INTERNATIONAL MARKETS AND DIGITAL DISTRIBUTION KEY TO FILM INDUSTRY'S FUTURE

By Peter Winkler

After experiencing a difficult year of declining box office revenues and nearly flat DVD sales in 2005, the international filmed entertainment market is bouncing back in 2006. Box office revenues in the U.S. and other large western European markets have increased five-plus percent through the first half of 2006, and this summer's major releases are generally performing well. This box office success is good news for the DVD sell-through market through the latter part of the year, which will also be boosted by the introduction of high-definition DVD formats – Blu-ray from Sony and HD DVD from Toshiba.

Notwithstanding these positive developments in 2006, film executives have significant concerns when it comes to assessing future growth prospects for their industry. Global box office revenues are unlikely to surpass the low- to mid-single-digit percentage growth range, and the DVD market in major territories is rapidly becoming saturated. In fact, the slowing DVD sell-through market indicates that the industry is approaching a major inflexion point – a place where the digital distribution opportunity will need to be fully embraced by Hollywood studios and other major players in order to spur further robust spending gains on filmed entertainment product during the next few years.

Film industry spending will average a 5.3 percent compound annual growth rate through 2010 to $104 billion, according to PricewaterhouseCoopers' *Global Entertainment and Media Outlook: 2006-2010*. To achieve that level of growth, the industry will need to embrace and capitalize on its two most critical and lucrative opportunities: 1) International market growth, as less saturated markets in Central and Eastern Europe, Asia and Latin America continue to grow at faster rates than the U.S. and Western Europe; and 2) Digital distribution, from video-on-demand, to online film rental services, to digital streaming and download services, and more.

In terms of international growth, PwC anticipates the following countries averaging double- or high-single-digit annual film industry gains during the next five years: Russia (11.1 percent), Turkey (10.4 percent), India (11.9 percent), and China (8.4 percent). The Russian film market has experienced a renaissance over the past few years, including 18.3 percent growth in 2004 and 16 percent in 2005. With the construction of modernized new cinema facilities and with major U.S. players aggressively investing in the film market, Russia is poised for further strong growth through the end of the decade. Turkey has also benefited recently from new cinemas and its population's desire for Hollywood films, and with a developing economy and further integration into the European Union, this market should also see impressive growth. While DVD players are present in more than 70 percent of U.S. households, DVD hardware penetration rates in many markets outside the U.S. are at levels of only 20-30 percent and even lower. This means that the traditional DVD market has plenty of room left to run in those markets.

The second key film industry growth factor – digital distribution – offers a number of near- and medium-term opportunities. Certainly, the increasing ubiquity of broadband Internet access and the public's growing expectation that they will be able to consume entertainment and media content exactly when they want, where they want and how they want, will play an important role in digital distribution's success. However, the speed and vigor with which major film studios and other key industry players move to truly embrace the transition to digital distribution will be the most important factor in determining how quickly VOD, online film rental, and digital download and streaming revenues grow.

It's likely that activities by consumer technology and distribution players – especially those with much to gain from rapidly commercializing digital business models – will cause the most disruption and also spur the most innovation during the next few years. Companies like Apple, Amazon, Netflix, TiVo, CinemaNow and others will push the envelope on developing the means for digital film distribution to become a more convenient, popular reality for consumers.

PwC's *Outlook* projects that the film digital download and streaming services market will grow to $400 million in the U.S. and $167 million in Europe, Middle East and Africa (EMEA) by 2010. Online film rental subscription services are projected to grow from $1.1 billion in 2005 to $3.2 billion in 2010 in the U.S.; from $216 million in 2005 to $2 billion in 2010 in EMEA; and from $17 million in 2005 to $1.4 billion in 2010 in Asia Pacific. We also project video-on-demand spending in the U.S. to grow from $330 million in 2005 to just more than $3 billion by 2010, and while some of this spending will be on TV programs, a major portion of it will be on film product.

While the transition to digital distribution is coming, there are factors that may slow its penetration, at least in the near future. Large discount retailers, for example, use discounted DVDs to drive consumer traffic to their stores and would protest a major shift by studios away from the retail and toward the electronic distribution channel. Hollywood studio executives are likewise concerned that migrating too quickly to digital distribution will cannibalize DVD sales revenues that, while slowing significantly in 2005 from their previous rapid growth rate, remain the largest cash generator in the international film market. Film cinema owners worry that if studios continue to make films available for digital distribution in an ever-earlier time window that will in turn make consumers increasingly reluctant to "go to the movies."

In order to get both the discount retailers and the studios moving forward, it's certainly worth considering the idea of a middle road – one that combines the physical DVD and the digital distribution model. Retailers are already beginning discussions with studios and other players about the possibility of installing kiosks at retail sites that are capable of playing digital film and TV content, and allowing customers to download this content on-site to their iPods or for burning onto DVDs. This type of facility would give customers access to an almost infinite digital catalog of film content, and give the retailers and studios the opportunity to team up on a model that merges the physical store with digital distribution and boosts the potential for monetizing content libraries.

At the end of the day, studio executives realize that digital film distribution represents the future of their business. "[2006 is] really a watershed year for the home entertainment industry," according to Universal Studios Home Entertainment president Craig Kornblau. "While the DVD market remains strong, we need to listen to what consumers are saying and respond. At the same time, we have to recognize that the keys to growth are the promising new delivery methods recently introduced into the marketplace." (Quoted in *The Hollywood Reporter*, July 11, 2006).

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