

Return of the Ogre: How DreamWorks Misjudged DVD Sales of Its Monster Hit ---
Fast-Changing Market Led Studio to Overestimate Demand for 'Shrek 2' --- A CEO's
Tough Lessons

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Last November, DreamWorks Animation Chief Executive Jeffrey Katzenberg power-talked his way through the flashy Beverly Hills eatery Spago at an event to promote the DVD release of his company's hit "Shrek 2." Flanked by the animated film's superstar voices, Mike Myers and Eddie Murphy, Mr. Katzenberg was on a mission to make "Shrek 2" as big a smash on DVD as it had been in theaters.

It worked -- for a while. The "Shrek 2" DVD made a killing over the holiday season, and DreamWorks put out a statement about the records it had broken in the important DVD market, now the most profitable piece of the movie business. But Mr. Katzenberg's enthusiasm ran ahead of itself. Earlier this year, DreamWorks got a shock as retailers started returning millions of unsold copies of the DVD. The Glendale, Calif.-based animation studio dropped a bombshell on May 10 when it disclosed the news. In just its second quarter since becoming a public company, DreamWorks fell short of earnings forecasts by 25% and its stock tumbled as Wall Street wondered why the mistake wasn't disclosed sooner.

The miscalculation by DreamWorks, a company founded by some of the biggest names in Hollywood, highlights how the fast-changing DVD market has become increasingly difficult for studios to navigate. After an aggressive campaign to promote and ship "Shrek 2" discs -- emblematic of Mr. Katzenberg's drive to expand the DVD market -- DreamWorks failed to adjust for a sea change that finds new titles burning out much faster than they did at the start of the decade. It stuck to generous forecasts for how the title would perform after its initial release, and assumed that "Shrek 2" would continue selling strongly.

Five years ago, a typical new DVD release would rack up about one-third of its total sales during the first week of release; the figure was even lower for animated movies, which tended to have longer legs. DVD sales would then steadily mount over weeks or months. But these days, DVD releases are generating a huge percentage of their total sales -- typically over 50% and in some cases, up to 70% -- in the first week. The reason for the change: intense competition for shelf space, as both movie studios and TV producers unleash a flood of new discs every week. DVD sales are now mimicking the big-bang nature of the theatrical business, where movies make most of their money in the first few days before being knocked out by a slew of newcomers. When a DVD title stops selling,

major retailers are quicker these days to send unsold copies back to make way for new titles. So while DreamWorks shipped tens of millions of "Shrek 2" discs, retailers started returning them once the title showed signs of running out of gas. "Shrek 2" sold 33.7 million DVD and VHS copies world-wide in its first eight weeks -- but only 1.3 million in the first quarter of 2005. "The DVD business has become extremely difficult to predict," says Tom Adams, of Adams Media Research, who abandoned his practice of forecasting the sales of major releases. "The 'Shrek 2' episode gives a rare peek into the phenomenon that drives profitability of the studios but that's usually hidden from view."

DreamWorks isn't the only studio to see hot titles slow down quickly. Huge holiday DVD hits such as "Spider-Man 2" and the latest "Harry Potter" also cooled in the new year. But because DreamWorks Animation releases only two films a year, the effect of miscalculating how big a title will be is substantial. By contrast, most other studios are shielded from the same scrutiny because they are part of much bigger companies. (DreamWorks Animation's sister company, closely held DreamWorks SKG, makes live-action movies.) It wasn't unreasonable to have high hopes for "Shrek 2." The sequel about the green ogre was the biggest box-office hit of 2004, bringing in \$920 million world-wide, almost twice as much as the original. "Shrek 2" went on to become the top-selling domestic DVD of 2004, according to Nielsen Entertainment. In January, DreamWorks said it had sold 37 million units world-wide, but that number later turned out to be too high. Studios usually book DVD revenues when they send the discs out to retailers. But retailers don't actually pay for the DVDs until 60 or 90 days later. Retailers can usually send back what they don't sell. Studios make a provision for returns, but if returns are higher than expected, studios can come up short. Studios bear the cost of shipping unsold units back to the warehouse -- which means that retailers can often be persuaded to take more, rather than less, stock.

For Mr. Katzenberg, the "Shrek 2" miscalculation is a hard lesson in running a public company. For a decade, he operated DreamWorks as a private concern with partners Steven Spielberg and David Geffen. The fallout from previous foul-ups -- like the studio's 2003 bomb "Sinbad: Legend of the Seven Seas" -- was largely hidden from view because DreamWorks was closely held. The businesses Mr. Katzenberg headed earlier in his career at Walt Disney Co. and Paramount Pictures were within the operations of much larger companies. "This company is still very new at the publicly held game," said Harold Vogel, a veteran film-industry analyst who heads Vogel Capital Management. "This has been very damaging from the standpoint of investor confidence." Mr. Katzenberg and other DreamWorks officials declined to comment for this article. A spokesman said the company is in a quiet period because of a coming stock offering.