STRATEGY & innovation

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Feature Story

Q&A: Reed Hastings

Netflix founder and CEO Reed Hastings was interviewed at Innosight's "Meeting the Growth Imperative" event in August 2008 by Innosight chairman and co-founder Mark Johnson, with added questions from audience members and from Innosight co-founder Clayton Christensen. The following is an excerpt from that interview.

Mark Johnson (MJ): Reed, the first obvious question to ask you is, did you set out saying, "I'm going to transform the industry and I'm going to disrupt Blockbuster?"

Reed Hastings (RH): No. Obviously that's a very competitively focused lens. Netflix is a single-product, domestic-only, 10-year-old company with $1.5 billion in revenue. But we set out to try to take advantage of a big, external dislocation.

It's not hard in the tech market to see that companies like Microsoft and Oracle have had these amazing 25-year runs because they've found a market in which Moore's Law has continued to deliver and propel their profit streams.

We looked at the market 10 years ago and said, "Broadband is going to grow around the world from 125 kilobit DSL to 50 megabits a second. And all of you will, in the next 10 years, have 50 megabits a second. Your PC will be a web browser, your cellphone will be a web browser, and the TV will be a web browser. So the thing that is your TV channel guide today will be a web browser. And we think the providers of those browsers will be web companies, not distinct regional cable or phone monopolies in the way that we have today."

So in thinking about that opportunity, the DVD by mail was obvious as a jump-start. From the beginning, DVD by mail was seen as a temporary play to simulate a digital network, to build up the rest of the web infrastructure, and build the brand.

So we're unique only in that our initial business model was never planned to be the long-term business model, and that's somewhat unusual. It has lasted longer than we ever thought. If you'd asked me when we started in 1997, "In 10 years, what percent will be downloading and streaming?" I would have said, "Oh, a majority." And, in fact, it's microscopic compared to DVD. And DVD continues to have lots of life. So even I overestimated the pace of change.

That's what's really unique about us, not so much that we disrupted Blockbuster. That's true, but so did Amazon against Wal-Mart, and so did lots of e-commerce companies. It turns out that on the Internet you become a software company and a consumer brand company. So those are the two big competencies. And store-based companies have a very different sophistication. They're certainly brands, but they're also store operations. I would never want to try to run store operations against an incumbent like Blockbuster. They're very good at it. But it's a very different skill set.

And did they make the same mistake that most people make, which is they look at the insurgent — us — and say, "Geez, low-margin business. Why do we want to compete with a niche low-margin business?" Yes, they made that mistake.

One of the reasons Clay lets me come to these meetings is that five years or so ago, some of his students who were interviewing us would say, "What are you most happy about?" We said that we were happiest that the Blockbuster team had apparently never read Clay's literature about the danger of the disruptive, low-margin business, and that they didn't act on it. And, of course, when they finally did, as Clay predicts, it was too late and we had enough accumulated experience — we were further down the experience curve — and were able to hold our own. So it's a beautiful, simple test case in real-time for Clay's theories.

MJ: How formed was your business model when you started out — even on the mail side of things — versus where it ended up? Did you get it right the first time, or is it fundamentally different now than it was?

RH: No, we didn't get it right the first time. We had a few hiccups in the first two years trying to figure out some things. We started off saying, "We can't be subscription, flat-fee because it's too radical. We should incrementally do pay-per-view, but through the mail." So we lacked courage. But within a year we could see, "Well, this isn't working very well." So by then we were willing to bet on the subscription model. For probably 10 years now it's been subscription and pretty constant.

But it just takes a lot of execution. We've been largely consumed with operational concerns, fighting these competitive battles and preparing for the end of the DVD. That's another thing that catches the press's attention about Netflix. Everyone knows DVD's going to go away soon — eventually — and so it takes on the fascination of, "Is Netflix going to be another road kill like, frankly, AOL was on dial-up networking?"

MJ: And to what extent do you put an understanding of the customer's jobs-to-be-done and the value proposition first before any business model? Because what you said is you looked at the mail business as a means to an end. You didn't think you were going to stay in that, right?

RH: That's true. We've considered the frustration that people have with cable and satellite to be the underserved market. There's so much on TV, but there's nothing on you want to watch. And there's so much video produced.

The real power on the Internet is in the "matching" businesses like eBay and others like match.com, businesses that match up people with products or services or other people. And there's a big match problem between consumers and producers of entertainment. If we can fundamentally improve on that matching experience using the Internet, we grow the market. So there's very much a consideration of nonconsumers.

The Internet has become this unbundling mechanism. Today cable and satellite companies are at the same time delivery mechanisms and content companies. Eventually such companies will unbundle, and you'll see companies that specialize in delivery, and companies that specialize in content.

So in that sense, we've always started with the job. The job being hired is a better video experience, where you enjoy more of what you watch because when you find a series that you like — let's say a television series — you're really excited, and you want to get to the next episode and next episode. But finding these series is not that easy.

MJ: What are your thoughts on managing a balance between short- and longer-term investments in the business?

RH: We do think a lot about that. In our language, there are the agriculturists, the small-game hunters, and the elephant hunters. You want a mix of those. The agriculturists are working on ideas that will improve our economics in the next two quarters and seeking efficiencies. A majority of our people are agriculturists; i.e., they are feeding the tribe dependably, on a daily basis. Then we have some small-game hunters, and they might bring something back once a quarter. They bring back a deer equivalent, some kind of improvement. The big-game hunters might go dry for two years and then bring home the elephant, the whale. And we try to allocate our investment in each of these types.

The importance of labeling them is because if you're an agriculturist and you see the elephant hunter eating your agriculture every day for a year and not delivering anything, you're filled with resentment. Unless you have a model to understand that: "Ten percent of our innovation effort is elephant hunting, and that's what that person does, and I'm glad they do it. And I'm okay feeding them because every two years they'll bring us an elephant."

And, yeah, the elephant hunters are harder to measure because they work longer-term. But by setting the context, then the different innovation groups are okay with each other and can understand each other more in a value system way, rather than resent each other, with the elephant hunter saying to the agriculturist, for example, "You only do day-to-day stuff." The context helps them understand that they're all related to the success of the tribe.

MJ: You started off in the mail business, DVDs, and now you've moved to set-top-boxes for video streaming. Is that an evolution of your model? Is that a fundamental change? And if it is a fundamental change, how painful has it been? What have you had to do to manage the transition? What are the real challenges that you face in making this transition?

RH: I would say the biggest challenge has really been the public investors, because we had to severely tax what would be our profit base to do these forward investments. Roughly speaking, operating income could be nearly twice as big if we weren't making these forward investments. Operating income is still growing. It's still growing nicely. But it could grow even faster if we just weren't investing so much in this darn Internet thing.

However, the investors who feel that way mostly select out, as long as we feel we've been clear — and we have always been since our IPO — about what we're doing and why. In our own eyes, we were born to do this Internet thing.

So is it hard? Not at all. It's been hard to hold back until we get to this stage. Is it costly? Yes. But we believe that there's an opportunity for a global video delivery franchise that'll be phenomenal in the future and is well worth investing in, because we think that the Internet is going onto the TV.

So the underlying core bet is that there will eventually be a pretty open architecture to get to the TV, which is certainly not the case now. The set-top-box you referred to is one little step in that process.

Relative to the "disruptive" and "sustaining" terminology, this is a really interesting example. The technology is radically different. The guys in our company who do DVD-by-mail have a very different operational focus and kind of character from the people who do our Internet streaming and set-top-box business.

But while it's a very different technology, it's not disruptive in your sense because it sells to the same customers. It is our current customers who want this technology now; they want instant Netflix, "I don't have to wait for the mail." So our customers see it as an improvement to the service.

MJ: So it's facilitating the business, too?

RH: That's right. So it really feels sustaining, even though it looks radically different, which is a nice illustration that disruptive and sustaining have nothing to do with technology. They have to do with customers.

Question from audience: As I listened to you, you were very clear that your strategic bet is on movies coming to the TV. You talked about the disaggregation of all the key suppliers, and you're attacking it through that market right now with this streaming capability, which I logically understand. But do you see other players that could come from a different angle and disrupt you?

RH: Yes. There's a wide range of competitors or potential competitors — Apple, Amazon, Hulu. Typically the disruptors that we would worry about are not the ones that have our business model, i.e. subscription streaming. So, as an example, one that we do worry about is Hulu, which does ad-supported video and streaming.

Today, advertising on a per-person basis does not support the cost of movies. That's why movies are released first in theaters instead of on ABC, simply because ABC can't afford them — the CPM, the amount of money they can get for ad sales, is not high enough.

Now if in principle, Google and others are able to increase personalization and relevance such that consumer traffic would support high-enough ad rates, then that's a disruption. Then we're screwed, because we haven't bet on advertising-based content reaching up that high. And by the time we are able to get there, how good are we going to be? Not good enough. So the threats that we worry about are the substitution threats.

Another threat is DVRs. When you have five gigabytes at home on DVRs and you've recorded every show on the planet, then broadcast architectures become more interesting. And obviously, we're not going to be effective competing on that substitute.

Those are things that we expose to investors, but that we can't fix. We say, "The bet on us is a secular bet on watching TV within a web browser." Obviously, everyone's kids are watching on a PC a lot more. That works great for us, and we just want to get it to all the screens. It's web-based, open-video viewing, versus the current closed-system, cable-satellite architecture.

Question from audience: You get to see some of the most interesting companies around, and you're one of Silicon Valley's brightest lights. Could you give your thoughts on business model innovation?

RH: Well, business model innovation is very scary because it's the toughest kind to take on. There are different kinds of innovation like the one that I just spoke about, advertising-based innovations. When you've got a product that you use to get revenue from the end customer, and then it switches so that now you use your product to attract enough of the right demographic of customers to get revenue from advertisers, that's a really big change in an ecosystem.

Media is largely ad-supported. So now the question is, well, what parts of software will become ad-supported? Databases probably won't, but many other kinds of software could be. Email largely has already become ad-supported. That's potentially a huge disruption that's very challenging, because they are such different competencies.

MJ: So how do you deal with that?

RH: We track it, but we recognize that if that happens, there's nothing we're going to be able to do about it, so we're just going to kind of segment it out of our risk profile. And everybody knows that's a secular risk to our business if that happens.

My point to the management team and the board is that the big risk we face is technology obsolescence. That is the dominant risk. The little risk is that somebody screws up some bug in some product or financial restatement. Those are not good things, but that's not how companies fail. How companies fail is the lack of technology or business model innovation. And so if we're going to be thoughtful stewards of value, we need to optimize around the big risks.

Part of the creative challenge is not having too many controls. We run extremely light on controls, and it scares people, for sure. But you have to compensate with values and influence. We talked about managing through context rather than control. This is not articulated much in the literature and in the boardroom.

MJ: How much do you believe in the rules aspect? To your point that you don't want to have a lot of controls, are the rules and norms that overlay the DVD mail business different than the rules and metrics and norms of the streaming-content business?

RH: Well, I would say they are different. Your team presented the quality characteristic and compared it to innovation, which is interesting because you see these big movements in business. Quality was the topic, and now innovation's the topic. And at that level, I agree.

But they're really different because quality is about reducing variation, and innovation's about increasing variation. It's the long tails in your innovation that produce the huge profits. And so you want to do it smartly, but how do you have a culture that is very quality-oriented and focused on reducing variation in manufacturing, but able to increase variation when innovating? Your big wins come from your exotic types of innovation, your elephant hunters. So you want a mix of types, but you can't have all elephant hunters.

To me, controlling innovation is almost an oxymoron. Innovation should be inspired, rather than tolerated. It's back to this necessity of surprise in innovation. If we set our expectations around, "We're going to figure out how to proceduralize innovation," we're not going to get there.

Now, how can we support innovation so that it doesn't get snuffed because it doesn't fit the desired growth margins? That's important. So I would always talk about supporting innovation so that these things see the light of day rather than managing, controlling, and proceduralizing it, because it's so creative. And you're looking to increase variance in the innovative sector.

Clay Christensen (CC): I'd like to look at the question another way. That is, I think you had a real benefit, Reed, because you defined the business model as focused on a job-to-be-done. That allowed you to create a kind of a vertical integration stream, which is your system for getting to know every customer's preference, and then cuing up content as well as delivering it in a convenient way.

If you had framed the business as, "We're in the delivery business," you'd be in trouble now because that part of the value chain's been commoditized. There are just so many ways to get this stuff to customers. But when you're integrated, it doesn't matter that delivery is commoditized.

Yet the customer still isn't being satisfied well enough. And I would describe that as, "Man, there is so much content and so many ways that I can get it. Would somebody please help me find what I want to watch?" And whoever solves that problem is the one who makes the money in the future. So you're actually in the midst of a change in business model where the core of the business now becomes, "I'm going to help you find exactly what you want to watch."

RH: That's right.

CC: And then you have another business model that may or may not be disruptive to you, which is YouTube. And whether you need to worry about YouTube, in my mind, would be predicated upon, is YouTube being hired for the same job as Netflix gets hired to do? And if it's not, then I think I'd feel okay. But if it is, then I think I'd worry.

RH: Then there would be some worries, yeah. I think that's right. In your classes when you do the Netflix case, an interesting question to ask the students is, "Should Netflix have gone into video games and renting video games?" It's the same disk. Blockbuster wants it. And guess what? It's one of the most requested things amongst our customers, "Can't you also rent games?"

Right now games are temporarily on disks. But as content increasingly goes online, games do not come through us. They go through the console providers.

However, if we were renting games, we'd be defining ourselves as a disk-based business. We'd say, "We're really good at shipping, what else can we ship horizontally in the disk competence?" Many of your students may say, "Well, how else can they monetize the existing assets?"

So we've left that profit on the floor in order to keep the brand promise and our internal focus on fulfilling the job of helping people find what they want to watch and using technology to provide that content quickly and easily. We've either been arrogant and ignored the customer, or we've been brilliant in defining our business as movie-choosing. We ultimately will see if that's smart or not.

Disrupt-O-Meter

Space Tourism—XCOR vs. Virgin Galactic

By Renee Hopkins Callahan

At publication time, American video-game developer Richard Garriott was enjoying a 12-day visit to the International Space Station, a trip for which he paid $30 million to Space Adventures Inc., a company that has for the last several years brokered trips aboard Russian Soyuz capsules to the space station. Phenomenally expensive excursions into space are now available only to the small handful of people with deep enough pockets, but that's about to change: many more among us will be able to afford a ride into space starting next year, when the space tourism industry officially blasts off. Several companies plan to offer short suborbital space flights in the $100,000 to $200,000 range. We look at two: Richard Branson's Virgin Galactic, which will start space flights in 2009, and lower-cost competitor XCOR, which aims to start flying in 2010. Which is more disruptive?

XCOR		Virgin Galactic
Those interested in "economy-class" space tourism	**CUSTOMER**	Those who want to go with a friend and/or are willing to pay more for pampering *(winner)*
30-minute suborbital flight for 1 person to 200,000 feet; 90 seconds of zero gravity; $100,000 per person; starting in 2010 *(tie)*	**SOLUTION**	2½-hour suborbital flight for 6 people to 360,000 feet and 4 minutes of zero gravity; $200,000 per person; starting in 2009 *(tie)*
Four flights per day; they own plane so could get other NASA business	**BUSINESS MODEL**	Two flights per day; planes are leased; expect to sell the "experience" and the Virgin brand *(winner)*
Space Adventures has announced a $102,000 flight; Amazon's Jeff Bezos is also developing a spaceplane that will directly compete on price	**COMPETITIVE LANDSCAPE**	None of the other competitors has an established luxury travel brand they can leverage to sell what still amounts to an ultra-luxury trip *(winner)*

Winner: Virgin Galactic. This is a classic case of how difficult it is to predict a truly unknown market. Determining which of these is more disruptive will hinge partly on learning what exactly constitutes “good enough” for space tourism, which is currently unknown. Will 90 seconds of zero gravity satisfy someone who’s spent a six-figure sum for the experience? Can Virgin make the experience so much better — given the longer, higher flight and the ability to travel with friends and family — that it’s worth twice the price? Is the target market of price-sensitive enough that a difference of $100,000 will matter? We can’t tell right now, but we can tell you what to watch out for as this business unfolds:

- **Business model:** Owning vs. leasing planes could be critical. NASA has announced its intention to buy time and space on these suborbital planes as well, so XCOR, which owns its planes, has a potential hedge if the consumer market doesn’t develop quickly enough. Virgin Galactic, which is leasing the spaceplanes they will use, won’t have this source of revenue, but also won’t face the expensive burden of trying to keep up with rapidly evolving technology, and can take advantage of emergent strategy, learning and refining their business model as the market evolves. Also, Virgin seems more likely to get the “job” of providing an experience done better than XCOR.

- **Brand extension:** Virgin is already in the aviation business and has a reputation for excellent customer service. If the quality of the space-tourism experience is critical, then Virgin could triumph.

- **Price:** The price of the flights has dropped significantly since plans began to be announced a couple of years ago. Virgin’s first announced price was $300,000, and still a year away from launch, they’ve lowered their price by 30 percent.

- **Competition:** Though the first flights have yet to take off, the field is getting crowded. Amazon’s Jeff Bezos, himself no stranger to disruption, owns Blue Origin, a hush-hush enterprise said to be aiming at 10-minute flights starting late in 2010. Notably, Space Adventures, the only way to get into space right now, has already announced plans to launch suborbital flights for $102,000, and could potentially match or undercut XCOR’s prices. Virgin could win here if they come up with a higher-end, hard-to-emulate experience.