

What You Have Always Done Isn't Working Anymore

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Don't Get Netflixed: Your Current Business Model Isn't Going to Last Much Longer

The nuclear industry measures how long a radioactive material will retain its potency by its half-life, which is the time it takes for the material to lose half of its radioactivity. For instance, the half-life of Uranium-235 is 700 million years. No wonder nuclear proliferation is so feared! During the industrial era the half-life of a business model has been measured in generations. Business models have always lasted a long time. Business models rarely changed and were handed down from generation to generation. Most business leaders have never had to change their business model. Most CEOs have led a single business model throughout their entire career. They never learned how to change a business model in business school or from their peers, who also have never had to change their business models.

During the industrial era once the basic rules for how a company creates, delivers, and captures value were established they became etched in stone, fortified by functional silos, and sustained by reinforcing company cultures. All of a company's DNA, energy, and resources were focused on scaling the business model and beating back competition attempting to do a better job executing the same business model. Companies with nearly identical business models slugged it out for market share within well-defined industry sectors.

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There was a mad rush to copy so-called best practices in order to not be left behind by industry leaders.

It should be no surprise that if you ask executives and corporate employees to define the term business model and to share their company's business model story you tend to get a lot of blank stares and very different stories from across the organization. For most, their business model has probably been in place since the business was started—before most employees joined the company. It hasn't changed. It is implicit. No one talks about it. No one shares business model stories because they are taken for granted.

Industry definitions are also taken for granted. As if industries were clubs with exclusive admission criteria and secret handshakes only revealed to companies that agree to play by understood rules. The industrial era has been defined by clearly delineated industries, making it easy to identify which sector every company is competing in. It was all so gentlemanly, as if competition was governed like boxing by a code of generally accepted Marquess of Queensberry rules. Companies were all conveniently assigned a numerical Standard Industrial Classification (SIC) code (now North American Industry Classification System, or NAICS) identifying which industry sector they fit into. Within each industry sector companies all migrated toward an identical business model competing for market share within the sector. Business models rarely changed.

Those days are over. The industrial era is not coming back. The half-life of a business model is declining. Business models just don't last as long as they used to. In the twenty-first century business leaders are unlikely to manage a single business model for an entire career. Business leaders are unlikely to hand down their businesses to the next generation of leaders with the same business model they inherited from the generation before. Leaders are either going to learn how to change their business models while pedaling the bicycle of the current one or they are going to be netflixed. The challenge in the twenty-first century for all leaders is how to avoid being netflixed.

If netflixed isn't a verb it should be.

netflix; netflixed

verb

1. to cause disruption or turmoil to an existing business model
2. to destroy a previously successful business model
3. to displace the way value is currently created, delivered, and captured
4. to be disrupted, destroyed, or displaced by a new business model

Blockbuster Gets Netflixed

Blockbuster started out with a compelling business model. Its value proposition was clear—enabling consumers to watch hit movies in the comfort of their homes. Blockbuster established an extensive value delivery network with stores conveniently located on every corner. Its first store opened in 1985 and it quickly grew to have over 5,000 retail outlets and 60,000 employees. It also had a smart financing model to capture value. It rented hit movies at a price consumers found attractive relative to the price of going out to the movies. Instead of paying a large upfront fee to buy videos from the studio (up to \$65 per video) Blockbuster entered into a revenue-sharing model with the movie studios including little to no upfront costs per video, which gave them a huge advantage, and fueled explosive growth. Blockbuster started out on a roll. At its peak in 2002 Blockbuster's market cap rose to \$5 billion. In 2010 it filed for bankruptcy. So what happened? Blockbuster was netflixed.

It wasn't as if Blockbuster didn't see Netflix coming. They were just so committed to their bricks and mortar business model they couldn't see or act beyond it. They were stuck in their business model. It became a straitjacket that eventually took the company down. You didn't have to be a fly on the wall of Blockbuster's headquarters during those years to imagine the management debate that took place on what to do about the emerging competitive upstart, Netflix.

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As is often the case, the Blockbuster business model story starts and ends with technology playing a leading role. Initially, technology enabled and then ultimately disrupted Blockbuster's business model.

Early versions of the videocassette recorder (VCR) first appeared in the late 1950s and through the 1960s, but it wasn't until the late 1970s that they began to have any mass consumer market success. Who doesn't remember the great format war between Sony's Betamax and JVC's VHS competing videocassette standards? VHS won out due to a longer two-hour recording time with the ability to extend the recording time up to four hours. The last obstacle to broad consumer uptake of VCRs was overcoming the resistance of movie studios. Like any industry facing a business model threat, whether real or imagined, the movie industry fought hard to block the spread of VCR technology. Jack Valenti, head of the Motion Picture Association of America, implored Congress to protect the movie industry from the "savagery and the ravages of this machine." In Congressional testimony Valenti said, "the VCR is to the American film producer and the American public as the Boston strangler is to the woman home alone."¹ The case went all the way to the Supreme Court ruling in *Sony Corp. of America v. Universal City Studios, Inc.* that VCRs were allowable for private use. Ironically the movie industry ended up finding a significant new revenue source by distributing video recordings of their movies.

With consumer acceptance of VCRs expanding after the favorable Supreme Court ruling in 1984, Blockbuster opened its first store on October 1985 in Dallas, Texas, and never looked back, or over its shoulder, for that matter. Wayne Huizinga saw the potential to scale Blockbuster nationally, as he had previously done with garbage collection at Waste Management, and bought the company in 1987,

¹From Jack Valenti testimony on April 12, 1982, before the Subcommittee on Courts, Civil Liberties, and the Administration of Justice of the Committee on the Judiciary House of Representatives on "Home Recording of Copyrighted Works."

starting with a few stores and quickly expanding through acquisitions and new store openings to become the largest retail video chain in the United States. In 1994 Huizinga sold Blockbuster to Viacom for \$8.4 billion.

How smart was Huizinga, because in 1995 the DVD was invented. It was inevitable and easy to see. During the same period (in the late 1980s and early 1990s) that Blockbuster was capitalizing on consumer acceptance and demand for video recordings of hit movies, the demand for CD music recordings was also exploding. In 1982, Billy Joel's *52nd Street* was the first record album released on CD in Japan, where Sony also launched its first CD player. In 1983 CD players were commercialized in the United States, along with 16 CDs released from CBS records. By 1988, 400 million CDs were manufactured in 50 plants around the world.

It was only a matter of time until the same optical disc storage technology enabling CDs to displace vinyl records would also displace videocassette recordings of movies. It happened in 1995 with the invention of DVDs, which had the storage capacity for an entire feature length movie. DVDs quickly gained consumer acceptance in the market over videocassettes. DVDs offered higher quality, more durability, and introduced an attractive interactivity feature allowing viewers to go directly to chosen scenes within a movie. As the price of DVD players quickly came down in the market, DVDs soon became the favored home movie format.

Blockbuster didn't see the emergence of DVD technology as a threat to their business model. They didn't see it as a disruptive technology. They saw DVDs as a sustaining technology to improve the performance of their current bricks and mortar business model. DVDs would sit alongside videocassettes and be just another product offering to their retail customers. Blockbuster didn't see DVD technology as a possible enabler of new business models or ways to change the way they created, delivered, and captured customer value. That all changed in 1997, when Reed Hastings got pissed off because he was charged a late fee by Blockbuster after failing to return the movie *Apollo 13* within the due date. Turns out, Reed

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Hastings was not alone in hating to pay Blockbuster's late fees. While consumers had no convenient alternative to renting movies from Blockbuster, the company extracted over \$500 million in late fees from customers like Hastings. Blockbuster was so focused on expanding its current business model it had no clue it was about to be netflixed.

Netflix didn't invent any new technology. DVD optical disc storage technology had already been invented. What Netflix invented was a new business model. Netflix recognized that DVDs were small and light enough to mail using first-class postage. Netflix thought it could trump Blockbuster's value proposition, enabling consumers to watch hit movies in the comfort of their home by delivering movies directly to a customer's home by mail, allowing them to avoid a trip to the corner store. Initially, the rest of Netflix's business model was identical to Blockbuster's. In the beginning Netflix captured value in the same way as Blockbuster with a pay-per-rental pricing model. The only difference was the ability to order a movie online and have it delivered directly to your home by mail. The original Netflix business model even had the same late fee as Blockbuster for not returning the movie on time. Uptake was slow initially as people preferred the convenience of renting and watching a movie at the last minute without waiting for it to come by mail. Blockbuster initially saw Netflix as a niche mail order business that didn't represent a significant competitive threat.

That all changed when Netflix introduced its real business model innovation. In 1999 Netflix moved away from Blockbuster's pay-per-rental model and introduced a subscription model where customers paid a flat fee for unlimited rentals without due dates, late fees, or shipping and handling fees. Netflix's business model story was to enable consumers to watch as many movies as they wanted in the comfort of their home for a fixed monthly price. The new business model caught fire, with annual sales going from \$1 million to \$5 million in its first year. Within five years Netflix was a \$500 million business and within eight years it had reached \$1 billion in sales. In 2002 Netflix had 1 million subscribers, growing to over

5 million in 2006 and over 14 million in 2010. Hardly a niche business!

So did Blockbuster see Netflix coming? Did senior management see the opportunity to think beyond its bricks and mortar network expansion and store operations to deliver customer value in new ways? Did management see the disruptive potential of DVDs? Did they see Netflix coming and decide to stick with their bricks and mortar approach? Or did they just miss the opportunity because they were so busy pedaling the bicycle of their current business model they didn't think about and experiment with potential new ones?

I think the evidence is clear: Blockbuster saw Netflix coming and chose to ignore them at first and then reacted way too slowly. You may be surprised to learn that Blockbuster had the opportunity to partner with Netflix before the upstart really took off. John Antico, Blockbuster CEO, actually received a visit from Netflix founders Reed Hastings and Marc Randolph in 2000. The founders traveled to Blockbuster's headquarters in Dallas to deliver an interesting offer to Antico. According to Barry McCarthy (Netflix CFO at the time), who joined Hastings and Randolph on the trip, the founders proposed that Netflix and Blockbuster collaborate. In an interview with The Unofficial Stanford Blog, McCarthy recounted the meeting saying, "Reed had the chutzpah to propose to them that we run their brand online and they run our brand in the stores and they just about laughed us out of their office. At least initially, they thought we were a very small niche business. Gradually over time, as we grew our market, his thinking evolved but initially they ignored us and that was much to our advantage."²

Blockbuster made the mistake most companies make in underestimating the disruptive threat of new technologies and innovative business models until it is too late. Blockbuster remained stuck in their bricks and mortar business model, naively treating Netflix as a niche player that they could ignore. They underestimated Netflix at

²See http://tusb.stanford.edu/2008/01/barry_mccarthy_chief_financial.html.

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their own peril. They attempted to react, but it was too late. The constraints and pressures of their existing business model proved too great to overcome. Blockbuster was netflixed.

As Netflix took off and began to look like more than a niche competitor to Blockbuster CEO John Antico, he began to push very hard to respond to the threat with significant investment in an online platform and offering of Blockbuster's own called Total Access. The new platform, with direct attention from the CEO and resources to grow, gave Blockbuster a credible offering to counter Netflix. Antico's move was late but may have worked given Blockbuster's considerable resources, strategic relationships with movie producers, brand recognition, and substantial market share. But Antico ran directly into a conflict with none other than Blockbuster investor Carl Icahn. In 2004 Icahn took a significant ownership position, owning 11.5 million shares (or about 9.6 percent) of the company. Icahn wanted Antico and the company to ignore Netflix and continue to scale its bricks and mortar business model, adding more stores to the network. Icahn was upset with Antico and was publicly critical about his focus and investment in an online platform. Icahn won, convincing the board to replace Antico as CEO.

Any hope of changing Blockbuster's business model left with Antico and the company proceeded to stick with its bricks and mortar business model. That strategy proved disastrous to Blockbuster. The company went on to lose billions of dollars in shareholder value and ultimately filed for bankruptcy in 2010.

Even Netflix Is in Danger of Being Netflixed

The Blockbuster story is about a business model that was successful until a disruptive technology and a new business model displaced it. The story isn't unique to Blockbuster. All business models are vulnerable to being netflixed. Even Netflix has to worry about being netflixed.

Netflix is vulnerable to being netflixed on multiple fronts. They could be netflixed by a company like Redbox that distributes DVDs through a kiosk distribution model. Started in 2003 with rapid growth, Redbox had more retail outlets than Blockbuster by 2007. The cost to place and operate a Redbox kiosk is significantly less than the costs associated with operating a retail video store. It is also less than the cost of operating a mail fulfillment operation like the one Netflix operates. Redbox can rent a DVD from its kiosk network for \$1 per-night, significantly less than both Blockbuster and Netflix are able to offer.

Of course the biggest threat of disruption to Netflix's business model comes from the ability to download or watch movies directly online. As broadband capacity becomes more ubiquitous it is now possible to watch movies on demand directly on the web. It is only a matter of time until both videocassettes and DVDs seem like an antiquated way to access digital video content. Netflix has been aggressively evolving its business model, experimenting with new online movie offerings and pricing models. It remains to be seen if Netflix can avoid being netflixed itself. It will face competition not only from traditional movie rental companies but also directly from movie producers and other media companies that can now directly distribute their content to consumers without needing capital intensive distribution channels.

Netflix initially tried to bundle streaming as a new product offering within its current business model. For customers that wanted to access movies through both the mail and online streaming, it offered a popular pricing plan of unlimited streaming and one movie out by mail at a time for \$9.99 a month. Many liked the offer but with increasing costs it wasn't a sustainable proposition for Netflix. The growing cost of streaming rights and the increasing costs for bandwidth, infrastructure, and support to make streaming available were making a one low price per month for unlimited streaming and DVD delivery untenable for Netflix. Without the cash to gain streaming rights for popular content, Netflix would not be able to please customers interested in streaming. And of course

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customers who were only interested in a low price mail delivery model had no interest in paying higher prices for real time movie streaming. Something had to give.

Netflix announced a whopper of a price increase to all of its customers in July of 2011. They decided to get rid of the \$9.99 bundled price plan and to separate the two offerings, each priced individually at \$7.99. It was a 60 percent price increase and customer reaction was immediate and angry. Blog posts and comments piled up across the web in reaction and over a million customers voted with their feet by unsubscribing to the Netflix service. The business model that had worked so well for the DVD-by-mail service did not work well to deliver online streaming bundled with the mail service.

Netflix was seeing attacks from all angles. Sensing weakness, both Amazon and Wal-Mart stepped up their streaming offerings. Amazon closed deals with both Universal Pictures (1,000 movies) and CBS (2,000 episodes of popular TV shows) to increase the number of streaming offerings in its Amazon Prime library. Wal-Mart integrated its acquisition of Vudu, an online streaming service, under its online umbrella. Wal-Mart doesn't offer an unlimited monthly streaming service, but instead offers movies ranging in price from \$1.00 to \$5.99. Netflix's business model was under siege.

It only took two months for Netflix's next move. In September of 2011 it decided to split up into two discreet business units. One for online streaming continuing to operate under the name Netflix and another independent business unit established under the new name Quikster to operate the company's legacy DVD-by-mail service. It became clear to Netflix that trying to grow the streaming business within the core DVD-by-mail business model wouldn't work. If they were going to thrive in the streaming market it would require a different business model, a model with a unique way to create, deliver, and capture value. While it was going to remain a wholly owned subsidiary of the parent company, Netflix, it was to have the autonomy to continue to serve those customers that value its DVD-by-mail services. Alternatively, Netflix as part of this strategy would

move quickly to leverage its leadership position in the streaming market in the face of significant competition.

In a blog post personally communicating the rationale for the business model changes at Netflix, CEO Reed Hastings provides wonderful insight into the mind-set of a CEO realizing his company is being netflixed. Hastings said, “we realized that streaming and DVD by mail are becoming two quite different businesses, with very different cost structures, different benefits that need to be marketed differently, and we need to let each grow and operate independently. It’s hard for me to write this after over 10 years of mailing DVDs with pride.”³

The most important lesson for all leaders to take away from Reed Hastings’ experience at Netflix is from his simple but profound admission, “In hindsight, I slid into arrogance based upon past success.” Hastings goes on to say in his blog post,

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

And then less than a month later, after losing over 1 million customers and the bleeding continuing, Reed Hastings announced Netflix had changed its mind again and would not be going forward with a separate Quikster business model and unit. They would continue to blend the online and DVD-by-mail offerings and pricing. He amazingly contradicted his comment that companies rarely die

³See <http://blog.netflix.com/2011/09/explanation-and-some-reflections.html>.

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from moving too fast in his announcement saying, “Consumers value the simplicity Netflix has always offered and we respect that. There is a difference between moving quickly—which Netflix has done very well for years—and moving too fast, which is what we did in this case.” It was painful to hear and to watch Netflix in the throes of being netflixed. At the time of this writing, it isn't clear how the movie will end, but it is clear that Netflix waited way too long to react to the disruptive potential of streaming and its schizophrenic actions have cost it significant customer loyalty and shareholder wealth. Stay tuned.

Here are a few other well-known examples of organizations that either have been or in the process of being netflixed:

- Amazon netfixing Borders
- Apple netfixing Tower Records
- E-mail netfixing the United States Postal Service
- Craigslist netfixing local newspapers
- Google netfixing encyclopedias and libraries
- Online education netfixing universities
- Peapod netfixing grocery stores

How vulnerable is your business model to being netflixed?

Business models just don't last as long as they used to. They are all vulnerable to being netflixed. No one and no organization are immune. But how can you become the disrupter instead of the disrupted? Could Blockbuster or any company with a successful business model proactively work on entirely new business models simultaneously to improving the performance of the current one? I think the answer is yes, and the solution is to create a business model innovation factory where technologies and capabilities can be combined and recombined in new ways to deliver value unconstrained by the current business model.

Think Apple. Imagine the day in 1999 when Steve Jobs came in to work and told senior management the company was going to open up its own stores to sell Apple products directly to the consumer.

Everyone in the organization at that time was vested in a business model where products were distributed and sold only through authorized retailers like Sears and CompUSA. All of Apple's capabilities were aligned with this authorized retailer go-to-market model. No one at Apple had any direct-to-consumer retail experience. All of the management job descriptions, performance management systems, and incentive programs were geared toward supporting Apple's authorized retailer network. The entire financial control and measurement process supported the existing business model. Everyone must have seen any plan to open Apple stores as disruptive and a direct competitive threat to the way they did business. Not Steve Jobs. He wanted more direct control over the customer sales experience.

In a typical Jobs flourish he told *Fortune* magazine, "We have to do something, or we're going to be a victim of the plate tectonics. And we have to think different about this. We have to innovate here."⁴ In January of 2000 Jobs hired Ron Johnson, who was then the vice president of retailing for Target, to lead the Apple direct retailing effort. Johnson led an internal project to design what is now the centerpiece of Apple's retail and customer experience strategy. At the time Apple only had two laptops and two desktop products to sell. There was no iPod or iPad yet. Instead of designing a traditional product purchasing experience into the retail space Johnson and his team designed an ownership experience, opening up the space to allow Genius Bars, training, and intimate customer service. The first store opened in 2001 in Virginia and by 2011 there were over 350 stores with premier locations around the world. It is hard to imagine Apple today without its compelling stores and customer experience, but unless Steve Jobs was willing to experiment with a new disruptive business model it would never have happened. In Johnson's own words, when he first arrived at Apple, "people thought I was crazy."

⁴"How Apple Became the Best Retailer in America," *Fortune*, March 8, 2007.

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It is not unusual for people vested in any business model to view new business models and the people associated with designing them as crazy. The leadership challenge is how to keep the current business model performing while simultaneously experimenting with new ones even if they and the people deployed to working on them seem a little crazy at first.

To avoid being netflixed all leaders and organizations must learn how to do R&D for new business models. A successful business model innovation factory moves new ideas quickly from concepts doodled on a whiteboard to real world experiments to explore the viability of a new business model in real market conditions. These are not incremental changes to the current business model but entirely new ways to create, deliver, and capture value. Organizations need a business model innovation factory to explore new business models unconstrained by the current one.

A successful business model innovation factory has the freedom and access to the resources it needs to explore even those business models that might disrupt the current one. It also maintains a strong connection to the core business so it can access the capabilities it needs to accelerate business model experiments. Most organizations know how to do R&D to develop new products and technologies to drive top line revenue growth of the current business model. What organizations need to do that they aren't doing now is establish an ongoing R&D capability for new business models.

Before you can create a business model innovation factory the first step is to understand the basic components of a business model and to clearly articulate and map your current business model.