

PIXAR ANIMATION STUDIOS

- Should Pixar seek a better distribution deal outside of Disney?
- Can it seek a better deal with Disney?

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I. Introduction:

In 1986, Steve Jobs purchased the computer graphics division of Lucas Films Ltd. for \$10 million and established Pixar Animation Studios. Since its inception, Pixar established itself as a leader and innovator in computer animation. Its first animated short films garnered many film awards, most notably *The Tin Toy*, which won the Academy Award for Best Animated Short Film in 1989. In 1991, Pixar entered into a three-picture co-production deal with Disney. Following the success of *Toy Story*, this relationship was extended to include three more pictures. A string of blockbuster hits followed, each film doing better than its predecessors. *A Bug's Life* was the highest grossing film of 1998. *Toy Story 2* became the highest grossing animated movie of its time in 1999, later topped by *Monsters, Inc.* in 2001, and then by *Finding Nemo* in 2003.

On January 30, 2004, it was announced that Pixar and Disney had failed in their negotiations to extend their contract beyond the animated film *Cars*, to be released in 2006. With the stellar success of *Finding Nemo*, Pixar felt entitled to a more profitable contract with Disney. The new Disney CEO Robert Iger has stated that he will continue negotiations with Pixar. Before Pixar makes its decision on its future relationship with Disney, it should consider its survivability and likely profitability in seeking distribution deals elsewhere.

II. Company Analysis

• **Company History (1)**

- 1984: Former Disney animator John Lasseter joins George Lucas' computer graphics group. He will eventually become one of the founders of Pixar and its creative director.
- 1986: Steve Jobs purchases the computer graphics division of Lucasfilm, Ltd. for \$10 million and establishes Pixar.
- 1991: Pixar enters into a 3 feature-length animated film deal with Disney.
- 1995: Pixar goes public. *Toy Story* is released, becoming the highest grossing film of the year
- 1996: John Lasseter is given the Special Achievement Award at the Oscars for his leadership in the making of *Toy Story*.
- 1997: Pixar and Disney enter into a new agreement to jointly produce 5 films, superseding their previous agreements. Pixar expands to a second building in Point Richmond.
- 1998: *A Bug's Life* is released, making over \$163 million in domestic box office receipts and \$362 million worldwide.
- 1999: *Toy Story 2* is released, grossing \$245 million in domestic box office receipts and \$485 million worldwide.
- 2001: Co-founder Ed Catmull is named Pixar's president. John Lasseter signs a ten-year contract to work exclusively with Pixar. *Monsters, Inc.* is released and becomes the 3rd highest grossing animated film ever.
- 2003: *Finding Nemo* is released and becomes 8th highest grossing film of all time.
- 2004: *Finding Nemo* wins Oscar for best animated film. *The Incredibles* is released.
- 2005: *The Incredibles* wins Oscar for best animated film.

• **Product Strategy**

- Specialize in 3-D computer generated animated feature films (increased novelty and differentiation from "normal" cartoons)
- Create heartwarming stories and memorable characters that target audiences of all ages.
- Develop brand reputation through entertaining, and successful box office films
- Use brand reputation to sell video products, toys, interactive games, and other merchandise with or without the Disney co-brand.
- Develop proprietary animation/production software that can be licensed. A source of revenue that can be exploited to sustain company operations in the future.

- **Business Model**
 - Strong brand and consistent successes ensure a more profitable future distribution agreement, allowing Pixar full ownership of its future properties
 - Home video sales are among the largest contributors to lifetime revenues of its films and are a continual source of revenue for the future (Finding Nemo, released in VHS and DVD, was the best selling home video of all time).
 - Expect favorable growth of DVD sales once DVD adoption rates have caught up to that of the U.S. in many foreign countries.
 - Sales moratoriums imposed periodically on home video titles prevent a declining sales price and support a potentially higher sales price upon re-release (a new practice started with Toy Story 1 and 2 in Spring 2004).
 - All film titles are available through various television markets: Pay-Per-View, pay television, broadcast and basic cable television, and international television. Films were licensed to Starz/Encore! premium cable network by Disney. Source of revenue to sustain future operations.
 - Revenue opportunities through licensing of toys, video games and other derivative products (Disney currently produces, markets, and sells Pixar toy merchandise. THQ has licensed rights to produce computer and video games for *Finding Nemo*, *The Incredibles*, and *Cars*).
 - Produce award winning short films showcasing new technology, released accompanying feature releases and feature DVDs, increasing respective values (.
 - Revenues: 95% animated films, related products; 4% software; 1% animation services (2)

- **Terms of 1997 Co-Production Agreement with Disney (2)**
 - Produce 5 original computer-animated feature films for distribution by Disney
 - Both would co-finance the production costs of the pictures
 - Both would co-own the pictures 50/50, with Disney having exclusive exploitation and distribution rights.
 - Both companies co-brand the pictures and share equally in the profits of each picture and its merchandise and other ancillary products
 - Disney would recover all its marketing and distribution costs before division of profits
 - Pixar would pay Disney a set distribution fee (12% of profits) and other mutually agreed upon fees and costs
 - Both companies have mutual control over the development of derivative works of films under agreement (i.e. sequels like Disney's planned Toy Story 3).
 - First four films under this agreement are: A Bug's Life, Monsters Inc., Finding Nemo, and The Incredibles. Cars, currently in production, is the final film.
 - After completion of this contract, Pixar has right to negotiate and enter into another distribution agreement with any 3rd party.

- **Other Third Party Agreements**
 - THQ Multi-Property Publishing Agreement (August 2004)
 - THQ has been granted interactive rights to four future Pixar computer animated feature films, beginning with the first film produced outside current contract with Disney. This ensures one source of complementary products for future films.

- **Other Products**
 - RenderMan software has been sold to studios to create visual effects in over 100 films. Customers include Disney, Lucasfilm Ltd., Sony Pictures Imageworks, and DreamWorks Animation SKG.
 - Marionette™ - animation software system for animating and lighting.
 - Ringmaster- a production management software system for computer animation projects

- **Conclusion**

- Pixar has a very solid track record of producing innovative and successful computer animated feature films. Its reputation for quality family entertainment has been well established outside of the Disney name. Having secured John Lasseter, whose creative vision and direction is a major reason for Pixar's success, in an exclusive contract mitigates the risk of producing films in the future, and the exclusivity of his talent is a barrier to entry. For the near future, Pixar's licensing agreements with THQ should provide a source of complementary products outside of its Co-Production Agreement with Disney, while other merchandising deals should follow. Pixar will also have a steady cashflow from ancillary products of previous successful films that will help to insure the company's survival. Its proprietary animation software is another source of revenue and another barrier to entry.

III. Industry Analysis

- **Product**
 - Family-oriented entertainment feature films
 - Proprietary computer graphics/special FX software
- **Substitutes**
 - Family-oriented, animated and live action feature films produced by major studios
 - Family-oriented theme parks
 - Home videos
 - Sporting events
 - Television shows
 - Novelty and appeal of the computer generated graphics and thoughtful storylines make Pixar's films less substitutable by generic family entertainment.
- **Complements**
 - Licensed merchandise including toys, apparel, and software games.
 - Currently bundling Pixar toys with McDonalds' Happy Meals for children (through Disney's exclusive agreement to provide Disney toys to McDonalds) provide great exposure that benefits all three companies.
 - Theme park rides featuring branded characters (currently have rides at Disney World and Disney Land) promote brand awareness, home video sales of previous films, and awareness of new films.
 - Release dates with no other family oriented film released by a major studio
 - Home video releases/ video rentals of previous successful films remind audience of Pixar's reputation and stir interest in new box office films.
 - Prequels/sequels
 - Movie soundtracks
 - Novel/comic book adaptations of films
- **Key Competitors (2)**
 - In Animated Feature Films:
 - Disney, DreamWorks Animation SKG, Inc., Studio Ghibli, Lucasfilm Ltd.
 - In Computer Graphics/ Special FX Software
 - Industrial Light and Magic, Rhythm & Hues/VIFX, Tippett Studios, WETA Digital, Digital Domain, and Sony Pictures Imageworks.
- **Competitive Factors**
 - In Animated Films
 - Creative content, talent, product quality, technology, access to distribution channels and marketing resources
 - In Software

- Technical and creative talent, patents, copyright and trade secret protection, nondisclosure agreements and cross-licensing arrangements, broad acceptance of product as standard
- **Entry**
 - Barriers for Animated Films
 - Proprietary animation technology
 - Significant learning curve for production
 - Talent- most proven animators are bound by contracts
 - Economy of scale (need many technical employees)
 - Vision and creative direction in creating valuable film content
 - Marketing power
 - Complementary products to promote film awareness/advertising
 - Brand reputation important to families seeking entertainment
 - Barriers for Computer Graphics/ Special FX Software
 - Learning curve for programmers and animators
 - Reputation
 - Acceptance and use of software by movie industry
- **Rivalry**
 - Little price competition for feature films. Ticket prices set by theatres.
 - Competition for release dates (July 4th, Memorial Day, Thanksgiving) where audience attendance is highest.
 - Releasing films with similar themes and target audiences within the same time window is a tactic used to undermine each other's sales. Currently Co-Production deal with Disney ensures family oriented films produced by Disney subsidiaries are not released within the same window as Pixar's films.
- **Buying Power**
 - Consumers for feature films include families with children and the general audience. Appealed by the novelty of 3-D animated films and Pixar's sophisticated plots.
 - Consumers for toys and video games include mostly families with young children.
 - Buyers are fragmented, have little buying power.
 - Exclusive licensing agreements for derivative products prevent competition.
 - Critics are able to sway the decisions of the public.
- **Supplier Bargaining Power**
 - Proven film directors, producers, animators, creative personnel and technical directors are crucial to Pixar's success and hence also have significant bargaining power.
 - Labor currently is not unionized but may be in the future.
 - Key individuals in the company include Steve Jobs, John Lasseter, Ed Catmull, Simon Bax, Sarah McArthur and Lois Scali.
 - Pixar is dependent on Disney's marketing power and distribution channels. However, there is heavy competition to be Pixar's supplier because of its proven track record.
- **Conclusion**
 - Brand reputation is a serious consideration in family entertainment. Having a proven track record and a halo effect from being associated with Disney should help Pixar overcome this obstacle. However, Pixar should expect higher marketing costs to replace the free marketing it currently receives through McDonalds and Disney theme parks. It should also expect greater competition during releases if it leaves Disney as Disney would no longer be bound to not release films that target Pixar's film audience during the same time windows. Also, Pixar's reliance on key individuals for success is less than desired but is common in an industry built on the creativity and leadership of the few.

IV. Should Pixar Seek a Distribution Deal Outside of Disney

- **Risks**

- Pixar's annual revenues are dependent on:
 - The success of feature films, extremely difficult to forecast
 - Timing of film releases (one film per 18 months, not annual)
 - The timing and amount of worldwide revenues and distribution costs, which vary per film.
 - Domestic and international socioeconomic and political events.
- Disney currently bears most of the downside risk for each Pixar film. By Disney's co-financing of the production costs and collecting of payment for the costs of marketing and distribution only when the films turn profitable, Pixar's risk is mitigated. In order to justifiably seek better profit sharing, Pixar will have to bear more risk.
 - Film production costs are also difficult to predict. Deal with Disney mitigates risk and financial consequence of budget overrun.
- Disney also initially bears the production cost of Pixar toys. Given the recent lackluster sales of Shrek toys by Dreamworks, there is risk in this as well. However, a proper licensing agreement where Pixar bears little risk would suffice.
- Disney had incentive to avoid directly competing with Pixar's films and products before. Now, Disney can release films that target Pixar films' audience within the same time window as Pixar's releases.
- Value of synergies offered by association with Disney, the halo effect of Disney's brand name, and Disney's marketing power and expertise is hard to quantify and replace.
- DVD sales of animated movies are now selling 50 to 70% of total sales within the first week of release as more and more new DVD titles are released by movie studios and TV studios each week, mimicking the competitiveness of box office releases. However, sale moratoriums and re-releases of library titles can renew interest and increase demand periodically for library titles. (3)

- **Survivability**

- Pixar is committed to the quality of its films, releasing one film every 18 months, compared to the 2 films per year goal of its closest competitor, Dreamworks SKG.
- Dreamworks SKG is now committed to solely producing CGI animated films. However, Dreamworks targets an older audience than Pixar, as shown by its Shrek movies.
- In 2005, Disney Animation Studios will release its first all computer-generated feature, *Chicken Little*, which appears to be directly competing with Pixar's audience.
- Current production costs consist primarily of salaries, equipment and overhead. \$140.0 million have been spent on production costs for *Toy Story 2*, *A Bug's Life*, *Monsters, Inc.*, *Finding Nemo*, *The Incredibles*, *Cars*, and other films under development, net of Disney's contribution under the Co-Production Agreement. Expect costs to double once separated from Disney (2).
- Pixar currently has \$48 million in cash with another \$474 million in short-term investments and \$197 million in receivable from Disney (2). This more than covers twice the previous production costs of its last five films under the Co-Production Agreement with Disney. Pixar has ability to fully finance its own films.

- Pixar's five titles for Disney have averaged \$239 million in domestic receipts.
- Total operating expenses for fiscal year 2004 are \$34,870,000 with \$2,484,000 spent on sales and marketing (2). Since Disney fully charges Pixar for all marketing and sales costs, we expect sales expenses to moderately increase. Additional costs in advertising would be required to make up for the lack of efficiency and the lack of complementary products such as Disney theme park rides and McDonalds toys..
- Conclusion
 - With production costs to double and marketing and sales costs to increase, the survivability of Pixar becomes an issue. However, with its current cash surplus and residual income from previous films, that risk is minimized. Not to be forgotten is that Pixar will be able to collect a greater portion of the profits from future films and merchandising.
- **Possible Future Partnerships**
 - Time Warner- owns several subsidiaries that can provide a great source of complements to Pixar's films (4)
 - Six Flags Theme Parks
 - More accessible and reaches a greater audience than Disney World and Disneyland. Patrons also frequent Six Flags more regularly due to the parks' accessibility and lower cost. More opportunities for advertisement.
 - In addition to attracting children, also attracts an older audience with greater discretion in spending.
 - WB's branded characters (Looney Toons) are less profitable and less popular than Disney's. WB would have less fear of cannibalization in introducing and aggressively promoting Pixar's characters in its parks.
 - DC Comics- comic book adaptations of films
 - Easy to produce art using the same animation software as films.
 - Can be used as proving ground for story ideas. If a story is well received, can translate the story into film.
 - WB records- licensing deal with film soundtracks
 - WB has a catalogue of music that can be licensed for film soundtracks and is a source of vertical integration to cut production costs.
 - Television networks- televised older movies are another complement to promote Pixar's future films
 - Home video distribution
 - Book publishing- novel adaptations of films
 - Burger King
 - Can offer exclusive toy distribution deal to Burger King to complement its children's meal. An alternative to Disney's relationship with McDonalds.
 - Conclusion
 - With Pixar's continuing success, it is in a good bargaining position to negotiate for more lucrative deals. Time Warner is a very viable alternative to Disney's one-stop shop for distribution and product complement needs. An exclusive toy licensing agreement with Burger King can complement both companies' products much like the agreement between Disney and McDonalds.

Mathematical Analysis of Pixar Strategy

According to Dreamworks, the average cost to distribute and market a film for theatrical release is \$125 to \$175 million. (5, page 16) Currently, Disney bears the risk of losing this money if the film is not profitable.

Under the new strategy, Pixar would bear much more of this risk. If the expected cost is very large, it may be more profitable to just stick with Disney.

The expected cost of bearing this risk can be approximated as (Probability of failure) * (Cost of marketing). So minimally we want this to be not much less than the distribution fee, or else Pixar is overpaying Disney for failure insurance. From a HBS report, the industry average is a 80% failure rate (6). So we want $.80 * 150,000,000 + e \geq .65 * \text{profits}$; Disney gets ~65% of the total profits (7). This is assuming that the failing films made no money at all, which is very conservative. For the past two years, the average profit to be split among both companies has been around \$300 million (8).

We then see that assuming Pixar was "the average film company", the film failure risk amortized over all the films should be insured against for not much more than \$120 million, but that the amount paid to Disney is \$195 million. Also, Pixar is not the average film company, and all its films have been profitable. Therefore from an insurance perspective we conclude that the current Disney agreement is unfavorable.

Because of the above analysis, Pixar can credibly claim that the present Disney deal is unfair and so can either find a new partner, or renegotiate with Disney. Here we estimate favorable deal sizes for partnering with Time-Warner or else partnering with Disney.

We have already shown above that Pixar can bear the risk of financing the films. However, it is likely that Time-Warner would be a better distributor than Pixar itself would, as it already has infrastructure and experience. Time-Warner would be interested in partnering with Pixar without assuming risk, because it would be pure profit. Also, Pixar can use the credible threat of partnering with Disney to reduce the payout to Time-Warner.

So we are interested in knowing the minimal amount of profit per film that Time-Warner would accept. As a ballpark estimate, assuming that Pixar will finance at least half of the production, we believe that Time-Warner would accept a deal whose expected profits met half the industry average of \$94 million for G-rated films (9).

We could structure the deal so that the expected profit for Time-Warner is \$47,000,000, by dividing \$47,000,000 by the expected total profit, which, recently, has been around \$300,000,000. So we then offer Time-Warner ~16% of the profits, which compares favorably to Disney's 65%. We also have the option of structuring it as a simple fee rather than a percentage of profits, but then Time-Warner would have much less incentive to aggressively and successfully distribute the films.

Currently, Disney is making \$195 million per film in profit, compared to the \$47 million that Pixar could offer Time-Warner. However, keeping the deal with Disney may have special synergies, which we estimate to be around \$50 million, split between both companies. Therefore we increase the nominal profit cost of \$47 million to Time-Warner by the implicit \$25 million cost.

So now we're at \$72 million given to Time-Warner versus \$195 million given to Disney, per film (in profit). Because there are switching costs associated with dropping Disney, we estimate that Disney meeting Pixar half-way would be favorable. This half-way point is \$133.5 million.

The strategy then is as follows (converted back into percentages):

If Time-Warner offers 24% per film or less in profits it receives per film, go with Time-Warner.

If Disney offers 44.5% per film or less in profits it receives per film, stay with Disney.

V. Conclusions and Future Strategies:

- Pixar should explore the possibility of a more lucrative distribution deal with Time Warner.

- With Time Warner as a possible buyer with similar capabilities as Disney, Pixar can renegotiate for the better terms with Disney or use Disney to get even better terms with Time Warner.
- Profit sharing of the box office proceeds should definitely be included in any distribution deal to encourage the distributor to better promote and aggressively advertise Pixar's films.
- Disney offers synergies not possible with other distributors. Pixar should consider this and discount other distributors' deals to take into account loss in marketing value.
- If Time-Warner offers 24% per film or less in profits it receives per film, go with Time-Warner. If Disney offers 44.5% per film or less in profits it receives per film, stay with Disney.

VI. References

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VII. Appendix

- Animation Process
 - Development of a story concept, "treatment."
 - First draft of a screenplay is written.
 - Screenplay is turned into storyboards that are transferred to video and electronically edited into a story reel.
 - Voices are selected, recorded and added to the story reel.
 - Shapes and dimensions of digital models are made for the characters. Rigging, set of controls for 3-D model movement, is added. Digital camera angles for scenes are positioned.
 - Digital models are animated by using rigging controls. Models are filled with pattern, texture, color, and finish and lighting is added.
 - Final rendered digital image is sent to Pixar Vision laser recorders to be printed on film. Films are also sent out to be shown digitally. Pixar's computer generated films are particularly suited for this next generation projection process.
 - Post production includes final editing and scoring the soundtrack.

Box Office Proceeds for Released Films

Film	Proceeds
<i>The Incredibles</i> 2004	\$260 million domestic
	\$368 million international
<i>Finding Nemo</i> 2003	\$340 million domestic
	\$525 million international
<i>Monsters, Inc.</i> 2001	\$256 million domestic
	\$268 million international
<i>Toy Story 2</i> 1999	\$246 million domestic
	\$239 million international
<i>A Bug's Life</i> 1998	\$163 million domestic
	\$200 million international
<i>Toy Story</i> 1995	\$192 million domestic
	\$170 million international