

PALI RESEARCH

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Media Industry The DVD Party is Over – Movie Industry Concerns Growing

While the DVD business has been visibly slowing over the past year, we are worried that 2007 could be the first year that US consumer spending on DVDs actually declines as shown in Exhibit A; dragged down by a decline in catalog sales (in 2006, we believe catalog sales will struggle to be flat). In turn, creative success will become the critical driver of individual company film performance (as the “halo effect” from an expanding DVD consumer base with its associated uptick in catalog and TV DVD sales now over).

- DVD household penetration is over 80% in the US (fully penetrating the most desirable demographic consumers).
- Wholesale DVD pricing IS going to come down on DVDs the question is simply how fast and how much.
- Studio Home Entertainment division management changes and/or restructurings highlight the difficulties facing the business.
- Reducing film production would NOT be occurring if the film industry outlook was vibrant.
- Digital movie distribution (particularly as the Internet is increasingly linked to the television) will enable the ultimate price competition pressuring “bricks and mortar” DVD retailers.
- Digital movie distribution (like in the music industry) is fighting against free, pirated versions readily available online (that are also burnable to a DVD and have no DRM issues).
- Next-Gen DVD (whether Blu-ray, HD-DVD or both) is NOT going to materially impact studio revenues/profits in 2007. It remains highly unclear which format will win (as both sides continue to make serious errors), not to mention that consumers without 50” or larger HDTV are unlikely to appreciate the significant improvement in picture quality.

While Q4 2006 may be quite strong for the industry given a great release schedule (box office of films to be released is up 12%), keep an eye on 2007, as expectations are likely to come down.

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- Studios such as Disney and Fox (News Corp) are the best positioned to weather the weakening state of the DVD business over the next 12-months, as successful theatrical releases flow into DVD, offsetting the negative impact from catalog sales. We also believe Paramount (Viacom) is less exposed as its release schedule over the past few years has been horrible and it did not aggressively exploit its library on DVD, in turn, improving creative success should drive growth in 2007.
- Studios like Warner Bros. (TWX) on the other hand appear particularly exposed as it has a tremendous library DVD business (that has driven profits) and its recent film releases have been notably weaker than in the past 3-4 years.
- We would also be concerned about smaller pure-play movie studio companies (such as DreamWorks Animation, Lionsgate, Marvel), whose profits are almost completely reliant on DVD sales, whereas the larger studios have other businesses to offset weakening movie industry economics.

Figure A: Consumer Spending on Home Video

\$ Billions	1999	2000	2001	2002	2003	2004	2005	2006E	2007E
DVD	1.5	3.2	6.8	11.6	16.3	20.4	22.5	23.6	23.4
% Change	259%	118%	113%	71%	40%	25%	10%	5.0%	-1.0%
VHS	13.2	12.8	10.1	8.7	5.9	3.8	1.5	0.4	0.1
% Change	0%	-3%	-21%	-14%	-32%	-36%	-60%	-75%	-70%
Total Home Video	14.7	16.0	16.9	20.3	22.2	24.1	24.0	24.0	23.5
% Change	7%	9%	6%	20%	9%	9%	-1%	0.0%	-2.1%
Rental	8.2	8.2	8.4	8.2	8.1	8.0	7.7	7.9	7.9
% Change	3%	0%	2%	-3%	-2%	0%	-4%	2.0%	0.0%
Sell-Thru	6.5	7.8	8.5	12.1	14.1	16.1	16.3	16.1	15.6
% Change	13%	20%	10%	42%	17%	14%	1%	-0.9%	-3.1%
DVD Sub-Categories									
TV DVD Sell-Thru	N/A	N/A	N/A	0.8	1.4	2.3	2.9	3.1	3.2
% Change					75%	62%	25%	8.0%	3.0%
Catalog DVD Movie	N/A	N/A	N/A	N/A	5.1	6.2	7.4	7.4	6.8
% Change						21%	19%	0.0%	-7.0%
New Release Movie DVD	N/A	N/A	N/A	N/A	9.8	11.9	12.3	13.2	13.4
% Change						22%	3%	7.3%	1.4%
DVD Household in US	4.6	13.0	25.0	40.0	47.0	65.0	84.0	92.0	97.0
% Change	283%	183%	92%	60%	18%	38%	29%	9.5%	5.4%

Source: Kagan, Video Business, Variety, MPAA and Pali Research estimates.

How Does the Movie Industry Benefit From Digital? While the music and television industries are likely to benefit from an increased array of opportunities from digital distribution, it is not clear to us how the movie industry benefits. We believe the inherent nature of what a movie is, implies that most consumers will want to view most movies in a high-quality experience.

- The music industry can benefit from selling music in so many more ways than simply selling a CD: ringtones, single tracks, subscriptions, ad supported music videos, accessing deep catalog that was never available in a store, as well as bundles of the above. However, even the music industry is still dealing with the negative impact digital has had on physical CD sales and it may take a few more years for growth to be truly apparent throughout the global industry.
- The television industry never had the ability to keep viewers interested in a show that they missed live on television by broadcasting programming direct to consumers over the Internet, nor a way for consumers to access individual catalog episodes in a pay-per-view or ad-supported method that put the consumer in control of the programming. Digital enables these opportunities. TV, by nature, is shorter form and plays more directly to the strengths of digital (particularly portability).

Yet, the more we think about the movie industry, we keep thinking what is the benefit from digital? Cheaper distribution and no physical inventory? That sounds great at first, but if the product has to be sold at a discount (comparable to the lower cost to create/distribute) because it is inferior to physical DVDs (in picture quality and usage restrictions/DRM), how does it help the studio business?

- If a consumer is really interested in deep movie catalog, they can easily sign up for Netflix or Blockbuster subscriptions for less than \$20 per month and receive unlimited new releases and catalog movies.
- While we struggle with the benefits of digital movie distribution, the Internet does offer meaningful promotional benefits for movies, allowing unique marketing that enables consumers to become far more connected to a particular movie release/franchise.
- Exhibit B illustrates the pricing of two DVDs released this week, two last week and two from much earlier this year across a variety of retailers.
 - Wal-Mart, Target, Best Buy, and Circuit prices are the in-store and online prices for physical DVDs
 - Apple is the price for a digital download using the iTunes Movie store.
 - Amazon is the price for physical CDs and Amazon Unbox is for the digital download of a movie via Amazon.

Figure B: Home Entertainment Pricing Comparison (Physical DVDs and Digital Downloads)

Movie	Studio	DVD Release Date	CC	BBY	WMT	TGT	AAPL	AMZN	AMZN-Unbox
Little Mermaid	Disney	10/3/06	\$16.99	\$14.99	\$14.87	\$14.99	\$12.99	\$14.99	N/A
X-Men The Last Stand	News Corp.	10/3/06	\$13.99	\$14.99	\$15.87	\$13.99	N/A	\$13.99	\$14.95
The Fast & The Furious	Universal	9/26/06	\$14.99	\$19.99	\$15.88	\$14.88	N/A	\$14.88	\$9.99
Curious George	Universal	9/26/06	\$24.99	\$19.99	\$15.87	\$15.87	N/A	\$15.87	\$15.87
Remember the Titans	Disney	3/14/06	\$17.99	\$14.99	\$13.88	\$13.99	\$9.99	\$13.99	N/A
Fun with Dick & Jane	Sony	4/11/06	\$14.94	\$14.99	\$14.88	\$13.99	N/A	\$13.99	\$14.99

Source: Company websites.

Beyond Disney We Do Not Believe the Studios are Excited by Digital Distribution. As we highlighted in our September 8th note: entitled: "Maybe the Studios Do Not Want Legal Internet Downloading to be Successful Right Now?," Amazon's Unbox pricing appears to be set (via studio wholesale pricing) to be unattractive to the vast majority of consumers (outside of a special promotion on a title like *The Fast & The Furious*). That makes sense in the context of our view that it is not clear how digital benefits the movie business. Unbox is essentially a way for studio executives to look like they are moving toward digital and trying to thwart a growing digital piracy problem, without endangering the core physical DVD business.

Conversly, we are unclear how iTunes pricing helps the movie industry, albeit it is abundantly clear how it will help Apple sell more iPods and increases its hardware domination. While we agree with Bob Iger's (Disney's CEO) argument that iTunes sales are largely incremental, at least until Apple's iTV product rolls out broadly and Wi-Fi technology improves – as the product offered on iTunes is inferior to a standard DVD. However, the more important issue is how do Wal-Mart and the other physical DVD retailers react to iTunes retail pricing they cannot afford to match, as their wholesale price is generally at least two dollars more than what iTunes is paying Disney.

- As Exhibit A illustrated, movie studios are already going to face increased wholesale pricing pressure from retailers over the next 12 months as DVDs are no longer a growth business – studios will begin to cut price or risk losing floor space.
- Cut-rate online pricing, especially as product can be more easily viewed via the Internet on televisions, would appear to only exacerbate the risk to wholesale DVD pricing at physical retail.
- So while incremental sales can be generated by low cost digital movie downloads, with virtually all home entertainment sales coming from physical DVDs, the risk of a \$1 reduction in wholesale price across all DVDs would appear to be far larger than selling extra units digitally.

Apple's Pricing Structure Likely to Change. While Disney's decision to embrace Apple's pricing model may have been influenced by Steve Job's role as a Disney board member, as well as Disney's limited catalog (especially deep catalog), we believe Apple will need to change its pricing structure in order to add additional studios – in other words, iTunes' pricing needs to become less attractive relative to current physical DVD pricing.

- We believe Apple is already quite frustrated with the major Hollywood studios (outside of Disney) and has begun to offer wholesale pricing that is above the \$14.00-\$14.50 that Disney is currently receiving (Disney does have an MFN).
- Without a clear benefit from digital movie distribution, we believe it is also hard for movie executives to understand why they should increase Apple's growing digital media dominance. Why create a near-monopoly situation as the music labels have essentially created?

Over the past year, the following events have occurred within the home entertainment industry at the major Hollywood studios:

- DreamWorks live-action movie business was sold to Paramount, resulting in new home entertainment management at Paramount.
- Sony lost its right to distribute MGM home entertainment and Sony changed the management of its home entertainment division.
- Time Warner completely restructured its home entertainment group and changed senior management.
- Disney restructured its film division, deciding to reduce its film output and it expanded the role of its domestic home entertainment management to a global role.

It is hard for us to imagine all of these changes would have occurred if the DVD business was vibrant. Rather, they are likely a reflection that the movie business is beginning to face the reality that 2007 is going to be a tough year.

No Help from Next-Gen DVD. Next-Gen DVD was supposed to be a catalyst to soften the pain of a standard-definition DVD slowdown. However, the failure of HD-DVD to aggressively market itself (combined with the lack of integration with X-Box 360 and no Fox/Disney titles) and the inability for Sony to bring Playstation 3 to market anywhere near their original time frame (particularly in terms of units sold for the 2006 holiday season) severely limits the benefit that a new DVD cycle will have on the movie business in 2007.

- Furthermore, we are growing increasingly concerned that the mass media is informing consumers that the benefits from Next-Gen DVDs is modest unless consumers have a large (over 50") HDTV. In addition, upconversion standard def DVD players with HDMI outputs are increasing in number at more attractive prices.

BOTTOM LINE: Keep an eye on 2007 film industry profits, we suspect the risk to expectations is increasingly to the downside, with downside risk growing into 2008 unless there is a notable acceleration in Next-Gen DVD sales and/or a more attractive business model emerges for digital movie distribution.

APPENDIX

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OTHER DISCLOSURES

Other Companies Mentioned:

- Apple (AAPL, \$74.83, NASDAQ, not rated)
- Disney (DIS, \$31.07, NYSE, Neutral)
- Dreamworks Animation (DWA, \$24.97, NYSE, Sell)
- News Corp (NWS/NWS'A, \$20.61/\$19.74, NYSE, Buy/Buy)
- Lionsgate (LGF, \$10.23, NYSE, not rated)
- Marvel Entertainment (MVL, \$24.90, NYSE, not rated)
- Time Warner (TWX, \$18.61, NYSE, Neutral)
- Viacom (VIA'B, \$38.20, NYSE, Buy)

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