THE BUSINESS OF SELLING MOVIES

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Once a movie is produced, it's all about getting as many eyeballs as possible to see it, as they say in the industry. But the competition is steep given the available entertainment options for consumers: Video games. Television. Home video. Music. Sports. In this sequel to "The Business of Making Movies" in the February issue of *Strategic Finance*, we'll present our research (which included data on more than 2,000 movies) on the key success factors that lead to box-office success. Now on with the show.

MARKETING AND DISTRIBUTION

The term "distribution" often covers both the marketing and placement of movies in theaters and, ultimately, other markets, such as DVD, video-on-demand (VOD), and television. For major studio movies, both the production and marketing budgets are committed simultaneously. While a studio makes the movie, its marketing division is developing a comprehensive marketing and distribution plan for the film.

Marketing

Many people now consider marketing to be the key factor that leads to box-office success. Over time, marketing costs have been escalating. An average amount for a Motion Picture Association of America (MPAA) film in 2006 was $34.5 million compared to $25 million in 1999, an increase of almost 40% in seven years.

A movie's marketing budget often reaches as high as 50% of its total negative cost (production cost) for blockbuster films (the ones that studios are betting will be their financial salvation for any bad decisions they made over the course of a year). Research from Harvard Business School shows a studio spends 90% of a film's marketing budget before the movie reaches theaters. While the marketing budget for each film is thought to be fixed, there's some discretion to increase it if the movie is faring well. According to an interview with William Murray, former executive vice president of the MPAA, television,

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print, radio, and outdoor billboards account for approximately 75% of the total marketing budget, with the lion's share (typically 40% or more) going to marketing on television. The remaining budget pays for trailers, posters, pre-release behind-the-scenes documentaries about the film, appearances, and, in general, attempts to develop a buzz about the film before the studio releases it.

Studios also use viral marketing techniques to promote their products, typically employing e-mail and other electronic media campaigns to encourage people to pass along messages about a new movie.

One of the best-known examples of viral marketing involved the 1999 release of *The Blair Witch Project*, an independent film that cost $60,000 to produce and that aired at the Sundance Film Festival. Artisan Entertainment purchased the rights to the film for $1 million, spent $20 million on a marketing campaign, and distributed the film. Launched on the Internet, the campaign suggested that the film was a real documentary about three students who disappeared in the secluded woods of Maryland. The movie went on to gross $249 million worldwide at the box office.

Licensing is another critical part of marketing. One of the best examples is the 10-year relationship between McDonald's and the Walt Disney Company. Said to be a $1 billion deal, McDonald's paid Disney $100 million a year and did 11 promotions of Disney films that included *Finding Nemo*, *The Incredibles*, *Cars*, and *Pirates of the Caribbean: Dead Man's Chest*. The deal ended when Disney decided to distance itself from the fast-food franchise.

Distribution

Regardless of its quality, a film will never see the light of day without a distributor. An independent company or a subsidiary of a major studio distributes the film by acting as a negotiator between the film-production company and theater owners, who are known as film exhibitors. A studio's distribution division distributes most major films, while a smaller proportion of films is distributed by independent distributors, such as Artisan's *The Blair Witch Project*. Distributors design and implement the marketing campaigns for the channels and territories in which they have distribution rights.

A distributor has a number of responsibilities. First, it must secure interest in its films by hosting industry screenings for exhibitors. Second, it contracts with exhibitors on the profit split for each party, which is based on a percentage of gross revenues after deducting the theater's overhead, known as the house nut. Third, it must determine the production company's share of the revenues and, if necessary, conduct an audit of the exhibitor's ticket receipts. The proceeds are then transferred to the production company. Finally, the distributor ensures that the studio provides the requisite number of film prints to the exhibitors for opening day. Then it monitors that contracted theaters are showing the films since they have guaranteed a certain number of seats, show times, etc. It's easy to see why all the major studios

Table 1: THE LARGEST THEATER CHAINS

THEATER	HEADQUARTERS	SCREENS	THEATERS
Regal Entertainment Group	Knoxville, Tenn.	6,403	539
AMC	Kansas City, Mo.	5,340	382
Cinemark Theatres	Plano, Texas	4,516	398
Carmike Cinemas	Columbus, Ga.	2,447	289
National Amusements	Dedham, Mass.	1,500	124

have distribution arms and how difficult it is to distribute a film without a distribution company.

Part of the distribution process also involves the MPAA movie rating. Industry analysts believe that different ratings have different revenue potential, a claim that has been examined in prior research. For instance, producers try to obtain the lowest rating they can since an R rating or above will limit the audience. On average, a movie rated R is estimated to make about 12% less revenue than it would if it had a lower rating.

Exhibition

Typically, a standard contract between the distributor and exhibitor specifies the general conditions that apply to all individual contracts. These terms include the profit-sharing rules and length of time the movie will be in the theater. Currently, movies run from four to eight weeks, but that can change based on how well a movie is performing. In these situations, holdover clauses allow the movie to run longer than the standard time.

A number of deals can be made between a distributor and an exhibitor. The type depends on each movie's perceived revenue potential and the relative bargaining power of the parties (e.g., a major studio vs. a small independent producer). The deal will also depend on the number of days the movie runs, when it opens, and many other factors.

There are two general types of deals. In the first, both distributor and exhibitor take a fixed percentage throughout the film's theatrical run. But most contracts involve a sliding-scale percentage of gross box-office receipts and have many variations, with the distributor getting the larger of two possible payments that change as the weeks go on. For example, consider the 90/10 deal. In the first week of a movie's run, the distributor will take the larger of two possible payments: 90% of ticket revenue after the exhibitor has deducted its overhead (the house nut) or a floor payment, which is a percentage of the box office (say 70%) *before* the exhibitor has taken out the house nut. As the weeks go on, the floor-payment percentage decreases, but the overhead doesn't. At first glance, it might seem that the distributor has the better deal, but the exhibitor usually inflates overhead, and, most important, the distributor doesn't share at all in concession revenue.

So how profitable are concessions for the exhibitor? Analysts say there's an 85% gross margin on concessions in theaters. While concessions are approximately 20% of revenues, they account for about 46% of profits. Theaters depend enormously on their concessions, and some have quipped that a theater is actually a restaurant that happens to show movies. Now you know why a bag of popcorn costs $4.50 and a soft drink $5.

The five largest exhibitors are major theater chains, all of whom own many theaters and screens. They include Regal Entertainment Group; AMC, which recently bought Loews Cineplex Entertainment; Cinemark Theatres; Carmike Cinemas; and National Amusements (see Table 1). Across the top-five chains, the average number of screens per theater is just under 12. The advantage of these large chains is they can show many copies of the same movie simultaneously. *Spiderman 3* holds the record for the widest opening of a film, filling 4,253 screens across the nation.

Today, the two most pressing issues for exhibitors are the pressure to install digital technology in their theaters and the pressure to provide a better movie-viewing experience for customers.

Digital cinema has a number of advantages for distributors since movies can be shown in theaters via DVD-like format, satellite, or hard drives. And distributors can save a lot of money on film since a single print can cost upward of $1,000. Thus, if a movie opens wide at 3,500 theaters, the cost savings would be $3.5 million. Multiplying this by the number of movies a studio releases a year amounts to substantial savings over other formats.

Satellite transmission is probably the most efficient, but it's prohibitively expensive. Although exhibitors see the benefits, they have balked at the overall conversion of their theaters. Currently, the cost to convert a theater to accommodate digital technology is approximately $250,000. Another critical factor is the cost of owning digital technology equipment because of the high risk of obsolescence and projected maintenance costs. With existing technology there's little risk to exhibitors since current projection equipment has an expected life of about 20 years. At this point, a key issue is who will pay for the theaters to change their technology. While there was initial agreement that the studios and exhibitors would split the cost, that agreement is no longer in place because negotiations failed.

The second issue for exhibitors relates to concerns that the movie-going experience has been degrading over time, which in part led to a box-office slump over the past few years. Many customers said discourteous patrons, ringing cell phones, and dirty theaters kept them away, so exhibitors recently launched campaigns to control rude behavior and cleaned up their theaters. Apparently their efforts are paying off as a three-year ticket slump ended with theaters selling 1.45 billion tickets in 2006.

ILLUSTRATION: MARK BREWER/WWW.MARKBREWERSTUDIO.COM

During opening weekend, executives nervously wait for the box-office numbers.

Theatrical Release and the Box Office

In Hollywood, there's an obsession with a film's theatrical release and its opening weekend box-office performance. This box-office period is critical because the numbers from that three-day period establish most subsequent deals for DVD, international distribution, cable and satellite television, and free television. During opening weekend, executives nervously wait for the box-office numbers. On Saturday morning they obtain the numbers for opening day, and by late Sunday night they see the entire weekend's take. Yet while executives focus on opening weekend, even the global box office of the entire theatrical run accounts for only about 20% of the total revenues for a film released in today's environment. The other 80% of the revenues come from other forms of distribution, including DVDs, television, etc.

Success Factors

Because of all the concern about box-office revenues, as part of our research we conducted an empirical study to determine which factors seemed to be the best predictors of opening and cumulative box-office revenues (the entire box-office receipts over the entire domestic theatrical run) in the U.S.

We gathered production, marketing, and revenue data from 2,023 movies released between 1990 and 2006 that were listed by Boxofficeguru.com and the *Motion Picture Investor*. As an example of some data we were working with, and as a point of interest, Table 2 shows the Top-20 all-time highest-grossing box-office films worldwide and their associated production and marketing costs.

We also incorporated several control variables in our study that might affect movie revenues. These include measures of actor and director star power we obtained from such sources as Hollywood.com and The-Numbers.com, which gauge actor and director star power. Star power is measured by taking the average of the cumulative box-office receipts of the movies in which the star acted or directed. We also controlled for movie genre (it affects movie revenue) by obtaining data on genre from the Hollywood.com and IMDb.com databases.

There were other control variables, too. Prior research has documented that sequels also may affect movie revenues. Hollywood.com includes in its description whether a movie is a sequel. Further, we divided movies into those distributed by a major studio vs. those distributed by an independent distributor, and we controlled for the various types of ratings from G to R. Another factor, the season in which a studio releases a film, typically includes the following time periods: normal (January through April and September through October), summer (May through August), and holiday (November through December). Finally, the number of theaters showing a movie is expected to affect box-office receipts. Since we focused on cumulative box-office receipts, we used the largest number of theaters showing a movie during the movie's entire running period as a control variable.

Table 2: HIGHEST-GROSSING BOX-OFFICE MOVIES OF ALL TIME (in millions, rounded)*

RANK	MOVIE	STUDIO	PRODUCTION COST	MARKETING COST	DOMESTIC BOX OFFICE	WORLDWIDE BOX OFFICE
1	*Titanic* (1997)	Paramount	$200	$31	$601	$1,845
2	*The Lord of the Rings: The Return of the King* (2003)	New Line	$94	$51	$377	$1,119
3	*Pirates of the Caribbean: Dead Man's Chest* (2006)	Buena Vista	$225	$52	$423	$1,066
4	*Harry Potter and the Sorcerer's Stone* (2001)	Warner Brothers	$125	$44	$318	$977
5	*Pirates of the Caribbean: At World's End* (2007)	Buena Vista	$300	**	$309	$961
6	*Harry Potter and the Order of the Phoenix* (2007)	Warner Brothers	$150	**	$292	$939
7	*The Lord of the Rings: The Two Towers* (2002)	New Line	$94	$43	$342	$926
8	*Star Wars: Episode 1 – The Phantom Menace* (1999)	Fox	$115	**	$431	$924
9	*Shrek 2* (2004)	DreamWorks SKG	$70	$52	$441	$921
10	*Jurassic Park* (1993)	Universal	$63	$33	$357	$915
11	*Harry Potter and the Goblet of Fire* (2005)	Warner Brothers	$150	$59	$290	$892
12	*Spiderman 3* (2007)	Sony	$258	$120	$337	$891
13	*Harry Potter and the Chamber of Secrets* (2002)	Warner Brothers	$100	$46	$262	$877
14	*The Lord of the Rings: The Fellowship of the Ring* (2001)	New Line	$93	**	$315	$871
15	*Finding Nemo* (2003)	Buena Vista	$94	$46	$340	$865
16	*Star Wars: Episode 3 – Revenge of the Sith* (2005)	Fox	$113	$43	$380	$850
17	*Spiderman* (2002)	Sony	$139	$51.1	$404	$822
18	*Independence Day* (2002)	Fox	$75	$46	$306	$817
19	*Shrek the Third* (2007)	DreamWorks SKG	$160	**	$323	$798
20	*Harry Potter and the Prisoner of Azkaban* (2004)	Warner Brothers	$130	$49	$250	$790

*All data come from Boxofficemojo.com.

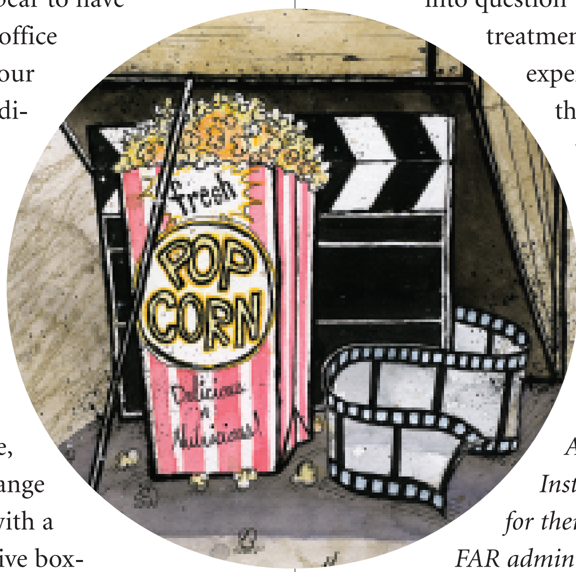
**Unavailable—Some movie marketing costs are guarded very carefully and not reported publicly.

After controlling for all these factors, we ran regressions and obtained the following results. We expected that star-studded and hi-tech (action with special effects) movies would have higher production costs than other types of motion pictures. Moreover, common wisdom in the industry suggested that sequels are costly to produce because expectations among moviegoers are higher. Finally, motion pictures can be distributed by three entities: major studios, independent producers (Indies), or distributors. Major studios often only finance those motion pictures that have large commercial potential, and, with this expectation, they're willing to heavily invest in those movies.

Our results support these expectations. We found that both acting and directing star power have significant positive effects on production costs. We also found hi-tech motion pictures and sequels have higher production costs than those that aren't hi-tech or sequels, and those that independent studios finance have lower production costs than those that major studios finance.

As for the determinants of marketing costs, we expected that production costs would, in turn, have a significant positive effect on marketing costs. Our results indeed indicate that the sheer size of production costs positively affects marketing costs where production costs account for 47% of the variation in marketing costs on average. We also expected that, similar to production costs, a movie's quality would drive marketing costs. Through marketing, for example, the studio can capitalize on the star as an input. And we found that movie features had similar effects on marketing costs; that is, sequels, motion pictures with big star power, those in the hi-tech genre, and those distributed by major studios have higher marketing costs. In addition, studios spend more money on marketing non-R-rated motion pictures than R-rated motion pictures and more money on movies released in the summer than on those released in other seasons.

We also found that both production and marketing costs have a positive effect on cumulative box-office receipts, but marketing costs appear to have stronger positive effects on box-office revenues. Overall, the results of our cost-revenue association tests indicate that marketing costs are much more strongly associated with revenue streams throughout a motion picture's product life cycle. In our regressions, a 10% change in production cost is associated with roughly only a 2% change in cumulative box-office revenue, whereas the same percentage change in marketing cost is associated with a roughly 10% change in cumulative box-office revenue.



Thus, our findings show that star-laden motion pictures, sequels, and hi-tech motion pictures have high production costs. On the other hand, motion pictures financed by independent studios are less costly than major studio motion pictures, yet our results indicate that motion pictures released by major studios don't earn higher cumulative box-office receipts than those released by independent distributors.

Therefore, the success of a motion picture depends on many factors. First, the movie has to be well made and appeal to a wide audience. Second, there must be a clear marketing plan and a distribution deal with exhibitors. Third, our research shows that the more money spent on marketing the better, as this will lead to greater returns at the box office.

ACCOUNTING IMPLICATIONS

Finally, we believe our study also has implications for accounting practices and regulations in the motion picture industry. The American Institute of Certified Public Accountants' (AICPA) Statement of Position (SOP) No. 00-2, "Accounting by Producers or Distributors of Films," requires capitalization of production costs of released movies and subsequent amortization for up to 10 years. On the other hand, SOP No. 00-2 requires immediate expensing of marketing costs even before studios release movies. Yet our results show that not only do production and marketing costs have positive effects on movie revenues, but the effect of marketing costs is larger than that of production costs for both opening box office and, particularly, cumulative box-office revenues. As such, from a matching-principle perspective, our findings call into question the rationale for the differential treatment of marketing costs—that is, expensing rather than capitalizing. To this end, we hope our results provide evidence that will further the debate in the movie industry much like that regarding the accounting treatment of research and development investments. ■

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