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A New Era for Foreign Investment in Cinemas

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Preface: Earlier in 2021, China's cinema industry saw its total box office exceeding RMB 1.7 billion on the second day of the year's seven-day Spring Festival holiday, breaking the record of daily box office in China. The box office gross reached RMB 7.8 billion during that holiday, a robust growth compared to 2020's figure. This could mean big opportunities for investors, including foreign investors, in the cinema sector. This article discusses some legal and regulatory issues which may be helpful for foreign companies who are interested in making investment in cinemas in China.

Affected by the COVID-19 pandemic, the operation of theaters in China were suspended for six months in 2020. During the overall shutdown of the industry, Shanghai Film and its controlling shareholder Shanghai Film Group established Shanghai Film Asset Management (Shanghai) Ltd., planning to invest in and integrate theaters in the Yangtze River Delta and its surrounding areas through merger and acquisition, capital increase and equity participation to ease the operating pressure. On July 16, 2020, the China Film Administration issued a notice allowing theaters in low-risk areas to reopen in an orderly manner after July 20.

In recent years, the emerging market has become the leading force for box office growth, and China has become the world's second largest film market. In 2019, China's box office grossed RMB 64.266 billion with 69,787 screens, and the number of movie-goers reached 1.727 billion[1] in urban cinema chain. In 2018, the China Film Administration expected the total screen number in urban cinema chain to reach 80,000 in 2020. **The boost of China's cinema market has gained worldwide attention.**

The fast-growing cinema market in China has been attractive to international investors. However, only a handful of them have ventured into the market. **One of the most important reasons behind is that due to the limitation imposed on China's film industry at the macro**

[1] Data Source: China Film Administration.

level, foreign investors are prohibited from investing in middle and upstream sectors, including film production, distribution, cinema screening chain, etc. Therefore, expansion into Chinese market by international companies is limited as they are not able to involve themselves in the whole industry chain.

For various reasons, the year of 2020 was a milestone for foreign investment in China, as three foreign direct investment (FDI) laws that had been in effect for decades were superseded by the new Foreign Investment Law. With the introduction of the new Foreign Investment Law as the guiding principle and its implementation regulations (collectively referred to as "FIL"), as well as the Negative List (2019 Version) which reduced the number of "prohibited" and "restricted" sectors to 40 within a year after the issuance of its 2018 version, a new foreign investment regulatory regime has been established. Among these proactive reforms and policies, we noted that film screening, which is the last node of the film production chain, was removed from the Negative List (2019 Version). The removal signifies that the industry of cinemas and theaters have stood out from the film production chain and become one of the few areas that can be controlled or wholly owned by foreign investors.

In light of the increasingly favorable policy for foreign investment, this article provides a review on the history of regulation of foreign investment in the cinema industry, an introduction to the regulation and the ways of foreign investment entering China's cinema industry based on the FIL and a forecast about the development of this industry.

(I) Evolution of Regulatory Policy on Foreign Investment in Cinema

As a form of entertainment, the cinema industry is closely related to the culture and ideology of a nation. Ever since cinema was established as an industrial sector in China, policies on foreign investment in cinemas have gone through nearly 20 years' evolution from prohibiting foreign investment, progressively loosening policies, tightening up policies to opening to foreign investment. To be specific: (1) Before 2000: foreign investment was prohibited in film screening; (2) Trial stage from 2000 to 2003: foreign investment was strictly limited to no more than 49% equity; (3) Opening stage from 2004 to 2005: in 7 pilot cities, foreign investment limitation was decreased to no more than 75% equity, and in the meantime restrictions on service providers from Hong Kong and Macau were relaxed progressively; (4) Tightening stage from 2005 to 2019: the pilot city policy was abandoned and the former no more than 49% equity policy resumed; (5) After July 30, 2019: in principle, a foreign investor is allowed to wholly own a cinema in China.

i. Before 2000: Preparation for open-up and deep collaboration

In the first decade of the structural reform of China's film industry, foreign investment was not allowed in any area other than co-production with foreign ventures, which was mentioned in the *Regulations on Administration of Films* released in 1996. Foreign investors in China's film market were mainly restricted to participate in co-productions during this period. Accordingly, both the 1995 and 1997 versions of the *Catalogue for the Guidance of Foreign Investment Industries* forbade foreign investment in film production, distribution and screening.

ii. 2000 – 2003: Foreign investors were permitted to hold no more than 49% equity

In 2000, in preparation for joining the World Trade Organization ("WTO"), China put policy making for globalization of its film industry on the national agenda. China promised, in the negotiation before joining the WTO, that "foreign investment with no more than 49% equity will be allowed to our cinemas and their construction, renovation and operation"[2]. With the approaching of China's accession to the WTO and speeding up of the film industrialization, the *Opinions on Further Deepening Reform of the Film Industry* was released on June 6, 2000, allowing foreign investment to transform film infrastructure and equipment and renovate cinemas by way of equity joint venture (EJV) or cooperative joint venture (CJV), provided that the Chinese partner controls the operation. The *Interim Regulations on Foreign-invested Cinemas*, which was released by the industry authority on October 25, 2000, further detailed regulation of foreign investors' participation in the operation of cinemas. Specifically,

- A foreign investor is not permitted to wholly own a cinema, but a cinema can be owned by way of EJV or CJV;
- A Cinema owned by the way of EJV or CJV shall not be named after a foreign media or cinema;
- For a cinema owned by the way of EJV, Chinese party shall hold no less than 51% of the registered capital;
- The term of EJV or CJV shall not exceed 30 years.

[2] Yun Shen. *History of China Film Industry*, China Film Press 2005 Version, Page 221.

Those rules marked the beginning of foreign investment in China's cinema industry, and foreign investors started to flood in. In January 2002, Warner Bros.[3] set up Yonghua Cinema City with a 49% foreign equity stake by cooperating with Shanghai Paradise Corporation. This cinema was the first foreign-invested cinema since China's accession to the WTO and was chosen to hold Warner Brothers' movie <Matrix II> premiere. Not long after that, Hong Kong enterprises started to pour in the mainland market. For example, UME international theatre, the first five-star cinema in Beijing and also a project invested in by a Hong Kong investor, finished its construction in June 2002.

Since China's entry into the WTO, the Chinese government has issued a series of rules promoting the development of the film industry. Global media giants have made large amounts of investment in China and provided fresh blood for China's film industry, effectively speeding up the development of the industry by introducing new ideas in production, high-tech, film promotion and release.

iii. 2004 – 2005: In 7 pilot cities, foreign investors were allowed to invest with no more than 75% equity, and restrictions on investors from Hong Kong and Macau were loosened by degrees

On January 1, 2004, the *Interim Provisions on Foreign-invested Cinemas (revised edition)* took effect, adding rules that forbid foreign investors to establish cinema chains during the ongoing structural reform of China's cinema chains. Beyond that, the interim provisions made other revisions that further opened China's cinemas market. For example,

- When investing by the way of EJV or CJV, with the restriction of no more than 49% shareholding equity, a foreign investor is allowed to hold up to 75% equity in a EJV or CJV cinema in any of the 7 pilot cities[4];

- The registration threshold was decreased from RMB 10 million to RMB 6 million[5];

- The requirement that an EJV or CJV cinema shall not be named after a foreign media or cinema was deleted.

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[3] The subject of the joint venture is Warner Bros. Cinema (Hong Kong) Co., Ltd.

[4] The pilot cities refer to Beijing, Shanghai, Guangzhou, Chengdu, Xi'an, Wuhan and Nanjing.

[5] On August 28, 2015, the National Radio Film and Television Administration deleted again the requirement for registered capital.

After the release of the said rules, foreign investment stepped further into the Chinese film industry. Warner Bros.[6] sped up its investment and established on January 8, 2004 Shangying Warner Cinemas, the first cinema controlled by foreign capital in China with 51% foreign equity. In addition, Wanda Group and Warner Bros. signed an agreement in February to cooperate on the development of 30 multi-functional cinemas in at least 15 cities. Under the agreements, Wanda Group is responsible for financing and construction of the cinemas, while Warner Bros. provides technical support and 24/7 operation and management service. The project was the largest cinema development venture with foreign capital at that time, manifesting Warner Brothers' determination and commitment to develop world-class multifunctional cinemas in China.[7] Benefiting from the revised Interim Provisions on Foreign-invested Cinemas, Warner Bros. had its name appeared in the cinemas ventured into by it with Shanghai film group and Wanda.

On May 8, 2005, the National Radio Film and Television Administration ("**NRFTA**") released the *Supplementary Provisions to the Interim Provisions on Foreign-invested Cinemas* ("**Supplementary Provisions I**"), which specifies that from January 1, 2005, service providers from Hong Kong and Macao shall be permitted to build, re-construct and operate cinemas in China's mainland in the form of EJV, CJV or WFOE. On February 20, 2006, the NRFTA released the *Supplementary Provisions II to the Interim Provisions on Foreign-invested Cinemas* ("**Supplementary Provisions II**"), which further opens the cinema market to the service providers from Hong Kong and Macao.

Thanks to the preferential treatment offered to service providers from Hong Kong and Macau, a foreign investor is able to control or wholly own a domestic cinema through a Hong Kong or Macau SPV. However, a SPV must meet what is required of a "service provider" defined by CEPA[8]. For example, a service provider shall engage in substantial business activities in Hong Kong or Macau. In 2004, Golden Harvest Group build Golden Harvest (Shenzhen) Cinema, which is one of the first Hong Kong funded cinemas benefiting from CEPA. Another typical example is Korean enterprise CGV, which wholly owned several cinemas in the mainland

[6] The subject of the joint venture is Warner Bros. Cinema (Hong Kong) Co., Ltd.

[7] Zhonglun website, *Giants hand in hand -- Warner Bros. and Wanda Group cooperate in an all-round way, Zhonglun provides legal services*.

[8] Closer Economic Partnership Arrangement, including the Mainland and Hong Kong's Closer Economic Partnership Arrangement signed by the central government and the Hong Kong SAR government, and the Mainland and Macao's Closer Economic Partnership Arrangement signed by the central government and the Macao SAR government.

through Hong Kong-based UVD Enterprise Limited.

iv. **2005 – 2019: the pilot city policy was canceled, and foreign investment restriction was resumed to no more than 49% equity**

While foreign investment in China's cinema market displayed promising prospects, the Ministry of Culture released the *Several Opinions on Foreign Investment in Cultural Industry*, which was considered as a withdrawal of the pilot city policy provided in the *Interim Provisions on Foreign-invested Cinemas*.

During this period, strategic layout by foreign investors had been massively affected. A case in point is that Wanda terminated its cooperation with Warner soon afterwards.

From 2005 to 2019, *the Catalogue for the Guidance of Foreign Investment Industries* was revised four times, and the first version of *the Negative List* was released, but the policy had remained restrictive until the release of t*he Negative List (2019 version).*

v. After July 30, 2019: a foreign investor is allowed to wholly own a cinema in principle

On June 30, 2019, NDRC and MOFCOM released *the Negative List (2019 Version)*. In this list, "construction and operation of the cinema controlled by Chinese party" appearing in the 2018 version was deleted. By then, restrictions on foreign investment entering in China's cinema market had been removed completely.

Despite the new policy, it seems there hasn't been any new case of well-known overseas film studios venturing into China's film screening industry by M&A or FDI. For one thing, the Chinese market has gradually reached a level of saturation. For another, as discussed above, production and distribution of films remain unavailable to foreign investors. It is less appealing to international companies, especially Hollywood film studios, which are accustomed to the standard production-distribution-screening model of film production. Besides, some foreign investors entered into the Chinese cinema market through a Hong Kong SPV in accordance with CEPA and completed their strategic planning in film screening sector.

(II) Outlook for Foreign-invested Cinema Market

i. Ways of Entering into China's Cinema Market – Setting Up v. M&A

Due to the long-term entry barrier, cinemas in China's local market are mainly controlled by domestic capital. Some foreign investors have entered into the Chinese cinema market through a Hong Kong SPV in accordance with CEPA or by joint venture or joint cooperation. After the restrictions on foreign investment in cinemas were lifted in 2019, more channels of entry are available to foreign investors, who may thus control domestic cinemas directly rather than going around through Hong Kong or Macau indirectly.

However, it came to our attention that during last 20 years with limitation on foreign investment, the domestic cinema industry has grown into a mature market and begun to take shape. Cinemas are facing some profitability problems. Besides, operation of cinemas requires theatrical property, and its costs are relatively high, whether owning or renting such property. Also, China is entering into an era of "Internet +", which presents a much more complicated environment of competition. From the commercial perspective, foreign investors' concerns continue. According to market speculation, foreign investors might try to enter the market through acquisition to integrate resources.

The cinema industry is greatly hit by the coronavirus pandemic, which might bring some changes to the market. Following are some illustrations:

- For some high-end cinema brands with a single profit structure and low coverage, strategic foreign investors' investment could bring a boost to the industry.
- After the coronavirus outbreak, some financial investors might seek exit, which would present a good opportunity for foreign investors to enter into the industry at a bargain price and proper timing;
- Setting up cinematic management companies through acquisition of cinemas will make their bargaining power stronger in the cinema industry chain, whether in box office share or pre-movie advertisement.

ii. Regulation of Foreign Investment in Cinema Market

Both the *Negative List (2019 Version)* and FIL establish the principle that, beyond the negative list, foreign investors shall be treated equally with domestic investors. Therefore, setting up or acquiring cinemas by foreign investors will no longer require approval of or filing with

MOFCOM, but only subject to information reporting procedures and registration with the corporate registry. Besides, the following issues might be worthy of your attention:

First, the limitation on shareholding by foreign investors in cinemas specified by the *Regulations on the Administration of Movies* and *the Interim Regulations on Foreign-invested Cinemas* will be revised in accordance with the *Negative List (2019 Version)* and FIL. For newly establishment or acquisition projects, it is advisable to consult local authorities first on whether the *Negative List (2019 Version)* has been implemented locally. According to the replies we have received so far in our consultation with corporate registries in Beijing, Shanghai and Shenzhen, whether a foreign-invested company can control a movie theater should be determined based on the *Negative List (2019 Version)*. If the negative list is silent, the authorities may proceed with registration.

Second, although foreign investment in cinemas is not subject to approval procedures, engagement in the film screening business still requires a license for public projection of movies.

In summary, with the fast recovery of the market, foreign investors may consider acquiring disadvantaged Chinese domestic theaters at a lower cost to enter the fast growing domestic cinema market and using their more refined management and marketing methods to upgrade domestic cinemas and identify new revenue generating sources through multi-dimensional upgrades in technology, service and business models. This, coupled with the current policy, may present the investors with a good opportunity to be part of China's cinema industry.