

Netflix has challenges on path to 'Internet TV' dominance

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Depending on whom you ask, Netflix is either a company that's poised for a remarkable resurgence or a washed-up has-been whose best days are behind it.

While both sides have a legitimate case to make, corporate raider [Carl Icahn](#) is betting on a rebound.

While they're at odds with Icahn, [Netflix's](#) managers - and some analysts - are optimistic about the [company's](#) prospects. The company is basically inventing what it calls "[Internet television](#)," getting smarter about how it operates and is investing in [international markets](#) to position itself for long-term growth.

"[Internet TV](#) is the future of television, and we are leading the charge," Reed Hastings and David Wells, Netflix's chief executive and chief financial officers, respectively, said in a letter to shareholders last month.

But other analysts and investors question Netflix's long-term prospects and its ability to ever resume the heady growth it recorded for much of the past decade. They see a company struggling to control the costs of its streaming business while letting its older but highly profitable DVD business wither away.

Netflix's management is very clear about the company's strategy, "but I don't think it's a good one," said Michael Pachter, a [financial analyst](#) who

covers the company for Wedbush Securities, adding that he sees only two paths ahead: It's either going to be "a high-growth, [unprofitable business](#) or a low-growth profitable one."

The future prospects of the streaming video company have been much debated in the wake of Icahn's move last week to take a 10 percent stake in the Los Gatos, Calif., company. Icahn said Netflix was undervalued and could be worth more if it were sold to another company. Other investors seemed to agree - or at least hoped that Icahn's involvement could juice the stock - and Netflix shares soared immediately after.

Netflix's shares have been in the dumps since last year when the company stumbled through a succession of setbacks. It angered users with a price increase and a later-aborted attempt to sever its DVD business. Then it turned off investors by announcing an aggressive international expansion that would depress profits. More recently, the company further aggravated investors by failing to sign up subscribers at the robust rate it predicted at the beginning of the year.

For optimists, the company's struggles are simply an indication of the challenging task the company has taken on: transforming its business from a largely subscription DVD service focused on the United States market to an international streaming video provider. They see a company that is positioning itself well in that new market.

Apps to watch Netflix videos are available on a range of devices - from smart TVs to tablets to game consoles - that its competitors can't match. Netflix subscribers are spending increasing amounts of time watching video through the service. And the company's content partners are starting to recognize the value Netflix gives them by offering an audience for their older movies and television shows, analysts said.

"When I look at the assets the company has, they are substantial," said

Colin Dixon, a senior partner at The Diffusion Group, a technology research firm. "Having so many clients on so many devices gives them a substantial advantage over any other player in the market."

But critics question the company's strategy. Since retreating from its move to split off its DVD business, Netflix has allowed that service to decline rapidly. In the last year, the service has lost more than a third of its subscribers, and its quarterly revenue has fallen by \$100 million over the last three quarters.

That decline is notable because even today - when it has nearly three times more U.S. subscribers to its streaming business than DVD subscribers - the DVD business still produces 40 percent more profit than its domestic streaming service.

Meanwhile, Pachter and others see huge challenges for Netflix on the streaming front. Netflix owes \$5 billion in coming years to Hollywood studios for the movies and TV shows it offers. Although that amount plateaued in the recent quarter, it skyrocketed early last year, and analysts warn that it could jump in the future.

The more popular Netflix becomes, the more Hollywood is going to want to be paid for its content, critics say. Because the company has little ability to negotiate those prices, its only way of controlling costs is by reducing the number of videos in its library, like it did earlier this year when it declined to re-sign a deal with Starz, which distributes movies for Sony and Disney. But the fewer videos it offers, the less attractive its service becomes, analysts warn.

"There truly is a tipping point where the content quality isn't good enough and they start losing lots of subscribers," said Pachter.

The company is already seeing slowing subscriber growth in the United

States. And that's likely to continue as that business matures, warn analysts. To boost growth here - and find ways to continue to attract high-quality content - the company might need to start offering different levels of service, said Greg Ireland, an analyst for market research firm IDC.

Unless it does that, Netflix will be "stuck with flat subscriber growth, with no way to grow their [business](#)."

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