

THE BUSINESS OF MAKING MOVIES

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The U.S. motion picture industry generates close to \$100 billion in revenues, is one of the country's largest exporters, and exerts enormous cultural influence worldwide. But today it also faces enormous pressures.

Going to the movies has always been one of society's most pleasurable pastimes. Over the past few years, though, enormous changes have occurred in the movie-making business: escalating production and marketing costs, the significant impact of increased piracy, the uncertainty in film financing, the proliferation of digital technology, and the increase in available entertainment options for consumers. These and other factors have implications for the motion picture business, the types of movies it will produce, and how and where people will view them.

Based on research sponsored by the Foundation for Applied Research (FAR) of the Institute of Management Accountants (IMA®), this is the first in a series of articles on the U.S. motion picture industry—one of the so-called creative industries. The goal of the series is to provide readers with current information about costs, revenues, and risks in this highly dynamic and influential industry. In this article, we'll discuss how the industry operates, the challenges it faces, and what goes into making a movie.

In a subsequent article we'll discuss the business of selling movies—distribution, the importance of advertising, opening box-office revenues, and the increase in new revenue streams from various forms of mobile technology.

THE INDUSTRY IN PERSPECTIVE

Motion pictures aren't only a significant source of revenue for many countries—they're also instrumental in shaping worldwide impressions of a country's intellectual, historical, and cultural environment. For instance, most moviegoers would have little difficulty associating Akira Kurosawa's *Seven Samurai* with Japan, Federico Fellini's *La Dolce Vita* with Italy, or Peter Faiman's *Crocodile Dundee* with Australia.

Globally, more than 3,000 feature films reached movie theaters in 2006, bringing in \$23.8 billion in box-office revenues. And total global annual revenues across all distribution channels such as video and DVD, cable, television, and mobile sources were forecasted to be \$450 billion by the end of 2007, according to the Motion Picture Association of America (MPAA). The largest distributors of feature films in 2006 were India with 800, the U.S. with 599, and China with 255.

Let's now look at the organization of the U.S. motion picture business. Six major studios make up the core of the motion picture industry: 20th Century Fox, Walt Dis-

ney Pictures, Warner Brothers Pictures, Paramount Pictures, Columbia Pictures, and Universal Pictures. The MPAA represents these studios internationally and plays a number of roles: It advocates for the U.S. film industry, protects producers from copyright theft, and fights piracy. In 2006, the MPAA studios released 203 films (34%), and other, independent distributors released 396 (66%).

Even though major studios have made their name in Hollywood, large, vertically integrated conglomerates own them today. These conglomerates also incorporate a number of other forms of entertainment and media, such as radio stations, cable and network television stations,

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newspapers, magazines, theme parks, and book publishing (see Table 1). As examples, News Corporation owns 20th Century Fox, Fox Broadcasting Company, Direct TV, *National Geographic*, and the *Sunday Times* (U.K.), while Disney owns Walt Disney Pictures, ESPN, ABC, Buena Vista Home Entertainment, and Disneyland. Vertical integration of this magnitude creates enormous barriers to entry for any entity trying to get into the business, in part because they have to gain access to the major distribution channels.

Each major studio has subsidiary studios that produce medium- and small-budget films (see Table 1), and since Paramount purchased DreamWorks and Disney bought Pixar, there are only a few truly independent studios. Currently, the most notable independent film company, Lionsgate Entertainment, produces critically acclaimed films such as *Monster's Ball* and *Crash*. But even with the existence of these subsidiaries and a few independent film companies, critics have raised concerns that, because distribution is in the hands of a few large companies, the general public has the opportunity to see only a limited number and kinds of films. While this debate goes beyond the scope of our article, there's concern that independent filmmakers need more opportunities to showcase their work to the general public. For example, film

Table 1: The MPAA Motion Picture Studios, Major Subsidiary Studios, Distributors, and Parent Corporations

MAJOR STUDIOS	MAJOR SUBSIDIARY STUDIOS	DISTRIBUTORS	PARENT CORPORATIONS
20th Century Fox Film Corporation	Fox Searchlight	20th Century Fox International Corporation	News Corporation
Walt Disney Pictures	Miramax Films Pixar Animation Touchstone Pictures	Buena Vista International, Inc.	The Walt Disney Company
Warner Bros. Pictures	New Line Cinema	Warner Bros. Pictures International Theatrical Distribution	Time Warner
Paramount Pictures	DreamWorks Pictures Paramount Vantage	Paramount Pictures Corporation	Viacom, Inc.
Columbia Pictures	Screen Gems Sony Pictures Classics	Columbia TriStar Motion Picture Group	Sony Corporation (Sony Pictures Entertainment)
Universal Pictures	Focus Features	Universal International Films, Inc.	General Electric Company

festivals offer such opportunities. There are tens of thousands of films submitted to 3,000 film festivals, but less than one half of 1% ever make it as part of the 3,000 total feature films.

PRODUCING A FEATURE FILM

Making a movie follows six phases: (1) development, (2) pre-production, (3) production, (4) post-production, (5) marketing and distribution, and (6) exhibition. Here we'll focus on the first four phases—the business of making movies—and our subsequent article will address marketing and distribution as well as exhibition.

Central to creating any movie is the producer. People often confuse the roles of the producer and another key person—the director. The best way to describe the difference between a producer and a director is that the producer is considered the chief of staff, and the director is the senior line manager. The major creative force behind the project, the director is the person who actually makes the film, and top directors can earn from \$3 million to \$10 million per film.

The producer, however, has ultimate control of the film and shepherds it from idea inception through distribution. Producers of major films often garner seven-figure salaries plus potential bonuses and participation in the net profit. (The term net profit is one of the most controversial financial constructs in the entertainment industry because the calculation of net profits isn't straightforward. For instance, the revenues that are included in



gross receipts and costs deducted as expenses are subject to protracted negotiations among the parties involved.)

There are many types of producers, such as executive producers, producers, co-producers, and associate producers, but we'll use the term "producer" to denote the key person responsible for the film. Who can actually call themselves a producer is a point of contention in the movie business. The Producers Guild of America (PGA) has developed a number of explicit criteria for someone to earn specific producer credits in terms of title. According to the PGA, a producer must play significant roles in many of the six phases of film production. While the PGA has guidelines, the studios argue they need flexibili-

ty in their negotiations to grant titles to individuals and their associates to entice them to participate in projects.

Development

In the development phase, the producer acquires intellectual property. A producer may purchase the rights to make a movie based on a novel, short story, play, or video game or as a sequel or remake of a film. Purchasing story rights can be very expensive. For instance, the cost of the story rights for M. Night Shyamalan's *Unbreakable* was reputed to be \$5 million. The producer also hires a screenwriter, who must transform the basic story idea into a usable script. A major screenwriter in Hollywood can earn up to \$1 million to write the first several drafts of a script. The producer often must obtain the initial financing, which is easier if he/she hires a well-regarded screenwriter and some key members of the cast, the director, and the crew.

This sequence of events is by no means linear. For instance, a producer may already be tied to a major studio or may operate independently. Because of a track record, being tied to a studio makes it more likely to find

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properties. An independent producer will have to put together a package with the script, some members of the cast, and then do a pitch to a studio.

With the major elements in place, studio decision makers then must determine whether the movie will be successful. A popular method in Hollywood uses the comparables approach where major parties to the film go through brainstorming sessions to identify a movie or movies that most closely resemble the project under con-

sideration. Decision makers match characteristics of the proposed film with comparable films based on the movie's budget, theme, genre, actors, and director, among other factors. Scenario analysis of potential box-office revenue uses profitability data from large databases. The comparables approach combines rigorous analysis with gut feelings to determine whether the movie should move forward. Once executives are satisfied with the predicted profitability and they secure financing, the studio head green-lights the movie.

Major studio movies have become extremely expensive to produce. In 2006, the average cost of making an MPAA film was \$100.3 million, broken down into \$65.8 million in negative cost (that is, production costs) and \$34.5 million in marketing costs. Some studios finance a film completely on their own using bank loans or other financing sources, while others enter into limited partnerships with other studios to reduce risk. In this case, the studios will negotiate a split of the revenues.

Since the budgets of most major movies are extremely high, reducing risk is of paramount importance. Moreover, predicting which movies will be successful is very difficult, but we'll address this topic in the March issue of *Strategic Finance*. Consider *Napoleon Dynamite* from Fox Searchlight and *Stealth* from Columbia Pictures. Purchased from the Sundance Film Festival, *Napoleon Dynamite* cost \$400,000 to produce and used a largely unknown cast, but the worldwide box office was \$46 million, a return of 5,600%. *Stealth*, on the other hand, had a budget of \$138 million and signed Jamie Foxx just after he won the Academy Award and Jessica Biel, a rising star in Hollywood. Worldwide box-office receipts for the film were \$64 million—or a loss of 75% of its budget.

A method known as slate financing has recently become popular in Hollywood. In slate financing, a hedge fund manager, for example, will purchase the next 25 or 30 movies from a studio and split the profit with the studio. Over the past three years, hedge fund managers have invested more than \$4 billion in Hollywood films, with most of the money going to the major studios. Today, all major studios have financing deals with a hedge fund. Universal, for instance, has a deal with Relativity Media, which states that it will put up \$1.6 billion to fund movies from Sony and Universal. The studios are very much in favor of using hedge funds because they take all the work out of financing. But hedge fund managers seem to have mixed feelings about the results, and some are beginning to directly sponsor specific producers and directors rather than giving money to the studios. (For

Table 2: Cost Breakdown for *Spiderman 2*
(Columbia Pictures, 2004)

Story rights: \$20 million

Screenplay: \$10 million

Producers (Stan Lee, Grant Curtis, Laura Ziskin, Avi Arad, Joseph M. Caracciolo, and Kevin Feige): \$15 million

Director: Sam Raimi, \$10 million

Cast: \$30 million, broken down as follows: Tobey Maguire, \$17 million; Kirsten Dunst, \$7 million; Alfred Molina, \$3 million; rest of cast, \$3 million

Production shooting costs: \$45 million

Visual effects: \$65 million

Music: \$5 million

Composer: Danny Elfman, \$2 million

Total Production (Negative) Cost: \$200 million

(Source: Discussions with Industry executives and www.boxofficemojo.com)



more information, see “Shaking the Money Tree,” which appeared in the May 21-27, 2007, issue of *Variety*.)

Pre-production

In pre-production, the producer will hire the director, cinematographer, unit production manager, production designer, and principal cast. The producer also will scout locations and approve the final shooting script, production schedule, and budget.

A critical job of a producer and casting agents is to hire the right talent to work at the right price. A key element that sets the motion picture industry apart from others is that the people who produce, direct, and star in movies have recognizable names and faces on which they trade. This contrasts sharply to, say, the airline industry, in which skilled individuals go about their work every day, but each is essentially unknown (except perhaps the CEO) outside of their immediate customers. A-list talent in Hollywood can make up to \$20 million per film, although studios are attempting to reduce these up-front payments in lieu of a larger percentage of net profits.

In addition, a small army of technical people, such as those who are set designers, camera operators, lighting specialists, transportation personnel, etc., work on the motion picture. The highest-paid member of the crew is the director of photography.

When negotiating the contracts to hire talent for the

film, the producer and casting agents also need to consider conditions established by different types of unions. The term “union” in the creative industries describes labor organizations that represent technical personnel, and the term “guild” describes labor organizations that represent creative people, such as actors, producers, and directors. For major motion pictures, more than 40 unions can be represented on a production set. Apart from well-known guilds such as the Screen Actors Guild (SAG), which represents talent such as actors and actresses, another guild, the Writers Guild of America (WGA), has become very recognizable by the public as, at the time of this writing, its members are on strike for a greater share of DVD and Internet residuals from the major studios.

The budget for a film is split into above-the-line and below-the-line segments. Above-the-line costs include everyone who can share in the profits, including the producer, director, and actors. The below-the-line part of the budget consists of the cost of the technical people such as the crew, materials, locations, etc.

Actors are also represented by business managers, agents, publicists, and attorneys (some agents and business managers are attorneys) to help them manage their careers. The existence of these intermediaries provides a layer of complexity in the creative industries that doesn’t exist in most other industries. The main job of intermediaries is to find jobs that suit their clients.

Production

Producers also are responsible for preparing production budgets, and the director implements the actual production (shooting) and post-production budgets. A film's negative cost—the cost of manufacturing the master print—has several components. These costs include any up-front payments to the talent, such as actors and actresses, and other employees; costs of sets; and other costs incurred during the production process. If it's a studio film, then the studio also charges a fee for using its facilities as well as interest on the negative cost and overhead.

During production, the producer will hire a line producer to monitor the physical aspects of making the film and oversee the principal shoot. The line producer also helps monitor the budget closely to make sure there aren't any budget overruns. Physical production can involve many elements, and specific requests often must be negotiated carefully. For instance, to make the film *The Italian Job* in 2003, Paramount closed two blocks of Hollywood Boulevard for more than a week at the cost of several hundred thousand dollars.

Of course, cost disasters can occur. Often cited as a way *not* to make a movie, Michael Cimino's 1980 *Heaven's Gate* had such enormous production delays and excessive filming costs that the final cost was approximately \$40 million, compared to its original budget of \$11.6 million. This film is reputed to have bankrupted the studio, United Artists.

Post-production

In post-production, the producer will work with post-production personnel, including the editor, composer, and visual-effects staff. He/she consults with all creative and financial personnel on the answer print or edited master and works with the financial and distribution entities concerning the marketing and distribution plans for the motion picture in both domestic and foreign markets. Major companies such as Industrial Light & Magic can employ hundreds of people if the computer-generated imagery is extensive. Post-production work on *Hulk*, for instance, is estimated to have cost \$10 million.

Another significant cost for a film is original music—whether it's original compositions or existing pieces. Major composers can garner seven-figure salaries for an original score. The cost of using an existing piece of music is exemplified in the film *Lords of Dogtown* where producers paid \$3 million to use Led Zeppelin's *Whole Lotta Love*.

In Table 2 we provide a comprehensive example of each significant cost for a major motion picture, using *Spiderman 2* as an example. One of the most expensive movies of all time, *Spiderman 2* in 2004 cost a staggering \$200 million to produce, but it also grossed \$784 million worldwide over its theatrical run. One of the biggest challenges facing the major motion picture studios is the pressure to outdo themselves, especially when it comes to sequels. Every sequel in the major Hollywood franchises has cost a lot more money to produce than the previous film in the series. A few examples include *The Lord of the Rings*, *Shrek*, *Pirates of the Caribbean*, and *Spiderman*. For example, *Spiderman 3*, which debuted in May 2007, is reputed to have cost \$258 million but went on to gross \$890.8 million in theatrical release worldwide.

THE RIGHT BLEND

Making a major motion picture is a complex task with many moving parts. It involves the blending of the right talent, money, management, technology, creativity, and a bit of luck. Even with all of these ingredients, though, a film's success is hardly guaranteed. In our next article, we'll explore the possibilities for success—the business of selling movies. ■

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