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Hollywood's Death Spiral

The secret numbers tell the story.

By Edward Jay Epstein
Posted Monday, July 25, 2005, at 11:48 AM PT

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Nervous about slow DVD sales? Don't be.

The screenwriter William Goldman famously explained Hollywood this way: "Nobody knows anything." He is right—up to a point. The six giants that dominate the industry (Fox, Time Warner, Sony, NBC-Universal, Paramount, and Disney) do not break down the sources of their revenues—even in their annual reports—into clear-cut categories such as theatrical release or DVD sales. Instead, they lump their revenues into vague, larger categories such as "entertainment." In the case of Paramount, this category includes earnings not only from a movie's theatrical run and DVDs, but also from theme parks, foreign movie theaters, music publishing, and library sales to television.

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Even though the studios do not provide a road map for outsiders to the precise sources of their wealth, the real numbers are available in Hollywood. Indeed, every 90 days, each major studio sends a precise breakdown of all its revenue from all its worldwide sources, including movie theaters, video distributors, and television stations, to a secretive unit of the Motion Picture Association called Worldwide Market Research, located in Encino, Calif. The unit combines the data into an All Media Revenue Report and sends it to a limited number of top executives. As the studios' trade organization, the MPA presumably can circulate such secret data without running afoul of antitrust laws. With this report, the studio executives have a benchmark with which they can compare their performance to that of other studios in the various markets. For example, Fox executives can see how Fox DVD sales in Finland stack up against their competitors. Studios go to some lengths to keep this data discreet—each page is stamped "Strictly Confidential—Not For Further Distribution"—and, in the best Hollywood tradition of keeping audiences in the dark, the report is not made available to newspapers, industry newsletters, or Wall Street analysts.

Without such information, however, it is impossible to render an accurate

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picture of Hollywood. Consider how earlier this year entertainment journalists rattled on for months about a slump in the American box office—"Box Office Slump In Its 19th Week"—as if it were a sporting event in which the Hollywood studios couldn't get winning hits. The story would have been different if they had seen the data on Page 16 in the 2005 Three Month Revenue Report. (Click [here](#) for that page.) Instead of a box-office decline, the studios actually took in more from the U.S. box office in the first quarter of 2005 (\$870.2 million) than they did in the similar period of 2004 (\$797.1 million). So even though the total audience at movie theaters declined during this period, this came mainly at the expense of independent, foreign, and documentary movies. For the Hollywood studios (and their subsidiaries), in fact, there was no slump at all.

Without access to the studios' revenue numbers, prognostications about Hollywood become little more than the blind leading the blind. While the media would be very cautious about projecting automobile sales trends without industrywide data (which Detroit provides), it is a different story when it comes to Hollywood. For example, following a DreamWorks Animation announcement that *Shrek 2* DVD returns wiped out much of its first-quarter earnings in 2005, the *Wall Street Journal* ran the headline: "In DreamWorks Earnings Woes, A Bigger Problem: Sales of 'Shrek 2' DVD Suggest Format Is Peaking As Hollywood Profit Center." The story speculated that the *Shrek 2* DVD returns (as well of those of *The Incredibles* DVD) "may be the front-end of an even bigger problem: a general slowdown in DVD sales growth."

One problem with that theory is that returns are not necessarily a measure of the public's appetite for DVDs. Even many of the biggest-selling DVDs have substantial returns. Indeed, it is built into the business model. Since the manufacturing cost of a DVD is relatively low (\$1.85), studios often "channel-stuff" by shipping as many DVDs to retailers as they can while setting up reserves in their accounting—usually between 20 percent and 30 percent of sales—for returns. As it turns out, even with some 7 million returns (which was 20 percent of the total sale), *Shrek 2* actually outsold the original *Shrek* in similar time periods. *The Incredibles* was also one of the biggest titles in history, selling (after returns) 17.7 million DVDs. In any case, the attempt to divine an overall "slowdown" in DVDs from the sales of any particular title is dubious: No one knows whether consumers who elected not to buy the title in question bought another title instead (in which case overall sales would be unaffected). To assess a "slowdown" or "peaking," one would need the results of all the studios' sales over a comparable time period. Fortunately, this information is available in the 2005 Three Month Revenue Report.

The numbers tell the story. In the first three months of 2005, the studios earned \$5.67 billion dollars from DVD sales, compared to \$4.375 billion in the same period in 2004. DVD sales were up \$1.29 billion, an incredible rise of 28 percent, which exceeded last year's increase. So there was hardly a slowdown in DVD sales. (Click [here](#) for the numbers behind the rise of the DVD.) Indeed, DVDs alone now provide 59 percent of the feature film revenues of the studios, as opposed to 48 percent in 2004.

The real issue that emerges in these secret industry numbers is not the rise of a new format. Just as the DVD replaced VHS, a more efficient digital format will eventually replace the DVD. (A high-definition digital recorder with massive storage is already available in the United States and Japan.) What has inexorably changed is the location of the studios' crucial audience. In 1948, with studios earning all their revenues from the box office, that audience was moviegoers. Even as late as 1980, when the audience had television sets and video players, studios still earned 55 percent of their money from people who actually went to movie theaters. In 2005, however, those moviegoers provided the studios with less than 15 percent of their worldwide revenues, while couch potatoes provided it with 85.8 percent. (Click [here](#) to see the numbers behind the rise of the home entertainment economy.)

This change in audience location altered the balance of power inside the studios. It reduced the once-almighty movie distribution arms to minor players while awarding star status to the home entertainment divisions that produced well over three times as much revenue. Through this reversal of fortunes, the stage has been set for what a top studio executive warned could be "Hollywood's death spiral."

The spiral begins with a shortening of the delay, or "window," that separates a movie's theatrical release from its video release. In the early 1980s, in order to avoid having new movies in theaters compete against themselves in video, pay-per-view, pay TV, or free television, the studios set up a series of insulated windows for each format. The video window opened six months after the theatrical release and four months before the pay-per-view window. With Warner Bros.' strategy involving selling massive amounts of DVDs on the first day of its release, by 2001 they had effectively shortened the window to five months so they could market the DVDs of summer blockbusters at Christmas time.

Other studios followed suit with a vengeance, shortening the window to four months—or, in a few cases, three months—in order to sell Thanksgiving-released children's movies at Christmas. Even worse, the home entertainment

divisions began to announce an upcoming DVD while the movie was still playing in theaters. For example, this July, only four weeks after opening *The Adventures of Sharkboy and Lavagirl in 3-D*, Buena Vista trumpeted the coming release of the extras-loaded DVD. Even if only a small percentage of moviegoers decide to wait for the announced DVD, it leads multiplex chains, which need to maximize their popcorn sales to stay in business, to cut the run of the movie in their premium theaters. The shorter the run, the less money the title takes in at the box office. As this spiral accelerates and studios earn a larger and larger share of their money from home entertainment, it adds to the pressure on studios to further reduce the video window. How far can this cycle go? After Hong Kong collapsed its video window in 2002, there was a 70 percent reduction in theater attendance. And, as a top studio executive pointed out after studying the problem, "A 6% reduction in attendance in 2000-2001 led to half the movie theaters in the world going bankrupt." How will Hollywood get out of the death spiral? "That is the \$64 billion dollar question," he replied. (Stay tuned for the answer next week.)

[Edward Jay Epstein](#) is the author of [The Big Picture: The New Logic of Money and Power in Hollywood](#). (To read the first chapter, click [here](#).)

Photograph on [Slate's](#) home page by Yoshikazu Tsuno/Agence France Presse. Still from *Shrek 2* from HO/AFP/Getty Images.



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