Chapter 2: Analyzing a Theater's Financial Statements & Operations

To analyze a theater's operations a close look must be taken at the day to day operations as well as examining the theater's financial history. Usually more emphasis is placed on financial ratio analysis. However, financial statements offer only figures. Many times more insight can be gained by simply walking through the theater.

Overview

Competition acts to drive profit margins and the returns on investment down to a free market minimum level. In other words, competition translates into lower prices. Therefore, in the long run, the analysis of profit margins (which is a component of return on equity) will depend upon the analysis of a firm's competitive position as well as the competitive position of the industry in which it operates.

Two factors determine the choice of a competitive strategy:

(1) The long-term profit outlook for the theater industry.
(2) A firm's competitive position within the theater industry.

Both are important. A firm can be in a profitable industry and still do poorly because of a poor competitive strategy, or it may have a good competitive strategy and do poorly because the industry is mature.

In order to forecast the profit margin of a company, and its return on equity, one needs to review the basic competitive forces that exist in an industry and assess the strength of each. In any industry, there are five basic competitive forces as put forward by Michael Porter in his book *Competitive Strategy: Techniques for Analyzing Industries and Competitors*:[1]

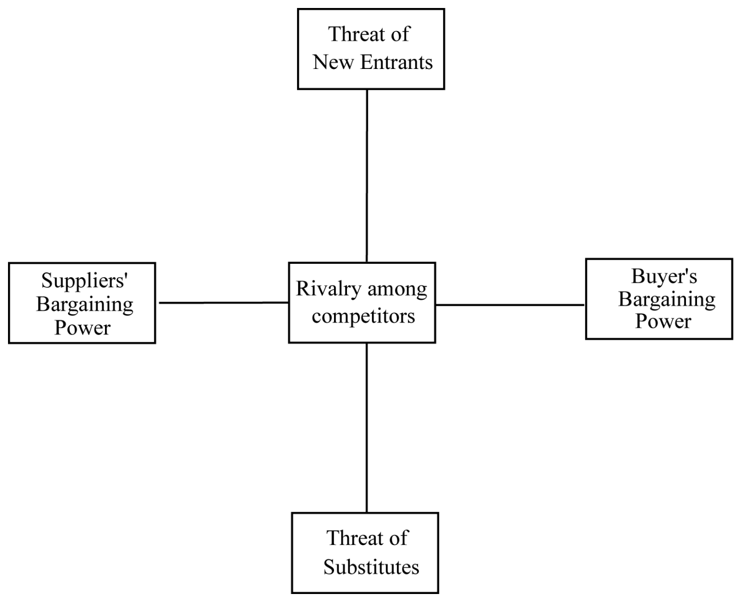
(1) Ease of entry and exit
(2) Rivalry between existing competitors
(3) Pressure from substitute products

1. Porter, Michael E. 1980. *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. New York: Free Press.

(4) Bargaining power of buyers
(5) Bargaining power of suppliers

These pressures are presented in Figure 2-1.

Figure 2-1: Five Basic Competitive Forces Facing a Theater



First, with respect to ease of entry, the following factors affect the decision of a theater to enter a given market: capital requirements, economies of scale, secure distribution channels, strong brand identification, government policy, technological differences, expected retaliation, and absolute cost advantages.

Second, rivalry between existing competitors involves such variables as the number of competitors, the relative strength of the competitors, the strength of their competitor's relationship with film distributors, the industry growth potential, the amount of fixed costs needed, concession product differences, and entertainment quality.

Third, pressure from substitute products can devastate the theatrical industry. The theatrical industry faces competition not only from within, but also from other industries. One needs to focus on substitute products and the minimum switching costs for potential customers, and high profit earning industries which can afford to reduce margins in order to broaden their market into the seller's market.

Fourth, with respect to their bargaining power, buyers can bargain for price cuts, better quality, and more services. Such actions by buyers tend to lower profit margins for sellers. The buyers' power depends on their bargaining leverage, their sensitivity to the price of the product being sold, and the relative availability of substitutes. These variables are: the volume of purchases by the buyer as a percentage of the seller's sales, the profitability of the buyer, the percentage of buyer cost that is represented by the product, buyer information, whether the buyer could duplicate the product from the seller, the product's impact upon the buyer's business, switching costs, and the seller's ability to influence the buyer.

Finally, the bargaining power of suppliers (film distributors) can reduce a firm's profit margins by raising costs or reducing quality. The conditions that give bargaining power to suppliers (film distributors) are: the relative size of suppliers versus buyers, the importance of the buyer to the seller, the switching costs, whether the supplier can penetrate the buyer's market, the degree of organization of the supplier, the supply of the supplier's product, and whether the government can control the supplies of certain products.

If economic forces are strong enough to create a competitive market, then they will place downward pressure on rates of return so as to equal the return to assets used plus a business risk premium. If an industry is earning above average returns, then capital will flow into it causing an expansion of supply and therefore placing downward pressure upon margins. If the industry is earning below average returns, then capital will exit and there will be upward pressure upon margins.

It is the degree of competition produced by these competitive forces that determines the ability of theaters within the industry to generate attractive rates of return. If these five factors are favorable, then many theaters can earn attractive returns; if they are unfavorable and lead to intense competition, then few theaters can do well despite good management. The theatrical industry profitability is directly related to the industry structure and not the product which the industry sells.

A Theater Operator's Business Strategy

For most theater operators growth has been primarily through new theater development. As a result, most operators try to operate the most modern theater circuit within the industry.

Most operators have built modern multiplex facilities in under-served mid-sized U.S. markets as well as in major U.S. metropolitan areas. In such markets an operator frequently is the sole or leading exhibitor in terms of first run screens operated within a film zone. An operator gains maximum access to film products, and thereby realizes a competitive advantage, by locating its modern multiplex theaters in new and existing film zones where there is little or no competition.

Some operators continue to maintain discount theater niches in the United States. These operators maintain their discount theater operations (admission of $0.50 to $2 per ticket) in the U.S. to serve patrons who miss a film during its first run exhibition or who may not be able to afford to attend first run theaters on a frequent basis. Multiplex discount theaters offer many of the same amenities as first run theaters, including wall-to-wall screens, comfortable seating with cup holder armrests, digital sound and multiple concession stands.

The industry is moving more towards closing many smaller, older and/or obsolete theaters, and focusing on the selective construction of larger multiplex or megaplex theaters and by expanding certain existing theaters. Multiplex theaters enable an operator to present a variety of films appealing to several segments of the movie-going public, while serving patrons from common facilities (i.e., box office, concession areas, restrooms and lobbies).

An operator relies upon advertising and movie schedules in newspapers as well as on websites to inform patrons of film selections and show times, as well as exhibit previews of coming attractions and films presently playing on other screens.

Additionally, most operators provide a comprehensive offering of remote ticketing services, showtimes, reviews and movie trailers through an internet movie portal.

Some operators have generated additional revenue through the leasing of theaters for motion picture premieres and screenings, corporate events and private parties. Some of these theaters have earned reputations as the "preferred" theaters for these events given their locations in key urban markets as well as their upscale settings.

Operating Revenue From Theaters

Theater's Revenue And Expense Sources

Theaters primarily generate their revenue from admission and concession sales. A list of the different sources of revenue and expenses from the operation of a movie theater along with a typical range calculated as a percentage of total sales can be seen in Table 2-1 on page 56.

Box Office Revenue

Box office revenues are directly related to:

1) Attendance, which is driven by the quality of the movie-going experience, including the comfort, cleanliness and convenience of the location of the individual theaters,

2) The content and quality of film product distributed by major motion picture and independent film studios,

3) The ticket price,

4) The quality of projection and sound presentation, and

5) The level of customer service.

Concessions

Concession sales are an operator's second largest revenue source, typically representing approximately a third of total revenues. Most operators have devoted considerable management effort to increasing concession sales and improving the operating income margins from concession sales. These efforts include implementation of the following strategies:

(1) Optimization of Product Mix
An operator's primary concession products are various sizes of popcorn, soft drinks and candy; however, different varieties and brands of candy and soft drinks are offered at theaters based on preferences in that particular geographic region. Some operators have also implemented "combo-meals" and "movie meals" for children and senior citizens, both of which offer a pre-selected assortment of concession products.

(2) Staff Training
Employees are continually trained in "cross-selling" and "upselling" techniques. Individual theater managers typically receive a portion of their compensation based on concession sales at their theaters and are therefore motivated to maximize concession sales.

(3) Theater Design
Newer theaters are designed to include at least two to three concession stands, with each stand having multiple service stations to make it easier to serve larger numbers of customers rapidly. Strategic placement of large concession stands within theaters heightens their visibility, aids in reducing the length of concession lines and improves traffic flow around the concession stands, in addition to offering franchise concessions.

(4) Cost Control
Operators negotiate prices for their concession supplies directly with concession vendors on a bulk rate basis.

Advertising Revenue

Theaters sell advertising including rolling stock commercials, intermission slides, intermission music, lobby monitor advertising and entertainment, coupon distribution and customer sampling. Revenues are primarily contingent upon the success of the sales efforts, as well as upon the location of theaters and attendance at the theaters.

Other Revenue Streams

Operators actively engage in efforts to develop revenue streams in addition to admissions and concession revenues. Certain theaters include electronic video games located in or adjacent to the lobby and on-screen advertising is provided on a number of operator's screens, each of which provides additional revenues to that operator. Therefore, revenue is derived primarily from electronic video games located in theater lobbies, theater screening and commercial rentals, and other miscellaneous sources.