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Rethinking strategies for building a European Film Industry

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Executive Summary

1. The US versus Europe and the impact of BRIC

A key argument for the success of the US film industry relative to the European industry has been the size of its domestic market. This, coupled with language which creates a natural barrier for European films in the US, has enabled the US film industry to become a world leader. But the US does not still rely on the domestic market alone to deliver its on-going success. US films export well, and that bodes well for their future as emerging markets grow and account for an ever greater share of worldwide box office.

In contrast EU films do not travel as well. What is particularly striking is the low market share EU films experience in EU countries other than their country of origin. To avoid becoming increasingly parochial and falling further behind the US, the EU film industry may need to deliver product more appealing to international audiences and/or partner with local operators in either distribution (to increase penetration of European product) or production (to gain local knowledge, networks and experience as well as potentially offering lower costs and local tax incentives).

2. Rising to the online challenge

A critical question facing the sector is how it can harness the digital revolution and the challenge of technology-driven changes in consumer consumption. Technology represents both an opportunity and a threat. For the European film industry it may offer more of an opportunity and less of a threat, but this may not be true for the more vertically-integrated US majors.

Whereas the impact of technology on pay and free TV appears to be possibly negative, it is possible that online distribution will benefit content owners, transferring value from aggregators/distributors to content owners, a view most recently articulated by none other than hulu's CEO, Jason Kilar.

The emergence of online distribution, which might well benefit EU independent film producers if not the US media conglomerates, need not necessarily go hand-in-hand with an equal expansion of piracy. In contrast to the music industry's experience, the film industry's experience of piracy could be very different, less revenue damaging, and for several reasons beyond the obvious such as film file sizes being much larger and more cumbersome to file share and download. Demographic factors along with the presence of legitimate retail alternatives and the fact that film is watched on TV rather than the PC may mute the impact of piracy relative to the impact it had on the music industry.

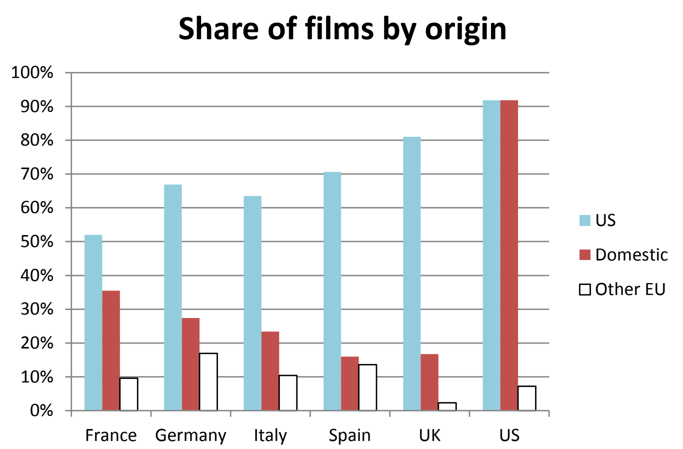
1. The US versus Europe and the impact of BRIC

A key argument for the success of the US film industry relative to the European industry has been the size of its domestic market. This, coupled with language which creates a natural barrier for European films in the US, has enabled the US film industry to become a world leader.

The EU is now more unified than at any point in its history, and the combined size of the EU film industry compares favourably with the US. The output of EU films is greater than US by number of films and the respective box offices are not dissimilar, $10.6bn in the US last year compared with a slightly lower figure in the EU.

But the US does not still rely on the domestic market alone to deliver its on-going success. US films export well, and that bodes well for their future as emerging markets grow and account for an ever greater share of worldwide box office.

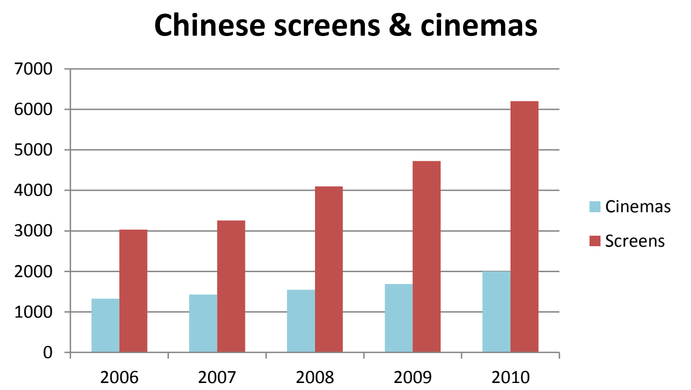
What is strikingly different between the US and EU is the market share of each region's films in different territories. Whereas in the US, domestic films enjoyed a >90% share of the box office, the share of EU films in the EU is much lower, in fact, US films outperform EU films in the EU. And what is particularly striking is the low market share EU films experience in EU countries other than their country of origin, as the chart below shows.



Source: CNC

The relatively weaker export performance of EU films may become an even more important factor than it is currently as the balance of world economic power is steadily shifting east. Forget about maintaining the current balance with the US film industry, if the EU film industry wants to avoid falling further behind the US it needs to exploit these new markets.

Emerging markets, particularly BRIC countries, will be key box office growth drivers. Take China, the largest of the BRIC markets, it is seeing explosive growth. The Chinese box office reached US$1.5bn last year, up from US$0.9bn in 2009, making China the world's 4th largest film market. This growth was fueled by rapid screen build out, total screens increasing a third to 6,200 in 2010. This pace of growth may be high, but with a 1.3 billion population and total screens totaling only around a fifth of the number in the EU, penetration is still low enough to leave plenty of scope for significant further growth.



Source: SARFT

Foreign films' earning potential will not be driven by screen build-out alone: Currently, only 20 foreign films per year are permitted to be shown in China on a revenue sharing basis (in addition China buys copyright to circa 30 other foreign films), but this limit will be lifted next month. Consequently a steady rise in the number of foreign films screened in China is expected. How much of an opportunity does this represent for the European film industry?

Despite the small number of foreign films screened their impact is large. Non-domestic films already account for circa 40% of the Chinese box office. China produced >500 films last year yet five of the top ten films at the Chinese box office were foreign, with *Avatar* at no.1, the others being *Inception* (no.4), *Alice in Wonderland* (no.7), *Harry Potter and the Deathly Hallows* (no.8) and *The Expendables* (no.10), all US films bar *Harry Potter*.

The Indian market is different. With a vibrant domestic industry producing more films than any other country's, foreign films have made only limited progress. Typically non-domestic films have achieved <10% box office share. Last year the best performing Western films, according to boxofficeindia.com, included *Inception* and *Harry Potter and the Deathly Hallows*, although neither film even ranked in the top 20 at the Indian box office. However, of foreign films, as in China, the only notable performers were US (or UK) productions.

It appears that if the EU film industry is to benefit from the challenge and opportunities presented by the rise of emerging markets such as China and India, several steps can be taken:

- Produce more product designed to appeal to foreign audiences, a skill US studios have apparently mastered with their increasing focus on event, special FX-driven films; and/or

- Partner with local operators in either distribution (to increase penetration of European product), or production (to gain local knowledge, networks and experience as well as potentially offering lower costs and local tax incentives).

Actioning any of the above options should enable the European film scene to avoid becoming increasingly parochial and falling further behind the US.

2. Rising to the online challenge

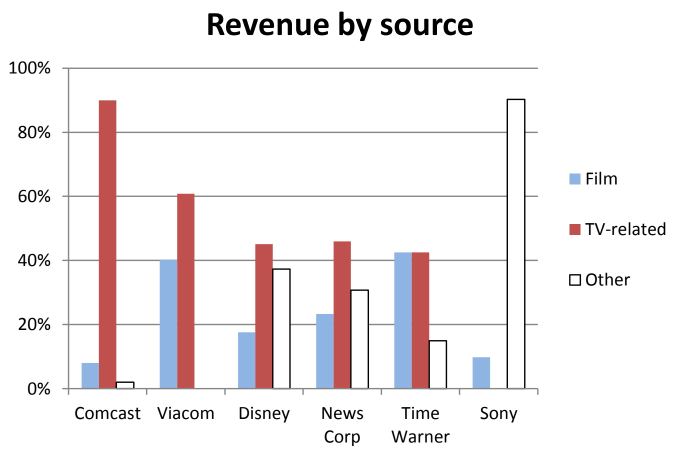
A critical question facing the sector is how it can harness the digital revolution and the challenge of technology-driven changes in consumer consumption. Technology represents both an opportunity and a threat. For the European film industry it may offer more of an opportunity and less of a threat, but this may not be true for the more vertically-integrated US majors. Piracy, however, represents a risk for both the EU and US film industries, although it may be less of a threat and cause less damage than that caused to the music industry.

Vertical integration

The online challenge is likely to be fought in the home rather than the cinema, worldwide box office revenues having demonstrated remarkable resilience and growth (although the poor box office performance over the Christmas period blew a chill wind through the industry). The cinema going experience is unlikely to be substituted by home cinema systems and digital viewing.

However, how the online challenge is faced in the home may vary between the US and the EU, at least in terms of how the film industry is concerned.

In the US, the acquisition of NBC Universal by Comcast is one of the most ground-breaking consolidation plays in the sector for some time. Universal is now part of a media conglomerate in which film represents only a small proportion of the group's total revenue and profit, in fact the smallest proportion of all the US media/entertainment conglomerates. The chart below shows the breakdown of revenues for the US studios from film, TV (satellite or cable channels / networks / distribution) and other non-film or TV-related revenues.



Source: latest full year company accounts except Comcast which are pro forma merger numbers provided by Comcast

The situation is different in Europe, with the film industry represented by players who are rarely integrated into large television (whether satellite, cable or terrestrial) broadcast groups.

Consequently, in contrast to the US media players, much of the EU film industry has no TV-related revenue to protect and so may adopt a very different approach to the possibilities of online distribution.

The US conglomerates' behaviour will be influenced by their dependence upon TV-related revenues because TV businesses are potentially vulnerable if viewers change their viewing from broadcast television to streamed online content, whether viewed via a PC or a TV. To date headline TV viewing figures mask the issue - UK TV viewing reached an all-time high in 2009, at over four hours per person per day, a level matched by the US. As the US audience share auditor, Nielsen, recently commented "consumers are watching more TV than ever" with the average American now spending 20% of their day watching TV. But this masks the demographic trends, a growing retired population watching more TV whilst the (shrinking) youth population reduces its TV consumption, and multi-tasks across media as they do so. As it is these young viewers whom advertisers crave most, the advertising spend migrates with them, reducing TV's share of the advertising pie.

Pay TV will fare differently than advertising supported free-to-air TV, but technology still represents a challenge. Pay-TV operations are effectively aggregation/distribution businesses and how the internet will impact these businesses over the medium term is not clear.

A significant attempt to address this issue is seen in hulu, owned by the three media conglomerates with the largest TV-related revenue streams Comcast, Disney and News Corp. Viacom recently announced that it too will be providing more content to hulu, and the new paid portion of hulu, hulu plus (launched November 2010).

This strategy, to have more of the digital pie, has not all been smooth-sailing. Hulu's CEO, Jason Kilar, suggests that near-term innovation in internet distribution will negatively impact traditional pay-TV distribution models. He believes that a greater share of spend will accrue to content owners and creators. In a message posted on his blog last week, Kilar stated "consumers will have more choice and convenience going forward. This competition will drive prices and margins down in pay TV distribution."

Kilar makes an important point for the European film industry, whatever happens to TV's aggregation and distribution businesses, he believes content owners are unlikely to be negatively impacted by online distribution, rather, they may see greater value accrue to them.

If greater value does accrue to content owners, i.e. film studios/producers, this will give rise to an interesting tension. On the one hand the US conglomerates will have a vested interest in protecting TV distribution and aggregation models and limit the take-up of online distribution models, on the other hand (EU) independent producers, as content owners, will be keen to accelerate the rapid take-up of online distribution.

Moreover, increased value from online distribution may help to offset the steep decline in DVD revenues which is having a serious impact on the economics of film production which has relied on DVD revenues to generate a high proportion of gross revenues. The latest Netflix results indicate that this may well be the case; subscriber numbers increased 3m in Q4 alone, up to 20m, a year-on-year increase of 63%.

It is interesting to note that Sony, the home of the only major without any TV-related revenues to protect, appears to be acting as a catalyst in accelerating the film online consumption of online film through as many media as possible, through both its Play Station 3 (it can be used on NetFlix and is the only game console through which LoveFilm streamed content can be accessed) and Bravia Internet Link.

Much of the EU film industry may be motivated to act like Sony, encouraging the growth of online film retailers. But if so it should bear in mind the lesson from the music industry and its experience of online sales; success is best achieved with the creation of a healthy, competitive online retail environment. Unfortunately the music industry perhaps created a monster, a monopsonist buyer in the shape of iTunes, something the film industry should be astute to avoid. Instead it should encourage and support the emergence of multiple retail outlets to sit alongside and compete with current players such as Netflix and LoveFilm.

Piracy

The emergence of online distribution, which might well benefit EU independent film producers if not the US media conglomerates, need not necessarily go hand-in-hand with an equal expansion of piracy. In contrast to the music industry's experience, the film industry's experience of piracy could be very different, less revenue damaging, and for several reasons beyond the obvious such as film file sizes being much larger and more cumbersome to file share and download.

Demographics: music consumption and home piracy is largely undertaken by youths, film audiences are more demographically diverse, and less likely to steal.

Retail presence: online music piracy flourished in the absence of pay alternatives, online film retailers are rapidly proliferating and maturing before pirate habits have become entrenched.

The medium: The TV is still the primary viewing medium, not the PC, creating a technology (and hassle factor) barrier for many would-be pirates.

The above factors indicate that piracy may be less of an issue for film than for music. And certainly the promotion of online film retail sites, something which we comment above should benefit independent producers, should, if anything, help to crowd out pirates.