The Fall of a Giant

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Abstract

The dynamic capabilities view, one important theoretical perspective developed in the strategic management literature, was advanced to explain why firms succeed in dynamic environments (i.e. environments in which companies are exposed to various types of exogenous shocks). This view states that the answer lies with firm's ability to respond efficiently and effectively to major changes in their competitive landscape. This thesis aims to make a connection between the dynamic capabilities literature and a real life business situation, by presenting a teaching case and using the theory to analyze the events described. The Blockbuster Inc. case provides further evidence that the top management team's perception of opportunities and threats is essential in shaping the response that a firm gives them. The case also suggests that the timing of a firm's decisions is very important to succeed in dynamic environments and that a firm's market-orientation level also helps to determine its success in the marketplace. Furthermore, the case provides evidence that resource base changes occur frequently and in many forms in fast changing environments, and also stresses the importance of correctly performing these changes. Finally, the case demonstrates the importance of dynamic capabilities in fast changing environments and the dangers that companies may be exposed to by not having these capabilities.

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Introduction

The topic of dynamic capabilities has received a lot of attention since it was originally suggested (Teece, Pisano, & Shuen, 1997). The literature has not only grown in number, but it has also expanded away from its original strategic management field, to areas such as information management (e.g., El Sawy & Pavlou, 2008), operations management (e.g., Holweg & Pil, 2008) and marketing (e.g., Menguc & Auh, 2006).

All this attention is likely due to the fact that this view gives an answer to an increasingly important question in strategic management: how can firms achieve sustainable competitive advantage (SCA) over their competitors in changing environments? Several scholars have proposed theories that try to answer how to achieve SCA. Some say it can be done by choosing the right industry to compete in (Porter, 1980) or by how well a firm interacts with rivals (Shapiro, 1989), but none explicitly addresses how to achieve SCA when a company's environment constantly changes. The dynamic capabilities view states that it is a firm's ability to respond efficiently and effectively to exogenous shocks (D'Aveni, 1994; Eisenhardt & Martin, 2000) that determines its success.

A substantial amount of literature has been published regarding the dynamic capabilities view. These studies have assumed many forms, such as conceptual studies (Winter, 2003; Zollo & Winter, 2002), empirical studies (Galunic & Eisenhardt, 2001; King & Tucci, 2002), simulations (Lee, Lee & Rho, 2002; Zott, 2003) and methodological studies (Hahn & Doh, 2006). In this paper, I will be putting particular emphasis in a recently proposed definition of dynamic capabilities, which states that "a dynamic capability is the firm's potential to systematically solve problems, formed by its propensity to sense opportunities and threats, to make timely and market-oriented decisions, and to change its resource base" (Barreto, 2010).

In spite of all the previous research efforts, more practical evidence is required to illuminate how companies actually generate these adaptation competences, crucial for success and survival. Furthermore, it would be interesting to examine what happens to a

firm's performance if it fails to develop dynamic capabilities in a fast changing competitive environment.

This type of practical insight could be gained by examining a company's response to technological shocks. Does the top management team (TMT) evaluate correctly the impact that such a shock could have in their business? If the TMT decides to act, are they quick and accurate to address new market needs? What changes in the organization to address such challenges? So my research question is: are those four dimensions of the dynamic capabilities definition actually important when a firm is trying to cope with technological shocks?

An improved understanding about the nature of a firm's dynamic capabilities can be achieved via a teaching case focusing on a company that faced and responded to multiple exogenous shocks in the last decade, by examining the shocks, the firm's response and the outcomes of their choices. Blockbuster Inc. was the company chosen to study because in the beginning of the 2000s they were undisputed market leaders in the video rental industry and a series of technological shocks and other events put them out of business in less than a decade, making the endeavor of understanding what happened a very interesting one.

Next, I present a review of the relevant literature, the teaching case, a teaching note, a discussion section and, finally, a conclusion section.

Literature Review

Antecedents of the Dynamic Capabilities View

To understand the origin of the dynamic capabilities view (Teece, Pisano, & Shuen, 1997) one must first comprehend the theories that were advanced before such a view emerged, as many theories had already been advanced to explain how companies achieved sustainable competitive advantage (SCA).

One of the strategic paradigms advanced to explain creation of SCA was the competitive forces framework popularized by Michael Porter (Porter, 1980). This framework was built upon industrial organization economics (Mason, 1949; Bain, 1959), a field in economics that studies how firms organize themselves and how they compete. The theory proposes that to achieve SCA a firm must first choose an "attractive" industry to compete in (attractive in this context means an industry in which the competitive forces are low). Then the firm should choose a competitive strategy to position itself favorably relatively to their competitors, acquire the assets needed to perform the strategy and implement it. The main implication that follows from this theory is that the key factor to achieve SCA is the industry where a company operates in and not the differences created at a firm level.

A different theory proposed to explain how companies achieve SCA is the strategic conflict approach (Shapiro, 1989). This approach has its foundations in game theory, a field in economics that analyzes how individuals or firms compete, while taking into account the adversary's possible actions (Neumann & Morgenstern, 1944). This approach proposes that in order to create SCA a firm must try to influence its external environment in order to achieve economic profits. In other words, the company should make decisions that will influence their competitors in such a way that their own outcomes are optimized. These decisions can be investments in capacity (Dixit, 1980) or advertising (Schmalensee, 1983), as well as giving signals to the market through pricing decisions (Kreps & Wilson, 1982) or reputational effects (Ghemawat, 1991). From this theory's point of view, what will determine a company's ultimate success is how well they interact with their competitors.

Another perspective that tries to explain how organizations develop SCA is the resource-based view (RBV) of the firm (Barney, 1991). Earlier propositions of this theory can be traced back to the 1960s (Learned, Christensen, Andrews & Guth, 1969) with the recognition that a firm's success is related with the capability to create distinctive competences. This theory argues that what makes firms achieve SCA is its unique bundle of resources and capabilities, meaning that a company can create SCA if it uses the assets it controls and deploys them through its organizational processes to achieve a specific goal. Furthermore, to provide SCA resources and capabilities must be valuable, rare, costly to imitate and nonsubstitutable (Barney, 1991). From this theory it follows that firm success is achieved by creating, developing and deploying resources and capabilities inside the boundaries of a firm, in order to create SCA over competitors.

Origin of the Dynamic Capabilities Literature

All of the previously mentioned theories have of course some degree of validity, some more than others depending on the specific context that we are dealing with. Still, all of these accepted theories had one common limitation, they do not explicitly consider dynamic external environments (e.g. Priem & Butler, 2001). In reality, companies face changes in their environments every day (e.g. technological, regulatory, etc.) that impact their strategy and competitive positions and the previous theories do not take into account these events. This type of phenomenon assumes particular importance today because of the emergence of what some have termed high-velocity environments (Bourgeois & Eisenhardt, 1988), environments characterized by high levels of exogenous shocks and innovation (i.e. microcomputer industry), but also by additional research suggesting that competitive advantage is becoming harder to maintain through time in a wide set of industries (Wiggins & Ruefli, 2005), which suggests that major environmental shifts are occurring more often, in many settings and having a considerable impact on a firm's competitive position.

These developments help to explain why the dynamic capabilities theory had such a great acceptance among scholars. In face of these indicators it seemed imperative to develop a theory that explains how companies can develop SCA in changing environments. It is exactly what the dynamic capabilities view aims to do: to explain how firms can achieve and maintain SCA over time in changing environments (Eisenhardt & Martin, 2000). To do this, the dynamic capabilities view arises as an extension of the RBV, in the sense that it proposes that for a company to succeed in a changing environment it needs resources and capabilities that provide SCA but also the ability to reconfigure and adapt them to new market realities (Eisenhardt & Martin, 2000).

Evolution of the Concept

In the last decade there has been a lot of discussion regarding the dynamic capabilities (DCs) view, which is natural since it is a young and emerging body of theory.

The question of what was the DC's role in the organization was widely addressed. The general idea was that they were supposed to modify internal firm elements, but there was some discussion about which internal aspects of the firm the DCs were supposed to change. For instance, some scholars argued that DC's role was to change operating routines of the firm (Zollo & Winter, 2002) while others sustained that DCs were supposed to change specific resources and capabilities (Eisenhardt & Martin, 2000).

The adequate context in which dynamic capabilities are relevant was also widely discussed among researchers and was not a consensual matter. The initial proposition was that dynamic capabilities would require a fast changing environment to be relevant (Teece, Pisano, & Shuen, 1997). Later some scholars proposed that DCs would also be applicable not only to extremely dynamic environments but also to markets that experienced a moderate amount of change (Eisenhardt & Martin, 2000). In contrast, some scholars contended that DCs would also be relevant in stable markets, even though its usefulness would increase with a faster pace of change (Zollo & Winter, 2002).

The manner in which dynamic capabilities are generated was also a point of discussion, although most scholars agreed that the emergence of DCs in a firm is related to organizational learning devices, such as repeated practice and past mistakes (Eisenhardt & Martin, 2000), knowledge articulation and codification processes (Zollo & Winter, 2002) and even improvisation and imitation (Zahra, Sapienza & Davidsson, 2006).

Some of this discussion also referred to the fundamental qualities of dynamic capabilities (i.e. what are dynamic capabilities). Even though the original work defined DCs as capabilities (Teece, Pisano, & Shuen, 1997), some scholars defined them as processes used to reconfigure assets inside the firm (Eisenhardt & Martin, 2000) while others defined them as routines used to adapt operating procedures in a company (Zollo & Winter, 2002).

The ultimate outcome from DCs was also not consensual (i.e. what outcomes can be achieved by having dynamic capabilities). While some authors explicitly linked dynamic with firm's performance (Makadok, 2001) and survival (Zollo & Winter, 2002), others were more restrained and stressed a rather indirect relationship between DCs and performance (Zahra, Sapienza & Davidsson, 2006), while some believed DCs were necessary but not sufficient to achieve SCA (Eisenhardt & Martin, 2000).

A New Definition

In an effort to review past research and findings, unify the large body of knowledge that the dynamic capabilities literature had become and address previous limitations and criticisms to the DCs literature, a new dynamic capabilities definition was proposed (Barreto, 2010). In this new proposal a dynamic capability was defined as a multidimensional construct formed by related but different dimensions, namely the company's propensities "to sense opportunities and threats, to make timely decisions, to make market-oriented decisions, and to change the firm's resource base". This definition presents several improvements regarding previously proposed definitions, such as successfully summarizing and displaying the core of the previous research efforts and also

offering the possibility of easier empirical testing of its four different but connected dimensions. It also helps to resolve some criticisms made to previous definitions, such as being obscure and tautological (Williamson, 1999) or even abstract and intractable (Danneels, 2008).

Teaching Case

Blockbuster Inc. - The Fall of a Giant

Blockbuster Inc. opened its first store in 1985 and quickly grew into a corporate giant by revolutionizing the way movies were rented[1]. In 1994 it was bought by Viacom in a deal worth several billions of dollars[2] and was already one of America's most recognizable brands. However, in the last decade Blockbuster's results have been very poor, supposedly due to changing market dynamics[3]. Nevertheless, in the same period, many newcomers developed successful ways of exploring the video rental market[4].

On September 23, 2010, Blockbuster Inc. filed for Chapter 11 bankruptcy burdened by its massive $1 billion debt and weak revenues. What type of strategic decisions could have put Blockbuster Inc. in such a fragile position? What changed in the video rental business? Can Blockbuster Inc. survive these events?

Company Background

Blockbuster's founder David Cook opened his first video rental store back in 1985 in Dallas, Texas. The video rental industry at that time was extremely fragmented and was composed of thousands of small privately owned stores. Blockbuster's superstores were significantly different from these smaller competitors: each store had more than 8000 titles available for renting, while competitors made available only about half of that number; the positioning of the stores was "family friendly", with bright and colorful stores that did not carry adult films and they introduced the "take from the shelf to the counter" concept[5].

In 1987 Cook had already opened 19 Blockbusters stores and was looking to grow his business further but was facing difficulties mainly due to lack of capital. That was when Cook thought of inviting Harry W. Huizenga, the man who had previously grown Waste Management Inc. from a single route garbage truck business into a Fortune 500 company,

to join him in business. In spite of initial doubts, Huizenga bought a majority stake in Blockbuster and started Blockbuster's growth spree, having already 250 stores in 1988[6]. By that time, Cook had already left due to divergences in the acquisitions policy. In the following years Blockbuster experienced an incredible growth by focusing on national marketing campaigns, positioning Blockbuster as "America's Family Video Store". Moreover, still under Huizenga's leadership the company adopted a diversification strategy, going into TV studios, music and play center businesses[7].

By 1994 Blockbuster had a presence of more than 4.000 stores worldwide and was still under Huizenga´s leadership. Later that year, the media company Viacom Inc. bought Blockbuster in a deal valued at $8.4 billion. The rationale behind this merger was to create a large entity capable of seizing new business opportunities and strengthen both companies' operational performance. As a result of the merger Huizenga stepped down[8]. The 1994-1997 period was very unstable for Blockbuster. Faced with increased competition from other channels, a maturing video rental industry, CEO successions and a relocation back to Dallas that left many key people out of the firm[9], Viacom eventually sold 20% of Blockbuster in 1999. Blockbuster's 1999 post-IPO value was $2.9 billion. Viacom had also stopped Blockbuster's product diversification and scaled down the business.

One of the most significant changes that happened for Blockbuster in 1997 was the arrival of a new CEO. Blockbuster hired John Antioco as its new president and CEO because of the reputation he had built as a turnaround specialist, first at 7-Eleven Inc. and then at Taco Bell. Antioco's 10 year tenure as CEO would be one of the most challenging in Blockbuster's history, as he would have to deal with several highly complex business decisions.

Early Movie Rental Industry

The movie rental industry had its origins in the 1970s, with the arrival of the videocassette recorder (VCR). The VCR gave its owner the possibility to tape whatever was showing on television to a cassette, as well as using pre-recorded cassettes to watch movies or shows.

Initially, renting movies did not seem like a viable business model because VCRs were still very expensive (around $1000 at the time), the pre-recorded tapes were few, outdated and expensive and the prevalent idea was that people would prefer to own tapes, rather than renting them. Even so, the late 70s saw the emergence of the movie rental industry. The industry was typically composed of small, independently owned stores who bought cassettes from big Hollywood studios and were allowed to rent them to the general public.

As time went by and the VCR became more disseminated (**Exhibit 1)**, the video renting industry grew explosively, reaching revenues of $2.55 billion and more than 14.000 video stores as soon as 1985[10], a trend that would continue until the end of the decade. The 90s saw the number of video stores reach more than 23.000 and the emergence of big chains such as Blockbuster Inc. and Hollywood Entertainment Corp., whose format would be very successful and dominate the industry. By the end of the 90s, the video rental market had matured, with small stores fighting to stay alive due to big retailers increasing competition. As it became harder to make profits, many small stores had to close their doors. According to research, approximately 4000 small video stores had to close in 1998 and 1999 alone[11]. By the year 2000, the big video rental stores were by far the preferred consumer channel, accounting for almost 60% of the market, followed at quite a distance by small video stores, which accounted for 30% of rentals[12]. Blockbuster was already the market leader of the video rental industry, with an astonishing 30% market share, well above their biggest competitor, Hollywood Entertainment, who had close to 10% of the market[13].

The Advent of the DVD

As the new millennium was approaching, so were new home entertainment formats. The digital video disc (DVD) was introduced to the market in March of 1997 and it was meant to be a digital replacement to VHS tapes. The DVD was far superior to VHS terms in several features, such as storage capacity, better sound and images and allowed interactive content. The DVD's main handicap was the fact that DVD players initially could not record shows, just play DVD movies.

At the outset, DVD sales, both discs and players, presented slow growth rates partially because of the DIVX, an alternative technology to the DVD that was being backed up by Circuit City. Eventually, the DIVX failed to gain critical mass to stand up against the DVD, mainly due to a business model that would make a lot of money for film studios and Circuit City but almost none for the other retailers[14]. This fact, combined with Blockbuster's eventual support to the DVD, would lead to the DIVX discontinuation[15]. With DIVX out of the picture, DVD player's sales soared (**Exhibit 2)** and DVDs market penetration accelerated. The DVD was rapidly taking over VHS tapes at Blockbuster, as DVD revenues went from 10% of the total in 2000 to 18.5% in 2001 and 39% in 2002[16]. In response to this, Blockbuster reduced 25% of its VHS inventory and expanded its DVD selection further[17].

Even though Blockbuster successfully adopted the DVD technology, it also brought additional challenges to their traditional business model. The first problem was that VHS tapes historically were priced between $50 and $80, which contributed positively to the video rental business because the average consumer was not willing to pay such a high price to buy a movie that he would probably only watch once[18]. However, with DVDs being priced between $10 and $20 the advantage of renting a DVD could be greatly diminished. In second place, this change in DVD pricing would take Blockbuster from competing in rentals with small neighborhood video stores to compete in sales with giant mass merchants such as Target and Wal-Mart, who were able to sell DVDs at a loss to attract customers to their stores to buy other products. Finally, low DVD prices would

enhance small video store's ability to compete against Blockbuster because the new DVD pricing model would allow them to increase their customer service level and erode Blockbuster´s relative cost advantage as a big player.

The DVD pricing model would indeed cause quite an impact on the economics of home video. With the VHS tape format revenues came almost exclusively from renting, due to sell-through prices so high that no one was interested in owning movies, but with DVDs that would not be the case. By giving DVDs much lower prices than VHS tapes, movie studios enabled the DVD sell-through spending to become three times higher than DVD rental spending in 2000, 2001 and 2002[19]. This was a worrying trend for Blockbuster.

Blockbuster executives would have to stage a difficult balancing act, trying to enter the DVD sell-through business without hurting their core rental business too much, in a very competitive market dominated by retail giant Wal-Mart. This meant that Blockbuster would have to shift from a rental-only strategy to a rental and sell-through strategy. To do so, Blockbuster implemented the "Rent it! Like it! Buy it!" program, which allowed Blockbuster members to buy a previously viewed movie at $10 and also gave a free rental to a customers who bought a DVD or video game[20]. With these measures Blockbuster made an attempt to increase DVD sales without competing directly with mass merchants in price. At the same time, Blockbuster execs wondered if the repositioning of the company as "the world's largest *rentailer*"[21] would adversely affect their corporate brand. Moreover, there were worries about the degree of cannibalization this type of strategy would create between renting and sell-through.

The Development of the Internet

In the same period of the DVD's emergence, the Internet's popularity had increased tremendously in the United States (**Exhibit 3)**. This trend opened the door to many new commercial ventures and to the modification of many traditional business models. The

home entertainment industry, Blockbuster Inc. included, were bound to feel its impact soon.

The simplest way the Internet would affect Blockbuster's rental business was via DVD sell-through. With the Internet, anyone could go online and order a DVD conveniently from their home PC and just wait for the delivery. In the online landscape, Blockbuster would have to compete with general mass-retailers such as Amazon.com as well as specialist DVD retailers like Express.com and Reel.com[22].

Blockbuster already had an online presence through its website, which it did not use to sell merchandise or rent DVDs. The company had always been in a traditional "bricks-and-mortar" business, only renting and selling VHS tapes and DVDs through its stores. In late 1999, Blockbuster's CEO John F. Antioco commented on Blockbuster's first move at the online environment: "[Blockbuster will] to continue to focus on growing market share in the growing VHS/DVD rental category through our retail store base and increasingly through blockbuster.com."[23]. The idea was to turn blockbuster.com into a "very vibrant e-commerce engine for the sale of DVD, VHS (video tapes), music and movie-related products"[24].

Since Blockbuster was essentially a retailer, it lacked the resources and capabilities to successfully become an electronic player. To address these deficiencies, Blockbuster took several steps. First, they outsourced the order and fulfillment processes for blockbuster.com to OrderTrust Inc., a move which according to Blockbuster executives would allow them to focus on marketing and branding instead of technology and infrastructure[25]. Second, Blockbuster signed a deal with TeleTech Holdings Inc. in which TeleTech would provide customer and technical support to blockbuster.com users, in order to achieve a high level of customer service[26]. Third, they created two new senior level positions, president of new media, occupied by Santo Politi, a former Matsushita and Panasonic engineer and manager, who would be in charge of pursuing new media opportunities and senior VP of e-commerce, Shellye Archambeau, an IBM veteran who had held positions in marketing and management, who would be in charge of executing Blockbuster's Internet strategy[27]. Finally, Blockbuster entered into a multi-year

partnership with AOL in which it would gain access to AOL's almost 20 million customer base and would be allowed to sell movies on AOL's platform. AOL would also invest $30m in blockbuster.com in order to further develop it. In exchange, Blockbuster would promote AOL's services and software in their stores[28].

Although Blockbuster was investing heavily to develop their Internet presence there were still many concerns. In the middle of 2000 Blockbuster's main rival Hollywood Entertainment had just decided to shut down Reel.com due to its inability to turn a profit[29]. Forrester Research analysts were predicting waves of consolidation and failures amongst online retailers, "with companies that sell DVDs, videocassettes and CDs solely online being some of the first to go", according to senior analyst Joe Sawyer[30].

Besides e-commerce, an additional threat came from Internet based firms that offered to bring rental movies right to their customer's home. Kozmo.com was the most preeminent company of this kind. Consumers would log on to Kozmo's site and order the items they wanted, ranging from DVD rentals to snacks. Then the order would arrive at Kozmo's distribution center and the items would be dispatched in the most efficient way possible to their clients. Kozmo offered to deliver the goods to their client's door within the hour, with no minimum order and no delivery fee[31].

Blockbuster executives knew that the promise of delivering rentals to customer's home was very attractive, appealing to more than 90% of active renters[32]. Blockbuster negotiated a deal with Kozmo.com in which they would provide the inventory and Kozmo would deliver and receive around $1 for each rental delivery. This deal eventually did not go forward so Blockbuster turned to Streamline.com, a Kozmo.com rival, to deliver their rentals directly to customer's homes. Even though the partnership worked, Streamline had to shut down in late 2000 due to a failure to find financing to keep operations running[33]. Eventually Blockbuster tried another home delivery partnership, this time with Food.com, an Internet-based meal delivery service with 16.000 partner restaurants and with close to 1 million members in 2000[34]. The companies would both receive orders from clients and then the Food.com delivery personnel would drop by a local Blockbuster to get the movie, go to the restaurant to pick the meal and deliver the order[35]. Eventually, when

the Internet bubble burst in 2000 these most of these Internet-based delivery services had to shut down, mainly because they held much promise but had a very difficult time turning their vision into a profitable business.

A third threat that the Internet enabled to Blockbuster's business model were internet-based subscription services. The leading company behind this idea was Netflix Inc. and they employed quite a disruptive business model. A Netflix subscriber would pay a $20 monthly fee and in return the subscriber would receive in his mailbox to up to three DVDs at the same time. Once the subscribers returned the DVDs, Netflix would send them the next DVDs in their online "rental queue", their movie wish list. This model meant that subscribers could keep the movies for as long as they wanted and eliminated the unpleasant late fees[36]. Furthermore, Netflix paid for the DVD transportation costs (the DVDs were sent via first class mail by the United States Postal Service).

Initially, Blockbuster executives dismissed Netflix as a threat as they believed the DVD-by-mail business would not appeal to the largely impulse motivated majority of renters and it would only capture a small fraction of the rental market[37]. But by 2002, Netflix was already publicly traded, its revenues had doubled since 2001, had close to 1 million subscribers even though its net income was still negative[38]. Blockbuster's first indirect reaction came in mid-2002 when the "Movie Freedom Pass" was unveiled. Under this subscription Blockbuster customers would pay a monthly fee between $25-30, would be able to take 3 DVD or tapes home at a time, without due dates or late fees but would still have to go to a Blockbuster store pick up and drop off movies[39]. Many market observers wondered if the profitability of this strategy would compensate for the loss of late fees implied[40].

Direct Digital Distribution

An additional challenge to Blockbuster would come from the evolution of direct digital distribution technologies which promised to deliver high quality content directly to customers TVs or PCs.

One manifestation of such developments was the Digital Video Recorder (DVR). The DVR presented many interesting features, such as digital recording, ability to skip commercials, record more than one show at the same time, freeze live TV and store up to 80 hours of TV shows[41]. A customer would just have to buy the DVR box, set it up and pay a monthly subscription fee around $10.

The potential threat that DVRs posed to Blockbuster was their ability to make the VCR obsolete, as they had the record function that most DVD players did not possess at the time and that function was the main reason people were still holding on to their VCR. Furthermore, combined with video-on-demand (VOD) the DVRs could make both the DVD and VCR obsolete, as one could order a film via VOD and record it with a DVR, making the DVDs and VCRs useless. Blockbuster executives were aware of these possibilities and entered into a partnership with TiVo in which Blockbuster would be allowed to supply videos directly to customers via TiVo's hardware. In exchange TiVo would be able to offer its members movies from Blockbuster's library, as well as being promoted in Blockbuster's stores[42]. Even though this deal announced in early 2000, it would take Blockbuster almost a decade to really act on it.

The other direct threat to Blockbuster's business model was video-on-demand (VOD), a service that promised to offer any movie to a customer's house instantaneously when he demanded it. Although VOD technology promised much its initial penetration efforts were hindered by the studio's fears of piracy and cannibalization with the rental business[43]. On the other hand, cable TV providers were expanding their movie offers up to 1000 titles but were still struggling with technical issues, as VOD required incredible amounts of bandwidth to be successfully delivered[44]. Moreover, research showed that penetration rates of VOD would increase considerably over the next few years and that in households that had VOD video store rentals would decrease considerably[45]. To address the growing VOD market, Blockbuster signed a three party deal in mid-2000 with DirectTV and the now defunct Enron Corp., in which Blockbuster would provide the movies, DirectTV would deliver them to households via their satellites and Enron would provide the broadband[46]. The deal caused some excitement in the industry but fell apart some months after being

signed due to commercial difficulties[47]. Later in 2003, Blockbuster tried yet another incursion in the VOD business, this time delivering content via the Internet in the form of legal downloads. To do this Blockbuster acquired a majority stake in Cinemanow.com to test the viability of this practice[48].

Blockbuster goes truly online: Blockbuster Online

In spite of all the technological threats that loomed over Blockbuster's rental business in the early 21st century, the company was still very well positioned in the end of 2003. With almost 9000 stores worldwide and almost $6 billion in revenues, Blockbuster was indeed the leading company in the movie rental business[49].

With the rental business decreasing due to the new economics and competitors that the DVD and the Internet brought with them, Blockbuster was searching for a way to expand and diversify their business. Blockbuster executives, who had dismissed Netflix's business model as a niche market, were now considering if that was a mistake. Netflix had gone through a successful IPO in 2002, had tripled the number of subscribers between 2002-2004 (**Exhibit 4**) and was dominating the online DVD rentals market with a whopping 78% of market share in the end of 2004, mostly due to lack of serious direct competition, but still beating giant Wal-Mart's online rental initiative in the process (**Exhibit 5**).

Finally, in their 2003's annual report Blockbuster announced that it would enter the online market aggressively in 2004, in an attempt to grow their business by bringing back customers lost to Netflix and attracting new customers who would like to enjoy the convenience of a "clicks and bricks" strategy. Blockbuster executives also announced that they were willing to suffer short term losses in the development of their online business.

Blockbuster Online would work as an internet rental subscription business, by running an online platform that would look very close to what Netflix was offering in terms of site design and subscription model but it would differentiate itself from Netflix by integrating the online business with the physical business. This meant initiatives like giving online

subscribers coupons for in-store use, using store inventory to fulfill online demand and trade a customer's old DVDs for online credit.

Observers noticed that Blockbuster Online certainly looked like Netflix but the actual user experience would be substantially different in two major ways. First, fulfilling the online orders would prove to be a harder than expected task because Blockbuster did not have experience in this type of logistics and did not have as many distribution centers as Netflix (23 vs. 30). This fact would increase the number of days it would take to deliver a movie and decrease consumer satisfaction. On the other hand, Netflix was exceptional in this critical point, with its in-house developed logistics software, special deals with the United States Postal Service and 30 distribution centers. As soon as 2003 they could deliver movies to 60% of their customers overnight[50]. The second problem Blockbuster faced was in terms of movie selection. While in the retail environment it was desirable to offer mostly recent hits and classics to make the most of the limited shelf space, in the online environment a significantly more diverse library would be useful to satisfy the "long tail" of the demand. Historically, Blockbuster had focused in offering their customer hits in their stores, which made their library and subsequent online offer poorer. In contrast, Netflix's movie selection was perceived by customers as superior because it had indeed more titles (30.000 vs. 25.000) but their recommendation software system would direct customers towards movies that had a good fit with their past preferences, which effectively increased this perception. Despite these weaknesses, Blockbuster quickly gained market share growing up to 2.2 million subscribers but had lost $120 million to create Blockbuster Online[51] and had not been able to turn it into a profitable business.

In the beginning of 2005, just months after launching Blockbuster Online, Blockbuster's management decided to eliminate the late fees, a move that was projected to forfeit up to $300 million in the company's operating income in 2005[52], taking an additional step to compete against Netflix's business model and hoping that it would increase the amount of money their customers spent and improve their overall image since these fees were historically a cause of major consumer dissatisfaction. Also in early 2005 Blockbuster announced a big decrease in the price of their online service, from $17.49 to $14.99. This

measure combined with the launch of Blockbuster Online and the end of late fees would, in the opinion of some industry experts "result in a significant deterioration of BBI's profitability"[53]. Management at Netflix declared that Blockbuster's strategy was unsustainable and that they would default on their $1.1 billion loan[54]. In another bold move, Blockbuster announced in November 2006 that it would implement the Total Access ™ program, a measure that would allow online subscribers that returned a mailed DVD to a store to get a free in-store movie rental[55], a policy that would be limited soon after being implemented due to its excessive generosity. This measure was set to take advantage of the "clicks and bricks" strategy and provide additional growth to their online business, which reached 3 million subscribers in the first quarter of 2007[56]. Albeit bold, Blockbuster's moves did not seem to impress Wall Street (**Exhibit 6**).

The New Blockbuster

In March 2007, after a decade leading Blockbuster (**Exhibit 7**) , John F. Antioco declared that he would leave the company after a disagreement regarding his 2006 bonus award[57]. To replace him Blockbuster hired James W. Keyes, a former chairman and CEO of 7-Eleven Inc., an international chain of convenience stores.

Keyes strategy for Blockbuster was to "to move in our customers' minds from a video-rental store to one that provides entertainment content"[58]. This meant being able to fulfill customer's needs in-store, manage the online DVD subscription business and somehow build capabilities that allowed Blockbuster to deliver movies via Internet streaming or download.

In July 2007, Keyes started with a substantial downsize in Blockbuster Online's marketing budget in an attempt to stop the losses the program was inflicting to the company[59]. Additionally, the prices for the Total Access were reviewed upwards, with the pricing plan that allowed clients to keep 3 DVDs at the same time and allowed unlimited free DVD exchanges at stores being raised from $17.99 to $24.99. The cheaper plans were also revised, especially the policy that allowed for free unlimited DVD exchanges at stores. In

some plans the policy was limited to 5 free DVD exchanges per month and in other cases exchanges were priced at $1.99[60]. With the implementation of these measures, Blockbuster lost half a million subscribers by November[61]. Keyes was quick to justify these decisions. ''Although Blockbuster Total Access allowed us to increase our subscriber base by 600,000 to a total of 3.6 million subscribers, the costs associated with the program affected our profitability''[62].

In August 2007, Blockbuster decided to acquire MovieLink, a site created by several movie studios that allowed pay-per-view download of movies, to address the emerging online movie market (**Exhibit 8**). Keyes commented on the move: "We have taken an important step toward being able to make movie downloading conveniently available to computers, portable devices and ultimately to the TV at home." However, as soon as October PricewaterhouseCoopers LLP, Blockbuster's auditor, expressed doubts about MovieLink's viability, due to recurrent losses from operation and negative cash flows[63].

One of 2008's biggest Blockbuster decisions was an attempt to buy Circuit City, a struggling consumer-electronics retailer, for more than $1 billion[64]. The announcement of the acquisition perplexed Wall Street analysts, who did not understand how this merger could benefit the firms. "We fail to understand the strategic value of the company's hostile bid and believe the combination has the potential to divert management and financial resources," said one analyst[65]. On the other hand, Keyes explained that the merger would "create a global retail enterprise uniquely positioned to capitalize on the growing convergence of media content and electronic devices"[66]. However, after completing the due diligence process Blockbuster dropped the bid to buy Circuit City[67]. Apparently, Circuit City was in worse shape than what was previously thought and eventually would go bankrupt. One of Keyes' objectives in acquiring Circuit City was to help diversify Blockbuster's stores offerings and shift from a renting only in-store strategy to an "entertainment retail environment," as Keyes had put it[68]. To achieve this goal, Blockbuster stores would start to offer electronic devices such as televisions[69], start to sell videogame hardware and accessories[70], instead of just renting and selling videogames and even start to sell concert tickets[71]. All of these measures were aimed at increasing same-

store sales and boosting store profitability. Although these measures gave Blockbuster a good 1st quarter in 2008, they would struggle in the coming months.

The other major development in 2008 was the deal Blockbuster made with NCR, a leading company in self-service technology to deploy Blockbuster-branded DVD vending kiosks (**Exhibit 9**). According to Keyes, this move would help to "transform Blockbuster into a multi-channel provider of media entertainment" and would allow Blockbuster to tap a market that was expected to grow 60% over the next three years[72]. Furthermore, going into the kiosk business would help to fend off another fast growing competitor, Redbox, which had grown from 2.200 DVD-rental kiosks in 2006 to more than 10.000 by late 2008 (**Exhibit 10**). With kiosks located in convenient places such as Wal-Mart and McDonald's restaurants, customers would pay just $1 a night for a movie rental, thus making it a low-cost threat to Blockbuster's stores[73].

The year 2009 was marked by poor quarterly performances, with losses in every quarter. In this period Blockbuster entered into multiple deals with several companies such as Sonic Solutions, a digital platform provider[74], telecom companies[75] and TiVo[76], in order to consolidate their position as a multichannel content provider. There were some early signs of financial distress with rumors of bankruptcy as early as March[77].

In 2010 Blockbuster went through severe cost cutting programs[78], difficulties to secure financing[79], assets being sold to pay debt[80], missed bond payments[81], de-listing from the New York Stock Exchange[82] and ultimately a filling with SEC for Chapter 11 protection to avoid liquidation[83].

Blockbuster Inc. went from being the world's leading and most profitable company in the video rental business to a bankrupt company in less than a decade. Was this failure a direct consequence of disruptive technologies and innovative competitors? Or is it possible that Blockbuster failed because it could not respond effectively to a fast changing environment?

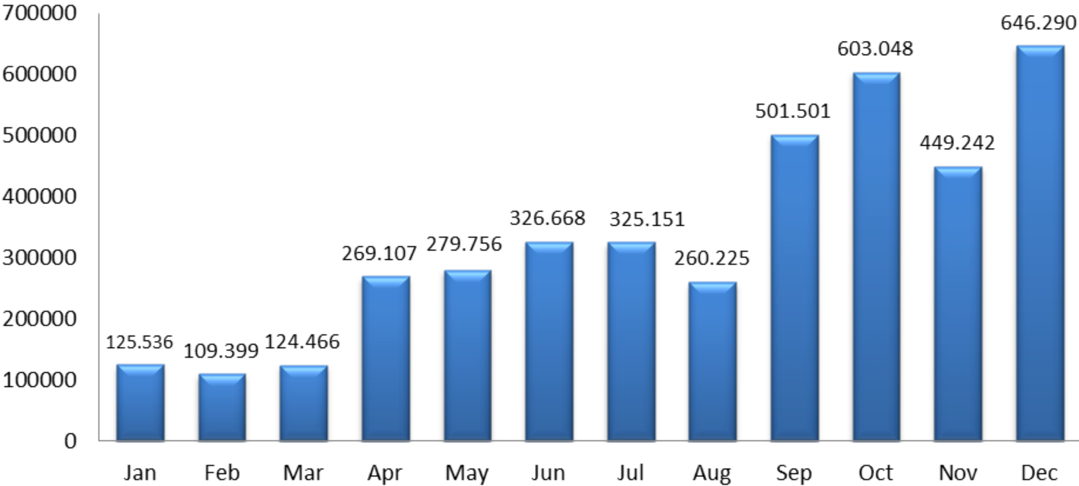
Exhibits

Exhibit 1 – Evolution of VCR adoption in the U.S.A.

	1980	1985	1990	1995
% of households with VCR	1.1%	20.8%	68.6%	81%

Source: Adapted from U.S. Census Bureau

Exhibit 2 - DVD player sales during 1999



Source: Consumer Electronics Association

Notes: 1) Blockbuster announced it would support the DVD format in April

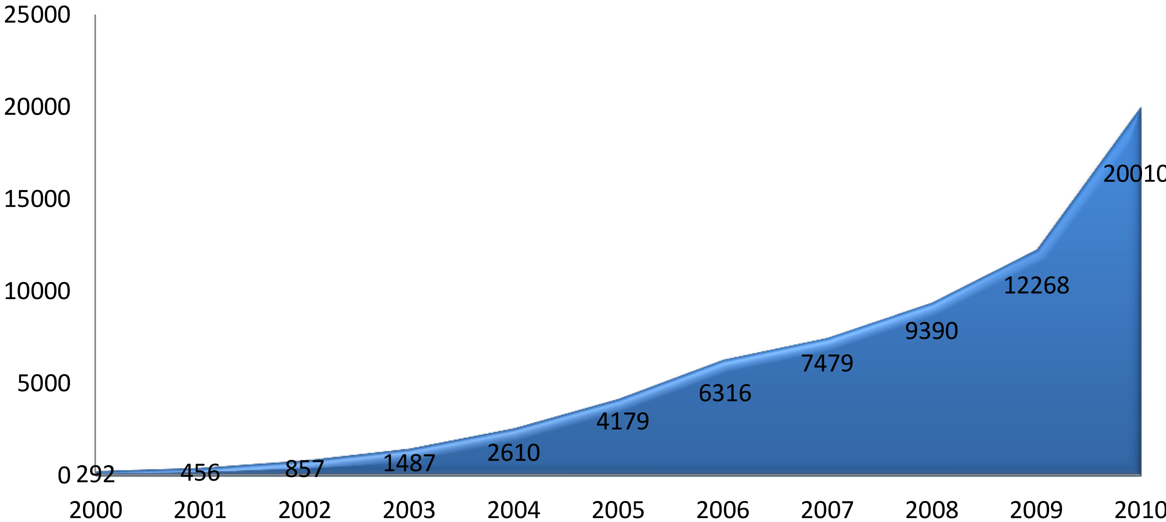
2) Circuit City abandoned the DIVX in June

Exhibit 3 – Households with Internet: 1997 to 2003

	1997	2000	2001	2003
Households with Internet use at home	18,0%	41,5%	50,4%	54,7%

Source: Adapted from U.S. Census Bureau, Current Population Survey,1997, 2000, 2001, 2003.

Exhibit 4 - Number of Netflix subscribers (in thousands)



Source: Company’s annual reports and Q4 2010 financial results

Exhibit 5 – Online Rentals Market (Late 2004)

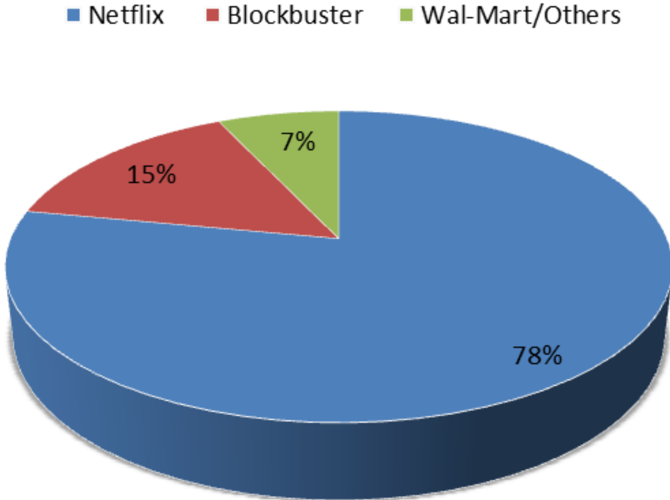


Exhibit 6 - Blockbuster and Netflix Stock Prices vs. Nasdaq

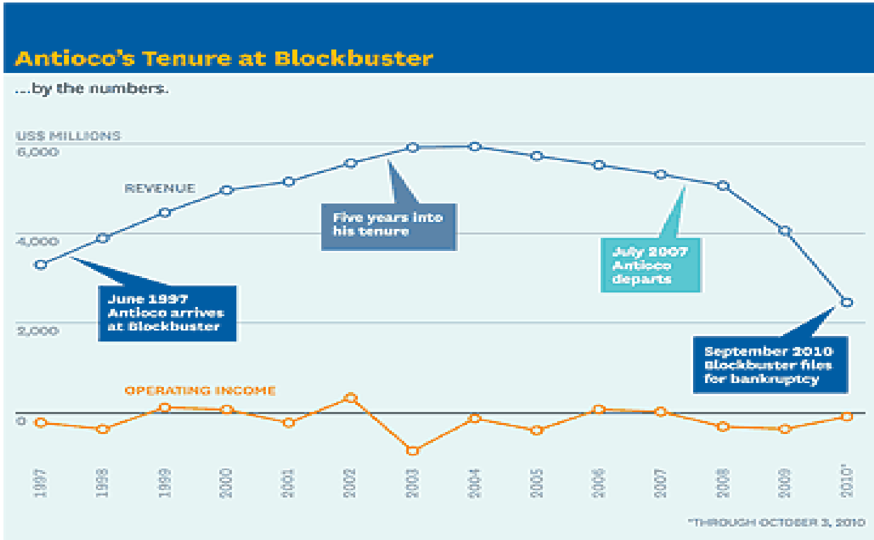
Source: Yahoo Finance

Exhibit 7 – Online Movie Market in 2007

Retailer model	Online brand	Major studio deals	Type of content	Pricing
Amazon.com	Unbox	All but Disney	VOD, download-to-own, Offered through TiVo	Pay-per-transaction
Blockbuster	Movielink	All but Fox	VOD, download-to-own	Pay-per-transaction
Movie Gallery	MovieBeam	All but Sony, MGM	VOD via set-top box	$ 199 for box, no other fees
Netflix	Watch Now	All but Disney	Streaming video	Subscription
Wal-Mart	Wal-Mart.com	All	VOD, download-to-own	Pay-per-transaction

Source: Video Store Magazine, 13 August, 2007

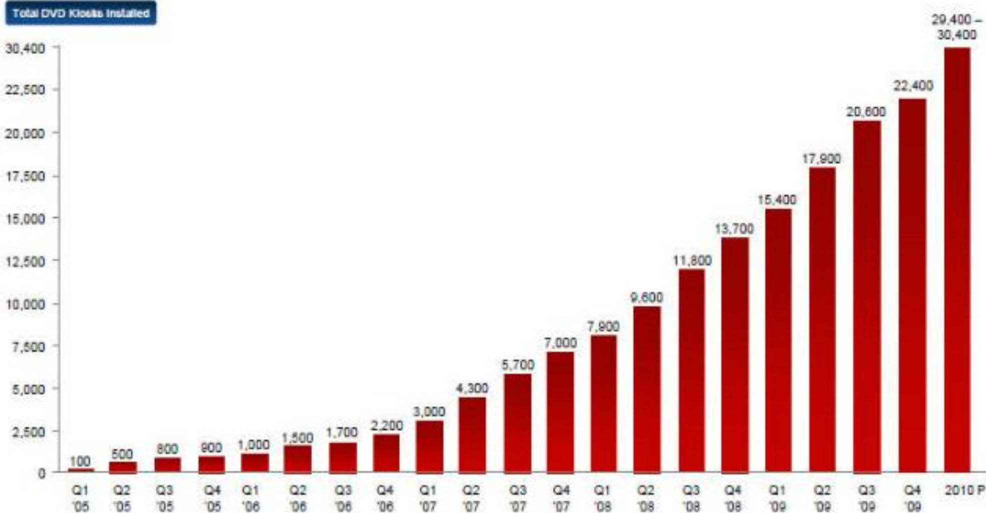
Exhibit 8 – Antioco's Tenure at Blockbuster



Source: Harvard Business Review, April 2011

Exhibit 9 – A Blockbuster kiosk

Exhibit 10 – Redbox installed kiosks: 2005 to 2010



Source: Coinstar, Inc.

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Teaching Note

Synopsis

The first Blockbuster video rental store opened its doors back in 1985, under the leadership of its founder David Cook. Blockbuster was among the pioneers of the video rental superstore concept, with big and bright stores that could stock up to 8.000 titles for renting, doubling what competitors were offering at the time. The company positioned itself as "family friendly", offering no adult movies, and also introduced the "take from the shelf to the counter" concept.

Blockbuster's business model was so successful that it grew to more than 4.000 stores in less than a decade and was valued at $8.4 billion by 1994, when it was bought by media giant Viacom. Blockbuster became the leading video rental company in the United States, commanding an impressive 30% market share of a multi-billion dollar industry by the year 2000.

However, these blissful times would not last forever. In the beginning of last decade Blockbuster faced several technological advances that had the potential to, in the worst case scenario, put them out of business or at least erode the company's profitability.

With the introduction of the DVD players, the technology that would replace the VCR, came the threat of DVD sell-through: that is, because DVD prices were so low, people could start buying DVDs instead of renting them. Additionally, the DVD sell-through model brought powerful competitors such as Wal-Mart.

As Internet adoption rates increased in U.S. households, the Internet became a channel to do business in novel ways. The new business models the Internet made possible would also represent a threat to Blockbuster's traditional "bricks-and-mortar" business model. Companies like Amazon could now sell DVDs directly to customers via Internet, other companies like Kozmo.com offered to bring movies directly to their customer's homes. Some companies, like Netflix, developed innovative internet-based subscription services, which would charge a fixed monthly fee and allowed unlimited movie rentals.

Direct digital distribution's development would also put Blockbuster under pressure by promising the delivery of high quality content directly to a user's TV or PC. Via DVR a consumer could record high quality content from TV, making VCRs obsolete. VOD cable providers also promised to deliver content directly to TV, making the trip to the video store outdated. Additionally, as technology progressed the Internet could be used as a vehicle for downloading movie directly to PCs.

All of these innovations eventually took a toll on Blockbuster's traditional business model, eroding profitability and market share, as the company struggled to adapt to new ways of doing business. In the final years of the decade, Blockbuster set itself "to provide convenient access to media entertainment", by trying (and failing) to become a truly multi-channel content provider, an attempt that ended on September 23, 2010 with a Chapter 11 bankruptcy filing.

This case examines Blockbuster's descent from prominent market leader in the video rental industry to a failing and unprofitable company in less than a decade. I carefully assess how the company responded to the emergence of several potential threatening technologies, namely by looking at the evaluation they made of the new technologies, the corresponding actions they took to address them and changes in the company's portfolio of resources and capabilities. Finally, I scrutinize the outcomes of their adaptation endeavors.

The first section of the case describes Blockbuster's beginning and successful growth, since its establishment in 1985 under David Cook´s leadership, to its unparalleled growth and success under Harry W. Huizenga's command. The section essentially tries to demonstrate what enabled to Blockbuster to achieve an undeniable market leadership.

The second section characterizes the early years of the movie rental industry. I address how the emergence of the VCR originated this industry, the small neighborhood stores that initially composed it and how it grew to the multi-billion dollar industry that Blockbuster would dominate.

The subsequent three sections, about DVD, Internet and direct digital distribution, analyze how the aforementioned technologies impacted and fundamentally changed the video rental industry, turning it into an exponentially more competitive industry. I also discuss the new competitors that emerged with these technologies, as well as Blockbuster's response to these changes in their competitive environment.

The sixth section explores the 2004-2007 period, when Blockbuster took several steps in order to expand their business online and made several significant changes in order to compete with Netflix and to become a "clicks and bricks" player.

The last section examines Blockbuster's 2007-2010 period, in which the company attempted to transform itself into a true multi-channel content provider, addressing the changes that occurred in the stores, in the online subscription business and the attempt to deliver content directly to clients. It concludes with a description of the difficulties the company faced, culminating in the Chapter 11 bankruptcy filing to avoid liquidation.

Teaching Purpose

The Blockbuster Inc. case is suitable to further develop the skills and competences of a graduate audience with a background in business, economics or technology. The case is intended to be taught in a graduate program, in courses like Technology Strategy, Innovation Management or Strategic Management, with the objective of understanding how new technologies can fundamentally change the nature of an entire industry in a relatively short period of time.

The case requires students to:

- ❖ Assess the threats and opportunities that technological change can bring to a business.
- ❖ Understand the dangers of failing to act appropriately in the face of a changing environment.
- ❖ Appreciate the kind of decisions a top management team has to make in an environment filled with ambiguity.

- Realize that entire industries can change completely in just a few years.

Intended Contribution

The main contribution the Blockbuster Inc. case intends to make is to demonstrate how a company can go from a well-positioned market leader to a bankrupt company in a relatively short period of time, by failing to address correctly external market changes. This case is an example of a failure to demonstrate adequate levels of the dimensions that compose a firm's dynamic capability, a fact which was determinant to the firm's failure. The case presents a detailed description of the emergence of the technologies and new competitors that ultimately led to Blockbuster's demise, as well as Blockbuster's response to these changes in order to allow the students to fully appreciate the difficulties that a fast changing competitive environment brings.

Instructor Preparation

The instructor is advised to read supplementary literature regarding the dynamic capabilities topic. A good starting point would be to read the article "Dynamic Capabilities: A Review of Past Research and an Agenda for the Future," (Ilídio Barreto, Journal of Management, January 2010), which presents an extensive review of the literature and also introduces the dynamic capabilities definition that is used in this teaching case.

The instructor can learn more about Blockbuster by reading the annual reports from the last decade, which are available in their website. To understand better the technological shocks Blockbuster faced the instructor is advised to read Professor Peter Coughlan's teaching cases ("Blockbuster Inc. & Technological Substitution" (A), (B),(C) and (D)), which characterizes in depth how these changes would likely affect Blockbuster.

To obtain more information about video rental industry the instructor is recommended to visit the websites of two trade magazines: Variety (former Daily Variety) and Home Media Magazine (former Video Store Magazine). Both of these magazines have websites with free research and industry news available.

Suggested Assignment Questions

1- Characterize Blockbuster's external environment in the 1990s. What changed in the 2000s?

Regarding this question students are not necessarily required to use a specific framework to perform this analysis although usually Porter's 5 Forces model can assist in carrying out this task. What is relevant here is that students are able to correctly identify what changed in Blockbuster's competitive environment and how that would ultimately impact their business.

Blockbuster's suppliers were always the large movie studios that produced the movies that Blockbuster would later rent. Although the studios had some negotiating power, they were generally interested in cooperating with Blockbuster to find ways to increase their own revenues. This variable remained fairly stable between the 1990s and the 2000s, meaning that there were no significant changes regarding suppliers in this period.

In the 1990s, the threat of potential new entrants was always already very high as it was easy for almost anyone to establish a video rental store even if they were very small and could not enjoy the procurement benefits scale brought. In the 2000s, for the most part the entry conditions for video stores were not altered, but becoming profitable was more difficult for other reasons. The problem is that the emergence of many new channels to deliver content also meant that the number of potential new entrants in this period would increase accordingly.

Considering the movie rental market, in the 1990s there were not many substitutes to renting a VHS movie in a video rental store. If one wanted to see a specific movie and did not want to rent it, one could buy it for a really high price or wait a really long time to see it on TV. In the 2000s this situation changed substantially, the possibility of buying a movie became much more viable as DVD prices dropped dramatically in comparison to VHS prices, and people could buy them on stores but also order them conveniently and at competitive prices online. The development of the Internet also allowed people to subscribe to flat fee internet based subscription services, instead of paying per one rental

as they used to do. Additionally, the Internet would also allow people to download movies directly to their PCs and other devices making the trip to the video store look more old-fashioned. Finally, the emergence of rental kiosks also emerged as a viable substitute to renting in a store, especially due to the low prices these kiosks offered. In conclusion, the 2000s saw the emergence of a multitude of viable substitutes to renting a movie in a video store.

Blockbuster's buyers were every individual that wanted to rent a movie, a fact that gave them no negotiating power at all. Additionally, in the 1990s the switching cost that customers faced when they chose to buy a movie instead of renting was very high, which made them reluctant in changing. In the 2000s the switching costs were radically lowered due to the emergence of new forms of renting movies that were both convenient and cheap, a fact that made consumers in the 2000s much harder to retain.

In the 1990s, Blockbuster faced two types of competitors: (1) large video rental store chains such as themselves, that offered almost the same as they did in terms of price and title availability, and (2) small neighborhood video rental stores that had limited movie availability and more difficulties in making profits. Blockbuster had advantages regarding these competitors, namely in terms of getting movies sooner and also cheaper by pioneering the revenue sharing contracts with studios, which gave Blockbuster a competitive advantage relatively to these competitors. In the 2000s, the competitors had changed quite a bit in terms of power and number. The DVD sell-through phenomenon brought giants such as Wal-Mart, with the ability to sell DVDs at very low cost (or even losses) to increase traffic in their stores, and Amazon, with the ability to sell a very large number of titles online and shipping them directly to the customer's house. The Internet allowed the emergence of new video renting business models, such as Netflix, that could potentially take away many customers from Blockbuster. Additionally, the development of the Internet also allowed for movies to be downloaded directly to PCs and other devices, which also increased the number of competitors Blockbuster faced. In the 2000s there was also a development in VOD technology that allowed cable companies to improve their direct-to-TV offer. The emergence of low cost renting kiosks, such as the ones provided by

Redbox, also added to the competitive strain. In sum, the competitor's pressure in Blockbuster's business was tremendously increased in the 2000s.

The following table summarizes the most relevant changes students are required to identify.

Environment Variable	1990s	2000s
Suppliers	Large movie studios	Remained unaltered
Potential New Entrants	Already very high due to small video stores, no barriers to entry.	Increased a lot due to the emergence of new channels to deliver content.
Substitutes	Buy VHS tapes (high cost) or watch movie on TV (long wait)	Buy DVDs in stores or online (at a cheap price). Internet based subscription services. Download movies directly to their PCs and other devices. Rental kiosks.
Buyers	Very dispersed with no power and high switching costs.	Very dispersed with no power but much lower switching costs.
Competitors	Large video rental stores. Neighborhood video rental stores.	Large video rental stores. Neighborhood video rental stores. Walmart (physical DVD sellthrough). Amazon (online DVD sellthrough). Netflix (internet based subscription services). Internet movie downloads. VOD by cable providers.

Students should conclude that the competitive landscape Blockbuster faced in the 2000s was much more intense than in the 1990s especially due to an increase in substitute offerings and competitors.

2- Use the four dimensions that compose a dynamic capability, suggested by Barreto (2010), to analyze Blockbuster's response to the emergence of Internet Subscription Services.

In this analysis students are expected to relate Blockbuster's conduct with the four dimensions proposed by Barreto (2010) and evaluate whether the company showed high or low levels of each dimension by evaluating its conduct.

Regarding the propensity to sense opportunities and threats, students should be able to state that Blockbuster executives dismissed Netflix's business model as a niche strategy because they believed that the DVD rental market was mainly moved by impulse purchases and this would make Netflix's business model appealing only to a modest amount of active DVD renters. The problem with this assertion is that while it might accurately describe customer's motivation to rent a DVD, it fails to address what made Netflix's value proposition different from what Blockbuster offered (e.g. fixed monthly fee

that allowed unlimited DVD rentals, no late fees, convenience of receiving DVD in the mailbox, etc.). By doing so, Blockbuster's assessment of the Netflix's threat was hindered and the subsequent response was greatly influenced by such an assessment. Furthermore, Blockbuster's management seems to have perceived the Internet shock only as a threat, downplaying the opportunities that this new technology could give the firm.

Concerning the propensity to make timely decisions, students should be able to realize that Blockbuster was very late in entering the internet-based subscription services market, meaning they were not the first to enter nor were they close to that. While it may be understandable to adopt a wait and see strategy to assess if this business model would catch on, entering the market only in 2004 was problematic, mainly because the initial doubts regarding the viability of this business practice had been long dissipated by Netflix's highly visible success, namely due to the 100% growth in revenues between 2001 and 2002 and also by their successful IPO in 2002. One of the main outcomes of not entering the market in a timely manner was that this decision effectively enabled Netflix to develop a sustainable competitive advantage in this type of service and made Blockbuster unable to compete effectively against them.

In what concerns the propensity to market-oriented decisions, students are expected to recognize that when Blockbuster decided to compete directly with Netflix they were unable to satisfy crucial consumer demands and faced several challenges in delivering the same levels of value to customers as Netflix. On one hand, Blockbuster simply could not match Netflix's delivery times; Netflix was particularly strong in fulfilling customer orders, as the company always believed that this was a critical point in driving consumer satisfaction up, the company could already fulfill close to 60% of orders overnight in 2003, even before Blockbuster entered the competition. Naturally, when Blockbuster entered the online business they had trouble in doing as well as Netflix because they did not possess the experience in logistics necessary to succeed nor enough distribution centers to execute properly at a national scale. On the other hand, another feature in which Netflix excelled was in making available an exceptionally vast DVD catalog, with more than 30.000 titles, a number unmatched by any rival (Blockbuster had 25.000 titles). This wide

range of DVDs would prove valuable in helping Netflix delivering superior value to their customers, as the demand for DVDs in the online environment was not only driven by hit movies, lesser known titles were also a very important factor, thus making a vast DVD offer crucial. At this point Blockbuster would also have difficulties in matching Netflix's offer since they had historically focused in hit titles: it was by doing so that they had succeeded in the retail environment but, in an online world, this would frustrate their competitive efforts.

Finally, regarding the propensity to change its resource base students should see that Blockbuster could not fulfill their customer's needs well because they had a somewhat inferior resource base when compared to Netflix, which was a result of an inadequate resource base change. As we have already seen, Blockbuster lacked adequate distribution resources and capabilities, namely sufficient distribution centers to supply a market as big as the United States and logistics know-how to make the fulfillment of demands work smoothly. Additionally, in order to compete successfully online Blockbuster would need a more wide-ranging DVD catalog to cater to the needs of an eclectic online demand, a change in resource base that they did not make. In contrast, Netflix simply had superior resources across a number of points that were crucial to value creation in this market, namely a large number of distribution centers spread across the U.S., proprietary logistics software to handle the fulfillment of the orders and an unmatched DVD catalog. An inadequate resource base is also important in explaining Blockbuster's failed attempt to provide an online streaming service. Blockbuster acquired a failing company to provide this service (Movielink) and failed to turn it around, thus clearly showing they did not have an adequate resource base for that market.

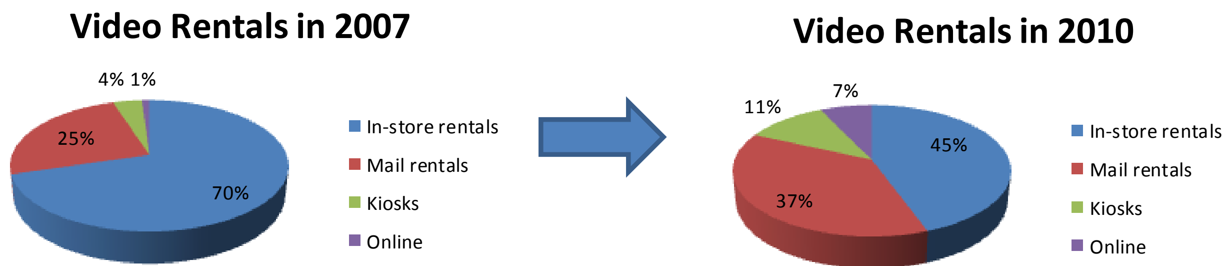
The levels of each dimension that Blockbuster displayed are summarized in the following table:

Dimensions	Level
Propensity to sense opportunities and threats	Low
Propensity to make timely decisions	Low
Propensity to market-oriented decisions	Low
Propensity to change its resource base	Low

Students should conclude that Blockbuster failed to address correctly this challenge because it showed low levels in each of the four dimensions that compose a dynamic capability.

3- **Imagine you are appointed Blockbuster's CEO in 2007 and you just received the following information. What would you do?**

Trends in the Content Market



Source: "The Battle for the American Couch Potato: New Challenges and Opportunities in the Content Market", Convergence Consulting Group

In this exercise students are expected to present creative solutions that would allow Blockbuster to take advantage of the information in the study and by doing so, they are expected to get a more accurate feeling of the difficulties that Blockbuster's top management team faced in the last years. Ideally, students should work in groups to make the exercise more stimulating and to simulate the kind of situation they will find in real companies.

Students are expected to present strategies to address each content channel and to provide concrete suggestions of what changes need to be done in order to succeed. The strategies students present for each channel should be coherent with the overall strategy they decide to follow.

Hopefully this question will provide some interesting discussion in the classroom about what would be the optimal strategies for Blockbuster in the aforementioned period, as well as interesting benchmarks to compare against what Blockbuster's top management team actually did.

Teaching Plan

Assuming a 90 minutes class, time should be distributed as follows:

Topic	Time (minutes)
Review of Dynamic Capabilities theme	15
Overview of the Blockbuster Inc. case	15
Question 1	10
Question 2	20
Question 3	15
Final considerations	15

Discussion

In this section I will try to make a clear and concise connection between the dynamic capabilities literature and the real life business situation that a company (Blockbuster) actually faced, in an effort to link corporate strategy theory with actual management practice.

To do so I will focus on the dynamic capabilities definition proposed by Barreto (2010):

> "A dynamic capability is the firm's potential to systematically solve problems, formed by its propensity to sense opportunities and threats, to make timely and market-oriented decisions, and to change its resource base."

This definition suggests that a dynamic capability is constituted by four different but connected dimensions, the firm's propensities "to (1) sense opportunities and threats, (2) to make timely and (3) market-oriented decisions, and to (4) change its resource base". It is important to notice that this definition suggests that it is having a sufficient level of each of the four dimensions that enables the existence of relevant dynamic capabilities. It follows that if a company has high levels of three of the dimensions and a very low level of the fourth it might not possess enough dynamic capabilities, a fact that is central to the Blockbuster case and, as I will illustrate in the subsequent pages, that might be the difference between success and failure.

A firm's ability to detect opportunities and threats in their external environment has been described by past research as one of the critical abilities a company needs to have in order to succeed in fast changing environments (Teece, 2007). Indeed, past research has shown that a CEO's perception of environmental changes helps to determine the probability of action being taking by the firm, as well as the scope and riskiness of the response (Plambeck & Weber, 2010). Furthermore, research has also suggested that the perception of an exogenous shock as a threat or as an opportunity also influences how the firm responds to the event (Gilbert, 2006). The Blockbuster case helps to illustrate that the top

management team's perception of opportunities and threats is critical in shaping the response that a firm gives. The fact that Blockbuster did not evaluate correctly the changes in their business environment is particularly important in explaining its failure. Indeed, one particular decision seems to have had a powerful negative impact in Blockbuster's performance: their assessment of internet subscription services (i.e. Netflix) as a residual competitor instead of a deadly threat to their business. Indeed, this faulty assessment was the beginning of a series of poor responses to this particular threat. The case provides further evidence that the ability to sense changes in a firm's competitive landscape is indeed an essential condition to develop dynamic capabilities and to succeed in fast changing environments.

The propensity to make decisions in a well-timed manner is also of great importance to firms competing in very dynamic environments. Several studies have argued that the timing of decisions, in particular being ahead of competitors (Eisenhardt & Martin, 2000; Teece *et al*., 1997), is essential for achieving competitive advantage. Indeed, it has been argued in the strategic management literature that a possible source of acquiring first-mover advantage was to acquire scarce assets before rivals (Lieberman & Montgomery, 1988). Again, the Blockbuster case seems to confirm that the timing of decision-making processes is fundamental to succeed in dynamic environments, particularly being ahead of rivals. Specifically, the Blockbuster case illustrates effectively what can be lost by taking decisions in a late fashion. By not entering the internet rental subscription services market fast enough, Blockbuster forfeited a valuable source of potential growth for the company in the beginning of the last decade. By doing so they also effectively allowed Netflix to flourish and to develop a sustainable competitive advantage in this market, in the sense that rival companies could not match Netflix's offer in terms of delivery times nor DVD catalog range. The case provides additional evidence that the timing of a firm's decisions is very important to succeed in dynamic environments, in addition to being a critical part of a firm's dynamic capabilities.

One additional dimension of the dynamic capabilities concept that has been put forward as fundamental in strategic management is the ability to create superior value for

customers (Priem, 2007), meaning the capability to satisfy consumer needs better than rival firms. Past research has shown evidence that strategic managerial decision-making is a statistically significant variable in explaining firm performance (Adner & Helfat, 2003), and the quality of such decisions is influenced by the measure in which such choices help to provide enhanced customer value. The Blockbuster case helps to shed some light on how differences in market-orientation levels can impact firm performance and value creation. In particular, by comparing Blockbuster's value proposition with the one Netflix offered it can be reasonably argued that one of the factors that explains the differences in performance is that Netflix's offer was more market-oriented, in the sense that their business model's features (e.g. no late fees, fixed monthly fee, unlimited rentals, etc.) created superior value for their customers when compared to Blockbuster. Thus, the case provides further evidence that a firm's market-orientation level helps to determine success in the marketplace and to have dynamic capabilities.

The strategic management literature has been consensual around the idea that the ability to modify, transform and change a firm's resource base is a necessary dimension in order to effectively display dynamic capabilities (Teece, 1997; Eisenhardt & Martin, 2000; Barreto, 2010). This proposal is aligned with and expands the resource-based view of the firm (Barney, 1991) that states that a firm's competitive advantage lies in its rare and difficult-to-copy resources, in the sense that not only firms have to somehow acquire these resources but in face of changing conditions also needs to reconfigure them to respond to environmental shifts. The Blockbuster case provides some insights regarding how firms choose to perform this change in resource base and how the quality of this change can affect a firm's performance. More specifically, the case provides several examples of how Blockbuster decided to reconfigure its resource base to address market changes, namely by changing their VHS inventory for DVDs, by hiring key people in certain fields, by making strategic alliance with companies that had the know-how they needed, by outsourcing tasks they were not good at or even by changing what they sold in their stores. Moreover, the case illustrates clearly the dangers of doing an inadequate resource base change, by describing the period when Blockbuster decided to compete directly with

Netflix but was faced with a structural relative disadvantage because it did not have the correct bundle of resources to provide a service of the same quality as Netflix (i.e. Blockbuster did not have enough distribution centers nor a large enough DVD catalog). Hence, the case provides evidence that resource base changes occur frequently and in many forms in fast changing environments and also stresses the importance of correctly operating these changes as a necessary condition in order to successfully display dynamic capabilities.

Thus, the Blockbuster case provides insight and illustrates with examples how actual management practice relates with strategic management theory, specifically with the dynamic capabilities literature.

Conclusion

The dynamic capabilities view was developed to fill the gap left by previous theories on sustained competitive advantage: how can companies be successful in fast changing environments? The sheer number of research studies concerning this topic in recent years is indicative of its current relevance, especially in markets with shorter product life cycles, faster technological innovation and increased competition.

The main theoretical groundwork that supported this thesis was the definition of dynamic capabilities developed by Barreto (2010) and its four dimensions. Using this conceptualization as a starting point, this thesis uses a teaching case to illustrate the connection between corporate strategy theory and actual management practice. Specifically, by analyzing Blockbuster's evolution the evidence seems to confirm that if a firm does not display satisfactory levels in all dimensions that compose a dynamic capability, it will probably not respond successfully to an emerging exogenous shock and might see its competitive position seriously damaged.

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