

**IMCA for DG EAC, Unit C1**  
**Study n° DG EAC/34/01**

Identification and evaluation of financial flows within the European  
cinema industry by comparison with the American model

**EXECUTIVE SUMMARY**

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Directorate-General for Education and Culture

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Under the programme of work established by the communication, a number of studies are currently in progress in an endeavour to focus greater attention on a possible review of the TWF directive, and also to gain a better appreciation of how to remove the potential hindrances and obstacles to the circulation and exploitation of audiovisual and cinematographic works.

In its resolution of 21 January 2002<sup>1</sup> the Council welcomes the Commission's intention to conduct a study on the identification and evaluation of financial flows in the European cinema industry in order to evaluate the key factors which determine the economic characteristics of the audiovisual industry.

In particular, this study will give the Commission the keys for analysing the financial flows which underpin the cinema industry at the different stages in the life of projects (pre-production, development, production, post-production) but also promotion, export and distribution. The study is also expected to bring out any correlation that might exist between the structure of funding, the distribution of revenue and the financial performance of films.

The study also purports to identify and evaluate certain key economic factors which characterise the cinema industry.

It sets out to identify and analyse the strengths and weaknesses over the different phases in the life of a film, from its conception (scenario) and pre-production to its marketing in the countries concerned by the study, initially through screening in cinema theatres, and subsequently via the different media for exploitation and distribution. The research presented here will be broken down as follows: :

**Chapter 1-** The methodology and analysis of professional practices

**Chapter 2-** The characteristics of the cinema markets in the various countries covered by the study

**Chapter 3-** Determination and analysis of a representative sample of European production, to which will be added a small sample of American production distributed in Europe

**Chapter 4-** Conclusions and formulation of recommendations for the Commission.

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<sup>1</sup> Official Journal C32/2002, p.04

# 1. METHODOLOGY AND ANALYSIS OF PROFESSIONAL PRACTICES

The methodological approach adopted for this study must incorporate several levels of information, particularly on financial flows. In addition, certain related areas are the subject of additional work recently initiated by the Commission (box office for video and DVD for the introduction of support for publishing under the Media+ programme, examination of national and local support systems, definition of European work, of independent producer, of independent work) and the findings of which are not yet available.

The film-by-film approach which the Commission wanted implies the collection of information which is not normally available anywhere except for some items which are available online on certain sites (see annexes for references), e.g. the European film box office. Others, e.g. production budgets (for applications for support from the Council of Europe's Eurimages fund), the official funding plans for accreditation from the French Ministry of Culture (*Centre national de la cinématographie*) or the Italian Ministry of Culture (*Fondo di Garanzia*) can be obtained from these bodies subject to the agreement of the producers.

Needless to say, the national and European statistical instruments relating to the cinema industry, with a few rare exceptions, are inadequate or inappropriate in nearly all countries.

The only reliable indication available at European level is the number of cinema admissions for 28 European countries, recorded on the Lumière database of the European Audiovisual Observatory. For the American market, too, the only financial data available online are those for the box office.

## **1.1. The limitations of the study**

The limitations of the study stem from the low level of availability of interviewees and the relative sincerity of the information provided.

Transparency is not very common in the sector. This is the first observation which strikes the consultants dealing with the matter of collecting financial data. There are a number of possible explanations. The authors of this report feel one of the main ones is the need to pay back those investing in co-production, which naturally generates reticence when it comes to divulging data on revenue, and even more so when many investors are involved and the investment proves profitable.

This explanation also holds good for American companies.

Moreover, no company has an obligation to provide figures other than under certain specific obligations stemming from applications for subsidies from public bodies, e.g. the Media 2 programme or advances on receipts in France.

Considering the relative sincerity of public information, the official figures are seldom the real figures. The difference between production budgets and the real cost of producing a film may vary in a range of 5 to 25% on average, depending on the country and the films involved. This difference, which also varies from one country to another, can be explained by the fact that the amount of aid is always calculated as a percentage of the film's budget. These budgets are moreover seldom subject to an audit.

The methods we applied prompted us to give preference to several sources of information in order to offset the intrinsic weaknesses of each one. For each of the films selected we looked for information :

- in public databases,
- in private databases,
- using questionnaires and interviews in companies (producers, distributors, sales agents),
- from professional bodies,
- from institutions in the sector (public organisations, European funds, banks, sales agents).

## **1.2. Problems of definition**

### **Definition of European work**

The definition of European work used in the study is the one used in the Media programme. The matter of this definition of work was the subject of a Commission communication in 2001. From the point of view of the professionals as a whole, the definition used in the Media programme is a working definition.

For the Media programme, a European film is any recent work of fiction (including animated films) or documentary lasting at least 60 minutes, majority produced by one or more European producers established in the countries taking part in the Media programme and produced with significant input from professionals who are nationals or residents of the countries taking part in the Media programme.

Several definitions of European work exist side by side (eg. *Eurimages*, *Centre national de la Cinématographie*, etc.) and despite many similarities these points-based systems do not always correspond.

Harmonising the different definitions of nationality would probably help to clarify certain grey areas surrounding the nationality of a work and allow European level harmonisation of certain domestic advantages to function in the context of the internal market.

### **Definition of independent producer**

The study uses the definition stemming from the guidelines of the MEDIA + programme, in order to categorise the films in the sample.

The independent producer is an entity not majority controlled by a broadcaster, whether in the form of participation or under a commercial contract.

### ***1.3. Structure of film factsheets***

The central idea was to follow the key stages in the life of a film as a function of the requests of the European Commission.

Each film dossier contains seven factsheets :

- factsheet 1: the film's cultural and economic identity
- factsheet 2: the film's production costs
- factsheet 3: the film's funding sources
- factsheet 4: the film's market revenue, and any public sector aid
- factsheet 5: analysis of the breakeven point for distributors in the coproduction territories
- factsheet 6: revenue of those to whom receipts from the film are payable
- factsheet 7: final gain or loss of those to whom receipts from the film are payable

## **2. THE CHARACTERISTICS OF THE CINEMA MARKETS IN THE COUNTRIES COVERED BY THE STUDY.**

The purpose of this part is to :

- assess the size and structure of European markets in the countries studied
- highlight the features that make up and account for national demand and film consumption
- highlight the features which constitute national demand for films
- allow inter-country comparisons
- understand the way in which an industry functions and produces as a function of the way the sector is organised

### ***2.1. European supply in relation to European demand***

The data which can be derived from the country matrices show substantial diversity from one country to another. However, it should be stressed that this diversity is more sensitive with regard to supply than with regard to demand. The main features which go to make up cinema supply and demand in the countries studied are described below.

#### **Cinema demand in the various countries**

Overall demand in the countries covered by our study is primarily determined by a number of socio-economic factors. These are :

- the demographic pattern of the country and, in particular, the younger segment of the population (under 25 years)
- the average per capita income
- the price of a cinema ticket
- the commercial diversity available to consumers

The importance of the demographic factor is seen when the percentage of under-25s in the population (30% for the European Union overall, 40% for Ireland and Iceland) is correlated with the level of cinema attendance (number of cinema tickets sold).

Lastly, it ought to be possible to base an analysis of demand on an aspect not directly covered by the study, but which could be correlated with the financial successes and failures of European films, i.e. the concentration of cinema-goers on a limited number of films and a limited number of theatres. This is not to

prejudge profitability film by film but may provide an element to explain some of the higher profitability rates (smaller theatres/good box office).

It would also be important to be able to measure the flexibility of demand in relation to all these socio-economic factors and also in relation to the supply of products which can compete with cinema-going by providing an alternative (if substitution is possible) form of leisure; examples are television, the renting or purchase of DVDs, the next generation of products which will be on offer thanks to new technologies such as ADSL.

### **Films**

A gap has opened up between five European countries and the rest of Europe. These five countries, Germany, the United Kingdom, Spain, France and Italy together account for 67% of European production. Yet the total of their respective productions in 2000 amounted to only 71% of American production.

During that year Europe and the USA produced a total of 1367 films. Europe, with 739 films, represents 54% of this total and the USA 46%, but when it comes to European theatre operation the market share of the American films represents 66% (which is in fact the lowest level achieved since 1997 according to the Focus 2002 World Film Market Trends study published by the European Audiovisual Observatory) whereas the group of European films represents only 4.51% of the American market for the same year.

As yet there is little concentration in European sector. This is probably the result, on the one hand, of quota mechanisms and professional practices, which restrict the use of the same companies by broadcasters and public support bodies and, on the other, of the extreme diversity and scale of public funding, which gives producers relative autonomy in relation to the traditional sources of funding.

Nevertheless, recent market trends are likely to generate a major "mortality" effect.

As regards the determining role of public funding in cinema production, this is probably even greater than is portrayed here, insofar as in each country there are local and regional funds which have not all been systematically recorded but which maintain production through various subsidies and obligations (for instance, the obligations of regional televisions with regard to production).

## ***2.2. A European market or a Europe of markets ?***

An analysis of the markets shows comparative homogeneousness in demand in most European Union countries. The proximity of standards of living, theatre

facilities, and demographic patterns, shows us that consumer behaviour is similar everywhere. At the same time, however, this does not make for a big European market, but a Europe of cinema markets in which the national European cinemas are still inadequately prepared, while their American competitor has already perfectly taken on board the concept of the "European" internal market.

### **3. DETERMINING THE SAMPLE AND ANALYSING THE DATA**

We submitted to the Commission a sample of films which initially comprised 120 films, 12 American and 108 European.

#### ***3.1. Number of films and national distribution***

The 108 European films were selected as follows: the number of films of the sample per country is the product of the ratio of the national production of a given country over the period considered, to European production during that same period.

#### ***3.2. The American films***

For the sample of American films we proceeded as follows:

In between independent production and studio production lies the very dynamic intermediate zone of the mini majors. Whether they be offshoots of the studios or linked to them by share-holding ties and/or distribution agreements, these companies have a dual culture.

For this category of production we selected :

- a small budget, focused on a promising young producer, and targeting largely exploitation of the international market, and
- a big budget (EUR 20 million) assembled partly thanks to the European tax shelters mechanism.

#### ***3.3. Funding of films***

For the purposes of this study we adopted the point of view of the production company.

The primary source of cinema funding in Europe is public sector support. The reimbursable and non-reimbursable funding of films accounts for a range of 42% on average (Italy, Spain) to 60% in certain cases.

The second source of funding is the contribution made by the executive producer. Percentages vary from one country to another within a very narrow range. The countries in which the contribution of the producer is lowest are Germany and Spain.

Lastly, the third source of funding are the television channels and represents an average volume of around 20%, except in Italy where the funding from television channels is around 2.40%. The situation in Italy prompts producers to

be more sensitive to public funding and to a range of subsidised loans and support from the *Fondo di garanzia*.

### **Funding of films from the countries of Central and Eastern Europe**

Funding of films from the countries of Central and Eastern Europe is structured differently. While in our sample the sums represented by the contributions of executive producers are on the same scale in terms of percentage as those of their counterparts in the European countries, the contributions of other producers and television channels are appreciably higher. What we see here is the cost-sharing economy characteristic of these countries and other countries which have a small production capacity.

Another significant feature is the anticipated weakness of public funding, reimbursable or non-reimbursable; the immediate and obvious explanation for this is the dearth of public resources in these countries. A second explanation is that the lion's share of supra-national public funding is taken up by the main producer countries of the European Union.

### **The funding strategies of European production.**

There are today two main ways of funding of European films :

- Like the majors, i.e. through the market, by incorporating an approach to distribution, negotiations with banks, the use of European tax advantages, the anticipated revenue by *genre* and/or as a function of the success ratings of the artists involved, etc.
- More pragmatically, basing approach on costs or funding capacity, taking account of the different sources of public funding, funding by the channels, the sale of part of the rights, the guaranteed minimum amounts brought by the distributors and the sales agents, etc.

The strategy most frequently adopted is that whereby the investment is recouped in the production countries and whereby anything achieved in other countries represents a profit margin. This remains very rare and difficult for big-budget films, for which exploitation in other countries can represent 35-50% of receipts.

For films belonging to lower budget categories, the contributions in terms of guaranteed minimum amounts by distributors or sales agents, when there is one willing to take such a risk, represent a traditional form of funding which can thus bring in up to 20% of the cost of the film. However, given the keen competition between national distributors, these investments are concentrated on a small number of national productions (generally comedies, or European films with American stars).

Nevertheless, funding by pre-sales is not an essential characteristic of the funding of films in Europe. The financiers increasingly prefer to judge how successful the film is after its release.

As for co-productions, these are often complex, for they have to simultaneously comply with international treaties and the points system which qualify the work for national aid or support, while seeking maximum advantage from the exercise and, where possible, the accumulation of advantages throughout the co-producers' territories. This is a delicate and, it has to be said, not very transparent exercise, for which only a small number of European producers are prepared, and which no doubt explains the many polite but firm silences encountered.

Yet one of the advantages of co-production is to defer or not trigger the payments of part of the production, which means that the risk is not borne for such a protracted period by the producer. However, pre-sales bring in cash and mechanically reduce financial costs.

### **Optimisation of financial arrangements**

This type of co-production is designed to use, for instance, a combination of German funds and the UK sale and leaseback system to offset deficit financing. It is this type of financial arrangement which suits high-budget films. This type of funding may be cumulated with Eurimages and Media for distribution if the film is distributed in three countries. This arrangement is the ideal formula.

While not reading too much into this, it could be concluded that the structure of European co-productions, which is so precious to countries in which there are little or no public funds, has been gradually taken over by the most developed cinematographic industry, an industry whose national funding system could have been expected to provide for the funding needs of the national cinema.

It should also be noted that with the development of the co-production system the big countries are able to produce more films on a co-production basis, the smaller countries fewer, while the countries of Central and Eastern Europe are unable to produce any (0 in 2001).

Within this emerging trend, the distributors are also co-producers. Certain distributors act as investors in a context in which previously they acted only as distributors. The level at which they intervene is to be found increasingly upstream of production and prompts them to become fully-fledged partners and to take certain risks in return for income rights guarantees. This type of funding, as we said earlier, affects big-budget films.

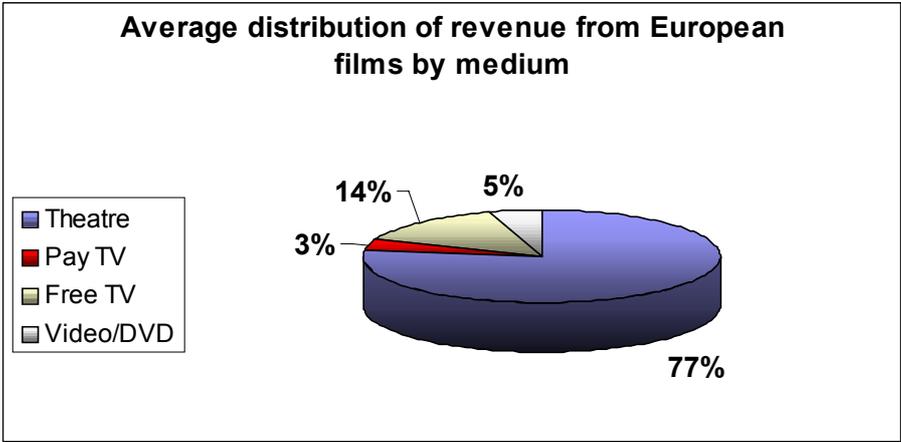
### ***3.4. The specific nature of the structure of American funding.***

A first differentiating element stems from the fact that there is no public support policy for the production of films and that there are no subsidies in the USA.

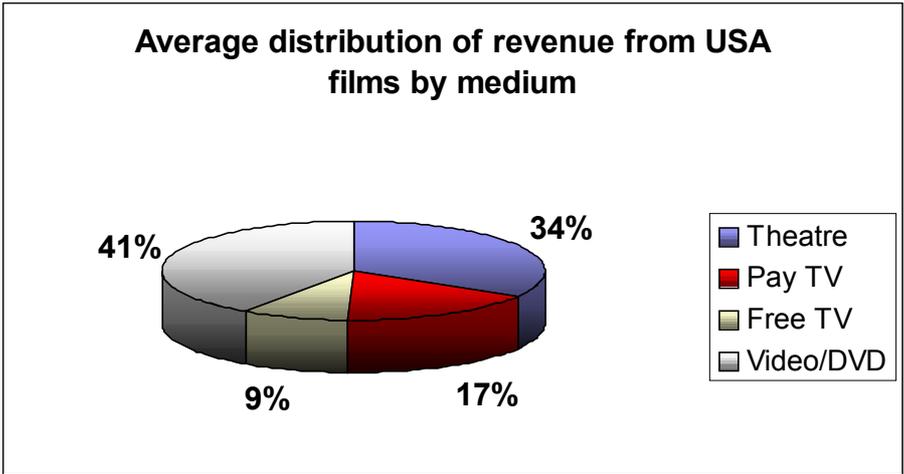
With the exception of studio productions, the funding of American films is secured by a local distributor and by a sales agent who often the act well ahead of the projects. As their investment often has to be increased by 50-100% on account of P & A costs, American distributors seek increasingly often to share the risk with international distributors

This market logic thus pushes the American industry out on to the international market where, not surprisingly, it does very well, as the analysis of our American film profiles attached in the annex shows. This is consistent with the points made by the MPAA which estimates that the international market today accounts for over 50% of the American cinema's revenue sources.

**3.5. Structure of revenue**



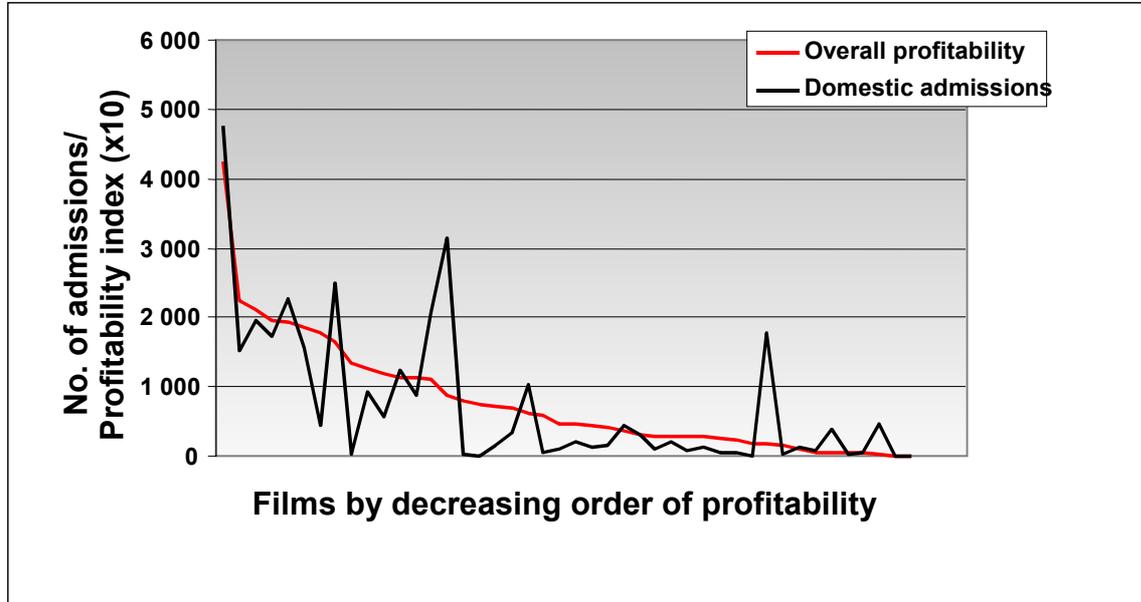
Source: IMCA



Source: IMCA

### 3.6. Impact of the theatre on profitability

Our analysis of the rate of return, correlated to the number of cinema-goers, shows just how important cinema success is to the profitability of works.



Source: IMCA

### 3.7. Profitability of films for producers

European producers do not enter into the same pattern as that described above. Our analysis of the sample shows situations which are very variable from one country to another, and from one category of film to another. This is what we wanted to illustrate through the European films profiles presented in the annex to the study and which, without having the value of a category as was possible for American films, nonetheless bring out certain European market patterns.

In Europe, the market shows us that profitability is calculated in a simple way and three possible situations can be distinguished :

- 1<sup>st</sup> situation : film 100% financed with no (or little) contribution from the producer

This guarantees immediate profitability inasmuch as the producer's salary, the overheads and the contingencies are covered by the funding and thus stand as a profit if not used up

- 2<sup>nd</sup> situation: box office success

Box office success of a film is a great opportunity for the company. The return accruing upstream is real and all the greater if the producer has been able to hold

on to the rights. However, the scale of the guaranteed minimum amounts required makes this return risky except in the event of a major success.

- 3<sup>rd</sup> situation :national and international box office + sales of television and international rights

This situation is very similar to the previous one and the scale of return will be proportional to that of the return accruing upstream.

The profitable films are those which make money on the domestic market. It is the theatre takings which provide the sources of the overall return on a film. Films which are very profitable make money on all markets.

In this category, the most profitable films are those which have an international life after their life on the domestic market. Profitability on the international market is linked to sound distribution options (efficient seller, efficient network). A producer who has succeeded in keeping distribution rights and copyright shares is better served by an internal selling service than if he were to use the services of an external seller.

The presence of the sales agent is not, however, a guarantee of film profitability: an agent can only serve to strengthen the international career of a film but not its financial success. This presence is nevertheless useful, for a good producer does not necessarily have the specific know-how required for international sales.

Co-productions are a factor of film feasibility but do not increase profitability for the producer, who tends to lose interest in the areas for which he no longer has the sales representation.

### ***3.8. Profitability for the national distributor***

We have observed certain correlations in distribution. While there is no systematic correlation between budget and box office, there is one between P & A and box office.

- Distributors and guaranteed minimum amounts

The sample observed shows primarily two types of contract :

- contract with guaranteed minimum amounts in terms of pre-sales:
  - approximately 20% of films
  - approximately 50% of countries
- contract without guaranteed minimum amounts in terms of pre-sales :
  - approximately 80% of films
  - approximately 50% of countries

- Distributors and distribution costs

The European films which are on average the most profitable are those for which the distribution costs (P&A) are the highest (ratio of four to one). As for American films, studio films have distribution costs 10-20 times higher than those of the European films which have the highest costs: independent films and a short film by a mini major are close to European films and, with fairly similar P & A costs, offer a profitability close to European films.

The analysis of non-profitable films on the other hand shows contracts without guaranteed minimum amounts (70% of cases), a viewing public of under 100 000 (80% of cases), distribution costs in excess of EUR 100 000 (70% of cases), losses in excess of EUR 100 000 (60% of cases).

### **3.9. Winners and losers**

#### **One out of three European films is profitable.**

In three films out of five, the executive producer does not get his producer's contribution back, but, when the film is successful, his return it is greater than anyone else's except when the co-producing channel gets more than the executive producer.

It is comparatively rare for associate producers to also recoup their input.

If this input is retrieved, it is always on a smaller scale than for the executive producer. There is probably a form of spontaneous market justice inasmuch as the executive producer, when he loses, loses as much as his associates, but when he makes money, makes more than his partners.

The information gathered from our sample shows that the big loser is always the public fund which provides reimbursable subsidies.

#### **The profitability of films from Central and Eastern Europe**

The work on our sample shows that the profitability of films from Central and Eastern Europe is today non-existent. Accordingly, of all the films from those countries in the sample only one Turkish film managed to achieve domestic level profitability. Exporting remains very difficult.

#### **The profitability of American films**

The success of a film in America is a determining factor in its international career, and distributors throughout the world are particularly sensitive to lack of success on the American market.

It is a market which functions according to a very segmented and market-driven pattern of production which is based on the premise that cinema production must target a universal and a specific public at the same time.

It should also be stressed that more than ever before American productions are largely financed by European money: advance payments from distributors, output deals, tax-free investment funds in the United Kingdom and in Germany, tax credits.

### **3.10. *The tops and flops in the sample***

#### **The bottom 10 films from the point of view of profitability**

The flops originate mostly from the smaller countries and the countries of Eastern Europe: one Dutch film, two Czech films, one Turkish film, one Bulgarian film and one Hungarian film which as yet have not achieved economic profitability, both considering non-reimbursable subsidies (overall profitability) and subtracting reimbursable subsidies from the result (economic profitability). With the exception of the Dutch film, these are small-budget works (under three million euros) which first and foremost have to contend with a narrow domestic market before being able to seek profits beyond their own borders.

#### **The 10 most profitable films**

Europe's 10 most profitable films confirm the positive impact of the geographical area and the sector of production and also the influence of language, inasmuch as with the exception of one Portuguese film, all come from the "big" five countries. They are films which have had an excellent box-office success and a European career.

### **3.11. *Recent market trends***

The European cinema market is changing in the wake of a number of factors the first of which is a change in European consumer habits.

The cinema market, despite European and national regulations, is tending to become a demand-driven market whereas since the 1980s it had been a supply market organised around public support, subsidies and the obligations of the broadcasters.

European distribution is a sector in difficulty and its involvement in the distribution of European films is changing under the pressure of competition whereas it is precisely today that the European cinema would need a dynamic sector.

Lastly, this sector is simultaneously supported and challenged by television: supported by broadcasters who have broadcasting obligations and - in terms of competition - challenged as a leisure activity by programmes which are the very essence of television. Whether we are talking about reality shows, national television fiction or sports programmes, the cinema is having to contend with this fundamental problem: its broadcasting partners are both sponsors and

intermediaries in relation to the public. The public's expectations are today different and the cinema has to resign itself to the fact of henceforth being merely a loss leader for television and share prime time with other forms of audiovisual production in the programme schedules.

The immediate consequence of this is increasing fragility of funding arrangements and film circulation.

Unlike the European cinema, the American cinema today derives 50% of its revenue from the international market where its distribution techniques guarantee it optimum exposure and distribution costs. Competing on this market through a European production worthy of the name requires co-ordinated action by the Member States and the European Union when it comes to public support. The role of public funding is determining in most countries.

Without these reimbursable subsidies (which are not very often reimbursed) many European films would not be made.

## **4. CONCLUSIONS ON THE FILMS**

At the close of this study we can draw a number of conclusions which the authors feel offer clear pointers as to the avenues to be investigated :

### ***4.1. Observations***

- Covering production costs is a problem
- Co-productions occupy an important place in a difficult market
- Funding patterns are transient
- Public sector action is fundamentally important, particularly for production
- The European cinema industry is a capitalist system without capitalists
- A threat hangs over medium-budget films which are increasingly difficult to finance on their domestic markets
- Cutbacks by broadcasters and investors are jeopardising the financial balance of production
- Distribution and theatre screening beyond the domestic film market are economic and cultural requirements
- These aspects of the Media + programme are essential to the European industry whereas at a time when distribution is going through a serious economic crisis
- There is a risk of medium-size companies disappearing
- Increased exploitation of niche markets

## **4.2. Stocktaking and recommendations**

The study also makes a stocktaking and recommendations relating primarily to needs in the area of knowledge and understanding of the international market, the need to rebuild the theatre market, and the training requirements in the area of company management.

As for the countries of central and eastern Europe, the recommendations focus primarily on :

- access to the funds set up by the European Union
- the circulation and marketing of works from the countries of central and eastern Europe
- the need for promotion

## **4.3. Conclusions**

Despite some reticence, it was possible to collect enough financial information to gain an in-depth understanding of the sector and its mechanisms. Greater transparency giving an objective and comprehensive view of the market would no doubt make for a better balance between needs and support policies.

In a sector in which political, cultural, social stakes are often very high, and in which competition between countries becomes a matter of seeking prestige or commercial advantage, building up an industrial policy may seem a daunting challenge.

Europe has nevertheless been successful, in a complex context, in putting in place technical and financial structures which complement the substantial resources which the Member States provide for their national sectors. In particular, Europe has introduced support mechanisms, albeit insufficient as yet, in respect of needs clearly identified by the industry itself.

The big changes, however, are still to come and for all Member States, whatever the state of their cinema industry, be it strong or weak, everything - structural changes on the market and in particular consumer behaviour and taste, competition between the different media, and the sensitivity of the media to the economic climate - points to the need for new and ambitious policies to be implemented if the fragility observed in this sector is not to turn into a fatal vulnerability.

Accordingly, policies need to be considered which will enable European cinema production to be shown on screens all over the world and secure the place it deserves in both cultural and economic terms.