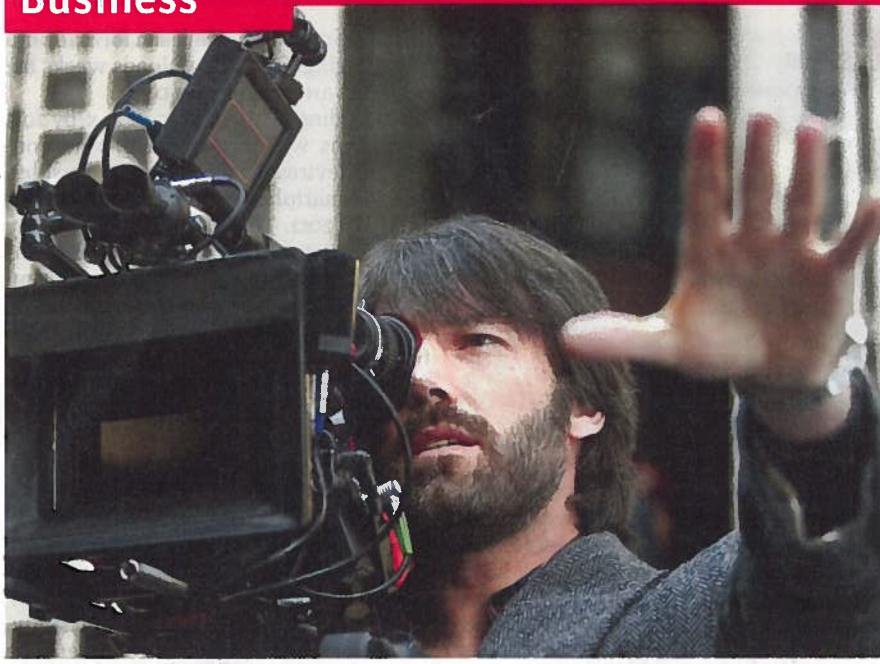

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Hollywood

Split screens

LOS ANGELES

A tale of two Tinseltowns

IN "ARGO", a thriller set in 1979, a CIA agent played by Ben Affleck (pictured) seeks the help of sharp-tongued Hollywood executives, and pretends to make a science-fiction film, in order to enter Iran and smuggle out six American diplomats who have been hiding in the Canadian embassy in Tehran. In the film, Hollywood helps liberate the trapped Americans. In real life, some are wondering whether Hollywood is the one in need of rescue. "Schizophrenic" is how one studio boss describes the state of Tinseltown.

The economics of the film industry are changing. Profits are down, even though Hollywood is making splashier films for new, fast-growing markets. Meanwhile, television, once the unglamorous sister, is enjoying record earnings and unprecedented critical acclaim. As a symbol of Tinseltown's shifting power, Seth MacFarlane, a comedian best known for creating the TV series "Family Guy", is hosting the Oscars on February 24th.

Hollywood executives have long been paranoid and insecure. Now they have cause to be. "The business model within film is broken," says Amir Malin of Qualia Capital, a private-equity firm. Between 2007 and 2011, pre-tax profits of the five studios controlled by large media conglomerates (Disney, Universal, Paramount, Twentieth Century Fox and Warner Bros) fell by around 40%, says Benjamin Swinburne of Morgan Stanley. He reckons the studios account for less than 10% of their parent companies' profits today, and by 2020 their share will decline to only around 5%. That is because the "big six" studios (the other is Sony Pictures, owned by the eponymous electronics maker) are growing more slowly than TV. In 2012 Time Warner grossed $12 billion from film, up 20% from 2002. That compares with a more than 84% rise in the company's TV-network revenues during the period, to $14.2 billion.

Film and TV are very different businesses, though studios like Warner Bros and Fox do both. TV is relatively stable and currently lucrative. TV networks earn money from advertising and from the fees that cable and satellite operators pay to carry their programmes. These fees amount to some $32 billion a year in America, and are growing by about 7% annually. People love watching TV, and, per hour, it is one of the cheapest forms of entertainment.

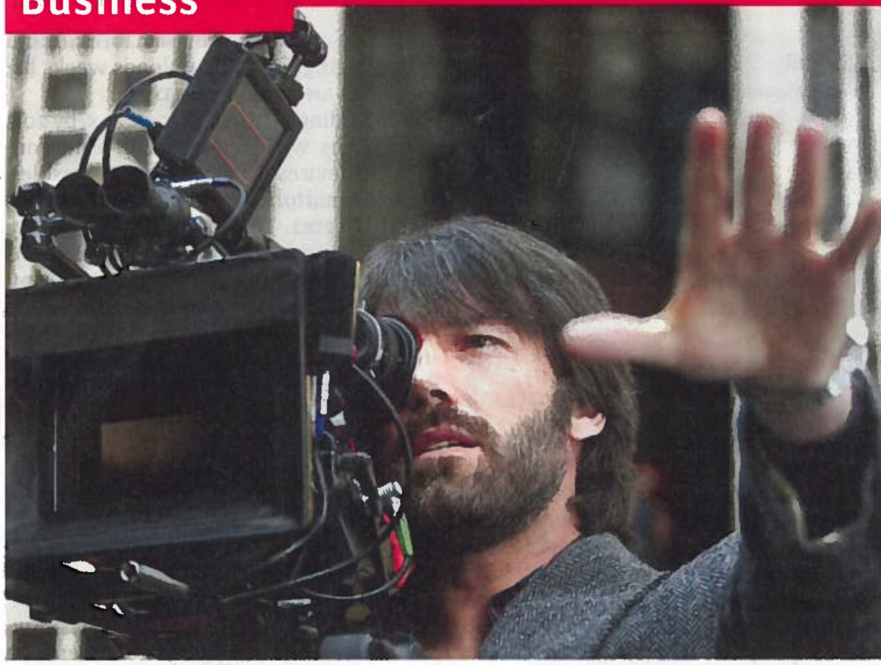
In contrast, film revenues are volatile. Attendance swings like the moods of Claire Danes's bipolar character, Carrie Mathison, in the TV show "Homeland". In 2011 American cinemas sold 1.28 billion tickets, the smallest number since 1995. Last year, ticket sales rose back to 1.36 billion and box-office revenues to a record $10.8 billion, thanks to blockbusters like "The Avengers". But film-going in America is not a growth business, especially now that people have so many media to distract them at home. The share of Americans who attend a cinema at least once a month declined from 30% in 2000 to 10% in 2011. Analysts expect revenue from American cinemas to be flat for the foreseeable future. Even people in Hollywood admit that America is a "mature" film market. That is no compliment in a town where ageing puts you out of work.

Hollywood's movie studios are confronting three long-term problems: less lucrative home-entertainment divisions, the rising cost of making films and the terms they get in fast-growing new markets.

Although a movie's box-office performance is usually what catches headlines, a studio depends on how that film performs later, when it is sold or rented to customers to watch at home. DVD sales peaked in 2004. Since then the sale of movies as VHS tapes, DVDs and Blu-ray discs (ie not downloads) has fallen around 36%, according to IHS Screen Digest. Rental kiosks, like Redbox, which offer cheap disc rentals, and video-streaming services, like Netflix, have exploded in popularity, but are not as lucrative as outright sales. "People are still watching the same amount of movies that they did a few years ago," says Todd Juenger of Sanford C. Bernstein, a research firm. "They're just spending $6 billion less a year to do it."

Blockbusted?

Meanwhile, costs are rising. Everyone had expected technology to make it cheaper to produce films, but the opposite has happened, says Michael Lynton, the boss of Sony Pictures. A move from analogue to digital film enabled perfectionist directors to shoot more takes and touch them up afterward, using up expensive production and editing time. Studios have also started ▸▸



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to make more "tent pole" films: big releases that can support the bottom line like a pole holds up a tent. These typically rely on expensive special effects, rather than compelling scripts, to attract a global audience. They often cost $200m to make and another $50m-100m to market.

When costly movies flop, the losses are scary. Disney took a $160m write-off after the failure of a single one, "John Carter", a confusing space adventure. Studios used to be able to sell tickets and DVDs even for duds. Now social networks and fan sites ensure that bad reviews spread quickly, sinking a film's reputation faster than a director can shout "cut".

Hollywood executives have been trying to roll out the red carpet to emerging markets, where more middle-class moviegoers are being minted every day. One boss of a film-production company calls the international box office "the lifeboat on the Titanic". Box-office revenues outside America are growing two and a half times as fast as they are domestically. China, the heartthrob of every studio executive, has overtaken Japan to become the world's second-largest movie market. Studios' business in China is "twice the size of what it was a year or two ago", says Mr Lynton of Sony Pictures.

But even though studios are selling more tickets in emerging markets like Russia and China, they are taking home less money for their hits. In America the big studios keep around half of box-office receipts. In China Hollywood studios keep only a quarter. Moreover, no more than 34 foreign films may be released in China each year. (Last year, the big six studios released 134 films in total.) These countries also generate puny home-entertainment revenues, and this will not change for years. To compete with pirates in Russia one studio starts selling DVDs only a month after a movie's release.

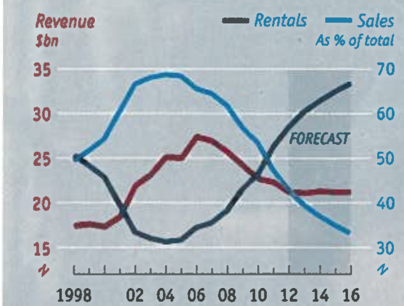
The hunger games

Squeezed between rising costs and falling revenues, the big studios have responded by trying to make more films they think will be hits: usually sequels, prequels, or anything featuring characters with name recognition. But, as William Goldman, a script writer, once wrote, "nobody knows anything"—ie, hits can't be predicted. Independent filmmakers can still make money on surprise hits but these have limited markets abroad: American dramas and comedies tend not to perform as well overseas as cartoon and action flicks.

Between 2006 and 2012, the six big studios also cut the number of films they made by 14-54%, according to Nomura. And they started to pay actors and directors far less. Several years ago a big-name actor might receive $20m for a film, and be offered three every 18 months. Today he or she might receive $10m, and get cast in only

Skyfall

America's spending on home video entertainment



Source: Morgan Stanley

one every 18 months. Some studios have also started to use first-time directors, because they cost less and it is easier to control their expenses. Talent agencies have felt the pain. Two big ones, William Morris and Endeavor, merged in 2009. "It's taken time for people to understand that there's less to go around," says Brad Grey, the boss of Paramount. "Not only can we not pay the same amount to all the players, we can't do the same number of projects."

Television has taken up some of the slack. Budgets for the flashiest shows have risen: some episodes now cost $5m-6m an hour. That is much less than a feature film, but double the cost of many network shows. Scenes in HBO's "Boardwalk Empire" and "Game of Thrones" are as spectacular as any movie. Film stars like Dustin Hoffman and Jeff Daniels have gone over to TV because networks are throwing money at shows and giving actors and directors more creative licence. The difference in quality between television and film is much smaller than it used to be.

Executives have changed their tune about whether the digital companies that have muscled into Hollywood, such as Netflix, are demons or diamond-mines. "Netflix has been the best thing to happen to Hollywood in a long time," says Chris Silbermann of ICM Partners, a talent agency. That is because it and other streaming services, such as Amazon's Prime, are paying billions for the right to stream studios' content to subscribers online. They are competing for rights with premium-cable channels, such as HBO and Showtime; this is probably pushing up prices. Netflix spent an estimated $4.8 billion buying streaming content in 2011-12. Studio bosses hope these services will expand globally.

But Netflix and other firms are changing the home-entertainment business profoundly—and studios are scrambling to keep up. Last year was the first in years that home-entertainment revenues did not decline (they were about flat, see chart). Now studios want to increase them. Their best bet is to beef up digital sales, which offer fat margins. Several are experimenting with "windowing" (making films available for a certain time in each format), and are releasing digital downloads weeks before films are available on DVD.

According to Mike Dunn of Fox, by 2015 Americans will have 861m internet-connected devices, such as games consoles, tablets, smartphones and laptops, up from 560m in 2012. That translates into every American owning 2.7 devices. Studios think they can make owning movies attractive again, if it is easier to watch them on all these gadgets. The big studios (with the exception of Disney) have got together for an initiative called "UltraViolet", which allows people to store the rights to watch movies they buy in the cloud. But even boosters of the plan admit consumer behaviour has changed. In the future, more people may prefer to rent, not buy.

So some want studios to go further and get rid of the theatrical window (when films are exclusively in cinemas) altogether. The idea is to let consumers watch movies at home for a higher price rather than trek to the cinema. Predictably, cinemas are not enthusiastic. Nor are most studios. "Movies are just too expensive for us to collapse the windows and effectively eliminate a separate source of revenue," says Alan Horn, the head of Disney's studio.

But some are flirting with it. Last year Lionsgate, an independent studio and distribution company, made "Arbitrage", a thriller about a fiendish financier, available in theatres and on "video-on-demand" at the same time. Michael Burns, Lionsgate's chairman, reckons it earned three times as much as it would have done otherwise, because it "found two different audiences". But if one big studio did this, cinemas could fight back and refuse to show that studio's movies. Few want to risk it. Poverty is awful. Have you seen "Les Misérables"? ■

You want me to work as a...film executive?