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China supersizes Imax's share price — but get ready for the next plot twist

Richard Gelfond doesn't believe in coincidences. An investment banker, Gelfond had just seen his first Imax film one long weekend in 1993, on a visit to the Smithsonian National Air and Space Museum in Washington, D.C., with his family, and he was blown away. So when he returned to his desk the following Tuesday and found an investment proposal to buy Imax, he did a double take.

"If I'd never seen an Imax film, that guy putting that on my desk that day wouldn't have meant a thing," he says. Gelfond and his business partner Brad Wechsler saw the potential, however, and they quickly developed a vision for taking Imax into the commercial theatres. They decided to buy.

A short time later, Gelfond's inspiration was confirmed. In 1994, Sony built a giant Imax screen at the new Loews Theatre multiplex opening in Manhattan. "That was the guiding light that we sought to follow," says the Imax CEO from his New York base. "The fact that the contract was in place and it was such a high-profile location, and the theatre was so huge and beautiful, it gave us a glimpse into the future."

Little did he know how long it would take him to realize that vision. It wasn't until the movie business saw its lifeblood—bums in seats—imperilled by the surge in home entertainment that Imax's technology seemed sexy enough for Hollywood.

Today, Imax screens are ubiquitous in North American multiplexes, and the company's 70mm-film technology has become the format of choice for blockbuster directors like Christopher Nolan (*The Dark Knight*) and Michael Bay (*Transformers*). That hookup has secured a place for Imax at the heart of the Hollywood ecosystem. The company whose Canadian-invented technology once seemed to limit it to a lifetime in a handful of museums now works with studios and filmmakers at every stage of the blockbuster process, from pre- to post-production, and even shapes the release windows for the biggest films.

That elevated status has inspired an improved share price: from a low of less than \$3 in 2008 to consistent mid-\$30s today (all currency in U.S. dollars unless otherwise noted). It has also translated to spectacular growth internationally, with the Imax format finding special favour with China's burgeoning middle class. In 2014 alone, the company signed 118 new theatre openings, of which 77.1% were in China.

But now that Imax has arrived, the dream Gelfond had back in 1994 may already be fading. Skeptics say the boom has peaked: Imax's monopoly on big is over, and China is maxxed out.

Gelfond, as CEO, isn't worried. He and Wechsler (currently Imax's chairman) have faced down shareholder lawsuits, erratic share prices, and extended periods of stunted growth in the long march from museum to multiplex. "We were a little naive in understanding how difficult that rollout would be," says Gelfond. "We didn't understand all the obstacles to get a beachhead in the commercial marketplace."

But now, with several new product lines rolling out and more theatres being built all the time, Imax is set, in a year flush with blockbusters, to reap the rewards of many years of expensive R&D and strategic partnership-building.

More than 20 years after that flash of inspiration in Manhattan, Gelfond has achieved his original vision. But he had to risk everything to get there.

When people talk about Imax's origins, they usually start listing animals—"movies about bears, whales and wolves," says James Hyder. As the publisher of the trade magazine LF Examiner ("LF" is short for Large Format), he has followed Imax's evolution from an institutional home for nature documentaries to a Hollywood format, a shift that meant completely renegotiating the public perception of the brand, and in some cases alienating the company's core customers.

Imax was founded shortly after Expo 67 in Montreal, where the original team of inventors experimented with using a complex system of interconnected projectors to create a much larger image than moviegoers had ever been exposed to. They decided there had to be a better way to do giant format. In 1971 the first permanent Imax projector—showing ultra-high-resolution 70mm film, 10 times the size of normal 35mm film—was installed in the Cinesphere at Toronto's Ontario Place. The first film screened there, *North of Superior*, set the tone for the next three decades of content: sweeping nature shots that were meant to showcase the technology and inspire awe. Thrills, not so much.

"Because Imax started out making those science-type documentaries, it had to expand," says Hyder. "By the mid-'90s, it had saturated the institutional market. Every museum that had enough money to buy an Imax theatre had already done so."

Shortly after he bought the company and took it public on Nasdaq, a well-timed building boom gave Gelfond a foothold in commercial theatres. "There was this massive explosion of multiplexes across North America," he says. Even though the company couldn't yet show Hollywood films, theatre operators began installing Imax screens as a special attraction.

But by 2000, it was obvious that the exhibitors had taken on too much debt too quickly, and Imax's building contracts evaporated. Meanwhile, the company's commercial screens weren't performing as well as hoped; both Imax and the exhibitors had to confront the blunt reality that most people don't go to the movies to see documentaries, no matter how impressive they look. "We really had a lot of difficulties," says Gelfond. "That period was tough."

The obvious solution was to start showing Hollywood films on Imax's own 70mm projectors. But the company still had too few screens for studios to justify making Imax films. Without those films, exhibitors couldn't justify the expense of purchasing the Imax theatre system—at a cost of roughly \$5 million, including the purpose-built auditorium.

To circumvent this "chicken-and-egg problem," Gelfond made two radical changes to Imax's business: First, instead of waiting for the studios to make Imax films, the company began converting existing Hollywood films to its own 70mm format, using a proprietary digital remastering (DMR) process first introduced in 2002; second, instead of asking the exhibitors to build special theatres for Imax, the company started installing its screens in existing auditoriums.

These changes created their own problems. Even the biggest auditoriums in the multiplexes were too small for traditional Imax screens. And while converting Hollywood movies to Imax was great for the commercial theatres, most of Imax's screens were still in institutional venues. They didn't always welcome the transition.

"The brand became something else," says Gary Monti, director of operations at the Cradle of Aviation Museum on New York's Long Island, which has a giant dome screen. "[Imax] completely changed its business model to be a Hollywood business model, and they left the institutional theatres to wither."

Showing Hollywood films split Monti's customers into two groups. "People who came for the theatre just came for the theatre. They had no interest in the museum at all," he says. The percentage of museum-goers who saw an Imax movie during their visit fell from 80% to 3%.

For Monti, Imax had diluted the brand beyond recognition, and seriously disrupted his museum's business in the process. To make matters worse, Imax started distributing most of its films in 3-D format,

which couldn't be shown on Cradle of Aviation's dome screen. It was more than he could take. "We dropped the Imax name," says Monti. "We don't want anything to do with them any more." The Cradle of Aviation Museum's giant screen later became a National Geographic-branded theatre. It isn't the only one. By James Hyder's tally, 30 giant-screen museums have quit the Imax brand.

The company's journey has also meant that it has left its Canadian-ness behind. A remark of Gelfond's is telling: "We used to think like an American company, and now we think like a global company." Imax's Mississauga facility develops the technology and makes the products, but its executive offices are in New York, and post-production is done in Los Angeles. Although three Canadians sit on the board, including Blue Ant Media head Michael MacMillan, Gelfond's statement is accurate: Imax is more American than Canadian, and more international than either.

Another leg of Imax's evolutionary shift came in 2008, and this time Gelfond wasn't just putting the goodwill of his institutional customers on the line. He was risking the trust of Imax's audiences directly.

Even though Imax had started to screen blockbusters in many of its institutional theatres, most Imax releases didn't occur until after the films' main commercial window, due to delays from the DMR process. The first simultaneous release was *The Matrix Revolutions* in 2003. But even with big titles on the marquee, the company was still only showing five to eight Hollywood films a year. Growth was slow. "It took us probably the better part of a decade to create a network of theatres that was big enough to justify the investment in releasing Hollywood films," says Gelfond.

Adding more theatres is a lot easier if you don't have to build them. The company significantly smoothed its entry into multiplexes with the introduction of two technologies: digital projectors and an accompanying system called MPX that allowed Imax to retrofit existing auditoriums to approximate the immersive experience the company was known for on giant screens.

Gelfond observes that at that point, the company became plug-and-play. "Instead of the exhibitors or studios needing to do it our way—using special cameras or special buildings—we did it their way."

Most multiplex theatres don't come equipped with eight-storey-tall ceilings, however, so apart from catapulting Imax into the Hollywood sphere, the main job of the new system was actually to fold the brand down into much smaller spaces.

The new digital system projects an aspect ratio that's closer to the size of standard screens: wider rather than taller, unlike the traditional Imax screens, which are more like the shape of old TV screens. In order to preserve the immersive experience, the company introduced a concept they call "theatre geometry." "There's a lot of math that goes into an Imax theatre," says chief technology officer Brian Bonnick.

When the company applies the patented MPX system to an existing auditorium and installs digital projectors, it takes out the old screen and the first few rows of seating, and installs a new curved screen closer to the audience. A small screen up close gives the same field-of-vision as a big screen farther away, Bonnick explains.

Hyder remembers the moment when Gelfond broke the small-is-the-new-big news at a meeting of the Giant Screen Cinema Association in 2008. "We don't think of [Imax] as the giant screen," Gelfond told those gathered, to everyone's surprise. He drew an analogy, one he is fond of, between Imax and BMW. The carmaker has several models, the argument went, but they're all BMWs.

The difference between BMW and Imax, Hyder pointed out in an article at the time, is that BMW distinguishes between its models by naming them differently, whereas Gelfond refused to distinguish Imax's smaller digital screens from its much larger purpose-built screens.

"I strongly believe that Imax is Imax. There's a lot more to the system than just a projector," says Gelfond. "Imax represents the best that technology has to offer. It would be confusing to the public to constantly be changing brands as technology changes."

Some of the public were confused anyway. Comedian Aziz Ansari posted a screed on his blog in 2009 after attending a screening of J.J. Abrams's *Star Trek* on one of Imax's new retrofitted screens. "Boycott them," he told his readers. Ansari was the most vociferous of Imax's celebrity detractors at the time, but he was joined by many online critics who dubbed the company "LieMAX."

By the time Imax made its digital push in 2008, the decline in North American theatre attendance was well under way. Imax offered a large part of the solution to that problem.

To make it easier for commercial exhibitors to host an Imax screen, the company introduced a new revenue-sharing model. Back when most of its clients were institutional theatres, Imax sold or leased its systems for a steep price, and the client shouldered the cost of installation and set-up. (Imax itself only owns a handful of theatres.) Under the joint-venture contracts, Imax installs its system at little or no expense to the exhibitor, and then takes 18% to 20% of the box office for that screen, as well as 10% to 15% in net box-office receipts from the studio. Since the DMR for any film is a one-time expense, each additional theatre added to the network multiplies the revenue at almost no extra cost.

Before the company went digital, one film print for a single theatre cost between \$30,000 and \$60,000; after the digital transition, the company could distribute hard drives for around \$100. As with Apple selling music on iTunes and publishers issuing e-books, costs were fixed; revenue, unlimited. By reducing this cost and shifting its revenue stream toward the box office, the company achieved much higher operating leverage, which would only grow as it built more theatres.

"Now they're shifting predominantly to taking nothing up front and a significantly higher piece of the back end from exhibitors," says Eric Wold, an analyst with San Francisco-based B. Riley & Co. He rates the company a strong "buy" at a price target of \$43.50. "All that increase in box office and revenue share is going to accrue to the bottom line." A strong majority of analysts share Wold's outlook, though most give Imax shares a more modest price target in the mid-\$30s.

Imax's increased dependence on box-office revenues can make the share price more volatile in the short term, with investors betting closely on the quality of the film slate. Yet the revenue-sharing model is actually more stable, says Aravinda Galappathige, an analyst at Canaccord Genuity Group who in February downgraded Imax from a "buy" to a "hold" and set a price target at \$35. "You're better off exposed to the box office—which is really not that unstable—than be exposed to the system-sale cycle," he says.

Once the digital projectors and joint-venture contracts had made the high-end Imax option so much more accessible, commercial exhibitors quickly started investing in the brand. At the time of the digital launch, the American chain AMC made a deal with Imax to install 100 joint-venture theatres, and shortly thereafter Regal Cinemas struck a deal to add 31 more. From there, growth has continued unabated. At the end of 2007, Imax had just shy of 300 theatres; now that number has more than tripled, with hundreds more in the pipeline.

The landmark boost came at the end of 2009, when James Cameron's *Avatar* was released. Of a worldwide box office of \$2.7 billion, Imax pulled a remarkable \$243 million from a relatively small number of theatres. Imax's shares started to skyrocket, from \$11.76 on the day *Avatar* was released to a high of \$37 and change in May, 2011.

Beyond the revenue and stock boosts, *Avatar*'s popularity in Imax theatres signified to other exhibitors that a branded screen could draw a lot of box office power to their theatres. This was particularly true in China, where, Gelfond says, the movie became "a cultural phenomenon," with leading members of the Communist Party taking special trips to see it on Imax screens.

After that, Imax's growth in China exploded, and the company started adding 110 to 120 theatres every year.

While it seemed to happen overnight, the surge was long in the works. Gelfond says he started laying the groundwork in the late '90s, back when Imax was in its nature phase, and well before any of the major studios had a foothold in China. "There was very little foreign content allowed into China, but I felt that the nature of the Imax content was such that we would be able to get our movies in and they would play well. No political aspects, no sex or violence, so they would be culturally acceptable."

China's censorship laws have long been a stumbling block for Hollywood. Regulators don't make a habit of publishing specific rules, but the overall idea is clear enough: Any movie shown in China must be appropriate for all audiences. At the same time that Gelfond was trying to leave behind Imax's association with nature documentaries for western audiences, they made a perfect calling card in China.

Building a base meant moving slowly and strategically—and not condescending to China, a sin the Hollywood studios are sometimes accused of. "We wanted to do it the Chinese way, not necessarily our way," Gelfond says. To prove his commitment to the country's film industry, he started travelling there regularly through the late '90s, meeting with government officials. At their behest, Imax built a theatre in the Shanghai Museum of Science & Technology, and the company subsequently moved its Asian headquarters from Singapore to Beijing.

Since Gelfond's first forays, the Chinese economy has undergone a radical transformation, with double-digit GDP growth in many years giving rise to an enormous middle class. And with the emergence of a new consumer class, China saw an unprecedented boom in theatre construction. Between 2002 and 2014, China's theatre network went from 2,000 to well over 20,000.

Even before the success of *Avatar*, Imax proved to be a uniquely strong brand in China. Chinese audiences in particular enjoyed 3-D—it's not uncommon for blockbusters to have a 3-D release added just for China—and enabled the company to develop a powerful strategic partnership with Wanda Cinema Line Corp., whose parent Dalian Wanda Group Co. Ltd., a real estate conglomerate, went on to buy the American theatre chain AMC in 2012 for \$2.6 billion, making the Chinese company the world's largest cinema owner.

Wanda is currently committed to Imax for 210 theatre systems, of which 195 are joint venture-operated. Imax's other big partner in China is CJ CGV Holdings Ltd., a large cinema chain based in South Korea, which has committed to 95 theatre systems, of which 75 will be in China. Now that AMC and Wanda are together, they represent 26% of the company's backlog of theatre systems.

According to the company's own estimates, Imax has currently penetrated 54% of the addressable Chinese market. The dollar value of the company's current backlog of signed contracts for theatre systems yet to be built is just under \$270 million. Many investors feel bullish about this long runway for growth.

But some analysts aren't so sure.

In their report, "A Growth Story Under Siege," **Michael Yerashotis** and **Kevin Dusseldorp** of **Veritas Investment Research**, write, "We believe Imax's valuation is premised on a story of operating leverage that no longer reflects economic reality and the new risks facing the company."

Several of the recent developments that have other analysts looking favourably on Imax shares are exactly what make the **Veritas** researchers skeptical. For example, in 2014 Imax sold a 20% stake in its China business to two local equity investors, private firm FountainVest Partners and state-backed investment fund China Media Capital. Partners like these will help secure Imax's position among its Chinese competitors and, the company hopes, protect its releases from unpredictable last-minute

censorship and other political interference. The sale is also a critical step toward an eventual Chinese IPO.

But in the assessment of **Veritas**, the shares were sold at well below their value, and on terms that are decidedly unusual. The investors gave themselves a guaranteed liquid exit, retaining the right to exchange their shares for the \$80 million they spent. **Yerashotis** and **Dusseldorf** ask, “If knowledgeable, well-connected investors in the Chinese media industry required a guarantee of their principal to invest in Imax’s fastest-growing business, what does this say about the risks to Imax China’s growth?”

A slowing economy and a swelling real-estate bubble are among those risks. According to **Veritas**, the guarantee given to China Media Capital and FountainVest suggests that state-owned competition is going to get in Imax’s way. In 2009, Imax filed a suit in Ontario against Gary Tsui, a former employee at the Mississauga office whom the company accused of stealing trade secrets. In 2014, the company was awarded nearly \$7 million (Canadian) in damages.

By then, however, Tsui was chief engineer of China Film Giant Screen (CFGs), a government-backed company that started rolling out giant-screen systems in 2012. Imax also filed a suit against Tsui in China; the case was settled on undisclosed terms in late 2014. CFGs continues to sell its systems in China, growing apace with Imax. Research by **Veritas** indicates that a CFGs screen retails to exhibitors for about half the cost of an Imax screen, and performs about half as well in revenues.

Success breeds imitation, of course, so it should be no surprise that CFGs has come on the scene. The whole industry can see that Imax’s immersive technology set the standard for the kind of premium offerings that have become the key revenue-driver for exhibitors in the digital era. Ticket sales are down, but revenues are up. Imax is now releasing approximately 40 Hollywood films a year.

CFGs is just one of the many competitors that Imax now faces internationally, though most prefer to label the relationship as complementary. All the major exhibitors have introduced their own “premium large formats,” many of which operate in the same multiplexes as Imax screens. Whether in Asia, Europe or the Americas, a cinema-goer today is likely to be confronted by as many as four or five ways to see the same movie. There’s the Imax screen, and a few doors down, the exhibitor’s own branded system (think UltraAVX at Cineplex) that might boast a larger-than-normal screen and a high-end projector, not to mention the VIP room, the 3-D option, and plain old 2-D down the hall.

Gelfond dismisses **Veritas’s** concerns, while acknowledging that the 20% sale of its China business had a low valuation. “We did it to get the right partners in business with us, and it’s proven to be a very good decision,” he says, adding that strong 2014 results—65 commercial screens added, high per-screen averages—show that Imax is already reaping the rewards of those relationships.

As for competition, Gelfond is quick to point out that none of these other formats treats the film in any way, unlike Imax’s DMR process. At the same time, the competition serves “to broaden the high end of the market.”

Still, the exhibitors are clearly focusing on developing their own brands rather than doing more business with Imax. In December, 2010, Cineplex had nine Imax theatres and 11 of its own branded UltraAVX theatres. Four years later, the company had 20 Imax and 66 UltraAVX. Cinemark went from six Imax theatres to 14 in that period, but from 47 to 169 of its own XD brand. The total number of exhibitor “premium large formats” in North America exceeded the number of digital Imax screens for the first time in 2014—374 to 353.

Veritas predicts significant declines in Imax’s per-screen averages in the coming years, due to rising competition and over-saturation in the Chinese market, where Imax is beginning to move into poorer regions. B. Riley & Co. Analyst Eric Wold puts more faith than **Veritas** in Imax’s Chinese partners. “They’re not going to build malls in the middle of nowhere,” he says.

And the Imax brand counts for something. The likes of UltraAVX and XD don't have a J.J. Abrams tweeting their logo while he's on set for his next big blockbuster, or a Christopher Nolan to give multiple extended interviews about why he prefers their format.

In some respects, the way forward for Imax is the way back. This year, the company is releasing its new laser projector, along with a significant upgrade to its proprietary sound system. These rollouts mark a return to Imax's large-screen roots. What's more, this year the company set up a \$50-million fund to make a set of 10 new documentary films on Imax cameras. "We're definitely re-upping our commitment to that market," remarks Gelfond.

While the company is simultaneously pushing how far it can shrink its brand—hawking a new line of ultra-high-end home entertainment systems—the most auspicious development is a recent burst of demand for its cameras. After all the years Imax spent knocking on their doors, the studios have come calling, and they're not asking for digital. They want 70mm film cameras, for giant screens. Imax bent over backward to break into Hollywood, and now it seems that Hollywood has taken the company's old slogan to heart: Think Big. And for the time being, anyway, that still means Imax.