

CASE STUDY—The Demise of Blockbuster

Teaching Objectives

The objective of this case is to discuss how different business models and supply chain structures impact the financials of the firms in the DVD rental business. In particular, the goal is to convey that the characteristics of the movie (recent/big hit or old/eclectic) affect whether it is best rented from a centralized or decentralized model. By comparing the financials of Blockbuster, Netflix and Redbox, we identify the strengths and weaknesses of each model. The centralized Netflix model displays strategic fit for a wide variety of somewhat older movies whose demand is hard to predict. The decentralized Redbox model displays strategic fit for a few new releases whose demand is large and predictable. The growth of both companies left Blockbuster squeezed in the middle because its model did not have the same level of strategic fit.

Case Questions and Discussions

1. In what ways did Blockbuster achieve better strategic fit than local stores?

Blockbuster started with the business model of having large physical storefronts in high-traffic neighborhood locations. By building stores that were larger than existing mom-and-pop rental stores, Blockbuster offered customers a wider choice of movies and better product availability. Movies were typically rented out for about \$5 for five nights.

Given that mom-and-pop stores were much smaller, even though they carried only a few hundred titles, it was very difficult for them to provide availability of these movies given the high cost of inventory (VHS tapes sold for \$60–\$80 each at that time) and space. Blockbuster built larger stores that aggregated demand across a wider area than a typical mom-and-pop store. The larger store allowed Blockbuster to provide greater variety and better availability at lower cost than mom-and-pop stores. The aggregation of inventory and physical space allowed Blockbuster to fill demand from its customers better than mom-and-pop stores.

2. How much implied uncertainty do Netflix and Redbox face? What levers do they use to deal with this uncertainty?

Redbox focuses on a few new releases. The demand for these movies is large and relatively predictable. As a result, Redbox faces a relatively low level of implied uncertainty that can effectively be served using decentralized inventory that is close to customers. In contrast, Netflix provides a very wide variety of older movies whose demand can be difficult to predict. The wide variety increases the level of implied uncertainty. Netflix, however, makes its customer wait a bit to get their movies, allowing it to lower the implied uncertainty to some extent. Netflix then pools this uncertainty and serves its customers using inventory that is stored in centralized warehouses, allowing it to further reduce the uncertainty it must absorb.

3. How did Netflix and Redbox achieve better strategic fit than Blockbuster?



Netflix and Redbox achieved better strategic fit than Blockbuster by targeting different segments of movie rentals. Whereas Blockbuster attempted to provide its customers both new releases as well as older movies, Netflix and Redbox divided the market among themselves. Netflix primarily targeted a wide variety of older movies while Redbox primarily targeted a much smaller variety of new releases. Blockbuster's attempt to serve both markets increased its cost for both new releases and older movies. In contrast, Netflix was able to provide variety to its customers more effectively (100,000 titles rather than 5,000 at Blockbuster) and at lower cost through its aggregate model of shipping from DCs. Redbox was able to provide new releases at lower cost than Blockbuster by using vending machines.

Whereas a Blockbuster store carried around 3,000 titles that were not recent releases, this represented a very small fraction of old movies. In contrast, Netflix carried a very wide variety of titles but in centralized distribution centers. Netflix had about 60 distribution centers (at its peak of mailing DVDs), where DVDs were processed and shipped all over the United States. Thus, Netflix had much lower facility costs than Blockbuster while providing a much higher variety of movies.

Only a single wall at a Blockbuster store was dedicated to new releases, (which constituted a significant fraction of the rentals). Given that Blockbuster was paying for the whole store, this increased the facility cost per rental because most of the space was used by other movies that rented at a much lower rate than the new releases. Redbox, in contrast, used very low cost vending machines (with low fixed installation costs of \$15,000) in high-trafficked locations such as grocery stores, supermarkets, and malls to rent the same recent releases (much lower PP&E/SG&A) compared to Blockbuster. As a result, the facility cost per rental was much lower at Redbox compared to Blockbuster.

Inventories at Blockbuster were high (relative to revenues) because of the decentralized nature of its operations. In particular, carrying many low-volume rental titles (after all, there were perhaps only about 30 movies at any given time that were renting in large quantities) exacerbated the inventory requirements. This increased the cost of both inventory and space for Blockbuster. Netflix carried a wider selection of titles in its distribution centers, but was able to carry lower inventories because of aggregation at its DCs. Redbox stocked newly released DVDs, which rented in large volumes with relatively predictable demand. As a result, there was much less inventory sitting around. Each Redbox kiosk carried close to 630 DVDs comprising 200 of the newest movie titles. Each DVD was rented out on average 15 times, after which it was sold to the customer.

Netflix used a centralized supply chain structure to provide variety in the form of old movies (high uncertainty) to its customers at low cost. Redbox used a decentralized supply chain structure to provide predictability in the form of new releases (low uncertainty) close to its customers at low cost. A combination of the two focused supply chains performed significantly better than the Blockbuster supply chain as illustrated in a comparison of the financials in Exhibits 1 and 2 (in the absence of Redbox financials, we use Coinstar financials).



Exhibit 1: Company Comparisons (%)

Metric	Blockbuster	Netflix	Coinstar
SG&A (% of Revenue)	49.50	24.16	13.60
COGS (% of Revenue)	46.30	49.20	69.60
Inventories (% of Revenue)	15.73	2.21	9.12
Inventories (% of COGS)	33.98	4.50	13.10
PP&E (% of Revenue)	58.47	15.92	66.57
PP&E with Depreciation (% of Revenue)	6.13	7.90	35.08
Liabilities (% of Revenue)	45.64	28.80	71.05

Exhibit 2: Blockbuster

Both Netflix and Redbox operated with lower costs because they were not burdened with the heavy fees of leasing thousands of retail locations as Blockbuster was. The table below shows that the general and administrative expenses for Blockbuster were 47.48 percent and 44.13 percent of revenues in 2009 and 2008, respectively.¹ The figures for Netflix for the same period were 3.1 percent and 3.6 percent, respectively.²

	Fiscal Year Ended	
	3-Jan-2010 (\$ in millions)	4-Jan-2009 (\$ in millions)
Total Revenues	4,062.4	5,065.4
Operating Expenses		
General and Administrative	1,928.7	2,235.3
Advertising	91.4	117.7
Depreciation/Amortization	144.1	146.6
Impairment of Goodwill	369.2	435
General and Administrative Expenses as a Percentage of Revenue	47.48%	44.13%

Source: Blockbuster 2009 Annual Report.

¹ Blockbuster 2009 Annual Report.

² Netflix 2009 Annual Report.

