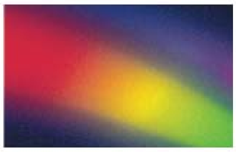





One more ride on the Hollywood roller-coaster

The Hollywood Studio system is preparing for yet another major transformation. After the changes imposed to its business model by the US Antitrust authorities in the late 40s, the rapid take-up of television in the early 60s, VCRs in the 80s and DVDs in the 90s, it is now the turn of 'digital technologies' in the production and distribution segments of the movie value-chain. They threaten a shake-up not only of the Studios' prospects but also those of their associated partners and stakeholders. Digital technologies, together with the proliferation of broadband and multimedia devices on the consumer side, are enabling more dynamic and cost-effective methods of film financing, production and delivery. Will this mean the end of the Studios or are forecasts of their imminent demise overly premature? We predict that, despite the radical changes required within the established system, the Studios will essentially retain their pivotal role in directing the way in which fame and fortune are created and distributed across the movie value-chain. In the process, new stakeholders will join the party and attempt to secure their share of the entertainment business.

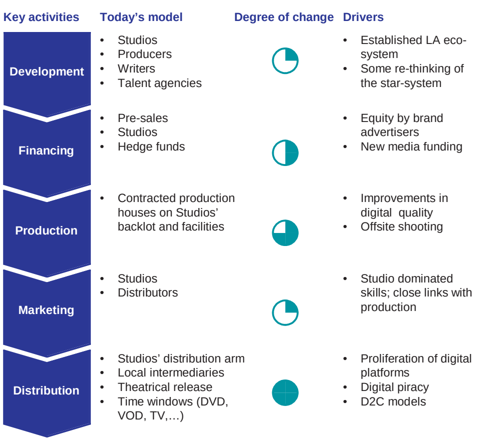
Background

Spectrum recently carried out an extensive review of the major trends affecting the American entertainment sector, in general, and the Hollywood Studio system, in particular. We conducted primary research in Los Angeles by meeting with senior executives from the leading Studios, talent agencies, deal makers, financiers, producers, writers and developers. In what follows, we highlight selected trends that, in our view, require the attention of not only the current stakeholders, but also of the emerging new players in the movie business - namely digital platforms (broadband portals, TV over DSL providers, consumer electronics manufacturers), private equity investors and consumer brands (as advertisers).

Key trends in action

Our analysis suggests Financing, Production and Distribution are the areas of the movie business system facing the most radical change, while Development and Marketing will undergo relatively marginal evolution.

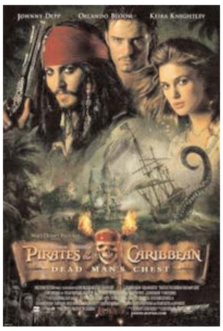
Fig. 1 - Simplified movie business value chain



Development: Hollywood becomes 'sensible'

The average budget for a Hollywood movie is currently around $60m, rising to $100m when the cost of marketing for domestic launch (USA only) is factored into the equation. However, we are now witnessing a polarisation of film budgets into two tiers: large productions ($120-150m) and niche features ($5-20m). The rationale is that the likelihood of success is maximised by coupling ultra-large budget and highly marketable features (e.g. "Pirates of the Caribbean: Dead Man's Chest"), with multiple low-cost bets (e.g. "Little Miss Sunshine"). Fewer $30-70m releases are expected.

Fig. 2 - Tentpole vs low-budget: two success stories




A recent study from Columbia University on the powerful and uncontrollable word-of-mouth viral marketing phenomenon supports this approach. At the same time, top Studio executives are re-thinking the star-system, in order to reduce the impact of big talent pay-cheques on 'above the line' production budgets. For example, the recent break-up of the multi-million production deal between Paramount and Tom Cruise is seen by Hollywood deal-makers as the first step on the path to re-establishing the multi-year talent 'lock-in' contracts of the 50s, where talent was employed by the Studio.

Financing: a new wave of stakeholders joins the party

Hedge funds are the latest wave of new investment to hit Hollywood, following in the footsteps of German tax breaks, insurance companies, banks, and consumer electronics giants. Spreading the risk by investing in film slates is the main rationale behind this category of investment; and in 2007 we should start to see whether they have been sound decisions. Two new sources of finance may be both promising and sustainable: (1) equity investment by consumer brands (2) co-productions with digital platforms (broadband ISP, mobile networks). Consumer brands have seized the opportunity of becoming more directly involved in film productions as a means of countering the increasing threat created by PVR adoption and ad-skipping. Coke, Adidas, BMW and Grey Goose have recently appointed "Head of Entertainment" executives to divert a portion of the advertising budgets from television and print to film financing. Adidas's investments in "Goal!" (2005), "Goal2!" (2006), "Goal3!" (2007) are noteworthy examples. Sony Pictures's NASCAR film, "Talladega Nights" (2006), is another example of how a feature-length movie can become a platform for a broad range of product integrations. The obvious challenge is to strike the right balance between business purpose and entertainment to avoid boomerang effects.

Fig. 3 - Advertising-funded features

We predict a second source of financing for Hollywood - from 'digital media': IPTV, VOD and mobile multimedia providers are continually searching for innovative ways to keep their brands fresh and their consumer propositions differentiated. Co-investment in original content is viewed as a potential way to achieving these corporate objectives. Release windows and reward arrangements on ancillary sales (DVD, VOD, etc) will play a critical role in ensuring the business case is sufficiently robust.

Production: digital lowering movie budgets

Rebel film-makers see the advent of digital production as a way of freeing their creative energies from the grip of the Studios: the equipment budget (camera, support) required for shooting digital is approximately 1/10th that for film, significantly lowering the production budget for independent features. At the same time, over the past 2-3 years, the quality of digital filmmaking has improved dramatically. In practice, the lack of control over the distribution channels has not significantly changed the Indies' prospects, at least until recently. Paradoxically the Studios have been the main beneficiaries of technological evolutions; their technology divisions are now well positioned to realise the vision of an end-to-end digital supply chain.

Marketing: Studios remain the rain-makers

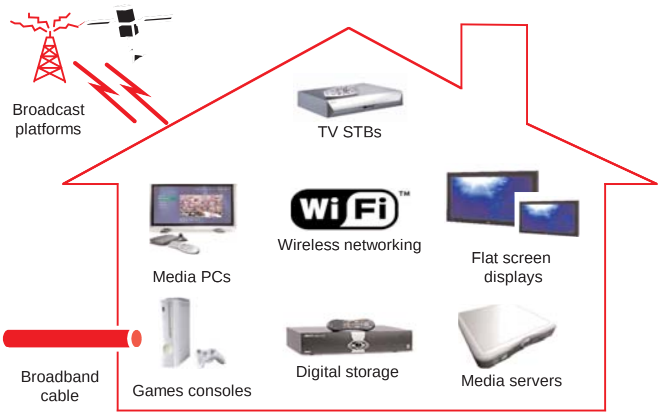
While Presidents of Marketing may be experimenting with online viral marketing techniques (e.g. with "Snakes on a Plane", 2006), no radical shifts in the way audience awareness is developed have yet emerged. The Studios' core role increasingly will be to act as 'marketing machines', given their ability to influence the development, production and post-production stages of the movie-making process. The recent promotion of several Marketing Presidents to be Studio Chiefs lends weight to this prediction.

Distribution: the collapse of release windows

Over the next 12-24 months, distribution and exhibition are likely to undergo radical restructuring. Digital, and the 'chain effect' it creates, is the driver behind this reshaping. A credible and cost-effective alternative to the traditional "cinema experience" is being created by the proliferation of digital devices - including 40-50'' flat screens, home-theatre, high-speed broadband (2-8Mbps), home media gateways (Microsoft's XBox 360), high-capacity portable digital players (Sony's PSP, Apple's iPod), and Apple's forthcoming iTV playing digital video downloads on regular TV screens.

Over the past 18 months, release windows have already compressed significantly - initially because of the pressure to ensure the success of DVDs, which account for a large share of a Studio's revenues and an even higher proportion of total net profits; more recently, digital piracy and P2P file sharing have been drivers. Over the past year, in the US, VOD and DVD windows have been merging - and are now only 3 months behind the theatrical release.

Fig. 4 - The networked home entertainment environment



Within the next 12-18 months, a number of Studio Presidents, led by Disney's Bob Iger, hope that the resistance of cinema owners will be overcome and simultaneous release, across all platforms, will become a reality. The rationale behind this push is (1) to fight digital piracy with legal forms of digital download; (2) to optimise marketing budgets across all platforms; and (3) to capitalise on returns from the highly profitable digital media distribution process (DVD, VOD).

Digital piracy appears to be the main driving force. The Studios have learnt the lesson of the music industry and are determined to lead the adjustments in their business models. All the Studios have now appointed Presidents of Digital and Wireless distribution and are trialling alternative strategies. Disney's $1m gross in one week for its 75 movies on the iTunes portal is an encouraging start. Direct-to-consumer ventures are being launched to take advantage of this ongoing trend. For example, Intel Corp. and Morgan Freeman's Revelations Entertainment have created Clickstar, a new company entirely focused on the VOD model for PC and TV screens.

At the same time, independent producers are starting to benefit more when involved in digital distribution and online marketing channels, rather than just in digital production. "Faster" (2004), a feature-length Moto GP documentary narrated by motorcycle fan Ewan MacGregor, was shot in digital and distributed online, aided by a combination of internet and street-based viral marketing techniques. It is an early example of what Indies can achieve outside the Studio system by exploiting end-to-end digital.

Fig. 5 - Leveraging online channels: FASTER (2004)

Key steps to success
- Promoted in Cannes with organised buzz effect from moto stunts on La Croisette
- Gained extensive press-coverage
- Launched FASTER.com website for fans
- Created online DVD order channel to sell the “preview edition” (no extras). $19 operating profit per copy
- Created an “ultimate edition” (with extras) to be sold in stores
- Marketed “ultimate edition” + motoGP t-shirt to the fan base (via email direct-marketing campaign)

What are the strategic implications?

Exhibitors: re-thinking the role of theatres

While the Studios appear well positioned to retain their central role in the movie-making business system, they will have to make significant adjustments to their distribution activities; this will require the renegotiation of their terms with some current stakeholders. The role of theatres will need to be reconsidered; their owners will clearly be adversely affected by the disappearance of release windows. Theatres already face challenges from the consolidation of their business in both Europe and the US; more fundamentally, with the Studios' support, theatre owners will need to address a number of strategic developments, in order to preserve a differentiated movie-experience. Fewer venues, higher quality theatres, 3D screening, and cross-selling, probably, offer some ways forward. US regulations impose separation between Studios and exhibitors; new business models might, however, include offering theatres revenue-sharing agreements and "first-to-sell" rights on some digital platforms (e.g. DVD, sync'n go). Forward integration should also be considered, if regulators allow it.

New financiers: securing the right deals

Gaining an equity share in the proceeds, while securing brand visibility via product integration or co-production, seems a highly compelling approach; this could be enabled if financing deals are appropriately structured when negotiated with the Studio executives. One entertainment lawyer we met in L.A. recently identified 60 accounting tools to ensure that inexperienced film financiers enjoy a high share of a "zero net profit"! If advertisers and new-media commissioners are to avoid disastrous financial experiments, they need to acquire the skills both to source mainstream content and to negotiate entertainment-sector deals.

Digital distributors: capturing the value add

For the broadband ISPs, identifying revenue models to capture the new value created is likely to be a challenge; they risk investing in increased bandwidth without being able to benefit from the increased customer-base. Direct billing and aggregator models are two options that might be explored.

Independents: leveraging digital distribution

Independent producers can benefit from digital end-to-end, avoiding traditional distribution bottlenecks. However, as in the early days of the internet, those who can identify compelling propositions and build strong brands are likely to gain most. Approaching the movie development stage with a clearly defined core audience, and a sound marketing and distribution approach, can help increase the chances of success and avoid expensive post-production format conversions across multiple digital standards.

Studios: re-aligning the international organisations

The simplification of time and geographic release windows will require some re-thinking of both business objectives and organisational roles. Alongside the task of devising a robust multi-platform digital strategy (that can withstand the transition from physical to virtual distribution), Studios also need to consider how to optimise the use of resources in their overseas operations.

Fig. 6 - Summary of key priorities

Key stakeholders	Priorities / opportunities
Studios	• Devise a cross-platform digital strategy • Restructure release and distribution model • Optimise international operations
Exhibitors	• Rationalise and consolidate • Innovate the customer experience • Reengineer the business model
Private equity groups	• Restructure medium size cinema chains
New media platforms	• Exploit content deals to promote core business (acquisition, retention, growth) • Extend brand beyond connectivity
Independent producers	• Leverage end-to-end digital to increase share of value and decision making power
Consumer brands	• Pursue product integration • Optimise media budgets

About the author

Alfonso Marone is a Senior Manager in the London office. He has 12 years of international advisory and strategic management experience in the media, entertainment and communications sectors. His recent focus has been on valuing television production assets, developing multi-platform distribution strategies and assessing alternative content sourcing and funding models. Alfonso holds an MBA from INSEAD, France and a Master's degree in Digital Communications from the University of Rome, Italy. He specialised in Film & Television at the University of California, in Los Angeles.

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How Spectrum can help

Over the years, Spectrum has worked with Hollywood studios, production companies, retail brands and media owners to design business strategies and re-engineer the entertainment value chain. Our management advisory services to the sector include:

- Business strategy, corporate development and M&A support, including target scouting, assessment and due diligence
- Brand extension, product development and business planning for media investments
- Content sourcing strategies and definition of consumer offerings for new media platforms (VOD, IPTV, Mobile TV, D2C models)
- Financial modelling and valuation of alternative business scenarios
- Partnerships and commercial negotiations in a complex multi-party environment
- Capability assessment, re-organisation and change-management
- Programme and interim management during the execution stage.

About Spectrum

Spectrum was established in 1994 and is a strategic management consultancy exclusively focused on the media, entertainment, telecoms and sports sectors, with its HQ in London and offices in Barcelona, Brasilia, Hong Kong, Rome, Singapore and Sydney.

We specialise in identifying, evaluating, and taking advantage of opportunities for growth, innovation, international expansion and performance improvement.

Our clients include the most respected sector brands, international sports organisations, financial institutions, governments and regulators in 45 countries around the globe.

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