

Business Process Outsourcing Goes Hollywood

Executive Summary

In the digital age, the number of distribution channels for creative content continues to proliferate at an accelerating rate. To keep pace, studios will innovate how they use working capital. They will focus on what they do best: making great movies, while they divest under-performing assets and outsource non-core operations.

Nowhere is this better illustrated than in the back office of studios' home entertainment distribution subsidiaries. Accounts receivable departments often find themselves overwhelmed by the sheer number of deductions taken by retail outlets and distributors. Altogether these deductions can aggregate to millions of lost dollars per year. By outsourcing revenue management, the studio can gain competitive advantage two ways: 1) by shedding back office infrastructure so assets can be better applied elsewhere, and 2) by exploiting best-of-breed competencies of organizations who have made receivables management their strategic focus. This results in faster cash collection, better relationships with business partners, and higher profitability. The result is also a better position from which to engage new channels of content distribution as those inevitably emerge.

Too Many Choices

For almost the first 50 years of the 20th Century, people had only four kinds of media with which to entertain themselves: print, movies, records, and radio. In the last ten years, however, there has been a proliferation of new media: digital cable, direct broadcast satellite TV, wireless telephony, instant messaging, video streaming, and the World Wide Web among others.

And if those weren't enough ...

Sony has developed a prototype product . . . that can store as many as 450 hours of DVD movie content, 1,500 CDs, and 600,000 high-resolution images. . . . [Sony president *Take*] Ando hinted that, by 2003, every TV as well as nearly every product Sony produces will be equipped with an Internet Protocol address.¹

Content distribution will always face
inevitably, heightening the need to embrace the



change. This very speed of change creates challenges for the bottom line of the studio. New channels require new fixed assets and new working capital. Operations have to be set up and people managed. At the same time, other operations will have to be terminated, their assets shed and their people let go or retrained. All this churn negatively impacts studios' cost structures yet must be accomplished at an ever faster pace.

The ability to restructure quickly is becoming a core competency — one the industry is rapidly adopting. Look at theaters:

"Most analysts figure there are way too many screens in the US," states Lindsay Chaney, a senior editor at *Variety*. "I think it's about 36,000 right now, and that may be 10,000 too many for the industry to be profitable. The basic problem with the theatrical exhibition business is that the chains have borrowed and spent an enormous amount of money over the past few years to expand and they aren't making enough money to cover their debt service. Many chains have built new megaplexes with stadium seating, etc., and these new theaters have taken business from their older theaters, which are often locked into long-term leases."²

Often the new channels demand new rules; margins may be thinner and cash flow less reliable. Look at what happened to the video business since the early 1990s. Previously, studios only sold videos directly to distributors. Then Disney began selling to Wal-Mart, shipping videos directly to thousands of stores, bypassing distributors. Similar relationships soon followed, with studios today shipping directly to the top 12 or so retail chains, as well as to the remaining distributors.

Shipping millions of boxes to thousands of stores required massive buildup of “front end” infrastructure and logistical capabilities — ordering, shipping, and managing inventory — much of which previously had been handled by distributors — and all of which drained resources away from making movies. Even worse, the shift also required something the studios hadn't anticipated and were not geared up to handle: “back end” processes to perform billing, returns, deductions, and receivables management. Mike Weetman, Senior Vice President of Finance at DreamWorks and former head of finance at Fox explains the problem:

¹ *Wall Street Journal*, 4/16/02.

² Naples, Florida *Daily News*, 9/20/00.

Cash Flow Challenges

“In the beginning, this was a distributor-based business that a small credit department could easily handle with limited IT [information technology] resources. There were only 10 to 15 distributors so there was less opportunity for deductions. You just drop a ton of pallets on their doorstep and you’re done. Ship to Wal-Mart and you ship to 4,000 stores. There are going to be ship shortages all over the place — late deliveries, early deliveries — all sorts of deductions. Aggregate those over a year and you are talking about millions of dollars in uncollected revenue. That’s what happens when you suddenly move into a channel where you don’t have expertise or infrastructure in place.”

Adapting to Change

Managing many different kinds of businesses in the same organization will be difficult enough, never mind constantly entering new businesses as part of an ongoing dynamic process. Looking ahead, Weetman sees revenue management only becoming more complex in the coming era of digital content distribution. “If [content distribution] is aggregated to network providers, you’ll just transfer your problem

Why Outsource?

When Mike Weetman, former Senior VP of finance at 20th Century Fox, needed to handle a growing mountain of receivables in the studio’s retail video subsidiary, he outsourced the problem to Creditek. Here’s why:

“We engaged Creditek in a moment of crisis when the credit department wasn’t skilled to deal with the receivables process. We had a high volume of transactions and massive volumes of deductions. Creditek clearly had the manpower with the skills and expertise — they had dealt with the customer base before. More importantly, Creditek had a complete system. They could deal with a large volume of deductions. For Fox to develop that internally would have committed a big chunk of money to buying IT resources — and, of course to hiring the people with the right skills.

“To convert the department to what I needed it to be would have been an 18-month job and we would have been hemorrhaging money for 18 months. Where as with transferring it to Creditek, it was probably two to three months of really intensive work. They took over. I think it went really smoothly.

“When I first got to Fox — three years before I took over the credit department — a lot of IT development had gone on at the front end of the business. All the critical IT investment has gone to the front end of the business — inventory management, sales forecasting and projections; all things to help sell product.

“Backend investments to help collect cash after the sale — that had to take a backseat. But once I took over the department I didn’t want to try to find the IT resources because to me they were all available at Creditek.

“To me, the payback on the fee I was paying was tremendous; not just in terms of the actual value of the deductions but in the time value of money, accelerating the process.

“Hopefully deductions won’t take place as often now because wherever Fox allowed a customer to deduct because of an error Fox is fixing that error. Also Fox is showing the customer that Fox has the capacity to respond when frivolous deductions are made.”

from a Wal-Mart to an AT&T that will serve its customer base and will also have promotional deductions, drop outs [content unavailable for technical reasons] or whatever. Studios will deal with those in addition to the physical channel, which is not going to go away anytime soon either.”

To succeed, studios will have to rethink how they have to employ working capital. Specifically, they must “decapitalize, shedding themselves of expensive physical assets and avoiding high-levels of working capital. Instead, they will partner with a network of smaller organizations that carry some portion of these burdens.”³

Business Case: Home Entertainment Distribution

Fox is a good example. The studio has virtually turned over its entire home entertainment receivables operation to Creditek. (More recently, MGM also hired Creditek to help with home entertainment accounts receivables.) Weetman explains why he hired Creditek at Fox: “The studio’s credit department has to keep updating its skills base to deal with these new channels of distribution. What I saw in my credit department was a strategic team of people focused on helping guide the company through the opening up of new channels and new customer bases — not on the nuts and bolts of cash collection and deductions management. It’s not core to the business. Someone else can do that so long as they have the right skills set and the right IT infrastructure. To me, that is a service that can be totally outsourced.”

Clearly, home entertainment is becoming much more important to studios’ bottom lines. Unlike theatrical releases where the profits happen relatively fast or never, video and DVD profits continue forever. Nor do these require mass-market appeal to be profitable. Witness *Star Trek*, Paramount’s single biggest franchise. Never a blockbuster, *Star Trek* aggregates profits over a full range of venues including movies, conventions, broadcast TV, syndicated TV, cable, DVDs, and video.

³ *Vying for Attention: The Future of Competing in Entertainment and Media, Our Industry Perspective 2001-2002*, PricewaterhouseCoopers, 2001.

To be successful, such aggregation requires at least one of two things: 1) the ability to scale lots of “micro profits” to pay the high fixed costs of a vertically integrated studio or, 2) the ability to decapitalize the business so that the studio no longer *is* vertically integrated. Actually both go hand-in-hand. The advantage of a “virtual studio” like DreamWorks is that it carries minimal overhead relative to the value of the content it can push through multiple channels — so it can easily mix and match channel investments based on the right formula for the particular product. Attacking lots of “profit pockets” simultaneously is a game of speed and dexterity.

That is the model for home entertainment. Each box on a retailer’s shelf represents a single “micro deal” between the studio and a retailer. Each deal represents an opportunity for profit or loss, depending on many cost components. Each component is small by itself but adds up quickly in total. What counts is managing things like deductions, cash flow, and credit terms aggregated with the studio’s multiple channels, and vast quantities of units in distribution.

Take deductions. Across all industries, Creditek has identified 162 reasons why a customer might deduct charges from an invoice. Of those 15 to 20 apply specifically to home entertainment retail. They include:

- Damaged products
- Mislabeled shipments
- Late shipments
- Early shipments
- Returned merchandise
- Wrong number of items per carton
- Wrong mix of items per carton
- Special marketing promotions
- Violation of administrative policies
- Reimbursement for advertising costs

When one of these events occurs, the retailer deducts corresponding dollar amounts from the invoice and sends a check for the reduced total sometimes (around 70% of the time) accompanied by a debit memo explaining the difference. Unless the studio can account for every detail in every transaction, the following complications can occur:

1. A studio may have hundreds of thousands of open (unresolved) debit memos on file at any one time — resulting in millions of dollars in write-offs per year. But tracking down all these debits and resolving them also takes time and money.
2. Because of the workload, deductions may have been lumped together (either by the retailer or by the studio) and applied against cash as a single total — making it virtually impossible to later track down the status of particular customer claims.
3. It is easier to apply credits for old deductions against more recent deductions (rather than dig through the files for the original paperwork) — thus making it unlikely that the new deduction will ever be investigated or reversed.
4. A studio may not be contacting retailers on a regular basis — sending a tacit signal that deductions are permissible.
5. The burden of proof is on the studio — they have to create an audit trail that shows how both sides handled the claim each step along the way.

Getting Control of the Process

It is important to find a partner that brings the appropriate mix of industry experience, process, and technology to have a true positive impact cash flow. Creditek's systems automate the identification, prioritization, and reporting of your disputes and deductions, tagging each with a tracking number and reason code(s). The system can automatically apply business rules as a predefined sequence of steps (the workflow) that determine when, to whom, and for how long an item is assigned to someone. Workflows can be optimized based on reason codes, studio policies, retailer policies, industry best practices, or alert status. The benefit to the studio that Creditek has created, a robust process that is highly adaptable and will serve as the company's back office without the large investments required in people, training, and technology.

Suppose a manager wants to know what's holding up payment on a receivable. Clicking on the item can reveal its current status; for example, that it's still pending five days after a phone conversation with a retailer's account payables supervisor. Electronic notes attached to the invoice might reveal that the supervisor approved the invoice verbally but there has been no follow-up since. The system would also alert

operators to check back with the supervisor after some predetermined amount of time has passed.

Process operators can even drill down to see where the problem items are: the most expensive items, a specific type of item, or the items that have been outstanding the longest. These, in turn, can be cherry picked to yield maximum return on effort. Nothing “leaves the system” until it reaches one of several end points — such as when a check is received for a credit or a determination made that a deduction is allowed to stand. Document imaging allows paper documents to be viewed side-by-side with the corresponding status information. Links to the web allow the studio credit department and the retailer’s accounts payable department together to view items in real time while discussing them over the phone, to quickly resolve disputes.

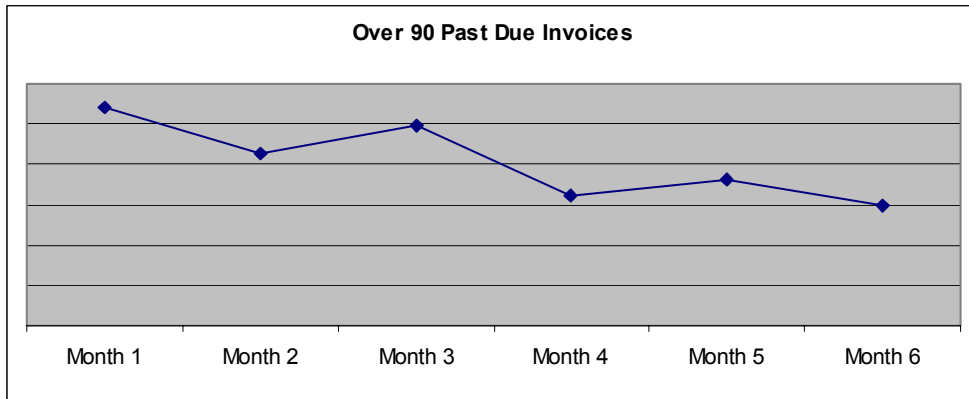
Shared Service Advantages

Leading edge systems like this don’t just happen. They reflect deep domain-specific expertise, decades of experience, and millions of dollars of capital investment.

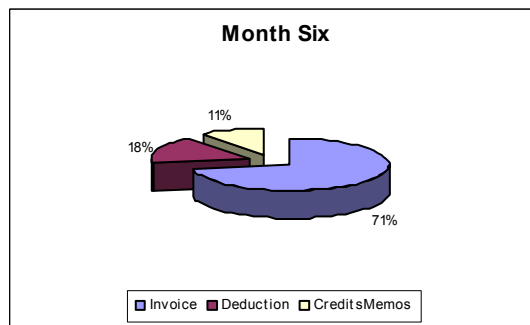
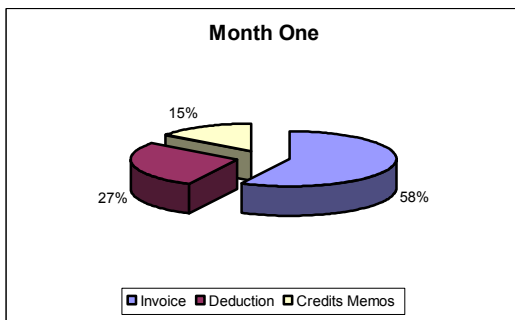
Studios are outsourcing these resources, and thereby realizing two key advantages: lower capital cost structures and best-of-breed competencies.

The bigger advantage is best-of-breed competency. Creditek knows how to tailor systems to match business rules that reflect retailer policies — policies that tend to be highly customized. It can offer retailers very individualized treatment, which results in more targeted attention and better relationships with suppliers. More consistent feedback in turn leads to continuous process improvement, which means fewer returns, faster payments, fewer deductions, and faster turns on inventory. Better communication also reduces the likelihood of erroneous or malicious deductions. Proprietary software can also speed collections even more. One example is algorithms that quickly match titles, shipments, invoices, and claims. Systemic mistakes are corrected, which also makes deductions less likely to occur in the future.

Payoffs from both economies and competencies can be very rapid. Studios should look for significant P&L improvements in home entertainment retail within the first two quarters of an outsourcing engagement. Significant balance sheet improvements will occur in about the same timeframe as studios divest assets and forego investments they no longer need.



Frequent and consistent customer contact allow for resolution to outstanding invoices and data on systemic problems



Through deduction resolution, process and policy decisions, and other reviews, the dollar value of the portfolio did little to change; yet the collectable value has increased dramatically.

Looking Ahead

Outsourcing receivables management illustrates how doing lots of small things well can quickly add up to big money. That is Hollywood’s long-term opportunity in the information economy. The greatest threats Hollywood faces today are the escalating cost of movie production, negative future growth in the number of theater screens, an ever expanding set of channels, and a price ceiling above which people simply stop

buying tickets. The only way out is market aggregation — a game that requires studios to engage in millions of highly individual “micro deals” with channel members and ultimately perhaps even with consumers. Each of these transactions requires a very specific set of competencies — not the least of which is figuring out how to get paid.

One thing is certain, the marketplace and competition are not standing idly by.