



ARTICLE

The Economics of Film

Changing dynamics and the COVID-19 world

In March 2020, the COVID-19 pandemic disrupted the feature film industry at every level, bringing content production to a standstill and cancelling cinema premieres. Worldwide, cinemas were shuttered and in turn, film goers forced to stay at home, eyeing old and new televisual content to fill the entertainment void.

In the intervening time, the major studios, led by Universal, began to explore ways of reaching their audiences through direct and digital alternatives. Without out-of-home entertainment (except drive-in cinemas), the shuttered cinemas closed off a significant distribution and income avenue for the studios. Moreover, the major studios with their newly created digital streaming platforms – Peacock, Disney+ and Warner’s HBO Max – were poised and equipped to offer an alternative. And, they did.

This article considers three critical areas for the film industry: (1) the current economics of film production and the significance of cinema theatre contribution within the film supply chain; (2) historical worldwide box office returns generated through the cinema distribution window and how that compares to the potential income from premium video-on-demand (“PVoD”) platforms; and (3) the level of marketing spend underpinning theatrical releases and the impact under a direct-to-consumer model.

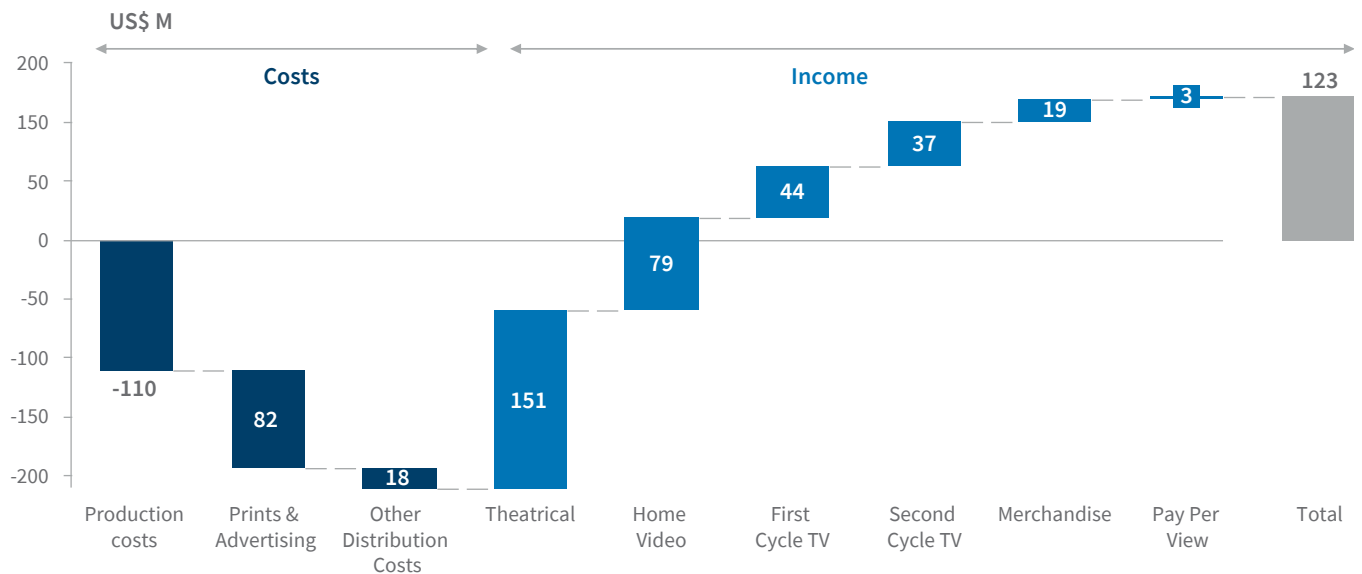
(1) The Economics of Film

Traditional economics of film – flow of money

Film studios are all too aware of how important theatrical cinema release is to generating income and contributing to the profitability of creating, producing, marketing and distributing a film.

Chart 1 (below) shows the costs and revenue associated with a big budget film. Studios receive on average 40% – 50% of the total film revenues from the theatrical cinema window, by a long chalk the largest and most significant contributor to income. The remaining percentages of income generated downstream are across several categories of revenues, including: (i) first and second cycle TV, (ii) home video, (iii) merchandise, and (iv) on demand, pay-per-view.

CHART 1: AVERAGE ESTIMATED REVENUE (LIGHT BLUE) AND COSTS (DARK BLUE) OF FILMS RELEASED BETWEEN 2016-19 WITH PRODUCTION BUDGETS GREATER THAN US\$70M (N:74)



Source(s): SNL Kagan, FTI Consulting Analysis

(2) PVoD vs Theatrical Returns

During the early stages of the COVID-19 lockdown, many studios started to defer their film releases, especially tentpole (major blockbuster) films that were scheduled for release across the summer 2020, to the autumn (for example, the highly anticipated *Tenet* from the acclaimed film director Christopher Nolan and Disney’s remake of *Mulan*). As time went by, and with no signs of the pandemic abating, the studios moved many other films (*Top Gun: Maverick*; *WonderWoman 1984*) off the 2020 schedule to 2021.

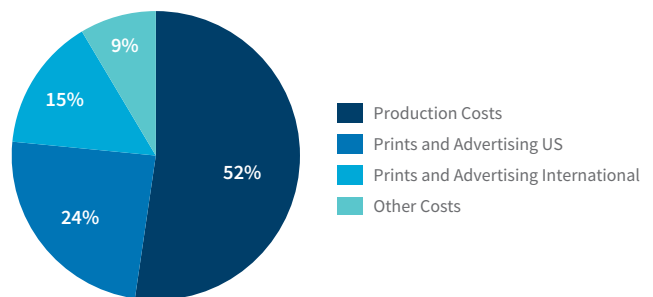
Others have sold/released their films via subscription-based streaming platforms (for example *The King of Staten Island*, *The One and Only Ivan*, *Hamilton*). Several have taken a third route: releasing films via PVoD. Universal premiered the sequel *Trolls World Tour* and Warner added *Scoob!* to the PVoD platform (see the case study below).

An important aspect of PVoD distribution is that unlike theatrical cinema distribution, it provides direct access to and control of the eyeballs of the customer. As we can see in chart 2, over and above the production costs for making a film, which are not insignificant and typically amount to over 50% of the total costs, almost 40% of the total costs are incurred in the advertising and marketing of the film.

Can active promotion of future PVoD releases on the platforms itself lessen the external promotional and advertising spend (see chart 2)? It remains untested. The two major films released to streaming this year, *Trolls World Tour* and *Mulan* benefitted from fully budgeted,

cinema style release marketing campaigns, and the campaign to launch *Mulan* started in July 2019 with the built-in assumption for a theatrical release.

CHART 2: COSTS OF MAKING AND PROMOTING A FILM RELEASED BETWEEN 2016-19 WITH PRODUCTION BUDGETS GREATER THAN US\$70M (N:74)



Source: SNL Kagan, FTI Consulting Analysis

The COVID-19 Impact

Studios, cinema owners and filmmakers now find themselves in a dilemma: wanting to leverage the legacy distribution route for films through the theatrical windows and overcome the spectre of the COVID-19 pandemic. However, as COVID-19 cases rise, studios are getting nervous. Cities that had lifted lockdown rules roll back their openings, studios are faced with no guaranteed income and increasing marketing costs, as their films are delayed (Disney is cited to have spent US\$120 - \$140 million on marketing *Mulan* before release).

For major tentpole releases the studios would expect: (i) at least 80% capacity, and (ii) all cinemas open in the major conurbation areas. As reported in the Financial Times, a

senior executive at IMAX stated, "... unless both California and New York City cinemas are open, the studios are not going to release their blockbusters."

One can see the reluctance of studios to spend a not insignificant amount of money to release the film against a backdrop of low consumer sentiment and unwillingness to return to the cinemas. Even with circa 40% of the cinemas open worldwide, as reported by the film magazine *Screen Dollars*¹, the major studios still have been and remain unwilling to release the films in the foreseeable future either domestically or worldwide.

Studio executives have been looking at results of the cinema re-openings to gauge consumer sentiment and income potential. A Korean-language film, *Peninsula* debuted in South Korea on 15 July and made US\$20 million in the box office. *Little Women* was released in Denmark soon after the lockdown, six months after it was rolled out in the rest of the world, and was also showing promising numbers. A senior executive for a European cinema chain is cited² as saying "... [*Little Women*] showed incredible pent-up demand for new films. At 50% capacity restrictions, it was tracking 90% of three-year pre-COVID-19 average levels."

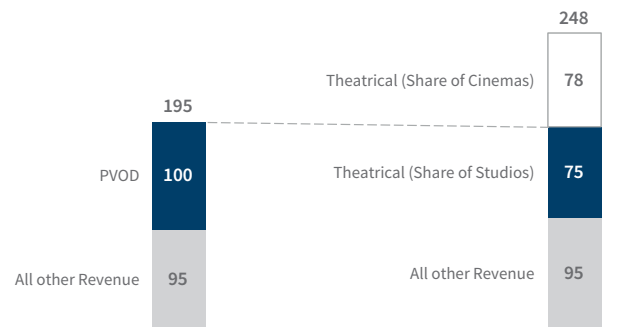
Notwithstanding these examples as encouraging, if only limited, they have proven simply not enough for the cinema executives and distributors to assuage film executives to release tentpole films across the summer and rest of the film release calendar year.

The theatrical release window of 75 days has been under debate for some years, and 'day and date release' of films has been a key strategy for studios as subscription video-on-demand ("SVoD") platforms increase in importance as an avenue to reach audiences. The COVID-19 situation and lockdown has put studios under greater pressure to consider 'day and date' release - for example, the Universal and AMC deal, has moved to compress the release window to 17 days.

Although these changes in film release strategies are precipitated by the COVID-19 crisis and the consequential financial burden on studios, in the short term, we see 'day and date' releases and SVoD/PVoD playing a greater role in studios' release strategies for film distribution and hastening a structural change in the industry in the medium to long term.

Case Study: Trolls franchise

CHART 3: FTI CONSULTING FULL-RUN REVENUE ESTIMATES OF TROLLS WORLD TOUR (2019) DISTRIBUTED ON PVoD (LEFT) AND FTI CONSULTING FULL-RUN REVENUE ESTIMATES OF TROLLS (2016) DISTRIBUTED IN CINEMAS (RIGHT) (US\$M)



(1) Note: Film revenue estimates are based on a publicly disclosed PVoD and Box Office revenues and revenue ratios estimated by SNL Kagan
Source(s): SNL Kagan, Box Office Mojo, FTI Consulting Analysis

In the first three weeks of release on Universal's Peacock platform (in addition to Amazon, Apple and other SVoD platforms), Universal's film *Trolls World Tour* reached circa US\$100 million in revenue from streaming platforms (which equates to US\$80 million Universal assuming 80/20 revenue split). *Trolls World Tour's* PVoD release benefited from the traditional pre-theatrical release marketing campaign (through Universal's vertically integrated Symphony advertising platform) and achieved higher revenues for the studio than the estimated revenue for the first instalment of the franchise (see chart 3 above). Headlines captured in April shows Universal reporting a "...record digital weekend; 10x higher than *Jurassic World: Fallen Kingdom* opening day³."

Universal released *Trolls World Tour* on digital platforms in April at a price of US\$19.99 for a 48-hour rental. The film turned out to be a digital blockbuster, earning more in its first three weeks of digital release than its 2016 predecessor, *Trolls*, made domestically during five months in the cinema theatres (see chart 3 above). With consumer behaviour patterns not yet established, assuming no impact on the downstream revenues (other SVoD windows, TV etc).

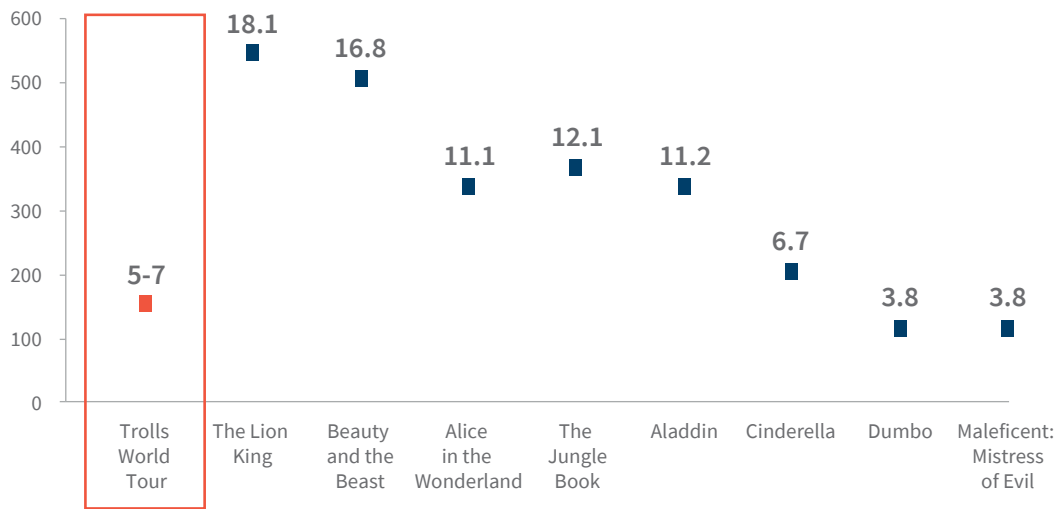
In May of this year, Warner Brothers released *Scoob!* on VoD platforms and found similar success. In July, following its second quarter earnings results, Disney announced *Mulan* was going to be aired on Disney+ and not released in the US cinemas on the 2020 film schedule.

¹ Screen Dollars newsletter, August 2020

² FT.com : July 24, 2020

³ Ibid

CHART 4. NUMBER (IN MILLIONS) OF PVoD TRANSACTIONS (@ US\$30) REQUIRED TO MATCH ECONOMICS OF DISNEY LIVE ACTION REMAKES. LEFT AXIS – HISTORICAL BOX OFFICE REVENUE (BOX OFFICE US\$M)



Source(s): Box Office Mojo, FT.com, FTI Consulting Analysis

Case Study: Mulan

How many people have to watch *Mulan* via Disney+ for the company to make as much as it would have releasing it in cinemas?

Disney is debuting a US\$200 million production budget film on its proprietary, PVoD service in September. Considering the actual performance of *Trolls World Tour* on SVoD platforms that reached five million transactions after 19 days of release. *Mulan*, on Disney+ (60 million subscribers⁴), could potentially match revenue benchmarks set by historical live action remakes released in theatres, which equates to 8% penetration of the existing Disney+ subscriber base.

Chart 4 above looks at the US box office performance of recent Disney live action remakes. It compares it to the data received on *Trolls World Tour* and the number of rental purchases required to match the economics to Disney putting their tentpole films on PVoD platforms. This reveals possibly not such an unachievable milestone, after all.

The rental offer (US\$29.99) for *Mulan* on release date is available to existing subscribers of Disney+ (paying US\$6 per month). *Mulan* will be released on the Disney+ platform only, and in cinemas only where Disney+ is not currently operating.

At US\$29.99 on Disney+, it would take about five million transactions to generate US\$150 million in revenue (assuming all transactions take place on Disney+) which is roughly equal to US\$300 million at the domestic US

box office – about average for recent live-action Disney remakes – where ticket sales are split roughly in half between studios and cinemas.

If *Mulan* followed a traditional rollout in US cinema theatres, it would be expected to attract a fair number of families – meaning parents taking children to the theatres, paying an average US\$9 a ticket, plus popcorn, drinks and parking.

Compared with that outlay, US\$30 could represent a bargain. Eventually the film is expected to become available to all Disney+ users as part of their normal subscription (US\$6 per month), which could look like an even better bargain for the families willing to wait.

(3) Marketing Spend

Chart 2 shows the substantial levels of P&A spend studios budget to promote their films – enticing film viewers to go to the cinema and to buy studios’ merchandise (mugs, caps, DVDs etc). In an era of streaming VoD, will the marketing spend shift to more targeted campaigns to attract VoD subscribers or will this remain a separate budget, and will studios continue to support the promotion of films through cinematic theatre releases? Will the overall budgets shrink? *Trolls World Tour* benefitted from fully budgeted, cinema-style release marketing campaigns, and the campaign to launch *Mulan* started in July 2019 with the built-in assumption for a theatrical release.

⁴ Disney quarterly results, company investors website, July 2020

We think studios will likely continue to use traditional methods of promotion in the short to medium term, as films are released under a hybrid distribution strategy of streaming/VoD and through cinema theatres. Where studios are likely to focus their attention is in the opportunity to optimise the P&A spend (budget allocation, targeting and audience reach, etc). Where the economics of film income starts to shift, as studios move towards 80%/20% (studio/SVoD) revenue model, the financial break-even point changes and there may be more leverage to optimise the marketing budget.

Summary

All eyeballs are directed towards Disney and how *Mulan* will play out: (i) how quickly it will replicate theatrical cinema revenues and recoup costs, (ii) how successful it will be at acquiring new subscribers to their proprietary platform, and (iii) how they plan to work with cinemas going forward.

These newly established digital film-viewing trends – and the success stories – have raised new questions around film releases, particularly with studios experimenting with releasing films exclusively to particular direct-to-consumer streaming services. Will PVoD become a viable alternative release method for all or just some cinematic productions? So far, Universal has shown they can replicate and improve on the revenues generated through cinema release, on their PVoD platforms.

These digital successes are likely to encourage studios to consider doing more digital releases in the future. However, it is unclear how that decision will affect the studio's relationship with cinema theatre owners. What is going to happen to Bond's new film, *No Time To Die*? When and where will it be released and more importantly, via which distribution mode – traditional cinema or PVoD? Is there a balance to be struck that supports cinema owners

and studios? Will PVoD have long-term consequences for the economics of film production? Will the AMC and Universal deal set a precedent for the industry – narrowing the cinema release window from 75 days to 17 days, equivalent to three weekends? We suspect a hybrid model will evolve: a combination of film releases in shorter cinema windows and across digital platforms.

One of the major incentives for the studios to continue to test the PVoD platform digital alternative to cinema distribution is potentially the studios' ability to focus and optimise the cost of promotion and advertising spend. An important aspect of PVoD distribution is that, unlike theatrical distribution, it provides direct access to and control of the eyeballs of the customer. The question studios with their own streaming proposition should be asking is: can active promotion of future PVoD releases on the platform itself significantly lessen external P&A spend?

Against the backdrop of a continuing pandemic, cinemas worldwide are trying to open without tentpole films and working from back catalogues (overall 47% are open in non-US territories), with the USA cinemas remaining mostly shuttered (22% open). The entire film trade watches with intrigue and in suspense as to the outcome and future of the film industry. Warner released *Tenet* at the end of August in 41 international markets with promising results, grossing US\$53 million in one weekend⁵. There is as much suspense off screen as on screen, with the US studios now looking towards Labor Day (in September) as a milestone for releasing major action and family tentpole films, including *Mulan*.

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MAUREEN KERR

Managing Director
+44 (0) 20 3727 1354
maureen.kerr@fticonsulting.com



DENIS CYBA

Senior Consultant
+44 (0) 20 3319 5562
denis.cyba@fticonsulting.com



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