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Edited by

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Edited by

Professor Dr. Dres. h. c. Arnold Picot
Ludwig-Maximilians-Universität
München, Germany

Professor Dr. Egon Franck
Universität Zürich, Switzerland

Professor Dr. Professor h. c. Dr. h. c.
Ralf Reichwald
HHL – Leipzig Graduate School
of Management, Leipzig, Germany

Professorin Dr. Kathrin M. Möslein
Universität Erlangen-Nürnberg,
Germany,
HHL – Leipzig Graduate School
of Management, Leipzig, Germany

Kay H. Hofmann

Co-Financing Hollywood Film Productions with Outside Investors

An Economic Analysis
of Principal Agent Relationships
in the U.S. Motion Picture Industry

Foreword by Prof. Dr. Christian Opitz



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RESEARCH

Kay H. Hofmann
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Meinen Eltern

Foreword

The formation of partnerships in which the project initiator and an outside investor jointly own a common project or venture is a widespread and increasingly important strategic approach. Examples include equity-backed alliances in research-intensive industries like biotechnology, pharmaceutical, telecommunication or automotive and international joint ventures. Moreover, providing financial resources to an entrepreneurial endeavor is the core business of venture capital and private equity firms. Besides spreading risk, these partnerships may aid firms in assessing new markets, knowledge, capabilities and other resources. Yet, largely because they are jointly owned, these collaborations are especially difficult to manage. Information asymmetries may lead to the well-known conflicts of interest between the co-financing partners: Before the investment decision is made, the investor is subject to a possible adverse selection of unfavorable partners and unprofitable projects. Ex post, there is a risk of moral hazard when one partner reduces her effort or engages in other opportunistic behavior that harms the interests of the other joint owners.

Compared to the amount of theory, empirical work that elaborates on the principal-agent problem in a co-financing context with an outside investor clearly lacks behind. Moreover, empirical studies tend to be restricted to a limited number of industries. In his dissertation Kay Hendrik Hofmann provides compelling empirical evidence on another sector, namely the motion picture industry. An application of the theory to real world data in this particular setting is promising due to the economic significance of the industry and the rather technical circumstance that a wide array of project-specific information is publicly available.

The research at hand is theoretically as well as empirically ambitious. Mr. Hofmann's findings broaden the empirical literature on the principal-agent problem in equity partnerships. Moreover, film producers and film investors may benefit from the presented analysis when structuring and negotiating future co-financing deals. Finally, the results are relevant for other related media, like for example video games and serial TV formats, where similar financing schemes are about to evolve. I am confident that this competent and well-written work will find a broad audience among both, academics and practitioners.

Prof. Dr. Christian Opitz

Preface

In recent decades, the management of motion picture projects has not only become more complex but with soaring budgets, film productions have also turned into significant investments and fairly risky business opportunities. At the same time, a range of private as well as institutional investors have entered the industry in the function of outside financiers. Today, co-financing and thus co-ownership of completed films is a common phenomenon in Hollywood. The work at hand is concerned with the organizational problems that may arise between the experienced major studios and investors with comparably low industry expertise. Guided by principal agent theory, the empirical analysis investigates the relationship between the co-financing parties and aims at illuminating the pitfalls of the current arrangements. The development of practical solutions that follows is not only relevant for current and future investors but also for studios and film producers who rely on the long-term availability of external funds.

Working on this project has significantly changed my perspective when ‘going to the movies’. While more details in the front as well as end credits catch my attention and my reflection of a film extends way beyond the storyline, the pleasure of consuming motion pictures has not vanished. In fact, it seems as if Moshe Adler’s (1985, p. 209) remark ‘the more you know the more you enjoy’ adequately describes my novel appreciation for filmed entertainment.

Deepest thanks are due to my academic teacher Professor Dr. Christian Opitz for inspiring conversations, wholehearted support and for more than four years of academic as well as personal thriving. The countless hours of joint efforts to straighten arguments and tweak papers have significantly improved my economic thinking and the past years do not allow for any other conclusion than remarking that the time at Zeppelin University has been a great pleasure and an outstanding experience. Undoubtedly, meeting and obtaining the opportunity to learn from Professor Dr. Christian Opitz belong to the lucky chances of my life. I would also like to express my gratitude to Prof. Dr. Helmut M. Dietl who agreed to become the second referee. I am indebted for numerous valuable comments and suggestions that have further augmented the quality of this dissertation.

Finally, I would like to thank my parents for their continued and unlimited support in all matters. The work at hand is dedicated to them.

Kay H. Hofmann

Table of Contents

List of Figures XIII

List of Tables..... XV

List of Abbreviations.....XVII

1. Introduction..... 1

 1.1 Co-Financing in the Motion Picture Industry..... 1

 1.2 The Filmmaking Business from an Economic Perspective..... 4

 1.3 Aims and Scope.....6

 1.4 Hollywood and Academic Research 7

 1.5 Content and Structure8

2. The Hollywood Mega Industry 10

 2.1 Historic Development..... 11

 2.1.1 The Rise of the Entertainment Industry in Southern California: 1907-1930 ... 11

 2.1.2 The ‘Old’ Hollywood: 1930-1950 12

 2.1.3 The ‘New’ Hollywood: 1950 - present 13

 2.2 The Value Chain of Motion Pictures..... 17

 2.3 The Players 24

 2.4 Revenue Windows and the Exploitation of Filmed Content 26

 2.4.1 Domestic Theatrical Market 27

 2.4.2 Ancillary Media Markets 34

 2.4.3 Merchandising Markets 37

 2.4.4 International Markets 38

 2.5 Profitability of Motion Picture Projects..... 39

3. Contemporary Co-Financing Practices in the Motion Picture Industry..... 41

 3.1 Studio-Distributor Perspective: Raising the Funds 41

 3.2 External Investor Perspective: Providing the Funds 44

 3.2.1 Financer Deals 46

 3.2.2 Slate Financing Arrangements 49

 3.3 Existing Research on Co-Financing in the Motion Picture Industry..... 53

4. Principal Agent Relationships in Co-Financing Deals 55

 4.1 Application of the Principal Agent Framework 55

 4.2 Information Asymmetries in Financer and Slate Deals..... 57

 4.3 Adverse Selection 57

 4.4 Moral Hazard during Production 60

 4.5 Moral Hazard during Distribution 62

 4.6 Consequences of Adverse Selection and Moral Hazard..... 63

5. Description of the Data and Variables 65

 5.1 The Data..... 65

 5.2 Dependent Variables..... 65

 5.3 Independent Variables 70

6. Agency Problems in Financer Deals: Results and Discussion	84
6.1 Descriptive Analysis.....	85
6.2 Analysis of Performance Differentials	86
6.3 Adverse Selection	91
6.4 Moral Hazard.....	93
6.5 Agency Problems and Film Quality	96
6.6 Managerial Implications	98
6.7 Summary and Limitations	103
7. Implications of the Appearance of Slate Investors	106
7.1 Development of the Co-Financing Market.....	106
7.2 Consequences for Financers	108
8. Agency Problems in Slate Financing Arrangements: Results and Discussion....	111
8.1 Descriptive Analysis.....	111
8.2 Analysis of Performance Differentials	112
8.3 Adverse Selection	114
8.4 Moral Hazard.....	116
8.5 Agency Problems and Film Quality	119
8.6 Managerial Implications	123
8.7 Summary and Limitations	126
9. Concluding Remarks	127
9.1 Summary.....	127
9.2 Transferability of Findings	128
9.3 Limitations and Further Research Questions.....	130
9.4 Outlook	131
References	135
Appendix	153
A.1 The Agency Problem in the Financial Contracting Literature	153
A.2 Summary Statistics (Financer Sample)	156
A.3 Correlation Matrix (Financer Sample)	157
A.4 Summary Statistics (Slate Sample)	158
A.5 Correlation Matrix (Slate Sample)	159

List of Figures

Figure 1: Basic Organizational Patterns and the Development of the Motion Picture Industry.....	15
Figure 2: Value Chain for Motion Pictures.....	17
Figure 3: Development and Distribution of Advertising Costs by Media.....	21
Figure 4: Revenue Flow for Motion Pictures.....	23
Figure 5: Development of Domestic and International Box Office Revenues.....	31
Figure 6: DVD Cost Breakdown.....	35
Figure 7: Distribution of ROI by Financing Type (Financer Sample).....	102
Figure 8: Distribution of ROI by Financing Type in High Budget Segment (Financer Sample).....	103
Figure 9: Production Budget Distribution of Projects with Double Financing.....	107
Figure 10: Distribution of ROI by Financing Type in High Budget Segment (Slate Sample).....	124

List of Tables

Table 1: Budget Breakdown for Spider-Man 2	19
Table 2: Development of Average Production Budgets (1985-2006)	20
Table 3: List of Major Studios Including Affiliated Mini-Majors	25
Table 4: Development of Worldwide Major Studio Receipts (1948-2004).....	28
Table 5: Theatrical Market Statistics by Segments (2003-2007).....	30
Table 6: List of Film Financers	47
Table 7: First Generation Slate Financing Deals	51
Table 8: Definitions of Variables	83
Table 9: Mean Characteristics of Externally Co-Financed versus Other Films.....	85
Table 10: OLS Regression Results with Performance Measures as Dependent Variables (Financer Sample)	87
Table 11: Probit Regression Results with Co-Financer Dummy as Dependent Variable ...	91
Table 12: OLS Regression Results Analyzing Moral Hazard During Production (Financer Sample)	93
Table 13: Regression Results Analyzing Moral Hazard During Distribution (Financer Sample)	95
Table 14: Regression Results with Quality Proxies as Dependent Variables (Financer Sample)	96
Table 15: ROI Regression Results with Quality Control (Financer Sample)	97
Table 16: Distribution of Financer Funded Films by Project Size.....	99
Table 17: ROI Regression Results Excluding Small Projects (Financer Sample).....	101
Table 18: Mean Characteristics of Co-Financed vs. Films with SPV Production Firms...	105
Table 19: Development of Co-Financed Films (2003-2007)	107
Table 20: Development of Co-Financing Funds (2003-2007)	108
Table 21: Mean Characteristics of Early and Late Financer Projects	109
Table 22: Mean Characteristics of Slate Co-Financed versus Other Films	112
Table 23: OLS Regression Results with Performance Measures as Dependent Variables (Slate Sample)	113
Table 24: Multinomial Logistic Regression Results with SLATE and FINANCER as Dependent Variables	116
Table 25: OLS Regression Results Analyzing Moral Hazard During Production (Slate Sample)	117
Table 26: Regression Results Analyzing Moral Hazard During Distribution (Slate Sample)	119
Table 27: Regression Results with Quality Proxies as Dependent Variables (Slate Sample)	120
Table 28: Nested ROI Regression Results (Slate Sample)	122
Table 29: Distribution of Slate Funded Films by Project Size.....	123
Table 30: Summary of Findings.....	128

List of Abbreviations

3-D	three-dimensional
AFTRA	American Federation of Television and Radio Artists
CAGR	compound annual growth rate
CARA	Classification and Ratings Administration
CBS	Columbia Broadcasting System
CEO	chief executive officer
CPI	Consumer Price Index
cf.	Latin <i>confer</i> : compare, consult
c.p.	Latin <i>ceteris paribus</i> : all else being equal
DVD	digital versatile disc
EStG	German: Einkommenssteuergesetz
et al.	Latin <i>et alii</i> : and others
etc.	Latin <i>et cetera</i> : and the rest; and so forth
EUR	Euro
e.g.	Latin <i>exempli gratia</i> : for the sake of example, for example
FMCG	fast moving consumer good
GBP	Pound Sterling
HBO	Home Box Office
HSX	Hollywood Stock Exchange
IATSE	International Alliance of Theatrical and Stage Employees
IPO	initial public offering
IRR	internal rate of return
IMDb	The Internet Movie Database
i.e.	Latin <i>id est</i> : that is (to say)
MPAA	Motion Picture Association of America
NATO	National Association of Theatre Owners
NYSE	New York Stock Exchange
OLS	ordinary least squares
PC	personal computer
P&A	prints and advertising
p.	page
POS	point of sale

PPV	pay-per-view
pp.	pages
R&D	research and development
ROI	return on investment
SAG	Screen Actors Guild
SPV	special purpose vehicle
TV	television
USD	United States Dollar
U.K.	United Kingdom
U.S.	United States of America
VC	venture capital
VCR	video cassette recorder
VoD	video-on-demand
WOM	word of mouth