Entertainment Capital Advisors

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Industry and Strategy Briefings

at http://www.entcapadvisors.com

Reflecting on 2010 - A difficult year

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ENTERTAINMENT CAPITAL ADVISORS

Executive Summary

2010 has seen the film industry continue to evolve dramatically as a consequence of tighter capital markets, the evolution of digital technologies and changing patterns in consumer consumption of film and entertainment.

Globalisation

- The US studios continue to dominate the markets globally with greater revenues deriving from international box-office. They have also stepped up efforts to produce local language films whilst also trying to improve local distribution of their English-language content.

- Indian and Chinese markets have grown in importance to the US studios but other international markets have also shown good growth.

Brands: An additional source of financing?

- Large multinational advertisers are looking for ways to make their advertising dollars more demographically focused and more subliminal. There appears to be broad industry consensus that the 30 second advertising slot is in long-term decline. Moving brands more embedded in filmed entertainment is seen as an increasingly effective advertising strategy, provided it does not take the form of crude product placement. New financing models are being created as advertisers and brands seek to entwine brand awareness through the medium of high-quality filmed entertainment. Despite their historical resistance, producers have begun to realise that the involvement and financing from brands does not necessarily compromise creative integrity.

Convergence of Creativity and Technology

- The sector needs to try and find solutions to the truism for younger consumers: **how to compete with free?**

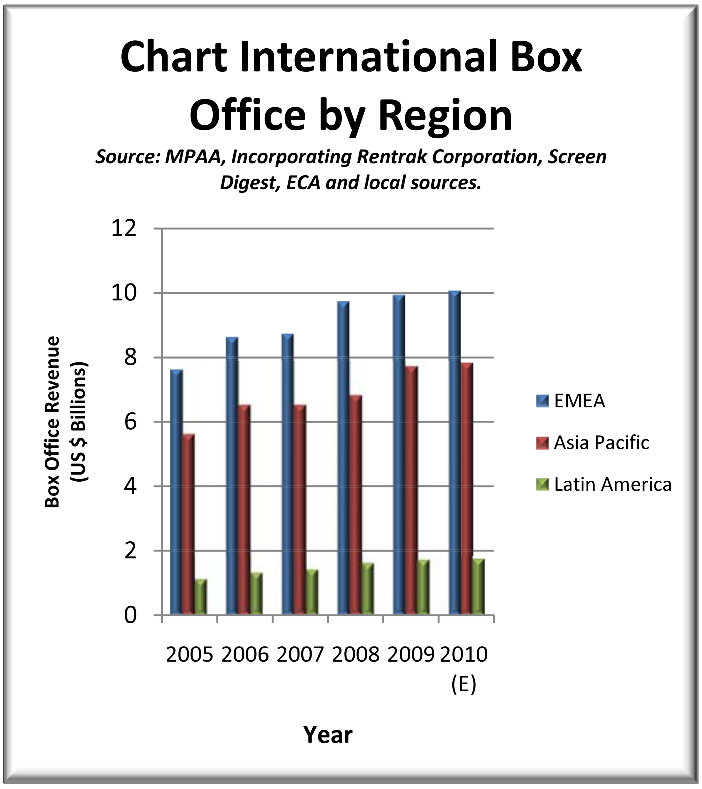
- Companies such as *Netflix* and *Hulu* have combined pragmatic solutions, originally developed by leaders such as *Apple*, with their premium programming, a combination judged favourably by both consumers and the industry. Both these digital distributors are today succeeding by understanding that fulfilling consumers' desire for control will allow them to capture a larger part of the entertainment value chain.

Globalisation

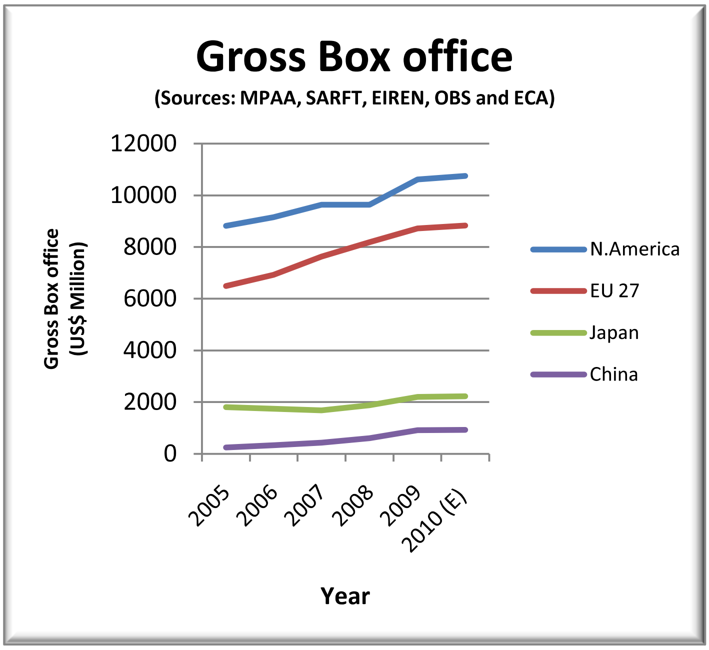
Clearly, in absolute terms, Hollywood has cultural dominance in film. However, there are several drivers of change:

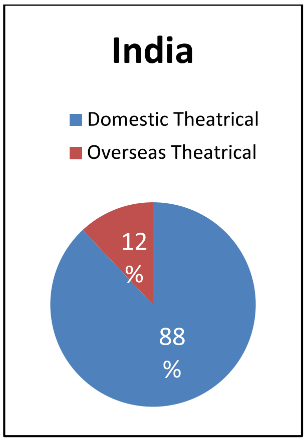
- International box office and revenues have been growing faster than domestic revenues. International box-office is growing as a *percentage* of overall box-office
- An example is the recent blockbuster **2012** with a budget of around $200m. Domestic box office was $166m with international box office of $603m.
- Countries like Russia, India and China are expected to generate significantly higher revenues – although these will be heavily tempered by piracy.

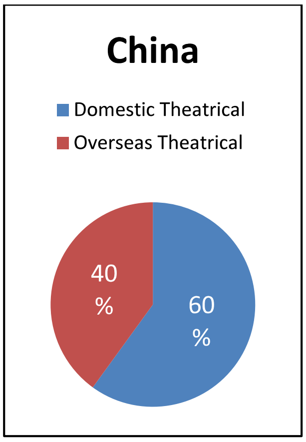
The graph below shows the continued increase of the international box office. EMEA still comprises the majority of the international box office; however Asia Pacific is steadily closing the gap and becoming a key region. Latin America is a largely untapped market, but with the investment from studios into non-English films, revenues in this region will increase further.



Despite the dominance of the US and Europe, emerging markets are steadily increasing. China especially will see an increase with recent overseas film restrictions reduced, and a large investment into the number of cinema screens. 1,500 new screens were built this year, raising the total to 6,000, and this is expected to double by the end of 2015.







- US studio films are only a minority of the world's two most exciting markets: India and China.

Therefore, deploying resources and committing to international markets offers the greatest potential for significant growth.

Local Language Films

In order to achieve growth and capture market share in these geographical markets, US studios have been both increasing production of local language films whilst also trying to get better local distribution of their English-language content.

This local partnering approach offers four advantages to new foreign entrants:

- gain local knowledge, networks and experience for both film production and distribution
- share the risk of international production
- access cheaper local production facilities
- qualify for any local tax incentives

As with other product and market entry initiatives, developing the optimum content mix will be one that will require a willingness to experiment. It is clear that studios have begun this process and are committed to accelerating their learning curve.

Brands: An additional source of financing?

Now that the more traditional sources such as hedge funds and investment banks have sharply curtailed their investment into the sector, many are wondering where the new sources of funding are to be found.

Independent studios are now more actively trying to work alongside consumer brands in order to tap into their advertising budgets.

Large brands have always sought to distinguish themselves and better connect with their target consumers. With the proliferation of digital media, new advertising opportunities have arisen.

With new digital channel distribution, it is easier for the brands to reach a wider audience, and film is being seen as a logical new opportunity. Indeed, McKinsey and Co estimates that by 2010 over $40bn worth of conventional advertising will be invested into wider and more strategic entertainment activities.

For decades, brands have worked with the studios via advertising agencies and media buyers using feature films as a method to access target groups of their consumers. This has been achieved by product placement or related cross-marketing activities. These are now established and proven methods.

Unlike TV advertisement, movies are not restricted by national language barriers or channel restrictions but also offer multiple additional streams in which advertisement costs can be recouped. The promotional value is not only confined to the film itself, but also through the multi-platform revenue generation opportunities through merchandising, DVD and digital markets. Through these related additional channels, brands can reach ever more consumers.

Initially, it is likely that these will be cautious moves, where producers will create partnerships with agencies to learn and benefit from their global reach and infrastructure in exchange for providing much needed additional sources of capital.

We believe some new financing models will be created given the very different investment parameters of such investors.

As top brands have financial resources and liquidity they might drive change and perhaps even bring innovation to the way Hollywood films are financed.

Convergence of Creativity and Technology

Much has been written about how traditional distribution channels are being challenged by new digital technologies, resulting in increased consumption of film through alternative media such as online downloads, mobile film and video, home cinemas and streaming.

With the decline of DVD sales and the challenges to distribution windows, content owners are concerned about trading *analogue dollars for digital dimes*.

While we have seen music and print suffer hugely from shifts in consumer behaviour, only recently consumer consumption of filmed entertainment has shifted in a meaningful way, with consumers increasingly accessing on-line and downloaded content.

Our view is that the *digital challenge* stems from two central issues:

- In this rapidly proliferating multi-device world, consumers are now forcing change by demanding more *control* of their media experience.

- The challenge (and opportunity) is to find a solution to the following truism: **how does one compete with free?** The value destruction that the expectation of free content has created is the elephant in the (living) room.

Those companies that have accepted (and welcomed) the transition to digital distribution and cloud-based aggregation models, and committed to provide solutions in the context of previously *consumer-paid* content have found some success. Further, directly addressing this reality provides an opportunity to shape developments rather than face the fate of the recorded music and publishing sectors.

Hulu

In October 2010, *Hulu* boasted:

- 30 million monthly users
- 260 million content streams
- 800 million ad streams
- 352 ad partners
- $240 million in revenue in 2010 (estimated)

The last statistic is especially interesting. The $240 million in revenue compares to $25 million in 2008 and $108 million in 2009. So, despite starting from a very small base, the shift in consumer behavior toward audio-visual content to digital technologies is clearly underway and *Hulu* is ramping up its profitability credentials impressively.

NetFlix

Netflix is a firm that could and perhaps should have been threatened by digital technology. Consumers could have abandoned an old-fashioned mail order DVD delivery service to stream movies on-line. Yet despite the many precedents of mail order companies being cannibalized by on-line operators, *Netflix* has not let that happen. Rather *Netflix* embraced the on-line opportunity. The result, *Netflix* is not just continuing to grow, but growing faster. In its 2010 third quarter results *Netflix* announced an impressive 52% year-on-year increase in subscriber numbers, subscribers now total 16.9m.

There can be no doubt that *Netflix's* impressive subscriber numbers and growth is being fuelled rather than threatened by digital distribution: *Netflix* now offer a comprehensive streaming service delivering all its TV and movie products on-line, direct to PCs and Macs, or to TVs via Xbox 360, Wii or PS3. This streaming service has seen rapid take up. In Q3 2010 61% of subscribers used the service, up from 41% a year ago. For Q4 *Netflix* is forecasting that a majority of its subscribers will watch most of their *Netflix* content streamed rather than delivered on DVD. Indeed *Netflix* now regards itself as primarily a streaming company that also offers DVD by mail.

Importantly, *Netflix* has not had to trade analogue (or mail order) dollars for digital (or streamed) dimes. 2010 Q3 results reported revenues were up 31% year on year and it has not had to sacrifice margin. Gross margins were up 2.8% points compared with 2009, to a healthy 37.7%.

So, how can other media businesses similarly transition from traditional to new media? It would seem that original and consumer-orientated thinking is rewarded:

- *Cede Control*

  Digital distributors who are succeeding have identified that fulfilling consumer desire for control are capturing the largest part of the value chain.

- *Bypass Piracy*

  In China, as a solution to rampant piracy, gaming companies have abandoned a device-sales approach but instead, have developed server-based multi-gaming models.

- *Build Flexibly*

  For studios, the key is to be ready to sense changes and adapt quickly, to bring to market, a compelling consumer proposition in response to any development whether it is derived from new devices, platforms or consumption habits.
- *Support Technology and Device Innovation*

  We believe that the iPad and new tablets have demonstrated that consumers are willing to pay for easily accessing, receiving and organising their content libraries through elegant and desirable consumer devices.

However, as content owners and distributors experiment in response to these challenges, their strategies will likely diverge.

Film and other media businesses will seek to be platform agnostic in order to close no paths and to ensure greatest licensing volume irrespective of channel, while distributors will focus on consumer loyalty.