Key Considerations in Film Finance

part three in a four part series

A **slated** PAPER

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Part III - Overview

The history of cinema can be seen as a succession of “new waves” that have transformed the way stories are told on screen. German Expressionists, Soviet Formalists, Italian Neorealists, France’s Nouvelle Vague, Brazil’s Cinema Novo, Hollywood’s Movie Brats, and even the so-called No Wave filmmakers, have all left their filmmaking imprints. The same can be said for film financing. The movie business has found itself constantly adapting to a similar ebb and flow of new financing waves.

With each financing cycle, the industry’s deal-making geography has changed too, particularly when it comes to independent film finance. During the 1980s, the Dutch division of Credit Lyonnais became the lending linchpin for the independent studios that grew up with the videocassette boom. In the ’90s, it was the turn of Germany and the dozens of tax-sheltered film funding vehicles listed on its Neuer Markt exchange that underwrote the world’s movie productions. At other times, British sale-and-leaseback schemes have been in vogue, so too U.S. insurance companies, Wall Street hedge funds, private equity firms, and sovereign wealth funds. Right now, it seems that the focus is turning towards wealth created in both the tech industry and the world’s emerging consumer markets.

> Smart investing boils down to well structured deals with **well-respected people**

While cinematic fashions have changed, the core principles of storytelling have not. New Wave filmmaker Jean-Luc Godard distilled this perfectly when he observed: every film should have a beginning, a middle and an end, but not necessarily in that order. The same can be said for film financing: the instruments may change and the geographies may shift, but the fundamentals of smart investments remain true. It still boils down to entering into well-structured deals with well-respected people.

Seasoned financiers have developed their own guidelines for achieving this. Paraphrased here, for example, are three eminently sensible rules offered by Kevin Frakes, co-founder and co-CEO of the film production and financing outfit PalmStar:

1. *Take the time to truly understand the many elements of film production, finance, and distribution, in particular the legal components and how the rights are created, distributed, and paid for.*
2. *Establish a high-level connection to the industry. In other words, get access to trustworthy people and have a good mechanism for filtering out people who are not reliable business partners. That means using good lawyers and consulting with the people best qualified to analyze your proposed deal.*
3. *Remain vigilant.*

Investors have been known to act against their better judgments, of course. In his chapter for the book Film And Risk, prominent Los Angeles-based entertainment lawyer Bill Grantham recalls coming across projects that were so obviously flawed he begged clients not to get involved with them, sometimes providing detailed written explanations of exactly how they were going to lose all their money. They did it anyway – evidence of a psychological component to film investing that stretches beyond steely business calculation.

Even the most coldly detached investor still needs to guard against common pitfalls. A film might be a roaring success, but because some investors chose to invest in the overhead and development costs of the production company in a "first-in, last-out” position, they may have lost out on windfall profits. Alternatively, investors may find themselves too far down the revenue sharing waterfall in a film whose budget over-runs have led its producers to stack new senior financing tranches on top of investors’ equity claims. With all this in mind, Part III of this Slated White Paper offers up a quick survey of how films are commonly financed in the hope of illuminating what is essentially an elaboration on more commonplace capital structures.

New business models will inevitably emerge as they always do, perhaps this time bringing some much needed simplicity and greater transparency to the money-raising process. In that same book, Grantham ends his chapter by asking what a rational model for film financing would look like. His answer is one that combines a “hard-nosed appraisal of the risk timeline” with a reduction in the complexity of film financing transactions. Such a reduction will “arguably restore clarity to the process of risk assessment.” Reading the following overview of film financing, investors new to film might well come away with the same conclusion and push for that new paradigm. But until that reboot happens, investors would be wise to understand the basic workings of the current operating system, its various permutations and moving parts.

What make movies marketable?

Films get financed because their producers have assembled a good “package”, that industry catchword for all the different elements that must combine to create a desirable project in the eyes of the industry. In the past, such packages were straightforward in concept, if not in execution. Secure the rights to a great movie concept, tease out a script that tantalizes in the first ten pages, attract a successful director and “attach” at least one “bankable” star: a male or female lead actor charismatic enough to ensure that the film will be distributed and attract a paying audience. Bingo – potential financiers and distributors come knocking.

Determining who such “A-list” actors are at any given time is a favorite media sport. Last year, Forbes magazine declared **Kristen Stewart**, the “Twilight Saga” star, as the world’s most “bankable” star based on the fact that her films earned $55.63 for every $1 that she was paid. More recently, Vulture.com teamed up with a statistician from The Guardian to determine that **Robert Downey Jr.** was Hollywood’s most valuable movie star, combining box office success in both action films and comedies with wide critical acclaim, audience likeability, and evident studio appeal among those who greenlight movies. But Downey Jr. is not the most reliable worldwide moneymaker of the last twenty years: that title is still claimed by **Will Smith**, even though he’s only made one movie in almost four years. And no Hollywood actor can claim to be the most popular movie star on the planet, a distinction that still goes to India’s **Shah Rukh Khan** according to many global news services such as the BBC and CNN.

Fortunately, given this confusion of rankings, an actor's perceived appeal is not the pre-determinant of success it once was. While stars' names increase investor confidence and serve as magnets for attracting other actors to a particular project, they are now just one part of a larger matrix of packaging elements that sum to a film's marketability. Other considerations now enter the equation, most particularly a solid business plan that lays out how financiers get their money back based on the film's capital structure and a realistic assessment of audience demand. Such plans should show how the producing team's relationships, skills, and market intelligence would maximize their project's industry appeal. Proper production budgets, reasonably priced talent, proven crew members, and a compelling marketing and distribution plan all lend further credibility. So too will details about ancillary opportunities, social media assets, committed marketing partners, built-in fan bases, and alluring artwork.

Stars are only one part of a larger matrix of **packaging elements**

Expensive superstars, on the other hand- particularly ones that are clearly miscast- may actually prove a liability. They are difficult to replace, for one thing. Agents will often insist on "pay-or-play" deals for their star clients, basically a guarantee that they will be paid their large fee even if they are not used in the production. Producers are somewhat protected in this arrangement since they are not required to honor the guarantee should they fail to secure any financing. Moreover, in return for that pay-or-play commitment, those producers are free to pre-sell rights to their film on the strength of that actor's name. But should the film actually receive funding, then that salary overhang makes it that much harder for a film to earn back its budget, especially if those actors have also negotiated "back-end" participation in the film's net profits.

Another warning light for incoming investors might be an ill-advised distribution deal. Perhaps it was a deal that was struck in haste during a vulnerable period in the film's development history: another telltale sign of amateurishness on the part of the producing team. So is the absence of a top-notch entertainment lawyer. For all such reasons, a thorough finance plan that comes fully represented asserts far greater marketability these days than any name actor can; in fact, you won't be able to land those stars without that professional underpinning. Just ask Jeff Steele, the chief financial officer for an equity fund that has been actively financing films. His very first blog post laid it all out:

"It doesn't take much for me or any other funder to tell the professionals from the amateurs. One look at a producer's finance plan (as well as their choice of attorney) tells me right away what kind of closing I'm in for. Being that a film finance closing can last anywhere from 4-12 weeks, this can be a relatively clean, straightforward experience, or three months of hell. Simply put, a finance plan is the best indicator of a producer's financial I.Q. We need to know that you know how much money you really need and where you're going to get it from."

As he says, if you going to do business with **CAA**, **WME**, **ICM**, **Gersh**, **UTA**, or any of the other packaging agencies or management companies, you'd better come in swinging with a major law-firm or attorney that has a verifiable track record of closing talent deals with the bigger agencies. Nowadays, these are the real marks of "bankability."

CAA CreativeArtistsAgency

WME A TALENT & LITERARY AGENCY

Gersh

uta

ICM

How do you finance a film?

While it is widely accepted that there are no set rules for independent film finance, certain structures and risk-mitigation strategies have taken root. Here is a run-through of the most common ones.

Pre-Sales

In the heady days of the home entertainment boom, pre-sales evolved as a way for producers to raise financing for films in development. Working usually through a sales agent, the financing for production budgets is pieced together by selling rights to that project in various "windows" (theatrical, DVD, video-on-demand, pay-television, etc.) to distribution companies who can then exploit these rights in their respective markets: Scandinavia, Benelux, Latin America, Asia, German-speaking territories, and so on.

The payment is usually termed a "minimum guarantee", an advance on royalty income from that particular window in that particular territory. In theory, should a film earn more than that "MG", then net profits ("overages") are also paid to the producer. Typically, upon signing a pre-sale contract, the prospective distributor pays a 20% deposit to the film's account, with the balance due once the completed film has been properly "delivered." Producers use the combined value of those distribution contracts as collateral for a bank loan to finance the film's production. The exact amount of that loan is based on the bank's assessment of the distributors' creditworthiness.

There are costs involved in putting such deals together. Packagers can take anywhere from 5%-15% of every sale. Sales agents' fees vary between 10%-25% for obtaining distribution contracts only – and as much as 30%-35% should they secure a cash advance or bank contract.

Completion Bonds

As mentioned earlier, pre-sales are really just pieces of paper that producers take to the bank to convert into the cash used in the film's production. In the case of certain territories or individual distributors with poor track records, letters of credit are needed before any sums are advanced. If the film is budgeted above $2 million, the bank will also demand that there is a completion bond in place to ensure that the film is completed and delivered to the foreign distributors with all the elements (such as stars, artwork, marketing materials, etc.) specified in the contracts. In return for providing this insurance policy, the completion bond company charges a premium that is usually a percentage of the film's cost. Based on its risk assessment, these premiums run from 3% to 6% of the budget. If the film overruns its schedule or budget, the bond company also has the right to take over its production and supervise its completion.

Gap Financing

While pre-sales remain one of the backbones of the independent film business, foreign distributors have become noticeably more cautious about the films that they choose to commit to ahead of actual production. Where once it was very possible to obtain all the financing for a film based only on a script, director, and a couple of stars, now there are shortfalls between what a film will cost to produce and what it is able to accumulate in minimum guarantees. "Gap financing" emerged to bridge that difference.

With gap financing, banks provide a loan of between 10%-20% of a film's budget against the value of all the distribution markets that remain unsold. An experienced sales agent is engaged to provide an estimate of what those territories could cumulatively be worth. The bank will typically lend half of that projected total and demand that at least two pre-sales are already in place as a measure of a project's viability. In return for its financing, the bank will be senior in the capital structure, receiving all income until its principal and accrued interest are fully recovered.

As the pre-sales market continued to soften, the gap has widened further. So-called "super-gap" financing has recently emerged, essentially a riskier form of gap financing in which more (up to 35%) of a film's budget is borrowed against future revenue projections. In return for financing more of the budget, super-gap lenders demand higher interest rates. The last two years have seen a gradual fall in the number of banks willing to engage in such "last-in, first-out" lending, replaced by a handful of specialist boutiques. This trend towards specialist or private capital can be seen across the spectrum of film financing, perhaps reflecting the impact of capital constraints on traditional (e.g. bank) financing, and the realization that focused expertise can greatly improve the risk/return profile in film investment.

Soft Money & Co-Productions

As budget shortfalls started to widen, producers looked to public funds – dubbed "soft" money – to make up the difference. Pioneered by the likes of Canada, France, and Australia as a magnet for drawing overseas film shoots to their countries, soft money started around 2002 to become an important part of U.S. independent film financing as states offered incentives of their own. A total of 43 different states granted at least $3.5 billion worth of subsidies to films, TV shows, and commercials between 2005 and 2010, according to a Tax Foundation calculation done for Bloomberg Businessweek.

> for film investors the more that soft money reduces the budget, the sooner **equity holders share in the profit stream**

Such production incentives come in many flavors. There are refundable tax credits, transferable tax credits, cash rebates, grants, sales tax immunities, lodging exemptions, and fee-free locations. Producers who qualify for these incentives are offered an average subsidy of 25 cents for every dollar of allowable production expense, a figure that rises to more than 40 cents on the dollar for shoots in Alaska and Michigan. In some cases, tax credits can be traded at a discount so that money is available to the production upfront.

For film investors the theory behind such incentives is obvious: the more that soft money reduces the budget, the quicker the film becomes profitable and the sooner equity holders get to share in that profit stream. Some incentives, after all, don't have to be repaid at all.

How long such enticements can keep going in the face of state deficits and budget shortfalls is subject to political debate in America. But not so in Europe. Germany, for example, already channels $285 million each year in "soft money" contributions to productions of all nationalities, including American – and there is actually more on the way despite all the talk of the Euro crisis. *"At a time when financing films is tougher than ever, Germany is proving something of a beacon in the storm,"* declared film business magazine Screen International earlier this year. *"Crucially, Germany's financing power has not been dented by the global crisis, with some funds even increasing their subsidy budgets."*

Much of this German soft money comes via big regional funds that only need to be paid back if and when the film is deemed sufficiently successful: their recoupment is entirely performance contingent. Combine this with federal and E.U. subsidies, take advantage of co-production treaties, negotiate pre-sales to neighboring Austria and Switzerland, and producers can cover their entire production budget by choosing to shoot and edit their films in Germany. Film projects are assessed on the basis of script, cast, talent package, budget, financing plan, local spend, chain of rights, distributors, international sales company, etc. While German cultural or historical content is seen as a plus, it is not a deal-breaker when it comes to approval – allowing films of all nationalities and subject matters to benefit.

Co-producing with other countries is often challenging, as anyone who has tried to tap into China's burgeoning film market can testify. Even Europe, where there is a more reliable framework for collaboration, can be difficult. "The language problems and the different legal systems, must not be underestimated," advises international producer Thierry Potok, who also runs a large Cologne-based production studio. "If you have 2 or more different co-producers, the problems are compounded, and you'd better foresee a comfortable budget for the lawyers and tax advisors. In any case, the most vital point is to select your local partners very carefully in order to find people who are experienced, who have a good reputation and do not end up constantly fighting it out in the courts." Once again, it pays to reap the benefits of a professional's inside track.

Private Equity, Debt & New Financing Models

What happens when your combination of presold minimum guarantees, gap financing, and soft money is still insufficient to cover the financing of a particular project? The answer is to turn to some kind of private financing. This might be in the form of direct loans from individuals and institutions that are made at higher interest rates than those charged by commercial banks. Or it might be straightforward equity in return for a substantial ownership position in the film and a privileged recoupment position. Some structures provide a blend of both.

The challenge with this late-stage financing is two-fold. The producer is lumbered with high transaction fees, on top of all the bank charges, agency commissions, pre-paid interest, deferrals, and other contingencies that have already taken a bite out of the budget. The investor is also buying into a movie in which all the saleable foreign markets have been disposed of already. As Edward Jay Epstein points out persuasively in The Hollywood Economist "the only real asset that remains is the 20% tier of the foreign contracts and subsidy contracts which is not covered by the bank loan. This is also the riskiest tier." If the producer manages to bring the movie in on budget, some of that equity investment can be paid back from the contingency funds released by the completion bond company. Beyond that, the investor must hope that the unsold American rights will find a distribution home.

> **equity investors**
> have become a
> market necessity

Fortunately, this precarious arithmetic has also led to some positive changes in dynamics of independent film financing. For one thing, budgets are dropping. Films that might have been made for $10 million a few years ago are now being shot for half that amount. Equity investors are coming into the financing picture far earlier in the process, allowing them greater potential control over their asset. If anything, their presence has been become something of a market necessity. Since not all movies that are sold end up being made, distributors are avoiding making any down payments until the film starts shooting, removing the up-front cash component that often serves as collateral. Cash-flowing a production can become more difficult under such circumstances.

In addition, talent agents are getting wise to sales agents who launch projects to the market before they are properly packaged and financed. "Agents want to be reassured on their client's behalf that the money is actually there, before their clients are used to shop the projects," film financier Maggie Montieth told Variety earlier this year. As a result, equity financiers are being asked to get directly involved in packaging indie film projects in order to provide validation that they are market-ready.

Entrepreneurial by nature, such equity financiers are also willing to turn to new forms of film financing. These include partnering with service-providers such as production facilities, raising financing from ancillary income flows from music and publishing rights, and turning to sponsorships. Using brands to stretch advertising dollars during a film's release cycle may be nothing new, particularly for Hollywood movies. But what is new- and potentially far-reaching- is how brands are now dabbling in film production itself. Already wrapped production, for example, is a new version of Shakespeare's **Romeo and Juliet** that was adapted for the screen by Oscar-winner Julian Fellowes. A substantial slice of its $17 million budget came from Swarovski Entertainment, the new film division of the Austrian crystal maker. It is likely to be the first of many similar deals.

How do films make money?

In the old days of cinema, feature-length reels of celluloid acetate had to be trucked around in huge cans that were delivered to theaters and unspooled to audiences. Tickets sold at the box office – an income stream that is split between distributor and exhibitor – remained the primary revenue stream for movies until the 1977 release of **Star Wars** demonstrated the considerable merchandising and other ancillary revenues that can come from a popular "franchise" that has captured the zeitgeist.

It is worth noting too that **Star Wars** only dethroned **Jaws** as the all-time box office champion a full seven months into its first-run in U.S. movie-houses. These days, even successful films are only seen in theaters for three months before they are made available for exclusive periods of time (known as "windows") in various distribution channels following that initial release. Such channels encompass everything from DVDs and airlines to the various TV windows: pay-per-view, pay-television, and free, over-the-air broadcast.

The fact that those movies can now be delivered digitally, rather than in physical form, has opened the door to new possibilities. Not only can films be piped directly into theaters, allowing for greater programming flexibility, they can also be summoned "on-demand" for viewing across all manner of TV, computer, and mobile screens.

Broadly speaking, there are four types of online movie services. Transactional video-on-demand (TVOD), essentially movie rentals chosen a la carte, is the natural outgrowth of the pay-per-view business. Electronic Sell-Through (EST) refers to the purchase of video content that is then downloaded and stored by the consumer. There are also two kinds of all-you-can-eat movie menus: those that are offered as a monthly subscription package (SVOD) and those that are streamed for free but preceded or surrounded by advertising (AVOD). Of all of these, the Netflix brand of SVOD is seen as having the highest growth potential around the world – and is consequently the most disruptive to the carefully orchestrated procession of distribution windows that has come to define established film business economics.

Also disruptive are the new hybrid forms of distribution that are opening up. Independent films are being given simultaneous VOD and theatrical releases by distributors that have access to both platforms. Despite the fear that such hybrid distribution strategies would lead to cannibalization of demand, the results have been seen as beneficial to producers and their investors. Not only do the films benefit from the exposure that comes with a cinema release (a promotional shop-window that reverberates throughout a film's distribution lifespan), but they also enjoy an accelerated revenue stream as customers from potentially 100 million North American homes order their film at various price-points. This applies even to relatively obscure titles such as the April 2011 documentary **American: The Bill Hicks Story** that Magnolia released simultaneously "day-and-date" in a limited theatrical run, and to cable viewers. Made for very little money and released on a miniscule budget of five hundred dollars, the producers actually broke-even on the theatrical release, where the film earned $90,000. They now stand to make a handsome profit from the $600,000 that they and Magnolia have officially estimated as their cumulative three-year VOD revenue.

How do investors make money?

From the onset, it is important to note that there are multiple exit strategies for film investors looking to get back their equity capital. Some don't even involve waiting until a film is released in theaters or watched on a small screen. Every year, at least one major film festival can point to an independent feature film whose distribution rights are sold on the spot for a multiple of its production budget. In such cases, everyone in that film earns a theoretical profit before the film has even begun its commercial life. This return of capital eliminates the investor's exposure to performance risk, the ideal outcome for an investor.

But more often than not, a film has to start generating an income stream from its distribution before investors begin to see meaningful returns. In some cases, investors might negotiate a fixed ROI on the capital they supplied – repaid after a set target has been met. In other cases, they might agree to a minimum ROI and arrange to receive a series of repayments over a film's lifecycle.

To illustrate how this all works in practice, let's look at a scenario involving a film that has secured theatrical distribution across North America and has performed well at the box office. Under typical circumstances, the exhibitor that operates the movie theaters, will retain about 60% of all ticket sales revenue. Before any financiers get to share in that remaining 40%, however, the distribution company will collect a distribution fee and also recoup its P&A expenses i.e. the money spent to both market the movie and to produce copies of the film, physical or virtual, to play in those theaters. Depending on what "back-end" agreements were struck with performers, residual payments and talent participations might also kick in, usually within sixty days of the film's release.

there are **multiple exit strategies** for film investors looking to get back their equity capital

Now comes the point that financiers and investors start to receive their money back. As a general rule, the first monies received from net distribution revenues are ring-fenced and automatically prioritized to repay all investments and debts incurred in creating the film. Once that production budget and any preceding overheads and development costs are "recouped", the film is said to have reached its break-even point. This then triggers a profit-sharing arrangement between the producer and investors. The film's stars, writers, and director tend to be paid from the producer's profit.

The contractual order in which financial contributors to a film's production are repaid is known as the "waterfall." Tax obligations and any bank debt are repaid first, followed by equity investors according to pre-negotiated terms, and finally the producers. This is a simplified picture. As with all industry-specific corporate financing, there are many structures which can significantly increase the complexity of the returns waterfall. This is why a well-structured business plan is so important, balancing the competing claims on any film in a fair and equitable manner. While investors tend to concern themselves with limiting their downside exposure, going so far as to insist on significant fees within the film's budget to help hedge their risk, it's often the allocation of the upside that can cause greater problems. Surrounding yourself with veteran producers, representatives, and other participants who are aligned with the equity holder's interests can help to ensure an equitable capital structure for both flops and blockbuster hits.

What kinds of films make money

Who wouldn't want a slice of Hollywood's big budget action, particularly those "tentpole" franchises such as **The Avengers** or **The Dark Knight Rises** that rake in nine-figure sums at the worldwide box office?

The six conglomerates that make up the studio system attract the top talent, compete for the choicest projects, enjoy access to capital, are in a strong position to control costs by extracting terms from suppliers and clients, and spread their production risks across a vertically integrated empire with a firm grip on every distribution medium and global market. Above all, with a broad portfolio of films these studios can subsidize the less successful pictures with their blockbusters' profits. Such in-built advantages help explain why investing in studio production output remains out of reach for most private individuals. Studios have the resources to finance their own movies, so why would they let others in? The answer, surely, is when the expected cost of outside capital is less than what the studios currently pay on their own funds. In other words, the studio's business relationship with the outside world is inherently asymmetrical.

That said, Hollywood investment channels are not completely closed off. Studios such as Warner Bros. turn to investment vehicles like Legendary Pictures and Village Roadshow as their regular co-financiers in order to shift their capital burden off their own balance sheet. In turn, these funds raise their own combination of debt, mezzanine, and equity capital from large institutional investors and banks.

But getting in on such funds for even the most sophisticated, well-connected investor is never straightforward, as film finance advisor Laura Fazio learned. During the last five years, she structured financings for Legendary, Roadshow, and a host of other giant Hollywood film deals totaling more than $4.5 billion while spearheading the entertainment practices of Dresdner Kleinwort and then Deutsche Bank. "It is tough for an accredited investor to invest directly in these tentpoles," she acknowledges. "We wrestled with this a bit at Deutsche and tried to use the high net worth guys as potential equity. But the regulations are very onerous. The best means to invest right now is, unfortunately, only via the public markets. One could invest via the institutional pools, but that is spotty. It is absolutely something we are aware of but have not yet been able to resolve."

getting in on film funds, even for sofisticated investors, was **never straight-forward**

Those that do manage to get through Hollywood's door had better hope for greater transparency and a better alignment of investor and studio interests than has so often been the case. There are a number of problems for the unwary private investor to look out for when seeking a piece of major Hollywood films. Here are five identified by Bill Grantham.

1. **The classic trap problem**: "Can you get into the good projects? Hollywood has been stingy about letting outsiders into the most lucrative films, and while there are some privileged entrants, this is a permanent worry. For 30 years or more, there's always been a risk that the outside money finances the dregs."

2. **The due diligence problem**: “Can you be sure that your money ends up on the screen? Many big Hollywood films are seriously over-budgeted, and investors need an experienced and forensic eye to scrutinize the numbers. The devil – in terms of cost and return – is usually in the detail and private investors need to commit the time and work to limit downside risk.”
3. **The waterfall problem**: “Even if it can obtain a relatively favorable recoupment position (e.g., ahead of deferrals) and a premium, a lot of money is paid out ahead of the investor. Too many investment propositions, if weighed carefully (see previous point) don’t have realistic chances for payback out of first cycle revenues (see next point).”
4. **The fast buck problem**: “The great appeal of the old presales model was the fast pace at which money came back: distributors paid on delivery, which was typically 12-18 months from the time the money went in. This is more difficult today, requiring investors to have a more realistic expectation as to the true rate of return that their money may obtain.”
5. **The soft touch problem**: “Investors and their advisers often simply lose their heads when offered film deals - and these are people who in other business activities are hard-headed realists."

While a couple of these issues also apply to independent film financing, they are magnified by Hollywood’s often-maligned but misunderstood accounting methods. The widespread belief that the studio’s bookkeeping methods do not correspond to general accounting practices reared its head again recently in a high-profile lawsuit. Melrose Investors 2, a New York-based financing entity that co-financed 29 films with Paramount Pictures in 2006, has questioned how $375 million invested in movies such as **Dreamgirls**, **Mission: Impossible III**, and **Transformers** that grossed $7 billion between them can still not amount to a dollar in profits.

The disparity certainly reinforces Hollywood’s reputation for opaqueness, and the allegations about concealed payments and secret agreements with third parties make for good copy. But lost in all the rhetoric is the reality that Melrose 2 actually made a decent ROI. “Vine Alternative Investments and the other investors in Melrose 2 are attempting to inappropriately parlay a successful motion picture investment into a windfall. Based on the performance of the films in which it invested, Melrose 2 is expected to make a double-digit return on its investment,” countered Paramount.

> for blockbuster returns avoid the tentpoles and **focus energy on the tadpoles**

The real problem is not so much fraud but how difficult it is to achieve anything beyond double-digit returns through Hollywood partnerships. In the UK, more than two thousand investors including celebrities such as David Beckham, Bob Geldof, Peter Gabriel and inventor Sir James Dyson contributed an average of £100,000 each to a film financing partnership created by London’s Ingenious Media. The average £50,000 in profit that they reportedly pocketed from that investment seems like an attractive return until you realize that Ingenious Film Partners 2 LLP owns a 25% chunk of **Avatar**, having put up $75 million of that film’s budget. **Avatar** is still the most successful film of all time when measured in the crude terms of "absolute box office profit", grossing nearly twelve times its production cost at cinemas worldwide for a profit of $1.15 billion from theatrical markets alone. If an outlier such as **Avatar** gives investors a putative ROI of no more than 50%, imagine the yield across a more typical Hollywood release slate.

If you are truly looking for blockbuster returns, the better play surely is to avoid the tentpoles altogether and focus your energies instead on the tadpoles – those independent films that stem from the nascent imaginations of tomorrow's generation of blockbuster filmmakers. Dig into the filmmaking origins of Chris Nolan and Bryan Singer, to cite just two of today's most consistently successful franchise filmmakers, and you'll see once-experimental directors who quickly graduated to Sundance film festival breakouts that offered eye-catching returns. Nolan's **Memento** made eight times its budget at the global box office; Singer's **The Usual Suspects** made nearly six. These indie sensations are also the very kind of films that enjoy long afterlives from on-demand revenue streams.

These are not isolated success stories. A wide range of independently financed hits – everything from **Winter's Bone** to **The Hunger Games**, to cite the films that star another Sundance discovery Jennifer Lawrence – have served as proof of concept that financial indie success is still very much possible in a fluctuating marketplace. After striking rich with **Black Swan**, a massive global hit, you might think that the group of Texas and Louisiana oil and gas tycoons that financed it would count their blessings and move on. After all, they put up $6.8 million on that film and realized a return of $54 million, larger than their entire film fund of $40 million.

Instead, brothers Timmy, Tommy, Todd, Tyler, and Bobby Thompson have come back for more. Much more. "We took the same investors from fund one, sunsetted it early, and they all came in at ten times their investment" says Brian Oliver, the president of Cross Creek Pictures after closing the new $300 million fund. If you want to know which kinds of films succeed, follow the money.

Coming soon...

Part IV: The Advantages of a Managed Fund

In the final paper of our four-part series, we look at how portfolio diversification offsets volatility, how industry experience can secure better terms, and ways in which investors can source marketable opportunities.

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