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# Banks Are at Risk of Becoming the Next Blockbuster

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In 2000, Reed Hastings, the founder of a then start-up called Netflix, flew to Dallas to propose a partnership to the management team of Blockbuster and its CEO John Antioco. The idea was that Netflix would run Blockbuster's brand online and Blockbuster would promote Netflix in its brick-and-mortar stores. Hastings was summarily laughed out of the room.

We all know what happened next. Blockbuster went bankrupt in 2010 and Netflix, as of January 5 2021, is now a $220+ billion dollar company, about eighty times what Blockbuster was worth. Today, Hastings is widely hailed as a genius and Antioco, well not so much.

As we look back at the "intersection" of Blockbuster and Netflix, it looks a lot like what we perceive today to be the relationship between community banks and fintech/neo banks. For the purpose of this paper, when we use the term "community banks" we include regional banks as well. Additionally, when we use the term "fintechs" we are referring to not only fintech companies but neo banks, insurtech, proptech and investech as well.

We believe that as you read our memories of the Blockbuster and Netflix relationship you can replace the name Blockbuster with community banks and think of the Blockbuster brick-and-mortar stores as brick-and-mortar community bank branches. Likewise, we can think of Netflix as a fintech company. So let's look back on how the Blockbuster and Netflix saga played out.

The Blockbuster and Netflix saga played out less than twenty years ago, although it seems like ages ago, and as I pen this report I realize that some of my younger coworkers may not even recall Blockbuster.

The CEO of Blockbuster (read bank), Mr. Antioco, was regarded as a competent CEO and in fact many considered him a retail genius. Yet for all of his operational acumen, he failed to see that networks of unseen connections, the internet, would bring about his downfall. In hindsight, it is quite obvious how the internet would disrupt the Blockbuster model but at the time the internet was at its infancy, streaming video was just an aspiration and Netflix (read fintech) was still operating under its early stage model of using the U.S. Postal system to distribute and collect its DVDs.

When Hastings, the CEO of Netflix (fintech), flew down to Dallas and proposed his deal in 2000, Blockbuster (bank) sat atop the video rental industry. With thousands of retail locations (bank branches), millions of customers, massive marketing budgets and efficient operations, it dominated the competition. So it's not surprising that Antioco and his team balked at simply handing over the brand they had worked hard to build.

When Netflix (fintech) launched in 1997, Blockbuster (bank) had for years been the undisputed champion of the video rental industry. Between 1985 and 1992, Blockbuster (bank) grew from one location in Dallas to more than 2,800 rental stores worldwide. Netflix (fintech) competing against Blockbuster (bank) seemed like a David vs. Goliath scenario. Hopeless.

But through a series of disruptions and changes to the video/home entertainment industry, the tables turned. In 1997, when VHS video was the industry standard, Reed Hastings saw an opportunity to introduce a monthly DVD subscription service by mail. Blockbuster (bank) was wedded to its brick and mortar retail outlet (branch) business model.

Yet Blockbuster's (bank) model had a weakness that wasn't clear at the time. It earned an enormous amount of money by charging its customers late fees, which had become an important part of Blockbuster's (bank) revenue model. (Just equate this to all the various bank fees and dependence on interest rates that we believe will not be rising anytime soon.) The ugly truth, and Blockbuster's (bank) Achilles heel was that the company's profits were highly dependent on penalizing its patrons.

At the same time, Netflix (fintech) had certain advantages. By eschewing retail locations (branches), it lowered costs and could afford to offer its customers far greater variety (read financial services). Instead of charging to rent videos, it offered subscriptions, which made annoying late fees unnecessary. Customers could watch a video for as long as they wanted or return it and get a new one.

Netflix (fintech) proved to be a very disruptive innovation, because Blockbuster (banks) would have to alter its business model and damage its profitability in order to compete with the startup. Despite being a small, niche service at the time, Netflix (fintech) had the potential to upend Blockbuster's (bank) well-oiled machine.

While Netflix's (fintech) model clearly had some compelling aspects, it also had some obvious disadvantages. Without retail locations (branches), it was hard for people to find. Moreover, because its customers received their videos by mail, the service was somewhat slow and cumbersome. People couldn't just pick up a movie for the night on their way home. Likewise, we believe today's fintech model has some obvious disadvantages. While they would like to offer an array of financial services, the fintechs do not want to be burdened with the regulation that comes with being a regulated bank and thus must utilize banking-as-a-service (BaaS) as a key part of their value proposition.

Still, Netflix (fintech) customers loved the service and told their friends. Some were reluctant at first, they actually liked putting the family in the car and driving to a Blockbuster retail location (branch) and browsing movies whenever they decided to have a family movie night, but others were on board with the Netflix (fintech) model right away. As more of their friends raved about Netflix (fintech), the second adopters tried it too, fell in love with it and convinced people they knew to give it a shot.

Network scientists call this the threshold model of collective behavior. For any given idea, there are going to be people with varying levels of resistance. As those who are more willing began to adopt the new concept, the more resistant ones become more likely to join in. Under the right conditions, the network effect becomes a viral cascade.

While ideas usually take hold in small niches of innovators, they can often spread to early adopters, who are only slightly more resistant to join in. Once they are on board, those in the early majority begin to feel comfortable giving it a try. As each threshold is past, the next group becomes more likely to adopt the new idea. That is how disruption happens.

Unfortunately, the timing of the network effect is hard to quantify. Social dynamics tend to be idiosyncratic and it is not always clear exactly where network thresholds exist. We believe it is difficult to evaluate whether an idea is spreading to new groups or just growing within a niche.

It is not clear when Blockbuster (bank) realized that Netflix (fintech) was benefiting from this network effect, but by 2004, six years before Blockbuster (bank) went bankrupt, Antioco's team sensed that Netflix had become a significant threat and sought to change his firm's policies.

Once John Antioco became convinced that Netflix was a threat, he convinced his team as well as Blockbuster's (bank) board of directors to discontinue the late fees that annoyed customers and to invest heavily into a digital platform to ensure the brand's future. Subsequently, the board had second thoughts as the reality of the fact that the costs of Antioco's plan would cost about $200 million to drop late fees and another $200 million to launch Blockbuster Online and profitability would suffer.

Eventually, an activist investor, Carl Icahn, began to question Antioco's leadership. The board was influenced by Icahn and lost confidence in Antioco's plan and Antioco was fired in 2005. Jim Keyes was named CEO and immediately reversed Antioco's changes in order to increase profitability.

In 2007, Netflix (fintech) transitioned from DVD shipments to online programming. Faster bandwidth and greater download speeds made this new service feasible. Blockbuster (bank) went bankrupt three years later in 2010 after incurring more than $1 billion in losses the previous year. The legacy of Blockbuster (bank) is one of stubbornness and missed opportunities.

**What are the key lessons that community banks can learn from the Blockbuster vs. Netflix saga?**

We believe the first lesson is that community banks need to embrace change. Netflix saw a technological and marketing opportunity to compete with Blockbuster with a subscription by mail DVD service. They then embraced technology and transitioned to an online video streaming, to online streaming content creation model and continues to embrace innovation.

Blockbuster saw itself as the dominant video rental player with locations all over the world. They fell in love with their business model more than they did with satisfying customer needs. We believe that community banks are not keeping up with customer needs. As highlighted by the recent "lockdowns" associated with COVID 19 and the adoption of services by businesses, for example video conferencing, entrepreneurs are more concerned with working efficiently and have embraced doing so remotely. Community bankers must now realize that the "community" is now online and worldwide and that the majority of entrepreneurs no longer have the desire or time for "relationship" banking in the traditional sense where they must spend hours on a golf course and eating steak dinners with the local community banker to receive a bank loan or other banking services. The person-to-person time, and getting to know people which was utilized in the underwriting process and often resulted in the exclusion of women and minorities has now been replaced by technology and underwriting driven by algorithms and artificial intelligence.

The second lesson is that community banks should not be afraid to fail. Netflix has constantly been willing to try new things. Many have worked out, such as their online streaming and content creation services but some, such as full length feature film production, has not yet succeeded. Today, 99% of community banks utilize one of three vendors to provide them with their core banking systems. This is despite the fact that these core systems are built on antiquated thirty plus year old technologies. Community bank management teams and boards have convinced themselves that they can differentiate themselves from their peers simply by selecting a different mix of ala carte services and technologies from the service offering menus from these core providers. We believe that community bank management teams are afraid to invest in the development of their own proprietary technologies and the people necessary to develop them and/or to embrace new core bank system technologies.

Finally, we believe that community banks need to be willing to disrupt themselves. While Blockbuster clung to its business model of being a video rental company, Netflix constantly disrupted itself. Netflix went from being a DVD subscription rental service, to a streaming of movies and TV series model, to being a creator of content. Netflix would always try to stay on the cutting edge of innovation, even if it meant disrupting its existing businesses. We believe that community banks need to embrace new strategies such as banking-as-a-service (BaaS), payment services, branchless or limited branch services, willingness or desire to be the backbone of a platform that includes multiple services via partnerships that include fintech, proptech, insurtech and investech.

**Revisiting the Community Bank Business Model**

We believe that the current pandemic has advanced the shift in community banking towards a digital model by three years. We believe this new model will integrate a digital banking platform with third party partners that provide payments, insurance and wealth management via new technology platforms such as blockchain/ethereum and new payment rails. For the winners, we believe this means community banks will have to embrace partnerships and adopt new technology. For losers, we believe it means surrendering business to new entrants which can offer superior customer service at a lower cost.

**We believe that Emerald's fundamental research process will benefit our shareholders as we identify management teams that we believe understand the changing community banking landscape. In a follow up to this report we will discuss neo banks and their strengths and weaknesses as well as what we believe community banks "winners" will do to be part of "community banking 2.0".**

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