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The Walt Disney Company and Pixar Inc.: To Acquire or Not to Acquire?

In November 2005, Robert Iger, the newly appointed CEO of the Walt Disney Company, eagerly awaited the box office results of *Chicken Little*, the company's second computer-generated (CG) feature film. He knew that, for Disney as a whole to be successful, he had to get the animation business right, particularly the new CG technology that was rapidly supplanting hand-drawn animation.[1] Yet the company had been reliant on a contract with animation studio Pixar, which had produced hits such as *Toy Story* and *Finding Nemo,* for most of its recent animated film revenue. And the co-production agreement, brokered during the tenure of his predecessor, Michael Eisner, was set to expire in 2006 after the release of *Cars,* the fifth movie in the five-picture deal. Unfortunately, contract renewal negotiations between Steve Jobs, CEO of Pixar, and Eisner had broken down in 2004 amid reports of personal conflict. When he assumed his new role, Iger reopened the lines of communication between the companies. In fact, he had just struck a deal with Jobs to sell Disney-owned, ABC-produced television shows—such as "Desperate Housewives"—through Apple's iTunes Music Store.[2] Iger knew that a deal with Pixar was possible; it was just a question of what that deal would look like. Did it make the most sense for Disney to simply buy Pixar?

Walt Disney Feature Animation

Walt Disney Feature Animation began with the production of *Snow White and the Seven Dwarfs* in 1934. Toys and memorabilia based on the movie's characters were stocked in stores such as Woolworth's around the film's release, a move that became a trademark of Disney's strategy. After many early successes, the animation division struggled for decades after Walt Disney's death but was rejuvenated with the arrival of Michael Eisner, as well as Jeffrey Katzenberg as chairman of Walt Disney Studios, in 1984. Under them, the studio produced a string of hit films that included *The Little Mermaid* and *Beauty and the Beast,* up to the enormous success of 1994's *The Lion King*, which alone generated over $1 billion in net income for the company.

Disney's Feature Animation unit was described as an open, collaborative environment. So open, in fact, that leadership relied on all employees to generate story ideas. Three times a year, Michael Eisner, Roy Disney, and two other Disney executives would host a "Gong Show" during which all employees had the opportunity to present their story ideas. The executives would cull the best ones and ultimately

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choose the winner. "It's a very collective approach to our work. We spend a lot of time in meetings arguing, discussing, and trying to come to a consensus,"[3] as one commented. Most of Disney's animated story lines came out of these meetings. The winner was remunerated for his or her contribution and, while figures were not made publicly available, some said winners earned up to $20,000.[4] Disney animators were compensated, in part, based on the success of the film, which made it difficult for other studios to lure talent away.[5]

Eisner believed in making clear who was good at their job, and who was not so good, and wanted to give control to leaders who had a sense of judgment about creativity and business. Seventy-five percent of the time, he was able to find a director who had these skills and wanted to work on a particular movie; the rest of the time directors would be told to "just do it."[6]

Katzenberg, who was known for his grueling work ethic and passion for animation, made it his personal mission to bring the studio back to its former glory. He supervised every aspect of the studio's films. According to one former Disney executive, "Jeffrey is the sheep dog and the wolf. He's the sheep dog guarding us, and the wolf hunting us."[7] Katzenberg was credited with hammering out the storytelling of each film and ensuring that each film had a moral resonance. He also brought on external talent to each movie, such as Elton John, who contributed songs for *The Lion King*.

Recent Box Office Performance

After *The Lion King* in 1994, every Disney-produced animated film fell below expectations (see **Exhibit 1**). When asked in 1997 about the division's disappointing performance, Eisner replied, "I don't think people quite understand our company. We have many avenues to make money from one of our animated films. The video revenues from one of our films are large, the consumer products huge."[8]

Some of the same features that observers credited for Disney Animations' success—large staff, large budgets, and lots of time—were also blamed for its demise. Disney Animation had just 275 employees in 1988; about 950 in 1994 for the release of *The Lion King;* and 2,200 at its peak in 1999.[9] Competition for animators in the 1990s also caused salaries, which accounted for 80% of each film's cost, to balloon, with top animators' pay rising from $125,000 in 1994 to $550,000 in 1999.[10] And these pay increases affected employees across the board.

In 1994, Eisner refused to promote Katzenberg to president of the company, prompting his swift departure. The absence of Katzenberg, who was generally considered to be the studio's creative force, struck many as the cause of the decline. As one commentator noted, "the company's once-invincible animation studio has fallen on hard times since studio chief Jeffrey Katzenberg left."[11] In 1997, Katzenberg, along with Steven Spielberg and David Geffen, started rival animation studio DreamWorks. According to reports, in the years that followed, DreamWorks attempted to lure away some of Disney's best animators.[12]

Joe Roth, former chairman of 20th Century Fox, became chairman of Walt Disney Studios after Katzenberg's departure. In charge for six years, he focused the studio's energy on live action films.[13] Peter Schneider, former head of Disney Animation, took over in 2000 after Roth left. Schneider's goal was to deliver "emotional, thematic stories."[14] He worked solely with established Disney directors and producers and relied on his younger development staff to broker deals with up-and-coming filmmakers, in contrast to the hands-on deal-making style of his predecessors, Katzenberg and Roth.[15] The product development group assigned directors for each animated movie.

In the late 1990s, Disney set up a "Secret Lab" in an old Lockheed plant near Burbank Airport as a response to the growing popularity of three-dimensional (3D) CG films. The group's first CG project was the costly *Dinosaur*, which was released in 2000 to a strong opening weekend, but which ultimately disappointed at the box office. The Lab was shuttered in 2001 after Roy Disney viewed and rejected the second project underway, *Wildlife*, which he thought was packed with adult themes and strayed too far from Disney's family-friendly brand offering. Disney then focused its animation efforts on traditional two-dimensional (2D) projects such as 2001's *Atlantis: The Lost Empire*.[16]

In 2002, under new feature-animation chief Thomas Schumacher, Disney embarked on an aggressive cost-cutting mission. *Lilo & Stitch*, the first movie made in the new environment, cost about $80 million to make, versus $150 million for the 1999 *Tarzan*. Instead of 573 animators crafting 170,000 individual drawings, a crew of 208 rendered 130,000 drawings.[17] Cost-cutting efforts took Disney's animation department from its high to around 1,100 in 2003. At that point, as rival studios, such as News Corp.'s 20th Century Fox, exited the market, salaries slid precipitously. The market rate for the animator who brought home $550,000 in 1994 was half as much by the early 2000s.[18] Apart from omitting redundancies, Disney Animation kept costs down by cutting corners where it could, in ways that were imperceptible to audiences. For example, the group eliminated things such as the number of characters seen in each frame or the amount of motion in the background.[19] The television-animation unit also produced very low-cost films, like *The Tigger Movie*, which could make money with only $45 million in box office receipts, since the production cost was kept down to $15 million.[20]

In 2003, Disney Studios finally set up its own CG animation department. However, many staff members needed to be retrained in the new technology, which cost Disney money, heightened tension, and depressed morale within the studio. Disney decided to slow production on its animated films to give the staff more time to work on them and hammer out the story lines. *American Dog* and *Rapunzel Unbraided*, the second and third releases after *Chicken Little*, were both pushed back.[21]

Throughout this period, Disney came to rely on revenue and characters produced by its partner, Pixar. Between 1998 and 2004, Pixar CG movies contributed a total of more than $3.5 billion to Disney Studio revenues, and more than $1.2 billion to Disney's operating income (**Exhibits 2** and **2a**). Pixar's contribution represented 10% of revenue and over 60% of total operating income for the studios over the period. In 2005, Disney even set up a group known as Circle 7 to produce sequels to Pixar movies. The 40-person staff working on *Toy Story 3* in March 2005 grew to 160 people during the following year.[22]

Movie Economics

While box office revenues from the theatrical release were the typical measure of a movie's success, financial success actually came from other revenue streams generated by the movie. By 2005, such sources included home video sales (originally on cassette tapes, but increasingly on DVD); pay-per-view and video-on-demand on cable channels; television showings, whether on free channels, such as NBC and CBS, or on cable channels; merchandise sales including toys, apparel, books, etc.; and video games and other electronic uses of the characters (see **Exhibit 3**). By 2005, the largest of these revenue sources was not theatrical box office but home video. Because character-related sales had such a long tail, revenue for a hit animated movie would come in over many years—up to decades for classic movies that were re-released theatrically and in home video form. Given the longevity of a great movie, film libraries were valuable assets. DreamWorks' film library, for example, was about to be sold to Paramount for $900 million.[23]

Sequels to successful movies were another important source of revenue. The sequels to *Toy Story*, *Shrek*, and *Ice Age*, for example, generated between 30% and 90% more box office revenue than the originals. Once a character had been established, the existence of a built-in audience for subsequent movies reduced marketing costs. Successful sequels would also extend the life of the original movie, particularly for animated features that appealed to successive generations of young children.

Pixar Inc.

Pixar was unusual among movie studios in generating a succession of box office hits. Its first five full-length films each grossed over $350 million.[24] Steve Jobs said, "Everybody has tried to break into the animation market since *Snow White* was released in 1937. So far, only two companies have ever produced a blockbuster production grossing more than $100 million, Disney and Pixar."[25]

Pixar's animation broke from the traditional model because the company did not use hand drawings but rather 3D computer-generated models. In 2D traditional animation, frames comprised hand-drawn cels, which required the skills of hundreds of people working for two to three years. Traditional animation constricted artists' flexibility, too—if a change needed to be made to a character or scene, all subsequent frames had to be changed. Three-dimensional CG, on the other hand, used mathematical models to redraw each cel and mimic camera angles in ways that traditional animation could not.

Pixar used its own proprietary computer animation technology to generate incredibly lifelike 3D images and backgrounds, although CG still could not quite make human characters look perfectly realistic. Said Jobs, "We have 10 years of proprietary software systems that you cannot buy anything close to in the marketplace. You have to build them yourself."[26] Pixar's technology allowed animators to manipulate hundreds of motion control points within a single character, to reuse animated images, and to edit easily.[27] These technologies enabled Pixar to make animated films faster than its competitors and at a fraction of their cost. For example, the company made *Toy Story* with just 110 staff members, who spent the time saved on animation to focus on story and character development, as well as fine-tuning visual details.[28]

History Pixar traced its origins to the University of Utah in the 1970s, where a young Edwin Catmull studied computer science in a program renowned for creating the new field of computer graphics. Around the same time, Alexander Schure, president of New York Institute of Technology (NYIT), hired a team of animators to make a film version of "Tubby the Tuba," a children's record. Frustrated by the limitations of hand-drawn animation, Schure flew to the University of Utah, where he met and recruited Catmull to work at the Institute. Catmull and his hand-picked team spent four years at NYIT, where they made inroads into the field despite never producing the Tubby the Tuba movie.[29]

In 1979, George Lucas approached Catmull's team with an offer to work on special effects for Lucasfilm, producer of the wildly successful *Star Wars* and *Indiana Jones* franchises. While working there in the early 1980s, Catmull met John Lasseter at a computer graphics conference and the two became friends. Lasseter, a young animator from Disney, had studied at California Institute of the Arts with the likes of Tim Burton. Skilled in art as a young boy, Lasseter read a book on the art of animation and Disney during his freshman year of high school and realized what he wanted to do with his life. After graduation, he joined the ranks at Disney and worked on *Mickey's Christmas Carol*. He commented, "I felt that Disney was, at the time, doing the same old thing. They had reached a certain plateau technically and artistically with, I think, *101 Dalmatians*, and then everything had been kind of the same ever since then, with a glimmer of characters or sequences that were special."[30] In 1984, Lasseter went to Lucasfilm's computer division under Catmull.

In 1986, Steve Jobs—who had left Apple Computer the year before—bought the Lucasfilm computer business, then called Pixar, for $10 million.[31] Initially, Jobs intended Pixar to be a computer hardware and software company. He spent the next several years subsidizing the company to the tune of nearly $50 million from his personal funds. When the graphics computers did not sell, Jobs cut a third of Pixar's staff in 1991 and left only the animation division.[32] Jobs said, "If I knew in 1986 how much it was going to cost to keep Pixar going, I doubt if I would have bought the company. The problem was, for many years the cost of the computers required to make animation we could sell was tremendously high. Only in the past few years has the price come down to the point that it makes business sense" (see **Exhibits 4** and **4a**).[33]

Software Pixar initially developed three proprietary technologies: RenderMan, Marionette, and Ringmaster. In 1989, the company released RenderMan, a software system that applied texture and color to 3-D objects and was used for visual effects. Pixar used RenderMan itself and sold it to Disney, Lucasfilm, Sony, and DreamWorks, which used it to create effects like the dinosaurs in *Jurassic Park.* The program served as Pixar's main source of revenue during the company's early years. As of 2005, it had developed special effects for 100 films, and 44 of the last 47 movies that won the Oscar in visual effects had used RenderMan. In 2001, Catmull, along with two other Pixar scientists, won an Oscar for RenderMan and its advancements to the field of motion picture rendering.

Marionette, the primary software tool for Pixar animators, was designed specifically for character animation and articulation, compared with other animation software that was designed to address product design and special effects. Ringmaster was a production management system used to track internal projects and served as the overarching system to coordinate and sequence the animation, tracking the vast amount of data employed in a three-dimensional animated film.

Short films and commercials To develop its computer-generated technology and storytelling creativity, Pixar had incorporated short films into its corporate strategy since its inception. In 1986, Pixar produced *Luxo, Jr.*, the first computer-animated film to be nominated for an Oscar. In 1989, *Tin Toy* won the Oscar for best short film. In 1997, *Geri's Game* not only won Pixar an Oscar, but also enabled the company to advance its technology in skin and cloth, while 2000's *For the Birds* advanced the technology in fur and feathers. By 2005, the Pixar team had won 20 Academy Awards.[34]

Pixar also sought revenue through the production of animated or partially animated television commercials for companies and products such as Coca-Cola, Listerine, and Lifesavers, but gave up this line of revenue in 1996 to pursue movies.

Animated feature films Jobs, Catmull, and Lasseter all had one ambition in common: to make an animated feature film. Said Jobs, "Ed shared with me his dream to make the first computer-animated feature film. And I bought into that dreamboat sort of spiritually and financially. And we bought the computer division from Lucasfilm, we incorporated it as Pixar, an independent company, and we were off to the races."[35] In 1991, Lasseter believed Pixar was finally ready to break into film. He pitched an hour-long made-for-TV movie to Katzenberg, who, impressed by Lasseter, came back with an offer to do a full-length movie backed by Disney.

Disney and Pixar's Relationship

CAPS Disney and Pixar's relationship began in 1986, when the two studios collaborated on the development of Computer Animated Production Systems (CAPS), a production system owned by Disney and used to make some of its two-dimensional cel-based animated movies. Disney's first use of CAPS was for *The Rescuers Down Under*, and the company continued to use CAPS for many of its animated feature films, including *The Lion King*. This relationship with Pixar surpassed Disney's expectations.[36]

Feature film agreement Following Lasseter's proposal, Disney and Pixar signed a deal in 1991 to produce the first of three full-length 3D CG animated movies (see **Exhibits 5** and **6**). Disney agreed to fully fund the production cost of the movie in return for owning the movie rights. While neither company disclosed the movie's budget, industry experts estimated that it was between $10 and $20 million.[37] Pixar was to be paid a participation fee based on total revenue for the movie and would fund the overage if production costs exceeded a certain pre-agreed budget (although Pixar could recover these costs if the film met certain profit targets). Disney retained control over scheduling the film's release dates. In its 1995 S-1 filing, Pixar stated: "Disney has been by far the most successful producer of animation feature films and other family oriented movies distributed by Disney are likely to be in the market concurrently with and competing with Pixar's animated feature films."[38] This three-picture deal resulted in the 1995 hit film *Toy Story*, directed by Lasseter, which garnered more than $350 million in box office and video sales, making it the highest-grossing film released in the United States that year.[39] Yet from 1995 to 1998, Pixar earned only $56 million in revenue. When asked if he had regrets about inking the deal, Jobs said, "None, no. We're working with the best in the business and we're learning a lot. We call it going to Disney University."[40]

Co-production agreement Following the success of *Toy Story*, Disney bought 5% of Pixar in 1997 just after its IPO,[41] paying $15 million for 1 million shares with warrants to buy an additional 1.5 million shares of common stock at higher prices.[42, 43] The purchase was part of a 10-year deal, signed on February 24, 1997, whereby Pixar would exclusively produce for Disney at least five original full-length animated films. Production costs, which averaged $120 million per film, would be shared equally between the two companies (see **Exhibit 6** and **7**). Disney would fund all of the marketing expenditures, which had to be covered before Pixar would receive half the remaining revenues from the box office and 50% of the other revenue streams after paying Disney's distribution fee. Pixar would receive no share of any revenues generated in the Disney theme parks, cruise ships, or other location-based entertainment. The net result was that Pixar would earn perhaps up to 40% of the total profits that the movie generated. Disney, in contrast, received a distribution fee of 12.5% of the box office earnings, in addition to its half share of the box office and the remaining revenue share of the other sources of income. In total, the company would receive at least 60% of each movie's profits (see **Exhibit 8**).[44]

Disney retained the exclusive distribution and exploitation rights to all feature films produced under the deal. This included the right to produce sequels, which Pixar could choose not to co-finance.[45] In contrast, if Pixar wished to exploit or distribute any of its films or characters, it would have to pay a license fee to Disney. Disney retained final control over all marketing and distribution decisions, although each partner's input would be considered and everything would be co-branded. One example was the release date of each year's Pixar movie. In principle, Disney could choose to give preference to one of its own movies for key release dates, like July 4. However, Disney could not release one of its own G-rated movies within a window of a certain number of weeks of the Disney/Pixar movie release. Pixar had final control over the production of each film.

The last two pictures under the original 1991 deal would be the first two pictures of this new deal, as would any sequels to *Toy Story*. The deal would take Disney and Pixar through the release of *Cars* in the summer of 2006. Citigroup estimated that the five-film deal added over $1.5 billion in operating income and $0.44 in EPS to Disney's bottom line throughout the decade-long partnership, including non-box office revenue sources.[46]

The co-production agreement also covered ancillary revenue streams, as follows:

- **Home video—**Home video sales constituted a large portion of the lifetime revenue from Pixar's films. The company believed that the popularity of the DVD format drove sales. *Monsters, Inc.*, for example, was the best-selling home video in 2002, and *Finding Nemo* was the highest-selling video of all time in the United States.

- **Television—** ABC Networks showed Pixar movies on its television channel at a fee of between 4% and 7% of the movie's domestic box office gross, with a cap of about $15 million. This was substantially less than Disney paid for *Harry Potter* movies and less than Fox paid for *Spider-Man*.

- **Licensing agreements**—In 2002, Starz licensed the pay-TV rights to *Monsters, Inc., Finding Nemo, The Incredibles,* and the forthcoming *Cars*.[47]

- **Merchandise and games** – Pixar and Disney awarded video game publisher THQ Interactive the rights to create games of *Finding Nemo*, *The Incredibles*, and *Cars*. In 2004, Pixar struck an exclusive deal with THQ that gave it the rights to four films beginning with *Ratatouille*, which came out in 2007.

Renegotiation for distribution-only deal Since 2002, Steve Jobs had been trying to broker a deal with Disney whereby Pixar would shoulder all of the films' production costs in return for 100% ownership of the films, leaving Disney with just a lower, fixed distribution fee.[48] Pixar's 2002 Annual Report stated, "We have produced four tremendously successful films to date, and we believe that this success, combined with the strength of our financial resources, position us to negotiate an arrangement with more favorable economic terms."[49] In September 2003, Pixar lobbied for a stake in the upcoming *The Incredibles* and *Cars*. Disney countered by offering a stake in return for a higher distribution fee. Final negotiations in 2004 covered how long Disney would hold the rights to future Pixar movies, whether Pixar would have the rights to any sequels, and who would get television rights.[50] Throughout the negotiations, Pixar often called for a deal akin to the one that George Lucas struck with 20th Century Fox for the *Star Wars* series (see **Exhibit 9**).

Pixar thought that, if it negotiated a new distribution deal with another studio, it would seek complete control in return for funding all costs and paying only an 8% distribution fee. In principle, this would give Pixar access to 90% of a film's lifetime revenue across all methods of distribution (in return, however, for bearing all of the cost and risk).[51]

The treatment of sequels was a sticking point in negotiations with Disney. Under the terms of the 1997 agreement, Disney could produce sequels to Pixar movies, without Pixar's involvement, for theatrical release or as direct-to-video releases. In its 2002 10K filing, Pixar stated, "Disney's decision governs,"[52] regarding disagreements over sequel production. Pixar feared that the cheaper sequels and direct-to-video quickies produced without its involvement, like *Cinderella II*, could potentially tarnish its brand. Indeed, Disney was intending to make *Toy Story 3* by itself, since Pixar had declined to be involved. Another point of contention was whether or not *Toy Story 3* would be counted against the five-picture deal; Disney didn't want it to, but Pixar did.[53] Reports surfaced in 2004 that Jobs wanted Disney to return the rights of two yet-to-be-released films, *The Incredibles* and *Cars*, thereby blocking Disney's attempts to produce sequels for the two films. Pixar's final offer to Disney was that the latter could distribute each of Pixar's films for five years, after which the rights would be returned to Pixar. Pixar also wanted Disney to give up its co-ownership of past films.[54]

Relations between Jobs and Eisner had been rocky.[55] One analyst said "they hate each other" and attributed Pixar's decision to walk away from negotiations over an earlier deal to personal conflicts between Jobs and Eisner.[56] Jobs had previously criticized Eisner publicly, saying that Pixar executives "feel sick" about the prospect of Disney marketing Pixar films.[57] Eisner, in turn, predicted that *Finding Nemo*, the next Pixar release, would be a flop and was infuriated by Apple's "Rip, Mix, Burn" advertising campaign, which he saw as an incitement to piracy.[58] Tom Staggs, Disney CFO, said that Disney could not accept Pixar's final offer because doing so would have cost Disney "hundreds of millions of dollars it is already entitled to under the existing agreement."[59] Others close to the deal attributed the rocky relations to the length and tone of the negotiations, during which Disney often left Pixar hanging for weeks on end.[60]

Pixar identified Sony, Warner Brothers, and 20th Century Fox as potential suitors. In 2003, Jobs noted, "We've talked to many of these studios, and we know we can get the deal we want."[61] On January 29, 2004, Pixar announced that it was ending its talks with Disney to renew the existing agreement and was looking for another partner.[62] The breakdown of the Disney/Pixar partnership lent strength to calls by some Disney board members to remove Eisner and was one of the factors that led to his eventual departure. In response to the news, former board members Roy Disney and Stanley Gold issued a statement: "More than a year ago, we warned the Disney board that we believed Michael Eisner was mismanaging the Pixar partnership and expressed our concern that the relationship was in jeopardy."[63] Warner Brothers immediately announced an interest in negotiating with Pixar.[64] Disney studio head Dick Cook responded by saying, "No one has a lock on talent, no one has a lock on creativity or technology or storytelling."[65]

Pixar's Corporate Culture

Jobs believed that Pixar's competition would feel pressure to replicate his company's style because they lacked the creativity, the technology, and the "blending." He noted: "We have spent 10 years merging two cultures together. It sounds really easy, like you put a technical person here, and a creative person there, and they go out to lunch, and somehow, it all works. It's not. It's really tough. And it took us 10 years to figure out how to do this."[66] At Pixar, the technical computer staff and the creative development group, including the animators, an art department, and a story department, worked together, driven by the mantra that the story came first, and that creativity existed at all levels of the organization.

Pixar believed in the primacy of people. Catmull noted, "If you give a good idea to a mediocre team, they will screw it up; if you give a mediocre idea to a great team, they will either fix it or throw it away and come up with something that works."[67] Pixar hired talented people and then created a supportive, trusting working environment in which collaboration could thrive. Employees were picked based not only on creative talent, but on whether they would be a good fit with the organization. According to one employee: "The most important thing I was asked over and over again was, 'Can I work with you?' Then it was, 'Are you qualified for the job?' You can have a lot of creative purity and still be the most dysfunctional group on the planet."[68] Pixar readily accepted prominent outsiders from companies like Industrial Light & Magic (ILM) and Lucasfilm's special effects division.

According to John Lasseter: "At Pixar, an animator is more an actor than an artist. Sure, they can draw, but the real trick is to make these 3-D characters come to life. That requires acting ability more than anything else."[69] The methodical nature with which Lasseter approached his films was well documented. Analyzing a two-second shot, Lasseter directed: "Let's return Mr. Potato Head's facial features to the default position, so it's easier for the baby to bite off his nose," or "And let's see if we can make the baby's slobber more elastic, so it sticks and stretches longer."[70]

Pixar operated according to three basic principles. The first was that "everyone must have the freedom to communicate with anyone."[71] Pixar corporate headquarters in Emeryville, California, was designed with exactly that principle in mind. After learning from Disney mentors that the company did its best work when staff members were all housed together in close quarters in the old Hyperion Studio, Jobs and Lasseter realized the importance of creating a single campus-like environment, with an atrium center that maximized chance encounters and employee interaction.

Second, "it must be safe for everyone to offer ideas." Each film was "filmmaker led" by the producer and director who had championed the idea and were committed to its success, and who received little oversight. If a problem arose, the team called on the "creative brain trust"—a group that comprised Lasseter and eight directors—to engage in a back-and-forth on how to make a movie better. It remained the team's job, however, to decide what to do with the advice.[72] According to reports, this group almost entirely reworked two of Pixar's movies when production team members themselves felt that their projects were not up the company's highest standards. Lasseter also imported and expanded on a review process—the "dailies"—from Disney and ILM. Rather than including only senior management, Pixar's daily review audience was the entire animation crew, who were encouraged to provide constructive feedback. The epitome of this approach was a philosophy of "Plussing," which Lasseter defined as "making something pretty good pretty great, making a fine-tune here and there until an idea sings."[73] The result was a deeply engrained culture that believed that everything Pixar produced had to be done to one excellent quality standard.[74]

Third, the company vowed to "stay close to innovations happening in the academic community."[75] In fact, most of Pixar's technical employees held PhDs. Lasseter firmly believed in the interplay between art and technology, and the infusion of better technology at each stage of production—an environment in which, as he said, "art challenged technology, and then technology inspired art."[76] The company also established Pixar University to offer classes in drawing, acting, and motion, as well as to encourage technical directors and artists to study alongside the animators.[77]

Lasseter signed a 10-year employment contract with Pixar in 2001 as head of the animation studios. He received a signing bonus of $5 million, an annual salary of $2.5 million, and options on 1 million Pixar shares. Eisner had once remarked that Lasseter was the only difference between Disney and Pixar.[78] The rest of Pixar's 750 employees were employed at will. And loyalty was high. Unlike other studios, where animators were hired and fired based on movie demand, Pixar retained its employees throughout the years. The company historically released one movie per year, a pace that kept the directors on staff busy, because each project took at least four years to complete. If there wasn't work to be done on a film, Pixar assigned employees to projects in research and development.

Pixar went public one week after the release of *Toy Story* in 1995, raising $140 million in the largest IPO of the year (**Exhibit 10**). Steve Jobs retained about 50% of the ownership of Pixar, and although he was occupied at Apple, he spent half his time at Pixar in the early years.

Competition

Pixar competed with other major film studios that produced movies targeting the family segment, such as Fox, Sony, Lucasfilm, DreamWorks, MGM, Universal, Paramount, and, to a certain extent, Disney. Because animated films generated the highest returns of all movie genres, and barriers to entry decreased as access to technology grew, competition in the CG space became fierce. Recent animated successes included *Ice Age* and *Robots* (Fox's Blue Sky subsidiary) and *Polar Express* (Warner Brothers). Even Disney, in conjunction with Vanguard, released *Valiant* and, through its own CG unit, *Chicken Little*. Also, a handful of fledging animation studios proliferated in California's Bay Area. Companies such as Orphanage, Wild Brain Inc., and CritterPix Inc. all announced plans to create CG feature films starring lovable, relatable characters. While each studio was at a different stage in its evolution—the Orphanage supplied special effects for movie studios while Wild Brain won an award for best computer-generated short film at the 2001 World Animation Celebration—all had the same ambition: to be the next Pixar.[79]

Pixar's most formidable rival was DreamWorks, Katzenberg's studio and owner of the *Shrek* franchise. Katzenberg was determined to create a studio that matched Disney's success in animation. But he invoked the inverse of the Disney formula—rather than making movies for children and the child that exists in everyone, the DreamWorks' motto was to make movies for adults and the adult in each child.[80] The studio's success did not happen immediately, but rather arose through much trial and error. The success of *Shrek* came as a bit of a surprise even to Katzenberg, who said: "It was one of the riskiest movies I'd ever done. It defied conventional wisdom in every way, the antithesis of everything an animated movie had been."[81] The failure of DreamWorks' *Spirit: Stallion of the Cimarron* in 2002 and *Sinbad: Legend of the Seven Seas* in 2003 signaled to Katzenberg "the last gasp of old-style animation."[82] Shortly thereafter, Katzenberg replaced 200 graphic artists with 200 computer artists. When efforts to lure Pixar away from Disney failed, DreamWorks executives renewed ties with U.K.-based animation studio Aardman Animations, who had worked with them on *Chicken Run*, for the upcoming *Wallace & Gromit*.

Between 1998 and 2005, DreamWorks' successful CG releases included *Antz, Shrek, Shark Tale, Shrek 2*, and *Madagascar*. The studio's average worldwide box office for that period was $317 million, compared with Pixar's $538 million.[83] However, DreamWorks, with its staff of 1,280, produced two CG films a year as opposed to Pixar's one, leading to $1 billion in revenue in 2004. Production costs were high—DreamWorks' average movie cost between $100 million and $130 million. Direct-to-video films, which cost roughly $30 million to make, were an integral part of DreamWorks' yearly release schedule, along with one original and one sequel. The studio boasted 14 directors on long-term contracts and included staff from 38 countries.[84] DreamWorks had a distribution deal with Paramount through 2012 by which it paid Paramount an 8% fee, which was lower than the industry average. That 8% fee applied to all revenue streams excluding merchandising, and expenses before revenue recognition.[85] In October 2004, the DreamWorks IPO separated DreamWorks Animation from DreamWorks SKG, Inc., a U.S. film studio. As part of the deal, DreamWorks SKG became responsible for the marketing and distribution of the animation studio's products; it also received an 8% fee.

Acquisition?

Robert Iger knew that he wanted to maintain his company's relationship with Pixar. The question was on what terms. Many media analysts argued for an acquisition, reasoning that animation was integral to Disney's corporate strategy because characters from animated films drove retail in its theme parks and consumer product divisions.[86] And Pixar's track record for producing smash hits was unmatched. "This is the kind of synergy that makes a good deal of sense," as one commentator wrote.[87] Merrill Lynch analyst Jessica Reif Cohen termed it a "near-perfect strategic fit."[88] Some said the move would transform Disney into the studio of the 1930s—a "boutique" that was "unencumbered by a large bureaucratic apparatus." Bringing Jobs and Lasseter into the fold, they argued, would be like bringing back Walt himself.[89]

Almost all media commentators recognized the cultural clash that was likely to occur when a small, independent studio was incorporated into a behemoth corporation. Who would end up running animation in the combined entity? Or would Pixar simply be left alone, as had occurred when Disney acquired the independent production company Miramax? Many feared the outcome when Jobs, and his forceful personality, entered the mix in the highly-charged Disney boardroom. "Steve Jobs on the Disney board would probably be good for Disney shareholders—but it could be hell for those who sit around the board table with him."[90] Others wondered what was in it for Apple, and worried that Jobs might be spreading himself too thin.[91] Jobs was once again at the helm of Apple, a company basking in the success of the iPod and poised for further product launches. Considering Jobs's point of view, one commentator suggested that brand association would be a positive outcome of the deal. "Having Apple's top executive and co-founder associated with the world's premier family-entertainment brand can't help but give Apple and its products a family-friendly stamp of approval in certain circles."[92]

And then there were the financials. Investment bank analysts estimated that if Disney purchased Pixar, it would have to pay an enterprise value fee of between $6.5 billion and $7.4 billion, given Pixar's $5.9 billion market capitalization. The deal would likely be done as an exchange of stock, which, at a price of $7.5 billion, would take place at a 2.3 : 1 Disney : Pixar share exchange ratio. Credit Suisse valuations of Pixar, which the bank compiled for Pixar's board using a variety of techniques, ranged from 1.093:1 to 2.365:1, although that price included the cash on Pixar's balance sheet (see **Exhibit 11**).

Many analysts believed that that the acquisition would be too expensive for Disney. The projected price-to-earnings (P/E) ratio for Pixar was 46. DreamWorks, its closest competitor with a market value of $2.6 billion and revenues of nearly $1 billion, had a P/E multiple of 30.[93] Deutsche Bank analysts called the potential deal "nonsensical" because it would be heavily dilutive with Disney trading at a P/E of 17, and because of a potential creative talent exodus.[94] If Pixar's creative talent walked out, "Disney just bought the most expensive computers ever sold," noted Lawrence Haverty, fund manager at Gabelli Asset Management.[95]

Deutsche Bank analysts rationalized that Disney could make 65 sequels to the Pixar hits for the proposed $6.5 billion purchase price.[96]

Amid acquisition speculation, reports surfaced that Disney was prepared to renegotiate the terms of the 1997 contract to cover the 2007 release of *Ratatouille*. Under the terms of the one-film deal, Pixar would fully finance and retain ownership rights for *Ratatouille*, paying only a straight distribution fee to Disney.

Bob Iger reflected on next steps. He believed that, as he said, "the importance of animation to Disney over the years is obvious. Nothing creates more of an impact at this company than a successful animated film. When we go into China, for example, it's not because we're called Disney, but because of *Snow White* and *The Lion King* and *Toy Story*."[97] Given this, should he reengineer Disney Animation to better compete with Pixar? Should he strike a distribution deal with another animation studio? If he stuck with Pixar, should he negotiate a new distribution deal and at what terms, or should he instead acquire the entire company?

Exhibit 1 Animated Film Performance by Studio as of November 2005 ($ millions)

Studio	Film	Format[a]	Release Date	U.S. Box	International Box	Total Box
Disney	Little Mermaid	HD	Nov-89	$112.0	$111.0	$223.0
	Beauty and the Beast	HD	Nov-91	$145.9	$207.0	$352.9
	Aladdin	HD	Nov-92	$217.4	$285.0	$502.4
	Lion King	HD	Jun-94	$312.9	$459.0	$771.9
	Pocahontas	HD	Jun-95	$141.6	$205.6	$347.2
	Hunchback of Notre Dame	HD	Jun-96	$100.1	$225.2	$325.3
	Hercules	HD	Jun-97	$99.1	$153.6	$252.7
	Mulan	HD	Jun-98	$120.6	$183.0	$303.6
	Tarzan	HD	Jun-99	$171.1	$264.2	$435.3
	Dinosaur	CG	May-00	$137.8	$210.0	$347.8
	Emperor's New Groove	HD	Dec-00	$89.3	$70.6	$159.9
	Atlantis: The Lost Empire	HD	Jun-01	$84.1	$84.6	$168.7
	Lilo & Stitch	HD	Jun-02	$145.8	$127.4	$273.2
	Treasure Planet	HD	Nov-02	$38.2	$71.4	$109.6
	Jungle Book 2	HD	Feb-03	$47.9	$87.3	$135.2
	Piglet's Big Movie	HD	Mar-03	$34.7	$39.8	$74.5
	Brother Bear	HD	Oct-03	$85.3	$164.3	$249.6
	Teacher's Pet	HD	Jan-04	$6.5	$0.0	$6.5
	Home on the Range	HD	Apr-04	$50.0	$53.9	$103.9
	Average			**$112.6**	**$158.0**	**$270.7**
Pixar	Toy Story	CG	Nov-95	$191.8	$166.4	$358.2
	A Bug's Life	CG	Nov-98	$162.8	$195.2	$358.0
	Toy Story 2	CG	Nov-99	$245.9	$239.9	$485.8
	Monsters, Inc.	CG	Nov-01	$255.9	$273.1	$529.0
	Finding Nemo	CG	May-03	$339.7	$524.9	$864.6
	The Incredibles	CG	Nov-04	$261.4	$370.0	$631.4
	Average			**$242.9**	**$294.9**	**$537.8**
DWA	Antz	CG	Oct-98	$90.6	$91.0	$181.6
	Prince of Egypt	HD	Dec-98	$101.2	$127.0	$228.2
	Road to El Dorado	HD	Mar-00	$50.8	$27.0	$77.8
	Chicken Run	SM	Jun-00	$106.8	$99.0	$205.8
	Shrek	CG	May-01	$267.7	$238.0	$476.7
	Spirit: Stallion of the Cimarron	HD	May-02	$73.2	$48.0	$121.2
	Sinbad: Legend of the Seven Seas	HD	Jul-03	$26.3	$54.0	$80.3
	Shrek 2	CG	May-04	$441.2	$477.3	$918.5
	Shark Tale	CG	Oct-04	$160.9	$202.6	$363.5
	Madagascar	CG	May-05	$193.2	$327.2	$520.4
	Wallace & Gromit[b]		Oct-05	$50.0	$67.8	$117.8
	Average			**$151.2**	**$169.1**	**$317.4**
Warner Bros.	Space Jam	HD	Nov-96	$90.4	$140.0	$230.4
	Iron Giant	HD	Aug-99	$23.2	$6.0	$29.2
	Osmosis Jones	HD	Aug-01	$13.6	$0.4	$14.0
	Looney Tunes: Back in Action	HD	Nov-03	$21.0	$47.5	$68.5
	Polar Express	CG	Nov-04	$162.8	$120.4	$283.1
	Average			**$62.2**	**$62.9**	**$125.1**
Fox	Anastasia	HD	Nov-97	$58.4	$81.4	$139.8
	Titan A.E.	HD	Jun-00	$22.8	$14.0	$36.8
	Ice Age	CG	Mar-02	$176.4	$206.3	$382.7
	Robots	CG	Mar-05	$128.2	$132.5	$260.7
	Average			**$96.5**	**$108.5**	**$205.0**

Source: SG Cowen & Co., "Walt Disney Company," November 3, 2005, via Investext, accessed October 2008.

[a] HD = Hand-drawn, CG = Computer-generated, SM = Stop-motion. [b] Still in release at time of reporting.

Exhibit 2 Walt Disney Company Financials ($ millions)

	9/30/1999	9/30/2000	9/30/2001	9/30/2002	9/30/2003	9/30/2004	10/1/2005
Net sales	23,435	25,325	25,172	25,329	27,061	30,752	31,944
Cost of goods	19,715	21,567	21,573	22,924	24,330	26,704	27,837
Gross profit	3,720	3,758	3,599	2,405	2,731	4,048	4,107
Depreciation, depletion and amortization, w/ impairment	1,377	2,287	3,001	1,042	1,090	1,262	1,339
Non-operating income	-109	605	-1,005	529	-459	320	491
Interest expense	612	497	544	723	NA	629	605
Income before tax	2,403	2,633	1,283	2,190	2,254	3,739	3,987
Provision for income taxes	1,014	1,606	1,059	853	789	1,197	1,241
Minority interest (inc)	89	107	104	101	127	197	177
Net income	1,300	920	-158	1,236	1,267	2,345	2,533
ASSETS							
Total current assets	9,727	10,007	6,605	7,849	8,314	9,369	8,845
Net property and equipment	11,346	12,310	12,906	12,780	12,678	16,482	16,968
Intangibles	15,695	16,117	20,483	25,818	25,957	25,719	25,132
TOTAL ASSETS	**43,679**	**45,027**	**43,810**	**50,045**	**49,988**	**53,902**	**53,158**
LIABILITIES							
Long-term debt	9,278	6,959	8,940	12,467	10,643	8,072	8,834
Total liabilities	22,356	20,571	20,756	26,166	25,769	27,023	25,700
Shareholder equity	20,975	24,100	22,672	23,445	23,791	26,081	26,210
TOTAL LIABILITIES AND NET WORTH	**43,679**	**45,027**	**43,810**	**50,045**	**49,988**	**53,902**	**53,158**

Source: Walt Disney Company SEC financial data extracted from Thomson One Banker, accessed October 2008, and Refinitiv, accessed November 2021.

Exhibit 2a Walt Disney Company Business Segment Results ($ millions)

	1995	1996		1997[a]	1998	1999[b]	2000	2001	2002	2003	2004	2005
Revenues												
Creative Content	$7,736	$10,159	Media Networks	$6,522	$7,142	$7,512	$9,615	$9,569	$9,733	$10,941	$11,778	$13,207
Broadcasting	414	4,078	Parks and Resorts	5,014	5,532	6,106	6,803	7,004	6,465	6,412	7,750	9,023
Theme Parks & Resorts	4,001	4,502	Studio Entertainment	6,981	6,849	6,548	5,994	6,106	6,691	7,364	8,713	7,587
			Consumer Products	3,782	3,193	3,030	2,622	2,590	2,440	2,344	2,511	2,127
			Internet	174	260	206	368					
	$12,151	$18,739	Total	$22,473	$22,976	$23,402	$25,402	$25,269	$25,329	$27,061	$30,752	$31,944
Operating Income												
Creative Content	$1,531	$1,561	Media Networks	1,699	$1,746	$1,611	$2,298	$1,758	$986	$1,213	2,574	3,209
Broadcasting	76	782	Parks and Resorts	1,136	1,288	1,446	1,620	1,586	1,169	957	1,077	1,178
Theme Parks & Resorts	859	990	Studio Entertainment	1,079	769	116	110	260	273	620	662	207
Accounting Change		(300)	Consumer Products	893	801	607	455	401	394	384	547	543
			Internet	(56)	(94)	(93)	(402)					
			Amortization	(439)	(431)	(456)	(1233)					
	$2,466	$3,033	Total	$4,312	$4,079	$3,231	$2,848	$4,005	$2,822	$3,174	$4,860	$5,137

Source: Company 10K filings.

[a] Before 1997, animation fell under creative content; after 1997, it fell under studio entertainment.

[b] Beginning in 1999, the company changed how operating segment information was reported, and it restated reports from 1997 to conform to new standards. In 2001, the Internet was no longer treated as a separate segment and amortization was no longer reported as a separate line item.

Exhibit 3 Aggregate Worldwide Performance of Pixar and DreamWorks Animation Movies

	Pixar[a] (Five Movies 1995–2003)			DreamWorks Animation[b] (Eight Movies 1998–2004)		
	Total Revenue ($ million)	**Average per Movie ($ million)**	**% of Total Revenue**	**Total Revenue ($ million)**	**Average per Movie ($ million)**	**% of Total Revenue**
Box Office	1,236	247	23.7%	1,069	134	26.9%
Home Video	3,103	602	59.5%	2,345	293	59.0%
Television	385	77	7.4%	335	42	8.4%
Merchandise	495	99	9.5%	224	28	5.6%

Source: Adapted from Richard Greenfield and Doc Horn, "Pixar vs. DreamWorks: Either, Neither, or Both?" Fulcrum Global Partners LLC research, October 26, 2004, via Thomson One Banker, accessed November 2008.

Note: Totals differ from those in Exhibit 1 due to timing of report.

[a] Pixar Movies = Toy Story, A Bug's Life, Toy Story 2, Monsters, Inc., and Finding Nemo.

[b] DreamWorks movies = Antz, Price of Egypt, Road to Eldorado, Chicken Run, Shrek, Spirit, Sinbad, and Shrek 2.

Exhibit 4 Pixar Financials ($ millions)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Revenues											
Software	3.3	3.1	3.3	4.5	3.8	5.7	9.1	6.9	8.1	12.1	12.6
Animation Services	2.3	2.5	3.9	1.6	0.6	0.9	0.8	0.0	0.0	0.0	0.0
Film	0	0	18.8	26.9	9.8	114.4	162.3	63.4	193.6	250.4	260.8
Patent Licensing	0	6.5	9.1	1.7	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Total Revenues	5.6	12.1	35.2	34.7	14.3	121.0	172.3	70.2	201.7	262.5	273.5
Costs											
Software	1.2	0.5	0.1	0.1	0.7	0.7	0.6	0.5	0.5	0.0	0.0
Animation Services	2	1.9	3	1	0.1	0.5	0.4	0.0	0.0	0.0	0.0
Film	0	0	1.6	1.5	0.0	30.5	36.0	11.8	41.0	38.0	29.9
Total Costs	3.1	2.4	4.7	2.5	0.9	31.7	37.0	12.3	41.5	38.1	29.9
Operating Expenses											
Research and Development	2.3	4.1	3.2	4.7	3.9	6.3	5.6	6.3	8.5	15.3	17.4
Sales and Marketing	2.2	1.6	1.5	1.5	1.3	1.5	1.6	2.0	1.3	2.4	2.5
General and Administrative	0.8	3	4.2	5.1	7.0	7.0	7.7	8.1	9.7	12.8	15.0
Operating Expense Reimbursement	0	0	0	-2.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Operating Expenses	5.3	8.7	8.9	9.1	12.1	14.8	14.9	16.4	19.5	30.5	34.9
Income from Continuing Operations	-2.8	1	20.3	23.1	1.3	74.5	120.4	41.5	140.7	193.3	208.7
Other Income, Net	0.5	0.7	8	8.8	8.8	7.5	13.0	14.4	10.3	10.5	12.4
Income Taxes	0	-0.1	-2	-9.9	-2.6	-32.9	-55.4	-19.9	-61.1	-79.7	-79.4
Net Income	-2.4	1.6	25.3	22.2	7.8	49.2	78.4	36.2	89.9	124.8	141.7

Source: Compiled from Prudential Financial Research, "Pixar" Company Reports, via Thomson Investext, accessed November 2008.

Exhibit 4a Pixar Balance Sheet (in $ thousands)

	10/1/2005	1/1/2005
Assets		
Cash and Investments	1,043,664	854,784
Total Assets	1,443,462	1,275,037
Liabilities and Shareholders' Equity		
Total Liabilities	55,977	54,942
Total Shareholders' Equity	1,387,485	1,220,095
Total Liabilities and Shareholders' Equity	1,443,462	1,275,037

Source: Pixar 10Q Filing, October 1, 2005, via Thomson One Banker, accessed March 2009.

Exhibit 5 Selected Clauses from Feature Film Agreement 1991 (13-page contract)

II. PICTURE 1 ("Toy Story")

. . .

b. Budget. The Final Budget of the Picture 1 shall not exceed [*][a] and shall be subject to the provisions of paragraph II.I above. Pixar agrees to make changes to the screenplay and production schedule of the Picture in order to accommodate this budget.

. . .

d. Approvals:

(i) Creative controls and decisions shall be subject to the mutual approval of WDPc and Pixar and in the event of disagreement with respect thereto, the decision of [*] [Walt Disney Pictures] WDPc shall be final.

(ii) Financial controls of the Picture shall be mutually retained by WDPc and Pixar so long as the cost of production is within the approved Final Budget amounts. If at any time the cost of production exceeds the budgeted amounts, financial control of the picture shall be solely retained by WDPc.

. . .

III. MISCELLANEOUS: ALL PICTURES

a. Exclusivity. The services of Pixar's animation Division including, without limitation, the key creative Pixar talent set forth in Section III below shall be exclusive to WDPc during the Term (as such may be extended) in all forms of theatrical motion pictures (except tradeshow demonstrations), all forms of TV (except TV commercials), all forms of home video (except video games) and theme parks and attractions. Pixar agrees it will not enter into a custom programming contract for non-WDPc film projects during the Term of this Agreement. The foregoing shall not preclude Pixar from selling standard commercial products to third parties.

. . .

k. Publicity. Pixar and WDPC shall have mutual approval of the press release regarding the Picture. Pixar shall have a consultation right with respect to the following: i) major publicity for the Picture, and ii) the initial U.S. advertising campaign and release pattern; provided in the event of disagreement, WDPc's decision shall be final.

Source: Pixar S-1 filing, October 2005, Amendment 10.4, via Thomson One Banker, accessed December 2008.

[a] Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portions.

Exhibit 6 Features of the Feature Film and Co-Production Agreements

	Feature Film Agreement	Co-Production Agreement
Date	May 1991	February 1997
Length	One movie. Two additional movies at Disney's option. Second movie: exercised in August 1995.	Until the fifth film was delivered (about 10 years).
General Description	Development, production, and distribution of up to three feature-length motion pictures that would extend to at least 1999 if the movie options were exercised.	Development, production, and distribution of five feature-length motion pictures. The first movie in the agreement was the third one of the previous agreement.
Exclusivity	Yes, during the terms of the agreement the animation division would be exclusive to Disney for all forms of theatrical motion pictures. All forms of television, all forms of home video, and theme parks and attractions.	Exclusivity on movies until 12 months after the fifth movie was featured.
Feature animated films	Disney exclusivity	Exclusivity until third movie was produced
TV	Disney exclusivity	Disney exclusivity
Home video	Disney exclusivity	Disney exclusivity
Theme parks and attractions	Disney exclusivity	Disney exclusivity
Commercials	Non-exclusive, Disney approval	Non-exclusive
Special effects for live films	Non-exclusive, Disney approval	Non-exclusive
Special effects for live TV shows	Non-exclusive, Disney approval	Non-exclusive
Costs		
Production expenses: budget	Disney was responsible up to a certain budgeted amount that had to be pre-approved (original budget for *Toy Story* was $17.5 million, increased to $21.1 million).	Costs were shared 50–50. Pixar had the final say on budget up to a certain limit. Pixar in charge of production, Disney representative—approved by Pixar—supervised costs.
Production expenses: over-budget	Pixar would cover a share of costs over budget, recovering this amount if the revenues exceeded a certain level (for *Toy Story*, the costs were $6 million over budget and Pixar had to contribute $3 million). Part of Disney's contribution would be deducted from Pixar's revenues.	Costs were shared 50–50. Pixar in charge of production, Disney representative—approved by Pixar—supervised costs.
Distribution	In Disney's hands. Disney decided when and how to release a movie.	Disney was solely responsible for financing and had final control of marketing and distribution. Restrictions on when to release a film (no later than 12 months after production finished; during summer or holiday period releases). Disney to market and distribute in the same manner as Disney's own premier animated movies. Pixar may appoint a Marketing and Distribution representative who had no decision-making authority. Pixar participated in licensing decisions.
Revenues	Small percentage (10–15) for Pixar. The percentage increased with the success of movies. Started with 10%.	50-50 percentage, with Disney receiving a 12.5% distribution fee. Pixar had the right to audit Disney's accounting.
Domestic theatrical exhibitions	Small percentage (10–15) for Pixar	50%—after distribution costs
International theatrical exhibitions	Small percentage (10–15) for Pixar	50%—after distribution costs
Domestic TV	Small percentage (10–15) for Pixar	50–50
International TV	Small percentage (10–15) for Pixar	50–50

Exhibit 6 (continued)

	Feature Film Agreement	Co-Production Agreement
Soundtracks	Small percentage (10–15) for Pixar	50–50
Merchandise	Small percentage (10–15) for Pixar	50–50
Domestic home video	Smaller percentage (10–15) for Pixar	50–50
International home video	Smaller percentage for Pixar	50–50
Theme parks and attractions, cruises, and location-based entertainment	None	None
Ownership		
Technology	Pixar could use technology. If it sold technology to others, Disney would have the right to get a license.	Pixar
Films	Disney	Pixar and Disney. Treatments that Disney didn't pursue reverted to Pixar. Disney had exclusive distribution and exploitation rights.
Characters	Disney	Pixar and Disney. Treatments that Disney didn't pursue reverted to Pixar. Disney had exclusive distribution and exploitation rights.
Credits	Pixar received production credits.	Pixar co-equal brand.
Sequels for any media	Disney. Pixar had right of first refusal to produce the sequel.	Pixar and Disney but Disney's decision governed. Pixar could either produce or participate on a passive financial basis.
Creative control	Mutual approval of Disney and Pixar; in case of disagreement the final decision was in Disney's hands.	Pixar and Disney, subject to dispute resolution mechanism. Pixar had full creative control of *Cars*.
Treatments	Pixar proposed, Disney decided.	Pixar and Disney. Pixar had final say on budget up to a certain limit. Treatments that Disney didn't pursue reverted to Pixar. Disney had exclusive distribution and exploitation rights.
Production	Pixar proposed, Disney decided.	Pixar. Disney maintained a production representative at Pixar.
Ancillary rights	Disney	Pixar and Disney
Termination	Disney could terminate the agreement at any time. Disney could abandon production at any time after paying a fee ($360,000). Disney retained ownership of films and characters even for abandoned films. If Disney decided not to proceed with the project, it could sell its rights to Pixar by a price equal to the costs incurred.	Disney could terminate if a competitor acquired 50% or more of Pixar.
Personnel	Pixar must have employment contract for key creative personnel.	Pixar must have seven-year employment contract for John Lasseter.

Source: Casewriter analysis of contracts.

Exhibit 7 Selected Clauses from Co-Production Agreement, 1997 (43-page contract)

3. CREATIVE CONTROLS

Pixar and Disney shall collaborate in the creative process of developing and producing the Pictures, as follows:

. . .

b. **Development and Production**. After approval or selection of a Treatment, Disney and Pixar shall have mutual creative control of the further development, pre-production, and production of each Picture, provided that in the event of a disagreement with respect to any particular creative matter in such Picture final creative control with respect to such creative matter shall be as follows:

(i) [*] shall have [*] in any of the Pictures which [*][a];

(ii) [*] shall have [*] in any of the [*] have previously [*] for [*] with [*]; or

(iii) if neither subparagraph (i) or (ii) is applicable, the [*] and [*] shall have [*] of such [*]. The [*] shall be [*] so long as [*] is [*] (unless [*] , on [*] or [*] to [*]); otherwise [*] shall appoint the [*], or if [*] is no longer employed by [*] will [*] the [*]. The [*] shall be [*] so long as [*] is [*] (and not [*]); otherwise [*] (or if [*] is no longer employed by [*], the [*] of [*]) shall appoint the [*].

c. **Final Cut/Rating**. Disney and Pixar shall have mutual control over the final cut of each Picture, provided that each party shall exercise its final cut rights in good faith and so not frustrate or delay the release of the Picture.

4. PRODUCTION

a. **Production Control**. Subject to the provisions of paragraph 3 above and this paragraph 4, Pixar shall control the production of each picture. . . . Pixar shall consult with Disney concerning the selection of the producers and directors of each Picture, provided that in the event of a disagreement the decision of Pixar shall govern.

. . .

b. **Disney Representative** . . . . The Disney Production Representative shall be entitled to maintain an office at Pixar's facilities, to monitor production of the Pictures, to review production and production finance books, records, and documentation, including creative materials (e.g., dailies, story boards, and scripts), to have access to Pixar production personnel and production meetings solely relating to the Pictures on a regular basis, and to receive periodic briefings from Pixar on production and production finance issues. . . . The Disney Production Representative shall not have decision-making authority over Pixar, and shall not have access to Pixar Technology (as defined in paragraph 13c).

6. DISTRIBUTION

Disney shall have control over all decisions relating to the marketing, promotion, publicity, advertising, and distribution of each Picture, subject to the following:

. . .

b. **Release Period**. Disney shall initially release each Picture theatrically in the United States either during the period from May 15 to August 15 ("*Summer Period*") or during the period from November 15 to December 31 ("*Holiday Period*").

. . .

f. **Consultation with Pixar**. Disney shall consult with Pixar relating to all such major marketing and distribution decisions . . . ., provided that Disney shall have the final decision on such matters.

8. BUDGETS

. . .

c. **Picture Budgets**.

(i) Approval of Picture Budgets . . . . If Pixar and Disney are unable to reach agreement on the Picture Budget within that period of time, the decision of Pixar as to the Picture Budget shall govern, so long as such picture budget does not exceed [DELETED] percent of the largest Picture budget for any prior Picture.

. . .

15. DERIVATIVE WORKS

b. **Decision to Produce**.

(i) Subject to the provisions of this paragraph 15, Disney and Pixar shall have mutual control of whether or not to develop, produce, or otherwise exploit any Derivative Works . . . during the term or thereafter. . . . In the event of a disagreement of whether or not to develop, produce, or otherwise exploit any Derivative Work, Disney's decision shall govern.

. . .

j. **Theme Parks**. Disney shall have the sole and exclusive right in perpetuity to use each Picture, the characters therefore and unique story elements thereof (excluding Pixar Technology) and/or footage from each Picture (*) in any of the following: (i) venues, retail operations, and location-based entertainment which are not Picture-Themed Location-Based Entertainment, (ii) Disney's major theme parks . . . (iii) cruise ships throughout the universe (collectively "Theme Park Rights") with no financial obligation to Pixar.

Source: Co-Production Agreement, Walt Disney Pictures and Television and Pixar, February 24, 1997, Pixar 10K, Amendment 10.16, via www.secinfo.com, accessed December 2008.

[a] Certain information on this page has been omitted and filed separately with the Commission. Confidential treatment has been requested with respect to the omitted portions.

Exhibit 8 Pixar and Disney Revenue Breakdown Using Estimates of *The Incredibles* ($ millions)

	Total Production Cost
Worldwide Box Office	
Domestic Box Office	250
International Box Office	300
Total Theatrical Gross	550
Theatrical Net	263
Marketing and Distribution Costs	(105)
Disney Distribution Fee	(33) a
Net Revenue to Partners	**125** b
Production Costs (shared equally)	(24) c
Profit to Partners	101
Pixar Revenue	63 b/2
Pixar's Total Theatrical Income	51 (b/2 – c/2)
As % of Total Theatrical Revenue	38%
Disney's Total Theatrical Income	84 (b/2 – c/2)+a
As % of Total Theatrical Revenue	62%
Worldwide Home Entertainment	
Home Video Sales (and Rental)	
Sales	551
Less costs	(109)
Gross Profit	442
Marketing and Distribution Costs	(106)
Disney Distribution Fee	(69)
Net Revenue to Partners	**267**
Production Costs (shared equally)	(52)
Partners' Income	215
Pixar Revenue	133
Pixar's Home Entertainment Income	107
Disney's Home Entertainment Income	176
Worldwide PPV and Pay TV Sales	
Sales	33
Disney Distribution Fee	(4)
Net Revenue to Partners	**29**
Production Costs (Shared Equally)	(5)
Partners' Income	24
Pixar Revenue	14
Pixar's Income	12
Disney's Income	16

	Total Production Cost
Worldwide Free TV Sales	
Sales	29
Disney Distribution Fee	(4)
Net Revenue to Partners	**25**
Production Costs (Shared Equally)	(5)
Partners' Income	20
Pixar Revenue	13
Pixar's Income	10
Disney's Income	14
Worldwide Merchandising Royalties and Licensing Fees	
Revenue	55
Disney Distribution Fee	(7)
Net Revenue to Partners	**48**
Production Costs (Shared Equally)	(10)
Partners' Income	39
Pixar Revenue	24
Pixar's Income	19
Disney's Income	26

Total	
Pixar Revenue	247
Pixar's Total Income	**200**
As % of Total Income	39%
Disney Total Income (including Distribution Fees)	**319**
As % of Total Income	61%

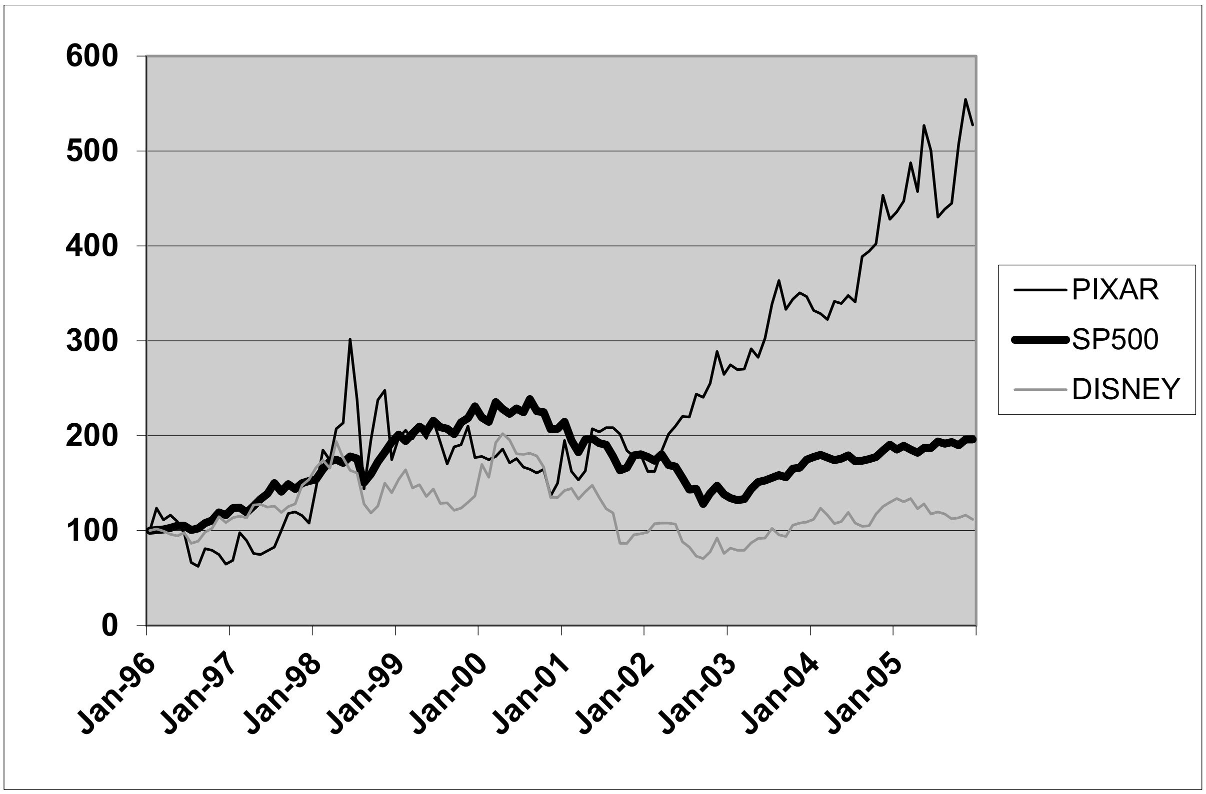
Source: Adapted from "Pixar: The Little Studio That Did," Bear Stearns Equity Research, October 5, 2004, via Thomson Investext accessed October 2008.

Exhibit 9 Disney/Pixar Deal vs. Fox/Lucasfilm Deal

	Pixar/Disney	Lucas/Fox
Distribution Fee	10%–15%	7%
Potential Revenue Streams	4 (box office, home video, TV, merchandise)	2+ (box office and home video; TV in certain territories only)
Sequels	Disincentive for Sequels	Sequel-Focused Strategy
Profit Split	50–50	100% wholly owned by Lucas

Source: "Pixar: The Little Studio That Did," Bear Stearns Equity Research, October 5, 2004, via Thomson Investext, accessed October 2008.

Exhibit 10 Stock Price Comparisons '96–'05 for Disney, Pixar, and SP500 (indexed at 100)



Source: Thomson One Banker, accessed January 2009.

Exhibit 11 Pixar Valuation Methods and Implied Exchange Ratios

Valuation Method	Exchange Ratio (Disney shares/ Pixar shares)
Discounted Cash Flow	
Estimated cash flows from 2006–2015	
Terminal value at 5%–6% growth in perpetuity	
Discount rate varied between 11% and 13%	1.093x–1.468x
Sensitivity Analysis	
Future box office performance assumptions	
Films released increase from 1 to 1.5 pa	
Discount rate range 10%–12%	
Growth rate in perpetuity 4%–5.5%	1.268x–2.356x
Comparables[a]	
(Based on closing stock prices on 1/23/06)	
20.0x–25.0x EBITDA for 2006	
12.0x–15.0x EBITDA for 2007	
Street Estimate	1.613–2.247x
Base Estimate	1.374–1.939x
Acquisitions[b] in Media and Entertainment Industry	
Reference range 2005 EBITDA of 20.0x–30.0x	
Reference range 2007 EBITDA of 15.0x–18.0x	1.716 - 2.365x

Source: Credit Suisse presentation to Pixar Board as reported in Walt Disney Company Form S-4, February 16, 2006, via Thomson Research, accessed October 2008.

[a] Disney, Time Warner, News Corp., Viacom, CBS Corp, and DreamWorks.

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