Netflix vertical integration strategy: I was right on the money | Entertainment law

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Where does Netflix stand, in terms of expanding its business model, content and distribution channels, worldwide? Where is it heading towards, in the current content distribution ecosystem?

1. Netflix's state of play in 2018

On 15 May 2015, during the "In conversation with Ted Sarandos" event at the Cannes Film Festival, I asked Netflix's chief content officer why not acquiring some major film studios in order to have more power and clout, while negotiating the shortening, or even removal, of the "first theatrical window" to release audiovisual content into the public domain worldwide. Surely, through vertical integration, Netflix would be able to successfully convince countries' governments and theatre owners, around the world, that adopting its day-and-date release strategy is a win-win solution for all?

Ted Sarandos was visibly annoyed by my question at the time, dismissed it entirely by saying something to the effect that buying independent or major studios would not work because Netflix would not get access to their back catalogue anyway, which was where the real cash was. I was baffled by the narrow-minded approach adopted by Sarandos in his reply to my points, but thought he may have snapped that back at me because I was putting him on the spot in front of an audience of more than 300 people, at the most prestigious film festival on earth!

Three years down the line, and my envisioned best strategy for Netflix to beef up its worldwide presence, not only online, but also in the brick and mortar space, is becoming a reality. I was dead on the money: Netflix reported yesterday that they are in advanced talks to acquire Luc Besson's EuropaCorp studios.

This is the only way forward, for Netflix, as it has almost reached saturation as far as the distribution of its content on its website and online applications are concerned, worldwide. Indeed, Netflix members with a streaming-only plan can watch TV shows and movies instantly in over 190 countries (Netflix is only not yet available in China, nor is it available in Crimea, North Korea, or Syria due to US government restrictions on American companies there). Moreover, in key markets such as the US, Mexico, Brazil and Argentina, Netflix had a penetration rate as high as 72% in the second quarter of 2017.

While more and more consumers subscribe to Netflix streaming plans around the world, with a total number of 117.58 million streaming subscribers worldwide in the fourth quarter of 2017, the average length of subscription to Netflix is 43 months per US broadband households. Therefore, Netflix benefits from a loyal and dutifully paying customer base, which is growing at a 18% rate year-on-year. Fixed as well as operating costs, and overheads, are relatively low for Netflix, since it only counts approximately 5,400 employees (by comparison, Microsoft has 124,000 while Apple has 123,000) and since it does not need any plush real estate or other types of tangible assets as part of its successful business strategy. Meanwhile, Netflix's revenues in 2017 were USD11.69 bn – increasing more than tenfold between 2005 and 2016 – and Netflix's net income in 2017 was at a comfortable and cushy USD559 million.

Basically, Netflix is swimming in cash, having now successfully implemented its scaling-up strategy in the online space, worldwide. All this disposable income needs being reinvested back into the business, co-founders Reed Hastings and Marc Randolph not being the types of guys slaving for Netflix's shareholders by splurging into annual dividends' distributions. In fact, Netflix never paid dividends to its shareholders in the past 10 years!

2. First step of Netflix vertical integration strategy: leap into content creation and production

In the last 5 years, 1997 founded Netflix, which started out as a postal DVD rental company, successfully implemented the first steps to its vertical integration strategy, no matter what Sarandos has to say on the subject.

The real decision-maker, here, is co-founder, chairman and CEO Reed Hastings, who has fully grasped that Netflix must own every product or service of its supply chain, to make real money. In this context, vertical integration entails owning distribution as well as content. Hence, the leap into content creation and production for Netflix, as licensing existing content was merely enough to beef up its budding catalogue and render it attractive to a wider and ever more culturally-diversified customer base growing exponentially around the world.

Making beaucoup bucks comes from owning 100% of the content, without any licensing royalties to pay back to rightowners. Such fully-owned content can even be licensed back, opening up new revenue streams such as content licensing or even a branded channel with traditional distributors, for Netflix. Films can be easily snatched up at film markets in Sundance, Berlin, Cannes and the American Film Market in Santa-Monica all year round, and Netflix's deep pockets let it pick the very best of the crop on offer from sales agents and distributors avid to ingratiate themselves with streaming video on-demand services ("**SVoD services**"). Film and show projects and productions are also brokered directly between the talent and Netflix, the most notable examples of that being Netflix's production and commission of the House of Cards, Orange is the new Black, The Crown, Making a Murderer, and Stranger Things. In 2018, Netflix Originals' busy-bee content pipeline is made up of 80 films that the company has either acquired or commissioned, which sounds positively outlandish compared to the 12 films released by Disney, and 20 released by Warner Bros, in 2018.

Owning the content also solves the headache posed by the theatrical distribution model which, according to Ted Sarandos, "*is pretty antiquated for the on-demand audiences we are looking to serve*". Netflix, he said, is not looking to kill windowing but rather to "restore choice and options" for viewers by moving to day-and-date releases. Indeed, Netflix has brokered many recent theatrical deals – it plans to release the sequel to Ang Lee's Crouching Tiger, Hidden Dragon day-and-date online and in Inmax theatres. This (overdue) move into day-and-date release positively enrages theatre owners and exhibitors, especially further to the snafu triggered by Netflix managing to get two of its original films, Okja and The Meyerowitz Stories, chosen to compete in the official selection of the 2017 Cannes film festival.

3. Next step of Netflix vertical integration strategy: film studios' acquisitions

Netflix's vertical integration and expansion strategy does not stop here, though, because it still has so much disposable income to invest and, hey, why not acquiring more content, stakeholders, market share and clout in the films' and shows' sectors, if you can, right? SVoDs like Netflix have declared an open war on the fragmented audiovisual content industry which has prospered for decades, grazing on horizontally segmented industry models. Netflix is at the forefront of structuring end-to-end vertical SVoD services, going direct to consumers and ruthlessly bypassing theatres, broadcasters, networks, cable operators and even television manufacturers. This digital revolution transforms television and filmed entertainment, especially traditional broadcast TV, and is fostered by the big and fast-growing inroads of internet and over-the-top ("**OTT**") video platforms such as Netflix, Amazon and Google's YouTube.

Shaken at its core, a wave of consolidation is subsequently coming to the entertainment content delivery industry, with Netflix ready to snatch up any shaky yet prestigious film studio that comes along, such as Luc Besson's EuropaCorp studio. Not only does the studio Besson co-founded in 1999 has a rich and high quality original content library and back catalogue (comprising Lucy, Taken, Le Grand Bleu, Valerian and the City of a Thousand Planets, among others), but striking an exclusive direction and production deal with seminal and highly creative Besson would reinforce the prestige of Netflix, while making the platform even more appealing to European, and Asian audiences, in particular.

I predict that, should the right opportunity comes along, Netflix will repeat this vertical expansion master stroke and acquire more major and/or independent studios.

It is true that vertical expansion has boundaries, in particular due to the anti-competitive risks that it entails, and that the issue of vertical integration in the entertainment business has been the main focus of policy makers since the 1920s. For example, in the United States v Paramount Pictures Inc. case, the US Supreme court ordered on 3 May 1948 that the five vertically integrated major studios, MGM, Warner Bros, 20th Century Fox, Paramount Pictures and RKO, which not only produced and distributed films but also operated their own movie theatres, sell all their theatre chains. However, today, many media conglomerates already own television broadcasters (either over-the-air or on cable), the production companies that produce content for their networks, and also own the services that distribute their content to viewers (such as television and internet service providers). Bell Canada, Comcast, Sky plc and Roger Communications are vertically integrated in such a manner – operating media subsidiaries and providing "triple play" services on television, internet and phone services in some markets. Additionally, Bell and Rogers own wireless providers, Bell Mobility and Rogers Wireless, while Comcast is partnered with Verizon Wireless. Similarly, Sony has media holdings through its Sony Pictures division, including film and television content, as well as television channels, but is also a manufacturer of consumer electronics that can be used to consume content from itself and others, including televisions, phones and PlayStation video game consoles.

In this context, it is quite difficult imagining Netflix slapped with any anti-competition lawsuits or investigations, because it goes on a buying spree of film studios, even one of the "Big Six" majors.

4. Master stroke of Netflix vertical integration plan: broadcasting networks and theatre chains

The next stage of the vertical integration and expansion strategy of Netflix, in addition to buying, producing and commissioning its own content, and in addition to acquiring film studios, is to delve into distributing its own content in the "real" world (i.e. offline sphere), either on other media distribution channels such as a broadcasting network, or in movie theatres.

I predict that, in 10 years, if TV is still a medium used by consumers, Netflix will have its own TV channels and broadcasting networks. In the future, if people still attend movie theatres from time to time, to watch special effects films there in particular, Netflix will also invest in buying back fledging exhibitors' chains, causing direct competition to China's Dalian Wanda-owned cinema group which is currently on a buying spree of theatre chains across Europe and the US.

This “online to offline strategy” is currently being implemented with brio by originally pure player Amazon, which is currently buying brick and mortar retail spaces all other the world, in order to continue its competitive assaults on traditional grocery stores and malls, increase its market share and get closer to its clients’ base worldwide. Amazon is at a way more mature growth point than Netflix, of course, but provides excellent footprint of the future roadmap that Netflix is undoubtedly going to implement.

5. No space for Apple in Netflix vertical integration strategy

Some commentators in the entertainment and finance industries pretend that Apple will buy Netflix but this is an oversight.

Firstly, Netflix has zilch incentive to accept an acquisition offer, even from a tech behemoth like Apple, because it is in such a strong strategical and financing position, and will be in that sweet spot for many more years to come in spite of its lesser-known SVoD competitors, such as Amazon Prime, Hulu and Vudu, tagging along.

Secondly, and thanks to such solid said vertical integration strategy and financials, Netflix’s valuation is simply too high, now. It is trading at all-time highs, with a USD94bn market cap.

Thirdly, co-founder Reed Hastings, who still very much keeps a tight rein on Netflix as its chairman and CEO and enjoys the ride, is unlikely to sell his business at a meagre premium of 6% or so (USD100bn).

Finally, Apple’s specialty and strength lie in its hardware and products, not so much in its software and services (apart, perhaps, from Apple’s video editing software, Final Cut Pro): the integration of Netflix into Apple will reinforce the latter’s positioning as a serious software and online applications’ provider, but will do absolutely nothing for the former’s vertical integration strategy, which now charges ahead towards film studios’ acquisitions, broadcasting networks’ acquisitions and theatre chains’ acquisitions.

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