 5 risk factors, the risks unrelated to the identified trends are left out, the bolded risks are analysed in depth, the markings signify the different trends (source: Netflix 2007; Netflix 2008; Netflix 2009; Netflix 2010; Netflix 2011; Netflix 2012; Netflix 2013; Netflix 2014; Netflix 2015; Netflix 2016; Netflix 2017; Netflix 2018)

In Figure 12 Netflix's top five risk factors are ordered between 2007 and 2018. The main trends that are evident is the continuously important *unsuccessful subscriber expansion and retention risk*, the competition associated risks (i.e. *inefficient ability to compete* and *competition changes (e.g. alliances) and piracy*) since 2010, the importance of growth risks (i.e. *inability to manage growth, failure to maintain or obtain a good reputation in new markets* and *international regulation problems*) during Netflix's international expansion in 2010-2016, and the rising importance of content associated risks (i.e. *The long-term and fixed cost problems of licensed content* and *the inability to license select content with acceptable terms*) since 2012. The risks associated with Netflix's content acquisition strategy are analysed in the following paragraphs.

Unsuccessful subscriber expansion and retention has been Netflix's most important risk factor since 2007. Before 2010 (2007-2009) subscriber expansion and churn rate were differentiated from each other, as seen in Figure 9. According to Netflix

(2018), their ability to attract customers is based on their content choices and quality of experience. Herbert et al. (2018) claimed that OTT services' main differentiator is content, and second is the pricing difference. Netflix (2018) further explains the risk, by stating that competitors' pricing and substitution (TV) can affect their attraction and retention. The high value of the risk is due to Netflix's revenue coming solely from the customers' subscriptions (Herbert et al. 2018). Additionally, according to Netflix (2018) many of their customers rejoin or originate from word-of-mouth advertising. Hence, member satisfaction to maintain retention and further attraction is important for Netflix, due to their increased content costs.

Thus, due to the increased competition in OTT services seen in the previous chapter, and Netflix's reliance on customers for revenue (and marketing) in the aforementioned risk, the customer and competition power are high.

Another consistently high risk for Netflix has been the risk of inefficient ability to compete, which was renamed to **competition changes (e.g. strategic alliances)** in 2014. In 2013, the inefficient ability to compete risk was defined by the increase of customers using internet delivered video, hence, capturing a meaningful segment of the market was essential. Netflix (2013) continues to state that several of their competitors at the time had long operating histories, large customer bases, strong brand recognition and significant resources at their disposal. Hence, there was a danger of the competition of securing better terms from suppliers (content), offering new exclusive content (in the OTT market), or the potential of competitors entering strategic alliances to strengthen their positions.

According to Netflix (2013 & 2018), if it *“was unable to successfully or profitably compete with current and new competitors, programs and technologies, its business will be adversely affected, and we may not be able to increase or maintain market share, revenues or profitability”*. This risk further illustrates the powers of the competition, and suppliers for Netflix's business model.

The long-term and fixed cost problems of licensed content risk joined the top 5 risks in 2012, (it was a lesser risk prior to 2012). The risk is due to Netflix's increasingly long-term and fixed cost nature of the licenses, which if hypothetically combined with a lower subscriber or revenue growth could adversely affect liquidity and operations (Netflix 2012). The long-term and fixed cost nature of the acquisitions also lower Netflix's flexibility in content management planning. For example, Netflix must license content in advance of entering a new geographical market, thus if the content is not well received,

it would affect subscriber expansion and retention due to the inability of agile content adjustment (Netflix 2012). In 2014, Netflix (2014) added to the risk, by mentioning their increased investments towards original programming, which is the risk of content not meeting their expectations.

In 2017, **the inability to license select content with acceptable terms** rose to the top five risks, they were risks in prior years but not listed in the top 5. Netflix’s speculation of their competition expanding into their own streaming services, could lead to their competition being unwilling to provide certain content or unwilling to provide it with acceptable terms (rising prices) to Netflix. For example, according to Clark (2019) due to NBC (Comcast) launching their own streaming service, Comcast may pull “The Office” from Netflix. In this risk, Netflix (2018) also speculates, that competition will also increase licensed programming costs. Netflix requires a compelling mix of content in their library, in order to retain and attain subscribers (Economist 2018).

Hence, licensing problems with competition is a rising risk mentioned in Netflix’s annual reports. These risk trends show that the increased competition along with the increased power of suppliers are forces Netflix considers as high risks.

Table 1. The significance of porter’s five forces for each relevant risk

<u>Porter's 5 forces & risk factors</u>	Competition in industry	Power of customers	Power of suppliers	Potential of new entrants	Threat of substitute products
Unsuccessful subscriber expansion and retention	Significant	Significant	Minimal	Minimal	Minimal
Competition changes (e.g. alliances) and piracy	Significant	Minimal	Significant	Minimal	Minimal
Long-term and fixed cost problems of licensed content	Significant	Minimal	Significant	Minimal	Minimal
Inability to license select content with acceptable terms	Significant	Minimal	Significant	Minimal	Minimal

In conclusion, the most significant forces that affect Netflix are the competition in the industry and the power of suppliers. It indicates that Netflix is wary of strategic competition changes and its growing issues with the supply of content.

4.1.2 Platformization causes

According to Ballon & Evens (2014), the changes of the industry are due to the changes of the platform positions in the industry. Platform markets work as intermediaries between two (or more) parties such as in Netflix's case, consumers and content producers. Prior to the OTT service disruption, the industry was characterised as a two-sided platform market, between consumers and advertisers. During the last 15 years the industry has changed from a two-sided market to a multi-sided market. This is due to the addition of independent content production companies, with which distributors need to liaise with, and the digitalisation of the industry which increased the number of platform players. (Ballon & Evens 2014)

OTT services are a new platform type that have a distinct advantage over the traditional platforms due to new complete end-user control (Ballon & Evens 2014). This is due to the increased strategic value of the end user experience, and hence the control of the customer information and relationship creates a competitive edge and can position OTT services more favourable in the entertainment industry value chain. For the goal of companies is to create customer value, customer management can be a significant sustained competitive advantage with long term profitability potential. Furthermore, the customer relationship has become increasingly important (Evens 2012). Hence, the most important bottleneck in the industry to gain platform leadership is the customer relationship bottleneck, and one all the industry players are striving for. (Evens 2012)

Companies have an incentive to manage the industry's architecture to control the bottlenecks in their industry (Ballon & Evens 2014; Evens 2012). Bottlenecks are scarce critical resources and crossing points of information, which have market leverage power (Ballon & Evens 2014; Evens 2012). Evens (2012) also evaluates the entertainment industry with the use of Porter's value chain map. In the value chain, value is added sequentially until it finally reaches the customer. Controlling the bottlenecks of the industry creates competitive edge, which can be used as barriers for new companies to enter the market. The disruption of the industry has destabilised the existing bottlenecks, which caused the value of distribution to decline and the value of the customer interaction to increase. Furthermore, the article claims that the value of content bottlenecks has also increased. Hence, the incumbents of the industry needed to change their business models to prevent competitive advantage losses, as seen in chapter 3. (Evens 2012)

Ballon & Evens (2014) claims that a profitable and durable platform must exert a level of control beyond its platform. Netflix as a platform works as an intermediary between consumers and content, due to their model being subscription based. This is different compared to traditional broadcast companies, and other advertiser-based models like Hulu (i.e. Hulu has an ad-free model and subscription model supported with ads).

4.1.3 Vertical Integration

Trade discourse and media scholarship have often claimed that media companies can acquire an advantage, by limiting the distribution of content they own via their own distribution channel(s). Hence, vertical integration would cause a synergistic effect. (Sanson & Steirer 2019) However, the further vertical integration of companies and the industry as a whole, results in a company or industry that is less specialized (Sieffert 2012). This can lead to higher barriers of entry to the industry and harm product diversity, quality and price. Yet higher barriers of entry are welcome for already significant players in the industry, such as Netflix. In his article, Sieffert (2012) says that the five advantages of the NBC and Comcast merger were: (1) more investment in risky endeavours and product diversification, (2) price deflation, (3) reductions in transaction costs, (4) benefits from content aggregation, and (5) economies of scale and scope.

Due to a merger in vertical integration not being equivalent to a normal expansion of vertical integration, the NBC and Comcast merger advantages are not fully applicable to Netflix. First, the higher the investment capability is not relevant for Netflix due to the aforementioned reason. Second, the price deflation is not applicable either, for Netflix is increasing investments in content and otherwise and has a history of raising prices. Third, reductions in transaction costs and fourth, benefits from content aggregation are both cost saving advantages for vertically integrated companies. The consolidation of costs and the bypassing of “double marginalization costs (i.e. each member of the chain taking a profit above marginal cost)” is a relevant benefit. The reduction of transaction and negotiation costs is lowered; when both parties are on the same side agreements are more easily/quickly solved. Although the main benefits of content aggregation are irrelevant from Netflix’s perspective, for it is already Netflix’s primary business model. The economies of scale advantage is a result of Netflix’s continued popularity, and also relevant to producing content. It is defined as a company producing more of a good with a decreasing amount of inputs, hence, the cost savings of other vertical integration effects in addition to the easily scalable and expanding nature of OTT distribution (Evens 2012). Netflix producing their own product does have economies of scale benefit from vertical integration. This additionally adds to Netflix’s inherent expansion of economies of scope,

for Netflix in regards to their expansion to creating their own studio(s). Economies of scope are born from companies reducing the average total cost of production by increasing differentiation in their products. This happens in TV/film production, when the same sets and employees (actors, directors) are used to produce a variety of content (horror, comedy). (Sieffert 2012)

Vertical integration in turn can cause scarcity and exclusivity to the entertainment industry content, however Meese (2019) mentions that scholars are more worried about horizontal (than vertical) market power/integration effects on content diversity.

4.1.4 Content scarcity, differentiation and horizontal integration

According to Herbert et al. (2018), currently OTT (video) services mainly compete on range and depth of catalogue. Television and film distributors pay upfront for licensed content for a set period of time, and even more for exclusive rights for the content. Licensing *all* television and film content is unfeasible, whereas the music industry (i.e. Spotify) operates by paying the content provider per listen. Hence, the catalogue of OTT (video) services is their main differentiator to their competitors, whereas their second main differentiator is price (Herbert et al. 2018). *“As with the modern middlemen, such as Hulu, Apple, and Amazon, revenues are gained from increasing the number of titles they offer”* (Sieffert 2012). Additionally, Meese (2019) mentioned that in the case of Australia, the competitive scene of the network sector has made content a major point of differentiation. This is further confirmed by Figures 13a & 13b regarding the importance of original content to Netflix and its users.

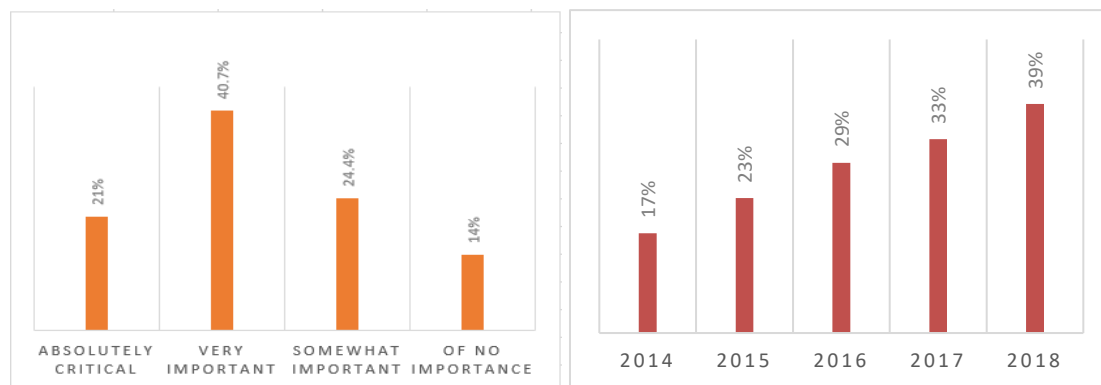


Figure 13a & 13b. (Left) Perspectives on the importance of Netflix original shows when deciding whether to keep using Netflix among users in the United States, January 2018. (Right) Share of consumers who believe Netflix is the service with the best original programming in the United States from 2014 to 2018 (source: TDG 2018; Stanley 2018)

The relationships between Netflix and TV/ film content providers has fluctuated often. Prior to Netflix's OTT disruption content providers had a contentious relationship with Netflix, but it has become increasingly complicated due to Netflix's increased market power and acquisition of exclusive content. (Herbert et al. 2018; Aguiar & Waldfogel 2018) Furthermore, Disney is currently pulling their content from Netflix, and other players may follow suite (e.g. NBC and The Office). Evens (2012) states that access to content is becoming more important in the ecosystem. The author also mentions that the control of critical resources provides the controller a competitive edge, and new entrants to the industry should be concerned if a content scarcity strategy is employed by incumbents. Hence, controlling the bottleneck of content is an important competitive strategy to achieve platform leadership. This conflict may already be underway, for Disney is horizontally integrating (Fox), and Netflix is horizontally expanding in the content industry.

4.2 New digital capabilities

The digitalization of content delivery in the entertainment industry has opened new capabilities and opportunities for the industry. OTT services are at the most opportune position to take advantage of the capabilities. For example, OTT service content can be viewed from any internet-based device and the services are able to utilize recommendation systems to enhance user experience (Kim et al. 2017; Radosinská 2017). The most significant capabilities, regarding Netflix's content acquisition, are related to the new data possibilities and scalability of OTT services, which are overviewed in the following subchapters.

4.2.1 Data

Data has always been important in the television entertainment industry, due to how audience research and specifically TV ratings have shaped choices and strategy. Nevertheless, there has been little advancement in audience research until recently, thanks to the new data streams and their volume also known as 'Big Data'. Previously audience research was conducted by analysing a small sample, and projecting that to the entire market. Kelly (2017) argues that small group sampling is not effective in the current climate, for audience demographics are in constant change and increasingly fragmented. Hence, the effective use of big data is the new frontier of audience research in the television entertainment industry. This is epitomized by Kelly (2017), "*the emerging consensus among network executives is that data has become an integral*

part of televisual culture; an essential tool for survival in the increasingly fragmented, crowded and competitive marketplace of digital TV.” (Kelly 2017)

Netflix, as a digital service has the capability to directly access a variety of new information, as it has full access to the data of end-user interactions. For example, Netflix can gather customer data such as the devices used, the location the content was accessed from, what and when users watch, ratings, and feedback. (Sathananthan et al. 2017) According to Evens (2012), the importance and understanding of customer ‘intimacy’ or experience has become more and more important. Subsequently, controlling customer information flows has become more important and what all the players in the industry strive for (Evens 2012). In the television entertainment industry, ratings are highly guarded and only of value when their availability is restricted (Kelly 2017). Kelly (2017) claims that Netflix’s entire business model revolves around the limited availability of its data, for the content licensed and produced revolves around this data.

The utilisation of big data gives more stability and predictability for audience research, allowing better strategic insights in a previously characterized as risky and uncertain industry (Kelly 2017). Data used to transform a business model is known as an external feedback loop data, i.e. the data (e.g. ratings, devices, and feedback) is used to innovate new offering or innovate interaction with the users. These transformations can be personalized recommendations systems, or further optimization of information flows in networks. However, it can also be used to further personalize the content available, by gathering data to identify market insights of what type of content is popular. (Sathananthan et al. 2017) This means there is a synergy to create new content for OTT services using data from content which has originally been produced by others. This is visualized in Figure 14. and Table 2.

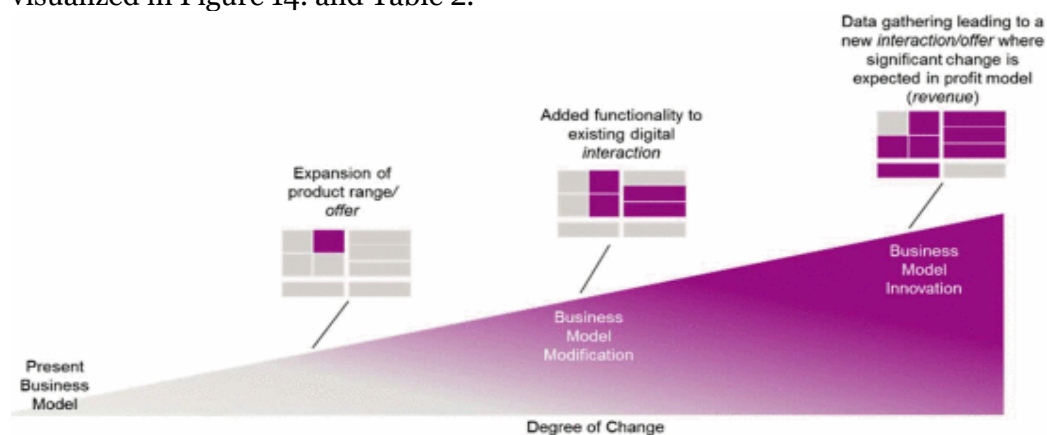


Figure 14. Business model modification to business model innovation (source: Sathananthan et al. 2017)

Sathananthan et al. (2017) claim that the transformation of Netflix’s business model to produce original content, is a natural evolution of Netflix’s digital business model. A similar transformation by the incumbents of the industry was conducted by analysing big data from twitter, to identify higher ratings and consequently increase the programming of sports, event television and other genres of live programming (Kelly 2017).

Table 2. Netflix - digital actions validated for key characteristics of digital business model (source: Sathananthan et al. 2017)

		Key characteristics			
	Netflix - Digital Actions	1. Epicenter	2. Type of data	3. Loop action belongs to	4. New epicenter
1	Digital Video Streaming	Interaction	External data: most watched content, ratings	External feedback loop	New/modified Interaction: Availability on more channels to expand to different age groups
2	Netflix Original Series	Offer	External data: seasonal interests, feedback & ratings	External feedback loop	New/modified Offer: targeted exclusive content, new offers based on season, age-group

4.2.2 Longtail content diversity

OTT services allow consumers to consume the content whenever convenient to them, content is not pushed onto the customer, instead the customer can decide what to watch and when to watch (Radosinská 2017). In comparison to the traditional outlets of the entertainment industry (broadcast, cable, satellite), OTT services do not suffer from opportunity costs for content. For example, traditional services have a fixed television schedule which can exclude content. (Wayne 2017; Economist 2018) Hence, the price of media content depends on the demands of the consumers, instead of being attributed as a cost on the supply side (Kim et al. 2017).

OTT services have a new opportunity to appeal to many (or even all) demographics, by using a long tail content diversity strategy (i.e. creating content for all the less popular niches, in order to appeal to more customers). Thus, Netflix can increase their subscriber count by appealing to more consumers. According to Herbert et al. (2018), “*the audiovisual sector is (similarly) dominated by services that achieve scale by targeting many different viewer tastes: Netflix, Amazon and Hulu.*” The Economist (2018) states, that current entertainment companies need two hooks in order to retain their customers: a

wide range of frequently renewed programming and a deep understanding of the consumer preferences. The ability of Netflix to gather and analyse customer data, has allowed Netflix to identify 2000 consumer taste clusters. Utilising data such as taste clusters, customer reach, allows Netflix to justify cost acquisitions. Along with personalized recommendations, Netflix is able to produce content for even more niches and deliver it to them without opportunity cost, which has not been possible previously. (Economist 2018)

4.2.3 International scalability

Due to the scalability of cloud services such as OTT services (Evens 2012), Netflix expanded to most of the world (the only major exception is China), whereas previously entertainment industry players have operated mostly within their own countries. As Reed Hastings (Netflix co-founder and CEO) said in 2016, *“Right now, you are witnessing the birth of a global TV network”* (Aguiar & Waldfogel 2018).

According to Aguiar & Waldfogel (2018), large scale producers (i.e. Disney) are attracted by the opportunity to distribute through an intermediary with global reach, yet they are also concerned of promoting a downstream player (i.e. Netflix), that can act as a bottleneck. Nevertheless, small scale producers still see Netflix as an outlet to distribute content that do not have a justifiably large audience for a theatrical distribution.

The most significant implication to Netflix’s strategy and business model choices regarding Netflix’s international scalability and expansion, is the economies of scale effect and its relation to the network sector of the industry. Due to the possibility of OTT services to relatively easily expand internationally, anything Netflix produces has an economies of scale effect by reaching far more customers than traditional media. Additionally, due to the weakening of net neutrality in the US, Netflix’s position has weakened. However, since Netflix is an internationally operating OTT service (over 50% of their subscribers are non-US) this has strengthened Netflix’s position in regards to the network sector companies and subverting net neutrality strategies.

5 Conclusions

Netflix's business model changes have had a significant impact on the US entertainment industry ecosystem. This was clearly inferred from the ecosystem analysis the thesis presented and confirmed in the literature referenced. The main trends of the major players in the industry has been the further vertical integration of their companies and the increased application of content scarcity strategies. However, Netflix was a forerunner in vertically integrating their business model, which was due to the risks of potential future strategies employed by the major players of the industry and Netflix's competitive digital advantages.

The trend of increased vertical integration allowed the content scarcity trend to appear, which in turn increased the importance of the critical resource of content. In platformization theory, companies have an incentive to control important critical resources to become platform leaders. Hence, Netflix's awareness of potential harmful strategies regarding content scarcity employed by its competitors, evident in the analysis of Netflix's risk, gave Netflix ample motivations to pre-emptively expand their operations into content creation and to compete for platform leadership.

Netflix's motivations to expand into content creation were also complimented by its own digital advantages regarding their customer data and scalability of their service. The importance of customer experience and data is constantly increasing and changing. Due to being an OTT service Netflix had complete control over the end user interaction, and hence better customer data in comparison to traditional media. In the entertainment industry TV ratings and audience research is important for strategic choices and cost justification in content production. Netflix had a better understanding of the customer's, due to data, and hence better insight for strategic choices and cost justification. Thus, utilising this data Netflix had a capability to produce better performing content. Combining this capability with their inherent ability to avoid opportunity costs as an OTT service, Netflix is able to produce more targeted content for more customers. This synergy is also relevant in regards to the increased importance of the supply of content and content differentiation. Furthermore, Netflix's better international scalability as digital service gives Netflix a better reach than traditional media. This creates an increased economies of scale effect, for Netflix to produce their own content.

Thus, in order to maintain their competitive edge, Netflix vertically integrated prior to the rest of the entertainment industry, by recognising the future threats of the industry and utilising its own inherent capabilities.

5.1 Limitations and implications to research

The thesis is a unique holistic look at Netflix's motivations for business model changes, and it mainly focuses on vertical integration causes and motivations in the OTT service. Hence, the thesis can be utilised as an exploratory study regarding Netflix and other OTT services within the entertainment industry ecosystem. Furthermore, it could be used to infer insights in other similar industries, for example, the music OTT service industry.

Due to the scope of the thesis and the length limitations of being a bachelor's thesis, there are limitations in the thesis and many potential starting points for future research.

The focus of the advantages for Netflix, could have additionally been complimented with disadvantages to put each advantage into better perspective. The research was also limited to just a few of the existing major players in the industry. A longer study could have included Sony and other current major entertainment industry players, and as well as researched the implications of tech giants (i.e. Google and Apple) potentially foraying into the industry. Moreover, Amazon as a competing player has an interesting relationship with Netflix, for Netflix uses Amazon cloud services heavily. Hence, a deeper analysis of Amazon in regarding to Netflix is worth expanding.

The thesis had many topics that could be further researched. These topics included piracy's effect, net neutrality's effects more in depth, different entertainment type effects (i.e. sports entertainment and user created content), ethics of Netflix's data stream use and the further comparison of international ecosystems.

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