



## Coming Soon: A Theater Near You

By the late 1990s, American movies had achieved unprecedented popularity around the world. With over 200 new films released in 1995, film output from the major studios was the highest it had been in many years. Theater admissions in North America were down slightly from 1994, but gross revenue at the box office was at a record level. Even with the growth of video rentals and cable television subscriptions, movie theater owners were confident about the prospects for the industry. "There's a fundamental need for people to experience group entertainment outside their home," Barrie Loeks, co-chair of Sony Theatres, explained. She predicted that, as theater companies continued to replace their older facilities with new ones, "you're going to see attendance take off."<sup>1</sup> To accommodate this expected growth in demand, most of the major theater companies had announced expansion plans.<sup>2</sup>

Not all industry observers agreed that prosperity was certain, however. Two of the largest theater companies had experienced difficulty raising capital in recent years. Return on assets and return on sales for the major exhibitors in 1994 both averaged 1.3%. Furthermore, a number of trends promised to alter the economics of the industry. First, new theaters were frequently built in suburban locations rather than in the central districts of cities. Second, exhibitors frequently installed multiple screens at each new theater location—a practice called "multiplexing." Third, there had been consolidation in the exhibition industry that had resulted in the creation of a number of large firms. Finally, a wave of mergers between large exhibitors and movie studios had occurred during the late 1980s and early 1990s.

### Exhibition in the 1990s

Companies in motion-picture exhibition purchased rights to films from studios and sold tickets to the movie-going public (see Figure A). Important exhibitor activities included the projection of films, the tracking of attendance, the local advertising of schedules, and the negotiation of concession arrangements.

While the motion picture industry was growing impressively on an international scale, in North America the industry's performance was uneven. Theater attendance had increased somewhat

<sup>1</sup> Quoted in David Lieberman, "Theaters' Big Comeback," *USA Today*, March 23, 1995.

<sup>2</sup> See Martin Peers, "Easy Money Tempts Exhibs to Expand," *Variety*, June 5-11, 1995.

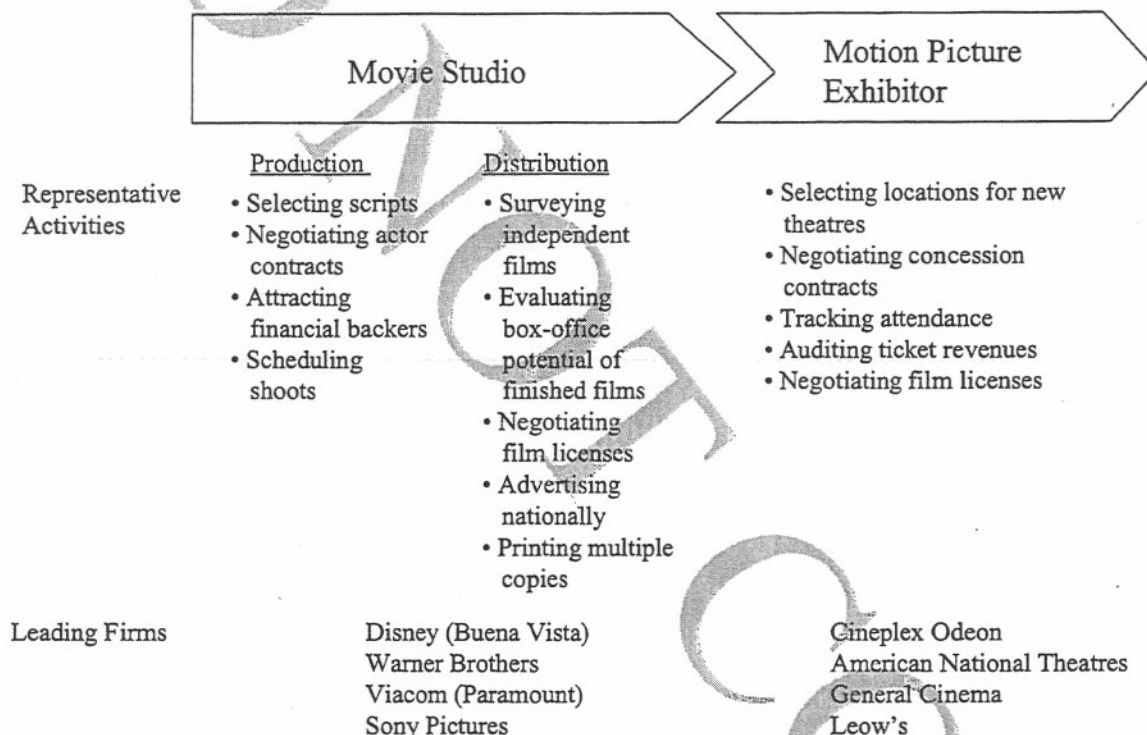
*Research Associate Geoffrey Verter and Associate Professor Anita M. McGahan prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.*

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from the mid-1980s to the mid-1990s, but year-to-year developments were erratic. At 1.26 billion, theater admissions in 1995 were down 2.5% from those in the previous year and virtually unchanged from the level in 1989. Box-office revenue, however, had grown consistently since 1991 to a record \$5.5 billion in 1995 (see Exhibit 1).

As theater admissions were flattening in the mid-1990s, studio output was increasing. The major studios alone distributed 212 new films in 1995, and most studios announced plans to increase production and distribution in 1996.<sup>3</sup> During the 1990s, the cost of making movies was escalating. Many releases failed to recoup their costs through exhibition at North American movie theaters. However, cable, video, and overseas distribution provided additional revenue to studios for finished films. By 1995, many of the major studios had merged into large, diversified corporations.

Figure A



## Moviegoers

Movie-theater attendance increased between the mid-1960s and the early 1980s partly because advances in theater-exhibition technology greatly enhanced the viewing experience. Even in peak years, however, admissions in the 1980s and 1990s were far below the levels of the 1940s and 1950s (Exhibit 2). There had been a sharp decline in attendance between the 1950s and 1960s as exhibitors faced strong competition from alternative forms of visual entertainment media, especially television. In 1995, movie exhibitors confronted new challenges from video rentals and cable TV.

Videocassette recorder (VCR) usage in American households had grown dramatically over the 1980s and 1990s. Between 1980 and 1995, the number of households with VCRs had grown from 1.9 million to 75.8 million, a growth rate of 28% a year. Nearly 80% of all households with televisions

<sup>3</sup> Tim Jones, "The Moguls' Lament: Too Many Films," *Chicago Tribune*, April 3, 1996.

also contained VCRs in 1995, up from 2.4% 15 years earlier. As VCR penetration grew, sales of prerecorded videocassettes grew as well. Sales to U.S. dealers rose from 3 million units in 1980 to 490 million in 1995—an annual growth rate of 45%. In the United States, video rentals in 1994 were estimated at \$9.4 billion and videocassette sales to households at \$5.0 billion.<sup>4</sup>

Cable television subscriptions were also growing rapidly in the United States. Between 1980 and 1995, the number of households that received basic cable grew from 19.6 million to 62.6 million, and the number of pay cable subscriptions climbed from 8.9 million to 50.3 million. Pay television generated \$4.3 billion in revenue in 1994.<sup>5</sup> Other growth areas included satellite TV and TV programming relayed through telephone lines.

As cable and satellite usage grew, programming had not kept pace. Some systems offered as many as 100 different channels, but media critics observed that much of the content was of poor quality. Musician Bruce Springsteen captured the frustration of many cable viewers in the lyrics, "We switched 'round and 'round 'til half-past dawn/there was fifty-seven channels and nothin' on."<sup>6</sup>

As video, cable, and satellite usage grew, box-office admissions remained relatively stable. Market research indicated that while there had been some early erosion in movie-theater attendance, increased usage of VCRs and cable TV had not damaged the theater industry. The research suggested a distinction between inside-the-home leisure and outside-the-home leisure. Substantial competition existed within a type of leisure, but not between the two types. Consequently, while VCRs and cable posed a threat to inside-the-home broadcast television, they did not substantially affect theater attendance.<sup>7</sup>

Market studies indicated that four major factors determined where moviegoers went to see a movie: (1) the film itself; (2) the location of the theater; (3) the starting time of the film screenings; and (4) the overall quality of the theater. Within the fourth category, some conditions mattered more than others. Screen size was important to moviegoers, particularly ardent ones. Some industry observers expressed concern that the multiplex-driven trend toward shrinking screen sizes could hurt attendance. Technological features such as Dolby sound and the quality of service were less significant. Reductions in ticket price did not dramatically increase attendance. The research also indicated that it was difficult for exhibitors to build loyalty. Moviegoers often did not associate locations they frequented with the companies that operated those locations.<sup>8</sup>

Because film selection was the most important determinant of attendance, theater companies licensed films with great care. Even experienced film buyers could not always predict which films would most appeal to moviegoers. The actors, the director, and the story were all important factors, but ultimately a film's appeal depended on how these separate elements interacted in a complete project. Attendance also was influenced by the timing of release relative to other movies. Moviegoers tended not to like to see the same type of movie on consecutive outings, so a big budget comedy might not draw large audiences if another big budget comedy had opened a week or two earlier. Multiplexes allowed theater operators to offer a wide selection and reduced the pressure to pick "winners" when licensing.

Opening weekend performance was often indicative of how well a film would play over the long term, because early attendees influenced the general population of moviegoers. Market

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<sup>4</sup> Paul Kagan Associates, *Theater Financial Record*, 1995, p. 1.

<sup>5</sup> Ibid.

<sup>6</sup> Bruce Springsteen, "57 Channels (And Nothin' On)."

<sup>7</sup> See Joseph Helfgot, Michael Schwartz, Frank Romo, and Jaime Korman, Marketcast, "Aging Baby Boomers and Declining Leisure Time," 1988.

<sup>8</sup> Richard Acello, "Nickelodeon Reinvents Film Palace," *San Diego Daily Transcript*, April 3, 1995.

researchers defined "avid" moviegoers as attendees who saw 20 or more films a year in a theater. "Avids" made up only 8% of the U.S. population, but influenced the whole moviegoer population by recommending or criticizing newly released films.

## Movie Studios

A small group of movie studios made most of the films displayed in American theaters. Some films were both produced and distributed by a major studio, while others were produced independently and then distributed by a major studio. In 1995, 382 new films were distributed in the United States, of which 212 were released by the largest studios. Films released by the top eight studios generated over 90% of domestic box-office revenue, and the top four studios alone generated 60% of the revenue. However, the distribution of market share among the top studios changed from year to year (Exhibit 3). In 1994 and 1995, Disney's Buena Vista distribution company was the market-share leader with about 19% of box-office revenue, but in the previous two years the top position had been held by Warner Brothers, a division of the Time-Warner corporation.

The major studios were not consistently profitable. For most studios, one big hit could mean the difference between a profitable and unprofitable year. The ratio of U.S. box office revenues to production costs for the average major studio fell from 11% in 1992 to 3% in 1995.<sup>9</sup> Rapidly rising costs accounted for some of this fall. The average cost to produce a feature film had risen from \$26.8 million in 1990 to \$36.4 million in 1995. The most expensive films cost more than \$100 million to produce, partly because top stars received as much as \$20 million to appear in a picture. Distribution costs, most of which were borne by the studios, added an average \$17.7 million to production costs. Exhibit 4 provides average per-film revenue and production and distribution costs, and Exhibit 5 gives major studio advertising expenditures for 1995.

Movie studios obtained revenue by selling or licensing their films for viewing through various vehicles, including cable television, home-video rental, and exhibition in theaters. The studios estimated that on average only 20% of film revenue came from movie-theater exhibition, and only half of that came from exhibition in U.S. theaters. Forty-two percent of revenue came from video rentals, and 38% came from television sales, which included cable, pay-per-view, and broadcast television (Exhibit 6).<sup>10</sup> A film's performance at the box office influenced how well the film performed in ancillary markets like video and cable.

The typical arrangement between a studio and an exhibitor was called a film licensing agreement, which stipulated a "film rental fee" that would be paid by the exhibitor to the studio. Licensing practices between studios and theater companies were constrained by antitrust decisions issued in the 1940s and re-interpreted in the 1980s.

**The matching of films with movie screens** As a result of legal proceedings from the 1940s, movie studios licensed each film for showing on a specific screen. The negotiation typically occurred two or three months before a film opened. Studios were prohibited from requiring exhibitors to purchase multiple films in a single contract ("block booking"). They were also forbidden from conducting "circuit deals," where films were licensed in a master agreement for every theater in an exhibitor's chain. Separate agreements were required for every screen on which a film was shown.

Exhibitors acquired films either through direct negotiation with a studio or, less frequently, through a bidding process that involved other exhibitors. Open bidding had been common in the

<sup>9</sup> For every dollar of production costs on a new movie, the studios received three cents in U.S. box office receipts on the studio's current releases. David Lieberman, "Hollywood Studios Woo Asian Market," *USA Today*, January 22, 1996.

<sup>10</sup> Bonnie Britton, "It's a difficult year to predict Oscar winners," *The Indianapolis Star*, March 24, 1996.



1980s before clarification of requirements by the Antitrust Division of the United States Department of Justice. In the late 1980s, the Antitrust Division indicated that bilateral negotiation between exhibitors and studios initiated at the studio's discretion would meet legal requirements as long as the studios negotiated each license "upon the merits." This reversed an earlier policy that required studios to offer all exhibitors in a market the opportunity to compete for a film.<sup>11</sup> Studios were allowed to consider factors other than the offered fee in their decisions to license films. These factors included the reputation of an exhibitor and the exhibitor's ability to attract an audience.<sup>12</sup> However, the newly articulated government policy did not excuse studios from considering competing offers from exhibitors they had not initially approached.

**The structure of film rental fees** Negotiations to license a film contained provisions for a fee paid by the exhibitor to the movie studio. In most cases, the exhibitor paid the studio the greater of two amounts, which were calculated under the following formulas:

- The *gross receipts formula*. Under this calculation, the studio received a specified percentage of box-office receipts, with the percentage declining over time. For a new film, the percentage usually was 60% or 70% in the first week and declined gradually to 30% after four to seven weeks. For an older film opening at a new location, the initial percentage might equal 35% and decline to 30% after a week or two.
- The *adjusted gross receipts formula*, typically called the "90/10 clause." Under this formula, the studio received 90% of box-office receipts after a deduction for theater expenses. The deduction, called the "house allowance," was negotiated between studio and exhibitor for each theater.

Table A provides a simple example of how each formula applied in a specific week at one theater. The example assumes box-office receipts of \$12,000, a gross-receipts percentage of 60%, and a house allowance of \$5,000:

Table A

	Gross Receipts	Adjusted Gross Receipts
Box-office receipts	\$12,000	\$12,000
Gross-receipts percentage	60%	
House allowance		<u>-\$ 5,000</u>
Subtotal	\$ 7,200	\$ 7,000
90% Adjustment		<u>-\$ 700</u>
Payment to Studio	\$ 7,200	\$ 6,300

In this example, the exhibitor would pay the studio the greater of the calculated amounts, or \$7,200. However, in a process known as "settlement," the formal agreement was subject to renegotiation if the formal terms meant that the exhibitor would not make a sufficient profit on the deal.<sup>13</sup> In most cases, the renegotiation occurred after an exhibitor had merely covered its costs at a theater on

<sup>11</sup> Michael Boudin and Frederic Freilicher, "Report of the Department of Justice on the Legality of Customer Selection under the Injunction in the Paramount Decrees Against Discrimination in Film Licensing" (Southern District of New York, 1988), p. 38.

<sup>12</sup> *Ibid.*, pp. 43-44.

<sup>13</sup> There were exceptions to this practice. A few studios were known as "firm term" licensors that did not renegotiate film rental terms after the license was agreed upon.

successive films from one studio. Exhibitors were also occasionally required to pay nonrefundable guarantees or advance rental fees in order to obtain a license.

**Factors affecting fees** Market conditions shaped the terms of film-rental agreements. These conditions included:

- The intensity of competition between different exhibitors in a geographic area. For example, rental fees might be higher in a region with several theaters than in a region with only a single theater.
- The availability of attractive films that had not yet been licensed. In general, the greater the supply of quality films, the lower the rental fees. Studio film output had been high in recent years.
- The number of screens at the exhibitor's location, and the agreements that the exhibitor had negotiated for those screens. An exhibitor with a multiplex managed the portfolio of films at the multiplex location.
- The perceived box-office potential of a film. Well-promoted productions with big stars often received high rental fees.

The average film rental fee paid by the major exhibitors in the 1990s was about 50% of box-office revenue. This percentage had increased from 40% in the 1970s and as little as 28% in 1949. In the mid- to late-1980s, film rental fees had been 55% on average, partly because open bidding was more common.

## History of the Motion Picture Industry

The motion picture industry had evolved through several phases since its inception in the late nineteenth century. Events at each stage shaped the process by which exhibitors obtained rights to show films.

### Early Years: 1888–1915

In 1888, Thomas Edison and his assistant William Kennedy Dickson invented the Kinetoscope, a four-foot tall box in which individual viewers could watch motion picture footage.<sup>14</sup> Seven years later in France, brothers Auguste and Louis Lumiere developed a much-improved camera and the first motion-picture projector. The projector allowed many patrons to observe a single screening at the same time.

The increased availability of cameras led to a surge in film production. Concurrently, the commercial availability of projectors from competing manufacturers advanced the growth of motion-picture exhibition. By 1910, nickelodeons—movie theaters with a five-cent admission charge—were drawing audiences of 26 million a week, nearly 20% of the U.S. population.<sup>15</sup> Initially, exhibitors purchased outright the short films they screened. As demand for variety in content grew, exhibitors began to trade among themselves, and entrepreneurs set up film exchanges to facilitate film

<sup>14</sup> The historical overview draws on Tino Balio, ed., *The American Film Industry* (Madison: The University of Wisconsin Press, 1985); Suzanne Mary Donahue, *American Film Distribution: The Changing Marketplace* (Ann Arbor: UMI Research Press, 1987); and Gorham Kindem, ed., *The American Movie Industry: The Business of Motion Pictures* (Carbondale, Ill.: Southern Illinois University Press, 1982).

<sup>15</sup> Balio, p. 86.

distribution. Exchanges purchased films from producers and then rented them to different exhibitors. The new system lowered costs for exhibitors and generated profits for film producers. In 1907, there were 125 to 150 exchanges serving the country, generally along regional lines.<sup>16</sup>

In 1908, the two major film-equipment manufacturers settled ongoing patent disputes, and together they formed the Motion Picture Patents Company, known as "the Trust." After entering into an agreement with the Eastman Kodak company, the Trust had exclusive access to the supply of raw film, and it held the major patents for camera and projector equipment. Through various licenses, the Trust collected royalties on the use of film by producers, the production of equipment, and the use of equipment in theaters. The Trust also attempted to control distribution and exhibition by requiring exchanges and exhibitors to license the rights to films that were themselves produced under Trust license. The Trust went as far as to forbid exchanges and exhibitors from trafficking in unlicensed films.

In 1910, the Trust entered the exchange business through a subsidiary called the General Film Company. Only 18 months after it was formed, the General Film Company owned 58 of the 59 exchanges in the United States. William Fox's Greater New York Film Rental Company remained independent. Even as the General Film Company was purchasing exchanges, independent producers continued to make unlicensed films. The Fox exchange and a new entrant called Paramount Pictures provided exhibitors with an alternative to the Trust by distributing independent films. Antitrust suits dissolved the Trust by 1917.

### Vertical Integration and Antitrust: 1916–1948

The next two decades brought new consolidation and vertical integration to the industry. In 1916, a leading movie producer named Adolph Zukor purchased the Paramount distribution company and merged it with his Famous Players-Lasky production studio. Zukor's studio retained many of the popular movie stars of the time, which gave him significant leverage in his negotiations with exhibitors over film-rental fees. In response, 26 of the largest exhibitor chains formed an organization to purchase, distribute, and finance films. To guarantee a supply of films, the exhibitors' organization merged with Warner Brothers Vitaphone, a leading movie studio. Zukor responded by integrating into the exhibitor business. As a result, the industry became dominated by two large motion-picture companies, each of which owned its own theaters. Three smaller companies, Loew's, Fox, and RKO (a division of the RCA company), soon followed suit and each fully integrated into production, distribution, and exhibition.

By the 1930s, a small oligopoly controlled the industry. The "Five Majors"—Paramount (Famous Players-Lasky), Loew's, RKO, Warner Brothers, and Twentieth Century-Fox—operated at all three levels of the industry: production, distribution, and exhibition. A new cohort of "Three Minors"—Columbia, Universal, and United Artists—were involved in production, distribution, or both, but not in exhibition.<sup>17</sup> Collectively, the eight studios dominated all stages of the motion picture industry. Other independent companies operated in each stage, but they were dwarfed in size and influence.

As the 1930s closed and the country recovered from the Depression, the United States government began to enforce antitrust policy more vigorously. In 1938, the government initiated a case that became *United States v. Paramount Pictures* ("Paramount").<sup>18</sup> Eight companies were named as

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<sup>16</sup> Ibid., p. 17.

<sup>17</sup> Columbia and Universal were involved in both production and distribution, while only United Artists was involved in distribution.

<sup>18</sup> The antitrust section draws heavily on Michael Conant, *Antitrust in the Motion Picture Industry* (Berkeley: University of California Press, 1960).

defendants—the Five Majors and the Three Minors—and the defendants were charged with anti-competitive dominance of the three major segments of the industry.<sup>19</sup>

**Production** The government argued that in five pre-war seasons, the defendants produced 62% of all feature films and accounted for “nearly all” of the best-quality films.

**Distribution** Collectively, the eight defendants distributed 71% of all domestic films released in the 10-year period ending in 1946. In 1944, the studios distributed 122 of the 123 released films, with gross box office receipts greater than \$1 million. The government argued that this dominance constituted illegal monopolization. The government also criticized the practice of block-booking, through which a studio required an exhibitor to accept numerous films in one contract.

**Exhibition** In 1945, the Five Majors owned 17% of the nation’s 18,076 theaters. Their theaters were among the country’s largest, so total seating capacity controlled by the defendants exceeded 17%. The Majors also controlled most of the theaters in major markets, which yielded the highest revenues. The charges against the defendants stipulated that this control constituted illegal monopolization. The government argued further that the defendants had actively colluded to maintain this dominance by explicitly agreeing not to compete in cities where more than one Major owned theaters.

In 1946, the District Court found the defendants guilty on a number of charges, and two years later the Supreme Court upheld the majority of the District Court’s findings. The Five Majors bore the brunt of the Court’s decision. While the Court did not find monopoly control at the production stage, it did find that “the percentages of first-run theater ownership and domestic film rentals controlled by the major defendants when coupled with the strategic advantages of vertical integration created a power to exclude competition from the distribution and exhibition markets when desired.” To dissolve this power, the Court ordered the Five Majors to spin off their theater holdings, and it ordered the spun-off circuits to divest one-quarter to one-half of their theaters. The Court also prohibited a number of industry practices:<sup>20</sup>

- Stipulation of theater admission prices by studios.
- The formal system that stipulated the amount of time after opening before an independent exhibitor could license a film.
- Contractual agreements between a studio and an independent exhibitor that lasted more than one year. After a year, agreements had to be terminable at will.
- “Circuit deals,” i.e., master agreements that stipulated licenses for all the theaters owned by an exhibitor.
- Block booking. Exhibitors could license films in groups, but they were given the right to reject subsequently 20% of all films under group contract. The Court did not forbid blind bidding, which was the solicitation of bids from exhibitors by a studio that refused to allow the bidders to preview the film. Blind bidding was prohibited by a number of states.
- Pooling agreements under which a studio and an exhibitor jointly operated theaters.

The Five Majors began to sign consent decrees on these terms in 1948.

<sup>19</sup> Columbia, Universal, and United Artists were not charged with conspiracy to monopolize exhibition because they did not own movie theaters.

<sup>20</sup> Adapted from Boudin and Freilicher, pp. 7-8, and Conant, pp. 98-99.



## Disintegration and Reintegration: 1949-1995

The *Paramount* decision created two separate camps in the motion picture industry: studios (participating in both production and distribution) and exhibitors. In the studio camp, many of the early industry pioneers prospered over the next 50 years and were still operating in some form in the 1990s, including Paramount, Warner Brothers, Twentieth Century-Fox, Columbia, Universal, and United Artists.

The exhibition camp, in contrast, went through a great deal of change. While the spin-off exhibitors initially owned many large theaters and had close connections to distributors, new entrants eventually overtook the dominant chains. By 1995, only Loew's (by then a part of the Sony Corporation) remained a major player.

As each segment of the industry developed, tensions grew. In the 1970s, studio output dwindled and film rental fees escalated, putting pressure on exhibitors. General Cinema, one of the largest theater chains, received less than 2% of its theater profits from admissions in 1980, even though ticket prices rose 50% between 1970 and 1979.<sup>21</sup> Concurrently, blind bidding increased in frequency. In 1979, exhibitors claimed studios were blind bidding 90%-100% of their releases; the studios claimed 60%-70%.<sup>22</sup>

Exhibitors also suffered a significant legal blow. Traditionally, the major exhibitors in a market had agreed among themselves which companies would negotiate for new films. This prevented multiple exhibitors from competing for the same film. The studios acquiesced to this practice because it relieved them of determining film allocation. In 1977, however, the Antitrust Division announced that it considered the exhibitor practice to be a *per se* violation of the Sherman Antitrust Act. Criminal charges were brought against an exhibitor in 1985.<sup>23</sup>

Despite this turmoil, by the 1990s, there was some indication that the two camps had achieved stable negotiating arrangements. Under Ronald Reagan's presidency, antitrust enforcement had become less vigorous, and federal authorities had let it be known that they would not oppose vertical integration in the industry.<sup>24</sup> Columbia Pictures made the first vertical acquisition in 1986 with its purchase of the Loew's chain.<sup>25</sup>

## Exhibitor Economics

Exhibitors obtained most of their revenue from theater admissions and concession sales. Film rentals and theater-operation expenses were the major components of cost. Exhibit 7 provides representative economics for large theater companies.

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<sup>21</sup> Bettye H. Pruitt, *The Making of Harcourt General: A History of Growth through Diversification, 1922-1992* (Boston: Harvard Business School Press, 1994), p. 136.

<sup>22</sup> Gary R. Edgerton, *American Film Exhibition and an Analysis of the Motion Picture Industry's Market Structure, 1963-1980* (New York: Garland Publishing, 1983), p. 80.

<sup>23</sup> Boudin and Freilicher, p. 30.

<sup>24</sup> See Julia Kou and Anita M. McGahan, "Antitrust and Competitive Strategy in the 1990s," HBS No. 795-059 (1995); and Pruitt, p. 184.

<sup>25</sup> Columbia was later purchased by the Sony Corporation, and Loew's was renamed Sony Theatres.

## Revenue

**Admissions** For the major exhibitors, box-office admissions in 1994 averaged 69% of total revenues. Admissions revenue in a year depended on the total number of patrons and the price per ticket. Average ticket price in 1994 among the large exhibitors was \$4.07. Ticket price depended on theater location, whether the film was a first- or subsequent-run, the age of the customer, and whether the customer held a discount pass.

Movie attendance for a particular film was difficult to predict. While a select group of actors and actresses was acknowledged to provide consistent box-office draw, even movies with top stars performed poorly on occasion. Similarly, less-heralded films sometimes proved unexpectedly popular among moviegoers. Film buyers at exhibition companies needed to evaluate studio offerings and select from among them the best mix for each theater's limited screen capacity. This was most difficult in the summer and during the holiday season, when the studios generally released what they believed were their best offerings.<sup>26</sup> Multiplexes gave theater operators increased flexibility in balancing screen capacity and moviegoer demand for particular films. In a multiplex, a popular film could start in a large auditorium or on two screens simultaneously, and as the audience for the film declined it could be moved to a smaller auditorium in the same complex to make room for a more popular film.

**Concessions** Concessions revenue in 1994 averaged \$1.64 on a per-person basis and 28% of total revenue, although this ran as high as 34% and as low as 25% among the major companies. Concession products consisted primarily of popcorn, beverages, and candy. By one estimate, gross margin was 90% on popcorn and beverages and 80% on candy. Exhibitors constantly evaluated new products they could sell at concession stands.

**Other revenue** Other revenue came from electronic video games located in theater lobbies and from on-screen advertising, and accounted for 3% of the total on average.

## Expenses

**Film-rental fees** Film-rental fees averaged 36% of total expenses and 52% of box-office revenue in 1994. The total cost of film rentals depended on the terms of the licenses, the number of picture openings, and the length of time the films played. A large number of picture openings raised total film-rental fees because fees were highest when a new film opened.<sup>27</sup> For the same reason, total film-rental fees were lower when films ran for many weeks because the film-rental fee was only 30% to 35% of box-office receipts in the sixth or seventh week of each run.

**Concessions Costs** Concessions costs consisted of payments for supplies—candy, popcorn, soft drink syrup, containers—and promotional expenses for the products. In 1994, concessions costs were 5% of total expenses. Costs were primarily variable with the number of patrons and the composition of the average order. In 1994, costs per patron came to \$0.27, which equaled 16% of per-patron concessions revenue of \$1.64.

**Theater-operation costs** Theater-operation costs consisted of payroll, the cost of supplies (such as theater tickets), utility payments, property and liability insurance, rent for leased buildings or properties, and some advertising costs. Employees at movie theaters—cashiers, concession staff,

<sup>26</sup> The summer season ran roughly from Memorial Day weekend through Labor Day weekend, and the holiday season ran from Thanksgiving through New Year's weekend.

<sup>27</sup> Most film rental fees were determined by the gross receipts formula, under which fees declined over time, rather than by the 90/10 adjusted gross receipts formula.

ushers, maintenance staff, and projectionists—were primarily nonunion, and most worked on an hourly wage. Leases for buildings and property typically ran 20 years, and lease payments usually consisted of (i) fixed monthly minimums, (ii) contingent payments based on a percentage of revenue above a specified amount, and (iii) property tax. Advertising costs were divided between studios and exhibitors. Studios were exclusively responsible for financing television and radio advertising and national print-media campaigns. Studios and exhibitors split the cost of “co-op ads”: newspaper advertisements that featured a single movie along with a list of theaters where the movie was playing. In co-op arrangements, exhibitors typically paid 20% of the cost, although this amount varied. Exhibitors were independently responsible for chain-specific advertising that displayed theater locations and film schedules. Advertising costs were between 2% and 3% of total revenue.

Most of the cost of theater operation was fixed by screen or location. Payroll varied somewhat by the number of patrons expected, but a core staff was needed to operate a theater no matter how many customers attended. Rent, insurance, utilities, and advertising were largely independent of the number of patrons. In 1994, the variable component of theater-operation costs came to \$0.24 per patron. Costs incurred per screen were \$47,000, and costs per location were \$318,000.

Theater operating costs declined as the number of screens per theater increased because ushers, concession stands, and ticket-sale areas could service multiple screens. In 1994, theaters with 6 to 11 screens had operating income of \$1.05 per patron, compared with \$0.88 per patron in theaters with fewer than 6 screens. Multiplexes with 12 or more screens had operating income of \$1.35 per patron.<sup>28</sup>

**Depreciation** Exhibitors owned some of the sites and buildings where their theaters were located, but most theaters were held on long-term lease. After World War II, theater development had shifted from downtown locations to suburban “population centers” like shopping malls, which were typically controlled by real-estate developers. Exhibitors differed on their preferences for leases and ownership. Leases had the advantages of lower up-front investment and a finite commitment to a particular location. However, ownership offered more flexibility because land or buildings could always be sold, while leases might tie an exhibitor to a poor location for 20 years. A distributor’s view on this tradeoff affected where its theaters were located. National Amusements, for example, was firmly committed to ownership, and consequently most of its locations were free-standing structures.<sup>29</sup>

**General and administrative** The major theater companies typically retained a number of film buyers who worked either out of the corporate headquarters or in a regional office, depending on the company’s geographic coverage and number of screens. The companies also retained legal staffs to manage acquisitions, monitor relationships with studios, and ensure compliance with antitrust policy.

## Competitors

In North America, 460 theater companies operated 27,805 screens, for an average of approximately 60 screens per company. Although American movies had been distributed internationally, no American exhibitor operated a significant number of theaters in overseas markets. International markets were considered major growth opportunities for American firms. In the United States and Canada, most exhibitors operated fewer than 10 screens, but the top 10 companies

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<sup>28</sup> Estimate from Paul Kagan Associates, p. 4.

<sup>29</sup> Claudia H. Deutsch, “Now Playing: Invasion of the Multiplex,” *New York Times*, June 25, 1995.

controlled more than 50% of all screens, up from 30% a decade earlier.<sup>30</sup> Thirty-one theater companies operated more than 100 screens, six operated more than 1,000 screens, and two ran more than 2,000 screens (see Exhibit 8). Among the largest exhibitors, profitability varied considerably in 1994, with ROA ranging from -5.1% to 6.5%.

Multiplexing and consolidation had already affected moviegoers' experiences. Between 1990 and 1995, as admissions grew 1.2% annually, the total number of screens grew at a rate of 3.3%. Although companies across the industry operated an average of 5.5 screens per location in May 1995, some averaged more than 8 screens per location. Some new multiplexes contained 24 screens. As the number of screens per location increased, the average size of each screen decreased. Summary financial data for fiscal year 1994 on publicly held major theater companies is provided in Exhibit 9.

**United Artists Theater Company (UATC)** UATC, the largest exhibitor in the United States by number of screens, was one of the oldest theater operators. The company was formed in 1926 by Hollywood personalities Mary Pickford, Douglas Fairbanks, and Sam Goldwyn, who had also formed the United Artists film studio as a separate entity. UATC theaters were located in 29 states, Puerto Rico, Hong Kong, Malaysia, and Singapore, and in 1994, 9% of the company's screens were outside the United States. The company planned further international expansion into India and Argentina. In the United States, UATC operated in both large metropolitan areas and small towns, with the highest concentration of screens in California, Florida, Texas, and New York. Although virtually all of the company's locations housed more than one screen by the mid-1990s, many theaters were considered to be antiquated and underscreened. Investment plans were hindered by high debt incurred during expansion in the 1980s, but the company had opened a combination theater/entertainment complex in Indianapolis in 1995. UATC suffered a net loss of nearly \$30 million in fiscal year 1994, following a loss of \$33 million a year earlier.

**Carmike** Starting from a relatively small rural base, by 1995 Carmike had grown to be the second-largest theater company by number of screens. Industry observers expected Carmike to overtake United Artists in 1996 and become the exhibitor with the most screens. As the "Wal-Mart" of the theater industry, the company had its strength in secondary, rural markets rather than in primary ones. Its biggest theater concentrations were in North Carolina, Tennessee, and Alabama, and the company was the sole or leading exhibitor in most of the markets in which it operated. On average, Carmike operated 4.4 screens per theater, somewhat below the industry average of 4.7. The company intended to increase this average as it expanded. Most theaters in the chain were leased rather than owned.

**American Multi-Cinema (AMC)** AMC was known in the industry as being a very aggressive theater operator. The company was a pioneer in multiplexing, and in the 1990s AMC had a very high number of screens per theater. Thirty-one percent of the company's screens were in multiplexes with 10 or more screens, and 88% were in multiplexes with 6 or more screens. AMC operated mostly in the metropolitan areas of 22 states and in Washington, D.C. Two-thirds of its screens were located in the 20 largest American cities. AMC had plans to expand internationally, and it was in the process of developing a 13-screen multiplex in Japan. The company had also recently introduced a frequent-moviegoer program designed to build consumer loyalty.

**Cineplex Odeon** Like UATC, Cineplex Odeon was one of the more established chains. The Canadian company was partially owned by the MCA film studio; MCA, in turn, had been acquired by Seagrams in 1995. Nearly all Cineplex Odeon theaters in the United States were located in large metropolitan areas such as New York, Chicago, and Washington, D.C. The majority of the company's theaters were leased. Along with UATC, the company had incurred significant debt in the 1980s, and high interest payments were hurting profitability. In 1994, Cineplex Odeon lost \$14 million, and two years earlier the company had lost more than \$40 million. In addition to its exhibition business,

<sup>30</sup> Lieberman, "Theaters' Big Comeback."



Cineplex Odeon also operated a small film distribution business, Cineplex Odeon films, which distributed primarily in Canada.

**Cinemark** Like Carmike, Cinemark operated most of its theaters in secondary markets. Major locations for Cinemark theaters included Texas, Kentucky, Ohio, and Utah. All theaters in the chain were multiplexes, and 96% had four or more screens. Cinemark's average number of screens per theater was one of the highest in the industry. In addition to its U.S. holdings, the company operated theaters in Canada, Mexico, and Chile. Cinemark had been engaged in merger talks with Cineplex Odeon in 1994, which would have created the world's largest chain, but the merger was called off in May 1995 after Seagrams purchased MCA, a major Cineplex Odeon stockholder. News reports suggested that the deal had fallen apart over the question of who would run the merged companies.<sup>31</sup>

**General Cinema** After playing a major role in pioneering the suburbanization of the theater industry in the 1950s, by 1995 General Cinema was considered a conservative theater operator. ROA in 1994 was 4.6%, among the highest of the major companies. Four decades after it opened one of the first mall-based theaters at Shoppers' World in Framingham, Massachusetts, the company remained a strong presence in shopping malls. Because General Cinema located in "population centers" like malls, virtually all of its theaters were leased. All but one of General Cinema's theaters were multiplexes, and 76% had six or more screens. Eighty-five percent of the company's theaters and 90% of its screens were in 35 of the 50 largest markets.

**Sony Theatres** Sony Theatres began as the Loew's chain, a theater circuit that dated to 1904. Until the 1948 *Paramount* decision, Loew's theaters had been part of a fully integrated motion-picture company. After years of post-*Paramount* independence, Loew's was acquired by the Columbia Pictures studio in 1986. Columbia was then acquired by the Sony Corporation in 1989, and the theater circuit was renamed Sony Theatres. In the industry, Sony Theatres was well regarded, but Sony's movie studio had performed inconsistently since the acquisition. Sony Theatres were located primarily on the East Coast.

**National Amusements** National Amusements was a privately held chain controlled by Sumner Redstone, who also controlled the Viacom media company and its Paramount studio subsidiary. Redstone had built the chain from a few theaters to nearly nine hundred by 1995, and the 72-year-old owner continued to maintain tight command over the circuit's operation. Redstone personally signed film rental checks, telephoned theater managers to discuss operations, and received a weekly Sunday night report on box-office performance.<sup>32</sup> Company management also strongly preferred ownership to leasing, so most National Amusements theaters were stand-alone structures rather than parts of bigger real-estate developments.

**Regal** Regal was the fastest-growing major exhibitor. The company acquired its first theater in January 1990, and by the end of 1994 owned 92 theaters with 704 screens. Growth had occurred primarily through acquisition. Most Regal theaters were on the East Coast, and the company was the sole operator in about 75% of its markets.<sup>33</sup> Regal had one of the highest ratios of screens per location in the industry. Nearly three-fourths of its screens were less than seven years old. The company planned to develop 125 to 150 screens annually for the next few years. It had also opened "Funscape," a combination 13-screen multiplex and family entertainment center that contained miniature golf, video and virtual-reality games, and a food court.

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<sup>31</sup> See Martin Peers, "Cineplex on Prowl," *Daily Variety*, May 15, 1995, and Jeffrey Daniels and Etan Vlessing, "Cineplex's Big Merger is Off," *The Hollywood Reporter*, May 15, 1995.

<sup>32</sup> Sallie Hofmeister, "Command Performance: Wall Street Gasps as Redstone, 72, Takes Charge of Viacom," *Los Angeles Times*, January 19, 1996.

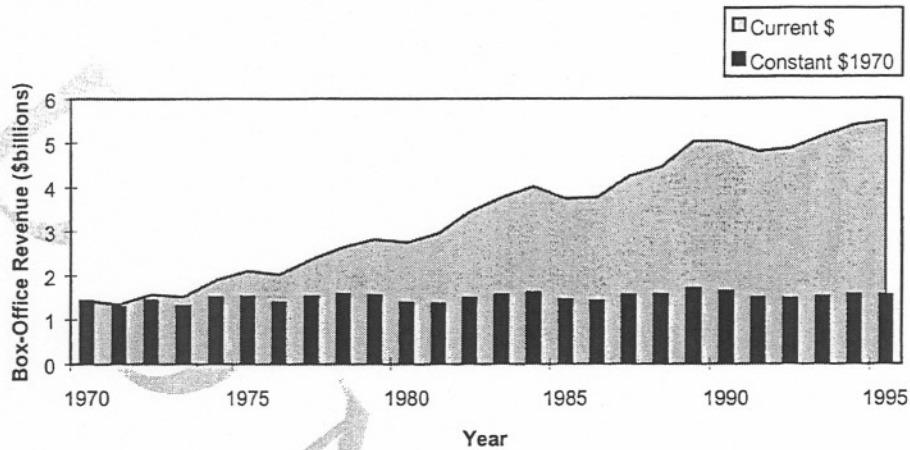
<sup>33</sup> Claire Mencke, "Regal Cinemas Inc.," *Investor's Business Daily*, February 15, 1996.

**Act III** Act III concentrated on developing theaters in smaller regional markets where it could build a powerful market presence. Its strength was in the Pacific Northwest (Washington, Oregon, Idaho, and Alaska) and Texas (Austin and San Antonio), and the company believed the majority of its screens were in areas where it was the leading exhibitor. Act III theaters charged moderate ticket prices to maximize attendance and cover fixed costs. Management preferred ownership to leasing so the company could control occupancy costs, avoid rent increases, and easily close underperforming theaters.<sup>34</sup> As of December 1994, more than 50% of its theaters were fully owned. Act III also operated its own warehouses for concession supplies.

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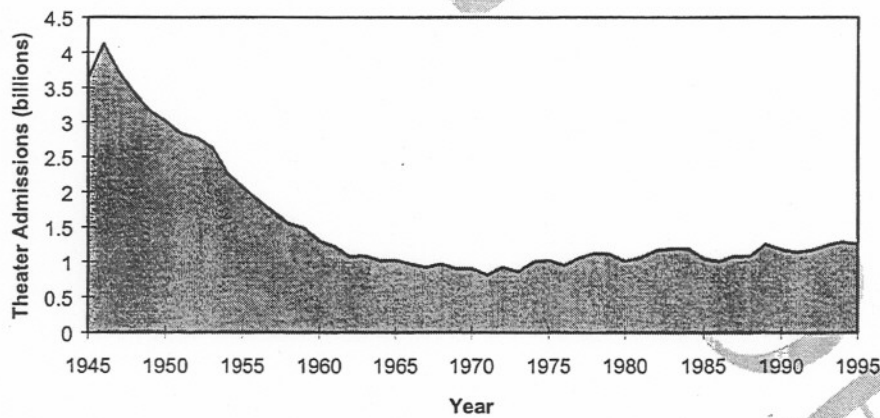
<sup>34</sup> Act III 1994 10-K, p. 4.

Exhibit 1 U.S. Box-Office Revenue, 1970-1995



Source: National Association of Theatre Owners (NATO)/Motion Picture Association of America (MPAA)

Exhibit 2 U.S. Theater Admissions, 1945-1995



Source: NATO/MPAA

Exhibit 3 Studio Box-Office Market Share, 1991-1995 (%)

	1991	1992	1993	1994	1995
Buena Vista <sup>a</sup>	13.7	19.4	16.6	19.7	19.4
Warner Bros. <sup>b</sup>	13.9	19.8	18.9	16.4	16.6
Sony <sup>c</sup>	20.0	19.1	18.2	9.5	13.1
Universal <sup>d</sup>	11.0	11.7	14.2	12.6	12.7
Paramount <sup>e</sup>	12.0	9.9	9.5	14.2	10.1
Fox <sup>f</sup>	11.6	14.2	10.9	9.4	8.0
New Line <sup>g</sup>	4.0	2.1	3.7	7.0	6.6
MGM/UA	2.3	1.2	1.9	2.8	6.3
Miramax <sup>h</sup>	1.4	1.1	3.1	3.9	3.6
Savoy			0.4	1.4	1.3
Grammercy			0.7	1.9	1.1
Orion	8.5	0.2	NA	NA	NA
Total	98.4	98.7	98.1	98.8	98.8

Source: 1993-1995, *The Hollywood Reporter*, January 2, 1996, p. 1; 1991-1992, *S&P Leisure Time Industry Survey*, p. 23.

<sup>a</sup>Disney's distribution arm.

<sup>b</sup>A division of the Time Warner Corporation.

<sup>c</sup>Sony Pictures includes Columbia and TriStar for the years 1991-1994 and Triumph for the years 1993-1994. 1995 was the first full year of Sony Pictures.

<sup>d</sup>In 1996, Universal was 80%-owned by Seagrams and 20% owned by Matsushita.

<sup>e</sup>A division of Viacom.

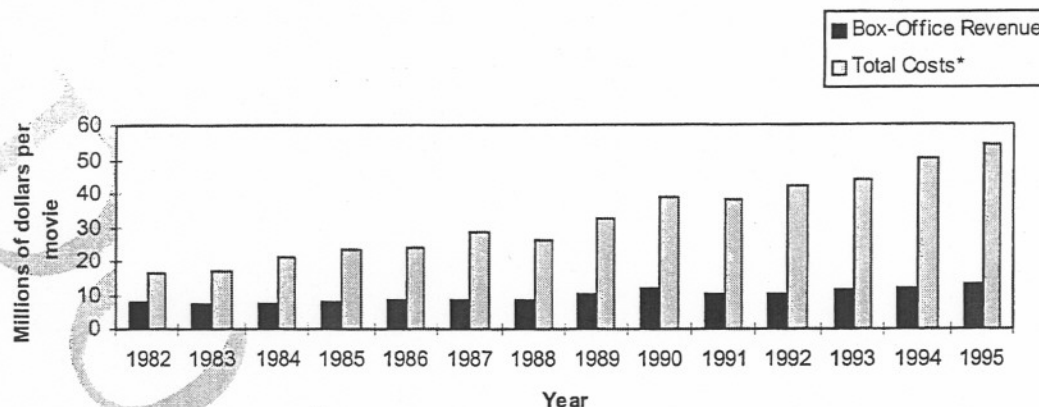
<sup>f</sup>A division of the News Corporation.

<sup>g</sup>A division of the Turner Broadcasting Company.

<sup>h</sup>A subsidiary of Disney.



Exhibit 4a Average per-Movie Box-Office Revenue and Costs



Source: Cost and revenue data from NATO/MPAA; estimates of distribution of film revenue from Harold L. Vogel, *Entertainment Industry Economics: A Guide for Financial Analysis*, Second Edition (Cambridge, England: Cambridge University Press, 1990), p. 52; David Lieberman, "Hollywood Studios Woo Asian Market," *USA Today*, January 22, 1996; and Bonnie Britton, "It's a difficult year to predict Oscar winners," *The Indianapolis Star*, March 24, 1996.

Note: Box-office revenue is for North America only. In 1995, North American box-office revenue accounted for approximately 10% of a studio's total film revenue (see Exhibit 6). In 1990, North American box-office revenue accounted for approximately 16% of total film revenue, and in 1980 approximately 30%.

\*Includes both production costs and distribution costs, which were 67% and 33%, respectively, of total costs in 1995; note that Exhibit 4b shows the breakdown of just production costs.

Exhibit 4b Production Cost Estimates for a "Typical Film"  
(millions of 1991 dollars)

<b>Pre-production</b>		
Story rights/script development	\$1.0	\$ .5
<b>Production</b>		
Actors/director	12.1	6.0
Production management	2.0	1.0
Production crew	2.0	1.0
Set design/construction	4.0	2.0
Transportation/locations	3.0	1.5
Wardrobe/makeup/hair	1.0	.5
Extras/props	1.0	.5
Lighting	0.6	.3
Special effects	0.6	.3
Other principal photography	2.0	1.0
<b>Post-production</b>		
Film editing	1.4	.7
Music	0.8	.4
Other post-production	1.6	.8
<b>All other</b>	3.0	1.5
<b>Total</b>	<b>\$36.1</b>	<b>\$18.0</b>

Note: The second column of figures in Exhibit 4b is taken from Exhibit 2 in the "Arundel Partners: The Sequel Project" case, under "Negative Cost."

Source: William A. Teichner and Timothy A. Luehrman, "Arundel Partners: The Sequel Project," HBS No. 292-140 (1992), Exhibit 2; NATO/MPAA data; casewriter estimates.

Exhibit 5 1995 Studio Advertising Expenditures  
(\$ millions)

Buena Vista	432.6
Sony	268.3
Warner Bros.	263.9
Paramount	210.7
Universal	191.1
Fox	134.4
MGM/UA	128.6
Turner/New Line	106.2
Miramax	67.9
Savoy	64.7
Gramercy	40.0
Samuel Goldwyn	8.1
Total	1,916.5

Source: Leonard Klady, "Hollywood Suffers Severe Sell Shock," *Variety*, March 11-17, 1996, p. 9.

Exhibit 6 Sources of Studio Film Revenue, 1980-1995 (%)

	1980	1990	1995
Domestic Box Office	30%	16%	10%
International Box Office	23	9	10
Home Video	7	39	42
Pay, Cable, and Broadcast TV	41	37	38
Total	100%	100%	100%

Source: Harold L. Vogel, *Entertainment Industry Economics: A Guide for Financial Analysis*, Second Edition (Cambridge, England: Cambridge University Press, 1990), p. 52; Bonnie Britton, "It's a difficult year to predict Oscar winners," *The Indianapolis Star*, March 24, 1996; David Lieberman, "Hollywood Studios Woo Asian Market," *USA Today*, January 22, 1996; casewriter estimates.

Note: Columns may not total due to rounding.

**Exhibit 7** Representative Theater Company Economics (\$, except unit volume/company)

	By Units					By Total Dollars				
	Per Patron	Per Screen	Per Location	Company Overhead	Total	Per Patron	Per Screen	Per Location	Company Overhead	Total
Admissions Revenue	4.07					321,400,412				321,400,412
Concessions Revenue	1.64					129,724,979				129,724,979
Other Revenue	0.16					12,499,419				12,499,419
<b>Total Revenue</b>	<b>5.88</b>					<b>463,624,810</b>				<b>463,624,810</b>
<b>Costs</b>										
Film Rental	1.05	52,285				83,087,302	83,087,302			166,174,604
Concessions	0.27					21,280,510				21,280,510
Theatre Operations	0.24	46,689	318,252			18,548,679	74,194,718	92,743,397		185,486,794
Lease payments			28,001					8,159,931		8,159,931
<i>subtotal</i>	1.56	98,975	346,253			122,916,492	157,282,020	100,903,328		381,101,840
Depreciation and Amortization		4,289	93,548				6,815,297	27,261,187		34,076,484
G&A		3,773	13,715	9,991,864			5,995,119	3,996,746	9,991,864	19,983,729
Other				3,195,200					3,195,200	3,195,200
Net Interest		2,476	53,998				3,933,951	15,735,803		19,669,754
Taxes				2,781,485					2,781,485	2,781,485
<b>Total Costs</b>	<b>1.56</b>	<b>109,519</b>	<b>508,237</b>	<b>15,968,550</b>		<b>122,916,492</b>	<b>174,026,387</b>	<b>147,897,064</b>	<b>15,968,550</b>	<b>460,808,492</b>
Unit volume/company	78,872,014	1,589	291							
Total Revenue	463,624,810				463,624,810	463,624,810				463,624,810
Total Costs	122,916,492	174,026,387	147,897,064	15,968,550	460,808,492	122,916,492	174,026,387	147,897,064	15,968,550	460,808,492
<b>Net Income</b>					<b>2,816,318</b>					<b>2,816,318</b>

Source: Casewriter estimates based on data from Exhibit 9.

Note: Representative cost data in this exhibit are allocated on the basis by which costs are incurred. For example, concession costs are strictly variable by patron because they are determined by moviegoer orders. Theater-operation costs, in contrast, vary by screen and by location. The component of theater operation expense due to labor partly varies with theater attendance, but a core staff is needed regardless of attendance. Other theater-operation costs are determined by the number of screens and by the number of locations. For example, the size of the cleaning staff may depend on how many screens are at a location, but utility payments are not closely related to the number of screens. The left-hand portion of this exhibit provides data on a per unit basis, whereas the right-hand portion provides the total dollars incurred. For example, of the total \$185.5 million cost incurred for theater operations, \$18.6 million was incurred on a per patron basis, \$74.2 million on a per screen basis, and \$92.7 million on a per location basis (right panel). To convert these total dollar costs to the unit cost per individual patron, screen, or location, divide the total dollar costs by the number of patrons, screens, or locations (left panel).

## Exhibit 8 Major Theater Companies, as of May 1, 1995

## Largest Theater Chains—as of May 1, 1995

	Circuit	Number of Screens	% of Individual Total	Number of Locations	% of Individual Total	Average Screens per Location
1	United Artists	2,295	8.9%	423	9.1%	5.4
2	Carmike	2,037	7.9%	467	10.0%	4.4
3	American Multi-Cinema	1,632	6.3%	233	5.0%	7.0
4	Cineplex Odeon	1,631	6.3%	357	7.7%	4.6
5	Cinemark USA	1,224	4.7%	164	3.5%	7.5
6	General Cinema	1,202	4.7%	202	4.3%	6.0
7	Sony Theatres	946	3.7%	170	3.6%	5.6
8	National Amusements	870	3.4%	98	2.1%	8.9
9	Regal Cinemas	861	3.3%	116	2.5%	7.4
10	Act III Theatres	575	2.2%	116	2.5%	5.0
11	Cobb Theatres	575	2.2%	71	1.5%	8.1
12	Hoyts Cinemas	561	2.2%	73	1.6%	7.7
13	Century Theatres	475	1.8%	65	1.4%	7.3
14	Famous Players	462	1.8%	108	2.3%	4.3
15	Edwards	460	1.8%	75	1.6%	6.1
16	Cinamerica Theatres	349	1.4%	65	1.4%	5.4
	Total	16,155	62.5%	2,803	60.1%	5.8

Source: NATO