PRIVATE EQUITY international

Second Floor
Sycamore House
Sycamore Street
London EC1Y OSG
Tel: +44 (0)20 7566 5444
Fax: +44 (0)20 7566 5455

Private equity goes to Hollywood

Private investment fund managers are flocking to the movie industry because they see it as – get this – a business with manageable risk. Are these GPs wise to the future of filmed entertainment, or have they simply 'gone Hollywood'? David Snow *reports.*

The 1994 movie *Ed Wood*, starring Johnny Depp, depicts the true story of a moviemaker who many believe to be the worst of all time. Working on the seedy fringes of 1950s Hollywood, Wood turns out stinker after stinker until, in a desperate ploy to finance his next film, he convinces the deacons of a local Baptist church to back his *Plan 9 From Outer Space*. Terms of the deal include the provisions that members of the cast be baptised, and that the original title – *Grave Robbers From Outer Space* – be changed.

While *Plan 9* may be held forth as among the less sophisticated examples of film finance, it contains a plot line that has been seen again and again in Hollywood – a group of investors, eager to be part of the magic of movies, sets aside reason in favour of artistic vision.

For the record, the slew of professional fund managers to have recently done deals in Hollywood say they are *not* chasing glitter, but returns. These investors – most of them hedge funds participating in equity and debt instruments – believe they have gotten their arms around the risks of the film business. They see an opportunity to partner with movie industry veterans and to enjoy predictable, moderate returns over the long term through the bundled ownership of filmed entertainment assets. On paper, it sounds like the kind of risk/return profile that would be particularly attractive to alternative investment money. But the history of the film business is littered with disillusioned investors who went in with dreams of backing *Star Wars* and ended up with *Plan 9 From Outer Space*.

The latest crop of investing aliens to descend on Hollywood come from the alternatives universe. Mickey Mayerson, managing partner of the Los Angeles office of law firm Loeb & Loeb and the firm's co-chair of the Corporate Media and Entertainment Group, says he has seen a big uptick in the past 12 to 18 months in the number of private investment funds chasing opportunities in Hollywood. “There is a whole load of deals we are working on now involving name-brand Hollywood people and name-brand private equity firms,” says Mayerson.

Unlike previous types of movie neophytes, adds Mayerson, these investors are armed with hard-to-obtain revenue statistics, have serious return expectations, and are focused on emerging forms of digital entertainment, not just the box office.

Gary Adelson, a managing director in the Los Angeles office of Houlihan Lokey Howard & Zukin, and co-head of the investment bank’s media sports and entertainment group, says today’s sophisticated and professional investors sense a “paradigm change” within the media space driven by digital distribution, whether this be video-on-demand, telephony, iPods, or video games. As a result, says Adelson, “You’re seeing a lot of big, reputable private equity firms invest in the space. They have a perception that content has significant value in today’s world. By owning content, you have value that you didn’t have before.”

Movie studios, eager to offset some of the risk of film production, are only too happy to work with these new, return-driven investors, and have even been granting some concessions not often seen in Hollywood.

PACKAGE DEAL

While there are a number of financial structures tailored for film production, the one capturing the most attention now in Hollywood is often referred to as a “slate financing”, meaning financial investors co-invest with a studio to back a slate of movies. Underpinning this structure is an assumption that a bundle of movies, not unlike a bundle of portfolio companies, is more likely to produce the expected returns and guard against loss of capital. In other words, the bombs can be offset by the hits.

Mayerson: big uptick in movie chasers

> *“One of the things that got everyone’s attention was Warner Bros’ willingness to dangle one of the studio’s family jewels”*

The good news about slate deals for larger private investment funds is that their ostensible benefits are accessible only to parties with lots of capital to put to work, given the expense of producing multiple films. As an industry source puts it: “It can be riskier to invest a smaller amount in a single picture than it is to invest a larger amount in a slate of pictures.”

A prime example of a recent slate deal is Legend Pictures, backed by a clutch of private equity firms, which is in the process of co-financing 25 movies over five years alongside Warner Brothers (see table, p. 69). Legend is the brainchild of Thomas Tull, the former president of media investment firm Convex Group. The deal was structured in tranches of mezzanine and equity, with M/C Venture Partners and Banc of America Capital leading the equity round.

Among the films financed to date by Legendary is *Superman Returns*. According to Mayerson, the fact that a group of outside investors got access to the valuable Superman franchise is evidence of the studio’s need to tap into the private equity market. “One of the things that got everyone’s attention was Warner Bros’ willingness to dangle one of the studio’s family jewels,” says Mayerson. “Usually, the studios kept the sure things for themselves and only offered [investors] pictures they don’t have as much confidence in.”

Mayerson adds that, given the escalating costs that they face in producing and distributing pictures, studios are more willing today than at any other time in recent memory to share the upside in their current slate of pictures, even those which would have been considered untouchable in the past. For example, during the 1980s, Disney’s co-financings with outside investors never included its prized animated titles.

Still, co-financing deals are stacked heavily in favour of the studios. It might even be said that co-financing deals rival only hedge funds in the degree to which the economics favor the sponsor.

Here’s how most co-financing deals work: whatever gross revenue is produced by a film is immutably subject to a “distribution fee” taken right off the top by the studio. Unlike carried interest, this fee cuts into all revenue, even if the film flops. Further cutting into investor profits, many films have “gross players” – often star actors involved in the project – who take a guaranteed cut of the gross revenue alongside the studio. Then the studio recovers whatever it spent marketing the film. Then, and only then, do financial co-investors begin to share in the profits of the film, if any.

An industry veteran notes that while the distribution fee charged by studios has traditionally been 30 percent, this rate has come down in recent years to as low as 10 percent. He describes the market distribution fee today as roughly 15 percent, indicative of studios’ efforts to attract outside investors to film production.

According to Adelson, studios are now willing to bring in outside investors as 50 percent owners of a film’s rights (after the layers of fees have been taken, of course). The studios often retain the right to buy out a partner after a specified period of time. From the investor’s perspective, this might alter the long-term return profile of a film slate, but may also create an attractive exit.

Mayerson says that, in general, private fund investors in slate deals are looking for returns of more than 15 percent, with a sweet spot in excess of 20 percent. “If they’re not looking for those kinds of returns, they shouldn’t be deploying capital here,” he adds.

Another major area of film finance that has lately attracted alternative investment funds has been so-called “gap financing” – the equivalent of mezzanine finance bridging the gap between a film’s bank loan and its equity capital. These deals have largely attracted hedge funds, many of which are already active as buyers of corporate loans. A number of slate deals, including Legend, have included this type of financing.

Many film projects also include “prints and ads” finance, a fairly secure form of loan that is backed up the film’s gross.

GUT FEELING

Despite Hollywood’s reputation as a factory where naïve money is turned into unseen films, professional investors are now more comfortable with backing filmed entertainment because they have access to what they believe is compelling data on how films make money, which films make money, and through what structure.

This approach is the polar opposite of the “gut feelings” that famously launched both epic screen success and epic failures of previous eras.

The fact is, if done correctly, films can be relatively low-risk ventures thanks to the many ways their intellectual properties can be milked for revenue. Studios in particular have become extremely sophisticated in analysing where profits come from in a changing world. Among the fallacies of today’s movie business is that opening weekend at the box office can make or break a film. In fact, the media’s focus on box office revenue – people buying tickets at the local theatre – overlooks the importance that years of global and digital distribution and other rights can bring to a film’s bottom line.

“There isn’t a full understanding of how box office and video revenue translate into profits,” says Ken Schapiro, a partner at Los Angeles private investment firm Qualia Capital, and a veteran of the film-finance business. “There are films that have received big box office but not profitability, and there are films that have had weak box office but strong profitability.”

Key to a film’s profitability, says Schapiro, are the “tremendous number of film rights” that come with ownership of a title. These include the ability of consumers to purchase film viewings across an expanding array of digital platforms. But they also include movie remakes, sequels, music publishing catalogues, video games and television spin-offs.

Qualia, formed last year and backed with capital from hedge fund Canyon Capital Advisors, recently acquired for a reported $100 million the film libraries of Gaylord Films and Rysher Entertainment. Among the titles in the deal was *Kingpin*, a 1996 Woody Harrelson comedy about a one-armed bowler. Schapiro notes the many ways the IP of this film could be licensed out. “It would make a great TV series,” says Schapiro.

Just as private equity GPs jealously guard proprietary data, studios have been less than generous in relating what they know about film revenues with outsiders. One movie market participant holds his fingers up in a sarcastic quotation gesture when describing how studios offer to “share” data with investment partners. Often, a studio will simply refuse to share its market intelligence with investment partners.

Among the private funds now active in Hollywood, the most sought-after form of human capital is a talented former studio executive, who has irreproducible skills from years of analyzing proprietary film revenue data. According to several sources, these executives have been known to arrive at their first day of work in a hedge fund or private equity fund with reams of useful empirical data, the source of which is never identified or asked for.

A FEW GOOD MEN

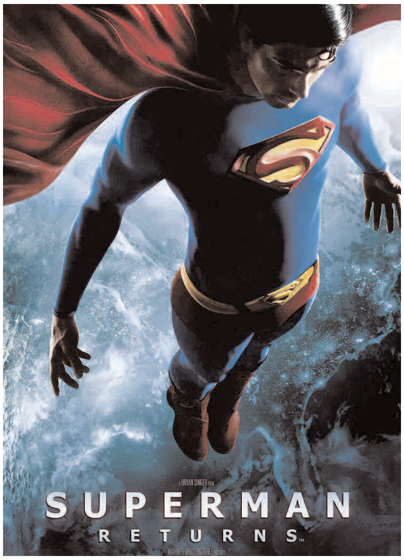
A cold fact for any aspiring filmmaker is that most films are never seen by a paying audience. Indeed, the ability to consistently produce profitable movies is a rare talent. "At this moment, there is no shortage of private equity firms looking for appropriate investment opportunities in Hollywood," notes Mayerson. "But there is a shortage of good deals."

Of course, finding good management is a problem for every segment of private equity. Qualia's Schapiro says successful film producers need to understand all aspects of the creative process, financing and accounting, intellectual property and technology. "Producing films requires very special and unique knowledge," he says.

That said, Schapiro notes that the limited population of skilled moviemakers has historically not been given the kinds of equity incentives common to private equity deals. Incentives for the people actually making the films have too often been a combination of salary, credits and lifestyle perks. This equals an opportunity. "Accountability has been a very difficult issue in film finance," says Schapiro.

Hollywood veterans have noted with great interest the arrival of professional money managers in part because for most of film's history, outside investors have been motivated not entirely by profits. For example, various country and US state governments became film investors to promote tourism or create some vague, artistic societal benefit. These investment programmes are often sold down to the citizens through tax-break schemes, as is the case with German film ventures, which back many Hollywood projects.

Wealthy individuals have always figured prominently as backers of movies. For example, Denver billionaire investor Philip Anschutz created movie production house Walden Media in part as a serious investment proposition, but in part to promote



Superman Returns: up, up and away with private equity money

family values in movies. He was behind the recent *Chronicles of Narnia* production, based on the book by Christian author CS Lewis.

"Not that wealthy individuals are not concerned with returns, but they don't always analyse things with the same emphasis on returns," says an industry vet. "You're more likely to hear words like 'passion' and 'vision'. The hedge funds are sitting there with a calculator."

As Mayerson puts it: "In the old days it was all about gut. Now the hedge fund guys are actually working on the numbers."

Noting the new analytical rigor that has entered the film financing business, Harold Flegelman, a Loeb & Loeb partner and also a co-chair of the firm's Corporate Media and Entertainment Group, mentions a recently completed deal. Flegelman, Mayerson and Susan Williams, a Loeb & Loeb partner, represented Cold Spring Pictures in the recent raising of a $200 million facility to co-finance 10 films to be produced by Montecito Picture Company and DreamWorks over five years. The facility consists of a combination of equity and bank debt. Flegelman notes: "The investors analyzed the structure and the numbers with a great deal of care, and we were all delighted with their enthusiasm for the opportunity."

Not every media investor is convinced about the new merits of the film content creation business. During a recent conversation among private equity media investors in New York, several GPs expressed great skepticism at the recent rash of slate financings, saying that the portfolio theory of film was far from proven. "It seems that hope springs eternal for film financing in Hollywood," said Mark Colodny, a managing director in the New York office of Warburg Pincus. "Over the decades there have been waves of different types of instruments and different groups of investors – domestic, European, Asian – attempting to find the secret of making money in Hollywood. But it is extremely difficult even for the pros to do this in a sustained way."

An added risk for film investors is, as one film industry insider puts it, "going Hollywood", which he describes as such: "The allure of the business becomes overwhelming. Someone straight-laced from Connecticut will get here and he'll get a Porsche, he'll look different, act different and he may see his marriage get busted up."

Schapiro, who was introduced to private equity when he became president of Bain Capital portfolio company Artisan Entertainment, which produced the low-budget blockbuster *Blair Witch Project*, describes himself as "immune" to the glamour siren song of Hollywood. "I'm the unique person who finds himself in filmed entertainment not because of a deep commitment to movies. I'm in this business for the business, not so that I can go to a premier. The private equity investors that get into this business instilled with discipline will do well." ■