**Home Movie Entertainment Industry** (estimates from 2006 BBI 10K)
Blockbuster is a part of the retail home video industry. Industry characteristics include
the sale and rental of DVD movies through several distribution channels. Some of these
channels include traditional video store retailers, online retailers, mass merchant retailers,
and video on demand services. The retail home video industry generated about $24
billion in revenue in 2006, a negligible increase from the year before which may suggest
that the industry as it is today is nearing its peak with consumers. About $7 billion of the
$24 billion generated by the retail home video industry came from movie rentals, a
decrease of about $500 million. The industry as a whole is dependent on the movie
studio release schedule to maintain its advantage over other non-theatrical distributors
like pay-per-view and premium television. In order to maximize revenues, movie studios
release their products at different times to different distribution channels. The future of
the industry is moving away from traditional retail and rental outlets and towards more
convenient and more easily accessible ways of acquiring movie content. As download
and streaming technologies and capabilities progress, the home movie entertainment will
shift more towards these forms of acquiring movies. New high definition formats (Blu-
ray and HD-DVD) may have more trouble than there standard definition contemporaries
penetrating the market, but they may be able to command a smaller niche segment of
consumers willing to pay a premium for higher quality at the expense of convenience.

**Competitors**
BBIs competitors include Netflix and Redbox in the DVD rental industry and Wal-Mart,
BestBuy, Target, and other big box retailers.

**Business** (figures from 2007 Q3 BBI 10Q)
Blockbuster is a world leader in the retail home video industry with over 7800 stores in
22 countries. They have a movie collection library of over 75000 films from which the
majority of their revenues are generated. In-store rental movie revenues made up 48% of
Blockbuster’s $1.2 billion in rental revenues this past quarter (13 weeks ended 9/30).
Online rental revenue made up 12%, the sale of old inventory accounted for 18%, and the
remaining 22% of revenues can be attributed to the sale of merchandise. International
operations contributed over 35% of Blockbuster’s revenues this past quarter.
Blockbuster’s online subscriber base totals about 3 million subscribers, compared to a 7
million online subscriber base for Netflix.

**Blockbuster’s Decline**
To fully appreciate the implications and scope of Blockbuster’s latest business decisions,
it is important to understand how the rental giant’s decline to a great extent was self
inflicted. The old management, led by former CEO John Antioco, guided the company
through several missteps that included failure to assess alternative distribution methods
and initiatives. One of these blunders included the lack of attention paid to competitors
arising in the industry that took advantage of alternative distribution methods most
notably Netflix and Redbox. Other, more quantitative missteps included the elimination
of late fees and the pricing of their Total Access program. The elimination of late fees
resulted in not only the loss of 20% of annual revenues, but longer average rental times
meaning stores could not re-rent popular titles and costumers could not rent the movies
they wanted.
Blockbuster’s Total Access program was a great business initiative that integrated the online business with its in-store operations. Total Access (TA) allows users to order movies online and return them to any store for free rental exchanges. TA is a good service, but the old management did not properly price the service, and spent far too much on marketing for the service. Antioco essentially promoted Blockbuster’s growing online business at the expense of its established in-store business. Blockbuster turned their biggest asset and differentiator in the industry into a liability. The old management tried to embrace the future of the business at the expense of the present-day operations.

**Investment Overview**

1. **Refocused Business Strategy**
   Any company undergoing a transformation must first solidify the ground they are standing on before they make any forward moving steps. Blockbuster is doing just that. Under newly appointed CEO James Keyes and his staff, Blockbuster is refocusing their attention and spending on the in-store operations that account for about 70% of BBI’s revenues. James Keyes and the new management know that the future of the industry and the business is online, but they recognize that this future is still a few years away from realization. Keyes has asserted that the best way to position BBI for the future is to not sacrifice the brick and mortar operations for the online business, but to re-instill consumer confidence and comfort when they think about the Blockbuster experience.

**I. Brick and Mortar Initiatives**

CEO James Keyes is refocusing the company’s short term goals to improving the in-store operations through several brick and mortar initiatives. Keyes is implementing an added emphasis on the retail aspect of the business, increasing spending on new releases to be sold, movie merchandise, popcorn, drinks, and higher margin electronics (cameras, mp3 players, video game consoles). Keyes’ experience in the retail industry as the former CEO of the convenience store chain 7-Eleven make the execution and success of these initiatives all the more likely. Other near term changes includes the addition of video game kiosks in the stores, and the testing of rental kiosks in Papa John’s restaurants. Several cost cutting measures have also gone into effect, with the simplifying of the management structure and the continued closure and sale of its unprofitable subsidiaries and stores. With these moves, Keyes is trying to improve the overall in-store costumer experience.

**II. Online Business**

Although the focus of the business for the remainder of 2007 is in shoring up the in-store operations, BBI has made significant strides in its online operations. The online operations of BBI are headlined by the Total Access program that takes advantage of BBI’s brick and mortar stores. Blockbuster’s Total Access program is a superior service to the industry leader in online rental movie distribution, Netflix’s service. When priced equally, consumers recognized the value of the TA service, leading to the first ever decline in subscriber base for Netflix. During Q2 2007, BBI subscriber base grew well beyond expectations while Netflix posted its first ever decline in membership. With the arrival of Keyes came the reduction of marketing spending on BBI’s Total Access program, and a limitation
on the number of in-store exchanges allowed under the program. These cost cutting moves will have an immediate impact on BBIs bottom line, but led to the loss of low margin TA subscribers. Keyes’ arrival also came with the completion of BBIs purchase of Movieline, a movie download company created by the four major movie studios. BBI purchased the service company for $7 million, but the important thing to take out of this transaction is that BBI purchased, along with the service company, the content rights to 6000 movies. This is an important part of the transaction that will be discussed in the VAR section. Blockbuster will integrate the Movieline service into its own online business at the beginning of 2008.

2. Strong International Business
Unlike many of its competitors in the movie rental industry, Blockbuster has a significant international business. More than 35% of BBIs revenues for Q3 came from its international operations, most of that deriving from their stores in the United Kingdom. Total international revenues increased by 6.4% this past quarter, minus the impact of exchange rates.

3. Weakening Competition
The second largest in-store movie rental company, Movie Gallery/Hollywood Video, declared chapter 11 bankruptcy in October. In accordance with the filing, Movie Gallery/Hollywood Video closed and liquidated hundreds of stores and inventory. The closest substitute for MG/HV costumers is Blockbuster, and BBIs Q4 revenues should show that.

Business Prospects
Short-term Cyclical Increase: The in-store improvements boosted by the MG/HV costumer influx and the record setting summer box office DVD lineup should significantly increase top line growth for Q4. Cost cutting measures should have an immediate positive impact on earnings.

Long-term Transitory Increase: The future of the business is clear; make stores enjoyable and relay that experience to future online businesses. Investment in stores will increase brand awareness and position BBI to take advantage of online opportunities when they arise.

Catalysts: 4th Quarter earnings release – Late January
Blockbuster is currently trading well below its 50 day and 200 day moving averages. The volatility of the stock price trends as exhibited by the 50 day moving average reveals the bullish attitude investors have in regard to this company, but the recent negative performances outweigh this desire. If BBI has a good fourth quarter, instilling confidence in investors, the stock price could surpass its 52 week high of 7.30. BBI is currently trading near its 52 week low which it set this past month.

Price: $3.84
52 week range: $3.64 - $7.30
Market Cap: 741.94M

Risks
1. Competitors able to create an affordable broadband service with an extensive library
Value added research interview with the President of Inside Digital Media Inc., a market research firm, suggests that movie studios will be reluctant to embrace broadband video technologies in the near future.

2. In-Store changes do not amount to realizable gains
Value added research initiatives hint otherwise. The increased emphasis on retail items, especially around the holiday season, has led to a noticeable increase in store traffic and movie and merchandise sales.

3. Decrease in consumer confidence
The recent deterioration of consumer confidence seems to be linked to rising oil prices and housing concerns. BBIs exposure to international markets enables them to remain profitable in economic down periods.

4. Piracy (International)
Blockbuster has exited international markets (Spain) where piracy has jeopardized their operations.

VAR Points of Contact

1. Phil Leigh, President of Inside Digital Media Inc
Movie Studios are reluctant to embrace broadband video technologies because they don’t want to alienate their current distributors like Wal-Mart, BestBuy, Target, and BBI that represent a very large portion of their revenues. The movie studios are now more focused on the next generation DVD formats, where they will have a greater control over pricing. Other than withholding content rights from online video services, current broadband speeds don’t allow for affordable and convenient movie entertainment at the same quality as current DVD technologies. It will take 5-10 years before broadband video services become the medium of choice for movie entertainment.

2. Leila, Blockbuster Store Manager
   There has been an increase in store traffic with the closing of Hollywood Video and the new DVD deals. Movie merchandise has sold well, but new and pre-viewed movies have been performing the best.

3. Kurt Scherf, Parks Associates Analyst
   Consumers want to rent movies not buy them. This preference is why previous movie download services have failed. Their focus has been on movies for sale, not rent.