

Blockbuster's bricks and clicks

By Gregory J. Millman

As part of a comprehensive business transformation initiative, the company launched a new online movie rental program that gives customers both Internet convenience and in-store benefits.



With 9,000 stores worldwide, Blockbuster has long been the clear market leader in video rentals in the United States. However, the video rental marketplace has become increasingly challenging, and changing buyer preferences have made an exclusively bricks-and-mortar approach to video sales and rentals a difficult business. In fact, analysts at Kagan Research describe the video rental market as "flat."

Fortunately, well before the marketplace difficulties began, Blockbuster was deeply engaged in a business transformation so fundamental that nowadays it looks less like a video rental company and more like a home entertainment enterprise with a diversified set of businesses, including an expanded games selection, DVD sales, online rentals and even used-movie and game trading.

That business mix positions Blockbuster at every major crossroads of the home entertainment market. Kagan Research says the home video business, which includes sales and rentals of both DVDs and VHS tapes, is "phenomenal." Across the industry, DVD sales are booming, thanks to a steep fall in prices for DVD players (in 2003, they sold for about one-fifth of their price in 1997).

Moreover, because DVDs wholesale for much less than videotapes, the shift in consumer preferences has helped stores increase overall gross margins as a result of movie sales. And while traditional, pay-as-you-go movie rental transactions may not be increasing overall, subscription rentals, both in-store and online, show potential.

Blockbuster

Headquarters: Dallas, Texas

Chairman and CEO: John F. Antioco

Employees: 81,350

Locations: nearly 9,000 throughout the Americas, Europe, Asia and Australia

Online subscribers: >750,000

2004 revenues: \$6.1 billion

SOURCE: BLOCKBUSTER

To be sure, there's plenty of competitive pressure. To make its transformation work, Blockbuster has to deliver value superior to that of Wal-Mart, which sells DVDs at close-to-cost prices, and Netflix, the trailblazer in online video rentals—not to mention innumerable local video rental shops. Solving the challenge of competition from online DVD rentals fell to Shane Evangelist, senior vice president and general manager of Blockbuster Online—a business unit that didn't exist until early 2004.

Brand power

Blockbuster's strategy builds on the company's brand strength, extensive presence and well-established customer base. For example, to meet the competitive threat from low-priced video sales and to build brand loyalty, Blockbuster recently introduced a trading program that allows customers to swap old DVDs for credits that are good toward anything in the store. Blockbuster also effectively slashed in-store rental prices with a monthly subscription program that lets store customers rent an unlimited number of movies each month for a set fee.

In the summer of 2004, Blockbuster launched an online rental program that combines bricks and clicks to provide a level of customer convenience and flexibility that will be challenging for its competitors to match.

Blockbuster's online initiative was years in development. In 2002 Blockbuster purchased FilmCaddy, an online movie rental company that became, in essence, Blockbuster's R&D lab for the Internet channel. Says Evangelist, "We used that company to look at consumer behavior online—rental patterns, how you acquired subscribers and so forth. We developed a good under-

standing of how the online rental channel worked. We could see what online customers were doing in our stores, and we learned that they continued to rent from stores even when they had an online program."

Blockbuster supplemented the FilmCaddy data with other consumer research, both qualitative and quantitative, and found that online customers clearly preferred a program that would give them both Internet convenience and in-store benefits. Instead of being an old-economy drag on the company's move into cyberspace, Blockbuster's extensive network of stores could provide a powerful competitive edge.

Still, exploiting that advantage was not going to be easy. "Initially we wanted to ship product directly out of our stores," Evangelist explains. "That might have been too ambitious. However, now that we are operating with distribution centers, our focus has turned back to making sure we can leverage our store inventory and ship product directly from our stores to satisfy online demand."

Shipping product directly from the stores to customers certainly makes sense. Blockbuster stores have an extensive inventory of films, yet some of those movies are sitting on shelves, not being fully utilized. Filling online orders directly from stores should allow Blockbuster to increase its inventory turns. The fact that the stores are close to consumers will ensure faster delivery.

Blockbuster turned to Accenture to help develop the systems and processes to launch the online business. Instead of tying the online venture to the stores from the start, Blockbuster and Accenture decided to take a two-stage approach. First, they would build a network of dis-

tribution centers fully dedicated to servicing online customers. Blockbuster wanted to offer one-day delivery to as many of these customers as possible, and that priority affected everything from the location of the distribution centers to the inventory they would stock.

That included the design of the envelope used to ship DVDs. After looking at how other online rental companies attacked the shipping challenge, Blockbuster came up with a package that could travel as first-class mail, making it easy for customers to return the DVDs at no charge to them.

Working with Accenture, Blockbuster also identified sites for distribution centers that could service as much of the DVD renting population as possible within a one-day delivery window. The development team learned that just being close to customers wasn't enough to ensure this.

Different postal processing facilities have different business mixes. Some process more inbound than outbound mail, for example, or vice versa; some have limited capacity. The most efficient Blockbuster distribution centers would combine proximity to the customers with proximity to the right kind of postal processing center.

To get the distribution centers up and running quickly, Accenture set up a test distribution center in Dallas that allowed Blockbuster to experiment with different processes, equipment and layouts. Once the right design had been nailed down, the managers of 10 live distribution centers came to the Dallas test lab for training.

In August 2004, just nine months after the approval to launch its online rental business, Blockbuster had the program up and running. Online customers select films from

an inventory of more than 30,000 titles, listing their choices in order of preference. Deciding what movies to stock at which centers was one of the most challenging and unique aspects of the overall effort, which also included development of the website for Blockbuster Online, the quality management system, the "ratings & recommendations" engine, billing procedures, account management, customer service, e-coupon management and more.

Return customers

The company's online rental program is unique, insofar as subscribers receive coupons for two free in-store rentals per month. Not only has online rental not cannibalized store sales, it has actually brought old customers back to the stores.

Says Evangelist, "At this time, more than 50 percent of Blockbuster Online customers are either new members or haven't rented from our stores in the last six months. The online coupons are sending new customers into our stores, and once there, customers are discovering that Blockbuster is more than just video rental. They're finding that we now have used DVDs to sell, opportunities to trade, more games. We are confident that we are growing our overall customer base."

And it's just the beginning. Blockbuster is planning a fuller integration of bricks and clicks in 2005, when it will begin to use store inventory and direct-from-store shipment to supplement the distribution centers. Coming soon to a Blockbuster near you will be a subscription offering that makes the online and in-store experience all but seamless.

"Our plan is to increase service levels with more one-day delivery and greater availability of inventory and to increase product availability

by tapping store inventory, thereby reducing costs," says Evangelist.

Blockbuster did not respond to the challenge of an increasingly competitive home entertainment market simply by doing old things better. Instead, the company evaluated its business model and found new ways to grow by exploiting an advantage some thought was a liability—an extensive bricks-and-mortar network of video rental shops. John Romanow, a partner in Accenture's Media & Entertainment group, sees a lesson for all businesses in the Blockbuster experience: "When consumers elect a different way to use a product, a company must be willing to change the way they do business to satisfy customer needs. Blockbuster has done just that."

Will Wall Street get the message? Will Blockbuster come charging back in time-hallowed Hollywood fashion, the underestimated contender who captures the crown? Those questions will surely be answered in the sequel—but the script looks promising.

Gregory J. Millman is a New Jersey-based business writer.