

(Block)Busting the Movie Rental Industry

June 1, 2005

BEM 106 Final Paper

Zhan Wang
Harrison Stein
Chin Yeung Siu
Ruiqi Rachel Wang

Introduction:

Since the 1910s when Charlie Chaplin created his first silent films, movies have been a staple in American culture. For over half a century, “the big screen” was the only link between first released Hollywood films and captivated audiences nationwide. The advent of modern technology like the VHS tape and the DVD, however, has provided viewers with a convenient way of viewing movies, new and old, no longer playing in theaters. In addition, cost considerations have made DVDs and VHS tapes ideal for short-time rentals. Thus these inventions and the terms of their usage have helped to create a movie-rental market within the larger movie industry.

Rentals and other theater substitutes have become essential to the movie watching experience because the theater no longer holds the monopoly it once did. While movie theaters are still widely popular, many people dislike the inconvenience of finding a local theater playing the right movie, driving there, and then standing in long lines to buy a ticket. Some do not appreciate the large crowds that often include cell phone talkers and loquacious teenagers. And some simply don't want to shell out ten dollars to a movie that has the chance of being *Ishtar*. For whatever reason, there is a large demand for rentals and substitutes from audiences who want to see the movies they missed in theaters, the movies released years ago, and the movies that aren't quite worth ten bucks

Industry Analysis

Product

VHS and DVD rentals are the primary product of the rental industry. Currently, customers can rent DVDs online or at rental stores to enjoy a movie at a much cheaper cost than watching it in theaters. DVD rentals give customers much needed flexibility, enabling them to enjoy movies in the comfort of their own homes.

VHS rentals were made popular in the 1980s when just-released VHS tapes were very costly. In recent years, however, DVDs have replaced VHS as the preferred medium for video distribution, and the rental industry has adapted very well to this transition. Customers can rent DVDs in two different ways: pay-per-movie and monthly membership plans. In-store customers are given both options but online customers are only offered monthly membership plans.

Substitutes

Although the entertainment industry is as profitable as ever, the growth of the movie rental industry is declining due to the advent of numerous substitutes. One substitute is In-Demand Pay-Per-View, a system where people can order movies through their Digital Cable

Box. Even though pay-per-view does not currently threaten the movie rental industry, it might as technology improves because pay-per-view appeals to the same time and cost-sensitive customers who use online rentals. [7]

Another substitute to movie rentals is movie sales from retail superstores like Walmart and Best Buy and large internet sites like Amazon. In particular, purchase, rather than rental, is preferred for family movies like *Cinderella* and *Shrek*. Families already go to places like Walmart to do everyday shopping, and conveniently, Walmart carries children movies that kids will watch over and over again. In addition, VHS and DVDs are cheaper than they once were, making movie sales more appealing than ever before.

Buyers

The service of video rentals is utilized by just about every demographic in America. Professionals are specific targets of video rental companies because many don't have time to see movies when they are first released in theaters. Blockbuster and similar companies also cater to cost-sensitive middle class families. Nonetheless, even if these two groups contribute more to the rental industry than most, the video rentals are consumed by everyone.

Buyers can be divided into two different categories: impulse renters and planned renters. Impulse renters are those who rent infrequently and do so without pre-planning. Pay-by-movie in-store rental services are particularly appealing to such renters because Blockbuster carries a wide selection of new releases, classics, and international movies and pay-by-movie doesn't require any monthly commitments. Planned renters are those who view movies frequently with specific ideas of what to rent. For such consumers, monthly plans and online services hold special appeal.

Buyer Bargaining Power

Even though there are numerous substitutes for video rentals, individual buyers have nearly no bargaining power within the industry. Blockbuster has multiple competitors and many substitutes to movie rentals are available, but single buyers don't have the ability to change rental prices. Because movie rental customers act independently, large corporations like Blockbuster will never feel the need to drop its prices due to complaints by a single client.

Suppliers

Video rentals are supplied by movie studios that create and distribute films. Suppliers have some bargaining power because there are several substitutes in the market, but rental companies won't lose their business with movie studios because none of the substitutes can

generate the profits that the rental industry can. Thus, suppliers only have a small amount of bargaining power because if one rental company shortchanges the studios, the studios could transfer more of their business to other competitors.

Complements

As DVDs have become Blockbuster's media of choice, the popularity of DVD players has complemented the number of movie rentals. In the last couple of years, the price of DVD players has fallen drastically, making it possible for more people to make the switch from VHS. As more consumers own DVD players, more will be willing to rent DVDs.

When major Hollywood movies debut on DVD, the studios advertise the film as if it were a new release in theaters. The film's release date is clearly expressed and the commercials recreate interest in a product that has assumedly lost its steam. These advertisements assist DVD rental companies because consumers will see the commercials of a given movie and want to rent or buy the film. Even though the commercials don't specifically advertise the rental companies, they promote their products.

Competitors and Rivalry

The video rental market can be grouped into two different categories: competition between in-store rental companies and competition between internet rental services. The internet has spawned companies like Netflix, who charge customers a monthly fee to order a few DVDs at a time from an online database. Blockbuster began its own online rental store recently and, until recently, has consistently undercut Netflix by about 3 dollars a month for similar services. (See Exhibit 7 for market share comparison) Such competition has become detrimental to Netflix, as it has suffered major losses in 2003 and 2004. [9] However, a recent merger with Walmart and rumors that Amazon will amass large amounts of Netflix stock could greatly increase Netflix's financial resources, and intensify the online competition. [9]

In the past, Hollywood Video was no match for Blockbuster, but its merger with Movie Gallery in 2004-2005 will pose threats to Blockbuster's in-store rental business. Blockbuster's 9000+ locations worldwide [1] still doubles the number of Hollywood/Movie Gallery stores, but Movie Gallery has recently reported an aggressive growth strategy to expand. Although Movie Gallery's concentration is in small towns, the addition of Hollywood allows it to ease into the suburban market, the largest source of Blockbuster's business.

Potential Entrants

Even though Blockbuster is the largest player in the video rental market, there are a number of potentially competitors including internet based companies like Amazon and other mega-stores like Target. Like Walmart, Target is a family superstore that carries DVDs and because it accumulates a massive variety of goods, it already has an advanced inventory system. Thus, Target seemingly has both the resources and the online infrastructure to enter the industry.

Amazon started its own online video rental service in the UK last December, and has been reportedly communicating with Netflix about partnering in the US market. [8] Due to price competition, both Netflix and Blockbuster have incurred significant losses and if Amazon does intend to invest in Netflix, Blockbuster will have a hard time fending off its primary opponent. Hollywood Video, before its merger with Movie Gallery, was also considering entering the online market. The plan was vetoed by board members however, due to the high projected cost of establishing an internet movie database. With the added financial resources of Movie Gallery, such an investment is more feasible for MG/Hollywood.

Growth of the in-store rental market is dwindling due to the success of online rentals. Thus, there is no room in the market for a third large company to compete effectively with MG/Hollywood and Blockbuster. Independent rental stores can enter the rental market locally but pose little threat to international giants like Blockbuster.

Strategies for Blockbuster:

Integration and Product Differentiation

Profitability in the video rental industry is heavily dependent on satisfying consumer preferences because market share is the predominant measure of profitability. Blockbuster has an advantage in this industry because it is much larger than its competitors and has a large reputation due to its first mover advantage in the in-store rental market. Thus, Blockbuster can be highly profitable for the foreseeable future if it can strategically position itself in the face of competition from Netflix.

Blockbuster can distance itself from its major competitors, Netflix and Hollywood/Movie Gallery by differentiating its service and its products. A Hotelling line can be drawn (See Exhibit 8) based on the time-sensitiveness of the video rental customers, ranging from patient customers who plan ahead and thus can afford to wait a few days for a movie to arrive, to impulsive customers who want to watch a movie immediately. Internet service is preferable to patient viewers because they have access to a greater selection of titles. Impulsive customers would prefer in-store options as many like to see the movie box and others don't know which particular movie they plan to watch.

Based on the “customer space” as defined above, it would be highly profitable for Blockbuster to position itself near the middle of the Hotelling line by integrating the online and in-store services to offer monthly plans that allow users to access both types of rentals. For example, customers can order DVDs online, receive them through the mail, and return them to a store. Conversely, they can rent DVDs from a store and return them by mail. They can also “split” their online rental quota between online and in-store rentals. This greater flexibility would appeal to more than 50% of the Hotelling Line.

This strategy is advantageous because it cannot be easily mimicked by Blockbuster’s two largest competitors, Netflix and MG/Hollywood. Though Netflix’s recent partnership with Walmart [3] will increase Netflix’s online customer base, neither has stores tailored for VHS and DVD rentals. Even if Netflix and Walmart decide to invest heavily in a rental chain to compete, Blockbuster’s well established reputation for rental stores will make it difficult for competitors to catch up. Blockbuster’s other major competitor, MG/Hollywood, is still in the process of integrating Movie Gallery and Hollywood stores. Thus it will not be able to invest and implement an online system soon. Blockbuster can expect to monopolize the integration plan for at least a few years before competitors can adopt it efficiently.

One possible way to implement the integrated service is to create two new plans: Movie Pass VIP and Movie Pass Mini. The current Movie Pass system allows viewers to rent two movies at a time from a single Blockbuster store for a flat monthly fee. [4] The Movie Pass VIP contains the same features as the current Movie Pass, with added online and mail-back services. Movie Pass VIP can be purchased at one dollar more than the current Movie Pass monthly fee. The mini plan has the same features but contains a six movie per month limit and is priced at the cost of Netflix’s online plan. Both plans will allow customers to rent and return videos to any Blockbuster store. The VIP plan will appeal to the existing 2 million Movie Pass users while the mini plan will attract typical blockbuster customers (the 18 million people who rent from Blockbuster at least once a month but are not enrolled in a monthly program). In addition, Netflix has recently introduced its own mini-plan offering customers two-at-a-time rentals with a maximum of four per month for \$11.99. [5] The proposed mini-plan will trump theirs, however, because it offers two more rentals per month and superior service for only a few dollars more.

We project a \$30 million increase in revenue within the first year and a \$130 million increase in revenue in 3 years as a result of the added integrated services (See Exhibit 1 for projections). The majority of these increases can be attributed to regular Blockbuster customers (customers who rent from Blockbuster at least once a month) who add a Movie Pass VIP or Movie Pass Mini plan. These gains are promising because integration can occur at little cost to Blockbuster. Thus, a large portion of the revenue increase generated will translate directly into profits.

Integration can best be achieved if it is accompanied by product differentiation. Netflix and Blockbuster's product is already different as Blockbuster's inventory is largely filled with new releases, big blockbusters, and family films and Netflix's inventory contains a sizeable selection of mature movies. Blockbuster can expand this difference by guaranteeing viewers new releases within a certain number of days; something Netflix is unable to do. Concurrently, Blockbuster should also allow Netflix to have a monopoly over NC-17 rated movies. This strategy complements the integration between online and in-store rentals because the impulse buyers targeted by integration also tend to be those who watch new releases and big hits. Also, the planned product differentiation will not affect Blockbuster's costs because it will trade the acquisition of one type of film for another.

Integration and product differentiation is also necessary to prevent Netflix from taking drastic measures, such as attempting to merge with MG/Hollywood. Such an action would give Netflix and MG/Hollywood a means to compete with Blockbuster should be prevented at all costs. By giving up the large selection of more adult movies, Blockbuster gives Netflix a stable niche in the rental industry and prevents Netflix's business from suffering large losses. At this point in time, Netflix will most likely accept this offer for a stable but smaller share of the market after suffering large losses in 2004 and 2005, and a 20% decrease in market share. [10] This segment is perfect for Netflix because the people that tend to watch these mature movies are also those who plan ahead. As a result, Blockbuster can reach its audience without gravely diminishing Netflix's.

The Library System

One of the primary complaints with Blockbuster and other nationwide rental chains is that the different store fronts act as self-contained outlets that don't properly network with each other. For example, only a few Blockbusters might carry a certain title and a person with a desire to see that particular movie will have to go the specific store that furnishes the film. If no stores nearby possess a given movie, the customer is simply out of luck. In addition, a person traveling far from his house may see a Blockbuster outlet store and instinctively decide to rent a movie. However, the person will think twice because rentals must be returned to the same store where the video was obtained. Also, as of now, Blockbuster's webpage tells you what movies are in stock at a given store, but does not clarify whether a movie is actually available. Finally, the Movie Pass allows viewers to check out two movies at a time for as long as they want, meaning a lot of hot new releases at certain stores might be out of stock for days at a time.

All of these problems have a common solution: Blockbuster should implement a "library system" where all Blockbuster chain stores are networked by an advanced online infrastructure. This system will give consumers the option of returning DVDs to any store regardless of where the rental originated, an online inventory detailing the DVDs available at each location, and the

chance to reserve/request certain DVDs in a certain store to be picked up later. If a given movie is only held in certain locations, a viewer will be allowed to request an inter-Blockbuster loan, either via the Internet or from a particular store. As a result, a less popular movie desired by a specific person can reach its target instead of sitting on the shelf in a far-away location. Also, a store that runs out of a new release can guarantee that a copy of the tape will be available the next day.

The library system is economically viable because the complaints about Blockbuster are universal and the solution has relatively low costs. Since Blockbuster already has an advanced network to monitor the inventory of its stock and the status of its customers, it wouldn't be difficult to implement this system. Revamping the network would probably be unnecessary, as most of the pieces are already in place. Currently, if one calls Blockbuster and asks if a movie is on the shelf, they can respond within seconds. To implement a searchable online database, they would merely have to make that information public. Also, the everyday costs of creating a library system will be minimal because Blockbuster would only have to pay to maintain the system and mail the DVDs between stores.

Such a service would appeal to both "planned rental" customers and "impulse rental customers" that have a specific title in mind. The library system would allow an impulse customer to quickly check which locations hold the title of choice. Knowing that a specific title is available at a certain Blockbuster location would make renting from Blockbuster more appealing going to a MG/Hollywood store with no such guarantee. For the planned rental customer, this system would enable him to choose specific titles in advance, and guaranteed their availability within days. Although this effect is similar to that of the online rental service, many customers still prefer to be able to access tapes themselves at a specific time without worrying about scratched or late disks that come in the mail.

Blockbuster would be wise to implement a library system because it has the resources available to make this unique system flourish. Blockbuster has enough locations to make the inter-Blockbuster loan a reality and it has the online network already built. On the other hand, Netflix and MG/Hollywood either don't have the store fronts or the resources available to implement such a system. Thus, Blockbuster can remain the sole distributor of this system for at least a couple of years. If Blockbuster acts quickly to create a library system, it can differentiate its service from that of its competitors, thereby revolutionizing the video rental industry.

Revamping current policies: Free Preview

In response to the Hollywood-Movie Gallery merger, Blockbuster tried to differentiate itself by announcing the "No Late Fees" policy in 2004. Unfortunately, Blockbuster stressed "No Late Fees" excessively when marketing the gimmick, and failed to inform consumers exactly what the policy entails. In its December 2004 commercials, Blockbuster claimed that

they would abolish all late fees for its movies and games. In truth, they have merely added a week grace period so that the movie rental period is essentially fifteen days, instead of the usual eight. However, at the end of fifteen days, if the customer hasn't returned the movie, he is charged the price of film, less the rental fee. In addition, not all store locations participated in this new policy, causing customer confusion and multiple lawsuits. [6]

In its marketing campaign, Blockbuster's target audience was lazy college students or busy working class adults who have conjured up excessive fees in the past. Unfortunately, this policy isn't particularly auspicious for this crowd because people unlikely to return the tape in the original eight day window are just as unlikely to return it given an extra week. At the same time, the targeted group is cost sensitive, and doesn't look fondly upon having a 20 or 30 dollar charge (or store credit if the movie is returned after the first 15 days). Thus, Blockbuster's unique new strategy has driven away many of the very customers it aimed to attract.

Even though "No Late Fees" is a failure in its current form, it could be marketed to benefit Blockbuster's video rental profits and its video sales. The "No Late Fees" policy might as well be renamed "Free Preview". Viewers essentially get a free look at a DVD they want to consider buying. For a small rental fee, they can preview the DVD by testing the special features and the picture quality. If they are satisfied, they can buy the movie and have their rental fees reimbursed. If marketed correctly, this policy could help Blockbuster dip further into the DVD/VHS sales industry because no major seller currently allows customers to preview movies before buying them. Once people understand how to properly utilize the "Free Preview" policy, they might be more comfortable buying and renting DVDs from Blockbuster.

Previewing is also a viable option because no other major player in the rental market is in a position to mimic this strategy. Walmart cannot duplicate this strategy because implementing this policy would cause customer confusion and threaten the store's retail profits, a much more significant portion of its gross income. MG/Hollywood could potentially adopt this policy, but it will not be able to compete with Blockbuster's local network and marketing power. Netflix can reproduce a policy that is similar to Blockbuster's, however; such a plan would not be as effective, because Blockbuster already has the reputation of being a source for video retail as well as rental. In 2004, more than 25% of Blockbuster's revenue came from movie sales (See Exhibit 5-6) whereas Netflix generates no substantial revenue from sales. As of now, Netflix is strictly known as a rental service, so it would have a large disadvantage competing against Blockbuster.

Implementing the "preview" policy is low cost and low risk for Blockbuster. Since the "No Late Fees" policy is already built on this structure, Blockbuster only needs to market the policy better. It appeals to all of Blockbuster's current buyers, especially families. Once consumers catch on, Blockbuster will see marked improvements in profits due to both movie

rentals and sales. In addition, Blockbusters' existing relations with DVD and VHS suppliers will make transition from rental into rental and sales quick and smooth.

The "No Late Fees" policy has been damaging to Blockbuster because the company has had to increase its costs in order to maintain its video library since so many people hold movies for weeks beyond the due date. Hence, even as the company's revenue has remained the same, costs have risen creating a net decrease in profits. Our plan alleviates many of these problems because more people will immediately buy the DVDs. Sales revenue will increase enough to offset any costs.

Conclusion

The video rental industry is a fast changing market due to the advent of new technologies. Even though the industry's growth is shrinking every year, now is the perfect time for Blockbuster to make its move. In implementing these new strategies, Blockbuster will show that it is willing to adapt to the changing world. While traditional video rental stores will suffer from inability to adapt to online services, Blockbuster can be assured through integration that no matter what happens to the market, they will be able to remain an industry leader.

The proposed strategies are effective because none of our competitors are able to mimic our strategies without major investments. Blockbuster's two primary competitors, Hollywood/Movie Gallery and Netflix, operate on two separate fronts that are both addressed by our new policies. Netflix cannot copy our strategies because they do not have the physical store fronts necessary to implement an integrated service policy or a library system. Hollywood-Movie Gallery can potentially copy our "free preview" strategy, but it would have trouble reproducing our integrated services, due to lack of an online rental system.

In addition, the strategies are ideal because they can be executed at low costs. Creating a library system will add very little to marginal costs because Blockbuster already has an advanced network infrastructure, and it merely has to make the network public to let the library system run its course. Inter-Blockbuster loans would only cost the price of postage, and Blockbuster can even charge a small fee to use the service. The "Free Preview" policy will only affect profits because it will reduce the revenue gained from video late fees. However, the added revenue from the video sales and the increased activity in the stores should more than offset the lack of late fee revenue. Even though Blockbuster has poorly marketed its "No Late Fees" campaign, the store has not experienced any negative effects from the removal of the source of income.

The net effect is that Blockbuster will improve its market share and long term profits without dealing Netflix any decisive blows. Consequently, Netflix will never be desperate enough to combine with Blockbuster's store-front rivals, Hollywood-Movie Gallery. Because Blockbuster's product is superior, it can charge more for the service and stop decreasing the

price of its online rental product. The end of the online price war will benefit both companies in the long run and ultimately encourage competition. Even though Netflix is Blockbuster's primary enemy, their products are different enough that both can benefit from a cooperative atmosphere. By implementing the proposed policies, Blockbuster can improve its product in the short-term while ensuring profitability in the long term.

Exhibit # 1: Projected Income Increase with New Movie Passes

- More people with no previous commitments will join the Movie Pass Mini Plan, and the average price will be \$18/month per person
- The Difference in prices between Movie Pass and Movie Pass VIP will be \$1, the difference between online and Movie Pass VIP will be \$10
- The average customer would spend \$9 a month on videos without a Movie Plan

After Year 1:

	# of People	Gain Per Person	Total Gain
Revenue Gains:			
Switching from Movie Pass to Movie Pass VIP	0.5 million	$\$1 * 12 = \12	\$6 million
Joining an Integrated Plan	0.2 million	$\$18 * 12 = \216	\$43.2 million
Switching from Online to Movie Pass VIP	10,0000	$\$10 * 12 = \120	\$1.2 million
			\$50.4 million
Revenue Losses:			
People No Longer Renting Casually	0.2 million	$\$9 * 12 = \108	\$21.6 million
Total Gains in Revenue:			\$28.8 million

After Year 3:

	# of People	Gain Per Person	Total Gain
Revenue Gains Since Time 0:			
Switching from Movie Pass to Movie Pass VIP	1.2 million	$\$1 * 12 = \12	\$14.4 million
Joining an Integrated Plan	1 million	$\$18 * 12 = \216	\$216 million
Switching from Online to Movie Pass VIP	30,0000	$\$10 * 12 = \120	\$3.6 million
			\$234 million
Revenue Losses:			
People No Longer Renting Casually	1 million	$\$9 * 12 = \108	\$108 million
Total Gains in Revenue:			\$126 million

Exhibit # 2: Blockbuster Financial Highlights for First Quarter 2005, Compared to First Quarter 2004 (From [2])

**BLOCKBUSTER INC.
COMPARATIVE FINANCIAL HIGHLIGHTS
(In millions, except per share amounts)**

	Three Months Ended March 31,	
	2005	2004 Restated
Revenues:		
Base rental revenues	\$ 1,075.5	\$ 975.9
Extended viewing fee revenues	29.8	175.1
Total rental revenues	<u>1,105.3</u>	<u>1,151.0</u>
Merchandise sales	425.9	330.9
Other revenues	17.7	21.2
	<u>1,548.9</u>	<u>1,503.1</u>
Cost of sales:		
Cost of rental revenues	357.4	324.7
Cost of merchandise sold	327.7	254.8
	<u>685.1</u>	<u>579.5</u>
Gross profit	<u>863.8</u>	<u>923.6</u>
Operating expenses:		
General and administrative	759.4	684.4
Advertising	119.0	50.0
Depreciation and amortization of intangibles	57.5	61.3
	<u>935.9</u>	<u>795.7</u>
Operating income (loss)	<u>(72.1)</u>	<u>127.9</u>
Interest expense	(20.8)	(4.6)
Interest income	1.0	0.7
Other items, net	(1.8)	(0.6)
	<u>(21.6)</u>	<u>(4.5)</u>
Income (loss) before income taxes	<u>(93.7)</u>	<u>123.4</u>
Provision for income taxes	36.2	(9.0)
Net income (loss)	<u>\$ (57.5)</u>	<u>\$ 114.4</u>

Exhibit # 3: Blockbuster Revenue Details for First Quarter 2005, Compared to 2004
(From [2])

BLOCKBUSTER INC.
SUPPLEMENTAL FINANCIAL INFORMATION
(Dollars in millions)

	Three Months Ended March 31,			
	2005		2004	
	Revenues	Percent of Total	Revenues	Percent of Total
<i>Revenues by Product Line:</i>				
Rental revenues:				
VHS rental revenues	\$ 69.6	6.3%	\$ 201.3	17.5%
VHS EVF revenues	1.8	0.2%	36.2	3.1%
DVD rental revenues	898.9	81.3%	668.0	58.1%
DVD EVF revenues	25.7	2.3%	119.8	10.4%
Total movie rental revenues	996.0	90.1%	1,025.3	89.1%
Game rental revenues	107.0	9.7%	106.6	9.3%
Game EVF revenues	2.3	0.2%	19.1	1.6%
Total game rental revenues	109.3	9.9%	125.7	10.9%
Total rental revenues	\$ 1,105.3	100.0%	\$ 1,151.0	100.0%
Merchandise sales:				
VHS sales	\$ 6.6	1.5%	\$ 6.9	2.1%
DVD sales	168.9	39.7%	140.0	42.3%
Total movie sales	175.5	41.2%	146.9	44.4%
Game sales	161.1	37.8%	93.8	28.3%
General merchandise sales	89.3	21.0%	90.2	27.3%
Total merchandise sales	\$ 425.9	100.0%	\$ 330.9	100.0%

Note: Certain prior period amounts have been reclassified to conform to current period presentation.

Exhibit # 4: Blockbuster Operations Data from 2000 to 2004 (From [1])

	Year Ended December 31,				
	2004	2003	2002	2001	2000
		Restated	Restated	Restated	Restated
	(In millions, except worldwide store data)				
Statement of Operations Data:					
Revenues	\$ 6,053.2	\$ 5,911.7	\$ 5,565.9	\$5,156.7	\$ 4,960.1
Cost of sales	2,441.4	2,389.8	2,358.7	2,420.7	2,036.0
Gross profit	3,611.8	3,521.9	3,207.2	2,736.0	2,924.1
Operating expenses(1)	4,865.0	4,358.6	2,859.5	2,953.2	2,856.9
Operating income (loss)	(1,253.2)	(836.7)	347.7	(217.2)	67.2
Interest expense	(38.1)	(33.1)	(49.5)	(78.2)	(116.5)
Interest income	3.6	3.1	4.1	6.1	7.3
Other items, net	1.6	(0.4)	2.9	(5.2)	1.7
Income (loss) before income taxes	(1,286.1)	(867.1)	305.2	(294.5)	(40.3)
Benefit (provision) for income taxes	37.3	(106.5)	(107.1)	55.2	(42.1)
Equity in income (loss) of affiliated companies, net of tax	—	(0.7)	(2.2)	0.5	1.3
Income (loss) before cumulative effect of change in accounting principle	(1,248.8)	(974.3)	195.9	(238.8)	(81.1)
Cumulative effect of change in accounting principle	—	(4.4)	(1,817.0)	—	—
Net loss	<u>\$(1,248.8)</u>	<u>\$ (978.7)</u>	<u>\$(1,621.1)</u>	<u>\$ (238.8)</u>	<u>\$ (81.1)</u>

Exhibit # 5: Blockbuster Revenue Comparison Between 2003 and 2004 (From [1])

Comparison of 2004 to 2003

Revenues. Revenues increased \$141.5 million, or 2.4%, from 2003 to 2004. The following is a summary of revenues by category:

	Year Ended December 31,					
	2004		2003		Increase/(Decrease)	
	Consolidated Revenues	Percent of Total	Consolidated Revenues	Percent of Total	Dollar	Percent
Rental revenues	\$4,428.6	73.2%	\$4,533.5	76.7%	\$(104.9)	(2.3)%
Merchandise sales	1,532.6	25.3%	1,281.6	21.7%	251.0	19.6%
Other revenues	92.0	1.5%	96.6	1.6%	(4.6)	(4.8)%
Total revenues	<u>\$6,053.2</u>	<u>100.0%</u>	<u>\$5,911.7</u>	<u>100.0%</u>	<u>\$ 141.5</u>	<u>2.4%</u>

	Same-Store Revenues Increase/(Decrease)		
	Worldwide	Domestic	International(1)
Rental revenues	(5.7)%	(6.4)%	(3.0)%
Merchandise sales	5.6%	(0.6)%	13.5%
Total revenues	(3.2)%	(5.5)%	3.0%

Exhibit # 6: Blockbuster Revenue Details For 2003 and 2004 (From [1])

Rental Revenues.

Rental revenues decreased \$104.9 million, or 2.3%, from 2003 to 2004, due primarily to decreased rentals of movies. The following is a summary of rental revenues by product category:

	Year Ended December 31,				Increase/(Decrease)	
	2004		2003		Dollar	Percent
	Consolidated Revenues	Percent of Total	Consolidated Revenues	Percent of Total		
Movie rental revenues:						
VHS rental revenues	\$ 595.0	13.4%	\$1,206.8	26.6%	\$(611.8)	(50.7)%
VHS EVF revenues	97.1	2.2%	228.9	5.1%	(131.8)	(57.6)%
DVD rental revenues	2,782.7	62.8%	2,185.9	48.2%	596.8	27.3%
DVD EVF revenues	455.0	10.3%	413.8	9.1%	41.2	10.0%
Total movie rental revenues	3,929.8	88.7%	4,035.4	89.0%	(105.6)	(2.6)%
Game rental revenues	428.5	9.7%	418.7	9.2%	9.8	2.3%
Game EVF revenues	70.3	1.6%	79.4	1.8%	(9.1)	(11.5)%
Total game rental revenues	498.8	11.3%	498.1	11.0%	0.7	0.1%
Total rental revenues	<u>\$4,428.6</u>	<u>100.0%</u>	<u>\$4,533.5</u>	<u>100.0%</u>	<u>\$(104.9)</u>	<u>(2.3)%</u>

	Same-Store Revenues Increase/(Decrease)		
	Worldwide	Domestic	International(1)
Movie rental revenues	(6.1)%	(6.8)%	(3.5)%
Game rental revenues	(2.8)%	(3.9)%	2.9%
Total rental revenues	(5.7)%	(6.4)%	(3.0)%

Exhibit # 7: (From [3])

Market Share of Online Rental Industry

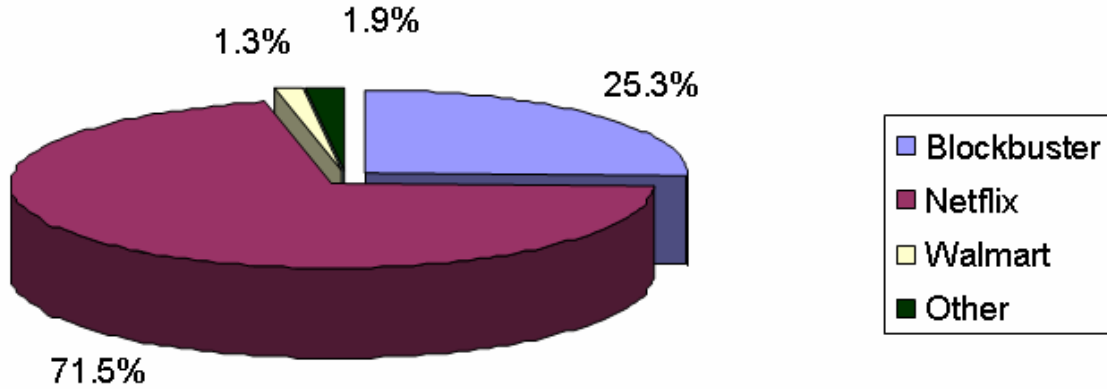
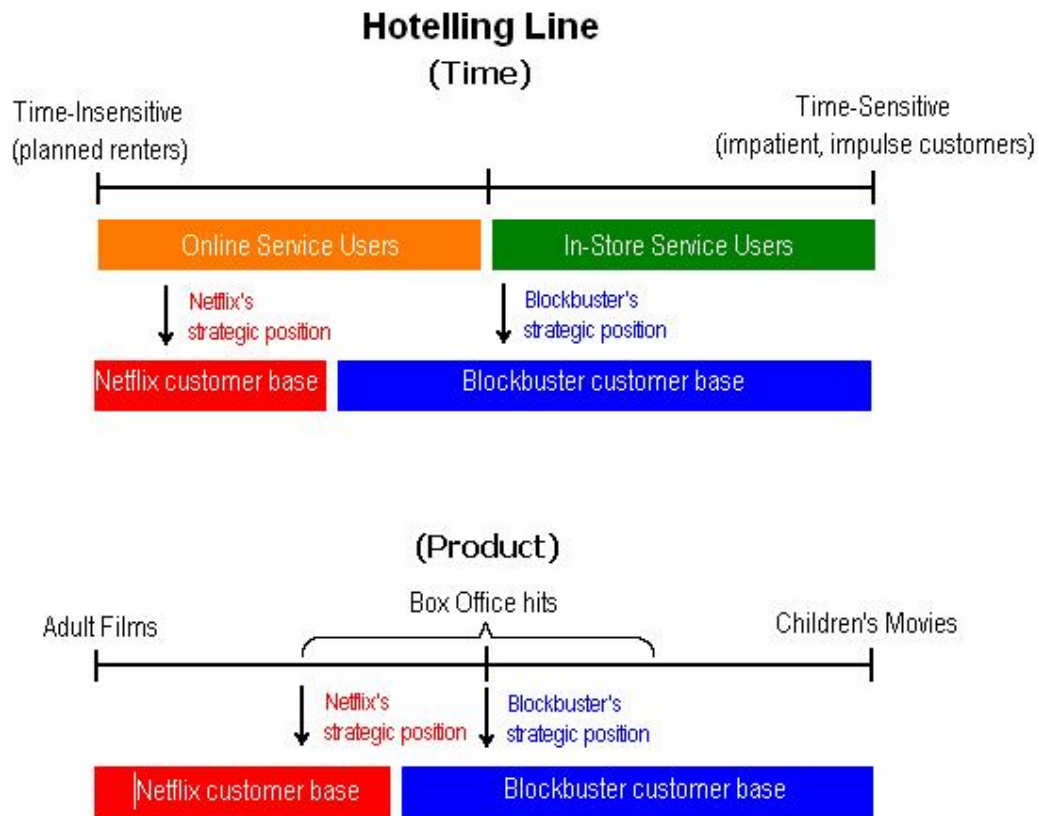


Exhibit 8:



Note: Blockbuster's customer base overlaps when we consider the Hotelling Line based on time and product differentiation.

Bibliography

- [1] Blockbuster, Inc. *2004 Annual Report*. March 29, 2005.
- [2] Blockbuster, Inc. *2005 First Quarter Earnings Release*. May 5, 2005.
- [3] Bloomberg Online. *Wal-Mart to End Online DVD Rentals, Promote Netflix*.
http://www.bloomberg.com/apps/news?pid=10000087&sid=aEurnp17wtoU&refer=top_world_news. May 19, 2005
- [4] Blockbuster Online. <http://www.blockbuster.com>. Visited on May 31, 2005
- [5] Marko Djuranovic. The Motley Fool. *Netflix's Spin Move*.
<http://www.fool.com/news/commentary/2005/commentary05051006.htm>. May 10, 2005.
- [6] Jessica Seid. CNN/Money. *Blockbuster Sued Over Late Fees*.
http://money.cnn.com/2005/02/18/news/midcaps/blockbuster_suit/index.htm?cnn=yes.
February 18, 2005
- [7] David Lazarus. San Francisco Chronicle. *Online Piracy, Cable TV Threaten DVD Rentals*.
May 20, 2005.
- [8] Verne Kopytoff. San Francisco Chronicle. *Online Piracy, Cable TV Threaten DVD Rentals*.
January 31, 2005.
- [9] Paul R. LaMonica. CNN/Money. *Revenge of the Netflix*.
<http://money.cnn.com/2005/02/25/technology/netflix/>. February 25, 2005.
- [10] Jennifer Netherby. *Blockbuster Nips Netflix Market Share*.
<http://www.videobusiness.com/article.asp?articleID=9978&catID=1>. March 3, 2005