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Five Lessons From the Netflix Startup Story
by Jim Cook with Suzanne Taylor

April 11, 2006

When we began building Netflix in 1997, most people thought we were nuts. DVD players had just started selling in the US in March, and by October we started executing our billion-dollar business plan with only $2 million in seed funding. Even with the dot-com era in full bloom, the idea of renting movies via mail struck most as somewhat ludicrous. Despite the odds and the obstacles, we persevered to create Netflix, which has revolutionized the movie rental industry.

Looking back on Netflix's startup story, five customer-focused lessons stand out as critical in creating this innovative Internet business.
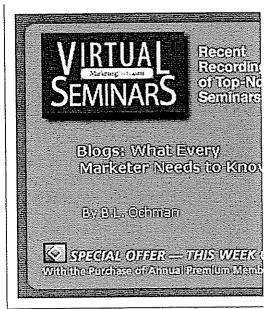
1. Don't let the naysayers get you down

Starting a new company takes a lot of persistence, positive thinking, and a never-say-die attitude. Many experienced people gave us long lists of reasons why our business idea wouldn't succeed.

Why would people wait for movies to come in the mail when they could just go down the street to Blockbuster? How can you cost-effectively mail out movies? Won't they get broken, stolen, or damaged? Seeing the negatives is always the easy part. Solving such problems requires a special kind of creative stubbornness.

Article continues below

One by one, we went through the list of objections and eventually figured out each of them with unique solutions. Our customer research led us to several key customer insights, including the fact that over 60% of customers planned their video rental decisions. They knew what they wanted over a week in advance. We obsessed

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on our customized mailer packaging, our "per-package" economics, and 1-2 day delivery. The weight (and therefore cost) of the package was critical. We built everything from the ground up, step by step, and always with the end in mind.

We mapped the processing logistics of each package backwards. We started with the intimate knowledge of US Postal Service operations, then customized our software and operational technologies to automate our picking/packing/shipping and finally linked it all to our customer-facing Web site. We defined our operational culture by speed, weight, and daily process improvement. In short, we figured out a way to make it all work. If we had listened too hard to the naysayers and not stubbornly found a way around their objections, there would be no Netflix today.

2. Build operations for a 'wow' customer experience

We knew that if we didn't find a way to work within the US Post Office's systems, we wouldn't succeed. We had to build operations to create an exceptional customer experience (the "wow!"). To understand how the Post Office backend worked, I spent hundreds of hours at a few of the largest regional Postal Centers, observing and asking tons of questions.

I noticed letters being sorted by several high spinning circular drums. While these crushing metal drums enabled the separation and processing of over 40,000 standard size letters per hour, it was obvious that a thin plastic DVD would not survive the journey. With a sinking stomach, I felt the business idea slip away. But then I noticed a separate conveyor belt sorting magazines and other larger pieces of "flat mail." How would I ensure that the package always used this flat mail machine and not the letter sorter?

I found out that if an envelope had certain dimensions and other characteristics, it would be sorted by this alternate system instead of the large, crushing metal drums. Better yet, this flat mail sorting machine would read a bar coded delivery address and could automatically sort the item into "carrier walking route" sequence. Now the wheels were really turning. The fact that we could provide the right-size packaging, bar code, and other characteristics would make it possible for extremely fast processing of a mail piece with absolutely no human intervention or other physical touch.

Our resulting "Netflix envelope" was one of our biggest "customer wows." Its design was critical not only for the customer experience but also for our operations and business model. We had to design the envelope so that it met several criteria:

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contracts.
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drive tod:

- Naturally, it had to effectively hold and protect the DVD.

- It had to meet stringent Post Office criteria so we could mail with the equivalent cost of a first-class stamp.

- It had to transform into the return envelope so that DVDs would find their way back to Netflix quickly and in good condition.

- It had to be "operational"—easy to insert and remove the discs and something that could be pre-printed in mass quantities.

- Above all else, this envelope was our "product." It was the only thing that our customers would touch and see. Therefore, it had to have all the key features of a great marketing piece.

Since 1998, there have been over 150 versions of this little red package. It wasn't always red, but we determined that red was the easiest color to see in the post office. It wasn't always paper thin— our first package was much thicker, and we shipped 3 DVDs in the same envelope. By testing, learning, and improving, we did such non-intuitive things as print the inside return address upside down to make processing more efficient. We had to build a mini "pocket" inside the package to ensure that the Post Office stamp-canceling machine wouldn't break the DVD inside. A very recent change added a little cut-out on the outside of the package, enabling one to check the disc in by "seeing" the inside disc barcode without having to open the package. The amount of time and motion this one little step saves is enormous given today's processing volumes of over 20 million DVD returns every month.

3. Develop three-step solutions

When I worked at Intuit in the early days, cofounder Scott Cook used to espouse the value of three-step (or less) solutions. Many high-tech products build in unnecessary complexity for consumers. By contrast, the most successful products take tedious and difficult chores and make them easy—so easy that consumers can solve their problems in three steps or less.

A great example of Netflix's three-step solution is the now famous and patented Subscription Queue. We knew our success would be limited if we required customers to come back to our Web site every time to place their next rental order. Our research told us that the average video rental customer rented 5-7 movies per month. Why make that customer come back to our Web site each and every time to rent something they already knew they wanted and could simply put on a list?

So, in 1999, we created the first ever online queue—a list of movies that customer knew they wanted to eventually watch. Within a few short months, our customer base had an average of 20-25 movies in the queue—the research was right! Of course, now, we literally had to re-customize our operational software and Web site to enable this new subscription queuing process.

Our new ability to automatically send out the next movie on the list also served another key customer goal of reducing delivery time and always ensuring a customer had at least one Netflix movie to watch at all times. This offered service customers could get nowhere else. It was fast and it was easy.

4. Copy the best

Why reinvent the wheel if someone has already come up with an easy-to-use, useful, and elegant solution? When designing the Netflix Web site, we turned to the best: Amazon. Some of the ideas that we adapted for the Netflix Web site:

- Product and button placements
- Overall color schemes
- Size of DVD images for fast page loading
- Customer reviews and movie reviewer articles
- Easy-to-use search with categorized searching by movie genre
- Overall Web site navigation

5. Focus on rabid early adopters

It's hard to believe, but Netflix launched and operated for the first five years without spending any significant advertising money. We had two secret weapons.

First, we had a meaningful connection with the rabid early DVD adopters on Usenet groups, the equivalent of early 90s bulletin boards and today's blogs. When we launched our Web site, we made no public announcements. We hoped that this soft launch would bring in volumes of more than 10 or so "friends and family" orders per day. Unexpectedly, 500 orders arrived the first day, almost exclusively from our Usenet advocates who noticed the site was live and announced it to their networks. Within 30 days, we were consistently processing 1,000 orders per day, within three months over 2,000 orders per day, and thereafter continuing ahead of Amazon's historical growth curve.

Our second key weapon was securing a coveted "ten free rental" coupon in every single DVD player sold by the big three manufacturers: Panasonic, Sony, and Toshiba. Combined, these big

three had 85% market share. Ordinarily, it is extremely difficult to persuade major manufacturers to put promotional material in their packages. But at the time, these DVD player manufacturers were actually in fear of becoming another failed LaserDisc or Betamax. It was far from a foregone conclusion that DVD would catch on.

By offering 10 free rentals to consumers when they opened up their new DVD players, we gave consumers access to a breadth of titles that were very hard to find in traditional retail stores. We paid nothing out of pocket for the placement of the 5" x 7" purple branded coupon inserts. It was in the manufacturers' interests to promote our service so that DVD technology wouldn't die. We made sure that the coupons were the "last in" on the assembly line and therefore one of the first items a consumer would see upon opening their new DVD player.

Today, word of mouth still drives over 80% of all new customers. The customers are no longer early adopters, but they are just as rabid.

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We started with an initial company goal of being bigger than the biggest single Blockbuster store in the US.

Today, the company's market value is twice as big as Blockbuster's. Netflix now boasts over 4 million customers and a market value of over $1.5 billion. Eight years later, the company is still quite young and services only 4% of all US households.
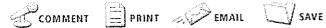
While the company faces many competitive pressures and a changing landscape of digital movie delivery, one thing is clear: Netflix's relentless focus on customer-driven innovations will continue to provide the golden keys to unlock its revolutionary and evolving business.

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