



# NETFLIXED

## The Epic Battle for America's Eyeballs

Gina Keating

PORTFOLIO / PENGUIN



# PROLOGUE

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They carry canvas cases with logos: Apple Computer, Sun Microsystems, Oracle Corp., and other hot technology companies. Most wear the Valley uniform of board shorts or Levis with a wrinkled T-shirt, a fleece jacket, and some form of Teva footwear. Several have “bed head” from not showering and a dazed look from long-term lack of sleep.

The Volvo pulls toward a space on the deserted far side of the lot, where a shining steel blue Toyota Avalon is the lone occupant. The Toyota driver sits in the driver’s seat, door wide open. At the sight of the Volvo, the Toyota driver jumps out of his car.

He is Reed Hastings, a tall lean man in his midthirties, wearing pressed Levis, a white T-shirt under a worn corduroy button-down shirt, brilliant-white running shoes, and black socks. He has close-cropped brown hair, a neat goatee, intense blue eyes, and a perpetually

guarded expression. His normal posture, slightly forward and a bit hunched in the shoulders, reflects years of staring at computer monitors in pursuit of “beautiful” mathematical algorithms to define all manner of natural and man-made phenomena.

Hastings paces impatiently, his hands jammed into the pockets of his jeans, as he watches the Volvo approach, park off-kilter, then vaguely repark.

Finally satisfied, the driver of the Volvo, Marc Randolph, gets out, stands up, and greets Hastings over the roof of the Volvo.

Randolph, in his late thirties, is as happy-go-lucky as Hastings—who is his boss at a soaring software company—is intense. Loose-limbed and lanky. with thinning dark hair, Randolph has engaging brown eyes, a bemused, wide mouth, and an easy laugh. Randolph is Hastings’s mirror opposite, a “people person,” exactly the guy you want to be your marketing manager when you are not.

Despite their differences, there is an obvious ease, trust, and camaraderie between them: They share that confidence conferred by privileged upbringings and a passion for spinning ideas into businesses.

Randolph, clad in a fleece jacket, T-shirt, torn jeans, and flip-flops, circles the car and stands next to Hastings.

“It came,” Hastings tells him.

Hastings reaches into the Avalon, digs an oversized rose-colored greeting card envelope out of a Pure Atria briefcase on the passenger’s seat, and holds it up. Randolph swallows hard, and nods for Hastings to go ahead and open it.

Hastings takes an antique monogrammed silver penknife from his shirt pocket and slits open the envelope. He pulls a silver compact disk out of the envelope and turns the disk in his hand, minutely inspecting it. It is in perfect condition.

“It’s fine,” Hastings says flatly.

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**LIKE ALL GOOD** stories, the one about the founding of Netflix Inc., the world's largest online movie rental company, mixes a little bit of fact with some entertaining fiction. But the version above is closer to reality than the company's official story—the one about how tech millionaire Reed Hastings had an epiphany for his next company after returning an overdue movie to his local video store and later dreamed up its signature subscription model on a treadmill at his gym.

"The genesis of Netflix came in 1997, when I got this late fee, about \$40, for *Apollo 13*. I remember the fee, because I was embarrassed about it. That was back in the VHS days, and it got me thinking that there's a big market out there," Hastings, Netflix's chairman and chief executive, told *Fortune* in 2009, one year before the magazine named him its Business Person of the Year.

"I didn't know about DVDs, and then a friend of mine told me they were coming. I ran out to Tower Records in Santa Cruz, Calif., and mailed CDs to myself, just a disk in an envelope. It was a long 24 hours until the mail arrived back at my house, and I ripped them open and they were all in great shape. That was the big excitement point."

As a financial journalist, I heard that story a lot in the seven years I covered Netflix along with a handful of other U.S. entertainment companies and their executives. I never gave Hastings's story much thought back then. It was simple and straightforward and conveyed perfectly what Netflix was all about: DVD rentals by mail that you can keep as long as you want without paying late fees.

The odds against Netflix surviving were long when I took over the Los Angeles entertainment industry beat at Reuters in spring 2004. Blockbuster, the world's largest movie rental chain, was preparing to launch its own online rental service, and online bookseller Amazon was lurking on the sidelines, posting employment ads for software developers for a yet to be announced movie rental service. Retail behemoth Walmart Stores was making a halfhearted stab at protecting its

enormous DVD store sales by offering online DVD rental, and Hollywood movie studios were belatedly forming joint ventures to test movie downloading. Netflix had just hit 1.9 million subscribers and was still showing losses as often as it booked profits.

In the ensuing years I watched Hastings and his underdog company claim an ever-larger share of the growing online rental market with gutsy moves that defied Wall Street predictions about the size of the market and the strength of his larger rivals.

I saw a gifted and disciplined team change the way people rent movies, not for the money, but for the challenge of disrupting a “real world” industry and taking it online. In the pursuit of elegant software and intuitive user interfaces, they created a tastemaker to rival Apple, an innovator on the order of Google, and a brand power equal to Starbucks. Netflix became a story about how powerful algorithms perfected in a Netflix-sponsored science contest resulted in technological breakthroughs that influence how anyone with a product or idea to sell rounds up likely buyers. By 2010, with a long-delayed international expansion underway, Netflix had changed how half the world watches movies.

I thought I had the story down cold when in 2010 I began to research and write a book about Netflix’s rise from a start-up with no clear path to profitability to a \$4 billion movie rental titan with a stake in everything from postage rates to Hollywood movie deals to federal rules on privacy, broadband use, and Web traffic.

I knew I would need good outside sources to solve a few mysteries about the company’s early days, because Netflix’s communications and marketing teams were excellent at staying on message with reporters and investors—and especially with consumers—on issues the company wished to either control or avoid talking about.

Some of the questions for which I could not get answers from Netflix included: What happened to Netflix’s other founder, Marc Randolph, and why is he never mentioned? Why was the *Apollo 13* founding story initially set at a Blockbuster store in Santa Cruz, then

changed in 1996 to a now defunct mom-and-pop video store in La Honda? Why did founding team member Mitch Lowe leave to start his DVD rental kiosk company Redbox, now one of Netflix's main competitors, instead of launching it at Netflix?

At first these seemed like minor details that had little bearing on the story that I knew so well and had watched unfold from a front-row seat in the financial press. But answering one question only led to another, and soon I was down a rabbit hole that changed everything I thought I knew about Netflix.

What I found was much richer and more nuanced than the official story. The complete history of Netflix comprises a long and untidy striving for greatness with multiple disasters, lucky breaks, betrayal, and heartbreak.

The company does not gratuitously mislead the public. The official story is simply more elegant and useful, and everything at Netflix, from its 2,180 corporate employees (who turn over at an annual rate of 20 percent) to the scripts followed by its executives on quarterly conference calls, must serve the company's goals or be eliminated.

After all, discipline and focus account for how a tiny, broke Silicon Valley company slew three giants of the \$8 billion movie rental world (the Blockbuster, Movie Gallery, and Hollywood Video chains), warded off Amazon, and forced movie studios into the digital age. Netflix is now employing the same tactics to undermine cable and satellite providers, but in an outwardly nonthreatening way, the better to sneak into these new markets and disrupt the competition.

"We're small enough that we don't want to incite World War II or World War III with the incumbents," Hastings said in early 2011, shortly before Netflix announced that its subscriber base had surpassed that of number one U.S. cable provider Comcast.

Hastings seemed to guide his company by stars invisible to others, often abandoning solid revenue sources or related businesses to pursue the one thing he was determined to do better than anyone—rent movies online.

Where Hastings pursued that goal, Wall Street analysts and the financial press saw only a seemingly simple business model (a software program, a bunch of warehouses, and some DVDs) and bigger companies with the means to buy what Netflix had invented. Their bleak prognostications resulted in frequent meltdowns for Netflix's stock price, which appeared not to bother Hastings. That his judgment proved correct, even visionary, was an added attraction to a story I believed showed the best of entrepreneurial culture in America.

It was in the wake of the terrible stock market crash of 2008 that I began to gather material for what I believed was a Wall Street fairy tale, in which the best ideas, a clean balance sheet, and the flawless execution of an inspired business plan allowed a company like Netflix to vanquish a bloated corporate giant or two and come out on top.

I got that and a lot more, starting with a conversation I had with Netflix's other founder on a bright, windy day in Santa Cruz, California.

**I WASN'T SURE** what to expect when we met for the first time at a breakfast joint in Los Gatos in August 2010—no one else had been able to tell me the circumstances that had led to Marc Randolph's departure from the company he helped found.

The fit, animated man who walked up to my outdoor table dressed in a fleece pullover and jeans showed every sign of enjoying a rather footloose life since leaving Netflix. He sat down, ordered eggs Benedict, and plunged into a tale that upended a lot of what I thought I knew—starting with the story of how Hastings's late fee for *Apollo 13* resulted in the founding of the company.

"That's a lot of crap," Randolph told me. "It never happened."

He explained that the *Apollo 13* story started as "a convenient fiction" to describe how Netflix's rental model works and became confused with its origins, because people wanted "a rage against the machine-type story."

Six months and several conversations later I persuaded Randolph to show me where the true Netflix founding took place, which was on a quiet stretch of downtown Santa Cruz.

At Randolph's suggestion I took a commuter bus from Silicon Valley "over the hill," on winding Highway 17 to simulate the drive he and Hastings made each day from their homes to and from the Sunnyvale offices of Hastings's software company, Pure Atria. On that commute in early 1997, they tossed around ideas for a new business that Randolph planned to start when he left Pure Atria, then in the process of merging with its largest rival, Rational.

Randolph, then head of corporate marketing, had long been particularly fascinated by how consumers respond to direct mail—catalogs, mail-in offers, coupons—or what most people, including Hastings, considered junk mail. Randolph saw in the Internet an instant way to monitor consumer response to such sales pitches, adjust the online "store" to make it more inviting, and theoretically boost sales. "Direct mail on steroids," he called it.

The drive on the two-lane mountain road through fog and forest was nerve-racking, and I felt as though I had arrived in a quaint Alpine ski town when the bus stopped to let off passengers.

Randolph picked me up in his immaculate Volvo station wagon at the tiny bus station in Scotts Valley, an affluent bedroom community in the foothills of the Santa Cruz Mountains where he had lived for about fifteen years. His Victorian farmhouse, tucked away on fifty acres of forest, is about three miles from Hastings's former home, a square yellow Victorian about a block from the ocean in Santa Cruz.

We drove to a nearly empty faux Mediterranean office park off Highway 17, where he and a team of about a dozen marketing specialists, programmers, and operations staff launched the Netflix Web site on April 14, 1998.

Hastings, who was studying for a master's degree in education at Stanford University and running a tech industry lobby group at the time, came that day to wish them luck. The one-room space of about a



thousand square feet, where Randolph ran Netflix for nearly two years, was at the back of the complex.

Next we headed three miles south, toward Santa Cruz. Randolph followed the coastal road and pointed out a wide, neatly groomed path curving along cliffs overlooking Monterrey Bay, where prosperous-looking adults strode along in pairs and threesomes, wearing baseball caps and fleece jackets bearing tech company logos.

What looked to me like groups of stay-at-home moms and dads taking exercise and sanity breaks actually could have been staff meetings of homeless tech start-ups. Randolph told me that many business plans and deals are hammered out along this stretch of road.

Santa Cruz, especially the section populated by well-to-do residents on the west side of the San Lorenzo River, is vehemently antigrowth and antimansion, and even fought a widening of Highway 17 that would have shortened the hourlong commute to Silicon Valley. The town's east siders share their wealthy neighbors' isolationism—not so much to keep out potential vulgarian McMansion builders but to preserve a surf-shack culture reminiscent of a 1960s beach party movie.

We turned north toward the center of town, near where the Pacific Coast Highway runs inland for a few blocks through a tony little business district, before it heads back toward the California coastline. Randolph parked the Volvo at a meter on Pacific Avenue, and we began to walk—past a vintage movie theater, a few upscale chain stores, and local boutiques.

He pointed out a café called Lulu Carpenter's, a hip coffee joint where people sat out front at sidewalk tables in the weak morning sunshine. He and Hastings often met at this café to discuss business—and formed the plan that brought Netflix to fruition.

One particular day their debate centered on how to distribute the movies they hoped customers would rent via a hypothetical e-commerce Web site, and they decided they had to test whether the new DVD format that Randolph had heard of could travel across the country on a first-class stamp and survive the hazards of bulk mailing.

They couldn't get their hands on a DVD, then available in only a half-dozen test markets, but a used book and music store called Logos Books & Records a couple of blocks down the street sold compact disks. When we drove up that day a giant Borders bookstore was liquidating its stock and preparing to shut down, another casualty of the inexorable move to online distribution of media that its parent company embraced too late. I wondered if Logos's staff had any idea of the role their iconic indie store played in helping Netflix bring down another huge bricks-and-mortar entertainment chain.

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They would later learn, through close collaboration with the U.S. Postal Service, that local mail was hand-canceled in Santa Cruz and not sent through postal service sorters—a fact that could have changed everything had they known it then, Randolph told me.

A day or two later, the two met up for their morning commute to Sunnyvale.

"It came," Hastings told Randolph, as he climbed into the car. "It's fine."

"And I thought, 'Huh, this might work after all,'" Randolph said, as he drove me back to the bus station. "If there was an 'a-ha moment' in the story of Netflix, that was it."



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