

MEMORANDUM

To: Members of Market Street Advisory Committee (“MSAC”)
From: Anne Mitchell, MSAC Member
Re: Articles Regarding Long-Term Viability of Movie Theaters
Date: April 26, 2018

There are numerous articles addressing the 25-year low in movie theater attendance and declining box office. There are also a number of articles discussing the growth of streaming companies such as Netflix. I have attached the following three articles from Barrons, Forbes and CNBC, which address these issues and which you might find helpful when considering the long-term viability of movie theaters, and I highlighted a few statements in each.

1. BARRONS (July 15, 2017)
The Picture Darkens for Movie-Theater Operators
2. FORBES (Aug. 20, 2017)
The Death Of Film: Moviegoing's Bleak Future Is Rapidly Approaching
3. CNBC (April 16, 2018)
Netflix soars after adding nearly 2 million US subscribers, beating estimates

The articles from Barrons and Forbes were published last summer when movie theater attendance hit a 25-year low. The authors cite various factors for the decline, including changes in technology and competition from companies like Netflix. (“*And just as technology is changing how we shop or hail a ride, it is stalking that hallowed temple of American entertainment we call the movie theater.*”).

The articles also address how theater operators have tried to respond to competition and changes in technology (live streaming) with “premium seating and gourmet concessions.” However, even with these changes, these authors predict that the future of movie theaters is dismal. As described by one author, it may not be a “happy ending” for movie theaters.

The CNBC article, published 10 days ago, confirms the predictions regarding Netflix - Netflix outperformed expectations and is predicted to have continued growth. For context, for the three months that ended on March 31, 2018, Netflix revenues increased 40% to \$3.7B.

The Picture Darkens for Movie-Theater Operators

By Kopin Tan

Summer is high season for going to the movies, when theaters earn nearly 45% of their annual take. Yet movie-theater stocks are wilting as the mercury rises, and plumbing 2017 lows. This may not have a happy ending.

Against a rallying stock market, cinema stocks have suffered declines this year of 34% for AMC Entertainment Holdings (ticker: AMC), 5% for Regal Entertainment Group (RGC) and 1% for Cinemark Holdings (CNK). In February, AMC raised millions by selling shares at \$31.50; they now fetch \$22. You can blame the mediocre summer box office on franchise fatigue, a chronic case of sequelitis, and more beguiling choices on HBO, Netflix (NFLX), Amazon.com (AMZN), and Hulu. And just as technology is changing how we shop or hail a ride, it is stalking that hallowed temple of American entertainment we call the movie theater.

Studios and distributors are debating how best to roll out “premium video-on-demand,” which lets viewers watch a movie at home for, say, \$30 to \$50 within a day to 50 days after it hits the big screen. Among the questions Hollywood is mulling: How much are Americans willing to pay, and how far can the industry compress the 90-day window between theatrical and home-viewing release? The

options being considered vary with the studios, which run the gamut from Universal Pictures—owned by Comcast (CMCSA), which already pipes content into your home—to Walt Disney (DIS), which sits atop the 2017 box office with hits like the remake of *Beauty and the Beast* and *Guardians of the Galaxy 2*, and sees no need to rock the boat.

Premium video-on-demand can benefit studios, but theaters have much to lose. It won't increase the cost of making a movie, but studios can now woo home audiences while the buzz from theatrical release is

still fresh, and they can spend less money marketing anew to home viewers.

A Morgan Stanley survey found 25% of respondents keen to try the format, and since these are already regular moviegoers, there's a risk of cannibalization. Among the firm's assumptions: It will take three years for the format to take hold. Studios will collect a 55% share of the \$9.70 estimated average ticket price in 2020, versus an 80% share of the premium video-on-demand price of \$35, split between two home viewers, on average. For studios, this makes premium video-on-demand worth two or three times more per user than movie tickets, and "collapsing the theatrical window is a risk worth taking," writes Morgan Stanley analyst Benjamin Swinburne. He estimates video-on-demand could generate \$2 billion of incremental revenue for studios. On the other hand, he sees a cash-flow hit of about 25% for Regal and 15% for Cinemark (the firm doesn't cover AMC).

Credit Suisse analyst Omar Sheikh says studios will push hard to begin premium video-on-demand in 2017, and that theaters "have less leverage over studios than studios have over them." He trimmed price targets for AMC, Regal and Cinemark in late June.

Make no mistake: Movies aren't dead. Directors with big budgets and bigger egos will insist their work must be seen on the big screen (and some of them will be right). **But it is unrealistic to think movie distribution is immune to technology. Live music, vinyl records, and books printed on paper all continue to exist in the age of digital distribution, but they exist in a changed state.**

Hollywood is no stranger to change. Movie-going might have peaked in 1946, when a whopping 57% of Americans went to the movies weekly. Then came a television boom that some say is in a second golden age, and younger generations that watch shows on—gasp—their phones. **From 2007 to 2016, total domestic box-office receipts increased from \$9.6 billion to \$11.4 billion, but annual theater admissions per capita shrank from 4.4 to 3.8, a sign that revenue growth came from raising ticket prices.**

Theater operators can blame studios for churning out movies that don't help their cause. Once upon a time, the June-to-August stretch introduced Americans to movies like *Jaws*, *Grease*, *Meatballs*, *Raiders of the Lost Ark*, *E.T.*, *Back to the Future*, *Ferris Bueller's Day Off*, *Stand By Me*, *Bull Durham*, *Ghost*, *Jurassic Park*, *Speed*, and, of course, *Wet Hot American Summer*. Summer movies have always targeted the young, or young at heart, but these days they seem to be made for juveniles with a spandex-and-superhero fetish.

Hopes run high that flat year-over-year revenue will rebound with fourth-quarter releases of *Star Wars: The Last Jedi*, *Justice League*, and *Thor: Ragnarok*, plus more sequels including *A Bad Moms Christmas*, *Daddy's Home 2*, *Pitch Perfect 3*, and *Saw 8*. We used to look to TV for recurring characters, but now it's movies that trot out the same characters, time and again. Often, what passes for innovation is the casting of a new actor in an old role, which has seen us go through five Batmen in 28 years, and three Spidermen in 15.

Theater operators have responded first with multiplexes that seek to offer something for everyone, and now by touting premium seating and gourmet concessions, for which they charge more. But that's a little like renovating the deck chairs on a sinking ship. Besides, we already have premium seating at home, without the olfactory onslaught of someone scarfing down nachos.

Theater stocks fetch 19.8 times projected profit today, just below a five-year average of 22 times. The stocks will be volatile as studios toy with new distribution, and while they might retreat to levels that justify short-term bounces, the long-term pressure remains. The U.S. has more than 40,174 movie screens. That's roughly 124 per million people, compared with 30 in China, 13 in Brazil, and two in India. Expect the number of big screens to shrink over time. Turns out Norma Desmond may have been right after all: It's the pictures that got small.

The Death Of Film: Moviegoing's Bleak Future Is Rapidly Approaching

By Schuyler Moore

I am sad to report the death of film, or perhaps more accurately, the death of theatrical films. First, let's look at some hard facts:

1. In the last 10 years, the U.S. population has grown by almost 10%. During that same time, the number of movie tickets sold in the U.S has decreased by almost 10%, so that is the equivalent of an almost 20% decline in tickets sold.
2. While gross U.S. box office has increased by about 10% in the last 10 years (before this year), it is entirely attributable to rising ticket prices. On an inflation adjusted basis, the U.S. box office has remained flat. Given that the number of tickets sold is decreasing, a flat box office on an inflation adjusted basis means that ticket prices are increasing faster than inflation, which just cannot last in the face of so many viewing alternatives, discussed below.
3. At the same time, the cost of making and marketing studio films has steadily risen. Although the MPAA has stopped giving averages, a rough estimate is that the cost of producing and releasing an average studio film has risen by 20% in the last 10 years.
4. In the last 10 years, there has been a steady expansion of viewing alternatives, including Netflix, Amazon, Hulu, YouTube, and now Facebook. Home screens have become the equivalent of mini-theaters, with high-definition screens and surround-sound, and younger people are more than happy to watch content on laptops or cell phones. Theaters are facing heavy headwinds in the face of this competition for eyeballs.
5. And if that weren't enough, the theatrical window is rapidly collapsing. If market forces don't close it, piracy will. The window

has gone from months to days, and in many cases there is just no window at all, since Netflix is happy to slam the window shut and others will have to follow suit.

6. No doubt due to a combination of these factors, and not just bad films, the U.S. box office has fallen off a cliff so far this year.

Against this backdrop, here are my predictions on what the theatrical landscape in the U.S. will look like three years from now:

1. One or more theater chains will have gone bankrupt.
2. Many theaters will have shuttered. The smart ones will have converted to location based virtual reality centers. It is no mere coincidence that IMAX is already exploring this option with test sites.
3. The theaters that survive will offer 4D seats, which move to match the film (where you feel like you are flying when a jet is on screen), and 3D sound, which seems to come from different angles at different times around you, like raindrops falling near you.
4. A theatrical release will be day-and-date with the online release, except for big-budget studio films that will play in the theaters with the enhancements described above.
5. Some studios will essentially become production companies for online distribution companies, such as Netflix and Amazon, and will get out of the distribution business, while other studios, like Disney, will compete with them.

So one day we will be telling our grandchildren about the wonders of going to a movie theater, and they will ask, "Did you really have to drive there, park, pay for it, and sit with all those strangers?"

Netflix soars after adding nearly 2 million US subscribers, beating estimates

By Anita Balakrishnan

Netflix added far more users than expected in the first quarter and posted quarterly earnings in line with expectations and revenue slightly above estimates.

The user growth sets the company up for a sunny outlook in the second quarter: The company's earnings guidance also came in well above Wall Street's forecast. Shares rose more than 5 percent after hours.

How Netflix did in Q1

- Earnings per share (EPS): 64 cents adjusted vs. 64 cents expected by a Thomson Reuters consensus estimate
- Revenue: \$3.7 billion vs. \$3.69 billion expected by a Thomson Reuters consensus estimate
- Total streaming net adds: 7.41 million vs. 6.5 million expected by a StreetAccount consensus estimate
- Domestic streaming net adds: 1.96 million vs. 1.48 million expected by a StreetAccount estimate
- International streaming net adds: 5.46 million vs. 5.02 million expected by a StreetAccount estimate
- Free cash flow was negative \$287 million.

In January, Netflix said it expected \$3.69 billion in revenue in the quarter and EPS of 63 cents, adding 6.35 million new customers in its streaming business.

A year ago, Netflix reported diluted adjusted EPS of 40 cents per share on revenue of \$2.64 billion.

Guidance for Q2

- Forward guidance on Q2 EPS: 79 cents per share vs. 65 cents per share expected by a Thomson Reuters consensus estimate
- Forward guidance on Q2 revenue: \$3.9 billion vs. \$3.89 billion expected by a Thomson Reuters consensus estimate
- Forward guidance on net adds: 6.2 million vs. 5.24 million (974,000 domestic and 4.27 million international) expected by StreetAccount

Stepping up to challenges from Disney and Amazon

Netflix has relied on international growth and heavy investments in original content to drive subscriptions — and Monday's results provided an update on their effectiveness.

Netflix's addition of more than 7.4 million international subscribers set a new record, marking growth of 50 percent from a year ago.

Chief content officer Ted Sarandos said Netflix has shot original content in 17 countries as it focuses more on local programming, and that many of Netflix's foreign-language shows would be considered "big hits" on American cable channels, thanks to artful subtitling. CEO Reed Hastings added that Netflix has also seen success on its international mobile app offerings. But Hastings also said that the company hadn't changed its view on expanding in China, and will continue to license content.

The company also said it expects to have \$7.5 billion to \$8 billion of content expenses this year, in line with previous estimates. Netflix had said it expects to grow to 60 million to 90 million members in the U.S. over time and that it would spend \$8 billion on content and \$2 billion on marketing this year.

The company highlighted Spanish-language hit "La Casa de Papel," unscripted series "Queer Eye," and beloved franchises such as "Marvel's Jessica Jones," "Grace and Frankie," "Santa Clarita Diet" and "A Series of Unfortunate Events." Netflix also credited new talent, such as Shonda Rhimes and Jenji Kohan, for their "proven track record of success" and for allowing Netflix to cut back "reliance on third-party studios."

"We're investing in more marketing of new original titles to create more density of viewing and conversation around each title," the company said in a statement.

The marketing spending comes after Netflix was barred from competing at the Cannes film festival due to a rule change — a setback the company called unfortunate.

One thing that's not on the spending slate, Sarandos said, is news programming.

"Our move into news has been misreported over and over again. We're not looking to expand into news beyond the work that we're doing in long-form and short-form documentary," Sarandos said. "Topical interview shows, absolutely, but keep in mind, those are entertainment."

Netflix faces increasing competition from Amazon and Disney, which have their own offerings, as well as traditional media companies and technology companies such as Apple. Hastings said the company still has a long way to go to compete with the likes of YouTube, and noted that Netflix's ability to raise prices depends on providing more value than competitors.

"If we get lazy or slow, we'll be run over just like anybody else," Hastings said.

At the same time, Netflix is expanding into cable bundles and recently announced a new offering with Comcast, in addition to bundles with Sky, T-Mobile and Altice.

Netflix said on Monday the bundles allow the company to upsell existing subscribers. Executives said on a conference call that the "new wave" of operator partnerships was a consistent shift across all geographic markets.

"We remain primarily a direct-to-consumer business, but we see our bundling initiative as an attractive supplemental channel," the company said.

On Monday, Netflix also announced the addition of Susan Rice, a former national security advisor and U.S. ambassador to the United Nations, to the board of directors.