Digital Distribution Troubles Home Entertainment Market

By Ethan Tussey

13-17 minutes

Digital distribution is the fastest growing area of the home entertainment market. Industry analyst In-Stat predicts that by 2014, digital businesses will generate the majority of home entertainment revenue. The entertainment industry, however, is transitioning to digital distribution with caution, because the sales of digital products are not yet robust enough to replace still-profitable revenue streams like DVD. The industry is faced with the challenge of growing digital businesses at the same rate their traditional businesses are declining. Entertainment companies are attempting this balancing act by strategically pursuing new opportunities while guarding existing business models.

Here are five things you need to know about home entertainment:

1. Hollywood studios are choosing different strategies for balancing traditional businesses with emerging digital opportunities.

2. The digital distribution market is more complex than previous

home entertainment markets.

3. Netflix redefined the price and convenience of home entertainment.

4. Critics claim lower cost rentals hurt below-the-line laborers.

5. Anxiety about cord-cutting is not supported by numbers or cable executives.

1. Hollywood studios are choosing different strategies for balancing traditional businesses with emerging digital opportunities.

The entertainment industry is experimenting with ways of propping up existing business models while building new digital revenue streams. At the Blu-ray market focused Blu-Con 2.0 Conference in November 2010, the presidents of five Hollywood studios — 20th Century Fox, Lionsgate, Sony Pictures, Universal Pictures and Warner Bros. — agreed that protectionist strategies, in which studios keep new release DVDs off of low-cost rental services, are producing positive financial results. However, Mike Dunn, president of Fox Home Entertainment, cautioned his fellow executives that consumers can become "confused or frustrated" with all of the different ways Hollywood is slicing up the home entertainment pie, which can hurt sales. Some of the strategies these companies are using to navigate the transition to digital home entertainment are:

- Toy Story Multi-Disc Pack
  Toy Story Multi-Disc Pack

Multiple Disc Packs and **Disc On Demand**: a variety of formats

— DVD, Blu-Ray, Digital Copy, and 3D-Blu-Ray — in a single purchase. These packs are an attempt to support existing business models while encouraging consumers to invest in new technology.

- **Revenue Sharing**: Paramount-Viacom was the first to enter into a revenue-sharing trial with Redbox when it signed a distribution deal with the DVD rental service in August 2009. In June 2010, the studio extended the deal, in which it provides Redbox with its DVDs for rental the same day the titles go on sale, until 2014.
- **Cloud Storage:** options that allow consumers to purchase the digital rights to content and access it from a variety of media platforms
- **Premium On-Demand** Services **(or "Home Theater on Demand"):** a distribution window that allows films to be available in the home while they are still in theaters
- **28-Day Windows:** a distribution delay agreement between some studios and Netflix and Redbox in which the rental services agree not to offer new-release DVDs and Blu-rays until 28 days after their official on-sale release date. In exchange for waiting, these rental services receive cheaper wholesale pricing and added streaming content. Some home entertainment executives appearing at the Blu-Con 2.0 conference claim this agreement has resulted in a 10 to 15 percent increase in new-release DVD and Blu-ray sales.

There is little consensus over the effectiveness of any of these strategies. The 28-day window is particularly contentious. Robert Iger, president and CEO of Disney, has stated that the 28-day window offers no economic advantage to the studios, the key reason Disney has to participate. On the other hand, in February 2011 Jeff Bewkes, CEO of Time Warner, expressed interest in extending the waiting period even longer to further boost Warner Bros. profits. Comparing the DVD sales for Fox's *Avatar* and Summit's *Twilight: New Moon*, both top-selling DVDs of 2010, it would seem that waiting periods ultimately have little bearing on the disc sales for blockbuster films as *Avatar* had a waiting period and *Twilight* did not. As of July 2011, 20th Century Fox, Time Warner, and Universal each employ 28-day windows while Disney, Paramount, Lionsgate, and Summit do not. In June 2011 Sony entered a 28-day window agreement with Netflix after performing a four-month test of select titles to see if the 28-day delay generated enough revenue to justify the licensing discounts Netflix and Redbox demand.

Read Home Media Magazines complete coverage of the Blu-Con 2.0 panel

Also, In March 2011 *The Economist* explored the evolving home entertainment business arena

2. The digital distribution market is more complex than previous home entertainment markets.

Digital distribution is unlike any previous "category" of home entertainment products. According to In-Stat, the digital distribution category is defined by a variety of products and experiences:

- *Transaction Video on Demand (T-VOD) encompasses online TV* *rentals, pay-TV VOD rentals, and pay-per-view*

- *Subscription VOD (S-VOD) includes online video subscription services, premium TV channels, as well as free VOD with a pay-TV service*
- *Electronic Sell-Through (EST) covers the purchase of TV and movie content, independent of subsequent content delivery methods*

While this variety gives consumers more control and choice over their home entertainment experience, it can also deter consumers because digital products are restricted to specific formats and devices. Ryan Lawler, writing for NewTeeVee, describes the problem: "If a user finds that he can't get the content he wants on the device he wants — for instance, getting a movie purchased from CinemaNow to play on an iPhone — it will be difficult to get him to use a supported service to buy content more than once." Previous home entertainment technologies had standardized price ranges and player devices. But a digital purchase is constrained by the companies, devices, and platforms of their partnered digital retailer. Despite this considerable difference in distribution technology and design, market analyses, such as those shown in the charts below, favorably compare the growth and revenue of digital distribution to that of the more universal DVD market.

Home Entertainment Spending 2010 thru 3Q

(Compared to 2009)

Disc Purchases	**Disc Rentals**	**Digital Distribution**

$6.5 Billion		$4.4 Billion		$1.7 Billion	
DVD	Blu-ray	DVD	Blu-ray	Sell-Thru	VOD
Down 8%	Up 80%	Down 4.4%	Up 40%	Up 37%	Up 20%

As Reported in Home Media Magazine

(Oct. 21, 2010)

As Reported in DEG 2009 Report

Determining the value of the digital distribution market is further complicated by revenue reports, which typically do not differentiate digital services from other home entertainment products. For example, Netflix had historically reported all of its revenue as DVD "rentals" despite the fact that their subscribers stream video more than watch physical discs. In the summer of 2011, Netflix seperated its streaming and DVD subscription businesses to better reflect the different costs of the services. It is likely that they will begin reporting the revenues from these two different businesses separtely in the future. Netflix's decision to seperate out its streaming services is unique, companies throughout the industry continue to conflate their digital services with their other products:ESPN3, Comcast's Xfinity, and DirectTV's NFL Sunday Ticket to Go are all digital services exclusively available with cable/satellite subscriptions. It would be easier to define and assess the digital market if each of these services were available and evaluated as separate digital products.

See how digital revenues are reported in analysis from DEG and In-Stat

3. Netflix redefined the price and convenience of home entertainment.

Netflix became an industry leader by changing the way consumers experience home entertainment. In his post-mortem analysis of Blockbuster, NewTeeVee reporter Ryan Lawler argues that Netflix vanquished the brick-and-mortar behemoth because its mail delivery service was more convenient than a trip to the video store and also cheaper, thanks to the low monthly subscription fee. Mike Fleming of Deadline Hollywood Daily makes a similar assessment, adding that Blockbuster adopted kiosks and streaming services far too cautiously to seriously compete. Comparisons between Netflix and Blockbuster highlight the way the former brought home entertainment into the everyday routines of its consumers (e.g., picking up the day's mail) and avoided the costs of physical stores by distributing their products through the mail and, in time, through streaming devices.

Rental kiosks ("automated retailing") and video-on-demand (VOD) services are two segments of the home entertainment market benefiting from Netflix's example. Rental kiosk revenues grew by 55 percent from 2009-2010 because services such as Redbox situate their merchandise in convenient, busy locations and keep prices down by automating their services. VOD services offer similar convenience and pricing. In June 2009, Erik Gruenwedel of *Home Media Magazine* saw that studios were increasingly investing in electronic rental services because consumers in the current economic climate were showing a preference for inexpensive, on-demand programming as opposed to pricier sell-through options. These newer services will get more expensive, however, as entertainment studios begin charging more for streaming licenses as demand increases. In addition, the low subscription tiers Netflix pioneered may have allowed them to gain a majority of the rental market, but at a cost: In November 2010, Will Richmond of Video Nuze pointed out that low fees have hurt Netflix's per-customer profits. Companies looking to replicate Netflix's convenience and pricing will need to attract enough customers to balance low per-customer income with higher licensing fees.

Read more about Netflix's business strategies from Silicon Alley columnist Dian L. Chu

4. Critics claim lower cost rentals hurt below-the-line laborers.

LAEDC Report on Low-Cost DVD Rentals

A 2009 report commissioned by the Los Angeles County Economic Development Corporation (LAEDC) argued that the devaluation of the home video market via rental services would devastate the production of entertainment content and thus, the local economy in which Hollywood productions play a crucial part. The report claims that Redbox's $1 price point poses a serious threat to production financing, the majority of which comes from home video revenues. As a result of this devaluation, the report predicted the following negative consequences:

- The loss of at least $1,493 million in economic output (as measured by business revenues)
- The reduction of at least 9,280 jobs with annual earnings of almost $395 million, of which at least 2,290 would be in motion picture and sound recording industries with earnings of at least $109 million
- Losses of up to $35.4 million in contributions to health and welfare funds for guild and union members, the majority of which would occur in union plans for below-the-line employees
- A deduction of over $30 million of tax revenues at state, county, and local levels

There are reasons to interrogate to these findings: LAEDC is essentially a lobbying group, and critics have questioned the methods used to compile these figures. Redbox, for instance, challenged the assumption that its kiosks will channel consumers away from sell-through options. (This assumption is responsible for the majority of losses predicted in this study.) In addition, in January 2010 *The Wall Street Journal* published a poll that found the market for renters at that point had, in fact, expanded, suggesting that the “channel conflict” may not be as devastating as the LAEDC was predicting.

5. Anxiety about cord-cutting is not supported by numbers or cable executives.

Redbox Kiosk

"Cord-cutting" — the decision of consumers to end cable/satellite television services because of dissatisfaction with pricing and content options — has received a lot of attention from the entertainment industry. Market analyst Peter Kafka believes digital home entertainment services are responsible for declining cable subscription numbers. "Over-the-top" (OTT) Internet-based services like Netflix, Hulu Plus, GoogleTV, AppleTV, Roku, ESPN3, and "convenience" kiosk services like Redbox have provided consumers with alternatives to cable and satellite. Both types of services give customers on-demand access to much of the same programming available on cable/satellite. This has led some observers to predict that cord-cutting is inevitable and will become a major challenge for cable and satellite companies. Despite doomsday predictions for these technologies, cable executives and market analyses maintain cord-cutting is far from a reality. In June 2011, Viacom CEO Philippe Dauman asserted that even in the depths of the recent recession, pay-TV viewing stayed strong, claiming it was the last thing most households were willing to cut back on.

Meanwhile, Nielsen studies have demonstrated that heavy viewers of over-the-top video, which is video watched through an Internet "channel," are also more likely to watch traditional television than other consumers. The evidence suggests that digital distribution options provide one more way to receive content rather than simply being a replacement for cable services. Still, tensions are not likely to ease: Deals such as

Netflix's 2010 two-year arrangement with EPIX, which makes Netflix the outlet for over 1,000 major studio titles that EPIX also distributes to cable operators, proves the competition continues for pay-cable viewers' cash.

For more on cord-cutting, check out NewTeeVee's web series on the subject