

How Netflix Lost 800,000 Members, and Good Will

By NICK WINGFIELD and BRIAN STELTER
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Reed Hastings was soaking in a hot tub with a friend last month when he shared a secret: his company, [Netflix](#), was about to announce a plan to divide its movie rental service into two — one offering streaming movies over the Internet, the other offering old-fashioned DVDs in the mail.

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Reed Hastings said that he had been guilty of overconfidence and of "moving too quickly."

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Netflix, in Los Gatos, Calif., says it still thinks its future lies not in DVDs but in streaming over the Internet, but not quite yet.

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James Best Jr./The New York Times

"That is awful," the friend, who was also a Netflix subscriber, told him under a starry sky in the Bay Area, according to Mr. Hastings. "I don't want to deal with two accounts."

Mr. Hastings ignored the warning, believing that chief executives should generally discount what their friends say.

He has since regretted it. Subscribers revolted and many dropped the service. The plan further tarnished a once widely respected Internet service that had already been wounded by an [unpopular price increase](#) in the summer. Mr. Hastings was forced to reverse the planned split — but not the price increase — three weeks later and [apologized](#).

On Monday, the company revealed the damage that had been done. It told investors that it ended the third quarter of the year with 800,000 fewer subscribers in the United States than in the previous quarter, its first decline in years. The stock plummeted more than 25 percent in after-hours trading. [In regular trading Tuesday, the stock fell more than 30 percent.]

Despite the decline in subscribers, the company did well financially [in the quarter](#). It reported net income of \$62.5 million, or \$1.16, a share, compared with \$38 million, or 70 cents a share, in the year-earlier quarter. Revenue rose 49 percent to \$822 million. Both revenue and income topped analysts' expectations.

Like many other companies built in Silicon Valley, Netflix prides itself on its analytical, data-driven approach to making decisions. But it made a classic business misstep. In its reliance on data and long-term strategy, the company underestimated the unquantifiable emotions of subscribers who still want those little red envelopes, even if they forget to ever watch the DVDs inside.

Mr. Hastings said in an interview last week, his most detailed discussion yet of the bruising period, that he had been guilty of overconfidence and of "moving too quickly." But he said he still believed — as do nearly all investors — that Netflix's future lay not in DVDs but in streaming over the Internet. "We still need to move quick in streaming," he said.

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Twice in the interview, Mr. Hastings linked the hostility toward Netflix's price change and proposed breakup to the angry mood of the country, even citing the Tea Party and the Occupy Wall Street movement by name.

He said — and repeated it on a conference call for investors on Monday evening — that subscribers had been bothered more by the summer price shock than by the breakup plan. Until September, a combination of video streams and DVDs cost as little as \$10 a month; now, that same package costs \$16. "We are done with pricing changes," Netflix said Monday in a letter to shareholders.

Mr. Hastings said he was not sure whether the plan to split the company had been presented to customer focus groups before it was made public. Mr. Hastings said he assumed it had been. But he said he did not recall what those focus groups had said about the plan.

He said Netflix was now trying to slow its decision-making to ensure that there was more room for debate about major changes at the company.

How Netflix came to be so out of touch with its customers is a cautionary tale for other companies that try to transform to new media from old. As the company's streaming Internet service caught on with consumers, subscriber numbers soared and, with them, the company's stock, rising ninefold from the start of 2009 to peak above \$300 in July.

Last year, Fortune magazine put Mr. Hastings, 51, on its cover as the [businessperson of the year](#) after he seemed to pull off the rare feat of finessing the "innovator's dilemma" by navigating Netflix to the digital future from its DVD rental business.

A key to its success was the way it blended its new and legacy businesses. While the library of material available for streaming was relatively sparse because of Hollywood licensing restrictions, Netflix customers could find many of those missing movies, especially new releases, in the company's far larger DVD selection.

But Netflix needed to spend more money to license additional material for its streaming service. Collecting \$10 a month from subscribers was insufficient as costs ballooned. Mr. Hastings defended the increase last week and again on Monday, but he said it was "too big a price change all at once." Hubris played a big role in the errors, he said.

For well over a year, all the signs seemed to indicate to Netflix that customers were ready to move quickly to a future in which movies and TV shows would come to them instantly over the Internet instead of in the mail. Mr. Hastings said the decision to form Qwikster, as the mailed DVD company was to be called, had been based in part on data that showed a faster-than-anticipated increase in streaming by its customers.

In the first quarter of this year, for the first time, DVD shipments were down year over year, leading Netflix to declare that the DVD business had peaked. "Very few" new subscribers were choosing to get DVDs in the mail, Mr. Hastings said.

Stuart Skorman, a Bay Area entrepreneur who previously ran a chain of movie rental stores and an Internet movie venture, last year worked with Netflix managers after licensing to the company a database of movie recommendations. He said he was struck at that time by how little Netflix seemed to care about its DVD rental business.

"I think they should have been paying much more attention to it because that was their customer base," he said. "That's what made them special."

Steve Swasey, a Netflix spokesman, disputed the idea that the company did not care about its DVD business, saying it was still acquiring discs for the service and was focused on speedy delivery of movies.

The breakup announcement in September seemed "very data-driven," said Rich Greenfield, a media analyst for BTIG Research. "I think the company thought, because many people aren't watching the DVDs, let's accelerate the transition."



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What the company seemed not to respect was the premium that consumers place on having options — even if they don't actually take advantage of all those options. Just ask any all-you-can-eat buffet operator, or a gym owner who sells six-month memberships.

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Netflix's red envelopes "were basically occupying slots in between the couch cushions for long periods of time," Mr. Greenfield said. "But even if there wasn't usage of the DVDs, there was a perception of value."

Mr. Hastings said he expected that the DVD-by-mail business would "last a long time." He identified two long-term markets for it: rural customers who cannot or do not have broadband Internet access for streaming, and "film school types" who want a comprehensive catalog of old films.

The scrapped plan to form Qwikster has led to speculation among analysts and executives, like Mr. Skorman, that Mr. Hastings wants to sell Netflix. While Netflix beat big rivals in the DVD rental business, like Blockbuster and Wal-Mart, it faces an increasing phalanx of formidable players in streaming movies, like Apple, Amazon and Hulu.

Mr. Hastings denied he had any such plans. "Mercenary C.E.O.'s are always preparing for a sale, and missionary ones are always preparing for the long term," he said. "I'm clearly in the latter camp."

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