JCAP

China Primary Insight

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Inside Commentary

Blow Up

Chinese Cinema Growth Is Half Illusion—And IMAX Has Fallen For It

- **What happened to Chinese box office growth?** Film revenue growth crashed in 2016. Regulator focus that year on box office fraud is likely responsible for bringing the industry back to earth.
- **Movie madness has been greatly exaggerated:** Yes, movie-going is popular in China, but the spectacular growth of 2009-15 was driven by speculators—in films, in stocks, even in real estate—and not really by cinema buffs.
- **Avoid grabbing falling knives:** IMAX is a play not only on Chinese movie-going but on the commercial real estate bubble. Its biggest worldwide partner is the beleaguered Wanda. Imax is a sound company but has some way to fall before finding its price.
- **Not so Great Wall:** This commercially and culturally embarrassing new film, co-funded by Universal Studios and LeEco, is an object lesson in why China's propaganda apparatus is at odds with commercial success.
- **A strong centrally sponsored cultural policy is a commercial poison pill:** This point is proven by the failures of China's epic productions in contrast to the successes of Indian, Japanese, and Korean film, to name a few.

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China's film industry has been a success story comprising surging box-office growth, rich ticket pricing, and increasing global engagement. Analysts attribute that glorious emergence to wealthy young urbanites who have developed a taste for leisure. As with so many narratives in China's investment dream world, this is only partly true. The reality is that China's flood of money has created a dual demand for investments and money-laundering channels, both conveniently provided by films. Because the inspiration for the movies themselves is principally financial, China's film industry is generating a surfeit of inexpensive and not particularly interesting or well-received content.

Those who have predicted the timing of Chinese deleveraging have been wrong month after month, year after year, and it is pretty clear that authorities would rather let the financial system hit a wall than make the hard political decisions involved in weaning the economy from investment-driven growth. This is no less true today, despite claims of financial "crackdowns," than it was in 2016. But when the moment finally comes, and money flows less freely through China's financial byways, the film industry will be one of the losers.

And as enthusiasm for the box office wanes, so will results of one of the U.S. companies most geared to the Chinese film miracle, Imax Corp. (IMAX US).

The Fabulous Film Industry

A short generation ago, films in China were uplifting stories of Communist purity and Kuomintang treachery or else a few selected imports from approved allies. Shows were generally free to State employees through their "work organizations," which would host screenings or hand out tickets in the same spirit in which they convened Saturday Political Study Sessions. A brief golden age after the relaxation of political controls on the economy in 1979 brought about the "Chinese New Wave" cinema under directors like Zhang Yimou (the now sadly coopted director of content ranging from the nationalistic spectacle of the Olympic opening ceremony in 2008 to this year's cynical hack job *Great Wall*) and Chen Kaige (once maker of brilliant movies like *Farewell My Concubine*, now directing antiseptic films such as *The Promises* and *Monk Comes Down the Mountain*). The reassertion of cultural control post-1989 brought back the anodyne patriotic fare of the 1970s, dressed up with lavish sets and CGI. When Paramount released the 2008 DreamWorks film *Kung Fu Panda*, Chinese critics bemoaned the fact that a hit starring China's national symbol was made not by Chinese steeped in martial arts traditions but by—gasp—Americans.

Still, there are the box office numbers. Market enthusiasm for China's film industry began, not coincidentally, with the stimulus of 2009. While, in 2005, reported total box office receipts had been around USD 230 mln, by 2009, the reported base was a meaningful approximately USD 900 mln. In 2010, reported box office receipts rose 64%, according to the regulator then called SARFT, and by 29% again in 2011, to reach USD 1.6 bln. Average annual growth 2011 through 2015 was 34%. That ended in 2016, with reported growth of just 4%. That year, also not coincidentally, was the one in which Chinese regulators focused on box office fraud and the overall accuracy of reported receipts. Analysts, always enthusiastic about the Chinese consumer, are still positive on the industry, but, through June this year, theaters collectively reported -1% revenue growth.

Chinese film is yet another story of excess capacity. By 2016, China reported USD 6.5 bln in box office receipts (though Chinese theaters collectively reported USD 7.2 bln to the China Film Distribution and Exhibition Association). There are around 7,000 cinemas nationally and about 45,000 screens, as well as 40-50 new films each month. Last year, more than 400 screens were being added every month, for growth of 30% through the year. The number of films made locally more than doubled, even as box office revenue growth slowed so dramatically.

IMAX

That brings us to Imax Corp. (IMAX US), the company that makes the building-high screens that we all take our children to at science and air-and-space museums around the country.

Imax cut out its China assets and floated the Imax China Corp. (1970 HK) on the Hang Seng in October 2015. But Imax U.S. still derives 31% of its revenue from its China business and has 67% of its backlog there.

Imax is all about building out international markets. The company has committed to building 498 new Imax screens, 88% in international markets. The vast majority of those are in China. Imax's single biggest partner is Wanda Film Holding, the theater affiliate of the property developed Dalian Wanda. With Wanda Film, Imax is developing 360 theater systems in China, 345 of which, or 96%, under the "JRSA" or joint revenue-sharing arrangement. The "traditional" JRSA requires no up-front payment. Under the agreement, Wanda gets free equipment. If the theater never opens, Imax gets stuck holding an empty bag.

The arrangement was good to Imax in the fat years, yielding about USD 200,000 per screen and repaying the investment in two years. But Imax's revenue per JRSA screen in 2016 dropped sharply, from USD 187,372 to USD 156,395, as screens expanded rapidly.

The company is largely valued based on its backlog, theaters which it has committed to install. Worldwide, Imax has a backlog of 498 theaters. Only 61 of those are in the U.S. and Canada; 437 are international and, of that international number, 334 are in China. This represents growth of 55% in Chinese theater commitments between 2015 and 2016, and that number grew aggressively in Q1, when Imax reported a flurry of new signings with Omnijoi, a Shenzhen-listed, Nanjing-based content provider with the motto "Discover, create, and share joy."

Some 82% of China's backlogged theaters are JRSA theaters. The importance of the backlog means that, for Imax, it is critical that Wanda be able to build out the new theaters and, even more importantly, that the shopping centers that house those theaters be opened and heavily trafficked.

So far, that has been a pretty good bet. But Wanda, overextended, has been blacklisted by Chinese banks. Although the film company, separately listed in Shenzhen as Wanda Film Holding (002739 HK), may still access capital, investors should be prepared for loans to be passed over to the property company.

What's more, commercial real estate is in lurid oversupply in China, leaving malls in cities everywhere dying in plain sight. Wanda malls have generally outperformed the B and C list malls but, at the current rate of breakneck expansion, that cannot continue.

Theaters of Convenience

Why do developers want to own movie theaters and film businesses in the first place? There are two reasons, one good and one bad. The good reason is that, for a developer of commercial shopping plazas like Wanda, a movie theater provides an anchor to bring traffic, create activity at night, and distinguish the shopping center from others in the city. Movie theaters are generally positioned in the very top floor of malls that host them, requiring visitors to pass through the whole department store before or after the movie.

The second reason is probably an equal motivation for Wanda as well as for that evergreen finance profligate, Evergrande: money laundering. An owned theater creates a convenient cash-churning facility for processing off-book loans and making billboard revenues look more impressive than they may actually be. Wanda is responsible for about 14% of China's total movie revenues, high in a very fragmented theater environment.

Imax is very dependent on blockbusters. Revenue per screen rose by almost 50% in 2010, for example, because everyone had to watch Avatar on an Imax screen. An Imax theater shows only about 20 big-event films per year, and the popularity of movies shown in any given year fluctuates a great deal. As China becomes increasingly important to the company's results, this is a problem. China is just constitutionally incapable of creating blockbusters and yet authorities have decreed that domestically made films be the majority of those shown in theaters.

Box Office Fraud

The high-growth period came to an abrupt halt in 2016, coincident with a regulatory crackdown on box office exaggeration. It has always been challenging to get accurate data on any box office events in China. The most exuberant revenue reporting can be based on total number of attendees at an event multiplied by the list price of the ticket but that may have little to do with actual receipts. For live performances and movies, there may be large numbers of complementary tickets. But there are other distorting processes as well. Deep discounts to the reported retail price can be hidden in marketing costs, promotion costs, advertising costs, and other service costs. Typically this is done with discount vouchers marketed through related third parties.

Currently *Despicable Me 3* is playing to good audiences in China's Tier 1 cities. The series has been very popular in China. In first-class Shanghai theaters, the posted ticket price is RMB 120 per person, so a group of four would generate revenue of RMB 480. However, the box office makes available a VIP card for RMB 300, which includes four admissions and a snack voucher worth RMB 120. Hence four admissions with a note that the single ticket price is RMB 120, suggesting an admission price that would be respectable anywhere in the world. But in actuality, the admission yield is RMB 45 per viewer—not so good.

Distributors also buy up tickets for a number of reasons. They may bunch the revenues from many films into those for a single film they then promote as a blockbuster. The current example in China is *Wolf Warriors 2*, proclaimed as the second highest-grossing Chinese film ever, earning an estimated USD 406 mln (RMB 2.73 bln) after 10 days in release, based on local reporting. "Local reporting" is the caveat here.

Why would distributors overpay for their own films? In many cases, the distributors use real money to buy real tickets so that films can play to empty theaters. It turns out there are three reasons:

- **Cheap advertising:** By manufacturing record-breaking opening weekends, distributors buying up their own tickets squeeze competing films out of the theaters and get effective advertising at a relatively low CPM. Setting a record at the box office wins coverage by all the major media and strong credibility among the public.

- **To attract investment:** Groups of speculators, connected to studios or independent, raise money for films and sell derivatives of film-financing products. Nothing works to raise the value of an investment as effectively as pumping box office on a current film. The 2016 crackdown was occasioned, according to China's press, by fraudulent box office income for *Ip Man 3*, the third in a series of popular biopics about Bruce Lee's martial-arts teacher. Featuring Mike Tyson as a mobster, the film reportedly took in half of its total USD 115 mln in revenue during its opening weekend. But it didn't. Apparently, financiers had bought the tickets to make the film look like a winner. Chinese regulators found that revenue from 7,600 screenings was faked. Before its release, *Ip Man 3* was purchased by an online finance company called Shanghai Kuailu Investment (Group) Co. Ltd., which has a related-party company, Shifang Holding Ltd. (1831 HK), whose its share price rocketed up as a result of the Ip Man results.

- **Money laundering:** A company that owns a theater chain need only have cash flow through other businesses to be able to claim a blockbuster with huge box office revenues—especially from online ticket sales. Three partners, for example, might chip in RMB 100 mln to make a film. The film is distributed externally and through owned theaters. Given big cash flows from an online payment system or, say, the sale of real estate, sister companies buy movie tickets and are reimbursed when the theater pays them for some service, like construction and renovation. The films reports 1 bln in revenue, which is distributed to the "investors." Given business tax of 3.3% and the original, RMB 100 mln investment, the total cost for laundering the 1 bln would be 4.3%, lower than the average channel. If the film is an international film, then the royalties have to be paid in hard currency, so this strategy moves money overseas. All the biggest movie theater operators in China—Wanda, Shanghai Film, Nan Hai Development, Zhejiang Times, Evergrande, to name a few—have large property development businesses and associated cash flow, so theater chains might be convenient.

The pervasiveness of faking is evidenced in part by the fact that holiday box office revenue growth is so much faster than revenue growth overall, making the average attendance rates implausible. Already this year, four major holidays have greatly outperformed the "average." On Spring Festival, Tomb Sweeping Day, the May break, and Dragon Boat festival this year, theaters reported revenues up by 100% over the comparable period the year before, yet overall revenue growth for the first half of 2017 has been negative. Holiday periods attract the best advertising recognition. Stories of high box office revenue on holidays are also probably more plausible than off-time revenue growth. It is the movie version of the Single's Day revenue explosion for online retailers.

Content Control and Feeding the Screens

There are few if any periods in China's long history when the imperial establishment did not maintain intense oversight of cultural production. A thousand years ago in the Song Dynasty the most brilliant poets, painters, and scholars, if not co-opted by the emperor through patronage and official emoluments, were frequently examined for possible hidden content that either directly or indirectly criticized the rulers. The same was true for local opera and other popular art forms. During Mao's years in Yan'an, a watershed event was his series of talks on literature and art that forcefully proclaimed all art and literature must serve the interests of the Party and the proletariat.

The last several five-year plans have elevated the goals of cultural production and global projection. Focus on these goals has grown so intense that expanded cultural production was a featured part of China's 12th and 13th Five-Year Plans, with generous central funding proposed. Independent surveys increasingly show that China considers itself to be "misunderstood" by much of the world, and China's inability to produce meaningful art is not improving even as its economy grows strength. In *The Martian*, as a script requirement for both Chinese production investment and access to China's box office, the Chinese aerospace vanguard, both good hearted and technologically peerless, comes to the rescue.

The film industry itself is core (and subject) to this ambitious soft power project. Certainly the successes of India's Bollywood, Korea's Gangnam culture, and Japan's modern literature and film industry were not lost on China's leaders, nor could China ignore the fact that these were lucrative commercial as well as powerful cultural successes, projections of soft power with a humanizing portrayal of the populations involved.

Epically Dull

A grandiose film of official glory was released in 2009 for the 60th anniversary of the People's Republic. This was also a year in which China was battling the multi-year post global financial crisis downturn of the economy with blasts of both capital and propaganda. *Jianguo Daye*, or "The Great Enterprise of Founding the Republic," was an awkward pastiche of official propaganda messages that extended from the patriotic performances of Hong Kong and Taiwanese actors who lent themselves to the Mainland myth of political and cultural unity to Mao Zedong's fake standard Mandarin accent. (By effacing Mao's strong Hunanese speech, producers emphasized the myth of Party representativeness.)

The film was the one and only available film ported to cinemas across the country. It was reported to have grossed USD 63 mln and been very profitable. Perhaps it was. In view of the fact that all cinemas were showing nothing else, even that relatively weak total revenue and claimed profit do not capture the story of subsidies and waste embodied in the production, which tapped patriotic contributions from almost all the actors, unpaid, as well as from crew, studio, and theaters.

The first colossal production of the Twelfth Five Year Plan cultural push was *Confucius*. This was billed in China, by investors and the studio in charge, as the most epic film ever made by China, and it relied on two mainstays of Chinese film production, huge casts populating massive military scenes and increasingly dense CGI to fill in the sense of epic proportions were sheer body count would not suffice. Described in reviews as a "painfully dreary epic," and panned by Rotten Tomatoes, with an audience approval rating of 37%, *Confucius* review comments emphasized the film's absolute lack of character development in Confucius himself, the Master; a thin and disjointed story line; and the hackneyed trope of vast sweeps of faceless humans on massive battlefields.

This year, we have the release of *Great Wall*, a commercial flop for which there is a convenient Chinese phrase: 四不像 or "resembling nothing in particular," neither fish nor fowl. *Great Wall* substitutes for the ocean of extras in *Confucius* a recognized international star in the person of Matt Damon. But this is still too little, as is an assault of computer graphics so endless and disorganized as to seem in the service of a monster film that can only be described as self-parodying. The plot turns on the familiar question of 'what lies on the other side of the wall,' which turns out to be embarrassingly derivative copies of the aliens in Alien. Of course, every viewer comes to the film knowing that the real aliens were actually non-Chinese people of Turko-Mongolian descent.

Rolling Stone declares that "Matt Damon Battles Monsters and Audience Boredom." Says reviewer Peter Travers:

> This co-production between the U.S. and China, the two leading spots on the map for mining gold at box office, is a $150 million mess of muddy 3-D computer effects and backward thinking.

Not only an interest in artistic value but also in the future commercial viability of Chinese films raises the question of why Chinese productions, no matter what the investment, are so devoid of character development, complexity and engaging storylines? Why such reliance on spectacle over genuine substance?

Those involved in the industry note that the required formal review by the Ministry of Culture is a minefield of uncertainty, because the potential intervention is unconstrained, the guidelines are vague, and there is no recourse. Censors can demand changes in characters, dialogue, plot lines, or even film titles, and they do so in what artists consider arbitrary ways. Sometimes these notes are "artistic;" often they are subjective, without any clear political meaning. They depend on the mood. Censors see problems in content that the producers simply have not intended and sensibility of the particular censors assigned to any given project, as well as on the whims of the government depending on political context. The results are necessarily watered down, consensus-driven films. This level of political engagement encourages script writers, producers, and directors to rely on spectacle rather than story or characters. It sedates potentially exciting innovation and exploration of profound human themes, and it raises a key question about the direction of China's cultural policy overall.

A Wider-Angle Lens

The discussion is well-developed of the pros and cons of a strong industrial policy, or the pros and cons of a central authority that eschews technology neutrality and makes technology investment choices. There is less examination of the impact of a strong cultural policy and granular intervention by political leaders in cultural production. Yet it is critically important not only to the commercial potential of endeavors like film production and theater revenue, but to the political utility of those endeavors as well.

Aside from a normal set of censorship criteria, there is very little government engagement in the successful pop culture worlds of India, Korea, and Japan, not to mention Europe, the U.S., Latin America, and Australia. The global (albeit ex-China) enablement of relatively unsupervised platforms like YouTube and Facebook has triggered unprecedented waves of creativity and brought public prominence and lucrative rewards to individuals from all walks of life who might otherwise never have been heard from. Simply put, cultural productions have reached a level of globalization and democratization that in an important sense is all about a future of access and pluralism. Competition for revenue is now on a global playing field, intense and highly sophisticated.

From the standpoint of business and value creation, the proper role and application of cultural policy crafted by central authorities is worthy of debate. The viability of everyone from actors to film producers to theater owners is dependent on enthusiastic consumer engagement, and the record of film production in China since 2009 does not suggest current policy is well-tuned to future growth and sustainability. Rules are intensely focused on content control, down to the number of minutes of positive China-related content and the number of Chinese actors required in an international, cooperative production. Rules are neither concerned with nor conducive to innovation, creativity, or the protection of artists. There is no discussion of the freedoms of expression necessary to artists to create meaningful art.

What seems to be missing in China is genuine encouragement of and tolerance for individuals to innovate in the cultural sphere, and, perhaps even more relevant, genuine protection of the intellectual property rights and fair financial rewards for those who do create successful cultural products. The great cultural achievements of our era may be the fruits of individual creativity or well-orchestrated efforts of creative groups. But viewed through the widest of lenses, there is absolutely no evidence that such achievements can result from the grinding mechanisms of government production or control.

Data Matters

No Longer Starring: Box Office Income

After years of stunning growth, China's box office income fell back to a mere mortal 4% growth rate in 2016. The previous year had clocked 49% growth. The big slowdown in 2016 came in the second half, which is when the regulatory crackdown began.

For the first half of 2017, things got worse. Although SARFT has not yet reported revenue in 2017, all the theater chains report their revenue, and the sum of those totals for January-June 2017 is down 1% from the same totals for H1 2016.

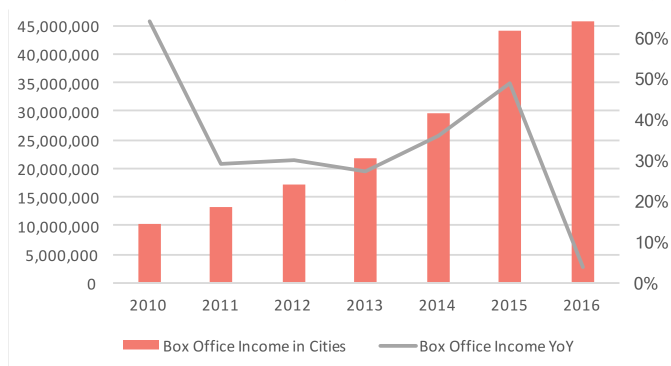
First Half Box Office Revenues: Theaters

(,000 RMB)	H1 Revenues	YoY
YTD 2015	2,261,987	
YTD 2016	2,603,606	15%
YTD 2017	2,582,256	-1%

Source: China Film Distribution and Exhibition Association

Despite the low growth overall in 2017, China reported phenomenal box office results for the big holidays. At Spring Festival, box office revenue growth was 111%. Qingming, the tomb-sweeping festival, saw a reported 103% increase, as did the May holiday, while the Dragon Boat Festival reported 98% improvement.

Box Office Revenue (,000 RMB and YoY)



Source: SARFT

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UPCOMING J CAP EVENTS

August Trips

Finance, banking and stimulus

Beijing, Tianjin, Shanghai, Chongqing. Are Chinese financial institutions really in a tightening cycle? Who is getting credit and who is not? What will happen to the RMB in Q3?

- **Led by Anne Stevenson-Yang, August 21-24.**

Online Travel: Ctrip and its Competitors

Shenzhen, Beijing, Hangzhou, and Kunming. Will Alibaba's Fliggy, Meituan, and JD's Tuniu harass Ctrip and force down its prices? Or has Ctrip conquered the competition?

- **Led by Jeff Dorr, August 14-17.**

Infrastructure

Jining, Shandong; Nanjing; Changsha, Deyang, Sichuan. To what extent is infrastructure construction still supporting steel and coal? Are there new financing strategies available? What is happening with supply-side reform? Visits to local government financing platforms, steel traders and mills, elevator distributors, engineering firms.

- Led by Tim Murray, September 11 - 14

September Trips

E-Commerce logistics and payments

Hangzhou, Shenzhen, Wuhan. Who is winning and who is losing? Alipay, Tenpay, JD Finance, the Cainiao companies, and their clients.

- **Led by Anne Stevenson-Yang, September 25-28.**

For preliminary trip agendas or to arrange a bespoke trip, please contact Brian Emanuelson, brian@jcapitalresearch.com or +1 617-308-5825.

Participants arrange their own travel to and from China and are responsible for the costs of domestic airfare and hotels. J Capital can extend a visa invitation. J Capital accompanies all trips and provides interpretation. Most meetings are conducted in Mandarin.

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