SUMMER/FALL 1999

**Conversations with:** Thomas Freston, Susan Berresford, Alan "Ace" Greenberg

# STERN*business*

## That's Entertainment:

an in-depth look at what all the industry changes really mean.

# a letter from the dean

Why devote this summer issue of STERN*business* to the entertainment industry? There are two reasons: First, Stern has many distinguished alumni in entertainment, media and technology (EMT). Second, we are committed to preparing the next generation of leaders in a field which has grown from a cottage business to a global industry.

In fact, the emphasis in the magazine reflects the specialized track in our curriculum. A little over two years ago we established the first EMT program in the country to educate and train both MBAs and undergraduate students for careers in these industries. We currently offer more than a dozen EMT courses in the areas of marketing, finance, accounting, economics and information technology.

These are some of the more popular electives for our students. They also attract students from the NYU Law School and the Tisch School of the Arts. We established links with the Tisch School of the Arts to insure students understand both the business and creative sides of these important industries.

The EMT program is among several exciting initiatives the Stern School has embarked on recently that have helped establish us as one of the premier business schools in the world.

As Professor Lieberman points out in his article, worldwide entertainment revenues are now $300 billion. Given the size of the industry, our location in New York City – the center of media and communications – and the fact that entertainment is now a leading American export, we are proud of our decision to train the next generation of leaders.

We are pleased to bring you this issue.

George Daly
Dean

STERN*business*

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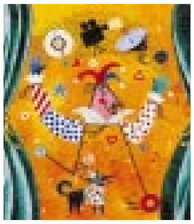
## That's Entertainment:

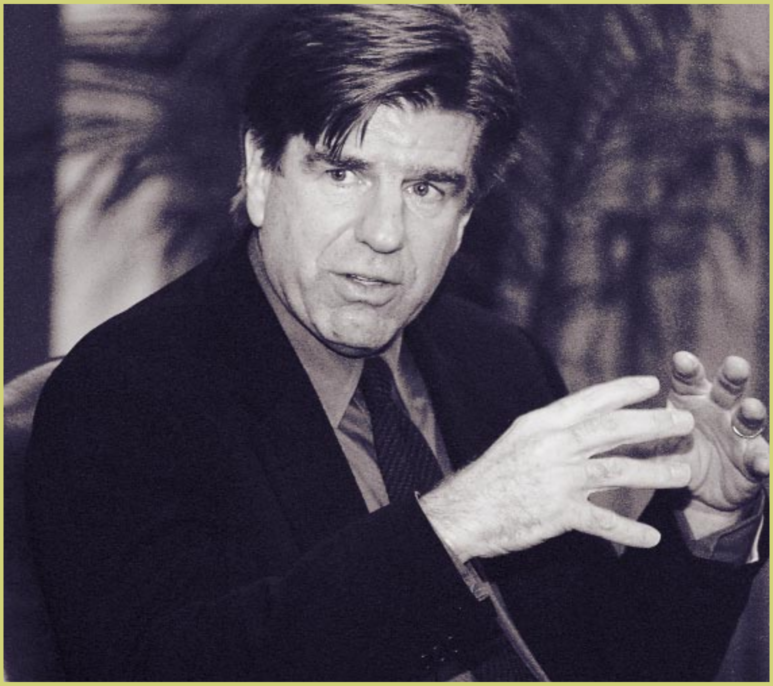




*Cover illustration by Tazewell*

# Thomas Freston

## chairman & ceo MTV



As chairman and chief executive officer of Viacom's blockbuster MTV Networks, Thomas Freston (MBA '69) provides international audiences with the world's leading niche-television programming. Surrounded by a staff of creative Gen-Xers, Freston is taking the enterprise into global markets where its innovative MTV, Nickelodeon and VH1 networks; movies; animation; on-line services; books; toys and home videos combine for a total venture that today is worth about $9 billion.

Freston began his career in advertising and moved to New Delhi, India where he established a textile and clothing business, a venture he ran for eight years. Upon his return to the United States, he answered an ad in *Billboard* looking for people to start a music video channel. He joined Warner AMEX Satellite Entertainment, a predecessor company to MTV Networks, in 1980.

One year later, as one of the original founding members, Freston helped launch MTV Music Television. As head of marketing, he oversaw the famous "I Want My MTV" campaign, which propelled the channel into what is now the world's largest global entertainment network. Freston was appointed CEO in 1987 and has successfully driven MTV Networks into new markets, both domestically and overseas.

**ML:** *You are known for creating and preserving a free-flowing corporate culture, where ideas count and where even the interns get heard.*

*As one of your top managers says, "It's a real challenge to maintain your guerrilla flavor when you've become the great corporate money maker." How do you do that?*

**TF:** Having a non-hierarchical type of organization, I think, is really one of the cornerstones of what has kept us successful over the years. In some sense, you have to remember the mediums we deal with – music, young people, Nickelodeon or kids – all of it comes off the street, so we tend to listen to lots of voices when we make program decisions and marketing decisions. It's just in the air.

It seems to me that if you can create a culture in which people still think they're in an entrepreneurial place where ideas count, where people can feel some passion for their work, it differentiates you

**Marshall Loeb**, the former managing editor of *Money* and *Fortune*, conducts a regular series of conversations with today's leading chief executives on the Stern campus.

from most other companies, because a lot of people in entertainment believe that companies are almost interchangeable these days.

As you have more and more consolidation into these megamedia companies, they become more and more impersonal. They almost become bunches of people working behind some logos. Our approach is to try and be different.

**ML:** *Your programming costs are quite low, is that correct?*
**TF:** For music videos. But we do spend an awful lot of money. It's funny, we spend more money, in many ways, on promotion than a lot of other people might do. And we also do a lot of original programming, be it our musical performance series, or MTV news specials, or non-music shows like "*The Real World,*" things like that.

**ML:** *I think much of this audience, but not all, know your five basic components. Please give us a brief rundown of the structure of the company and the role each one plays.*
**TF:** Well, there's MTV, which is our namesake, which now has 16 different feeds throughout the world. MTV reaches about 330 million homes. Nickelodeon is really our biggest business. That's focused on kids up to age 15, and it's the number one cable network in the United States in terms of ad sales and ratings. Nickelodeon has a rating of about 1.9, which is the highest among any of the cable networks. On a Saturday morning when everyone is programming against us, we'll beat ABC, CBS, Fox, on an absolute basis. VH1 is another business that we have, which is basically sort of MTV for people who graduated from it.

**Rap** music has become easily the **most pervasive cultural force** in music today.

**ML:** *But is it for baby boomers or the Gen-Xers or whom?*
**TF:** 25- to 40-year-olds are really the core of the VH1 audience, the people we originally created MTV for 17 years ago. That has become a very good business for us. It sort of languished for many years, but it found its voice and an identity, and we're really happy. It's probably the fastest growing part of our company.

We have Nick at Nite, which is classic TV that is packaged in a unique way. There's a thing called TV Land, which we just launched last year, which is a 24-hour classic TV channel. It's now in about 40 million homes. We have M2, which is a companion music network to MTV.

Those are our basic businesses in terms of trademark. Now, we have movies, home video, on-line operations, as businesses related to those trademarks. And we view our business as a global business.

**ML:** *We'll get into some of those global networks in a moment. But you've got these terrific brand names, like MTV and Nickelodeon, among others which you've mentioned. How are you trying to extend those brands into other services and other products?*
**TF:** We have a big movie, our first animated movie; this is a big deal for us. "*The Rugrats Movie"* was probably the biggest single deal we have done. But related to "*The Rugrats*," which is a big series on Nickelodeon, we have macaroni and cheese in the stores, Plush Dolls and other things. I will add though, that a lot of classic TV animation's real purpose has been to be an advertisement for toys.

Our approach originally was to set Nickelodeon up as a network that sort of expanded pro-social values. It is gender-neutral. There is no violence on it. We would not make a property for the purpose of selling toys.

**ML:** *But you're selling a lot of toys?*
**TF:** We're selling a lot of toys, despite those decisions.

**ML:** *What else can we expect in the future in the way of brand extensions?*
**TF:** I don't think the consumer gives us permission to be in a lot of businesses. We're in licensing and merchandising with Nickelodeon, along with macaroni and cheese and toy lines. We don't do much licensing and merchandising for MTV.

We think that the worlds of feature film and on-line companion networks for websites to our networks are probably the two biggest businesses that make the most sense for us. If the consumer gives us permission, we could use them to make our businesses bigger places. And that's where most of our efforts will be.

**ML:** *Music devours its young at a very frightening rate. Hot*

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# Susan Berresford

## president Ford Foundation

A longtime community activist, Susan Berresford has spent nearly her entire career working at the Ford Foundation. After graduating with honors from Radcliffe in 1965, she came to New York to help fight the war on poverty. She worked briefly for the New York City Neighborhood Youth Corps and for the Manpower Career Development Agency before joining the Ford Foundation as a program assistant, an entry-level position, in 1970.

She became president in 1996 and has reorganized and strengthened the Foundation's grant-making apparatus as well as instituting a more aggressive corporate outreach program. Today, Berresford presides over the nation's largest foundation with 600 employees, 16 field offices around the world, including Vietnam and Russia, and more than $7 billion in capital. It has provided more than $9 billion in grants and loans to address economic, intellectual and societal issues.

**ML:** *Tell us something about the Ford Foundation. It's a uniquely American phenomenon.*

**SB:** The Ford Foundation was created in the late '30's by the Ford family. For the first period, to 1950, it was really a small family foundation, spending its money in Michigan following the family's interests. By 1950, an enormous amount of Ford stock had come into the Foundation from Ford family members. They decided they had to rethink what the institution really was. They selected a group of people who decided it should be an international foundation, not just a local foundation. They laid out democratic values, reducing poverty, international relations, peace and democracy, as the life blood of the Foundation.

While the Ford Foundation is a uniquely American creation, now there are more and more foundations like this in different parts of the world. Some of them follow the model of growing out of a major corporate success, and the family and wealth that grew that way, and others are built out of community contributions. Now there must be 25 foundations Ford has helped to create around the world, and there are hundreds of others, so we have many counterparts.

**ML:** *I gather this is a growth industry. Are more and more foundations being created all the time, or is it a relatively small number that are being created?*

**SB**: In this country, foundations are growing very rapidly, reflecting wealth. Many countries first assumed the government would do almost everything. They now recognize that governments can't do everything, and that the nonprofit sector has to take an important role around the world. More and more, you're going to see foundations growing around the world, not just in very, very wealthy countries but also in places that have great need. We have created a foundation in Mozambique. There isn't a lot of wealth in Mozambique right now, but there is a foundation there, and people are putting resources into it. I think you'll see more and more of that.

More and more, you're going to see **foundations** growing **around the world**, not just in very, very wealthy countries but also in places that have great need.

**ML:** *I would think that ... at least argue, the greatest problem in the global world today is the gap between the haves and the have-nots. Can you tell us several of the things that the Foundation is doing to alleviate that gap?*

**SB:** I agree. I think, first of all, that the levels of poverty that countries have around the world, and that we have in our own country, are really insupportable and immoral. Ford has made the reduction and the alleviation of poverty one of our three major areas of concern, and our current approach has a very strong emphasis on asset and not just income development. Many foundations that work on poverty try to think how to create jobs, how to get people working up the job ladder. But if people don't have some assets to fall back on, and the job goes away, they fall into poverty, so what we have been interested in is stimulating home ownership and control of natural resources in countries that have fledgling economies.

For example, in this country, we have just funded a very large experiment, a $15 million grant we just made a couple of weeks ago to The Center for Community Self-Help, and it is essentially a guarantee fund for five commercial banks that will now begin to make loans to very low-wealth homeowners, first-time homeowners. We believe that there are a good number of people who can own a home, who are regular bill payers, and who have sufficient income to pay the mortgage but who have rather spotty credit histories. Our money will guarantee the loans that are made by the bank; the banks will sell the loans to this group to which we've given a guarantee function, and in turn those loans will be sold to Fannie Mae, the Federal National Mortgage Association.

**ML:** *How can the Ford Foundation work together with large corporations to reach mutual goals, such as the alleviation of poverty and the creation of wealth ... at least overseas?*

**SB:** Let's start with this country, and then go to overseas. We find it very attractive to collaborate with business groups in this country, individual corporations, and business associations, in pooling our money. Very often, corporations have an interest in building a community and addressing problems of low-income housing. They don't necessarily want to be the grantor themselves; they would like to put their investment into a third party, and have the third party use it professionally and then return it. The low-income housing issue I gave earlier is an example of it. There are banks that find it interesting to see if there's a new market to serve for mortgages to low-income people. The deal we struck for this $15 million grant is an example. The banks are going to learn what loan instruments work. They have a guarantee for a while that we're going to cover the loans that don't work.

Overseas, I think we ought to be looking more and more to business leaders and associations of business leaders who are interested in human rights, and support good business practices and ethical codes that govern behavior. We also ought to support, within the country, human rights organizations. They've got to make their own demands on foreign investors that come in. There's a trade-off. They want foreign investment – they need the investment, they want the incentive that comes with that, but they also have to protect the interests of their own people, and I think we, by investing in human rights groups and citizen groups overseas, can help that debate take place. Ultimately the country has to decide for itself how it's going to define its laws.

**ML:** *Is there more pressure on you, and more opportunity for you to undertake certain projects and programs because governments are cutting back?*

**SB:** Well, they are cutting back, and there is a lot of pressure ... to pick up things that the government is getting out of, but that is not our role. We are not a government funder. We're like an R&D funder. We try to do new things, and develop ideas from them, develop practices, help develop understanding about them, and then figure out how to apply it in the community.

## Q & A with Students

**Q:** *How does the Ford Foundation determine which groups to help, and which countries to go to, which companies to partner with?*

**SB:** The first question we ask about countries is where in the world can we learn the most about the topics, like poverty or educational reform,

*cont'd. on page 9*

sternChiefExecutiveseries

A born trader, Alan "Ace" Greenberg began his career as a clerk at Bear, Stearns & Co., Inc., in 1949 and rose within the company to become a partner at the age of 31. He became CEO in 1978. As the head of America's sixth largest brokerage house, Mr. Greenberg spends most of his time on the trading floor at Bear Stearns. He is considered one of the brightest and most dynamic experts in the field. He has long been a valued friend of New York University and the Stern School of Business and serves as a trustee of NYU.

# Alan Greenberg

## ceo Bear, Stearns & Co., Inc.

**ML:** *Let's talk a bit about the U.S. economy. Do you see a recession dead ahead, or do you think that the economy will continue to grow, however moderately, over say the next 12 months or the next 18 months?*

**AG:** I think the economy will do just fine. I think if you're a company and you're selling a lot of your product overseas, you're obviously going to have trouble because of the currency devaluation and the problems they're having. If you're a company that makes a great deal of your product overseas, of course you're the beneficiary. I'm sure that's not a pair-off. I'm sure that we sell more over there than we bring over here in terms of manufactured goods. So those companies – and you know who they are, companies like Gillette or Procter & Gamble or Coca-Cola – are having a problem right now, but basically I think the economy here is in great shape. We had some problems a few years ago. I was talking to a member of the faculty a few minutes ago about California, on its own the fourth largest country in the world, I think. California certainly had some problems a few years ago with its defense industry, real estate, high unemployment, and even that didn't really affect the rest of the United States. Right now, there are major problems with farm issues in the upper Midwest. But it hasn't really crippled the economy of New York City, certainly, or the rest of the country. So these pockets will continue, but I think that overall the country is in fabulous shape.

**ML:** *What in the world can be done to pull Russia out of the economic mess that it's in?*

**AG:** I'm not sure anything, frankly.

**ML:** *How worried should I be?*

**AG:** I don't think you should be very worried. I'll tell you why. Russia is not the Russia of 20 years ago. It used to have 250 to 280 million people. Now the thing we call Russia has about 145 million people because of the satellites that have spun off. I hate to say it, but Nigeria has a major problem. It has for years, and I don't see them coming out of it, and they have fabulous natural resources. Zaire certainly has fabulous natural resources, and I don't see them coming out of it. And I don't see Russia coming out of it. They don't collect taxes. Bribery and corruption are everyplace. The currency has gone to virtually nothing. I

There is no question the **discount brokers** are here and they're going to stay here. And there's no question that a huge part of the population **will** actually **use** them. But I would also point out to you that **there's room** in this world for Neiman Marcus and Saks, and also for the Dress Barn. So they're not going to take away our customers if we **provide a service** for our customers.

feel sorry for them, but I don't see them turning around. I hope that they do. I don't see it. I don't see Nigeria turning around, either.

**ML:** *You require employees of a certain level and above at Bear Stearns to give a minimum of 4% of their total compensation to charity. How does that system work, and why do you have it?*
**AG:** Well, that applies to what we call the senior managing directors. There are about 300 of those. And it was instituted when we were a partnership, before we went public in 1985. So I'd say it's maybe 30 years old by now. When we put it in, we thought it was fair to give back, certainly by the people who were making a lot of money. When we put this in, it only applied to about 30 people because that's how many partners we had then. And we've grown a little bit since then, obviously. But we thought it was good for the people. And the odd thing was that after doing it, in almost every case, the people gave even more.They got involved with the local library or the hospital in their town, and they became involved, and they realized the joy of giving.

**Q & A with Students**

**Q:** *The top three firms are going towards asset management and getting bigger by the day. At the bottom, especially in trading, you are getting hammered by discount brokers and discount-oriented, Internet-based brokerage houses. What's Bear Stearns strategy to tackle this problem and to expand its business in the future?*
**AG:** Well, first let's talk about the brokerage. There is no question the discount brokers are here and they're going to be here. And there's no question that a huge part of the population will actually use them. But I would also point out to you that there's room in this world for Neiman Marcus and Saks, and also for the Dress Barn. So they're not going to take away our customers if we provide a service for our customers. In this country, if you provide a service, you will get paid. You may have to ask for it, but you will get paid. So if we perform a service for our clients, we will continue to do business with them and continue to get a commission, regardless of the Internet and everything else. But we must provide a service.

The other areas of our business are all growing considerably, and in the past have been highly profitable. And I'm talking about the arbitrage business, the risk arbitrage business and the bond business and the municipal business and the conglomerate business and the movies business and the government business. But they have their ups and downs. For instance, ten years ago many guys started getting out of the municipal business. One firm had 10% of the market and they just said, "We're quitting." I couldn't believe it. They said they weren't making any money. Now, if they would have said, "We're going to start charging more. We may lose our market share," I could understand that.

The municipal business has been very good the last couple of years. Very good. So these things have their ups and downs. And I can't tell you today what part of our business is even going to be good three months from now, much less a year from now. I just think you have to have very good people in all these areas, so when the trolley comes around, they hop on and maximize the profits. That's what we really do, just trying to get better at what we're doing.

**Q:** *My question is related to the European corporate debt market. Can you comment at all on the development of the corporate bond market in Europe, particularly high-yield and non-dollar denominated debt?*
**AG:** Well, it's had its problems lately, like the high-yield market here. It's a natural outgrowth, frankly. I mean, if you can sell common stock, and you can sell high-grade bonds, why can't you sell so-called low-grade bonds and get a higher rate of return to support that higher risk and

*cont'd. on page 9*

*Thomas Freston, cont'd.*

*groups grow cold and disappear overnight. How do you go about inventing new stars?*

**TF:** It's not really our job to invent the new stars. The new stars, hopefully, invent themselves.

**ML:** *Well, you pick obscure groups and individuals and give them positions on MTV and pretty quickly they become quite popular.*

**TF:** They only become popular if the viewers really respond to them.

**ML:** *Of all the countless groups and individuals out there, you have to make a lot of choices.*

**TF:** Yes, at MTV, we get 70-80 videos a week to look at, and we pick maybe 15 or 20. We pick the ones that we think have the greatest probability of being successful and resonating with our audience. And there's nothing like television exposure.

**ML:** *Yes. What are you doing on the Net and how radically is the Net going to change your business?*

**TF:** I'm not sure how radically it's going to change our business. I doubt that the Net is going to eliminate the old basic television experience, where people come home and want to be entertained, and they sit down and watch what some professional group of people has programmed for them. I'm not sure that everybody wants to be involved in interactive television and invent their own sitcoms and their own endings to movies. You want to be surprised and involved by somebody else's craft and, hopefully, the movie business is picking the right people to do that. So I don't see the regular business as we know it disappearing. It will continue to change.

But we do see on-line becoming a huge new world. It is one already, but it's still a very disparate one. We think that in the next couple of years people are really going to begin to make money on it in a much bigger way, and we want to be there. With MTV and Nickelodeon, we already have the top websites in our demographic. A year ago, there were 85,000 music-related websites, just for music. And MTV is number one in terms of reach. Nickelodeon, among kids, is number one.

## Q & A with Students

**Q:** *In the past year, you've introduced a lot of music-oriented original programming, and I'm curious as to the reason behind that? Has it been successful versus just playing music videos?*

**TF:** Yes. I'm happy to say in the last two months, the amount of people who watched MTV was the highest level in any of the 17 years we've been on the air. That's largely due to a new programming approach, and a great new programming staff. We have a creative enterprise, we kind of bob and weave in terms of how successful we are or where our focus goes.

It's fair to say that MTV has made a real right turn back to its musical roots. I think we might have strayed off the path along the way, and become a little more like regular TV.

It's been very clarifying for all the people who work there, because I think there was some kind of schizophrenia before that. MTV was evolving into something it wasn't initially intended to be.

**Q:** *MTV has been taking a lot of chances on a lot of different programming options and in a lot of different shows, but I have a question about your decision to remove "Yo, MTV Raps" from your line-up. Considering the fact that MTV is a cutting-edge network and hip-hop cultures are very important in the country, why was that decision made? And also, just in general, as a CEO of a company like MTV with so much influence, what keeps you up at night? What things are bothering you about your industry and what do you think of the problems we're out to deal with in the millennium?*

**TF:** MTV was really the first outlet to put rap music on the air. We started in the early- to mid-80's with a show called "Yo, MTV Raps." We ended that in January. We had another show called "Alternative Nation" that really started in '92, that focused on the up and coming.

Rap music has become easily the most pervasive cultural force in music today. We eliminated it because rap music and hip-hop music comprise so much of our around-the-clock playlist.

Like alternative music, it's basically integrated into the mainstream. If you were to count, maybe 40%-45% of all the music you hear on MTV is hip-hop, R&B or rap music.

**Q:** *It does seem that over the past few years, you sort of lost sight of the original purpose of MTV, which was playing music videos on your principal network. I've been reading that there's now a bit of backlash among record labels, particularly with the mounting costs of video production, and the shrinking playlist, to invest the money that would have gone into video, into other forms of promotion. I'm wondering whether you see this trend continuing, and videos becoming less important as a means of promoting an album or artist, or whether you think it might be possible for an upstart music channel to steal that full-time music programming niche from you, and then music videos would continue to be important in the promotion.*

**TF:** Well, there's always a chance those will knock you out of the box, and that's something that keeps you up. We play more music now than we did last year or the year before. We're playing more music on MTV than we did five years ago.

If you watch VH1 or MTV, it isn't just music videos. We've decided there's a lot you can do in terms of other ways of presenting music on television, be that concerts or other types of programming. We have a show called "*Behind the Music*" on VH1 that's very successful. We have a show called "*Biorhythm*" which is very innovative. The record labels have said, since 1984, they were going to stop making music videos. Every year they made more. But the idea of somebody coming up and competing with us and beating us is always very real. ■

*Susan Berresford, cont'd.*

that we want to work on. Where is the most interesting thing happening? For instance, we recently opened an office in Hanoi, and another office in Moscow. Those are new offices for us. We went there because we thought we'd learn a lot from being there. We are going to stay there now. Even if it isn't as good a learning environment, we will stay there for at least ten years because we're going to learn from the ups and downs, the peaks and valleys that societies go through.

Second are organizations; we look for organizations that have fresh ideas, strong leadership and the capacity to build some kind of a track record that adds up in the end, and is related to other groups around the world or in the country. Our staff are out and around all the time. The staff mostly are out, and they are talking to people in the communities, they're responding to mail. We get 50,000 requests a year just in the mail, and we make 1,500 grants a year, so there's this huge flow of interesting things, most of which you have to say no to. You're creating this huge wake of disappointed people every year but those are things you learn, and our system is very, very decentralized.

**Q:** *To what extent, if any, do you think it's possible to get those corporations to be starting these projects on their own, without you or some other non-profit guiding them through the whole process?*

**SB:** Well, some do. I think there are some corporations that are fantastic social lenders, social grantors. Where I think they will be reluctant is putting large amounts of money into significant organizations. They prefer to have some kind of partnership with other donors, other corporations and foundations, and I understand that. We are in the business of developing non-profit systems, and corporations are in the business of making money, and if they are prepared to put some of it into a social purpose fund, it's entirely appropriate for us to try and help create those systems and those funds with them. I don't think it's a shortcoming, or a failing if they're not willing to put staff work into it. It's a condition of responsibility. ■

*Alan Greenberg, cont'd.*

so forth. The spread, as I'm sure you've read, between all corporate debt – whether high-grade or low-grade – in U.S. Treasuries has widened considerably. Because of the problems throughout the world and the stock market here, there was a so-called flight for safety, so the U.S. Treasuries have been very strong. ■

# Do You Believe in Magic?

Michael Eisner, chairman and CEO of the Walt Disney Co., knows a thing or two about entertainment.

As head of the world's second largest (behind Time Warner Inc.) but most well-known media and entertainment company, Eisner oversees entertainment in just about every guise you can imagine. There are the theme parks and movies; the Disney channel and ESPN on cable; ABC is one of the major television networks; Hyperion is now a big player in book publishing, and there are numerous magazines as well. The company is a radio syndicator, a growing force in interactive media, and has become not only a major sports promoter but a force on Broadway as well, through shows such as *The Lion King* and *Beauty and the Beast*.

Given all this, we were intrigued with the answer Eisner gave when the authors of a new business book, *Lessons from the Top: In Search of America's Best Business Leaders* (Doubleday), asked him: "Who do you consider to be Disney's competition?"

"I think anybody dealing in the leisure world, or the education world, or the world of dealing with people's available time is a competitor. It can be a motion picture company. It can be a music company. It can be a broadcast company. It can be an Internet company. It can be a hardware company that has aspirations to be in software. It can be Microsoft or a phone company. Every industry is in competition for people's time, whether they're shopping at a mall or going to a sporting event."

Eisner's answer goes a long way toward explaining Disney's success. It also goes a long way toward explaining why we have devoted this issue of STERN*business* to the entertainment industry.

As Professor Al Lieberman correctly points out in the introduction to our package of stories, what used to be thought of as a cottage industry has turned into the playground for multibillion dollar corporations based not only here, but around the world. Bertelsmann, Newscorp, Polygram and Sony are all major factors in what is now a $300 billion global industry.

When you are talking about numbers this big, you want to make sure that everything is accounted for properly. That sets up an interesting tension. The people who run entertainment companies must be – by definition – innovative. So, how much latitude – if any – do you give them when it comes to the way they keep their books?

If you answered none, how would you book such intangible assets as brands, advertising, research and development, patents, subscriber lists, franchise fees, film libraries and foreign rights that make up the bulk of what an entertainment company is worth? Professor Stephen Ryan tack-

ILLUSTRATION BY PATRICK MILBOURN

les that question for us in his piece, *Creative Accounting*.

**Hands-on involvement** Not surprisingly, in an industry as important as this one, you can find Stern graduates everywhere. We turned to three of them for an inside look. To understand the cable industry, we wanted to learn how the established players got there, and how the new ones gain a toehold. That's why we went to Gene Klein of HBO and Liz Manne of Sundance Channel. And while we like to think we know something about magazines, Gretchen M. Tibbits, director of MC $^3$ Ventures, a division of MacDonald Communications Corp., showed us the world we grew up in is fading fast.

But of course when you think about entertainment, you think about movies and television. We asked Professor S. Abraham Ravid a simple question: If we wanted to make a fortune in the movie business tomorrow, what kind of flick should we make? His answer will surprise you.

And speaking of surprises, when it comes to television, Professors Henry Assael and David F. Poltrack argue convincingly that television advertisers are going after the wrong audiences for very understandable, shortsighted and ultimately wrong reasons.

**Summing up** What does all this mean? For that we turned to Professor Mike Uretsky. His conclusion? The evolution of entertainment into a major force in our lives – both personal and professional – was inevitable. His reasoning is intriguing.

Even if you don't believe in magic, enjoy.

PAUL B. BROWN *is editor of* STERN*business*

# THAT'S ENTERT

## What is entertainment? A definition

What's "entertainment"? ✧ Though the word itself has become an often abused cliché, it is understood by several billion consumers. ✧ That's the good news, as we start off a series of articles about entertainment and, more specifically, the entertainment industry. ✧ The bad news? Each one of those consumers has his own unique definition of what the word means. ✧ So, as a preamble to our cover package of stories, we need to settle on a definition we can all agree on. To develop one, a broad overview will help.

By **Al Lieberman**

Perhaps the best place to begin is with a definition of what it is not.

If we divide the world of entertainment into software or content, and hardware or conduit, it is clearly not the latter. That leaves out television sets, hi-fidelity components or other forms of home entertainment appliances on which content is played, viewed, listened to or interacted with. It also omits the Internet, the telephone, cable wire or the satellite dish which are all enablers.

So, where does it leave us? It leaves us here: Entertainment is the result of creative ideas and products or services that can be experienced by consumers in all languages, and across global, social and cultural boundaries.

It was best described by the late and great Steve Ross, founder of Warner Communications and architect of the merger between Warner and Time-Life which created the world's largest entertainment and media corporation.

In his last speech, at the Variety/Schroder entertainment conference, Ross described entertainment as:

"That magical experience when a film, a song, a book, an article, a soap opera, a concert, a ballet or any of the myriad forms of artistic and creative production causes one to be mentally transported, leaving behind his troubles, cares, concerns of day-to-day living, and providing reason to suspend reality, to cry, laugh or scream in terror at that manifestation called entertainment."

There are other definitions but none better. However, there are expansions upon Ross' premise, as various forms of entertainment have been generated through strategic alliances, and new forms of cooperation, between corporations and talents. The new process of linking entertainment images with rides or merchandise or electronic games, or applications of education and information has built an industrial complex with over $300 billion in


ILLUSTRATIONS BY TAZEWELL

**and exploration, to set the stage.**

worldwide revenues, half of which come from the United States.

The entertainment industry that we used to think of as a cottage business of entrepreneurs has become home to corporate giants like Disney, Time Warner Inc., News Corporation, Viacom, Sony Corporation, Seagram's Universal, Bertelsmann, GE/NBC, CBS and others.

The new players have created more than new terms such as "edutainment" and "infotainment." They have created new products and have become a strong force throughout the entire industry, especially in areas such as creating CD-ROM, and Internet programming for children, students and do-it-yourselfers. They have excelled at blending learning with fun, creating an entertaining format.

The earliest known form of edutainment on television, which occurred almost back in the pre-color era, was *Sesame Street*, and it remains – some 30 years later – at the top of the list, complemented by the A&E *Biography* series, PBS, the Learning Channel, Discovery and others of this kind.

At the other end of the spectrum, much of today's news programming is presented more as an entertainment magazine – influenced by everything from *USA Today* and *Entertainment Tonight* to *The National Enquirer* and *Hard Copy* – rather than in the hard news format we remember from watching Walter Cronkite deliver the *CBS Evening News*.

But before we revel in the detractors' point of view, let's remember the business really is still in its infancy, many of its transmission points are now no more than one or two decades old, and the enablers of the future – such as DVD, NVOD and HDTV – are still being developed and refined. These new media will offer new opportunities to enjoy entertainment and perhaps change or expand the experience.

**This much is clear** No one knows what the next hot technology is going to be. But this much is clear about the entertainment business: It has advanced the export of American culture to the entire Western world, much of the Eastern world and has been given credit by some for toppling non-capitalist regimes, bringing down the Wall and instilling the remaining communist countries with an urge to go "Hollywood."

Like current blockbusters which depict annihilation, or contact with new forms of alien life, the future of this industry will be daunting, gripping, frightening – and totally entertaining.

AL LIEBERMAN *is a clinical associate professor of marketing and the executive director of the Entertainment, Media & Technology (EMT) Program at Stern. He served 10 years as president and founder of Grey Entertainment and Media, a wholly owned subsidiary of Grey Advertising.*

**Psst, Hollywood moguls. Want to increase your chances of having a hit? Make sure your film is G-rated.**

# BAMBI AS A HEDGE

By **S. Abraham Ravid**

The future seemed perilous. Production was six months behind schedule and way over-budget, and executives at Fox were seeing shadows of *Heaven's Gate*, the 1980 Michael Cimino film that sank United Artists.

The similarities were striking. Both films featured a director obsessed with historical details who didn't seem to care about costs. (*Heaven's Gate* ended up costing more than three times the original budget.) Not surprisingly, studio executives in this case wanted to hedge their bets. And so, for $65 million dollars (out of more than $200 million that the film ended up eventually costing), Fox sold Paramount an estimated 40% of all the rights to *Titanic*, the highest grossing movie of all time.

ILLUSTRATIONS BY GREG CLARKE

In hindsight, this was a phenomenally expensive hedge for Fox, and a spectacular investment for Paramount. Accounting figures are (as usual) not available, but the film has grossed close to $2 billion worldwide as of January 1999.

If the success of a film is a random event, one can justify Fox's move as a prudent hedging strategy. In that case, *Titanic* had just as much chance of sinking as it did floating to the top of the box office lists.

However, the decision to seek additional financing was made when much of the project was already complete. If Fox executives had somewhat better information than the market at large, they should have known they were looking at a terrific hit. That is, if there is any "inside information" in the movie business.

**Films with stars had significantly higher revenues, and were significantly more visible (larger number of reviews). Similarly, when one divides the sample into all films, vs. films with cast members and directors with no track record, the latter have lower revenues and lower visibility.**

Is there such a thing? Do studio executives know, based on how they spend their days, whether a film will be a hit? That was the starting point of my recent study (forthcoming in the *Journal of Business*).

The decision Fox executives made in the Titanic case seems to support the view that the success of any specific film is a random event.

But in the process of doing the research I found some unexpected and interesting determinants of success in the movie business.

**What makes a movie successful?** A small group of academics has tried for years to understand why some movies make money while others don't. In general, their strategy has been to correlate gross revenues with variables such as the participation of stars and top directors, critical reviews, genres, time of release and the like.

My study tests the view that if studio executives can assess a project's worth, they can use stars as signaling devices. In other words, if you are attaching an expensive star to a project, you are signaling you have a good thing going. This view is supported by the industry concept of "bankable stars" who can "open" a movie. In fact, many projects move forward only when a star actor or a star director signs on.

I collected a random sample of films from the early '90s – some of them very successful, some real failures and others in between. This randomization may account for the difference in my results as opposed to other studies that typically use a data set consisting of top grossing films. Also, I included international and video revenues. Video revenues now account for about half the total revenues on average, according to 1997 figures, the latest available. (In my sample period [1991-1993] it was about 25%.) I considered not only revenues (as most studies do) but also a measure of return on investment.

When I compared the set of films with stars to the set of films without stars, it seemed that the industry view was correct. Films with stars had significantly higher revenues and were significantly more visible (with a larger number of reviews). Similarly, when one divides the sample into all films versus films with cast members and directors with no track record, the latter have lower revenues and lower visibility.


However, when I added other variables into the equation, the significance of stars disappeared.

Not surprisingly, the big-budget films brought in more revenues, and critical attention seemed to matter. Interestingly, a variable that measured the quality of reviews (what reviewers said about the film) did not seem to be significant. In other words, attention and publicity matter, but the views of reviewers are not that important. (I also found that, contrary to popular belief, critics tend to be positive – over two-thirds of film reviews are classified by *Variety* as pro or neutral.)

**The surprising result was the strong role of ratings. PG- and especially G-rated films seemed to produce more revenue, everything else being equal.**

However, the surprising result was the strong role of ratings. PG- and especially G-rated films seemed to produce more revenue, everything else being equal. When I calculated rates of return, the results were even more striking. G and PG ratings (and to some extent being a sequel) were the only determinants of success. (We'll talk more about this in a minute.)

Depending on the specification, big budget films on average seemed to be a recipe for failure. Stars still did not matter.

These results seem to support the hypothesis that stars receive in salary the marginal value they generate, leaving on average little profit for the studio. Indeed, since the demise of the studio system in the 1950's, stars have become free agents, and examples abound of stars whose fees change dramatically to reflect changing market value. Here are just two quick examples. John Travolta, who had reportedly earned only $150,000 for *Pulp Fiction* (a much lower fee than he had commanded earlier in his *Saturday Night Fever* days), increased his fee to $10 million after the success of that film. Alicia

Silverstone, who had received $250,000 for *Clueless*, increased her fee for her next film to $5 million.

**The importance of the letter "G"**

The finding that G movies do so well, everything else being equal, seemed initially surprising. However, upon further reflection, it makes sense. There are surprisingly few G movies made. In my sample, G movies constituted 3.2% of all rated films. Among the 3,923 rated movies produced between 1980 and 1995 (about 260 a year) that are listed in the *Blockbuster Guide to Movie and Video*, there were on average less than six movies a year that were rated G. Therefore, the selection available to parents with small children is very limited.

The other factor at work is the increasing importance of video revenues.

In my sample period, the average film derived about a quarter of its income from video, whereas for G-rated movies, video accounted for close to 50% of total revenue. Furthermore, if anything, my data tends to underreport revenues for G-rated films, which are very amenable to merchandising. *The Lion King*, one of the great G successes, reportedly cost $55 million to make, took in $313 million in this country, $454 million abroad, $520 in video revenues, and another $3 billion dollars in merchandise. And have I mentioned the Broadway show?

**It is possible of course that if and when the number of G-rated films increases, the marginal return per film will decrease.**

I then took a closer look at *Variety*'s data on the most successful films of all time. Although they report rentals (revenue to the studio) rather than grosses, and do not have rates of return, the evidence is too strong to ignore.

When I performed an approximate adjustment for inflation for *Variety*'s "top rental champions" as of December 1998, using as a base date the year of release, the table on page 19 emerges. As you see, the list is sprinkled with G movies. In fact, seven of the top ten are rated G or were so rated in video release. The other three are rated PG. This is in spite of the relative rarity of G-rated films in the population at large.

| Film | Year of Release | Rentals (Revenue to studios) in millions of '98 dollars | Variety Rank* |
|---|---|---|---|
| Gone with the Wind | 1939 | 936,680 | 48 |
| Snow White | 1937 | 927,045 | 49 |
| Star Wars | 197 | 488,382 | 2 |
| Bambi | 1942 | 486,498 | 163 |
| Fantasia | 1940 | 484,335 | 204 |
| Pinocchio | 1940 | 470,175 | 212 |
| Sound of Music | 1965 | 414,229 | 53 |
| Jaws | 1975 | 401,826 | 15 |
| ET | 1983 | 391,008 | 3 |
| 101 Dalmatians | 1961 | 372,480 | 78 |
| The Empire Strikes Bk | 1980 | 361,033 | 7 |
| The Godfather | 1972 | 340,858 | 40 |
| The Exorcist | 1973 | 337,615 | 38 |
| Titanic | 1997 | 329,523 | 1 |
| Return of the Jedi | 1983 | 316,670 | 5 |

*The Variety ranking is by total rental revenues, not adjusted for inflation.

In order to get a feeling for the phenomenal success of some of the films on the list, just look at the year 1942. *Bambi,* the top rental champion that year, had (unadjusted) rentals of over $47 million. A very distant second was *Mrs. Miniver* which had won six (!) Academy Awards. It came in with under $5.4 million in unadjusted rentals. In third place was *Casablanca* with only $4.8 million. Neither film, obviously, makes the list.

Recently, it seems the industry has begun to understand the importance of a G rating. Thanksgiving 1998 featured an unusual abundance of G-rated films. Other family films have been issued directly to video, bypassing the costly promotion of a theatrical release.

It is possible of course that if and when the number of G-rated films increases, the marginal return per film will decrease. But for the time being it seems a solid strategy for hedging your financial bets.

S. ABRAHAM RAVID *is a professor of finance at Rutgers University and a frequent visiting professor at Stern, where he has taught an Entertainment Finance course.*

# Debunking the Myth of the Older Consumer

## Advertisers pay a premium to reach Generation Xers. The question is why...

By **Henry Assael** and **David F. Poltrack**

There is a major disconnect in TV media buying. The prized target for most media buyers is the 18- to 34-year-old group, commonly referred to as Generation Xers. The 55+ group (the mature audience) with substantially more discretionary income tends to be ignored.

In this article, we plan to demonstrate the existence of this "youth premium" and explore reasons why it exists.

In 1995, we analyzed Nielsen TV data, and CBS (which tends to have an older audience) conducted its own survey among viewers, to investigate whether this youth bias existed. During the 1994-1995 television season, we identified 13 programs most likely to be watched by the 55+ group and 11 most likely to be viewed by those 18-34.

The average cost of a 30-second commercial for shows targeted to Generation Xers was $132,500. The cost of a 30-second spot for shows targeted to the mature market was $75,500.

What might justify a 75% premium for targeting younger viewers?

There are three possible explanations. **One**, greater audience size; **Two**, higher-rated shows; **Three**, the audience has more discretionary income. Yet we found none of these assumptions to be true.

First, the total audience size for 18- to 34-year-olds is 63.4 million viewers compared to a total audience of 51.8 million for those 55+. This 22% differential hardly justifies a "youth premium" of 75%.

Second, the average Nielsen rating – basically how many people are watching a show at a given time – programs aimed at the older audience was 6.9%. The average rating for a show aimed at the younger group was 5.8%.


ILLUSTRATIONS BY HANOCH PIVEN

This differential essentially offsets any advantage in audience size for younger viewers.

Further, *Murder She Wrote*, the show most heavily skewed to older consumers for the 1994-1995 season, had a rating of 11.8%, while *The Simpsons*, the show most heavily skewed to Generation Xers, had a rating of 5.5%. Yet a 30-second spot on *Murder She Wrote* was $100,000, while on *The Simpsons* it was $220,000. The cost of advertising is simply not in line with program reach. And that fact does not seem to be changing. In the 1997-98 season, a 30-second spot on *Diagnosis Murder*, the show now most heavily skewed to older consumers, cost $52,400. A 30-second spot on Dawson's Creek, the show most heavily skewed to younger consumers, cost $93,200, a 77% differential.

Third, per capita discretionary income was $3,857 for the 55+ group and $1,357 for 18- to 34-year-olds. If anything, there should be a premium for reaching older consumers.

**Why the age bias?** So why does Madison Avenue continue to pay a premium to reach the youth market? Let us propose five hypotheses.

✧ Advertisers believe older consumers are less likely to spend discretionary dollars.

✧ Advertisers believe older consumers are less likely to try different brands.

✧ Advertisers believe older consumers are not as attentive or responsive to advertising.

✧ Advertisers are willing to pay a premium for reaching the younger viewers because they represent larger families and account for new family formations. Therefore they'll buy more.

✧ The people who create advertising and buy media are almost all under 40, and have little understanding of the potential of the mature market.

We will suggest that the first four hypotheses provide little basis for supporting a youth premium, while the fifth might, in large part, explain it.

Let's take the hypotheses one at a time.

**1. Older consumers are much less likely to spend discretionary income compared to younger consumers.**

To find out if this were true, CBS surveyed viewers of *Murder She Wrote* and *The Simpsons*, the shows that most closely identify the 55+ and 18- to 34-year-old groups, and asked viewers of each whether they had purchased a car, a VCR, a personal computer (PC), or PC software in the last year. (*Murder She Wrote*'s audience was not only older, but also significantly more skewed to females, and computers and software are purchased primarily by males. So including these categories was stacking the deck in favor of younger viewers.)

Purchase incidence was higher for *Simpson* viewers, but not high enough to justify a premium of 2.2:1. Accounting for audience size, projected purchases for viewers of *Murder She Wrote* were greater than those of *The Simpsons* in each category except computers, where they were nearly equal.

**2. Older buyers are less inclined to try different brands.**

To investigate this question, CBS asked viewers of *Murder She Wrote* and *The Simpsons* the following question: "Some people buy the same brand of product all the time, while others try different brands. Do you, yourself, tend to buy the same brand all the time or try different brands?"

Viewers were divided into three groups, those who said they tend to buy the same brand (loyalists), those who tend to try different brands (experimenters) and those who said they did both depending on sales promotions (shoppers). Advertisers are going to be most interested in experimenters, since this group is more likely to try something new and is not as price-sensitive as shoppers.

The survey found that 36% of viewers of *Murder She Wrote* were experimenters compared to 41% of viewers of *The Simpsons*. So much for the hypothesis that older viewers are less likely to try different brands.

**3. Older consumers are not as attentive or responsive to advertising.**

The CBS survey asked viewers of *Murder She Wrote* and *The Simpsons* if they recalled each of the commercials that ran in the last episode they viewed. Viewers of *Murder She Wrote* correctly identified an average of 5.2 commercials whereas viewers of *The Simpsons* correctly identified an average of 3.7 commercials. When we account for audience size, viewers of *Murder She Wrote* represented 5.3 million effective commercial impressions compared to 3.2 million for *The Simpsons*. So much for the hypothesis that older viewers are less attentive and responsive to advertising.

**4. Younger viewers account for more expenditures overall because of larger families and new family formations.**

Despite the findings above, a youth premium might still be justified if younger viewers accounted for more expenditures because of larger families and new family formations.

Do they?

To find out, we matched viewers of *Murder She Wrote* and *The Simpsons* with their usage of nine key brands and products – Colgate Toothpaste, Crest Toothpaste, Kodak film, McDonald's, cereals consumption, Tide, Coca-Cola, shopping at Home Depot and visiting Disney Parks.

With the exception of Disney Parks, the number of users were greater for viewers of *Murder She Wrote* than *The Simpsons*. So, intriguingly, targeting the older-skewing program will attract more users for products generally associated with younger households.

A more rigorous comparison would be to hold audience size constant and see if projected users for the younger-skewing program outnumber those of the older-skewing program. This would show whether there are more users among younger families. This is in fact the case. When we hold audience size constant, there are likely to be more users for every category. There are anywhere from 29% more users of Tide to 164% more visitors to Disney Parks for viewers of the younger-, compared to the older-skewing, show. But the cost of a 30-second spot on *The Simpsons* is 120% more than that of *Murder She Wrote*. So the only justification for the youth premium charged by *The Simpsons*, again holding audience size constant, might be to advertisers for Disney Parks and, marginally, for McDonald's. In any case, advertisers cannot hold audience size constant, so *Murder She Wrote* was a better buy to reach users of all the products listed with the exception of Disney Parks.

So, while younger viewers are likely to spend more on a large range of product categories, this greater propensity to buy does not justify the youth premium.

**5. Individuals who create advertising and buy media are almost all under 40. As a result, advertising executions and media buys do not reflect an understanding of the mature market.**

According to 1996 Census Bureau figures, 58% of ad agency professional staffers are under 40 and 85% are under 50.

In reporting these figures, *American Demographics* magazine wrote that "agencies rarely have creative professionals with a true understanding of life after 40, not to mention life over 60 or 70."

That is especially true of most media buyers who, as a rule, are in their 20s and 30s. As the magazine added:

"Most young agency staff, reflective of their life phase, are fixated on advertising that's hip, cool, impressive to their peers and award-winning. The driving force behind the agency youth bias is a disconnect between agency demographics and those of the marketplace. Unresolved, this disparity will continue to cost sales."

So to a large extent, the age disconnect in media buying is caused by the disconnect between agency and marketplace demographics.

**Why should age be the criterion for selection?** In citing the age disconnect in media buying, we have assumed that age is the valid criterion of media selection. But why should it be?

Age has been an entrenched criterion of media buying ever since Nielsen decided to report its ratings on the basis of age categories – namely 18-49, 25-54 and 55+ – in the 1950s. As the American marketplace became more fragmented, these gross age categories became more meaningless. But age as a criterion remained entrenched, the only difference being that more refined age categories began to be used.

The question remains: "Why age?" All product categories are not governed by age.

We studied 27 brands and product categories to determine the relevance of age. Categories ranged from Coca-Cola Classic usage to home computer ownership to whether respondents shopped in K-Mart.


We determined the demographic profile of heavy users, owners or shoppers for each category. Age was the primary criterion in identifying users, owners or shoppers for only three categories: usage of Pepsi Cola, usage of indigestion aids and moviegoing.

Family-related criteria that could be regarded as surrogates for age (e.g., number of children in the household) identified another three categories: usage of Kellogg cereals, ownership of video games and going to fast-food outlets. Income and region were more important than age in identifying ownership or usage, with income being the primary criterion for nine of the 27 product categories and region for seven.

The only justification for using age, region, income or other demographics is that they are in some way associated with usage or ownership. If this is the case, why not use purchasing behavior or ownership as the criterion for selection? It is always better to use the operational variable as the selection criterion rather than a surrogate.

To use ownership or usage as the selection criterion, one would need data on both an individual's media exposure and purchases (so-called single-source data). If you had this single-source data, a company that wanted to advertise yogurt to users of the category could then determine what TV programs are most likely to reach yogurt users, for example. This would be a more direct method of selection than saying that yogurt users are likely to be women between 35 and 54, and then selecting media based on this demographic profile. Indeed, our previous research found that age criteria were not good surrogates for purchase behavior in selecting media. Further, we found that direct selection did a better job of predicting future program performance than selection using traditional age demographics.

**Conclusion** Advertisers are paying a premium for TV shows targeted to younger viewers without justification based on either audience size or purchasing power. This major disconnect between media buying and viewer potential cannot be explained by any characteristics of older consumers. Those 55+ are likely to spend discretionary dollars, to try different brands and to be attentive to advertising.

The best explanation for the youth premium is the demographic correlation between those making the decisions about whom to target and whom they select. Those making the decisions are generally under 40 and are most sensitive to targets in their own age group.

A more basic question is whether age should be the selection criterion in the first place. Age seems to be used by default because, historically, program data has been reported by traditional age categories. But there is little evidence to suggest that age is a dominant demographic to the exclusion of other demographic variables. Further, demographics serve as surrogates for product usage or ownership, and if usage or ownership data is available, our analysis suggests it should be used rather than demographics.

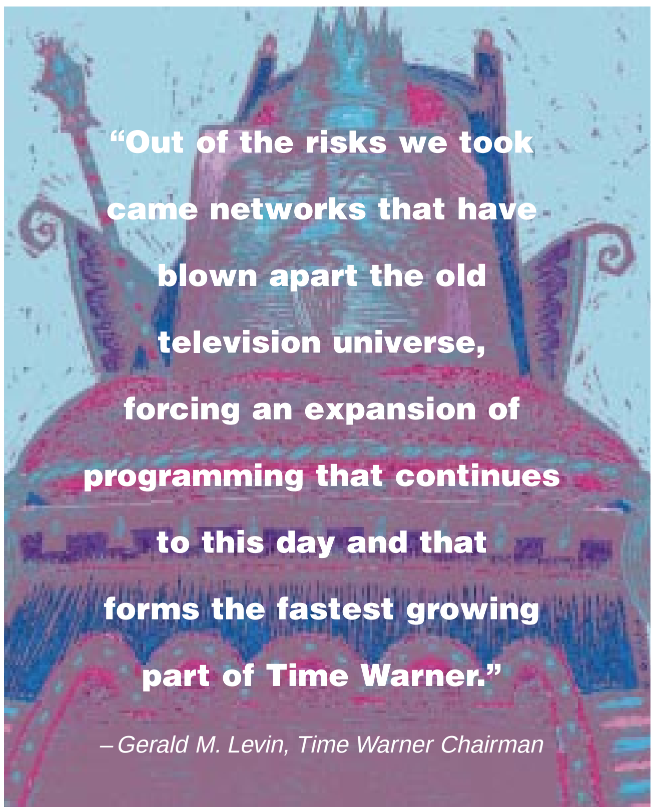
The age disconnect in media buying will probably continue until advertising agencies start changing their creative values and corporate cultures.

HENRY ASSAEL *is professor of marketing at Stern.* DAVID F. POLTRACK, *an adjunct professor of marketing at Stern, is executive vice president of planning and research at CBS.*

# How HBO Survived

**With everyone wondering about what the future of entertainment will look like, it is instructive to take a look back.**

On February 3, Time Warner's Home Box Office (HBO) division reported 1998 operating earnings of $454 million, which included results from its HBO and Cinemax services as well as HBO's 50% stake in Comedy Central. The announcement confirmed HBO's status as one of the most profitable TV networks around. ✧ The earnings announcement, while notable, wasn't front-page news. And therein lies a tale. By **Gene Klein**




We take HBO – with its movies, original programming, comedy specials and boxing – for granted these days. But it wasn't always the case. Given all the talk about what technological advances are going to mean to programming as we know it, it is instructive to look back on how one success story – and by any measure HBO, which combined with Cinemax has nearly 35 million subscribers, is a success – evolved.

In the years immediately after HBO's launch in 1972, the network's biggest challenge wasn't programming, it was distribution. Since it was not a broadcast network, HBO had to rely on microwave transmission, a mode that was both expensive and inefficient. Microwave transmission is easily affected by weather conditions, and a cable system could only receive the HBO signal if it were along a microwave route. This mode of distribution, and lack of alternatives, hampered HBO's efforts to become more than a small, regional network.

However, in 1975 then-HBO chairman Gerald Levin convinced an impatient Time Inc. Board of Directors to allow him to lease a satellite transponder and build an uplink that would allow HBO to distribute its signal to cable systems via satellite.

But that was only part of the battle. HBO then had to persuade cable operators to invest in an "earth station" that would receive the signal. The impediment was cost, of course. Those large satellite dishes initially cost nearly $100,000, but Levin was able to demonstrate to cable operators that the dishes would pay for themselves relatively quickly with a modest increase in pay-TV penetration. HBO introduced satellite delivery to cable systems in three states with the Ali-Frazier "Thrilla in Manila" fight on Sept. 30, 1975. Since HBO was available only on cable, it became synonymous with cable television and quickly became the selling point for cable operators as they tried to sign up new customers.

That first satellite broadcast was a watershed event for HBO. It turned in its first profit just two years later.

**Everyone else follows** The move to satellite distribution was also a watershed event for the whole television universe, as other networks – most notably the ones, such as CNN and TBS, owned by Ted Turner – soon followed HBO onto "the bird."

ILLUSTRATIONS BY ROBERT GUTHRIE

As now Time Warner Chairman Levin noted in a speech late last year, "Out of the risks we took came networks that have blown apart the old television universe, forcing an expansion of programming that continues to this day and that forms the fastest growing part of Time Warner." (Turner Broadcasting, of course, is now part of Time Warner.)

However, by the mid-1980's, the expansion of pay TV had virtually stopped. One reason was that much of the programming on HBO and rival pay-TV services, like Showtime and The Movie Channel, was non-exclusive. HBO and its competitors raced to premiere the same movies as they became available, and the first few days of each month were filled with exhibitions of the same movies nearly simultaneously across the pay channels.

Eventually the pay services began to strike exclusive deals with the movie studios. But there was another more menacing reason for pay-TV to worry: the mid-1980's brought the rise of the video cassette recorder (VCR). VCR penetration in the U.S. rose from approximately 2% of U.S. households in 1980 to over 50% by 1987. HBO and other pay-TV services were no longer the only way for people to watch uncut Hollywood movies at home.

The movie studios quickly jumped on the invention. It was their chance, they believed, to correct an imbalance.

The studios, which earned tremendous incremental revenue in pay-TV, had initially bristled at the business

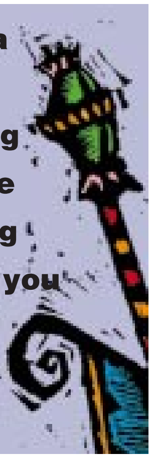
# **Birth of a Station:** The launch of Sundance Channel

By **Liz Manne**

HBO built by essentially acting as a deliveryman of their product into the home. Four major studios even tried to form their own pay service in 1979, but a Federal court ruled favorably on an antitrust suit filed by the Justice Department and blocked the attempt.

But with the emergence of VCRs the studios quickly opted to release their films on videotape before making them available to pay TV. Home video quickly became a more important source of revenue for the studios as annual sales of prerecorded videocassettes rose from around 3 million units in 1980 to over 100 million units just seven years later.

**Its goal? To build a reputation for providing programming options unavailable and unlike anything anywhere else – if you don't have HBO you are missing something.**



Nearly everyone in the entertainment business predicted a swift death for pay-TV, but HBO was already hard at work implementing a strategy to become much more than an in-home video store.

Original programming was a way for HBO to differentiate itself from other pay services, so the network responded to the VCR challenge by expanding its slate of original programs. It

Whether it's something for an analyst to ponder, I don't know, but it's definitely some kind of milestone: this past January, for the first time in 10 years of non-stop screenings, freezing temperatures and bizarre state liquor laws, I got the flu at the Sundance Film Festival in Park City, Utah.

It was also the first year I wasn't competing with Miramax for distribution rights to the hottest new film and the biggest banner headlines. After 12 years in the independent film business – seven of them as head of marketing for Fine Line Features, which I co-founded with Ira Deutchman in 1990 – I had just finished my first year as senior vice president, programming and creative marketing, at Sundance Channel.

Maybe my immune system just didn't know what to do with itself.

I joined Sundance Channel at the same time as Larry Aidem, president and COO, and Tom Harbeck, executive vice president, programming and creative director. Together with Tom Christie, senior vice president of sales and marketing and Rob Sussman, CFO, both of whom were at the network from the beginning, the five of us form the operating committee responsible for plotting the network's course.

As I sniffled miserably in the waiting room of the Park City Emergency Clinic, I could rest secure in the knowledge that Sundance Channel was all over the Festival, airing regular news updates and features on everyone from first-time directors to the festival programmers, hosting Internet chats, and covering the awards ceremony. Perhaps most important, we saw movies by smart, original filmmakers who, along with the audience, are the Channel's raison d'être. On the eve of its third birthday, Sundance Channel was right on track.

**The Back Story** In 1981, Robert Redford founded the Sundance Institute, a non-profit organization dedicated to the support and development of filmmakers and other artists. The Institute runs year-round "labs" for independent filmmakers, screenwriters, composers and theater artists. Modeled on theatrical workshops, the labs encourage experimentation, on the principle that out of failure comes true artistic growth. (Makes you want to switch careers, huh?)

The Institute's approach worked and acclaimed films like *El Norte* and *The Trip to Bountiful* began to emerge from its labs.

But in the early 1980s there weren't many outlets for

ILLUSTRATION BY ROBERT GUTHRIE

produced the first made-for-pay-TV movie (“The Terry Fox Story”) in 1983 and was soon making several original movies each year in addition to offering a line-up of concerts, comedy specials and sports.

Along the way HBO established itself as a home for projects that can’t be done elsewhere, since the channel isn’t hampered by the same content restrictions as the broadcast networks, and because its financial success is not directly dependent on ratings or nervous advertisers. In 1988 HBO won three primetime Emmy Awards®, the first ever for a cable network, and has garnered a slew of Emmys® and other awards ever since (including the Emmy® for the best television movie for the past six years in a row). HBO has developed the making and marketing of its programs into an art. Its goal? To build a reputation for providing programming options unavailable and unlike anything anywhere else – if you

**The challenge for HBO is to continue to find ways into the consumer’s home in a changing distribution environment.**

these kinds of films. One of the few places for exposure was Park City’s U.S. Film Festival, founded in 1978. By 1985, the Festival had grown so large, thanks in part to the many films originating at the Institute, that year-round staffing and programming became necessary. The Sundance Institute stepped forward to handle these responsibilities and incorporated the Film Festival into its slate of programs.

The story of the Sundance Film Festival (it was officially renamed in 1991) is, in many ways, the story of contemporary independent film and its steady rise in influence and market power. In 1989, Steven Soderbergh’s *sex, lies, and videotape* premiered at the Festival; it went on to gross $25 million domestically and permanently alter the cinematic landscape. Suddenly people began to believe that independent films were viable financially as well as artistically, and the place to see them – and discover new talent – was the Sundance Film Festival. Among the commercial and critical hits launched at the festival are *Four Weddings and a Funeral*, *Hoop Dreams*, *The Brothers McMullen*, *Shine* and *The Full Monty*.

Independent film also benefited from the advent of home video, which created additional demand for new film product.

The results have been impressive:

✧ Independent films accounted for 18.2% of U.S. box office revenue in 1998.

✧ Of 1998’s top 100 video renting titles, 21 were independents.

✧ 60% of the 1998 Oscar® nominees and 5 out of 6 of the winners in the top six categories were independents.

Approximately 1,300 films were submitted to the Sundance Institute for the 1999 Sundance Film Festival, an increase of 50% in four years. It’s a scenario not unlike the one the Institute faced in 1985: a lot of films without a lot of places to go. And potentially a lot of people who'd like to see them.

Which brings us to Sundance Channel.

**The Plot Thickens** Recognizing that both audiences and independent filmmakers were underserved on television, Robert Redford entered into a joint venture in 1996 with Showtime Networks Inc. and Polygram Filmed Entertainment to create Sundance Channel, a new pay-TV service devoted to independent film.

Launching a premium cable/satellite network, even one with Robert Redford's name attached, is not easy. For one thing, space on cable systems is very limited. We had to make cable operators want the service, which meant that viewers had to want the service, and to want don't have HBO you are missing something. The network has captured this attitude with its current tag line, "It's Not TV, It's HBO."

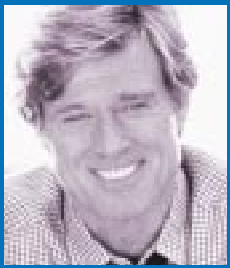
**Where does HBO go from here?** The challenge for HBO is to continue to find ways into the consumer's home in a changing distribution environment. The current challenges to wrestle with are the arrival of digital cable and the continued growth of DBS (direct broadcast satellite).

The deployment of digital cable boxes will make cable competitive with DBS in terms of channel capacity and will also mean that the 500-channel universe that was supposed to arrive years ago will finally be a reality for much of America. Paul Kagan Associates, a media research and analysis firm, projects that digital cable boxes will be in nearly 5 million homes by the end of this year and in nearly 10 million homes by the end of 2000.

In an environment of expanding channels it will be harder and harder to get viewers' attention – just ask the major broadcast networks, whose combined primetime viewing share has fallen below 50%. To take advantage of the expanding channel capacity, HBO has created a megabrand package, called "HBO The Works™" which consists of six distinctly branded channels. The package will be offered at no incremental cost and each channel in the package will have its own on-air look and, eventually, its own unique

it they had to understand what it was. We needed to create a strong brand in a crowded environment.

We decided to follow Redford's lead. In all his Sundance ventures, Redford's policy has been simple and potent: let the artist lead. He has created opportunities for artists and craftspeople to have their work exhibited and sold, unencumbered by a corporate agenda – and success has followed. Applied to the Channel, this policy means that we are committed to seeking out the best independent films available – including features, documentaries, short films and international cinema – and showing them as their creators intended – no compressing credits, no "editing for content," no commercial breaks – just pure film.



*Robert Redford*
*President, Sundance Institute*

**Approximately 1,300 films were submitted to the Sundance Institute for the 1999 Sundance Film Festival, an increase of 50% in four years.**

This makes us forge what I like to call the unholy alliance between art and commerce. After all, Sundance Channel is a commercial enterprise devoted to quality independent films. The question is how to "sell" art without compromising it, keeping in mind that you're not doing art any favors if you can't get it to an audience. It's a constant balancing act.

But every so often, the interests of art and commerce coincide and a film that happens to be very good happens to sell like crazy. I enjoyed one such moment of divine congruence at Fine Line with *Shine*, a wonderful film that grossed pots of money and received seven Oscar® nominations, winning one for Best Actor (Geoffrey Rush).

We aim to make something similar happen at Sundance Channel. By presenting the best films possible in the best manner possible, we believe we can achieve the ends of both art and commerce. Last year, Sundance Channel launched four new primetime destinations, specific times during the week devoted to different facets of the independent spectrum, e.g., new films, documentaries, shorts and so on. In addition, whenever possible, we enhance the viewer's experience with contextual information. For instance, in April, Sundance Channel aired its own version of a film festiprogramming. HBO's internal research has shown that both subscriber satisfaction and subscription growth increase with the number of channels offered.

The network's ultimate goal is to provide content across a variety of distribution platforms. HBO has already announced plans to work with information-enhanced platforms like WebTV and Wink (which give a viewer the ability to get more program information as well as additional content) and customized viewing platforms like TiVo and Replay (which allow viewers more choice over what and when they watch).

New applications and platforms are developing every day, but HBO's efforts on one of these new platforms provides a glimpse into the future: the network will create a "showcase," essentially a program guide focused on HBO, for TiVo subscribers that will alert them to upcoming programming.

TiVo describes itself as a "personal television service," and the foundation of the service is a receiver/video server that is essentially a digital video recorder. The TiVo software will learn viewing preferences and auto-

val retrospective featuring the work of the Maysles brothers, the fathers of Cinema Vérité. And we followed the showing of their film *Gimme Shelter*, which documents the tragic episode at the 1969 Rolling Stones concert at Altamont Speedway, with an exclusive interview with Albert Maysles.

We're also distinguishing ourselves by bringing viewers films that they literally cannot see anywhere else - not even in their local art house. Like the Sundance Film Festival, Sundance Channel is dedicated to supporting new filmmakers and exposing new work; it's what's expected of us and it's at the core of our mandate. Last November, we initiated a formal plan to acquire for broadcast new independent films that, for whatever reason, have never received theatrical distribution. We committed to buy six of these world premieres a year, and by mid-February had already met our goal. That's a measure of our dedication, sure (said with all due modesty), but it's also an indicator of how many good films are out there in the world, going unseen. That is happening for a number of reasons.

**Among the commercial and critical hits launched at the festival are *Four Weddings and a Funeral, Hoop Dreams, The Brothers McMullen, Shine* and *The Full Monty.***

As independent films grew more successful during the '90s, studios took note and began their own art film boutique divisions, whether through acquisitions (Disney/Miramax, Warner Brothers/New Line/Fine Line) or new banners (Sony Pictures Classics, Fox Searchlight). Expectations rose as films like *The Brothers McMullen, Il Postino* and *The Full Monty* (not to mention the juggernaut known as *Pulp Fiction*) generated huge profits in proportion to their budgets.

Complicating the situation is the fact that there aren't enough movie screens to go around. Event movies – such as the latest in the *Star Wars* series – from the major studios can command six screens at a tenplex. Independent films can disappear after one week, long before word of mouth can build.

I must admit to some culpability here. By proving that independents can turn handsome profits, I, my colleagues at Fine Line and our counterparts at Miramax, October and the rest, created a monster: the mainstream matically record favorite shows and shows that might appeal to viewers. The TiVo system also allows viewers to pause or rewind live television programs and begin watching them again where they left off, as the video server continues to record the real-time program when a viewer uses one of the VCR-like functions. Since HBO shows more than 90 movies every month, subscribers with HBO and TiVo will have better opportunities to find the programs they want to watch.

There are many more hurdles on the horizon for HBO: Internet delivery, interactivity and other "convergence" issues will keep it and its competition busy for a long time to come. And if there's a lesson to be learned in the last 25 years of TV history, it's that the next 25 years will look nothing like whatever the forecast du jour may be.

During the past 25 years, HBO has shown the ability to adapt and grow. It will need the same ability – in spades – during the next 25.

GENE KLEIN *has been at HBO for five years and is a director of film programming for the network. He earned his MBA at Stern.*

film in independent clothing. The real independents – films without a well-known lead that don't have major studios behind them – are left out in the cold.

Sundance Channel helps ameliorate this situation by giving edgier or less conventional films a shot at long life and broader audience exposure. At the same time, these films help the Channel remain dynamic.

**A Happy Ending** In 1998, the Sundance Channel team focused on putting across our message to viewers: you will see films here that you won't see anywhere else. By the end of the first quarter of 1999, Sundance Channel was available via cable or satellite in 20 million homes in the U.S., and we had 5 million subscribers, an impressive figure for a three-year-old start-up.

Allison Burnett and Nick Davis, two filmmakers whose movies were chosen as Sundance Channel world premieres, compared the experience to receiving the Good Housekeeping seal of approval. We like that. The Channel also became profitable last year. We like that, too.

This progress is crucial because of the challenges ahead. Entertainment options are dividing and multiplying like exceptionally fervent amoebas. Television no longer means just free network TV and cable – there's DBS, the Web, and pay-per-view.

As a network, we must figure out how to harness new technologies to meet and satisfy viewer expectations. In current terms, that means creating a sophisticated, informative website that complements what viewers see. It also means dedicated programming for that website – for instance, the live reports and panoramic views posted from the '99 Sundance Film Festival.

That's what new technology means for Sundance Channel at this moment. Six months from now, it will probably mean something different. Change is happening that quickly.

As consumer choices multiply, a network's first line of defense is to build and maintain a solid relationship with its audience. The best way for Sundance Channel to do that is to continue bringing viewers quality films they can't see anywhere else, along with the information and behind-the-scenes insight they crave. As long as we offer programming that is unique, we think viewers will stay with us.

In delivering that programming, we are partnering with filmmakers all over the world, of all artistic stripes. We must support these artists and ensure them an environment where creativity and innovation can flourish. After all, we're only as good as the movies we show.

It's the Sundance formula: let the artists lead.

LIZ MANNE, *Sundance Channel's senior vice president of programming and creative marketing, received her MBA from Stern in 1988. She says she'll get fired from her nice, new job unless everyone who reads this article calls 1-800-SUN-FILM and subscribes to Sundance Channel (or at least logs onto www.sundancechannel.com to get further information).*

# CREATIVE ACCOUNTING?

**When it comes to what they do for a living, the people who run entertainment companies must be – by definition – creative. Should they have the same latitude when it comes to the way they keep their books?**

By **Stephen Ryan**

No one doubts that managerial judgment is necessary in the operations, and even the financing, of the entertainment industry. But, accountants who work in the industry have always been torn about allowing management to exercise judgment in the preparation of the financial statements that record management's performance. In every industry, judgment is often necessary for executives to tell a meaningful story about how a firm creates value. But allowing for judgment also opens the door to creative accounting, for the story told to be a fairy tale, not a documentary. Perhaps nowhere is this tension more apparent than in the entertainment industry. There are at least three reasons for this:

ILLUSTRATIONS BY TAZEWELL AND JAMES YANG/SIS

✍ Entertainment companies are characterized by disproportionate amounts of hard-to-value intangible assets, the benefits of which may extend over long periods and be highly uncertain. Examples of intangible assets include brands, advertising, subscriber lists, franchise fees, film libraries and, of course, goodwill. Three letters by themselves don't mean very much, but how much would you pay to own the brand represented by MGM?

✍ Second, these industries are characterized by complex financing arrangements that interweave the operations of multiple firms or projects, thus making operating performance difficult to measure. Examples of such arrangements include joint ventures, limited partnerships, split-rights deals and the sales of licensing and syndication rights. And finally,

✍ These industries are characterized by continuous radical change, never the friend of the accountant and fertile ground for the fairy-tale teller.

So what is an honorable accountant to do? To rule out managerial judgment entirely is to render meaningless the accounting for the whole industry. (It wouldn't be unprecedented. We would just treat the entertainment industry as we do many Internet firms who have sky-high market values but few accounting assets and no income.)

But to allow for the judgment of creative sorts such as the recently notorious Garth Drabinsky of Livent may be to court financial reporting disaster.

In October 1998, the AICPA proposed to reduce the role of judgment in the accounting done for producers and distributors of films. The goal was to make the accounting more comparable across firms that had been exercising their judgment in very different ways.

Did the AICPA choose correctly? And to pose the question more broadly, should the role of managerial judgment be similarly reduced in the accounting for the other parts of the entertainment industry?

In this article, I'll discuss two cases that I use in my class at Stern. One concerns America Online and asks whether the costs of intangible assets should be capitalized or expensed. The second deals with a financing arrangement that was used to obscure operating performance at Orion Pictures. After reading both cases, ask yourself "did the accountants do the right thing?"

(I promise I won't duck the issue. I'll provide my views of both cases, and what I think the proper role of managerial discretion is in accounting, at the end of the article.)

**Entertainment companies are characterized by disproportionate amounts of hard to value intangible assets, the benefits of which may extend over long periods and be highly uncertain.**

**Case #1: Should the cost of intangible assets be capitalized?** America Online (AOL) is the largest provider of both access and content on the Internet. AOL's profitability, market share and growth depend on it attracting and keeping subscribers.

In the pursuit of these subscribers, AOL spends huge amounts each year on direct-response advertising (primarily mass mailings of CD-ROMs that contain its software).

Up until late 1996, AOL capitalized direct response advertising costs and amortized those costs over the subsequent two years, a period that management said was actually shorter than how long it historically retained subscribers.

By doing so, AOL was in conformance with generally accepted accounting procedures. AICPA Statement of Position 93-7 allows direct-response advertising costs to be capitalized if customers can be demonstrated to have responded to the advertising and if these customers are expected to yield probable future benefits to the firm. Capitalizing costs treats the advertising expenditure as an asset.

However, as AOL grew, it was subject to progressively greater pressure from financial analysts to stop capitalizing these costs. Analysts were concerned that historical customer-retention rates might not persist into the future and thus that the "quality" of AOL's current earnings might be low.

In late 1996, succumbing to analyst pressure, AOL wrote off its $385 million advertising asset (leaving it with an accumulated deficit of approximately $500 million) and now treats its direct advertising cost as an expense.

Did AOL do the right thing by succumbing to analyst pressure?

Surely its financial statements became more conservative as a result, and in this sense the "quality" of its earnings rose. Moreover, no managerial judgment is needed to expense advertising costs going forward.

But AOL's decision also leaves no room for its financial statements to convey management's judgment about the future benefits associated with direct-response advertising. If these benefits are significant, then AOL's financial statements have been diminished as a source of information about its value.

What should management have done?

**Case #2: Funny Business at Orion Pictures?** During the 1980's, Orion Pictures was a moderately successful film and television producer and distributor that was best known for its regular association with Woody Allen.

By February 1990, however, Orion Pictures' financial condition had turned bleak. A mediocre fiscal 1989 had been followed by a terrible fiscal 1990, which would end February 28. Fiscal 1990 included the virtually total loss on the expensive *Valmont* and a string of box office misses, with only *Crimes and Misdemeanors* proving mildly successful.

New financing was desperately needed for Orion's slate of 14 movies to be produced in the coming year. Financing wasn't going to be easy to obtain, however, since the financial statements that were to be released at the end of the month would show the damage of the past two years. Or would they?

Before the end of the fiscal year, Orion sold to

**Orion was a known practitioner of the inappropriately slow film cost amortization practices that the AICPA is attempting to eliminate with its proposal for film industry accounting.**

Columbia Pictures the licensing rights to a sizeable portion of its film and television library, as well as the foreign theatrical and home video distribution rights to all the movies Orion would produce over the coming four or five years. (These foreign rights likely would have comprised about 40% of the revenues Orion would have expected to receive on these movies.)

In return for selling both sets of rights, Orion received $175 million in cash from Columbia.

Despite the fact that the essence of this transaction was to mortgage Orion's future for the next four plus years, the transaction had two salutary effects on Orion's fiscal 1990 financial statements. First, all the cash received from Columbia was classified as operating (not financing) cash flow. Why? Because libraries and movies are Orion's "inventory," and sales of inventory are deemed to be operating transactions, even if the inventory will not be produced for years.

Second, Orion recorded $50 million of the sales as income in the current fiscal year, saying this was the portion of the $175 million that was attributable to the sale of the existing film and television library. (Industry analysts speculated, after Orion's subsequent bankruptcy, that this amount was greatly exaggerated, but it is impossible to tell whether this is true from Orion's disclosures.) The remaining $125 million was estimated to be attributable to the sale of the foreign rights and was accounted for as deferred revenue.

Did Orion account for the sale correctly?

**The Answers** As discussed earlier, the exercise of managerial judgment in accounting can be for good or ill, and I chose AOL and Orion to indicate both ends of the judgment spectrum.

The AOL case is one in which judgment was applied in a reasonable way to value an intangible asset that is central to the valuation of AOL as a whole.

True, analysts reasonably could have complained that AOL still did not provide sufficient disclosure about subscriber retention rates in the aftermath of the write-off – information which would enable them to assess what this asset is worth – but this is an argument for better disclosure, not for more restrictive asset recognition.

In contrast, in the Orion case the financing arrangement provided cover for problematic accounting. The accounting treatment of the transaction suggested nothing of its essence, and both operating cash flow and income were overstated. Moreover, this financing transaction was but one of Orion's many accounting deceits; for example, Orion was a known practitioner of the inappropriately slow film cost amortization, a practice that the AICPA is attempting to eliminate with its proposal for film industry accounting.

As a consequence of its various accounting choices, Orion's financial statements were essentially uninformative about its impending bankruptcy.

Should instances in which managerial judgment has been abused, such as in the Orion case, cause us to restrict the role for such judgment in accounting? I think this is a poor tradeoff. Managerial judgment is an essential element in any meaningful accounting system, especially in the entertainment industry, which is characterized by disproportionate amounts of intangible assets, the benefits of which extend over long periods and are highly uncertain.

For example, the AICPA's proposed accounting for the film industry would restrict the capitalization of film and television production costs to a period of no more than ten years. Does this make sense for a firm such as Disney which has a history of creating properties that generate significant value decades after they are made?

There is no easy fix to the problem of abuse of managerial judgment in accounting, but in my view the more fruitful course is to improve disclosure about the basis of those judgments, not to reduce the scope of what is included in the financial statements.

STEPHEN G. RYAN *is associate professor of accounting and Peat Marwick Faculty Fellow at Stern.*

**The most valuable thing about a magazine is its relationship with its customers. That's why we are seeing so many brand extensions.**

# If you loved the magazine, you'll love the....

If you subscribe to *Inc.* magazine, you can count on being invited to conferences and seminars during the course of the year. Read *Forbes*? You'll not only get a chance to buy an investment newsletter published by the company but you may also have had the chance to buy land it owns. *Sports Illustrated* more your speed? Well, if you play golf, they'll send you a magazine customized with more links-related stories. ✧ What is going on is straight out of a business school textbook: Companies develop a core competency and a certain knowledge about their customers through the publication of a magazine, and then the magazine companies – Time Warner, Meredith and countless others – try to expand that core competency and knowledge through product extensions. By **Gretchen M. Tibbits**

ILLUSTRATION BY HANOCH PIVEN

The idea? Turn a product – the magazine – into a brand, and capitalize on the relationship between the brand and the people who buy it through product extensions.

Those brand extensions can include conferences, seminars and expos; books, videos and software; consulting; custom publishing; special issues; licensing; international distribution and websites.

These brand extensions further define the market and solidify the perception of the company as an expert in its field.

**What's new?** In the past, brand extensions provided some incremental revenue, but were not considered crucial to the success of a publishing company. Today, however, the focus is different, as more and more companies are attempting to create true brands around their magazines. *Working Woman* sponsors conferences for its Top 500 Women-Owned Businesses, presents Entrepreneurial Excellence Awards and licenses its name to Mattel for a Barbie doll. Martha Stewart has a magazine (*Martha Stewart Living*), paint, household goods and television shows. *Inc.* dedicates an entire division to its brand extensions which include books, videos, software, custom publishing and conferences.

**Why the change?** Why is all this going on? Competition for one thing, as well as an attempt to increase the value of the underlying publishing company. Let's deal with each reason separately.

Here's a bit of news that won't stop the presses: Competition in the publishing industry continues to increase. While advertisers have stepped up the amount of money they are willing to pay for space, the number of vehicles they have to choose from is growing even more dramatically. At the beginning of 1998, there were over 18,000 U.S. consumer and business magazines being published, yet 1,000 new titles were launched in that year alone.


This increasingly competitive environment has resulted in publishers trying to differentiate their products, as they attempt to get larger pieces of the advertising-dollar pie. Some relatively new publications, such as *ESPN* magazine, have been able to accelerate their growth as a result of their success in creating a brand. Some established publications have also been able to solidify their strong position through brand extensions. Existing publications from Time Warner, such as *Sports Illustrated* and *People*, have leveraged their brand with new magazine introductions, *Sports Illustrated for Kids*, *Sports Illustrated for Women*, *Teen People* and *People En Español*. Television specials have served as yet another means of extending brand recognition that helps drive the valuation of the underlying magazine company.

When investment bankers determine the value of a magazine, they have a series of criteria, which include: ✧ Leadership within the category ✧ Strength and definition of the editorial product ✧ Circulation vitality ✧ Strength of management ✧ Financial status and growth prospects ✧ Brand extensions ✧ Mass of revenue stream, readership and advertising

Not only are brand extensions one of these criteria, they are a component of every other factor.

**How can you tell whether a brand extension will work?** Now that it is clear why brand extensions are important, the next question is how to identify which ones might work. After all, the magazine graveyard is littered with the remains of scores of extensions that didn't. When you analyze which extensions work and which didn't, this fact jumps out: The efforts that were successful were driven by expansion of the company's core competency. Those that failed shared one common trait – deviation from the company's core competency.

Many of the smaller publishing companies have had a disproportionate share of successful brand extensions primarily because they tend to have more defined mission statements. (They are also motivated to work harder at it, since it takes less capital to expand a brand than to create a new one.)

MacDonald Communications Corporation (MCC), the company for which I work, is a good example of the focus publishing companies have on brand extensions.

When formed in June 1996, MCC owned *Working Woman*, *Working Mother* and *Ms.* magazines. Its mission was to provide intelligent products and services for affluent, professional, entrepreneurial women. Through that mission, the company defines itself not as a magazine company, but as a communications company that reaches its target market through any number of media. In less than three years MCC has: ✧ Formed $MC^2$ Conferences,

**Martha Stewart has a magazine (*Martha Stewart Living*), paint, household goods and television shows. *Inc.* dedicates an entire division to its brand extensions which include books, videos, software, custom publishing and conferences.**

which produces business conferences ✧ Acquired the National Association for Female Executives, the largest businesswomen's association in the country ✧ Formed the Businesswomen's Research Institute which conducts primary research studies ✧ Developed a presence on the Internet ✧ Formed MC$^3$ Ventures, a division dedicated to pursuing brand extension opportunities.

Each of these divisions is a direct outgrowth of the mission of the company. By being able to provide these different channels to reach its target market, MCC has created strong relationships with advertisers, some of whom are involved with every division. MCC has also been able to expand the products and services that it provides, increasing its value to women in its target markets.

We are not alone in this. Companies such as the Goldhirsch Group, publisher of *Inc.* magazine, have been successful in their brand extensions because their products and services are complementary to the magazine and its mission. *Inc.* has established itself as the authority in the small business market and has done an excellent job of creating a brand. The information that *Inc.* has gathered for the magazine is disseminated through an array of peripheral products and events, thereby generating significant incremental revenues and providing value to its readers and its advertisers. In effect, *Inc.* has become a marketing partner with its advertisers, with relationships extending in many creative ways. Consequently, *Inc.* has firmly established itself as the authority in the small business market.

Magazines such as *Sports Illustrated* have been successful in their brand extensions because of the natural expansion of the core product into other magazines and products. *Sports Illustrated for Kids* and *Sports Illustrated for Women* are recent launches that arise directly from the content of the original magazine. Books and videos provide not only a lucrative revenue stream but are very successful at driving circulation for the magazine.

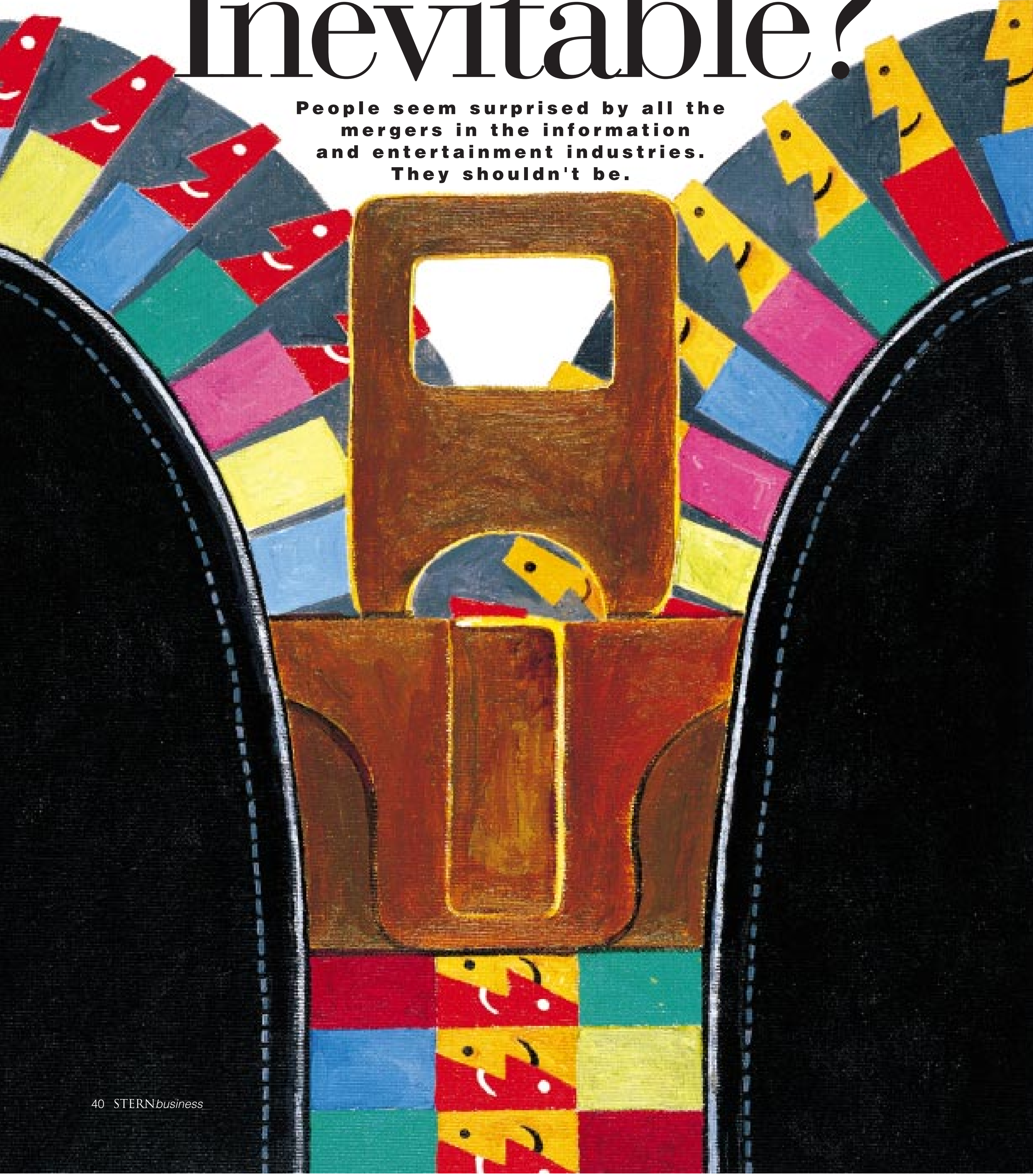
Among the current types of brand extensions, conferences and custom publishing are large-scale initiatives that can have a significant impact for a publishing company. Conferences that reach the core reader of the magazine have benefits that are twofold. They allow the publisher to further the magazine's relationship with readers and attendees by interacting with them on a face-to-face basis rather than through the printed page alone. Both conferences and custom publishing – a common brand extension where a newsletter or magazine is created to give an advertiser the opportunity to customize a message and deliver that message to a preselected constituency – strengthen the partnership with advertisers, providing the advertiser or sponsor unrivaled access to customers. In addition, the advertiser's sponsorship and increased expenditures as part of a "marketing partnership" are significantly higher than would be obtained by the magazine through page advertising alone.

When a publishing company has a strong mission reflected both in the magazine and in a series of brand extensions, it can establish itself as "the" authority on a market. When this perception of the publishing company as the authority is fully developed, readers feel that they have a partnership with the company. The relationship between magazine and reader becomes symbiotic. A sense of community in which the magazine is the symbolic leader is created. Once established as the authority and leader of that community, a publishing company has leverage with its advertisers, charging fees to access the community through any number of ways. Hence the power of brand extensions.

GRETCHEN M. TIBBITS *is the director of MC$^3$ Ventures, a division of MacDonald Communications Corporation. She received her MBA in finance and management from Stern.*

# Inevitable?

**People seem surprised by all the mergers in the information and entertainment industries. They shouldn't be.**



While the lengthening list of mergers between cable and phone companies makes headlines, and we are all interested in seeing which entertainment companies will team up, all this activity is really more inevitable than surprising. ✧ It is just the latest in capitalism's never-ending evolution. ✧ The industrial economy was based, in part, on the ability to manufacture goods. Finished goods were then shipped by physical conveyances to distribution points and consumers. These activities were supported by a large number of intermediaries – salespeople, stock clerks, purchasing agents, etc., along with the large volumes of paperwork needed to document these activities. ✧ All this still takes place. But widespread use of computers, and the advent of the Internet, have changed the nature and economics of these processes. In brief, they have generated information goods and have provided at least one new highway running parallel to the traditional physical one.

By **Mike Uretsky**

This set of phenomena has, in turn, given rise to growing discussions about "convergence." The argument goes that widespread digitization will lead to an increase in collaborative activities, mergers or similar amalgamations, and possibly a redefinition of traditional industries.

There are examples supporting this forecast. While the transitions are not yet over, we are seeing a realignment reflecting the shift to electronic-based commerce. Specifically, we are seeing companies and product lines converge around specific places where customers and businesses can access products and information.

**Convergence Around the House** On the consumer front, the house is the focus of the battleground and the infrastructure is now being put into place. While the specific form – satellites, cable, telephone line – may still be up in the air, it is clear that most U.S. homes will eventually have access to a broadband digital highway. That highway will give us access to a large variety of digital media, a phrase that covers a broad spectrum, ranging from digital television, to on-demand entertainment, to... Since the common denominator is "digital," this list extends to anything that can be digitized, including access to the Internet and telephony. The battles will be over who provides the services, how they relate to each other, and how you use them.

A casual reading of the newspapers reveals that the battle is already underway. The end result will be that there will be Internet access through the telephone or television – as well as through computers located elsewhere in the house.

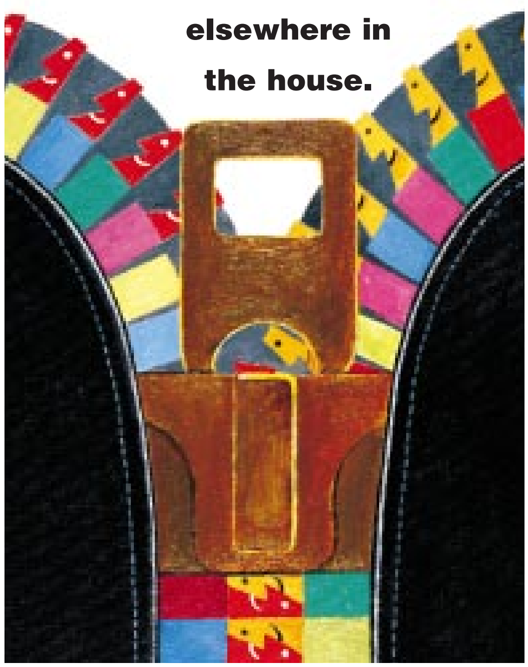
Once you have access to the Internet, many daily chores begin to change. Consider the following example. An increasing number of companies are now experimenting with cross-channel marketing where instead of going to a designated site to shop on the Internet, there may be

ILLUSTRATION BY TAZEWELL

a window on your television or computer screen that automatically opens, shows you a customized advertisement, and takes you to "one-stop shopping" where you can buy the advertised product.

**Influx of Digital Products** The changes will be wide-ranging and will extend far outside the home. Digital media – a term that is broader than you might think – are interesting because they are so easily modifiable.

**The end result will be that there will be Internet access through the telephone or television – as well as through computers located elsewhere in the house.**



Consider an animated cartoon, as an example. In the old days, a cartoon movie was simply a script, a sound track, the drawings themselves and distribution prints of the final product. A cartoon now gives rise to a large number of digital products: art (physical, digital, computer graphics, title treatments), audio (music, sound tracks), documents (scripts, director's notes, legal agreements, promotions, plans), animations (game content, avatars, Java content drivers).

Each of these items can be separately or jointly licensed. Each of these items has value, alone and in combination. Moreover, the value of these products is enhanced by the existence of agreements with firms that can market them. A Disney film is not just a film, but a package of licensable products. The fact that Disney owns a television network and theme parks enhances the value of each film effort. (These observations partially explain the company's recent expansion.) Moreover, the ready availability of these added market outlets greatly enhances the ability to finance production of the initial product.

**Competition for the Highway** Most of us would agree that there has been and will continue to be significant increases in the volume of web-based trade. (And the amount gets much larger when you consider business-to-business and customer-support transactions such as FAQs).

Battle one is thus providing access to the business or house.

Telephone companies have traditionally provided this service. Cable companies have come on the scene more recently. Services from both groups are limited. The telephone has traditionally been very reliable, supported by sophisticated switching equipment and use-based accounting systems, but it is regulated, and some say unable to carry the large volume of digital traffic needed to support growing home use of computers. (Phone companies would disagree with this latter assertion.)

Cable systems are newer, have higher bandwidth (capacity), more modern facilities and are already making inroads to home Internet access through the cable modem. But cable systems were designed to take signals downstream from concentration points. They need upgrading to handle larger data volumes and true interactivity.

The battle between these two conduits is exacerbated by the fact that they can transmit any form of digital media, be it television programming, Internet access, traditional telephony or, more recently, Internet-based telephony.

On the surface the needs and capabilities of the telephone and cable company are complementary. An alliance of sorts permits them to share existing facilities, open new competitive fronts and obtain access to potentially new sources of funding.

Consider the recent AT&T/TCI merger as an example of this trend. The merger reflects several different forces. The first, and most obvious, is that both companies are in

**The bottom line is clear.
Portals are important sources of revenue and control.**

the signal distribution business. They have different types of facilities that, once made compatible (a nontrivial and costly effort), will enhance the communications needs of both. This amalgam is made more valuable by the existence of a common denominator, digital signals that can represent anything from data, to telephone, to video.

Like most cable companies, TCI developed a broad network of content suppliers. Its Liberty Media subsidiary is one of the country's most powerful content organizations. Liberty Media is particularly interesting. Its inclusion in the package could represent a more explicit movement of AT&T into the content business. Other than that, it does not have a natural fit. Thus, while the alignment of TCI/AT&T has a natural synergy, as a digital signal distribution utility, it would not be surprising to find that Liberty Media is eventually spun off.

**Competition for the Portal** There are far-ranging advantages to being the gatekeeper for access to electronic services. For one thing, gatekeepers certainly provide a large volume of traffic, and hence access to potentially larger sources of advertising revenues and usage information. This explains why many of the major service providers are positioning themselves as so-called portals.

The search engines, such as Yahoo, want your personalized front page to be your point of entry to the web. Microsoft Network and AOL have the same objectives. So, too, do vendors of financial information and services, such as E*TRADE, the on-line brokerage firm. They want to capture a portfolio of your interests that will cause you to keep coming back.

Some of these portals accomplish this by providing a combination of news, e-mail and convenient access to sites that interest you. Others do it by providing specialized information, e.g., stock prices, an analysis of your portfolio, access to financial research, and the ability to trade stocks. The bottom line is clear. Portals are important sources of revenue and control.

**Financial Realities** The forces noted above are made stronger by financial realities that force a company like Microsoft to find new markets. It is highly unlikely that Microsoft can continue its growth rate based on a traditional (and now largely saturated) desktop market. It must find new revenue sources, and the most likely hunting ground is the home. Analogous comments can be made regarding companies like Amazon.com. It is difficult to justify their high market caps based on their traditional business – selling books – and their reported financial results. To the extent that there is some rationality associated with the high market valuation, it must be related to an assumption that there will be additional revenue streams in the future.

The most likely assumption is that Amazon is the prototype electronic department store of the future, that it will expand to add other product lines. These objectives will be satisfied through a combination of acquisitions and strategic alliances. The company has already taken steps in that direction.

One must ask similar questions about other companies. Can E*TRADE, for example, continue to grow without significantly expanding its offerings? If it must expand, will it look towards more formal relationships with firms having complementary product lines?

The preceding comments appear to suggest that electronic goods and markets are coming together. Alternative explanations are equally plausible. For example, I have a student who has been arguing that all of this is a form of atomization (not convergence). According to his line of reasoning, the fact that these goods and services are electronic makes them analogous to atoms that can then be combined and recombined as economic and business needs change.

I'm not sure what convergence is or whether it is taking place. I am sure that companies are adapting to reflect changing markets, technologies and competitive forces.

MIKE URETSKY *is chairman of the Information Systems Department and professor of Information Systems at Stern. In this position, he develops and runs seminars dealing with the impact of information-related technologies. One of these seminars gave rise to the current EMT track at Stern.*

# endpaper

# Fun facts

All you have to do is listen to people talk to understand how pervasive the entertainment industry has become. Top corporate performers are called "stars;" products that come out of the gate quickly are "number one with a bullet" and if they continue to sell well they have "legs."

Given all this, we figured it would be fun to look at the numbers behind the glamour. All figures are provided by Booz•Allen & Hamilton, the management consulting firm.

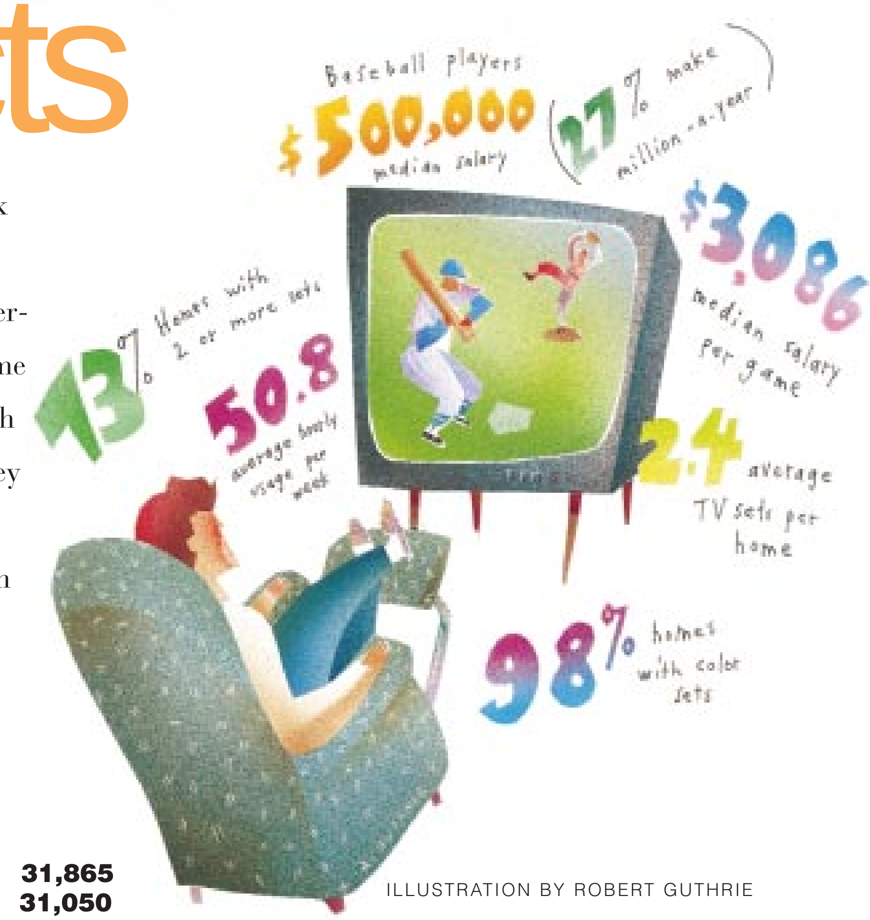



ILLUSTRATION BY ROBERT GUTHRIE

## Movies

| | |
|---|---|
| **Number of movie screens** | **31,865** |
| **Indoor** | **31,050** |
| **Outdoor** | **815** |
| **State with the most movie theaters:** | |
| **California** | **760** |
| **State with the fewest theaters** | |
| **Delaware** | **14** |

## Television

| | |
|---|---|
| **Percentage of homes with color sets** | **98%** |
| **Percentage of homes with two or more sets** | **73%** |
| **Average number of sets per home** | **2.4** |
| **Average weekly usage (hours)** | **50.8** |

## Radio

| | |
|---|---|
| **Share of listeners by station band** | |
| **AM** | **19.1%** |
| **FM** | **80.9%** |
| **Share of listeners by location** | |
| **At home** | **38.9%** |
| **In Automobile** | **31.7%** |
| **Other** | **29.4%** |

## Sports

### Median Salary

| | |
|---|---|
| **Baseball** | **$500,000** |
| **Basketball** | **1,000,000** |
| **Football** | **410,000** |
| **Hockey** | **600,000** |

### Million-a-year Men (% of the total)

| | |
|---|---|
| **Baseball** | **326 (27%)** |
| **Basketball** | **174 (50%)** |
| **Football** | **456 (29%)** |
| **Hockey** | **244 (38%)** |

### Median Salary Per Game

| | |
|---|---|
| **Baseball** | **3,086** |
| **Basketball** | **20,496** |
| **Football** | **25,625** |
| **Hockey** | **7,317** |

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