



*Martin Burns, Jason Parker, Erin Baldinger, Chet Wall*

Arizona State University

*One billion rentals is an incredible milestone as Redbox has quickly become the local video store for millions of consumers nationwide. Our popularity is a testament to our consumers' loyalty and our steadfast commitment to making movie rentals affordable and convenient for our consumers.*

**MITCH LOWE**

REDBOX PRESIDENT, SEPTEMBER 5, 2010

## Introduction

After nearly twenty years of plodding diligently along, it has been a busy time for Coinstar. Within a three-year period beginning in 2008, Coinstar expanded through its acquisition of Redbox, changed its CEO, shuffled executive management, and sold off three of its four differentiated lines of business. In addition, it amassed over \$350 million in debt that is now convertible, maturing, or subject to a spread higher than the current bank market would dictate and representing over 30 percent of assets. Despite its growing pains while searching for a long-term strategic identity, Coinstar was also able to increase consolidated revenue by \$382.5 million (or 58.8 percent) in 2009 and \$403.8 million (or 39.1 percent) in 2010.<sup>1</sup>

Coinstar's recent growth was primarily fueled by revenue generated by Redbox—a DVD rental kiosk business with almost 31,000 retail locations. Consumers made penny wise by the recession flocked to Redbox in search of cheap entertainment in the form of \$1 per day DVD rentals. The popularity of Redbox helped Coinstar nearly double revenues to \$1 billion and made it a Wall Street darling with its stock trading as high as \$60 a share.<sup>2</sup>

As of 2011, Coinstar consisted of two primary lines of business—coin-counting kiosks and Redbox kiosks—and had many decisions to make as it continued to compete in these segments. From developing future product

lines, to becoming more streamlined, to restructuring its balance sheet to fund expansion and support long-term sustainable returns to shareholders, Coinstar leaders had a few late nights ahead.

## More Than Just a Jar of Chump Change... Lots More

As have so many iconic American entrepreneurial enterprises, Coinstar's humble beginnings were born and bred on a college campus. Coinstar was founded by Jens Molbak in 1991 and officially, and literally, began turning a dollar after Molbak installed his first coin-counting machines in four San Francisco grocery stores in 1992. The immediate success of those first four machines prompted aggressive expansion plans and, under the leadership of Molbak, the company went public in 1997. By 2002, Coinstar had installed its 10,000th machine and processed more than \$4.5 billion worth of coins and, despite not having turned a profit yet, was valued at an estimated \$130 million.<sup>3</sup> In a rather mind-boggling feat, by 2001, Coinstar machines were collecting and returning into circulation more coins annually than those being produced by the US Mint. In fact, in 2002, the US Mint began reducing its workforce and by 2010, it was producing less than one third of the average number of coins it had produced annually over the last 30 years,<sup>4</sup> a fact nearly wholly attributed to Coinstar.

In an effort to diversify its revenue stream, Coinstar invested in four primary subsidiaries in the early to mid 2000s: a money transfer business called GroupEx, an electronic payments service, an entertainment business consisting of gumball machines and crane games, and Redbox. While the former three of these businesses had combined revenues of over \$261 million in 2008, by 2010, revenues had plunged to \$104 million. Having already initiated an evaluation of its product lines, business segments, and corporate structure in 2008, by 2010,


**Exhibit 1** Segment Revenues

Coin Revenues				DVD Revenues			
2005	2006	\$ change 05 to 06	% change 05 to 06	2005	2006	\$ change 05 to 06	% change 05 to 06
220.7	261.0	40.3	18.3%	239.0	273.4	34.4	14.4%
	2007	\$ change 06 to 07	% change 06 to 07		2007	\$ change 06 to 07	% change 06 to 07
	307.4	46.4	17.8%		238.9	-34.5	-12.6%
	2008	\$ change 07 to 08	% change 07 to 08		2008	\$ change 07 to 08	% change 07 to 08
	261.3	-46.1	-15.0%		388.5	149.6	62.6%
	2009	\$ change 08 to 09	% change 08 to 09		2009	\$ change 08 to 09	% change 08 to 09
	259.1	-2.2	-0.8%		773.5	385.0	99.1%
	2010	\$ change 09 to 10	% change 09 to 10		2010	\$ change 09 to 10	% change 09 to 10
	276.3	17.2	6.6%		1160.1	386.6	50.0%
<b>Cumulative</b>		\$ change 05 to 10	% change 05 to 10	<b>Cumulative</b>		\$ change 05 to 10	% change 05 to 10
	276.3	55.6	25.2%		1160.1	921.1	385.4%
e-payment revenue included with Coin				Inclusive of all "entertainment" revenue			

Source: Data taken from 2007, 2008, 2009, 2010 Coinstar 10-K

Coinstar made the decision to divest all but Redbox thus demonstrating its commitment to its two primary business segments—Redbox and Coinstar kiosks (see Exhibit 1).

### Redbox Division

*With more than 27,000 locations nationwide, Redbox is the fun, fast, easy way to rent the latest new release movies for just \$1 a night for DVD rentals and \$1.50 a night for Blu-ray Disc rentals. The network of bright red Redbox kiosks are located at leading grocery stores, mass merchant retailers, drugstores, restaurants, and convenience stores nationwide. Featuring up to 200 titles and 630 movies, Redbox is a fully automated video rental store contained in 12-square feet of retail space.<sup>5</sup>*

McDonald's, the popular fast food chain, created Redbox in 2002 as a way to generate revenue by renting DVDs at its restaurant locations. In 2005, McDonalds entered into a joint venture with Coinstar, spinning Redbox off into its own corporation and giving Coinstar a 47 percent ownership stake with future ownership options. On January 1, 2008, Coinstar increased its Redbox ownership as allowed by its operating agreement to 51 percent and, in February 2009, Coinstar acquired the remaining shares of Redbox.<sup>6</sup> With a combination of stock and cash, the total transaction cost Coinstar an estimated \$176 million.<sup>7</sup>

After two years of test piloting at more than 5,000 kiosks, in 2011, Coinstar introduced video game rentals to more than 21,000 of its 31,000 Redbox kiosks. With its sole remaining bricks-and-mortar competitor Blockbuster already reduced through store closings to a whisper of its former self, Coinstar has targeted expansion to include an additional 14,000 Redbox kiosks nationwide—adding to the four kiosks it has already

placed within a five-minute drive of every Blockbuster location.<sup>8</sup> In response to the increasing popularity of streaming video and to compete with its other major rival—Netflix—Redbox CEO Mitch Lowe confirmed that plans were in the works for Redbox to offer a video streaming subscription service.<sup>9</sup>

### Coin Business

Coinstar's coin-counting kiosks have been a steady source of revenue and the foundation of the company since its inception. As of 2011, Coinstar operated 18,900 coin-counting kiosks in the US, Canada, the UK, and Ireland.<sup>10</sup> Jens Molbak, a second year MBA student at Stanford, came up with the idea while staring at a jar of loose change on his desk. He later rolled the questions of 'what do people do with their loose change?' and 'exactly how much loose change is out of circulation?' into a graduate research project. What he discovered after surveying 1,500 consumers confirmed his own sentiment that it was a hassle to roll the coins and cash them in. What surprised him however was, based on what people were telling him, the astronomical dollar amount of coins he estimated to be sitting in jars just like his, across the nation.

*Coinstar estimates that the average consumer touches about \$600 in change every year and has between \$30 and \$50 worth of change sitting out of circulation at home. That amounts to about \$144 billion in annual coin flow, with more than \$7 billion in change sitting idle across the nation.<sup>11</sup>*

Central to Coinstar's success are the original five patents Coinstar holds for its coin-counting machine technologies. The machine counts unsorted change poured in by a customer at a rate of 600 coins per minute—separating the coins from common debris,

Globe: © Jan Rysavy/iStockphoto.com



lint, and other random tidbits sometimes found in coin jars. When the sorting is done, the machine provides a voucher for the total amount counted less the Coinstar processing fee. Customers then exchange their voucher for cash at the retail location hosting the machine. Because the alternative is to do it themselves, Coinstar customers offered little resistance to its recent processing fee price increase from 8.9 percent to 9.8 percent of gross. The fee increase was expected to raise same store growth by at least 5 percent.<sup>12</sup> One year later, Coinstar reported a decrease of over 640,000 transactions across its fleet of machines. Despite this however, the fee increase ensured positive growth of same-store revenue of 5.3 percent (see Exhibit 2).

As a new alternative to paying the processing fee, customers may instead choose to receive a fully funded (i.e., no processing fee deducted) gift card or eCertificate in lieu of cash.<sup>13</sup> Additionally, Coinstar customers can now also opt to have a Coinstar Account whereby users can track their coin redemptions online, make charitable donations to large partner charities, and receive exclusive offers via e-mail.

**New Ventures**

With the divestiture of its three other product lines, starting in 2011, Coinstar will be reporting a new segment called New Ventures. Per Coinstar's SEC filings, in the past, the company reported the segment under the Redbox and Coin segments. Currently, the segment is mostly involved in what is referred to as "Coffee and Chirp" businesses, along with other trial kiosk concepts.

*The Coffee kiosks can dispense a "real brewed" cup of coffee, designed by the person who developed the Starbucks stands that are commonly found in grocery stores. The Chirp kiosks will sell ladies merchandise to women shopping at grocery stores, with an inventory that will be completely replaced each week. Other ideas include a kiosk called Gizmo selling small high-value electronic gadgets and consumer goods, Face Cube which is a photo booth connected to the Internet, and a*

*partnership with ecoATM which is a kiosk that recycles old cell phones.<sup>14</sup>*

All the kiosk concepts replicate the existing service model whereby kiosks are updated weekly and designed to attract specific demographics in particular locations. Coinstar is able to leverage its existing infrastructure to deliver more goods to more people in what holds the potential to be a one-stop shop. Coinstar has trademarked the term "4<sup>th</sup> Wall," which is "a merchandising strategy based on the variety of front-of-store businesses and including coin conversion, pay-as-you-go products/services, DVD rental, money transfer, and coffee kiosks"<sup>15</sup>—and Coinstar's plan for future growth.

**A Strong Collective of Expertise**

Jens Molbak founded and served as the CEO of Coinstar from 1991 until February 2000 when he retired at age 39. At that time, Daniel Gerrity, Coinstar's President and COO, assumed the role of CEO, serving for only nine months before turning in his own resignation. Succeeding Gerrity was David Cole who served as CEO from 2000 to 2009. Currently serving as CEO and member of the Board of Directors is Paul Davis.<sup>16</sup>

**Paul Davis, Chief Executive Officer**

Paul Davis came to Coinstar as the COO in April 2008 and assumed the role of CEO and Director of the Board in April 2009.<sup>17</sup> Before joining Coinstar, Davis held a variety of sales and executive management positions with Kettle Foods, Barilla America, Starbucks North America, PepsiCo's Frito-Lay Canada, and Procter and Gamble. Davis holds a bachelor's degree from the University of Central Missouri.<sup>18</sup>

**Gregg Kaplan, President and Chief Operating Officer**

Gregg Kaplan was hired by Coinstar from Redbox as President and COO in April 2009 upon the promotion of Paul Davis.<sup>19</sup> Kaplan started with Redbox as part of McDonald's strategy and development team, becoming

**Exhibit 2** Same Store Sales Growth

DVD Kiosk Same Store Sales				
	Q1	Q2	Q3	Q4
2010	21.0%	3.5%	17.2%	12.5%
2009	35.0%	33.0%	26.0%	21.0%
2008	37.4%	63.2%	40.6%	64.3%

Coin Kiosk Same Store Sales				
	Q1	Q2	Q3	Q4
2010	0.5%	7.9%	7.9%	—
2009	-5.0%	-4.3%	-5.4%	-3.9%
2008	-0.2%	-3.2%	-1.8%	-5.0%

Source: Data taken from 2010 Coinstar 10-K

Copyright 2012 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

5823494 Feng Helen Liang

Redbox CEO in 2005 when it became a separate company. In his almost seven years with Redbox, he grew the business from its first kiosk to over 14,000—from a team of five employees to over 1,200. Before McDonald's, Kaplan worked with Internet start-ups and as an investment banker. Kaplan holds a bachelor's in philosophy from the University of Michigan and an MBA from Harvard Business School.

### J. Scott Di Valerio, Chief Financial Officer

Scott Di Valerio came on board with Coinstar in March 2010 as CFO.<sup>20</sup> With prior work experience at Lenovo, Microsoft, and Mindwave Software, Di Valerio also leads Coinstar's corporate IT functions. Other experience includes time spent with Walt Disney and Pricewaterhouse Coopers. Di Valerio holds a bachelor's in business administration from the University of San Diego and is a Certified Public Accountant.<sup>21</sup>

### Mitch Lowe, President, Redbox

Like Kaplan, Mitch Lowe started his career with Redbox as part of the McDonald's team tasked with its development.<sup>22</sup> After splitting from McDonald's in 2005, Lowe was hired by Redbox as the COO and named President in 2009. Prior to McDonald's he held the Chairman and Director positions of the Video Software Dealers Association and was a Founding Executive of Netflix.

### Mike Skinner, President, Coin

Mike Skinner was hired by Coinstar at the end of 2004 and held various senior management roles prior to his promotion to President of Coin in 2009.<sup>23</sup> Prior to Coinstar, Skinner had amassed over 30 years of experience with companies including National Beverage, PIA Merchandising, and Impli Media. Skinner received his bachelor's in business administration from Oregon State.<sup>24</sup>

## Setting the Tone

The majority of Coinstar sales and operations are in the US with no formal plans for significant international expansion. Generally, the US population is growing larger through longer life expectancy due to medical advancements and an increase in immigration. Always considered a "melting pot," the US is becoming an even more diverse society than before, a fact that is already significantly affecting the current and future target audiences businesses are identifying. Collectively, these trends continue to expand the consumer market of the US.

The US economy officially endured a recessionary contraction from December 2007 through June 2009. However, because the primary driver of the recovery has been loose monetary and fiscal government policies, the economy remains weak. Additionally, the US budget deficit remains at a record high, raising concerns about the long-term creditworthiness of the US government and diluting the value of the US dollar in global markets. To Coinstar's advantage however, this weakened economy makes low-priced goods and services (i.e. Redbox) very attractive to consumers and a prolonged recovery could bode well for low-cost goods and services providers as consumers remain wary of spending beyond their means.

As it affects mostly the Redbox division, physical DVD sales are expected to drop \$4.6 billion from 2009 to 2014 due to technological advances such as video streaming over the Internet and the variety of viewing portals available including televisions, computers, phones, tablets, and music players. General improvement of Internet data transmission speeds and data storage advancements continue to be a key factor in this development.

## Taking a Toll

Coinstar's Redbox division has more competitors than its Coin division including Netflix, Vudu (owned by Walmart), AppleTV, and recently Amazon.com. In any discussion of the industry, it is important to also note that, while movie studios have historically relied upon distribution contracts and royalties for post-production revenue, recent technological advancements have simplified electronic distribution—a fact the studios could leverage at any time to not only maximize their revenue streams, but pocket any advertising dollars generated by their Internet portals. Coinstar's Coin division's most notable competitors include Global Payment Technology (GPT) as well as the installation of free coin-counting machines and the daily cashing operations of bricks-and-mortar banks.

### Redbox DVD Segment Competition

**Blockbuster / DISH.** The success of Redbox has caught the attention of many companies and, despite its bankruptcy and seeming demise, the most notable of these is Blockbuster. Seeing the opportunity the kiosk market offers, Blockbuster launched its own kiosk network with 600 kiosks as of year-end 2010 and plans to install another 4,000 outlets in the future.<sup>25</sup> With Blockbuster's brand recognition, sentimental appeal, and newfound resources via its new owner, DISH Network, it cannot be counted out of the running just yet.<sup>26</sup>



**Netflix.** With 20 million subscribers, Netflix offers a formidable challenge to Coinstar's Redbox division. While Netflix and Redbox both serve the consumer in search of recent releases, Netflix has also amassed a large collection of special interest (foreign, independent, and hard-to-find) movies and a large audience of subscribers interested in this content. Netflix reported \$2.16 billion in annual revenue in 2010—a 29 percent increase from 2009 following a 22 percent increase from 2008. Because Netflix is a flat-rate service, barring rate increases, revenue increases are the result of additional subscribers.<sup>27</sup> Netflix subscribers have two subscription options: for \$7.99 per month, subscribers can stream an unlimited number of movies and television shows or, with a \$2.00 upgrade, they can also choose to receive DVDs at home via mail in as few as two business days.<sup>28</sup>

The number of Netflix subscribers continues to grow unabated (see Exhibit 3). Netflix believes that by continually improving the customer experience, it will continue to add subscribers. By increasing its number of subscribers, Netflix has greater leverage when negotiating with studios and is able to obtain more content. Netflix's subscription growth enables additional investments in research and development to improve services thus leading back to the start of the cycle—subscriber growth.

**Walmart's Vudu.** Founded in 2004, Vudu entered the video-on-demand market in April 2007. Like Netflix, Vudu allows viewers to watch movies via the Internet by streaming them to a home television, Sony Playstation, DVD player, or laptop. However, unlike Netflix, viewers only pay for what they watch—currently \$2 for two nights of access. Also, Vudu allows consumers to stream more movies in HD and offers customers the ability to

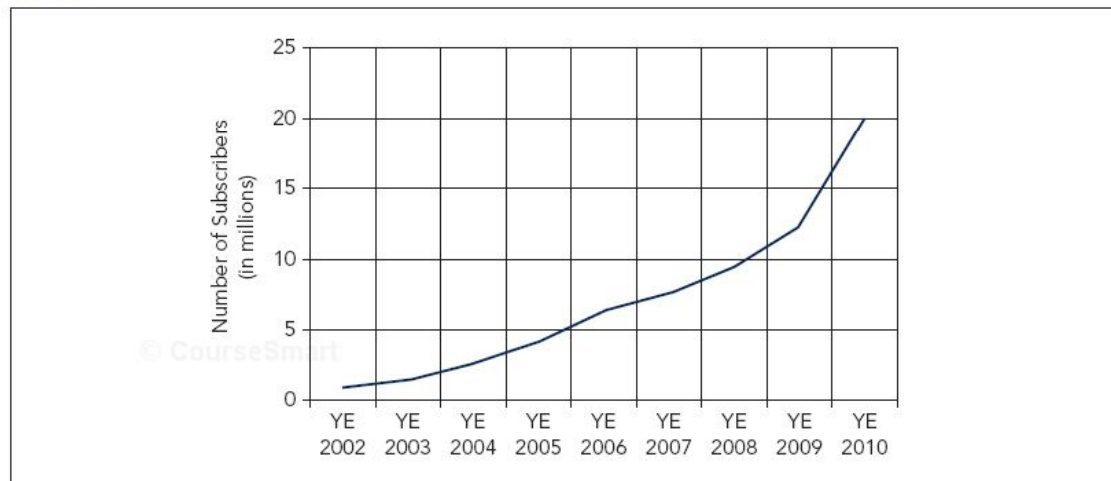
stream movies the same day they are released.<sup>29</sup> Redbox and Netflix on the other hand each require 28 days from the day of release before being able to offer the physical DVD, and delivery via streaming can take significantly longer if available at all.

Walmart acquired Vudu in 2010 because it provided the opportunity and means to enter the streaming market and begin to offset its anticipated future losses in the sales of DVD and Blu-ray as these formats become obsolete. Vudu currently has licensing agreements to distribute 16,000 separate titles.<sup>30</sup> Vudu's main selling point however was not only its licensing agreements, but also its unique digital technology that demonstrates a real expertise in the Internet streaming business.

**AppleTV.** Apple has not ignored the growth potential in streaming movies and television shows and has developed its own device—AppleTV (\$99)—onto which users can stream content. The niche of AppleTV is that it co-promotes iTunes as well as allows access to recently released television shows.<sup>31</sup> In an effort to expand the reach of this product, Apple recently negotiated a partnership with Netflix that provides AppleTV owners with access to Netflix's catalog. The alliance gives Netflix users the ability to watch instantly released movies via streaming. Apple gains because its owners are notoriously loyal and AppleTV drives traffic to iTunes for streaming video.

**Amazon.com.** Amazon.com, a publicly held corporation based in Seattle, entered into the streaming media market in February 2011. Its streaming offering, Amazon Prime, allows users to stream unlimited amounts of data over its network for an annual fee of \$79. Currently, the free unlimited streaming videos are limited to late 90s

**Exhibit 3** Netflix Subscribers



Source: Data taken from 2005, 2010 Netflix 10-K



and early 2000s movies as well as some television shows. It is estimated that Amazon currently offers just over 5,000 free (with annual membership fee) titles. In addition to access to streaming content, Amazon Prime also offers unlimited free two-day shipping on any order placed on its website, as well as one-day shipping for an upgrade fee of \$3.99 per shipment. Though its streaming services are new, Amazon.com has offered the shipping discounts as part of its Amazon Prime membership since 2005. The company is currently offering new Amazon Prime members a monthlong trial of its services at no cost.<sup>32</sup>

Accessibility to Amazon's movie database is currently only available through Samsung, Vizio, Sony, and Panasonic Internet connectable HD televisions and Blu-Ray players as well as TiVo and Roku set-top boxes and DVRs. As the newest player in the streaming market, Amazon's movie and television show selection is not of the same size or quality of Netflix. Even so, the company is actively working to expand its library to include additional popular titles in the near future.<sup>33</sup>

### Coin Segment Competitors

**Global Payment Technologies.** Global Payment Technologies (GPT) is a worldwide leader in the design and manufacture of currency handling equipment used in payment systems, tickets, gaming, and vending machines. Its core competency is its combined hardware and software that allows companies to offer secure and reliable currency handling and recordkeeping.

GPT's customers are companies and not individuals. One of its largest typical customers is a bank as the sensors in its equipment allow for the verification of bank notes. With a global presence in over 50 countries, GPT's equipment has the ability to reject counterfeit bank notes while accepting 99 percent of genuine currency.<sup>34</sup>

Financially, GPT has been struggling with annual revenues of \$10.98 million and a negative net income of -\$3.97 million. Despite projected growth of 22 percent, GPT will need to improve its profit margins to obtain favorable funding for future innovations and expansions.

**Banks.** An increasing number of banks have begun to install coin-counting machines as a value-added convenience for their customers—including 400 banks that have contracted with Coinstar for its machines, rebranded with the bank logo.<sup>35</sup> In some areas of the US, regional banks have begun offering full price coin redemptions in the form of a no upfront fee gift card. Having free coin-counting services has been a way to attract more customers to banks. For non-customers, many of these regional banks charge a 6 percent service fee.<sup>36</sup>

## Customers

Customers of Redbox are credit or debit card holding individuals that want to watch movies without the hassle of being tied down to a contract or subscription. Customers can rent movies by either reserving a specific movie online to pick up at a nearby kiosk, or by simply selecting and renting a movie at a local kiosk without a reservation. Redbox customers are primarily in search of comedies and action movies and, with a flat rate of \$1 per night, overwhelmingly state "good price" as their reason for patronizing Redbox. Additionally, some 45 percent of customers take advantage of the fact they can return a rented DVD to any Redbox kiosk,<sup>37</sup> resolving an oft-mentioned complaint of Blockbuster customers and making Redbox a very appealing service for travelers.<sup>38</sup> As an impetus to adding electronic download and streaming options, in a recent survey of its Redbox customers, Coinstar found that 65 percent were already familiar with downloading content (as compared to 52 percent of the general population).<sup>39</sup>

Quite simply, customers of Coinstar coin kiosks are those that have excess loose change and a desire to trade it in for coupons, paper money, or gift cards.

## Spreading the Word

Coinstar's overall success stems from its sales and marketing efforts and strong relationships with retailers contracted to provide space for both Coin and DVD kiosks, with Walmart, Walgreens, and Kroger accounting for 19.6 percent, 13.7 percent, and 10.6 percent, respectively.<sup>40</sup> These relationships have enabled the rapid growth of Coinstar and, in particular, its Redbox DVD segment. Contracts with retailers vary but typically last three to five years for both Coin and DVD kiosks and include a percentage of sales for the host retailer. Contracts are customized based on the potential and success of a location.

While Coin kiosks are less affected, Redbox experiences seasonality in its DVD rentals due to cyclical lifestyle and movie release patterns as well as the introduction of new television series.<sup>41</sup> DVD rental income is higher in summer months when children are out of school and many television series are on hiatus for the summer travel months. Revenues then typically drop in September and October due to the start of the school year and the resumption of fall television programming.

In 2010, Coinstar's marketing expenditures totaled \$14.7 million—an 80 percent increase over 2009. Those increased marketing dollars were utilized for national programs such as radio advertising, search engine marketing, and social media outlets for the Redbox segment<sup>42</sup> (see Exhibits 4 and 5).

**Exhibit 4** Marketing Expenses

	Year Ended December 31,		Change	
	2010	2009	\$	%
DVD Services	\$ 14,726.00	\$ 8,212.00	\$ 6,514.00	79.3%
Coin Services	\$ 9,092.00	\$ 7,242.00	\$ 1,850.00	25.5%
Share-based payment expense	\$ 18.00	\$ 25.00	\$ (7.00)	-28.0%
<b>Total</b>	<b>\$ 23,836.00</b>	<b>\$ 15,479.00</b>	<b>\$ 8,357.00</b>	<b>54.0%</b>

(dollars in thousands)

	2009	2008	\$	%
DVD Services	\$ 8,212.00	\$ 7,018.00	\$ 1,194.00	17.0%
Coin Services	\$ 7,242.00	\$ 7,682.00	\$ (440.00)	-5.7%
Share-based payment expense	\$ 25.00	\$ 50.00	\$ (25.00)	-50.0%
<b>Total</b>	<b>\$ 15,479.00</b>	<b>\$ 14,750.00</b>	<b>\$ 729.00</b>	<b>4.9%</b>

(dollars in thousands)

Source: 2010 Coinstar 10-K

© CourseSmart

**Exhibit 5** Marketing Expenses as a Percentage of Revenue

	2008	2009	2010
DVD Services	1.8%	1.1%	1.3%
Coin Services	2.9%	2.8%	3.3%
<b>Total</b>	<b>2.3%</b>	<b>1.5%</b>	<b>1.7%</b>

Source: 2010 Coinstar 10-K

## Making It All Possible

Redbox kiosks are stocked with DVDs that it purchases from licensed distributors, including movie studios. However, recognizing its phenomenal appeal and success, studios are very concerned that Redbox is hurting their DVD sales—the studio's primary source of revenue after a movie leaves the theatre—which dropped 13 percent in the fourth quarter of 2008 and was projected to keep falling.<sup>43</sup> With Redbox kiosks in so many convenient locations, fewer customers are willing to drive to spend \$20 per DVD when they can rent it for only \$1. However, because Redbox continues to grow and each kiosk continues to generate an average of \$50,000 per year in revenue, the studios have not been willing to pull Redbox's access to content knowing that this distribution network exposes more people to their movies thus translating into more revenue. Even though it has not yet been done in the US, the possibility remains for studios to decide to distribute content themselves if its supply contracts become less fruitful as well as to better protect themselves from piracy.

Coinstar depends on strong relationships with movie studios to build its Redbox DVD inventory. Redbox has established its DVD inventory by entering into licensing

agreements with movie companies such as Paramount, Universal Studios, 20th Century Fox, Warner, Lionsgate Films, SBHE Scan Based Trading Corporation, as well as wholesale distributors.<sup>44</sup> Inventory management is a delicate balancing act for Redbox as each kiosk has a fixed amount of DVD storage within each unit. For this reason, correctly choosing the DVD titles and quantities that will generate business at any particular location is critical as Redbox strives to meet optimal availability levels for its customers.

As an example of when this did *not* work out, in the fourth quarter of 2010, Redbox purchased too many copies of certain new release DVD titles, forcing the premature removal of older titles from its kiosks. Consequently, there was a negative impact on revenues and gross margins due to removing these older titles too early.<sup>45</sup>

Coinstar's dependence on its relationships with movie studios caused a disadvantage for Redbox when, in exchange for reduced rates on its purchases, it entered into a licensing agreement with Warner, Universal Studios, and 20th Century Fox in 2010 agreeing to delay the availability of new releases until 28 days after the DVDs were available for sale. The majority of competing movie providers however remain able to offer the content the same day as DVD release. This new "delayed rental window" creates a negative impact on Redbox business as, by the time Redbox can offer a new release, many customers have seen it via a competitor.<sup>46</sup> DVD rental has indirect competitors—including video on demand, digital downloads, and video streaming—that are all a major threat to the future of Redbox. Even so, Redbox still has a pricing advantage: with rentals priced at \$1 a night, Redbox maintains a strong foothold in today's movie rental business. Nevertheless, with DVDs going the way

of VHS, Coinstar must invest in some long-term strategic planning if it intends to keep this segment alive.<sup>47</sup>

Coinstar places its coin-counting machines primarily in supermarkets and other retail locations. While the strategic location of a kiosk determines its success, the provider of the location benefits as well through a share of the kiosk's revenue and as, more often than not, customers spend their exchanged money at that same location.

At year-end 2010, Coinstar employed 2,585 people, 1,718 of whom were field service employees, throughout the US and internationally. However, Coinstar outsources many functions to third parties including kiosk manufacturing, coin pickup and processing, and kiosk servicing and repairs. Because these functions are outsourced, Coinstar depends on its relationships with these suppliers, without whom it could not continue to provide exceptional customer service, nor expand.<sup>48</sup>

Coinstar's investment in research and development and technological advances is evident through the number of patents the company holds related to its kiosks. Its kiosk technology is central to the Coin and Redbox segments. Collectively, Coinstar holds 100 patents in the

US and international markets, 90 of which are related to its self-service coin-counting machines, including patents for machine networking, fraud avoidance, and voucher authentication. The remaining 10 patents held are related to the Redbox DVD business and include kiosk security and inventory management technologies.<sup>49</sup> Additional patents are pending.

#### Income Statement

Coinstar's healthy increases in revenue are due in large part to its increases in capital expenditures associated with adding 8,700 new DVD kiosks in 2009 and another 7,800 in 2010 coupled with increased marketing expenditures over the past few years (see Exhibit 6). Aggregate marketing expenditures have increased from approximately \$15.5 million in 2009 to \$23.8 million in 2010 with the majority of the increase due to marketing of the DVD business.<sup>50</sup>

Where revenue growth is driven almost solely by the DVD business, margins are a different scenario. The Coin margin has consistently outperformed the DVD operating margin—33.9 percent compared to 16.6 percent in 2010. This is primarily due to the expenses associated

**Exhibit 6** Income Statement Analysis

<b>DVD Segment</b>			
<b>Periods/Months Covered Statement Date</b>	<b>Historical Unqualified</b>		
	<b>12/31/2008</b>	<b>12/31/2009</b>	<b>12/31/2010</b>
Number of DVD Kiosks	13,700	22,400	30,200
Revenue (\$)	\$388,453	\$773,511	\$1,160,110
Revenue Growth (%)	379.0%	99.1%	50.0%
Operating Income (\$)	\$ 50,169	\$101,908	\$ 192,563
Operating Income as a % of Revenue	12.9%	13.2%	16.6%
Direct Operating Expenses (\$)	\$276,262	\$583,926	\$ 855,642
Marketing Expenditures	\$ 7,018	\$ 8,212	\$ 14,726
<b>COIN Segment</b>			
<b>Periods/Months Covered Statement Date</b>	<b>Historical Unqualified</b>		
	<b>12/31/2008</b>	<b>12/31/2009</b>	<b>12/31/2010</b>
Number of Coin Kiosks	18,400	19,200	18,900
Revenue (\$)	\$261,626	\$259,112	\$276,311
Revenue Growth (%)	4.1%	-1.0%	6.6%
Operating Income (\$)	\$104,395	\$101,601	\$ 93,652
Operating Income as a % of Revenue	39.9%	39.2%	33.9%
Direct Operating Expenses (\$)	\$130,260	\$130,196	\$137,339
Marketing Expenditures	\$ 7,682	\$ 7,242	\$ 9,092
<b>OVERALL</b>			
Net Income (\$)	\$ 14,112	\$ 53,643	\$ 51,008
Net Profit Margin (%)	1.55%	4.69%	3.55%

Source: 2010 Coinstar 10-K



with the DVD contracts, maintenance of DVD inventory levels, and marketing expenditures whereas research and development expenditures that have not been capitalized remain approximately proportionate to sales. Though margins have remained disproportional between the Redbox and Coin segments, Redbox was the primary driver of Coinstar's net profit in 2010 of \$51 million.<sup>51</sup>

**Balance Sheet**

The Coinstar balance sheet is best characterized as one surrounded with uncertainty regarding what the optimal capital structure would be going forward to maximize shareholder wealth as well as maintain strong future financial performance (see Exhibit 7). At year-end 2010, Coinstar showed a \$400 million revolving credit facility that will mature in 2012 as well as senior convertible notes outstanding in the amount of \$173.1 million. In addition, Coinstar's Board authorized additional share repurchases up to \$74.5 million bringing the total authorized to \$134.1 million. In 2010, it had repurchased \$55.8 million in shares leaving \$78.3 million authorized as of December 31, 2010.<sup>52</sup>

Cash flow leverage for 2010, as measured by total debt to EBITDA, showed marked improvement over

2009 from 2.39x to 1.44x. This is due to the coupled effect of aggressive debt pay down fueled by increased cash flows.

**Cash Flow**

EBITDA growth year over year has been driven by the aforementioned net profit and revenue increases (see Exhibit 8). However, much of this cash flow was used in 2010 to pay down debt as well as expand property and equipment assets. The majority of this property and equipment increase was due to additional kiosk installations as demonstrated by the \$170.8 million spent in 2010 and the \$148.5 spent in 2009.<sup>53</sup>

**Forward Thinking**

Without question, Coinstar faces more than a few serious issues. First and foremost is the likelihood that DVDs will soon be considered obsolete. Over the past few years, many Redbox competitors have implemented robust networks of streaming applications into their distribution channels. For example, Netflix distributes its streaming media through Internet enabled televisions, DVD players, gaming consoles, and more. In 2010, Netflix management predicted that the majority of its

**Exhibit 7** Balance Sheet Analysis

Period/Months Covered (\$-000's)	Historical Unqualified	Historical Unqualified	Historical Unqualified	Historical Unqualified
Statement Date	12/31/2007	12/31/2008	12/31/2009	12/31/2010
Periods/ Months Covered	12	12	12	12
Working Capital	104,724	(16,317)	16,106	(255,223)
Quick Ratio	1.25	0.64	0.68	0.33
Current Ratio	1.53	0.96	1.04	0.6
Total Liabilities	272,651	351,370	468,957	397,487
Total Net Worth	305,130	320,028	412,391	443,122
Tot Liab/TNW	0.89	1.10	1.14	0.90
Adj Tot Debt/Adj. Cap.	0.55	0.59	0.57	0.61
Total Debt / EBITDA	2.19	2.22	2.39	1.44

Source: 2010 Coinstar 10-K

**Exhibit 8** Cash Flow Analysis

Period/Months Covered (\$-000's)	Historical Unqualified	Historical Unqualified	Historical Unqualified	Historical Unqualified
Statement Date	12/31/2007	12/31/2008	12/31/2009	12/31/2010
Base Cash Flow (EBITDA)	124,431	158,320	196,245	275,578
Cash Provided By Oper. Activities	58,066	169,670	123,890	315,619
Cash Used by Investing Activities	(99,273)	(168,881)	(148,105)	(143,087)
Cash Provided (used) by Fin. Activities	58,285	4,646	41,939	(122,046)

Source: 2010 Coinstar 10-K

Copyright 2012 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

5823494 Feng Helen Liang

customer consumption would be through its streaming channels rather than its traditional mail based distribution system.<sup>54</sup> Netflix continues to see tremendous growth as indicated in its share price, revenues, and profit margin due to its continued push toward streaming.<sup>55</sup>

And while the industry's push toward streaming just follows the natural path of technological development, what prevents movie studios from taking over the entire lifecycle of their products? Aside from the risk of drawing the ire of customers accustomed to finding movies at a 'one stop shop' and the fact that to do so most effectively a studio would need to acquire an established movie distribution company, it only makes sense that they consider this option. To prevent this, Coinstar must determine if it is doing everything possible to keep its relationships with movie and television studios co-dependent, and not just dependent.

Another recent industry eye opener was the closure of over 500 Blockbuster locations and its subsequent purchase out of bankruptcy by DISH Network.<sup>56</sup> This can be seen as a positive in that it creates more customers for Redbox as traditional bricks-and-mortar customers move to the convenience of Redbox. However, Blockbuster's demise can also be seen as a negative in the sense that the traditional movie rental industry is on a downward trend.

Coinstar also faces questions regarding what its optimal capital structure should be going forward to maximize shareholder wealth as well as maintain strong future financial performance. As of 2010, Coinstar had its revolving credit facility maturing in 2012, the share buyback program, as well as senior convertible notes. As the company's expansion reached an inflection point in 2010 with a 10 percent decline in Redbox installations in 2010 and another 20 percent decline projected in 2011, would a larger share buyback program signal to investors that Coinstar believes its stock is undervalued and its business model has sustainable long-term growth potential?<sup>57</sup>

There are several implications when deciding on a capital structure including the cost of capital, the effects of ratings agencies, the key financial ratios affected and, perhaps most importantly, the combined effects these decisions have on shareholders. Going into this, one thing is certain: some serious decisions surrounding the capital layout of Coinstar will be made in the near future that will have long-term implications on Coinstar's share price and sustainability. The question is, what is the most advantageous capital structure to achieve the long-term prosperity associated with these short-term capital structure decisions?

This is the optimal time for Coinstar to consider capital structure alternatives as well as overall strategies going forward. When looking toward refinancing its existing debt, lenders and market investors will become more and more concerned with these strategies. Technology is, without a doubt, fast moving and, going forward, Coinstar's current distribution method is questionable at best.

And what does the future hold for its New Ventures segment? In many cases, diversification is a wise move if ones main business is threatened. However, with a host of other failed products introduced in its attempt to take over the fourth wall of supermarkets and the like, does Coinstar have the demographics research power to make profitable product placements or will it simply employ an "it worked here, let's try it there" methodology?

Finally, Coinstar has announced its intention to grow its namesake segment by 1 to 5 percent year over year by making improvements to its coin kiosks and additional marketing. Considering the recessionary climate, it seems odd that the Coin segment experienced *declines* in revenue in 2008 and 2009. In view of the number of Americans making every dollar count, were customers just holding back everything they could in reserve and temporarily unwilling to part with their loose change? With a margin that outperforms the DVD segment two to one, how to make this segment more functional is a critical challenge.

© CourseSmart

## NOTES

1. Coinstar, Inc. Form 10-K for the fiscal year ended December 31, 2010. SEC.gov. <http://www.sec.gov/Archives/edgar/data/941604/000119312511029330/d10k.htm>
2. Baker, M. S. Redbox: Coinstar's red-hot growth machine. Nov 2010. *Seattle Business*. <http://www.seattlebusinessmag.com/article/redbox-coinstar%E2%80%99s-red-hot-growth-machine>
3. Coinstar installs 10,000th machine; Supermarkets continue to add service to satisfy growing customer demand. 27 Jun 2002. *Business Wire*.
4. Appelbaum, B. Yes, coins too. 7 July 2011. *New York Times*. <http://economix.blogs.nytimes.com/2011/07/07/yes-coins-too/>
5. Media Center. Facts About Redbox. Redbox. <http://www.redbox.com/facts>
6. Coinstar, Inc. Form 10-K for the fiscal year ended December 31, 2009. SEC.gov. <http://www.sec.gov/Archives/edgar/data/941604/000119312510037612/d10k.htm>
7. Ali, R. DVD kiosk firm Redbox bought out by Coinstar for up to \$176 million; McDonald's paid out. 13 Feb 2009. *PaidContent.org*. <http://paidcontent.org/article/419-dvd-kiosk-firm-redbox-bought-out-by-coinstar-for-up-to-176-million-modo/>
8. Murphy, M. UPDATE: Coinstar 1Q profit jumps on Redbox revenue; Year view raised. 28 Apr 2011. *Wall Street Journal*. <http://online.wsj.com/article/BT-CO-20110428-727091.html>
9. Pepitone, J. Redbox plans to take on Netflix with video streaming service. 17 Feb 2011. *CNN Money*. [http://money.cnn.com/2011/02/17/technology/redbox\\_streaming/index.htm](http://money.cnn.com/2011/02/17/technology/redbox_streaming/index.htm)

User name: Feng Helen Liang Book: Strategic Management: Concepts and Cases: Competitiveness and Globalization, 10th Edition Page: cases-98. No part of any book may be reproduced or transmitted by any means without the publisher's prior permission. Use (other than qualified fair use) in violation of the law or Terms of Service is prohibited. Violators will be prosecuted to the full extent of the law.



10. Coinstar, Inc. Form 10-K for the fiscal year ended December 31, 2010. *op.cit.*
11. Murphy, M. *op.cit.*
12. Seitz, P. Coinstar raising fees for its coin-counting machines. 11 Feb 2010. *Click – IBD's Technology Blog*. <http://blogs.investors.com/click/index.php/home/60-tech/1118-coinstar-raising-fees-for-its-coin-counting-machines>
13. Coin to Card. Coinstar. <http://www.coinstar.com/FreeCoinCounting>
14. Hachman, M. Redbox parent trialling "Gizmo" EBay-in-a-kiosk concept. 17 Feb 2011. *PC Magazine*. <http://www.pcmag.com/article2/0,2817,2380549,00.asp>
15. Marching Orders. Coinstar. <http://www.coinstarinc.com/us/WebDocs/A3-2-1>
16. Senior Management. Coinstar. <http://phx.corporate-ir.net/phoenix.zhtml?c=92448&p=irol-govmanage>
17. *Ibid.*
18. Paul Davis Profile. *Forbes*. <http://people.forbes.com/profile/paul-davis/21014>
19. Senior Management. *op.cit.*
20. *Ibid.*
21. Executive profile: J. Scott Di Valerio. *Bloomberg BusinessWeek*. <http://investing.businessweek.com/research/stocks/people/person.asp?personId=22509296&ticker=CSTR:US&previousCapId=26674&previousTitle=COINSTAR%20INC>
22. Senior Management. *op.cit.*
23. *Ibid.*
24. Mike Skinner. *Linked In*. <http://www.linkedin.com/pub/mike-skinner/28/44/864>
25. Chmielewski, D. C. Redbox's \$1 vending-machine video rentals worry studios. 30 Mar 2009. *Los Angeles Times*. <http://articles.latimes.com/2009/mar/30/business/ft-cotown-redbox30>
26. Spector, M. and Checkler, J. Dish wins blockbuster. 7 Apr 2011. *Wall Street Journal Online*. <http://wsj.com>
27. Netflix, Inc. Form 10-K for the fiscal year ended December 31, 2010. SEC.gov. <http://www.sec.gov/Archives/edgar/data/1065280/000119312511040217/d10k.htm>
28. Unlimited TV Episodes and movies instantly over the Internet! *Netflix*. <https://www.netflix.com/>
29. Stambor, Z. Wal-Mart to buy a movie-streaming company. 23 Feb 2010. *Internet Retailer*. <http://www.internetretailer.com/2010/02/23/wal-mart-to-buy-a-movie-streaming-company>
30. *Ibid.*
31. Chapman, R. and Hoskisson, R. E. 2007 "Apple Computer, INC.: Maintaining the Music Business While Introducing iPhone and Apple TV"
32. Amazon.com. [www.amazon.com](http://www.amazon.com)
33. *Ibid.*
34. Global Payment Technologies. *GPT World*. <http://www.gptworld.com/GPT.htm>
35. Carms, A. Banks where you can still count your change. 2 Jun 2011. *New York Times*. <http://bucks.blogs.nytimes.com/2011/06/02/banks-where-you-can-still-count-your-change/>
36. Coin to Card. *op.cit.*
37. Lowe, M. Coinstar, Inc. Analyst Day. 16 Feb 2011. <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzY1Mjc4M3x0aGZlZlEPTQxNDU3MxUeXBIPtI=&t=1>
38. Dixon, E. Redbox customers get more rental freedom and lower cost than Blockbuster and Netflix. 13 May 2011. *newStaar MEDIA*. <http://newstaa.com/redbox-customers-get-more-rental-freedom-and-lower-cost-than-blockbuster-and-netflix/353361/>
39. Gruenwedel, E. Redbox eyeing catalog rentals. 16 Nov 2010. *Home Media Magazine*. <http://www.homemediamagazine.com/redbox/redbox-eying-catalog-rentals-21162>
40. Coinstar, Inc. Form 10-K for the fiscal year ended December 31, 2010. *op.cit.*
41. *Ibid.*
42. *Ibid.*
43. Chmielewski, D. C. *op.cit.*
44. Coinstar, Inc. Form 10-K for the fiscal year ended December 31, 2010. *op.cit.*
45. *Ibid.*
46. *Ibid.*
47. Fontevecchia, A. Coinstar sinking but cheap movies are a lifeboat. 14 Jan 2011. *Forbes.com*. <http://www.forbes.com/2011/01/14/coinstea-redbox-netflix-markets-equities-video.html>
48. Coinstar, Inc. Form 10-K for the fiscal year ended December 31, 2010. *op.cit.*
49. *Ibid.*
50. *Ibid.*
51. *Ibid.*
52. *Ibid.*
53. *Ibid.*
54. Netflix, Inc. Form 10-Q for the nine months ended September 30, 2010. SEC.gov. <http://www.sec.gov/Archives/edgar/data/1065280/000119312510235785/d10q.htm>
55. Netflix, Inc. Form 10-K for the fiscal year ended December 31, 2010. *op.cit.*
56. Strott, E. Blockbuster to close 500 stores. 25 Feb 2010. *MSN Money*. [http://money.msn.com/market-news/post.aspx?post=00000065-0000-0000-bf4d-190000000000&\\_blg=310](http://money.msn.com/market-news/post.aspx?post=00000065-0000-0000-bf4d-190000000000&_blg=310)
57. Mahaney, M. S. Netflix Inc (NFLX) Q1:11 "Cheat sheet" and preview. Rep. Citigroup Global Markets. 21 Apr 2011