The Chinese film industry seems to have reached a golden age—new carriers, an influx of capital, as well as innovative business models are all propelling China's film industry to the top of the film pyramid.

New Era of China's Film Industry

By / Po Hou, Roger Chung

With box office revenues reaching RMB 44 billion in 2015, today China is the fastest growing film market in the world. By 2020, China's box office revenues are expected to reach RMB 200 billion, at which point it will overtake North America as the world's largest market for cinema, both in terms of number of movie-goers and revenue. How did this happen? And what can we expect of the film and entertainment industry in the future?

Three main developments in the entertainment industry have made this breakneck growth possible. A concerted government policy to encourage the growth of the culture and entertainment industry, the spectacular growth of the Internet and Internet related services, and fresh injections of capital from new investors in particular, Internet giants, led by BAT (Baidu, Alibaba, Tencent), and real estate developers such as Wanda. These 'new players' have used their scale and capital advantages to gradually penetrate the entertainment industry and build an ecosystem. For instance, Wanda Group, a Chinese property developer, has merged its culture and property resources, taking advantage of its commercial property to build movie theatres, and expanded into the upstream film industry. Since its acquisition of AMC Entertainment Holdings Inc. (AMC), Wanda Group has become the largest cinema chain operator in the world. In early 2015, Wanda Cinema was listed on the SME Board of the Shenzhen Stock Exchange, and became the first cinema chain stock to list on the domestic stock market. Competition between the 'new players' and industry stalwarts has led to this dynamic growth within the film industry.

Faced with a rapidly evolving situation both inside and outside of the industry, the traditional film industry stalwarts have embraced change too, particularly Internet Plus-based change and comprehensive industry chain restructuring. For example, with Disney as its model, Huayi Brothers have launched a "de-cinematic" strategy that integrates the traditional film business, Internet entertainment, and location-based entertainment, and expands into upstream and downstream industry chains to alleviate dependence on the film industry.

In the next five years, China's culture and entertainment industry will develop rapidly. Mainstream forms of entertainment such as film, online videos, and TV will prosper; competition between new entrants and industry stalwarts will become fiercer; cross-industry cooperation and competition will continuously come into play and the industry chain will be re-shuffled and transformed.

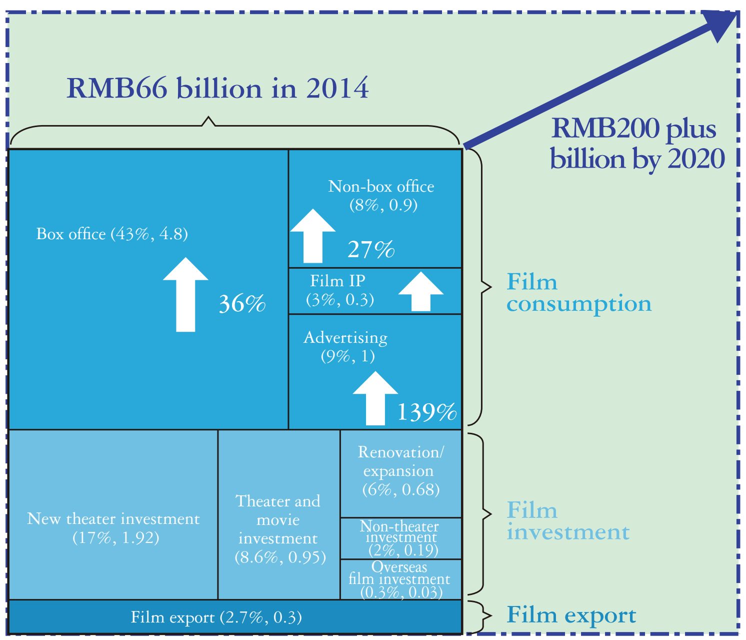
Here are seven key trends to watch for.

Trend One: From Bigger to Biggest

1.1 China's box office revenues and number of movie-goers are expected to surpass North America by 2020

China's film industry is made up of three different elements: film consumption, investment in films and theaters, film exports. Each has a different profile and therefore will grow at a different rate. On the film consumption front, China's film industry maintained rapid growth, with a combined revenue of RMB 66 billion1in 2014. In recent years, revenue generated from non-box office activities, copyright, and advertising (theaters, TV, and Internet) has grown rapidly, providing important support for the continuous expansion of China's film consumption. Regarding film and theater investment, investment in new theaters is expected to stabilize, and the extensive operation model will be replaced with an intensive one. Moreover, against a backdrop of theater glut and high costs in first-tier cities, steady expansion into second, third, and fourth-tier cities will be rewarded with better returns. As for film exports, due to cultural differences between China and foreign countries, legal considerations, and other factors, only mild growth is expected, with little impact on the industry as a whole. According to Deloitte's forecast, by 2020, China's film industry will see further expansion, with revenue reaching RMB200 billion. By then, China will overtake North America in box office revenue and number of movie-goers, and will become the largest film market in the world.

Figure 1 China's film industry market size forecast (2014-2020)[2]



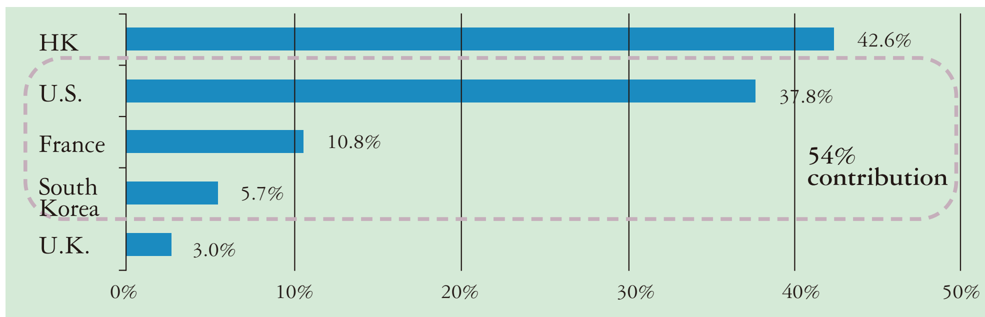
Trend Two: From "Made in China" to "Made for the World"

The size and attractiveness of the domestic Chinese market has attracted a number of foreign film investors and directors. The box office success of co-productions like Wolf Totem (Sino-French, 2015) which earned RMB700 million in the first 35 days, has increased the interest in co-operating with Chinese partners. But the eventual objective of these co-productions is not to 'create' for the domestic market alone but to 'create films for the world'.

2.1 Co-productions will increase, resulting in a "win-win" partnership for China and its foreign counterparts

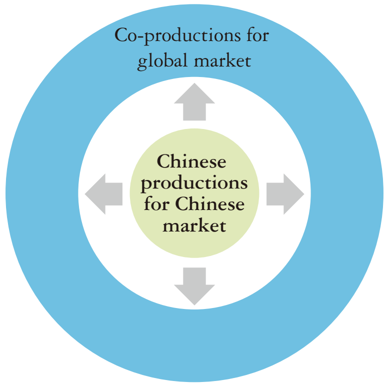
In the past, China's investment in the foreign film market and China's film exports were small. However, in recent years, as China has become the world's second largest market (based on box office returns) and a number of foreign investors and film producers have shown willingness to cooperate with China. Co-productions are a way for Chinese films to enter foreign markets and for foreign films to gain access to China's audiences. At present, half of the countries listed as 'top 10 international box office markets' have signed co-production agreements with China, and the number of co-productions are increasing, albeit slowly. In 2014, though co-productions accounted for only 6 percent of total productions screened in China, they contributed around 50 percent of total box office revenue. In the first quarter of 2015, co-productions contributed ~60 percent of total box office revenue. Co-productions can achieve "win-win" outcomes for both parties because co-produced films are considered to be "Made in China" and enjoy the same treatment as domestic ones. Compared to imported films, co-productions enjoy better distribution, revenue sharing percentage, and policies. Nonetheless, co-productions are still faced with many challenges such as copyright ownership, cultural differences, and different work styles.

Figure 2 Box office contributions by nations/regions (2015 Q1, Top five)[3]



2.2 Co-productions for the global market

Figure 3 Co-productions for global market[4]



Currently, most co-productions are targeted at the Chinese market. Wolf Totem, released in early 2015, was a Sino-French co-production which used many Chinese elements. Most of the filming was done in China, and almost all of its actors were Chinese. Western resources were mainly used for content creation, such as direction, and diversified capital support. This film had great success in the Chinese market, earning RMB700 million at the box office in 35 days!

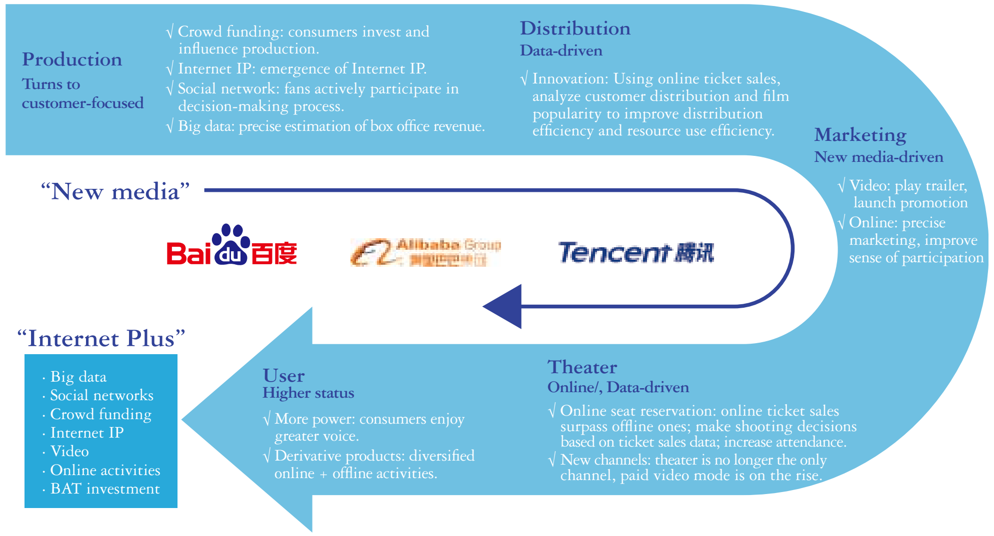
However, achieving success in the Chinese market is not the ultimate goal for such co-productions. For instance, Fast and Furious 7, screened in 2015, was not only targeted at the Chinese market but also at foreign markets. It leveraged the best resources in the world, received investment from global investment platforms and made RMB2 billion in its first 15 days. Achieving worldwide success like this is the ultimate goal for Chinese films. With co-productions becoming more frequent, and cooperation deepening, the appetite for co-productions is bound to grow, fueling the co-production trend and bringing more and more Chinese films to the international market.

Trend Three: From "non-intelligent" to "Intelligent"

3.1 Big data will be used to drive decision optimization and profit growth

The wealth of information about people's tastes, lifestyles and interests generated by the Internet and internet based technologies has had a huge impact upon the Chinese film industry. Internet and the use of 'big data' has transformed the domestic film industry chain – particularly in the fields of IP (Intellectual Property), production, marketing and promotion, distribution, and ticket sales. Internet giants such as BAT have invested continuously in the film industry - Tencent Pictures, iQiYi Films, and Baidu Pictures have all been trying to get a foothold in the movie business. Traditional film companies have responded to this situation through mergers and acquisitions and other methods. For example, Shanghai New Culture Media (listed on the A-share market) along with other film companies announced private placement and investment plans in Internet and big data technologies totaling several billion yuan.

Figure 4 Impact of Internet and big data technologies on the value chain of the film industry[5]



The use of Internet technologies and Big data is set to transform the movie business in the following ways throughout the ecosystem:

Production and distribution: With the exception of some high quality scripts, filmmaking and production will be more driven by market demand. The right to select content and creative personnel will gradually move from producers and directors to movie-goers. More film IP will be based on Internet creations. Investment and production decisions will be based on data on movie-goer's preferences regarding content, actors, etc. taken from the Internet and social networks, thereby achieving more precise market positioning and box office forecasts, and higher investment returns.

Marketing: Data on new media users makes it possible for precise marketing of films. Traditional marketing methods such as posters and trailers are not sufficient for large scale marketing and promotion of new films. New media technologies are being used for film marketing, which match film content to the target audience, and audience feedback on preferences are being used for adjustment of marketing strategies, which will increase box office earnings.

Online ticketing: Another change to the film industry brought about by the Internet is that online ticketing has upended traditional ticketing channels. Online ticket sales accounted for 63 percent of total ticket sales in Q1 2015.6 Online ticketing platforms have great influence and related marketing is essential to drive film consumption and penetrate the upstream film industry to help integrate the film industry and Internet. The online ticketing sector has attracted many competitors such as Meituan, Gewara, Wepiao, Taobao movie, and Dianping, among others. In addition, online ticketing platforms have streamlined the film-watching experience.

Cinema screenings: Where cinema screenings are concerned, there is big potential for data analysis, which will be used for decision and service optimization. Breakup Buddies, prior to its official screening in 2014, used the online booking platform Meituan to lock up over RMB100 million in box office revenue through online booking. On the basis of the film's online sales, its screening rate in domestic theaters reached over 36 percent, substantially surpassing other films screened during the same period. Based on online ticketing data and box office forecasts, theaters are able to adjust screening schedules more efficiently, improve an audience's movie-watching experience, and increase ticket sales.

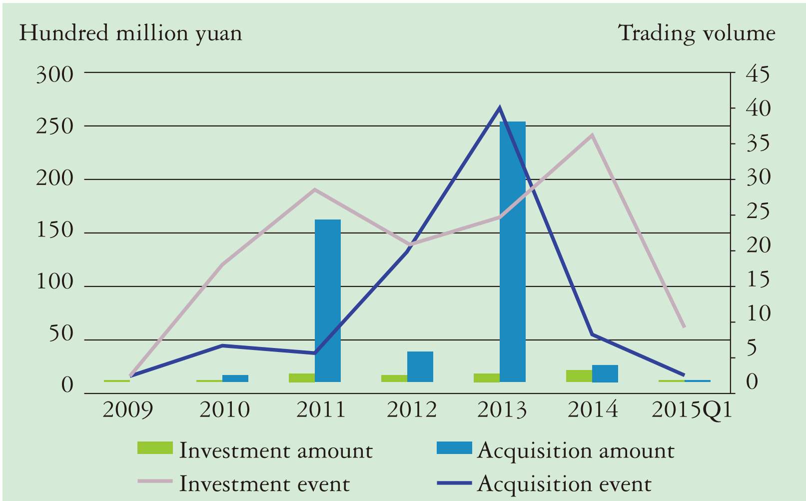
Trend Four: From "Highly Concentrated" to "Diversified"

Responding to the arrival of industry 'outsiders', the traditional film companies have gone on an acquisition spree, buying up smaller production houses and integrating 'upstream' and 'downstream' along the production line. This has led to a much greater 'concentration' within the industry. At the same time, in order to take advantage of internet based film products, many big companies have hived off their internet and new media departments, creating entirely new companies that can then go public independently. Another element of 'decentralization' is crowd-funding. This is being used by big and small film production houses either as publicity tools or as ways of getting funds for small budget 'experimental' films.

4.1 Investment in the film market is steadily increasing, and non-industry acquisitions are also rising

Since 2014, investment in the film sector has totaled RMB 1.28 billion, with year on year investment in 2015 up by 15 percent. In the market, there are four types of investments favored by investors: "online ticketing platforms," "film + Internet platforms," "transnational co-productions," and "fan films."

Figure 5 Investment and acquisition trends in the film industry(2009-2015Q1)[7]



Acquisition mania has also spread to other industries, and acquirers from non-film industries accounted for 49 percent of total acquirers. Among these acquirers, Internet enterprises have accelerated their expansion into the film industry. One of the most notable acquisitions last year was Alibaba spending RMB 6.24 billion to acquire a 60 percent stake in ChinaVision and renaming it Alibaba Pictures.

Shanghai Zhongji Investment Holding, a traditional enterprise, spent RMB1.5 billion to acquire Beijing Ruyi Xinxin Film Investment—producer of Old Boys and Youth Days—with a view to shore up its strong growth points, take advantage of the rapidly growing film industry to slow down its recent trend of decline, and realize strategic transformation of its enterprise. Industry giants like Huayi Brothers, Enlight Media, and Huace Film and Television will continue to acquire small scale film companies with a single profitability model, and improve their industry chains. However, judging from the current situation, many companies have yet to achieve satisfactory results after integrating film enterprises, because significant differences in management and culture can make it difficult for these combinations to gel.

4.2 Film enterprises might delist from foreign stock markets and return to domestic A-share market

The main reason for Chinese film companies delisting from foreign stock markets is the long-term undervaluation of their American stocks. Bona Films, for example, helped produce or invested in 12 domestic films in 2014, which generated 2.6 billion in box office revenue for the whole year, accounting for 15 percent of total box office revenue, and its total market value was around RMB 5 billion. Enlight Media, however, released 12 films in 2014, contributing about RMB3.1 billion in box office revenue, and its total market value was about RMB 59 billion; Huayi Brothers released 10 films, contributing about RMB1.1 billion in box office revenue, and its total market value was RMB70.9 billion. Bona Films also invested in building theaters, and has 22 theaters in operation. In fact, Bona Films was equivalent to about one third of SMI Holdings Group in market value, while total market value of SMI Holdings was 12 billion HK dollars. By comparison, Bona Films was seriously undervalued on the American stock market.

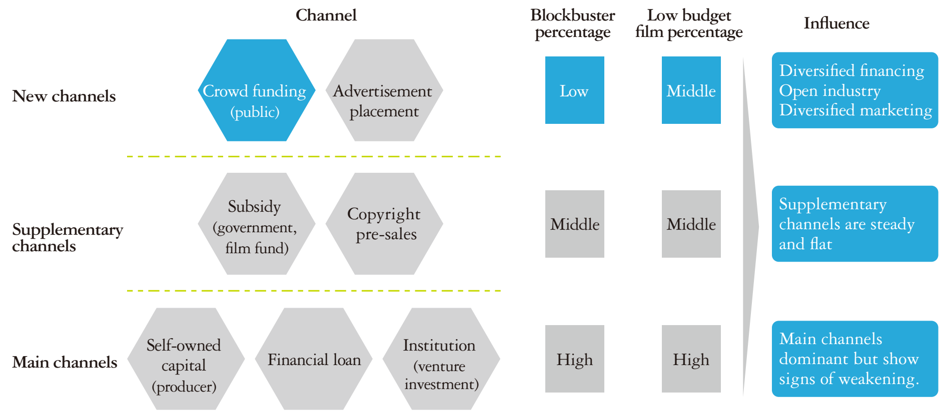
4.3 "Internet Plus" will drive film companies to split into separately listed companies and go public individually

In the wake of "Internet Plus", many giants in the film industry intend to fully develop the Internet entertainment sector by dividing themselves into separately listed companies that will go public individually and adopt a capital market operation model for expansion. For example, Huayi Brothers plans to make their new media and Internet entertainment business into an independent Internet entertainment company that can go public on its own. These spin-off companies are one way to build an Internet-based entertainment company. Different from a traditional entertainment company, the spin-offs will have some degree of independence, and incorporate "Internet Plus" while retaining a traditional film company business model. This will become one of the development trends for film companies in the wake of Internet Plus.

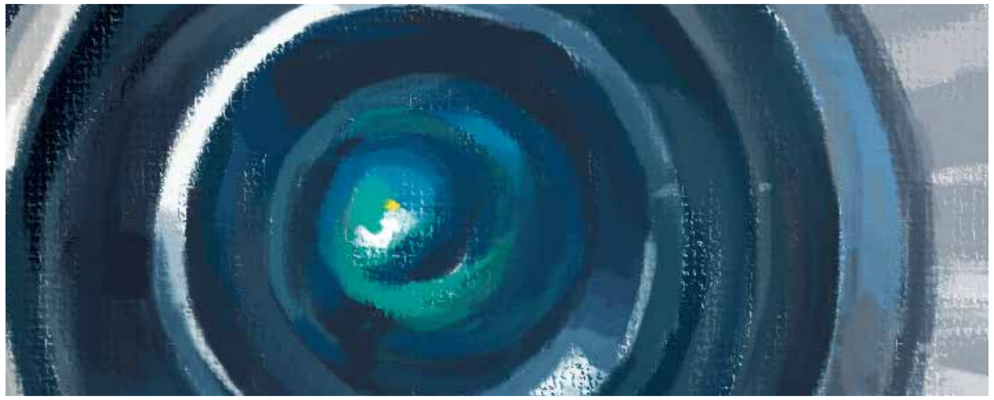
4.4 Crowd funding provides supplementary financing for the film industry

In 2015, there were over 100 crowd funding platforms in China, whose impact on the film industry can be gauged in three areas: new financing channels, open transition, and marketing means. Generally speaking, capital raised through crowd funding only amounts to around ten million RMB, which is a fraction of the amount (billions) required for film production. For small film companies, crowd funding offers a viable way to raise capital. For large film companies, however, crowd funding is mainly used for promotion and testing market response.

Figure 6 Impacts of crowd funding on China's film financing channels



In the future, there will be three types of crowd funding. The first type is "reward-based", using games to encourage public participation while acting as a mean to promote films; the second type is to adopt a "low threshold and reasonable returns", allowing the public to profit from box office; the third type is "equity-based" crowd funding, requiring a high threshold (need to have certain level of net assets) to film investors.



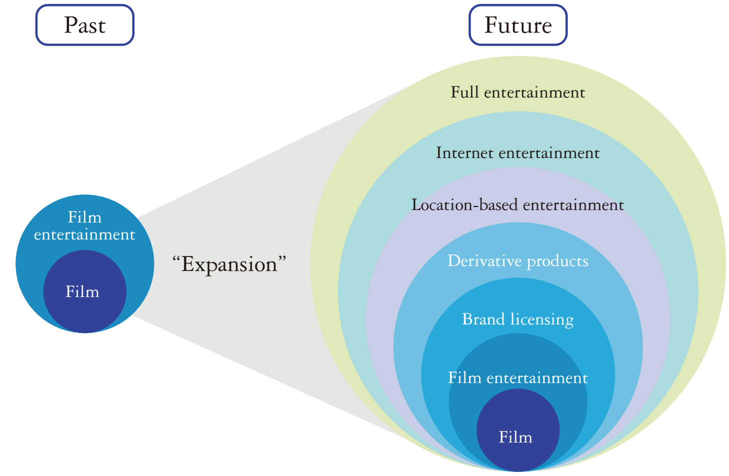
Trend Five: From "Long Tail" to "Thick Tail"

Currently the Chinese film industry relies almost entirely upon box office revenue and therefore the risks are high. However, using the business model of international companies like Disney as a blueprint and taking advantage of the growth of Internet technologies and Big Data domestically, film companies are now restructuring their revenue structures and will continue to do so in the future.

5.1 The current single profitability model will require a diversified strategy

Though the domestic film market is thriving, only a few film companies actually make profits and the risk involved is very high as in China covering film production costs relies heavily on box office revenue. However, the Disney model offers a successful blueprint for the Chinese film industry to follow. At present, Disney's production and entertainment business only contributes 15 percent of its total revenue, the rest comes from diversified business including theme parks, toys, books, video games, and media networks. Core IP, derivative products, licensing, and entertainment projects also help provide Disney with stable sources of income.

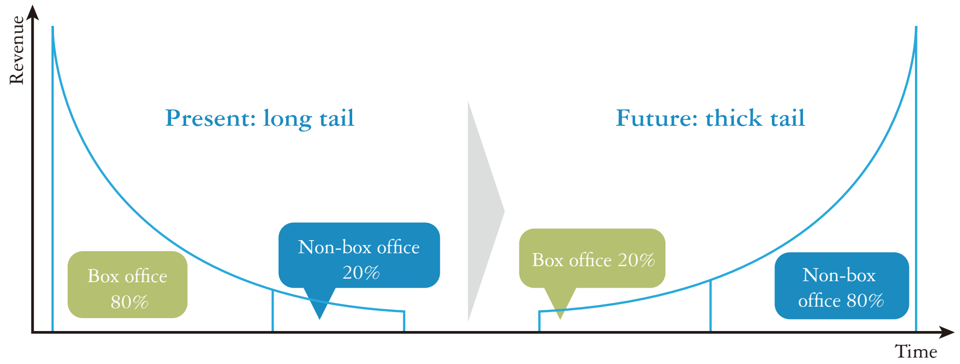
Figure 7 Diversifying revenue sources



In China, Huayi Brothers took the lead in launching a "de-cinematic" strategy, and its expansion resulted in continued adjustments to revenue structure. By implementing this "de-cinematic" strategy, Huayi Brothers gradually decreased its dependence on the traditional film industry and maximized overall value by expanding 'upstream' and 'downstream' on the industry chain. Enlight Media, another traditional entertainment company, followed Disney's model and launched projects that entered into several industries including gaming, animation production, and location-based entertainment development.

5.2 Revenue structure will be re-balanced, shifting from "Long Tail" to "Thick Tail"

Figure 8 From "Long tail" to "Thick tail"



Besides extended development, China's film companies have opted for three other ways to re-balance their revenue structures:

1. Video on demand: In 2015, the number of Internet video subscribers in China exceeded 500 million, and competition for exclusive film content royalties rose accordingly, providing a reliable source of income for film producers with in-demand content.
2. TV networks: In 2015, over 30 provincial and municipal broadcasting and TV network companies co-established the "China TV cinema alliance", enabling them to purchase film content or adopt revenue-sharing methods with film producers to generate new sources of revenue for the film industry.
3. Derivative products: As China pays more attention to copyright protection and intensifies its crackdown on pirated movies, various enterprises are trying to develop derivative product markets and reap more film-related revenue.

These three methods have helped improve the post-film market and in the future will continue to fully develop potential markets. Together with the extended development of enterprises, China's film revenue structure is expected to re-balance through a shift from "long tail" to "thick tail."

Trend Six: From "single IP" to "IP franchises"

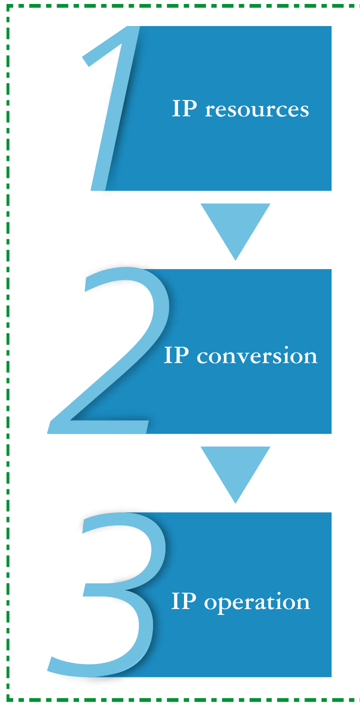
6.1 IP sequels are vital for future success

One can judge the importance and value of IPs (Intellectual Properties) from the following observations: first, high quality IPs can earn higher box office revenue; second, IP-based fan bases form an established market, which is conducive to more efficient marketing; third, based on the above two points, IP owners have greater bargaining power in the market, can influence the direction of capital flow and compete with big enterprises. Fast and Furious, a record-breaking box office success in 2015, existed for ten years as a television series, and has become the hottest car racing "super IP" in film history. In China, there are three key elements required for IPs to become "Super IPs":

1) IP resources, or, the competition for quality IPs.

By 2015, the rights to 114 novels had been bought by either Internet or traditional giants. Currently, 90 are being adapted for television, and of which 24 works will probably be made into movies. Internet companies have begun to hoard source IP resources. For example, Baidu set up Baidu Literature; Tencent Game, Literature, and Animation have also accumulated many IP sources to conduct cross-platform expansion by centering on IP authorization.

Figure 9 IP development "trilogy"



2) IP conversion:

How to find the right people to adapt and build an IP series, thus improving its commercial value is a crucial element in the whole IP game. The process of converting quality IP involves the whole cultural industry chain. After being created in one field, an IP needs to extend to other fields in order to enhance its commercial value, form an IP system, and evolve from "single brand" to "cluster brands", thus achieving maximum benefits.

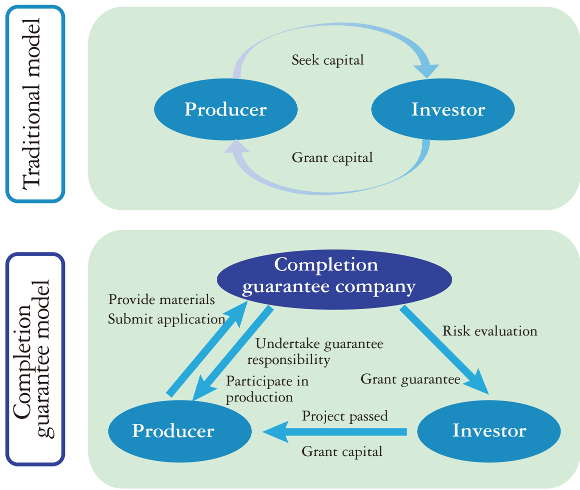
3) IP operation:

Operation of an IP ecosystem can prolong an IP's life span. Integrating content making and distribution, platforms, and hardware terminals enables the same IP content to be converted into multiple forms (films, cartoons, mobile games, novels, toys). In the future, IP operation mode will shift from a "single model" to an "integrated model". Disney's Toy Story 3 earned US$1.1 billion in global box office, but its IP full line development such as games, books, DVDs, copyright and authorization, etc. generated US$8.7 billion. With this in mind, domestic film companies should seriously consider the development and operation models of IP series.

Trend Seven: From a lack of standards to "Standardization"

With the rapid development of China's film industry, problems in film production are beginning to surface. Due to lack of standardized processes and methods for creating films, it is quite common for films to become 'overdue and over-budget'. About 70 percent of the 600 or more films produced annually in China are never screened; this is a colossal waste of resources for producers and the film industry as a whole, and furthermore, poses potential hazards for investors. It is imperative to standardize and normalize the film production process. Enforcing a guarantee system will reduce these risks and allow greater growth.

Figure 10 Moving to a standardization model



7.1 Completion guarantees will promote industry standardization

Completion guarantees are a relatively mature film financing and production supervision model in the United States. As a third party (neither investor nor producer), the completion guarantee company is responsible for supervising the whole process of film production, including distribution. The company also conducts comprehensive reviews and is responsible for ensuring that film production and distribution are on budget and on schedule. If the film cannot be delivered on schedule, the completion guarantee company will take over film production and compensate the investor with a guaranteed amount.

The impact of this system on China's film industry is two-fold: first, the system helps resolve issues of non-standardization in film production, and helps to enforce quality controls. Second, it helps solve financing problems for small and medium-sized film companies, and establishes a sound financial security system, providing a bridge between film and finance industries.

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Note

1. *ENT Group.*
2. *ENT Group, Deloitte Projection.*
3. *ENT Group.*
4. *Deloitte Analysis.*
5. *Deloitte China Analysis*
6. *ENT Group.*
7. *Zero2ipo.*