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Netflix: A Prime Example of Innovation, Adaptation, and Generative Leadership

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Executive Summary

In 1978, the first video rental store appeared in Los Angeles, California. In just a few short years, video rental stores could be found in every major shopping mall, convenience store and corner block. Blockbuster stood out from the 7,000 other stores for one main reason. Blockbuster's founder David Cook, a computer programmer, developed analytic software to determine the likes and dislikes of moviegoers. With this program Cook stocked the shelves with the favorites and ditched the rest. In the late 1990's a new majority of customers exposed weaknesses in Blockbusters revenue sources and in stepped Netflix. Netflix empathized with the new majorities need for lower rental prices and lower later fees. Netflix took over the video rental industry and brilliantly innovated an entire new industry for television. Netflix was able to accomplish these feats because it empathized with the customer, and developed solutions for their needs. Netflix developed an advanced algorithm, known as Cinematch, to track customer movie wish lists and recommend alternative movies too. In 2010, Blockbuster filed for bankruptcy.

Both Cook and Reed Hastings, founder of Netflix, started their business while the early majority was still adopting the new innovations. Blockbuster and Netflix, rode to success as the later majority jumped on board. The difference though, is Blockbuster did not take advantage of the Internet and Netflix did. Call it shortsighted or being loyal to old assumptions, these blind spots in organizational thinking are killers. Netflix embodied innovation, adaption and creative thinking in its business model and flourished.

Timing is crucial. As will be illustrated, innovation cycles are timed and each part of the cycle has different types of customers. Thinking about the next innovation cycle while building revenue in the current cycle is a fortuitous idea. Two entrepreneurs Alistair Croll and Benjamin Yoskovitz in their book *Lean Analytics*, discuss how to empathize, build a sticky—viable idea, take the idea viral, build an impressive source of revenue, and scale the idea into new verticals and geographies. Theses concepts will each be used against Blockbuster, Netflix, and their three innovation cycles to illustrate the importance of disruptive innovation, and generative leadership. Netflix will be showcased to illustrate *how* a 21st Century organization needs innovate, adapt and generate revenue.

1975-1985 Innovation Cycle: Visionary to Early Majority
Video rental stores first emerged in Los Angeles, California in1978 by George Atkinson.[1] The business was in its innovation cycle[2]. Since then, video rental stores grew to become a social hit[3]. In 1983, just five years after its rental stores appeared, the early majority of home entertainment movie watchers had bought into its idea. By 1985, the year Blockbuster opened its first store, 28% of all households in America had a VCR and that number was expected to double in five years[4]. Consumer electronic companies like Sony and Victor Company of Japan (JVC) spearheaded the videocassette recorder industry. According to Cususmano et al., "the VCR surpassed color television to become the largest single consumer electronics product in terms of sales by the early 1980's."[5] Cususmano et al., wrote, "In the case of the VCR, the potential global market measured hundreds of millions of units. Its very scale created a window of opportunity lasting a few years."[6] Had Blockbuster waited any longer to open its first store it would have missed the early majority adopters. From the beginning, competition in the video rental store industry was steep. By the time Blockbuster opened there were already 7,000 outlets positioned in every convenience center or shopping mall,[7] making it easy to stop by a store on the way home from work and pick up a movie[8]. However, Blockbuster swiftly entered the market and in less than three years it had become the largest video chain store in the world and was worth $18 million[9].

1975-1985 Lean Analytics Stage: Empathy & Stickiness
Empathy. Croll and Yoskovitz think, the empathy stage is about "discovering what is important to people and being empathetic to their problems."[10] In this stage innovators discover what is important to people through qualitative feedback.[11] What innovators are looking for are a problem worth solving and a solution that will stick.[12] Not all video rental stores were able to solve the problem of the rapidly growing home entertainment industry with a viable solution. Just as it was noted above, there were 7,000 outlets before Blockbuster opened. Entrepreneurs were opening stores all over the country. Yet, these stores were closing just as fast. By 1998, 5,000 stores had closed and revenues in video stores fell to $180,228 from $219,223[13]. Blockbuster's founder, David Cook, was able to find a viable solution to the home entertainment problem. Cook became empathic when he realized that customers were leaving his store without a desired movie title.[14] This fact explained why revenues were dropping at stores all over the country. It also helped to explain why stores were closing as fast as they had opened. According to Cususmano et al., "While a market is unfolding, both early and later entrants can maneuver a sustainable winning position before the fame is decided. Each has particular advantages and disadvantages associated with the timing of decisions and the extent of commitments."[15] In the case of the video rental industry the winner was not crowned and Cook rightly determined that if he could solve this problem he would have a viable product.

Stickiness. In the sticky stage, leaders want to focus solely on retention and engagement.[16] Leaders do this by focusing on metrics of daily, weekly or monthly active users.[17] These metrics can be used to determine when and how users behave differently.[18] To solve Blockbusters customer problems Cook, a computer programmer, developed analytical software to keep track of inventory and that gave him a daily report of what customers were renting.[19] The software enabled Cook to determine which older titles to keep and which titles to dismiss.[20] In the years to come, Cook's computer program yielded its stores' huge dividends by leaving customers fully satisfied.

1986-1996 Innovation Cycle: Late Majority to Laggards
For decades, videocassette player producers considered several different types of magnetic video recording technology. Products ranged from U-matic, Beta, VCR and other lesser-known players.[21] While the visionaries and early adopters fastened quickly

to this emerging technology the late majority of consumers were still undecided. This is in part due to the high price point of a videocassette player and the lack of product clarity from manufacturers. Competing manufacturers could not agree on interface standards, so retail stores were stocked with U-matic, Beta and VCR products. Uncertainty in product also slowed down mass production, kept prices high and hindered broad distribution channels.[22] Eventually it was the public market that settled the quagmire. Through a process known as 'positive feedback'—where the perceived benefit of a product is substantiated because others purchase it too—the VCR took flight.[23] By 1985, the VCR was on its way to become a standard electronic product in the American home.[24] The late majority had finally decided to join the movement. As VCR sales boomed with the increased availability of prerecorded tapes, the video rental store industry in turn helped to shape the VCR industry.[25] Over this ten-year period Blockbuster rode the coattails of the videocassette recorder industry. As a result, Blockbuster experienced explosive growth.

1986-1996 Lean Analytics Stage: Stickiness, Virality, Revenue & Scale
Stickiness. The computer program Cook had built worked. The next problem Blockbuster ran into was that there was simply not enough supply of new release videos to keep pace with the demand. Each weekend the shelves holding new release videos would be emptied.[26] Blockbuster used analytics to ensure that each store had enough copies of consumers second pick choices so customers left the store with a movie.[27] During this time period 70% of Blockbuster sales came from second pick movie rentals.[28] The situation Blockbuster was in was so sticky that the organization went viral.

Virality. People love movies and in the 1990's they were beginning to enjoy movies even more in the comfort of their home. Blockbuster was a business, sweetly positioned in an industry, where there was inherent virality. Blockbuster succeeded because it was able to pivot the customer to their stores. The customer, however, was loyal to the movie experience not to the VHS. As the world moved closer to digital technology the original assumption of what made a Blockbuster customer happy quickly became extinct. The analytics used by Blockbuster measured these past assumptions and revealed that rentals were dropping. The fundamental issue that Blockbuster originally solved was no longer the fundamental issue. Customers wanted digital downloads.

Revenue & Scale. Up to the digital age, Blockbuster knew how to make money. In fact, the organization did everything right. It listened to the customer's problem and it found a viable solution. It used metrics to continually analyze what customers wanted to watch and it fulfilled those desires like a well-oiled machine.[29] Blockbuster was a machine that could turn pennies into dollars. In 1991, it had grown to over 1,654 domestic stores and by 1994 Blockbuster was worth $8.4 billion,[30] with close to 3,000 stores[31]. Looking back, it is no wonder then that to investors the video rental store was attractive and determined to have market potential. Investor Scott Beck said, "It was like IBM and McDonald's had opened a video store"[32]. In 1996, at the end of this innovation cycle Blockbuster changed ownership. The original investors sold Blockbuster because they could not figure out how to bridge the emerging technology gap[33]. Instead of venturing into unfamiliar waters it was sold to Viacom[34]. Ignoring the importance of emerging technology, Blockbusters' new owners never scaled the brick-and-mortar video rental chain and instead focused on selling MTV merchandise, books, toys and clothing[35]. By 1996, Blockbuster lost half of its organizational worth[36] on the cusp of an entirely new innovation cycle.

1996-2000 2nd Innovation Cycle: Visionary to Early Majority
Organizations like Netflix that entered the stage as early innovators had an eight-year lead over Blockbuster, the industry's former giant. While Blockbuster was latently selling merchandise in its stores, the global consumer market was expeditiously moving

towards an internet consumer who was interested in renting on-line, and streaming videos. Internet technology was not the only changing trend to have an impact on the video rental industry. DVD technology caught on faster than VHS technology.[37] DVD's were priced to sell. A new era of consumers opted for the purchase of favored movies at low-cost stores like Target, Best Buy and WalMart.[38] Combined, the Internet and DVD technology exposed gaps in Blockbusters' assumptions and subsequently its strategic capability to meet specific consumer needs.

In December of 1996, there were already 36 million Internet users.[39] One year later, in 1997 when Netflix started fulfilling mail order subscriptions there were 70 million Internet users.[40] In 2000, Netflix started a fledgling service of renting digital downloadable media[41] to an audience of over 300 million Internet users.[42] Hastings brilliantly captured this massive audience in a way similar to how the analytic software developed by Cook ensured consumers had a second pick movie which pivoted customers to Blockbuster.

1996-2000 Lean Analytics Stage: Empathy & Stickiness

Empathy. At the outset empathetic leaders seek to understand what is important to consumers.[43] According to Croll and Yoskovitz, "That means discovering and validating a problem and then finding out whether your proposed solution to that problem is likely to work."[44] Hastings listened to Blockbuster customers and discovered a major problem with Blockbusters source of revenue. Blockbuster's revenues came from $5 new release rentals and $2 non-featured rentals. Additionally, Blockbuster earned approximately $200 million a year by penalizing customers with high late return fees.[45] Blockbuster customers hated the exorbitant high fees.[46] Hastings listened to these concerns and developed a monthly subscription for $19.95 that allows unlimited rentals and no late fees.[47] Blockbuster answered the empathy question by providing movies to rent, whereas Netflix answered the same question by providing customers a convenient service.[48] Eventually, Netflix's strategy to listen to consumers' concerns turned Blockbuster upside down.

Stickiness. Regarding stickiness, Croll and Yoskovitz write, "The big question now is whether or not what you have built is sticky, so that when you throw users at it, they will engage."[49] In this stage, the focus for Netflix is squarely on retaining and engaging[50] an audience of DVD users. To accomplish this, Netflix used an outward strategy and reached across its ecosystem.[51] Netflix partnered with Hewlett-Packard, Apple, Toshiba and other computer manufactures to increase the purchase of computers with DVD players.[52] Netflix offered free DVD rentals anytime a DVD player was purchased.[53] The partnership was a brilliant move. According to Goldstein, Hazy and Lichtenstein, "A true ecology of innovation was developed by Netflix; it was an ecology that helped create the company and catalyze an entire industry."[54]

To increase stickiness, Netflix entered a partnership with Amazon. Goldstein, Hazy and Lichtenstein write, "This innovative partnership allowed both firms to avoid head-to-head competition; Amazon.com gained a small customer base, whereas Netflix gained a huge amount of additional advertising, and in addition, became focused on a much more distinct niche of DVD rentals."[55] In the end, the low cost subscription plan, various partnerships with DVD and computer manufacturers and the alliance with Amazon created a platform of opportunities where success built off of success.[56] Netflix was now stickier than Blockbuster.

2001-2015 3rd Innovation Cycle: Visionary to Laggard

During this innovation cycle, Netflix's mail order subscription service went viral. Before 2006 ended Netflix was mailing 1.4 million DVDs a day.[57] By 2007, Netflix had nearly 7.5 million subscribers. In 2009, it had 12 million.[58] Masterfully, Netflix was able to build massive revenues and scale its size internationally, but mail order DVD subscriptions are not how Netflix will be remembered. Instead, Netflix will be remembered for how it embodied the heart of innovation, adaptation and high performance by spearheading the online video streaming innovation cycle. Still in Netflix's infancy, Hastings believed that the future of the Television Industry was in streaming videos over the Internet.[59] Like the early history of electronic consumer products (VHS, U-Matic or Beta), digital capability was new and a viable consumer solution to online video streaming was still unmet. Fortunately, all Hastings had to do was connect Netflix's growing list of subscribers to online video streaming and the rest would be history.

2001-2015 Lean Analytics Stage: Empathy, Stickiness, Virality, Revenue & Scale
Empathy. As stated earlier, in terms of meeting changing customer needs, Netflix had a massive lead over Blockbuster. By 1997, Netflix was in the business of fulfilling mail order subscriptions.[60] Just four years later, in 2000, Netflix was discovering ways to enter the market of digital downloadable media[61]. Blockbuster did not even start its mail order video rental services until 2004. This illustrated that there was a disproportionate level of thinking between what Netflix was solving and Blockbuster thought was the primal problem.

Stickiness. Netflix was sticky from the time it listened to Blockbuster's growing concerns over price. Blockbuster had the growing base of support, but Netflix had the answer that Blockbuster could not solve. Customer migration from Blockbuster to Netflix was just a matter of time.

Virality. During the mid-2000's an unprecedented reversal in market power took place. For every customer that Blockbuster lost Netflix gained two new customers. Netflix started streaming video content to 12 million subscribers in 2007.[62] One year later it was in competition with NBC, FOX, ABC, and CBS as they launched their own versions of streaming video.[63] Netflix developed and maintained an extensive recommendation system based on rating and reviews by customers. This was a positive feedback loop that created virality through an online version of word-of-mouth.

Revenue. Additionally, Netflix used both the Internet and developed an attractive price point for video rentals and online streaming videos. Revenues poured in through different price point packages. The cost per month varied based on how many DVD's a customer wanted to rent and how many hours he or she wanted to stream.[64] To keep competition away, Netflix adjusted these prices and packages as necessary. In 2006, Netflix total revenue was $688 million.[65] Before 2007 ended, revenues were well over $1billion and in 2015 revenues were close to $5 billion.[66]

Scale. With revenues coming in, Netflix could now think about scaling the business and reaching a new market of customers from new verticals and geographies. If listening solved the original empathy problem then analyzing things quantitatively would solve the scaling issue.[67] Netflix's solution was to enter the business of original television show programming.[68] According to Kovacs, "Using its data mining and predictive analytics algorithms Cinematch, Netflix managed to produce success television-quality shows such as 'House of Cards' and 'Orange is the New Black' winning several Emmys and diminishing its dependency on content owners."[69] Cinematch is Netflix's own in-house recommendation system.[70] Kovacs notes, "Cinematch uses the customer's past viewing behavior to suggest new content for the [customer]."[71] Through constant innovation and continually revisiting the empathy question, Netflix became a disruptive innovator that not only unseated Blockbuster but also changed the way we watch Television.

Conclusion

Blockbuster failed not because it was a well-oiled machine, but because there was no room in its organizational thinking to allow for creativity, innovation and adaptation. Yes, Blockbuster had a strong culture and it's culture provided continuity to its tens of thousand employees however as new technology was introduced, Blockbuster remained loyal to its out-dated assumptions of what the early majority customers wanted. The late majority and laggards were a different set of movie watchers. They could not afford the exuberant prices of VHS products nor did they agree with the high price of late return fees. May said, "Visionaries look at technology as an opportunity to create competitive advantage."[72] With the invention of the Internet technology, Netflix swept the late majority adopters off of their feet and took the early majority of Blockbuster customers too.

The example of disruptive leadership set by Netflix is a prime example for what a 21st Century organization should look like. In that Netflix was able to seek out, foster, and sustain a vibrant ecology it proved a critical element of generative leadership. Generative leadership requires a nuanced understanding of the environment and an ability to structure situations and manage interactions. Before the first innovation cycle of mail order subscription was complete, Netflix keenly observed another cycle of online video streaming beginning. Simultaneously, Netflix fostered both innovation cycles and emerged as a triumphant leader in the Television Industry. To succeed, organizations need to continually adapt to its new customers wants and needs. Unlike Blockbuster, before organizations scale they need to re-enter the empathy and stickiness stages found in lean analytics to ensure they have captured the entire audience.

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