STANFORD
GRADUATE SCHOOL OF BUSINESS

ROCK CENTER FOR CORPORATE GOVERNANCE

CASE: CG-19
DATE: 01/15/10

EQUITY ON DEMAND: THE NETFLIX APPROACH TO COMPENSATION

INTRODUCTION

Netflix was among a small group of Silicon Valley companies to emerge from the technology bubble of the late 1990s a clear winner in terms of growth, market share, and profitability. The viability of the company's business model, however, was not always a foregone conclusion. Netflix had to build a subscriber base from scratch and prove the merits of its strategy to an investment community that was skeptical it could achieve the necessary scale in terms of customer base and profits to justify its market valuation. Along the way, the company had to weather an onslaught of competition from Wal-Mart, Blockbuster, Amazon, and a host of start-ups that directly sought to derail the company's growth.

That Netflix was able not only to prevail over this competition but also to thrive was largely attributable to the culture of freedom and responsibility inculcated by founder Reed Hastings. It was a culture that emphasized hard work, initiative, creativity, and accountability among its employees. To foster this culture, the company adopted a series of unique employment practices that were meant to attract, retain, and motivate the type of employee that Netflix valued. Among these practices was a compensation system with several unconventional features. Whereas most companies provided compensation packages with a predetermined mix of cash and equity-based awards, Netflix turned the model on its head and allowed employees to request their own mix. This practice was not reserved only for the senior-most executives but was available to all exempt employees. After working with its novel pay approach for a couple of years, management was interested in finding out whether this practice supported or detracted from the company's main objectives for its employees. These were to increase the economic efficiency of its compensation, to provide stronger incentives for performance, and to reinforce culture.

Professor David F. Larcker, Allan McCall, and Brian Tayan prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The Rock Center for Corporate Governance is a joint initiative between the Stanford Graduate School of Business and the Stanford Law School.

Company History and Business Model

Netflix was founded in 1997 by Reed Hastings, who first conceived of a subscription-based online movie rental business after he incurred a $40 late fee renting the movie *Apollo 13* from Blockbuster. Hastings had earned a bachelor's degree in mathematics, a master's degree in computer science, and then volunteered for the Peace Corps, teaching math in Swaziland for two years. He had also worked at Adaptive Technology, where he developed debugging software. He went on to found the company Pure Software, which he managed over a six-year period before selling it to Rational Software Corp for $750 million in 1997. He took what he learned from this experience of starting, growing and selling a business and applied it to his next project.

The Netflix business model was simple. The company offered a subscription service whereby customers paid a monthly fee that allowed them to rent an unlimited number of movies, with requests for titles made over the Internet. At the company's inception, the DVD format was beginning to be adopted as a standard medium for viewing movies. The standard subscription package was priced at $19.95 per month and allowed a customer to receive up to three movies in DVD format through the mail at any one time.[1] Customers were allowed to keep movies as long as they wanted, without incurring any late fees. To order movies, they created a queue on the Netflix.com website which specified the order in which they wanted to receive individual titles. When one movie was returned, the next movie in the queue was automatically mailed to the customer. The postage both ways was paid by Netflix.

A few elements were required for the business model to succeed. First, the company needed a critical mass of customers to cover the fixed costs of the business. Predicting customer behavior was also important. Because the subscription price was constant but the cost of services were variable with each movie delivered, customers who frequently rented movies were more expensive to Netflix than infrequent renters. On the other hand, customers who used the service too infrequently tended to cancel their subscription.[2] In order to keep customers appropriately engaged, Netflix offered a comprehensive collection of movie titles that were readily available upon demand.

Second, delivery service was important. Because movies were delivered to the customer through the mail, Netflix needed to ensure efficient turnaround to the customer in order to decrease waiting time. For that reason, Netflix leased a network of shipping centers near concentrated customer populations. By 2008, the company claimed that approximately 95 percent of its customers were located in areas that could receive DVDs in one business day. Next-day mail service was an important contributor to customer satisfaction and customer retention.

Third, Netflix needed to maintain a website that was easy to navigate and encouraged usage. To this end, the company developed a recommendation system that relied on collaborative filtering to suggest additional movies based on the customer's predicted preferences. Customers were asked to rate movies that they had viewed by assigning between one and five stars. Netflix

[1] Over time, multiple plans were offered to customers. In 2009, the company offered plans for one movie at a time for $8.99 per month, two movies for $13.99 per month, three movies for $16.99 per month, and up. Plans also eventually included unlimited streaming of movies over the Internet or through an Internet connected television box.

[2] Netflix indicated that the average customer viewed approximately six DVDs per month.

analyzed the ratings using computer algorithms to identify other movies that the customer might like based on the ratings of customers with similar preferences. Netflix believed that its recommendation system increased customer satisfaction and built loyalty.[3]

Netflix grew rapidly from its inception. In 2000, the company prepared for an initial public offering of its shares. The collapse of the market for technology companies forced the company to shelve its plans temporarily. In April 2002, Netflix revived these plans and sold 5.5 million shares at $15, valuing the entire company at $330 million. The next year, the company crossed the milestone of 1 million subscribers and posted its first annual profit. By 2008, Netflix boasted a customer base of almost 10 million users, generating $1.3 billion in revenue and $83 million in profit. Its market capitalization was close to $2 billion. (See **Exhibit 1** for selected financial and operating data.)

Competition and Industry Trends

The company's first major challenge came in October 2002 when retail giant Wal-Mart announced that its Internet subsidiary (Walmart.com) was launching a competing online movie subscription service, at a price that was $1 per month less than Netflix. Hastings believed the offering inferior, primarily because Walmart.com would ship movies from one centralized distribution center in Georgia. Netflix, by contrast, had 10 distribution centers at the time and therefore could offer quicker delivery to more customers. Nevertheless, Netflix's stock plummeted on the news, falling from $15 to $5. Shortly thereafter, however, the stock price recovered as it became clear that Netflix was continuing its explosive growth. In 2005, Wal-Mart announced that it would shutter its online movie subscription service, due to unsatisfactory integration with the rest of its business, and transfer its subscribers to Netflix. (See **Exhibit 2** for stock price history.)

In August 2004, Blockbuster entered the online movie subscription business. The threat of Blockbuster was in many ways more severe than that of Wal-Mart. Blockbuster had an established brand and extensive catalog of movie titles. It also boasted a retail network of 5,500 stores across the country. While Blockbuster's online movie subscription business was at first kept separate from in-store rentals, the company soon integrated the two. This allowed customers the convenience of returning movies either in the store or through the mail. Blockbuster also announced that it would discontinue its practice of charging customers late fees.

Hastings stated that the competition was something the company was prepared for: "We have long awaited meaningful competition as a measure of the strength of this market and as an opportunity to further prove our service is one that customers ultimately will choose."[4] Still, Netflix stock fell over 50 percent following the announcement. Despite aggressive investment, however, Blockbuster's subscriber base remained significantly below that of Netflix.

A third competitive threat also came late in 2004 when Amazon announced that it would launch an online movie subscription in the United Kingdom. The prospect of going head-to-head with

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[3] The company also used rating and rental history information to aid its title acquisition process and thus manage some of their fixed costs.

[4] Eric J. Savitz, "Free-Falling: Netflix Shares Are Down over 58% as It Battles Blockbuster Online," *Barron's*, August 16, 2004.

Amazon was a serious challenge because of Amazon's dominant position in online retailing and its extensive logistics and delivery system. In response to the news, Netflix reversed a decision that it had recently made to expand into the United Kingdom, instead choosing to concentrate on expansion in the U.S. It also reduced its monthly subscription fee for three-at-a-time movie rentals from $21.99 to $17.99. The price reduction squeezed operating income the following year but proved to be the right strategic move, as Amazon did not expand into the U.S.[5]

While Netflix was able to overcome fierce challenges from these established companies, it still was faced with the fact that the technological standard for watching movies at home was shifting away from the DVD format to instant viewing over the Internet. Hastings referred to the trend as "known obsolescence," and recognized it as a fundamental threat to Netflix.[6] Cable operators offered video-on-demand, whereby single movie titles could be ordered and watched instantly on home televisions. Internet start-ups were experimenting with services that allowed users to download movies over the Internet and watch them either on their computers or through Internet-connected televisions. While still nascent, instant viewing was superior to watching movies on DVD because titles could be downloaded instantly and the cost of delivery was lower.[7]

While Hastings recognized the seriousness of this threat, he explained that Netflix had been preparing for it for a long time: "It's why we originally named the company Netflix, not DVD-by-mail. From day one we've been focused on how to be the broadband delivery company."[8] Netflix's strategy for online delivery was two-fold. First, it entered into licensing agreements with studios that allowed subscribers to download a limited selection of movie titles directly over the Internet. Instant viewing was included at no additional charge in a customer's subscription package. Second, Netflix partnered with hardware manufacturers to allow subscribers to download movies to Internet connected entertainment devices such as high definition DVD players and video-game consoles. This allowed the customer to watch downloaded movies directly on their television. Partners included LG Electronics, Samsung, Microsoft (Xbox), Sony (PlayStation), Tivo, and others.[9]

A few factors played in Netflix's favor while it transitioned to instant viewing as the primary method of home movie viewing. One was that customer preferences were not quick to change. Many were happy with the DVD format and did not mind waiting to receive movies in the mail. Another was technological. Internet-ready television consoles were not standard in most homes, and many households continued to lack broadband connections. A third factor was that movie studios were slow to embrace instant viewing. They continued to rely on the sale of DVDs as a

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[5] One logistical challenge that Amazon faced was in the area of fulfillment. Whereas the United Kingdom could be serviced from one shipping center, the United States required a more expansive network. Amazon's operating model was built around large distribution facilities in the United States with an emphasis on economies of scale. This was counter to the requirement of dispersed shipping centers in local markets that would be needed to satisfy next-day shipping.

[6] Nick Wingfield, "Netflix vs. Naysayers—CEO Hastings Keeps Growth Strong; Plans for Future after Death of DVDs," *The Wall Street Journal*, March 27, 2007.

[7] It cost roughly $0.05 to download a movie using a broadband connection compared with over $0.80 cents to mail a DVD to and from the customer's home.

[8] Ken Brown, "DVD-Rental Firm May Be Victim of Its Success," *The Wall Street Journal*, November 20, 2003.

[9] For a time, Netflix considered building its own proprietary consoles but decided instead to partner with hardware manufacturers.

significant source of revenue, and instant viewing was seen as cannibalizing these sales.[10] Movie studios also had lucrative agreements with cable operators, in which they granted exclusive rights to broadcast movies on cable channels or through video-on-demand services. The existence of these agreements complicated efforts by Netflix and others to gain access to a broader selection of movie titles, particularly new releases.

Hastings believed that, while the transition to instant viewing was inevitable, the DVD would remain the standard format for five to ten years. In the mean time, Netflix would pursue its strategy of having its rental service accessible through Internet-connected devices so that it was positioned to capitalize as the transition took place. Confident of the company's prospects, Hastings set an ambitious target of 20 million subscribers (20 percent of U.S. households) by 2012.[11]

Culture and Employment Practices

Netflix had a high-performance culture, which Hastings described as encompassing "freedom and responsibility."[12] The company expected its employees to work hard, take ownership, show initiative, and act like owners by putting the company's interests first. In return, Netflix afforded them considerable flexibility in how they performed their duties. The company also sought to minimize rules and bureaucracy that would inhibit their performance. Marketing manager Heather McIlhany described the company as having a "fully formed adult" culture.[13]

In hiring, the company targeted high-performance employees who were capable of doing the work of two or three people. According to Hastings, "We endeavor to have only outstanding employees. One outstanding employee gets more done and costs less than two adequate employees." To attract these individuals, the company was willing to pay top-of-market wages. Netflix did not want a talented employee to leave the company to work elsewhere in a similar position for the same or higher wages. The company's philosophy was, "Pay them more than anyone else likely would. Pay them as much as a replacement would cost. Pay them as much as we would pay to keep them if they had a higher offer from elsewhere."[14]

Similarly, the company was demanding in its expectations for on-the-job performance. Only the highest-performing employees were retained. All others were let go so that their positions could be made available to more effective replacements. According to Hastings, "At most companies, average performers get an average raise. At Netflix, they get a generous severance package."[15] To that end, involuntary turnover at the company was very high—nearly double the rate of voluntary turnover. Still, the company would not terminate outstanding employees due to recent poor performance if their managers believed performance was likely to improve.

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[10] Movie studios received approximately $15 from a retailer for the sale of a DVD compared with $2 from a cable operator for video-on-demand.

[11] "Business Briefs: Netflix Inc.: Subscribers Are Expected to Reach Five Million in 2006," *The Wall Street Journal*, September 9, 2005.

[12] Netflix, "Reference Guide on Our Freedom and Responsibility Culture," http://www.slideshare.net/reed2001/culture-1798664 (August 25, 2009).

[13] Michelle Conlin, "Rewards Netflix: Flex to the Max," *BusinessWeek*, September 24, 2007.

[14] Netflix, "Reference Guide on Our Freedom and Responsibility Culture," loc. cit.

[15] Michelle Conlin, op. cit.

The annual review process at Netflix provided an opportunity for managers to take a fresh look at performance and compensation. The company did not budget annual raise pools, in which employees received a cost-of-living adjustment or merit-based increase. Instead, management considered the most recent market data on compensation and any changes in the employee's role and responsibilities, and if necessary, the salary was adjusted to reflect current conditions. In this way, Netflix applied the same methodology during the annual review as it did upon initial hire, with employee compensation set at above-market rates. This practice reassured employees that they were being well compensated relative to similar jobs in the market. It also reinforced Netflix's willingness to fight to retain top performers.

Employees were not asked to track vacation time. Instead they were granted unlimited vacation during the year, with the expectation that they would take only the time that was prudent, given the level of performance the company required. Patty McCord, chief talent officer at Netflix, explained: "When you have a workforce of fully formed professionals who have been working for much of their life, they understand the connection between the work they need to do and the time it takes to do it. You don't need to have a clock-in and clock-out mentality."[16] Hastings believed this policy was consistent with a culture of "freedom and responsibility."

The company's other benefits were more conventional. Employees were offered comprehensive health, dental, vision and life insurance. Netflix also offered a 401(k) and an employee stock purchase plan (ESPP), which allowed employees to invest up to 15 percent of their salary in company stock purchased every six months at a 15 percent discount to the lower of the starting and ending trading price for that six-month period.

What was unique to Netflix, however, was the way in which *compensation mix* was determined. While compensation levels were set at top-of-market, the percent of compensation that was awarded in cash versus stock options was largely at the discretion of the employee. For example, if an employee was to be paid total compensation of $100,000 per year, s/he could request to receive the entire amount in cash, 50 percent cash and 50 percent stock options, or some other mix (up to a maximum 60 percent in stock options). While the company retained discretion to lower the requested stock compensation (and correspondingly increase the cash compensation) if necessary, such discretion was rarely exercised. Hastings believed that such a practice was both more economically efficient and provided better incentive value for performance.

The Economics of Stock Options

Employee stock options are contracts that give employees the right, but not the obligation, to purchase company stock at a predetermined price over the life of the contract. Most employee stock options carry a 10-year term and are granted with an exercise price equal to the price of the stock on the date of the grant (referred to as *at the money*). Typically, employee stock options carry restrictions that limit the ability of employees to exercise them immediately. For example, stock options usually vest in predetermined allotments, and only once they have vested are employees free to exercise them.[17] It is up to the board of directors to determine the terms of the

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[16] Ken Belson, "When Flexi Is Sexy," *Today*, September 1, 2007. Edited for clarity.

employee stock option awards, although plans under which they are granted must be approved by shareholders.

An employee realizes value from a vested stock option by exercising it when the price of the stock is higher than the exercise price of the option. For example, if an option has an exercise price of $20 and the stock is trading at $25, the employee can realize a profit of $5—the difference between the two, which is known as its *intrinsic value*—by exercising the option. The potential benefit that an employee realizes from a stock option award is a function of the firm's future stock price movement. If the employee believes that the stock price will go higher, s/he might wait to exercise the option at a later date. Otherwise, the employee might exercise the option early to lock in current profit.

In addition to a vesting requirement, employee stock options typically carry a termination restriction. Employees who voluntarily resign or are involuntarily terminated by the firm are typically given a 30-to-90 day window to exercise all vested, in-the-money options. Any options that are not exercised within this time frame are forfeited.

Because the value that the employee ultimately will realize from the option is unknown at the grant date, the company must estimate the cost of the option using an approved valuation method for purposes of expensing through the income statement. Many companies value options using the Black-Scholes pricing model, which relies on expectations about future stock price volatility, interest rates, dividends, and number of years until exercise to arrive at an estimated value.[18] For example, in a normal market environment, a technology firm stock option for shares that are currently trading near $20, with an exercise price of $20, might have a Black-Scholes valuation of $10.[19]

Companies attempt to determine the optimal mix of cash and equity incentives to attract, retain, and motivate employees:

- *Attraction*: In general, stock options are used to attract employees who have the skills needed to substantially improve the value of the company and who are not highly risk averse. This may include young individuals in executive and managerial positions or those with important specialized knowledge. These individuals may be looking for a risky employment opportunity that can produce substantial personal wealth if the company is a success.

- *Retention*: Vesting and termination restrictions serve to retain employees by restricting their ability to realize the full value of options if they leave the firm. Annual stock option grants also contribute to retention by laddering additional compensation into future years.

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[17] Employee stock options may carry a vesting requirement of two to five years. Among technology firms, it is common for 25 percent of an award to vest on the first anniversary, and for the remainder of the award to vest monthly on a pro-rata basis thereafter. If an employee quits or is let go prior to the vesting date, the option is cancelled.

[18] An alternative method is the lattice-binomial model.

[19] This computation assumes a volatility of 50 percent, risk-free rate of 5 percent, five-year term, and no dividend yield.

- *Motivation*: Stock options are used to motivate employees by tying the value of their compensation to overall firm performance. Because stock options have no intrinsic value at the grant date, they encourage employees to take actions that increase the value of the company, potentially rewarding both themselves and the company's shareholders. However, because stock options offer significant upside with a downside of zero, they might encourage employees to engage in value-increasing, but risky, investments.[20] On the other hand, when stock options are considerably in the money, employees may become risk averse in order to preserve the intrinsic value of their holdings. As a result, excessive concentration of wealth in the company stock may discourage employees from taking appropriate risk on behalf of the firm.

The mix of cash and equity granted to each position varies based on job level, function, industry, and the supply and demand for talent (see **Exhibit 3** for industry statistics).[21]

If the incentive or motivation impact of stock options is small, awarding compensation in the form of stock option grants may be less economically efficient than paying that same compensation in cash.[22] This occurs because the expected cost to the firm of granting the stock options can be larger than the perceived value of the option to the employee.[23] Some studies suggest that employees value stock options at only half of their Black-Scholes valuation as of the grant date.[24]

Furthermore, other behavioral and economic factors influence the manner in which employees realize value from stock options. Because the options themselves are non-transferrable, the only way for an employee to realize value from them is to exercise them. Importantly, employees who hold stock options tend to exercise them well before the expiration of their 10-year term. In doing so, they forfeit the remaining time value of the options, which may be significant. Early exercise can be attributed to several factors, such as using a heuristic for exercising (e.g., exercise the option when it is 100 percent in the money), the desire to monetize a vesting allotment to enable consumption, and acting on private information about future stock price movements.[25] Employees may also be forced to exercise an option early due to voluntary or involuntary termination from the firm. These factors are not easily accounted for in the Black-Scholes pricing model.[26] Still, they significantly influence the economic efficiency and incentive value of stock options.

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[20] For this reason, stock options are said to provide *asymmetric incentives*.

[21] According to some estimates, approximately 3-4 percent of workers in the United States receive stock options as a component of their total compensation. See: Kelley Holland, "When the Share Price is a Factor in Pay," *The New York Times*, April 27, 2008.

[22] For a review of the academic literature on equity compensation, see: John E. Core et al. (2003), "Executive Equity Compensation and Incentives: A Survey," *FRBNY Economic Policy Review*, April 2003.

[23] The theory behind this hypothesis is that, because individuals are risk averse, they value *uncertain* compensation (in the form of stock options) less than *certain* compensation (cash). Employees may also undervalue options because their wealth is concentrated in company stock (i.e., they are not well diversified) and they are unable to easily hedge option payoffs.

[24] See: Richard A. Lambert et al., "Portfolio Considerations in Valuing Executive Compensation," *Journal of Accounting Research*, 29:1, pp. 129-49.

[25] See: Chip Heath et al., "Psychological Factors and Stock Option Exercise," *The Quarterly Journal of Economics*, May 1999.

Compensation at Netflix

Compensation practices at Netflix had continued to evolve since the company's initial public offering in 2002. Hastings' ideas about compensation were based on the concept that the most efficient form of compensation was a large cash salary. He recognized the potential inefficiencies of stock option compensation that caused employees to undervalue them relative to their inherent value.[27] Still, he strongly believed the incentives provided by employee stock ownership were important: options allowed employees to participate in the success of the organization.

To this end, Netflix senior management devised a unique compensation arrangement, which began to take shape in 2003 and was fully formed by 2006. The key components of this system were as follows:

- *Compensation Mix*: At the end of each calendar year, exempt employees at Netflix were allowed to request their own personal compensation mix for the following year. Rather than have the company make this election for them, employees were given a total compensation amount and allowed to allocate it between base salary and options in the manner they felt was best for them (up to a maximum of 60 percent in options). For example, an employee earning total compensation of $125,000 might decide that s/he wanted to take all salary, whereas another employee earning the same total compensation might elect to receive $25,000 in stock options and $100,000 in salary. The company retained discretion to lower the proportion of compensation delivered in stock if circumstances made it appropriate; however, such discretion was rarely utilized. At the end of the year, employees could change their allocation for the subsequent year; however, changes to the allocation during the course of the year were not allowed.[28]

- *Pricing*: Option grants were made monthly, with one-twelfth of the annual allocation granted and priced on the first trading day of each month. For example, an employee electing to receive $12,000 of the total salary in stock options would receive a monthly stock allocation of $1,000. The number of shares underlying each monthly allocation was calculated using the formula:

  Number of shares = monthly allocation / (stock price on grant date * 25 percent)

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[26] Companies attempt to deal with these problems by using the "expected term" (which is less than 10 years) as an input in the Black-Scholes model, although few if any companies explicitly model these factors.

[27] He also recognized the tendency of companies to underestimate the cost of options because they did not involve an upfront cash payment. To combat this, Netflix was one of the first technology companies (along with Microsoft and Amazon) to voluntarily recognize the value of stock option grants as an expense on the income statement starting in 2003, three years before all publicly traded companies in the U.S. were required to do so under Financial Accounting Standard (FAS) 123.

[28] At first, only executives (director level and above) were allowed to steer compensation from cash to stock options. In 2006, the program was expanded to include all exempt employees. By 2009, approximately 500 employees were included in this program. Non-exempt employees, who primarily worked in the company's shipping centers, continued to be paid on an hourly basis in cash.

This formula was meant to provide a very generous valuation for the employee—a roughly 50 percent discount relative to the Black-Scholes calculation for an option with a 10-year term.[29] This meant that an employee who gave up $1,000 per month in cash was being granted options worth approximately $2,000 in expected value.

- *Vesting*: No vesting restrictions were attached to stock option awards. All stock options vested immediately and became exercisable as of the date of the grant. Management believed that vesting restrictions encouraged employees that were not appropriately engaged with the company to stay until more of their option awards were vested. This created perverse incentives that contradicted the company's emphasis on high performance. The company referred to vesting restrictions as "golden handcuffs." According to Steve Swasey, director of corporate communications, "If they're just there because they have a 'golden handcuff' for four or five years, that's not a productive employee. That's not an employee who's working for today. We don't incent people to hang on. We incent people to perform now."[30] The removal of vesting restrictions also made it easier for managers to terminate underperforming employees, because managers knew that in doing so they would not be forcing employees to forfeit potentially valuable compensation that they had not yet received because it had not yet vested.

- *Termination*: The company eliminated the requirement that employees exercise vested options following termination of employment. Instead, former employees—regardless of whether termination was voluntary or involuntary—could continue to hold unexercised options for the remainder of the 10-year term. The company believed that post-termination forfeiture was inappropriate, because employees had elected to give up salary that they had properly earned in exchange for options.[31]

- *Cash Bonuses*: No cash bonuses were offered by the company. Compensation was computed in such a way that any cash bonus that the employee might stand to receive at a competitive firm was instead added to their total salary at Netflix. The company believed that a practice of no cash bonuses was consistent with its high-performance culture and willingness to terminate underperforming employees.[32]

The Netflix approach to compensation was unique and intended to solve traditional problems relating to the economic efficiency and incentive value of compensation. At the same time, Netflix wanted to develop a program that extended to all employees—not just senior executives—and was consistent with the company's employment practices and culture of "freedom and responsibility."

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[29] The company, however, took the full value of the awards as an expense in its financial statements. The firm used the lattice-binomial pricing model for purposes of determining the expense associated with stock options.

[30] Christina Fuoco-Karasinski, "Netflix Bucks Traditional Total Rewards," *Workspan*, August 2007.

[31] Until 2004, employees had a traditional 90-day window following termination of employment to exercise all options. From 2004 to 2006, that window was extended to one year. In 2007, termination restrictions were fully lifted.

[32] According to the company's proxy, Netflix "expects all individuals to perform at a level deserving of a bonus and therefore such bonus amounts are taken into consideration in determining total compensation." Source: Netflix, form DEF 14A, filed with the Securities and Exchange Commission, April 6, 2009.

EFFECTS OF STOCK OPTION PARTICIPATION

Netflix was interested in the impact of its stock option program on the efficiency of compensation and on employee performance. **Exhibit 5** provides summary statistics of the population of exempt employees during the period 2007 to 2009. Voluntary turnover at Netflix was generally lower than that of the typical technology company in the same geographic area (Silicon Valley), while involuntary turnover was higher. Total employee turnover was also somewhat above average market levels. Over the sample period, approximately one-third of employees chose to receive part of their compensation through stock options, while approximately two-thirds chose to receive compensation entirely in cash.

Exhibit 6 describes the determinants of participation in the stock option program. Using a multivariate logistic regression, it was found that male employees and employees with longer tenure were less likely to participate, while female employees, employees with higher salaries and employees at the vice president level were more likely to participate. Netflix also investigated the relationships between participation and involuntary turnover and between participation and subsequent raises. They found that employees who were involuntarily terminated were less likely to have participated in the stock program in the preceding annual pay cycle. Also, employees who received larger raises were more likely to have participated in the stock option program the year prior.

Exhibit 7 shows the exercise behavior of employees who participated in the stock option program. Employees did not typically hold all of their stock options for the full 10-year term. Approximately 50 percent of stock options were exercised within 4 years of the grant date. On average, employees exercised their stock options when they had a 40-60 percent gain over the strike price.

Exhibit 8 contains selected clauses from the company's insider trading policy. The insider trading policy restricted the rights of any employee or director to trade the company stock when in a position of having material inside information. The insider trading policy also discouraged all employees from trading in derivatives relating to Netflix stock.

Study Questions

1. Describe the key features of the Netflix compensation program? Explain whether the program is consistent with the company's culture, strategy, and business model.

2. Evaluate the economic efficiency of the Netflix compensation program. In what ways is it more efficient than the more standard practice whereby the firm decides the compensation mix for employees at the beginning of the fiscal year? In what ways is it less efficient?

3. What economic and behavioral factors might explain the findings in **Exhibits 6 and 7** regarding:

    a. an employee's election to allocate a portion of his/her salary to stock options,
    b. demographic variables that influence this decision,
    c. correlations between electing to receive stock options and job performance, and
    d. the decision of when to exercise stock options?

4. Given your answers to question 4, what changes would you suggest that Netflix make to its compensation program?

5. Why would an executive or employee desire to hedge their stock options? Why would the board adopt the insider trading policy described in **Exhibit 8**?

6. What is the broader applicability of the type of compensation program used by Netflix? In what types of companies or industry settings would such a system work? In what settings would it be less effective?

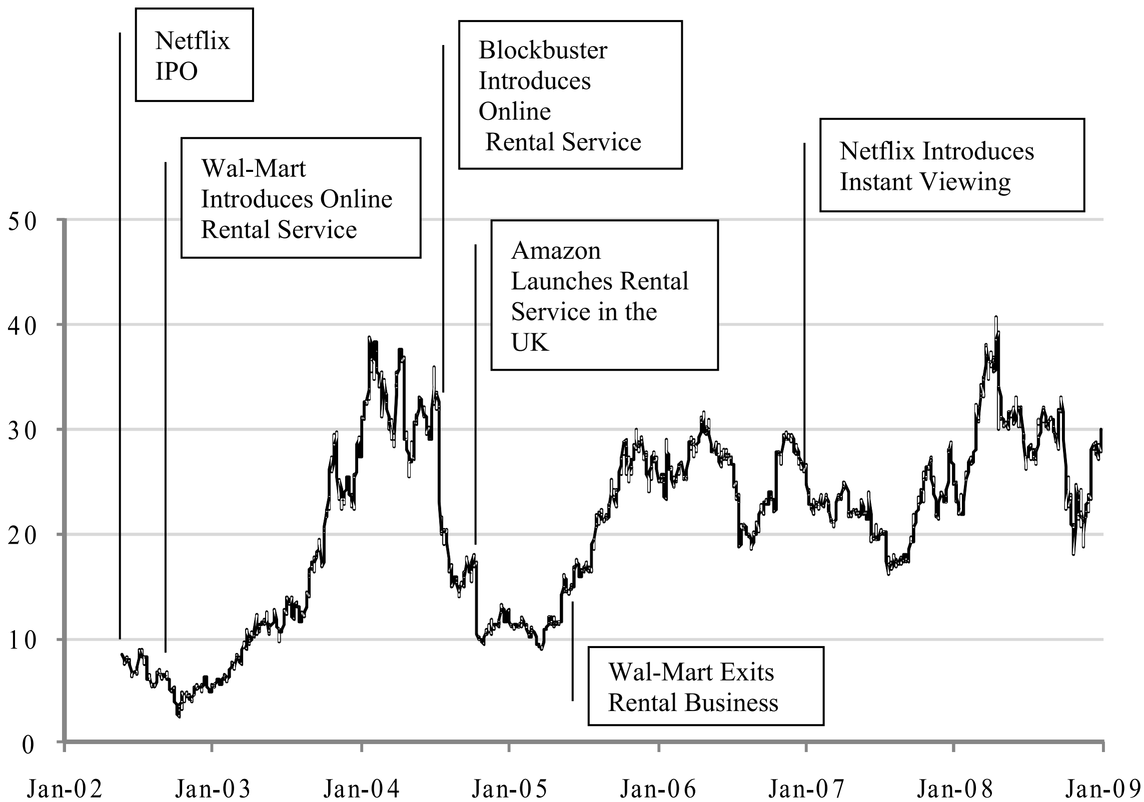
Exhibit 1
Netflix: Financial and Operating Data (2002 – 2008)

(in millions, except per share)	2002	2003	2004	2005	2006	2007	2008
Revenues	$ 152.8	$ 272.2	$ 506.2	$ 682.2	$ 996.7	$ 1,205.3	$ 1,364.7
Gross Profit	74.7	123.9	230.0	217.7	369.7	419.2	454.4
Operating Income	(10.7)	4.5	19.4	3.0	64.4	91.2	121.5
Net Income	(20.9)	6.5	21.6	42.0	49.1	67.0	83.0
Shareholders' Equity	$ 89.4	$ 112.7	$ 156.3	$ 226.3	$ 414.2	$ 430.7	$ 347.2
Earnings Per Share	$ (0.74)	$ 0.10	$ 0.33	$ 0.64	$ 0.71	$ 0.97	$ 1.32
Ending Share Price	$ 5.5	$ 27	$12	$ 27	$ 26	$ 27	$ 30
Average Basic Shares	28.2	47.8	52.0	53.5	62.6	67.1	61.0
Average Diluted Shares	28.2	62.9	64.7	65.5	69.1	68.9	62.8
Market Value Equity	$ 155	$ 1,700	$ 775	$ 1,770	$ 1,800	$ 1,860	$ 1,880
Subscribers	0.9	1.5	2.6	4.2	6.3	7.5	9.4
Subscriber Churn	6.3 %	4.8 %	4.4 %	4.0 %	3.9 %	4.3 %	4.2 %
DVD Titles	14,500	18,000	35,000	55,000	70,000	90,000	100,000
Instant Viewing Titles	-	-	-	-	-	5,000	12,000
Shipping Centers	13	23	30	32	40	47	50
One-Day Delivery	60 %	80 %	85 %	90 %	90 %	90 %	95 %
Employees	381	576	940	985	1300	1542	1644

Notes: Share information adjusted for 2-for-1 stock split February 2004. Market value of equity based on average diluted shares outstanding and year-end share price. Subscriber churn represents the percent of customers who cancel their subscription each year. Subscriber churn for years 2002-2006 based on fourth quarter statistics; annualized for years 2007-2008. One-day delivery represents the percent of subscribers estimated to have one-day mail service to and from the nearest shipping center. Approximately 70 percent of employees work in distribution centers (paid hourly); 30 percent at headquarters (salaried). 2005 net income benefited from one-time reversal of deferred tax assets that had previously been written down.

Source: Netflix annual reports and case writer estimates.

Exhibit 2
Netflix: Stock Price History (2002 – 2008)



Note: Adjusted for 2-for-1split February 2004.

Source: Center for Research in Securities Prices (University of Chicago).

Exhibit 3
Industry Data: Compensation Mix and Turnover (2008)

Compensation Mix (Selected Positions)

Job Function	% Cash Salary	% Equity Awards	% Cash Bonus
Software Engineer	87 %	9 %	4 %
Marketing Manager	77 %	13 %	10 %
Finance Director	59 %	16 %	25 %
Chief Marketing Officer	31 %	18 %	51 %
Chief Financial Officer	24 %	19 %	57 %
Chief Executive Officer	16 %	18 %	66 %

Turnover Statistics

	Summary Statistics
Average annual total employee turnover	18 – 20 %
Average annual voluntary employee turnover	10 – 13 %
Average annual involuntary employee turnover	6 – 10 %

Compensia. Sample includes employees at technology companies in Silicon Valley, 2008.

Exhibit 4
Netflix: Executive Compensation (2006 – 2008)

Compensation for Chief Executive Officer and Named Executive Officers

	Year	Salary	Cash Bonus	Option Awards	Other	Total
Reed Hastings	2008	$ 994,231	-	$ 1,766,353	$ 270	$ 2,760,854
CEO, President, and	2007	850,000	-	1,568,307	270	2,418,577
Chairman	2006	500,000	-	1,802,842	270	2,303,112
Neil Hunt	2008	795,000	-	704,994	7,170	1,507,164
Chief Product Officer	2007	670,000	-	608,872	7,020	1,285,892
Leslie Kilgore	2008	748,077	-	1,334,546	7,080	2,089,703
Chief Marketing Officer	2007	700,000	-	1,291,555	6,930	1,998,485
	2006	650,000	-	987,864	15,810	1,653,044
Barry McCarthy	2008	796,138	-	1,077,060	7,674	1,880,872
Chief Financial Officer	2007	699,600	-	1,144,650	7,164	1,851,414
	2006	500,000	-	1,255,936	7,914	1,763,850
Ted Sarandos	2008	896,538	-	177,414	13,580	1,087,532
Chief Content Officer	2007	810,000	-	166,053	13,430	989,483

Note: Dollar amounts in the option awards column reflect the compensation expense recognized by the company for financial statement reporting purposes with respect to stock options during the 2008 fiscal year in accordance with SFAS 123R. The dollar amounts set forth in the Option Awards column are different than the stock option allowance amounts described in the section entitled "Compensation Discussion and Analysis" because the stock option allowance amounts are reflective of the total compensation amount attributable to stock option grants, not the accounting valuation under SFAS 123R.

Options valued using lattice-binomial pricing model (2007 and 2008) and Black-Scholes model (2006). In 2008, the assumptions were: expected volatility of 50 to 60 percent, risk-free rate of 3.68 to 4.00 percent, dividend yield of 0 percent, and suboptimal exercise factor of 1.76 to 2.04.

Compensation Discussion and Analysis

The company does not specifically benchmark compensation for its named executive officers in terms of picking a particular percentile relative to other people with similar titles at peer group companies….

By permitting employees to request a customized combination of salary and stock options, the company believes it is better able to take into consideration personal compensation preferences and thereby offer a more compelling total compensation package. In addition, offering grants monthly provides employees with a "dollar-cost averaging" approach to the price of their option grants. Option grants made on an infrequent basis are more susceptible to the whims of market timing and fluctuations. By granting options each month, the company believes it alleviates to a

Exhibit 4 (continued)
Netflix: Executive Compensation (2006 – 2008)

great extent the arbitrariness of option timing and the potential negative employee issues associated with "underwater" options….

The actual number of options to be granted is determined by the following formula: $10,000 / ([fair market value on the date of grant] x 0.25). Each monthly grant is made on the first trading day of the month, is fully vested upon grant and is exercisable at a strike price equal to the fair market value on the date of grant….

In 2008, the salary and stock option components for the named executive officers were allocated as follows:

	Annual Salary	Annual Stock Option Allowance	Monthly Stock Option Allowance
Reed Hastings	$ 1,000,000	$ 1,000,000	$ 83,333
Neil Hunt	800,000	400,000	33,333
Leslie Kilgore	750,000	750,000	62,500
Barry McCarthy	800,000	600,000	50,000
Ted Sarandos	900.000	100,000	8,333

Chief Executive Officer: Stock Option Exercises

Year	Shares Acquired	Value Realized	Exercisable Options	Unexercisable Options	Value Realizable
2008	168,000	$ 4,429,220	1,841,914	-	$ 31,067671
2007	130,000	2,651,909	1,869,613	-	30,250,031
2006	130,000	3,162,800	1,843,406	-	31,135,815

Note: Value realizable from options is based on their intrinsic value at year end.

Executive Stock Ownership

	Shares Beneficially Owned	Percent of Class
Reed Hastings	3,766,877	6.25 %
Neil Hunt	290,759	-
Leslie Kilgore	271,069	-
Barry McCarthy	648,032	1.10 %
Ted Sarandos	69,163	-

Note: Includes in-the-money stock options, as of March 31, 2009.

Source: Netflix, forms DEF 14A, filed with the Securities and Exchange Commission, April 6, 2009, April 2, 2008, and March 27, 2007.

Exhibit 5
Netflix Stock Option Program: Descriptive Statistics

Stock Option Elections and Turnover

	Summary Statistics
Employees who elect to receive 100% cash compensation	59 – 75 %
Employees who elect to receive some portion of their compensation in stock options	25 – 41 %
Average compensation allocated to stock options (includes only employees who elect > 0 % stock options)	7 – 8 %
Average annual employee turnover	16 – 28 %
Average annual voluntary employee turnover	3 – 14 %
Average annual involuntary employee turnover	14 – 20 %

Summary statistics includes range of results for the years 2007 to 2009. Sample includes all exempt employees, including executive officers.

Source: Netflix and case writer analysis.

Exhibit 6
Netflix Stock Option Program: Correlations

Demographic Variables and Stock Option Elections

Variable	Relationship with the Likelihood of Equity Participation
Gender = Male	-
Gender = Female	+
Job Tenure	-
Salary	+
Job Level = Vice President	+

Includes only statistically significant results. "+" indicates positive correlation with electing to receive stock options; "-" indicates negative correlation with electing to receive stock options.

Stock Option Elections and Job Performance

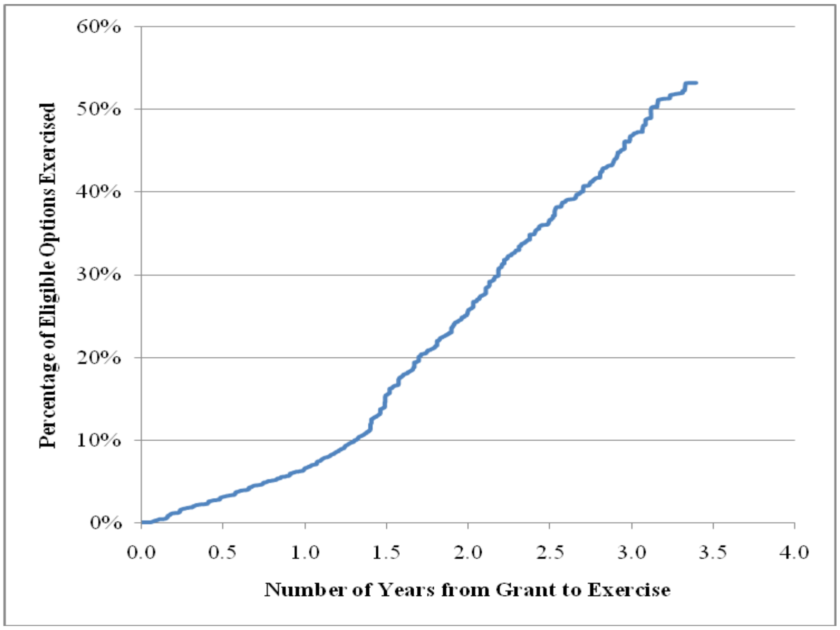
Variable	Relationship with the Likelihood of Equity Participation
Involuntary Turnover in the Next Year	-
Raise in the Next Year	+

Includes only statistically significant results. "+" indicates positive correlation with electing to receive stock options; "-" indicates negative correlation with electing to receive stock options.

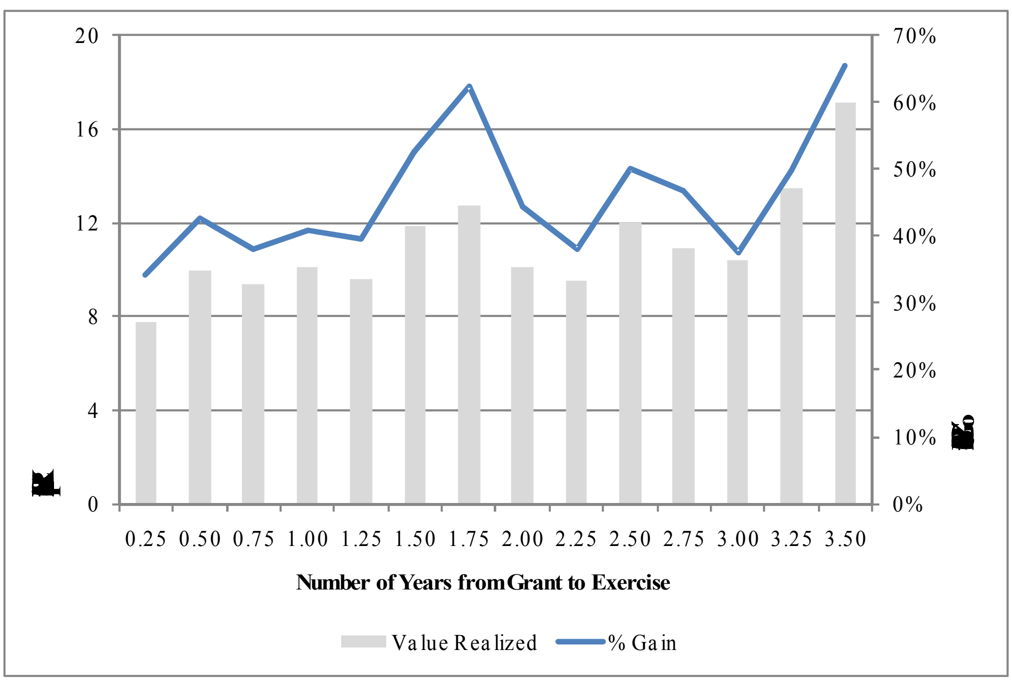
Source: Netflix and case writer analysis.

Exhibit 7
Netflix Stock Option Program: Exercise Behavior

Percentage of Options Exercised over Time



Value Realized at Exercise



Source: Netflix and case writer analysis.

Exhibit 8
Netflix: Insider Trading Policy (selected clauses)

Applicability of Policy

This Policy applies to all transactions in the Company's securities, including common stock, options for common stock and any other securities the Company may issue from time to time, such as preferred stock, warrants and convertible debentures, as well as to derivative securities relating to the Company's stock, whether or not issued by the Company, such as exchange-traded options. It applies to all officers of the Company, all members of the Company's Board of Directors, and all employees of, and consultants and contractors to, the Company and its subsidiaries, who receive or have access to Material Nonpublic Information regarding the Company.

Trading on Material Nonpublic Information

No director, officer or employee of, or consultant or contractor to, the Company, and no member of the immediate family or household of any such person, shall engage in any transaction involving a purchase or sale of the Company's securities, including any offer to purchase or offer to sell, during any period commencing with the date that he or she possesses Material Nonpublic Information concerning the Company, and ending at the beginning of the second Trading Day following the date of public disclosure of that information, or at such time as such nonpublic information is no longer material.

Additional Information—Directors and Officers

Directors and officers of the Company and certain other persons identified by the Company from time to time must also comply with the reporting obligations and limitations on short-swing transactions set forth in Section 16 of the Securities Exchange Act of 1934, as amended. The practical effect of these provisions is that officers, directors and such other persons who purchase and sell the Company's securities within a six-month period must disgorge all profits to the Company whether or not they had knowledge of any Material Nonpublic Information. Under these provisions, and so long as certain other criteria are met, neither the receipt of an option under the Company's option plans, nor the exercise of that option is deemed a purchase under Section 16; however, the sale of any such shares is a sale under Section 16. In addition, the receipt of stock under the Company's Employee Stock Purchase Plan is not deemed a purchase under Section 16, but the subsequent sale of such stock is not exempt from Section 16.

Section 16 prohibits executive officers and directors from ever making a short sale of the Company's stock. A short sale is a sale of securities not owned by the seller or, if owned, not delivered. Transactions in put and call options for the Company's securities may in some instances constitute a short sale or may otherwise result in liability for short swing profits. All executive officers and directors of the Company and such other identified persons must confer with the Insider Trading Compliance Officer before effecting any such transaction. The Company strongly discourages all such short-swing and short sale transactions by executive officers, directors and all employees.

While employees who are not executive officers and directors are not prohibited by law from engaging in short sales of the Company's securities, the Company believes it is inappropriate for employees to engage in such transactions and therefore strongly discourages all employees from such activity. The Company has provided, or will provide, separate memoranda and other appropriate materials to its executive officers and directors and those identified employees regarding compliance with Section 16 and its related rules.

Source: Netflix Insider Trading Policy. Available at: http://ir.netflix.com/documentdisplay.cfm?DocumentID=74 (November 1, 2009).