The Home Video Industry

Luís Cabral

beta version: October 2009

During a 1982 US Congress hearing on home recording technologies, Jack Valenti, then president of the Motion Picture Association of America (MPAA), made a statement that would frequently be cited in years to come:

> I say to you that the VCR [video-cassette recorder] is to the American film producer and the American public as the Boston strangler is to the woman home alone.[1]

However, many would agree that the VCR did Hollywood more good than harm (Valenti himself retracted his initial gibe). As the first mass-market VCRs were launched in the mid 1970s, the idea was to allow viewers to record TV content. But from the early 1980s on, home movie watching became the main use of consumer VCRs: the new technology thus created a multi-million dollar industry.

By 2008, video-cassettes were becoming a technology curiosity, long replaced by DVDs as the leading hardware support for movies. But the industry was still going strong, accounting for 54% of the US film industry's $45 billion revenue.[2] Over almost three decades, the history of the home video industry is the history of how technology and business strategy interact mutually to create value and shift value along the chain that leads from content creation to home delivery.

Standards battles

The first years of the video-rental industry were dominated by the battle between two alternative, incompatible VCR standards: Sony's Betamax and JVC's VHS. The story is well known: as Betamax's market share shrunk, fewer video-rental stores were willing to carry Betamax tapes, which in turn led to a decrease in the demand for Betamax machines. Finally, in 1988 Sony capitulated: it stopped producing Betamax VCRs for the consumer market (though it successfully continued producing in the professional market).[3]

Part of JVC's strategy in pushing the VHS standard was to license it to a considerable number of producers, Japanese and non-Japanese alike. As a result, by the late 1990s, as the VHS camp celebrated victory in the standards battle, competition in hardware sales was fierce. Winning the standards battle was small consolation for relatively low profit margins.

Written by Professor Luís Cabral for the purpose of class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The author thanks Professor Julie Holland Mortimer for comments on an earlier draft.

Blockbuster

The movie rental business continued to blossom. From the small independent neighborhood store, large chains emerged which soon accounted for about one-half of total business. One of the earlier chains, and still one of the dominant players in the US market, was Blockbuster. Founded by David Cook in 1985, Blockbuster opened its first store in Dallas, Texas. International expansion began in 1989 with store openings in Canada and the UK. Australia, Chile, Mexico, Spain and Venezuela followed suit in 1991. By 1992, Blockbuster's network included more than 3,000 stores. In 1994, the company was sold to Viacom for \$8.4 billion. Expansion continued, both within the US and abroad: Denmark, Ecuador, Portugal, El Salvador and Panama were all added in 1996. The 8,000 mark was passed in 2001 with a store opening in São Paulo, Brazil.[4]

In 1999, Blockbuster was listed in the New York Stock Exchange (NYSE). After a series of yearly losses, in 2004 Viacom spun off Blockbuster, at which time the chain's market value was around \$500 million. In 2008, the company recorded revenues of \$5.5bn, of which about 65% originated in domestic sales, 13.6% in the UK, 8.5% in Canada, and 12.8% in the rest of the world.[4]

Revenue sharing

Video stores obtain DVDs and video-cassettes from movie distributors, and then rent them (or sell them) to individual customers. Traditionally, retailers acquired tapes at a fixed, or linear, unit price. Price per tape was typically in the \$65–\$70 range.[5] Then in 1998 a new type of contract acquired wide acceptance: revenue sharing. Under revenue sharing, the retailer paid a per tape upfront fee in the \$3–\$8 range and then shared rental receipts with the distributor, typically in a 45–55 percent split.

Both under linear pricing and under revenue sharing the retailer decided how many tapes to hold in the store. Moreover, the retailer could choose to purchase or revenue share on a title by title basis. However, once the contractual choice was made, it applied to all of the tapes of that particular title.

The precise details of revenue sharing contracts varied across movie distributors and also over time, but the main qualitative features remained: a lower upfront fee in exchange for a revenue sharing clause. For example, in January 1999, a typical contract offered by Fox Video and Buena Vista Home Video (and monitored by intermediary Rentrak) included the following clauses:

- The rental store paid a \$8.30 upfront fee;
- The rental store kept 45% of rental revenues;
- Sixty days after release, the rental store could:
  - sell the tape to consumers for a revenue split of 50%;
  - return all but one copy of each title or purchase them for \$2–\$4 each.
- The rental store had to keep its stock of each title in a range which was a function of the store's revenues and the title's box office revenues.

In order for a revenue-sharing agreement to take place, it was necessary for the retailer to have the computer technology required for monitoring sales transactions (monitoring both by the retailer and by an external party). Several technological changes during the 1990s made all of this easier. First, the cost of computer networks decreased considerably, especially when measured on a computing-power basis. Second, several software packages became available for tracking and downloading data in a standardized format. Third, the development of the Internet enabled third parties to easily monitor the operation of these computer networks.

While the costs of implementing revenue sharing were lowered, the benefits remained high. Under revenue sharing, the retailer had an incentive to purchase more tapes of the more popular titles, thus avoiding customer frustration when looking for the latest hits. In this way, the customer became better off; the retailer became better off; and the distributor also became better off.

The economic theory of revenue sharing is fairly straightforward, though measuring its effects can be tricky. The accompanying technical note, "The Economics of Revenue Sharing: Theory and Measurement," explains why. But by most accounts revenue sharing was a success for those stores that implemented it. Two years after it was first introduced, about one half of the 20,000 retail firms in the US had implemented some form of revenue sharing.

Blockbuster was one of the leaders in implementing revenue sharing. One analyst described its effects as follows:

> How many times are you willing to go out for Titanic and come back with The Poseidon Adventure? Eventually you just stop going out. And that's exactly what happened: traffic slipped, new memberships decreased, and in April 1997, Blockbuster revealed that earnings had sagged 20% ...
>
> No more: these days Blockbuster is stocking its shelves with three times as many copies of new releases and guaranteeing that such hits as Good Will Hunting will be in stock, or next time they're free.[6]

Independents sue Blockbuster

Not all retailers benefited from revenue sharing. First, there were many independent small stores that did not have the size or the ability to invest in the technology required for sales monitoring. Second, revenue sharing made Blockbuster and other revenue-sharing stores very attractive: within a short time span, consumers went from deeply frustrated to happily satisfied ("anytime I've looked for a new release, it's been there," a satisfied Chicago customer said).[6] Third, even when independent stores managed to sign revenue sharing agreements, they were unable to get the same deal as Blockbuster. Sumner Redstone of Viacom acknowledged publicly that Blockbuster was keeping as much as 70% of rental revenue, whereas independents were getting at best a 50–50 split.

A Louisiana store owner explained why Blockbuster was taking business away:

> They're deep on everything. I'll have seven copies of a movie and they'll have 50 or 60. And that just kills my business, because once a customer comes to my place for a movie, can't find it, and then sees plenty of copies at Blockbuster, he's gone.[7]

Blockbuster however denied that it was receiving favorable treatment. CEO John Antioco stated:

> We have no — zero, nada, nil — exclusive deals ... We have done nothing contractually or otherwise to prevent the studios from signing deals — even better deals — with other retailers, large or small.[7]

Unconvinced, independent stores sued Blockbuster, arguing it had "conspired with the studios to deny independent retailers long-term output revenue-sharing agreements functionally equivalent to its own." The case was decided in 2003 in favor of Blockbuster.

Netflix

The biggest threat to Blockbuster did not come from rival stores, rather it came from a completely new home video delivery concept. Shortly before revenue sharing was introduced into retail stores, another game-changing innovation was taking place. Founded in 1997 in Los Gatos, California, Netflix introduced the concept of a flat-rate rental-by-mail service. The idea is simple: depending on the particular deal, customers get to keep one, two or three DVDs at any given time; once a DVD is returned by mail, another one of their choice is mailed back.

Blockbuster responded by creating its own online rental system. In April 2006 Netflix sued Blockbuster, accusing it of violating two of Netflix's patents (both related to customer movie preferences management). A year later the companies agreed on a settlement, the terms of which were not disclosed. (Shares in Netflix jumped $1.26, almost 6.5 percent, to $20.78, while Blockbuster's slipped 2 cents, to $4.20.)[8]

Both Blockbuster and Netflix had to return to court multiple times during the 2000s. For example, in September 2004 a consumer class action lawsuit accused Netflix of the practice of "throttling," the allocation policy whereby customers who return DVDs with higher frequency are given lower priority. Although Netflix was confident claiming that "the large majority of our subscribers are able to receive their movies in about one business day,"[9] it could not deny that some customers were treated differently (a practice Netflix internally refers to as "smoothing").[10] A final settlement was reached in 2006; among other things, Netflix's Terms of Use were amended to exclude any subsequent class-action claims.

In 2001, Blockbuster was sued in Texas for charging "exorbitant" late fees.[11] Blockbuster agreed to issue $450 million in late fee refund coupons, of which 10 to 20% were redeemed. A few years later Blockbuster introduced a "no late fees" policy, but even then it got under fire: In 2005, 48 states and the District of Columbia sued Blockbuster, claiming that the retailer's "no late fees" policy was false advertising because it did not disclose that consumers would be automatically charged a tape's full price if it were not returned after a one-week period. In a settlement, Blockbuster agreed to pay the plaintiff's legal costs, clarify its policy, and refund customers who were charged restocking fees. The state of New Jersey was not part of the settlement and filed its own case.[12]

Whereas Netlix weathered the storms relatively well, Blockbuster continued to decline all through the 2000. More than the courts, Blockbuster fell victim of Netflix's better business model, richer movie inventory (100,000 DVD titles in 2009) and larger customer base (over 10 million paying subscribers).[13] From the beginning of 2008 and until September 2009, Netflix market cap increased by about 60% to $2.45bn, whereas Blockbuster's decreased by about 60% to $233m, less that one tenth of Netflix's.[14] In May 2009, as Blockbuster settled on another court case (overcharging customers for popcorn), an analyst predicted that

> This could end up being one of the final nails in the coffin for Blockbuster, who has all but lost in its rivalry with Netflix.[15]

Red Box

In 1982, as the home video industry was just getting under way, entrepreneur Mitch Lowe, then 29 years old, had an idea: a video-cassette vending machine. The idea failed, partly because customers felt uncomfortable using credit cards at the machines, partly because the tapes frequently broke down, partly because it is difficult for a vending machine to hold such bulky objects.[16]

Twenty-two years later, Lowe tried the same idea with DVDs. In 2004, Redbox started with 12 kiosks in Illinois. Five years later, it was processing 80 transactions a second on Friday nights.[16] Redbox's business model is simple: let customers rent recent title hits with convenience and at an affordable price: $1.

Consumers like the idea. According to the NPD Group, as of 2009, kiosks represented 19 percent of the rental market (mail services accounted for 36 percent and traditional stores 45 percent).[16] Traditional stores, however, are less than enthusiastic. Ted Engen, president of the Video Buyers Group (a trade organization for 1,700 local rental stores), put it simply:

> These machines are to the video industry what the Internet was to the music business — disaster.[16]

Studios too are concerned. First, a $1 rental price is bound to place downward pressure on the rental market, indirectly affecting the studios' revenues. Moreover, Redbox follows the practice of selling its used DVDs (after about a dozen rentals or so), which further cannibalizes the revenue pool where the studios feed.

One studio took to action: On August 26, 2008, Universal Studios Home Entertainment (USHE) VPs Jamie Guzzaldo and Dick Longwell paid a visit to Redbox's headquarters in Oakbrook Terrace, Illinois. They presented Redbox COO Mitch Lowe a copy of Universal's revenue-sharing agreement along with a simple message: you have until tomorrow to sign it; it's take it or leave it.[17]

The agreement proposed by Universal prevented Redbox from renting Universal movies until 45 days after they were first offered for rental; limited the number of Universal DVDs Redbox could stock; and required Redbox to destroy Universal DVDs after they left the kiosks (instead of being sold as used to consumers).[17] Finally, Universal threatened that, if Redbox did not comply, then the studio would terminate Redbox's two distributors (Video Product Distributors and Ingram Entertainment), effectively preventing Redbox from acquiring Universal's DVDs.[17]

On October 10, 2008, Redbox filed a federal suit against USHE in the US District Court in Delaware, alleging the studio's new terms violated antitrust laws and misused Universal's copyrights.[17] As of this cases' writing, the case remains undecided.

The present and the future

People will continue watching movies at home for a long time. The question is, How will consumers get those movies? Where is the home video industry heading toward? Some say that, as Internet bandwidth continues to increase, direct movie streaming will become the norm.

If so, we are still far from getting there. In 2009, Netflix boasted a library of 100,000 DVD titles, but only about 12,000 were available via online streaming—and most of these were not recent or A-list films. Not surprisingly, streaming still represented a very small fraction of home video revenues (see Exhibit 1).

But music downloads also started as a very small share of music sales. And Netflix seems committed to the streaming strategy. Netflix CEO Reed Hastings stated that

> We've got one singular objective, which is 'Be successful in streaming' ... If we do that, that's a homerun.[13]

But the early, if limited, success of Redbox's business model seems to tell a different story: the idea that DVDs, Blu Ray disks, or whatever their hardware successors will be, maintain an advantage over the online model.

Time will tell.

Exhibit 1

Selected US 2008 data on movie-rentals and related businesses. Source: see Endnote 18.

	Value	Change
Movie rentals and sales		
DVD and BluRay rentals	\$7.5bn	0
DVD and BluRay sales	\$14.9bn	−8%
Internet movie downloads	\$.142bn	
Movie rentals by store type		
Stores (e.g., Blockbuster)	69%	
Online (e.g., Netflix)	25%	
Kiosk (e.g., Red Box)	6%	200%
Video-game rentals and sales		
Video-game software rentals	\$.541bn	8%
Video-game software sales	\$11.7bn	22.9%
Video-game hardware sales	\$7.81bn	11%

Exhibit 2

Milestones the home video industry. Source: The Entertainment Merchant Association.

1975–1979	
Fall 1975	Sony Betamax goes on sale in the U.S.
October 1977	RCA begins selling the first VCR in the U.S.
November 1977	Magnetic Video, first company to provide theatrical motion pictures on home video.
December 1977	George Atkinson in LA or Arthur Morowitz in NYC launch the first video rental store.
September 1979	George Atkinson renames store chain "The Video Station" and begins franchising stores.
November 1979	Columbia Pictures enters the home video market, releasing 20 films.
1980–1989	
November 1981	The Video Software Dealers Association (VSDA) is formed as a trade association for video retailers.
1981	Tower Records begins testing video rentals.
March 1982	Magnetic Video changes its name to 20th Century Fox Video.
Summer 1982	First major theatrical title sold directly to consumers: *Star Trek II: The Wrath of Khan*.
March 1982	Legislation introduced in US Senate giving copyright holders exclusive right to authorize the rental of prerecorded videos.
October 1983	Video stores around the country close down for several hours on this Friday to draw attention to threats to the public's right to rent videos, including legislation before the Congress to exempt videos from the First Sale Doctrine.
1983	VCRs are in less than 10% of U.S. TV households.
January 1984	In *Sony Corp. v. Universal City Studios, Inc.*, US Supreme Court affirms consumers right to videotape television programs for "time-shifting" purposes.
February 1984	Reversing previous course of legislation, Congress affirms consumer's right to rent prerecorded videos from a video store.
June 1985	First video with anti-copying technology: *The Cotton Club*.
October 1985	Former Texas oilman David P. Cook opens the first Blockbuster Videos store, in Dallas, Texas.
1986	Combined video rentals ($3.37 billion) and sales ($1.01 billion) eclipsed box office revenues ($3.78 billion) for first time.
1988	Rentrak Corporation pioneers revenue sharing for video rentals.

Exhibit 2 (cont)

1990–1999	
March 3, 1995	The Lion King is released on home video. It sells 32 million copies on VHS and DVD over the years, making it the best-selling video of all time.
December 1995	Competing consortiums seeking to develop an optical disc format for motion pictures announce a compromise format, the digital versatile disc (DVD).
March 1997	DVD is introduced in the U.S. The initial batch of titles includes Bonnie & Clyde, The Mask, and Twister. The DVD player soon becomes the most rapidly adopted consumer electronics product in history.
1998	Direct revenue-sharing between motion picture studios and major video retailers is implemented.
April 1998	Netflix launches the world's first online DVD rental service, offering more than 900 titles.
November 1998	Amazon.com opens its virtual video store, with more than 60,000 theatrical and general-interest videos and more than 2,000 DVDs.
April 1999	Titanic is the first motion picture DVD to ship one million units.
December 1999	Netflix introduces online DVD rental using a subscription model.
1999	Amazon.com is ranked as the number one online retailer of video and DVD, a position that it retains to this day.
2000–Present	
2000	Video sell-through revenue totals $8.6 billion, surpassing theatrical box office ($7.7 billion) for the first time.
February 2002	MGM becomes the first major studio to permit its movies to be made available online on a pay-per-view basis, through CinemaNow and Intertainer (available both as downloads and streams).
November 2002	MovieLink launches its Internet video-on-demand service.
February 2003	Netflix surpasses 1 million subscribers.
March 2003	DVD rental revenues exceeded VHS rental revenues for first time.
May 2004	McDonald's launches "Redbox" DVD rental kiosks, offering $1 per night rentals, at its restaurants in the Denver area.
August 2004	Blockbuster launches its online DVD rental service, "Blockbuster Online."
April 2006	Toshiba begins selling the first high-definition DVD players in the U.S.
June 2006	The first Blu-Ray high-definition discs are issued.
July 2006	CinemaNow launches the first "download to burn DVD" service for major theatrical motion pictures.
December 2006	Following a liquidation sale, Tower Records & Video ceases operations.

Endotes

1. Jack Valenti, Testimony at 1982 House Hearing on Home Recording of Copyrighted Works.

2. Eric Savitz, "Netflix: Movie Studios Pose Greatest Threat," www.seekingalpha.com, May 13, 2009.

3. David Backus and Luís Cabral, "Betamax and VHS," NYU Stern Mini-Case, Revised August 2002.

4. Datamonitor, *Blockbuster* Company Profile, April 2009.

5. Julie Holland Mortimer, "Vertical Contracts in the Video Rental Industry," Harvard University, 2006.

6. Daniel Kadlec, Andrew Keith, and Aixa M. Pascual, "How Blockbuster Changed The Rules," *Time Magazine*, August 03, 1998.

7. Thomas K. Arnold, "Independent Video Stores Struggling," *Video Store magazine*, December 23, 1998.

8. "Blockbuster Settles Fight With Netflix," *Reuters*, June 28, 2007.

9. www.netflix.com

10. www.hackingnetflix.com

11. Sarah Hale, "Blockbuster to settle lawsuit over late fees," *The Los Angeles Times*, June 6, 2001.

12. Jill Kipnis, "NJ Sues Blockbuster Over Late Fees Policy," *BillboardBiz*, February 18 2005.

13. Daniel A. Begun, "The Future of Netflix is All About Streaming," hothardware.com, February 20, 2009.

14. Yahoo! Finance.

15. Stephen Kersey, "Blockbuster Resolves Popcorn Lawsuit," May 19, 2009.

16. Brooks Barnes, "Movie Studios See a Threat in Growth of Redbox," *The New York Times*, September 7, 2009.

17. Chris Tribbey, "Redbox Sues Universal Over Rental Terms," 13 October 2008.

18. The Entertainment Merchant Association (US), Annual Report, 2009.