Blockbuster: Looking Ahead in a Competitive Market

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Introduction

Blockbuster is the largest movie rental retailer. With its opening in 1985, Blockbuster has pursued an ambiguous program of growth and expansion. Currently, Blockbuster owns and operates over 9,000 stores both domestically and internationally. In addition, Blockbuster franchises about a quarter of its stores.

It is important to note that Blockbuster is undergoing a managerial struggle at the present time. The current CEO, John Antioco, and a major shareholder, Carl Icahn, are disputing Blockbuster's strategy. Mr. Antioco has threatened to resign if Mr. Icahn succeeds at attaining a position on the Board of Directors[1]. Mr. Antioco believes that Blockbuster needs to develop new strategy to respond to the current market conditions, whereas Mr. Icahn believes that Blockbuster is fine the way it is, and wants to stop spending. This is an important issue, and we believe that it may determine Blockbuster's immediate success or failure. However, this is not an issue of strategy; rather, it is an issue of politics, and we include it here only for completeness.

Blockbuster has recently become an independent company after Viacom has sold off its stake in 2004. Blockbuster's share price has fallen approximately 65% in the past two years, and the company is facing intense rivalry from many sources. We plan to address specific problems facing Blockbuster:

- Online movie rental websites such as NetFlix have been eroding Blockbuster revenue streams, as more and more people opt out for online movie rentals.
- Mass retailers such as Wal-Mart and Target have been able to undercut Blockbuster's DVD sales by maintaining a limited inventory and discounting DVD titles.
- Blockbuster faces potential competition from underdeveloped technologies such as video on demand. Such technology, coupled with a favorable legal atmosphere may pose a serious threat to in-store movie rental.
- Blockbuster has a strong reliance on movie studios, since changes in contract can have significant impact on Blockbuster's profits.

[1] At the time of this writing, Mr. Icahn has secured seats on the Board. The board, however, has asked Mr. Antioco to stay on as CEO in order to avoid having to disperse Mr. Antioco's golden parachute.

We will then offer strategic solutions that may position Blockbuster for increased profitability:

- Create a Frequent Renter Program that would reward loyalty
- Alter current price structure
- Integrate Blockbuster Online and Blockbuster stores
- Create new renting distribution channels
- Address high cost of DVD titles for sale
- Other operational and strategic suggestions

Ultimately, we believe that there will always be demand for in home movies, and as long as that demand cannot be satisfied by the limited movie selection of cable TV or satellite, Blockbuster should always have the customer base necessary to ensure profits.

Competition

Blockbuster faces fierce rivalry from a few sources. Retailers that rent, sell or trade movies or video games comprise a large fraction of Blockbuster's competition. In addition, online movie distributors such as NetFlix have become serious sources of rivalry. Cable, satellite, network television, video on demand (VOD) services, and any other direct home viewing services are in direct competition with Blockbuster. Blockbuster also competes with pirated movies that are obtained over the internet, or sold as bootleg copies. Retailers and online game and movie distributors are posing the greatest rivalry for Blockbuster, so it is necessary to examine both more closely.

Retailers:

Blockbuster is facing intense competition from retailers such as Wall-Mart and Target that sell DVDs and from other video rental stores, such as Hollywood Video and mom-and-pop shops. As DVD technology becomes cheaper, retailers such as Wall-Mart are able to price DVDs at levels that undercut the sale prices at Blockbuster. Target, Wal-Mart, and other retailers use the DVD's as loss leaders, which makes it hard for Blockbuster to compete on price. Some retailers are also entering the online rental market, thus expanding their competition with Blockbuster.

Hollywood Video, recently acquired by Movie Gallery, is the leading competitor for Blockbuster in the rental market. With over 2,900 Hollywood Video stores and over 2,500 Movie Gallery locations (mostly in suburban and rural markets), the conglomerate is a serious competitor to Blockbuster's approximately 5,000 stores in the US. The price structure is similar for single movie rentals, and Hollywood Video offers the Movie Value Pass, which is a restricted version of a flat rate fee for unlimited rentals. Currently, there is no indication that Hollywood Video or Movie Gallery has plans to enter the online movie rental market, although the low barriers to entry may make it a lucrative option in the future.

Online Movie Rental Distributors:

NetFlix is by far the largest online distributor, with over 3 million subscribers. There are other online movie rental distributors, but NetFlix has the most market share, and thus we will focus entirely on them. NetFlix operates distribution warehouses that ship DVDs to customers, who have signed up online and have created movie "queues". All shipping is paid for by NetFlix, and once the DVDs are returned to the distribution center, new ones from the queue are automatically sent out to the customer. Currently there are four pricing plans offered by NetFlix.

$9.99	$11.99	$14.99	$17.99
1 DVD at a time	2 DVDs at a time	2 DVDs at a time	3 DVDs at a time
Unlimited/month	4 DVDs/month	Unlimited/month	Unlimited/month

NetFlix has recently turned a profit, due to its extremely fast growth in subscribers, and its falling variable costs. However, NetFlix suffers from two major competitive drawbacks. First, it has a very high attrition rate, losing 7.2% of subscribers every month on average. Second, NetFlix is in a market that has very few barriers to entry. Blockbuster launched its online movie rental service in 2004, and already boasts over 750,000 customers. Strong growth has minimized the problem faced by the attrition rate, yet this cannot continue indefinitely. Another potential, yet relatively minor concern is that on average, NetFlix customers tend to rent more movies per month today than they did a year ago. If this trend continues, there may be a point when variable postage costs become too large. NetFlix also suffers from a fundamental problem: it usually takes 2 business days to receive a movie. So for the spontaneous or impulsive customer, NetFlix is not a viable alternative to in-store movie rentals just because there is a delay of gratification.

Video On Demand, piracy, and other competition:

VOD is a growing source of competition for Blockbuster. It theoretically offers great convenience and the same product. It is hindered by technological and legal factors. As of now, there are a few sources for VOD. HBO has recently launched HBO On Demand, and similar services exist for Showtime and Starz. These services have limited title selections, and are still relatively expensive. There are internet based on demand movie services, but they have limited title selection. High bandwidth technology is still not readily available for most customers, and until the technology is easily attained, VOD remains an underdeveloped business idea. Once the technology becomes available and affordable, movie studios may pursue different legal avenues that may limit title selection and otherwise hinder VOD. Needless to say, VOD is not a main concern at the present time and with information available today, one can do little more than speculate about the VOD industry of the future.

Piracy is a problem that faces all legitimate movie centered businesses, including movie studios, retailers, and rentals. The issue of piracy is an important one for governments to battle, but is not something that Blockbuster can respond to in any meaningful way.

Blockbuster also faces competition from devices such as Tivo and other digital video recorders and cable and satellite providers. This competition is not a significant source of revenue loss for Blockbuster.

Supplier Bargaining Power

Blockbuster has exclusive contracts directly with studios, and does not go through distributors in order to attain its movie inventory. The exception to this is the inventory for Blockbuster Online, which is mostly attained from a separate distributor. For the stores, movies are purchased on a title by title basis directly from the studios, and sometimes they are purchased as part of a revenue sharing program where the revenues generated by the rental are split between the movie studios and Blockbuster. DVD titles are sold to Blockbuster without a rental window, which allows the consumer to purchase the DVD at the same time the movie is released for rent, and thus erodes the rental market.

Movie studios, as the principal suppliers to Blockbuster, tend to carry a modest amount of bargaining power. However, they rely on Blockbuster and other movie rental businesses (such as Hollywood Video and NetFlix) for substantial revenue, especially for films that have had weak theatrical performances. Aside from theatrical release, the next distribution channel for movies is the rental market. Movie studios have already limited this advantage by releasing DVD titles for rent and for sale at the same time. If movie studios decide to limit further this advantage, Blockbuster will be negatively affected. Ultimately, Blockbuster's core product is owned by the movie studios, which results in a moderate bargaining power.

Blockbuster does not have a heavy reliance on third party distributors, and thus such distributors do not have a lot of supplier bargaining power.

Buyer Bargaining Power

Customers are numerous and each one contributes a small portion to Blockbuster's revenue streams. Thus, customers have little bargaining power, and in reality can only exhibit their bargaining power through the use of a substitute. Customers have the alternative to buy movies from retailers, rent at competing rental stores, or use an online rental service. There are plenty of substitutes to watching rented movies (see substitute section) and consumers tend to be price sensitive to the price of the rental. Blockbuster competes for the leisure time of customers, and since leisure is a large industry, the customer has many options.

Substitutes

The consumer who wishes to view a movie has several alternatives to renting one (either from NetFlix or Blockbuster) that essentially provide the same service.

Piracy:

This illegal form of movie acquisition is available to a select type of consumer. The consumer must be computer savvy enough to navigate the internet and download the movie, then burn it onto a DVD and watch on the home theatre (the assumed preferred method of movie watching) or else watch on a smaller computer screen. The other type of consumer can buy pirated movies from street vendors for approximately 1/4th of the cost of purchasing a new movie. So for the cost of renting a movie from Blockbuster, one can often purchase it pirated. The MPAA estimates that it lost $3.5 billion in revenue to piracy last year. Considering that last year the movie ticket sales made up $16 billion and post-theatre distribution (the type in which Blockbuster is involved) made up $8 billion, we can infer that the home rental industry lost approximately $1.75 billion last year to pirates. This substitute represents a substantial and growing threat as more consumers become aware of the ease of pirated movie acquisition and computer literacy grows. A moral campaign against piracy seems to be fruitless, and the only real argument against piracy that can be made to consumers is the guaranteed quality that comes with purchasing a legal version of a movie.

Purchase DVD from superstore such as Wal-Mart or online:

This is a great threat to Blockbuster. Wal-Mart and Best Buy undercut Blockbuster's prices. For approximately three times the cost of rental, a movie can be purchased from a superstore. Blockbuster typically offers the same movies at 10-25% higher rates. Amazon.com and other internet retailers typically also offer movies for reduced prices compared to Blockbuster. Recently, Wal-Mart and NetFlix has teamed up in an attempt to narrow their services. Wal-Mart has exited the online movie rental market, and has referred all of it's customers to NetFlix. In return, NetFlix refers customers who wish to purchase movies to Wal-Mart. This is a good opportunity for Blockbuster to attain a considerable share of customers for Blockbuster Online, since previous Wal-Mart customers are not obligated to continue with NetFlix. The current price war, waged by Blockbuster, in the online rental market, may make it lucrative to "displaced" Wal-Mart customers.

Borrow:

Rather than pay to rent a movie from Blockbuster, a consumer can borrow a movie from their friend who already owns it. This does not appear to be a significant threat at this time, since most friends cannot hope to rival the collection of new releases that Blockbuster carries. Since approximately 90% of Blockbuster's rentals come from these new releases, the remaining 10% could conceivably lose share to these friendly renters. However, this is a small fraction of their revenue.

Complements

There are several products that may have a synergistic effect if sold in conjunction with a movie rental service.

Delivered Food (Pizza):

Pizza delivery is an extremely popular leisure activity in America. Perhaps Blockbuster could sign an agreement with Pizza Hut, Dominos, and other national chains to offer the customers newly released movie rentals along with their pizza. Blockbuster would have to pay some of its movie fee to the pizza distributors, but this method seems that it would substantially increase impulse buys. If proper advertising were implemented, customers could benefit greatly from a freely delivered movie and Blockbuster + pizzerias could benefit from increased sales. The movies could be return via mail or to the local blockbuster store (mail return is an increasingly popular option as seen by NetFlix, and should be examined by Blockbuster).

Video games – Blockbuster already has a strong foothold in the video game rental market. They should expand this. Many consumers with high end electronics like DVD players will also have console devices to play the video games.

DVD player / VCR / Console Rentals:

Some consumers still do not have these high end electronics, whether for financial reasons or other. Blockbuster may be able to capture a significant amount of revenue at minimal expense by reemphasizing the rental of the actual devices that play the media that they rent, as well as the media itself. A rental/lease agreement with the option to buy could be lucrative, especially in less wealthy areas.

Online Rental:

This could be combined with the in store rental to maximize customer convenience. Customers could order movies online, have them delivered to them in the mail (or by pizza delivery man, or even Blockbuster delivery man depending on the cost structure), or rent from the traditional stores. Customers could return the movies to the stores in person, or by mail, regardless of the method that they had rented. Collection kiosks could be set up in more remote areas with less Blockbuster traffic to minimize customer inconvenience. This would hopefully have a synergistic effect by maximizing Blockbuster brand recognition by increasing total share of the rental market (by increasing share of the online rental market). This segment is the most important portion of our strategy to get Blockbuster back on track. The price structure for this service is detailed in the relevant section.

Soundtracks:
Blockbuster could emphasize the audio component of the movies it sells. It could package soundtracks with movies to increase revenue, or sell and advertise popular soundtracks at the front of the store to increase sales. Admittedly, there are only a few soundtracks that gain mass popularity with consumers (i.e. Garden State), and perhaps a very limited inventory of soundtracks for sale could be advantageous.

Barriers to Entry

Studio Copyright Agreements:
It is difficult to purchase the rights to rent a movie from the major motion picture studios. Blockbuster pays has a longstanding reputation with the movie studios, and the movie studios have come to rely upon Blockbuster to distribute their movies for rental and for sale. An entrant must be able to secure such contracts, which in general is not an easy task.

Brand Name Recognition:
Like most industries, brand name recognition goes a long way. Blockbuster is a recognized company, and everyone knows that finding the nearest Blockbuster is as easy as logging onto the net and typing in one's zip code. Small local competitors might have trouble reaching their local audience if they are in a similar location to a Blockbuster, even if they have superior price structure.

Blockbuster faces a similar hurdle in its overseas operations. Blockbuster is an American brand that is not well known overseas. To overcome this hurdle they have successfully operated under names of locally recognized movie rental stores. It is suggested that since the barriers to entry in foreign countries are rather insignificant to Blockbuster, they may be able to substantially increase their revenues by increasing operations overseas. Also, given the relative value of the dollar, an increased international presence can reduce exposure to currency risk.

Movie Distribution and Storage:

The largest hurdle is maintaining inventories close enough to subscribers so that rapid movie delivery is available. The issue that needs to be balanced is the number and size of distribution centers. Having a few, very large, distribution centers allows Blockbuster Online to minimize overhead costs, but reduces the accessibility of the customers, since on average they will be farther away from the warehouses. Many small distribution centers allow Blockbuster to spend less on freight (presumably shipping charge is a function of distance) and deliver more quickly, but overhead costs quickly skyrocket. The costs of implementing these warehouses in the first place can be considerable in and of themselves and represent a large expense to a fledgling operation. However, some Blockbuster stores can act as distribution centers (as discussed later in the paper).

Strengths

- Blockbuster is a well-recognized name in the video rental market, being the first mover into the market.
- Blockbuster has about 9100 company-operated and franchised locations in the U.S. and abroad. No other competitor has the same extent of locations.
- Blockbuster uses software that records customer transactions, which aids in marketing to consumers.
- Blockbuster makes revenue-sharing agreements with studios in which it can copy newly-released DVD’s and share the revenue on the rental of these DVD’s with the studios. The copy depth of newly-released films that are in high demand means that Blockbuster can buy fewer units and increase the profit margin per unit while also having available enough in-demand films [12].
- Blockbuster has a low-cost structure, earning multiple the costs of high-demand units.

Weaknesses

- Customer service varies across stores. A bad experience at one store may prevent one from ever going to another.
- Overhead (namely rent) is a significant cost to Blockbuster compared to the revenue on rentals.
- Blockbuster's low-cost structure is also a weakness because the cost to entry into the market is low.
- Blockbuster has been trying many promotions for customers, signaling a lack of focus of strategy on its part.
- The largest shareholder to Blockbuster, Carl Icahn, has criticized the company, accusing it of not misusing shareholder money [13]. In the upcoming election, he has nominated a board of directors, threatening the position of Blockbuster CEO and Chairman John Antioco, who will leave the company if not re-elected. The different goals of the current chairman and the Icahn pose a problem for the company. Icahn feels that the company should be put up for sale [14].

Opportunities

- Blockbuster can create synergies between its online and physical store locations. By creating a "One Blockbuster" approach they would be the only company able to provide the majority of people with both online and in-store rentals. This also provides an amazing distribution system for online rentals.
    - 9,100 stores throughout the US, its territories and 24 other countries
    - 40% of the home video rent market [1]
    - 65% live within a 10-minute drive of a Blockbuster store [1]
- Blockbuster can focus more on video sales.
    - Of the $24 billion in revenues of the retail home video industry 2/3 were generated by movie sales and 1/3 by movie rentals.
- Blockbuster can become more price-competitive by reducing costs. Specially, an automated in-store distribution system could be created which would significantly reduce employee overhead. This would not be a replacement for traditional in-store purchases but rather supplement the in-store experience by allowing customers to quickly rent the most popular movies, even if the store is closed.
    - 58,500 employees in the US, only 1,270 are at the distribution center

- Blockbuster can use its huge supply of used movies to enter into the retail market without any additional cost to acquire the movies. Unlike current policy, Blockbuster could retain the original DVD case, and sell the used DVD in a like-new case.
- Blockbuster could increase movie sales by allowing customers for apply their rental fee towards the purchase of the movie. In effect this would mean after a customer rented a movie that Blockbuster prices could quite easily compete with even the cheapest retailers.
- Re-create rental agreements with the studios, as was done with VHS tapes. This would give blockbuster (and other rental outlets, including NetFlix) a window of time, during which they would be the only place that new releases could be found. [2] In effect this would help grow the entire industry; although, such an attempt may not be welcomed by the movie studios.
- Create an active DVD renters program, which lowers costs to regular movie renters, and offers them special deals to purchase new movies, video-games, candy, etc. Active renters could also be offered deals to purchase used DVDs before they are available to the general public.
    - NetFlix customers are active DVD renters, with average rentals per month at 5.75 [8]
- Distribute DVDs with an established delivery company such as Domino's Pizza.
    - Over 660,000 deliveries made in the U.S. in 2004. [9]
- Add small blockbuster stores to large grocery stores. Member of either Blockbuster Online or Blockbuster could access the limited movie selection of these grocery store kiosks.
    - 6,5000 in grocery store banks in 2004. [10]

Threats

- Mass merchant retailers such as Wal-Mart, Best Buy, and Target pose a threat to Blockbuster's movie sales
    - Wal-Mart has 35% of the retail movies sales market [2]
    - Both Target and Wal-Mart use DVD sales as loss-leaders, making it difficult for Blockbuster to compete on price [2]
- Online movie rentals, in particular the competition between them and NetFlix.

- NetFlix has over 3,000,000 subscribers compared to Blockbuster Online's 750,000 subscribers
- Blockbuster's 3-at-a-time plan is $14.99/month [4], NetFlix is $17.99/month for the same plan [5]. Intelliflix charges $16.95/month or $99/year for their 3-at-a-time plan, Intelliflix also offers adult DVDs at a higher monthly rate.

- Supermarkets, pharmacies and other small rental places can reduce blockbusters total rentals.
- Other video rental companies, both local and national, such as Hollywood Video
  - Hollywood Video has about 9% of the video rental market. [6]
  - A recent attempt to acquire Hollywood Video failed. [11]
- Video-On-Demand could cause an substantial decrease in overall movie rentals. TiVo and other DVR system pose a similar risk, by creating an almost video-on-demand experience for the DVR owner.
  - Showtime, The Movie Channel, and Flix have in aggregate 39.5 million subscribers. Showtime offers On-Demand service. [7]

Strategy

We believe that the first priority for Blockbuster is to integrate its store operations with Blockbuster Online, its internet operations. In order to do this, we propose several changes.

- **Centralize store and online inventory in one database, and allow stores to act as "mini-distribution" centers.** This would allow a customer to log on to Blockbuster Online, and check the inventory of the local stores. Then, the customer would have the option of picking the movie up from the store or having the movie shipped directly from the store/online distribution center. This carries high start up cost, since databases need to be created and maintained, and employees need to spend time packaging the requested DVDs. Nevertheless, there are many Blockbuster stores around, and the distribution burden will be distributed throughout the stores.

- **Create a new price plan.** Currently there are three pricing plans in effect. A Blockbuster customer has the option to rent from Blockbuster on an individual

DVD basis, enroll in a flat fee unlimited rentals store based program, or join Blockbuster Online and pay a flat fee for unlimited rentals. The flat fee programs allow the customer to check out DVDs one, two, or three at a time. Below are the current pricing schemes :

Online	3 @ a time:	5 @ a time:	8 @ a time:
Price ($)/mo	14.99	27.49	37.49
DVD (*Store Only)*	4.32 (in store)		
In store	2 @ a time:		
Price ($)/mo	25		

We believe that customers would prefer a plan that would allow them to rent movies off the website and in the stores, all for the same flat fee. For instance, a customer subscribing to a three DVDs at a time plan can rent two DVDs from a store and one DVD from Blockbuster Online (or any combination thereof). This binds the store and the website together, thus creating opportunity for all types of customers. Not all customers will want to be on a flat fee program, however, and individual DVD rental pricing needs to remain. Also, current online pricing can remain for customers who want to remain on an "online only plan". However we suggest the following expansion and change to pricing:

Online Only	3 @ a time	5 @ a time	8 @ a time
Price ($)/mo	14.99	27.49	37.49
DVD (*Store Only)*	4.32 (in store)		
Store/Online	2 @ a time:	3 @ a time:	
Price ($)/mo	24.99	29.99	

This allows customers to rent movies at the store or over the internet, and the prices are computed assuming an average consumption of 6 DVDs/month. It should be noted that if the customer is on a "Store/Online" plan and rents less than 5 DVDs per month on a 2 @ a time plan, or less than 6 DVDs per month on a 3 @ a time plan, then the customer will be charged a per DVD rate of $4.32/DVD, instead of the flat fee.

As next steps, Blockbuster should consider more creative solutions to increase revenue, decrease consumer inconvenience, and increase convenience.

- **Create DVD vending machines.** When a brick and mortar store tries to directly compete with online vendors it is essential that the brick and mortar location reduce costs. One of the best ways to reduce costs is automation. In the case of Blockbuster, it would be possible to implement a vending-style machine where customers could directly rent a new release. Customer information would be collected by swiping the customer's Blockbuster card, or attached credit card. Standard charges and return policies would apply. The system would be available for all customers regardless of whether they are on a subscription plan. Machines such as this are already in production, and Blockbuster should easily be able to team up with one of these companies to produce a custom designed machine. One machine, offered by V&L Tool, Inc. holds 630 DVDs (and up to 112 different titles), has two LCD monitors for advertisements and trailer previews, and a touch screen. [15]

  The vending-style machine strategy offers two direct benefits to Blockbuster. First, there are direct cost-savings by reducing the number of employees required to check-out customers. Second, many customers will find the machines to be a faster and a more convenient way to rent movies. The machines can also allow customers to rent movies 24 hours a day. Downsides include potential fraud, vending machine theft, equipment maintenance and purchase price, and user difficulties. As with most automation system, it is strongly recommended that the machines first be tested in select areas to gauge customer response and profitability.

- **Movie Delivery.** There are two avenues for physical movie delivery (not mail services, and thus much faster) to the customer that might be undertaken by Blockbuster.

  First, a partnership with large pizza delivery stores like Pizza Hut, Dominos, Round Table, etc. Pizza restaurants retain a percentage of the revenue from the sale of the movie rental. The rest of the revenue is returned to Blockbuster. The restaurant's compensation should be based on sales volume rather than a flat fee to implement the program; this provides incentive for the pizza corporations to train their employees in how to sell the add rentals in order to raise overall earnings. Any rental that Pizza Hut sells is pure profit, the only expense they incur is the added time to pitch the rental offer to the customer over the phone. This program holds the greatest potential as a marketing tool. The new price structure, while not complicated, definitely needs to be elucidated to the customer. Marketing materials would be attached with each pizza rental to inform the customer about the new online services and invite them to visit the stores (with newly revamped customer service). This would serve as a direct way to reach out and educate the customer, and could potentially be a source of many new memberships.

Second, Blockbuster can undertake delivery by itself. Customers could order online, or call their local store to order over the phone. There is definitely a convenience benefit to ordering online. We would charge the customers $1-2 delivery fee for this service. Possible ways to reduce costs would be to provide the delivery drivers with mopeds or bikes rather than ask them to use their own vehicles (pizza delivery drivers are compensated for gas for each run they make).

Costs to Implement:
Upper Bound - $160 Million/year. This number is the amount in wages Blockbuster would pay if it added one eight hour shift at each of the 9100 stores, 365 days a year. *Lower Bound* - $23 Million/year. This number is the amount in wages Blockbuster would pay if we added delivery service for only 4 hours a day on two peak evenings (Friday/Saturday). This means that at an average cost of $90 million/year, assuming a $1 profit per rental, Blockbuster would have to rent out 90 million rentals a year to break even. If 180 million people order pizza on a regular basis (say, twice a month) and Blockbuster can reach half of those people with the program, and have a 5% success fee (in a liberal estimate), then the market base is approximately 100 million rentals/year. Considering that Blockbuster has limited resources to spend on new investments, the rather high initial investment cost of these opportunities and the low return (based on back of the envelope computations) makes this less than enticing at the time, but can be a worthwhile endeavor given extra cash flow.

- **New Movie Contracts.** Blockbuster had previously secured extremely favorable rental to sales contracts with the movie studios. In the days of VHS, the movie studios had implemented a distribution window; a period when movies were available for purchase at a very high premium, but were available for rent for the same low prices. This was a time of high profitability for Blockbuster. With the advent of DVD, movie studios have eliminated the distribution window, and movies are now available for sale on DVD at the same time (with no premium attached) as they are available for rental. We advise Blockbuster to attempt to renegotiate contracts on more favorable terms, but realize that this may not be easy to do since move studios have an interest in selling as many movies as possible. However, Blockbuster remains a powerful player in post-theater movie distribution, and we believe that there may be opportunities to leverage that bargaining power. In addition, this would benefit the entire industry, so perhaps lobbying for movie studio contract change alongside Hollywood Video, and other top rental chains may be beneficial.

- **Address high costs of DVD sales.** Blockbuster cannot compete on price in its DVD sales business. Mass retailers carry limited inventory and sell DVDs as loss leaders for a discount. Since Blockbuster cannot afford this strategy, it must look in other avenues in order to effectively compete. This includes expanding the used DVD sales, growing the DVD trading programs, and in some cases limiting DVD inventory to reduce overhead costs.

- **Create uniform customer service.** Currently, there are many consumers who have had bad experiences with the customer service in Blockbuster. Websites such as *www.ihateblockbuster.com* and litigation over late fees have given Blockbuster a somewhat negative image. This needs to be fixed before the problem gets out of control. Some possible solutions are consistent employee training, anonymous customer hotlines, stronger employee incentive programs, and clear and unambiguous pricing.

Conclusion

Blockbuster is facing major challenges as new competition and new technology enters the marketplace. It is our belief that Blockbuster cannot sit still, but must adapt to the new market conditions. With proper programs put in place – some of them being the strategic changes suggested here – Blockbuster should be able to continue to stay in business. However, in the future, as even newer technology such as video on demand become available, Blockbuster will not be positioned for continued profits as movie studios may start to move away from the rental distribution market. At that point, it will be necessary for Blockbuster to consider appropriate exit strategies. However, this is all speculative at this point, and we believe that for the current scenario, Blockbuster can turn around and become profitable again.

Exhibits

Exhibit A*: Blockbuster Revenue vs. NetFlix Revenue (WSJ)*

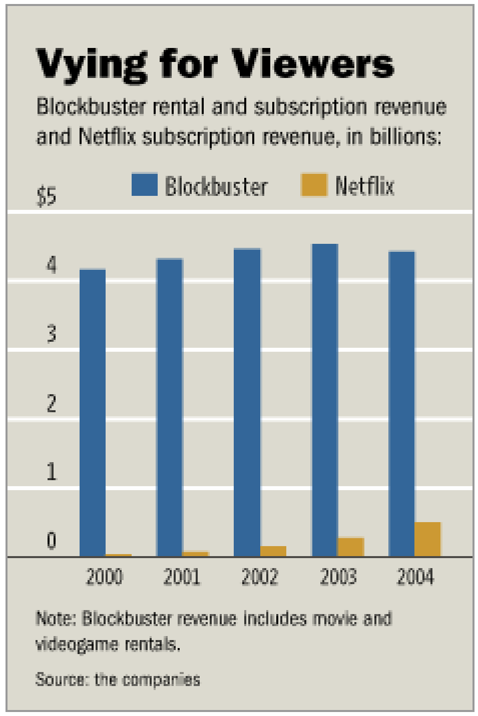

Exhibit B: *Blockbuster Stock Performance (Yahoo! Finance)*

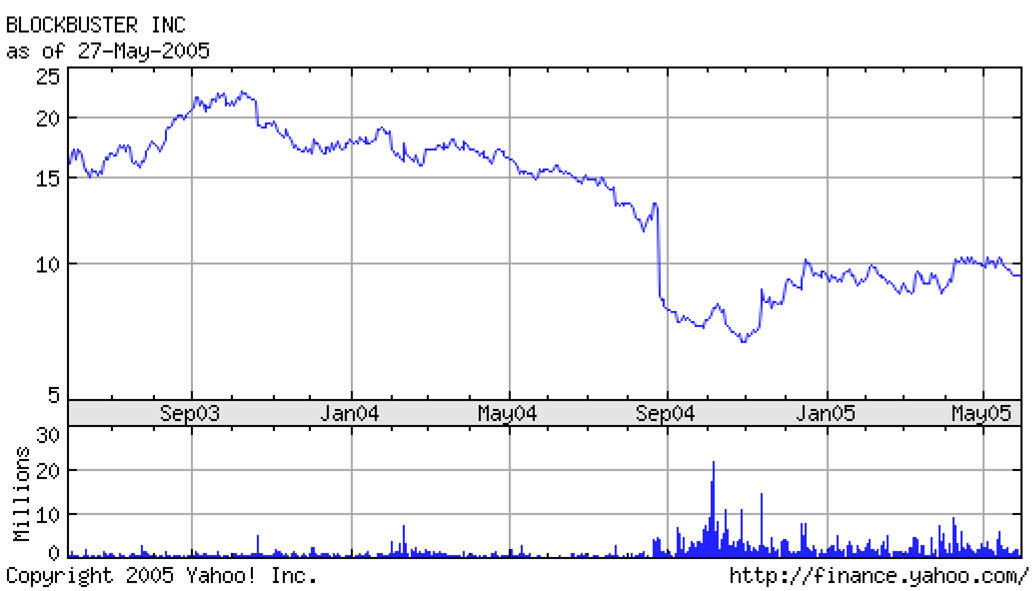

Exhibit C: *Financial Performance – Income Statement (Yahoo Finance)*

PERIOD ENDING	**31-Dec-04**	**31-Dec-03**	**31-Dec-02**
Total Revenue	**6,053,200**	**5,911,700**	**5,565,900**
Cost of Revenue	2,441,400	2,389,800	2,358,700
Gross Profit	**3,611,800**	**3,521,900**	**3,207,200**
Operating Expenses			
Research Development	-	-	-
Selling General and Administrative	3,110,900	2,804,300	2,636,300
Non Recurring	1,504,400	1,304,900	-
Others	249,700	257,900	233,800
Total Operating Expenses	-	-	-
Operating Income or Loss	**-1,253,200**	**-845,200**	**337,100**
Income from Continuing Operations			
Total Other Income/Expenses Net	5,200	2,700	4,800
Earnings Before Interest And Taxes	-1,248,000	-842,500	344,100
Interest Expense	38,100	33,100	49,500
Income Before Tax	-1,286,100	-875,600	294,600
Income Tax Expense	-37,300	103,200	103,000
Minority Interest	-	-	-
Net Income From Continuing Ops	-1,248,800	-979,500	189,400
Non-recurring Events			
Discontinued Operations	-	-	-
Extraordinary Items	-	-	-
Effect Of Accounting Changes	-	-4,400	-1,817,000
Other Items	-	-	-
Net Income	**-1,248,800**	**-983,900**	**-1,627,600**
Preferred Stock And Other Adjustments	-	-	-
Net Income Applicable To Common Shares	**($1,248,800)**	**($983,900)**	**($1,627,600)**

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