

SLOW AND CAUTIOUS 1

In a time of economic crisis, particularly for the automobile industry, the film industry observer can only be amused by the fact that Fast and Furious 4, a film about high-powered cars, is quoted as a leading contributor to the upturn in cinema admissions.

According to figures supplied by the National Association of Theatre Owners (NATO), cinema attendances in the United States increased by 5.6% and box office receipts by 8.8% in the first quarter of 2009. As that organisation likes to point out, attendances rose in five of the last seven recessions experienced by the American economy. More than any other form of entertainment, and perhaps because the prices of cinema tickets have risen less rapidly than others, going to the cinema is said to be the best consolation for households in a period of crisis. The American film exhibitors are all the more optimistic as they believe that digital cinema and films in 3D are likely to attract new audiences. Though in dollar terms American and international box office receipts may have broken records in 2008, attendances in the United States actually fell by 2.6%, reaching their lowest level since 1997, whereas they remained stable in Europe. The growth of international box office receipts can be explained more by the weakness of the dollar than by a trend towards strong growth in admissions (which can be seen only in China and Russia).

We should therefore be wary of jumping to conclusions. The volatility of cinema attendances is such that underlying trends cannot be assessed over a period of just a few months. The good performance of the American cinema market in the last few months can be explained by strictly domestic reasons within the film industry, especially the fact that the distributors seem to have discovered the benefits of spreading release dates better throughout the year and that January and February are not necessarily slack months after the end-of-year peak. We do not yet have much European data for the first quarter of 2009 but it is interesting to note that, for example, the Kinopolis circuit, which has a presence in five countries, recorded a fall in cinema attendances of 17%. In France, the first-quarter drop was 15.2%. These two figures, which are of the same magnitude,

are clearly skewed by the exceptional character of the first quarter of 2008, which was marked by the success of *Bienvenue chez les Ch'tis* (*Welcome to the Sticks*). By contrast, in the United Kingdom, the first two months were better than in 2008, with attendances rising by 7.7% in January and 16.4% in February, thanks in particular to the success of *Slumdog Millionaire*.

In an industry like the cinema, the effects of the crisis are likely to be slow in making themselves felt. This is because, while attendances are rising, production has been hit head-on by the crisis. According to a Reuters article widely carried by the press, the hedge funds to which Hollywood has been turning since 2005 have virtually disappeared, while the amount they provided to help finance "slates" between 2005 and 2008 is estimated at 15 billion US dollars. Some investors that had banked on quick returns are said to have tried to sell off their positions in slate deals at discounts of 30 to 70% to specialised investors that are able to bear the risks over the long term. Most banks have also reduced their positions in film production and raised their interest rates. It is estimated that in 2009 the majors are likely to further reduce the number of releases, which already fell from 205 in 2006 to 162 in 2008. Wide releases for 2009 are estimated at 118 compared with 140 the previous year. The studios have also broken up their "mini-majors", thus making room for foreign productions, with European films like *Slumdog Millionaire* or *Taken* among the first to benefit. Most studios deny in public that there will be a reduction in the number of releases in 2010 and 2011 but, as *Variety* recently noted, "privately, most foresee a change".

What future for the home video market?

The optimism of those who claimed the film sector was recession proof must be qualified all

the more as the resources of this sector are not only based on box office receipts but also, to the tune of an estimated 40 to 50%, on home video receipts. However, the home video market is evolving.

The crisis on the DVD market is currently plain to see: in the United States, DVD sales fell from 24 billion US dollars in 2006 to 22 billion in 2008. Depending on the source, the decline in 2008 compared with 2007 was 8.4% (NATO), 9% (Digital Entertainment Group) or even 11% (Screen Digest). This recession has not been compensated for by sales of Blu-ray Discs, which rose from 270 million US dollars in 2007 to 750 million US dollars in 2008.

According to Screen Digest, the rapid rise of the Blu-ray Disc (BD) has only partially compensated for this decline: total sales in fact fell by 9%, compared with an 11% decline in DVD sales alone. The rental market was more resistant: it fell by just 0.3% (including BDs) and 2.6% (excluding BDs). In U.S., the stabilisation of the rental market is all the more surprising as it has occurred after six consecutive years of decline. The better performance of the rental market could be explained by the rise in the number of internet rental services offered by companies and by the success of rental vending machines. The number of subscribers to the Netflix service rose from 6.3 million in 2006 to 10 million at the beginning of 2009, while Redbox – which works in association with McDonald's and Wal-Mart – increased its network of kiosks from 2,300 in 2006 to 13,700 at the beginning of 2009 and is aiming to have 20,000 at the end of the year.

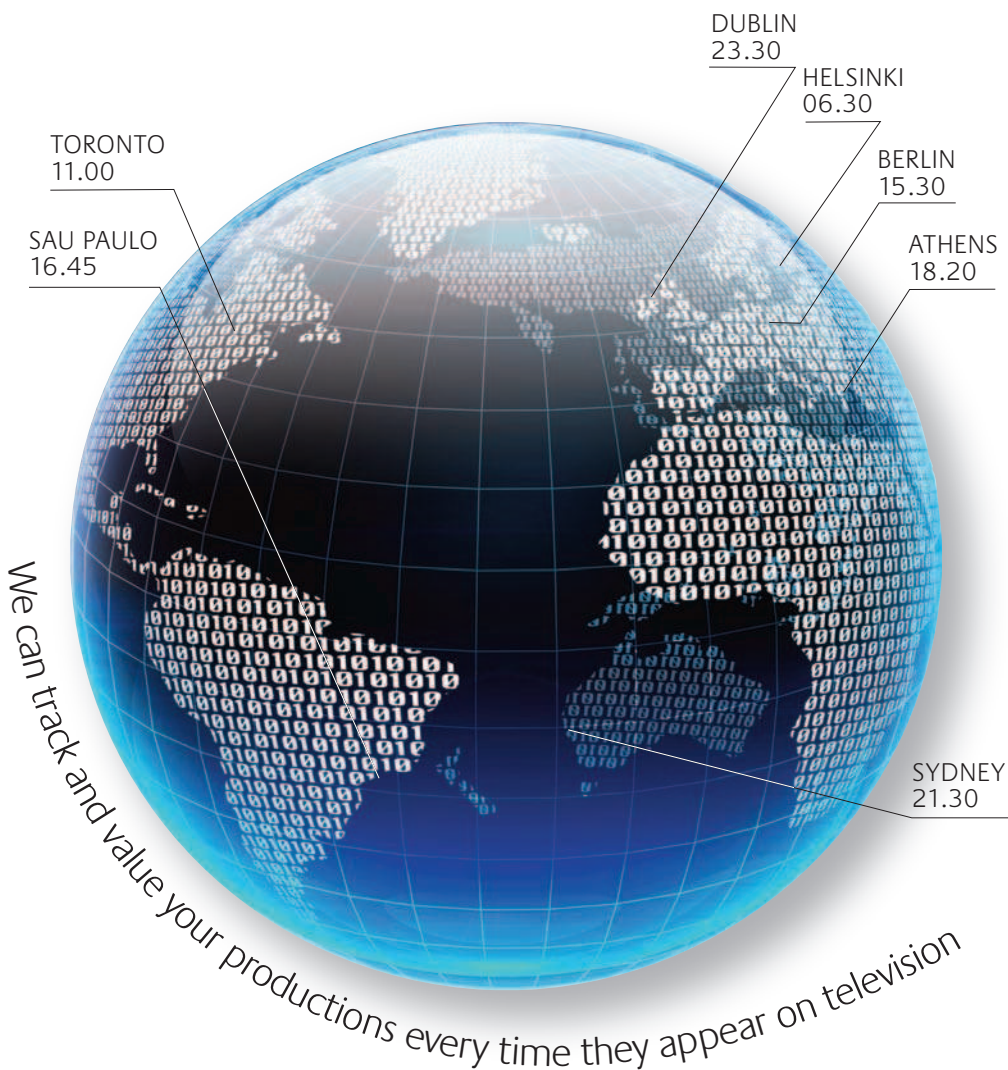
In Europe, the first national figures available show contrasting results. In the United Kingdom, according to the first BVA estimates, the number of DVDs sold rose by 1.9% in 2008 compared with 2007. However, owing to a drop in the average price, the value of the market went down by 2.5%. Sales of Blu-ray Discs were higher than anticipated (3.7 million). In France, sales recorded a decline for the fourth year running, with a fall in value of 7.5% to 1.38 billion euros and a fall in volume of 5.5%. This means that the market has lost nearly one-third, or 600 million euros, in four years. According to SEVN, this fall in value would have been higher (around 10%) without the first encouraging figures for sales of Blu-ray Discs, which quadrupled in 2008. In Germany, purchases of DVDs dropped by 5.4% in value and 1.9% in unit terms. The money spent

on Blu-ray Discs amounted to 43 million euros, thus reducing the decline in sales when all formats are taken together to 2.2%. In Italy, DVD sales dropped by 15.5% in value and 13.9% in volume.

According to Screen Digest, the stabilisation of the rental market in the U.S. does not seem to extend to other markets. The decline in DVD rentals in the Eurozone was 12% in euro terms and 6% in dollar terms and in the United Kingdom 9.5% in pounds sterling and 16.2% in dollars. In Japan, rentals increased by 13.8% in dollar terms but actually dropped slightly by 0.1% when calculated in yen. In Europe, internet rentals are already available but seem destined to remain more marginal than in the United States and distribution by rental vending machines is already a well-established feature. The development potential of rentals thus seems to be lower than in the United States, especially as the rental segment appears threatened by the slow but noticeable upsurge of VOD. Ultimately, the stabilisation of the rental market in the United States would be more an indicator of the fact that consumers have stopped building up their personal video libraries and are therefore ready for the dematerialised consumption represented by VOD.

Hardware manufacturers dominate the VOD market

It is still not easy to assess the development of the VOD market because almost no data are supplied by the service providers or collected by the national cinema agencies. According to Screen Digest, sales or rentals of films available as VOD constitute a market of 156 million US dollars in the United States and 38 million US dollars in Europe and are likely to be ten times higher in 2013. In Europe, the different types of player (telecommunications operators, cable operators, broadcasters, retailers, producers, film libraries, etc) invested money on this new market in 2007-2008. However, it is the IT and video games companies, such as Apple, Microsoft, Sony and Nintendo, that now seem best placed. According to Screen Digest, the Apple iTunes Stores, which offer a catalogue of 2,500 films, 600 of them in HD, in North America, the United Kingdom, Australia and New Zealand, are already the world leader for VOD devoted



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to the cinema. Film catalogues will probably be progressively introduced in iTunes Stores in other countries, as was demonstrated by the recent launch of a service in Germany. The producers of games consoles are also trying to move into film downloads. When connected to the internet, Microsoft's Xbox 360 or Sony's PlayStation 3 already offer catalogues of films. According to *Variety*, Sony has registered more than 380 million downloads (free and paid) through the online PlayStation Network service of its PS3 console. VOD, which is only available in the United States, is said to have earned the company around 180 million US dollars in one year. Microsoft has been offering a VOD service in Europe for the past eighteen months but the company does not provide any figures on download volumes. Nintendo is considering launching a service in Japan. In the United States, the iTunes Stores and Microsoft's Xbox service are said to account for 85% of all transactions, while in Europe, the two services are reported to have a 16% market share already, despite their very recent and still limited rollout, and will probably have 65% of the market from 2010. This domination by two players that are also manufacturers is already leading to some critical assessments: as their main objective is to sell their hardware, the two companies could afford to cut the prices of films at the expense of their competitors. Even if it is the leading model, operators appear to be disillusioned by iTunes Stores results. At the launch of its catalogue on the platform in September 2006, Disney announced target first-year revenues of 50 million US dollars. This implies, roughly speaking, a target of 25 million downloads at 1.99 US dollars. At the end of July 2008, Disney discreetly admitted that only 5 million films had been sold to date and VOD sales were qualified as "incremental". Over the last few months, Apple has been even more low-key in the publication of data on film downloads.

Speculation is rife among analysts and professionals as to the respective chances that the Blu-ray Disc and VOD in high definition have of winning the favour of consumers. Recent announcements such as an on-demand DVD manufacturing service proposed by Warner for its film library, film downloads to SD memory cards as announced by MOD Systems and Toshiba, or a new cable connecting iPods and HD TV sets announced by Apple, show that the challenges of distributing films through new digital technologies are greater than ever. In the absence of detailed data, the honest observer can only call for a little more transparency on the operators' part before offering an assessment. If that transparency is not assured, then the strategic choices, investments and development policies will remain risky. And those who defend unauthorised downloading will have a good hand when it comes to continuing to argue that the unwarranted profits earned by the industry justify their practice of free consumption – but that is another story...

The observer's watchword will therefore remain "slow and cautious", even if that does not provide a very attractive film title. Well, I was just pitching...

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on Markets and Financing
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