The Benefits of Film Investing

part two in a four part series

A **slated** PAPER

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Part II - Overview

The film business has an impressive history of stability. Even at the height of the last financial crisis, as stocks whipsawed, banks imploded, and real estate holdings cratered, demand for film remained stable.

As in any given year, many of the films made then would have lost money, but across a diversified portfolio there have historically been a sufficient number of moneymakers to ensure that the film business as a whole remains consistently in the black.

Such resilience is magnified during downturns as film ends up outperforming other investment options. Some of the most profitable films of all time (see chart) - “**Paranormal Activity**”, “**Once**”, “**Friday The 13th**”, “**Mad Max**”, “**American Graffiti**”, “**Gone With The Wind**”, “**The Big Parade**”, “**The Birth Of A Nation**” – coincided with either major recessions or world wars. Indeed, “**Avatar**”, the highest grossing film of all time, broke records in 2009 as the world economy struggled to recover from the credit crisis. But this resilience in downturns tells only part of the story.

Just as many other films on that all-time list of the twenty most profitable – as defined by the crude metric of net box office revenues in excess of estimated costs, divided by that cost – were released during economic booms. This history of non-correlation makes film an ideal alternative asset to hold against seesawing fortunes.

	Year	Movie	Budget	Worldwide Gross	% Return*
1	2009	**Paranormal Activity**	$15,000	$196,681,656	655,505
2	1980	**Mad Max**	$200,000	$99,750,000	24,837
3	2004	**Super Size Me**	$65,000	$29,529,368	22,614
4	1999	**The Blair With Project**	$600,000	$248,300,000	20,591
5	1993	**El Mariachi**	$7,000	$2,041,928	14,485
6	1968	**Night of the Living Dead**	$114,000	$30,000,000	13,058
7	1976	**Rocky**	$1,000,000	$225,000,000	11,150
8	1978	**Halloween**	$325,000	$70,000,000	10,669
9	1973	**American Graffiti**	$777,000	$140,000,000	8,909
10	1994	**Clerks**	$27,000	$3,894,240	7,111
11	2007	**Once**	$150,000	$18,997,174	6,232
12	1969	**The Stewardesses**	$200,000	$25,000,000	6,150
13	2004	**Napoleon Dynamite**	$400,000	$46,140,956	5,667
14	2004	**Open Water**	$500,000	$52,116,982	5,411
15	1980	**Friday the 13th**	$550,000	$59,754,601	5,332
16	1939	**Gone with the Wind**	$3,900,000	$390,525,192	4,906
17	1915	**The Birth of a Nation**	$110,000	$11,000,000	4,900
18	1925	**The Big Parade**	$245,000	$22,000,000	4,389
19	2004	**Saw**	$1,200,000	$103,096,345	4,195
20	2004	**Primer**	$7,000	$565,846	3,941

* The percentage returns figures are estimations. They are based on the assumption the 50% of the box office receipts were returned to the distributors by the theaters. These figures are based on theater ticket sales only. They do not include earnings from other revenue sources such as DVDs, video, VOD, TV licencing etc. Source: www.the-numbers.com

Any profitability chart highlights the film industry's potential for eye-popping returns on investment, particularly when it comes to independent films, which account for all but two of the titles in that top twenty. It also plays to the frequent characterization of film as an exclusively hits-driven enterprise. This is a misleading perception. With production costs dropping and cheaper distribution channels opening up, "home runs" are no longer a pre-requisite for covering the sunk costs of content development. Moreover, since so much hinges on how much is spent actually releasing and marketing a film – a line item known as print and advertising or "P&A" – cost control over distribution can have a greater bearing on profitability than the actual grosses generated by box office "hits".

> the history of non-correlation makes film an **ideal alternative asset**

In many ways, this is the secret story of film investment. For every spectacular box office success that is trumpeted in the media, there are dozens of films that make their money back in far more discrete ways. Some entirely bypass theaters in favor of cable, video-on-demand, and various emerging platforms that generate lower cost returns from niche consumers. Others have a sizeable portion of their production budgets already offset before even being seen by an audience. The use of pre-sold foreign distribution contracts, sales estimates based on commercially tested actors, and various government production incentives ("tax credits" and "soft money"), can all minimize risk to investors by reducing the equity investment and thereby accelerating recoupment. By the time they are sold for domestic distribution, intelligently budgeted films that take full advantage of these financing strategies can mitigate much of their performance risk while still preserving some upside exposure to performance and a long library life.

Many high-net-worth individuals seem sold on such benefits, judging by the continuing flow of new money into film. Some of this funding has come from the world's emerging economies where film demand is growing in lockstep with a growing middle class. Money is also coming from opportunistic U.S. equity participants that sense a financial gap in the market vacated by the Hollywood studio conglomerates and their institutional backers. At last month's American Film Market (AFM), the annual Santa Monica convention where rights to independent films are traded around the world, industry newspaper Variety listed several contributing factors to the increase in independent film demand:

- As the Hollywood majors ratchet back on mid-budget projects to focus primarily on producing $75 million-plus blockbusters targeted to a 12 to 29 year-old demographic, new North American theatrical distribution companies have emerged to take up the slack. The result: more buyers focused on independent films.
- There's been a real savings in talent costs, which have been recalibrated in the post-2008 era. Star actors have realized that their careers can really be helped by doing indie films, noted one entertainment attorney, particularly as stars start to age.
- Foreign markets have been robust, particularly in the BRIC countries. AFM saw more than 750 buying companies from 70 countries send some 1,500 representatives to its tradeshow. South Korea had the most new buyers with 25, followed by China (13), the U.S. (11), Japan and Turkey (6), Russia (5), France and Italy (4) – reflecting healthy growth across both mature and emergent markets.

- High net-worth individuals continue to want to invest. "I do get a sense that there's enthusiasm for rate of return and the speed of that return," said the head of one seasoned sales company.
- There were more than 2,000 projects for sale, a reflection of industry bullishness after solid business at other industry conventions and another impending independent hit with the final "**Twilight**" film. This follows on the heels of other indie-financed titles including "**The Hunger Games**," "**Beasts of the Southern Wild**," "**Looper**" and "**The Best Exotic Marigold Hotel**".

In the past, infusions of new money have only served to increase the volume of high-priced “vanity projects” that are made with little hope or expectation of a financial return. Product gluts ensued, followed closely by company closures. But as evidenced by the AFM, deal-making has become rather more measured – and will likely remain so in the long-term. As one prominent sales executive told film magazine Screen Daily: “Buyers are becoming more risk-averse. They are looking at everything more forensically than before. It’s still a great business but everyone now has to be smarter, more focused and more intelligent.” From an investor’s point-of-view, this wariness can only enhance the sector’s appeal since it means both buyers and sellers are likely to remain in the game that much longer, offsetting a liquidity-driven boom/bust microcosm in lower-budget movies. The precious rights-trading ecosystem, around which so much of the independent film financing world hinges, is that much more sustainable.

It would seem too that investors are approaching film in a similarly disciplined and educated fashion, with an eye fixed firmly on bottom-line driven analysis and market validation. They see in independent film a surprisingly stable yet high-yielding asset class provided it is organized around a diversified and relatively low-cost film portfolio. Where others may have seen peril before, they now see a greater degree of certainty, an attractive risk/reward profile, a low correlation with the equity/bond markets and a recession resilient history of film returns. Informed investors engage in a calculated risk, in other words, rather than a starry-eyed gamble.

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High Return Potential

One of cinema’s enduring appeals is that, like in venture capital, exponential returns can seemingly come out of nowhere. You don’t need a celebrated cast for that to happen, you don’t even need good reviews and you most certainly don’t need big budgets. In the case of “**The Devil Inside**”, a micro-budget ‘found footage’ exorcism, all it took was a clever marketing campaign. The advertising included a graphic online trailer and taped reactions of moviegoers at an advance screening that appeared to take place in an old church. By the time the audience had wised up, it was too late: the universally panned film had opened to $34.5 million at the US box office and usurped the $145 million-budgeted “**Mission: Impossible – Ghost Protocol**” as the number one film across North America at that time. Inevitably, the film quickly disappeared from the box office top ten - but it still was a huge commercial success, grossing $101 million worldwide in 2012.

Set against the $1 million minimum guarantee that Paramount paid to distribute the film through its fledgling Insurge label, that $101 million figure amounts to a putative 4,950% return on investment even after theaters have taken their slice. Paramount's marketing and distribution expenses, which are all charged to the studio anyway, are not included in that figure. But neither are all the subsequent DVD, video-on-demand, television, airline or Internet-derived revenues that will accrue later. While undoubtedly profitable, pinning down the exact ROI is at best a product of educated guesswork. There are so many tranches of debt and equity involved in film production, each of them claiming a position in the recoupment stream, that determining ROI is a matter of perspective and requires information that is seldom made public. What can be a loss for a studio-financed film may even be a gain for an institutional investor. There are simply no set averages for ROI. Every film is a standalone business that is subject to distribution agreements and profit participation shares whose only clues are the reported box office numbers.

> What can be a loss for a studio-financed film **may be a gain for an investor**

Occasionally, that accounting veil is lifted enough to see how the real numbers stack up. In the case of the Oscar-winning independent drama "**Crash**," court records showed that this was a $7.3 million budgeted production that yielded gross receipts of $33.8 million after a worldwide box office release that generated $98.4 million. Once all residuals, expenses, deferments and interest were deducted, that left $23.5 million in the "pot" for producers and investors. Assuming the film was funded entirely through equity, and those investors enjoyed a 50:50 split with the production company after first being paid their original investment, their ROI was 158% over a period of up to six years.

Impressive as that figure may be, the "all equity" assumption ensures that it does not fully represent the potential returns that investors stand to gain from a film like "**Crash**". If that film were shot today on location in Los Angeles, it would qualify for generous California film tax credits of up to 25% that have since been introduced to encourage local shoots. Combine that, for argument's sake, with the federal income tax break for film known as Section 181 (Jobs Creation Act) that was enacted in 2004 and has now expired, and those investors would have seen an initial immediate return of between 40%-60% on that initial $7.3 million spend. Under such a scenario, an even more impressive ROI picture emerges. Looking at it from an IRR perspective, the front-loaded nature of profits on a theatrically released hit like "**Crash**" should not be overlooked. A film's effective revenue-generating shelf life may be up to ten years, but much of that money comes during the first two or three.

Tax incentives are an important part of the investment calculus. Since a film's commercial performance is subject to so many different factors, many of them beyond anyone's real control, projecting ROI based simply on box office and other distribution revenues becomes an exercise in wishful thinking. As much as your film might exhibit many of the same characteristics as a previous hit – a so-called "comparable" - you still have no way of telling what the prevailing market conditions will be when it comes to release time. Even leaving timing aside, this methodology can be difficult to apply: what would the comparable have been for “**My Big Fat Greek Wedding**”, for example? For this reason, a more robust approach is to focus on maximizing returns that are available before any performance revenues accrue. An ROI based on global distribution advances and/or tax incentives may not offer the elastic upside of a box office breakout, but at least that number is far more quantifiable, more immediate and serves as benchmark for establishing a viable budget. Look at “**The Devil Inside**.” The filmmaking team responsible could hardly have predicted its theatrical performance since so much revolved around Paramount’s marketing inspiration. But what they could control was the decision to shoot the film documentary-style on a shoestring in Bucharest and Rome, cities that come with their own advantages in terms of production costs and local film funds, and then build a case for why a film might be sold for a multiple of cost to a studio on the prowl for the next “**Paranormal Activity**”. Experienced producers will look to tight budgets and fully avail themselves of financing alternatives in order to maximize the equity investment recouped through a distribution rights sale. The devil is in these early details.

Non-Correlated Returns

The 2012 U.S. presidential elections may have spooked Wall Street and even sent shares of stock market darling Apple into a brief tailspin on fears of fiscal uncertainties and its effects on consumer demand, but it was business as usual for cinema. Screen entertainment has a history of stability through recessions. When money’s too tight to mention, there is nothing quite like a darkened movie-house to provide a cheap diversionary fix in the shared comfort of strangers. For producers and investors, the only suspense is in determining exactly which films will end up resonating with their paying public.

> **box office gross**
> rose during five of the last seven economic downturns including the dot-com bubble

A big part of what drove hedge funds and investment banks into pouring billions of dollars into Hollywood movie slates starting around 2004 was the long-held assumption that movies are both “non-market directional” and “non-correlating”. No matter how much the equity markets and the economy as a whole fluctuated, investors could still count on getting a piece of Hollywood’s 15% internal rate of return, with a possible kicker in the event of a blockbuster hit.

Such a belief is well founded. Box office grosses rose during five of the last seven economic downturns, including the 70’s oil crisis and the burst of the dot-com bubble. And look at the Great Depression. The 30’s occasioned both America’s rock-bottom low in terms of general living standards but also Hollywood’s high-point in terms of box office admissions as millions sought escape in Marx Brothers comedies, musicals and monster flicks even with their jobs on the line and the threat of global hostilities hanging over their heads.

Back then a movie ticket bought you a cartoon, a newsreel and a supporting feature – four hours of entertainment for the price of a gallon of gas. The average U.S. film ticket today costs twice that amount and there are myriad other ways to watch both at home and on mobile devices that were simply unimaginable during Hollywood’s heyday. Theatrical admissions come nowhere close to matching the days of “**Gone With The Wind**”, whose global box office would equate to an astonishing $3.2 billion at today’s prices. Nonetheless, total revenue keeps expanding, even when adjusted for inflation. Last year, studio-released movies not only made a record $31.6 billion at the global box office, but they grossed another $53 billion from a combination of pay-per-view TV, cable and satellite channels, video rentals, DVD sales, online subscriptions, and digital downloads – the very technologies that were supposed to supplant cinema watching. This paradoxical growth is evident around the world. In the UK, for example, the box office broke the £1 billion ($1.4 billion) barrier for the first time last year as cinema admissions returned to their second highest level since 1971. So much for austerity.

Not every year can be considered a boom year for film. There are periods when profits are shared more widely than others. But the point is that those economic cycles bear no relation to other investments such as real estate, industrial commodities, precious metals, fixed income, equities, international currencies, fine wine and art. For investors looking to balance their portfolio with an asset class that does not correlate with the ebb and flow of Wall Street, this holds obvious appeal. But they can go even further in their non-correlation quest.

Until now, the focus has been spreading bets across individual Hollywood film slates. Such a strategy certainly helps investors achieve a similar diversification to that which has historically benefited Hollywood studios. However, these studios rely on just a few key decision-makers to greenlight films. This leads to limited variation in the kinds of films being financed, a problem exacerbated by the studio's retraction to $75+ million blockbusters targeted to the 12 to 29 year-old demographic. To avoid this concentration risk and achieve fuller diversification, investors should seek out slates of films that come from the widest range of tastemakers. A portfolio of independent films, particularly one that combines boundary-pushing titles with more generic ones that are custom-designed for particular audience niches, would fulfill that non-correlating mandate.

A Capital-Deprived Industry

The 2008 financial collapse may not have dented ticket sales, but it did scare off many of the Wall Street players who had only just started to trickle back into film financing. Institutional investors retreated from the billion-dollar slate financing deals just as quickly as they came in. Deutsche Bank, for example, promptly shut down its film-funding unit after failing to corral other investors willing to shoulder the senior debt component on a $450m fund for Paramount Pictures that would have shared the cost of making 30 films including "**Tropic Thunder** "and a proposed sequel to "**Transformers**".

Since that retreat, even the biggest Hollywood players have been turning over rocks in search of equity. With their parent conglomerates suffering from the same credit crunch, finding financing partners that can take up some of the capital burdens associated with blockbuster-focused Hollywood moviemaking has taken on greater urgency. Indian moghuls, Russian oligarchs, Middle Eastern potentates and Silicon Valley luminaries and scions have all joined various sovereign funds on Hollywood's speed-dial list. DreamWorks' deal with India's Reliance exemplifies this shift. So does Paramount's $350 million co-financing deal with Skydance, the production company run by David Ellison, the son of Oracle founder Larry Ellison. $150 million of that Skydance fund is made up of equity, the rest a four-year $200 million revolving credit facility led by JPMorgan Chase.

It's not just Hollywood that has found its supply of available investment capital more constrained. The independent film industry is also more capital-deprived, creating a new financing landscape that has tilted in favour of those with cash. While the studios have tapped into institutional sources, indie producers have to patch together creative combinations of equity, debt finance and "soft money" from tax shelter funds and public subsidies in order to cover their budgets. Frequently, they find themselves having to defer their fees for producing the movie in order to bridge any shortfalls. In the past, producers used to turn to banks to secure such "gap financing", essentially borrowing money at a steep premium against the promise of distribution revenues and tax credits. But, as Variety noted in 2010, the banks have become skittish too.

"Only Los Angeles banks such as Union, City National, Comerica and U.S. Bank are left in the business, offering conservative deals way below the 20% or even 30% of budgets that producers could secure against unsold territories in the not-too-distant past. The European institutions that used to dominate film banking, whether for single projects or slate deals -- Deutsche, Dresdner, Societe Generale, Bank of Ireland, Allied Irish Bank, Royal Bank of Scotland -- are long gone. Even finding one willing to discount pre-sales and tax credits can be a struggle. Gap finance is now largely the preserve of a few specialist boutiques that represent private investors, whether rich individuals or funds."

As gap finance dwindles, independent producers have also found themselves turning to private investors from the U.S., Europe, Asia and the Middle East to pick up the slack. On face value, equity investing would seem rather more speculative than the lower-risk business of debt finance. But these wealthy individuals seem more motivated by equity investment than any lending opportunities. This is not just glamour talking. Smart investors sense that these are favorable investment conditions. Starved of capital, producers are giving away most of their potential upside from the success of a film simply to get them financed. Their investors benefit accordingly.

There is also a Darwinian upside to all this contraction. Only the fittest film producers will stay the course, and with this thinning of the herd ought to come a corresponding reduction in the number of dubious "vanity" projects. In an effort to find equity partners and foreign companies willing to share risks, producers are having to become more commercially minded – which bodes well for the marketplace. In an interview with the L.A. Times, Michael London, the producer involved in such films as "**Sideways**", "**The Visitor**" and "**Milk**" acknowledged such a strategic shift. "We've cut our overhead, changed our business plan and gotten a lot more proactive about what movies to make. Budgets have to be much lower. Material has to be a little more commercial, and you have to fight like hell for domestic distribution upfront," he observed in 2010. "The money is still out there. It's the business opportunities that dried up. Independent producers have to offer investors a rational investment with lower costs, smarter movies and better returns."

Coming soon...

Part III: Key Considerations in Film Financing

Find out what makes a film project marketable, how they are financed and how you as investors make money from them. Above all, learn which kinds of films have the highest profit-making potential.

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