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PERSPECTIVE

Investing in films: Strategies to minimize risk

By Sara L. Terheggen

While Hollywood certainly has a way with appearances making it seem that every movie made is a smashing success, the reality is that movies fail, sometimes miserably. Of course, the same can be said for venture capital, where companies create the appearance of wild success and convince investors to put their money into the next start-up on the promise of it being the next unicorn. Film finance investors do the same when they put their money into the next blockbuster hit or the next franchise. This is, of course, why portfolio investing makes the most financial sense in both of these types of investments. Having diversification, whether it be in films or start-ups, provides some risk mitigation.

With the growing presence of streaming and mobile video, the domination of streaming giants like Netflix and Amazon, the desire and need for content in 2019 and beyond is paramount. According to Deloitte's Digital Media Trends Survey, 55% of American households now subscribe to paid streaming video services. Pay-TV subscribers continue to be on the decline with many consumers opting for streaming video on demand and replacing their pay-TV subscription with multiple streaming subscriptions. It is anticipated that over-the-top (OTT) will overtake box office revenues in 2019, with an estimated $46 billion in revenue compared to $40 billion for box office.

To keep up with growing consumer demand for content, companies are seeking out valuable acquisition and/or intellectual property library targets. The industry is continuing to see roll-ups, consolidation and even partnerships. The production of original content is also increasing as you see a number of production companies proliferate across the industry. As this explosion in content production continues, this is generating many opportunities for talent but also bolstering another opportunity in film finance.

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Benefits and Risks of Investing in Films

While often considered an extremely risky asset class, there are also many benefits to investing in film. These include:

- An ability to capitalize on B2B in addition to back-end B2C performance;
- Long revenue streams in certain cases;
- Opportunity for outsized success, similar to venture capital investments;
- Less exposure to market downturns;
- Possibility for faster ROI given pre-sale licensing and distribution in domestic and foreign markets, as well as tax credits and grants; and
- Diversification of portfolio.

Some argue that the benefits are not outweighed by the outsized risks that come from investing in film. In truth, managing risk is the critical piece of any good investment platform. This is no different in the media and entertainment industry.

It is no surprise that investing in films is a risky proposition. For every blockbuster hit, there are many who cannot even recoup their own budgets let alone turn a profit. The key is identifying those films that have the greatest chance of outsized success and minimizing those that will incur significant losses. There can be no assurance of the economic success of any film since revenues derived from the production and distribution (which do not necessarily bear a direct correlation to the production or distribution costs) depend primarily upon its acceptance by consumers, which is difficult to predict. The commercial success of a film also depends upon the quality and acceptance of other competing films released into the marketplace at or near the same time, the availability of alternative forms of entertainment and leisure time activities, general economic conditions and other tangible and intangible factors, all of which can change and cannot be predicted with certainty. Further, the theatrical success of a feature film is generally a key factor in generating revenues from other distribution channels, such as home video.

To have the greatest chance of financial success, an investor has to simultaneously consider both production and distribution risks and be able to formulate the right mix of investment tactics unique for each film to help ensure better downside protection. Given the myriad of film finance structures and the difficulty in determining which tactics are right for which film, it can also be helpful for an investor to entrust their money to a fund with experience in the industry who can provide both expertise and diversification.

Investment Strategy and Investment Structure Tactics: Keys to Minimizing Risk

Investment Strategy

When investing in film (which can also be said for any type of investing), one key strategy is diversification. You can achieve diversification through investing in a slate of films offered by a production company or by investing in a content fund. In both instances, money is being invested in multiple movies which provides better odds of getting a hit that can compensate for any losses in the broader portfolio.

Another investment strategy that is helpful in minimizing risk is divorcing the creative from the financial analysis. Everything can sound like a great movie with the right pitch, the right angle, the hottest director, the top celebrity. Film investors often get caught up in this hype and finance the film based solely off of their own personal judgment about the quality of the film or the fact that they can tell all of their friends they backed a movie with the next hot "fill in the blank" celebrity. While the creative is important and certainly contributes to the likelihood that the film will get distribution and ultimately bring in revenue, it is also the investment component over which an investor has no control. This is where investment structuring can make a significant difference in minimizing risk and maximizing profits.

Investment Structure Tactics

Film finance can utilize a number of different investment structures. Every film will be unique and not all of these tactics are likely to be incorporated into one investment structure. However, part of the investment strategy will be determining which structural tactics contribute the most downside protection for each particular film and packaging the structure in such a way that is appealing for both the production team and the financiers.

Budget: Budget is always key. As obvious as it sounds, the higher the budget, the more revenue the film will need to generate just to break even. If the movie is a large franchise hit, then an outsized budget may be warranted but an investor will want to use other investment structure mechanisms to help control losses or consider smaller budget films where the likelihood of a profit can be higher relative to the amount needed to return capital.

Completion Bond: A completion bond is a written contract that guarantees a film will get finished and delivered. In the event production fails, the investors are at least guaranteed their money back. Because a completion bond offers an investor downside protection against loss of capital, this is an important backstop mechanism. Note that certain films may have trouble getting a completion bond if the budget is very small.

Insurance: There are several types of insurance that can be used in the context of film production. These include, but are not limited to, (i) cast insurance to protect against the death or illness of a key cast member, (ii) errors and omissions insurance to protect production companies from lawsuits involving personal rights, libel or slander and (iii) general production insurance which can protect against delays due to weather, set damage and equipment failure. Delays in production can create serious consequences on delivery of the film and ultimately impact investment returns.

Tax Credits: These credits, or incentives, are offered by individual states to encourage production to lure films from other states. The purpose is to save money owed to that particular state on taxes, or get other perks in exchange for choosing that particular state to film in. Other perks include cash rebates, sales tax exemptions, lodging exemptions and fee-free locations to shoot. While tax credits may seem more important for the production team, they can be collateral for an investor and offer a secure backstop from which an investor would be willing to front the initial capital.

Capital Structure: From an investment perspective, this is one of the most critical ways to help ensure ROI. This pertains to where an investor sits in the capital structure. For example, if an investor is going into the equity, they can negotiate to obtain seniority in the waterfall over other investors. The more senior the position, the more likely there will be a return of capital plus any premium, even if the movie has difficulty being sold or does not meet consumer expectations if it goes theatrical. If there is an opportunity to provide debt on a film finance project, this can be an even better position as any proceeds would generally go first to pay back debt before equity.

Security: Collateral that provides security for a transaction is generally in the context of an investor providing debt financing for a film. As a lender, an investor can often get a pledge of equity interests from the production LLC, penalty interest in the event the money is not returned by the maturity date, and other covenants or rights in the event of a default. Other arrangements like backstop agreements, which are a pre-sale of distribution rights before a film is even made, can also offer an excellent source of collateral as generally the proceeds from the backstop agreement can be tied directly to repayment of the debt.

Control: As an equity investor, control over sales and distribution decisions is an important component. If the managing member of the production LLC is caught up in the creative, they may not be capable of making sound financial decisions regarding sales and distribution, especially if the movie turns out to be below expectations. One should always negotiate for an approval right but at a minimum should obtain meaningful consultation.

It's a Wrap

Investing in films can have many benefits but it is not without risk. As with any type of investing, but particularly in films, an investor can minimize risk through a prudent investment strategy or by choosing the right fund manager. In particular, understanding and implementing the right mix of investment structure tactics for each film can offer a strong defense against a complete loss of capital, and hopefully provide enough outsized success to produce strong financial returns from the portfolio.

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