Movielink™

Downloadable Movies are Here

May 31, 2006

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BEM 106 – Competitive Strategy
Professor R. Preston McAfee
Spring 2006

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Executive Summary

Movielink faces several challenges as it pioneers the emerging market of downloadable movies. One primary concern is its limited differentiation from other movie download vendors in terms of quality and selection. To remedy this situation, Movielink should pursue a strategy of content differentiation through the signing of exclusive distribution rights with movie studios. This move would allow Movielink to consolidate its position as the vanguard vendor of major feature films, while leaving independent films to its rivals. Exclusive distribution rights would also present a barrier to potential entrants to the movie download industry. Movielink's unique status as a joint venture of five major movie studios is instrumental to its acquisition of exclusive movie content.

Another challenge is opposition from the three largest movie studios not currently invested in Movielink (Fox, Buena Vista, and Dreamworks SKG). They may be reluctant to grant exclusive distribution rights to Movielink, thereby stifling Movielink's consolidation strategy, and they may even invest in an alternate movie download firm. In order to align incentives, Movielink and its parent studios should offer these holdouts a share of the ownership, so that Movielink's owners would encompass a majority of the movie market. This will give Movielink and its parent companies a strong market position.

Finally, Movielink should compensate for the value disparity between movie downloads and DVDs by decreasing its prices to 30 percent lower than corresponding DVD prices. Such a decrease in price would substantially improve the appeal of downloadable movies as well as silence the chorus of critics who have ridiculed the high price of movie downloads, which are currently comparable to DVD prices.

Introduction

Movielink is a joint venture of MGM, Paramount, Sony Pictures, Universal and Warner Bros. Studios (See Appendix A: Market Shares of Major Movie Studios). It offers movies that can be downloaded for rent or for purchase. A rented movie can be stored for up to 30 days before activation, and can be played for a 24-hour period once activated. Purchased movies can be activated on up to three PCs and can be played at any time on those three PCs. The company is currently considering a number of other delivery methods.

Its primary opponent is CinemaNow, an independent firm that has also recently entered the market. The two firms are currently similar (although not identical) in terms of selection, pricing, and delivery. The industry itself is very young, with the purchasable movies coming about as recently as April of 2006.

Strengths

Movielink has the major advantage of being the largest movie download service that is currently online. Also, since it is directly owned by five major movie studios, it can potentially get exclusive content fairly easily and at a reasonable cost. Many other

studios license their content to Movielink, which allows them to have a very reasonable library.

Weaknesses

Unfortunately, the concept of "downloadable movies" is currently treated with some skepticism, and furthermore the waters are untested. Specifically, the threat of piracy looms and the digital protection that is currently used has its flaws (See Appendix B: Digital Rights Management). Since an increase in downloaded movies might cause a decrease in DVD sales, Movielink needs to be diplomatic and convince the studios that it is in their best interests to give them better prices and options. As it is, many home consumers prefer the DVD anyway. Most of Movielink's rivals are fairly similar, and there is little differentiation.

Opportunities

Although downloadable movies are not currently a very lucrative industry, it can be expected to grow very quickly in the near future. As broadband becomes available to more of America, downloaded movies will soon become very convenient. Other technologies will eventually emerge that will allow the downloaded content to be played directly on the television. It may be possible to synergize with a product like the Xbox 360 to increase demand for both the Xbox and Movielink; such opportunities may be very valuable.

Different strategies need to be explored, and pricing in particular needs to be addressed. Usually, the internet only has space for one or two big firms in a mature industry: Google is the major search provider, eBay is the major source for auctions, and Movielink (being larger than its competitors) has a good chance to become the major source for downloadable movies.

Threats

The industry is still very young, and even if Movielink secures a dominant position now it may still be superseded by a powerful entrant backed by a name like Apple or Google. Also, many feel that prices currently are too high.

Competition from related companies such as NetFlix may also pose an issue. Finally, the alternative of simply downloading the movie using a peer-to-peer network must also be considered.

Industry Analysis

New entry into the downloadable movie industry is limited; many of the big studios (with the large exception of Twentieth Century Fox) are aligned with an existing firm[i], leaving a smaller content market for a new firm to exploit. The established firms' hold on their content thus represents a barrier to entry. While it is true that smaller studios could use the internet as a means of distributing their own content, it won't overlap with the content currently being sold by the industry, making it distinct from the "hit-and-run" competition often seen in airlines. In fact, given the moderate degree of market power held by the existing firms and the relative lack of bargaining power for the

smaller studios, these new entrants might find it to their advantage to license their content to an existing firm rather than trying to handle the fixed costs and responsibilities themselves.

In the past, half of the customers to movie download websites have been younger than 35, and about 80 percent have been male. They are also typically heavy renters, although as time goes on analysts predict movie downloads will capture a more mainstream market.[ii] Each individual buyer is quite small compared to the download service, meaning that the firm can effectively dictate price, at least within the limits allowed by its competitors. While buyers can switch services (e.g., from Movielink to CinemaNow), the content served by different firms does not necessarily overlap, making them less-than-perfect substitutes. In the case of a movie only offered by a single firm, the only alternatives available to the buyer are the corresponding DVD or piracy. Consequently, buyers have little bargaining power.

Suppliers, which in this case are considered to be movie studios, have considerably more bargaining power than buyers, primarily because there exists a fixed content market that the studios control and the downloadable movie industry needs. Constituent studios (e.g., Paramount within Movielink) have bargaining power within their firms[iii], as would any major shareholder. But since these firms have an interest in Movielink succeeding, their bargaining power will probably not erode profits. External suppliers (e.g., Fox) also have bargaining power, since they could, conceivably, grant exclusive access to a Movielink competitor and leave them at a disadvantage. The threat of such action could give Fox leverage in negotiating prices for its content.

There are many strong substitutes for downloadable movies, but the profits from these substitutes still end up going to the studios themselves. These include DVDs and to a lesser extent pay-per-view and television movies (which may garner profits on commercials). Substitutes are also present in downloadable TV shows, television itself, and more traditional media, but the effects of these are relatively weak because the content is fairly distinct from movies. Finally, piracy is another substitute, but given the success of other downloadable media (e.g., iTunes[iv]), it doesn't seem to be a crippling condition.

The downloadable movie industry is currently in its nascent stages, so it's not exactly clear how rivalrous it will be, or even how rivalrous it currently is. That said, one can look at the current state of the industry and make a few conjectures about where it might be headed. One possible equilibrium would be a single conglomerate, possibly Movielink, gaining exclusive distributive access to most or all studio material. Such a firm would be monopolistic, so rivalry would be low and profit margins high. Another scenario would be an oligopoly, with the studios breaking up into competing conglomerates (e.g., Movielink, CinemaNow, and 20th Century Fox), all serving exclusive content. Since the product is somewhat differentiated (that is, they aren't selling the same movies), there wouldn't be so much rivalry, although customers might be willing to switch services if one firm's prices rise too highly. Finally, there could also be a two-tiered market, wherein a few giants like Movielink might have a sizable amount of exclusive content, with many smaller studios selling their content to the giants. While exclusive content would remain non-rivalrous, the non-exclusive content would be quite open to rivalry and price competition. Thus, depending on its ultimate configuration, the industry could assume varying degrees of rivalry.

One of the clearest complements for the industry is broadband internet access; the more people who have it, the larger the pool of potential users. Digital soundtrack downloads (e.g., Walk the Line) could cross-promote movie downloads, as well. Also, deals like Movielink's partnership with the Xbox 360 could buttress its efforts at market penetration; there's no reason why similar deals couldn't be secured with other next-generation gaming consoles.

Competitors

CinemaNow

CinemaNow, Inc. poses the most direct competition to Movielink. On the surface, both services are nearly identical. Both companies offer movie rentals and purchases for similar prices, from $4 to $5 for new rentals and $10 to $25 for purchases. The nature of distribution, DRM, and movie quality is nearly indistinguishable to customers (CinemaNow previously required an internet connection to watch its movies even after they were downloaded, but no longer does). Although the two services are similar in many ways, CinemaNow differs on three main points: company structure, purchase selection, and rental selection.

CinemaNow is a privately owned company with major investments from Blockbuster, Microsoft, and Lionsgate, compared to Movielink's status as a joint venture of five major studios. Consequently, CinemaNow does not have the same level of connections with studios that Movielink enjoys. Without the direct backing of major studios, CinemaNow is at a disadvantage when it comes to acquiring licenses for popular films, especially from the parent studios of Movielink. Currently, movie licenses from studios are non-exclusive, so supply limitations are not yet apparent, but this may change in the future.

CinemaNow's purchase selection for new releases is far more limited than Movielink's. CinemaNow sells only movies from Sony, MGM, and Lionsgate, and lacks purchasable content from Warner Brothers, Universal, Paramount, and Fox[v], all of which have download-to-own to deals with Movielink. This represents a clear advantage for Movielink in the realm of movie purchases. However, the rental selection is a vastly different case.

CinemaNow offers rentals on more than 7,500 featured films, shorts, and music videos while Movielink offers about 1,400 rental films. However, much of CinemaNow's movies are B-movies and X-rated videos, and the difference in selection among new releases is minimal. The difference in rental selection leads to a modicum of differentiation, as CinemaNow provides a greater selection of independent and obscure films compared to Movielinks relatively focused selection of large studio, feature films. Since creative content is highly differentiated (a particular movie is usually a poor substitute for any other movie), the offering of independent, obscure, and X-rated films from CinemaNow does not compete with Movielink's collection of movies. Since independent and X-rated films are not within its expertise, Movielink should not expand its selection to cover the plethora of obscure films offered by CinemaNow.

The current differences between Movielink and CinemaNow suggest a differentiation strategy based on content. Movielink should focus on providing

downloads of major studio films while leaving independent films to CinemaNow. Content differentiation between Movielink and CinemaNow would make an accommodation strategy feasible. One way to force CinemaNow to comply with this strategy is by obtaining exclusive licenses that prevent the studio from licensing the film to other distributors. However, CinemaNow may resist this tactic because many other firms, such as MovieFlix, already specialize in independent films. Another issue is the legality of exclusive licenses.

NetFlix

NetFlix is a large, internet movie-rental company currently servicing about 4 million subscribers. Although NetFlix is currently not in downloading market, it is watching the medium closely and has stated its intent to enter once content is available and the technology is ready. NetFlix will only compete in the rental aspect and not in purchase.

The means of delivery for NetFlix differs from that of Movielink in two key aspects: first, NetFlix subscribers pay one monthly fee, whereas Movielink's customers pay a fee for every movie downloaded. Second, whereas movies downloaded from Movielink can only be played on a limited number of computers, NetFlix is waiting for technology that will immediately transmit the media from the computer to the television, where the home consumer presumably wants to watch it. The monthly subscription model will need to change somewhat to accommodate downloadable movies. Currently, NetFlix can expect to rent out a small number of movies to each paying subscriber per month. With instantly downloadable content, a consumer can watch as many movies as desired for the same flat monthly rate. Probably, their pricing scheme will have to change to accommodate this possibility, but to do so in the conventional manner (charging per movie downloaded) would destroy the uniqueness of NetFlix.

On the plus side, Movielink has a better relationship with its suppliers, being owned by several movie studios. If NetFlix were to pose a severe threat, then the studios could potentially raise their subscription costs to NetFlix (although this may raise anti-trust issues). On the other hand, if NetFlix were to capture more regular customers, this would eventually benefit the movie studios, too, which would make money from subscription fees.

For the moment, NetFlix is still waiting. When it does make its move, its model will probably be differentiated from Movielink enough so that customers would prefer one model or another. Finally, Movielink will probably continue to claim the downloadable movies segment as their own, leaving rentals open to NetFlix.

However, the success of NetFlix is worth emulating. A more detailed analysis of the company's model and its distinctly online advantages can be found at Appendix C: The NetFlix Model.

New Entrants

To enter into the industry of downloadable movies, a firm needs only to establish a website and sign contracts with a few major movie studios. If the business proves to be profitable, many firms will consider entering in during the growth phase. The most dangerous entrants would be those that could quickly and efficiently penetrate the market. Movielink should watch for entrants backed by large names and whose existing

products would synergize with movie downloads. One such example is Apple leveraging its existing and successful iTunes infrastructure. In fact, it seems that Apple already has some plans to do so.[vi]

To deal with this threat, Movielink should seek to establish its position in the market and create barriers to entry. To accomplish the former takes time and effort, but it may help if prices are cut so that more customers will be attracted to Movielink (although this may only prompt entry if other firms can do likewise). Barriers to entry can be created by establishing exclusive contracts or by aligning interests with Fox, and details on this can be found under the Strategy Recommendations. Movielink has a competitive advantage in that its suppliers are its owners, but this is not absolute. It may possibly be in the best interests of the movie studios to license their content through more popular venues such as iTunes if such a move would greatly increase the appeal and demand for movie downloads. On the other hand, successful management of Movielink will translate into reduced bargaining power for Apple, which would then find itself with reduced profits and incentive to expand into downloadable movies.

Strategy Recommendations

In the short term, Movielink needs to increase the appeal of its content. Cutting prices and taking advantage of partnerships with emerging technologies is a good first step. In the long term, Movielink would ideally be the sole digital distributor of major motion pictures, as consolidation (wherein Movielink acquires towering market share) is probably the industry's best hope for sustained profits. An offer of equity to holdout studios should be made, which would give Movielink dominating control of studio content. Finally, Movielink should attempt to gain exclusive access to their content to force the exit or differentiation of rival firms and to deter potential entrants.

Pricing and Emergent Technology

One of the chief concerns of downloaded movies is that the decrease in quality is not sufficiently compensated by the increase in convenience. Compared to DVDs, downloaded movies come with many more restrictions (for example, it cannot be played on the television easily) but are still priced equally, for fear that reducing prices would cannibalize existing DVD sales. To deal with this threat, Movielink should push to reduce prices and minimize the effect of restrictions with emergent technology such as the Xbox.

Roughly a third of the cost of a DVD movie goes into distribution costs, but the distribution costs for a downloaded movie amount to nickels. Being the first to announce a price cut would garner attention and publicity, and in the long run it would be more profitable than the current plan. Additionally, Movielink should look into alternative pricing plans. One innovation that can be done with digital media is a "try before you buy" plan – to upgrade a good rented film into a purchased one with a discount. Several customers have also expressed desire for a subscription plan similar to that of NetFlix, perhaps limiting the number of movies that can be watched per month.[vii] In addition, Movielink may also choose to allow the customer to burn the movie to a DVD when it is finished downloading. Doing so would bring the product closer in quality to the DVD equivalent, but even here, a price cut should be in order, as the distribution costs are still

cheaper. Unfortunately, these plans require the cooperation of the movie studios, which are in turn influenced by the DVD distributors. However, it is in the best interest of the studios to innovate and make downloadable movies popular and appealing.

Movielink may want to start with a fairly sharp price reduction (perhaps 30 percent) to capture more of the price-sensitive audience and especially to attract those who might simply download the movie illegally. In this way, Movielink could attempt to grow the market but still save money on distribution costs. A price reduction would also inhibit intervention by the Department of Justice if exclusive contracts are pursued.

The other side of the coin is that Movielink should seek out partnerships and technology that would increase the convenience and quality of its product. The Xbox 360 complements Movielink very well in this regard. Microsoft gains an additional feature to its premier console, and Movielink finds a way into the homes of many households. Moreover, this feature requires the Media Center Edition PC, so it supports Microsoft's own internal plan of complements.[viii] It is also generally more difficult to frustrate copyright protection on a console, because one cannot easily download and execute a program to get around the protection.

Other such synergies should be carefully watched for, and will contribute greatly to Movielink's growth. Unfortunately, details must be handled on a case-by-case basis.

Holdouts

Buena Vista, Twentieth Century Fox, and DreamWorks SKG have not yet signed on with Movielink. With about 30 percent market share, these three studios are large enough to rival Movielink simply with their own content. While none of these large studios has yet declared any intentions of creating a competitor to Movielink, if Movielink hopes to sustain profits in the market, it needs a strategy for dealing with them.

One way of gaining their content could be offering them ownership in Movielink, similar to that of the "equity partners" currently sitting on Movielink's board. In this situation, the holdout firms would stand to profit from their involvement with Movielink, aligning their incentives with the good of the company. While Movielink would have to yield some of its ownership, any other deal with these studios would have probably involved royalties, anyway, making the downside potential fairly low. With this approach, Movielink would avoid having to pay a large premium for their content and could head off the possibility of a strong third-party in the market. This strategy would seem to be the most painless way of configuring the market to best capitalize on the profitability of downloadable movies.

One alternative, less preferable strategy would be continuing to acquire exclusive licenses, wherever possible, to copyrighted content, particularly targeting the holdouts and their rather large market share. As it stands now, they sell their content to Movielink on a strictly non-exclusive basis. If Movielink could convert this contract—through cash incentives or otherwise—to an exclusive content-sharing arrangement, Movielink would have an exclusive hold on much of the industry's content. With so much of the market already theirs, Movielink could reduce supplier bargaining power and coerce smaller studios into cooperating.

If the holdouts are uninterested, a less attractive strategy is possible. Movielink could go to smaller firms (i.e., firms with much smaller market share than Fox or Buena

Vista), where its cash or other incentives would presumably be larger relative to the size of the target firm. It would probably be easier to deal with these smaller firms, given their lack of bargaining power, though not as productive for market share. If enough of these firms can be persuaded to sign on, the holdouts, now small compared to Movielink, could be persuaded to do so, as well. Of course, if Movielink succeeds in merging or vanquishing its rivals, such an arrangement could prove to be moot.

The one situation Movielink wants to avoid—at all costs—is an independent firm dominated by exclusive Fox or Buena Vista content. At roughly 14 percent market share each, these firms alone have enough weight to challenge Movielink. If the "empire building" strategy is performed too aggressively, the holdouts might be provoked into forming a distribution arm for their own content. If this occurs, the industry could rapidly degenerate into a tight oligopoly dominated by two firms.

Consolidation

As mentioned in the six forces analysis, there are a number of visions that could one day describe the downloadable movie industry. The vision of a single, dominant firm (one would assume Movielink, given its greater size[ix]) controlling most of the industry's content would be the most favorable outcome for the company's shareholders, since it most closely approximates a monopoly.

Advantages:

1. Collective action avoids costly price competition and rivalry. In contrast to many firms competing on price over the same content, Movielink could more or less dictate pricing.
2. Lack of other firms holds down marketing costs; with only one firm in the market, Movielink's need to market against other firms is diminished.
3. A larger organization can take advantage of economies of scale, e.g., bulk bandwidth discounts; if Movielink has a large piece of the market, its economy of scale will be greater than, say, three firms sharing that piece.
4. A single firm further reduces the buyer's bargaining power, since the only choice they will have is between Movielink and no downloadable movies.
5. Movielink could better organize and promote complementary goods, like next-generation video game consoles.
6. One organization—speaking for the entire industry—would be better-suited for dealing with the likes of Microsoft (particularly the Xbox 360, which will have Movielink capabilities).

The real question here is how Movielink can structure itself to bring about such a configuration. Not all paths are equal—signing one studio before another could ease further signings.

One possible route would be a merger with CinemaNow, Movielink's chief competitor. With the only other major firm out of the way, even Movielink's non-exclusive content (e.g., 20th Century Fox) would effectively be exclusive, for lack of a distributive competitor. However, a merger strategy might prompt entry by another firm, and barriers to entry must be made such as with exclusive licenses.

Another side of the same coin would be aggressive price competition against CinemaNow, so as to drive it out of business. This would leave Movielink as the only major firm in the industry. Depending on acquisition costs, advertising, and pricing, this strategy could be more or less costly than buying CinemaNow outright. If negative advertising becomes involved, it could also harm Movielink's image beyond the obvious financial damage. Given the differentiation in content, however, it is unlikely that CinemaNow would be driven out of business by price competition. A more plausible strategy is to deny CinemaNow content with mechanisms such as exclusive licenses to force them to differentiate.

Exclusive Licenses

Exclusive licenses ensure that only one vendor receives the rights to distribute a movie. While they could be lucrative to movie download firms, they may be perceived as a form of collusion and in violation of anti-trust laws. The Department of Justice began an investigation of Movielink in 2001 on suspicion of violating antitrust laws but dropped its case in June, 2004 when it concluded that "the evidence did not support a finding that Movielink had adversely affected competition through increased prices or decreased output."[x] The investigation examined whether the joint venture had facilitated collusion among Movielink's parent studios to limit licensing to third party online movie vendors. Currently, Movielink's licenses to rent and sell movies over the internet are on a non-exclusive basis[xi], a policy that may have convinced the DOJ to drop its investigation. If Movielink were to pursue exclusive licenses, it may spark a new investigation. However, an anti-trust case is not inevitable: DVDs present a major substitute for movie downloads and will likely prevent Movielink from gaining monopoly power through the use of exclusive licenses. The lack of price-setting power may persuade the DOJ that exclusive licenses will not harm the industry in terms of price or output. In this case, exclusive licenses would be very appealing to both Movielink and CinemaNow. Since prices for movie downloads are set by the licensor studios[xii], a movie download firm can only increase its revenue from a particular movie by increasing the quantity sold or rented. The signing of exclusive licenses would be the strongest method of increasing the quantity sold because any customers seeking a specific movie would have to purchase it from a single website, instead of having the option of multiple vendors. The profitability of exclusive licenses is reinforced by the strong differentiation between different movies (each movie is unique) and the near absence of differentiation between copies of the same movie (a copy of a movie from CinemaNow is essentially the same as a copy from Movielink, in both quality and content). If exclusive licenses are accepted by the DOJ, Movielink could use them to acquire exclusive distribution rights to all major film releases and force CinemaNow into the independent film market.

Movielink's connection to five major movie studios puts it in a strong position to secure large portions of the market share through exclusive licenses. While studios would generally demand extensive compensation to sign an exclusive license, Movielink could readily obtain exclusive distribution rights from its parent studios because its profits directly benefit its owners. Since the five parent studios account for about 50% of box office sales[xiii], these licenses would concentrate a majority movie content on Movielink's website and leave CinemaNow with a limited movie selection. If Movielink could also secure exclusive licenses from Fox and Disney by offering extra incentives,

CinemaNow would be reduced to selling small studio and independent films. Movielink would then dominate the major feature film market, having secured exclusive rights to all major movies.

It would be difficult for CinemaNow or another private firm to pursue the same strategy of monopolizing licenses because it lacks the same studio connections as Movielink. For each major studio, a private firm would have to offer considerable incentives to obtain an exclusive license since an exclusive license with a single distributor would be less profitable for the studio than non-exclusive licenses with many distributors. The additional costs faced by CinemaNow and other movie download firms make them unlikely candidates to dominate the downloadable movie industry.

An alternative outcome of exclusive licenses is an allocation of distribution rights among multiple, most likely two, firms. While Movielink would gain exclusive rights from its parent studios, CinemaNow or another movie vendor would gain exclusive rights from the other major studios. Studios such as Fox and Disney may realize that a single, dominant firm would have stronger bargaining power when negotiating licenses. In view of this potential problem, major studios not invested in Movielink would either sign non-exclusive licenses with both Movielink and its competitors, or support CinemaNow by giving it exclusive distribution rights. The danger posed by a monopolistic Movielink could give CinemaNow the leverage to demand exclusive licenses from studios which are opposed to a single dominant online distributor. The result of these events would be two firms with completely differentiated content: Movielink would have only content from its parent studios, and CinemaNow would have content from the other major studios. This scenario is not as favorable as the first outcome, in which Movielink dominates the big-budget movie market, but is better than the present situation because of industry differentiation. To increase the feasibility of the first outcome, Movielink should offer guarantees of fair deals to Fox and Disney or offer them equity in order to secure exclusive licenses.

Also, exclusive licenses would create a barrier to entry. Companies planning to enter the movie download business will have limited access to content if the incumbent firms have already obtained exclusive distribution rights for most major films. Without the ability to sell mainstream content, an entrant could not reproduce the profitability of the firms already providing movie downloads, thus discouraging entry. This strategy may be the only way to keep out popular media purveyors such as Apple, which could use its existing popularity among music customers to bolster an entry into the downloadable movies market.

By making movie licenses exclusive, Movielink can deny competitors content and force the movie download industry to differentiate. Exclusive distribution rights would also build a barrier to entry. The overall benefit from exclusive licenses to the movie download industry warrants efforts to support the legality of such licenses.

Final Thoughts

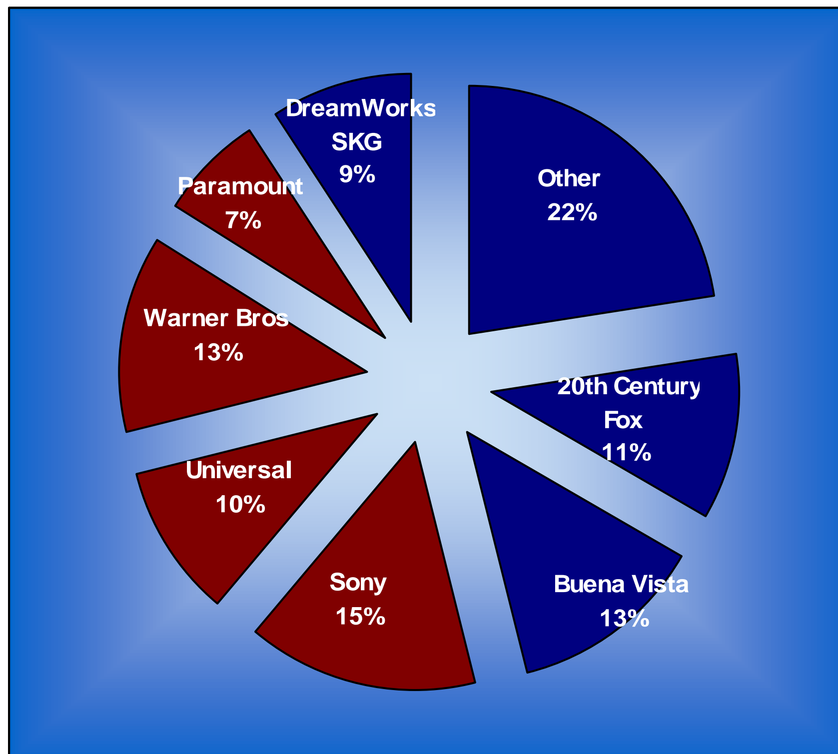
The immediate profitability of downloadable movies is currently in question. The largest players such as Apple and NetFlix are biding their time, and the initial forays of Movielink and CinemaNow into this market have met with limited success. Although four of the seven largest studios have ownership in Movielink, there is still potential for the remaining three to unite under an opposing banner. The downloaded movies themselves have been overpriced and heavily restricted. Even if "Downloadable Movies are Here," there is still something lacking, and it is not clear whether Movielink's current strategy will lead to increasing profits.

What *is* clear is that the industry has an extremely bright future. Broadband is on the rise and new technologies (not just the Xbox) will emerge that can simultaneously deter piracy and increase convenience, making downloadable movies more palatable for the studio executive and more profitable for Movielink. It is not unrealistic to expect that movie downloads will replace DVDs within the next twenty years. For this reason, Movielink needs to act diplomatically to lower prices and increase the quality of its product. It must market aggressively and prove that it can rival the likes of iTunes or Google Video so that it can more easily secure exclusive contracts and the support of other studios. Strategically speaking, this means that Movielink should be prepared to invest heavily and absorb some losses now so that it may reap sustained profits as the sole distributor in the future.

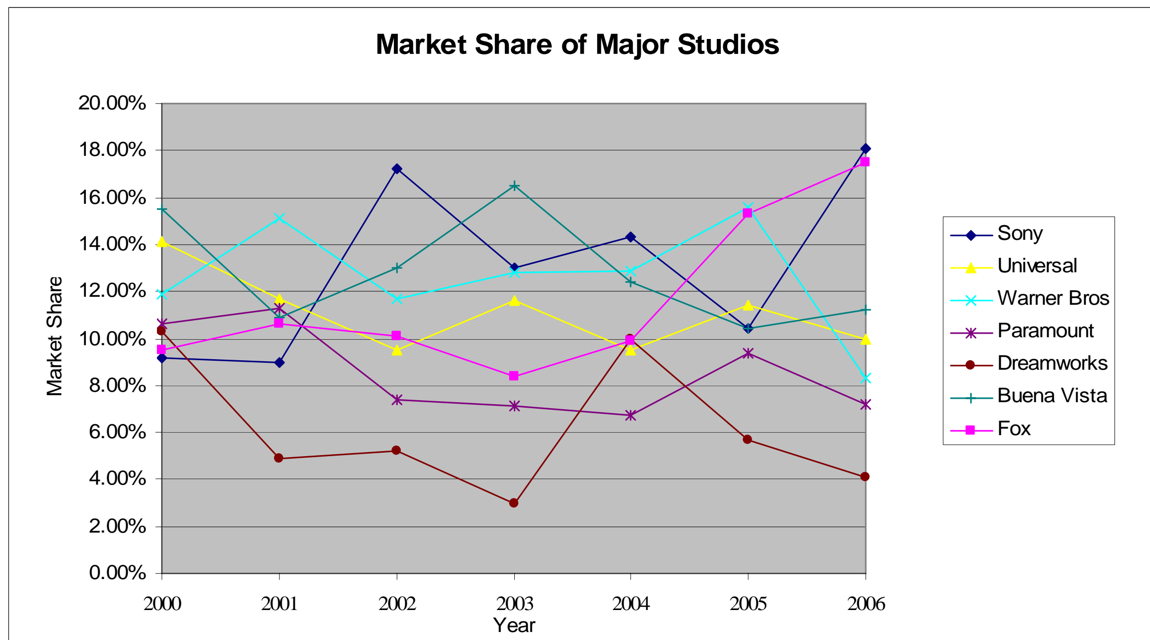
Appendix A: Market Shares of Major Movie Studios

Major Studio Market Shares			
Studio	*Total Gross*	***Market Share***	*Affiliation*
Sony	3250.7	15.2%	Movielink
Warner Bros.	2708.7	12.6%	Movielink
Buena Vista	2703.6	12.6%	
20th Century Fox	2338	10.9%	
Universal	2128.5	9.9%	Movielink
DreamWorks SKG	1979.8	9.2%	
Paramount	1494.3	7.0%	Movielink
New Line	977.6	4.6%	
Lions Gate	757.9	3.5%	CinemaNow
MGM/UA	397.8	1.9%	Movielink
Other	2694.1	12.6%	
Total	21431		

Total Gross is in millions, and is over 2004 to May 2006. [xiv]



Red companies have some ownership in Movielink. Blue companies do not. "Other" category now includes all studios smaller than Paramount.



Appendix B: Digital Rights Management

If piracy or misuse become serious problems in the downloadable movie industry, finding an effective copyright protection mechanism may become necessary. There has been much progress in Digital Rights Management (DRM) in recent years, and Movielink currently employs both Microsoft's and RealNetworks's versions to protect its content[xv].

In trying to fight piracy, however, Movielink needs to bear in mind that it may not be desirable to eliminate it completely. Take pollution, for instance: when anti-pollution legislation first took effect, the marginal cost of reducing pollution by, say, another one percent was quite low. But as the environment gets cleaner, it becomes harder and harder to purify another one percent. Indeed, at some point, the marginal cost of reducing pollution exceeds the marginal benefit. So even if it were possible to clean the environment to 100 percent purity, society would be worse off for having done so.

This lesson is instructive for dealing with the threat piracy poses to the industry. If the current DRM systems fail to curb it, Movielink might be tempted to resort to draconian measures to reduce it. In so doing, however, its user base may be so alienated that the firm loses more money to customer antipathy than it does to pirates. Sony BMG's rootkit scandal illustrates this perfectly: the public backlash due to its copyright protection probably cost the company far more than any piracy it prevented[xvi].

That said, recent experience suggests that even small barriers to piracy can be effective in dealing with the problem. Even though programs exist to bypass Apple's FairPlay, for example, the iTunes online music store has been incredibly successful, having sold well over a billion songs[xvii]. If Movielink can make piracy sufficiently difficult—rather than trying to make it impossible—many erstwhile pirates may find it preferable to simply buy the content rather than find a way around the copy protection.

Appendix C: The NetFlix Model

Out of all the assorted attempts to penetrate the market for online movies, NetFlix stands out as being one of the only successes to date. The monthly subscription model that NetFlix uses has proven to be popular with customers, and the firm turns a large gross profit from its success. It then aggressively reinvests a full 20 percent of its revenue (two thirds of its gross profit) into marketing and advertising in order to pursue its goal of capturing 20 million subscribers (more than four times the current number) within seven years. The income statement is reproduced below.[xviii]

Despite its success, NetFlix does have some problems. It suffers from a high attrition rate, because customers who have run out of movies that they want to watch will simply unsubscribe to save money. Other issues include costs of postage and (tellingly) "Alternative Video Delivery," an issue that is addressed in the second text page of the 2005 Annual Report. The official NetFlix opinion is that "We also anticipate the emergence of a significant downloading market … We are absolutely focused on positioning Netflix to lead this market… The winners in downloading will be the companies that provide the best content and the best consumer experience, and that's what we do best." For this reason, NetFlix must be considered a strong potential competitor in the downloading market.

Compared to a traditional rental store such as Blockbuster, NetFlix spends much more on marketing and much less on general and administrative operating expenses. This highlights the primary advantages of internet sales: there is much less overhead because there is no store to keep. This allows NetFlix customers to get more movies for the dollar, since more of their money passes on to the studios and less to overhead costs. On the other hand, because NetFlix is not a local store, it needs to be more creative and aggressive in marketing in order to find customers.

Percent of Revenue Spent On …	NetFlix	Blockbuster
Advertising	20%	4%
General & Administrative	4%	57%
Subscription Costs	57%	30%
Total rental revenue	$682 million	$3.25 billion

NetFlix's Consolidated Statement of Income

	Year ended December 31,		
	2003	2004	2005
Revenues	$270,410	$500,611	$682,213
Cost of revenues:			
Subscription	147,736	273,401	393,788
Fulfillment expenses*	31,274	56,609	70,762
Total cost of revenues.	179,010	330,010	464,550
Gross profit	91,400	170,601	217,663
Operating expenses:			
Technology and development*	17,884	22,906	30,942
Marketing*	49,949	98,027	141,997
General and administrative*	9,585	16,287	29,395
Stock-based compensation	10,719	16,587	14,327
Gain on disposal of DVDs	(1,209)	(2,560)	(1,987)
Total operating expenses	86,928	151,247	214,674
Operating income	4,472	19,354	2,989
Other income (expense):			
Interest and other income	2,457	2,592	5,753
Interest and other expense	(417)	(170)	(407)
Income before income taxes	6,512	21,776	8,335
Provision for (benefit from) income taxes	—	181	(33,692)
Net income	$ 6,512	$ 21,595	$ 42,027

Blockbuster's Consolidated Statement of Income (Partial)[xix]

	Year Ended December 31,		
	2005	2004	2003
Revenues:			
Base rental revenues	$3,520.3	$ 3,231.3	$3,253.5
PRP revenues	594.6	574.9	557.9
Extended viewing fee revenues	90.3	622.4	722.1
Total rental revenues	4,205.2	4,428.6	4,533.5
Merchandise sales	1,586.5	1,532.6	1,281.6
Other revenues	72.7	92.0	96.6
	5,864.4	6,053.2	5,911.7
Cost of sales:			
Cost of rental revenues	1,411.9	1,250.7	1,362.1
Cost of merchandise sold	1,235.2	1,190.7	1,027.7
	2,647.1	2,441.4	2,389.8
Gross profit	3,217.3	3,611.8	3,521.9
Operating expenses:			
General and administrative	2,800.8	2,853.5	2,605.9
Advertising	255.3	257.4	179.4
Depreciation and intangible amortization	230.9	249.7	268.4
Impairment of goodwill and other long-lived assets	356.8	1,504.4	1,304.9
	3,643.8	4,865.0	4,358.6

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