Entertainment Capital Advisors

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Industry and Strategy Briefings

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Film: Changing Landscape in a Post Financial Crisis World

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Executive Summary

The film industry, as we know it, is evolving rapidly as a consequence of tighter capital markets, the evolution of digital technologies, and changing patterns in consumer media consumption. What are the implications, and what impact, will these factors have on the business of film? This briefing considers three key issues:

Globalisation Outlook

- Although the globalisation of Hollywood is set to continue, local language films will grow in importance. US studios must step up efforts to successfully produce local language films whilst also trying to get better local distribution of their English-language content.

- The Chinese market has to date been an opaque and regulatory minefield. Our recent trips have convinced us that perseverance will bring rewards.

Will the New Sources of Capital Come From the Emerging Markets?

- The Middle and Far East will play an even greater role in film investment, with new financing models being created to satisfy the very different regulatory and investment parameters of such investors.

Converging Creativity with Technology in Distribution

- With the loss of physical DVD sales, the ability of distributors to enforce distribution windows and a younger generation no longer expecting to pay for information, distributors need to find a way to compete with free content

- Original and pragmatic thinking will be rewarded – for example, successful digital distributors have understood that fulfilling the consumer desire for control will allow it to capture the largest part of the entertainment value chain.

This briefing contains extracts from a presentation to be given at the FT Business of Film Summit – Rethinking Strategies in an Evolving Landscape – Doha, 22-23 March 2010

ENTERTAINMENT CAPITAL ADVISORS

FT FINANCIAL TIMES

Globalisation Outlook

We believe that while the globalisation of Hollywood is set to continue, local language films will grow in importance and will be a key driver for growth.

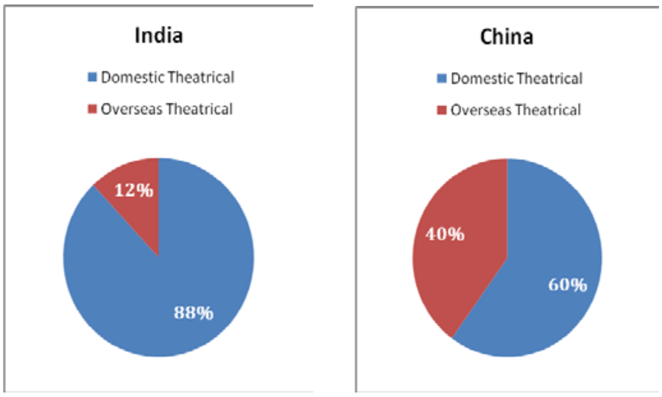
Growth Drivers

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

- International filmed entertainment revenues have been growing strongly, particulary in the Far East. China recorded a 188% increase in filmed entertainment revenues between 2004 and 2009 breaching the $1bn mark in 2009[2].

- For US studio films, international box-office revenues are continuing to grow which is of increasing importance to studios as large blockbuster films fail to make a profit on the US domestic market alone. International box office revenues grew from $14.3bn in 2005 to $19.3bn in 2009 whilst capturing 64% of global box office revenues, an increase of 2% over 2005 figures[3].

- US studio films are still a small percentage of the world's two most exciting markets for growth potential: India and China.



Source: FICCI-KPMG/China Daily/ECA

Local Language Films

We believe that in order to achieve growth and capture market share in these these markets, US studios must try to increase production of local language films whilst also trying to get better local distribution of their English-language content.

2 PricewaterhouseCoopers: Global entertainment and media outlook: 2009-2013

3 MPAA Theatrical Market Statistics 2009

We recommend greater experimentation with a series of local language pictures, initially through alliances with well regarded local producers.

Alongside this, we recommend stronger alliances with established local players experienced in the development, financing, marketing and/or distribution of local programming or those with extensive distribution operations.

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

- access to local knowledge, networks and experience in film production and distribution

- a partner in the risk of international production

- access to cheaper local production units

- qualification for local tax incentives

These all help studios reduce risk, produce higher quality films and lower costs.

However, to date, none of the US studios have committed significant amounts of money or their reputations to making bold, long term plans in the region.

We believe this is set to change with 2010/11 likely to see some significant moves in this direction: a concerted attempt by the US studios to transpose their proven ability to establish an efficient film project evaluation and execution process which generates a pipeline of diverse projects with wide commercial appeal.

But, what should an optimum local-language slate consist of? Entirely original projects in the local style or adaptations of US hits? Or, more complex, thought-through "cross-over" films which include a blend of US and local elements?

We believe that developing the optimum content mix will be one that will require a willingness to experiment.

We therefore believe that new entrants need to begin this process early and then commit to accelerating their learning curve.

China

After India, China remains *the* market to address.

The Chinese market has, however, to date, been opaque and a regulatory minefield. However, our recent trips to China have convinced us that perseverance will bring rewards.

Since China has such a large population, Chinese-language film producers can create and promote content solely for this market and do not need to export their product to be profitable.

Film: Changing Landscape in a Post Financial Crisis World

Given the incredible growth in media and entertainment consumption from $34.3bn in 2004 to $74.7bn to 2009[4], China's entrepreneurs will soon assert themselves in media as they have done in the technology, internet and telecoms sectors, leading to notable home-grown national champions. We expect to see the emergence of clear Chinese media front-runners in the next 12-18 months.

There are already signs of a more favourable operating environment with the relaxation of foreign investment restrictions and import restrictions on foreign films which will enable market expansion. Up until 2001, only 10 films a year were allowed into China although this has now been doubled to 20.

Therefore, we believe developing a well-funded Chinese strategy to position for this more favourable operating environment will greatly afford foreign film producers and distributors significant growth opportunities.

Will the New Sources of Capital Come From the Emerging Markets?

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 will be be found.

As with other Western industries looking for capital injections, such as the investment and commercial banking sectors, is it clear that more investment will be sought from, and offered by, the Middle East and Far East.

For example, Al Noor Holdings, the media unit of Qatar's Al-Hashemi group, started a $200 million international film fund, investing in at least 10 "high-profile" films over five years.

4 PricewaterhouseCoopers: Global entertainment and media outlook: 2009-2013

In addition, India's Reliance Entertainment last year provided $325m of equity to fund recreating Steven Spielberg's DreamWorks studio as an independent entity.

Now, this month, Reliance Entertainment is reported to be preparing to compete with Time Warner, News Corporation and Lionsgate for Metro-Goldwyn-Mayer, which would bring Bollywood deeper into Hollywood.

Whilst Reliance may not secure this prize as well, its appearance on the list of prospective buyers is demonstrative of the de facto shifting landscape and growing awareness (and welcomed acceptance) in the West of this shift.

Clearly, other Middle-Eastern, Indian and even Chinese investors will enter the international film sector, attracted to the opportunity to achieve above average returns.

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

We believe new financing models will be created to match the very different regulatory and investment parameters of such investors.

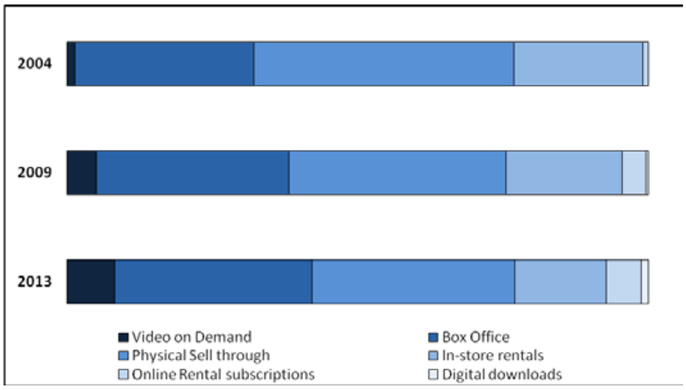
As many of these sources may very well operate in very different liquidity conditions, we foresee that they will drive change and perhaps even bring innovation to the way Hollywood films are financed.

Converging Creativity with Technology in Distribution

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

With the loss of physical sales and the lack of ability to enforce distribution windows, content owners' business models are in danger of trading *analogue dollars for digital dimes.*

While we have seen music and print suffer hugely from shifts in consumer behaviour, only recently has filmed entertainment consumer consumption levels shifted in a meaningful way:



Source: PricewaterhouseCoopers: Global entertainment and media outlook: 2009-2013

As can be seen above, whilst video on demand, online rental subscriptions and digital downloads are projected to capture a total of 15% of global revenues (up from 2.5% in 2004), the physical sell through market is expected to contract by 10% over the 9 year period whilst box office revenues remain a static yet stable component of global filmed enteretainment earnings.

As is evident, the shift in consumer behaviour toward audio-visual content to digital technologies is clearly underway.

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 for younger (and therefore, soon all) consumers: *how does one compete with free?* The value destruction that the expectation of free content has created is the 800-pound gorilla in the (living) room.

It is critical for the industry, both generators and distributors, to accept the transition to digital distribution and cloud-based aggregation models, and work out how their distribution models can compliment this, and use the opportunity to shape developments rather than face the fate of the recorded music and newspaper publishing sectors.

So, how can studios and other media businesses transition from traditional to new media? We are convinced 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*

  Studios must be ready to sense changes and adapt quickly, to bring to market, a compelling consumer proposition to respond to any development whether it is derived from new devices, platforms or consumption habits.

- *Support Technology and Device Innovation*

  We believe that the iPhone and e-readers have demonstrated that consumers are willing to pay for easy accessing, receiving and organising their content libraries through intuitive user environments and elegant and desirable consumer devices. Assist Apple and Amazon with their efforts to grow the market.

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.

Conversely, cable operators will develop further ways to avoid subscriber churn and capture more value for itself through interactive features, such as PVR functionality fees, which need not be shared with the content owner.