Filmed Entertainment as an Attractive Asset Class

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part one in a four part series

A New Business Rationale for Film

What a difference a quarter-decade makes. When this White Paper was first published by Slated, as part of a four-part series in late 2012, the film industry was still trying to sell itself as a sensible investment proposition. Back then, there were only eight or nine specialized banks lending money to film companies and their projects. And multi-picture ‘slate' financing deals were rare enough to warrant major headline articles in trade papers and business publications. Independent film, in particular, was still regarded as something of an untouchable for rational-minded investors, more akin to a gamblers’ playground or a philanthropists’ pulpit than a bona fide business worthy of being called an asset class. Not any more.

Today there are at least twenty banks financing film and TV projects, a reflection of the increased comfort zone in which the entertainment industry now finds itself. Filmmakers are now borrowing money at the lowest interest rates seen since 2008, the tailend of the last film financing boom. At the same time, equity money is gushing back into the entertainment sector around the globe. The sudden arrival of China as a filmmaking superpower has not only tilted the global axis but also broadened the range of films being produced. As evidence, look no further than STX. Flush with Chinese backing, this new Hollywood studio-in-the-making has targeted the very $20m-$80m budget bracket that falls between indie minnows and studio whales that had been written off as a cinematic dead zone in 2012.

> with **so much capital** chasing film right now there is more money than bankable talent

In fact, there is such a wealth of capital chasing the entertainment business that a different problem has since arisen: there is currently more film money available than film talent - or at least investment-grade talent. Just because there is an abundance of funding doesn’t mean everything and everyone is suddenly bankable. Until the film industry takes a wider angle view of film packaging, cost inflation will again be the inevitable result of too many projects chasing the committed signatures of the same precious few star names.

So what better time to refresh our White Papers to take into account these latest market shifts and strategies? In doing so, all the numbers have been revisited and every assertion re-examined. Many of the core issues and underlying principles still apply of course. No matter what cycle cinema finds itself in, bullish or bearish, there is such little margin for error in a business still set up to satisfy too many simultaneous and sometimes competing interests. You not only have to find that impossible needle, you have to thread it multiple times as well. Lionsgate co-president Erik Feig has described this well:

> *“Every single movie that we make has to be sold twice. First, on a pre-sale basis, to a bunch of independent foreign distributors who are worried about losing money. And second, to a consumer who wants to see something that they haven’t seen before. Trying to find the right project and the right package that can satisfy both of those moments in time, separated by eighteen months of hopefully good execution, is really, really hard.”*

But that doesn't mean that cinema is one unmanageable crapshoot. As these Papers demonstrate, the industry's most reliable practitioners are those who combine a microscopic understanding of the prevailing marketplace with a grounded business plan that not only shields them from disaster but arms them for success. It's no good mitigating against the likelihood of downside risk if you don't also capture the upside when that happy occasion comes. If you have a great script, chances are you will get your film made these days - particularly if you know how to surround that project with the right team and creative elements. The real challenge comes in making sure you and your partners are positioned to fully benefit from all that assembled talent. Read on.

Part I - Overview

The business of making, marketing and profiting from feature films has been around for just over a century. Cinema was the first industrialized form of mass entertainment and even today, in the face of all other competing diversions that have evolved since, global filmed entertainment revenue is expected to reach $110.1 billion in 2018 according to PwC calculations. That figure represents a compound annual growth rate of 4.5% from its corresponding figure of $88.3 billion for 2013.

> the film business will reach **$110 billion** in global revenues by 2017

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

In terms of rate of return and market share variability, the industry has remained relatively stable and moneymaking. Somebody must know something after all. The film industry may not be able to predict audience taste with absolute certainty, but those at the top tier have shown a consistent track record in managing the risks involved in banking on such predictions. There is every indication that what people are willing to spend on watching films each year exceeds what it spent providing that entertainment. This is an inherently attractive business; how its spoils have been shared, however, is a very different question.

A rare glimpse behind Hollywood's accounting curtain came in November after hackers broke into Sony Pictures Entertainment's data files. The media fixated on the revealing emails. Those who looked beyond the histrionics and prejudices saw evidence of a cold-eyed, analytical approach that seems to serve the studio system surprisingly well. A leaked document from the studio's finance department claimed that Sony Pictures could expect its 2013 production slate to deliver $500-$600 million in profits on a total production spend of $1 billion. Further cost management was expected to lift those outside margins even higher - which would have helped ease any shareholders anxieties when also saw what executives are being paid at the studio.

Sony expected **50%-60% profit** margins on its 2013 film slate

Several Sony titles popularly characterized as theatrical miss-fires ended up in paper profit once all the 'ultimates' were tallied up from all the various global and ancillary markets. With prudent budgeting, proportionate advertising spends and tough-minded creative choices, all those available revenue streams can turn into rivers of gold.

The studios are not alone in seizing the opportunity. In what has been billed as a "new golden era of film finance", high net worth individuals and institutional players alike have been suddenly magnetized by a compelling macro picture that is rippling across the planet: accelerating global demand for content, ever more distribution platforms competing for those titles, business efficiencies enabled by low-cost technology, a painful contraction that has forced the industry into bottom-line thinking and low returns from other investment opportunities. The attendant risk of a bubble driving up costs is an ever-present, but so too the constant possibility of breaking new performance ceilings. With every year comes yet more surprise hits in unexpected places – a reminder that there is an embarrassment of niches out there still ripe for exploitation.

There are also unanticipated flops – an occupational hazard for a creative business that hinges on timing and taste. But managed in a way that allows room for both analytical and intuitive responses to story ideas, those performance risks can be structured to accommodate all levels of investor tolerance – just as with so many other speculative enterprises.

The purpose of this White Paper series is to lay out the different strategies for managing such performance risks at acceptable levels, while at the same minimizing the much bigger problem of delivery risk. Investors can only capitalize on film's proven ability to generate robust and non-correlated returns if those films get made. Here is how the White Papers break down:

Part I introduces the case for film investing as a rational business and dispels some popular industry myths.
Part II will delve deeper into the distinctive benefits of film investment as an asset class.
Part III will break down the various ways that independent films are financed and where investors fit into those scenarios.
And, finally, **Part IV** will look at the future of film funds, comparing the new possibility of a data-driven index fund with a traditional managed fund as vehicles for capitalizing on film slate opportunities.

Market size

The Motion Picture Association of America (MPAA) reported that global ticket sales reached $36.4 billion in 2014 – a new theatrical market record that is largely a reflection of continuing growth in the Asia Pacific region where new theaters are still being built. And that is just the annual box office receipts for the MPAA's own member companies. Add in all the films made and released outside the Hollywood studio system, including both independent and foreign films made for local-language audiences, including China's own homegrown blockbusters, and the full total exceeds $40 billion.

Some MPAA facts and figures from 2014:

International made up **72%** of global grosses, an all-time high.

Chinese box office jumped **34%** to **$4.8 billion**

China is first international market to exceed **$4 billion**

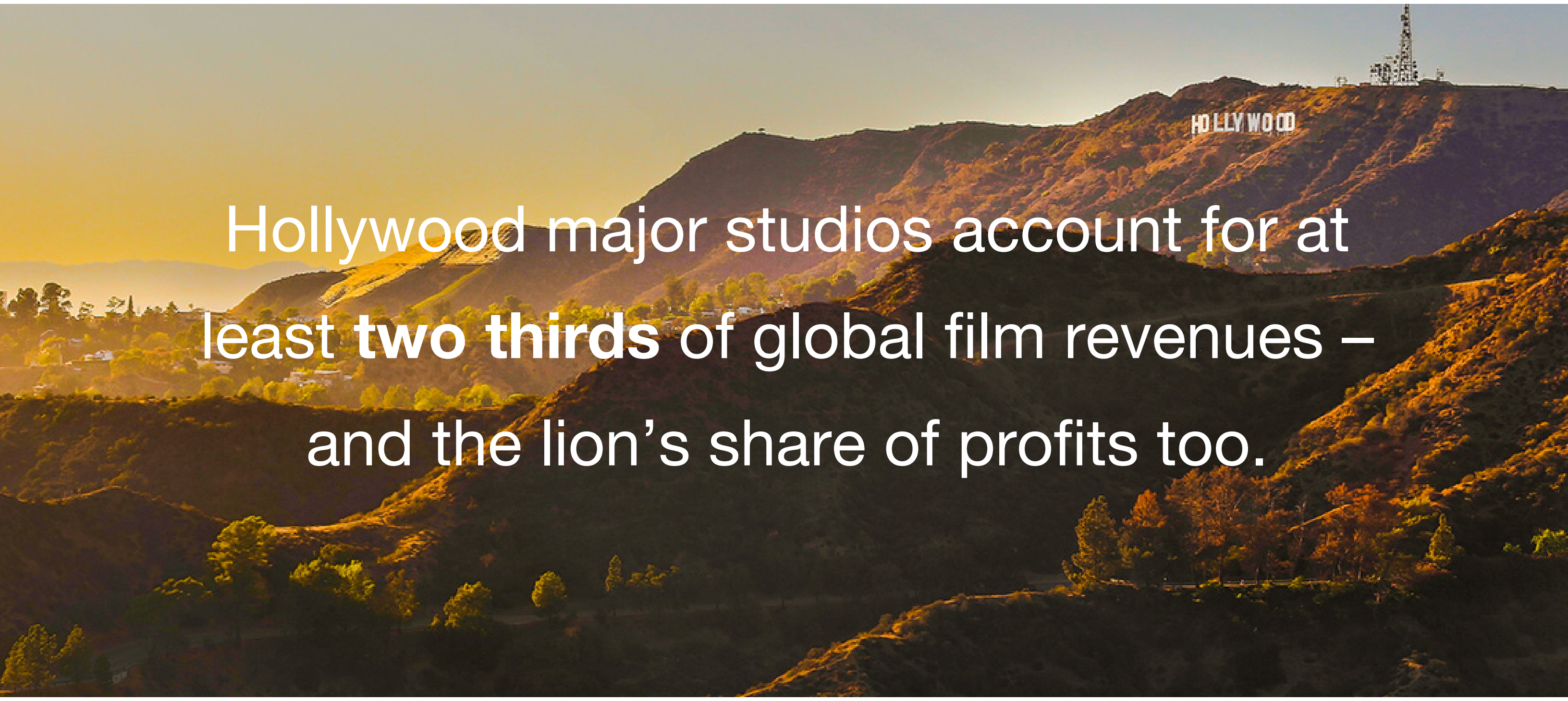
Cinema screens increased by **6%** worldwide in 2014 to **142,000+**.

North American admissions and average tickets sold per person both declined **6%**.

73% of frequent US/Canada moviegoers own at least four different types of key technology products e.g. smartphones & tablets

Geographic expansion at the box office is only part of the picture. New technologies continue to carve open new outlets for viewing both at home and on the move, increasing the potential revenue-generating life of every title that achieves commercial distribution. The video-streaming capabilities of web-enabled televisions, iPads, PlayStations and Xboxes and the like, mean that films are reaching more people than ever before and on a global scale that is giving politicians a legislative headache. Right now the EU is faced the unenviable task or reconciling the anytime-anywhere demands of the mobile viewing public across its multilingual continent with the territory-by-territory licensing practices of film distributors.

Indeed, in its latest and much followed “Global Entertainment & Media Outlook”, PwC predicts that both box office and video streaming revenue will each continue to grow over the coming years. Globally, it sees the total combined revenue from the over-the-top streaming platforms and broadcasters’ video-on-demand services will grow at a CAGR of 19.9% to overtake physical home video revenue (the sale and rental of DVDs and Blu-ray discs) in 2018. But not at the expense of cinema exhibition. By PwC’s reckoning, global box office revenue has reclaimed its primacy in the distribution food chain, overtaking physical home video sometime in the last few months. By 2018, box office revenues will have climbed to $45.9 billion at a CAGR of 4.9%. Such box office resilience attests to the continuing popularity of the cinematic experience.



The bulk of that $100 billion film entertainment business – at least two-thirds depending on the combined strength of local blockbusters in any given year– still lies in the hands of the Hollywood studios, an oligopoly of six diversified media conglomerates whose core focus is releasing ‘tentpole’ movies with average production spends of $75 million (before financing partners) and global marketing costs that have reached $200 million on the biggest juggernauts.

Despite those costs – or perhaps because of that massive investment – the six studios take home most of the movie profits too. If calculations by Deadline are anywhere close to reality, then that same six accounted for 18 of the top twenty most profitable releases of 2014 – for a combined profit total of $2.555 billion. Commanding as that presence might be, there’s still considerable headroom for others to make handsome returns.

Since the late 1960s there has also been a fiercely resourceful “independent” sector (existing outside of the studio system) that has exploited a lucrative array of specialized market niches with smaller budget movies that require lower advertising expenses. On occasion, these independent films have become huge mass-market hits in their own right, generating spectacular returns on investment. According to the Independent Film & Television Alliance, its membership of the world's leading indie film and television suppliers generate more than $4 billion in revenues annually. The 500 films its members generate each year represents just a fraction of the worldwide production. There were as many as 4,100 narrative and documentary feature films submitted to this year's Sundance Film Festival – split roughly 50/50 between US and internationally sourced stories. The combined production costs of those indie submissions comes to $4.65 billion, estimates Adam Leipzig of Entertainment Media Partners. That amounts to one enormous cottage industry operating under the industry radar for which more than 410,000 people worked in some capacity during 2014. As a combined population, that workforce would rival Miami.

> The combined cost of films submitted to Sundance totaled **$4.65 billion**

With few Hollywood exceptions, independent films represent the most effective way for individual investors to capitalize on the voracious global appetite for filmed entertainment. But only if certain conditions are met: one being that the film will end up with some kind of commercial distribution. This is by no means a foregone conclusion. Of those four thousand plus films made in the hope of premiering at Sundance, only 125 ended up being selected for this year's festival in January. Not every Sundance festival film secures a distribution deal; and many of the films overlooked by Sundance programmers will be end up being shown elsewhere in front of audiences. But the reality of so many films left by the wayside underscores the need for a proven winnowing process. As an investor you need to know your film has a high probability of being paid for.

Market Characteristics & Risks

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

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

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

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

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

A more immediate way to participate in these dynamics is through independent film. Independent films are those financed outside the major studio system. These lower-budgeted films are not only cheaper to invest in than Hollywood movies, they can also offer investors a fairer and more logical recoupment position that will yield faster returns.

Adding to the attraction of independent film is the rare possibility of outsized returns from unexpected places. This is where you will find cinema's outliers since by definition independent filmmakers operate outside the studio mainstream. There are parallels here with other business sectors. Harvard Business School studied eight bosses whose firms outperformed the S&P 500 index by more than 20-fold over their business careers. All of them, it turns out, were outsiders who brought with them fresh perspectives on their respective industries as a result of looking at the world through a marginal lens.

Find a way to apply the same portfolio thinking across such independent films that you see applied in Hollywood and you have the basis for an attractive asset class, one that offers the potential of impressive – and sometimes extraordinary - returns but without being tightly correlated to other investments such as stocks, bonds and real estate.

Cinema's business-to-business model **cuts both ways** for film investors

Diversification is only half the battle, however. More than 95% of independently financed films never go on to be seen in theatres, meaning that the vast majority have a hard time making back their investment. There are growing numbers of producers who are bypassing the traditional distribution infrastructure and reaching their audiences directly. They might turn to Tugg for an on-demand theatrical release in targeted communities or else use VHX to build an online customer base of viewers around the world. These self-publishing models may well represent the future for independent filmmakers. But until such time, success will depend largely on determining which independent films have the highest probability of being sold to distributors in different territories. That is not the same thing as trying to work out which films will perform at the box office. You don't have to second-guess the audience so much as know what will sell.

In most cases, no matter how well a film performs in a specific country, the only money the producing team will see from that success is the minimum guarantees offered for those territorial rights. In this respect, an independent film investment's financial fate can often be sealed long before it is shown to the public. In some instances, this business-to-business reality plays to the investors' advantage. There are plenty of films that have scored big deals at Sundance only to then fail to live up that festival promise once they play outside Park City. Having already essentially cashed out, this is no longer the investors' problem. But with films that have gone to achieve breakout success, investors have found themselves shortchanged. The arrival of better predictive tools may help solve this by providing both sides of the negotiating table with a more reliable yardstick by which value film rights. At that point audience reactions will finally matter – and the independent world will be that much closer to a self-publishing paradigm.

Myths & Misconceptions

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

Some popular industry myths

It's all about getting into theaters

Because cinema releases involve hefty advertising expenses, it sometimes pays to aim for a more captive outlet: pay-television premieres can often eclipse theatrical runs in terms of audience reach; video-on-demand have been known out-gross cinema releases although those figures are notoriously hard to come by.

It's all about casting stars

Independent films certainly benefit from having stars; their names help drive industry sales and attract other cast members to sign on. But it is also possible to have a breakout hit with unknowns who then go on to achieve stardom: none of the young leads in Ghost World (Scarlett Johanson), Bend It Like Beckham (Keira Knightley), Beasts Of The Southern Wild (Quvenshané Wallis), The Spectacular Now (Miles Teller and Shailene Woodley) and Winter's Bone (Jennifer Lawrence) were household names at the time of those films.

It's all about US box office grosses

While US theatrical release is certainly a harbinger of audience appeal and an indicator of demand, more profits actually derived from ancillary revenue streams and sales to distributors around the world, not the weekend numbers the press focuses on.

Revenues are what drive profits

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

Bottom Line: Bet On Proven Teams & Rainmakers

As pointed out earlier, many hundreds of movies are completed each year and never distributed. For early-stage investors looking to lower their exposure to such bad investments, one option is to trust the curatorial instincts of those with a proven development process strong enough to screen out all but the best ideas. These tastemakers might take the form of festival programmers, or top talent labs or script evaluation systems that have established industry track records. Another is to invest alongside similarly incentivized production companies that have a track record of working with “packaging” and sales agents who validate these projects’ potential in the marketplace before even a dollar is spent. They are part of inner circle of industry gatekeepers and powerbrokers that understands the convoluted process of meshing together creative talents, story ingredients and financing into a cohesive project that has perceived value for sales and distribution companies.

The best of these agents - each taking a commission on the sale of a film - are financially aligned with the investor and have a long reputation of successful film sales to protect. They have clout, are informed about market demands and know how to play the industry field to their best advantage. When it comes to evaluating projects, those agents look at the combined pedigree of the creative team involved. Here’s how IM Global’s senior vice president David Jourdan explained that process during one of Slated’s Filmonomics Talks earlier this year.

> *“You have different buckets and at the end of the day they have to even out. So if the director bucket is weak, then your cast bucket or your concept bucket or your budget bucket has to compensate for that. There is no sure thing but I would say that most distributors won't pre-buy a project by first-timer unless there was a very good producer on board that would offer them all the assurances they need when committing part of their annual capital. They don’t want to have deal with the uncertainties of whether a film is going to be delivered or what it is going to look like in their P&L projections. Those distributors are running a business.”*

Investors themselves would do well to pursue a similar calculus. Slated’s scoring systems, for example, can be used to establish an early baseline on the delivery capabilities of the team and the market credentials of their project. Armed with this information, they should seek additional counsel from those in the industry who have their fingers on the pulse of the global markets. In this regard, film investment can be compared to angel investors looking to invest in start-ups. As with any new venture that has no history from which to forecast potential performance, the best the angel can do is harness all the information sources at their disposal to assess the track record of those behind those ideas. In this scenario, the packagers and sales agents serve as the cinema’s super angels, powerful industry insiders to bet alongside. Just as with independent films, some 90% of startups don’t make their money back for investors. The difference is how many come back to invest again after such failures. The more that capital is looked after the happier it is to return regardless of performance upsets.

Next: Part II: The Benefits of Film Investing