Independent Film

as an

Attractive Asset Class

A **slated** PAPER

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Part I - Overview

The business of making, marketing and profiting from feature films has been around for just over a century. Cinema was the first industrialized form of mass entertainment and even today, in the face of all other competing diversions that have evolved since, it is fast approaching $100 billion a year in global revenues in terms of spending across all distribution media.

Film has captured the worldwide imagination to such a degree that it is subject to constant and often sensationalist media scrutiny. The popular perception is of an industry that is inherently unpredictable and prone to extreme and idiosyncratic events. The phrase "Nobody knows anything," which Hollywood screenwriter William Goldman coined in 1983 to describe what he saw as a clueless business, has been repeated so often as to have become accepted wisdom. And yet, for all its volatile characteristics, the film business as a whole has been almost boringly profitable for the past hundred years – even during severe economic downturns – and it still keeps growing.

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In terms of rate of return and market share variability, the industry has remained relatively stable and moneymaking. Somebody must know something after all. The film industry may not be able to predict audience taste with absolute certainty, but those at the top tier have shown a consistent track record in managing the risks involved in banking on such predictions. This White Paper will demonstrate how you, as an investor, can best identify and engage with this industry-critical top tier. In doing so, you will find yourself as well positioned as anyone to profit from film's ability to generate robust and non-correlated returns.

Part I is the first in a four-part series on independent film investing that will be published by Slated.
Part II will delve deeper into the distinctive benefits of film investment as an asset class.
Part III will break down the various ways that independent films are financed and where investors fit into those scenarios.
And, finally, **Part IV** will present the arguments for why a managed fund, when properly structured, is the ideal vehicle for capitalizing on the available opportunity and capturing its upside.

Market size

The Motion Picture Association of America (MPAA) reported that global ticket sales reached $32.6 billion in 2011 – a new theatrical market record that is largely a reflection of growth in territories such as China and Russia where new theaters are still being built. And that is just the annual box office receipts for the MPAA's own member companies. Add in all the films made and released outside the Hollywood studio system, including both independent and foreign films made for local-language audiences, and the likely total exceeds $40 billion.
Some MPAA facts and figures from 2011:

- Chinese box office grew **35%** to **$2 billion**, on par with France.
- India's annual box office was **$1.4 billion**, putting it ahead of Germany.
- International box office grew **35%** over the last five years.
- **$10.2 billion** U.S./Canada box office, down 4% compared to 2010 (where Avatar broke box office records) but up 6% from five years ago.
- Total overseas box office climbed to **$22.4bn**, up 7% from 2010.

Geographic expansion at the box office is only part of the picture. New technologies continue to carve open new outlets for viewing both at home and on the move, increasing the potential revenue-generating life of every title that achieves commercial distribution. Nascent formats such as streaming on web-enabled televisions, iPads, PlayStations and Xboxes, mean that films are reaching more people than ever before. This is not just an American phenomenon. In the UK, revenue from such digital distribution platforms is expected to more than double from £286m at present to £600m by the end of 2015.

While there is a danger that these devices might cannibalize existing revenue streams, and lead to further commoditization of the movie-watching experience, the net effect of this proliferation is still seen as positive. In its latest and much followed “Global Entertainment & Media Outlook”, PwC projects that global spending on filmed entertainment will keep rising at a 3.1 percent compound annual rate over its five-year forecast period, reaching $99.7 billion in 2016 from its current figure of $85 billion. This projection comes even in the face of continuing piracy, particularly in Asia Pacific, Latin America and a number of countries in EMEA.

> **80%** of the film business lies in the hands of the major Hollywood studios

“Moderating price growth, new multiplexes, and growth in 3-D screens will stimulate the box office market, although the incremental impact of 3-D is diminishing. A shortening home video window and experiments in modifying the current windowing structure… will benefit electronic video spending. Emerging over-the-top/streaming services and growth in digital cable and telephone company TV subscription services that promote video-on-demand will also boost digital distribution, along with the availability of content on tablets and other devices as well as Internet-connected TVs.” [Source: PwC]

The lion’s share of that $100 billion film business – an estimated 80% - lies in the hands of the Hollywood studios, an oligopoly of six diversified media conglomerates whose core focus is releasing blockbuster movies with average production budgets of $75 million and global marketing costs that can be almost as much. Commanding as their market share might be, these studios certainly don’t have a monopoly on success. Since the late 1960s there has also been a fiercely resourceful “independent” sector (existing outside of the studio system) that has exploited a lucrative array of specialized market niches with smaller budget movies that require lower advertising expenses. On occasion, these independent films have become huge mass-market hits in their own right, generating spectacular returns on investment. Provided certain conditions are met, these independent films represent the most effective way for individual investors to capitalize on the voracious global appetite for filmed entertainment.

Six Major Hollywood Studios

Market Characteristics & Risks

Films have been characterized as high-risk and complicated investments. So complex that even experienced film professionals struggle to understand how all the various moving parts of the process fit together. While there are always the odd micro-budget exceptions, many more film productions are capital-intensive and involve significant sunk costs before most income streams start to kick in. There are completion and final product delivery risks in film production to consider; there are also acquisition and marketing risks in film distribution; and then there's the fickle nature of moviegoer tastes. Since it takes so long for a story idea to end up on the big screen, who can possibly tell what will resonate with audiences two or more years down the road? Such performance risks carry over into all the other ancillary revenue streams too: DVD, video-on-demand, pay- and free-television.

It is not surprising then that film financing has been generally met with some skepticism from portfolio managers, private equity groups, high net worth investors, family offices, pension funds and the like. They will cite the common complaints leveled against film as justification for their wariness: opaque accounting methods, cutthroat competition, soaring costs and so on. But in practice, there are many reputable banks, funds, companies and individuals that do good business committing sizeable sums to the film industry year after year.

In 2007, the last year that the Hollywood studios released data on their combined production and marketing expenditure, the extrapolated funding for all films shown in US movie theatres exceeded $30 billion. Some $3 billion went towards co-financing big-budget studio films at the height of Wall Street demand for Hollywood "slate" deals. And a further $11 billion was funneled into producing and releasing independent films. Given the myriad risks commonly cited in association with film, that is a considerable allocation of institutional capital. It begs the question – what are we missing?

$11 billion went into the production and distribution of independent film

To understand the rationale behind such investments, you need to look at historical patterns. Not only has the film industry remained demonstrably profitable since its beginnings but a stable core of studios have stayed dominant throughout. They have achieved this through their portfolio theory approach and a tight control over distribution channels. Diversify the audience and budgets of your annual output of films and much of cinema's unpredictability is ironed out, so long as proper management controls are implemented and revenue flows are fully exploited. In any given year, different studios will be hot or cold, but over the long-term all have generally come out ahead. Better still, from an investor's perspective, is that any fluctuations in their performance are unlikely to follow the same economic cycles that other businesses do. Since people have traditionally flocked to cinema as a relatively cheap form of escape during times of hardship, film has shown itself to be one of the better hedges against recessionary forces.

There is a catch, of course. The Hollywood studios are not in the habit of sharing their spoils with private investors. They will happily partner up with large financial institutions in order to shift hefty capital requirements off their balance sheets; some will entertain co-financing arrangements with major investment funds. But for everyone else, the only way to own a piece of a blockbuster franchise is through buying shares in the parent company. Talk about indirect.

A more immediate way to participate in these dynamics is through independent film. Independent films are those financed outside the major studio system. These lower-budgeted films are not only cheaper to invest in than

Hollywood movies, they can also offer investors a fairer and more logical recoupment position that will yield faster returns. Find a way to apply the same portfolio thinking across such independent films that you see applied in Hollywood and you have the basis for an attractive asset class, one that offers the potential of impressive returns but without being tightly correlated to other investments such as stocks, bonds and real estate.

Diversification is only half the battle, however. More than 95% of independently financed films never go on to be seen in theatres, meaning that the vast majority have a hard time making back their investment. Success therefore depends on determining which independent films have the highest probability of achieving distribution. Thankfully, that is not the same thing as trying to work out which films will perform at the box office. You don't have to second-guess the audience; instead you should pay close attention to the industry gatekeepers, packagers and powerbrokers. They are the ones that generate profits based on their sense of the convoluted process of meshing together creative talents, story ingredients and financing into a cohesive project that has perceived value for sales agents and distribution companies. As this White Paper will show, an independent film investment's financial fate can often be sealed long before it is shown to the public.

Myths & **Misconceptions**

Cinema enjoys such a high profile, thanks to its own star-making prowess, that its business dealings are as much the stuff of popular legend as the films themselves. It's hard to find anyone on the street who does not share strong views on what really makes the business tick. Unfortunately, so much of this pop-cultural knowledge is based on skewed statistics and ill-informed readings of the market. The wrong conclusions are drawn from success stories and the wrong lessons learned from failures. Films that end up making money are labeled flops; supposed hits turn out to have been overhyped. Such pre-conceptions make it that much harder for potential investors to make objective evaluations of the film business.

Some popular industry myths

It's all about getting into theaters | because cinema releases involve hefty advertising expenses, it sometimes pays to aim for a more captive outlet: pay-television premieres can often eclipse theatrical premieres in terms of audience reach; video-on-demand can also out-gross cinema releases.

It's all about casting stars | independent films certainly benefit from having stars; their names help drive industry sales and attract other cast members to sign on. But it is also possible to have a breakout hit with unknowns who then go on to achieve stardom: none of the respective leads in Bend It Like Beckham (Keira Knightley), Beasts Of The Southern Wild (Quvenshané Wallis), and Winter's Bone (Jennifer Lawrence) were known at the time. They are now.

It's all about US box office grosses | while theatrical success is certainly a harbinger of audience appeal and an indicator of demand, most profits actually derive from DVD and other ancillary revenue streams, not the weekend numbers the press focuses on.

Revenues are what drive profits | the real determinant of profitability is the film's cost and payout structure. A film really does not need to be a box office success in order for an investor to make money – sound financial structuring can also make a significant difference, and in certain instances can guarantee 100% or more of invested capital is returned before the film even hits theaters.

Bottom Line: Bet On Packagers & Powerbrokers

Many hundreds of movies are completed each year and never distributed. For early-stage investors looking to lower their exposure to such bad investments, the best option is to identify and invest alongside similarly incentivized companies that have a proven development process strong enough to screen out all but the best ideas. Investors should invest in production companies that have a track record of working with "packaging" and sales agents who validate these projects' potential in the marketplace before even a dollar is spent. These agents - each taking a commission on the sale of a film - are financially aligned with the investor and have a long reputation of successful film sales to protect. They have clout, are informed about market demands and know how to play the industry field to their best advantage.

In this regard, film investment can be compared to angel investors looking to invest in start-ups. Since each film project is analogous to a new venture that has no history from which to forecast potential performance, the best the angel can do is harness their considerable industry experience and insight to assess the track record of those behind those ideas. The packaging and sales agents, like super angels, are therefore the ones to bet alongside in the independent film world: the industry's true insiders. An estimated 90% of startups don't make their money back for investors. The same is true of independent films, although the stigma seems so much greater.

Packagers, Sales Agents, Gatekeepers & Tastemakers

Coming soon...

Part II: The Benefits of Film Investment

Find out why independent films offer the potential of high returns on investment, why those returns are essentially non-correlated, and how the withdrawal of debt financing has created a huge opening for equity investors.

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