

Institutional Distressed Debt Research Blockbuster, Inc.

Performance Plus Advisors, Inc.
Bids4bonds.com
8/16/2010

Distressed Debt Research
Stephen P. Vlahos
Managing Director

Blockbuster Bonds- "Sizzle and Steak"

Distressed debt investors and traders will find "sizzle and steak" in the distressed debt securities of Blockbuster. Blockbuster bonds trade at prices that indicate its restructuring efforts will fail and the video rental chain will go out of business.

The Steak

Blockbuster has \$610 million remaining of senior 11.75 percent notes, due in 2014. These senior secured notes currently trading at 50 cents on the dollar have traded in a range of 50-75 this year. We expect this debt to be reinstated and or refinanced under either a refinancing scenario or a Chapter 11 proceeding. These notes are senior secured obligations and are guaranteed by Blockbuster's domestic subsidiaries. The notes and guarantees are secured by first priority liens on substantially all of Blockbusters assets.

The Sizzle

Blockbuster has \$300 million of 9 percent subordinated notes, due 2012. These notes currently trading at 4 cents on the dollar contain "all of the risk" in a Blockbuster restructuring. It will be challenging to provide a clear picture of the future outcome for the holders of the 9 % notes.

It looks like a pre-arranged Chapter 11 bankruptcy is coming. On July 1, 2010 holders of 70 % of the outstanding principal of the 11.75 % senior secured notes and Blockbuster entered into a Forbearance Agreement with respect to amortization and interest payments. Blockbuster put investors on alert that it might file for Chapter 7. On Friday 8/13 the Forbearance Agreement was extended to September 30. Blockbuster has engaged restructuring advisors at investment bank Rothschild and has hired law firm Weil, Gotshal & Manges, prominent bankruptcy attorneys.

We rate the senior debt of Blockbuster currently facing a probable Chapter 11 filing a BUY. We feel the 11.75 % Senior Secured Notes due 2014 currently trading at 50 cents on the dollar are undervalued in relation to our estimation of possible recovery values. The risk reward ratio makes sense at this time. This is the pivot security for investors in the distressed debt of Blockbuster.

For investors willing to take on above average risk we believe that the 9's due 2012 selling at approximately 4 cents on the dollar could offer investors an attractive speculative investment. Those investors will be speculating that after a reorganization of Blockbuster and a probable Chapter 11 filing, bondholders will receive a higher valuation than the current market. Investors may wish to wait for a "Disclosure Statement" to get a clearer picture of the new restructured company and for court evaluation and approval. As the specifics unfold the price of the 9's should begin to reflect more accurately the amount of equity that will be distributed in the new company to bondholders, if any.

See Important Disclosures

Bricks or Clicks

David Cook opened a local computerized video rental store in 1985. A year later he called the store Blockbuster Entertainment. In 1987, Wayne Huigenga took a one third stake. In 1993, Blockbuster became an acquisition target for Viacom. In 1999, Viacom took Blockbuster public again. A \$5 a share dividend to Viacom in 2004 created the debt that Blockbuster struggles with today. That dividend was financed through the proceeds from a \$300 million offering of senior subordinated notes and a \$1.5 billion bank credit facility. At the time, Blockbuster was making \$500 million a year in profit.

Blockbuster has launched several new strategies. The company added video games to its Mail service. Blockbuster has teamed up with Comcast to launch DVDs by Mail. This site allows Comcast subscribers to sign up for its mail service at a discounted rate. Blockbuster in Canada is offering members a \$9.99 per month plan to rent movies. Blockbuster has a long standing partnership with NCR for Blockbuster Express kiosks.

Competition has been fierce. Netflix and Coinstar are major competitors. Netflix is the provision of access to anyone with an internet connection. Netflix has a different cost structure than Blockbuster with its heavy overhead for its stores. Netflix's fixed costs are primarily its distribution centers, inventory, and website maintenance.

Redbox DVD service, a unit of Coinstar Inc., rents \$1 DVD's using kiosks. NCR and Blockbuster currently have a similar business model. An interesting competitor is HuLu, owned by Walt Disney Co. Another strong competition is video on demand. These technologies allows customers to access their preferred video almost instantly.

Blockbuster has been trying to reinvent itself in a changing market in which they have fallen from the "leader" to a "wanna be" position. Still, sales are \$750 million per quarter, and operating income is over \$400 million. We feel that there is room for all players that can efficiently operate their businesses and manage cash flow.

Second Quarter Results, EBITDA, Financial Statements

Total revenues for the second quarter of 2010 was \$788 million. Net loss for the second quarter was \$69 million, or a loss of 32 cents per share. Net loss for the quarter was affected by the closure of company stores, a decline in sales, and costs for recapitalization and lease terminations. Blockbuster operates with two reportable segments.* The domestic segment is comprised of all store operations and by-mail subscription service operations in addition to vending kiosks and the digital delivery of movies through Blockbuster.com and Blockbuster On Demand. As of July 4, 2010, there are 3,425 stores operating under the Blockbuster brand in the U.S. and its territories, of which 402 stores were operated through franchisees. There are 5,300 vending kiosks operating under the Blockbuster Express brand in the U.S. and its territories. The international segment is comprised of all non-U.S. store operations including operations in Europe, Latin America, Australia, Canada, Mexico and Asia. As of July 4, 2010, there are 2,383 stores operating under the Blockbuster brand and other band names, located in 16 markets outside of the U.S. Of these stores, 745 stores were operated through franchisees. In Canada, Italy, Mexico and Demark the company operates freestanding and store-in-store game locations under the Game Rush brand. On August 28, 2009, the company completed the sale of its subsidiary in Ireland. The results for Ireland have been classified as discontinued operations for all periods presented.

Stores + Distribution Centers*

	<u>Total</u>	<u>Sq. Footage (in thousands)</u>
Domestic Stores	3023	16,784
Distribution Centers	39	1,119
Offices	8	400
International Stores	1,638	5,255
(Company Operated)		
Distribution Centers	8	178
Offices	6	88

*10Q Blockbuster, 2nd Qtr 2010

EBITDA*

2Q10	?	4Q08	124
1Q10	31	3Q08	34
4Q09	17	2Q08	18
3Q09	27	1Q08	110
2Q09	32	4Q07	121
1Q09	85	3Q07	39

The Future - Blockbuster or Block/busted

If Blockbuster can lower the fixed cost portion of operations then the average cost curve will shift down. Blockbuster could be profitable at lower sales volumes. Blockbuster could operate without a loss at lower volume under a new cost structure. Blockbuster has a great brand and its foot in many new growth businesses. They need Chapter 11 help and cash. Only time can tell if Blockbuster meets the challenge.

* Source Bloomberg

BLOCKBUSTER
CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In million, except per share amounts)

	July 4, 2010
Assets	
Current assets:	<u>2010</u>
Cash and cash equivalents	\$ 64.3
Receivables, less allowances of \$4.8 and \$6.0 for 2010 and 2009, respectively	55.0
Merchandise inventories	222.4
Rental Library, net	286.7
Deferred income taxes	13.6
Prepaid and other current assets	<u>149.8</u>
Total current assets	791.8
Property and equipment, net	208.5
Deferred income tax	94.8
Intangible, net	6.5
Restricted cash	35.6
Other assets	<u>18.7</u>
	<u>\$ 1,155.9</u>
Liabilities and Stockholders' Equity (Deficits)	
Current liabilities:	
Accounts payable	\$ 160.5
Accrued expenses	377.6
Current portion of long-term debt	598.2
Current portion of capital lease obligations	5.3
Deferred income taxes	<u>98.8</u>
Total current liabilities	1,240.4
Long-term debt, less current portion	300.0
Capital lease obligation, less current portion	16.9
Other liabilities	<u>49.4</u>
Stockholders' equity (deficit):	1,606.7

BLOCKBUSTER
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In million, except per share amounts)

	July 4, 2010
Revenues:	<u>2010</u>
Base rental revenues	\$ 510.0
Previously rented product ("PRP") revenues	<u>96.3</u>
Total rental revenues	606.3
Merchandise sales	177.6
Other revenues	<u>4.4</u>
	<u>788.3</u>
Cost of sales:	
Cost of rental revenues	224.5
Cost of merchandise sold	<u>132.2</u>
Total cost of sales	356.7
Gross profit	<u>431.6</u>
Operating expenses:	
General and administrative	433.5
Advertising	9.3
Depreciation and intangible amortization	<u>26.5</u>
	<u>469.3</u>
Operating income (loss)	(37.7)
Interest expense	(32.1)
Interest income	0.1
Other items, net	<u>0.7</u>
Income (loss) from continuing operations before income taxes	(69.0)
Benefit (provision) for income taxes	<u>0.6</u>
Income (loss) from continuing operations	(68.4)
Income (loss) from discontinued operation, net of tax	<u>(0.3)</u>
Net income (loss)	(68.7)
Preferred stock dividends	<u>(0.6)</u>

Summary and Recommendation

The Steak

Institutional investors should consider the Blockbuster, Inc. 11.75 % senior notes, due 2014 currently priced at 50 cents on a dollar. We rate this distressed debt security as a BUY. We expect full recovery of principle, through reorganization, a Chapter 11 filing and or possible debt to equity swap. Major risk to investors would be a Chapter 7 liquidation. Our recommendation is based on the senior position the security has in the capital structure of the company and on a moderate improvement in financial variables such as EBITDA and a successful strategy for reorganization. This is our pivot security for investing in a Blockbuster restructuring.

Recovery Estimates For 11 ³/₄ Based on EBITDA Ranges

Estimated	3.5x	4.0x	4.5x	4.0x	3.5x	4.5x	4.0x
EBITDA 160M	160mm	160mm	160mm	185mm	185mm	185mm	200mm
Enterprise Value	560	640	720	740	648	833	800
Less Dip And Fees	125	125	125	125	125	125	125
Value left for Senior Secured Notes	435	515	595	615	522	707	675
Estimated Recovery On SR. Notes	72%	85%	98%	100%	85%	100%	100%

The Sizzle

The Blockbuster 9% notes due 2012 contain “all of the risk” in a restructuring or Chapter 11 filing. Institutional investors should consider these securities a speculative investment. It will not become clear the value of these securities until a Plan of Reorganization is filed. We expect enough “sizzle” for investors that wish to trade these securities.

Discloser - Certification

The research analyst does not have a financial interest in any security or derivative mentioned in this report. Performance Plus Advisors, Inc. has no knowledge of any material conflict of interest involving the subject company(s) mentioned in this report and our firm. The research analyst or any team member does not have any material conflict of interest, or knows or has reason to know of any conflicts of interest, relative to any of the securities mentioned in this report. Performance Plus Advisors, Inc. and its research analysts do not beneficially own more than 1% or more of any class of common equity of any company mentioned in this report. Performance Plus Advisors, Inc., the research analyst nor members of the research analyst's household serve as an officer, director or advisory board member of the subject company or any security mentioned herein. This report accurately reflects the analyst's personal views about the subject company(s). The analyst has not and will not receive compensation with respect to the insurance of this report.

Disclaimer

Information or opinions contained herein does not constitute a solicitation or offer to buy or sell any security or financial instrument or provide investment advice. The securities mentioned in this report may not be suitable for all types of investors. This report does not take into account the investment objectives, financial situation or specific needs of anyone. Before making an investment decision with respect to any security mentioned in this report, the recipient should consider whether such investment is appropriate. Investors should consider this report as only a single factor in making any investment decision. Information, opinions and statistical data contained in this report were obtained or derived from sources believed to be reliable but Performance Plus Advisors, Inc. does not represent that any such information, opinion or statistical data is accurate or complete, and should not be relied upon. All estimates, opinions and recommendations expressed herein constitute judgments as of the date of this report and are subject to change without notice. Estimates for the target value of securities discussed may not be realized. Combined risk factors make our estimates statistically unreliable. Performance Plus Advisors, Inc. does not accept any liability whatsoever for any direct or consequential loss howsoever arising, directly or indirectly, from this report or its contents. By accepting this report you agree to be bound by foregoing limitations.

Rating System Explanation

Buy: We generally expect "Buy" rated investment returns to be greater than or equal to plus + 20% from date of the original recommendation.

Neutral: We generally expect "Neutral" rated investment returns to deviate plus or minus + or - 20 % from the date of the original recommendation.

Sell: We generally expect "Sell" rated investment returns to be equal to or greater than minus -20% from the date of the original recommendation.

Analyst Rating Distribution as of 8/16/2010

	Number of Companies	Percent of Total
Buy	2	67%
Neutral	1	33%
Sell	0	
Total	3	100%