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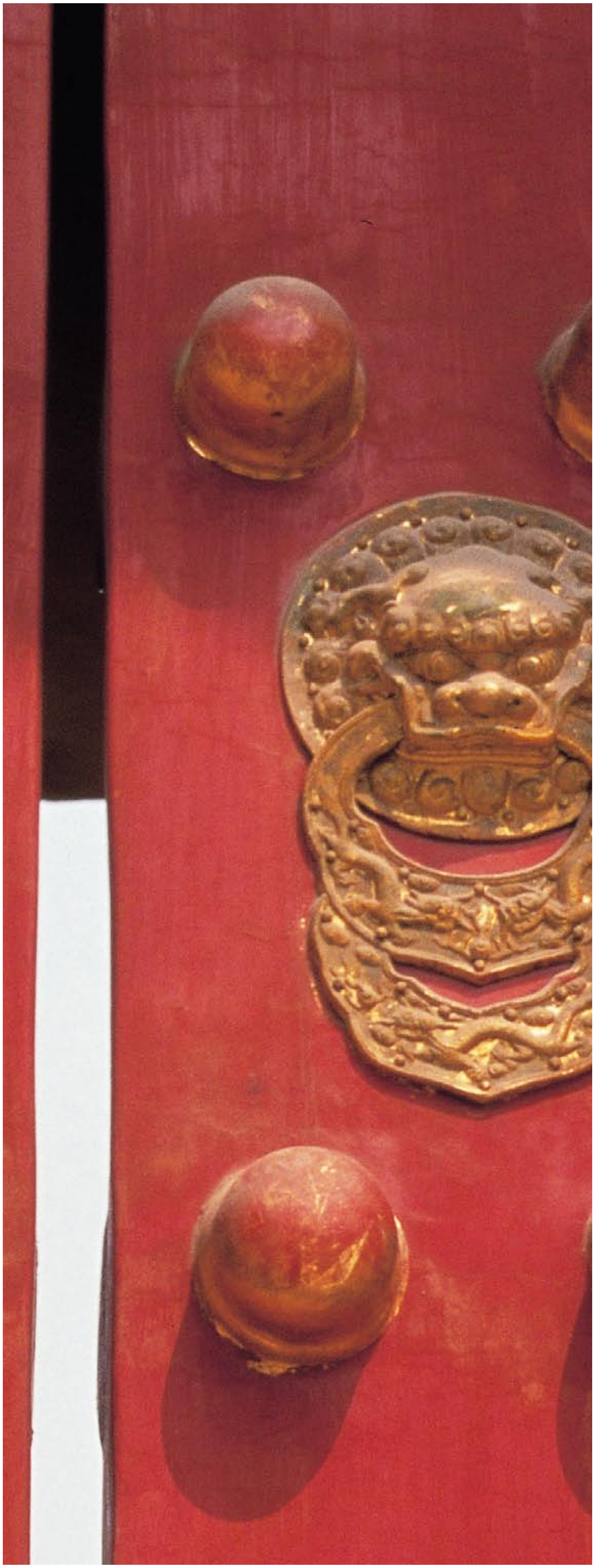

doing business in china*

new frontiers in entertainment & media

During the week of May 9, 2005 PricewaterhouseCoopers (PwC) hosted two groups – one in Los Angeles, the other in New York City – of senior entertainment & media executives at a roadshow seminar series called, “New Frontiers in Entertainment & Media-Doing Business in China.” Each event included a presentation by Marcel Fenez, PwC’s Asia/Pacific Entertainment & Media (E&M) Practice Leader, on the E&M market outlook for China, followed by a panel discussion on doing E&M business in China, which featured senior E&M industry executives who shared their personal experiences and suggestions.

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china's entertainment & media industry:

investment and growth prospects on the rise

Gradual regulatory openings and the emergence of media industry opportunities in China are going to represent significant investment and growth prospects for foreign investors, according to Marcel Fenez, PricewaterhouseCoopers' (PwC) Asia/Pacific Entertainment & Media Practice Leader.

In a presentation during PwC's "New Frontiers in Entertainment & Media: Doing Business in China" seminar on May 12 at the St. Regis Hotel in New York, Fenez also cautioned that stringent content censorship, continuing piracy problems, and ongoing uncertainty regarding how the Chinese government will work with potential international trade partners, remain important factors in the market.

Looking ahead to 2009, PwC is forecasting a compound annual growth rate (CAGR) of at least 18 percent in China. "It might be 25 percent, but will not be lower than 18 percent," Fenez said. "It really doesn't matter, because at any rate it will be a lot larger than in the U.S."

The impact of China's "one-child" policy, as well as a decrease in women of child-bearing age, will result in the country's population maxing out at about 1.31 billion by 2014. Currently 36 percent of the population is younger than 25. That figure is expected to drop to 20 percent by 2024. At the same time, the older-than-40 population, which now stands at 37 percent, will increase to 58 percent by 2024.

In addition to an aging population, China will also have a growing middle class, meaning that a greater number of households will have a relatively high disposable income. While the young adult market will grow in the short term, its importance diminishes beyond 2010 as young- and middle-aged households come to dominate the market. Currently the most dominant household segment is the young "marrieds" with a child under 10 (making up 27 percent of the population). That figure decreases to 10 percent by 2024, by which time the dominant segment will be the working-age empty nester, at 31 percent (compared to the current 16 percent).

China will maintain its number two position (behind Japan) in Asia in terms of total advertising spending, while increasing its percentage of the region's ad market from 10 percent in 2004 to 14 percent in 2009. Leading the way for the country's entertainment & media growth will be Internet advertising and access spending, with a CAGR of 36.2 percent, and online games, at an astounding 45 percent. Multi-channel households are expected to increase by a 10.1 percent CAGR, with Internet penetration – currently estimated at a con-

servative figure of 9-to-11 percent – increasing by a CAGR of 25.5 percent during the same timeframe.

Television advertising is expected to grow much faster than any other advertising medium, with terrestrial advertising spending predicted to increase from $1.3 billion in 2000 to $6.6 billion by 2009. In terms of TV subscription spending, China is expected to grow at a CAGR of 18.9 percent to nearly $8 billion by 2009.

China maintains the largest Internet market in Asia, with Internet access spending expected to increase from $19 billion in 2004 to $90 billion in 2009 – a CAGR of 36.3 percent.

The country's online gaming market, already one of the world's largest at $159 million in 2003, is expected to grow to $810 million by 2007. The figures are all the more impressive, Fenez said, when considering that there are only about 20 companies of significance currently active in the segment. Internet cafés offering online gaming continue to dominate the landscape, and local companies are continuing to grow; however, Fenez noted, foreign companies are currently in a superior position in research & development as well as creative design.

Turning to the regulatory environment, Fenez noted that in 2000 he would have predicted China's entertainment & media sector would be more open to foreign concerns by 2020; today he believes that will occur by 2010. Driving factors include China's accession to the World Trade Organization (WTO), further liberalization of its regulatory policies, and the signing of the Closer Economic Partnership Arrangement with Hong Kong, allowing Hong Kong-based companies an advantage in operating on the mainland.

Fenez drew a parallel to China's involvement with the Olympics, noting that, traditionally, it only entered a handful of events, but that over time the nation increased its participation once it felt sure that it could win gold medals in additional events. Similarly, he said, the country will only embrace foreign investments in its media market when they are seen to be necessarily helpful to the growth of its domestic market and hence enhancing China's competitiveness on the world stage.

As a result, while joint ventures between Chinese and foreign concerns are allowed in some segments of the television and broadcasting, film, publishing, outdoor media and advertising segments – usually with the Chinese government controlling the actual content – foreign involvement in some segments remains forbidden, including the printing of publications and the ownership of Internet content provider licenses.

Still, he added, the content gap is increasing, which is why China introduced new regulations in late 2004 to allow production joint ventures. In addition, the growth of digital television will require a lot of content: for example, with about 50 children's channels expected to launch during the next three years, there will be a need for the production of roughly 30,000 hours of programming. Currently, there is only about 30,000 minutes of indigenous programming being produced.

Gabriel Wong, director of PwC's China team, presented a case study on Shanda Interactive Entertainment Ltd., the market leader in China's online gaming industry, which was able to thrive in part due to offshore vehicles for foreign investors. "Any business model must be adaptable to changes in China – the structure must be very flexible," he said.

Fenez concluded by noting that there are ample opportunities for foreign investors to take part in China's growing revenue stream, if not in the content itself. "If you want to be in the Chinese market, you may need to take a more holistic approach," he said. Rather than approach the market with preconceived notions of making a non-Chinese product work there, he said, "It may be best to view the market first, and then determine how you can get involved to build a long-term sustainable business."

advice from experienced execs

doing business in china's entertainment & media market

Details of how life in China has changed – and, in some ways, remained the same – during the past five years dominated a panel discussion that was part of PricewaterhouseCoopers' "New Frontiers in Entertainment & Media: Doing Business in China" seminar, held on May 12 at the St. Regis Hotel in New York.

Grace Tang, partner, PwC's Entertainment & Media Practice, said that during her seven years in Beijing she's seen televised content in general become more sophisticated and appealing, and the news in particular more balanced. She also attested to the pervasive appeal of online gaming among the city's youth, noting that the majority of PwC's Beijing office staff is younger than 25 and can often be found late at night trawling gaming sites, as well as conducting research, on their office-supplied PCs, as home computers remain expensive propositions for most consumers.

Robert Chua, chairman and founder of The Interactive Channel Co. Ltd., agreed that programming has improved even as he decried the increasing cost of on-air advertising. More importantly, he said, was a growing sense that the Chinese government has come to recognize the potential benefits of working with foreign companies.

He cited, as an example, the plight of the satellite channel he founded in 1994, CETV, which after several years of financial setbacks, found itself on the brink of closure. As a family channel and therefore sensitive to Chinese culture ("No sex, no violence, no news," he said. "Some people think that equals no viewers, but in China that's not true."), CETV was able to garner support from the government, even in the face of non-payment for use of the satellite. Chua was able to bring in Time Warner as a partner to extend internationally as a Hong Kong-based Chinese TV station. "If you do something positive for the Chinese," he said, "the government and the people can be very supportive."

Edward Cunningham, CEO, Clear Channel Entertainment China, noted that while the government has become more open to some corporate ventures, its cultural traditions have remained very much in place. "Every significant entertainment venue and asset is owned by the government," he said. "What's important to the officials you meet is not always money – it's more important for a political official, in any country, to be involved in works that benefit the people and cutting the ribbon for high-profile, culturally positive projects is an important part of political life.

"Bringing in culture and live events directly improves the lives of the citizens in a very high-profile and recognizable manner," he continued. "The key is to approach them with something that they want, not what you think they need. If you don't provide the officials with the opportunity to reach their objectives for China and their own political careers, you won't have a career in China. This is no different than any other country or

business relationship, except that the Chinese government is the most powerful single authority in the new world economy. We're just guests there – if they feel that you are not working with them to reach their objectives for the country as a friend and partner, you will not have their support, and your success in China will be very limited."

Peter Wolff, senior vice president, international, office of global public policy at Time Warner, echoed Cunningham's remarks, saying that building and maintaining relationships in the market matters greatly. "A basic requirement is to go there frequently," he said. "It's a show of respect, and that you care about China." Patience is also a basic requirement, he added, given that change in attitudes can occur very slowly in the country.

He added that building relationships with junior executives can be just as important as working with mid- or high-level officials. "Having lunch with them, even something as seemingly simple as signing a visa guarantee, can be very helpful and please them greatly," he said.

Wolff went on to term the piracy levels in China "gruesome," saying that the streets of major cities are filled with street vendors selling illicit product and estimating the piracy rate for films, DVDs and VCDs at as high as 95 percent. While anti-piracy regulations and penalties have been strengthened, he said, "Without enforcement, who cares?"

Time Warner has begun manufacturing and selling DVDs for the Chinese marketplace at less than $3 each, only moderately more than what pirates charge but offering a better quality. The theatrical window has also been reduced greatly and, Wolff said, if the government would allow more than 20 foreign films a year to be imported – and would institute a ratings system – the problem could also be alleviated as demand for product could then be sourced legitimately rather than from private sources.

Cunningham opined that the high level of piracy has actually helped educate Chinese consumers about American popular culture, to the point where they have learned English and have come to know such western icons as Tom Cruise and Bon Jovi. "They see every movie – they're probably watching 'Star Wars' right now," he joked. "If we can somehow control piracy, we would all find a built-in market for our product."

Moderator Marcel Fenez, PricewaterhouseCoopers' Asia/Pacific Entertainment & Media Practice Leader, theorized that when China's domestic film industry evolves and matures – and it begins to be hurt by piracy at a level commensurate with western content providers – then a government crackdown will be more likely.

The panel concluded that, while many of the issues surrounding entry into the Chinese market are similar to entering any new market, the fact is that China remains a relatively unpredictable entity. Wolff noted that, while last October there seemed to be great enthusiasm for allowing international joint ventures, the environment is now "more quiet," as incoming ministers familiarize themselves with the ins and outs of the business.

Fenez encouraged companies interested in entering the market to consider a 5-to-15 year plan, rather than one predicated on immediate gratification. Chua underscored the point that showing face and educating oneself about the particulars of the market are of paramount importance. "You must show passion," he said, "and prove that you're looking to make money with – rather than simply from – the Chinese people."

voices from the china hands

Disney has been in China since the 1930s. Electronic Arts is taking aim at the growing market for online games among the country's rapidly increasing number of sophisticated, well-paid urbanites. As president of international television, Gary Marenzi oversaw the multi-billion-dollar distribution of Paramount features and TV programming overseas. Grace Tang has been in Beijing for seven years, helping major entertainment & media companies establish a foothold in the world's most populous entertainment & media market.

These experts from the trenches provided the audience the benefit of their experiences at the PricewaterhouseCoopers' (PwC), "New Frontiers in Entertainment & Media: Doing Business in China" event on May 10 at the Four Seasons Hotel in Beverly Hills.

"What excites you – and what frustrates you?" asked moderator Marcel Fenez, PricewaterhouseCoopers' Asia/Pacific Entertainment & Media Practice leader.

Andy Bird, president of Walt Disney International, is excited about the company's prospects in China. The company's years of experience there gives it an advantage in a country where long-term business relationships are the key to success. Since introducing the Snow White character to the Chinese market, Disney followed up by starting a branded consumer products business. In the 1980s, Mickey Mouse and Donald Duck appeared on the national television service, CCTV, allowing Disney to use the globally popular toon figures as a base from which to build brand and character awareness.

The company doesn't focus on any one product segment. Disney's strategy has been to concentrate on establishing product diversity within a mixed media portfolio. They're in publishing – books, Mickey Mouse magazine, ESPN magazine. They're active in the mobile space, the Internet space, and in the consumer products arena through licensing. There are also 1,600 Disney Corners in China – shops within larger shops.

In September 2005, Hong Kong Disneyland will add theme parks to the product mix. Given the solid transportation infrastructure and increasing levels of disposable income, the company expects that 35 to 40 percent of its customers will come from mainland China. Disney also wants to expand the number of dates for Disney on Ice, which in recent years has played 40 dates in the largest Chinese cities.

"If you offer quality entertainment, the amount of buzz is tremendous," said Bird. "The value of tickets is high."

The overall Disney strategy is to build a Chinese Walt Disney, rather than a Walt Disney Company/China. "A Chinese manager oversees our businesses because you can't run a business in China – or anywhere else – unless you give local authority and autonomy. I don't get frustrated

because you have to be in China for the long term. You build one small block of business at a time. If we can operate in a segment where consumers will buy Disney branded characters or products, we want to play there. But you have to have patience and respect for their culture," he said.

Owen Mahoney is vice president of corporate development for Electronic Arts, the largest U.S. videogame company that is relatively young compared to media & entertainment companies operating in more traditional market segments. "Since the [China business] culture depends on long personal relationships, it can be challenging to navigate in that environment," he observed.

But a number of factors are very favorable to videogame companies. The number of people with high-speed broadband service has grown so that there are more broadband customers in China than in North America. The country's huge market segment of young people who want to play online games is also very large. Even those who don't have PCs can play games online by going to Internet cafés, popular throughout the country. The cafés have become centers of socializing as well, so that games are embedded in the social life of this group.

EA and other foreign videogame companies face some challenges. Mahoney commented, "The regulatory environment is extremely difficult – China's order of magnitude is more difficult than other countries. In addition, there are pricing power issues."

"Everything is less expensive there," Mahoney continued. "You can't charge $15 a month subscription like you can in North America. It costs us a lot of money to run a server. However, the Koreans have figured out how to lower those costs. The most successful games in the Chinese market come from Korea, but it is a big challenge for us."

As in the case in many territories, the traditional filmed entertainment business of motion pictures and television meets head-on with strongly-held Chinese cultural values. As a result, the amount of foreign product that can enter the country may be quite limited: Only 20 movies are legally imported into China each year, and only a small percentage of television programming from foreign sources can be aired.

The censorship criteria are also formidable, especially for many Hollywood products. Content cannot have drug-based crime, police investigations, Internet crime, extramarital affairs, extreme violence, religious or political overtones, ghosts, horror, or tragic endings. If content can pass through this gauntlet, it can get in.

Gary Marenzi, founder and president of Marenzi & Associates, knows the difficulties first hand. "Every entertainment company wants to plant a flag in China, but few know how or have the patience. They look at the censorship and approvals process [in China] and say, 'Just sell more to Belgium and forget about it.' And the irony is that as hard as it is to get content through the censors, consumers can get it on the street through piracy. That's the real dilemma for content owners in China."

From her position in Beijing advising many clients on entering the Chinese market, Grace Tang, partner, PwC's Entertainment & Media Practice, offered counsel to potential newcomers. "If you are not putting together a wholly-owned enterprise, do thorough due diligence, not just with the financial aspects of the deal, but also with the legal side. It is easy to get in – and it can be difficult to get out. Plan for a good mix of locals and expatriates.

"I'm more aggressive than some people in my perspective on doing business in China," said Tang. "However, you have to understand that there is always risk. But 10 years ago, the risk was much larger – there has been considerable progress since then. Today, Chinese leaders seek stability, so the chances of nationalization or a crackdown on the specialized structures that companies put together to accommodate foreign investment are unlikely," she commented.

The Chinese market is open for business, the panel concluded. Any entertainment company that is focused on international business must look at India and China. As Fenez observed, "In China, the train has left the station. It was slow getting started and it may make a few stops on the way, but it has already left."

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