

Chapter 1: Overview of Industry

A macro overview of a company's industry and the economy are critical starting points for any valuation analysis. In many cases, the industry trends are better indications of the future than a review of the company's historical operations. The theater exhibition industry is entering into a new generation of digital content that will transform the operational structure of the exhibition industry. Theaters are transforming from traditional theater houses exhibiting motion picture films into becoming entertainment centers complete with satellite hookups, libraries and contents previously never available.

Introduction

This chapter will focus on the history, trends, movie theater demand, supply of quality first run films, current renovation trends of facilities, movie distribution channels, film negotiations and licensing competition, revenue streams in relation to DVDs, risks in the industry and the regulatory environment of the industry.

History

Begun over a century ago, motion pictures have developed into a complex mixture of art and commerce, capturing worldwide audiences and having a significant impact on political, social and economic behavior of our society.

At the turn of the 20th Century, the motion picture theater industry was born with the 1903 release of the feature film, **The Great Train Robbery**. Cinema was in its infancy. This twelve minute long picture introduced pioneering editing techniques and a narrative style that transformed the entertainment experience for the viewing public. In the final scene, a gun being fired toward the camera had a profound effect on audiences alike. Many people who saw the film thought that they were actually about to be shot - the beginnings of movie magic.

Prior to motion pictures, people entertained themselves with live theatrical and operatic performances from a range of independent theaters and opera houses, live performances, magicians, comedians, dancers and singers. As the technical quality and popularity of films grew, so did the construction of grand

movie palaces, becoming attractions in and of-themselves. The first movie house devoted exclusively to movies opened in Manhattan, New York, in 1913.

Movie theaters quickly became Americans' primary and most desired source of entertainment during the 1920s and onward. Elaborate venues seating as many as 5,000 were built in cities and towns across the United States, often upstaging their featured films with grandeur and majestic qualities, mimicking the architectural styles of Greek, Spanish and Egyptian cultures. Imported marble columns, crystal chandeliers, and gold-painted figures were common decor, along with pipe organs in many theaters to provide music for the early silent film era. Services included immaculately uniformed doormen, ushers, and lounge attendants along with an admission price of 5 cents.

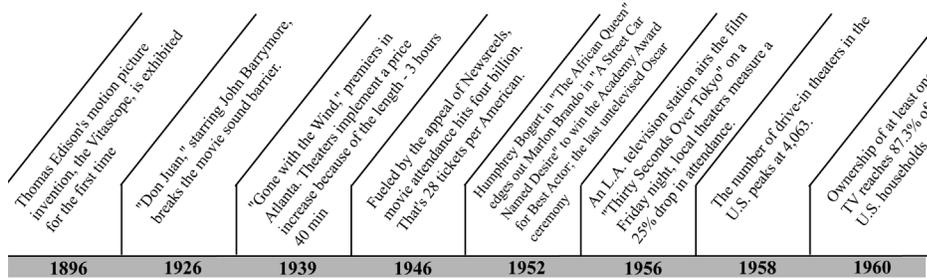
The advent of sound in motion pictures required movie palaces to upgrade and invest heavily to incorporate the new technology. Many theaters partnered with or were acquired by rich Hollywood movie studios. Since its inception, the motion picture theater industry has predominately always been dominated by a handful of companies: Paramount, Twentieth Century Fox, Warner Bros, MGM, and RKO Pictures. The big five produced, distributed and exhibited films in company-owned theaters, thus creating an industry wide vertical integration structure.

The five major studios exclusively dominated the industry throughout the 1920s, 1930s, and 1940s. Together they produced 95 percent of all big-budget features released before 1950 and owned 70 percent of all first-run theater houses in the United States. An oligopoly quickly formed as the five majors collectively exchanged access to first-run films for reciprocal privileges, creating high barriers of entry, impenetrable by outside competition.

The collusion of Hollywood's top studios also enforced "block booking." Block booking was a Hollywood signature practice whereby independent theater owners wanting to run a big-name movie had to agree to buy bundled packages. A movie theater that wanted one of the A-pictures would be forced to buy several of the inferior B-pictures. Block booking created a guaranteed market for even the most mediocre studio films, as independent theaters were compelled to buy the bundled films. The studios even dictated admission prices and screening schedules.

This common Hollywood practice spurred much controversy as the industry grew in scale and size, to the attention of the United States government. The federal government ordered the five majors to divest their theater holdings; the ruling was handed down by the Supreme Court on May 4, 1948. The industry had been the object of scrutiny by the government since the 1920s, when the major studios emerged. *The decision favored the independent producers on practically every point. The Supreme Court affirmed the statutory ruling that declared the studios guilty of violating antitrust laws. Once and for all the Supreme Court abolished block booking, ending over 30 years of controversy, by requiring all films henceforth to be sold on an individual film-by-film, theater-by-theater, and zone-by-zone basis.*¹

Figure 1-1: Historical Timeline 1896-1960



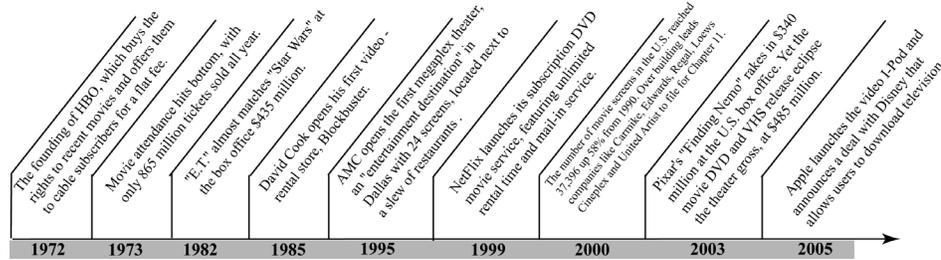
The industry operated under this “non block booking” format until 1980, when President Reagan allowed studios to once again become vertically integrated by giving them the right to own movie theaters and re-establish block booking. This new application of the antitrust doctrine under President Reagan was used by the studios to reshape the motion picture industry. Under the Reagan administration's policies, consent decrees from 1948 were not enforced, and the movie studios once again reassembled to some degree, the vertical integration structure. By 1985 the studios were overcome with acquisition fever and were purchasing theaters at a record pace. Although some studios waited with cautious observance to analyze the Justice Department's response, it raised no objections. Between 1985 and 1988, movie companies spent more than \$1 billion to purchase independent movie theaters. The motion picture industry reverted back to the structure that existed before the theater divestiture in 1948.

For much of their 100-year history, movie theaters were the exclusive venue for Hollywood to exhibit its glittery goods. In the heyday of movie-going, which stretched from the grand urban palaces of the 1920s through the quintessential 1950s drive-in, theaters were the ultimate escapist destination. For less than a dollar you were swept into another world (complete with air conditioning, buttery popcorn, and if you were lucky, a date). Back in 1946, fluttered by the appeal of newsreels, movie theaters sold some four billion tickets in the U.S. at a time when the total population was 141 million. That's 28 movies a year, on average, for each and every American. However in the 1950s, television began to gnaw away at movies' stranglehold on entertainment, and by 1973 ticket sales fell to 864 million. Today, the average American goes to the movies less than five times in a year.

After World War II, the flight of affluent city dwellers to the suburbs – the suburbanization of America - was the final blow for traditional downtown metropolitan theaters. The birth of the shopping center mini malls and multi-screen cinemas with free abundant parking and within proximity to the growing population of American suburbanites has continued to divert interest away from movie theaters.

1. http://cobble.com/simpp_archive/paramountcase_6supreme, 10/23/2007.

Figure 1-2: Historical Timeline 1960-Present



National – International Trade Organizations

The movie theater exhibition industry is represented by the National Association of Theater Owners (NATO). NATO was formed through the 1966 merger of the Theater Owners of America, which was founded in 1920, and the Allied States Association of Motion Picture Exhibitors, which was created in 1939. The organization compiles and publishes statistical and historical information on the economics of theater and concession operations, film producers and distributors, theater equipment, box-office sales, and attendance.

The Motion Picture Association of America (MPAA) and its international counterpart, the Motion Picture Association (MPA) serve as the voice and advocate of the American motion picture, home video and television industries, domestically through the MPAA and internationally through the MPA. Today, these associations represent not only the world of theatrical film, but serve as the leader and advocate for major producers and distributors of entertainment programming for television, cable, home video and future delivery systems not yet imagined. Founded in 1922 as the trade association of the American film industry, the MPAA has broadened its mandate over the years to reflect the diversity of an ever changing and expanding industry. The initial task assigned to the association was to stem criticism of American movies, which were then silent, and to restore a more favorable public image for the motion picture business. Today the association continues to advocate for strong protection of the creative works produced and distributed by the industry, fights copyright theft around the world, and provides leadership in meeting new and emerging industry challenges.

Exhibition Industry Overview

Movies remain a cornerstone of domestic entertainment, with consumers dispensing billions of dollars annually to view films in various formats: theaters, home video-DVDs, satellite, pay-per-view, on-demand, and recently, online. In 2005, moviegoers in the United States purchased approximately 1.4 billion

movie admission tickets, totaling \$8.7 billion in box office sales, an average of about 3.8 million tickets per day at an average price of \$6.41 per ticket. This is only a small portion of the total consumer spending on film entertainment reported at \$94.9 billion in 2005, according to Standard and Poor industry reports. There are presently 590 companies competing in the theatrical exhibition industry in the U.S. and Canada, of which approximately 350 companies operate four or more screens. Industry participants vary substantially in size, from small independent family owned operators to large international circuits owned both publicly (NYSE) and privately (Private Equity Firms).

Trends

Over the past decade, the domestic motion picture exhibition industry experienced a period of extraordinary new theater construction. From 1995 to 1999, the number of screens increased 58%, a compound annual growth rate (CAGR) of approximately 8%. This growth was more than double the industry's screen growth rate of approximately 3.5% from 1965 to 1995. This industry expansion was primarily driven by major exhibitors upgrading their asset bases to an attractive megaplex format, which typically includes 14 or more screens per theater and has enhanced features such as stadium seating, improved projection quality, superior digital sound systems and accommodating premium services such as restaurants, cocktail bars, arcades, shopping amenities, corporate services and private event rooms.

Screen Expansion

Due to the saturation of theater screens and unmatched admissions growth, exhibitors experienced financial difficulties in the late 1990s. During the 1990s, the US movie theater industry over expanded, opening more than 15,000 new US movie screens while closing an insufficient number of older screens. This expansion can be seen in Table 1-1 on page 24. Most major exhibitors updated their theater portfolios to the megaplex format during the late 90s expansion period, incurring heavy capital investments. As a result of this and other factors, about half of the 12 largest U.S. exhibitors entered bankruptcy protection proceedings between 1999 and 2001. By 2005, all companies had emerged from bankruptcy.

As of 2007, most major exhibitors have reduced their capital spending and new screen growth has returned to historical patterns existing prior to the late 1990s expansion. Another evolution of theater formats beyond the current megaplex is unlikely to occur in the foreseeable future. Theaters larger than 18 screens, typically, are not able to generate attractive returns in most locations. The profitability of the cash flow per screen begins to fall as the number of screens at any location goes over 18. Consequently, many megaplex exhibitors are incurring increasing direct labor expenses in an effort to raise service quality. Average wage rates from ushers, lobby attendants and ticket takers has increased 22% in six years from \$6.02 to \$7.35 in 2005, largely due to the