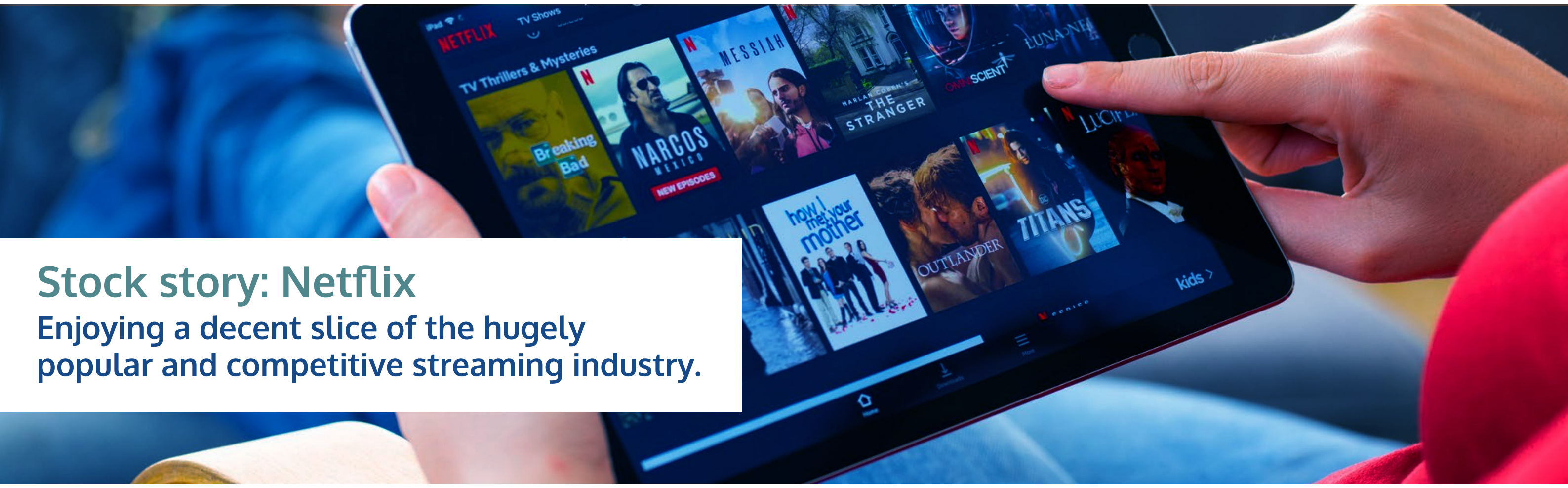

Stock story: Netflix

Enjoying a decent slice of the hugely popular and competitive streaming industry.

Competition under the capitalist system in theory works something like this. An entrepreneur has a bright idea. That leads to a business making, or promising to make, excess profits on the capital invested. Others see the riches to be made. They set up rival companies. The extra competition reduces the prices consumers pay. Profits decline, even for the pioneering business. The loss-makers fold while the industry survivors eke out their cost of capital.

Let's see how the theory applies to the on-demand-video or streaming industry. The pioneer for watching TV shows and movies over the internet in a personalised way is Netflix. In 1997, Reed Hastings and Marc Randolf founded the company in the US as a movie-rental service, where people ordered DVDs via the Netflix website that were then posted out. The company listed in 2002 and successfully saw off a challenge from Blockbuster. Recognising that streaming was the future of video distribution, in early 2007 Netflix introduced its Watch Now product as part of its DVD subscription that allowed people to choose from about 1,000 movies they could watch instantly on their PCs.

What a great idea. By 2012, Netflix had expanded its catalogue of streamed content significantly and amassed sufficient viewership to begin its inevitable transition towards original content. Netflix's first original series, House of Cards, was a huge hit. By 2016, Netflix's streaming service was available globally (ex-China) as Hastings moved rapidly to take advantage of a "competitive window that will be open only temporarily". One year later, Netflix cracked 100 million subscribers of whom more than 50% came from outside the US, won its first Oscar (for a documentary) and released its first feature film.

There was always competition in a broader sense for the streaming services of Netflix (which still operates the legacy DVD and Blue-ray-disc hiring business). The company was always competing with linear free-to-air and cable TV for people's viewing time and early on Amazon, Walmart-owned Vudu, and Hulu, owned by a consortium of media companies, offered rival streaming products. More recently, however, the Hollywood studios arrived. Long concerned with cannibalising existing revenue streams, they responded belatedly by launching streaming services.

WarnerMedia, NBCUniversal, ViacomCBS and Disney arrived with immense backlogs of content, the money to create more, and huge marketing budgets to try to convince households to add their service to the emerging streaming bundle. A critical early move of Hollywood was to reclaim their most popular content such as the Friends series. In just over a year, Disney's iconic content has seen it attract more than 90 million Disney+ subscribers worldwide, complementing its nearly 40 million Hulu subscribers in the US over which it has control following its 2019 acquisition of 21st Century Fox. WarnerMedia's HBOMax has over 40 million subscribers. Although Netflix's 204 million subscribers worldwide as at the end of 2020 still provides it with 'scale' advantage, the competitive set in streaming is broadening.

With this increase in competition, is Netflix destined to be a business grafting out its cost of capital? We don't think so. The streaming industry comes with characteristics that when combined with Netflix's bespoke advantages are likely to ensure the company can earn bumper returns on capital for the foreseeable future.

The most notable features of streaming are its popularity and the scalability of content spend. Industry leaders including Netflix are likely eventually to sign up hundreds of millions more households around the globe. As they do so, a portion of the incremental revenue will be reinvested in expanding their content offering, improving the value of the service while concurrently creating ever-growing barriers to new entrants.

Another benefit of these economies of scale is that streaming services are relatively cheaply priced (especially compared with the fees and commitments for pay TV). That means most households will be able to afford two or more streaming subscriptions (reducing direct competition between providers), can easily absorb increases in fees and are likely to hang onto the services they now consider necessities if economic times get tougher. Netflix is well positioned to be one of the services most people pick.

That leads to Netflix's bespoke pluses. Netflix's early-mover advantage has allowed the company to build the reputation as the must-have basic offering that, while innovative, is easy to understand and use. People are likely to subscribe to Netflix and

then line up one or two other services that complement Netflix's increasingly broad and deep offering of films, documentaries and series. Given the aforementioned scale advantages, dislodging Netflix from this position will be incredibly difficult.

Another advantage Netflix has is that it has operated in most countries for at least five years, well ahead of its peers. Netflix has thus gained a fair assessment of what people from Brazil to Japan to Germany want to watch, how they interact with the service, and the most efficient way to attract new subscribers. Another benefit from this early global start is that Netflix has a pipeline of local original content that differentiates its service and positions it well to meet local-content requirements that may emerge.

Netflix's positioning as one of the must-haves that dominate the industry gives it 'pricing power'. This term describes Netflix's ability to boost revenue by raising its prices because higher prices won't cost it customers. Even after the Hollywood competition arrived in 2020, Netflix increased the price of its most popular US plan for the second time in two years, raising it US$1 to US$14 a month, and raised prices by a similar amount in many other markets. We think the emerging industry structure and the value of Netflix's service mean this will persist for an extended period. It all makes for a stock that is well positioned to deliver attractive returns for investors willing to take a long-term view.

To be sure, while Netflix is nicely positioned, execution still matters. In an industry where low switching costs create the potential for churn, Netflix will need to spend its growing content budget wisely to maintain strong engagement and attract new segments of the market while avoiding controversy. The threat emerging from streaming aggregators – including smart TV manufacturers, Roku and Amazon's FireTV that are looking to become the starting point of household viewing sessions and participate in the rapid growth in video streaming – also needs to be managed carefully. Netflix's challenge to match the record subscriber additions in 2020 due to pandemic-induced lockdowns could create pressure from investors focused on near-term performance rather than the journey ahead.

While the entry of Hollywood has intensified near-term competition in streaming, the flipside is that there are unlikely to be many more other entrants into this flourishing industry. Netflix's ability to withstand the Hollywood push indicates it will thrive in coming years in an industry better explained by theories on oligopolies rather than those on perfect competition.

Sources: Company website, Bloomberg, Dunn & Bradstreet.

info@magellangroup.com.au +61 2 9235 4888