A FAKE LETTER ABOUT REAL PROBLEMS

by Steve Brown

Dear Shareholders: Undoubtedly you heard as shareholders of Blockbuster Inc. of our filing for bankruptcy last Thursday. The insolvency that caused this reorganization stems from many factors, but basically boils down to our

Company's inability to react to the marketplace. In the coming weeks you all might be hearing a lot about what caused our problems, but I caution you to look beyond the headlines. For example, most of the press over this last weekend had to do with our capital structure and our inability to make debt payments. While failure to payoff our creditors pushed us into filing Chapter 11, this wasn't the main cause. Our leverage was only 3x assets to capital and thankfully not 8x leveraged like some other industries. Considering we didn't have to take too much credit and interest rate risk, our leverage was appropriate. Further, the cost on our debt is much cheaper than what other companies have to pay for common equity, so most of our problems were not a result of our capital structure.

The main problem was our cost structure, profitability and consumer demand. First, we were under the notion that we had to "look our customer in the eye," that we could deliver better service through our stores and that we needed to be "in the market" to understand what was going on. While all these assumptions might have been true, having 3,300 stores was very costly. Further, having this real estate created high fixed costs relative to overall cost, the exact opposite of the structure you want when sales drop. Our chief competitor, Netflix, for example didn't have stores, carried only a fraction of our cost structure and had a much more flexible delivery channel. When their demand dropped, they were able to quickly reduce variable expenses to maintain margins. Ironically, they garnered higher customer satisfaction ratings despite not having any stores.

Having the branch network we did also created problems in profitability. While we didn't actually know the profitability of our customer until about 3Ys ago, when we figured this out, this really helped. What we found is that we could not afford to just rent 1 DVD to a customer. For a while there, we made up for this issue with late fees. These penalties on customers for not managing their account were helpful, but when our competitors used this as a competitive advantage against us, we had to stop the practice. Then, in order to be profitable, we had to sell 3 to 5 movies per household at a time. Knowing that we couldn't do this easily, we pushed high margin popcorn, Milk Duds and Coke bottles the size of small refinery tanks. We also started a rewards program, ran targeted promotions and had a customer tracking program.

While focusing on profitability and cross-selling helped, it was not sufficient to overcome the basic flaw in our business model - our understanding of "convenience" was not our customer's. We thought the customer wanted a social outlet in their community to shop and be "wowed" by the "Hollywood experience." The reality is that the average customer just wanted movies when they wanted them, without having to drive 3 miles. Those consumers that were willing to pay for convenience gravitated towards buying movies from cable, satellite or over the internet (from the likes of Hula or iTunes). For those value conscious customers, Netflix offered unlimited movies delivered right to their mailbox. While we copied this structure, we didn't do it until last year, which was simply too late. It is also important to note that Netflix's fastest growing segment is their internet channel, a service we are still trying to figure out.

In summary, our failure to adapt, reduce the cost structure and a deeply held belief that we need to have a large store network caused our demise. Hopefully we can figure this equation out as we come out of bankruptcy. On the good news front, most likely you will be hearing a lot about other industries, such as book sellers, having the same problem so we won't be alone.

Sincerely, Your CEO

BANK NEWS

Closed (127 YTD)

The FDIC placed into receivership: 1) Haven Trust Bank Florida ($149mm, FL) and sold it to First Southern Bank ($448mm, FL). First Southern acquired all deposits for no premium and 86% of assets under a loss share. 2) North County Bank ($289mm, WA) and sold it to Whidbey Island Bank ($1.6B, WA). Whidbey acquired deposits for a 2% premium and about 77% of assets under a loss share. For more information, follow the link in our related links section below to "Failed Banks List"

Corporate CUs Closed

The NCUA seized 3 corporate credit unions: Members United Corporate FCU, Southwest Corporate FCU and Constitution FCU. The NCUA plans to strip $50B in troubled assets from the failed corporate CUs and market them to Wall Street investors with up to a $35B in Gov't guarantee.

Small Business Jobs Act

President Obama is scheduled to sign the small-business lending bill at 1:45pm ET, creating a $30B fund to provide capital for community banks (assets < $10B). Once signed, Treasury will work with banking regulators within a week to develop a term sheet and application.

Will it Work?

A survey by the NFIB found 91% of small business owners said all of their credit needs were met; while only 4% said finding financing was an issue. Overall, small business capital spending is at a 35Y low.