W33828

LEVELFILM: BUILDING A BALANCED FILM PORTFOLIO

Danielle Brennan wrote this case under the supervision of Kyle Maclean solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

In December 2022, Evan Attard was reading an email that had just appeared in his inbox. Attard was the manager of sales strategy at levelFILM Inc. (levelFILM), based in Toronto, Ontario, Canada. The email was from the producers of an independent film with an offer for levelFILM to buy the film's Canadian distribution rights. One of levelFILM's recent drama acquisitions had been released in theatres the previous month and had performed disappointingly at the box office. Attard was not optimistic that this new film would recoup the company's investment in that project. He wondered if levelFILM needed to reassess its acquisition strategy, but there were many approaches to consider, including specializing in one genre, investing heavily in one project at a time, or building up a large portfolio of films across a selection of genres.

As Attard was well aware, the level of uncertainty in the business was very high, with no guarantees of success. The issue of uncertainty was especially challenging for an independent distributor with low access to capital, compared to the high revenues of major studios. In the past, levelFILM had focused primarily on a few genres, but should the company fully specialize in one specific genre? Or should it consider diversifying its film portfolio across numerous genres? What would be the benefits of either strategy? Attard needed to consult relevant data before making a decision.

THE FILM INDUSTRY

The overall film industry generally consisted of three types of businesses: producers, distributors, and exhibitors. Producers secured the required funding for the entire production of a film. Distributors bought the rights to the finished film from producers and sold the film to exhibitors, earning a profit in the process. Exhibitors earned revenue by charging viewers to see the film.

Producers

Producers, or production companies, were responsible for the financing needed to produce a film, including all content, talent, equipment, and services. This process included script development, hiring talent, filming, and post-production. Fixed costs at this stage were extremely high because producers needed to pay for—among other things—expensive equipment, salaries of technical and creative talent, and location rental fees. Producers also required large amounts of investment funding if they wanted to hire notable actors and directors, who usually had high bargaining power.[1] Producers and their investors assumed a high level of risk due to the extreme uncertainty of the finished product's quality and public reception. Financing was typically secured based on only a script and a partial list of associated talent, such as the director. This was one of the key factors that made it a considerably greater challenge for first-time or independent filmmakers to secure funding. Unlike major film studios, independent film companies lacked a proven track record of successful projects and the ability to afford high-priced famous talent.[2] However, barriers to entry in the industry were gradually lowering due to equipment becoming more affordable.[3]

The primary concern of a production company was delivering the project on budgets and on time. The company's financial viability depended on this one factor. Any delays, reshoots, and other unexpected expenditures could significantly lower its profitability prospects.[4]

Distributors

Distributors, or distribution companies, acted as intermediaries between producers and exhibitors. These companies purchased the rights to distribute a film from its producers (or from its independent filmmakers directly) and generated revenues by selling it to exhibitors who were interested in showing the film to viewers or hosting it on a video streaming platform.

Distributors typically paid a "minimum guarantee" to producers in exchange for the right to exploit the content in a given territory for a given time. The distributor retained all proceeds from the film until the minimum guarantee had been recouped. Filmmakers and producers typically received a portion of any proceeds from the film that were above the minimum guarantee, which were called "overages."[5]

Major production studios such as Sony Pictures Entertainment Inc., Warner Bros. Pictures, Walt Disney Pictures, and Paramount Pictures Corporation typically undertook distribution in-house. However, distributors tended to provide value to independent filmmakers or smaller studios through their expertise in the local market. These companies maintained "continuous and extensive contact" with key industry personnel, including theatre chains, video-on-demand platforms, and streaming services.[6] These relationships allowed distributors to coordinate film releases across platforms and to strategically plan around other major releases. Distributors also often provided marketing and publicity services to successfully roll out a film's release.[7]

Distributors acquired films from producers or independent companies in different ways. Film festivals were the most effective and important way to do so. Filmmakers routinely submitted films to major events such as the Toronto International Film Festival, Cannes Film Festival, or Sundance Film Festival.[8] These events, which were widely attended by industry professionals, provided an opportunity for global distributors to view films before acquiring them. Another option consisted of sales agents hired by producers to sell their film to a distributor. The agents normally had strong connections in the industry and could often negotiate deals for multiple films. A third option was for an independent film company to seek a distributor directly by submitting a script or screener. Finally, some distributors entered into an "output agreement" with a producer that consisted of a commitment to acquire the rights for a specific number of films from that producer or production company over an agreed period.[9]

Exhibitors

Exhibitors provided film content to viewers in various different formats such as on the large screen of a cinema, through a video-on-demand platform (e.g., Apple iTunes), over a streaming platform (e.g., Netflix, Disney+) and various other non-theatrical vehicles (e.g., libraries, in-flight consoles).

The success of this particular segment—and of the entire industry—hinged on the discretionary spending habits of consumers, which could be sensitive to various economic and socio-political factors.[10] For example, recent years had seen a steady increase in at-home viewership of films, challenging the historical financial success of traditional cinemas.[11] This trend was especially accelerated in 2020 after the outbreak of the COVID-19 pandemic, when many movie theatres across the world were forced to shut down and subscriptions to the largest movie streaming services increased by 50 per cent in response.[12] During the pandemic in May 2020, a survey found that 70 per cent of viewers would rather watch a new film release at home than in a theatre for a comparable cost.[13]

Distributors typically received a fee of 40–50 per cent of box office sales for films played in multiplex cinemas.[14] For smaller, independent cinemas with uncertain patronage, distributors often negotiated a minimum flat fee. For example, a cinema could agree to pay the distributor $200[15] or 35 per cent of the weekly box office proceeds, whichever was greater. As of 2022, cinemas were relying more heavily on concession sales and, increasingly, subscription programs to cover their fixed costs.[16]

Many major production studios (e.g., Walt Disney Pictures, Paramount Pictures Corporation) had integrated both distribution and exhibition into their business models. For example, Walt Disney Pictures distributed its films in-house and created its own streaming platform, Disney+. These studios also had significant power in their relationships with theatrical exhibitors as the primary and most important suppliers of content, so they typically received screen priority and long runtimes in theatres. For example, in May 2022, Marvel Entertainment LLC's *Dr Strange in the Multiverse of Madness* played more than 60 times in one day at a cinema in New York.[17] Theatre owners generally had little bargaining power, regardless of their preferences. Major studios could threaten to withhold future key films from any theatre that did not agree to their terms.

In 2015, US film director and filmmaker Quentin Tarantino claimed that he had experienced "extortionist practices" related to his film *The Hateful Eight*. Tarantino's film apparently lost its screen times at one Los Angeles theatre after executives from a major studio strong-armed the theatre owners. Despite a previous agreement with Tarantino, the theatre was forced to show the film *Star Wars: The Force Awakens* in place of Tarantino's film to avoid being blacklisted by Walt Disney Pictures.[18] Veteran US film director Martin Scorsese also famously lamented the influence on theatres by major studios such as Marvel Entertainment LLC. In a widely-viewed 2019 interview, Scorsese referred to the studio's films as "not cinema" and called for movie theatres to "step up and show films that are narrative films."[19] Later, in a follow-up opinion article in *The New York Times*, Scorsese wrote that "if people are given only one kind of thing and endlessly sold only one kind of thing, of course they're going to want more of that one kind of thing."[20]

SOURCES OF RISK IN THE FILM INDUSTRY

The financial success and performance of films tended to vary greatly, with extreme levels of outliers (see Exhibit 1). The variations were partially due to a wide discrepancy between the box office results of major studio franchise releases versus those of independent titles.[21] However, even among films with similar budgets, there were a variety of reasons why individual film performance was nearly impossible to predict. As Oscar-winning screenwriter William Goldman famously remarked about the film industry, "Nobody knows anything."[22]

The first variable was consumer preference. Consumer tastes were constantly in flux and having a high budget or even premium quality (from a filmmaking standpoint) did not guarantee commercial success.[23] In fact, some poorly reviewed films were extremely profitable. For example, the 2009 film *Transformers: Revenge of the Fallen* received an approval rating of only 20 per cent by critics from the popular film review website Rotten Tomatoes, who described the film as “a noisy, underplotted, and overlong special effects extravaganza that lacks a human touch.”[24] However, the film still grossed over $800 million worldwide on a $200 million budget.[25] Conversely, some critically acclaimed films failed miserably at the box office. For example, the 2021 film *West Side Story* reportedly lost over $25 million on a $100 million budget,[26] despite favourable reviews and seven Academy Awards nominations, including Best Picture.[27]

Another challenge was that current events and external factors outside the control of producers, distributors, or exhibitors could have a massive impact on the commercial reception of a film. For example, in 2017, actor Anthony Rapp accused *House of Cards* star Kevin Spacey of making a sexual advance toward him when he was 14 years old.[28] After Rapp’s accusation, more than 30 individuals came forward with their own allegations that Spacey harassed, groped, or assaulted them.[29] In light of the accusations, director Ridley Scott removed Spacey’s supporting role in his already-completed film *All the Money in the World* and re-filmed scenes with Christopher Plumber as a replacement. However, the film *Billionaire Boys Club*, distributed by the US distribution and production company Vertical (owned by Arc Entertainment LLC) had been filmed two years earlier and proceeded with its theatrical release, with Spacey in a leading role.[30] On its opening weekend, the film grossed a meagre $618 domestically in 10 theatres.[31]

ABOUT LEVELFILM

levelFILM was an independent film distributor based in Toronto, Ontario. The company was formed in 2013 by Michael Baker, an English and cultural studies graduate from McGill University, and David Hudakoc, an HBA graduate from Ivey Business School. As an independent Canadian film distributor, levelFILM’s major competitors included Mongrel Media, Elevation Pictures, Vortex Productions, VVS Films, and MK2 Productions, all of whom had released various notable films across Canada (see Exhibit 2).

Each year, levelFILM typically released 10 to 20 films in theatres, with their other titles being released directly to streaming and rental platforms. Box office proceeds from theatres were a significant portion of the company’s annual revenue. In 2022, the films levelFILM acquired for release in theatres ranged widely in cost, from approximately CA$10,000 to CA$350,000, for an average of CA$60,000 per film. The genres of films that the company distributed consisted mainly of drama and comedy, plus some romance and thriller films (see Exhibit 3). According to Attard, drama and comedy provided the bulk of films for independent distributors. However, he had noticed that some of levelFILM’s larger competitors, such as Elevation Pictures, were investing in various other genres, such as action and horror.

PORTFOLIO STRATEGIES IN THE FILM BUSINESS

Diversified Portfolio Approach

The high volatility of the film industry led to a level of concern about risk among the industry’s executives. However, film companies had been able to manage quantifiable risk through their product portfolios since the 1920s.[32] The portfolio approach helped shift the risk objective from the highly uncertain success of any one project to a broader success rate of the entire portfolio. Generally, most films were not profitable.[33] However, some films were hugely successful, which could offset losses incurred by most films in the portfolio.

A film company's decision-makers aimed for a "idiosyncratic" or diversified portfolio by making the risk associated with various specific films unrelated to each other.[34] For example, a film portfolio that consisted exclusively of horror films could be riskier than a portfolio that was balanced across genres because certain risk factors could have an impact on all films in that genre. The aim of decoupling the risk factors of various products within a portfolio, commonly known as diversifying an investment portfolio, helped mitigate risk by ensuring that any one risk factor did not harm the entire portfolio (see Exhibit 4).

Blockbuster Approach

In her book *Blockbusters: Hit-making, Risk-taking, and the Big Business of Entertainment,* Harvard professor Anita Elberse suggested that making large investments in a few blockbuster projects was an ideal strategy in the entertainment industry.[35] Her theory countered the traditional diversified portfolio approach. Elberse accepted that "flops are inherent in a blockbuster strategy," but cautioned against taking a low-risk approach, "Although there is no way to play it safe in the entertainment industry, a blockbuster strategy is the safest way to play. In investing, we intuitively think we should make a number of small bets . . . [but] people aren't talking about the smaller movies that failed to overcome their costs. If you add all the smaller bets that didn't pan out, you'd see a worse failure rate than for the larger bets."[36]

Many major studios typically adopted the blockbuster approach. For example, various releases from large studios in recent years seemed to fall under the genre of action or adventure and often consisted of the next instalment from a popular franchise (e.g. *Star Wars* Franchise, Marvel Universe series, James Bond series). The studios that released these films generally made large investments in production, marketing, major stars, and intellectual property. This approach tended to follow the traditional adage of "striking while the iron is hot." Knowing that familiar cultural remakes and franchise instalments had built-in audiences, the studios stood to generate higher box office revenues than with an original screenplay, while also reducing some of the risk associated with a wide theatrical release.[37] Many large studios were growing larger through consolidation, arguably to make implementing such a strategy more feasible. For example, in 2019, Walt Disney Pictures acquired Twenty-First Century Fox Inc. for over $70 billion.[38]

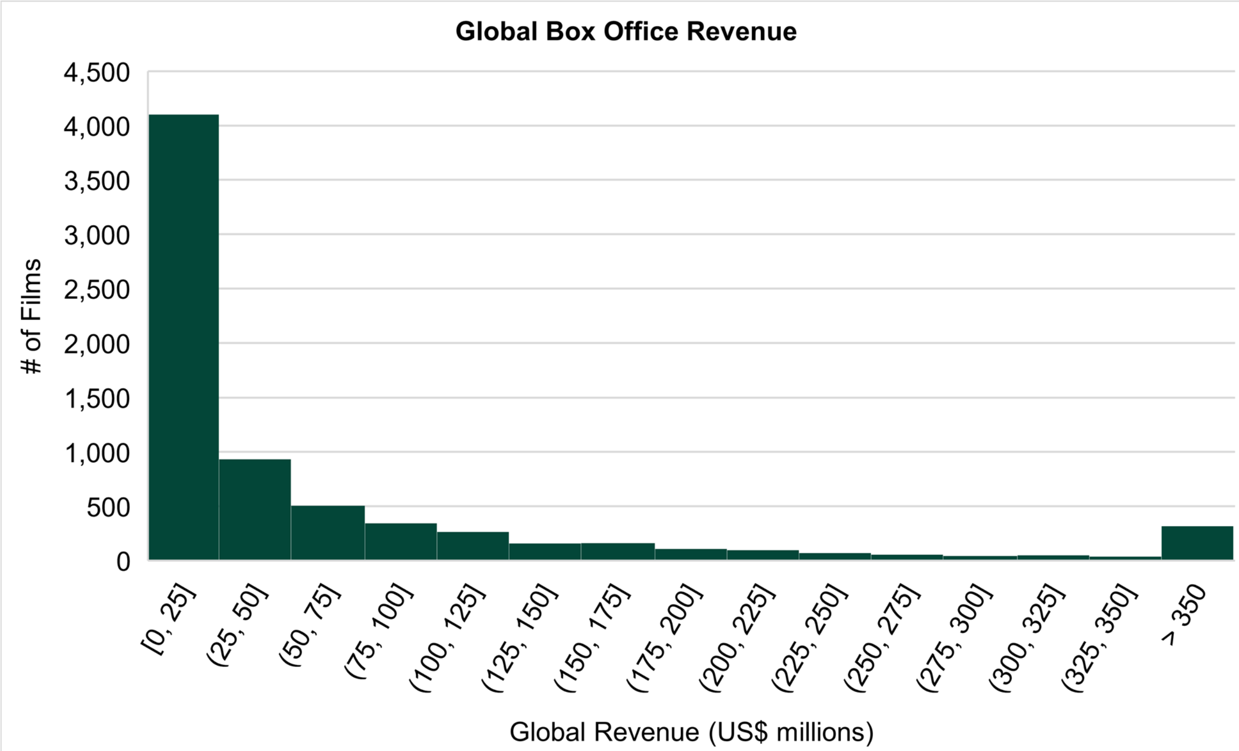
However, the blockbuster approach also had its limits. In the 1990s, the US independent production company Intermedia Films adopted an "all-eggs-in-one-basket" philosophy by investing heavily in one project at a time and then using the investment proceeds to fund the next project. The strategy left Intermedia Films highly exposed to risk with each project. Ultimately, the company was forced to declare bankruptcy, after just two major box office failures.[39]

LOOKING TO THE FUTURE

Attard sat back and wondered whether levelFILM's recent box office performance warranted a change in the company's acquisition strategy. He understood the merits of following a blockbuster strategy but wondered if levelFILM had the needed access to capital, intellectual property, and risk tolerance to apply it effectively. levelFILM could opt for a diversified and efficient portfolio, but how would Attard use data to assess which films the company should acquire? How would this strategy impact levelFILM's current portfolio?

Attard had access to historical film data for over 40,000 releases between 1915 and 2017 (see Exhibit 5). Could he use this data to make a strategic decision for his company? What constraints should he use in his analysis? As he prepared to start his analysis, Attard had to wonder if Goldman was right in concluding that "nobody knows anything." Was the film industry too erratic to predict? Could analytics help an independent film distributor like levelFILM effectively manage risk?

EXHIBIT 1: DISTRIBUTION OF GLOBAL BOX OFFICE REVENUE



Source: "The Movies Dataset", Rounak Banik, accessed May 16, 2023, https://www.kaggle.com/datasets/rounakbanik/the-movies-dataset.

EXHIBIT 2: SELECTED COMPETITOR RELEASES

Distributor	Title	Theatrical Release Date
Elevation Studios	*Moonlight*	September 10, 2016
Elevation Studios	*The Imitation Game*	December 25, 2014
Elevation Studios	*Midsommar*	July 3, 2019
VVS Films	*I, Tonya*	January 5, 2018
VVS Films	*The Gentlemen*	January 24, 2020
VVS Films	*After*	April 12, 2019
VVS Films	*The Lighthouse*	October 25, 2019
Mongrel Media	*Call Me By Your Name*	December 15, 2017
Mongrel Media	*Ex Machina*	April 24, 2015
Mongrel Media	*Midnight in Paris*	June 3, 2011
Mongrel Media	*Manchester by the Sea*	November 25, 2016

Source: "Moonlight," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt4975722/; "The Imitation Game," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt2084970/; "Midsommar," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt8772262/; "I, Tonya," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt5580036/; "The Gentlemen," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt8367814/; "After," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt4126476/;"The Lighthouse," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt7984734/; "Call Me By Your Name," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt5726616/ 2520Name; "Ex Machina," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt0470752/; "Midnight in Paris," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt1605783/; "Manchester by the Sea," IMDb, accessed May 16, 2023, https://www.imdb.com/title/tt4034228/.

EXHIBIT 3: LEVELFILM'S CURRENT FILM PORTFOLIO

Genre	Percentage of Portfolio
Drama	35%
Comedy	30%
Romance	15%
Thriller	13%
Other	7%

Source: Company files.

EXHIBIT 4: PORTFOLIO FORMULAS

Suppose that there are n assets. An asset i has a rate of return r_i with a standard deviation of σ_i. Assume that the covariance between asset i and j is denoted by COV_{ij}. A portfolio is constructed based on these assets, where each asset is assigned a weight w_i. The weight represents the proportion of value it represents in the portfolio. Under this setup, the following formulas can be used to find measures of risk and return:

Expected Portfolio Return = $\sum_{i=1}^{n} w_i\, r_i$

Portfolio Standard Deviation = $\sqrt{\sum_{i=1}^{n} w_i^2\, \sigma_i^2 + \sum_{i=1}^{n} \sum_{j=1, i \neq j}^{n} w_i\, w_j\, COV_{ij}}$

For example, with 10 assets, and a simplifying assumption that returns between assets are independent (i.e., their covariance is 0), the formulas simplify make the following calculations:

Expected Portfolio Return $= w_1 r_1 + w_2 r_2 + \ldots + w_{10} r_{10}$

Portfolio Standard Deviation $= \sqrt{w_1^2\, \sigma_1^2 + w_2^2\, \sigma_2^2 + \ldots + w_{10}^2\, \sigma_{10}^2}$

Portfolios can be assessed by their efficiency; an efficient portfolio is one which provides the highest level of returns given a certain level of risk.

Source: Thorsten Hennig-Thurau and Mark B. Houston, "Creating Value, Making Money: Essential Business Models for Entertainment Products," chap. 6 in *Entertainment Science: Data Analytics and Practical Theory for Movies, Books, Games, and Music*, 1st ed. (Cham, Switzerland: Springer, 2019), 206–16.

EXHIBIT 5: SAMPLE FILM BOX OFFICE DATA

Film Title	Genre	Release Date	Budget (US$)	Global Box Office Revenue (in US$)	Tagline	Runtime (Minutes)
Avatar	Action	December 10, 2009	237,000,000	2,787,965,087	"Enter the World of Pandora."	162
Star Wars: The Force Awakens	Action	December 15, 2015	245,000,000	2,068,223,624	"Every generation has a story."	136
Beauty and the Beast	Family	March 16, 2017	160,000,000	1,262,886,337	"Be our guest."	129

Note: Each film's row is replicated for each genre type that it is.
Source: "The Movies Dataset", Rounak Banik, accessed May 16, 2023, https://www.kaggle.com/datasets/rounakbanik/the-movies-dataset.

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