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China's Film Industry
– a New Era

Contents

Introduction

China's culture and entertainment industry has entered into an unprecedented "golden age". With box office revenue of RMB44 billion in 2015, China is the fastest growing film market in the world. By 2020, China's box office is expected to reach RMB200 billion and will exceed North America as the world's largest market in box office revenue and audience numbers.

Driven by policy, Internet, and capital, "new giants" are emerging. In particular, Internet companies, led by BAT, and real estate developers such as Wanda, have used resource 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 with its channel advantage. 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.

These "new giants", backed by vast user base and channel advantages, are eroding the influence of "traditional giants". Faced with a rapidly evolving situation both inside and outside of the industry, "traditional giants" have sensed the urgency for change. To "traditional giants" in the culture industry, Internet Plus-based transformation and comprehensive industry chain restructure have become common trends. For example, with Disney as its model, Huayi Brothers has 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.

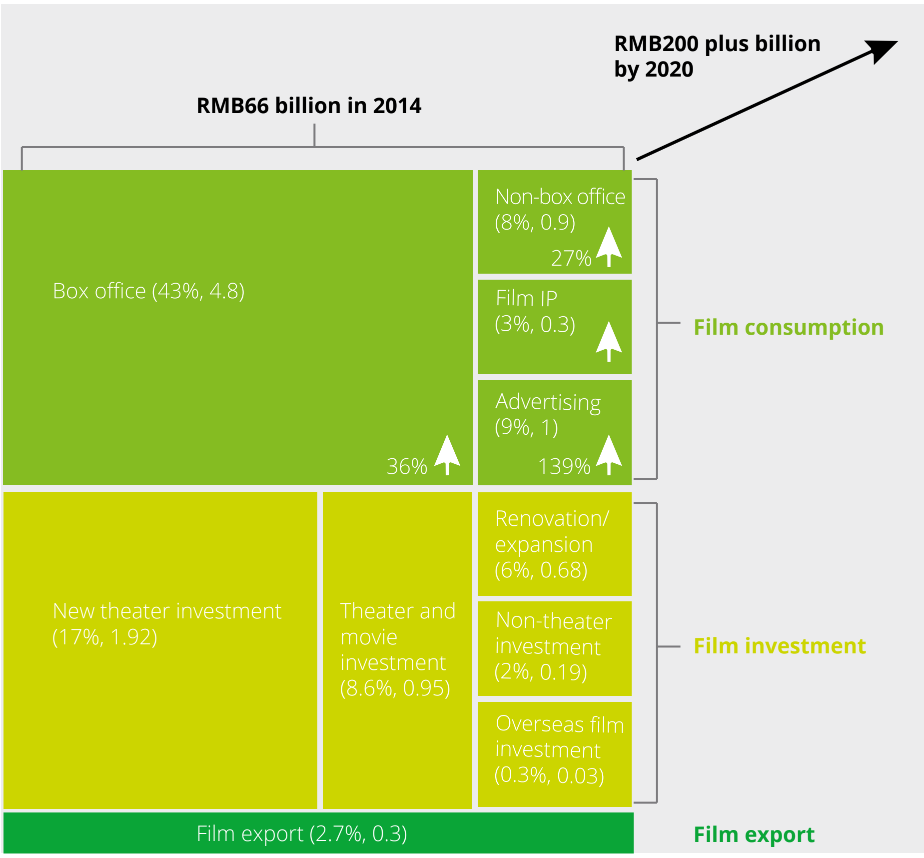
In the next five years, China's culture and entertainment industry is on track for speedy development. Mainstream forms of entertainment such as film, online videos, and TV will experience prosperous development; competition between "new giants" and "old giants" will become fiercer; cross-industry cooperation and competition will continuously come into play, the industry chain will be shuffled and transformed, and opportunities and challenges will co-exist. The culture and entertainment industry is ushering in a new era, and the film industry should witness the following seven key trends.

Trend One: From Bigger to Biggest

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

The size of China's film industry is made up of three parts: film consumption, film and theater investment, and film export. On the film consumption front, China's film industry maintained rapid growth, with combined revenue of RMB66 billion[1] in 2014. In recent years, revenue generated from non-box office, film 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 the backdrop of theaters overflow and high costs in first-tier cities, steady expansion into second, third, and fourth-tier cities will be rewarded with better returns. For film export, 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: China's film industry market size forecast (2014-2020)[2]



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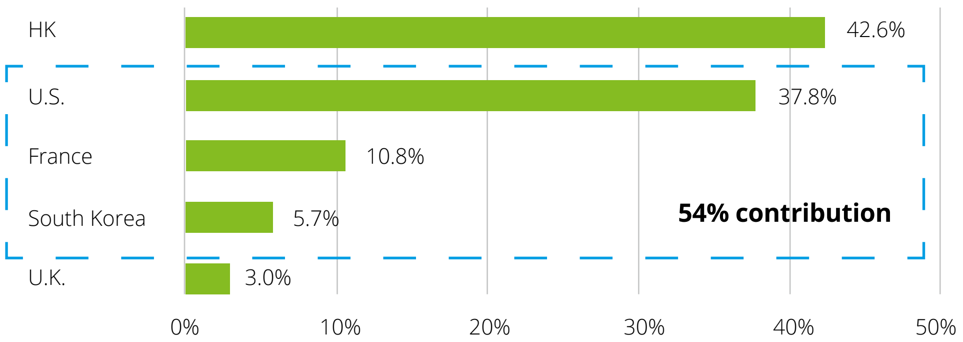
2 ENT Group, Deloitte Projection

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

2.1 Co-productions should enjoy favorable status, resulting "win-win" for China and its foreign counterparts

In the past, the scale of China's investment in the foreign film market and China's film exports were unsatisfactory. However, in recent years, as China has become the world's second largest box office market, an influx of foreign investors and film producers have shown willingness to cooperate with China. Co-productions are a way for China's films enter global and for foreign films to gain access to China. At present, half of countries listed as top 10 international box office markets have signed co-production agreements with China, and the number of co-productions has increased to some extent. Though co-productions only accounted for a small proportion of the total number of productions in the Chinese film market, they contributed a significant percentage of total box office revenue. In 2014, co-productions accounted for 6 percent of total productions screened in China, but 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 because co-produced films is considered as "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.

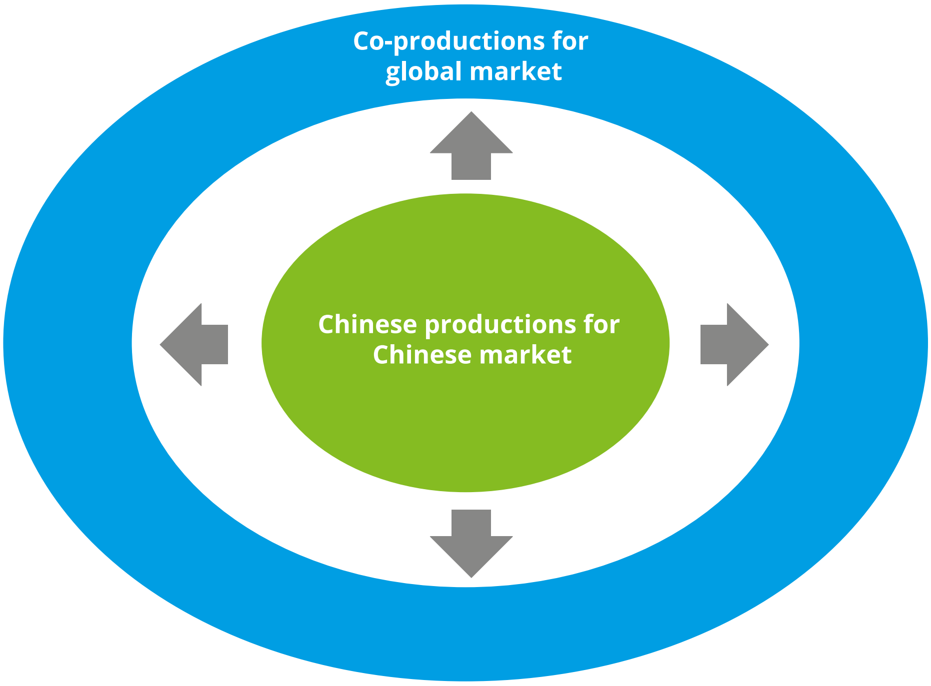
Figure: Box office contributions by nations/regions (2015 Q1, Top five)[3]



2.2 Co-productions for the global market

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

Figure: Co-productions for global market[4]



However, achieving success in the Chinese market is not the ultimate goal. For instance, *Fast and Furious 7*, screened in 2015, was not only targeted at the Chinese market but also the global market. It leveraged the best resources in the world, received investment from global investment platforms and made RMB2 billion in its first 15 days. Like this movie, achieving success in the global market is the ultimate goal for Chinese films. With co-productions becoming more mature and cooperation growing deepener, there will be an expanded co-production market, thus fueling the co-production trend and achieving success for Chinese film in the global market.

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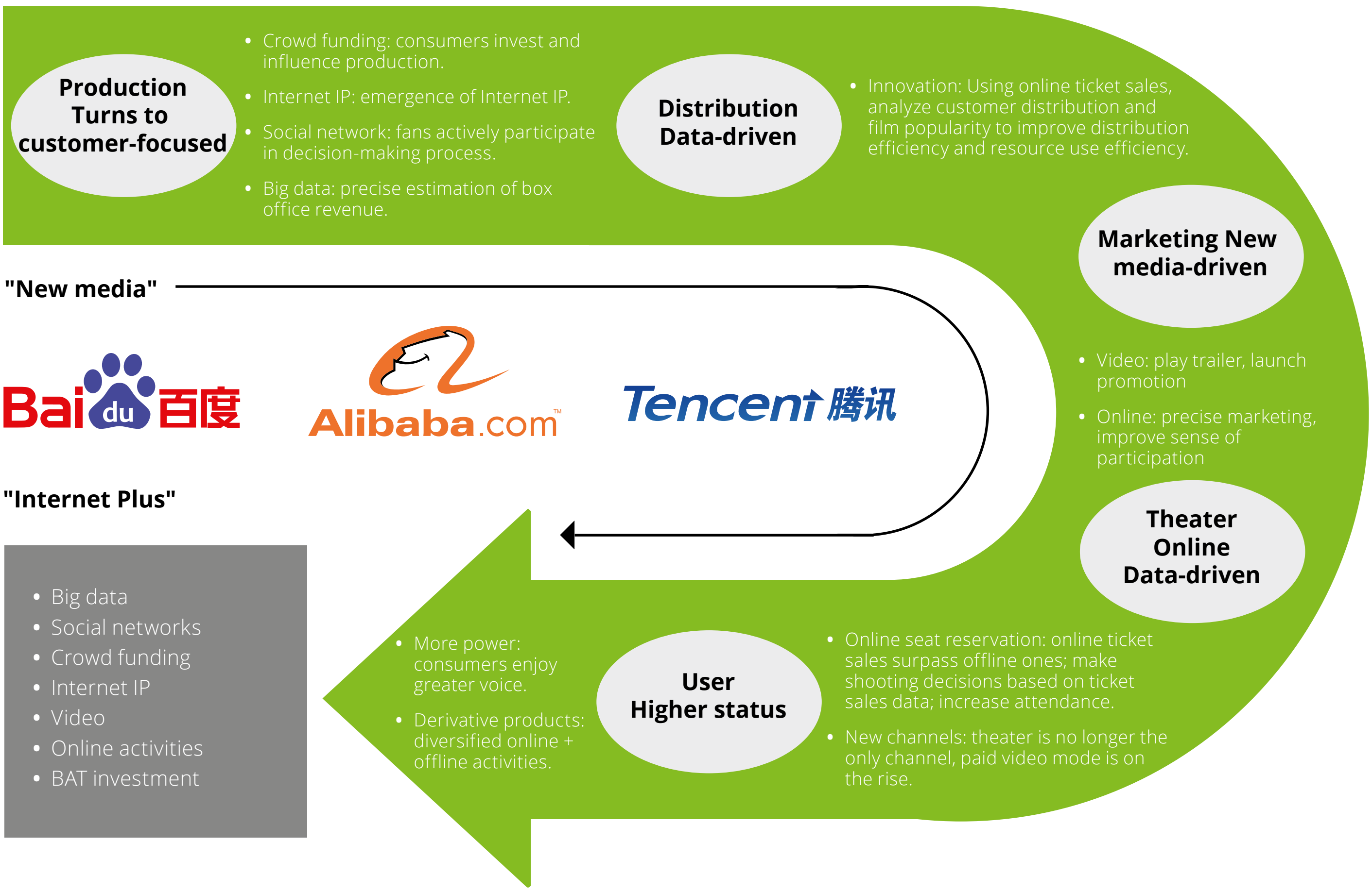
Trend Three: From "non-intelligent" to "Intelligent"

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

At present, the utilization of Internet and big data has impacted the whole film industry chain including IP, production, marketing and promotion, distribution, and ticket sales. Among these, Internet giants invested continuously in the film industry, and Internet film companies such as Tencent Pictures, iQiYi Films, and Baidu Pictures, are all entering the movie business. Traditional film companies are also actively responding to this situation. For example, Shanghai New Culture Media (listed on the A-share market) along with others all announced private placement and investment plans on Internet and big data technologies, with a total amount of over several billion yuan.

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



5 Deloitte China Analysis

Production and distribution:
With the exception of some high quality scripts, film making and production will be more driven by market demand. The right to select content and main creative personnel will gradually transition from producers and directors to movie-goers. More film IP will be based on Internet creations. Films will be invested and produced based on data on movie-goer's preferences regarding content, actors, etc. from Internet and social network, 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 film marketing and promotion. New media technologies are being used for film marketing, which will match film content to the target audience, and audience feedback on preferences will be used for adjustment of marketing strategies, which should increase box office earnings.

Online ticketing:
Another change to the film industry brought by Internet is that online ticketing has upended traditional ticketing channels. 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. Online ticket sales accounted for 63 percent of total ticket sales in Q1 2015.[6] In addition, online ticketing platforms have streamlined the film-watching experience.

Cinema screenings:
In the link of cinema screenings, 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 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 ticket 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.

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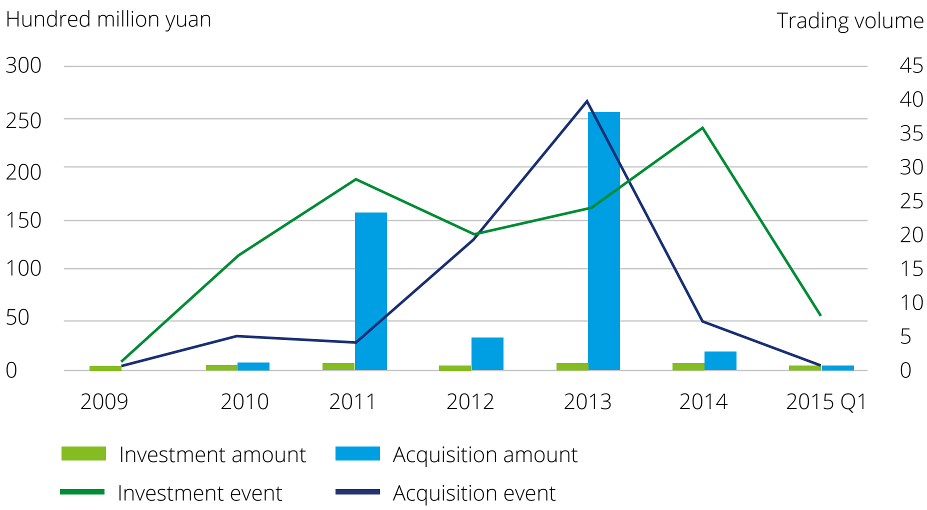
Trend Four: From "Highly Concentrated" to "Diversified"

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

Since 2014, investment in the film sector has totaled RMB1.28 billion, with yearly investment in 2015 up by 15 percent. In the market, there are four types that are favored by investors: "online ticketing platforms," "film + Internet platforms," "transnational co-productions," and "fan films."

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



Industry giants like Huayi Brothers, Enlight Media, and Huace Film and Television will continue their pace of acquisitions, integrate many small scale film companies with a single profitability model, and improve their industry chains. Acquisition in the film industry 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 was Alibaba spending RMB6.24 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. 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.

7 Zero2ipo

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

The main reason for film enterprises delisting from foreign stock markets lies in 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 RMB5 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 RMB59 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.

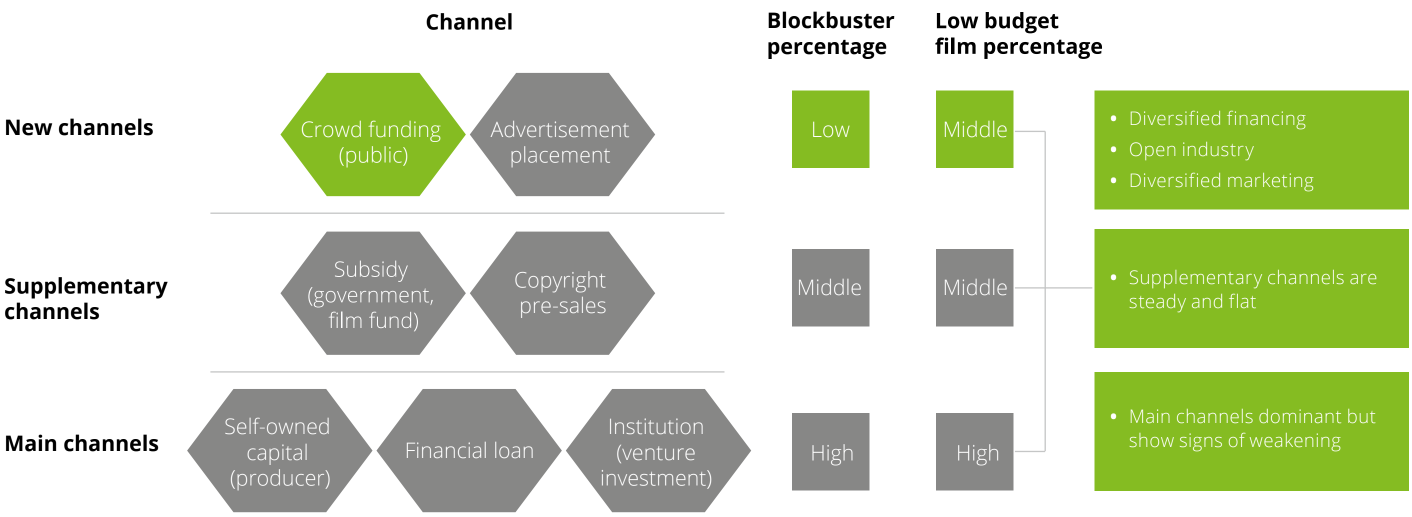
4.3 "Internet Plus" could drive film companies to split into separately listed companies and go public individually

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

4.4 Crowd funding should provide supplementary financing for the film industry

In 2015, there were over 100 crowd funding platforms in China, whose impacts on the film industry were mainly reflected through three aspects: a new financing channel, 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 the market response.

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



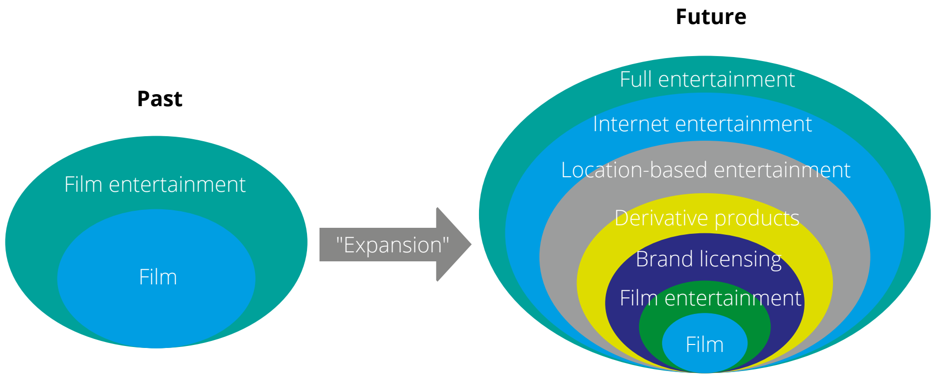
In the future, the crowd funding may be characterized by three models. The first model will be represented by rewarding crowd funding, using games to encourage public participation, and also as a means for film promotion; the second model will adopt a low threshold and reasonable returns, allowing the public to profit; the third model will be represented by equity-based crowd funding and debt-based crowd funding, using a high threshold (investors need to have certain level of net assets) to make the public serve as film investors.

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

5.1 The current singular profitability model will require a diversified strategy

Though the domestic film market is thriving, there are only a few film companies making profit, and 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 provide Disney with stable sources of income.

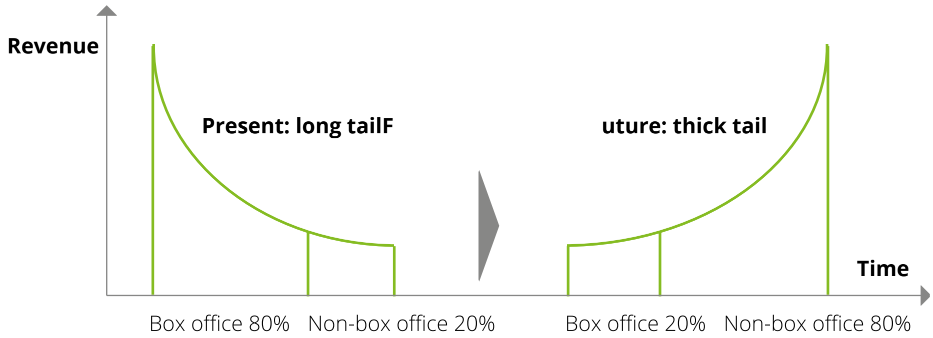
Figure: Diversifying revenue sources



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 industry chains. Enlight Media also launched projects that entered into several industries including gaming, animation production, and location-based entertainment development, and followed Disney's model in trying out a full industry chain layout.

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

Figure: From "Long tail" to "Thick tail"



Besides extended development, there are three ways to re-balance the revenue structures of China's film enterprises:

- Video on demand: In 2015, the number of Internet video subscribers in China exceeded 500 million, and competition for exclusive film content led copyright royalties to rise accordingly, providing a reliable source of income for film producers with in-demand content.
- 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 market.
- 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 will help improve the post-film market and 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

The value of IPs are reflected in three aspects: 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 more bargain power in the market, can influence the direction of capital flow and compete with big enterprises. Fast and Furious, a record-breaking box office film in 2015, has lasted ten years as a 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":

Firs, IP resources, or, the competition for quality IPs. By early 2015, the rights to 114 novels had been bought by either Internet or traditional giants. Currently, 90 works are planned to have television adaptions, with 24 expected to be made into movies. Internet companies hoarded a large amount of 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.

Second, IP conversion: how to find the right people to adapt and build an IP series, thus improving commercial value. The process of converting quality IP runs through the whole cultural industry chain. After rising 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.

Third, IP operation: operation of an IP ecosystem can prolong IP's life span. Integrating content making and distribution, platforms, and hardware terminals enables the same IP content to be converted in multiple forms (films, cartoons, mobile games, novels, toys). In the future, IP operation mode should 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.

Figure: IP development "trilogy"

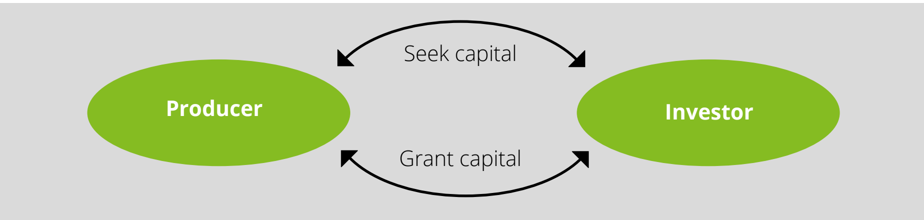
Trend Seven: From "non-Conforming" to "Standardization"

7.1 Completion guarantee will promote industrial standardization

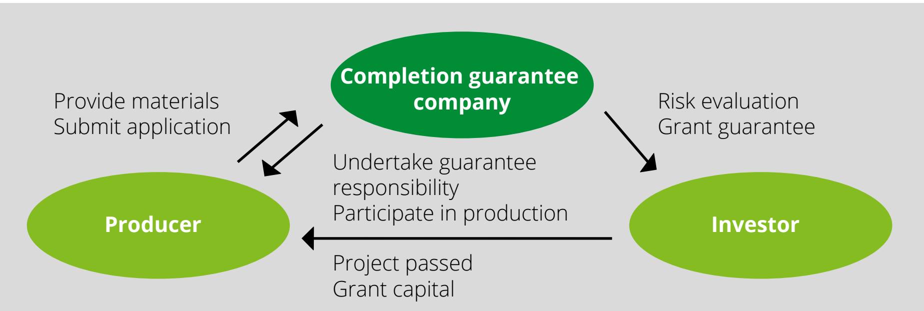
With the rapid development of China's film industry, problems in film production are beginning to surface. Due to the lack of standards on domestic film production, films being "overdue and over-budget" is quite common. About 70 percent of the 600 or more films produced annually in China are never screened; 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. Completing a guarantee system may drive industry transformation.

Figure: Moving to a standardization model

Traditional model



Completion guarantee model



Completion guarantee is 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 from film production to film distribution, including comprehensive review and commenting on various aspects such as script, capital, creative control, production, and distribution, among others, and 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 impacts of this system on China's film industry are two-fold: first, the system helps solve issues of non-standardization in film production, and helps ensure the quality of produced films and steady development of the whole industry. Second, it helps fix financing problems for small and medium-size film companies, establishes a sound financial security system, and connects the film and finance industries together.