Balancing Price, Content and Experience Creates Winners and Losers of Streaming Video

By: Michael Jones

Three basic levers determine the success of any streaming service from a consumer perspective – the cost of the subscription, the content included in that subscription, and the quality of the viewing experience. Service providers are constantly trying to balance these levers to create satisfied and loyal subscribers for long-term success. Improving content or the quality of experience (QoE) can grow subscribers or compensate for potential churn from a price increase. Likewise, lowering prices can increase subscribers, as Hulu did in February 2019.

Price

In 2007, Netflix signed an agreement for the online streaming rights of Starz, providing access to more than 2,500 titles, including recent premium movies from Disney and Sony. Streaming these titles was available, for free, to Netflix DVD subscribers with plans of $8.99/month and higher. This essentially established the standard pricing structure of streaming services as we continue to know it today, and it did so without taking into consideration the cost of content development and licensing. If a provider increases prices well beyond what exists today, it will impact subscriber count (e.g. historically, Netflix subscription counts have been price sensitive). Otherwise, it will need to consider ad-based VOD (AVOD) options to subsidize its costs.

Content

The content lever is a difficult one as content owners are now starting to realize the true value of streaming rights (e.g. the cost of streaming rights for *Seinfeld* increased 5X over a 5-year period). According to Netflix, the company spent 85% of its streaming content budget in 2018 on originals, yet Nielsen data shows this content only accounted for 37% of viewing time. AT&T has been aggressive in licensing content for HBO Max as it has little control over the price lever given existing price structures for pay TV and HBO Now.

Viewing Experience

QoE can help streaming services differentiate in an increasingly competitive market. Frictionless set-up among devices, easy-to-navigate electronic programming guides and an optimized viewing experience for any given device are examples of how experience can gain new subscribers – and potentially command higher pricing.

Let's look at Netflix to examine these key levers further.

By the time Starz terminated its streaming rights deal, Netflix had the financial strength to license rights directly from content owners, including top films from studios as well as popular television series. Netflix found that many viewers "binged" by watching many episodes of popular TV series in a row, and this meant that these were the most watched content on Netflix. According to Nielsen, the top three programs for Netflix in 2018 were The Office, *Friends* and *Grey's Anatomy* – all having more than 200 episodes.

When Netflix started streaming video, it was included for free with its DVD mailing service. By 2011, the price had increased just $1, to $9.99 per month. In July 2011, Netflix separated its DVD and streaming services into discrete subscriptions, each priced at $7.99/month.

At the end of 2011, according to Netflix data from its annual report, the service had 21.6M global subscribers. By the end of 2018, the number had risen to 139.3M. ARPU had actually dropped from $11.84 (representing customers subscribing to both DVD and streaming services) to $10.31 per streaming customer. Netflix had kept prices low, relying on new subscriptions to grow revenues. In a 2016 survey by Cowen and Company, cost effectiveness was cited by 58% of respondents as a reason to subscribe.

Netflix also offers a very strong QoE. In 2018, the company spent $1.2B on R&D and has spent the past decade optimizing VOD delivery. The company has pioneered new technologies for streaming, such as the Open Connect distributed CDN, which optimizes cost and performance by hosting content directly in ISP's data centers. Likewise, their Dynamic Optimizer offers extremely efficient compression, minimizing bandwidth costs and increasing resilience to network performance issues. Netflix also works with hardware vendors to qualify products as "Netflix supported". Finally, Netflix has extensive

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analytics data for QoE and user behavior. According to Sandvine, Netflix accounts for 3% of all upstream internet traffic, representing the vast analytics data they collect. This allows them to optimize service quality, provide a strong recommendation engine and gain deep insights for the creation of original content. Netflix built strong subscriber growth by using two of the three levers for a streaming service – increasing content and QoE while keeping pricing relatively flat. Going forward, Netflix is losing some key content for the U.S. market (*The Office*, *Friends* and *Grey's Anatomy* are all moving to competitors) and has no stated plan to lower prices. Its growth will depend on leveraging analytics data to provide tailored content and user experiences, as well as utilizing new international content to expand in international markets.

Today, Netflix has a market cap of $120B.

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At the end of 2018, Netflix had 2.7M DVD subscribers, down from 3.3M in 2017 and 4.0M in 2016. If not for streaming, Netflix would be dying or dead.

Disney and AT&T Say "Not So Fast!"

Building off of the Starz deal in 2008, Netflix has created a huge amount of shareholder value, as well as a strong User Data Base (UDB) of hundreds of millions of users. Netflix has also built a very strong recommendation engine, a treasure trove of user behavior and QoE data, and a strong glass-to-glass streaming video delivery chain. Netflix does not share the data of, or access to, their subscribers.

Disney, AT&T and others have taken notice. They doubtless realize that Netflix is approaching an inflection point in content ownership, whereby their original content will overtake licensed content as the primary driver of viewership. Netflix is also aggressively building out its global content and subscriber base.

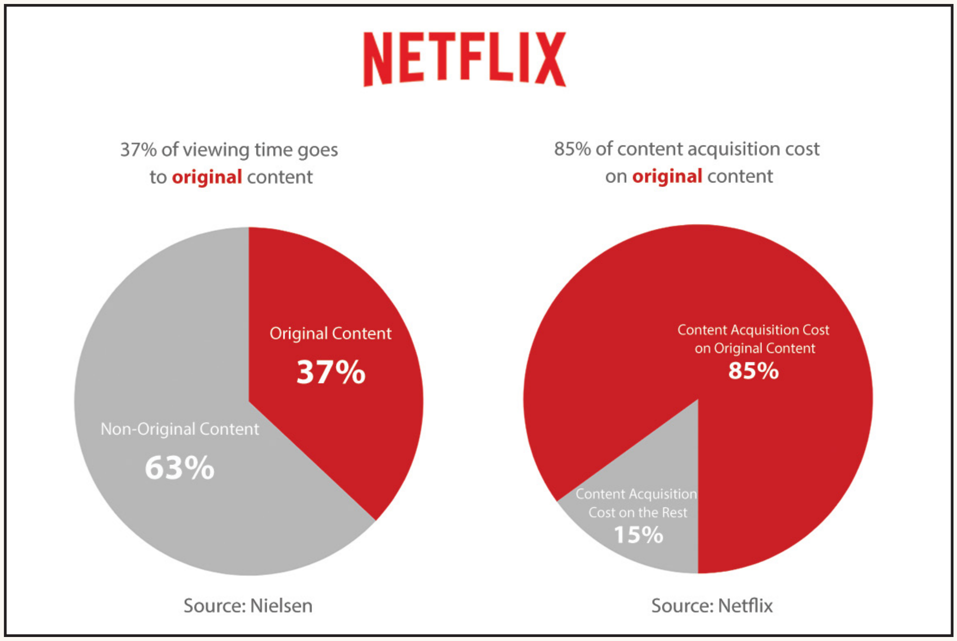
Disney spent $2.5B to gain a controlling interest in BAMTech, which has become Disney's streaming technology provider and operator. Disney is also forgoing billions of dollars of content licensing fees – The Wall Street Journal estimates that Disney was receiving $500M annually just from Netflix for streaming licensing.

Disney is also spending billions to build and market Disney+. Meanwhile, the starting price is $6.99 per month – and discounts are available to Disney's D23 fan club members for under $4 per month. Under CEO Bob Iger's direction, Disney will lose billions building up Disney+ in order to gain a strategic position in the future of video.

While Disney has top-tier content, including Marvel, Star Wars and Pixar, the Disney+ library is much smaller than that of Netflix, with approximately 500 movies and 7,500 TV episodes at launch; roughly half the size of the Netflix library, according to data from the unofficial Netflix online global search website. To provide a larger library, Disney is bundling Disney+ with ESPN+ and Hulu for $12.99 per month, a discount of about $5 based on individual prices.

Despite the consumer-friendly $6.99 price of Disney+, it is unlikely that Disney will keep that price in the long term. Furthermore, in 2016, Netflix had a global streaming ARPU of $8.61, offering Disney and other studio content as well as their own originals – which likely represented a better value than Disney+ or the Netflix of today.

Meanwhile, AT&T's WarnerMedia is building out HBO Max. While pricing has not yet been announced, it is widely believed that pricing will be the same as HBO Now ($14.99 per month) or, at most, a few dollars more. AT&T does not want to undercut existing HBO Now and HBO pay TV subscribers, so is being aggressive in building out high-demand content to make the service compelling (i.e. using the content lever to build subscriptions). In addition to HBO content such as *Game of Thrones*, *The Sopranos* and *The Wire*, AT&T has spent an estimated $2B+ to secure the rights to *Big Bang Theory*, *Friends*, and *Two and a Half Men*.



How to Stand Out in a Glut of Streaming Services?

As the D2C market expands to include Apple+, NBCUniversal Peacock, Discovery/BBC, etc., subscription fatigue is a real threat. Consumers simply will not want to navigate different apps, keep track of what is playing where and not benefit from comprehensive interactive features such as recommendations. Ultimately, disparate D2C service offerings will be a less compelling solution for consumers from a price and convenience standpoint. Technology can make up for this somewhat by leveraging the advantages that streaming has over linear TV. It can offer customized experiences, allowing viewers to choose their desired camera angles and replays, watch multiple streams on the same screen and tailor their viewing experience for their viewing environment and device.

Consumers will have the option to rotate monthly subscriptions, do without, or find ways to access content for free (e.g. piracy or account sharing). These issues place content and streaming services in a difficult position: content development and licensing is expensive and prices need to support these costs. Also, as Netflix has shown, building a strong connection with the subscriber, and collecting the associated analytics has tremendous value. The value of this data is driving the D2C trend – services will be loath to allow aggregators to control customer data and access.

The easiest and cheapest lever is QoE. In 2018, Netflix's R&D spending was 10% of its content expenditures. Furthermore, Netflix's technology not only helps deliver better experiences, but also saves bandwidth, saving money and allowing the service to reach customers who otherwise might not have connections suitable for watching video. This, ultimately, can open up new markets, new customers and new business models.