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Netflix's Patent May Reshape DVD-Rental Market

By NICHOLAS THOMPSON

In the brewing battle in the online DVD-rental marketplace, [Netflix](#), the market leader, has been given a potentially significant new advantage.

On Tuesday, Netflix was granted a patent that covered many of the basic features of the company's business model, a development that may well alter the nature of the competition between Netflix, a company based in Los Gatos, Calif., and the corporate giants, [Wal-Mart](#) and Blockbuster, that are entering the online DVD-rental market.

Netflix's rental service has grown steadily since its introduction in 1999. The company, which has 1.1 million subscribers, had first-quarter revenues of \$56 million this year, an 82 percent climb from last year.

As its competitors pointed out, those numbers still represented only a small fraction of America's nearly \$10 billion annual video and DVD rental market. Netflix's stock has more than doubled since the beginning of the year and has climbed \$1.60 since the announcement of the patent.

Subscribers of Netflix, which does not offer videos, are allowed to rent three DVD's from the company at a time and to create an online list of movies that they would like to see. After watching a movie, customers return it to Netflix in the envelope provided; the company then sends them the next DVD in their rental list. Customers are never charged late fees and may hold on to the DVD's for as long as they like so long as they have no more than three at a time.

The patent gives Netflix intellectual property protection over the technology at the core of its business: the way that a customer sets up his or her rental list; and the way the company sends the DVD's. The patent also grants the company exclusive control over many other small parts of the process of online DVD rental.

The patent, which was filed in 2000, has 100 claims over all. The company has other applications pending with the United States Patent Office, including one on the intricately designed envelopes it uses to send the DVD's.

"On the surface, the patent looks quite sweeping and quite meaningful," said Arvind Bhatia, an analyst for Southwest Securities, a Dallas-based financial services firm. Depending on whether the patent or its enforcement is challenged in court, Netflix could use it to try to stop its competitors from setting up online rental services. Or it could charge royalties to other companies that license the patent, giving Netflix a financial advantage.

Neither Blockbuster nor Wal-Mart would comment specifically on the patent, pointing out that they had not had time yet to analyze it. "We have just gotten a copy of the patent," said Karen Raskopf, a spokeswoman for Blockbuster. "But we can't imagine that there is a patent out there that will keep us from serving our customers as best we can."

Both Wal-Mart and Blockbuster are relatively new to the online rental market. Wal-Mart introduced a pilot program similar to Netflix's last fall and began the full service only this month. In 2002 Blockbuster bought the online DVD rental company, FilmCaddy.com. Now Blockbuster plans to integrate online and in-store rentals some time next year.

Although the online services of those companies are currently much smaller than Netflix, many analysts point out that both Wal-Mart and Blockbuster could provide stiff competition by taking advantage of their available capital, customer bases, and name recognition.

For example, Wal-Mart could package DVD rental subscriptions with its sales of DVD players. Blockbuster says that its plan will allow subscribers to return DVD's to their local Blockbuster outlets.

Gale Daikoku, an analyst at GartnerG2, said that she believed that Netflix currently provided superior service and that the patent could play a significant role in the company's effort to defend itself. But, she added, "If Wal-Mart wanted, they could send their big guns out and bury Netflix."

The patent office grants protection for 20 years to inventions that are novel, useful, fully disclosed and not obvious. Some analysts question whether Netflix's innovation should have passed that last test.

The patent "pretty much covers their entire process of having a subscription method for a product and how to manage the flow in and out of the company," said R. J. Jones, an analyst at Delafield Hambrecht. Because of that, Mr. Jones said, Blockbuster or Wal-Mart could challenge Netflix for patenting something obvious.

But he added that he believed the patent would make Netflix a more attractive company for one of the big players to acquire.

Asked about that possibility, Lynn Brinton, a Netflix spokeswoman, said the company was "not discussing specifics," but she noted that Netflix filed the patent for royalties and to protect its business model.