Investment Opportunities in Film Finance

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Introduction

Movies are a popular form of entertainment enjoyed by millions. However, the box office success of an individual film is notoriously difficult to predict, so film production might not initially appear to be a sound investment. The inevitable clash between the execution of an artistic vision and the commercial pursuit of profit makes production and financing different for every film. However, the variety of film financing options warrants closer examination; with the appropriate risk appetite and risk mitigations, an investor may find worthwhile opportunities in this niche strategy.

A few comments about terminology: In this analysis, “production company” and “producer” will be used interchangeably to refer to companies that make movies and borrow money for this purpose. The terms “debt financier,” “financier,” and “lender” will be used interchangeably to refer to third parties that loan money to production companies for film projects unless otherwise stated; these third parties typically refer to banks but can also refer to film finance companies and investment funds.

I. An Overview of the U.S. Film Industry

The film industry is a prolific contributor to the cultures and economies of the U.S. and Canada. According to the Motion Picture Association of America (MPAA), film and television production generated $131 billion of sales for the U.S. economy in 2014 while providing 1.9 million jobs across production, marketing, and distribution, as well as in sectors related to media distribution.[5] The total number of films released in the U.S. and Canada increased 19% from 2006 to 2015, while the number of films released by independent producers (561 in 2015) grew by 44%.[6] Over this time frame, box office revenues in the U.S. and Canada grew by 20.7%.[6] In 2015, revenues were $11.1 billion from sales of 1.3 billion tickets to 68% of the U.S.-Canadian population.[6] Notably, these revenues did not decline during the economic downturn in 2008 - 2009 but actually grew 10.4% over this recessionary period.[6] The long-term growth within the movie industry and its strength during an era of economic decline underscore the sector’s resilience. Further, the movie industry’s cultural significance will ensure continuing demand for sequels and new ideas alike. As long as there is an appetite for film projects, the need for financing will continue to exist. This report will emphasize the financing of independent film productions (“indies”) in the United States. Smaller budgets and resources, less prominent reputations, and more creatively ambitious projects relative to major studio releases mean more investment opportunities for the private investor.

[5] MPAA’s “The Economic Contribution of the Motion Picture & Television Industry”
[6] MPAA’s “Theatrical Market Statistics 2015”

II. The Making of a Movie

Creating a film is a daunting, costly process involving numerous crew members and tasks, and the level of complexity varies with the nature of the project. But the process can be broadly classified into the following stages: development, pre-production, production, and post-production, followed by marketing and distribution. The developmental phase is the basic starting point of a film project, where the fundamental conceptual elements of a film are assembled. A writer (who may be either independent or employed by a larger studio) develops a concept, determines the plot, characters, and story, and writes the script.[7] The development stage might also be an acquisition in which a film producer buys the right to make a movie or buys a screenplay; regardless of its source, the script must be revised and finalized before any financing is sought for the new project.[8,9] The final screenplay and the producer who is now attached to it form the foundation necessary to begin assembling the labor and financing needed to make the film.

This next stage is called pre-production, which involves searching for and gathering all of the human, physical, and financial capital necessary to shoot the film. A director and cast must be hired, along with a production crew, including a diverse assortment of roles such as hairstylist, camera operator, and technical specialists.[8,9,10] Meanwhile, the processes of choosing shooting locations, creating sets, costumes, and props and preparing budget and production schedules also occur at this stage.[8,9,11] The preparation of budget and production schedules is particularly important because once the producer has assembled a cast and director for the finished screenplay, the process of seeking, negotiating, and signing distribution agreements with distributors begins.[11,12] The payouts contractually promised to producers in such distribution agreements and any other financing guarantees obtained for the film may then be offered as collateral when the producer seeks debt financing, which will be discussed in greater detail in subsequent sections.[11,12]

Production, also known as "principal photography," refers to the period when the movie is actually filmed under the director's guidance; principal photography typically takes a few months for a feature film, but actual shooting time varies with the needs of the project.[7,8,9]

Finally, post-production is the stage at which footage is edited and assembled into the final version of the movie: visual, special, and sound effects are added, any relevant animation and musical scoring is prepared and test screenings are conducted.[7,13,14]

Under the terms of a distribution agreement, the producer agrees to complete and deliver to the distributor a film within the constraints of the approved budget by the designated deadline.[11,15] The final product must conform to the approved script and any technical specifications required by the distributor.[11,15] The distributor will market and distribute the finished movie within a specific territory through a specific medium for a predetermined period, as stated in the terms of the agreement.[16] In exchange for this right, the distributor usually pays the producer a minimum guarantee once the film is completed and delivered to the distributor.[11] The expenses that the distributor incurs are known as prints

[7] LAvideoFilmmaker's "The Movie Making Process: From Development Hell to the Shark Pool of Distribution"
[8] Motion Picture Capital's "Pre-Production & Production" and "Acquisition / Development"
[9] Eliashberg, Elberse, and Leenders' "The Motion Picture Industry: Critical Issues in Practice, Current Research & New Research Directions"
[10] The California Film Commission's "California Chart of Accounts" lists all qualified expenditures under the California Film & Television Tax Credit Program as of April 2016.
[11] Eshman, "Bank Financing of a Motion Picture Production"
[12] Garon, "Film Financing: Equity and Debt Financing"
[13] Motion Picture Capital, "Post-Production"
[14] Empire State Development, "New York State Film Tax Credit Program Guidelines"
[15] Phillips, "The Role of Completion Bonding Companies in Independent Productions"
[16] Litwak, "Distribution and the Indie Filmmaker"

and advertising (P&A) expenses, which include the costs of making the film prints that will be given to theaters, promotional posters, trailers, and other materials; advertising across different media; etc.[17]

III. The Production Loan

Initial funding of a small independent film (typically made by an unknown producer lacking resources and industry connections), often comes from family and friends. As the project progresses and these early sources of capital are exhausted, a key source of funding for independent films is a production loan, whereby the producer borrows money from a traditional bank, a film finance company, or possibly an investment fund to pay for the costs of principal photography and post-production. Since filming cannot commence without these funds, the producer must obtain a production loan before principal photography begins. Depending on the timeline for principal photography and post-production, the maturity of production loans is generally no greater than two years.[11] This improves the lender's probability of being repaid since the period in which adverse events can occur (and make the borrower insolvent) is shorter. Interest rates charged on bank loans can vary from 0.125% to 1% over the prime rate, which was 3.5% as of July 2016; other financing sources may be significantly more costly.[11,18] As part of the underwriting process, a lender commonly requests the following documents to evaluate total costs that the producer is likely to incur and its ability to repay: distribution agreements (discussed below), evidence that applicable tax incentives (dicussed below) have been secured for the project, and schedules for the project's expected cash flows, budget, and filming timeline.[11,19] The lender completes UCC-1 filings to establish its lien on the collateral securing the production loan. This collateral takes the form of financing guarantees - tax incentives, offered by many states for filming in those locations, and distribution agreements for marketing the final film and bringing it to market. In some cases, the lender may require the production company to transfer the rights to receive distribution agreement payments directly.[11] In making the production loan, the lender faces credit and execution risk from the producer borrowing the funds and counterparty risk from the distributors on the other side of the distribution agreement collateralizing the loan. The production company must secure this collateral before any loan applications are made.

IV. Film Tax Credits

The first loan collateral option available to the producer is a film tax incentive: Local governments subsidize economic activity through the reduction of taxes, either by offering a tax break to companies that qualify (tax credit) or by giving a tax rebate for applicable expenses incurred. These programs promote the production of movies and television and are prevalent across the U.S. - roughly 70% of states had an incentive program in 2015.[20] Factors that may affect project eligibility for this program include budget size minimums or restrictions, the types of production expenses that qualify, any per-project limitations on the amount of applicable tax incentives, requirements regarding the amount of in-state filming, and, most importantly, whether or not the tax benefit is transferable. Because these are the most common factors affecting a movie's eligibility for tax incentives, they indirectly influence how easily a producer can reduce a project's costs or secure a production loan. Transferable incentives are most useful due to the existence of a liquid secondary market; if the production incurs no income tax

[17] Fischer, "So You Want To Be In Movies?"
[18] The Federal Reserve's published "Selected Interest Rates (Weekly)"
[19] ABF Journal's "Film Financing . . . It's Not About Box Office Performance"
[20] McDonald, "2015 Production Retrospective"

liability in the state from which it obtained the incentive, the value of the incentive can be resold to the state or to a taxpayer with income tax liability in that state. Projects that do utilize tax incentives rather than selling them still benefit since the producers end up with more cash on hand to repay lenders.

To provide a better understanding of these incentives, let us examine California's Film & Television Tax Credit Program as an example, which differentiates between independent and non-independent projects. An "independent film" (which under California rules must be produced by a private company, which is no more than 25% owned by a public company) must have a production budget greater than $1 million in order to be eligible for a 25% transferable tax credit, applicable to the first $10 million of qualified expenses.[21] The state permits independents to transfer their tax credit to a third party, who is then able to apply the purchased credit to its own California income tax liability.[21,22] Unfortunately, the third party is not permitted to subsequently resell the credit.[21,22] Since California's credit is applicable solely to the buyer's income tax liability and cannot be resold to the state of California, the secondary market for such credits is less liquid there.[23] A producer would need to find a buyer who fits this narrow profile and pay taxes on the proceeds of selling the credit, which is typically sold at a discount to face value.[22,23] These barriers limit the ease with which a producer can monetize unused California tax credits, making them a less liquid form of collateral.

An example of a more liquid secondary market for film tax credits is Louisiana's Motion Picture Investor Tax Credit program. Louisiana offers a 30% tax credit on total qualified production spending within the state, which can be resold at a discount to the state for 85% of its face value if a producer does not incur any in-state tax liability, or resold on the open market for 80 - 90% of face value.[24] The ease with which projects in Louisiana can convert their credits to cash provides greater reassurance to debt financiers whose safety of principal is contingent upon the producer's ability to repay; a program like Louisiana's, in which a liquid market for the resale of tax incentives exists, is the most desirable form of incentive.

Foreign tax incentive programs also offer compelling cost reductions that are equivalent or superior to programs offered within the United States. One example is the British Columbia (BC) Production Services Tax Credit Program, which is available for international projects produced in BC. This program offers: a 33% tax credit on qualified labor spending in BC, a 17.5% tax credit on qualified spending in BC for digital animation or visual effects, *and* a 6% tax credit based upon days spent filming in BC.[25] There are no production caps, no annual caps and no minimum amounts that producers are required to spend in BC.[25] However, some foreign programs may require that projects pass minimum spending levels and a cultural test related to film content and production activities in order to be eligible for the tax incentives offered. For example, the Czech Republic offers a 66% cash rebate on withholding taxes paid by certain production members as well as a 20% cash rebate on purchases from Czech taxpayers.[26] But eligibility for these rebates is contingent upon spending requirements; the project must also achieve a minimum score on a test that awards points for featuring key cast members who are Czech citizens, utilizing Czech businesses, producing a film in a language native to the European Economic Area, and/or meeting additional cultural criteria.[26]

[21] The California Film Commission's "California Film & Television Tax Credit Program 2.0 Guidelines" effective July 1, 2016.
[22] The California Film Commission's "Fact Sheet: Using the Tax Credits"
[23] The State of California Franchise Tax Board's "California Form 3551: Sale of Credit Attributable to an Independent Film"
[24] Louisiana Economic Development, "Motion Picture Investor Tax Credit"
[25] Creative BC, "BC Production Services Tax Credit" and "PSTC FAQs"
[26] Czech Film Commission's film tax incentive eligibility guidelines and Cultural Test - Summary

V. The Distribution Agreement

The other financing guarantee that collateralizes the production loan is the distribution agreement (defined above in Section II, "The Making of a Movie"), which is necessary for the successful dissemination of the final film. Assuming that (1) the terms of the contract provide the producer with enough production flexibility and financial liquidity and (2) the distributor possesses a reasonable track record of reliability and effectiveness, the distribution agreement allows the lender to recoup all or most of its principal without being subject to the unpredictable nature of box office revenues. Before distributors agree to such a contract, they perform due diligence analysis of a film project and the producer behind it in order to assess the project's viability within the given financial and scheduling constraints, the credibility of key production members such as the director and cast, and the film's overall box office potential. In addition to the documents that a lender would request (see Section III, "The Production Loan"), the distributor would ask for the script and for information about the producer, director, cast and other major members of the production as part of this due diligence.[27]

The distribution contract terms that a producer is able to negotiate will influence the producer's ability to fulfill its requirements and define the compensation structure between producer and distributor. It is in the producer's best interests (and thus indirectly the lender's best interests) that the distribution agreement is limited in territorial scope and by length of time during which the distributor possesses the exclusive right to distribute in that territory, includes minimum guarantees or advances, defines distributor fees and defines how box office revenues will be divided, including which expenses and what portion of them the distributor is entitled to recoup.[28] Ideally, the producer would give territorial rights to the distributor who is most effective within a particular geographic region (for example, a distribution agreement with the best U.S. distributor for U.S. distribution, another contract with the best European distributor for European distribution, etc.) so that the film receives the most exposure possible.[28] The distributor often demands the longest distribution term as it can negotiate (10 years or longer), but the producer benefits from limiting the term so that it can switch distributors if the initial one turns out to be ineffective.[16,28] The existence and size of any minimum guarantee (a sum that the distributor will pay the producer for the right to distribute the movie - which may be upon completion and delivery, upon signing of the agreement, or in multiple installments over the course of production) is also defined in the contract; the producer prefers earlier payment schedules since the cash flow can be used to pay down production loans or to finance the rest of the film.[11,16,28] Furthermore, the minimum guarantee is a sunk cost that incentivizes the distributor to make a genuine effort to generate publicity and disseminate the film; higher box office revenues make it more probable that the distributor can recoup its P&A expenses as specified in the distribution contract.[16,28] How these cash flows are structured in the final distribution agreement will present different levels of risk to the debt financier because of their impact upon the producer's solvency.

Another key cash flow factor defined in a distribution contract is how box office revenues will be allocated between producer and distributor. The distributor receives a distribution fee calculated as a percentage of box office revenues (ranging from 15% - 40%, depending on the medium and territorial scope), and the size of the fee generally increases with the amount of the minimum guarantee, since the distributor's risk of not recouping the advance is greater.[28,29] In addition, the distributor typically has the right to retain 100% of box office revenues until it has recouped the minimum guarantee advanced, plus any P&A costs that the producer contractually permits the distributor to recover.[16,28]

[27] Allen Financial Insurance Group's overview of the "Film Production Completion Bond"
[28] Satorius, "Distribution Contracts"
[29] Blake, "Film Distribution Basics"

It is easy to see how all of these factors in a distribution contract will have some influence over the producer's ability to repay a loan, which is why close scrutiny of the agreements must be a critical component of the debt financier's due diligence if such agreements are collateralizing the loan. For example, large distribution fees or high levels of P&A recoupment reduce the share of revenues that the producer will ultimately retain and prolong the amount of time it must wait to begin receiving money. The choice of distributor may affect how successfully the film is advertised and disseminated, directly impacting the production company's top line. Close scrutiny of each distribution agreement collateralizing a loan, as well as the distributor involved as a counterparty in each agreement, should be an important part of the lender's due diligence.

As mentioned in Section III, "The Production Loan," several risks inherent to the distribution agreement (in addition to the above risks related to cash flow and producer solvency implied by the contract) can jeopardize the lender's ability to regain its principal. First, the producer may not be able to finish and deliver the film in compliance with the terms of the distribution agreement, which relieves the distributor of its obligation to pay the minimum guarantee to the producer (or to the lender, if the producer has transferred its rights to distributor payments).[11,16,28] This execution risk associated with the producer may be mitigated by a completion guarantor. In addition, it is possible that the distributor might (1) arbitrarily refuse or fail to pay the minimum guarantee or (2) become financially insolvent or otherwise unable to make any payments for the completed film; insurance may mitigate this counterparty risk.[11,16,28]

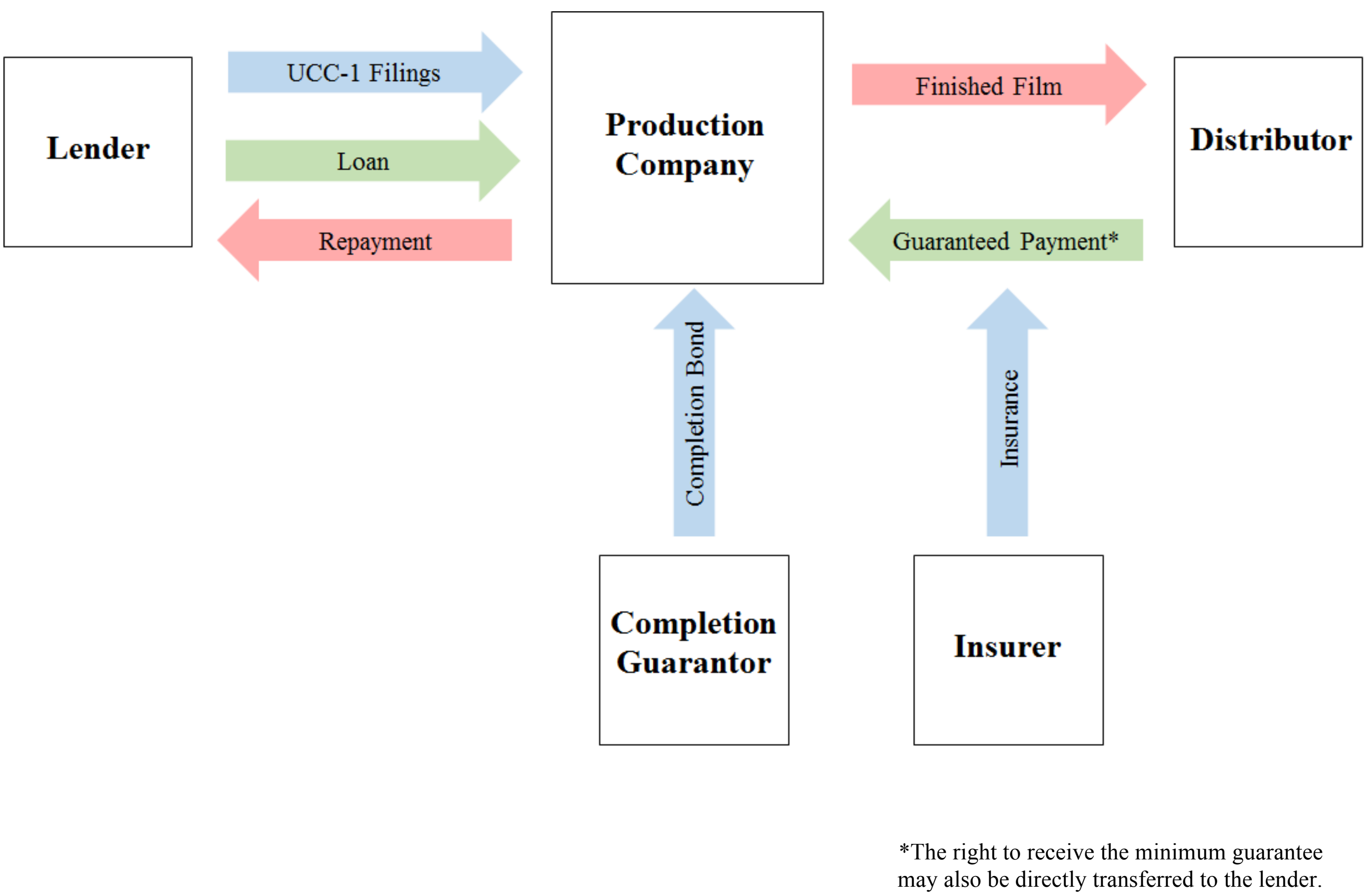

Figure 1: Anatomy of a Production Loan

VI. The Role of the Completion Guarantor

Lenders may require that production companies obtain a completion bond (also called a completion guaranty) as a condition of furnishing production funds.[11,12] The bond is designed to protect the lender's principal from the producer's execution risk, ensure that the distributor receives the contractually promised final product, and assist the producer with appropriate management of a project's budget. The producer will pay a fee to the guarantor ranging from 2% - 5% of the film budget for bond transaction costs; the guarantor also requires the producer to reserve a portion of the budget (10% is standard) as a contingency fund for unexpected costs that exceed the budget.[11,27,30,31] The completion guaranty is important because the producer's ability to repay its debt hinges, in part, upon receipt of the minimum guarantee that the distributor contractually promises to pay, which in turn rests upon the producer's ability to deliver the finished film on time and on budget. Furthermore, the guarantor's stipulation that the producer set aside a contingency fund increases the likelihood that the producer will remain solvent and manage its spending efficiently in the event of financial problems. (See Figure 1 above for a visual summary of a typical production loan.)

If the producer fails to meet its obligations under distribution agreements of staying on budget, on time, and on script in delivering the finished film, the guarantor assumes responsibility for repaying any production loans.[27,30] In addition to securing this debt, the guarantor's obligations include providing additional funding or taking action necessary to ensure the film's timely completion and delivery.[15,30,31] If the costs of making the movie exceed the approved budget, then the production company must exhaust its contingency fund before the guarantor will cover over-budget costs.

The guarantor's due diligence on the production company includes most of the previously discussed criteria that a distributor or lender would consider. For example, UniFi Completion Guarantors is a film and television completion bond company based in Calabasas, CA, that requests "the approved screenplay or teleplay(s), budget, cash flow schedule, shooting schedule and post-production calendar" along with "cast, crew, and contact lists" and other documents when evaluating prospective clients seeking completion bonds for their projects.[32,33] This information enables the guarantor to evaluate how realistically the company can produce the given screenplay within the proposed timeline and budget and make an educated assessment of the film's ability to generate enough revenue to break even. It is possible that the guarantor may also require the production company to possess various types of insurance coverage, such as general liability insurance and errors and omissions (E&O) insurance, for example.[34,35] General liability insurance covers bodily injuries and property damage related to the production - though separate workers' compensation (specifically for key cast and crew) is often necessary in addition to general liability.[36,37,38] E&O insurance is a common requirement because it protects the producer from lawsuits related to copyright infringement and unauthorized use of characters or other film elements, defamation of character, slander, libel, and invasion of privacy.[36,37,38] Insurance coverage reduces the risk that an accident on set or some other unexpected event might significantly delay or derail the project.

To ensure that the movie is finished and delivered to the distributor in accordance with the conditions of the distribution contract, the guarantor will monitor principal photography and post-

[30] UniFi Completion Guarantors' sample "Completion Guaranty" form, available online
[31] UniFi's "Frequently Asked Questions" section on their website
[32] UniFi's "Who We Are" page
[33] UniFi's "Production Information" request form, available online
[34] UniFi's process overview, "How We Work"
[35] UniFi's summary of required "Basic Insurance Coverages"
[36] Film Emporium's definitions of "General Liability Insurance" and "Errors and Omissions Insurance"
[37] Wong, "Errors & Omissions & Rights, Oh My! A Guide to Protecting Your Film"
[38] Willoughby, "Production Insurance for Filmmakers: Understanding the Basics"

production by requiring the production company to submit regular reports regarding filming and expenses.[15,27] UniFi requires the company to submit "daily production reports[,] weekly cost reports," and other records.[33,39] If the guarantor reasonably believes that the project is at risk of falling behind or failing to meet the conditions of the bond, the guarantor may intervene and make recommendations to get the film back on track.[15] As a last resort, the guarantor has the right to take over production entirely.[15,27,39] Thus, the completion bond functions as the lender's protection against the execution risk that the producer may not possess cash for repayment as a result of not finishing the film and receiving the minimum guarantee. The bond also reduces some counterparty risk because completion of the film in accordance with the distribution agreement eliminates the primary reason why a distributor may be relieved of its obligation to pay. However, it is still possible that the distributor may arbitrarily refuse to or become unable pay the guarantee despite the producer's fulfillment of its obligations.

VII. Insurance Against the Counterparty Risk of the Distributor

In addition to the execution risk of the producer, the lender also faces counterparty risk from the distributors, who are under obligation to pay minimum guarantees under any distribution agreements that may collateralize a production loan. To protect itself against the possibility that a distributor may default on its payments, the lender may choose to obtain insurance for the receivables expected. If a distributor fails to pay due to cash flow problems, insolvency, bad faith, or other scenarios that can be covered, the insurer would cover the loss up to the amount specified in the policy.[40,41] Such a policy would provide an additional safeguard for the lender's principal.

VIII. Gap Financing

In some cases, particularly for smaller, less established independent projects, it may be difficult to obtain distribution agreements or qualify for tax incentives such that their value collateralizes a production loan sufficient to fund the project's entire budget.[42,43] Gap financing is one solution to this problem. Gap financing is a form of mezzanine production debt that is junior to the original production loan and secured by distribution rights that have yet to be sold, typically foreign distribution rights.[44] In other words, the gap loan is made against the predicted value of future distribution agreements and is equal to the difference between distribution contracts already sold and the budget.[44] These loans are so named because they close the "gap" between the amount of financing guarantees already secured by the production company (which in turn affect the size of the production loan) and the amount of money still needed to finance the full project.[42] Thus, gap loans are not intended to serve as the primary funding source (the typical gap loan is 20% of the total budget).[42] One disadvantage of gap financing is that, because unsold distribution rights constitute an uncertain form of collateral, the gap lender demands an additional "gap finance fee" ranging from 5% - 10% of the budget, raising project costs for the producer.[42] This junior debt is far riskier than the original production loan since it is essentially a bet on the production company's ability to sell its movie, which is affected by the film's perceived potential for box office success.[42,43]

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[39] UniFi's sample "Completion Agreement," available online
[40] Sullivan, "Protecting Your Business, and Your Bank Account, in Case Clients Don't Pay"
[41] Meridian Finance Group, "Receivables Insurance"
[42] Cones, *43 Ways to Finance Your Feature Film: A Comprehensive Analysis of Film Finance*, 3rd ed.
[43] Litwak, "Borrowing Against Pre-Sale Agreements"
[44] Tuthill, "The Low Down on Gap Financing: How Does it Work, and is it for You?"

IX. P&A

As defined above in "The Making of a Movie," P&A refers to the costs that the distributor incurs for the materials and effort required to market and distribute a movie. The "P" refers to the physical *prints* of the film that need to be made and distributed to theaters so that they can show the film; the "A" refers to the *advertising* across different forms of media needed to generate publicity and awareness.[17,45,46] However, P&A may not always be borne by the distributor. In cases where a production company has not yet secured distributors, or distributors are otherwise not assuming all P&A costs, the producer may need to take out additional debt when the film is near completion to make prints and generate publicity.[47] P&A financing takes the form of a short-term loan from a P&A lender that is repaid within a year; once the distributor takes its cut of movie revenues, the P&A loan is repaid first before other debts (P&A is "last in, first out").[17,45,46,47] Interest rates on P&A financing can range from 12% - 20%; creditors also typically receive a small percentage of revenues (10% or lower).[17,45] P&A's first position claim on revenues makes recovery of this principal more likely, even if the film is not a huge success.

X. Other Revenue Sources and the Shift Toward Streaming

Although bringing movies to the big screen is the most common method of film exhibition, there are a variety of revenue streams for films outside of theatrical distribution. One potential source is product placement, a practice by which a producer receives compensation (which may or may not be monetary) for incorporating an item or a brand into a film. [48,49] The scope of the product placement might be a display of an item or logo lasting just "a few moments or seconds," but the placement can also go as far as having a character use the product as an integral part of the plot.[48] The benefits of product placement for the manufacturer include the opportunity to market to a "large . . . captive audience" (roughly two-thirds of the U.S.-Canadian population, or about 235 million people, visited a theater at least once in 2015) and target particular demographic groups with preferences for certain movie genres, which increases the likelihood that people will become familiar with a product and develop favorable associations with it.[6,48] Because product placement presents companies with an efficient way to advertise, encourage brand loyalty, and eventually convert these factors into greater sales, the demand for product placement is likely to continue into the future. One caveat is that the less well-known cast members and overall reputations of independent films may make it more difficult to secure such placements, and they are often less lucrative for these films than for major studio productions: an indie may expect to receive $50,000 to $250,000 for featuring one product.[49]

Other alternative revenue sources include pay-per-view television, video-on-demand (VOD), DVD and Blu-Ray sales, and subscription streaming services such as Netflix.[28] The rapid expansion of this last mode of media consumption is indisputable. Streaming allows the distribution of content directly to consumers without the intermediaries of theaters or cable networks, which in turn has the potential to reduce distribution costs and expand audience outreach to people who may lack the time to visit theaters or find it inconvenient to do so. According to Deloitte's November 2014 Digital Democracy Survey[50]:

[45] Zapalac, "P&A funding allows films to be marketed to general public"
[46] Faith Film Funding's explanation of "The Basics of Print & Advertising (P&A) Fiinancing"
[47] Elevado Media, "P&A Distribution – Intermediate term loan"
[48] PricewaterhouseCoopers, "Product Placement in Movie Industry: Strategic Insights & Fashion Apparel Case Studies"
[49] Epstein, "Pushing the Pseudo-Reality Envelope"
[50] Deloitte, "Digital Democracy Survey: A multi-generational view of consumer technology, media and telecom trends"

- 82% of U.S. consumers owned a laptop computer in 2014 (which facilitates the ease with which people may sign up for subscription services and consume media)
- 80% of U.S. consumers ranked pay TV as a highly "valued" digital service in 2014 (including 75% of "Leading Millennials" defined as between the ages of 26 – 31, and 58% of "Trailing Millennials" defined as between the ages of 14 - 25)
- 54% of U.S. consumers ranked video streaming as a highly "valued" digital service in 2014 (including 63% of Leading Millennials and 72% of Trailing Millennials)
- 56% of U.S. consumers used an online streaming service to watch movies at least once a month (including 65% of "Generation X," defined as being between the ages of 32 - 48, and three-quarters of Millennials as a whole)

As both subsets of the Millennial population grow older and drive demand for video streaming services, it is highly probable that their spending and viewing habits will fundamentally shift distribution and film revenue streams over the long term, which in turn may potentially change the methods by which movies can be financed. Though it is too early to predict the degree to which streaming revenues may complement box office monies earned from traditional theatrical distribution, particularly for independent films, streaming services are clearly becoming an integral aspect of the movie landscape as a distribution option available to producers.

XI. Equity

The production company's other option for closing the funding gap is to solicit equity. A disincentive for the producer is that equity investors - particularly major studios with greater resources who choose to finance independents - are more likely than debt financiers to demand some influence upon the production or otherwise interfere with the producer's creative vision of the film.[51] This influence includes changing movie endings or scenes featured, which in turn can affect elements such as character or plot that contribute to the project's ultimate box office success.[51] The degree of this influence depends on whether equity investors are classified as active or passive. Active investors contribute to the making of the film and have "relevant industry" expertise that facilitates their regular participation in the process; for example, producers are frequently active investors.[52,53] In contrast, passive investors have no say in the filmmaking process and simply contribute capital.[53,54] They are analogous to the non-voting shareholders of a corporation. Either position is a far riskier investment than debt because of its junior status in relation to creditors; unlike lenders, equity investors generally do not have the protections of a guarantor or UCC-1 filings that increase the likelihood of recovering principal. Furthermore, it is difficult to earn a positive rate of return in a hard-to-predict industry driven largely by consumer tastes and cultural trends.

The investor should be forewarned that rates of return in the filmmaking business are extremely volatile and difficult to predict due to the lack of transparency, disclosure, and uniform data collection methods; these problems are exacerbated for independent films. The following graphs underscore the potential for substantial gains and losses from movie investments. Figures 2 and 3 were generated using historical box office gross revenue data for more than 2,000 movies produced during 1915 – 2016; the sample was limited to projects with budgets of $10 million or less in order to reflect independent films'

[51] Fee, "The Costs of Outside Equity Control: Evidence from Motion Picture Financing Decisions"
[52] Independent Film Finance Group's "Definition – 'Active Investor'"
[53] Cones, "That Pesky Equity Component of Independent Film Finance Plans"
[54] Independent Film Finance Group's "Definition – 'Passive Investor"

limited financial resources.[55] Foreign revenues were excluded from gross return calculations since not all films in the sample were distributed outside of the U.S. Due to the unavailability of other relevant data, these gross returns do not account for the distributor's cut of revenues, P&A recoupments, or other previously discussed costs that must be paid out before the producer receives its share. Therefore, actual net returns to equity investors would be lower than the returns depicted here.

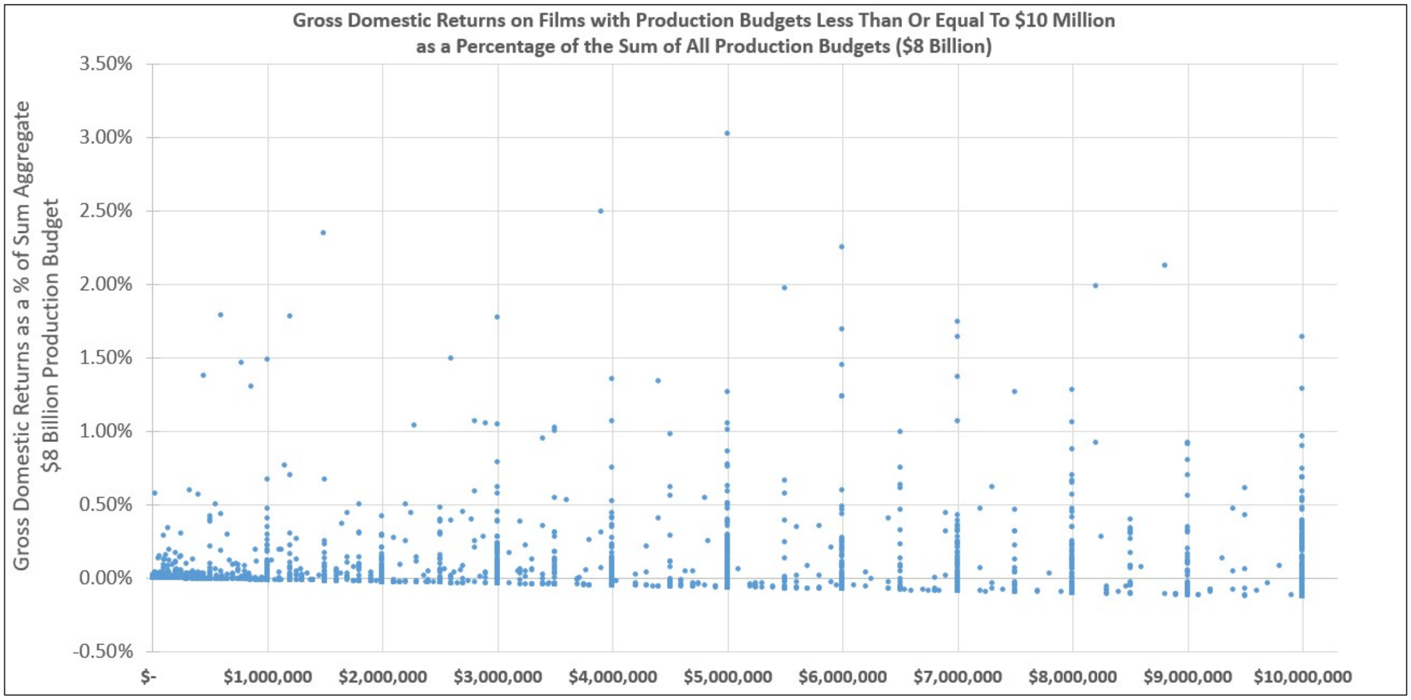

Figure 2: Gross Domestic Returns on on Films with Production Budgets Less Than or Equal to $10 Million, as a Percentage of An Aggregate Production Budget of $8 Billion[55]

Each movie's individual budget was divided by the sum of all production budgets in the sample (totaling approximately $8 billion) in order to determine that movie's size as a percentage of the whole. Individual gross domestic return was calculated as the quotient of budget divided by gross domestic box office revenues. To generate the data depicted in Figure 2, each film's individual return was multiplied by its size in order to weight that return as one component of a hypothetical portfolio consisting of all movies in the sample. There is no discernible pattern in the graph, though the majority of movies appear to generate positive returns.

[55] Data for both Figures 2 and 3 was retrieved from The Numbers, an online collection of box office data managed by Nash Information Services, LLC. Unfortunately, the source does not explain its methodology for determining the composition of movies included in its database.

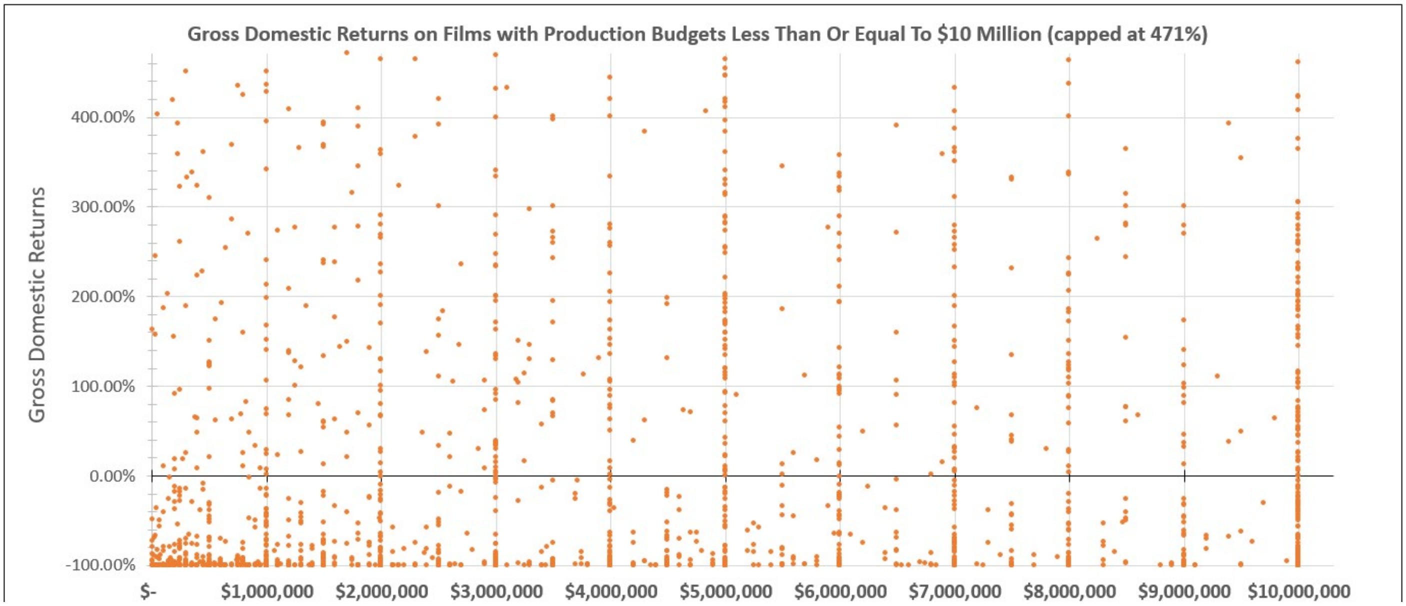

Figure 3: Gross Domestic Returns on Films with Production Budgets Less Than Or Equal to $10 Million[55]

In figure 3, the raw gross domestic returns are presented (without weighting each return by film size). In order to reduce the influence of extreme values upon the data, the set of returns depicted in Figure 3 are capped at the average gross return of the sample (471%), with a floor set at -100%. When the data are unweighted, the lack of predictability and large variations in rates of return become even more apparent. For example, the vertical trail of data points at the center of the graph depict how a $5 million movie can produce gross returns north of 400% in some cases or result in major losses in others. Equity investors face the greatest risk to their principal, and even the most thorough due diligence cannot always predict unexpected blockbusters or flops.

XII. Slate Financing

An equity investor may choose to furnish capital for a single film project or a single production company. However, investors who wish to diversify their exposure may opt for slate financing, a form of equity co-financing in which a large sum is applied toward the production of multiple movie projects over several years.[56] Slate financing can take the form of a pool of funds contributed by a group of individual investors, but it can also refer to co-financing partnerships that occur among major studios. For example, in 2005 - 2006, Sony and Universal jointly funded 17 movies with the assistance of "$600 million in hedge fund investment dollars" (in addition to debt), and investors had the flexibility to "[choose the] projects in which to invest from an initial pool selected by each studio."[56,57] The fund was called Gun Hill I (a second fund was subsequently created for a similar deal), giving investors a 50% stake in the 17-project pool.[57] The arrangement also required each equity dollar to be matched by mezzanine debt at a 3:1 ratio since the mezzanine investment provides a higher return (of over 20%) sooner.[57] A little more than half of the projects (10) would make a profit for investors, with a 13% - 18% IRR for the fund.[57]

[56] Owczarski, "Becoming Legendary: Slate Financing and Hollywood Studio Partnership in Contemporary Filmmaking"
[57] Siegel, "Gun Hill slate a sound investment"

The slate financing arrangement spreads the risk of loss across multiple films, so that a series of modest successes and/or a single strong performer can offset losses incurred on box office flops.[56] However, every slate presents different risk-reward profiles for investors because the terms of each slate financing deal will be different. Other disadvantages of this position include the lack of liquidity and the longer term compared to production or gap debt (production loans are typically due in less than two years, as discussed above in Section III, "The Production Loan"). Furthermore, although slate financing provides diversification, there is no guarantee that *any* of the projects within a given group will produce positive or breakeven returns—another reason why equity is riskier than debt.

XIII. Conclusion

The preceding discussion demonstrates the multiple film financing avenues available to investors at various phases of film production, and depending on the investor's risk appetite. Given the unpalatable level of volatility of equity returns in an industry characterized by constantly shifting audience preferences and cultural trends, production debt is the advisable path to investment due to the predictability promised by repayment and the protections for creditors. The limited resources of the independent filmmaker, as well as the lack of star power or brand recognition, ensure continued demand by the independent filmmaker for production loans. The distribution agreement eliminates the need to hunt for box office hits. The completion guarantor is legally bound to see that the movie is finished, which ensures payout of the distribution guarantee and protects the lender's principal; insurance may also be obtained to protect against the distributor's failure to pay. In conjunction with careful due diligence of all parties involved, these factors improve the risk-reward profile of the film finance landscape and make production debt an investment opportunity worth exploring.

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