CASE 5

Blockbuster Fights for Survival Against Intense Competition

Synopsis: *Blockbuster has consistently faced competitive challenges throughout its history. However, changing technology and shifting customer preferences with respect to movie distribution have become Blockbuster's biggest challenges to date. Today, the company finds itself trapped in its bricks-and-mortar business model of the past, while strong competitors have emerged to dominate movie distribution via the mail (Netflix), kiosks (Redbox), and online (Apple, Amazon, Hulu, and others). Looking to the future, Blockbuster's very survival depends on its ability to adapt to and adopt new technology and marketing practices—issues the company has struggled with in the past because of its reactive, rather than proactive, stance toward a rapidly changing market.*

Themes: *Changing technology, changing consumer preferences, competition, competitive advantage, product strategy, services marketing, pricing strategy, distribution strategy, nonstore retailing, customer relationships, value, implementation*

Blockbuster has recently been described as a dinosaur—some say a dinosaur on life support. What a dramatic change from the company's peak only a few years ago. In 2005, Blockbuster, Inc. sat at the top of the global home video rental industry. However, that dominant position has quickly eroded in the face of stiff competition on a number of fronts. Until recently, Blockbuster dealt with a change in competition fueled by changes in technology and consumer preferences. Whether it involves movies delivered via mail, cable on-demand, or online, Blockbuster has struggled to figure out the best way to compete against Netflix, Apple, Amazon, cable providers, and a host of online services. Most recently, Blockbuster has faced a different form of competition from Redbox and its vending-based solution to movie distribution. Blockbuster now finds itself in the unenviable position of having to compete on both price and convenience. As more and more consumers move to these and other types of movie distribution services, Blockbuster has become trapped in its bricks-and-mortar business model of the past.

Keith C. Jones, North Carolina A&T State University, prepared this case for classroom discussion rather than to illustrate effective or ineffective handling of an administrative situation.

Blockbuster's History

Blockbuster started in 1985 as a small entrepreneurial venture. David Cook sold his computing services business and started a handful of computerized video rental stores. Then in 1986, he transformed his company into Blockbuster Entertainment. As the company showed strong growth and potential, investors eyed the company as a potential investment opportunity. One of these investors was Wayne Huizenga, who in 1987 brought the company a large financial boost ($18 million) and a vision to expand the company into the largest video rental company in the United States. By the end of 1987, Huizenga bought full interest in the company. In three years Huizenga took the company from 130 stores to 1,500 stores. The growth included the acquisition of Major Video (175 stores) and Erol's, which was the third-largest U.S. video rental chain at the time.

Early Expansion

In the 1990s, the company maintained a very aggressive expansion and acquisition program. Blockbuster expanded into the music industry when it acquired Sound Warehouse and Music Plus in 1992. These acquisitions allowed the company to develop the Blockbuster Music component of its overall business. While this was taking place, the company also expanded internationally. One of its largest international moves was the purchase of Cityvision, which provided Blockbuster with 875 stores throughout the United Kingdom. Then in 1993, Blockbuster made its next expansion move with the acquisition of the Spelling Entertainment group. This provided Blockbuster with key industry access. Huizenga's final visionary action before moving on to other entrepreneurial ventures was the handing off of Blockbuster to Viacom, which created the Blockbuster Entertainment Group.

The mid-1990s were a tumultuous era for Blockbuster. From 1994 to 1997, Blockbuster experienced frequent turnover in upper management and a repositioning—changes that almost proved fatal to the company. When Huizenga stepped down as CEO, Steven Berrard filled the vacancy. Berrard stayed on as CEO until 1996 when he left the company and joined forces with Huizenga. Then Bill Fields stepped in from an executive position at Walmart. Fields brought with him the Walmart persona and immediately started repositioning Blockbuster from a rental format to a retail sales format. During this repositioning, Fields closed 50 of the music stores and moved the corporate headquarters from Florida to Dallas, Texas. Some members of the upper management group opted not to follow the company to Texas, creating critical vacancies in the company. Fields resigned from his position in 1997.

Back to Basics

In a lifesaving move, Blockbuster's board brought in John Antioco as the next CEO. After a review of the company, Antioco immediately repositioned the company back to its traditional competitive advantage in home entertainment rentals. In doing so, Antioco reformatted the stores as rental facilities for movies and games. He retained a minimal retail sales component but focused all promotional efforts on the rental industry. To improve the competitive advantage of the company, Antioco renegotiated contracts with movie studios. Traditionally, movie rental companies were required to pay large sums of money per copy of a movie (as much as $120). Antioco developed a revenue-sharing approach that allowed Blockbuster to obtain more copies of a movie (paying a smaller fee) but sharing with the movie studio a royalty per rental. This provided Blockbuster with the ability to develop an availability guarantee for new releases through a larger inventory holding.

The next major strategic change Antioco instituted was the harvesting of the Blockbuster Music component of the company in 1998. This finalized the transformation of Blockbuster back to a focus on the movie and game rental industry. When Viacom spun off a partial interest in Blockbuster in 1999, Antioco restructured the company into three operating units: retail, e-commerce, and database and brand marketing. This new operating structure allowed Blockbuster to be on the forefront of innovation as DVDs had solidly replaced VHS tape in 2001.

Not all of Antioco's changes during this time were successful. In 2001, Blockbuster attempted to partner with Radio Shack by providing store space to sell necessary equipment to renters. This was a short-lived relationship as Radio Shack pulled out in 2002 and accused Blockbuster of limiting access to customer information. This was a mutual dissolution as Blockbuster accused Radio Shack of selling unnecessary items to customers and thus negatively impacting the image of Blockbuster in the eyes of the consumer.

Blockbuster Evolves

By 2002, customers' demands for home entertainment had evolved beyond traditional movie rentals. In a letter to Blockbuster shareholders, Antioco stated, "In 2002, we again began to change the way we do business to capitalize on the changes in the home entertainment marketplace brought about by DVD and introduction of the next-generation game platforms." The mission for Blockbuster was to become the complete source for movies and games. This led to the purchase of Game Station (a retail format specializing in electronic games) and an expansion of the gaming section of the stores to include equipment sales and rentals. To stay competitive, Blockbuster also purchased a chain of movie trading stores and an online company called Film Caddy. Antioco also recognized the threat posed by the growing popularity of rent-by-mail formats such as Netflix. And, not forgetting the international component of the company, Blockbuster began testing a nonsubscription online rental with a postal delivery approach in the United Kingdom.

By 2003, Blockbuster had launched its rental subscription program, which allowed subscribers to rent an unlimited number of movies during the subscription period (there were limitations within the program). Through this program, subscribers no longer had to worry about the extended viewing fees to which renters were subject. The company also continued to expand and improve on its in-store concepts, especially in the DVD and electronic game sections. Finally, Antioco continued to emphasize the importance of the e-commerce component and the Blockbuster.com website. During this time, the main function of the website was to provide potential renters with movie, promotion, and feedback information. Although contemplating entering the online rental market in the United States, Blockbuster did not make the jump during 2003.

Blockbuster was able to capitalize on the home entertainment growth trends during this time. Game software sales in the United States grew from $5.8 billion to $6.2 billion. The movie rental sector was growing at 7 percent annually and was expected to be a $1.1 billion industry by 2008. While Blockbuster continued to improve its rental subscription programs and the movie and game trading components, the company's critical move was the launch of its online movie rental program in 2004. This strategic move was a reaction to the burgeoning level of competition in alternative movie rental options. However, Blockbuster did not want to abandon its flagship in-store offerings, so the company gave online subscribers two free in-store rentals (movies or games) each month. This program was designed to overcome customer complaints about having to wait for online movies to arrive. It was also seen as a competitive advantage against Netflix.

Another Change in Command

Antioco's term as CEO came to an abrupt end in July 2007 after he clashed with the board of directors over his compensation package. In a swift and decisive move, the board of directors enlisted James Keyes to replace Antioco. Keyes was the turnaround artist for 7-Eleven (CEO from 2000–2005) and had entered "retirement" after the sale of 7-Eleven in 2005. Keyes came on board with two clear initiatives. First, he wanted to use technology to transform Blockbuster into a dominant force in both the in-store and online formats, thus making content more readily available. Second, he wanted to change the image of the company from being a rental shop to a content shop.

The environment Keyes stepped into was not a comfortable one. In 2006, Blockbuster closed 290 stores and planned to close another 280 in 2007. Financially, Blockbuster and Keyes were under the gun: The company's stock price had fallen from a high of just over $26 in 2002 to $4.30 when Keyes took over. Under Keyes, store closings continued. After closing 217 stores in 2007 (less than projected), the company planned to shutter another 167 stores in 2008.

Changing Movie Distribution Technology

Since the creation of home entertainment systems, technology has played a leading role in the evolution of the movie industry. For example, the growth of home theaters created a change in the competitive environment. A study by the Pew Research Center reported that 75 percent of adults prefer to watch movies at home rather than go to a theater. The study also reported that half of adults watch at least one movie per week via DVD rental or pay-per-view. This increase in home movie watching was largely a result of vastly improved and less expensive home theater electronics and the readily available access to movies through movie rental chains or pay-per-view cable and satellite services. The result has been challenging for the traditional movie theater business, where ticket sales have declined dramatically in recent years.

Now, evidence is mounting that a similar fate is awaiting the traditional movie rental industry. Several of the major movie production companies have now opted to bypass the theater experience and instead promote a selection of their movies directly to the home viewing audience. Consequently, movie distribution is slowly moving more toward a direct model where customers can access movies via on-demand services or via broadband downloads. This trend creates an interesting relationship between the movie studios and the movie distribution channel. Through increasing disintermediation (bypassing theaters and rental chains), movie studios stand to increase profit margins dramatically. Of the various movie distribution methods, many experts believe that broadband distribution stands to gain the most traction with customers. Broadband technology did not really gain steam until 2000 with the widespread access to high-speed Internet services in millions of U.S. households. Now, as broadband speeds have improved, customers have the ability to quickly download full-length feature films. The same is now true of handheld devices such as iPods and smartphones.

The increasing capabilities of ever-improving broadband technology caught the attention of the movie industry. In 2002, five major Hollywood studios (MGM, Paramount, Sony Pictures, Universal, and Warner Bros.) created Movielink, LLC—an online service that offered both sales and rentals of movies from their vast libraries, plus movies from Disney, Miramax, Artisan, and others. Movielink customers could rent movies by downloading them to their computers. Movies remained on the hard drive for 30 days or until they were activated (rented movies could not be burned to a DVD). Once activated, a movie could be watched as many times as possible within 24 hours. Rental prices started at 99 cents, but most new releases rented for $4.99. Recognizing the importance of the online market, Blockbuster acquired Movielink in 2007 after the studios realized they lacked the expertise needed in the retail business. By December 2008, Movielink had been fully incorporated into Blockbuster's product offerings.

Competition Forces Blockbuster's Hand

Many companies have danced in and out of the movie rental industry since the 1980s. When Blockbuster was first formed, the competitive market consisted of many small local and regional entrepreneurial businesses. Major players such as Walmart dabbled in the industry but didn't stay long. From 2005 to 2007, Blockbuster faced increasing competition, primarily from Movie Gallery and Netflix. To remain competitive, Blockbuster fine-tuned its rental program and introduced a "no late fee" policy. This strategy became a legal nightmare for Blockbuster when a barrage of lawsuits followed over the language and the fine print of the rental contract.

To further promote its online service and create a more efficient service, Blockbuster began online rental order fulfillment through 1,000 of its local stores. This change in fulfillment process allowed the company to get to customers in remote locations in an expedited nature. By the end of 2005, Blockbuster had approximately 1.2 million online subscribers, with a goal of reaching 2 million subscribers within the next year. To further entice new subscribers, Blockbuster changed its tactics by giving new subscribers a free movie or game rental each week (rather than two per month). Through these changes, Blockbuster was attempting to integrate click-and-brick to create an image and level of service that Netflix was unable to duplicate.

Today there are at least 21 major competitors in the sales and rental industry that compete with Blockbuster. These include major retail firms such as Walmart, Target, Best Buy, Amazon, and Time Warner. In the rental sector, Blockbuster continues to face intense competition from Movie Gallery, Netflix, Redbox, Hastings Entertainment, and a variety of online-only services such as Apple, Amazon, and Hulu.

Movie Gallery

It is ironic that Movie Gallery—the number two company in the movie rental industry—was also founded in 1985 in a manner similar to Blockbuster. Through the acquisition of Hollywood Video, Video Update, and Game Crazy, Movie Gallery peaked in 2005 with 4,800 stores (owned or franchised) in the United States, Canada, and Mexico (all stores in Mexico were closed in 2008). Before its international expansion, Movie Gallery focused on small communities with little or no competition. However, Movie Gallery's growth forced the company into very intense competition with Blockbuster. This rivalry came to a head in 2004 when Movie Gallery successfully outbid Blockbuster in its $1.2 billion acquisition of Hollywood Entertainment (i.e., Hollywood Video). Unfortunately for Movie Gallery, the Hollywood Entertainment purchase was the root cause for its bankruptcy filing in 2008. Movie Gallery moved into online rentals via its acquisition of VHQ Entertainment of Canada in 2005. Today, Movie Gallery owns or franchises 3,300 stores located throughout the United States and Canada. The company has experienced a decrease in revenues and recorded losses for the previous four years of operation. Their current focus is on expanding the gaming component of the company rather than their movie rental business.

Netflix

Intense competition from Netflix was a main reason that Blockbuster dropped its late-fee program in 2005 (a shift that led to a $400 million loss in revenue for Blockbuster). Netflix, with over 10 million subscribers, touts itself as the largest online entertainment subscription service. CEO Reed Hastings set a goal of reaching 20 million subscribers by 2012—a number that would equate to roughly 20 percent of all U.S. households. This goal far exceeds analysts' growth projections of 13 million subscribers. In addition to its subscriber base, Netflix also enjoys increasing sales. Quarterly sales topped $320 million in late 2008, followed by $394 million during the first quarter of 2009. Even more impressive, Netflix managed to increase sales at a time when the entire movie rental industry experienced an 8 percent sales decline.

Netflix built its success around the online rental of movies with next day delivery (in most cases). Netflix subscribers can rent as many movies as they want within a month for one flat fee. Once they return a movie, the next movie on their list is shipped to their home. Shipping is free in both directions. Netflix achieves this fast turnaround time because it ships over 2 million DVDs per day from 58 different locations around the United States.

Netflix's strategy differs somewhat from those of Blockbuster and Movie Gallery. Within its catalog of 100,000 movie titles, only 30 percent of Netflix rentals are new releases. This compares to 70 percent for Blockbuster. Netflix makes over 17,000 of these titles available via its Watch Instantly service. Customers can watch movies instantly using a computer, or they can use third-party devices—such as the Roku Digital Player, the Xbox 360, TiVo, and Internet-enabled Blu-Ray players and televisions—to stream movies wirelessly to their televisions.

Looking forward, CEO Hastings is cognizant of the new technology entering the home entertainment industry. The company is confident that the traditional DVD format will be the mainstay of the rental industry for at least the next decade. With that said, however, Netflix has explored the viability of online movie downloads. The company has also explored moving away from the mainstay movie studios into investment in small film production products. This strategy of content creation and ownership is similar to HBO's strategy of releasing its own content for distribution via DVD.

Hastings Entertainment

Compared to Blockbuster, Movie Gallery, and Netflix, Hastings Entertainment is a small player in the industry. Founded in 1968 as a part of Western Merchandisers, Hastings is primarily a regional company with more than 150 stores in 20 western and midwestern states. Its stores, which are rarely larger than 20,000 square feet, are located in small communities with a population base ranging between 33,000 and 150,0000 people. Some of Hastings' larger stores offer unique amenities including coffee bars, reading chairs, listening stations, and play areas for children. Roughly 50 percent of the company's sales are generated through the sale and rental of movies and video games. Another 15 percent comes from sales of new and used CDs; the remainder is generated by books, magazines, and related electronics. Hastings' growth is slow and methodical, with only one or two store openings per year. The company has felt the impact of mail-order rental houses and video-on-demand competitors, and has experienced a drop in the movie rental component of its business.

Redbox

Whether you are ordering a hamburger at McDonald's, getting gas at 7-Eleven, buying groceries at Walmart, or waiting on a flight at the airport, your favorite movie may be available for a low rental fee of $1.00 per day at a Redbox kiosk. Each kiosk holds 700 DVDs, with about 150 different movie titles, virtually all of which are six months old or less. Customers pay $1 per day and can return movies to any Redbox kiosk anywhere in the country. Customers can even reserve movies online before visiting a kiosk. The advantage of Redbox over Blockbuster, in addition to the price, is that renting a movie doesn't require a special trip. Since its initial launch with just 12 kiosks, Redbox has grown to roughly 18,000 kiosks located in all 48 continental states. That level of penetration maximizes convenience for customers, who now rent movies while they are out doing other things.

Surprisingly, the idea for Redbox began as a new business venture for McDonald's in 2002. At that time, McDonald's was experimenting with vending machines to sell a variety of different items. After the concept proved to be a success, Redbox was sold to Coinstar—a Bellevue, Washington, company that also operates coin-counting machines and gift card dispensers. Soon after, Coinstar inked deals with Walmart, Kroger, Winn-Dixie, Walgreens, Kangaroo (gas stations), and other national outlets to place Redbox kiosks in high-traffic locations. As it turned out, the timing couldn't have been better. As a consequence of the most recent economic recession, customers who began to reconsider their $15 per month Netflix plans or $5 DVD rentals from Blockbuster suddenly saw the $1 Redbox rentals as a bargain.

Redbox's sales in 2008 were only $400 million—a figure dwarfed by the $14.5 billion spent on DVD sales in the same year. Nonetheless, Redbox has achieved phenomenal sales growth in a very short time: up 110 percent in the first quarter of 2009 (after achieving 180% growth in 2008). This number is startling when compared to the 9 percent decline in DVD sales during 2008 and the 13.5 percent decline in the first quarter of 2009.

Fully Digital Competitors

In addition to firms that rent traditional DVDs, Blockbuster faces increasing competition from digital-only competitors. Although digital movie rentals are an emerging business, at some point in the future digital downloads will replace DVDs as the de facto standard for movie rentals. Still, DVDs are likely to remain dominant for some time due to their ubiquity, low cost, and compatibility with older televisions and home theater systems.

A number of firms offer downloadable movie rentals. Apple, for example, offers thousands of titles in both standard and high-definition formats via its iTunes store. Apple's key advantage is that iTunes works seamlessly with the millions of iPods and iPhones that have sold in recent years. What Apple is missing, however, is an easy way to connect its handheld devices to older televisions—many of which do not have wireless connectivity or even HDMI ports. Amazon offers over 14,000 titles for rent via its Video on Demand service. Amazon's key advantage is its partnership with Roku's Digital Video player that allows consumers to wirelessly stream Amazon's movies to their televisions. The "Roku Box," as it is called, costs only $99 and allows users to watch both Netflix and Amazon titles, in addition to the recent addition of Major League Baseball broadcasts.

In 2008, NBC and Fox joined forces on a new venture called Hulu (www.hulu.com) which has experienced a steady growth since its inception. Hulu is a web-based service that provides access to movies and traditional broadcast shows such as *Lost*, *Grey's Anatomy*, *Miami Vice*, and *Desperate Housewives*. Hulu offers a video menu exceeding 100 providers, including such names as ABC, NBC, FOX, MGM, and Sony. These companies provide access to over 900 television series and full-length movies streamed on demand. Although Hulu is ad-supported, its biggest advantage is that the service does not charge a fee for viewing shows or movies.

Other competitors are expected to enter the digital rental market soon. Microsoft has already ventured into movie rentals via its Xbox 360 gaming platform. Most recently, YouTube announced that it is in negotiations with Sony Pictures, Lions Gate Entertainment Corp., and Warner Bros. Studios to offer movie rentals via its popular website. YouTube already offers ad-supported films from Sony and MGM.

Blockbuster's Uncertain Future

As Blockbuster looks toward the future, one key challenge on the horizon is that the traditional DVD rental industry is clearly heading into its decline phase. The continued growth of Netflix, Redbox, video on-demand, digital downloads, as well as the coming move to IPTV (Internet Protocol Television), offer dramatic increases in moving-renting convenience for consumers. Given this level of increasing competition, it is not surprising that Blockbuster lost $36.9 million in the second quarter of 2009. As the company looks for ways to compete with advancing technology—especially electronic distribution—Blockbuster has recently unveiled several new strategic initiatives:

- Close approximately 960 unprofitable stores (22% of current stores).
- Expand access to standalone Blockbuster kiosks (up to 10,000).
- Offer movie rentals on Motorola phones.
- Offer streaming movie rentals on TiVo systems and Samsung televisions.
- Reconfigure 250 stores to a smaller format.

Although these decisions are likely to help in the short-term, Blockbuster still finds itself reacting to the competitive environment rather than proactively searching for newer, better alternatives. The heart of this challenge is simple in concept but difficult to execute in practice: How can Blockbuster increase the value-added components of its product offering in order to offset the inconveniences associated with its traditional brick-and-mortar movie rental business?

Questions for Discussion

1. What role has Netflix played in the development of Blockbuster's strategic planning? How important is Netflix to Blockbuster's future strategic plans?
2. How will new competition from Redbox and digital content providers force Blockbuster to alter its strategy?

3. As an adviser to Keyes, what strategic options would you recommend for Blockbuster as the company moves forward? In particular, how would you approach the technology issues facing the company?
4. What value-added components could Blockbuster offer to the movie studios that might entice them to more closely align with Blockbuster as a distribution channel?
5. In the long term, how can Blockbuster increase the value-added components of its product offering in order to offset the inconveniences associated with its traditional brick-and-mortar movie rental business? Will Blockbuster survive as we know it today? Explain.

Sources

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