

# 4

## Making and marketing movies

*Dough makes bread and dough makes deals.*

Some people would argue that deals, not movies, are Hollywood's major product. "Contract-driven" is a handy way to describe the business.

Although studios are often viewed as being monolithic enterprises, they actually function as intellectual property clearinghouses simultaneously engaged in four distinct business functions: financing, producing, distributing, and marketing and advertising movies.<sup>1</sup> Each function requires the application of highly specialized skills that include raising and investing money, assessing and insuring production costs and risks, and planning and executing marketing and advertising campaigns. And every motion picture and television project must inevitably confront and then cope with three main risks: first in financing, then in completion, and then in performance. This chapter describes the framework in which these functions are performed.

### 4.1 Properties – Tangible and intangible

A movie screenplay begins with a story concept based on a literary property already in existence, a new idea, or a true event. It then normally proceeds in stages from outline to treatment, to draft, and finally to polished form.<sup>2</sup>

Prior to the outline, however, enters the literary agent, who is familiar with the latest novels and writers and always primed to make a deal on the client's behalf. Unsolicited manuscripts normally make little or no progress when submitted directly to studio editorial departments. But with an introduction from an experienced agent – who must have a refined sense of the possibility of success for the client's work and of the changing moods of potential producers – a property can be submitted for review by independent and/or studio-affiliated producers. Expenditures at this stage usually involve only telephone calls and some travel, reading, and writing time.

However, should the property attract the interest of a potential producer (or perhaps someone capable of influencing a potential producer), an option agreement will ordinarily be signed. Just as in the stock or real estate markets, such options provide, for a small fraction of the total underlying value, the right to purchase the property in full. Options have fixed expiration dates and negotiated prices, and depending on the fine print, they can sometimes be resold. Literary agents, moreover, usually begin to collect at least 10% of the proceeds at this point.

Now, in the unlikely event that a film producer decides to adapt one of the many properties offered, the real fund-raising effort begins. This effort is legalistically based on what is known as a literary property agreement (LPA), a contract describing the conveyance of various rights by the author and/or other rights-owners to the producer. To a great extent, the depth and complexity of the LPA will be shaped by the type of financing available to the producer of this project.

For example, if the producer is affiliated with a major studio, the studio will normally (in the LPA) insist on retaining a broad array of rights so that a project can be fully exploited in terms of its potential for sequels, television series spin-offs, merchandising, and other opportunities. Such an affiliation will often significantly diminish, if not totally relieve, the producers' financing problems because a studio distribution contract can be used to secure bank loans. Better yet, a studio may also invest its own capital. But more commonly, "independent" producers will have to obtain the initial financing from other sources – which means that they are thus not fully independent. In pursuit of such start-up capital, many innovative financing structures have been devised.

Even so, funding decisions are normally highly subjective, and mistakes are often made: Promising projects are rejected or aborted, and whimsical ones accepted (i.e., "green-lighted" in industry jargon). The highly successful features *Star Wars* and *Raiders of the Lost Ark*, for instance, were shopped around to several studios before Twentieth Century Fox and Paramount, respectively, agreed to finance and distribute them. *Jaws* was, moreover, nearly canceled midway in production because of heavy cost overruns, *Home Alone* was placed in turnaround well after its preparation had started, and the script for *Back to the Future* was initially rejected by every studio.<sup>3</sup>

Of course, for funding to be obtained, a project must already be outlined in terms of story line, director, producer, location, cast, and estimated budget. To reach this point, enter the talent agents, who play an important role in obtaining work for their clients, sometimes by assembling into “packages” the diverse but hopefully compatible human elements (and, more recently, the financings) that go into the making of good feature films or television programs.<sup>4</sup>

The largest multidivision talent agencies are the Creative Artists Agency (CAA), which became a Hollywood powerhouse in the 1980s, William Morris Endeavor, United Talent Agency, International Creative Management (ICM), and United Talent Agency.<sup>5</sup> In addition, there are also smaller and highly specialized firms, among which are “discount” agencies that place talent for fees of less than the standard 10% of income.

Agents, in the aggregate, perform a vital function by generally lowering the cost of searching for key components of a film project and by relaying and replenishing the constant and necessary industry database known as gossip. As such, gossip is a natural offshoot of an agent’s primary purpose, which is to advance the careers of clients at whatever price the talent market will bear. The use of agents also permits talent employers to confine their work relations to artistic matters and to delegate business topics to expert handling by the artists’ representatives.

## 4.2 Financial foundations

Some of the most creative work in the entire movie industry is reflected not on the screen but in the financial offering prospectuses that are circulated in attempts to fund film projects. On the financing front especially, studios also always face a risk-inducing cash flow timing condition in that outflows of funds for production and marketing are largely concentrated over the short run, while inflows from sales and licensing in various markets are dispersed over the long run. Financing for films can be arranged in many different ways, including the formation of limited partnerships and the direct sale of common stock to the public. However, financing sources fall generally into three distinct classes:

1. *Industry sources*, which include studio development and in-house production deals and financing by independent distributors, talent agencies, laboratories, completion funds, and other end users, such as television networks, pay cable, and home-video distributors
2. *Lenders*, including banks, insurance companies, and distributors
3. *Investors*, including public and private funding pools arranged in a variety of organizational patterns

The most common financing variations available from investors and lenders are discussed in the following section. Industry sources are discussed in Chapter 5.

## Common-stock offerings

Common-stock offerings are structurally the simplest of all to understand. A producer hopes to raise large amounts of capital by selling a relatively small percentage of equity interest in potential profits. But as historical experience has shown, offerings based on common stock do not, on average, stand out as a particularly easy method of raising production money for movies. Unless speculative fervor in the stock market is running high, movie-company start-ups usually encounter a long, torturous, and expensive obstacle course.

The main difficulty is that a return on investment from pictures produced with seed money may take years to materialize, if it ever does, and underlying assets initially have little or no worth. Hope that substantial values will be created in the not too distant future is usually the principal ingredient in these offerings. In contrast to boring but safe investments in Treasury bills and money-market funds, new movie-company issues promise excitement, glamour, and risk.<sup>6</sup>

Straight common-stock offerings of unknown new companies are thus generally difficult to launch in all but the frothiest of speculative market environments.<sup>7</sup> Strictly from the stock market investor's viewpoint, experience has shown that most of the small initial common-stock movie offerings have provided at least as many investment nightmares as they have tangible returns.

A rare exception, however, was the late 1995 IPO of Pixar, in which 6.9 million shares were sold at \$22 per share, raising a total of around \$150 million. The Pixar offering was a great success because the company not only introduced new computer-generated technology in the making of *Toy Story* (released the week of the IPO) but also was backed by a multifilm major studio distribution agreement with Disney and led by a team of management and creative executives with impressive and well-established credentials.

## Combination deals

Common stock is often sold in combination with other securities to appeal to a wider investor spectrum or to fit the financing requirements of the issuing company more closely. This is illustrated by the Telepictures equity offering of the early 1980s. At that time, Telepictures was primarily a syndicator of television series and feature films and a packager and marketer of made-for-television movies and news.

As of its initial 1980 offering by a small New York firm, Telepictures had distribution rights to over 30 feature films and to about 200 hours of television programming in Latin America. The underwriting was in the form of 7,000 units, each composed of 350,000 common shares, warrants to purchase 350,000 common shares, and \$7 million in 20-year 13% convertible subordinated debentures. In total, Telepictures raised \$6.4 million in equity capital.

Another illustration of a combination offering was that of DeLaurentiis Entertainment Group Inc., which in 1986 separately but simultaneously sold 1.85 million shares of common stock and \$65 million in 12.5% senior subordinated 15-year notes through a large New York underwriting firm. In this instance, the well-known producer Dino DeLaurentiis contributed his previously acquired rights in the 245-title Embassy Films library and in an operational film studio in North Carolina to provide an asset base for the new public entity. Among the several major films in the library were *The Graduate*, *Carnal Knowledge*, and *Romeo and Juliet*.

The underlying concept for this company, as well as for many other similar issues brought public at around the same time, was that presales of rights to pay cable, home video, and foreign theatrical distributors could be used to cover, or perhaps more than cover, direct production expenses on low-budget pictures. The subsequent difficulties experienced by this company and several others applying the same strategy, however, proved that the concept most often works better in theory than in practice. The reason is that companies in the production start-up phase of development normally encounter severe cash flow pressures unless they are fortunate enough to have a big box-office hit early on.<sup>8</sup>

### Limited partnerships and tax shelters

Limited partnerships have in the past generally provided the opportunity to invest in movies, but with the government sharing some of the risk. In fact, before extensive tax-law adjustments in 1976, movie investments were among the most interesting tax-shelter vehicles ever devised. Prior to that revision, limited partners holding limited recourse or nonrecourse loans (i.e., in the event of default, the lender could not seize all of the borrower's assets, thus making these loans without personal liability exposure) could write down losses against income several times the original amount invested; they could experience the fun and ego gratification of sponsoring movies and receive a tax benefit to boot.

Such agreements were in the form of either purchases or service partnerships. In a purchase, the investor would buy the picture (usually at an inflated price) with, say, a \$1 down payment and promise to pay another \$3 with a nonrecourse loan secured by anticipated receipts from the movie. Although the risk was only \$1, there was a \$4 base to depreciate and on which to charge investment tax credits.

In the service arrangement, an investor would become a partner in owning the physical production entity rather than the movie itself. Using a promissory note, deductions in the year of expenditure would again be a multiple of the actual amount invested – an attractive situation to individuals in federal tax brackets over 50%.

Tax-code changes applicable between 1976 and 1986 permitted only the amount at risk to be written off against income by film “owners” (within a

strict definition). The code also specified that investment tax credits (equivalent to  $6\frac{2}{3}\%$  of the total investment in the negative if more than 80% of the picture had been produced in the United States) were to be accrued from the date of initial release.<sup>9</sup> Revised tax treatment also required investments to be capitalized – a stipulation that disallowed the service-partnership form.

Beginning with the Tax Reform Act of 1986, however, the investment tax credit that many entertainment companies had found so beneficial (it had helped them to conserve cash) was repealed. And significantly, so-called passive losses from tax shelters could no longer be used to offset income from wages, salaries, interest, and dividends. Such passive losses became deductible only against other passive-activity income. Since 1986, accordingly, notably fewer and differently structured movie partnerships have been offered to the public. Most of the more recent ones have appeared outside the United States.<sup>10</sup>

More prototypical of the partnership structures of the 1980s, though, was the first (1983) offering of Silver Screen Partners. Strictly speaking, it was not a tax-sheltered deal. Here, Home Box Office (HBO, the Time Inc. wholesale distributor of pay cable programs) guaranteed – no matter what the degree of box-office success, if any – return of full production costs on each of at least ten films included in the financing package.

However, because only 50% of a film's budget was due on completion, with five years to meet the remaining obligations, HBO in effect received a sizable interest-free loan, while benefiting from a steady flow of fresh product.<sup>11</sup> For its 50% investment, HBO also retained exclusive pay television and television syndication rights and 25% of network TV sales. This meant that partners were largely relying on strong theatrical results, which, if they occurred, would entitle them to "performance bonuses."<sup>12</sup> Subsequent Silver Screen offerings with substantially the same structure, but of larger size (up to \$400 million), were also used to finance Disney's films (see Table 4.1).<sup>13</sup>

Such partnership units, though, are not the only types available. Quasi-public offerings that fall under the Securities and Exchange Commission's Regulation D, for example, may still be used by independent filmmakers in structuring so-called Regulation D financing for small corporations or limited partnerships. Regulation D offerings allow up to 35 private investors to buy units in a corporation or a partnership without registration under the Securities Act of 1933.<sup>14</sup>

Limited-partnership financing appeals to studios because the attracted incremental capital permits greater diversification of film-production portfolios: Cash resources are stretched, and there are then more films with which to feed ever-hungry distribution pipelines.<sup>15</sup> Also, even though a feature might not, as determined by the partnership structure, provide any return to investors owning an equity percentage of the film, it may yet contribute to coverage of studio fixed costs (overhead) via earn-out of distribution fees that are taken as a percentage of the film's rental revenues.<sup>16</sup>

Table 4.1. *Movie partnership financing: a selected sample, 1981–1987*

| Partnership                               | Total amount sought (\$ millions) | Minimum investment (\$ thousands) | Management fee as % of funds raised                                        | Limited partners' share of profits                                                                                                                |
|-------------------------------------------|-----------------------------------|-----------------------------------|----------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------|
| Delphi III (January 1984)                 | 60                                | 5                                 | 1.16% for 1985–1989, then 0.67% for 1990–1994                              | 99% to limited partners, 1% to general partners until 100% capital return; then general partners entitled to 20% of all further cash distribution |
| SLM Entertainment Ltd. (October 1981)     | 40                                | 10                                | 2.5% of capitalization in 1982, 3% in 1983–1987, and 1% in 1988–1994       | 99% until 100% returned, then 80% until 200% returned, and 70% afterward                                                                          |
| Silver Screen Partners (April 1983)       | 75                                | 15                                | 4% of budgeted film costs + 10% per year to the extent payment is deferred | 99% until limited partners have received 100% plus 10% per year on adjusted capital contribution; then 85%                                        |
| Silver Screen Partners III (October 1986) | 200                               | 5                                 | 4% of budgeted film cost + 10% per year on overhead paid to partnership    | 99% to investors until they have received an amount equal to their modified capital contribution plus 8% priority return                          |

Source: Partnership prospectus materials.

From the standpoint of the individual investor, most movie partnerships cannot be expected to provide especially high returns on invested capital. Few of them have historically returned better than 10% to 15% annually. But such partnerships occasionally generate significant profits, and they have provided small investors with opportunities to participate in major studio-packaged financings of pictures such as *Annie*, *Poltergeist*, *Rocky III*, *Flashdance*, and *Who Framed Roger Rabbit*. More often than not, however, when the pictures in such packages succeed at the box office, most investors would probably find that they could have done at least as well by investing directly in the common stock of the production and/or distribution companies

(if for no other reason than considerations of liquidity) than in the related partnerships.

### Bank loans

Established studios will normally be able to raise capital for general corporate purposes through debt or equity financing, or through commercial bank loans. In these situations, there is a considerable amount of flexibility as to the terms and types of financing that may be structured; a wide variety of corporate assets may be used as collateral.

For example, studios have recently been more willing to consider *loan securitization* structures similar to those used to create intermediate-term securities backed by packages of assets such as car and home equity loans. In the movie industry, investors contribute relatively small amounts of equity capital to form specially created “paper companies,” and banks then arrange for loans and for the sale of commercial paper and medium-term notes to fund production costs – with the contributed equity and the projected value of the films to be produced over a three-year period serving as collateral. In this way, production costs are kept off studio balance sheets, earnings can be smoothed, borrowing costs may be reduced, and some of the risks can be shifted to equity investors even though ownership rights eventually revert back to the studio.<sup>17</sup>

Production loans to an independent producer, however, are quite another story. An independent producer may have little or no collateral backing except for presale contracts and other rights agreements relating directly to the production that is to be financed. As a practical matter, then, the bank, which views a film as a bundle of potentially valuable rights, must actually look to the creditworthiness of the various licensees for repayment not only of the loan itself but also of the interest on the loan. This accordingly makes a production loan more akin to accounts receivable financing than to a standard term loan on the corporate assets of an ongoing business.<sup>18</sup>

From the producer’s standpoint, such bank loan financing may be attractive because it can provide a means of circumventing the high costs and the rigidities, both financial and artistic, that come with a studio’s distribution and financing deal. However, the fractionalization of distribution rights across many borders and across many different media absorbs time and effort that the producer might better apply to a project’s creative aspects.

### Private equity and hedge funds

Hollywood has always been dependent on large-scale financing and has often benefited from funding fervor that has materialized in unexpected places. In the 1980s, public equity was popular as a way to finance independent new studios such as Carolco. The end of the 1980s then brought direct investment from Japan into Columbia Pictures (Sony) and MCA (Matsushita). This was

followed by a phase involving foreign banks (e.g., Credit Lyonnais and MGM) and insurance-backed investors. And later, German public equity and Middle Eastern sovereign wealth sources provided financial support.

This was followed (around 2004) by private equity and hedge funds, which had by then become much more active in funneling large pools of production capital into portfolios of films through special arrangements with both major studios and established independents.<sup>19</sup> Such pools are collectively funded by pension plans and wealthy individuals and often seek to diversify into areas that are alternatives to stocks, bonds, and real estate. As such, these pools contributed some of the financing that had previously been done through tax shelters and partnerships. Along the same lines, a concept of a futures (i.e., derivatives) market was also developed.<sup>20</sup>

With their ability to commit several hundred million dollars to a slate of perhaps 10 or 20 pictures at a time, these funds provided a welcome source of capital that allowed studios to retain territorial rights as well as a large amount of control over creative issues. Studios, in effect, were able to transfer some of the risks – including those relating to financing, completion, and marketplace performance – to the funds. And the funds, for their part, expected to receive above-average returns while at the same time lowering their overall risk through diversification into (what are presumed to be relatively low-covariance) film asset investments.

The typical deal here is for an even split of carefully defined profits after a studio deducts a 12% to 15% distribution fee. The studio often also puts up money for prints and advertising, which is recouped before profits are split. In structuring a deal, large investment banks will normally provide senior debt instruments that are paid back first and that will be priced to reflect this relatively low-risk position. Private equity or hedge funds then take on the progressively riskier positions. For “mezzanine” investors, the expected return is at least 15% (annually), whereas equity players will expect the return to be at least 20%. The guiding principle is that diversification over a large portfolio of film projects will considerably reduce risk exposure for all participants.

Nevertheless, unlike what happens in other industries, such structural arrangements for funding are in fact a form of venture capital investment in which the high-risk fund money is invested early and up front, but with returns seen only later, after the studio has first recovered various expenses – prints and advertising (p&a) and distribution fees.<sup>21</sup> Because of such deductions, the studios will always retain a senior and less risky position as compared with the outside investors.

Independent filmmakers who are not in some way tied to the studio system have also developed innovative financing alternatives that are potentially less risky than direct equity investments. Borrowing against tax credits that are offered in several states can often be advantageously used. For example, an \$8.5 million advance contingent on a state granting producer incentives worth \$10 million (upon which the investor retains the difference) might be arranged. Another alternative might be “finishing funds” in which a film

needs additional capital for completion and the investor is the first to be repaid. There are also p&a funds designed to raise capital for marketing and advertising of a completed film and on which perhaps up to a 15% return might be earned. Funds can also be lent against presold domestic and foreign distribution rights.<sup>22</sup>

### 4.3 Production preliminaries

#### The big picture

Costs in this industry always tend to rise faster than in many other sectors of the economy because moviemaking procedures, although largely standardized, must be uniquely applied to each project and because efficiencies of scale are not easily attained. But other factors also pertain.

For example, during the 1970s, fiscal sloppiness pervaded the industry as soon as it became relatively easy to finance productions using other people's tax-sheltered money. Indulgence of "auteurs," who demanded unrestricted funding in the name of creative genius, further contributed to budget bloating. And "bankable" actors and directors (popular personalities expected to draw an audience by virtue of their mere presence) came to command millions of dollars for relatively little expenditure of time and effort. It was only a short while before everyone else involved in a production also demanded more.<sup>23</sup>

By the early 1980s, the burgeoning of new-media revenue sources, primarily in cable and home video, also naturally attracted (until the 1986 tax-code changes) relatively large and eager capital funding commitments for investments in movie and television ventures. But none of this could have gone quite so far without the ready availability of funds from so-called junk-bond financing, an upward-trending domestic stock market, and the spillover of wealth and easy credit from Japan's "bubble" economy.<sup>24</sup> In fact, it was not until the early 1990s, when more stringent limitations on access to bank financing were imposed, and when movie stock takeover speculation was cooled by the onset of an economic recession, that cost pressures abated somewhat.

Data from the Motion Picture Association of America (Table 4.2) indicate that between 1980 and 2007, the *negative cost*, which is the average cost of production (including studio overhead and capitalized interest) for features produced by the majors, rose at a compound annual rate of more than 7.5%, far above the overall inflation rate for this period. By 2007, the last year of officially available data – ostensibly because of the increasing difficulty of arriving at representative calculations – the average cost of producing an MPAA-member film had risen to approximately \$70 million.<sup>25</sup> And as of 2014, a reasonable extrapolation of the prior trend would suggest that such costs have risen to around \$100 million, given that studios have largely decided to release fewer films and concentrate instead on development of relatively expensive *tentpole* projects.

Table 4.2. *Marketing and negative cost expenditures for major film releases, 1980–2013*

| Year                             | MPAA releases (total) | Average cost per film (\$ millions) |                   |        | Total releasing |
|----------------------------------|-----------------------|-------------------------------------|-------------------|--------|-----------------|
|                                  |                       | Negatives <sup>a</sup>              | Ads               | Prints |                 |
| 2013                             | 114                   | 93.0                                | 48.0 <sup>c</sup> |        | 141.0           |
| 2012                             | 128                   | 85.0                                | 45.0 <sup>c</sup> |        | 130.0           |
| 2011                             | 141                   | 77.0                                | 43.0 <sup>c</sup> |        | 120.0           |
| 2010                             | 141                   | 81.0                                | 41.0 <sup>c</sup> |        | 122.0           |
| 2009                             | 158                   | 79.3                                | 39.0 <sup>c</sup> |        | 118.3           |
| 2008                             | 168                   | 74.5                                | 37.0 <sup>c</sup> |        | 111.5           |
| 2007                             | 189                   | 70.8                                | 35.9 <sup>c</sup> |        | 106.7           |
| 2006                             | 204                   | 65.8                                | 34.5 <sup>c</sup> |        | 100.3           |
| 2005                             | 194                   | 63.6                                | 32.4              | 3.8    | 99.8            |
| 2004                             | 179                   | 65.7                                | 31.0              | 3.7    | 100.4           |
| 2003                             | 180                   | 66.3                                | 34.3              | 4.2    | 104.8           |
| 2002                             | 205                   | 47.8                                | 27.1              | 3.3    | 78.2            |
| 2001                             | 183                   | 47.7                                | 27.3              | 3.7    | 78.7            |
| 2000                             | 191                   | 54.8                                | 24.0              | 3.3    | 82.1            |
| 1999                             | 200                   | 51.5                                | 21.4              | 3.1    | 76.0            |
| 1998                             | 235                   | 52.7                                | 22.1              | 3.3    | 78.0            |
| 1997                             | 253                   | 53.4                                | 19.2              | 3.0    | 75.7            |
| 1996                             | 240                   | 39.8                                | 17.2              | 2.6    | 59.7            |
| 1995                             | 234                   | 36.4                                | 15.4              | 2.4    | 54.1            |
| 1994                             | 183                   | 34.3                                | 13.9              | 2.2    | 50.3            |
| 1993                             | 161                   | 29.9                                | 12.1              | 1.9    | 44.0            |
| 1992                             | 150                   | 28.9                                | 11.5              | 2.0    | 42.3            |
| 1991                             | 164                   | 26.1                                | 10.4              | 1.7    | 38.2            |
| 1990                             | 169                   | 26.8                                | 10.2              | 1.7    | 38.8            |
| 1989                             | 169                   | 23.5                                | 7.8               | 1.4    | 32.7            |
| 1988                             | 160                   | 18.1                                | 7.1               | 1.4    | 26.6            |
| 1987                             | 129                   | 20.1                                | 6.9               | 1.4    | 28.3            |
| 1986                             | 139                   | 17.5                                | 5.4               | 1.2    | 24.1            |
| 1985                             | 153                   | 16.8                                | 5.2               | 1.2    | 23.2            |
| 1984                             | 167                   | 14.4                                | 5.4               | 1.3    | 21.1            |
| 1983                             | 190                   | 11.9                                | 4.2               | 1.0    | 17.1            |
| 1982                             | 173                   | 11.8                                | 4.1               | 0.9    | 16.8            |
| 1981                             | 173                   | 11.3                                | 3.5               | 0.9    | 15.7            |
| 1980                             | 161                   | 9.4                                 | 3.5               | 0.8    | 13.7            |
| CAGR <sup>b</sup> (%): 1980–2013 |                       | 7.2                                 |                   |        | 7.3             |

<sup>a</sup> Negative costs (\$millions) for the years 1975 to 1979 were \$3.1, \$4.2, \$5.6, \$5.7, and \$8.9, respectively. Costs include studio overhead and capitalized interest. Cost estimates for after 2007 by author. Data frequently revised.

<sup>b</sup> Compound annual growth rate.

<sup>c</sup> Prints and ads combined in releasing cost estimates after 2005.

Source: MPAA and author estimates.

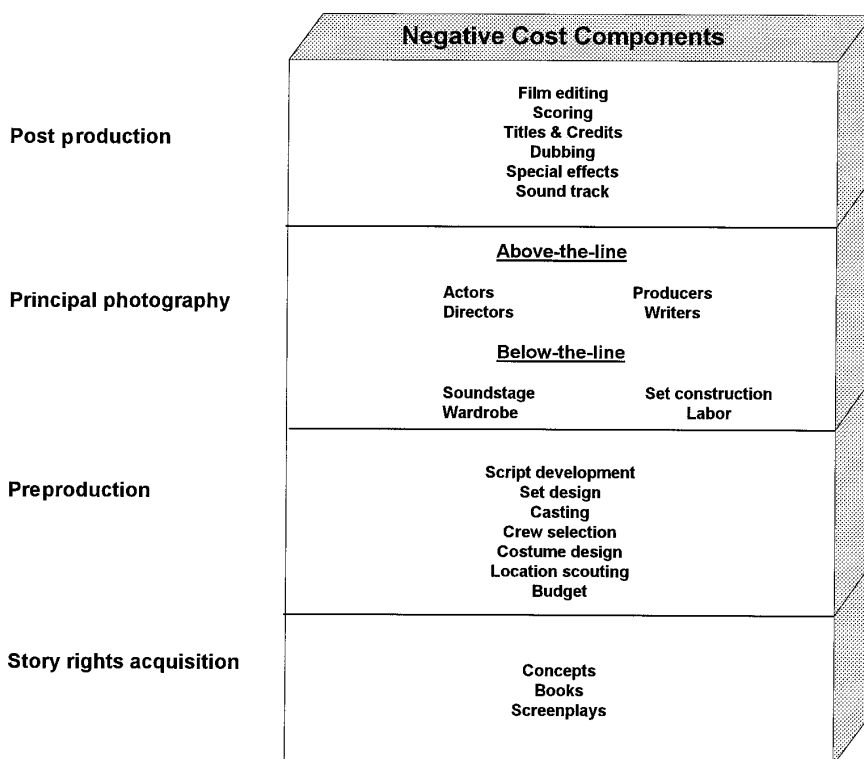


Figure 4.1. Negative cost components.

Even under the best of circumstances, though, production budgets, in which there are thousands of expense items to be tracked, are not easy to control.<sup>26</sup> The basic cost components that go into the making of a film negative, for example, are illustrated in Figure 4.1.

In the category of *above-the-line costs* – that is, the costs of a film’s creative elements, including cast and literary property acquisition (but not deferments) – contracts are signed and benefits and payments administered for sometimes hundreds of people.

Good coordination is also required in budgeting *below-the-line costs* – the costs of crews and vehicles, transportation, shelter, and props.<sup>27</sup> For each film, wardrobes and props must be made or otherwise acquired, locations must be scouted and leases arranged, and scene production and travel schedules must be meticulously planned. Should any one of those elements fall significantly out of step (as happens when the weather on location is unexpectedly bad, or when a major actor takes ill or is injured), expenses skyrocket. At such points of distress, a film’s completion bond insurance arrangements become significant because completion guarantors have the option to lend money to the producer to finish the film, to take full control of the film and finish it, or to abandon the film altogether and repay

the financiers.<sup>28</sup> Additional below-the-line costs also would be incurred in postproduction activities.<sup>29</sup>

In general, the smaller the budget, the higher will be the percentage of the budget spent on below-the-line costs and vice versa. But, interestingly, the larger the budget, the more a distributor would likely be willing to pay for rights because – regardless of cast, script, or anything else – financing requirements are usually calculated as a percentage of the budget.

### Labor unions and guilds

Unions have an important influence on the economics of filmmaking, beginning with the first phase of production. Indeed, union guidelines for compensation at each defined level of trade skill allow preliminary below-the-line production cost estimates to be determined with a fair degree of accuracy. Major unions in Hollywood include

Directors Guild of America (DGA)

International Alliance of Theatrical and Stage Employees (IATSE)

SAG-AFTRA (Screen Actors Guild merged with American Federation of Television and Radio Artists)

Writers Guild of America

Individuals belonging to these unions will normally be employed in the production of all significant motion pictures. The unions, in turn, will negotiate for contract terms with the studios' bargaining organization, the Alliance of Motion Picture and Television Producers (AMPTP).<sup>30</sup> Generally, these organizations and their members receive so-called residual payments (evolved out of old practices in vaudeville and on Broadway), which, for theatrical films, are calculated on gross revenues obtained from video, television, and other nontheatrical sources whether or not the production is profitable. The Producers Guild of America, however, is not strictly a labor union, as it does not negotiate working conditions or set wages and its members do not receive residuals.

Still, it is possible to produce a film with no noticeable difference in quality for up to 40% less in nonunion or flexible-union territories outside of Hollywood, and independent producers may sometimes attempt to reduce below-the-line costs by filming in such territories.<sup>31</sup> Studios may sometimes also make use of an IATSE contract provision (Article 20) that allows the financing of low-budget nonunion movies and television shows if the studio claims to have no creative control.<sup>32</sup>

## 4.4 Marketing matters

### Distributors and exhibitors

*Sequencing.* After the principal production phase has been completed, thousands of details still remain to be monitored and administered.

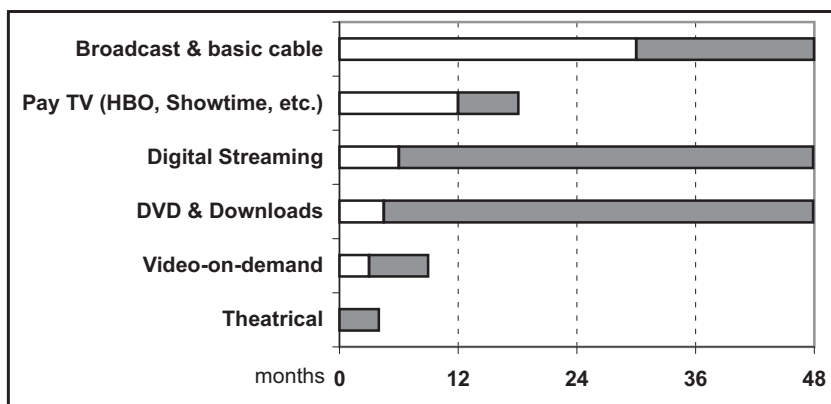


Figure 4.2. Typical market windows from release date, circa 2014.

Scoring, editing, mixing sound and color, making prints at the film laboratory, and conversion to digital formats are but a few of the essential steps. Once the film is in the postproduction stages, however, perhaps the most critical preparations are those for distribution and marketing.

Sequential distribution patterns are determined by the principle of the second-best alternative – a corollary of the price-discriminating market-segmentation strategies discussed in Chapter 1. That is, films are normally first distributed to the market that generates the highest marginal revenue over the least amount of time. They then “cascade” in order of marginal-revenue contribution down to markets that return the lowest revenues per unit time. This has historically meant theatrical release, followed by licensing to pay-cable program distributors, home video, television networks, and finally local television syndicators. Distribution “is all about maximizing discrete periods of exclusivity.”<sup>33</sup>

However, because the amounts of capital invested in features have become so large and the pressures for faster recoupment so great, there has been movement toward earlier opening of all windows (Figure 4.2) – including the worldwide initial theatrical, in which an estimated 95% of total box-office receipts are now generated within the first month. Changes in the historical window time sequencing have already occurred in DVDs and are also occurring for video-on-demand, Internet downloads, and mobile, small-screen viewing platforms.<sup>34</sup>

Sequencing is always a marketing decision that attempts to maximize income and, as such, it is often sensible for profit-maximizing distributors to price-discriminate in different markets or “windows” by selling the same product at different prices to different buyers.<sup>35</sup> Control of windows creates scarcity, which is crafted through use of contractually specified terms and times of exploitation exclusivity that are achieved through the use of what are known as “holdbacks.” In so doing, recent films are, in effect, quarantined (by the major pay-cable networks) for periods lasting as long as five to

seven years, during which time the films are accordingly unavailable to online service distributors.<sup>36</sup>

It should not be surprising, however, to find that, as new distribution technologies emerge and older ones fade in relative importance, shifts in sequencing strategies occur.<sup>37</sup> For example, the Internet's ability to make films instantly available anywhere now requires simultaneous worldwide day-and-date theatrical or DVD release for major projects. Such "windowing" is also a way in which the public-good characteristics of movies used as television programs can be fully exploited.<sup>38</sup>

Moreover, as studios increasingly interact directly with their ultimate audiences through social media and cloud-based digital-locker services (e.g., UltraViolet), the behavioral data that are thereby generated enable marketing to become more efficient.<sup>39</sup> Such behavioral data are already well established at digital distributors such as Amazon, Netflix (subscription video-on-demand or S-VOD), and iTunes.

*Distributor-exhibitor contracts.* Distributors normally design their marketing campaigns with certain target audiences in mind and marketing considerations are prominent in a studio's decision to make (i.e., *green-light*) or otherwise acquire a film for distribution. Indeed, in the earliest stages, marketing people will attempt to forecast the prospects for a film in terms of its potential appeal to different audience demographic segments, with male/female, young (under 25)/old (known as "four quadrant"), and sometimes also ethnic/cultural being the main categorizations.<sup>40</sup>

Distributors will then typically attempt to align their releases with the most demographically suitable theaters, subject to availability of screens and to previously established relationships with the exhibition chains. They accomplish this by analyzing how similar films have performed previously in each potential location and then by developing a release strategy that provides the best possible marketing mix, or platform, for the picture.<sup>41</sup> Sometimes the plan may involve slow buildup through limited local or regional (*platform*) release; at other times, it may involve broad national release on literally thousands of screens simultaneously.

Although no amount of marketing savvy can make a really bad picture play well, an intelligent strategy can almost certainly help to make the box-office (and ultimately the video and cable) performance of a mediocre picture better. It has accordingly now become characteristic of distributors to negotiate arrangements with exhibitors for specific theater sites and auditorium sizes.

However, instead of negotiating, distributors may also sometimes elect, several months in advance of release, to send so-called bid letters to theaters located in regions in which they expect (because of demographic or income characteristics) to find audiences most responsive to a specific film's theme and genre.<sup>42</sup> This would normally be the preferred method of maximizing distributor revenues at times when the relative supply of pictures (to screens)

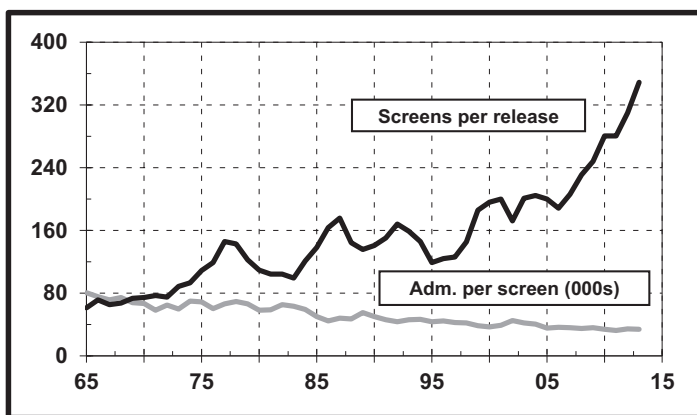
is limited, as had happened in the late 1970s (Figure 4.3a). Theaters that express interest in showing a picture then usually accept the *terms* (i.e., the implied cost of film rental and the playing times) suggested by the distributor's regional branch exchange (sales office).

Such contracts between distributors and exhibitors are usually of the boilerplate variety (fairly standard from picture to picture) and are arranged for large theater chains by experienced film bookers who bid for simultaneous runs in several theaters in a territory. Smaller chains or individual theaters might also use a professional agency for this purpose. The key phrases used in all contracts are *screens*, which refers to the number of auditoriums, and *playdates* (sometimes called *engagements*), which refers to the theater booked (even if the theater shows the film on several screens at the same location).

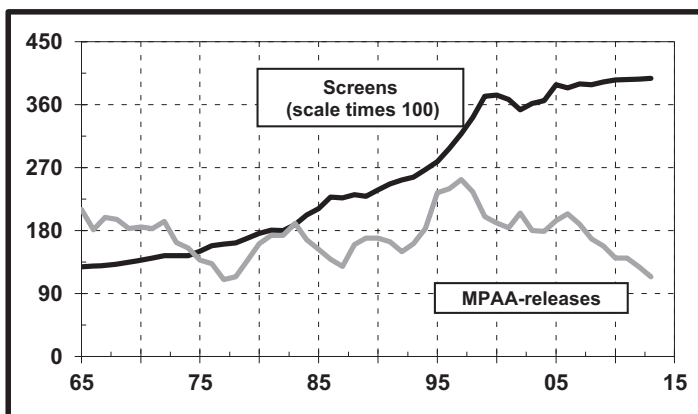
Still, there can be variations. For example, in the early 1970s the film *Billy Jack* received wide publicity for its distribution through "four-wall" contracts. Here the distributor in effect rents the theater (four walls) for a fixed weekly fee, pays all operating expenses, and then mounts an advertising blitz on local television to attract the maximum audience in a minimal amount of time. Yet another simple occasional arrangement is flat rental, where the exhibitor (usually in a small, late-run situation) pays a fixed fee to the distributor for the right to show the film during a specified period. And, more recently, there has been a trend toward simple aggregate booking contracts in which all box-office revenue is divided by a negotiated percentage formula that does not include provision for the theater's expenses (i.e., the house "nut," as explained later). With such arrangements, which are becoming more common, box-office receipts of, say, \$10,000 might be split 55% for the distributors and 45% for the exhibitors, so that the theater would retain \$4,500.

Although they are not used to anywhere near the same extent as previously, conventional contracts (i.e., what are known as standard agreements) between distributors and exhibitors would, however, almost always call for a sliding percentage of the box-office gross after allowance for the exhibitor's nut (house expenses, which include location rents and telephone, electricity, insurance, and mortgage payments). This house allowance is now largely a function of the quality of the theater location, number of screens, and number of seats, and is also often supplemented by payments for placements of trailers, which are ads for coming attractions. Whether assumed or negotiated, however, it is generally conceded that the allowance will normally provide exhibitors with an additional cushion of profit.

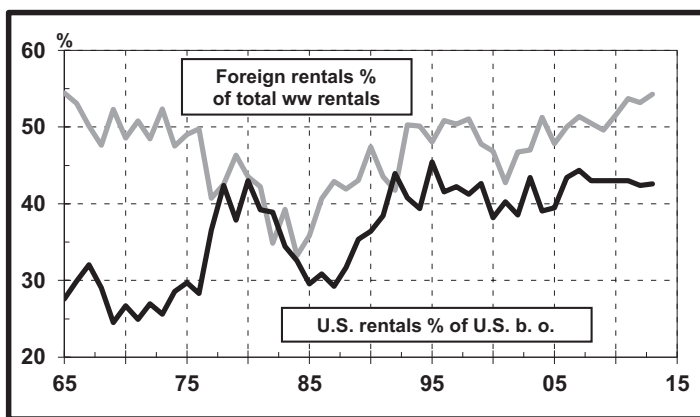
For a major release, sliding-scale agreements may stipulate that 70% or (sometimes) more of the first week or two of box-office receipts after subtraction of the nut is to be remitted to the distributor, with the exhibitor retaining 30% or less. Every two weeks thereafter, the split (and also the floor) may then be adjusted by 10% as 60/40, then 50/50, and so forth in the exhibitor's favor.<sup>43</sup>



(a)



(b)



(c)

Figure 4.3. Exhibition industry trends, 1965–2013: (a) screens per release and admissions per screen, (b) number of screens and number of MPAA-member releases, and (c) rentals percentages – foreign versus total and as a percentage of U.S. box-office receipts.

If it is assumed that the house nut is \$10,000 a week, and that the first-week agreement on a picture that sells \$50,000 in tickets is 90/10 with a 70% floor, the distributor would receive (see also Table 5.7) the larger of

90/10 split:  $90\% \times (\$50,000 - \$10,000) = \$36,000$

or

70% floor:  $70\% \times \$50,000 = \$35,000$ .

But by the fifth week, with the film taking in \$30,000, the arithmetic might be

70/30 split:  $70\% \times (\$30,000 - \$10,000) = \$14,000$

or

50% floor:  $50\% \times \$30,000 = \$15,000$ .

The distributor's gross (otherwise known as *rentals*) is thus in effect received for a carefully defined conditional lease of a film over a specified period. Lease terms may include bid or negotiated *clearances*, which provide time and territorial exclusivity for a theater as well as conditions relating to the size of the auditorium.<sup>44</sup> No exhibitor would want to meet high terms for a film that would soon (or, even worse, simultaneously) be playing at a competitor's theater down the block. In addition, such contracts usually include a *holdover* clause that requires theaters to extend exhibition of the film another week (and also perhaps revert to payment of a higher percentage) if the previous week's revenue exceeds a predetermined amount.

Should a picture not perform up to expectations, the distributor also usually has the right to a certain minimum or *floor* payment. These minimums are direct percentages (often more than half) of box-office receipts prior to subtraction of house expenses, but any previously advanced (or guaranteed) exhibitor monies can be used to cover floor payments owed. And for many films (especially for those that flop), the distributor may reduce (in a nonbid situation) the exhibitor's burden through a quietly arranged settlement.<sup>45</sup> The upshot is that, on average, exhibitors have typically retained almost 50% of box-office receipts in the United States (but closer to 70% in the United Kingdom and 75% in China).

As a result, the largest profit source (and about one-third of revenues) for many exhibitors is often not the box office but the candy, popcorn, and soda counter – where the operating margin may readily exceed 70% (and 90% on purposely salty popcorn). Theater owners have full control of proceeds from such sales; they can either operate food and beverage stands (and, increasingly, video games) themselves or lease to outside concessionaires. The importance of these concession profits to an exhibitor can be seen in the numerical example in Table 5.7. In addition, since the early 1980s, a third significant source of profit for theater operators is on-screen advertising, which generates margins of 90%. Together, concession sales and advertising might provide 75% of operating income for the typical multiplex.<sup>46</sup>

Given the high percentage normally taken by the distributor, it is in the distributor's interest to maintain firm ticket pricing, whereas it may be in the exhibitor's interest to set low ticket prices to attract high-margin candy-stand patronage. In most instances, exhibitors set ticket prices and the potential for a conflict of interest does not present any difficulty to either party. But there have been situations (e.g., the releases of *Superman*, *Annie*, and a few Disney films) in which the distributor has suggested minimum per capita admission prices to protect against children's prices that are too low. What distributors fear is that low admission prices will divert spending from ticket sales (where they get a significant cut) to the exhibitor's concession sales.

Although most theater operators will also attempt to enhance profitability through sales of advertising spots, some distributors (e.g., Disney since the early 1990s) may limit or bar exhibitors from showing advertisements before the film is run.<sup>47</sup> Many such industry tactics and pricing practices – for example, why ticket prices for almost all films are pretty much the same no matter what film is being shown, or why popcorn at the concession stand is priced so high – are now receiving greater empirical attention from economists.<sup>48</sup>

*Release strategies, bidding, and other related practices.* Large production budgets, high interest rates, and the need to spend substantial sums on marketing provide strong incentives for distributors to release pictures as broadly and as soon as possible (while also, incidentally, reducing the exhibitor's risk). A film's topicality and anticipated breadth of audience appeal will then influence the choice of marketing strategies that might be employed to bring the largest return to the distributor over the shortest time.<sup>49</sup> Of greatest interest to the market research departments are a film's *marketability* – how easily the film's concept can be conveyed through advertising and promotion – and its *playability*, which refers to how well an audience reacts to the film after having seen it.

Many alternatives are available to distributors. Some films are supported with national network-television campaigns arranged months in advance, whereas others use only a few carefully selected local spots, from which it is hoped that strong word-of-mouth advertising will build. Sometimes a picture will be opened (limited release) in only a few theaters (i.e., playdates) in New York or Los Angeles during the last week of the year to qualify for that year's Academy Award nominations and then later be taken into *wide release* of up to 2,000 national playdates (i.e., engagements/theaters). Or there may even be massive simultaneous *saturation release* on more than 3,000 screens at the seasonal peaks for which strategically important prospective dates (that purposely exclude World Cup and Olympic event periods) are staked out for up to five years ahead of time. Regional or highly specialized release is appropriate if a picture does not appear to contain elements of interest to a broad national audience. And simultaneous global release is now often used to thwart unauthorized copying.

In any case, different anti-blind bidding laws (laws that prohibit completion of contracts before exhibitors have had an opportunity to view the movies on which they are bidding) are effective in at least 23 states. These statutes were passed by state legislatures in response to exhibitor complaints that distributors were forcing them to bid on and pledge (guarantee) substantial sums for pictures they had not been given an opportunity to evaluate in a screening – in other words, buying the picture sight unseen. Distributors now generally screen their products well in advance of release, but large pledges from exhibitors may still sometimes be required for theaters to secure important pictures in the most desirable playing times, such as the week from Christmas through New Year's. This is because not all weekends in the year are equally valuable, and for these seasonal high periods theaters might sometimes have to offer a substantial advance in nonrefundable cash against future rentals owed (i.e., guarantees).

Whereas in theory movie releases from all studios can be expected to play in different houses depending only on the previously mentioned factors, some theaters, mostly in major cities, more often than not end up consistently showing the products of only a few distributors. Industry jargon denotes these as theater *tracks* or *circuits*. Tracks can evolve from long-standing personal relationships (many going back to before the Paramount consent decree) that are reflected in negotiated rather than bid licenses, or they may indicate de facto *product-splitting* or *block-booking* practices.<sup>50</sup>

Product splitting occurs when several theaters in a territory tacitly agree not to bid aggressively against each other for certain films, with the intention of reducing average distributor terms. Each theater in the territory then has the opportunity, on a regular rotating basis, to obtain major new films for relatively low rentals percentages. Block booking, in contrast, occurs when a distributor accepts a theater's bid on desirable films contingent on the theater's commitment that it will also run the distributor's less popular pictures.<sup>51</sup>

As may be readily inferred, symbiosis between the exhibitor and distributor segments of the industry has not led to mutual affection. The growth of pay-per-view cable and the possibility of simultaneous domestic and foreign releases (known as day and date in the industry) in video and Internet-related formats may further strain relations. As De Vany and Walls (1997) have noted, the legal constraints stemming from the Paramount decree have prevented multiple-picture licensing so that

[N]o contracts can be made for the whole season of a distributor's releases, nor for any portion of them. Nor is it possible to license a series of films to theaters as a means of financing their production. The inability to contract for portfolios of motion pictures restricts the means by which distributors, producers and theaters manage risk and uncertainty. (p. 796)

*Exhibition industry characteristics: (a) Capacity and competition.* The long-run success of an exhibition organization is highly dependent on its skill

in evaluating and arranging real estate transactions. Competition for good locations (which raises lease payment costs) and the presence of too many screens relative to the size of a territory will generally reduce overall returns.

To achieve economies of scale, since the 1960s exhibitors have tended to consolidate into large chains operating multiple screens located near or in shopping-center malls. Meanwhile, older movie houses in decaying center-city locations have encountered financial hardships as the relatively affluent consumers born after World War II have grown to maturity in the suburbs, and as crime and grime and scarcity of parking spaces have often become deterrents to regular moviegoing by city residents. (Ironically, the same social pressures contributed to the disappearance of many drive-in theaters situated on real estate too valuable to be used only for evening movies.<sup>52</sup>)

In 2014, there were approximately 39,600 screens, a diminishing proportion of which were drive-ins and a growing percentage of which were in the giant screen (100 feet wide and 80 feet high) IMAX format that was initially developed for museums and that is especially effective for exhibiting (both in 2D and 3D) sci-fi, fantasy, and historical epics. Such large screens, known as *premium large format* (PLF), are also being built by conventional theater chains. The total number of screens has been increasing since 1980 at an average rate of 2.5%, with box-office gross per screen rising an average 1.7% per year (see Table 3.3). During this time, operating incomes and market shares for large, publicly owned theater chains operating so-called *megaplexes* of at least 12 screens at one location have obviously gained rapidly at the expense of single-theater operators. For example, as of 1982, the top-grossing third of screens generated half of the box office, with the bottom third generating about one-sixth of the box office (Murphy 1983 and Figure 4.4). Currently, the top one-third of screens probably account for at least 75% of all theater grosses.

Although the number of screens in North America has been increased substantially (Figure 4.3b), the number of separate theater locations has not grown by nearly as much because many locations have been multiplexed. It is now therefore more difficult to “platform” a film because there are essentially only two types of theaters: first-run multiple-screen houses and all others. Previously, there had been at least three tiers of theater quality, ranging from first-run fancy to last-run, small neighborhood “dumps.”

Whether or not a film has “legs” (i.e., strong popular appeal so that it runs a long time), the maximum theoretical revenue  $R$  is a function of the average length of playing time  $T$ , the number of showings per day  $N$ , the average number of seats per screen  $A$ , the number of screens  $S$ , the average ticket price  $P$ , and audience suitability ratings (G, PG, PG-13, R, NC-17/X). Exclusive of the ratings factor, which also influences the potential size of the audience,<sup>53</sup>

$$R = P \times N \times A \times S,$$

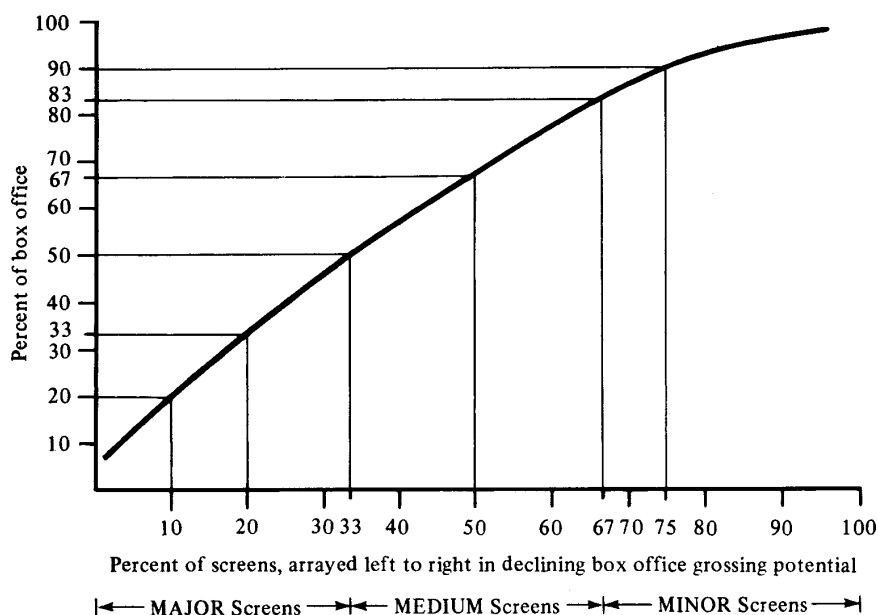


Figure 4.4. Domination of box-office performance by key U.S. movie theaters. *Source:* *Variety*, July 7, 1982. Copyright 1982 by A. D. Murphy.

where

$$N = f(T).$$

For example, if the average ticket price is \$10, the average number of showings per day is four, the average number of seats per theater is 300, and the number of screens is 500, the picture can theoretically gross no more than \$6 million ( $10 \times 4 \times 300 \times 500$ ) per day, or \$42 million per week. This type of analysis is of interest to distributors as comparisons are made to the potential of pay-per-view cable release, from which there is the possibility to earn, on a \$4-per-view charge, at least \$20 million overnight.<sup>54</sup>

Because the preceding figures used in calculating a theoretical weekly total gross for a single picture are about average for the whole industry, they can also be used to estimate an aggregate for all exhibitors. Following this line, it can be determined that in 2013 the maximum theoretical annual gross, based on 39,783 screens, was about \$286 million per day, or about \$105 billion per year. The industry obviously operates well below its theoretical capacity, because there are many parts of the week and many weeks of the year during which people do not have the time or inclination to fill empty theater seats. In 2013, the industry's average occupancy rate per seat per week was roughly 2.1 times, and box-office receipts of around \$10.9 billion in 2013 were thus only around 10.4% of theoretical capacity.

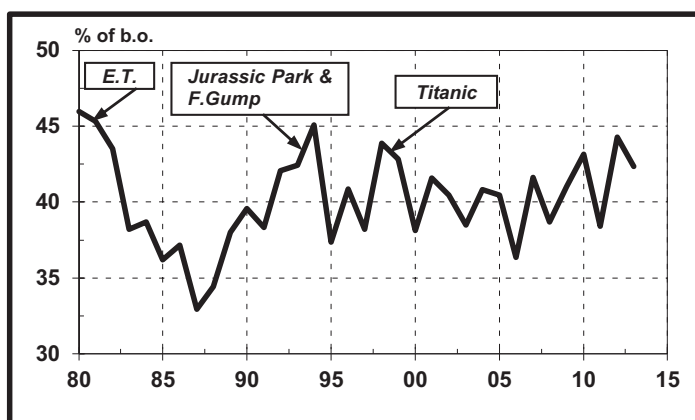
For the major film releases most likely to be opened during peak seasons, calculations of this kind do not actually have much relevance because there are no more than about 12,000 quality first-run screens, of which perhaps only 4,000 can normally be simultaneously booked. By far, the most important effect of severe competition for quality playdates in peak seasons is that marketing budgets must be raised to levels much higher than they would otherwise be (and for economic reasons explained in Section 1.3). In such an environment, modestly promoted films, even those of high artistic merit, may have little time to build audience favor before they are pulled from circulation.<sup>55</sup>

In comparing the popularity of different films in different years, most media reports merely show the box-office grosses: Film *A* did \$10, and film *B* did \$11; therefore *B* did better than *A*. In addition, a deeper, but still often misleading, comparison is sometimes derived by calculating an average gross per screen (which is often misinterpreted and is actually per location). Close analysis and comparison of box-office data require that variables such as ticket-price inflation, film running time, season, weather conditions, number and quality of theaters, average seats per theater, and types of competing releases be considered.<sup>56</sup>

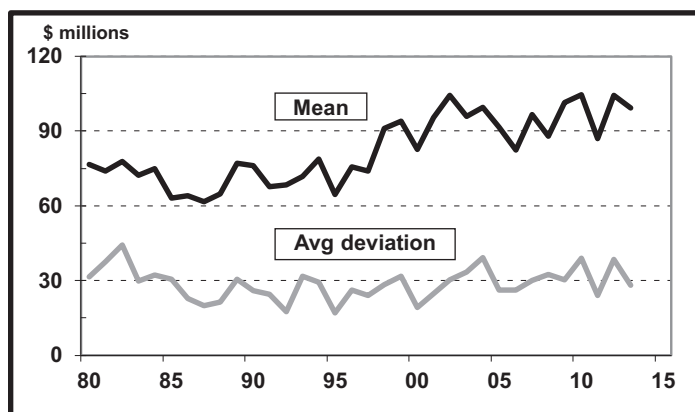
*Exhibition industry characteristics: (b) Rentals percentage.* All other things being equal, when the supply of films is small compared with exhibitor capacity, the percentage of box-office receipts reverting to distributors (the rentals percentage) rises.<sup>57</sup> Faced with a relatively limited selection of potentially popular pictures, theater owners tend to bid more aggressively and to accede to stiffer terms than they otherwise would. Especially in the late 1970s, for example, there were loud complaints by exhibitors of “product shortage” as the total number of new releases and reissues declined by 43% to 110 in 1978 from the 1972 peak of 193. As might be expected, distributor rentals percentages (and thus profit margins) were high in the late 1970s (Table 3.3 and Figure 4.3c).

To some extent, however, the rentals percentage also depends on ticket prices and on how moviegoers respond to a year’s crop of releases. A poorly received crop tends to reduce the average distributor rentals percentage as floor (minimum) clauses on contracts with exhibitors are activated, as advances and guarantees are reduced in size and number, and as *settlements* are more often required. Even important releases now tend to have only one or two weeks of box-office presence before fading and thereby denying theaters the higher percentages that would be earned if pictures were to play more strongly over more weeks, as they had often done prior to the late 1990s.

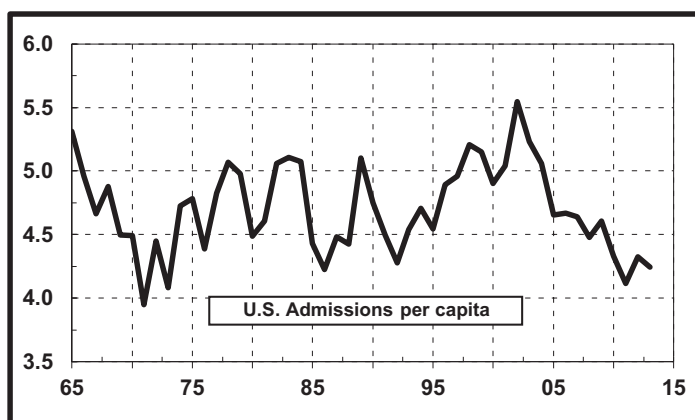
Although theatrical exhibition is inherently volatile over the short run, over the longer run there is nevertheless a remarkable consistency in the way the domestic business behaves. Since the 1960s, for instance, in a typical week approximately 8% to 10% of the U.S. population buys admission to a movie. And as can be seen in Figure 4.5a, the top 20 grossing films of



(a)

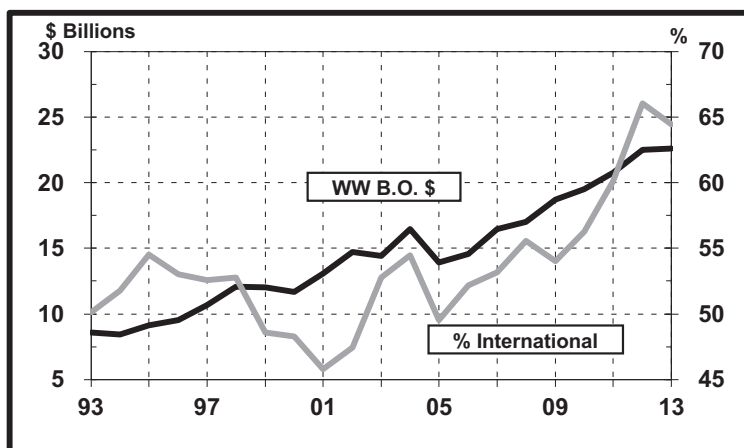


(b)



(c)

Figure 4.5. (a) Top 20 films, domestic box-office gross, 1980–2013; (b) top 20 films, domestic box-office gross, constant dollar mean and variance, 1980–2013; (c) U.S. per capita theater admissions, 1965–2013; (d) top 100 films, domestic and foreign gross comparisons, 1993–2013.



(d)

Figure 4.5 (continued)

any year will normally account for an average of around 40% of that year's box-office total, with a giant hit every so often temporarily boosting the percentage. Figure 4.5b meanwhile suggests that the variance of results for the top 20 is not large and that growth in constant dollars has been modest. The long-term per capita admissions trend is depicted in Figure 4.5c, and Figure 4.5d shows that the top 100 films of any year have been consistent in drawing more than half of their total box-office income in foreign markets.

### Video, output deals, and merchandising

*Video.* Until the 1980s, moviemakers both large and small were primarily concerned with marketing their pictures in theaters. But starting in 1986, distributors generated more in domestic wholesale gross revenues from home video (about \$2 billion) than from theatrical (\$1.6 billion) sources. Home video has thus forever altered the fundamental structure of the business and changed the ways in which marketing strategies are pursued.<sup>58</sup> Digital video disc players (DVDs) are familiar items in households around the world and have had great impact since being introduced in 1997. And because of the enormous installed base, DVDs remain a powerful funds-flow engine for filmmakers.<sup>59</sup>

With the profit per unit on a DVD around twice as high as that on a tape, studios have had an incentive to return to the simple consumer purchase model that has long been used in the recorded music business.<sup>60</sup> DVDs undermined the rental tape-pricing model (as well as the revenue-sharing

model) that had carried the home-video industry through its first 20 years. And DVDs caused a shift of profitability structure toward one more favorable to studios (now able to retain a comparatively larger portion of a film's total revenues than with exhibitors).

As a result, sales of prerecorded home-video software had grown into a business that at its peak around 2006 generated more than \$20 billion in domestic retail revenues. The bulk of those revenues (two-thirds or so) had been derived from sales or rentals (to the consumer) of feature films.<sup>61</sup> Also, given that some 45% to 60% of Hollywood's aggregate releasing costs are covered by domestic home-video and digital media receipts, it is easy to see why filmmakers and distributors cannot afford to treat video marketing campaign strategies lightly.

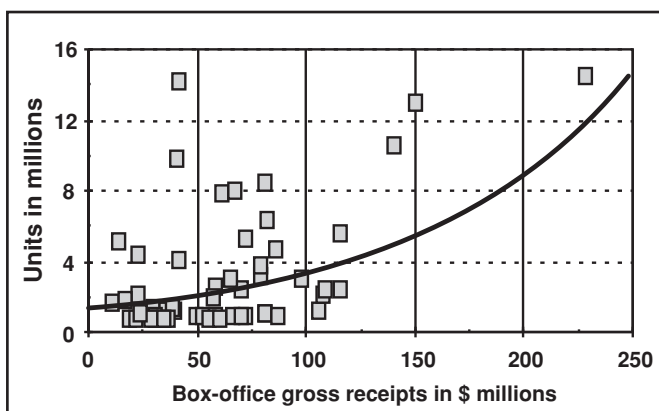
Perhaps the most important decision for the video divisions of the major studios concerns pricing. Up until the late 1990s, when steep discounting became available to high-volume retailers not participating in revenue-sharing plans (as described later), the choice had been either to price high for the video store *rental* market or to price low for what is known as the *sell-through* (consumer) market. Because the cost of manufacturing and marketing a cassette or DVD is about the same (under \$4 a unit) for all regular feature films, the decision has always come down to whether the distributor can earn more from rentals or from sell-through to individuals.<sup>62</sup> In recent years, more than 50% of total U.S. consumer spending on video has been for sell-through products, with more than half of this total generated by feature films.<sup>63</sup>

For "evergreen" titles, such as many of the Disney animations, the decision is normally to go for sell-through because the arithmetic can be so compelling. Nevertheless, the much likelier alternative (prior to revenue sharing) had been to set the suggested retail price of the cassette much higher so that it would become primarily a rental item. Most such "A"-title releases, as films with the potentially widest appeal are known, would list for \$89.95 or above, and of this price the distributor would probably retain around \$56.57 (i.e., 63%) from the initial sale.<sup>64</sup> In this situation, a distributor would *not* participate further in the cash flow that is derived from retailers' rentals of the cassette.<sup>65</sup>

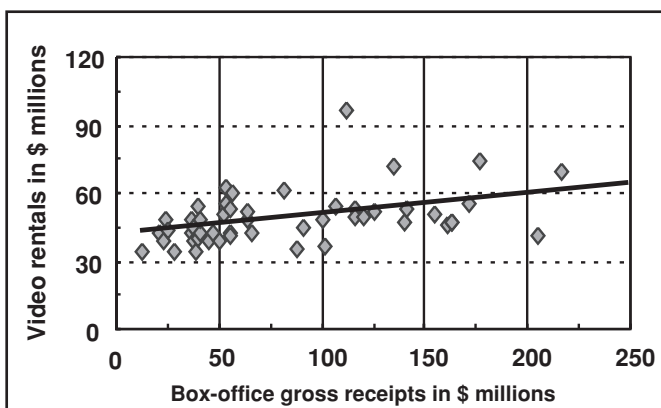
All other things being equal, then, the studio distributor (in effect, the video's publisher) would select the larger of the following options:

Expected number of rental units times 63% of rental unit retail price or  
Expected number of sell-through units times wholesale unit price.<sup>66</sup>

Yet because marketing costs figure prominently in the success of sell-through titles, with normally around 10% of expected revenues allocated to promotional budgets, the distributor generally must be able to project sales of at least seven to eight times as many copies of a sell-through than of a rental



(a)



(b)

Figure 4.6. An example of box-office gross receipts ( $x$ -axis) versus (a) video unit sales and (b) rental dollars, circa 1995.

title to justify the decision. Such projections would be made, for example, on a typical fitted curve (Figure 4.6), off which the number of video (and also film-related video game) units demanded might be estimated as a function of the domestic box-office (dbo) performance.<sup>67</sup>

Nevertheless, given the decline of the DVD market and the brightening prospects for video-on-demand (VOD) as distributed through cable, mobile, and Internet services, a significant shift to such *electronic sell-through* (EST) modes of delivery has already begun.<sup>68</sup> Studios can generate profit margins of up to 60% on VOD-delivered films, which is often at least twice the average margin on physical DVD sales: It is estimated that studios might on

average generate only 20 cents on the dollar per DVD rental, but 60 to 70 cents on the dollar from VOD sales.<sup>69</sup>

Independent filmmakers (“indies”) would, of course, face a different set of problems. To finance production, they will typically be most interested in preselling (or fractionalizing) rights to their pictures. For this purpose, they can approach one of the majors or submajors, or go to an independent video distributor.<sup>70</sup> Rights fractionalization proposals, however, are not normally welcomed by large distributors.<sup>71</sup>

Although the ideal, much-sought-after arrangement for independents has historically been theatrical distribution, with a minimum guarantee and back-end participation included, this is for the most part not a likely outcome for the vast majority of such features.<sup>72</sup> Nowadays, the ability to finance, market, and distribute through the auspices of pay-cable networks or organizations such as Amazon or Netflix may be the easier and more direct and realistic route for an “independent” filmmaker to take.

So-called direct-to-video features, which are designed to skip a theatrical release phase entirely and go directly to the video market, have also become more important, especially in the family film and horror genres. Elimination of relatively high theatrical releasing costs here enhances the profit potential of such titles.<sup>73</sup>

In addition, all film distributors must of necessity now take the projected rapid growth of pay-per-view/video-on-demand (PPV/VOD) cable and Internet distribution into consideration. At a minimum, the rise of PPV/VOD digitally distributed technology has reduced DVD unit demand and altered the sequential release patterns for certain types of films.<sup>74</sup> This is occurring through the changeover to Internet-delivered films where profit margins for studios are higher (perhaps approaching 70% on a \$5.00 download versus 30% from a \$20 at retail DVD), but the unit dollar amount to which this margin is applied is much lower.

*Output deals.* In the early formative years for pay-cable networks such as HBO, Starz, and Showtime (see Chapter 8), it was evident that availability of relatively recent movies was essential to attracting new subscribers and thereby building a service brand. Pay-channel operators found that they could distinguish themselves by arranging for exclusive, long-term output deals with studios, which were only too happy to oblige. That is because, in a typical year, a studio receiving an average of \$15 million per film for 20 films might be able to readily cover much if not all of its annual overhead costs from just the U.S. market, with significant additional funds coming from abroad. By 2012, Hollywood was collecting nearly \$2 billion from this rich source of income.

More recently, however, saturation of potential premium-channel subscriber households and proliferation of other ways to watch movies, through DVDs, iPads, digital downloads, and advertiser-supported networks, has led

pay-channel service providers to turn toward more self-produced original programming (e.g., *The Sopranos*, *Dexter*, *Game of Thrones*, and *Boardwalk Empire*) and to become much less dependent on Hollywood features. This has accordingly resulted in a reduction of financial support for major and independent feature studios and production companies and the closure of specialized distribution entities such as New Line, Picturehouse, Warner Independent, and Paramount Vantage.<sup>75</sup>

*Merchandising.* Product merchandising opportunities relating to film characters and concepts began in earnest in the 1970s with *Jaws* and *Star Wars* and have increased noticeably since then. “Franchise” pictures able to sustain a long series of sequels using the same major characters (e.g., James Bond, *Star Wars*, *Jurassic Park*, Batman, Spider-Man, Superman, *Toy Story*) are the main vehicles. Studios are highly sophisticated in marketing tied directly to the action and children’s film genres, where licensing potential in music, books, comics, multimedia and other interactive formats (DVDs, audio books, etc.), fast food restaurants, and toys abounds.<sup>76</sup>

An important product license to a major toy manufacturing company might, for instance, return at least 6% to 7% of wholesale merchandise revenues to the studio (and likely provide for guaranteed minimums and advances). For releases such as Disney’s animated features *Beauty and the Beast*, *Aladdin*, and *The Lion King* and Universal’s (MCA) *Jurassic Park*, merchandise sales at retail can sum to billions of dollars and license profits can easily exceed \$200 million. Disney’s *Cars* franchise, for instance, amounted to \$10 billion in retail sales over five years.<sup>77</sup>

### Marketing costs

In theory, studios have much greater cost-control potential in a film’s marketing phase than in its production and financing phases. But distributors have no choice but to spend aggressively on marketing, if only to defend against and offset the efforts of many other films and entertainment pursuits vying to be noticed at the same time. In effect, the distributor must shape and create an audience with advertising and promotional campaigns (i.e., “drives”) that have only one quick shot to succeed immediately upon theatrical release.

As a result, expenditures on the marketing of films have long tended to rise considerably faster than the overall rate of inflation and restraint in such expenditures is rarely seen. In fact, studios will often readily add 50% to a picture’s production budget, just for advertising and publicity, as they attempt to maximize capital turnover when quality, peak-season exhibitor playdates are at a premium and unavoidable seasonal, cyclical, and other factors routinely contribute to the bunching of important releases.<sup>78</sup> The only relief is that as digital downloads and video-on-demand services take share away from older home-video products, studios will have greater opportunities to

tailor and target their promotions much more effectively than in the past, when they knew much less (and less quickly) than they do today about audience tastes and shifts in preferences.

In practice, marketing decisions in filmmaking and distribution have an important effect on how a movie is initially perceived and on how it might play out in ancillary-market exposures. The notion of “high concept” films – the underlying premises of which can be described in a sentence – is closely related to all such marketing aspects.<sup>79</sup> In this regard, as De Vany and Walls (1996) note, “the opening performance is statistically a dominant factor in revenue generation.”<sup>80</sup> Yet it is also clear that audiences sift the good from the bad and that no amount of spending or targeted promotion can save a poorly made, ill-conceived, or boring film once the information about its true quality is in circulation.

## 4.5 Economic aspects

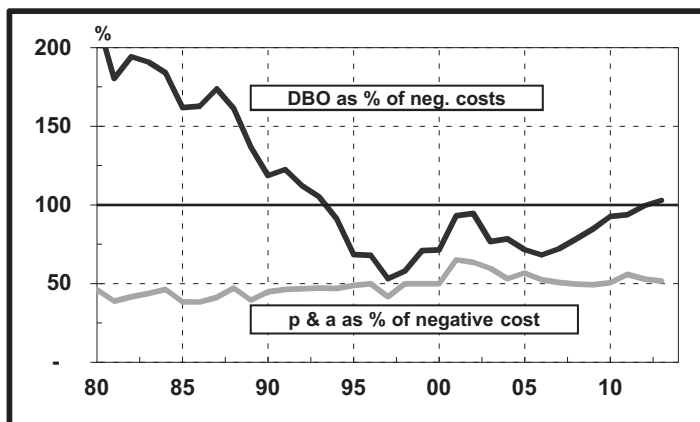
### Profitability synopsis

That a person can drown in a river of an average depth of six inches underscores the difficulty of analyzing data by means of averages alone. Many, if not most, films do not earn any return, even after taking account of new-media revenue sources; it is the few big winners that pay for the many losers. Outside investors, who, in terms of the funds-flow sequence are often the first to pay in and the last to be paid out, thus often incur the greatest risks.

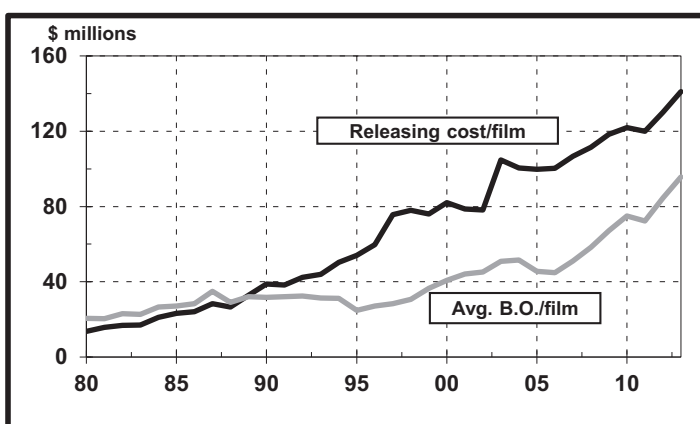
Because pictures are financed largely with other people’s money, there is an almost unavoidable bias for costs to rise (Parkinson’s law again) at least as fast as anticipated revenues. This implies that much of the incremental income expected from growth of the new-media sources is likely to be absorbed, dissipated, and diverted as cost. And it is especially daunting if only a much-diminished share of such costs is recovered directly from domestic theatrical rentals (Figure 4.7a). Figure 4.7b illustrates that costs have often grown faster than revenues, whereas industry operating margins have been erratic and have generally trended lower (Figure 4.7c).<sup>81</sup>

By combining data on the number of releases, the effects of ancillary-market revenue growth (Sections 3.4 and 4.4), average negative and marketing costs, and aggregate rentals (Section 3.3), there emerges a profile suggesting that, in a statistical sense, most major-distributed films do no better than to break even financially, with extreme deviations from this mean in both directions (Table 5.9).<sup>82</sup>

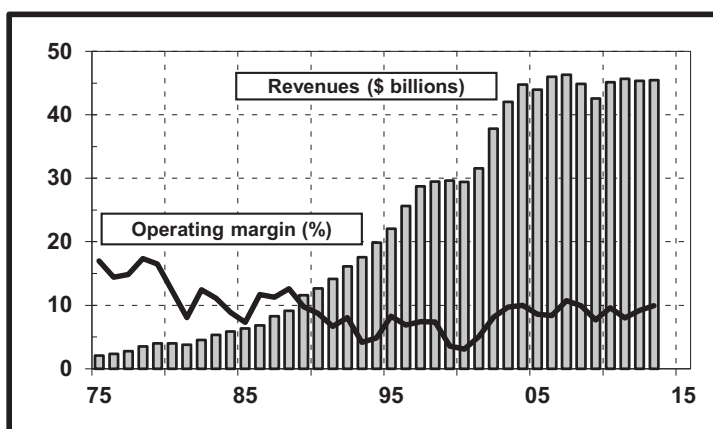
In fact, the “average” movie does not really exist and average industry revenue and profit are primarily determined by only a few runaway hits. This pattern, a Pareto law that is illustrated in Figure 4.8, is true not only



(a)



(b)



(c)

Figure 4.7. Film industry revenue and cost trends. (a) Domestic box-office gross receipts as a percentage of MPAA-member production (negative) costs and prints and advertising (p & a) as a percentage of production costs, 1980–2013; (b) Average per MPAA-film: releasing cost (including negative plus p & a) and domestic box-office revenue, 1980–2013. (c) Revenues and operating margins for major studios, 1975–2013.

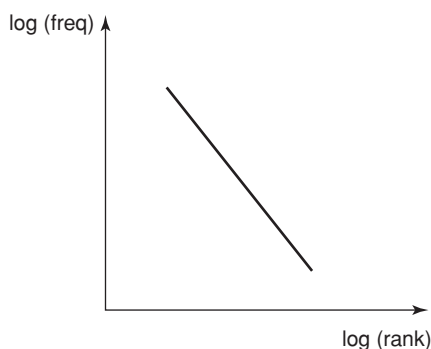


Figure 4.8. An idealized Pareto (power) law. Many films have box-office grosses of under \$50 million, and only a few gross more than \$400 million. *Avatar*, with the highest current dollar worldwide gross, exceeding \$2.4 billion, would be at the far lower right. Big winners have a high rank but a low frequency, as they are uncommon.

for movies in general but also for films with small or large budgets from different genres and with or without stars.<sup>83</sup> The financial performance of a movie is unpredictable because each one is unique and enters competition for audiences in a constantly shifting marketing environment. Moreover, the situation is unlike that in most other industries: Although ticket prices are relatively inflexible, the supply is elastic because it can quickly respond to unexpected demand through dynamic expansion of the length of run and the number of screens on which the film is shown. The marginal costs of doing so are low.

The remarkable aspect of all this is that, despite the potential for loss, most major studios, bolstered by distribution revenues related to library titles and television programs, have long been successfully engaged in this business.<sup>84</sup>

The existence of profitable studio enterprises in the face of apparent losses for the “average” picture can be explained only when it is realized that the heart of a studio’s business is distribution and financing and that therefore the brunt of marketing and production-cost risk is often deflected and/or transferred to (sometimes tax-sheltered) outside investors and producers. Indeed, it is worldwide distribution (licensing) to television in all forms (network TV, cable and local syndication, foreign, etc.) that truly carries the load.<sup>85</sup>

Although the front-end production and release attracts all of the attention, studio profits are thus actually focused and highly dependent on the much more prosaic functions of collecting distribution and other fee income.

### Theoretical foundation

That the movie industry is complex and that it often operates near the edge of chaos in the midst of uncertainty is almost an inescapable inference for

anyone who has been even a casual observer of, or participant in, the process of financing, making, and marketing films. Seemingly sure-bet, big-budget films with “bankable” stars flop; low-budget titles with no stars sometimes inexplicably catapult to fame, and some releases perform at the box office inversely to what the most experienced professional critics prognosticate.

In recent years, though, economists have begun to build a framework that explains why these things happen and why the industry is structured in the way that it is. The theoretical foundation that is emerging is based significantly on the combined works of De Vany and Walls (1996, 1997), Caves (2000), and, to a more limited extent, modern portfolio theory.

Caves found that a only a few basic features (described in Section 13.5) typify the organizational structure of all creative industries, be they movies, art, music, books, or live performances. Prominent among the features is the large sunk-cost nature of these activities and the resulting need to use option contracts among the many coordinating parties involved in the financing, production, and distribution of creative goods and services.<sup>86</sup> Modern portfolio theory further suggests that studios inherently ought to adjust and mitigate their risk exposure to the uncertain performance of any single film by balancing the mix of high, medium, and low-budget films in their yearly crops of releases.<sup>87</sup>

In further attempts at minimizing risks by eliminating the traditional but highly inefficient approach of optioning hundreds of properties to end up filming only two or three of them, studios and producers have also begun to use, prior to the optioning, so-called Monte Carlo statistical methods that test combinations of different variables (e.g., stars, directors, release dates, running time, etc.) to determine early on the probability of turning a profit.<sup>88</sup>

These cornerstone concepts connect with the studies of De Vany and Walls, who found that movie viewers, randomly exchanging information about their preferences, end up generating box-office revenues that are not normally distributed (i.e., the probability density function, or pdf, is bell-shaped, clustered around a mean in the center, and tailing off sharply at the tails). Box-office returns instead follow power laws that differ from normal distributions in that variation is not symmetrical: A few “blockbuster” outliers in the upper tail influence the mean. (The departure from a normal distribution is not as severe, however, if revenues from video and international markets are included.)

Movies, in other words, have a low probability of earning high revenues and a high probability of earning low revenues. And here as well as in other similar businesses for which returns have a fat-tailed distribution (music, books, television shows, plays, etc.), the *mean revenue is always much higher than the most probable revenue*. This leads to an estimate that perhaps 10% of movies (released by the majors) earn about 85% of the industry’s total profits and that exhibition on a large number of screens can as easily lead to rapid failure as to quick and great success.<sup>89</sup>

Such power-law-distributed behavior, in theory, makes it futile to attempt partitioning of movies into genre or budget categories because, no matter how detailed the categorization, the same distribution appears (i.e., the behavior is fractal).<sup>90</sup> According to this body of work – which explains the movie business as a complex system (i.e., with nonlinear feedback in the information cascade and sensitivity to initial conditions) – just about the only thing that can be predicted with some degree of confidence is a film’s revenue next week based on last week’s (with the best predictor of film revenues being the number of screens played).<sup>91</sup> Movie box-office performance can thus be modeled as a weekly contest for survival in which a film’s likelihood of being held over another week is a (hazard-rate) function of the time that it has been in theatrical release.<sup>92</sup>

This analytical methodology – an approach to thinking about films in terms of power laws, fractals, and hazard rates – is readily applicable and relevant to the study of all entertainment and information-based products, services, and attractions. This is because, no matter what the entertainment industry segment, when it comes to new product introductions, the position between risk and uncertainty implies that anything from a huge hit to a total flop might occur.<sup>93</sup> In statistical terms, there is thus great behavioral similarity between movies, television series, books, music recordings, stage plays, video games, and toys. Fads come and go. And under 20% of the items often produce more than 80% of the revenues or profits (the “long-tail” effect of Internet distribution notwithstanding).

“There is no typical movie and averages signify nothing . . . The movie business is completely and utterly non-Gaussian because it is a business of the extraordinary.”<sup>94</sup>

## 4.6 Concluding remarks

Since the mid-1970s, the movie industry has been in a transition phase characterized by diminished control of distribution and product pricing through traditional organizational arrangements. The changes extend from the making of 3D films to the proliferation of digital distribution platforms and the globalization of social media networks. Although this transition has already provided consumers with an increasingly varied selection of easily accessed, low-cost entertainment, it has not been beneficial to all industry segments. Technological development has, however, made it possible for more content to be created by more people and to be distributed more widely and at lower cost (e.g., via the Internet) than ever before.

Despite these changes, the movie business remains as fascinating as it is unique. That feeling has been summarized by veteran movie writer A. D. Murphy (1982), who observed:

Even after a history of over 100 years, the business remains entrepreneurial and capitalistic.

Films are by nature research-and-development products; they are perishable and cannot be test marketed in the usual sense.

The film industry manufactures an art form for the masses.

Despite long-standing trade restrictions, a strong export market reinforces a fairly stable domestic market.

From acquisitions of literary properties to final theater bookings, every phase of the industry's operations is negotiated and this, contrary to widespread opinion, implies that personal trust and high standards of professional integrity largely prevail.

As Squire (1992, p. 23; 2004, p.4) further said:

In no other business is a single example of product fully created at an investment of millions of dollars with no real assurance that the public will buy it. In no other business does the public "use" the product and then take away with them [as Marx (1975) observed] merely the memory of it.

## Notes

1. The clearinghouse concept, which aptly sees the modern studio as an intellectual property rights service organization that collects and then disburses fee income as would a bank's clearinghouse, originated in Epstein (2005, p. 107). Risk issues are discussed in Eliashberg, Elberse, and Leenders (2006). Studios also function as risk transfer agents.

2. See, for example, Root (1979) and Nash and Oakey (1974). Also, even though writers always believe that their stories are original creations, literary analysts have in fact long recognized that there are only a small number of basic story patterns, with only the details and names changed. Tobias (1993), for instance, suggests that there are only 20 fundamental plots: "quest, adventure, pursuit, rescue, escape, revenge, riddle, rivalry, underdog, temptation, metamorphosis, transformation, maturation, love, forbidden love, sacrifice, discovery, wretched excess, ascension, and descension."

3. Other box office hits, such as *Driving Miss Daisy*, *Gandhi*, *Love Story*, *Teenage Mutant Ninja Turtles*, *Gosford Park*, *Black Hawk Down*, *Private Benjamin*, *Cocoon*, and *My Big Fat Greek Wedding*, also encountered difficulties in finding distributors. *On the Waterfront* was rejected by every studio (see the *Los Angeles Times*, June 5, 2005). The same thing happened to the *Lord of the Rings* trilogy, which was ultimately financed by Time Warner's New Line subsidiary, and to *The Graduate* (Turman 2006, p. 216). After several years in development at Universal, *Gravity* was placed in turnaround (see Fritz and Steinberg, 2013), which enabled Warner Bros. to acquire it in 2010. And DreamWorks passed on an opportunity to partner with Warner Bros. on *Harry Potter* (Elberse 2013, p. 26).

Independent studio Summit Entertainment picked up rights to the highly successful *Twilight* series of films based on four novels that had sold over 70 million copies worldwide after Paramount passed. Even the first *Star Wars* was turned away by Universal (Bruck 2003). The *Turtles* story is described in Brown (1991) and the *Gandhi* experience in Eberts and Ilott (1990). *Daisy's* situation is mentioned in Landro (1990), *Gosford Park's* problem in finding \$6 million for North American rights is covered in King (2002), and the *Greek Wedding* story is reported in Eller (2002). In 2011, *The Help* was also a hit that was rejected nearly everywhere.

Moreover, *Independence Day* was rejected by Sony, Fox lost faith in *The English Patient*, which Miramax (Disney) distributed, TriStar put *Pulp Fiction* into turnaround, and Universal passed on the opportunity to cofinance *Titanic*. Warner Bros. also passed *Forrest Gump* to Paramount. Paramount passed on the *Twilight* franchise. As described by Shone (2004, pp. 46–52) and Rinzler (2007), even *Star Wars* had an uncertain and problem-filled start. And Leipzig (2005) shows how improbable it is that even a completed project is ever accepted for distribution. Goldstein (2005) further recounts how Best Picture Oscar nominees *Ray*, *Finding Neverland*, *Sideways*, *Million Dollar Baby*, and *The Aviator* were initially unable to find major studio financing but were instead jump-started by entrepreneurial outside sources such as Graham King (*Aviator*) and Phil Anschutz (*Ray*). The rejections occurred even with legendary Clint Eastwood already attached to *Million Dollar Baby* and with Martin Scorsese and Leonardo DiCaprio already attached to *Aviator*.

McNamara (2006) indicates that pictures that have already been approved for production are, because of budget concerns, sometimes canceled. Sometimes even the studio is canceled. Just before being shuttered, Warner Independent Pictures had paid \$5 million for distribution rights to *Slumdog Millionaire*, the 2009 Oscar winner for Best Picture. The rights were then sold to Fox Searchlight and the film went on to generate more than \$100 million in domestic box-office receipts. Sometimes films bounce around studios and gestate for many years: for instance, *Forrest Gump*, 10 years; *The Curious Case of Benjamin Button*, 20 years; and *Shakespeare in Love*, 10 years. A more scientific approach to script selection appears in Eliashberg, Hui, and Zhang (2007). Barnes (2011b) writes of the opposite type of mistake, in which the \$175 million production cost of *Mars Needs Moms* shouldn't have been greenlighted. See also Mlodinow (2006).

In television, errors in judgment are just as common. Bart (2006, pp. xi–xiv) describes how the initial reaction to *I Love Lucy* “was less than loving,” and how *All in the Family* was met with critical scorn. *The Mary Tyler Moore Show* initially tested poorly and it only got on the air through a lucky scheduling break.

4. To preclude excessive charges (“double-dipping”) on the talent packages put together for television, agencies have devised alternative compensation approaches for themselves. The alternative, in its simplest form, and as described by Davis (1989), is to receive “the equivalent of 5 percent of the money paid the show’s production company by the network, 5 percent of half the profit, if any, the production company gets from the network, and 15 percent of the adjusted gross – basically, syndication sales less the costs not picked up by the network. . . . An agency like [William] Morris can expect to make anywhere from \$21,000 to \$100,000 from every episode of a network show, and the eventual take from the syndication of a hit can be staggering. The *Cosby* show, a Morris package, is expected to give the agency an income of \$50 million from reruns alone.” In return for negotiating and structuring television deals, many powerful agencies will charge 5% of revenues (including those derived from syndication). Others may charge a 3% packaging fee plus 10% of the “backend” revenues.

A so-called 3%-3%-10% package had been the most common in the late 1980s, but more aggressive agents have extracted 5%-5%-10% formulas. The first figure is a percentage of the per-episode license fee that is paid to the agent, which the agent receives for the life of the show. The second figure, also based on the license fee, is tied to the profitability of the series and is deferred until a net profit is achieved. The third figure, however, is the one that is most lucrative to the agencies and is tied to the backend, or syndication, revenues.

In the movie business, package deals essentially turn studios into banks that finance film ideas generated outside the studio. More recently, talent agencies have become active

in arranging financing packages from private equity and hedge fund operators in return for consulting fees and perhaps an economic interest in projects. However, as noted in Hoffman (2006a), it is not clear whether such economic interests are antagonistic to a previous Screen Actors Guild agreement, which expired in 2002, that barred agencies from involvement in the production business. See Akst and Landro (1988), Gubernick (1989b), and especially Davis (1989). Such package deals effectively offset the condition that agents are not allowed to own pieces of television and movie productions. See also *Variety*, March 25, 1991, and *Broadcasting*, September 23, 1991.

5. ICM was a subsidiary of Josephson International, which had been publicly traded. With the exception of the years in which Josephson was public, financial statements are not available. However, estimated revenues (in \$ millions) and the number of agents in 2002 were approximately as follows:

|                                   | Revenues | Agents |
|-----------------------------------|----------|--------|
| Creative Artists                  | 250+     | 184    |
| William Morris                    | 250      | 215    |
| International Creative Management | 150      | 165    |
| United Talent Agency              | 100      | 80     |

Source: *Wall Street Journal*, February 22, 2002.

The number of clients represented by agencies ranges from 1,200 at CAA to 2,200 at ICM. But in 1999 the agency business experienced major upheaval, with many veteran agents and clients shifting their positions. As noted in Horn (2005a), CAA is considered to be the most powerful agency, with William Morris, United Talent, Endeavor, and ICM the other majors. See also Kelly (2005), Kelly (2006a), Fleming (2006), Gimbel (2007), and Cieply (2008b). Problems in the agency business and a shift of pricing power to the studios are discussed in Fleming (2008b). The lead-up to the 2009 merger between William Morris and Endeavor is discussed in Barnes and Cieply (2009). See also Lippman (1995), Cieply (2007c), and Littleton (2013b), in which it is indicated that as of 2013 the number of clients by major agency was: CAA (6,100), WME (5,800), UTA (2,700), ICM (2,900), Paradigm (3,000), Gersh (2,400), and APA (2,000). A major transformative event was the late 2013 acquisition of giant sports rep company IMG by WME as described in Barnes and Gelles (2013), Belson (2013), and Fritz and Schwartzel (2014b). In 2013, WME's agency business generated revenues of about \$365 million and EBITDA of \$76 million.

CAA was founded by former William Morris agents in 1975 and over the next 20 years went on to become the most powerful movie packager in Hollywood as well as the most broadly influential agency across all entertainment industry segments.

By the late 1990s, however, talent managers had also come into prominence. Managers, unlike agents, are not licensed by the state and are not allowed to solicit employment or negotiate deals for their clients. But they have the right to produce and own a piece of television and movie productions. As Masters (1999) suggests, the line between agents and managers has blurred. By 2002, a revision of Screen Actors Guild rules (dating from 1939) had been negotiated with the Association of Talent Agents. The new rules would have permitted the purchase of talent agencies by advertising agencies and/or allowed them to be more economically linked to production companies (but not to the large media conglomerates like Disney or Viacom). Also, talent agencies would have been allowed to invest up to 20% in an independent production company. However, in April 2002, SAG members rejected the proposed changes, in part reflecting fear among actors that agents

would be biased toward producers of TV shows in which the agents had an interest. See Lippman (2002b), Whitaker (2002), and Hoffman (2006b).

6. The following example of a common-stock offering in the 1980s is illustrative. In the case of a Kings Road Productions offering in the early summer of 1981, rapidly deteriorating market conditions caused withdrawal of the proposed sale of 1.8 million shares at prices between \$10 and \$12 per share through a large managing underwriter. Experienced producer Stephen Friedman contributed as a core of assets his previously released theatrical features – *Slapshot*, *Blood Brothers*, *Fast Break*, *Hero at Large*, and *Little Darlings* – several of which had already been profitable. United Artists, moreover, was at that time about to distribute Friedman's *Eye of the Needle*, a \$15 million picture based on the best-selling novel of the same title. Options on several promising literary properties were also among the Kings Road assets.

It was not until 1985, however, that Kings Road Entertainment finally raised capital from the public in an offering, led by two small underwriters, of 1.5 million shares at \$10 a share. The assets included profit participation in the aforementioned pictures and in five others, the most prominent of which was *All of Me* (domestic rentals as of 1987 were \$6.7 million). At the time of the offering, MCA Universal had been granted domestic theatrical and most other distribution rights (except for home video) in most of the company's upcoming productions. MCA, in turn, had agreed to provide material cash advances for the production of those films.

In the 1980s, many other new companies raised or attempted to raise public capital through common stock offerings at low prices. Although most of these small companies began with the intention to eventually produce films on their own, some of them were organized solely for the purpose of developing and arranging financing, production, and distribution for others; that is, they functioned as executive production outfits.

7. Arguably, an exception in 1993 was the flotation of the Australian *Lightning Jack* Film Trust of 36 million units solely to finance the \$26 million Paul Hogan production. Still, nearly \$3 million and three months were spent putting the deal together. Australian tax laws had helped by allowing investors to deduct 90% of their investment over two years. See *The Hollywood Reporter*, 1993 Independent Producers Issue.

8. This occurs despite the fact that presales for domestic home video may be payable 25% upon commencement of principal photography, 25% upon delivery of an answer print, 25% three months after initial theatrical release, and the remainder on availability in home-video markets.

9. Until the Tax Reform Act of 1986, which caused the gradual withdrawal of investment tax credits (ITCs) for the entertainment industry, such credits had been one of the most important sources of cash for movie and television-series producers. Feature films – recognized in the tax code as capital assets having useful lives of over three years – had been eligible for ITC treatment. Such qualification had resulted from the industry's lobbying efforts directed at Congress and from precedents set in tax litigation involving Disney and MCA. In the 1970s, both companies won ITC benefits in appeals-court rulings. Dekom (1984, p. 194) discussed the ITC options available to filmmakers under Section 48K of the pre-1986 IRS code.

Good examples of widely distributed pre-1986 U.S. limited partnerships are to be found in the 1981 SLM Entertainment Ltd. offerings of participations in a package of MGM's films and in the 1982, 1983, and 1984 Delphi-series packages of Columbia Pictures films that Merrill Lynch originated. The SLM limited partnership was sold in units valued at \$5,000, with a general partners contribution of 1%. Investors shared up to 50% ownership of some 15 films with MGM (5 films were initially specified) and were entitled to 99%

of capital-contribution recoupment and a sliding percentage of profits generated by those productions.

Similarly, in Delphi II (1983), the partnership retained all distribution rights, and until the limited partners received cash equal to their investment they were entitled to 99% of all cash distributions and equal allocation of all income, loss, or credits. After cash payments to limited partners equaled the proceeds of the offering (less selling commissions and marketing and sales management fees), the general partners were to receive 20% of all cash distributions. Any partnership losses were thus compensated out of distribution fees due the studio.

Delphi III (1984), also offered in units of \$5,000 (for a total of \$60 million), was even more favorable to investors because all distribution fees were to be deferred until the partnership recouped 100% of its share of a film's negative (production) costs. Only after that condition had been satisfied was the distributor entitled to recoup its deferred distribution fee of 17.5% of gross receipts from the film. In addition, Delphi III partners were entitled to 25% of net proceeds earned by a film (after deducting a 17.5% distribution fee), or 8% of gross receipts, whichever was greater. This ensured some payment to the partnership even if the film was unsuccessful.

**10.** For example, a more recent variation on tax-sheltered film financing appeared in Germany in the late 1990s. Under German tax law, which didn't require that the films be shot locally or with nationality quotas, investors in films deducted 100% of their investment up front and then reported license receipts as ordinary income. The structural core of such deals was a sale-leaseback arrangement in which the film studio effectively charged from 6% to 8% of the production budget to a pool of capital funded by German investors. That is, the partnership bought the film from the studio and then leased back worldwide distribution rights, with the studio retaining the option to repurchase the copyright from the investment partnership at the end of perhaps as little as seven years. By leveraging the amount invested through nonrecourse loans, with additional write-downs of up to three times the original investment, potential tax-sheltered returns from successful films could then be greatly magnified. By the end of 2002, however, proposed changes to Germany's tax laws and collapse of the Neuer Markt caused many German investors to reduce capital commitments to films, with the amount shrinking by at least 60% from an annual average that had been €5 billion.

As Moore (2002, pp. 22–3) notes, the funds are of two types: defeased and equity. An example is *Alexander*, an epic costing more than \$150 million, which was financed with a package assembled by IM Internationalmedia AG. See also "Hollywood's Big Loss," November 21, 2005, and "How to Finance a Hollywood Blockbuster: Start with a German Tax Shelter," April 25, 2005, both by E. J. Epstein at [www.slate.com](http://www.slate.com), and Epstein (2010, pp. 104–6). Additional references include Bardeen and Shaw (2004) and Desai, Veblen, and Loeb (2002a, b).

Film industry development incentives differ by country or region and can be in the form of direct subsidies, grants, levies on box-office receipts, and tax credits or deductions. Incentives for filming in Hungary and other Eastern European countries are discussed in Barrionuevo (2004). Hungary, for example, provides 20% tax breaks on film productions. In France, the film industry is subsidized by a box-office tax on American films. In Britain, filmmakers receive some proceeds from the national lottery. See also Brown (2002), Gorham (2002), Tunick (2002), Gerse (2004), and Meza (2005). Domestic tax-credit policies are discussed in Foderaro (2008), and the likelihood that they will be modified downward appears in Hayes and Thielman (2009). The Film Production Services Tax Credit supported by the Canadian federal government provides foreign producers with similar subsidies

[Epstein (2012, p. 101)]. As of 2012, the European Commission in Brussels proposed caps on how much public subsidy may be used to attract foreign film production to the region. Foreign productions with budgets of under 10 million euros would still be able to draw half of their funding from subsidies, but this will drop to 10% for films costing more than 20 million euros. See *Variety*, March 14, 2012.

**11.** From the investors' perspective, the interest-free loan contains a not so obvious cost of inflation (i.e., the guaranteed return of capital is in absolute dollars, not inflation-adjusted dollars). Moreover, because HBO retains pay-TV and syndication rights, major theatrical distributors would normally be reluctant to distribute Silver Screen features – perhaps unless offered a juicier-than-average distribution fee.

**12.** As may be inferred, this type of partnership arrangement and HBO's other participations (e.g., in TriStar Productions and in Orion Pictures) have made HBO a major force in feature-film production, as well as in distribution on pay-cable systems. HBO's interest in filmmaking stems from a simple economic fact: Given its large subscriber base, it often costs less (\$10 million on average as of the early 2000s and as little as \$4 million) to produce an original feature directly for cable than to buy rights on a per-subscriber basis from the other studios. Also see Mair (1988).

**13.** According to Securities Exchange Commission 10-K filings, as reported in *Variety* of May 10, 1989, Silver Screen Partners (SSP) I through IV were all profitable in 1988. SSP IV ended 1988 with net income of \$16.15 per unit. Each unit was sold for \$500 in June 1988. In the same year, SSP III, which raised \$300 million and invested in 19 pictures – including *Good Morning Vietnam*, *Three Men and a Baby*, and *Who Framed Roger Rabbit* – netted \$61.63 per unit. Roughly, that would suggest that the return for the year, including these three extraordinarily popular films, was 12.3% on the base of \$500 a unit. A discussion of film partnership financial performance through the 1980s appears in *Variety*, November 5, 1990.

**14.** Under Regulation D, accredited individual investors (as of 1986) are those with at least \$1 million of liquid net worth and \$200,000 of annual income in each of the two most recent years. Rules for a Regulation D offering are differentiated for issues of over and under \$5 million. As Cones (1998, pp. 143–55) notes, Reg D exemptions from securities registration are governed under specific rules 504, 505, and 506. Rule 506 does not impose a ceiling on the amount of money that can be raised, whereas rules 504 and 505 do impose ceilings. Perhaps the most noteworthy of such Reg D partnerships was FilmDallas, originally established in 1984 as a private limited partnership with an initial capital contribution of \$2.4 million. This company subsequently produced the well-regarded low-budget pictures *Kiss of the Spider Woman* and *The Trip to Bountiful*. Note, however, that a filing under the SEC's Regulation A is actually a small registered public offering limited to \$5 million during a given one-year period. The JOBS Act passed in 2012 and implemented a year later allowed private companies to have 2,000 accredited investors (up from 500) before needing to file annual reports with the SEC. See also Muller (1991).

**15.** As in modern portfolio theory applied to stocks and bonds, diversification over many projects reduces overall risk. However, systemic risk (i.e., risk inherent to investment in the movie industry as a whole) cannot be diversified away. See, for example, Elton et al. (2003).

**16.** In the mid-1990s, new financing structures, not all fully tested against tax and accounting challenges, began to emerge. The goal is to finance with off-balance-sheet debt through, say, a bank joint venture that can defer and smooth some of the risks through pooling (cross-collateralization) of potential profits while still allowing the distribution company to earn its fees. See *Daily Variety*, February 21, 1997.

**17.** As of the late 1990s, Fox, Universal, DreamWorks, and PolyGram had all made use of securitization structures, with loans provided by Citigroup, Chase, and others that allowed the studios to tap into commercial paper and note markets. See Hazelton (1998). Cofinancing deals and fractionalization of rights (see Chapter 5) are another aspect of this. Cofinancing as a means of reducing risk was shown to be questionable in Goettler and Leslie (2003), and is covered in Amdur (2003). As described in greater detail in Eisbruck (2005), deals are generally of three types: future film (“slate”) portfolio financing, in which investors are entitled to share in future “first-cycle” revenues after distribution fee and p&a deductions; film revenue advance deals, in which funds are invested *after* films have been released; and library sales, in which first-cycle performance is already known so that risk is relatively low and predictability is high. An example of this is the sale of Viacom’s DreamWorks’ 59-feature library (including Oscar-winning titles such as *Gladiator* and *American Beauty*) in 2006 for \$900 million to George Soros and Dune Capital. Viacom has the right to repurchase the asset after five years, retains a small interest, and collects an 8% distribution fee, while Soros bought the rights to sell DVDs and rebroadcast the films. Paramount also collected an 8% distribution fee from a DreamWorks Animation pact that ran through 2012. See *Wall Street Journal*, March 17, 2006.

As told in Marr (2007), a new firm called Content Partners has been established to basically buy out the profit-participation receivables that are due to producers, actors, and directors for work that has already been played through a first cycle of exhibition. The structure is akin to the music industry’s ten-year “Bowie” bonds of the late 1990s, which raised \$55 million from anticipated record royalties on music released earlier. Such buyouts enable participants to receive current cash in return for relinquishing rights to future payments and free them of the burden of pursuing such payments. Smith (2011a) writes of TuneCore Inc., an online music distributor attempting to unlock from what’s known as the “black box” millions of dollars in royalties held in escrow accounts around the world. Songwriters often don’t know the size of the royalties owed as they are collected in countries in which there is no direct path from collection to disbursement. For a small fee, TuneCore collects online royalties directly from the sources and passes them on to publishers and writers. Also, in 2012, Sesac, Inc., a company entitled to receive a cut of royalties transferred from broadcast outlets to music companies and songwriters prepared a \$300 million bond backed by its performance rights from several prominent artists (e.g., Bob Dylan, Neil Diamond).

**18.** Receivables formed by aggregation of presale contracts for major territories may nonetheless sometimes be used to draw financially subsidized production-cost loan guarantees from the foreign government agencies, primarily European, that have been established for this purpose. In the United Kingdom, Article 48, which expired in 2005 and was replaced by a tax credit scheme (16% above £20 million, 20% under), was representative. Lenders would be exposed to loss if, for whatever reason, a licensee failed to accept delivery of a completed picture in foreign jurisdictions, where remedies might be difficult to obtain. Also, a motion picture loan will often be made for a term of more than three years because it will usually require more than three years for full syndication, network television, and other downstream revenues to be realized. The longer the term, the greater the risk that the underlying credit conditions will become substantially changed. For all these reasons and more, a bank will advance less than the total value (usually less than 75%) of the presales advances.

**19.** As discussed in *Variety* of August 8, 2005, two such large pools include Legendary Pictures and Melrose Investors. The typical deal is for the studio and investors to each fund half of the budget and sometimes half the cost of p&a. The studio then takes a fee of 10%

to 20% of revenues. After the studio recoups p&a and sets aside other money to pay for participant points and incidentals, the remainder is split 50/50. The investors here put up as much as half of a film's budget, with the studios retaining creative control and distribution rights. Legendary is discussed in Barnes and Cieply (2013).

The main problem generally faced by such funds was that the pool of pictures made available for their potential investment often excluded the major studio franchise titles and that returns came after studios deducted distribution fees (which are typically around 12.5% and at most 15%). Melrose 2 was one of the few examples in which a studio (Paramount in this case) could not withhold the best prospects for itself. Given that returns were generally dependent on the accounting procedures followed by the studios, there was eventually also considerable misunderstanding and mistrust of motion picture and television accounting (covered in Chapter 5) methods.

The funds often assume that film *slates*, as opposed to individual films, generate portfolio returns that are close to being normally distributed. Professor Art De Vany, as quoted in an article by John Gapper in the October 9, 2006, *Financial Times*, notes, though, that benefits from the portfolio effect are likely to be more than offset by greater variability in returns. Investors, he says, "do not know what probability distribution they are up against." Modern neural network and statistical approaches are discussed in Gladwell (2006a). See also Holson (2006b), which describes how hedge and private equity funds had made deals directly with veteran producers, who can thus potentially share in 100% of DVD sales instead of the normal 20% in a studio deal. Abrams (2012b) indicates that such slate financing terms have become more accommodating to the interests of the funds, who may now get to select the films in which they participate. Bruck (2012) writes of disappointing returns.

Mehta (2006) also discusses such deals, including a J.P. Morgan Hemisphere Film Partners fund that had been designed to invest only in pictures budgeted at more than \$100 million. That is because the fund's analysis showed a historic cash-on-cash return of 32% for such films, as compared with a 2% return for films in the \$75 million to \$100 million range and 5% for those in the \$50 million to \$75 million range. See also Kelly (2006b), *Variety*, November 21, 2005, and the *Los Angeles Times*, January 20, 2006.

Active private equity firms as of 2006 also included Qualia Capital, Dune Capital Management, and Relativity Media (Gun Hill Road), which had raised \$700 million to cofinance 19 films at Sony and Universal. Results of Gun Hill Road I are covered in DiOrio (2007), and in Hiltzik and Friedman (2008), who express skepticism that the original expected return targets have been met. As noted in Schuker and Sanders (2008), the flood of financing ended up generating a glut of independent films in 2008–9, many of which ended with losses. A Reuters article of March 2, 2009 ("Wall Street Pulling Out of Hollywood") confirmed the skepticism, as many of the larger funds had by then begun to sell their earlier eagerly sought slate packages to longer-term private investors for discounts of 30% to 70%. See also Fritz and Schwartzel (2014a).

The basic slate financing structure (now sometimes called film portfolio risk-sharing) began around August 2004 with the Melrose I \$231 million fund and has since expanded to include several major broker-dealer sponsors behind a deal total of around \$19 billion as of early 2009. Part of the problem for investors in the early deals was that the usual restrictions (including limits on marketing budgets) that had been imposed by traditional lenders were not imposed by the funds. Terms for investors in subsequent deals have been sweetened.

Horn (2006b), however, discusses how *Poseidon*, with a \$160 million budget, may have resulted in a \$50 million loss to the private equity fund (Virtual) that participated

in financing the picture. Virtual covered around half of the \$250 million that it cost to produce and market *Poseidon*. In the deal, Warner Bros. and Virtual split production and marketing costs, but Warner recoups p&a and collects interest and also a distribution fee of 12.5% before sharing any revenue with Virtual. An offsetting example of a private equity financed (by Legendary) picture that succeeded (with a domestic box office of more than \$200 million) was *Batman Begins*, distributed by Warner in 2005. A quick success was also achieved by Cross Creek Partners, whose first movie, *Black Swan*, generated worldwide box-office receipts of \$228 million. Cross Creek investors put up \$6.8 million and realized a return of \$54 million.

By 2011, financing for purposes of studio risk transfer had evolved into a private swaps market that was allowed by the Dodd–Frank bill and that instead based returns on simple box-office results, hence the name “box financings.” Such swaps could be applied across a slate of films or to individual films. As an example, on production of a \$100 million film, a studio might want to limit risk to \$50 million. The studio raises \$50 million from investors and agrees to return 50% of the domestic box office (dbo) to the investors. If the film flops, with a dbo of only \$10 million, the studio pays out \$5 million and retains the \$45 million balance. If the film generates a dbo of \$100 million, investors are paid \$50 million, and the studio retains all other worldwide rights and profits. The payments owed to investors would be treated as an additional accrued cost of the film or as equity. See Moore (2011) and “Heavy Hitters,” by M. Graser, in *Variety*, February 27, 2011.

Funds have occasionally also made deals directly with the talent (actors and directors, primarily) by offering part ownership of the copyright. However, as attractive to the talent as such deals appear to be, they often cannot compare with percentages of first-dollar gross. For the funds, there is no particular reason to expect higher returns with this direct-to-talent structure. Also, with ownership pieces subject to trading and with many different parties involved, it becomes difficult to obtain high value, as the power still largely remains with the distributor. See Fleming (2007) and Marr and Sanders (2007).

**20.** The basis for such derivatives contracts was in the play-money betting on the “Hollywood Stock Exchange” (HSX.com), which was bought by brokerage Cantor Fitzgerald in 2001. A competing operation in Chicago that supports only professional and institutional investors is called Trend Exchange and is affiliated with Veriana Networks. In response to strident MPAA-member objections, Congress banned the use of such derivatives in its Financial Regulatory Reform Act of 2010. The Cantor Futures Exchange had intended to offer contracts that trade at \$1 for every \$1 million that a movie is expected to generate at the domestic box office during its first few weeks in theaters. (It is estimated that a typical film nowadays takes in 99% of its ultimate theatrical gross within the first eight weeks.) Such contracts had been expected to enable participants to manage risk exposure in ways that are similar to those long used by producers of other perishable commodities. See Plambeck (2010b).

**21.** See Snyder (2006). As noted in Weiss (2007), the independent producer “will supply the high-risk venture capital, buying the script, remaking it, then green-lighting a production and shooting it. The studio money shows up when everything’s done: marketing and distribution. . . . In any other business, the high-risk investor gets paid back first, or if the business fails, is paid the highest percentage of the leavings. In Hollywood the studios get paid back first, for their distribution piece and the p&a. In no other business is that the case.”

**22.** Independent film, television, and other creative projects have sometimes been able to raise sufficient seed capital through Web-based crowdsourcing sites such as Kickstarter and Indiegogo. In these structures, however, a drawback is that investors cannot participate

in any capital returns. See Steinberg (2012), Gamerman (2013), and Fritz (2014a). Martin (2013) discusses such sourcing applied to music.

**23.** Wealthy people from outside the Hollywood establishment also decided to apply fortunes earned in diverse other endeavors to the movie business. Their infusive and intrusive effect on the industry's financing rhythms and processes added visibly to the aggressive bidding for scarce talent resources. As summarized by Kiger (2004), outside investors usually do not fare well in Hollywood. In the 1970s and early 1980s, these outsiders were probably led astray by extrapolating the then record-breaking box-office performances of *Jaws* and *Star Wars* and by enthusiasm for the "new media" revolution. More recently, however, such outsiders, guided by experienced agents, have been much more successful. As Goldstein (2006b) notes, many of the 2006 Oscar-nominated films were made for under \$14 million and were financed at least in part by outsiders such as Mark Cuban (Dallas Mavericks owner) and Todd Wagner (*Good Night, and Good Luck*); Bill Pohlad, owner of the Minnesota Twins (*Brokeback Mountain*); and real estate entrepreneur Bob Yari (*Crash*). The rationale for "bankable" stars has also come to be questioned, as their casting has not been reflected recently in box-office results. On this, see Ravid (1999), Barnes (2009a), and Nelson and Glotfelty (2012).

**24.** Easy credit conditions in Japan during the late 1980s enabled Japanese companies to borrow at tax-adjusted rates of as low as 1% and boosted Japanese real estate and equity values to incredible heights. As a result, Japanese industrial companies such as Sony and Matsushita could bid for American movie studios (Matsushita bought MCA in 1990) at prices that no one else could come close to matching.

**25.** This could arguably be compared with the average production cost for a major feature of \$300,000 in 1940 and \$100,000 during the depths of the Depression in 1932. Marr and Kelly (2006) also show that newer special-effects technology for major "tentpole" releases by the major studios has also contributed to rising costs of production.

The statistical difficulties of extending the series beyond 2007 begin with the substantial cost differences between production of projects by major companies and those of the much smaller affiliate companies (e.g., Sony Classics). Also, as deal complexity has increased, with numerous outside financing coproducer participants, studios have become more reluctant to share cost information with the MPAA. Potential double-counting has also become a problem.

**26.** There are still a few instances in which small studios produce feature films for modest sums. For example, Troma Inc., based in New York City, specializes in the production and theatrical distribution of raunchy comedies that are also of interest to pay-cable networks. In addition, several other independent filmmakers had specialized in the production of low-budget features. EO Corporation (Earl Owensby) was one such company (in North Carolina), which, in the early 1980s, specialized in films that appealed primarily to working-class and rural audiences.

Troma was featured in Schumer (1982) and Trachtenberg (1984). See also Cox (1989b). EO Corporation was described in *Variety*, July 23, 1980, in *Esquire*, November 1980, and on the CBS *60 Minutes* program of August 8, 1982. Rosen and Hamilton (1987) also describe low-budget independent feature marketing and financing in more detail.

**27.** It is estimated that labor fringe benefits add 20% to 30% to above-the-line costs and 30% to 40% to below-the-line costs. Such costs had, on average, approximately doubled to \$200,000 a day (for an "A" title) in the early 1990s as compared with the cost ten years earlier, while average shooting schedules had expanded from around 40 days to 60 days over the same time. Goodell (1998, p.111) notes that the cost of below-the-line personnel ranges generally between 11% and 15% of the total budget, regardless of its size. As Moore

(2002, p. 46) explains, “deferments and participations are not included in the budget,” even though self-charged “producer’s fees” paid to the producer are included. See Clevé (2006) for details of production.

**28.** To avoid major financial losses in case of natural or other catastrophes, and to secure the positions of major lenders on a picture (be they studios or banks), completion-bond guarantees must therefore normally be obtained from specialty insurers. The usual exception is for own in-house productions of major studio/distributors. Such contracts were historically priced at about 6% of a film’s budget, and with a 50% rebate in the event there were no claims. Part of this fee goes to insurance companies. However, there is some variation, depending on the riskiness of the location, on the previous experience of the director and producer, and on the size of the production budget. As a practical matter, lending institutions do not provide interim financing for projects whose completion is not ensured. To activate loan agreements, independent producers must thus always obtain completion bonds in conjunction with signed distribution contracts from creditworthy organizations. The completion guaranty protects financiers, ensuring either repayment or completion of the film. If a film is going substantially over budget or encounters other completion problems, the guarantor is required to provide funding but also has the right to invade producer and director contingent and/or cash compensation arrangements. A standby investment commitment to cover over-budget costs differs in that it allows the investor to join in the profit participations of other earlier equity investors. See Moore (2002, pp. 71–80) and Rudman and Ephraim (2004). Bond companies will typically require 10% of the budget to be set aside for unexpected contingencies and “deliverables” such as duplicate negatives for foreign distributors.

The worldwide completion-bond business is about \$700 million in size and, as Angeli (1991) notes, two companies, Film Finance, Inc. and The Completion Bond Company (a part of Transamerica Insurance since 1990), dominated the business in the early 1990s. Each of these companies had been guaranteeing over 100 pictures a year. By 1993, however, price competition, with rates often as low as 1% of budget, forced The Completion Bond Company to discontinue operations. As a result, a third company, International Film Guarantors (IFG), owned by Fireman’s Fund Insurance (and in turn owned by German insurance giant Allianz), has become dominant. As Morrissey (2012) writes, as of 2012 this company insured 80% to 85% of all major Hollywood films produced in the United States and 60% of all television reality shows. See *The Hollywood Reporter* of June 29, 1998 for history. Also see Scholl (1992), *Variety*, April 12, 1993 and June 7, 1993, and *The Hollywood Reporter*, May 9, 2000, in which Film Finances is described. As of 2002, IFG and Film Finances were the industry leaders in writing new business, with Cinema Completions (a CNA and AON joint venture) and Motion Picture Bond Co. (St. Paul Insurance) dropping back. As of 2005, active companies also included Near National Group.

**29.** The accounting classifications for below-the-line costs are thus normally broken into three components: production, postproduction, and other.

**30.** It may be argued that the unions’ featherbedding and work-restriction rules have also contributed to unemployment. Hollywood unemployment rates, as estimated from industry pension-plan contributions that depend on person-hours worked, are chronically high; they vary cyclically with changes in production starts and, to a lesser extent, secularly with growth of new entertainment media. Perhaps as a result, negotiations between the AMPTP and the guilds have not normally been cordial. Indeed, with regard to DVDs, one reason production has run away to Canada is that the unions there allow producers to buy out residual royalties. From the standpoint of producers, as Lubove (2004) notes, “In what other business do you get paid handsomely for a day’s work – and then keep getting paid

over and over again for years to come.” See Barnes (2014) about revised residual contracts based on a percentage of rerun licensing fees.

Relations became especially bitter during bargaining sessions in 1980 and 1981, when SAG and the Writers Guild demanded significant participation rights in license fees from new media sources such as pay cable, discs, and cassettes. Then again, in 1988, the Writers Guild and the AMPTP sustained a lengthy strike centered on the issue of television residual payments. Settlement was on a formula with elements similar to those used for television-license residuals originally negotiated with MCA in the early days of television by SAG’s then president, Ronald Reagan. This early television agreement, as reviewed in Bruck (2003, pp. 120–3), was approved by the SAG board. See also McDougal (1998, pp. 183–6). As summarized by Barnes (2007a), such residual payments originated in the radio networks of the 1930s, where performances were always live and three in a row were needed to play across different time zones. Once performances began to be taped, performers remained on hand in case of problems, and this created a precedent for payment of rerun residuals.

In deals prior to 2008, writers had agreed to 2% of producers’ revenues after the producer had recouped \$1 million per hour of taped programming and \$1.2 million per hour of filmed programming from any combination of sales to pay-television systems, videodiscs, and cassettes. Actors had received residuals for original programming made for pay television and 4.5% of a distributor’s gross after a program had played for ten days within a year on each pay-television system.

The writers’ 100-day strike that began on November 5, 2007 centered around residual payments for Internet downloads. The strike ended with a doubling of the residual rate for movies and TV shows sold online while securing the WGA’s jurisdiction over content created specifically for the Internet. In this deal, writers are paid a fixed residual of around \$1,300 for streamed programs and, in the third contract year, payments of 2% of the distributor’s revenues from such streams. Also, residuals for downloads of programs are nearly double the rate paid historically for DVDs. See the *New York Times*, February 10, 2008. The WGA contract of 2011 included a 20% increase in pay-TV residuals. See also Handel (2011).

Terms of the SAG settlement of 2001, as discussed in the *Los Angeles Times*, July 4, 2001, included a 3% raise in minimum payments for TV work the first two years of the contract and 3.5% the final year. However, actors received no increase in payments for video and DVD sales. Studios held the line on changing the current system, under which they can claim 80 cents of every \$1 of video or DVD sales as a manufacturing and marketing cost and then allocate 5.4% of the remaining money to actors. As noted in Marr (2004), studios try to limit the share of overall revenues from all sources that goes to talent to 25% of a film’s total and have been particularly protective of margins on DVDs, which can be as high as 50% to 60%. Also, *Variety*, February 23, 2004, notes that only a few actors and directors can command 35% to 40% of home-video/DVD revenues as a base for royalties.

A 2006 agreement by the SAG and the studios covers the use of television programs on cellphones and serves as a blueprint for residual payments on other new distribution platforms. The agreement, as described in Verrier (2006b), calls for writers and actors to receive minimums per two-minute episode, and after the episodes are run for 13 weeks, writers and directors are to receive residual payments that equal 1.2% of ABC’s license fee (on the show *Lost*), while actors are to receive 3.6%.

The 2008 DGA settlement contained a sunset provision that allows directors to revisit new-media residual formulas upon contract expiration. This agreement guaranteed one-time payment of around \$1,200 for one-hour TV dramas streamed over the Internet in the first year. The DGA also obtained jurisdiction over Web episodes based on existing

scripted TV shows at certain defined thresholds. See <http://www.dga.org/negotiations/index.php> for the January 17, 2008, press release.

Major strikes in the industry involved SAG in 1980 for three months, writers in 1988 for 22 weeks, actors in 2000 for six months, and writers for 14 weeks in 2007.

**31.** Seligman (1982) supports the notion that, in the absence of union featherbedding and other work-restriction rules, the available capital resources for production could be spread over more film starts, capital costs would be lower, and moviemakers would not be as eager to shift production to foreign locations, where wages are lower. Labor inefficiencies also raise the cost of capital by inordinately increasing investors' risk of loss. In the long run, such higher capital costs would tend to reduce employment growth opportunities by decreasing the number of film starts.

**32.** Article 20 is controversial because studios can cut costs by developing a film concept, farming it out to a nonunion independent, and then taking it back for distribution as a negative pickup while claiming to have no creative control. See Cones (1998, p. 56) and *Variety*, September 14, 1992.

**33.** Quotation is from Ulin (2010, p. 31).

**34.** By 2009, the average theater-to-DVD window had been abbreviated to 4 months and 11 days, as compared with 5 months and 22 days in 1997. And, as explained in Smith and Schuker (2010), it continues to shrink even as it becomes more flexible, as with Disney's 2010 release of *Alice in Wonderland*. The traditional 45-day DVD-to-VOD window continues to be compressed, and streaming services such as those offered by Amazon and Netflix reinforce this change in timing. In 2011, Warner Bros., Universal, and Fox attempted to offer a new early (two months after theatrical release and before DVD release) Home Premium VOD service priced at \$30, but exhibitors strongly objected and it was discontinued. In 2012, Fox decided to offer high-definition downloads, about three weeks ahead of typical DVD and VOD release dates, for \$15. See Cieply (2012a). Fritz (2014b) describes how Warner Bros. in 2014 arranged to have online sale and rental of *Veronica Mars*, a crowd-funded low-budget picture, available at the time of theatrical release by renting theaters (i.e., "four-wallings") through a special agreement with AMC.

A more important and sustainable resequencing approach for low-budget, documentary, and genre films is to release them as a download, followed by theatrical, and then other releases. Kung (2012) describes the low-budget 2012 release of *Bachelorette* by Radius-TWC, a division of The Weinstein Co., in which download to iTunes was followed by theatrical release, which was then followed by an exclusive distribution agreement with Netflix. This placed Netflix and video streaming in the release sequence typically occupied by pay-cable channels such as HBO, Showtime, or Starz. See Vance (2013) for Netflix details.

Unauthorized copying of movies on the Internet had by 2003 already risen to the point that many films were commonly available on the Net even before theatrical release. However, by 2008, major studios had agreed to allow Apple Inc.'s iTunes to sell movies on the same day as they are released on DVDs. Previously, there had been a delay of a few weeks. On iTunes, new films will cost \$14.99 (with studios receiving \$16 –making this a loss leader for Apple). Warner Bros. was first to change its strategy, but Disney and Universal then also collapsed the window between release on DVD and availability for rental on cable or Internet services. See Chmielewski (2008) and Schuker and Smith (2010), who discuss Hollywood studio interest in making films available for home viewing 30 days after theatrical release.

The television windows after theatrical release are in approximately the following sequence: pay-per-view to satellite and cable, 180 days after; subscription TV (HBO,

Showtime, etc.), one year after; network television (usually three runs), two years after; cable, one year after network television or just after subscription TV if no network showings (usually seven years duration); local television stations, just after cable (duration up to 30 years). However, by 2010, a new Web-streaming service created by Netflix and pay-cable channel Epix (owned by Lions Gate, MGM, and Viacom) had carved out a new window, which makes films available to Netflix 90 days after they appear on the Epix on-demand and traditional TV channels. Also, in 2011, Time Warner Cable created controversy by extending streaming of movies beyond the cable network to iPad devices. Time Warner Cable maintained that an iPad was, by streaming several dozen channels, functioning as just another television set. The Viacom and Scripps networks then felt that this was a contract violation, asking cable distributors to pay for the privilege to stream. Schechner (2010), Lowry (2010), and Stelter (2011b) cover streaming. Grover and Green (2003) and Holson (2005b) cover disruptive effects of new technologies. See also Healey and Phillips (2005) for a description of the film piracy process, and Fowler (2006) and McBride and Fowler (2006) for estimated losses.

**35.** With widespread availability of pay-per-view cable, for instance, studios will have the potential to generate millions of dollars from one-night showings of their most important films. This would, in effect, raise viewing prices per person well beyond those traditionally received from subscription-television channels (see Chapter 8) and Owen and Wildman (1992).

**36.** Exclusivity of this type is especially important for the major pay-cable networks such as HBO, Showtime, Starz, and Epix. These services derive significant subscription income that is dependent on presentations of relatively recent films. In turn, the services pay high fees to studios to obtain such rights immediately after the theatrical and DVD windows expire. Because online services cannot currently afford the going rate commanded by the majors, they will thus tend to favor original productions. For the time being, it is obviously not in the interest of the studios to disturb these windowing arrangements.

**37.** Conceivably, major pay-per-view film events might occasionally be scheduled just ahead of theatrical release. In 1995, Carolco and Tele-Communications Inc. planned to make the first attempts at this, but with no follow-through. However, an old (and odd) example of rearranged sequencing occurred in 1980, when Twentieth Century Fox showed *Breaking Away* on network television before showing it on pay cable. Fox even contemplated simultaneous release in theaters and on videocassettes. Unsuccessful contemporaneous release in several distribution windows was also attempted by a small distributor in 2004 for the film *Noel*. Exhibitors were also upset in 2005, when *Ray* was released to DVD in February while the film was still playing in theaters. As described by Carr (2005), a more ambitious approach also began in 2005, when 2929 Entertainment set up a venture to make films simultaneously available in theaters, on DVD, and on high-definition broadcast and cable networks. The first feature to be released in this way was the low-budget *Bubble*, which did not perform impressively at the box office. For most pictures, the greatest marginal revenue per unit time remains that derived from theatrical issue, and most pictures need theatrical release to generate interest from sources further down the line. For the foreseeable future, theatrical release will thus come first for the great majority of films. See also Section 3.4, Holson (2005a), and Weinberg (2005).

**38.** A pure public good is defined by economists as one for which the cost of production is independent of the number of people who consume it. This would apply, for example, to television programs or to other performances, as discussed in Section 13.5. See also the glossary.

**39.** All of this threatens exhibitors, who – if they were to lose first-play rights on important films – would find it difficult, if not impossible, to survive on just leftovers. The resulting shrinkage of the theatrical-distribution pipeline would then potentially make it more difficult to nurture lightly marketed but nonetheless promising releases to the point at which such releases could attract enough attention to be profitable.

**40.** Marich (2013, p. 45) notes that the two quads of most importance are for those under age 25. That's because, according to MPAA survey data, ages 12 to 24 accounted in 2011 for around 18% of the population but 35% of frequent moviegoers. Marich (2013, pp. 44–5) discusses several different types of research, including concept testing, positioning studies, focus groups, test screenings, tracking surveys, advertising testing, and exit surveys. By 2014, box-office prediction research began to significantly rely on social media tracking. For instance, a 2013 Google study found that searches for trailers can help predict box-office performance with 94% accuracy.

The major research companies are National Research Group (NRG), the oldest and owned by Nielsen (which also owns IAG); MarketCast; Ipsos OTX Motion Picture Group (Online Testing Exchange); and several smaller firms, including Screen Engine. See also Barnes (2009b) about ARSgroup, and Frankel (2010), who writes of the problems with tracking. The key report with respect to appeal to different quadrants and selection of opening weekends is the weekly NRG Competitive Positioning report. Studios want to avoid having films aimed at one type of audience competing with another film with the same characteristics. The effects of changing demographics appear in Barnes and Cieply (2011), and Barnes (2013a) writes of attempts at forecasting beginning at the script level. See also Derrick, Williams, and Scott (2014).

**41.** “Platforming” is an extension of earlier “roadshow” strategies that attempted to mark certain film debuts as special events through advance ticket sales, reserved seating, and a limited number of screen engagements. See also Orden (2012).

**42.** Such bid letters would always include a schedule of admission prices, the number of showings on weekends and weekdays, the number of seats in the auditorium in which the film is expected to play, and other conditions that the distributor might find desirable. Some studios prefer to bid their pictures and some don't, or they will bid their pictures only in some cities or under special circumstances. The process itself, however, is often in the nature of a public auction. As already noted, the majority of exhibition licenses are negotiated. Whether bid or negotiated, under a gross-receipts formula, first-run film rental usually begins at 70% of box-office admissions receipts and gradually declines to as low as 30% over a period of four to seven weeks. Second-run rentals begin at 35% of box-office admissions and often decline to 30% after the first week. For instance, in the 1995 release of *Batman Forever*, the admissions revenue-sharing formula terms were 90/10 (after house expenses) for the first three weeks and 80/20 for the next three weeks; or, under the gross-receipts formula, theaters paid 65% of the aggregate box-office receipts for the run, whichever formula was higher.

Although there has been little formal economic analysis of bidding behavior in the movie business, game theory provides many economic bidding models that could be readily adapted; for example, see Davis (1973).

**43.** Given the increasingly common first-week saturation booking strategies and consolidation of exhibition chains in the early 2000s, the industry has begun some movement toward simply leaving exhibitors with 40% of box-office receipts averaged over all the weeks that a picture plays. See, for example, *Variety*, March 25, 2002. However, as Goldsmith (2004) reports, by 2004 the industry had begun to move to an even 50/50, “aggregate settlement,” split taken over the life of the film. Although this change appears on the surface

to favor exhibitors over distributors as compared with the traditional sliding scales from the first week onward, in practice it is much simpler to implement and, for each of the parties, usually generates approximately the same income as under the prior method. For the majors, foreign settlements averaged around 43% or 44% in 2005. This suggests that even if a film's foreign box-office receipts are above those in the U.S. market, the distributor will see approximately the same income from each market. However, disagreements are sometimes noted publicly (*Los Angeles Times*, December 19, 2007). In late 2007, for instance, the Marcus Theatres chain was unable to agree with domestic distributor Paramount Pictures on the revenue split for *Sweeney Todd: The Demon Barber of Fleet Street*. In May 1998, Sony Pictures found that some theaters balked at paying 80% of receipts to Sony for the release of *Godzilla*. And in 2013, Disney tried to raise its share of the revenue split on *Iron Man 3* by 3%, but major theater chains balked. See Fritz (2013b).

**44.** Use of "clearance" rights became an issue with Sony's June 1996 release of *Cable Guy*, in which Sony attempted to open the picture as widely as possible in metropolitan areas by asking national theater owners for a waiver on clearances. Some theater owners agreed to honor Sony's request. See *The Hollywood Reporter*, June 13, 1996. Also, it seems probable that film rental and clearance agreements are basically evolving into being negotiated on an annual aggregate basis instead of picture by picture and theater by theater, as had been the tradition. This was the norm in Canada, where the duopoly of Cineplex Odeon and Famous Players provided near-national coverage and bookings did not need to be done on the basis of American-style geographic zones. However, for distribution purposes, Canadian box office is combined with that of the United States into what is called the domestic market.

**45.** Doman (2001) notes that in the early 2000s distributors began to negotiate "firm terms" on film rentals *before* release. And so-called aggregate deals, wherein a percentage is applied to a film's entire run, are also an alternative to the usual 90/10 weekly box-office computations. As noted in the 2003 AMC Entertainment Inc. Form 10-K, "under a firm terms formula, we pay the distributor a specified percentage of box office receipts, with the percentages declining over the term of the run. Firm term film rental fees are generally the greater of (i) 70% of box office admissions, gradually declining to as low as 30% over a period of four to seven weeks versus (ii) a specified percentage (i.e., 90%) of the excess of box office receipts over a negotiated allowance for theater expenses (commonly known as a 90-10 clause). The settlement process allows for negotiation based upon how a film actually performs. A firm term agreement could result in lower than anticipated film rent if the film outperforms expectations, especially in regards to length of run, and, conversely, there is a downside risk when the film underperforms." More details on this and on the issue of settlements can be found in Section 5.3, where a sample calculation illustrating split percentages and minimum conditions can be found. The historical backdrop for settlements is in Hanssen (2005). It is worthwhile noting, too, that the subjective nature of settlement adjustments affects profit participations.

**46.** More recently, exhibitors have begun to benefit from digitally delivered alternative programming that includes operas, orchestral concerts, and Broadway productions. In effect, theaters are becoming local community performing arts centers.

**47.** As of the late 1990s, advertisers paid theaters an average of \$1.25 million for 60 seconds of time in screenings during a film's four-week run. See Gubernick (1999).

**48.** A full discussion appears in McKenzie (2008). See also Gil and Hartmann (2007) and Orbach and Einav (2007).

**49.** To this end, the marketing tail may sometimes wag the production dog: Studios will now often attempt to build already well-accepted titles into long-lived strings of

brand-name sequels, among the best examples of which have been the *James Bond*, *Batman*, *Harry Potter*, and *Lord of the Rings* lines. Whereas sequels had, on average, usually been able to generate 65% of the original's box-office gross, they are now often able to far surpass the performance of the original release as, for instance, *Austin Powers* and *Rush Hour* have done. See also Lyman (2002), Waxman (2003), and Kung and Schuker (2011).

**50.** Tracks have historically been more prominent in Canada, where, according to Marich (2005, p. 200), “before AMC’s entry, Famous Players booked on a national basis movies from Disney, MGM, Paramount, and Warner Bros. (and more recently DreamWorks). Cineplex Odeon was the circuit for Columbia/Sony, Twentieth Century Fox, and Universal Pictures.” Theaters also had historically relied on geographical exclusivity contractually defined by local exhibition zones. However, with the rise of multiplexes, such zoning no longer has any practical relevance.

**51.** In mid-1983, a U.S. district court ruled that splits are a form of price fixing and an illegal market allocation in violation of the Sherman Antitrust Act. According to the court’s ruling, split agreements entered into by Milwaukee exhibitors caused the amounts paid to distributors to be reduced by 92% from \$1.8 million in 1977 to \$140,000 in 1981. The ruling had been appealed by the defendant exhibitors (see *The Hollywood Reporter*, June 22, 1983, *Variety*, March 23, 1988, and other legal transcriptions regarding the Kerasotes Theater cases). The practice of product splitting was brought to the attention of the Department of Justice by distributors, who responded to exhibitors’ charges that distributors had been illegally engaged in the practice of block booking. See also Stigler (1963), note 3 of Chapter 8 on cable-channel bundling, and Elberse (2010) on music bundling.

**52.** Real estate value is the key determinant for whether existing theater sites can be used more profitably for office buildings, parking lots, or other purposes. Standard discounted cash flow and internal-rate-of-return modeling methods, as in Damodaran (1996), can be applied.

As an illustration, consider a theater generating an average annual net income of \$100,000 over its expected ten-year life. The internal rate of return on an original \$500,000 investment will be just over 15%. However, if the required rate of return is 18%, then, using the net present value (NPV) method, the net present value of this theater is about \$450,000. Typical operating profit margins for a theater range between 15% and 45% and are closer to the lower end if the theater is leased as opposed to owned by the operator. Leases for new theaters, normally financed by real estate developers, raise the exhibitor’s return on investment (ROI) over the near term, whereas full ownership may provide long-run participation in a property’s potential rise in residual value. Lease financing may also induce greater earnings variability because payments may be tied to the exhibitor’s revenues.

**53.** Ratings are now set by the Classification and Ratings Administration (CARA), an autonomous unit associated with the MPAA. The ratings are as follows: *G*: General Audience – all ages admitted; *PG*: Parental guidance suggested – some material may not be suitable for children; *PG-13*: Parents strongly cautioned – some material may be inappropriate for children under age 13; *R*: Restricted – under age 17 requires accompanying parent or adult guardian; *NC-17*: No one 17 and under admitted.

**54.** If each household pays \$4, if one-third of that is remitted as a rental to the distributor (the remainder to cable operators and program wholesalers), and if there are 15 million households, then \$20 million will be generated. There is an additional benefit to the distributor because of the much faster cash return than from theaters.

**55.** Pressure to do well on opening weekends has been significantly intensified in recent years. It all began with *Jaws* in 1975, which was the first major film nationally advertised

and widely released, on over 700 screens. Nowadays, pictures that do less than \$25 million in domestic box office on an opening weekend are likely to be pulled rather quickly. Conversely, a film that declines by 20% or less on its *second* weekend is considered to be a potentially large winner. As of 2004, it was no longer unusual for films to drop 50% by the second weekend, as compared with half that percentage ten years earlier. As Lippman (2002a) notes, first weekends used to account for an average of 20% to 25% of a film's total receipts, but that percentage has risen toward 33%. Since the early 1990s, seasonality has begun to blur at the edges, and it is thus less of an issue given the large number of screens in modern theaters and the sophisticated marketing campaigns that studios now launch year-round. Such campaigns are significantly influenced by prerelease audience research provided by the dominant NRG, or by MarketCast, which also conducts movie-tracking reports.

In response to fewer films released by the majors, abbreviation of video release windows, and poor overall box-office results in 2011, exhibitors have established distribution companies of their own. For example, Open Road Films, specializing in mid-budget films, is owned by AMC Theatres and Regal Entertainment Group and discussed in Cieply (2012b). The strategy is to produce modestly budgeted films with recognizable stars and then rely on publicity and showing of trailers on 12,000 owned screens rather than expensive media advertising. For winning films, Open Road thus captures distribution fees that would otherwise go to the major studios, but for losers the loss is in both production and exhibition. For its agreement to distribute *JOBS*, about Apple founder Steve Jobs, Open Road arranged a "service deal" with producer Five Star Feature Films in which Five Star bore the costs of marketing.

One strong film will, however, occasionally block another. Such a situation arose when the long-running *Star Wars* blocked the timely exhibition of a previously booked run of *Close Encounters of the Third Kind*, thereby starting a round of lawsuits involving distributors and an exhibitor. Details on this particular situation can be found in *Variety*, December 21, 1977. In early 2010, the ongoing theatrical strength of *Avatar* partially blocked another 3D film, Disney's *Alice in Wonderland*, from obtaining the desired number of 3D screens. Paramount's *How to Train Your Dragon* and Warner's *Clash of the Titans* encountered a similar problem a few weeks later. See Cieply and Barnes (2010). To get around this problem, exhibitors occasionally "piggyback" one film with another, in violation of their contracts. A somewhat similar situation developed in 2008 with a shortage of digital screens when *Hannah Montana* pushed out *U2 3D*, a concert film that had opened a week earlier. See Halbfinger (2008b) and Sanders (2008a).

**56.** An even better measure of how one film has performed as compared with another can, in theory, be derived by calculating the percentages of potential total weekly exhibitor capacity that the films have utilized. It would, for instance, be interesting to see how opening-week receipts from *Indiana Jones* compared with opening-week receipts from *Superman* by deriving for each picture a capacity-utilization percentage – profiled first across the whole industry's capacity and then across the capacity of theaters that played both pictures in their initial weeks of release. Unfortunately, data of this kind are rarely available. As of 2012, a strong opening would be an average of more than \$12,000 per location.

An additional new complication is that variable pricing strategies such as those used by airlines for "yield management" are only now being considered by theater owners, who, in response to challenges from DVDs and the Internet, are beginning to charge premium prices for more comfortable reserved seating and for 3D films. As 3D is no longer a novelty, most films will on average generate less than 40% of total box office in this format even

with 3D ticket prices \$3 to \$5 higher than for 2D. *Gravity* was a notable exception, with 80% of its October 2013 record \$55.6 million opening weekend box-office receipts coming from 3D screenings. See also Lyman (2001), Leonhardt (2006b), and Kung (2011).

Opening weekend gross receipts and the subsequent decay patterns for important releases are always carefully analyzed and compared with those of previous important releases. In 1990, the opening week might have represented 20% to 25% of the total domestic box office, but by 2010 it had typically risen to above 50%. Also, the dropoff to the second week will often be 50%. DVDs now tend to follow a similar decay pattern, with most sell-throughs bought in the first two weeks after release.

Until Disney/Marvel's *The Avengers* (cost \$220 million) in May 2012 hauled in \$200.3 million at the domestic box, the top three-day weekend openings belonged to *Harry Potter and the Deathly Hallows: Part 2* released in July 2011, with a U.S./Canada gross of \$168.6 million (\$476 million global), and *The Dark Knight* (cost \$185 million), which took in \$158.4 million in July 2008 and set a domestic record, collecting \$314.2 million in the first ten days. The last Potter film also benefited from the higher ticket prices from wide release in 3,000 3D screens. Parts I and II of *Deathly Hallows* were filmed at a cost of around \$250 million and propelled the entire ten-year, eight-film Potter franchise take to around \$7.5 billion, the largest in history. Although the May 2013 Warner Bros. *Man of Steel* opening weekend total of \$128.7 million was impressive, the film did not have strong follow-through.

*Spider-Man 3*, with a production and release cost of around \$400 million (production cost \$258 million), opened May 4, 2007 and generated a strong three-day North American total of \$151.1 million (worldwide \$373 million). This was slightly exceeded in March 2012 by Lions Gate's *The Hunger Games*, which took in \$152.2 million on its opening weekend. Summit Entertainment's *The Twilight Saga: New Moon* sold \$142.8 million of North American tickets (plus another \$118.9 million overseas) in its first three-day weekend in November 2009. *Pirates of the Caribbean: Dead Man's Chest* (cost \$225 million) in 2006 had the next highest opening weekend at \$135.6 million. The subsequent *Pirates: On Stranger Tides*, released in May 2011, had the best foreign opening ever, with \$256.3 million, but did not set a domestic record. *Iron Man 2* had a U.S./Canada opening of \$133.6 million in May 2010, but Disney/Marvel's *Iron Man 3* opened higher at \$175.3 million in May 2013, and this was below the \$207.4 million opening for *The Avengers* in May 2012. *Pirates of the Caribbean: At World's End* pulled in \$126.5 million on Memorial Day weekend 2007. Just \$2 million behind for the Memorial Day weekend was 2008's *Indiana Jones and the Kingdom of the Crystal Skull* (cost \$185 million, marketing \$150 million).

*Transformers: Dark of the Moon* (cost around \$200 million) set a Fourth of July weekend record in 2011 with \$116.4 million domestic gross. *The Lost World: Jurassic Park* had previously (in May 1997) generated the largest three-day opening weekend up to that time, with receipts of \$72.4 million, and a four-day total of \$92.7 million. The largest five-day opening was 2005's *Star Wars: Revenge of the Sith*, with \$172.8 million in tickets sold. And the largest first-quarter opening weekend and 3D opening of all time was Disney's early March 2010 release of *Alice in Wonderland* (cost \$200 million), with \$116.3 million in North America and \$210.3 million worldwide.

*Transformers: Revenge of the Fallen* set a weekday opening record in 2009 with an estimated \$60.6 million of ticket sales in the United States and Canada. *I Am Legend* of 2007 holds the December record at \$77.2 million, just a hair above 3D epic *Avatar* of 2009 (\$237 million production cost), which grossed \$77 million domestically (\$232.3 million globally) on a December weekend in which the potential East Coast box office was diminished by a snowstorm. For earlier records, see note 48 of Chapter 4 of the seventh

edition of this book and online services such as Boxoffice Mojo.com, ercboxoffice.com, The-numbers.com, and IMDb.com.

**57.** The correlation between number of releases and rentals percentage is about  $-0.4$ . Eliashberg, Elberse, and Leenders (2006) note that the industry rule of thumb is that with per capita moviegoing frequency of 5.5 films a year, one screen is needed for every 10,000 people.

**58.** At first, of course, it was not at all known how the home-video market would evolve. As with subsequent new media, including DVDs and the Internet, the only sure thing was that the pornographic entertainment segment would be an early adopter. See Lane (2001), Rich (2001), and “Porn in the U.S.A.,” broadcast on CBS’s *60 Minutes* on September 5, 2004, and November 21, 2003. See also Boldrin and Levine (2006) and *Metro-Goldwyn-Mayer v. Grokster*.

Lardner (1987) notes that it was not at all evident that the videocassette recorder (VCR), introduced by the Sony Corporation in 1975, would prevail. The machine was not perceived as something for which plentiful software in the form of movies would be available. At the time, there was no prerecorded software. The machine known as the Betamax could also only record on one-hour magnetic tape cassettes. Worse still, it soon faced competition from a noncompatible but similar two-hour videocassette format, VHS (Video Home System), which was introduced by Sony’s manufacturing rival Matsushita. This battle of the formats caused great confusion and hampered the initial growth of the market for VCRs, following as it did close on the heels of earlier home-video technologies that had notoriously failed. Those technologies included the so-called Electronic Video Recording (EVR) system developed by Dr. Peter Goldmark at CBS Laboratories in the late 1960s, and Cartrivision. See Lessing (1971) for a description of Cartrivision, Donnelly (1986) for a quick overview of the EVR, Wasser (2002) and Sweeting (2004) for a history of the VCR’s impact on the movie industry, and Epstein (2005, Chapter 17) for a concise history of the DVD’s development and impact. Taylor, Johnson, and Crawford (2006) cover details of technology and history.

After a prolonged battle, the computer and movie industries finally agreed on a DVD standard that enabled introduction of DVDs in late 1997. These first-generation DVDs held 4.7 gigabytes (GB) of information, or about seven times the 650 megabytes of a CD. With a dual layer (one opaque, one shiny), storage can be almost doubled again to 8.56 GB. By early 2008, Warner Bros., Best Buy, and Wal-Mart had decided to go exclusively with Blu-Ray, thus effectively ending the format competition and making Blu-Ray the de facto standard. See also Brinkley (1999), Lake (2002), Belson (2003, 2006b), Rothman (2003), and Kane and McBride (2008).

The early evolution of DVDs also had been confused by the introduction of a controversial variant of DVD called DIVX (discontinued in 1999), which was a DVD disc with a lower initial price to the consumer of around \$4 but with a built-in 48-hour viewing-time limit after the disc was activated. Netflix Inc. then took advantage of the DVD’s size and convenience by offering monthly mail-delivered subscriptions. See also Lippman (1999), Ramstad (1999), and Taub (2003).

Going back even further, in the late 1970s, consumers were introduced to so-called videodisc players that did not have a recording capability and were therefore useless for “time-shifting” (i.e., the recording of a program for delayed viewing). These videodisc machines were developed in two versions: a laser/optical system (closely related to the now standardized system in compact disc players), which used a laser beam to read encoded video and audio signals, and a capacitance system, which used a stylus to skim a recording and measure changes in electrical capacitance. Both versions fared poorly and were eventually withdrawn by their respective corporate sponsors. The optical videodisc was at the

time promoted by MCA and Pioneer, whereas RCA spent hundreds of millions of dollars before scrapping the capacitance system in 1984. See Graham (1986) for details on RCA's system.

**59.** Domestic retail sales of DVDs peaked in 2006 at more than \$20 billion, the bulk of which (two-thirds or so) had been derived from sales or rentals of feature films.

**60.** The cost of manufacturing the tape is perhaps \$1.75 a unit. However, for a DVD sale, the average revenue to the studio per unit is closer to \$16, with the manufacturing cost around one-third lower than for a tape. A good example of the potential profitability of DVD sales is *Spider-Man*, in which the DVD generated around \$190 million in its first weekend of sales and an estimated \$160 million of that reverted to the studio (*Los Angeles Times*, November 19, 2002). Although studios receive about half of a \$10 theater ticket and almost nothing for a home-video rental, the studio usually takes more than 50% of the DVD's price. As noted in Kirkpatrick (2003), high DVD unit sales for action films have also influenced the types of films that are made. Johnson (2005b) similarly notes that DVDs sold abroad have added significantly to studio profits and indeed affected how the movie business is run. Marr (2005) shows how DVD sales projections (*Shrek 2*) can go awry. And Belson (2006a) discusses implications of the slowing of DVD sales relative to the growth of movie downloads, which might generate a profit per unit of no more than \$2.40 for the studios (approximately one-fourth the profit from a DVD unit sale).

**61.** Revenue-sharing was a concept promoted by Viacom and its Blockbuster stores as a way of increasing A-title availability, and with minimum revenues conditioned on retailers taking all of the studio's offerings. The offset, however, is that with more A-titles available, the demand for nonhit titles would normally be diminished. See also *Variety*, July 20, 1998, and Mortimer (2000, 2008), who notes that retailers had chosen revenue-sharing for about half of all movie titles for which both fixed-fee and sharing terms were offered (excluding direct-to-video releases). Mortimer's study found that, with sharing, both distributor and retailer profits are increased modestly and consumers benefit substantially. As discussed in McBride (2008a), revenue-sharing was an issue in Universal's suit against kiosk operator Redbox. That is because retailers such as Blockbuster typically share a portion of their rental revenues with studios. But Redbox, charging \$1 a night for DVD rentals, does not share rental revenues.

Inventory restrictions also appeared to increase distributors' profits and decrease profits for retailers, as compared with sharing agreements without such restrictions. Gross margins for retailers renting DVDs had generally been above 70%, as compared with around 60% for revenue-sharing on tapes. It is significant that Blockbuster did not share DVD rental revenues with most studios, though it did share on tapes. As noted in *BusinessWeek* of September 16, 2002, "Blockbuster buys most disks outright from the studio, for an average \$17 each – end of deal." On rental tapes, under revenue-sharing agreements, the cost per tape ranged between \$22 and \$25. As explained in Peers (2003), Blockbuster in 2002 enjoyed a profit margin on its rental business of 65%, as compared with 15% in its retailing activities. However, late fees, which were discontinued in 2005, are estimated to have contributed at least \$250 million, or around 15% of annual revenues, when they were in effect.

**62.** As described by Blumenthal and Goodenough (2006, p. 23), for example, the typical cost breakdown for a DVD is as follows: \$30 retail price, retailer's markup (cut) \$15, mastering and authoring \$2, packaging \$2, warehousing and inventory \$1, and marketing perhaps another \$2. All of this leaves between \$8 and \$10 as profit. See also Caranicas (2010), who describes the difficulty of making up for sales declines in DVDs through gains in box office or VOD.

**63.** From the retailer's perspective, at an average price of \$3 per rental and an average cost per tape of \$66, it takes at least 22 turns over a period of four to six weeks to reach breakeven. The early weeks usually generate 40% of the total expected for the first six months after release.

**64.** Film company distributors, in effect the "publishers" of home-video titles, generally sell units designated for the rental market at a 37% discount from the suggested retail price. As noted by R. Childs in *Squire* (2nd ed., 1992), this figure is derived from a "30 plus 10" formula in which the retailer buys at a 30% discount, and 10% of the balance (7%) goes to wholesalers. This then leaves the film distribution company (the publisher) with 63% of the suggested retail price.

**65.** This is because of the First Sale Doctrine. However, if special arrangements known as pay-per-transaction were agreed on in advance, there is no theoretical reason for the distributor not to participate in subsequent rental income. Several companies have, with varying degrees of success, established such pay-per-transaction operations.

**66.** The indicated crossover point in the mid-1990s was around 1.6 million sell-through units, or about four times what could be expected from the rental market. But in consideration of higher marketing costs, most distributors would want to be assured of a ratio of six to ten times the number of rental units before deciding on a sell-through strategy.

As of 1992, for example, the priced-for-rental best-seller of all time was *Ghost*, which shipped about 645,000 units. This, in effect, implied that a realistic ceiling in the rental unit market was on average around half a million units. If so, the marketing decision becomes relatively easy, because the rental revenues under these conditions peak at roughly \$32 million ( $\$100 \text{ a unit} \times 0.63 \times 500,000$ ). If a \$13.50 wholesale sell-through price is assumed, for-rental market revenues would be exceeded with sell-through shipments of 2.4 million units. And on *Top Gun*, for example, Paramount decided to promote sell-through by going with a suggested retail price of around \$25. In this situation, Paramount almost surely generated more profit by targeting the sell-through rather than rental market.

For DVDs, comparisons of first-cycle gross (FCG) revenues to domestic box-office totals have become a favored performance metric, even though relatively few films with production costs of more than \$75 million will generate an FCG/DBO ratio above 1.0. In 2010, two strong North American DVD performers were *Avatar*, which sold 19 million DVD units, and *Twilight: New Moon*, which sold 4 million in two days.

**67.** Revenues still often turn out to be the same percentage of production costs as the costs of p&a. It is thus convenient to assume that video revenues approximate p&a. Ault (2009) indicates that prior to the downturn in sales in 2008, DVDs had been generating around 85 cents for each dollar of box-office gross, but that this has dropped to below 70 cents per dollar. Also, in calculating profitability to studios, return reserves and retailer inventory liquidation rates are sometimes important. See Ulin (2010, pp. 199–204).

**68.** In 2006, DVD revenues for a film had tended to be equal to domestic box-office totals. By 2014, this had fallen to under 50% of dbo. See also Arango (2008b,c), Siegel (2010), Stelter and Chozick (2013), and, on EST, Ault (2013).

**69.** This comparison was not as important as long as DVD unit sales were rising and had come to account for half of studio profits.

**70.** *Fractured-rights* deals – in which producers could package a film idea, presell domestic and international video rights, and then arrange for a major studio to distribute the film (for a fee) in domestic theatrical markets – flourished during the first days of the home-video business in the early to mid-1980s. Such presales typically covered all of the production and most, if not all, of the domestic releasing costs – leaving the producer's share of

theatrical revenues and television rights as potential sources of profit. Such deals worked until the studios developed strong video distribution facilities of their own and as long as banks were willing to fund such production costs. Once the value of home-video and international rights failed to keep pace with the rise of production and releasing costs, the viability of such deals fell apart. By the early 1990s, so-called split-rights deals, in which a studio took *all* domestic rights, with producers retaining international rights, came into greater use. Studios today will rarely split domestic rights. Dawtre (2011) describes the complex distribution-rights financing of Oscar winner *The King's Speech*, a \$15 million film that attracted U.S. domestic box-office receipts of \$125 million. See also Alberstat (2004), Finney (2010), and Dargis (2014) about the flood of indie films, and Fritz (2014a).

Separated rights are another variation that is derived from Writers Guild contracts stipulating that the creator of a TV show retains the show's movie rights. Studios or independent producers can acquire the rights that allow the property to be made into a movie separately, but only following narrow guidelines. As a result, lawsuits involving separated rights have become more frequent in recent years as Hollywood has come to rely more on previous television-show concepts. See Lippman (2005).

**71.** As a result, even if an independently made film is fortunate enough to obtain domestic theatrical distribution, it will likely not benefit proportionately from ancillary markets, especially in licensing to broadcast television and cable outlets. Note also that, in return for making a commitment to finance (or partially finance) a picture, an independent home-video distributor would normally insist that the picture receive a predetermined amount of support in initial theatrical release through spending on p&a. Such p&a commitments are important because they, in effect, "legitimize" the picture by bringing name recognition to what is hoped will be a broad audience for the home-video product. Home-video distribution-rights contracts with independent filmmakers typically extend over seven years. The producer might normally receive an advance against a royalty base of between 20% and 40% (i.e., the producer of a \$20 million picture could expect an advance of between \$4 million and \$8 million for domestic home-video rights). Graser (2008) indicates that studios currently require independents to put up p&a and will then charge distribution fees of 8% to 12%. Perhaps the best-known home-video independent of the mid-1980s was Vestron, which went public in 1985 but ultimately was unable to become an important video alternative to the majors. The history of independent producer-distributors shows that theaters must be offered a steady supply of films or else they pay late or not at all, thereby severely crimping the cash flow of the independent. A quotation in Horn (2007) from a theater chain executive is telling: "Don't pay the independents until a day before they take you to court." The Horn article refers to the independently made and distributed film *Redline* (Chicago Pictures).

**72.** Barnes (2008a) discusses the problem that 3,600 independent features were submitted to the Sundance Film Festival in 2008 (and 4,000 in 2014), yet not even 5% were ever distributed in theaters. Finding a distributor is the largest hurdle for producers of such films. For investors, the absence of an exit strategy presents the greatest risk. The major studios significantly reduced exposure to independent smaller-film divisions between 2007 and 2010 as Disney sold Miramax to a private equity firm and Warner Bros. largely eliminated New Line. See also Barnes and Cieply (2014).

As the number of screens has grown slowly, it is unlikely that the situation will change. Many more such films are instead being distributed on Internet sites and through cable on-demand services. Meanwhile, indie films that do make it to a big screen require much more in promotional marketing expenditures than previously and will normally earn a rentals percentage from exhibitors that is around 10% below those of major studio releases. See also Carr (2008a), Schuker (2009b), who discusses the decline of indie film rights sales

in a recessionary environment, and Dodes (2013) about indie financing adventures. Martin (2009, p. 330) covers minimum guarantees (MGs), likening them to nonrecourse loans, with interest accruals. MGs are therefore advances against the filmmaker's future backend receipts – which is basically the same arrangement used by record labels when they sign artists. To obtain theatrical distribution, independents will also occasionally do “service deals,” the equivalent of rent-a-studio arrangements done for pictures with larger budgets. See also Malloy (2009).

**73.** Interest in this area was heightened with Disney's 1994 direct-to-video release of the *Aladdin* sequel, *Return of Jafar*, which at a production cost of \$5 million generated estimated wholesale revenues of \$120 million on unit sales of 11 million. See Hofmeister (1994). Since then, the business has moved to direct-to-DVD, with Disney's *Lion King 1½*, released in 2004, bringing in \$160 million in sales. Disney's *High School Musical*, produced for \$4.2 million, generated sales of 8 million DVDs and operating income of \$100 million. *Beta House*, discussed in Barnes (2008b), cost less than \$10 million, sold more than 1 million units, and generated more than \$30 million, including revenues from rentals and licensing to cable networks. In 2007, there were nearly 700 direct-to-DVD films, generating around \$1 billion in sales. Among the most expensive (estimated cost \$20 million) of the direct-to-DVD releases was Warner's 2009 release of *Tales of the Black Freighter*. See also Marich (2013, Chapter 4); *Variety*, September 13, 2004; *Wall Street Journal* articles by M. Marr, April 20, 2007 and August 17, 2007; and Marich (2012). Successful release in the horror genre is covered in Schwartzel (2013b).

**74.** For example, there was evidence that the frequency of home-video rental – which had averaged almost one tape a week for the typical VCR-owning household of the late 1980s – had declined in the 1990s even though the cost of an overnight rental (averaging around \$2.50 per night in 1997) had remained low. And newer video-distribution methods via Internet downloads had already begun to undermine the video store business model, which had benefited greatly from late-return fees (estimated to be \$1 billion in 2003). Digital VOD services offered by cable systems for \$5 to \$10 a month on top of normal cable bills plus \$3.95 for recent titles and \$2 or \$3 for older titles had also gained importance.

See Orwell, Peers, and Zimmerman (2002), Orwell (2003), Pogue (2006), and *Los Angeles Times*, February 14, 2006. McBride, Vascellaro, and Schechner (2009) explain that studios were working with YouTube to make full-length films available on the same day as the DVD release for a fee of \$3.99, the same price that Apple charges for streamed new movie rentals. The companies include Lions Gate, Metro-Goldwyn-Mayer, and Time Warner.

Large video superstores such as Blockbuster Entertainment, and more recently giant retailer Wal-Mart Stores, had long been Hollywood's major customers. Wal-Mart in 2006 accounted for 40% of home-video and DVD sales (more than \$3 billion at wholesale) and 20% of all music sold in the United States. And Target accounted for 15%. But by 2008, Apple's iTunes had become the top seller of digital music, with Wal-Mart second, Target third, and Best Buy and Amazon tied at fourth. Horn (2005c) indicates that as of 2005, Wal-Mart, Target, and Best Buy accounted for half of a new DVD title's sales, with 60% of that coming in the first six days of release.

Video rental store profits are derived from fast turnover of a title in the first six months after release. With overhead and other costs included, the normal retailer would probably require at least 30 turns to break even.

**75.** Studio output deals with the major premium cable networks generally lock up electronic transmission rights for eight years after release in video stores, thereby limiting the access of streaming service providers (such as Netflix) to recently made films.

**76.** In 2013, sales of single-issue comics were around \$870 million, with Marvel (bought by Disney in 2009) and DC Comics accounting for around three-fourths of the market. Although comics and children's books are among the most obvious categories, most, if not all, fiction and some nonfiction also qualify. Moreover, newspapers and magazines often have entertainment motives in mind when they publish about personalities or develop "lighter" subjects or "style" or "leisure" sections. Indeed, as Table 1.4 illustrates, sales of newspapers, books, and magazines are included in National Income Accounting data as part of recreation expenditures. Marvel Enterprises, which owns rights to Spider-Man, the Hulk, and many other such characters, produces 60 comic book titles a month. See Warner (2004), Gustines (2010), Barnes (2012), and "In the Footsteps of Marvel," *Wall Street Journal*, July 9.

The largest film-related franchise is *Harry Potter*, which over ten years generated \$1 billion in profits for Warner Bros. and \$20 billion of retail sales (consumer products, \$7.0 billion; box office, \$6.3 billion; home entertainment, \$3.9 billion; video games, \$1.5 billion; and television, \$1.0 billion) for Warner and its partners. See Smith, Kung, and Guth (2011) and Chapter 9.

**77.** The first movie merchandising license, according to Marich (2013, p. 207), was probably issued in 1929 for a Mickey Mouse image placed on a children's writing tablet. And the first licensed Mickey Mouse-themed watch was sold in 1933. See also Marich (2013, Chapter 6).

Most royalties would be in the area of 5% to 6% of the value of wholesale shipments, but the percentages can be higher and terms might also include advances and guarantees against royalties. Food and confectionary license percentages generally range lower than others, between 3% and 7%. Of such revenues, producers might, depending on contractual details, be entitled to perhaps a 25% to 50% share. On products using an actor's visage, the percentage can range from 2.5% to 8.0% of the studio's net. According to the *Licensing Letter Royalty Trends Report* of 2013, the average 2012 royalty rate for licensed merchandise as measured across all property types is 8.7% of the manufacturer's selling price, but the range is wide, with art-based properties around 6.4%, sports and entertainment around 9.9% and sometimes much more, and toys and games around 10.4%. The average length of contract was 2.3 years.

An example of how lucrative merchandising can be is provided by the 1989 release of *Batman*, in which Warner Bros. received licensing fees ranging from \$2,000 to \$50,000 plus royalties of 8% to 10% on revenues estimated to be \$250 million in the first year of release. Mattel reportedly agreed in the year 2000 to pay Warner Bros. a \$35 million advance and a 15% royalty for toy rights to the Harry Potter book series. Disney/Pixar's animated *Cars* generated retail merchandise sales of \$2 billion in its first year (2006). And Pixar's *Toy Story 3* of 2010 generated \$1.1 billion in global box-office receipts and \$7.3 billion in global licensed-merchandise retail sales, with licensing revenues to Disney of around 8% (*Wall Street Journal*, November 2, 2012). For a licensing deal overview, see Ovadia (2004), and also Lippman (1990), Lane (1994), and Bannon and Lippman (2000).

**78.** Other factors include producer demands to at least match ad budgets and marketing campaigns to those used on the comparable films of other producers. Marketing cost is also seasonally influenced by Oscar nomination concerns, which tend to concentrate releases of those films thought to have the strongest creative elements into the fourth calendar quarter of the year. This is done to use essentially the same advertising expenditures to attract general audiences and Oscar voters simultaneously. See Goldstein (2006a).

An empirical study by Prag and Cassavant (1994) suggests the importance of marketing expenditures to a film's success. Independent producers in particular also incur additional costs in attempting to market their pictures directly at various international marketing conventions, the most important of which are the American Film Market, based in Santa Monica in early November; Sundance, in Park City, Utah, in January; the Cannes Film Festival, held in Cannes, France, in early May; and one in Berlin in February. In television, MIFED (*Mercato Internazionale del Cinema e della Televisione*) and a somewhat similar event held in Milan, Italy, each October are important. Negotiations between foreign sales agents and foreign distributors' representatives form the core of these conventions. Sales agents' fees are often 15% to 20% of defined rental revenues. The sales agents' trade group, the American Film Marketing Association (AFMA), provides credit reports on foreign distributors. The group is now known as the Independent Film Trade Association (IFTA).

Television producers and distributors also have several marketing conventions, including the midwinter convention of the National Association of Television Program Executives (NATPE), held in the United States, and the *March Internationale des Programmes de Télévision* (MIP), held each spring in France.

**79.** Wyatt (1994, p. 7) writes that "high concept can be considered as a form of differentiated product . . . This differentiation occurs in two major ways: through an emphasis on style within the films, and through an integration with marketing and merchandising." He continues (p. 19), "high concept films are accompanied by striking graphic print and television advertising campaigns. . . . High concept films lend themselves to merchandising and marketing by their abstraction of a key image from the film (e.g., the hot rod forming the *Grease* logo)."

**80.** The study by De Vany and Walls (1996) delves deeply into the dynamics of demand for movies, suggesting that the industry's structure is well suited to adapt sequentially to changes in supply and to provide reliable signals of demand given relatively fixed admission prices and real-time reporting of box-office revenues. This study, also found in De Vany (2004a), indicates that (a) weekly revenues are autocorrelated; (b) audiences select or ignore films largely through an informational cascade in which individuals follow the behavior of preceding individuals or "opinion-makers" without regard to their own information; (c) widely released films show more variance in revenues and, on average, shorter run lives; (d) distribution of box-office revenue is not lognormal; and (e) revenues in the industry follow a Bose–Einstein distribution in which outcomes differing "in the extreme are equally likely and similar outcomes are extremely unlikely" – "the quintessential characteristic of the movie business." Informational cascades are analyzed in Bikhchandani, Hirshleifer, and Welch (1992). See also Hand (2002), Dellarocas, Awad, and Zhang (2004), De Vany (2004b), Ravid (2004), Rusco and Walls (2004), and the informal overview by Mlodinow (2006).

Ravid (1999) also found from a random sampling of nearly 200 films that

- Lower-budget movies tended to be more profitable than those with big budgets.
- Movies with lesser-known actors tended to be more profitable than star-driven films.
- There was no correlation between the strength of reviews and profitability, but there was a relationship between the number of reviews, no matter how positive, and profitability.
- The strongest correlation for profitability was a G or PG rating.
- Sequels tend to be more profitable than the average film.

- Stars may bring in higher revenues, but the profitability is smaller. (This means that stars tend to capture their “economic rent.”) See also Basuroy, Chatterjee, and Ravid (2003).

Although the aforementioned studies ascribe relatively little importance to the presence of stars for purposes of predicting film results – even with big stars, films sometimes do poorly – Albert (1998) found that stars have value as markers that help a film to be made and also provide information about the probability of a film’s potential success.

**81.** But generally, as Kagan (1995) illustrates, the following relationships derived over a large sample of major studio releases between the years 1989 and 1993 would seem to apply:

- To reach cash-on-cash breakeven, *domestic box-office receipts should approximate the negative cost* (or, comparably, half the negative cost should be recovered from domestic theatrical rentals).
- Worldwide rentals (including all theatrical, home video, cable, TV receipts, etc.) tend to be twice the domestic box-office receipts.

See also Cieply (2007b) regarding the costs of participations and the effects on studio profits.

**82.** Although it is not usually practicable to precisely calculate the return on investment (ROI) for a specific production, such a figure could be approximated by taking the total profit (if any) of all participants (including the distributor), adding the cost of capital, and then dividing by the total amount invested. To be placed in proper perspective, this rate should always be annualized and compared with the risk-free rate of return available on government securities during the period the film project went through its life cycle (from production start to ancillary-market release). The statistical distribution characteristics of film profits and the associated risks are described in Pokorny and Sedgwick (2012), in which it was also found that for films of the 1990s, the Spearman rank correlation coefficient between film budgets and profits was 0.059 and that between production costs and box-office revenues was 0.254.

**83.** The financial characteristics of movies are thus fractal in nature. The discussion here follows Postrel (2000), who cites the De Vany and Walls (1996) work that can be found at [www.socsci.uci.edu/mbs/personnel/devany/devany.html](http://www.socsci.uci.edu/mbs/personnel/devany/devany.html). As Postrel notes, “stars have their main effect not so much by helping movies open as by extending their runs. But most stars do not really make a difference.” See also Ravid (1999) and Elberse (2006) about the influence of stars and Eliashberg and Shugan (1997) about the influence of critics. The ability of online reviews to be used as a box-office forecasting tool is presented in Dellarocas et al. (2004), found at <http://ccs.mit.edu/dell/papers/movieratings.pdf>. Word-of-mouth’s impact appears in Moul (2007).

**84.** Even with the aforementioned advantages, however, it is not always easy for a major studio to be profitable. A market share of box-office receipts consistently in excess of 10% almost always assures profitability, but there have often been years when various studios have fallen below 10%.

**85.** MPAA worldwide gross profit data for the six major studios and subsidiaries in 2004 (revealed in “Hollywood’s Profits, Demystified: The Real El Dorado Is TV” by E. J. Epstein in *Slate.com*, August 8, 2005) indicates that theatrical release generated an estimated loss of \$2.2 billion, whereas video (DVD and VHS) generated a gross profit of \$14 billion, and television licensing in all forms brought gross profits of \$15.9 billion.

**86.** Game theory and what is known as the “winner’s curse” may in addition be applied to bidding situations of all types, be they for scripts, acting talent, books, or whatever. As

indicated by Thaler (1992, p. 51), the winner of an auction is likely to be a loser and, somewhat counterintuitively, the more bidders there are in competition, the less aggressive the bidder ought to be.

**87.** The Capital Asset Pricing Model (CAPM) is widely applied in finance and suggests that the risk of holding a portfolio of securities, or in this case films, can be reduced through diversification. Pokorny (2005) attempts to relate this to the release portfolios of the major studios in the 1990s, and Pokorny and Sedgwick (2012) discuss studio profitability as dependent on construction of diversified film portfolios. Elberse (2013) suggests that major studio concentration on tentpole productions is a rational strategy and Fritz (2013a) writes that by 2014 much high-budget production had shifted to independents.

**88.** The approach is discussed in Jones (2009). Monte Carlo methods are all about determining probabilities through statistical trials that include random components. The goal is to determine the percentage of time that a film is likely to be profitable and the expected profit per run. Such methods are discussed in econometrics texts.

**89.** Pokorny and Sedgwick (2010, 2012) support the view that the top 10% of most profitable films accounted for the bulk of profits generated by the majors in the 1930s and 1990s.

**90.** Pareto power laws were originally used to describe the distribution of incomes in the form  $P(\mu) \sim C \mu^{-\alpha}$ , where  $\alpha > 0$ . Such laws are also sometimes known as Zipf's law. If we were to rank box-office revenue totals by frequency of occurrence within a specific interval of time, we would find that the vast majority of releases generate under \$100 million worldwide and that few generate more than \$1 billion: Until the release of *Avatar* in 2009, which resulted in a worldwide gross of more than \$2 billion, *Titanic* had been the only film to approach \$2 billion, but there are many films that made \$40 million. The *Lord of the Rings* trilogy, however, also ranks high, with a worldwide gross of \$3 billion in ticket sales and \$1 billion in domestic DVD sales. Another finding related to power laws, explained in Angier (2010), is that director's cuts have over time become more like what's known as 1/f noise. Gabaix (2009) reviews the important presence of power laws in economics and finance.

**91.** Quotation from Alan Horn in Elberse (2013, p. 69).

**92.** A hazard function,  $h(t)$ , of this type may be estimated as the proportion of films surviving in an interval per unit time given that the film has already survived to the beginning of the interval. A Weibull probability function that allows for constant, increasing, or decreasing hazard-rate functions of time is well suited for, and is thus most often used in, such analyses.

**93.** This follows observations in De Vany (2004a, p. 68).

**94.** Quotation from De Vany (2004a, p. 2).

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