Netflix, Redbox and Hulu

Offering New Business Models in Home Video Entertainment

After years of declining revenue and the rise of several innovative competitors, Blockbuster, which had been the long-time market leader in the movie rental industry, had collapsed. James F. Keyes, Blockbuster's CEO since 2007, had seen the writing on the wall for several years. Rapid technological change had provided inroads for competitors with distinct cost advantages and unique value propositions unmatched by Blockbuster. Upon joining the company, Keyes moved quickly to improve the in-store experience for customers, leveraging Blockbuster's historic core competency. But new business models launched by competitors Netflix, Redbox, Amazon.com, and others left the box-store looking like a high-cost modern artifact. Blockbuster's bottom line was left bleeding in the face of plummeting revenues, and Blockbuster filed for Chapter 7 bankruptcy protection in 2011. Coming out of bankruptcy, Blockbuster tried to mimic or beat competitive offerings by Redbox, Netflix, and Amazon by growing its kiosk rental business, allowing mail-order DVD rentals to be returned by mail or at the store and introducing Direct Access, or in-store access to mail inventory.[1] But it was too little, too late. Dish Network finally stepped into purchase Blockbuster's assets for $320 million in 2012, but it appeared that Blockbuster had lost its death match with smaller, more nimble competitors, armed not with slings and stones, but with kiosks and broadband.

History of the Home Video Entertainment Industry

When the first motion pictures were released in the early 1900s, there was only one way to view them—at a theater. It wasn't until television became popular in the 1940s and 1950s that people could watch some movies at home, although viewing was subject to the schedules of the television networks.

In 1975, Sony introduced its Betamax video cassette recorder (VCR) to the American public. This was closely followed by Panasonic (formerly known as Matsushita) launching a Video Home System (VHS) VCR, which was then licensed to many companies, including Philips, GE, and RCA. These products could record and play movies, but they were expensive, selling for roughly $1,000 in 1977.[2] In December 1977, the first video rental store, Video Cassette Rentals, opened its doors, offering both VHS and Betamax videos. Customers joined as "members" for a fee of $50 per year (or $100 for a permanent membership), and then paid $10 to rent each video.

Soon afterward, video rental stores began cropping up all over the United States, and more and more studios began to enter the home video market.[3]

The adoption of the VCR by the American public was slow at first. In 1980, only 1.1 percent of US households had a VCR. By 1985, that number had grown to 20.9 percent of US households.[4] By the end of the decade, VCR penetration was at 68.6 percent,[5] and the price of an average VCR had dropped below $400. As the number of VCRs increased, so did the number of video rental outlets. George Atkinson launched a chain of stores called Video Station, which quickly grew to become the market leader, with a total of 500 stores by 1984. But Video Station was soon challenged by Blockbuster, a video rental chain that opened its first stores in 1985. In 1987, Blockbuster acquired the chain Movies to Go, bringing its total number of stores to 67. During the next two years, Blockbuster grew rapidly through franchising. By 1989, Blockbuster was the largest video rental outlet in the country, with more than 1,000 stores, and it had begun to expand into overseas markets.[6] Hollywood Video opened its doors in 1988, following a growth strategy similar to Blockbuster's. It quickly became the second-largest video rental franchise in the United States.

Box rental stores continued to proliferate through the early 1990s, with no apparent technological or competitive threats in sight. Then, in late 1995, a consortium of electronics manufacturers developed the digital versatile disk (DVD). The technology was introduced to the United States in 1997, and by mid-1998, Netflix had launched the world's first online DVD rental service. Later that year, Amazon opened the first online video store, offering 60,000 titles for purchase, including 2,000 DVDs.[7] During this time period, the technological landscape continued to evolve, and in 2002, MGM became the first major studio to allow online pay-per-view consumption.[8] Redbox launched the same year, with its kiosks providing head-to-head competition with Blockbuster's 5,566 domestic box-stores.[9] In 2003, the year Netflix surpassed 1 million subscribers, annual DVD rental revenue surpassed annual VHS rental revenue for the first time.[10]

In 2004, CinemaNow was the first company to introduce a service that allowed customers to purchase and download digital movies for unlimited viewing. By 2005, Apple had launched online, digital video services, a move followed by Microsoft and Amazon the next year.[11] Viewing quality technology took a leap forward in 2006 with the introductions of high-definition (HD) DVD and Blu-ray. In the same year, PlayStation3 became the first gaming console to feature an HD DVD player. Online providers followed suit, increasing video quality as bandwidth became more widely available.[12]

The next several years brought a rapid contraction of the physical DVD and VHS rental markets as cost-efficient competitors (most notably Netflix DVD and Redbox) grew, and online content providers lured viewers away from physical rental. Between 2006 and 2013, the physical DVD rental market dropped from $10.7 billion to $4.5 billion.[13] During the same years, total physical DVD-rental industry employment plunged from 141,000 to 55,000.[14] The growth of online content providers threatened to further shrink the physical rental market.

The battle for the growing online market continued to unfold in 2013. Facing continued growth of Netflix's online streaming business, Redbox and Verizon partnered to launch their own streaming service called Redbox Instant. In similar fashion, NBC and Fox joined forces to launch Hulu, offering free, ad-supported viewing, and later launching a premium subscription service to rival Netflix's streaming service. In 2013, both Netflix and Hulu began offering original content, a move highlighting the important and sometimes tenuous relationship between content providers and distributors.

Throughout the history of the home entertainment industry, content producers had held significant supplier power. Producers, who owned the content rights to their movies, held the power to negotiate hard contract terms with distributors. Additionally, content producers, like consumers, showed little loyalty to specific distributors, switching channels and partners to maximize profits as the technological landscape shifted. For example, in 2007, NBC and Fox, who were key content providers with their Hulu partnership, showed a willingness to sidestep outside distributors altogether in favor of direct, cost-effective online distribution.

Netflix's decision to produce and distribute its own originally produced shows—such as political drama *House of Cards*, comedy-drama *Orange is the New Black*, and historical drama

The Crown—was a move to weaken the power of content producers and differentiate its offering from competitors. The initial results from these shows—in terms of positive feedback from consumers and advertisers—have been positive. The battle between content producers and distributors continues to significantly shape the competitive industry dynamics.

Major Players

During the history of the home video industry, several players have entered with innovative business models that have changed the competitive landscape. Leaders have been Blockbuster, Netflix, Redbox, Apple, Microsoft, Amazon, and Hulu. A look at each provides insight into the industry's rapidly changing dynamics and the strategies and business models deployed by its strongest players.

Blockbuster

The first Blockbuster store opened in Dallas, Texas, in 1985. The store was successful, which prompted Blockbuster to open several more stores in the area and eventually a local warehouse to provide and manage inventory. Taking a lesson from his previous experience in database management, Blockbuster's founder, David Cook, designed the warehouse to efficiently stock a selection of titles customized to each store according to its local demographic. This innovation brought a convenient, customized choice of VHS titles to customers in the exciting new arena of home entertainment.[15]

The company decided it could grow more quickly if it pursued a franchise model like the one used by McDonald's and many other fast food giants. With a franchise model, individuals in different cities and regions paid an upfront franchise fee (anywhere from $200,000–$400,000),[16] which gave them the right to own and operate a Blockbuster store at a specific location. In addition to receiving the fee, Blockbuster received an ongoing percentage of revenues generated from each store. Although the franchise model meant that Blockbuster had to share profits with the franchisees, it allowed Blockbuster to grow at a much faster rate than would have been possible if Blockbuster had tried to finance and build all of its stores.

After a period of strong financial performance, Blockbuster was acquired by John Melk and Wayne Huizenga, a successful entrepreneur who had founded Waste Management and AutoNation. Huizenga became CEO and grew the business aggressively, both organically and through the acquisition of key competitors, including a 250-store buyout of mid-Atlantic rival Erol's.[17] Pushing into international markets, Blockbuster purchased the 875-store Ritz video chain of England in 1989. In 1991, Blockbuster entered the Japan and Australia markets through a mix of partnerships and acquisitions.[18] By the early 1990s, Blockbuster had come to dominate the home video rental market in the United States, with more than 3,500 stores around the country.[19] (see store growth in **Exhibit 1**). Each store carried more than 1,000 different movie options. Blockbuster needed to make this large investment in stores and inventory in order for customers to be able to conveniently find a store—and a desirable movie to rent.

Blockbuster's growth often came at the expense of traditional mom-and-pop video stores that found it hard to compete on selection and price. Customers often preferred the consistency of experienced, well-trained employees, as well as the variety of locations offered by Blockbuster compared to smaller stores and franchises. Blockbuster quickly discovered that it didn't make money from the videos sitting on the shelves. It needed to get customers to rent the DVDs and return them as quickly as possible so Blockbuster could rent them to another customer. To encourage customers to return DVDs quickly, it charged late fees. These fees were unpopular with customers, but Blockbuster couldn't make money if it didn't get the DVDs back quickly. This pain point would later pave the way for industry disruption through Netflix's subscription-based model.