

Redbox's machines take on Netflix's red envelopes

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(AP) -- With more subscribers than ever flocking to its DVD-by-mail service, Netflix Inc. is one of the few companies to prosper during the worst U.S. recession in 70 years. Yet Netflix CEO Reed Hastings still has something to worry about: an even cheaper DVD rental service run by one of his former lieutenants.

Once just an incongruous experiment amid the burgers and fries at McDonald's restaurants, Redbox has emerged as the largest operator of DVD-rental kiosks, with more than 15,400 vending machines set up to dispense \$1-per-day discs in supermarkets and discount stores.

With Redbox opening an average of one kiosk per hour to lure budget-conscious consumers, Hastings is concerned that this upstart might upstage [Netflix](#), whose cheapest mail-order plan costs \$5 for two movie rentals in a month.

"By the end of the year, kiosks will likely be our No. 1 competitor," Hastings said in a recent conference call. "There are already more kiosks in America than video stores."

The fight for DVD-rental loyalties figures to intensify as Netflix, Redbox, [Blockbuster](#) Inc. and others vie for the attention of frugal consumers looking for inexpensive home entertainment. According to research from PricewaterhouseCoopers, Americans last year spent less money buying DVDs and more on rentals from stores, kiosks and online services like Netflix. The trend is expected to continue this year.

Redbox began in 2002 as a way for McDonald's Corp. to expand beyond the burger business. A strategy group inside the company tested a few "automated retail" ideas, as it called them.

"Vending sounded so last-century," said Gregg Kaplan, who led Redbox from inception until April, when he became chief operating officer of its parent company, Coinstar Inc.

McDonald's also tried a machine that made fresh french fries and an 18-foot-wide automated convenience store that sold everything from toilet paper to fancy sandwiches. Only the DVD kiosk stuck.

The group running Redbox grew from operating 12 of the DVD machines to about 900 in three years. By the middle of 2005, Redbox was itching to expand beyond burger joints, and McDonald's agreed to let it seek out another partner.

Coinstar already had a national sales team placing machines that converted loose change into bills in supermarkets, drug stores and other retailers - relationships it could use to pave the way for Redbox kiosks, too. In 2005 and 2006, Bellevue, Wash.-based Coinstar invested \$37 million in Redbox and took majority ownership, and this year Coinstar bought out McDonald's and other investors for up to \$25 million.

Redbox, still based near McDonald's in Oakbrook Terrace, Ill., said last May it planned to go public, but the economy deteriorated and an IPO never materialized. Now DVD kiosks account for more than half of Coinstar's sales and profit. That profit more than doubled in the last quarter on sales that rose even more swiftly to \$154 million. (An undisclosed portion of that came from DVDXpress, a much smaller kiosk chain Coinstar also owns.)

Meanwhile, Netflix grew at a slower pace, with first-quarter revenue

rising 21 percent to \$394 million.

Mitch Lowe, Redbox's president, came to the company after six years with Netflix, where he was vice president of business development. While at Netflix, he managed one of the company's competitive advantages: a popular system that recommends lesser-known movies to subscribers based on ratings for films they've already watched. That helps Netflix's 10.3 million customers sift through 100,000 movie titles.

In contrast, Redbox machines carry about 700 discs with 200 titles, mainly recent releases, and rely instead on the \$1 nightly rate to encourage people to experiment. Four million people have swiped a card at one of the kiosks in the past month.

Another difference: Because Netflix pays postage twice for every DVD it rents out, it does best when customers choose ambitious subscription plans but are slow to watch and return movies. By comparison, Redbox's profits depend on it renting out each disc as many times as possible before demand for the movie peters out.

To that end, Redbox tracks rentals to predict the right mix of titles and the right number of copies for each location. It also lets customers go online and reserve a DVD in a specific kiosk, then pick it up in person. The \$1 price may be the initial draw, but most people end up paying to keep DVDs for two or three days.

If Redbox grows into a serious challenge to Netflix, it will have done what two much larger companies, Blockbuster and Wal-Mart Stores Inc., could not.

Both tried to match Netflix's DVD-by-mail success. Wal-Mart quit the business and gave all its customers to Netflix. Blockbuster still trails Netflix in DVDs by mail, and is also closing a growing number of

unprofitable stores.

Now Redbox's success has prompted Blockbuster to promise 10,000 DVD kiosks of its own in a deal with NCR Corp. The maker of ATMs and cash registers acquired the second-largest movie kiosk company, TNR Holdings Corp., in April.

Redbox kiosks also sell used DVDs for \$7, sometimes less than two weeks after they're available to rent, rather than the two or three months video stores usually wait. The practice irked some Hollywood studios - which may jeopardize the \$1-a-day rental model that helps make Redbox so attractive.

Last year, NBC Universal's DVD distribution arm, Universal Studios Home Entertainment, pressed Redbox to limit the number of Universal DVDs its kiosks could carry and to destroy used discs instead of selling them at cut-rate prices. When Redbox refused, Universal ordered its partners to stop selling DVDs to Redbox at wholesale prices. Redbox sued Universal for violating antitrust laws, among other claims.

The case is still underway and Redbox would not say what effect it might have on its DVD rental or resale prices. But Wedbush Morgan Securities analyst Michael Pachter bets that if Redbox loses the lawsuit, other studios could follow Universal's lead, pushing Redbox to either agree to restrictions or buy movies at retail prices, then raise rental rates.

Universal Studios Home Entertainment did not return a call for comment.

In the era of YouTube and Hulu, video iPods, Netflix's own streaming video service and devices that connect TVs to the Internet, storming an industry by way of supermarket vending machines seems very yesterday.

But while DVDs will someday disappear, for now the market dynamics still work for Redbox: almost 90 percent of U.S. homes have a DVD or Blu-Ray player, while only a sliver download movies to their computer or stream them from the Internet, said Russ Crupnick, an entertainment analyst for market researcher NPD Group.

Crupnick doesn't expect streaming services to fully catch on until the technology is built into more television sets. And since many people just invested in new flat-screen TVs, it will be years before they replace them.

"Digital options and physical options can coexist," said Crupnick.

"People think there's this balkanization - 'Once I get Netflix, I never go to Blockbuster. Once I go to Redbox, I don't need Netflix.' That's really not the way that it works in the world."

On the Net:

<http://www.redbox.com>

<http://www.netflix.com>

<http://www.blockbuster.com>

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