A COMPETITIVE ANALYSIS OF THE U.S

MOTION PICTURE INDUSTRY

by

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Ingénieur Civil des Mines
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(1988)

Submitted to the MIT Sloan School of Management
in Partial Fulfillment of
the Requirements for the Degree of

Master of Science in Management

at the

MASSACHUSETTS INSTITUTE OF TECHNOLOGY

May, 1990

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ABSTRACT

In 1990, the American motion picture industry is in the midst of a total restructuration. A series of mergers and acquisitions has completely transformed the competitive environment, and movie production companies are facing new strategic issues. The main purpose of this thesis is to examine the consolidation of the industry, its causes and consequences.

Technological innovations, expansion of foreign markets and the deregulation of the movie theater industry are the main reasons for the restructuration of the film production industry. Because of their global advantage, American film studios have become a means for international corporations not only to make profitable investments, but also to reinforce their position in the global entertainment industry. The examples of the acquisition of Columbia Pictures Entertainment by Sony Corp and of the formation of Time Warner illustrate the strategic benefits of owning a film studio.

But the consolidation of the film industry, which is likely to continue, also brings a number of challenges for the future. The differences in culture between major corporations and studio executives will lead to management difficulties. The domination of the industry by a few major companies with increasing power is threatening the existence of small production companies, which are key to the American Cinema's competitive advantage. Moreover, the resulting reduction in the number of movies produced is dangerous.

I wish to thank my thesis supervisor, Maurice Segall, for his useful advice and opinions, as well as Duncan Clark, from Columbia Pictures Entertainment, for taking the time to discuss some key strategic issues with me.

Thesis Supervisor: Maurice Segall

Title: Senior Lecturer, Management

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CHAPTER I: INTRODUCTION

I.1 BRIEF HISTORY OF THE INDUSTRY'S SRUCTURE

After World War I, the U.S motion picture industry was dominated by a few major companies.

Universal Film Manufacturing Co pioneered the development of the "full-service" studio. In that period, a single company handled most of the aspects of the film making process:

- Production
- Edition
- Technical functions, such as lighting

This concept was pushed even further by Adolph Zukor, founder of Paramount Pictures, when he signed contracts with thousands of exhibitors (theater owners). This gave the studio two major competitive advantages:

- It assured a market for its products
- It raised barriers to the competition

Soon Zukor's example was followed. In the late 1940s, the market was completely dominated by seven companies. They owned the majority of first-run theaters, and had most actors under contract. That was the "Golden Age" of Hollywood. However, two fundamental changes were about to occur:

1. In 1948, the Supreme Court ruled it illegal for studios to own theaters. This Antitrust decision forced all the major companies to sell off the theaters they owned.

2. The apparition of television had a dramatic effect on the movie industry. In 1948, only 172,000 American households owned TV sets. In 1956, this figure was up to 35 million.

In ten years, movie audiences dropped by half. Los Angeles saw employment in the film industry fall by 40%. The profits of all major studios decreased sharply. After a few unsuccessful attempts to bring audiences back into theaters with technological innovations - such as 3-D and Cinerama, the industry was poised for its first major restructuration.

In an effort to reduce their costs, the major studios cut their permanent staffs, started selling off valuable assets and began contracting out film production. Until then dominated by a few major companies, the industry suddenly offered new business opportunities. Between 1966 and 1982, according to a study by Michael Storper and Susan Christopherson, the number of companies doing film editing increased by a factor of 28, and the number of lighting companies by a factor of 11. Production companies increased 162%. Most of these firms were very small -they averaged fewer than twelve permanent employees.

In that "entrepreneurial era", small firms were highly specialized.There was a large number of them, and the competition between these companies forced them to achieve differentiation, for instance through technology. The effervescence of special effects firms in the 1970s, with the outstanding example of George Lucas, is a perfect example of that type of competition. Meanwhile, the large companies would spend most of their resources financing and marketing movies, relying on small companies for production and technical innovations.

In the meantime, however, technology had offered the audience new products. In addition to Network Television, movies could now be seen on videotape or on cable stations. These changes were about to cause the industry's second important restructuration.

The distribution system was now diversified, and new markets had been created for motion pictures. Major studios saw an opportunity to apply "Zukor's principle" again. They started acquiring theaters, television stations and cable channels. They created subsidiaries that assured the distribution of their movies to the cable stations and to the home video market. Soon, all major companies found themselves running impressive distribution networks, and felt the need to have a better control over the product they manufactured. The result was a need for additional financial resources, which were obtained through mergers and acquisitions. The consolidation of the U.S film industry is still taking place today, with the recent acquisitions of Columbia Pictures Entertainment by Sony Corp, and of MGM/UA by Pathe Communications.

I.2 OBJECTIVES OF THIS STUDY

This thesis is an attempt to analyze the U.S motion picture industry today. I have two complementary goals:

1. I will examine the restructuration that has been taking place in the last few years. I will try to identify the economic factors which motivated the recent mergers and acquisitions. The consolidation of the industry is bringing a multitude of new strategic issues. I will point out what the most important ones are, and give an opinion as to how I feel these issues should be approached.

2. The technology of entertainment continues to change quickly, as do popular tastes. I will focus on the new competitive tools that are available to the players. I will try to determine how the industry will evolve in the future, and how this should affect today's decisions.

To illustrate this study, I chose to analyze in more detail the behavior of two companies, Warner Communications and Columbia Pictures Entertainment. I believe that this will enhance the study, by providing several meaningful insights:

- Having two specific examples will allow me to make practical recommendations and to make a comparison between two strategies.

- The two companies are in very different situations. Until its merger with Time, Warner had been able to maintain a relatively stable organization. With *Batman*, the studio has recently recorded the greatest box office success of its history. On the other hand, Columbia has been crippled by bitter management battles, and is coming off a series of box office disappointments.

- Because of the recent associations the two companies have been involved in - Warner merged with Time Inc and Columbia was acquired by Sony Corp -, I will be able to examine the interactions between the motion pictures industry and the media and electronics industries.

CHAPTER II: STRUCTURAL ANALYSIS OF THE U.S MOTION PICTURE INDUSTRY

II.1 THE COMPETITORS

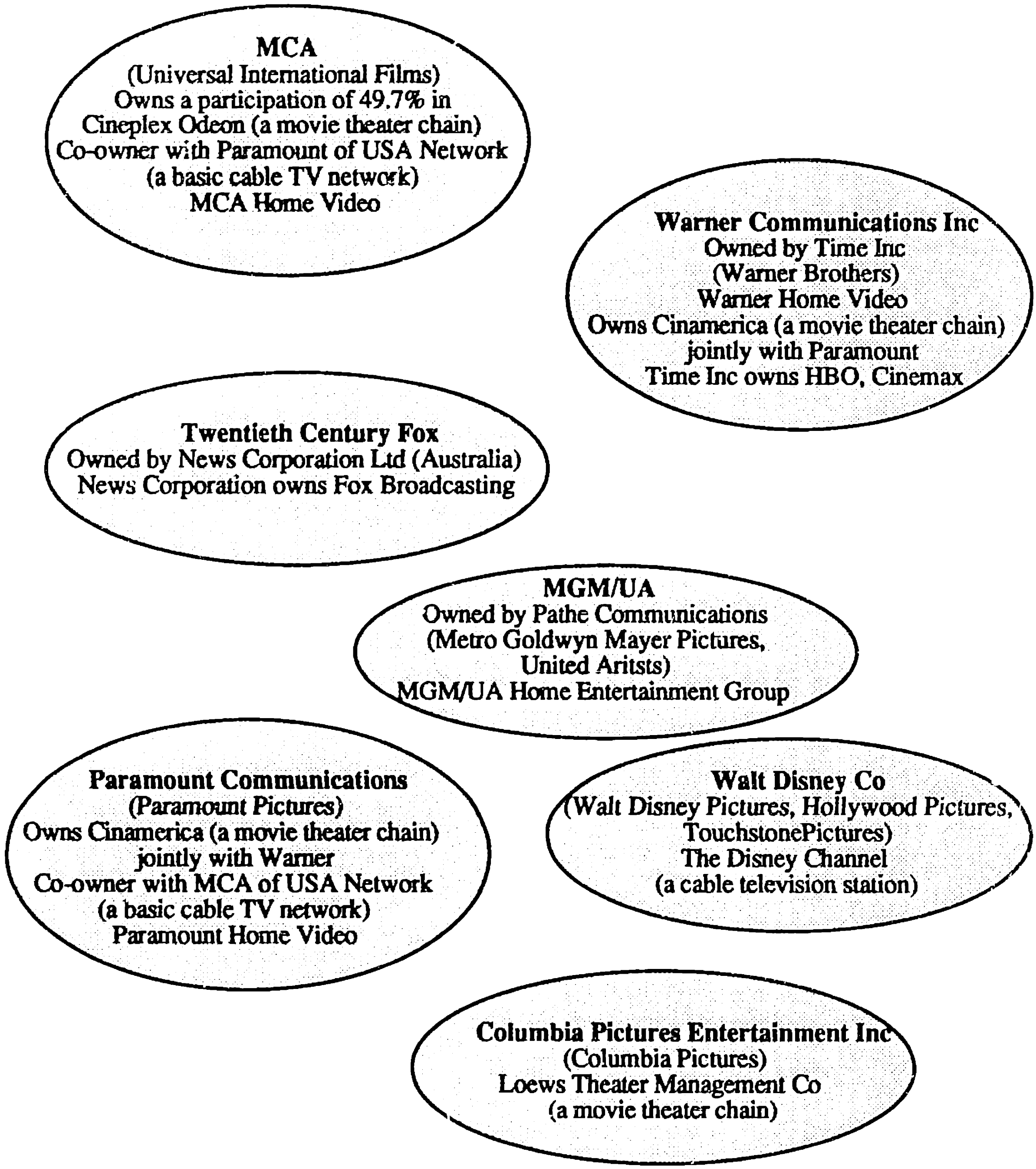
Appendix 1 shows the principal participants in the U.S motion picture industry, with basic information concerning their activities and recent financial results. Although Appendix 1 does include Cineplex Odeon and General Cinema, two companies which are engaged in the exhibition of motion pictures and not in their production, I am interested in this study by the competition between movie production companies. Other industries such as the television, home video or movie theater industries will be examined here solely for the effect they have on the film production industry.

As we can see from Appendix 1, many of the companies which operate a film studio are also engaged in a variety of other activities. Walt Disney Co is the example of a company which extracts a large portion of its revenues from activities such as real estate development. However, as shown in Appendix 1, many of the companies which operate a film studio are also engaged in activities that are related to the entertainment industry.

Another important observation is that most of major film production companies have developed, mostly through acquisitions, a structure that allows them to have control over other aspects of the industry, such as theatrical distribution, cable television or home video. To illustrate this point, Figure II.1 shows the seven major American film companies and their key subsidiaries.

Although separating seven major studios from the rest of the industry is somewhat arbitrary (in particular, Orion Pictures and MGM/UA are nearly equivalent in size), it is interesting to notice that all these firms were dominating the industry during the Golden Age.

The objective of Part II is to analyze and explain these and other characteristics of the U.S motion picture industry today, and to detect trends in that industry.



(Source: Company Reports)

Figure II.1 The seven major players and their key U.S subsidiaries

II.2 DISTRIBUTION

The objective of this section is to analyze the structure of the distribution network, and to study the trends that are developing in the different markets for American motion pictures.

II.2.1 The effects of technological changes

Technology affects the film industry in two ways:

- It changes the way movies are made
- It changes the way movies are seen

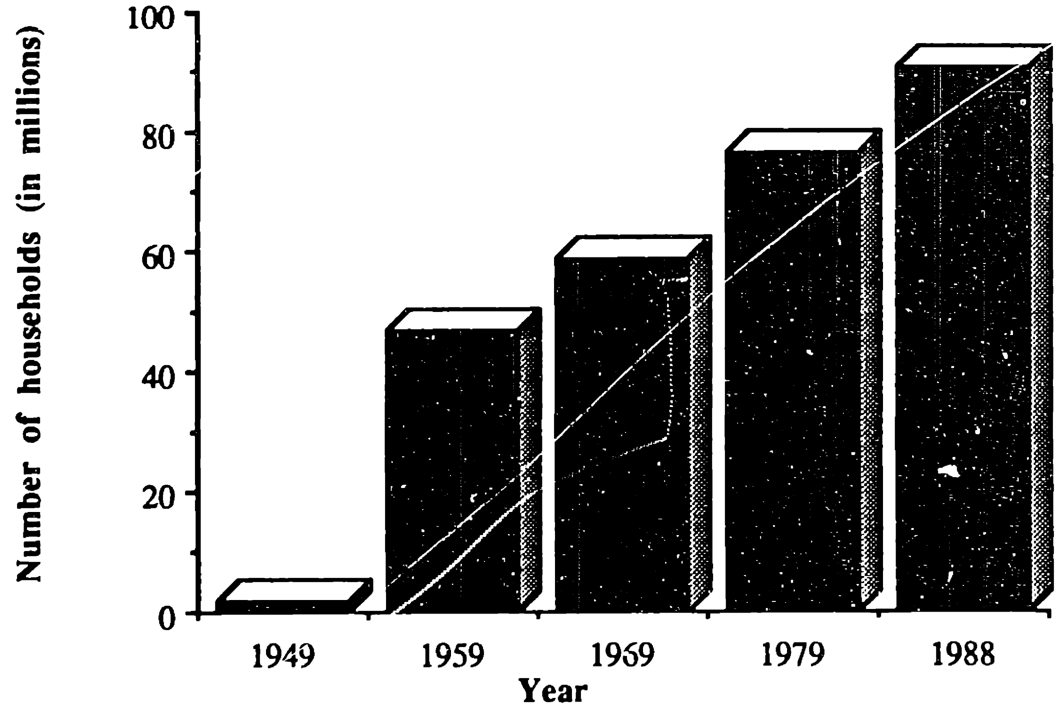
Technology brought sound, then color. It achieved Technicolor, Cinemascope, Dolby-Stereo. It has provided directors with more and more ways to express their vision. It has consistently improved the quality of photography. It has given the industry gimmicks such as 3-D, Cinerama, or entirely computerized movies. The influence of technology on film making has been dramatic.

In this paragraph, however, my goal is to examine how technology has affected the distribution of American motion pictures.

In the early days of the industry , distribution was simple. The only way to see a movie was to walk into a theater. The distribution network was constituted only of movie theaters.

The apparition of television in the late 1940s has deeply transformed the U.S motion picture industry. On the one hand, television offered the public a different form of entertainment, that would compete with the film industry. On the other hand, television was about to bring motion pictures into American homes, thus offering new oppotunities to U.S movie producers.

Since 1949, as shown in Figure II.2, the market reached through television has consistently grown. In 1988, 90.4 million homes - or 98% of all American households - were equipped with television.



(Source: Nielsen Media Research)

Figure II.2 Penetration of Television in the American households

Technology has been used to improve reception and to provide the viewers with a larger variety - and a better quality - of programmings. Two of the innovations that occurred during that period had a dramatic effect on the distribution network for motion pictures: cable television, and home video.

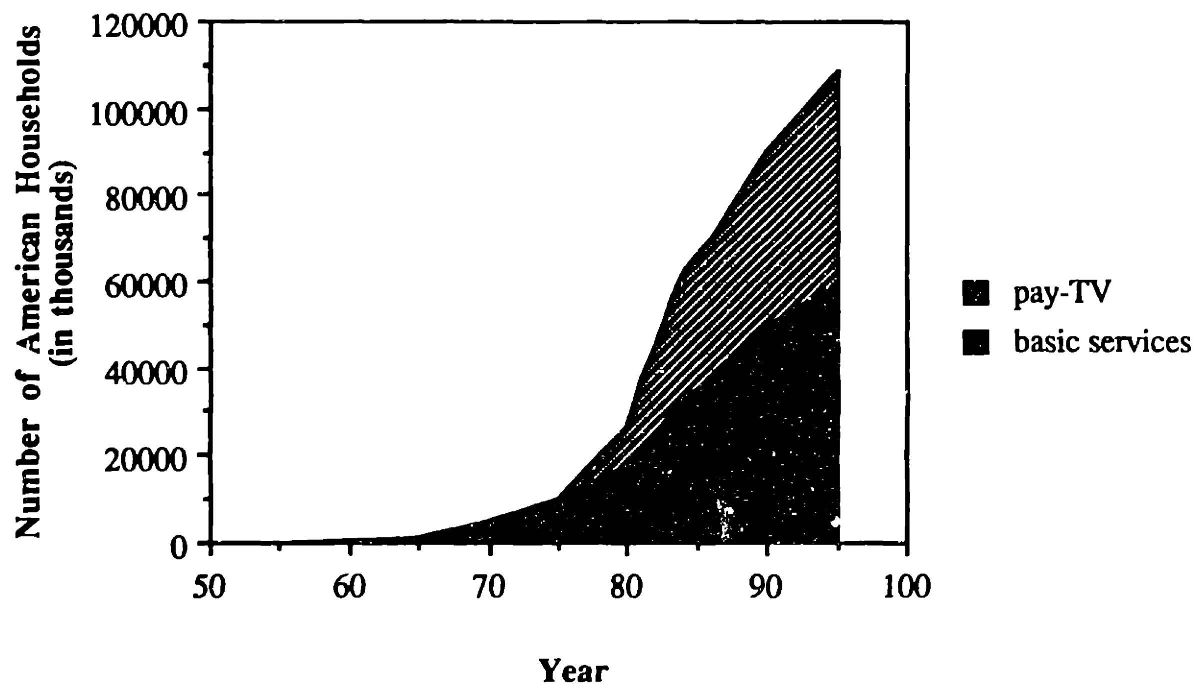
Cable television

Cable television (CATV) started in the late 1940s, as some entrepreneurs viewed this technology as a way to boost television sales in areas that were underserved by standard broadcast stations. The CATV system grew in these areas during the 1960s.

In the early 1970s, however, the attempts to wire major urban areas failed, because the cost of doing so was extremely high, while the demand in these areas, which were well served by regular television, was not sufficient.

But in the mid-1970s, demand for CATV increased considerably after Time Inc's Home Box Office (HBO) used CATV to distribute its pay-TV service. Other companies started distributing their own programs through cable television, making the system far more attractive to consumers in urban and sub-urban areas.

Figure II.3 shows the growth in the cable television market, distinguishing basic services from pay-TV stations. Numbers for years 1990 and 1995 are projections. Today, more than half of all American households have cable television, while more than one third have subscribed to pay-TV. The rapid growth illustrated in Figure II.3 has provided movie producers with an new and expanding market.



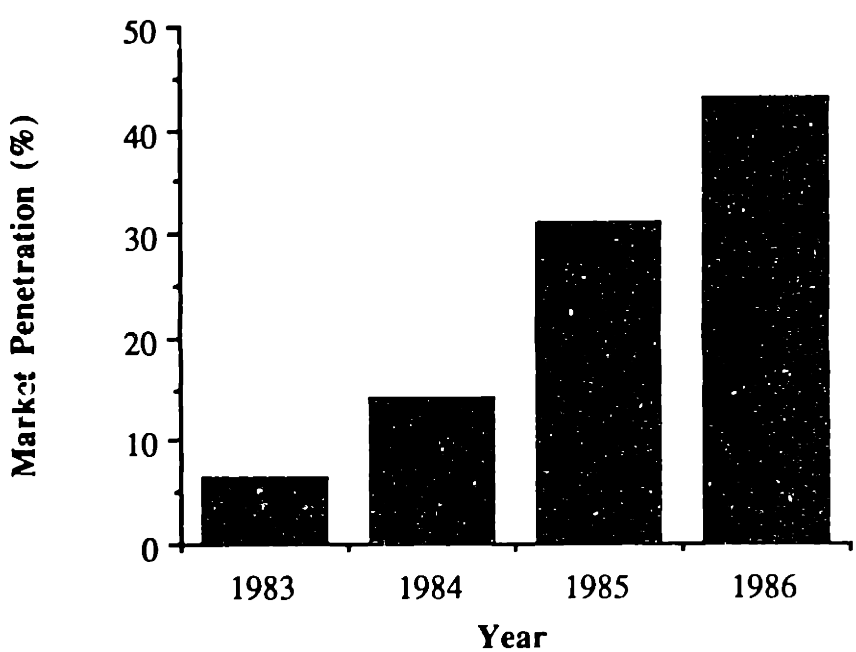
(Source: U.S Bureau of Economic Analysis)

Figure II.3 Growth of the Cable television market between 1950 and 1995.

The home video market

Another important technological innovation that was brought to the American consumers is the apparition of home video. During the first half of the 1980s, home video grew from insignificance to become a major source of entertainment. Figure II.4 shows the progression of household penetration of VCRs during those years. Today, it is estimated that two thirds of American households own a Video Cassette Recorder. In the United States, consumer purchases of prerecorded videocassettes has been increasing at a significant rate. For instance, consumer sales grew from $1.1 billion in 1987 to $1.5 billion in 1988.

While a variety of forms of programming are distributed through videocassettes (musicals, sports, music videos), motion pictures account for the vast majority of cassette rentals and sales.



(Source: U.S bureau of Economic Analysis)

Figure II.4 Penetration of VCRs in the American market.

Conclusion

Advances in technology during the 1970s and 1980s have allowed entrepreneurs to offer television owners new services. Although most of these services were not free, they were able to compete with free television, because of the following competitive advantages:

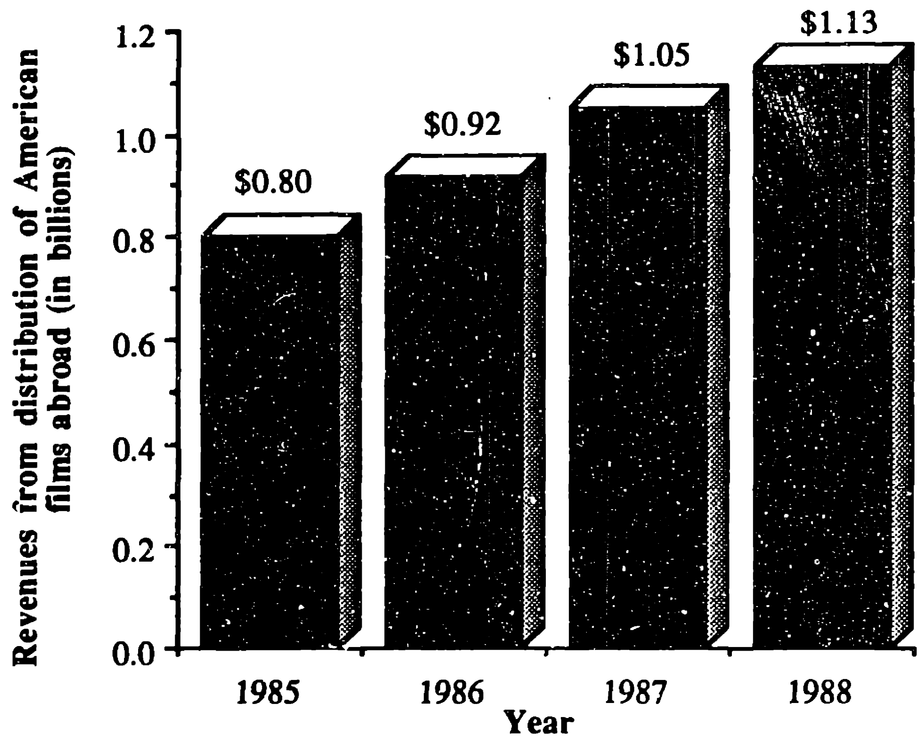
- Pay-service CATV and home video offer consumers a wide variety of programmings to choose from. Motion pictures are generally available in cable television or in home video before they are programmed on free television.

- Both the cable television and the home video industries receive income directly from consumers. Therefore, they are less dependent on advertising than Network TV or local stations. Thus, they are able to present motion pictures in their unedited, uninterrupted version, which is a very attractive feature to many consumers.

While both cable television and home video continue to grow, pay-per-view TV is expected to generate increasing revenues for the U.S motion picture industry. New technologies such as satellite broadcasting and High Definition Television are already entering the market. Others, such as digital equipment, are being developed. These technologies will continue to provide improvements in both the efficiency of transmission and the quality of reception, making filmed entertainment products more and more available to American homes.

II.2.2 Foreign markets

In 1988, almost 38% of worldwide revenues from distribution of American movies came from abroad. In 1985, only 33% of those worldwide revenues came from foreign markets. Figure II.5 shows the revenues from distribution of American motion pictures during the period 1985-1988.



(Source: Paul Kagan Associates)

Figure II.5 Revenues coming from foreign markets

This growth is essentially the reflection of two different phenomenons: the increasing international demand for motion pictures, and the United States' dominance on the industry.

<u>International demand</u>

Three main forces have caused the increase in the international demand for motion pictures:

- With cultural changes, new foreign markets are opening up for entertainment products, especially in Asia. One of the principal international trade barriers in the motion picture industry has been the absence of copyrights to protect foreign intellectual properties. More countries, such as Indonesia - which represents a market of 180 million people - have agreed to protect foreign copyrights.

- In the second half of the 1980s Western Europe's broadcasting system has been widely deregulated. Until deregulation, European televisions were ruled by a small number of government controlled channels. In that environment, there was virtually no competition between channels. As a result, governments were free to promote their domestic motion picture industries. There was only moderate demand for foreign movies, which were acquired at very low prices. With deregulation, however, some of the public channels became private, while new private channels were created. With an increased number of stations serving the same markets, and without their governments' financial resources, these private channels found themselves engaged in an intense market share competition. This created heavy demand for relatively inexpensive programming. Broadcasting popular foreign movies is an effective way of increasing ratings, and it is less costly than producing original programmings. From 1985 to 1988, for instance, the share of American programs in Western Europe increased from 10 to 20%.

- The technological changes presented above also reshaped the Japanese and European markets. Although the growth of CATV has been much slower in these markets than in the United States, home video expanded tremendously over the last few years, thus creating increased demand for movies. This worldwide increase in VCR penetration rates, as well as the espansion of satellite broadcasting have largely compensated for the decrease in leisure time observed in occidental countries.

The tremendous political changes that took place in Eastern Europe in 1989 will be accompanied by transformations in the needs and leisure habits of the people who live there. New markets and new opportunities will emerge as the structure of the television and theater industries evolve, creating more demand for motion pictures. The deregulation of the European broadcasting system is still in its early phase and, as we saw before, technology will continue to affect the structure of the entertainment industry. Therefore, worldwide demand for motion pictures will continue to grow in the future.

The United States' global advantage

The United States is by far the world's largest exporter of motion pictures. In countries such as Canada, England and Australia, American films represent the majority of the total ticket sales. In each country of Western Europe, American films are almost systematically among the two box office market share leaders. As a result, the United States is the major distributor of motion pictures in Western Europe. Today, all the major American production companies have started or intend to increase their presence in the growing European film market:

- In January 1990, Paramount Pictures announced a movie production unit that will be based in England, and that will use European writers, directors and technical crews.
- Universal is planning to construct a studio and theme park outside London.
- Twentieth Century Fox expects to be producing six to eight movies a year at a production unit based in Britain by 1993.
- Warner Brothers, which in the last two years has opened three 10 screen multiplex theaters in Britain, expects to have over 100 screens in Britain by 1991, and to open new theaters in West Germany and Denmark.
- Walt Disney Co, which will open Euro-Disneyland, a theme park, outside Paris in 1992, may build a working studio at Euro-Disneyland. That studio would be similar to the one Walt Disney Co recently built in Florida.
- Pathe Communications Inc, which recently acquired MGM/UA, also owns Pahé Cinéma, a French film production and distribution company.
- Columbia Pictures Entertainment has recently taken the responsibility of distributing in Europe the movies produced by Orion Pictures.

The objective of this paragraph is to suggest a few explanations for the United States' tremendous competitive advantage over foreign producers, and to determine whether this advantage is sustainable in the long run.

Reasons for the United States' advantage:

- American movies are recorded in English, which give them an easy access to the critical Canadian, British and Australian markets.

- Hollywood represents the world's largest concentration of creative and production talent. This gives U.S studios a wide range of possibilities in terms of script development and casting. Furthermore, the world's most extensive technical facilities are located in Hollywood, thus improving the technical aspects of all the movies that are produced in the United States.

- The major U.S studios have extensive film libraries (the world's largest seven film libraries belong to American studios). This provides a steady stream of revenues which give these film companies additional resources.

- The U.S domestic market is the world's largest. Therefore, film producers can rely on a domestic audience that is larger than anywhere else in the world. As a result, American films have a higher budget than foreign pictures, because their producers can recover higher costs without any revenues from abroad. In turn, high budget films often have the features that attract audiences worldwide (talented directors, major stars, beautiful locations or sophisticated special effects).

- Because the American companies have penetrated the foreign markets a long time ago, they were able to build an important marketing structure abroad. Thus, American studios can give their films a great boost at each foreign release.

Most of these advantages are sustainable, because they rely either on the long history of the film industry, or on demographic characteristics (like the size of the U.S market). There are, however, some issues that need to be pointed out, because they may influence the competition between the United States and Europe. These issues are related to the upcoming elimination of trade barriers between the countries of the European Community.

One of the United States' principal competitive advantages, as we mentioned before, is the very size of its domestic market, which allows American producers to recover the cost of high budget movies in their own country. Will Europeans soon be able to produce high budget films that could appeal to the entire European audience and then compete in the American market? The argument is that, since films will be traded more freely between countries, audiences will have more exposure to foreign European movies. That means that film producers will soon be able to rely on these additional spectators when devising the budget of their films.

The counter-argument is that, to be able to reach important audiences abroad, Europeans will have to overcome more than international trade barriers: they will also have to deal with the differences in languages and cultures.

The strong presence of American movies in countries such as West Germany, France or Spain is here to prove that language is not a great problem in Europe. There, techniques such as dubbing or subtitles are widely accepted.

But the differences between cultures certainly are a major obstacle that may prevent European motion picture producers from ever being able to direct their products towards a single, wide European audience. Although recent films such as *The last Emperor*, *The Bear* or *The Name of the Rose* have shown that European high budget productions can appeal to most European audiences, the attempts that were made specifically to reach the European market as a single audience, such as *The French Revolution* or *Torrents of Spring*, have failed.

Torrents of Spring, for instance, is based on a Russian novel. It tells the story of a Russian landlord (played by an American actor), who travels from Italy to Germany to sell his French land. The movie was recorded in English, and was directed by Jerzy Skolimovski of Poland. Although this is only one example, it does show the difficulties that film producers will have to identify - or to establish - a single European culture.

And the main reason why there may never be a European culture is that the countries which constitute the European Community simply do not want such a culture to emerge. Of all negotiations that surround the preparations of 1992, those dealing with the entertainment industry - and especially with television - are among the most passionate, because television has a direct influence on a country's culture. In particular, France claims that, in order to preserve the national culture, it is necessary to impose quotas not only to reduce American importations, but also to ensure a certain level of domestic programming in each country of the European Community.

Therefore, my opinion is that 1992 will not allow European film companies to spread the cost of making a movie over a larger base like American studios do. The discussion about the differences among European cultures also reveals what may be the United States' greatest competitive advantage: its culture, which is young and derived from several international cultures. The American audience, because of its origins, is a good indicator of international tastes. Moreover, Hollywood film makers have brought to the American film industry their foreign cultures. Major directors such as Woody Allen, Francis Coppola, Milos Forman, Stanley Kubrick or Martin Scorsese are all strongly influenced by foreign cultures. As a result, their films appeal to audiences beyond the domestic market.

Because of the affluence of foreign movies in each country of the European Community and because the governments want to protect domestic production, 1992 will certainly cause the rate of growth in revenues from distribution of American films in Europe to decrease. However, the characteristics of international competition will not undergo any major changes in the near future. The United States will continue to have a global advantage, which should be the opportunity to make tremendous profits in the fast growing international market.

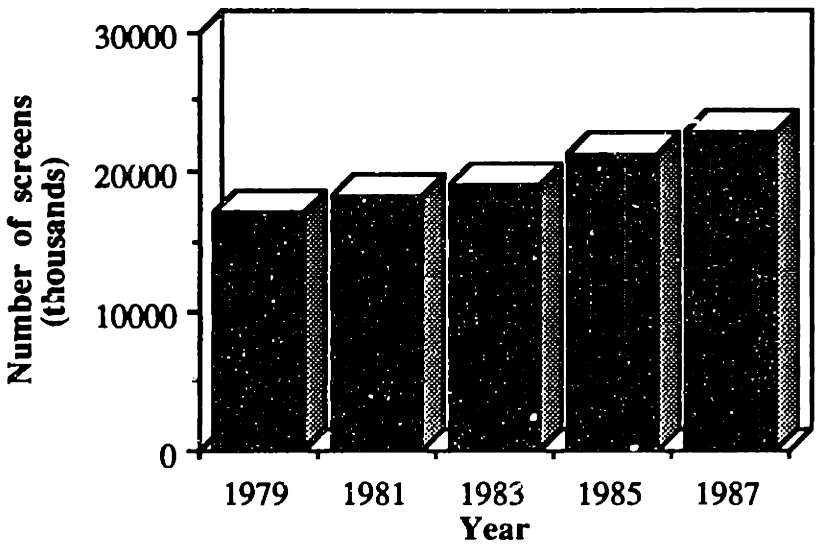
II.2.3 Domestic theaters

Despite the technological changes and the growth of foreign markets, the domestic theater release of its films remains a critical factor for any motion picture production company. In this paragraph, we review the main aspects of the movie theater industry.

Growth and consolidation in the U.S movie theater industry

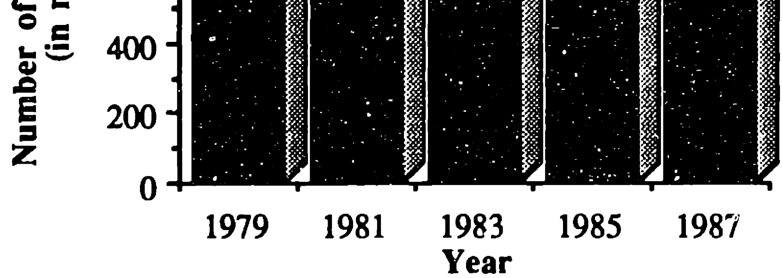
Between 1979 and 1988, the number of movie theaters in the United States has increased by almost 40%, from 17,095 screens to 23,600. This rapid growth is illustrated in Figure II.6.

At the same time, as shown in Figure II.7, the number of tickets sold has remained stable. In fact, the number of tickets sold in the United States has been at the same level - around one billion - since the late 1960s. Thus, the reason for the growth in the number of screens described above is not the expansion of the market.



(Source: National Association of Theater Owners)

Figure II.6 Evolution of the number of screens in the United States over the period 1979-1987



(Source: National Association of Theater Owners)

Figure II.7 Number of tickets sold in the United States over the period 1979-1987

In my opinion, there are primarily two reasons why the theater industry underwent such a rapid expansion over the last decade:

- The first reason is the modifications in the structure of American suburbs, with the multiplication of malls. Tremendous traffics were created towards these shopping centers. Like restaurant owners, movie theater chains exploited these new opportunities, and built multi-screen facilities.

- But the principal reason for this sudden screen explosion is the relaxation of the antitrust law of 1948 that prohibited U.S motion pictures from owning movie theaters. The antitrust law was decided in 1948 to prevent the major studios from using their financial resources to exercise a monopoly over the industry. But the Reagan Administration allowed exemptions to the 1948 law. The consequence of that policy shift is that the major studios acquired or took participations in theater chains in order to ensure a market for their products.

Because of this consolidation, the competitive characteristics of the industry completely changed. The major chains suddenly had new financial resources. And since the market did not grow during that period, competition became more intense. In that battle for market share, theater chains started to build new facilities and invested to renovate their old ones.

In 1989, the largest six theater chains owned 40% of all U.S screens, up from 24% in 1986, according to a study by Morgan Stanley. (The six major chains are: United Artists Communications Inc, Cineplex Odeon Corp, AMC Entertainment Inc, General Cinema Corp, Loews Theater Management Co and Carmike Cinemas Inc). But their rapid growth caused tremendous increases in operating expenses. Appendix 2 shows the capital expenditures and profit margins between 1979 and 1987. As shown in Appendix 2, capital expenditures increased by a factor of 27 in eight years, growing from 19 millions of dollars in 1979 to 516 millions in 1987.

Smaller chains did not have the financial resources to undertake the expansion that was necessary to maintain a sufficient market share against the major companies. Moreover, the number of theaters increased, while the number of films produced remained at the same level. Therefore, the price that theaters had to pay for the rights to show first-run movies exclusively rose sharply, leading to further difficulties for small companies.

Today, smaller movie theater chains do not have the tools to compete effectively against larger companies, which own multi-screen facilities at strategic locations, and exercise monopolies over certain metropolitan areas. Unable to increase their number of theaters or to undertake major renovations, these companies will have to achieve differentiation otherwise.

An example of the efforts made by small theater chains to achieve differentiation is given by the case of Cinema 'N' Drafthouse, which owns about 40 theaters. This exhibitor shows movies which have already been showing in other theaters for six to eight weeks, at a cost of $2 per admission and serves dinners and drinks to the customers. As a result, in 1988, Cinema 'N' Drafthouse collected more than $5 per customer in food revenues, while the industry average food revenue was $2 per customer.

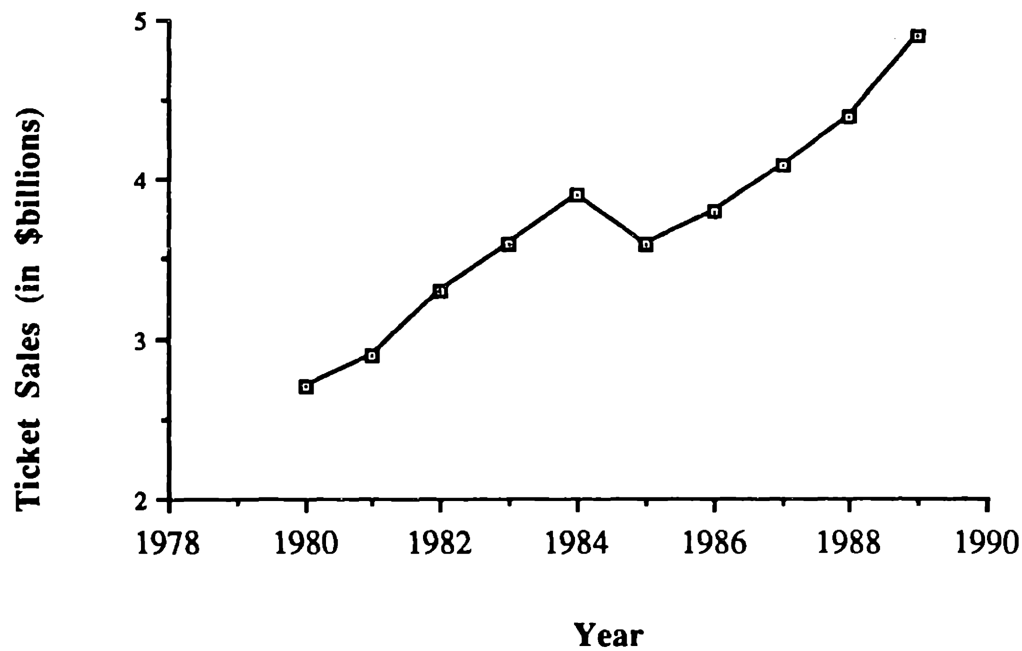
Another way to achieve differentiation may be to develop niche markets through the exhibition of a different kind of movies (foreign movies or classics, for example). This would represent two competitive advantages for theater owners:

- It would allow them to appeal to a segment of the audience which is not satisfied with the abundance of "mainstream" movies on the American screens (provided, of course, that this segment exists and represents a significant number of customers).
- These distributors would no longer have to compete against major chains for the acquisition of the rights of first-run movies. Thus, they could reduce their operating costs.

<u>Competition against television</u>

The growth of the other chains is not the only issue facing movie theater companies today. In the mid-1970s, when cable television started to become popular and the first video cassette recorders made their apparition, there was much concern that theater audiences would decrease sharply. A study by Arthur D. Little even suggested that these new substitutes would deal a fatal blow to the industry, and that there would be no theaters left in the United States by 1985.

Instead, as was seen in the previous paragraph, the number of movie theaters increased greatly. Of course, I highlighted the fact that this increase was due primarily to changes in demographic characteristics and in the legislation of theater ownership by film production companies. But audiences did not drop and, as shown in Figure II.8, ticket sales increased steadily during the 1980s.



(Source: U.S Bureau of Economics)

Figure II.8 Admissions to motion picture theaters during the 1980s

How could theater audiences be maintained at the same level while cable television and home video were experiencing the growth that we described in section II.2.1? In my opinion, two factors contributed to that seemingly paradoxical growth in ticket sales.

The first explanation I suggest is the intensity of the competition between movie theater owners that we have just depicted. Because the number of theaters increased, moviegoers are now able to find theaters at convenient locations more easily. More importantly, much of the capital expenditures that resulted from the growth and consolidation of the movie theater industry was used to achieve differentiation by focussing on customer service. Today, most of the theaters have been remodeled. They now offer better sound and projection systems than a decade ago. They have more efficient food counters. The major chains have started training their employees for a better customer service. In California, the last two years have seen the construction of large complexes that include over ten screens, and provide the customers with a wide variety of foods, games and other services.

My second explanation for the growth in ticket sales during the 1980s is the behavior of the audience. The customers who go to the movie theater represent a segment of the audience which values highly some of the following advantages:

- Going to the the theater is a relatively inexpensive way to spend an evening out of the house.
- Movie theaters offer first-run films earlier than any other media.
- They provide the opportunity to share the experience with an audience.
- They show the film exactly the way the director intended it - provided the sound and projection systems are adequate.

Cable television and home video do not achieve any of these advantages. However, they do address some of the needs of these customers: they offer the possibility to see a larger number of movies, including old classics and films that they did not see at the time of their theatrical release. Cable television and home video also give them the opportunity to see movies that they had particularly enjoyed again.

There are, of course, other reasons why the predicted decrease in theater audiences was avoided. For instance, the American films that were produced during the 1980s showed a very positive hero (Rocky, Rambo, Indiana Jones,...) who seemed to have deserted the screen during the 1970s.

The importance of the U.S theatrical release

Today, the U.S theatrical release of any movie is crucial to motion picture producers and distributors, for the following reasons:

- As we showed earlier, the domestic theater ticket sales represent a $5 billion market. Film companies rely on the cash flow generated by the theatrical release of their current films to convince Wall Street investors.

- The success met by a movie at its American theatrical release will, in most cases, determine its success in home video. It will also determine the price that cable television and free networks will pay for the right to show the movie exclusively.

- Success in the United States gives a film more exposure to foreign distributors. Moreover, foreign distributors will, in most cases, consider the performance of a movie at its first U.S theatrical release as a good indicator of its performance in their home country.

Therefore, despite the tremendous technological innovations which have been taking place over the last twenty years, one of the main challenges for movie production companies is still to get audiences to go to the theater and see their latest film. In the next section, I examine the characteristics of the competition a firm has to face when releasing a movie in the United States.

II.3 COMPETITION BETWEEN FILM PRODUCTION COMPANIES IN THE DOMESTIC BOX OFFICE MARKET

II.3.1 Competitive characteristics of the market

In this section, I will review the competitive tools that are available to the players to have their films gain market share in terms of ticket sales.

Production costs: The cost of producing a movie is fairly independent of the history of the company, of its structure and of the number of films it produces. There are examples of companies which were able to achieve significant production economies of scale. In the "Golden Age", for instance, the major studios would have most actors under contract. They would cast Cary Grant or Bette Davis in up to five or six movies a year, thus considerably reducing their unit production costs. In the 1960s, Roger Corman, the champion of low budget production, would use the same sets, artists technical teams to produce several movies.

Today, however, the actors have increased their power, and the audiences' needs have changed. It is much more difficult for motion picture companies to achieve substantial production economies of scale.

Brand name: Unlike in most manufacturing industries, the name of the company which makes or distributes the movie has very little effect on the consumer's decision whether or not to buy the product. Of course, there are some exceptions. Cannon Group, for instance, rose to great success in the early 1980s, but acquired at the same time a negative reputation because of the violent, simple minded movies it had produced. Although the studio did make efforts to overcome that negative image, in particular by having a strong presence in prestigious film festivals, Cannon's image was instrumental in the company's subsequent failure. Another example is the case of Walt Disney Co, which continues to distribute its children movies under the name of Disney. This name represents a history of successful movies, and certainly influences parents when they choose which movie their children should see.

But, in general, motion picture companies have not been able to establish brand loyalty, essentially because customers consider the artists as the real makers of a film. Hence, the audience is loyal to actors, directors or screenwriters, but not necessarily to film studios.

Distribution: As we saw earlier, most major film companies own or have a participation in movie theater chains. This provides them with an advantage in the competition for market share, because it enables them to distribute their product more efficiently. However, this advantage offers only limited opportunities, mainly for the following two reasons:

- The Antitrust law of 1948 which prohibited film studios from owning movie theaters was redefined by the Reagan Administration, as was explained in section II.2.3. However, even if film production companies are now allowed to own theaters, they are still prohibited from abusing their new powers to form a monopoly by acquiring a large number of theaters and then refusing to show pictures that were produced by other companies.

- The second reason is purely financial. It was noted in section II.3 that movie theaters were engaged in a very intense competition for market share. To compensate for the tremendous capital expenditures that are caused by this competition, film companies which own cinema chains need high revenues from their exhibition businesses. Therefore, they have to choose to show the movies which are the most promising - in terms of projected ticket sales - regardless of which company produced it.

Price competition: The ticket price is determined by theater owners. Therefore, film production companies are unable to use price competition as a tool to gain market share.

Film companies do have the possibility to reduce their costs. In particular, they can minimize their marketing costs through an efficient distribution network. However, it is very difficult for a motion picture company to devise a strategy that would provide an important and sustainable competitive advantage in the competition for market share. Essentially, each movie is a profit center for its producer.

There are so many different and unpredictable factors that influence the box office performance of a movie that it is impossible to evaluate - or even determine - the company's strategy to gain market share. In this section, I will limit my study to the aspects of the competition for market shares upon which the company has most control: marketing and advertising.

II.3.2 Marketing and advertising

Because of all the reasons that were dealt with in the previous paragraph, the only advantage that a film company may have to win the competition for market share, besides the commercial appeal of its movies share is its marketing structure, and the financial resources it has to support the release of its pictures.

Because it has specific characteristics, each film has to be marketed separately. The marketing plan starts the day the company undertakes a project.

An important aspect of that plan is market research. Film companies use the information they have gathered about the movie (director, actors, subject, location...) to find out about the attitude of the public. Although the results of this research are used primarily to monitor the advertising campaign and to determine the release schedule, they sometimes affect the way the film is made (reductions or increases of the budget, changes in the script,...). Of course, the effect of market research on the film making process is limited because of the reaction artists would have if their work was altered in that manner.

The market research continues until the moment of the theatrical release of the movie. In particular, film companies keep track of the level of awareness and interest that the public has for the movie. For instance, if it appears that, one week before the release of a movie, most of the public is not aware of its existence, the studio will redesign the advertising campaign and will increase advertising expenditures - provided it has the necessary financial resources.

Sneak previews are the latest stage of market research. Today, they are more and more widely used. The film studio shows a version of the movie to a sample of the audience and tests its reaction, in order to predict the reaction of the general audience, and to find out what specific characteristics of the movie the advertising campaign should emphasize. However, the sneak previews are also often used for the editing of the movie, and are sometimes the cause for major artistic changes. A famous example is the case of Paramount Pictures' Fatal Attraction. In the original version, the possessive mistress committed suicide. But the tests conducted during sneak previews revealed that the audience had come to hate her so much that they wanted her to suffer more. As a result, the scenario was changed. In the final - and very successful - version, the woman is drowned by the husband, then shot by the wife.

Another important decision that faces a motion picture company's marketing department is the schedule of the movie's theatrical release. This decision encompasses the date chosen for the release, the number of cities and of theaters where the film should be showing. These decision are influenced by numerous factors. Among them:

- The findings of the market research.
- The traditional habits of the audience. For instance, the American audience usually wants to see comedies or action movies during the summer.
- The segment of the audience to which the movie is likely to appeal. Some films are more likely to succeed in urban areas.
- The competition that the movie will have to face at a given date.

Therefore, the advertising campaign for a movie is closely monitored by market research. Because the level of awareness is so important for a movie to succeed in theaters, advertising is a crucial aspect of the marketing process. In 1988, the motion picture industry was one of the ten largest in terms of advertising expenditures. Table II.1 shows the five film companies which spent the most money in advertising in 1988.

Company	Expenditures in 1988 (in millions of dollars)	% of total expenditures for the industry
Columbia Pictures Entertainment	85,630	13
Warner Communications	77,218	11.5
Walt Disney Co	71,151	10.5
MCA	70,652	10.5
Paramount	69,421	10

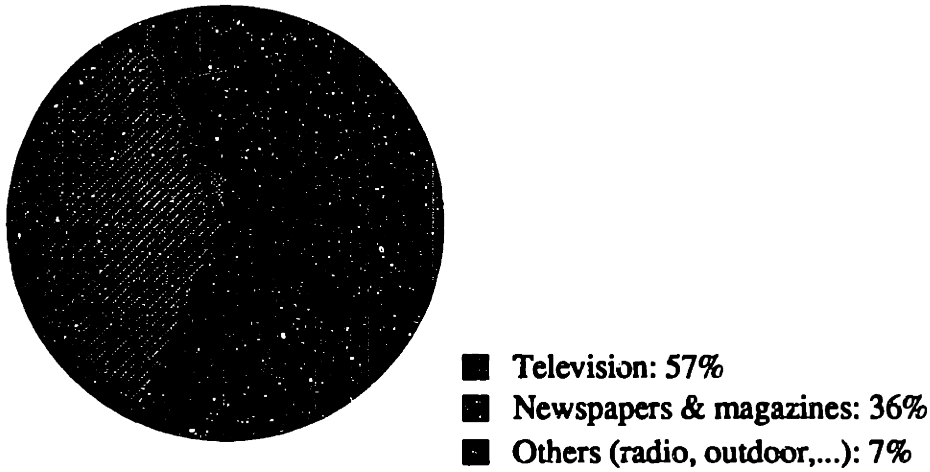
(Source: Marketing and Media Decisions)

Table II.1 Advertising expenditures by motion picture companies in 1988

The total advertising expenditures for the industry during that year amounted to $675,700 million, or 15% of all ticket sales. This figure illustrates the intensity of the competition for market share, and the importance given by motion picture companies to advertising.

As shown in Figure II.9, which breaks down total advertising expenditures by medium, television is the medium which is the most often used.

The conclusion of this section is that effective competition in the box office market requires large investments in advertising. At a time, when, as we saw in section II.2, the American companies are getting ready to tackle new foreign markets and to reinforce their position in the European market, the need for tremendous financial resources will grow increasingly important.



(Source: Marketing and Media Decisions)

Figure II.9 Breakdown of advertising expenditures by medium

II.4 MERGERS AND ACQUISITIONS IN THE U.S MOTION PICTURE INDUSTRY

Our purpose in this section is twofold. On the one hand, we are looking to use the main conclusions of the previous sections to explain the strategic motivations behind the recent mergers and acquisitions that have transformed the motion picture industry. On the other hand, we will try to point out the main strategic issues caused by this restructuration of the industry.

II.4.1 Description of the consolidation of the film industry in the 1980s

The consolidation of the American motion picture industry has taken many different forms.

Many motion picture companies have grown through the acquisition or creation of new subsidiaries. This form of development has occurred through various types of operations. Table II.2 shows the different types of development of film production companies with a few examples to illustrate each kind of operation.

Type of operation	**Examples**
Acquisition of theater chains	Columbia acquired Loews
Acquisition or creation of cable outlets	Walt Disney Co created the Disney channel, MCA and Paramount acquired USA Network
Acquisition of smaller motion picture production firms	MCA purchased a portion of Imagine Film Entertainment
Creation of motion picture production subsidiaries	Walt Disney Co created Hollywood Pictures and Touchstone Pictures
Creation of subsidiaries engaged in the distribution of home video	Warner Communications created Warner Home Video, MCA MCA Home Video
Acquisition of television production companies	Warner Communications purchased Lorimar Telepictures

(Source: Company reports)

Table II.2 Growth of motion picture production companies through acquisition and creation of new subsidiaries

Other relationships were forged through joint ventures between U.S production firms. Agreements were signed with cable and free television networks and home video distributors. Moreover, international links were created between American and foreign firms through financial deals and co-productions.

But the most dramatic aspect of the consolidation of the industry has been the series of acquisitions of prestigious motion picture companies by major corporations. Table II.3 summarizes this history of acquisitions.

U.S film company	Buyer	Country	Year
Columbia Pictures	Coca Cola	United States	1982
20th Century Fox	News Corporation	Australia	1985
Cannon Group	Giancarlo Paretti	Italy	1988
Metro-Goldwyn-Mayer / United Artists	Qintex Group	Australia	1989
Columbia Pictures Entertainment	Sony Corp	Japan	1989
Warner Communications	Time Inc	United States	Merger in 1989, acquisition in 1990
MGM/UA	Pathe Communications (G. Paretti)	Italy	1990

(Source: Company Reports)

Table II.3 Acquisitions of U.S film production companies by large corporations

II.4.2 Causes for the consolidation of the U.S film industry

In section II.2, the following general trends in the U.S motion picture industry were identified:

- The American distribution system is being diversified by technology, thus offering motion picture companies the possibility to reach a larger market in the United States.

- The worldwide demand for motion pictures is growing and will continue to grow because of the opportunities offered by technology, and because of the opening of new foreign markets.

- The American movie production firms have a significant and sustainable global advantage.

The three main conclusions to be drawn from these general trends are the following: American movie production companies will generate increasing profits, they will need tremendous financial resources to compete on the global scene, and technology will reinforce the links that exist between the motion picture industry and other industries.

Therefore, the U.S motion picture industry represents not only a promising investment for a company with large financial resources but also, for firms which are engaged in industries related to the communication and entertainment industries, the opportunity to benefit from vertical integration. Next, I will expose the strategic benefits and costs of vertical integration for entertainment and media companies. Then, I will examine the entry barriers which explain why major corporations have chosen to diversify into the American motion picture industry through acquisitions rather than internal developments.

Strategic benefits and costs of vertical integration

Entertainment and media corporations can find several advantages, besides additional revenues in owning an American movie studio. Among them:

- Many of these corporations already have a strong international presence. They have a marketing structure which allows them to market movies abroad at a lower cost.

- Engaged in businesses like publishing or television, these corporations have a good knowledge of the culture of their audiences, and of their needs in terms of entertainment. The ownership of a movie studio enables such companies to further benefit from their experience.

* As was established in section II.3.2, newspapers, magazines and television are the most important advertising support for movies. Companies which already have a strong presence in these media are in a better position to promote the movies produced by their studio at a lower cost.

* Entertainment and media corporations which are involved in the television or cable industry can use a motion picture studio to produce programmings. This might reduce both the cost of operating a television station and the access that competing film studios have on distribution outlets.

The strategic costs of vertical integration are the costs of growth, which include capital requirements, management of larger personnels, and problems in the organization of the corporation. But vertical integration also causes problems because of diversification. Top management has to combine the skills of companies which have different objectives and different cultures.

The massive entry of media and entertainment corpora[illegible] into the U.S motion picture industry will be described in Chapter IV, as the formation of Time Warner is examined. The problem of managing different cultures will also be considered at that time.

<u>Barriers to entry in the U.S film industry</u>

As we noticed in section II.1, the seven largest film production companies were already dominating the industry in the 1940s. In this paragraph, we examine the entry barriers that have prevented motion picture companies from competing effectively with the major studios.

Capital requirements: The cost of producing a movie requires important financial commitment. The production costs have increased tremendously over the last few years, partly because movie tax shelters have been circumscribed by 1976 tax legislation. Furthermore, as we showed in paragraph II.3, the competition for box office market share causes major expenditures in advertising. Therefore, competing effectively in the motion picture industry requires initial investments which are not only very large, but also risky and unrecoverable. Established companies have the advantage of being able to diversify this risk over a large number of movies, and receive revenues from all the motion pictures they have have made in the past.

Access to distribution: Established motion picture companies often own or have developed relationships with movie theater chains. This and the reputation they have built give them an advantage over entrants. Similarly, as we described in the previous sections, established firms now own cable channels, or have worked out exclusive relationships with cable stations, television networks and home video distributors. For these reasons, access to distribution channels represent a significant barrier to entry.

Favorable location: The U.S motion picture industry is extremely centralized (it is often simply referred to as Hollywood). Major companies have developed a strong advantage by acquiring the land and other real estate properties necessary to build their studios in the Los Angeles area before prices increased sharply, thus creating an important entry barrier.

Relationship with suppliers: Established firms have developed a reputation and relationships that give them an easy access to the raw materials of the industry: the scripts, and the artists. New entrants rarely have this advantage.

Experience: Movie studios have been able to establish relationships with artists and agents, but also a know-how that enables them to handle the production of a large number of movies at the same time at a minimal cost.

Therefore, the U.S film industry presents very important entry barriers in terms of financial requirements, risks, and competitive advantages that established firms have been able to develop over the years. As a result, corporations choosing to enter the American motion picture industry are likely to do so by acquisition of film studios.

CHAPTER III: COLUMBIA PICTURES ENTERTAINMENT

In September 1989, only two years after it bought CBS Records, Sony Corp purchased Columbia Pictures Entertainment. Although this acquisition was in part motivated by the characteristics of the U.S motion pictures industry described in Chapter II, it was also the result of Sony's long-term strategy, combined with the development of the consumer electronics industry. After briefly describing the difficulties experienced by Columbia Pictures and its parent company, Coca-Cola, during the 1980s, I will examine the specific strategic issues linked to the acquisition of Columbia Pictures by Sony.

III.1 REVIEW OF COLUMBIA'S BEHAVIOR DURING THE 1980s

In the mid-1970s, Columbia Pictures had to deal with a management crisis. David Begelman, head of the studio, had caused a scandal because of his embezzlements and misappropriations. Moreover, the financial health of Columbia Pictures was preoccupying. By 1981, however, Columbia's management was stable again. A series of box office successes, which included *Midnight Express* and *Kramer vs Kramer* had enhanced the company's cash flow. The film studio had become a valuable asset.

In an effort to diversify, the Coca-Cola Company acquired the studio for a price of about $750 million.What followed is a perfect illustration of the efforts that were produced to take advantage of the new, diversified distribution network described in the first part.

Columbia entered a joint venture with CBS and HBO, Time Inc's cable station. In their agreement, both CBS and HBO would contribute financially to the production of Columbia movies for the license to show them exclusively. The price they agreed to pay was proportional to each movie's sales and video rentals. Moreover, a new production entity, Tri-Star Pictures was created. Tri-Star was owned one third each by Columbia, Time inc., and CBS. Details of the agreement appear on Appendix 3.

Although that agreement was financially sound for Columbia, it was short-lived, because the tremendous success of *Ghostbusters* ended up costing Time Inc a lot of money. Then, the studio was going to run into a series of difficulties. Although Columbia's television division was performing well, its movies were losing market share at the domestic box office to fall to 10% in 1988.

I believe that most of these problems were caused by the fact that Coca-Cola had trouble managing its two conflicting strategic objectives. On the one hand, Coca-Cola was determined to benefit as much as possible from the financial advantages of being involved in the growing U.S motion pictures industry. But the acquisition of Columbia Pictures, a prestigious film studio probably had another purpose. Coca-Cola wanted to change its image of a mere soft drink marketer, and to be perceived as a more creative company.

An illustration of Coca-Cola's resulting hesitations is the choice of David Puttnam, a British independent producer to become head of the studio. Although he was considered very talented - he had produced, among others, the successful and critically acclaimed *Midnight Express*, *Chariots of Fire* and *The Killing Fields* -, the choice of David Puttnam to run Columbia was rather dubious, since he was well known for his desire to be autonomous, and his dislike of Hollywood's mentality. During his one year tenure, Mr. Puttnam, frustrated by the impossibility to make the movies he wanted, had difficult relationships with several powerful individuals in Hollywood, including the agent Michael Ovitz, Bill Cosby, and the stars of *Ishtar*. Most of the movies produced while David Puttnam was head of the studio were major disappointments at the box office.

Another example of Columbia's mismanagement was the statute of Tri-Star, which on many projects behaved as Columbia's competitor. As a result, in 1989, Columbia Pictures Entertainment was in a very difficult position, and Coca-Cola, which had decreased its participation in the company to 49%, and its attempt to diversify into the movie industry was ready to come to an end.

III.2 SONY'S STRATEGY

According to most financial analysts, the price offered by Sony to acquire Columbia Pictures Entertainment was well over the value of the company's assets. Figure III.1 shows how Wall Street analysts valued Columbia.

(In millions of dollars)

Theatrical............	**$2400**
Distribution...........	500
Library.................	1,050
Home Video..........	850
Television............	**$1,670**
Other Assets.........	**$915**
Theaters....................	840
Burbank Studio...........	50
Other.......................	25
TOTAL ASSETS	**$4,985**
Debt...................	**$1,300**
Obligations...........	**$600**
Preferred Stock......	**$150**
TOTAL LIABILITIES	**$2,050**
NET VALUE	**$2,935**

(Source: Wall Street estimates based on 1990 Cash Flow predictions)

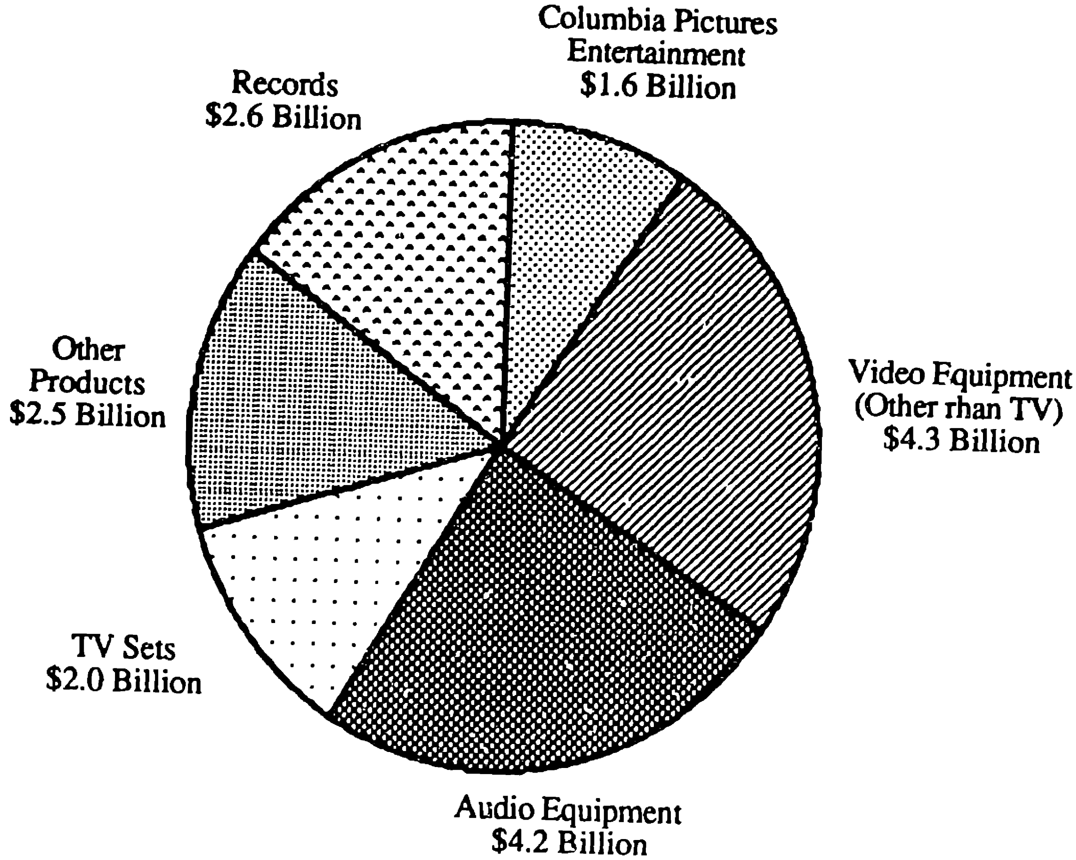
Figure III.1 How analysts valued Columbia Pictures Entertainment in September 1989

As I described earlier, the film division of Columbia Pictures Entertainment was in a very difficult position, with a disappointing market share in ticket sales and very pessimistic cash flow predictions. The short-term returns that Sony could expect from Columbia - even if the TV division was more promising - can hardly be regarded as the sole purpose of the operation. In any event, financial considerations alone could not explain the high price that Sony agreed to pay.

Instead, I believe that the acquisition of Columbia Pictures Entertainment is consistent with Sony's recent strategic decisions. In the past five years, Sony has led an aggressive strategy to obtain its own movies, music and other creative materials, that could be played on its audio systems, VCRs, compact-disc players and any other hardware it will develop in the future. I suggest essentially three reasons for this drive toward vertical integration: the trends in the consumer electronics market, the promotion of new products, and globalization.

III.2.1 Trends in the market for consumer electronics

The competition in the consumer electronics industry has undergone important changes. It is forecast that the world sales of audio and video equipment will increase only by 4% per year over the next decade. By contrast, software such as music and movies will continue growing 17% a year or more. Because of the acquisitions of CBS records and Columbia Pictures Entertainment, a substantial portion of Sony's revenues (about 23%) now comes from these growing product segments. Figure III.2 shows Sony's sales by product group.



Source: Company Reports

Figure III.2 Sony's sales by product group*

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* Sales for Sony for the year ended March 31,1989 at $1 = 132 yen
Sales for Columbia Pictures Entertainment for the year ended Feb 28, 1989

Another important transformation in the consumer electronics market is the international expansion of cable television and satellite broadcasting. More specifically, the Japanese Postal Ministry predicts that 13 million households will have cable television by 2000. Therefore, Sony will be able to follow the American examples of Walt Disney Company or Time Inc which simultaneously own a cable station and a movie production company.

To benefit from both the growth that the film and music markets are experiencing and the tremendous opportunities in the Japanese broadcasting industry, Japanese companies have made an effort to acquire the necessary software. JVC, one of Sony's chief rivals founded its own film production company in a joint venture with Lawrence Gordon, an American independent movie producer. These are the first signs of an intense competition. The control over software will be a key competitive advantage in the consumer electronics industry.

III.2.2 New product promotion

Sony became the world leader in audio and video equipment by using technology to introduce new, innovative products into the market. In the mid 1980s, however, Sony Corp. suffered a severe setback when its Betamax videocassette recorder lost the battle for consumer acceptance to the VHS format. This was an example of how a hardware manufacturer like Sony could fail distributing a new product without the support of software. Although the ownership of software itself does not enhance technological innovation, it does provide a great competitive advantage, because it makes promotion, and market penetration, much more effective. That was expressed by Akio Morita, Sony's founder and chairman:

> " We can't guess where innovations will lead. But we will be prepared with the software."*

In 1987, Sony purchased CBS Records. The Japanese corporation then proceeded to convert the CBS library, which includes such popular artists as Michael Jackson and Bruce Springsteen, to the Compact Disc format. The CBS discs helped boost sales of Sony

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* Business Week, October 16 1989

CD players from 2.9 million machines in 1987 to 6.5 million in 1988. Of course, this example does not show how the ownership of software can help create a market for a new product, because CD players had gained customer acceptance prior to the acquisition of CBS records by Sony Corp. But it does show how Sony was able to have some control over the Compact Disc market.

However, the acquisition of CBS records must not be considered as a short-term operation designed to enhance the sales of Sony CD players. Already, Sony expects to use its music software to promote its new digital audiotape players.

To see how the acquisition of Columbia Pictures Entertainment, and of its 2,700 film library, can serve the purpose of promoting Sony's new products, I suggest to examine two examples:

1. The 8mm videocassette: Sony has been trying to establish its 8mm videotape technology as the new world standard, at the expense of the VHS format. Introduced in 1986, Sony's smaller sized format has become increasingly popular as a camera-recorder. Today, it accounts for about 60 percent of the camcorder sales in Japan, and for 40 percent worldwide. The main reason why the home version of the 8mm VCR has not been able to penetrate the market is the lack of pre-recorded films to buy or rent in that format. Obviously, having access to Columbia's rich film library will allow Sony to release a great number of pictures in 8mm.

2. High Definition Television: The Japanese have invested $1.4 Billion in their HDTV technology. However, Japanese HDTV has had access only to its domestic market. To benefit from tremendous economies of scales, and to make their investments pay, the Japanese need to win the intense competition for the access to the American and European markets. Therefore, they need Europe and the United States to accept the Japanese standard. A few American studios are already using Japanese HDTV production technologies, especially for the creation of special effects. With the acquisition of Columbia, Sony will be able to accelerate the pace, and produce movies with Japanese HDTV technology. If this technology proves efficient, and if it gains the support of American film makers and audiences, then the Japanese will be able to establish their HDTV equipment as a de facto standard.

Therefore, the acquisition of Columbia provides Sony with a total control over software. The example of the 8mm videotape system shows how the ownership of films will help Sony's products penetrate the market. However the criticism that Sony could have achieved its strategic goals at a much smaller cost simply by acquiring the rights to reproduce films to the 8mm format is incorrect, for two reasons:

- This criticism assumes that Sony's strategy is essentially short-term oriented, and that the 8mm videotape system is the only technology that will be promoted with Columbia's library. In fact, Columbia's library will provide Sony with the adequate software for any of its future innovations. The acquisition is part of a long-term strategy, which does not have to show immediate returns to be successful. This make the initial price paid by Sony a less important issue.

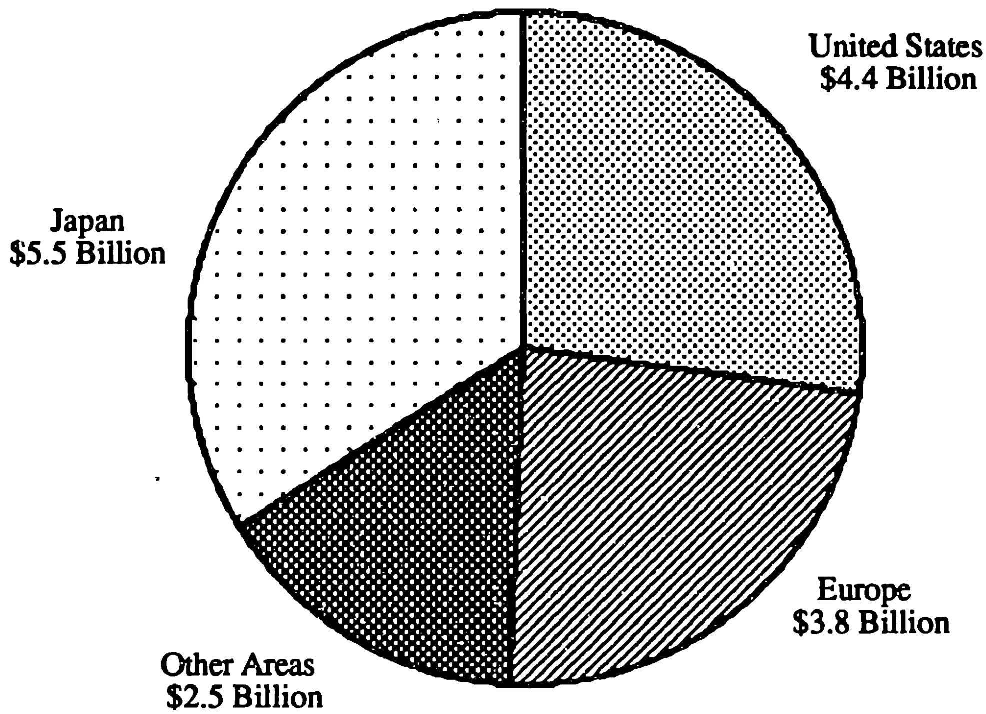
- This criticism also overlooks the fact that, by purchasing a major studio, Sony acquired not only a film library, but also the control over the production of future films. The example of High Definition Television shows how Sony will get a chance to impose their new technologies more easily. Even if this strategy failed with HDTV, it might work in the future with other technologies.

III.2.3 Globalization

Another characteristic of Sony's strategy has been globalization. Figure III.3 shows Sony's sales in the Japanese, European and American markets. As it appears on Figure III.3, the Japanese manufacturer has a strong - and balanced - presence in all international markets.

This global strategy provides Sony with several key competitive advantages, which we review briefly below:

Production economies of scale: The production of hardware products in the consumer electronics industry requires tremendous investments in Research and Development for technological innovation. These investments are independent from the volume produced. Furthermore, as in most manufacturing industries that involve advanced technical knowledge, learning increases with volume. Therefore, high volumes lead to lower unit costs. A presence in international markets allows for a higher volume of production.



Source: Company Reports

Figure III.3 Sony's international markets

Marketing economies of scale: Although each market requires specific methods, being present in different national markets gives Sony the possibility to reduce its marketing costs. Not only can the same sales force be used for different countries, but it is possible, as Sony did, to establish brand name recognition internationally.

Product differentiation: In an industry where technology is important, a global strategy gives Sony an edge in reputation and credibility. The image of a worldwide company gives people confidence in the technology used by Sony.

The choice of Columbia Pictures Entertainment as the source of software to complement Sony's hardware equipment is consistent with its globalization strategy, for many reasons.

I described, in section II.2.2 the United States' global advantage in the motion picture industry. Today, entertainment products are the United States' second largest source of exportations (Aerospace is first). Most of these products are software. The United States is by far the world's largest exporter of motion pictures and television programs. Moreover, Hollywood is the world's largest concentration of internationally famous artists. Only American software could achieve Sony's objective of gaining strong market shares simultaneously in Japan, Europe and the United States.

Columbia is engaged in worldwide distribution of films. Movies produced or acquired by the studio benefit from Columbia's international distribution network. Marketing efforts to promote Columbia's products are carried out separately in each country. Sony will therefore profit from an experienced and efficient international sales force.

Furthermore, unlike JVC, whose motion picture company will provide control and ownership of future productions, Sony will also be able to take advantage of Columbia's rich film library. It includes internationally known motion pictures such as *On the Waterfront, Bridge on the River Kwai, Lawrence of Arabia and Gandhi*. These and many of the 2,700 other films in the library will constitute a solid basis to tackle all national markets with Sony's new products.

To achieve its global objectives, Sony needed to obtain both an international distribution network, and a prestigious library. The acquisition of Columbia gives Sony that combination of competitive strengths.

III.3 IMPACT OF THE ACQUISITION ON COLUMBIA PICTURES

Its acquisition by Sony will have several effects on Columbia Pictures. Like other studios acquired by major companies, Columbia will have more financial resources to compete, and will be more dependent on its parent's vision. Columbia, however, will have to face specific issues because of its acquisition by Sony. Following are the ones I believe to be the most important:

The studio's image: Columbia Pictures Entertainment is only one of the several companies which have been acquired by foreign corporations in the recent years. Yet, the acquisition raised much concern, expressed both by the public and by business or political analysts. In a poll it conducted after the operation, Newsweek reported that 43% of the Americans thought that the acquisition of Columbia by Sony was a "bad thing"* . Analysts complained that , as there exist legal restrictions on the foreign ownership of television networks, foreign companies should be prohibited from owning a movie studio. The main reasons for these expressions of disapproval are:

1. Columbia is a major movie studio and U.S movies, like television, are a reflection of the American culture.

2. The acquisition of Columbia by Sony is the largest U.S acquisition by a Japanese company. And Japan is regarded as the United States' main competitor.

The consequences of this negative image, however, are difficult to evaluate. As I stated in section II.3.1, consumers rarely choose the movies they see because of the company that produces them. The issue of Columbia Pictures' image will be further discussed in Chapter V.

Introduction of new technology: I pointed out earlier that Sony would probably use Columbia to promote its new technology. This means that the studio will benefit from Sony's R&D resources and have access to state-of-the-art music and video equipment. However, this competitive advantage may also cause problems, because technicians and artists will have to adapt to these technological innovations. For instance, great film directors who are used to working with film might be reluctant to produce movies using HDTV technology.

Management: At the time it acquired Columbia, Sony also purchased Guber-Peters Productions for $200 million. The main purpose of this operation was to get Peter Guber and Jon Peters, the two successful producers of *Rain Man* and *Batman* to run Columbia

* Newsweek, October 9 1989

Pictures. As was explained in section III.1, much of Columbia's difficulties in the 1980s was due to its management problems. The new top management team, acquired at the price of a legal battle with Warner Communications, should resolve these problems. Peter Guber and Jon Peters have an excellent reputation, and they have developed strong relationships with Hollywood's artists and agents, which might enable them to improve Columbia's results at the domestic box office.

Corporate culture: Obviously, Sony and Columbia Pictures have very different corporate cultures. Not only do they come from different countries, but they also are engaged in very different products, and their skills are not in the same areas. I do not believe, however, that these differences will cause great problems to Columbia Pictures, because I do not expect Sony to interfere with the film studio's creative decisions. This opinion is based on the following factors:

1. Since its acquisition of CBS Records in 1987, for example, Sony has let the music producer make all creative decisions.

2. One of the principal reasons why Sony chose to purchase Columbia, as stated earlier, was to benefit from Hollywood's talents in order to improve its position in the global competition. Interfering with American management would prevent Sony from reaching this objective.

CHAPTER IV: WARNER COMMUNICATIONS

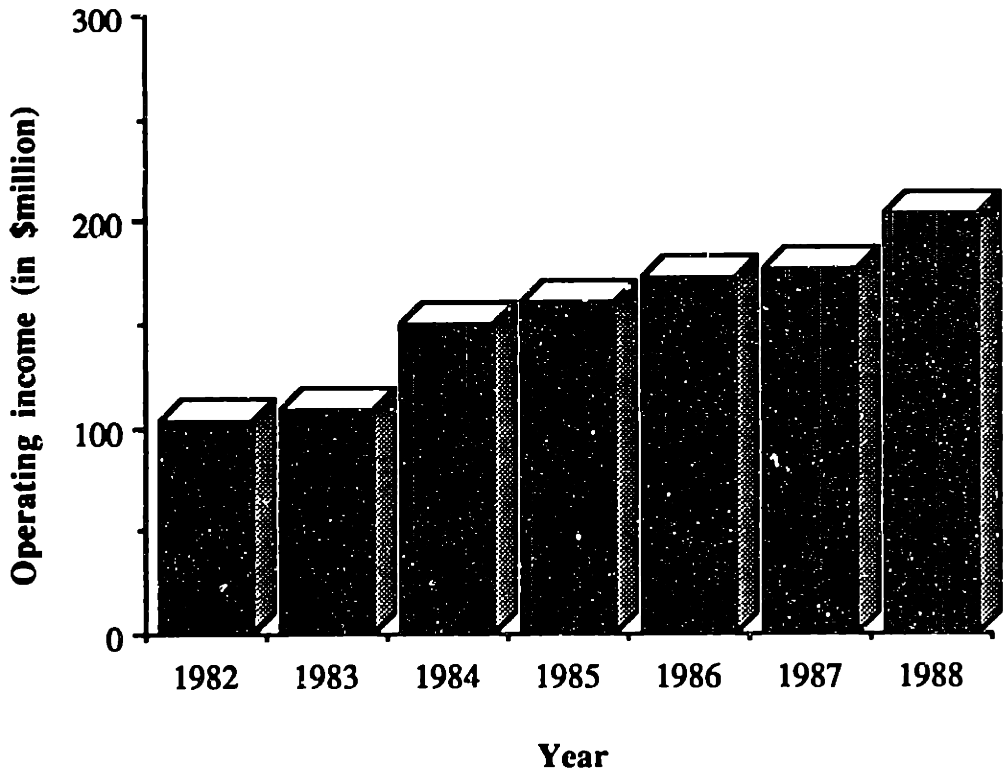
In March 1989, Time Inc and Warner Communications announced that they would merge to form Time Warner. In January 1990, Time completed its acquisition of Warner for $14 billion. In their statements that accompanied this business combination, Steven Ross, CEO of Warner Communications, and J. Richard Munro, CEO of Time, emphasized that their goal was to build a company that would be able to compete in the global entertainment and media industry. Appendix 4 shows extracts of both CEOs' statements in their annual reports, while Appendix 5 gives a list of the principal subsidiaries that were combined by the association of the two parent companies.

My objective in this chapter is to examine more closely the strategic motivations of this merger. I will also analyze the competition that Time Warner is now facing, and review the other challenges caused by the merger. Another objective of this chapter will be to determine the consequences the operation is likely to have on the movie industry and on Warner Bros, the company's film studio.

In the next section, I begin my analysis by reviewing Warner Communications' strategic orientations before the formation of Time Warner.

IV.1 WARNER'S STRATEGY PRIOR TO THE MERGER

Warner Communications is engaged in three main businesses: filmed entertainment, recorded music and music publishing, and cable and broadcasting. Over the period 1982-1988, the operating income of the filmed entertainment division has steadily increased, from $103 million to $203 million (Figure IV.1). As shown on Figure IV.1, earnings increased by 15% in 1988. Warner Bros' worldwide revenues increased sharply over 1987 levels as international film rentals and worldwide video sales increased tremendously, as a result of the expansion of foreign markets described in Chapter II.



Source: Company reports

Figure IV.1 Operating income of Warner Communications' filmed entertainment division over the period 1982-1988

IV.1.1 Cable television and home video

Since the early 1970s, Warner Communications' management has been consistent in its effort to be well positioned to take advantage of new technology. In 1971, Warner made its first investment in cable television, at a time when, as seen in section II.2.1, cable television was essentially a service that delivered broadcast television to underserved urban areas. When, a few years later, the U.S pay television industry started, and used cable systems to transmit its programs, Warner Communications benefitted in two ways:

- Like every U.S motion picture producer, Warner profited from the increased demand for its product.

- The company also benefitted by its ownership of cable television properties. Warner Cable Communications is the fifth largest cable operator in the United States. BHC Inc, which is 42.5 percent owned by Warner operates seven television stations in some of the nation's major markets, including Los Angeles and San Francisco. Even before its merger with Time, its ownership of cable systems had enabled Warner Communications to build strong ties with HBO. HBO used Warner's products, while Warner would distribute HBO productions through its cable systems.

Home video is another sector where Warner has proven its ability to benefit fully from technological innovations. The main strategic advantage that Warner Communications had over its competitors was its music division. Because the organization for the worldwide distribution of records was already established, and was readily expandable to include video, Warner was in an excellent position to take advantage from the explosion of the video market in the early 1980s. Today, Warner Home Video is the world's largest distributor of videocassettes. Not only does this give Warner the ability to benefit further from its own products, but it also enables Warner to distribute the motion pictures produced by other companies (such as United Artists or Cannon) for the international market.

For the last twenty years, Warner has been growing - through acquisitions and creation of new subsidiaries - in order to take advantage of the expansion of the industry.

Another illustration of Warner Communications' aggressive strategy is the position the company has already taken in two sectors that are expected to expand dramatically in the next few years: pay-per-view television and satellite broadcasting.

- The number of American pay-per-view homes has passed 12 million in 1989, and revenues are expected to increase as individual events continue to be released through this medium (for a fixed fee paid by the consumer for each event). Warner Bros has been actively involved in the development and promotion of the pay-per-view market, by distributing various special events.

- In 1989, British Satellite Broadcasting and Sky Channel, two competing services, became operational in the United Kingdom. In 1988, Warner Communications had entered agreements with these services to give them rights to show Warner's motion pictures and television productions. By doing so, Warner Communications has taken a strong position in a market that may expand quickly: today, other countries in Western Europe, as well as Japan, have already developed new direct broadcast satellite systems.

IV.1.2 Theatrical distribution of motion pictures

Like every other major motion picture company, Warner Communications exploited the relaxation of the 1948 Antitrust law, and took a 50% interest in the Gulf and Western / Paramount domestic operation, which has over 460 screens. And, as was mentioned in section II.2.2, Warner has also started acquiring movie theaters in Western Europe.

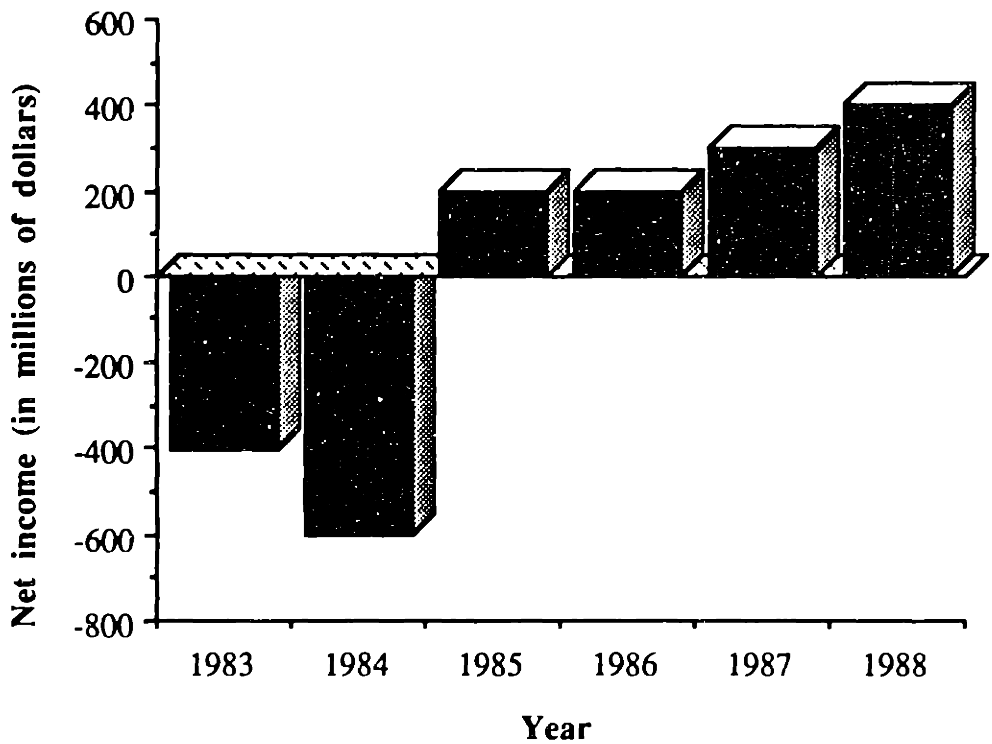
Historically, Warner had been handling the international distribution of its products through joint ventures. In 1987, however, the company made the decision to gain total control over the theatrical distribution of its products. The rationale behind this change was that it would allow Warner Communications to gain flexibility in its distribution system, which would place the company in a better position to expand in overseas markets. This decision also enabled the company to enter an agreement with Walt Disney Company, whereby Warner Bros would distribute all of Walt Disney Pictures and Touchstone Pictures' movies in foreign markets. In this way, Warner Communications now benefits not only from Warner Bros' films, but also from the international box office performance of Walt Disney Company's movies.

IV.1.3 Warner Communication's philosophy

I described in Chapter II the growth of the motion pictures industry, which is driven by two interdependent forces: the new opportunities offered by technology, and the opening of new foreign markets. Warner Communications has focussed on becoming as well positioned as possible to profit form this growth of the industry. This strategy was translated by some important investments that were at first considered very risky (cable television, in particular, was hardly perceived as a sensible investment in the early 1970s). The growth of the company, with its many acquisitions, was aimed at building the necessary structure to remain at the forefront of technological innovations.

However, Warner Communications has also directed its efforts and financial resources to the optimal exploitation of new foreign markets. The examples that were given in this paragraph showed how Warner Communications developed the means to compete in the growing European market. Moreover, I indicated in section II.2.2 that Asian countries have started to recognize foreign copyrights, thus considerably enhancing American opportunities in these countries. Its aggressive exploitation of this growing market-place has made Warner Communications the world's largest exporter of entertainment products.

As a result of this expansion strategy, Warner Communications has been able to become profitable again, after the heavy investments had caused the company to incur losses in the early 1980s. Figure IV.2 shows Warner Communication's net income over the period 1983-1988.



Source: Company reports

Figure IV.2 Warner Communications' net income over the period 1983-1988

IV.2 GLOBAL COMPETITION IN THE ENTERTAINMENT AND MEDIA INDUSTRY

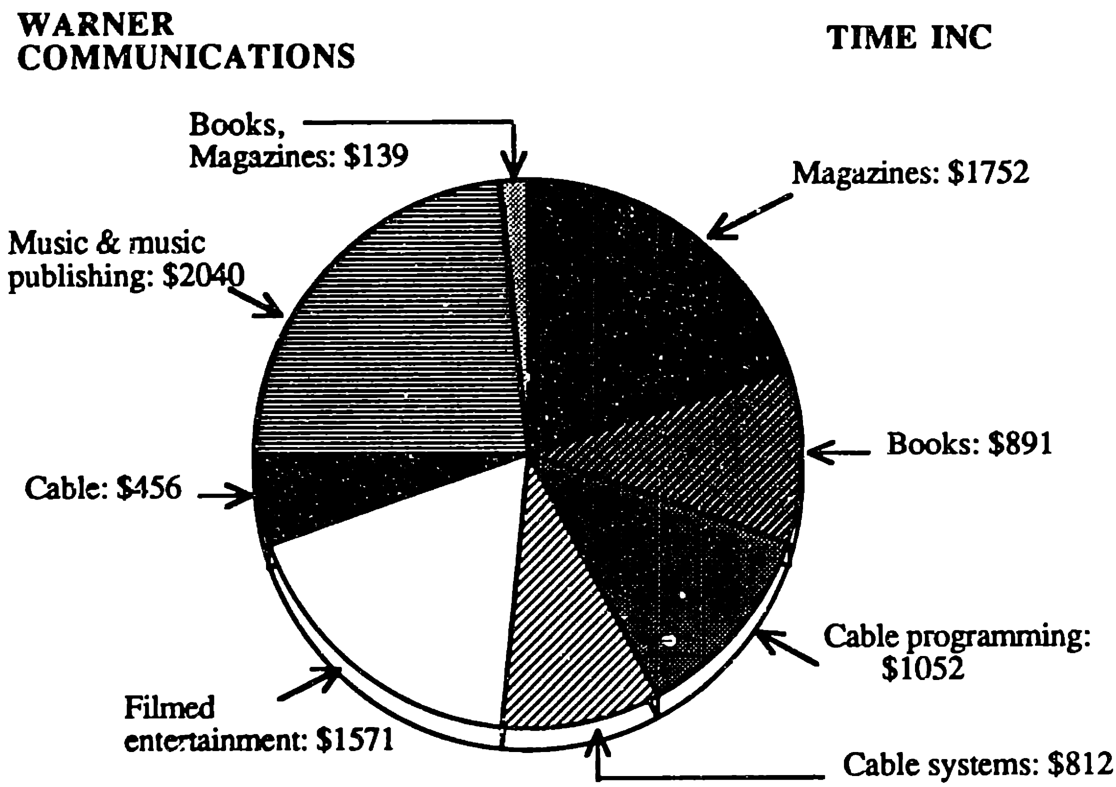
As it appears on Appendix 4, by agreeing to the merger of their two companies, Time's and Warner's top managements intended to build a company that would be a dominant force in the global competition for market share in the entertainment and media industry. The goal of this section is twofold: on the one hand, Time Warner's competitive weapons will be highlighted. Then, I will briefly review the principal participants in the entertainment and media industry, and examine the strategic issues in this global competition.

IV.2.1 Time Warner's competitive strengths

As both Steven J. Ross and J. Richard Munro emphasized (Appendix 4), Time Warner was, at the time of the merger, the largest media and entertainment company in the world in terms of revenues, with aggregate sales of $10 billion. However, it is clear that the merger will not provide Time Warner with tools to compete more effectively in the international market unless some synergy is created by the business combination that eventually led to the acquisition of Warner Communications by Time Inc. I believe that some of the most important strengths created by the association of the two companies are the following:

- I established in section II.4.2 how entertainment and media companies can benefit from vertical integration to compete in the global industry. Financial strength, a wide variety of products and a powerful distribution network are valuable assets. But having control over the production, distribution, marketing and production of all its products will be necessary for Time Warner to acquire the flexibility needed to compete in the global industry. Figure IV.3 shows the scope of products that were combined by the formation of Time Warner in March 1989. It also shows that, based on 1988 revenues, the balance that existed between the two companies.

Note: All revenues are in million dollars for the fiscal year 1988



Source: Company reports

Figure IV.3 Time's and Warner's revenues by product

- Another important source of synergy comes from the cultural changes that have strengthened the links between news and entertainment. Time Warner Inc is an integrated company which will be able to address the new needs of the audience. Except for a network television and a newspaper, Time Warner has control over every kind of media and entertainment business.

- Finally, I noted in Chapter III the negative reaction of the American public and analysts to the increased power of foreign companies in the U.S entertainment industry. Time Warner should benefit from a very positive image in the United States, because top management succeeded in presenting the company as a great American power that would be able to compete against the foreign corporations which are purchasing more and more prestigious U.S entertainment companies.

This positive image has been reinforced after the foreign presence intensified with the acquisitions of Columbia Pictures Entertainment by Sony Corp, and of MGM/UA by Pathe Communications, raising much concern about the future of the United States' competitiveness in the critical entertainment and media industry. Moreover, I pointed out in Chapter II that the consolidation of the motion picture industry is likely to continue. With the formation of Time Warner, Warner Bros became an unlikely target for a takeover by a foreign corporation.

Of course, if it is well managed, Time Warner will also benefit from Time's and Warner's individual strengths, which include Warner's aggressive global strategy, depicted in section IV.1, and Time's leadership in book and magazine publishing.

IV.2.2 The competitors

Time Warner has entered an industry which is dominated by a few major corporations which have been rapidly growing. Over the past few years, these aggressive companies have been acquiring several entertainment and media companies, mostly in the United States. Based on the revenues for years 1987 or 1988 (depending on available data), Time Warner's primary competitors* are: Bertelsmann, Capital Cities, News Corporation and Hachette S.A. Next, we give a brief description of each of these companies. Table IV.1 shows the revenues of the main participants, with their country of origin.

Corporation	Home Country	Annual Sales (1987 or 1988, in millions of dollars)
Bertelsmann	West Germany	6.6
Capital Cities	United States	4.8
News Corp	Australia	4.4
Hachette	France	4.1

Table IV.1 Time Warner's main competitors in the global entertainment and media industry

* Sony Corp has been voluntarily excluded from this discussion for two reasons:
a. Because it does not own any media or communications subsidiary, Sony will not be considered here as a "media and entertainment" company.
b. The strategies and competitive positions of Sony are discussed elsewhere in this study.

Bertelsmann: Started as a small publishing firm, this German company began to diversify into movie production after World War II. Since the 1970s, Bertelsmann has aggressively entered all the markets of Western Europe through the acquisition of publishers of books and magazines, and through joint ventures with foreign televisions. Then, in 1986, Bertelsmann bought RCA/Ariola Records from General Electric, and Doubleday for a total of $800 million. As a result, Bertelsmann's sales in the North American market accounted for almost one third of the company's total revenue in 1988.

Capital Cities: Although it has acquired some foreign concerns, Capital Cities is not as aggressively engaged in the global competition as the other corporations. However, Capital Cities has built a strong power in the American communications industry. The corporation owns eight profitable television stations and twenty one radio stations, in addition to its 80 percent participation in ESPN, the sports cable network. Capital Cities has also a strong presence in publishing. However, Capital Cities' growth has been slowed by the difficulties experienced by ABC, its television network, and by the legal restrictions that keep the corporation from making more investments in the movie, television and cable industries.

News Corporation: Founded by Rupert Murdoch, News Corporation has been among the most active in the entertainment and media industry, purchasing publishing companies, newspapers, magazines, TV stations and Twentieth Century Fox, one of the seven major American film studios introduced in section II.1. Most of News Corporation's acquisitions have been executed in the United States, where Rupert Murdoch has even started a fourth American television network with Fox Broadcasting Co. And News Corp has continued to increase its already substantial debt by pursuing acquisitions of interests in the filmed entertainment industry.

Hachette: Hachette's primary strength is in publishing (books, magazines and newspapers). Over the last three years, a series of acquisitions in the United States has made Hachette a major American publisher. Hachette's strategy is to grow rapidly by acquisitions in the United States in order to have the size that is necessary to compete in the global industry.

Gulf and Western and Maxwell Communication Corp are two other main participants which have also been growing rapidly, and which will be among Time

Warner's principal competitors. Table IV.2 summarizes the products in which each of these seven corporations are engaged.

	Books	Magazines	News papers	Film, TV production	Broad-casting	Cable systems	Music
Time Warner	X	X		X	X	X	X
Bertelsmann	X	X		X	X		X
Capital Cities	X	X	X	X	X		X
News Corp	X	X	X	X	X		
Hachette	X	X	X	X	X		
Gulf & Western	X				X	X	
Maxwell	X	X	X		X		

Table IV.2 Products in which each major competitor is engaged

IV.2.3 Challenges ahead for Time Warner

Time Warner, despite its size, will have some serious problems to overcome in this global competition. By acquiring Warner Communications, Time has incurred a debt superior to $8 billion. This high leverage may prevent Time Warner from expanding as aggressively as its competitors.

Even more importantly, the structure of the competition raises important questions for Time Warner. Each of the major foreign competitors has an extremely solid base in its own country, where it faces little competition besides that provided by the other foreign corporations. Hachette, for instance, publishes one of every three books sold in France. Bertelsmann and News Corp dominate the German and Australian markets. Robert Maxwell has started to build a media and entertainment empire in Britain, as Mr. Sylvio Berlusconi has in Italy. One of the reasons why all these companies have come to the United States to expand, is that their domestic countries are close to saturation, and that the battle for market share in Europe is so intense that they have to look for expansion through the extremely rich American market.

In these conditions, how is Time Warner going to position itself in the European competition? To be a global competitor, Time Warner needs not only to respond to the increasing power of its competitors in the United States, but also to gain market share in foreign countries. While Warner Communications - as was described in section IV.1.1 - has developed a strong presence abroad, Time Inc's participation to the European media industry has been limited to a few joint ventures. The main challenge for Time Warner will be to find opportunities to grow abroad, in markets that are already dominated by international corporations.

IV.3 IMPACT OF THE MERGER ON WARNER BROS AND THE U.S MOTION PICTURE INDUSTRY

The most important effects that the formation of Time Warner will have on the U.S motion picture industry are related to the increased control that Warner Bros now has on home video and, even more importantly, on the cable industry.

Time and Warner are complementary to perform well in the U.S cable industry. Time's cable operation, American Television, and Warner Cable Communications are both considered to be more sophisticated than the industry's leader, Tele-Communications. As I described in section IV.1.1, Warner, in the last twenty years, has been investing in state-of-the-art innovations in order to deliver entertainment to American homes. Time's expertise, on the other hand, is to sell media, particularly magazines, through direct marketing. By combining these skills, Time Warner should be able to increase its cable customer base, which included 5.5 million customers at the time of the merger.

The control of a larger portion of the American cable system will enable Time Warner to have more leverage in the negotiations it leads with independent cable networks (such as FNN or USA Network) to let them use Time Warner's cable operations. Combined with the increased efficiency of Time Warner's marketing methods, this will produce increased revenues and power from cable systems.

But the main advantage that Warner Bros has acquired through the merger between Warner Communications and Time Inc is the association with HBO. HBO, with Cinemax, is an important force in the American motion picture industry because it is the principal exhibitor of movies on television. This gives HBO a great bargaining power in its negotiations with film studios. HBO assures Warner a market. Moreover, Warner Bros will be able to produce more motion pictures for HBO. And HBO will have incentive to produce its own movies, because Warner's distribution system will give these films an expanded market (especially overseas). That will increase HBO's bargaining power in its negotiations with other film studios.

However, this situation is subject to the reaction of Time Warner's competition. Television network owners, in particular, may use the tremendous power acquired by Time Warner in the cable industry in their negotiations with the government for the right to own cable stations. If they succeeded, this would reinforce the position of companies like News Corporation, Capital Cities, CBS or General Electric.

Another problem that Warner Bros is facing is the disparity between the cultures and management styles of Time Inc and Warner Communications.

Warner Bros has been characterized by an aggressive expansion strategy that was described earlier. By contrast, Time Inc has been mostly trying to increase its power in the United States. Moreover, even if they have been handled by the same companies, media and entertainment are two different industries, which do not necessarily require the same skills. Because of the growth of the motion picture and television industries, some Time executives have expressed the concern that entertainment might become their company's primary business (As can be seen on Appendix 4, in their announcement of the merger to their shareholders, Steven J. Ross referred to Time Warner as the "preeminent entertainment and media company", while J. Richard Munro called it the "preeminent media and entertainment company").

Top management is also an issue. While Steven J. Ross and J. Richard Munro are still CEOs of Time Warner, they will soon be replaced by N.J Nicholas Jr., who was President and COO at Time. This may cause problems for the film studio, because Mr. Ross spends a lot of time developing strong relationships with Hollywood powers, such as movie stars and agents. The replacement of Mr. Ross by Mr. Nicholas, who has very few ties with the motion pictures industry, may make the transition difficult for Warner Bros.

CHAPTER V: CONCLUSION

This chapter is intended as both a summary of the main strategic issues that were highlighted in this study and a prediction as to how the U.S motion picture industry will evolve in the future. In particular, I will point out what I believe to be the principal dangers that the industry will have to cope with. I will give my opinion about the competition between Warner and Columbia. I will also try to predict the evolution and consequences of the consolidation of the industry.

The issues facing the U.S film industry are multiple, because this industry is intertwined with many others, such as television, communications or consumer electronics.

Although leisure time is expected to decrease in occidental countries, the worldwide demand for movies will continue to grow tremendously. Technology will keep on finding new ways to improve home entertainment. Western European countries have not completed the deregulation of their broadcasting systems. And cultural changes will continue to transform Eastern Europe and Asia. The main beneficiary of this increasing international demand will be the U.S motion picture industry, which, despite the European competition, will be able to sustain the global advantage it has acquired over the years, and which has already started to position itself in the fast growing foreign markets. This growth will provide the American film industry with great opportunities, which were examined in this study. However, I believe that the expansion of the distribution network also represents a few dangers for the U.S motion picture industry if it is not managed properly.

One of these dangers is the possible reduction of the number of movies produced by American companies. Their rationale is the following. Film producers now have the ability to sell their movies through cable, television or home video, and they get more revenues from foreign markets. As a result, film studios prefer to spend their financial resources improving their distribution networks, and setting up gigantic international promotion campaigns for a handful of high budget movies which are expected to yield enormous profits in ticket sales, and cable and video revenues over the world. This explains the "blockbuster" trend, which has started a few years ago. The number of movies produced in the United States, which only remained stable during the 1980s, has decreased from five hundred to four hundred and fifty between 1988 and 1989. If the major studios were to pursue this strategy, I believe it might prove harmful to the American motion picture industry, in several ways.

First, the impact of a decreasing number of pictures on the movie theater industry has been studied here. To differentiate themselves, and to avoid the cost of showing first-run American movies, small theater chains might begin to show more foreign movies - which would open new opportunities to foreign producers who, until now, had very little access to the vast American market. Moreover, if small theater chains failed to survive, this would weaken the movie theater industry as a whole in its competition against home entertainment products such as cable television and home video. In the long run, this would hurt the overall performance of American movies in the domestic box office. And, as a result, foreign distributors and television owners, who buy movies partly on the basis of their U.S box office sales, might turn towards other suppliers.

Furthermore, the "blockbuster" approach represents an increased risk for individual film production companies. I have mentioned in my study that one of the competitive advantages a major studio has is its possibility to diversify its risk by producing a large number of movies. By focussing on one or two movies a year, and by investing great amounts of money to promote them, studios relinquish their ability to reduce risk, and count on these few movies to produce sufficient profits.

Finally, a decrease in the number of movies produced by the American studios hurts the industry by making it less attractive to technicians, artists and other creative talents, who are offered fewer opportunities to work. In order to maintain its global advantage, Hollywood must continue to attract not only the best American talents but also, as it has in the past, some of the greatest artists in the world. At a time where televisions have increasing demand for these skills, the U.S should start producing more movies instead of fewer.

Another consequence of the increase in the international demand for American movies has been, as described in Chapter II, the consolidation of the industry, and the multiple acquisitions of American film studios. I have examined the global competition in the entertainment and media industry, and I have singled out two issues for the United States' largest competitor, the newly formed Time Warner: the difficulties it will have to penetrate the seemingly saturated European market, and the aggressive competition it will have to face in the United States.

As far as Europe is concerned, I believe that the opportunities in publishing will be scarce, because of the already powerful, and still growing, presence of Hachette, Bertelsmann and Robert Maxwell. The best strategy that Time Warner can follow, in this context, is probably to multiply joint ventures in order to gradually increase its presence in Western Europe. However, Time Warner does have a strength which may play an important role as the television system continues to develop in the countries of the European Community. Although cable has not experienced the same growth in Europe as it has in the United States, it may become a more international business, in which case HBO, and the expertise both Time Inc and Warner Communications have developed in cable operations will be extremely valuable assets. Furthermore, even if cable never becomes as popular in Europe as it is in the United States, Time Warner still can profit from its strengths to increase its power in the European television industry. There exist in Europe several legal restrictions which prevent private television stations from programming a large number of "made for screen" movies. Therefore, these television stations have a need for quality made-for-TV movies, which Warner Bros could produce for HBO, then distribute overseas.

In the United States, I think that the consolidation of the industry will continue. As I mentioned in Chapter IV, television networks are obtaining more leverage in their negotiations with the Federal Communications Commission (FCC) as Time Warner gains more power in the cable industry and foreign companies acquire movie studios. As a result, television network owners may soon be allowed more freedom in their mergers and acquisition in the cable and movie industries. Then, companies such as Capital Cities, CBS or General Electric (owner of NBC) would undoubtedly be looking to reinforce their position. Furthermore, major film production companies such as Walt Disney Co, MCA or Gulf + Western have started to expand into foreign markets. Hence, they will need more weapons and resources to compete globally. In addition, these companies are not likely to let Warner acquire such power in the U.S cable industry without responding. For these reasons, I believe that more mergers and acquisitions should be expected in the future, and the competition will become more intense for Time Warner.

But, although Time Warner is engaged in the global competition with other large media and entertainment companies, there is no doubt that Warner Communications' chief rival at this moment is Sony Corp which, with CBS and Columbia, will compete with Warner in its two major businesses, music and filmed entertainment. Although it is difficult to predict who is better positioned in the competition between Columbia and Warner, I do believe that the transition will be easier for Columbia than for Warner after the transactions the two studios have been involved in.

As I have explained in my study, Columbia Pictures, since its acquisition by Sony, may have resolved its top management problems. Although the acquisition of such a prestigious studio by a Japanese company was negatively perceived by the American public, this should not have any impact on the performance of Columbia Pictures' movies. This negative image may translate into substantial consequences in the future only if the Japanese presence in the U.S entertainment industry were to intensify with the entry of new companies through the acquisition of other studios, because the public could have a strong reaction against the industry as a whole. It is not likely that such a negative response could be caused only by the ownership of Columbia by Sony, which has acquired a reputation not to interfere with management's decisions and corporate culture in its international subsidiaries. On the other hand, as described in Chapter IV, Time Warner will have to deal with considerable differences in cultures and management styles.

I think that, as much as it will give American film companies increased resources and an easier access to foreign markets, its consolidation may cause an important problem to the U.S motion picture industry: the future of independent and small production companies. Since the apparition of cable and video, and the relaxation of the 1948 antitrust law, major studios have gained more and more power in the industry. With the tremendous financial resources these companies will gain from mergers and acquisitions, it will be increasingly difficult for small companies to compete effectively. Yet, I believe that the survival of these companies is critical for the competitive strength of the American Cinema. Specifically, I think that they are very important with respect to the perception that foreign audiences have of U.S motion pictures. The major studios produce mostly "mainstream" movies, which are considered, especially in Europe, to be entertaining but in most cases lacking of artistic qualities and ambitions. Movies like the recent *Sex, lies and videotape*, *Do the right thing* or *When Harry met Sally...*, which were all produced by small companies, help the overall image of the American Cinema abroad. This, in turn, improves the international sales of all American motion pictures.

APPENDIX 1: The principal participants

This appendix provides information on the major companies which are engaged in motion picture production or theatrical distribution. Firms that are engaged only in motion picture production for TV are excluded.

Walt Disney Co

47,000 employees

- Primary line of business: - Theme parks
- Other lines of business:
  - Motion picture production, except TV
  - Motion picture production for TV
  - Real estate development
  - Audio and computer services for the educational market

Filmed entertainment sales ($000):

Fiscal Year End	Sales
9/30/88	1,149,200
9/30/87	15,700
9/10/86	

Warner Communications, Inc

15,500 employees

- Primary line of business: - Motion pictures production, except TV
- Other lines of business:
  - Motion picture production for TV
  - Phonograph records
  - Miscellaneous publishing
  - Book publishing
  - Periodicals

Filmed entertainment sales ($000):

Fiscal Year End	Sales
12/31/88	1,571,000
12/31/87	1,355,000
12/31/86	1,251,300
12/31/85	1,200,963

Paramount Communications, Inc

12,000 employees

- Primary line of business: - Motion picture production except TV
- Other lines of business: - Motion picture production for TV
  - Book publishing
  - Miscellaneous publishing
  - Periodicals
  - Sport Clubs, Managers and Promoters

Filmed entertainment sales ($000):

Fiscal Year End	Sales
10/31/89	2,071,800

MCA, Inc

17,700 employees

- Primary line of business: - Motion pictures production for TV
- Other lines of business: - Motion picture production, except TV
  - Gift and jewelry shops
  - Tours of Universal Studios
  - Phonograph records
  - Miscellaneous publishing

Filmed entertainment sales ($000):

Fiscal Year End	Sales
12/31/88	?
12/31/87	1,330,288
12/31/86	?
12/31/85	1,187,658

General Cinema Corp

24,200 employees

- Primary line of business: - Motion pictures exhibition
- Other lines of business: - Specialty Retailing

Filmed entertainment sales ($000):

Fiscal Year End	Sales
10/31/89	446,300
10/31/88	379,685
10/31/87	363,685
10/31/86	349,432

Columbia Pictures Entertainment, Inc

7,095 employees

- Primary line of business: - Motion pictures production, except TV

Sales by year ($000):

Year	Sales
1989	1,615,724
1988	1,065,987
1987	1,354,989
1986	1,076,292

Twentieth Century Fox Film Corp

1,636 employees

- Primary line of business: - Motion pictures production, except TV
- Other lines of business: - Motion picture production for TV
  - Film or tape distribution for TV
  - Services related to motion pictures

MGM/UA, Communications Co

830 employees

- Primary line of business: - Motion pictures production, except TV
- Other lines of business: - Motion picture production for TV
  - Phonograph records

Sales by year ($000):

Year	Sales
1989	876,533
1988	674,886
1987	427,574
1986	255,402

Cineplex Odeon Corp

24,200 employees

- Primary line of business: - Motion pictures exhibition and distribution

Sales by year ($000):

Year	Sales
1989	?
1988	695,815
1987	520,153
1986	356,989

Orion Pictures Corp

630 employees

- Primary line of business: - Motion pictures production, except TV
- Other lines of business: - Motion picture production for TV

Sales by year ($000):

Year	Sales
1989	?
1988	466,863
1987	426,948
1986	327,638

Cannon Group Inc

2,609 employees

- Primary line of business: - Motion pictures production, except TV

Pathe Communications Corp

2,206 employees

- Primary line of business: - Motion pictures production, except TV
- Other lines of business: - Motion picture production for TV

Sales by year ($000):

Year	Sales
1989	?
1988	371,107
1987	423,366
1986	352,747

Vestron Inc

630 employees

- Primary line of business: - Motion pictures production, except TV
- Other lines of business: - Motion picture production for TV
  - Services related to motion pictures
  - Phonograph records

Sales by year ($000):

Year	Sales
1989	?
1988	334,893
1987	217,545.
1986	195,365

New World Entertainment Ltd

580 employees

- Primary line of business: - Motion pictures production, except TV

Sales by year ($000):

Year	Sales
1989	?
1988	279,373
1987	320,616
1986	188,923

Carolco Pictures Inc

180 employees

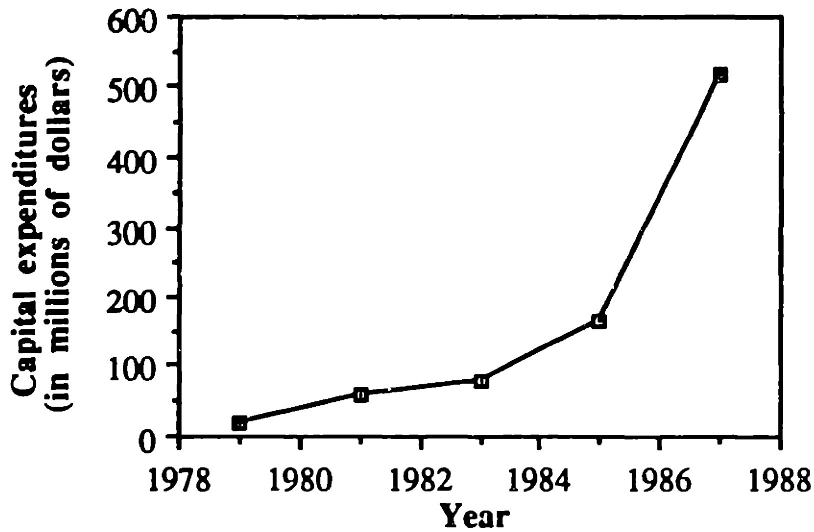
- Primary line of business: - Motion pictures production, except TV
- Other lines of business: - Motion picture production for TV

Sales by year ($000):

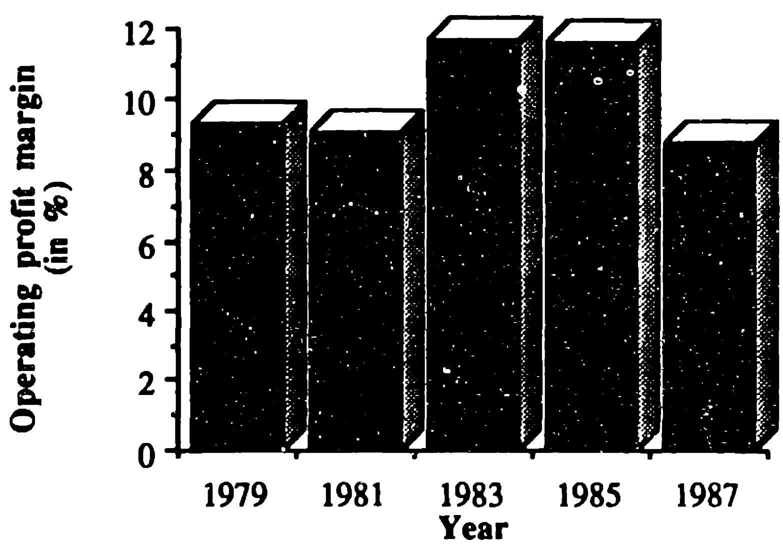
Year	Sales
1989	?
1988	164,609
1987	103,721
1986	57,193

Appendix 2: Capital expenditures and operating profit margins in the movie theater industry during the 1980s

Capital Expenditures



Operating profit margin

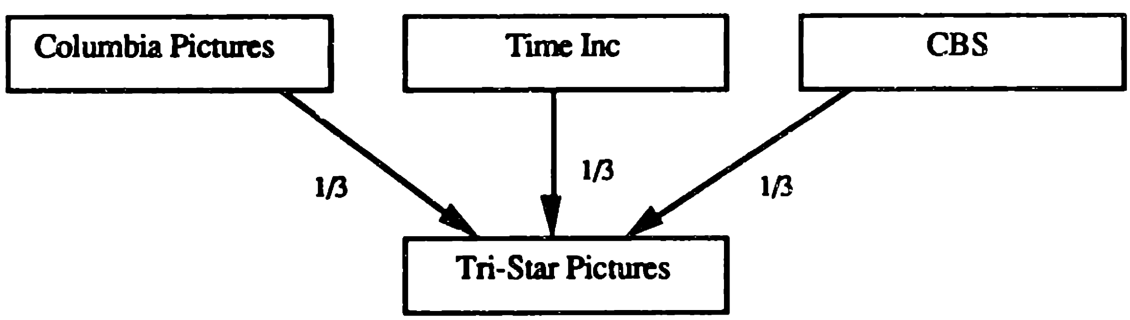


Source: National Association of Theater Owners

Appendix 3: Terms of the 1982 agreement between Columbia, CBS and Time Inc.

Columbia Pictures:	agrees to give CBS Network TV and HBO pay-TV the license to show Columbia movies.
Time Inc:	agrees to contribute 50 percent of the production cost of each film, plus a premium depending on the film's video rentals.
CBS:	pays $2 million for free TV rights.

<u>The formation of Tri-Star Pictures</u>



Appendix 4: Statements by the CEOs of Warner Communications and Time at the time they announced the merger of the two companies

This appendix reproduces extracts from the statements Steven J. Ross and J Richard Munro issued in their letters to shareholders concerning the formation of Time Warner. These statements were published in the companies' 1988 annual reports, which were both released in March 1989.

Warner Communications:

"I am pleased to report that the boards of Warner and Time Inc have agreed to a business combination that will create Time warner Inc - the world's preeminent media and entertainment company with aggregate annual revenues of $10 billion.

This new American enterprise will have all the resources that are necessary to compete globally within our industry [...]

Our new company will enhance the overall international competitiveness of U.S business in the media / entertainment sector. At a time when debate over foreign ownership of U.S assets has raised important questions, we are confident that our new company can confront the demands of the world marketplace in the years ahead.

Maintaining and improving the nation's competitiveness is primarily the responsibility of private industry - driven by market forces."

Steven J. Ross, Chairman and CEO
March 4, 1989

Time:

"On March 4, 1989, [...], Time Inc and Warner Communications announced an agreement to merge through the exchange of Time stock for Warner stock. With combined revenues of $10 billion, Time Warner will be the preeminent media and entertainment company in the world. [...]. The proposed merger will enable us to achieve the strategic goals described in our Letter to Shareholders and, at the same time, enhance American competitiveness in today's global markets."

J. Richard Munro, Chairman and CEO

N.J Nicholas Jr., President and COO

APPENDIX 5: Time and Warner's subsidiaries

This appendix shows the subsidiaries of both companies before the merger in March 1989. Showed here are the key subsidiaries related to the entertainment industry. (Source: company reports)

Filmed entertainment (including home video production and distrinution)

From Time:
HBO Home Video

From Warner:
Warner Bros
Warner Bros Television, which includes Lorimar Telepictures
Warner Home Video

Cable and broadcasting

From Time:
Home Box Office (HBO) and Cinemax
American Television and Communication

From Warner:
Warner Cable Communications
BHC (42.5% owned)

Music

From Warner:
Warner Bros records
Atlantic Records
Elektra Entertainment
WEA Corp
WEA International
WEA Manufacturing

Publishing

From Time:
Magazines: Time, Life, Sports Illustrated, People, Money, Fortune...
Books: Time-Life Books
Book-of-the-Month Club
Oxmoor House
Little, Brown
Scott, Foresman

From Warner:
Warner Books
DC Comics
Mad Magazine
Warner Publisher Services

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John Case: *Return of the Giants*, INC, December 1989

Media and Entertainment financial outlook, Financial World, December 26 1989

Top Five Advertisers, Marketing and Media Decisions, December 12 1989

Joshua Hammer: *Fast fade for a cinema king*, Business Week, November 6 1989

David Lieberman: *Even for Walter Yetnikoff, this will be a stretch*, Business Week, October 30 1989

Neil Gross and William Holstein: *Why Sony is plugging into Columbia*, Business Week, October 16 1989

Invasion of the studio snatchers, Business Week, October 16 1989

John Schwartz and Joshua Hammer: *Japan goes Hollywood*, October 16 1989

Janice Castro: *From Walkman to Showman*, Time, October 9 1989

Jack Egan: *Sony's big picture strategy*, U.S News and World Report, October 9 1989

David Sanger: *Sony aims to marry the best of two nations*, New York Times, September 27 1989

Geraldine Fabrikant: *Sales to Sony approved by Columbia Pictures*, New York Times, September 27 1989

Laura Landro: *Hollywood ending*, Wall Street Journal, September 26 1989

Geraldine Fabrikant: *Deal is expected for Sony to buy Columbia Pictures*, New York Times, September 26 1989

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Time Warner would be big fish, but on crowded pond: Wall Street Journal, March 7 1989

Geraldine Fabrikant: *Time Warner raises concerns on power of a giant*, New York Times, March 7 1989

Geraldine Fabrikant: *Time deal worrying competitors*, New York Times, March 6 1989

Laura Landro: *For Time's Nicholas, tomorrow the world*, March 7 1989

Laura Landro: *Creating a giant*, Wall Street Journal, March 6 1989

Company Reports:

Company	Fiscal Year(s)
Columbia Pictures Entertainment	1987 and 1988
Warner Communications	1987 and 1988
Walt Disney Company	1988
Paramount Communications	1989
MCA	1987
General Cinema Corp	1989
MGM/UA Communications	1989
Cineplex Odeon Corp	1988
Orion Pictures Corp	1988
Pathe Communications Corp	1988
Vestron	1988
New World Entertainment Ltd	1988
Carolco Pictures	1988
Sony Corp	1987 and 1988