Netflix light on flicks as viewers soak up TV shows

February 10 2012, By Ben Fritz and Joe Flint

Like most fresh faces that arrive in Hollywood, Netflix wanted to be a movie star. But now it's learning what many in Tinseltown have known for decades: Movies are sexy, but the real money is in television.

Launched in 1997 with a goal of eliminating the drive to the video store, Netflix Inc. became a hit with consumers and helped push the movie rental chain Blockbuster into bankruptcy. By charging customers a small monthly fee for unlimited DVDs by mail, then expanding into Internet streaming in 2007, it amassed almost 25 million subscribers in the U.S. and in 2011 had revenue of $3.2 billion.

For most of that time, Netflix was all about flicks. More than 80 percent of the discs it shipped and virtually all of its streaming content when that service began consisted of movies.

Not anymore. More than 60 percent of the 2 billion-plus hours of video streamed by Netflix subscribers during the fourth quarter of 2011 originated on the small screen.

In a sign of just how far it has come as a television powerhouse, Netflix this week premiered its first original series, a crime comedy called "Lilyhammer," starring Steven Van Zandt of "The Sopranos."

"It's been a fundamental shift in our business, but it wasn't by design," said Ted Sarandos, Netflix's chief content officer. "The rise of TV viewing has happened in a really organic way."

The company's transformation has been driven in part by a fundamental change in the way people consume television in an on-demand, digital age. Watching a movie via Netflix streaming isn't much different from renting a DVD, but for TV it offers fans a unique way to view one episode after another of addictive series such as "Gossip Girl" and "Mad Men."

"We have found that what differentiates our service is the ability to sit down, pick a show and dig in," Sarandos said. "People will watch six or eight episodes in one sitting."

To fuel that demand, Netflix has in the past few years become one of the entertainment industry's largest buyers of television reruns, committing billions of dollars to multi-year deals. Many of its most popular shows, such as "Breaking Bad" and "24," are serialized dramas.

That's been a big boost to the television industry, as those types of programs typically make less money in reruns than sitcoms such as "The Big Bang Theory" and police dramas such as "Law and Order." Most channel surfers won't stop on a random episode of "Lost" because they can't follow the story. But a Netflix user can easily watch the whole series in order.

"This is all great news," said Bruce Rosenblum, president of Warner Bros. Television Group. "Netflix gives studios a bigger appetite to take risks because we know now there is more upside for these shows."

As it moves into original programming, the Los Gatos, Calif., company is becoming more than one of Hollywood's top buyers. It's also becoming a direct competitor to cable channels.

Along with "Lilyhammer," a popular Norwegian show to which it bought the exclusive U.S. rights, Netflix has committed to "House of Cards," a pricey political drama starring Oscar winner Kevin Spacey; a new comedy from the creator of "Weeds"; and new episodes of "Arrested Development," the critically acclaimed comedy that Fox canceled six years ago. The company is also negotiating to pick up at least two other shows that it has not publicly identified.

Sarandos said Netflix is "dabbling in original programming" in part because he expects traditional networks to make fewer serialized programs. "We need to develop the muscle in case it becomes necessary to produce more ourselves," he said.

Refocusing its core business is essential for Netflix as it tries to recover from a brutal 2011. Last summer, Netflix lost 800,000 subscribers and its stock plummeted more than 75 percent after an unpopular price hike and an aborted attempt to separate its DVD business into a new brand dubbed Qwikster. It has since regained some ground with subscribers and on Wall Street. Netflix shares closed Tuesday at $127.88, up 85 percent since the start of the year but far below a high of $295.14 last July.

Amid rapid changes in the way consumers watch movies and new threats from competitors including Amazon.com Inc., Hulu and HBO, Netflix is trying to transition its customer base away from DVDs by mail and make them loyal users of its Internet streaming service, which is now available on more than 700 different digital devices including Internet connected TVs, iPads and smartphones.

And as it faces concerns that the number of customers in the U.S. may be reaching a plateau, Netflix has expanded into Canada, Britain and Latin America and is considering moves into other markets such as Spain and South Korea. To pay for its overseas launches, the company in the current quarter expects to report its first net loss since 2005.

To prosper, Netflix has to give TV-hungry consumers what they want. It also must cope with divergent views in Hollywood on its desirability as a partner. TV executives are almost universally thrilled at the fat new wallet Netflix has opened to them.

"Netflix is a new buyer that's adding value that didn't exist before in the television business," said Steve Beeks, president of independent studio Lionsgate.

But many in the movie industry see things differently. Starting a few years ago, they became concerned that Netflix's bargain-priced rentals were a key reason that DVD sales were plunging, squeezing studios' profit margins. Wall Street noticed it too, leading Time Warner Chief Executive Jeff Bewkes to downplay the threat by famously referring to Netflix as "the Albanian army."

Many film companies decided to scale back the availability of their content. Warner Bros., Universal Pictures and 20th Century Fox in 2010 instituted a 28-day delay from the time DVDs went on sale at retail outlets to when they could be rented from Netflix. (Warner Bros. last month extended that delay to 56 days). Last year, the cable channel Starz, which has the rights to sell movies from Sony Corp. and Walt Disney Co. to Netflix, sought renewal terms so exorbitant that the two companies ended their relationship. After this month, Netflix will not have access to movies from either Sony or Disney.

The results of that conflict are evident in the fact that of 2011's top 100 movies at theaters in the U.S. and Canada, only 18 will be available on Netflix's streaming service this year. The vast majority of the nearly 10,000 films available via Netflix streaming (a number compiled by the website InstantWatcher; Netflix does not release data on its inventory) are independently financed pictures such as "Limitless" and "Drive" or older pictures like "The Hunt for Red October" and "On the

Waterfront."

"It's been in theaters, it's been on DVD, it's been on video on demand, so by the time it gets to us, it's in the bargain bin at Wal-Mart," Sarandos said.

A tough-talking 47-year-old, Sarandos was a Hollywood outsider with a background in video distribution when he joined Netflix in 2000. Now he moves among the media elite, even making the cut to attend the exclusive Allen & Co. conference of big media moguls held every summer in Sun Valley, Idaho.

Sarandos oversees a team of about 25 at Netflix's Beverly Hills office who negotiate contracts worth billions of dollars with virtually every television and film studio in Hollywood. Although the company won't say how much it's spending on digital deals, it said in its latest earnings report that the amount doubled in the first quarter of 2012 compared with just a year earlier.

Much of that money has gone to TV reruns. Last year, Netflix signed a 4-year deal worth as much as $1 billion for every program on the CW network, home of "The Vampire Diaries" and "Supernatural."

Sarandos' unit draws on a massive database of Netflix customers' viewing patterns and quality ratings to predict what will prove most popular and bid accordingly. The content team is willing to pay more than the networks, which require massive audiences, for shows that attract a smaller but more dedicated niche of viewers. For the low-rated but award-winning period drama "Mad Men," for instance, Netflix outbid competitors by agreeing to pay Lionsgate $77 million, or $850,000 for each of 91 episodes.

"They're an incredibly sophisticated buyer because, more so than any other company, they know what's going to work with their audience," Beeks of Lionsgate said.

Sarandos' most surprising move to date may have been his deal to bring back "Arrested Development," a feat that the producers had been trying to accomplish with traditional networks for years.

"Their enthusiasm and aggressiveness was a little bit unexpected," said Gary Newman, chairman of 20th Century Fox Television, the studio behind the beloved but low-rated series. Netflix outbid other networks including Showtime by agreeing to spend $2.5 million to $3 million per episode of "Arrested," a knowledgeable person not authorized to speak publicly said.

But the series, which stars Jason Bateman, Will Arnett and Portia de Rossi, won't look exactly the same as fans remember it on Fox. Episodes of the new version, which are scheduled to debut in 2013, are expected to focus on one character at a time, rather than tightly interweaving them all.

Besides its checkbook, Netflix is also bringing a new approach to making television shows. The company doesn't have a traditional network's gaggle of development executives to supervise productions and bicker over scripts. It will even take the highly unusual risk of ordering multiple seasons of a show without a pilot episode.

Netflix committed to 26 episodes of "House of Cards," at a cost of about $4 million per episode, based on the concept and talent involved. And Netflix has already signed on to a second season of "Lilyhammer" before finding out if the first is popular with its viewers.

Sarandos downplayed the risk, arguing that Netflix's strength ultimately lies in the software that recommends programs users will like and lets them watch it on demand.

"The worst thing we'll do," he said, "is create mediocre shows."