GREED IS GOOD GREED WORKS | WE ALL USE MATH EVERY DAY

GORDON GEKKO & PROF EPPS PRESENT…

WALL STREET

NUMB3RS

AND THE ART OF FILM FINANCE

2007

CONTRARIAN VISION

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THE│ ART OF FILM FINANCE

2007

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GLOBAL FILM FINANCE ANALYSIS IN 2007

INTRODUCTION | TO A SCENE 2007 | 2008

"We use math everyday…to predict weather… to tell time… to handle money…math is formula and equations…math is logic… its rationality… it is using your mind… to uncover the biggest mysteries we know…"

NUMBE3S | TV DRAMA

2007 saw the use of NUMBE3RS to justify accelerated private equity investment in motion pictures. Numbe3s were rational and logical equations that made Greed Good Again. Better still, they lured a new breed of hot shot Wall Street investor by seemingly answering the mystery of how to predicatively make money out of ART. Behind the mystery lie secrets and an astonishing discovery. The secret was that the prestige of being involved in the film business overcame any flaws in math perceptions and all common sense.

"Their analysts don't know preferred stock from live stock"

Gordon Gekko | WALL STREET

The slate portfolio model using Monte Carlo simulation, turned equity investment into a crap shoot. Rigging the ABS wheel in this way insured only that the banks and the distributors could win. The probability equations behind this new game of chance were anything but predictive. Risk of loss was down sold then split off by on sale to once-removed players - unknowing players, who like their counter parts holding sub prime clay, remained ignorant of the reality. Greed may be good, but in the last year **Wall Street** ***has proved it is also dumb.***

"Behind the Mystery Lie the Secrets. Behind the Secrets Lies an Astonishing Discovery"

THE PRESTIGE | Tag Line

The discovery behind the mystery of how to create a viable capital market for film finance via a slate investment approach was found wanting. The astonishing discovery was that the model could only work if bottom private equity remained the burn money in the deal.

PREQUEL │ TO A MELT DOWN

"If the Heat doesn't get you, the pressure will."

Boiler ROOM │Tag line

In turbulent times in a troubled world, too few take the time to look behind the veil of sanity that masks the reality of every day life. America, the world's most provocative economic power is caught in the web of its own hubris. What started with **ENRON** is now in its final death struggle with **SUB PRIME**. Corporate venality matched by misplaced confidence in what appears reel, is leading inextricably toward a new age economic Armageddon.

Hollywood is an emblematic harbinger of why the world faces the clear and present danger of total financial chaos. The sub prime mess is not the principal culprit but the ensuing damage will not be restricted to the leafy homes of the shrinking American middle class as many think. The rise of the Private Equity phenomena backed by the regulatory and fiscal black hole known as hedge fund money, is the next deadly deal domino whose inevitable free fall has begun but is as yet to fully hit home.

Through its story telling, the motion picture industry has always told deeper and greater truths than any would suspect possible. Now the easy money behind these cinematic tales is a dramatic work worthy of its own film.

Any one attending the annual AFM Film Finance Conference in 2006 would have been impressed with the seeming expertise of those on display. Backed by the NUMBE3S, bankers it seemed had found the Holy Grail with the ability to invest Hedge Fund money in the Hollywood dream. The talk was fast, the company even faster and the reliance on illusion absolute. The pedestrians among us could hardly keep up with the magic of portfolio slate investment theory. The quixotic elegance of the *Monte Carlo* simulations and the sleight of hand relating to packaging risk through asset backed securitization, all part of the voodoo that wowed an incredulous audience. Magic, real magic was taking place as Billions were being pulled from Bankers Black Hats without pause or reel insight. It seemed that money was no object as the film business was awash with cash but sadly no talent. Bottom money from civilian Bankers and Investors who should know better paraded and praised itself in the lime light of Hollywood. Suddenly film financiers became genius and insightful art driven crazed moguls, who like those who founded Hollywood were more God than human.

In our 2006/2007 article **THE PRODUCERS GUIDE TO THE DA VINCI CODE OF FILM FINANCE**, we flagged the flawed and fragile thinking behind these seemingly magical solutions to the industry's constant conundrum, where to find new cash yesterday. Our prophecy while unwelcome to some, was accurate and these grim warnings are coming home to roost far faster than even we thought was possible.

ART │BY NUMBERS

"Greed is for want of a better word Good, greed is right…Greed Works. Greed clarifies, cuts through and captures the essence of the evolutionary spirit. Greed in all its forms, greed for life, greed for money, greed for love, and greed for knowledge has marked the upward progress of man."

Gordon Gekko│ WALL STREET

Art often imitates life and Edward Pressman in 1988, post the 1987 stock market crash, released **Wall Street**. "Greed for want of a better word is good" accorded to the flawed mantra of Gordon Gekko. Hauntingly in 2007 the sequel **Money Never Sleeps** is in pre-production for release in 2008. Prophetically the story line as known to date deals with the unchanged Gordon Gekko playing in the private equity and hedge fund debacle in 2007. In 1987 the real world drama focused upon junk bonds and corporate raiders of benign asset rich public companies. In 2007 the real world story line has a similar beat but different labels for the same line of dramatic action.

Asset backed securities (ABS) financed by Collateralized Debt Obligations (CDO) are the new junk bonds of 2007 and is an exact mirror image replay of 1987. The pirate equity methodology of 2007 is no different from junk bond asset stripper madness of 1987. The only difference is the sophistry of a booming global economy being used as the rationale for the hype. The result is inevitable disaster despite the world economic performance. The rhetoric that paints China and India as the salvation will not help put Humpty Dumpty back together again. Bubbles are bubbles and bubbles always burst.

The US and its many financial cohorts are in for a beating. The only questions that remain unanswered relate to how hard and when. The substance is that no amount of credit manipulation by the US Government can hide the substance of real loss. The non Greenspan inspired US Federal Reserve, attempts to solve the credit crisis among banking institutions by pumping in fresh money. Liquidity interventions can never solve underlying flaws relating to core credit vulnerability in capital markets.

The sub prime market is estimated to be worth US$700 billion. It is predicted that 20% of this market will default by the end of 2008. At the time of writing only some 10% of this gapping hole in the world's financial fabric has been reported as missing in action. The sleeping giant of private equity hedge fund investment lies dormant, silently waiting to cause in the now failing US economy even deeper chaos.

In 2001 ENRON was the start of the financial collapse of the integrity of the US financial markets. Rather than ending the decline of venal corporate conduct it lead to the whole market and the US Government itself into embracing the off balance sheet partnership model.

Just as the off balance sheet black hole partnerships at ENRON collapsed under their own weight, so to will many of the highly levered hedge funds. Essentially a global Ponzi scheme had been created. Asset values were pumped up by loans based on over priced asset values pumped up by more loans. The residential housing market was one all too visible sign of what was wrong with the American dream turned nightmare on every street front.

The other was HOLLYWOOD where the wave of really DUMB money provided by Private Equity Hedge Fund Investors was yet another WARNING beacon to the whole economy. When real risk is parted from real return aided by those managing money having little accountability, then the result is always financial loss.

Some of the Hollywood hedge fund deals have been hit already while others are oblivious to the fact. Many use words buzz words like exclusive corridors, retranched or expanded, to rationalize a way to keep funding the addiction.

Most seem unfazed as after all it is not their money on the table and fees are fees no matter who pays them. Like gamblers everywhere, they dream of a new day enjoying the comforting illusion of seeking a better way to beat a house that has them truly hooked. Like card counters in Las Vegas, they remain blithely unaware that the house knows they are coming. In fact the house planned it and was banking on it. New money is after all just that.

The film finance game is at best an **ILLUSIONISTS** paradise, one where it is all and only about **THE PRESTIGE**. What is happening, why and how are very ephemeral constructs to even the most sophisticated of players. The economic fall of the US capital markets and the impact of this on film finance business is the subject of this work. We predict what and why things will happen. As always we give timely advice as to what to do to and how to shelter from a storm that is already here raging unseen by most.

LAST YEAR | THE NUMBE3S

I have to proffer a "mea culpa" the moment you showed the equations to me I recognized the immediately these are calculations for card counting….

Larry Fine Heart | NUMBE3S

In our last work we warned of the coming demise of Hedge Fund money and the trend by Governments every where to stop tax shelter abuse relating to film industry generated transactions. Our analysis was far more prophetic than even we had thought possible.

BIG TRENDS | MACRO ECONOMICS

“Marvin, I have got a feeling we are going to make a killing today.”

Bud Fox | WALL STREET

Film finance capital market sectors are interdependent in relation to their capacity to fund film and television productions. Major event horizons in one market sector explode or implode rippling through the film finance market as a whole. Many look merely to the surface flow of money available to the business, drawing numeric perceptions that are always a beat behind. To see truth one must appreciate the underlying currents that shape what is really happening. Much banking and financial analysis proceeds upon what appears to be rather than what is in train. Truth however is always an elusive being at the best of times.

The film industry is according to most accepted reportage, currently awash with capital. This has resulted in too many over priced films being made without regard to the underlying economic reality in train. Talent over priced relative to its inherent economic value from the tax shelter boom, still is due to inflated production numbers. Snapshots are always however misleading as they are just that. Our prediction of past, current and future trends comes as always from a contrarian viewpoint.

TAX SHELTER | BLACK HOLES

“I know this Guy who has a way to make money. He is so smart he can never lose.”

Bud Fox | WALL STREET

Prior to the wave of Hedge Fund money, film production risk money was being substantially co-financed from soft sources flowing from tax shelter investors and government incentive programs.

The advent of government soft money programs, created the runaway production phenomenon.

Tax shelter money was more than location incentives paid to Hollywood as a bribe to film in the country/state of their origination. Most tax shelter programs could be molded with other soft money incentives. Tax shelter money due to its structural form, gave the illusion of being an investment. The off balance sheet nature and form of private ownership by the investors of interests in intellectual property or production business activity was worth more than gold to Hollywood.

Billions were raised from 2000 to 2006 through such programs that represented approx 30% of Hollywood's total production funding. These funds, either under a pre-determined incentive program did not need to be paid back, or that was purely the result of a tax structure that created no real economic interest, requiring no actual return. It is the Hit Money the game burns as the price of bad Art and needs to be paid by someone, just not Hollywood.

The soft money bubble in itself had replaced the previously vibrant foreign pre-sales market and insurance backed loan schemes. Now this bubble was also shrinking during 2005-2006 as per our prior articles. As one by one the sources of foreign tax payer equity coin dried up, Hollywood faced a cash crisis. No cash and worse no bottom tier cash like the tax shelter equity (e.g. German tax funds and UK Sale & Leaseback). Wall Street then stepped in to become the new bottom tier equity finance contributors.

DEEP SYMMETRY | 2 PLACES ONE SPACE

"These note books are full of numbers and equations…lucky for us we know a guy… we sure do know a guy…"

Detective Epps | NUMBE3S

The idea of off balance sheet investment grade equity investments in film production is not new. Initially it was seen in Silver Screen Partnership capital raisings by Disney in the 1980s. Hollywood in search of cash had found a deceptively simple answer.

Private Equity Hedge Fund money could be used to finance off balance sheet production via direct investment in the intellectual property assets within a slate of productions. The Hedge Funds highly levered with thin equity and high collateralized debt obligations, leapt at the chance to make what appeared to be secured double digit returns and the lure of blue sky super returns.

The sell used had itself been propped up by the illusions of the past tax shelter money (and the recent DVD revenues boom) to postulate a continuation of economic returns.
In our last article we pointed to the fact the economic profile of the movie business is not that certain and is not that predictable. Perversity in such mathematical prediction is the constant companion of those who assign judgment to the realm of the calculator.

PROBABILITY EQUATIONS │GAMES OF CHANCE

“Black Jack is all about math the point is to hit 21 without going over. The game is ruled by conditional probabilities, what you see is going to affect what you are going to see… as with every card dealt there is one less ace left in the remaining cards…”

Prof Epps │ NUMBE3S

A math theory can be right or wrong but a financial model can be totally irrelevant. The so called confounding variable is the nemesis of all math derived formulae when applied to real life business situations. Hedge fund guru mathematical assessments of the macro economic trends in play never saw what was coming to Wall Street.

Hedge Fund money was its own confounding variable in that it confounded its own rationale for it own investment philosophy. The explosion of equity cash created many more films than a capital market minus this new investment source would have ever been capable of making.

The portfolio theory mantra behind the Hedge Fund slate approach is captive to the notion that a few big winners pick up all the losers. The wave of new private equity money increased the number of films seeking revenue in what was and is essentially a static entertainment market. No more TV stations are being created, no new theatres are being built and DVD sales have passed through their evolutionary bubble.

This means more loser films than usual are now competing with each other for the same revenue pool. Hence the ratio of loser to winner films has in the last two years skewed the market potential of every slate portfolio invested by these players. The NUMBE3S simply no longer add up but this is not to imply that they ever could have. The more films the fewer slots for them in theatres and the less time for a real run. The net result is almost a self perpetuating ability to create self inflicted bombs and to make the hurdles higher for good films to reach optimal revenue.

The film industry is dominated by the reality that most films lose money. With more losers coming to the table the winners have to carry a heavier load by having more losses than usual to cover. Higher production costs and more production competition pitched against static market revenue curve is a recipe for failure in any business. The careful math hand driven assessment of past film industry revenue models projected from inception was in these circumstances always a flawed intellectual perception.

Projections over a slate do not create mathematical risk aversion because films do not follow normative bell curved shaped revenue distributions.

The slate model in fact when applied to film intellectual property assets increases statistical risk of loss because they follow what are known as Paretian Distribution patterns. In such patterns most events account for a small part of the revenue wins. Small numbers randomly wild are responsible for a large part of the revenue wins.

The reality is that unlike a bell curve distribution where there is a cluster affect in Paretian Distribution patterns very few winners are characterized by the so called fat tail. The fat tail revenue of a winner is in contrast to a winner under a bell curve distribution five of six times the standard deviation from the mean revenue. The lure of jackpot winnings many times the standard deviation is what has always lured risk takers to the film business.

Given this underlying truth the economic paradigm of an intellectual property asset at the production stage remains the least suitable and least predictable asset in which to invest naked capital into. The hype talks of multiple revenue streams and all the pretense of the ability to recover production costs lies dormant in every film deal. In reality a dog film is an economic disaster no matter how you cut it. The only thing one can perhaps safely assess is the fail safe revenue margins from worse case sales values. Even then some dogs don't hunt.

The Hollywood talk was that such slate driven investments amounted to a direct access corridor to the internal rates of return of the studios. The securities law reality of how one could, over many different corporate enterprises in a vertically integrated media global conglomerate possibly achieve this, remains an unfathomable notion. To date no one has asked why if such internal rates returns were possible in the first place would one seek to outsource them to third party non shareholder investors? Perhaps because they never really existed outside of some math guru driven analysis is one answer. In economic truth all that the Studios parceled out was risk of loss from their production business, whilst the gold from their other businesses relating to the exploitation of productions was effectively enhanced.

Problematically the current Hedge Fund private equity investment model is the exact opposite of what we have long postulated as being viable. The time fuse before the melt down of past and current private equity investment is in the range of three to five years, or less if the debt component part gets smart. Like all casinos who allow punters a certain number of wins to keep them hooked on the slot machines, film slate investors may at some time enjoy the illusion of some capital recovery.

However, most will be forced to roll the dice again and again to bet more and more money. Some already have and that money is already gone even while it sits awaiting drawdown. No doubt some may genuinely win and create the return profile predicated. Few will have the discipline in such a unique circumstance to appreciate their good fortune and leave the studio table ahead.

At the macro economic level the film industry capital market profile is hostage to the whole US financial market's health. Hedge Fund Private Equity faces attack from regulators seeking to remove their ultra low tax advantage and the ability to avoid timely report of the truth of investment results under the cloak of the private equity mantra. The coin currently raised will not last that long and already in a new money poor, the smart seek new ways.

JUNK BONDS │ CDOS NO DIFFERENCE

"Sir …if I could just have five minutes of your time I would like to explain the extraordinary opportunities emerging in the international debt market… Sir…. Hello…"

BUD FOX │ WALL STREET

While the jury is still out on past and current year Hedge Fund investments, one impact on film capital markets has been the adverse impact on other traditional entertainment lenders. The independent production market faces a harder finance battle as fewer players are left in the vanilla lending side of the business. The slate approach left only single picture finance market open to traditional lenders. In a newly lean equity market post 2008 such lending if loans can be made will return with a rush to fill the hole in equity funding.

The fall out on the film finance sector has yet to be seen. The talk remains bold but the reality in a nation where the largest home lender Country Wise had to be propped up to just write housing loans is still to be seen.

Hedge fund money will inevitably have to flee this market sector, as it will absent direct risk aversion, never sustain the losses flowing toward it. The Silver Screen Limited Partnership investment offerings of the 1980s struggled to barely return the original principal. The cost of capital for highly levered Hedge funds borrowing 10:1, means that to stay even in the game and protect the capital invested over a 5 year time horizon, an investment must return 140%+.

No hedge fund looks near attaining this level of performance in relation to film investment. No fund appears to have garnered the civility of even being principal protected as such obligations would have to appear in the disclosure statements of the Studios. Many equity players allude to the existence of understandings in relation to such principal protections but the reality is that senior lenders and shareholders appear to have never been consulted nor informed. The future will see studio and leading independent producer production deals creating new zero risk principal protected products.

The mantra of 2008 and beyond as we have long predicted will be SINGLE PICTURE FINANCE. By this we mean that slates of film may still be grouped together but each film must stand alone economically. As we have said many times in past articles this business is about bespoke tailoring of finance strategy. One size fits all, off the rack finance solutions are never optimal nor are they even appropriate to the project finance challenges each and every film creates.

The ENRON doctrine of borrowing money to create asset values to borrow more money is a critical part of the private equity boom of recent times. Unlike real estate or shares in a leveraged buyout deal, film assets at the point of initial production enjoy no security of tenure. Values are largely unknown and wildly unpredictable and unlike ENRON one cannot pump them up by re-buying in - although we are sure someone is working on this!

Long term reality must prevail as capital markets see that such assets require a different approach. Our contention has always been that a different way of approach thinking could create the basis for a stable capital market for the industry.

"***Art needs money to thrive but the real art will now be to get money once the current bubble market ends."***

The math driven manta of a stable investment approach to film production was something we first raised in early 2004. Our work was mainly misunderstood in its application. Mathematical models can assist in film finance strategy but to do so they must be factually relevant. The problem with the recent sweep of deal making was that the math behind it did not account for the substance of realities behind the business. Some staple fail safe math analysis is possible and predictive. The flaw lies in how one uses it and how one proceeds with the application of it.

RISK RISES | MONEY RUNS

"What is looking good? If I knew this I wouldn't be in this business."

Marvin | WALL STREET

The future of the industry capital markets pertaining to the provision of finance for pre-sales, gap, super gap and soft money remains problematic. The existing rates of interest in 2008, absent further Fed intervention, appear set to rise of reflect new perceptions of risk in world capital markets. Risk may well not just be a driving factor in relation to interest rates, but also in relation to the very ability to obtain finance at all.

Pre-sales

In the pre-sale market the safety reserves required by banks to discount letters of credit from foreign banks may rise.

Gap

Gap loan finance may be harder to acquire and the collateral coverage ratios required may increase while the maximum loan values may decline.

Super Gap

Due to the demise of foreign tax shelter risk mitigated lenders, Super Gap has already become expensive and scarce. The hope provided by the potential entry of new players into the market in the form of private equity players has, we think evaporated in the sub prime crash fallout.

Soft Money

Soft money lenders who provide up front cash to producers through securitization of tax credits is still viable. The only issue is cost and the amount of the credit that can be turned into cash after deduction of the interest and safety margin reserves. In timid times these two deductions may see in many deals, only 65-70 cents of the potential credit delivered as a contribution to negative cost before interest.

BACK TO│ THE FUTURE

"Stick to the fundamentals, that is how Hilton and IBM were built … good things… some times take time."

Lou │WALL STREET

The industry's capital markets ultimately reflect the economic realities of the business. 2007/2008 will see the following intra sector forces shaping the business of film.

TV & Movies│ Product Switch

The product switch illusion in the current filmed entertainment market continues at pace. The strange reality is that now every major movie producer does a better job making television drama than movies. Stranger still is the fact that television shows especially drama have become like small movies.

Movies have equally due to the IPOD third screen generation become more like television products in their use. The quality of production and rebirth of name older stars coupled with great writing and the zeal to create cinematic quality television production is on the rise.

Sadly this in the drama and action genre has been matched by an equal decline in production values at the cinema. After watching **24** and **Prison Break** and being seduced by the elegant mind play of **CSI** and **Numbe3s**, the fare at the movie end of the business seems today all too tame.

Producers are it seems sick of the roller coaster ride of the film business and have found new solace and fortune in the Television side of the industry. Indeed the DVD staple of the modern movie business is now facing considerable competition from the television fare now on sale. DVD is a new boom revenue kicker to television production and has added significantly to the revenue streams available. In fact many television products can out sell even the most expensive movie block busters in this market. The long term impact on syndication values appears not to have been adversely impacted.

The revenue curve of a television series picked up by a network, with low initial pilot production costs and the comfort of a more predictable worse case finance outcome, tempts many away from film. Television also creates a stable work flow for talent and has created a mini in-house studio of an old type star system of its own. In the face of new competition from VOD and Internet products like U TUBE and FACE BOOK, the networks have to make programs that can make you sit down and that make you watch.

Third│ Fourth Screen Hi Tech

New technology in the forms of Blu Ray, Hi Def and Apple I TOUCH and I PHONE all present new distractions and new windows for movies and television to compete against and to use to compete with each other as well as the Internet.

DVD│ VOD

The business economics of the DVD market remain problematic. The boom is over and while the new players in relation to Blu Ray and Hi Def have yet to reach the take off point of wide player penetration, it is happening.

The long term issues pertain to VOD via cable and Internet, which as with the music business are now eating their way into traditional revenue sector sales.

The many unanswered legal questions that surround whether or not streamed/VOD delivered movie products are covered by older form distribution agreements lurks unaddressed in the background. The death of the Home Video window long term due to VOD is another industry issue that is already changing the economics of the game.

The film business in the long term may in fact merge with the television business. In the end there may in an internet age, be no difference apart from theatrical release. Delivery via internet rather than print will make movies more competitive once theatres are reformulated for the new delivery mechanism, due to the abolition of print costs.

The good thing about these trends is that movie revenues will long term become more stable. The bad thing is that in such a market controlled by large corporations owning the supply chain, revenues while less volatile will shrink the shares available to producers as already seen in the television markets.

The revenue profile of films is slowly but surely undergoing change. The statistics used by the studios to fly the idea of stability in relation to film production earnings all quote the reality that less than 20% of their revenue now comes from theatrical releases. The problem is that the Numbers mask the best illusions of all.

The problem is that without the blessing of a good box office run, a movie rarely enjoys solid revenues in other sectors. A few movies dominate all the numbers through theatres, DVD and merchandising and pay per view down load. If a film lacks profile in a sea of entertainment options it faces an unknown ride.

Public acceptance is always going to be a driving factor in the filmed entertainment business. The new struggle in a technology driven age where people spend more and more leisure time at home playing with high tech toys is how to create and monitor such acceptance. The 2007 year to date has seen the use of U TUBE/WEB to release longer trailer clips to seduce theatre goers. This is only the start in a time where day and date release of movies for theatrical and DVD purposes looks ever more viable. The time lag and price point between these and other internet generated delivery windows is facing constant change.

Piracy rages and the only long term answer as it was in the music business is beat them at their own game. The upside for producers is that such delivery systems may create new independently verifiable streams of revenue. The downside will be like the 80/20 Home Video trap getting ones fair share of those earnings from the major players in these markets. The Hedge Funds have already claimed they have broken the strangle hold in their current film investment deals with the studios. Although one wonders at what level the whole dollar will ever be accounted for to them in relation to their share of the total earnings on offer.

SMALL DETAILS | MICRO ECONOMICS

In each capital market sector the last year has seen fundamental change take place since AFM 2006.

The following took place during the 24 HOURS between then and now…

SOFT MONEY | HARD TIMES

"Remember there are no short cuts. Quick buck artists come and go with every bull market, only a real player can make it through a bear market. You got to know when is the time not to do things… you cant be a little bit pregnant Bud."

Lou | WALL STREET

Our landmark 2005 article GET INTRA NATIONAL predicted two years ahead of time the demise of the UK and German tax shelter markets and the new trend in Australia, New Zealand, Canada, South Africa and United States to move to the delivery of soft money benefits via incentive driven payouts rather than tax shelter thinking. The revenue authorities of the major foreign nations all collectively closed down their various tax shelters all at the same time and most importantly for all time.

This lead to a frenzy of private equity deals to fill the bottom money hole left in the wake of this collective action. Without this coin, production may have been drastically impacted. The problem missed by most is that it was not only the volume of coin that went missing but the nature of it that hurt the financial perception in the play.

More new money than ever was needed and was raised but the story line had changed. Soft tax shelter money was burn money, hard equity in the naïve eyes of those providing it was not. So while the hole in production finance was filled it has been filled from a different deal perception point. The hard equity in play now is unknown to itself potentially the new bottom money. It has to be as only by raising similar kinds of money could the system ever survive.

Tax Shelter | MIA

"I guess if a man lives long enough he gets to see everything and I do mean everything. What else is in your bag of tricks Mr. Gekko…?"

Mr. Fox Senior | WALL STREET

The tax shelter model of the last five years saw the bottom money burned year in, year out. Nothing in the macro economics of the business has changed to facilitate paying out the new bottom money. Studios are not going to reduce shareholder returns thanks to private equity investment in production activity – far from it.

The urge to grab more than was needed has ensured the percentage of bottom money in the system has risen. The bloated production costs fueled by the tax shelter boom have short term been maintained and accelerated by the equity boom. Now bottom equity is hoisted on a petard of its own making.

The Wall Street suits could not see that more film products means more risk and more bottom money being burned than usual meant double down the risk.

The tax shelter models used in Germany, UK, Australia and New Zealand as described endlessly in our prior writings had to fail. The reality was that these arrangements were in substance commercial black holes. Investors may have been sold on the economic nirvana of block buster film revenues but the deal templates ensured no real money would ever flow to them.

In review all that was happening was that tax savings generated by their film investment were being shared with a producer who created the benefit for them. Neither the producer nor the real industry investors ever intended to do anything other than share tax benefits. In essence this silent conspiracy of motives was never a true tax shelter. Most nations too late caught on to the fact that their tax revenues were flowing tax free back to Hollywood.

If tax shelters had returned revenue and if the long term flow of tax impacts had been at least neutral then the “lurks” may have lasted. Sadly “greed is not always good” and in the soft money game it is nearly always bad. Tax enclaves create tax shelters and incentives because they are economically positive in terms of tax revenue. Many take the money and run without thought of consequence.
Some tax shelters remain, yet they too face extinction if Producers finds them and do not change their old ways.

Tax shelter providers in the UK and Germany particularly are now out of the business. The only resort is to become high price brokers of finance for soft money tax credits. However, this money sorely needs low finance cost if it is to be effective in the post tax shelter production finance model, but which to date has spawned the growth of high priced broker fees, double digit interest costs and unmerited back end participations

One key factor that is now missing is the comfort of having what appears to be a wrap around equity investor in the form of a tax shelter participant to close deals with. Worse is the reality that soft money incentives are paid after a film is shot. Tax shelter money occurs prior to production and is therefore certain at deal inception. Another sadly missed reality is the fact tax shelter money was an after tax capital driven source of finance.

In other words it was tax free in its contribution to deal financial planning. Many soft money incentives are in this brave new world in result taxable in many jurisdictions. The net impact of these tax and related financing costs is to reduce the core value of such incentives in a production finance model.

SAG Residuals │ Kills Section 181

"This guy is about greed. He does not give a dam about Blue Star or the Union. He is an in and out fellow. He doesn't take prisoners… I will let the members make up their own minds."

Mr. Fox Senior │ WALL STREET

Last but not least is of course SAG via the threatened actors strike. The union fails to appreciate the looming reality that the production bubble is about to burst. When it does its leading members inflated worth will plummet with or without a strike.

The residuals structure under SAG agreements has also effectively limited the potential under the American Jobs Creation Act 2004 via Section 181. The inability to buy out residuals for a defined capital sum up front as in other nations, has created an unintended outcome. Under Section 181 the costs of residuals paid during the exploitation of a project are taken into account into whether or not a production stays within the maximum spend thresholds. In non-economically disadvantaged zones the limit is US$15m and in disadvantaged economic zones it is US$20m.

The possibility that after production is completed a pay out of residuals and participations could take a production budget past these limits and instantly disentitle it to any tax breaks is a sobering handbrake on the ability to use this tool. Therefore most will only invest in films well inside the threshold limits. The impact is less investment and less on shore US spend on SAG member's wages which is the very opposite result of this new laws intent and SAG rationale for existence. Third party assumption agreements also appear to run foul of the law as residual liability rests with the production company claiming the write off under Section 181.

UK NEW WAY │ NEW DAY

"You are nothing but a two bit green mailing pirate Gekko! You would sell your own Mother for a dollar and send her COD."

Sir Larry Wildman │ WALL STREET

Late in 2006, the sale and lease back merchants were still hard at work. We warned that the Inland Revenue (IR) who had already signaled the demise of Sections 48 and 42, would no longer take things lying down. The estimated $3 billion dollars worth of deals on the table in early 2007 faced one last ignominious hit.

Black Friday │ Two Sequel

"You don't understand how truly narcotic gambling is for me. I am at the precipice looking into the abyss of an event horizon that is a black hole."

Larry Fine Heart │ NUMBE3S

In early 2007, Black Friday 2 saw the IR freeze many transactions seeking to close in that tax year. After pressure they relented and while they passed the last sale and lease back deals, they still killed many of the new tax shelter products on offer. The GAAP deals designed to get around the new rules ostensibly allowed investors to write off production expenses by casting them as production activity.

The so called side way tax relief schemes which allowed passive investors to use such deductions to defer tax on their current non film income were effectively stopped. The IR remains firmly focused on any attempt to revive them. Some P&A tax schemes have been attempted but the risk of almost certain attack is a deal killer in and of itself. The EIS investment tax rules were also looked at. Under this provision certain types of essentially venture capital investment companies involved in prescribed business activities enjoy tax breaks. Film production being one such activity offered a new false beacon of light. The EU insisted on tighter controls designed to stop unfair competition by the UK film production business therefore reducing its attractiveness to investors.

Since 2004, the UK has lost Sale Lease Back, Sections 48 & 42, Side Ways Production GAAP deals and EIS tax shelter status as the price for the unconscious conduct of the middle men. The UK was perhaps the most valuable finance tool in the world. The ability to simply drag tax shelter money into a deal while not requiring a project to do anything meaningful within the UK's borders except post production, was a great deal for Producers. This financial contribution was also combined with the creative flexibility provided under the European Media Convention, whereby 3 x EU nations (and sometimes only 2 i.e. shoot Ireland, post UK) plus the USA could combine to essentially make US-themed films.

Our published views since 2001 have always maintained that the deal forms behind such tax shelter arrangements were never legally or morally sustainable. The IR finally came to the same conclusion.

Many UK investors, lawyers, accountants and brokers can think themselves lucky that the IR has not as yet had the political will behind it to revisit the recent past.

Tax Credits │ Not Tax Deductions

"We reached an agreement to split the world up between us."

Bud Fox │ WALL STREET

The UK ran from all tax shelter driven investment models for the film industry. The new Film Tax Relief system in force from 1 January 2007, is a new and effective way of delivering tax incentives to the film industry. It also cuts the cost to UK Treasury in half by eliminating investors being rewarded for avoiding tax on their normal non-film income.

The incentive is only claimable by Film Production Companies who make eligible UK films that are either official co-productions or British Films. Films intended for theatrical release must expend 25% or more of their core production expenditure in the UK and must past a British Culture points test.

The incentive cannot be claimed by individuals, trusts or other pass through entities. The company claiming the Film Tax Relief must be the actual producer of the film. By this it is meant the company actually in charge of the manufacturing process creatively, financially and management wise.

Much detail is given in the rules as to what is meant by this and applicants need to be careful to document the deal history to ensure the correct claimant is applying or risk complete denial of the benefits.

The incentive works on a multi level basis for qualifying films via (enhanced) tax write offs and credits as follows:

Where Total Core Expenditure of the film is 20m gap million or less the production will be entitled to receive the following:

- tax credit at a level of 25% and
- an enhanced deduction of 100%

Where Total Core Expenditure of the film is greater than 20m gap million the production will be entitled to receive the following:

- tax credit at a level of 20% and
- an enhanced deduction of 80%

In the case of a limited-budget film (under 20m), where 80% or more of the core expenditure is UK expenditure, and the film production company has sufficient income to absorb all of the additional deduction, the additional deduction will be 80% (= 80% x

100%) of total core expenditure and assuming a rate of corporation tax of 30%, the value of the Film Tax Relief is equivalent to 24% (= 80% x 30%) of the total core expenditure. Where the film production company of a limited-budget film claims the maximum amount of tax credit, and where again 80% or more of the core expenditure is UK expenditure, the value of the Film Tax Relief will be 20% (= 80% x 25%) of the total core expenditure.

In the case of other films (i.e. those with total expenditure greater than 20m), where 80% or more of the core expenditure is UK expenditure, and the film production company has enough income to absorb all of the additional deduction, the amount of additional deduction is 64% (= 80% x 80%) of total core expenditure. Assuming a rate of Corporation Tax of 30%, this value of Film Tax Relief is equivalent to 19.2% (= 64% x 30%) of the total core expenditure.

Where the film production company claims the maximum amount of tax credit, and where again 80% or more of the core expenditure is UK expenditure, the value of the Film Tax Relief will be 16% (= 80% x 20%) of the total core

The credits are claimable through the tax returns of the Applicants who file their returns with normal expense and income data as if no loss or credit system existed. The only difference is the choice is made to take the loss or surrender it for a cash credit.

Core production expenditure does not include costs related to the development, marketing or finance (brokers, legal and audit). Care must be taken to ensure the deal is optimally reflective of these rules otherwise losses or credits may not be all they could be.

In summary the new credit system is designed to assist a producer who manufactures films, not those who own or finance them. The IR and DCMS are linked in their administration roles to prevent abuse.

In summary the UK incentive delivers a 20 cent tax credit to small films and a 16 cent tax credit to larger films. Given the time lines to claim the incentive over a project's total production period, perhaps only 75 percent of the credit may flow into the finance plan due to interest costs and lender safety reserves. This means the net incentive may for small films contribute 15 cents and for large films 12 cents, in effect creating the same level of incentive as under sale and lease back.

Co-productions appear to have been relatively abandoned under the new incentive regime. Once the forte of the UK film business, now there remains little incentive to structure a minority co-production with the British.

For example under a 30/70 project, the new incentive may net 6 cents for a small film or 4.5 cents for a big film. Under a sale lease back deal the same project may have netted between 12-15 cents of tax shelter equity money and under a GAAP model even more was possible.

Top up equity from a UK post house or the British Film Council may of course help, however the opportunity cost of moving spend from a high or similar tax credit nation with a low exchange rate, to the UK under a co-production model is now less attractive.

The new Australian model would, even for non qualifying films, match the incentive but at a fractional economic cost after currency values are accounted for. However, co-productions may still fly with the UK as a major partner as the incentive is still attractive.

AUSTRALIA │ BEST AND FAIREST

"If I was feeling any better it would be a sin"

Bud Fox │WALL STREET

Like the UK, the rate of change in law and practice in AUSTRALIA between AFM 2006 and AFM 2007 was dramatic. Australia's equivalents to the UK's Sections 48 and 42, Division 10B and Division 10B were under siege in late 2006.

Past Karma│ Will We Ever Learn

They just got a favorable ruling in a law suit that will… even the Plaintiff doesn't know yet. How do I know? I just do.

Bud Fox│ WALL STREET

The real story is unknown by most even those in the business. These Australian tax shelter write offs operated through the eye of a hybrid cultural/qualification activity test that allowed investors accelerated deductions of film expenditure which otherwise would have been depreciated as capital items. These provisions after detailed debate with the ATO through the film industry partnership were enjoying a potential rebirth. Just as the ATO were getting comfortable once more with the local industry, promoters of tax shelter deals from foreign jurisdictions were planning to introduce deal models sourced from the UK and Germany.

Some initial tax approvals were given but as the ATO consulted with the UK, New Zealand and South Africa, they realized that a potentially big tax "hit" was on its way and they began delaying approvals The industry meanwhile lobbied for a tax credit system similar to that already in play to lure runaway productions under the 12.5% Tax Offset incentive program (introduced in 2001).

In May of 2007 a new tax credit system was introduced for the domestic industry to be operative by 1 July 2007. At the same time the Division 10B & 10BA tax shelters were scrapped which saw the demise of some very useful finance tools. These incentives provided cash upfront at deal inception and were after tax capital devoid of interest costs, acting as a wrap around packaging tool for the remaining deal finance elements.

The new Tax Credit system will see the incentive paid through the Applicant's tax return after production completion. Therefore most productions will be required to secure loan finance to cash flow it into the finance plan which carries with it interest costs and discounting margins from the initial face value estimates.

In many cases, for every $1 of face value credit only 70 cents may be used toward financing the negative cost of production.

The new system is at face value generous and currently by far the best anywhere in the world. Given the global web of Co-Production Agreements Australian enjoys with other countries the new deal enables synergistic use of the credit system as an international film finance tool.

The credits like the UK come in two sizes. Non qualifying Australian films & tv productions are entitled to a tax credit of 15 cents and Qualifying Australian Films a credit of 40 cents for theatrically released films and 20 cents for TV, Documentaries and Direct to DVD/telemovies.

The first credit known as the Location Offset is designed to attract foreign runaway productions to Australia. It is an activity based test that requires a minimum qualifying spend of A$15m. Where this spend is between A$15m-A$50m, it must represent at least 70% of the project's total production expenditure (as defined under the program). The 70% test does not apply to films that have over A$50m qualifying spend. The system has been in place for seven years and has seen more than A$1 billion in qualifying production spend. A useful lowering of these threshold spend limits and percentages also now applies as a stand alone incentive to post production qualifying expenditure in excess of A$5m.

The only real economic change this year to the Location Offset was that it increased from 12.5% to 15%. The tax credit is also paid through the tax return of the Applicant and the ATO to date have accepted special purpose entities of foreign corporations as appropriate claimants.

Long term the jury on the tax risk of creating such direct links back to the deal motivators, is in our view still out. The wise will form genuine arms length production relationships with onshore providers to insure against the enforcement of OECD permanent establishment principles and transfer pricing rules in relation to multi-national corporations.

The major change in Australia has been the introduction of the Producer Offset. This is what has the world excited as the face value of the credit is 40 cents for every dollar of qualifying spend for motion pictures. The credit does come with some limitations in relation to what will qualify. There is a 20% cap on above the line qualifying spend. Finance expenditure such as interest, broker fees, completion bonds and marketing costs also do not qualify. The minimum spend for qualification is A$1m. The qualification process for the incentive requires a film to either be an Official co-production or pass an Australian Cultural Test administered by the new Australian Screen Authority.

The initial legislative intent was to create a points test identical in form to the UK. After lobbying the points test was not implemented and the process will follow the old tests applicable under Division 10BA with two important exceptions:

- Copyright ownership does not necessarily need to be held in Australia
- Financing can be sourced from anywhere

However these elements will be examined if the other factors in relation to the particular project do not lead to a strong conclusion that it has Significant Australian Content (SAC).

This makes Australia very co-production friendly. How the new litmus test of “what is Australian” is to actually work to exclude de facto foreign originating projects (except for official co-productions) attempting to “dress up” in Australian clothes, is yet to be seen. Care must be taken to represent only genuine material as the very real prospect of initial approvals of Australian qualification being withdrawn exists if prior to payment of the tax credit some undisclosed non-culturally compliant elements surface.

The tax credit is paid only to corporate entities and not to individual, partnerships, trusts or other pass through structures.

The tax credit can only be claimed by the Producer, being a company who actually manufactured the film. Care must be taken to ensure that the tax credit claimant is the creative and financial manager of the film. A special purpose entity whose actual conduct does not meet these tests is not the producer of the film. The object of the program as it name suggests, is to empower the Australian producer(s) of qualifying projects.

Therefore the value of the tax credit will need to be reflected by real economic interests being retained by Australian producers to deal revenue. The ATO will be looking to see that the economic value of the Tax Credit is not transfer priced or artfully exported offshore. The real value of the domestic credit system for film and television is less than it appears to be on face value. The costs of interest, fees and safety margin reserves may mean only 70 cents can be cash flowed into finance plans per dollar of credit. For players who finance their own product it is in reality a major bonus.

Unlike the UK which offers the choice of an accelerated tax write off or a tax credit the Australia system offers only a credit. Qualifying expenditures still have many subtle quirks and great care must be taken at the production and execution stage to ensure the rules are being followed. The apportionment of costs in co-production arrangements in relation to the wearing of non-qualifying elements is a thorny issue. The producer must work actively during the budgeting and actual spend phases to ensure the maximum tax credit potential of a film spend is actually attained.

The left of field issue at the heart of tax credit compliance is the ATO ability to deny or delay credit payment if there are outstanding tax issues unrelated to the credit. The certification process sees an initial approval of the budget, elements and production process. A final certification upon completion is needed to obtain the credit. Tax credit compliance and claim processes are as much art as science as they require that sophisticated levels of risk mitigation from initial application to final approval be used. Daily deal monitoring of financial facts and actual business circumstance is a vital aspect of such risk mitigation as even the smallest of circumstances can have unintended consequences. Pandora can never be put back in the box. The ATO circumspectly wait for the film industry to change its ways but make no mistake they are watching and their scrutiny is a pervasive fact of life. The anti-avoidance provisions in relation to unfair market value transactions and non arms length parties, is a matter of special concern to them. Prohibitions exist in the rules like the UK to disallow claimants to filing expenditures created via illusions of round robin type transactions.

The ability to cash flow a tax credit into a deal and get an additional equity contribution from a local Government Agency is very attractive (the FFC and State Agencies are allowed to invest in qualifying projects to a certain limit). The new film investment policy, will it is thought favor small films of genuine local origin not foreign blessed co-productions.

Already a number of players are circling to finance the tax credits under the Producer Offset. The interest rate will be critical as many Hedge Fund type scenarios postulate 15+ annual returns. This would over 18 month time lines with broker fee, see 25% of every dollar of tax credit gone. The state of world capital markets will determine new risk premiums for these types of transactions.

Ideally they can be structured to cost producers interest of 10% or less with low entry fees. Tax credit financing is the game Hedge Funds should have been involved in as opposed to direct investment in productions with no known outcome values.

Australia is now the world leader, with crew depth, high quality production capability and currency exchange rates below the UK and the US. Productions get a substantial tax credit and potentially an equity investor in the Federal Government.

Australian State incentive programs (like Canada provincial incentives and US State tax credits) can provide an additional layer of finance to the deal. Queensland, New South Wales and Victoria have substantial incentive and cost mitigation programs relating to

local spend. State rebates are taxable income but some States will capitalize them into an equity investment in the picture.

The Holy Grail of a substantial after tax equity contribution via a tax credit system now exists in Australia. The problem as always is that the industry never knows when to stop playing games. The credit system is an honor system of sorts. What it is saying essentially is here is some money up front. If the film bombs out here is the tax portion of the benefit paid even if you were not a taxpayer. However, if it is successful then we get back the tax portion when the income begins to flow.

Attempts to export the tax credit and remove income from the Australia Producer when a film hits are going to end in disaster. The ATO will use the anti-avoidance, controlled foreign entity, permanent establishment, transfer pricing and the rebate qualification rules to block abuse. Sham transactions aimed at making the tax credit the new bottom equity exported off shore without commercial ability to create real economic benefits locally will be shot down. If the income is held offshore by others and the Australian Producer is merely a service entity then the real issue is whether that Producer was in fact the Producer?

In a tax credit game they have the time and the power. The industry if it plays the game has a valuable new finance tool, one not requiring the abuse of civilian investors.

AMERICA | NEVER SLEEPS

"Money never sleeps pal. It is not a zero sum game. Money is not made or lost. Money simply is transferred from one perception to another."

Gordon Gekko | WALL STREET

Meanwhile back at the ranch just as the UK and Australia are killing off their tax deduction driven models America goes back to the future. The long awaited regulations needed to support and make viable Section 181 of the America Jobs Creation Act 2004 were released in early 2007.

For qualifying films (total budget of $15m - $20m or less), a 100% accelerated tax write-off is available for investors upfront. In essence it is a replay of 10BA in Australia but without any cultural subject matter tests. A year one tax shelter write off not tied to domestic cultural issues, opens the door to the creation of global product.

The tax shelter game that died in Australia, Germany and the UK now seems once more to have been reborn. The problem is that the US is not an easy sell. The section has a drop dead provision that effectively and retroactively removes the tax shelter write off status if a film budget exceeds either of the appropriate threshold levels. This means

advisors and promoters of such investments must take extreme care to not risk exceeding the limits.

The word budget in terms of practical application under the section is a little wider than most producers will ever have been used to. Total Film Cost under this provision includes finance expenditure including interest, audit, brokerages fee, legal and set up costs for a tax shelter. Account must be taken also of producer overhead and depreciation on capital assets used in production.

However, total production costs also include talent residuals and participations paid during the exploitation phase. Therefore these future costs could see a production exceed the applicable threshold. Even if these costs are paid by a third party, the IRS views them as being part of the total production cost. Most deal makers will stay well away from films whose initial budgets go near these limits.

The other lurking land mine relates to how Section 181 plays out in relation to a number of film industry related issues.

Is film production under this section a trade or business for the taxpayer in question? For individuals, pass through entities and closely held C corporations that answer appears to be yes and this effectively removes any negative Alternative Minimum Tax consequences.

The real issues for individuals pass through entities and closely held C Corporations lie in the application of passive loss rules and the "At risk" rules. Widely held C corporations do not have either issue to consider.

The issue in relation to passive loss rules is whether or not one can offset this loss against different types of income or not. The answer depends on the taxpayer and the situation. The Holy Grail is to be to create a tax shelter that can used by individuals, LLP's, LLC's, Sub Chapter S corporations and closely held corporations with 50% control held by less then 5 people who can use the loss to offset against different types of income.

The real sticking point from a tax shelter structuring perspective remains the At Risk rules relating to the provision of non recourse loan finance. The Holy Grail is to create a tax shelter write off using debt finance sourced from the deal itself. Such money creates a tax deduction and freeing up in investor tax dollars without any need for them to stump up real cash.

The "at risk" rules basically prohibit any tax deductions generated from debt obligations where the taxpayer is not at economic risk as to repayment of the loan. This was a legacy from the pre 1986 Packwood Act Tax Reforms which were aimed at the tax shelter days of old. Now they have new life and new import.
A pre-sale is not such an arrangement as while its presence effectively ensures a bank loan pending its collection will be repaid it is subject to commercial risk. The

commercial risk lies in that reality that the buyer may refuse delivery so at the point of loan creation there is no mitigations of risk relating to a pre-sale.

State Tax soft incentives also appear not to be classified as non recourse loan mitigations. While they are at a Federal level, taxable revenue in their own right, they still are subject to determination and collection at the point of loan creation. No inherent certainty as to their existence or collection exists.

However, formal underwriting guarantees given by third party players to take out a loan obligation are on past case law caught by that at risk rule provisions.

The real issue today pertains to finance from Gap and Super Gap lenders where the loan agreements are secured only over film assets. Such agreements to the extent they are not repaid in the event there is no revenue from the film are not at risk.

Only loan agreements that in substance create direct liability over a wider pool of assets and whose repayment is required irrespective of the performance of the film are truly at risk. The form and substance issue is where the IRS sees a borrower's residual asset pool outside the film is not sufficient to repay the loan. This may occur in circumstances where, despite on the surface the borrower as direct liability, they however have proven inability to pay down the loan may be a breach of the "at risk" rule.

Also a point to note is that when non-performing Gap and Super Gap loans are written off they become ordinary income that must be reported in the year of write off by the borrower.

The problem can be avoided altogether by using a widely held regular C as the tax shelter investor as such entities are not subject to the "at risk" rule. However they must also pass other tax shelter abuse criteria. The deal must have a profit motive and economic substance that reflects a commercial arrangement. Using a widely held Regular C corporation to avoid the "at risk" rules and passive loss rules are not a total safe harbor.

Deal structures that would face attack under those rules will still have to face the litmus test of being real and not sham transactions. If the UK and German wiring diagrams emerge once more they will not pass the test as there is clear evidence against them. Outside of the tax laws the net of US securities law when applied against small players creating private placements can be brutal. No film deal we have seen in the UK, Germany or Australia made via deferral schemes would have passed the Securities Law prohibitions in play in the US. Worse, the private equity hedge fund deals 2004-2007 in relation to form, set a standard of commercial conduct by which to assess the commercial validity of any US based tax shelter deal.

Vanilla deals will as they did with 10BA and Section 48 pass without much problem other than for those who breach the threshold rules. Where one pays out coin or a loan with real cash and there is a real loss then there is no abuse problem to consider. The timing of losses due to the write off and reporting of pre-sale, state incentive cash and

later sale revenues does appear to create some benefits. How much will depend on each circumstance. What Section 181 does is create for a real equity player a hedge against loss.

Those seeking to structure levered tax shelter money that unlocks a tax benefit that is then divided between investor and producer are following a predictable path. The subsidy after fees, interest and other set up costs from a deferred income deal appears to be about 12-15 cents post tax per dollar of budget.

The acid test will be to find a deal model that passes the passive loss, at risk and commercial reality requirements of the law. Such deals are possible but they look very different from anything seen in Australia, UK or Germany. As the karma of old wiring diagrams plays out in the courts of Germany would be US imitators need to take note. UK Sale and Lease back refugees are already setting up US bases but will find America a much tougher nut to crack.

In summary much talk about setting up funds to do $100m dollar deals under Section 181 are doing the rounds. Will they happen? It happened before. The real question is when it happens will it last?

The US has since the explosion of state incentives in 2002-2007 become once more an attractive place to make movies. Section 181 only impacts the small budget sector and because of legal imperfection in threshold formula will only see films up to $12m being made. This said the ability to get television stars on hiatus at a good price and not pay in GBP and Euros is attractive. Also the additional economic benefits from leading states such as New York, Louisiana, New Mexico, Hawaii and Connecticut, is currently a significant bonus.

Private EQUITY if it were smart would step in to fund these forms of soft money as this would at least insure they would get paid.

Section 181 and how it evolves under the new regulations will be closely watched as we approach the end of 2007. The first impacts will no doubt be seen in 2008 but the worry is the program is due to end 2009.

GERMANY │ SHAKES THE WORLD

"I thought this was an informal gathering. What is you attorney doing here?"

Mr. Fox Senior │ WALL STREET

In Germany it moved from Spring Time for Hitler to court time and potentially jail time. The VIP media fund trial is underway as we write. Prosecutors are claming VIP is guilty of questionable accounting practices in relation to the validity of the guarantee structure built into two of its funds VIP 3 and VIP 4. The allegations are that VIP in raising hundreds of millions of Euros deceived investors by not making adequate disclosure of the risks or past returns on earlier funds. The company appears to have not told investors that the projected return of $37m in relation to VIP 3 had instead only yielded $637,000. The only surprise to us is that even got their money back.

The prosecutors claim that VIP 4 investors would never have put their money in if they knew of these facts and of the real risks. The cash from these offerings was invested in high end films like "**The Punisher"** "**The Upside of Anger"** and "**The Jacket"** as well as up coming releases "**All the Kings Men"**, "**Soul of the Age** and **Perfume" : "The Story of a Murderer"**.

Investment bankers in Germany now see the film investment quagmire for what it really is. The factual replay of the results of some of the first Hedge Fund investments in the US that have seen disappointing results but lead to second round re-investment are hauntingly similar to what is being alleged in the German context.Interesting to regulators of both Tax and Securities law in Germany and the US, is the extent the double speak by all involved. Logically, if the new Wall Street Equity deals are economically viable then they give lie to the tax status and investment song of the immediate past in the UK and Germany. To the degree they are similar they prove the reality that the Hedge Fund money boom of today must die a similar death. Hollywood is between a rock and hard place. VIP in their defense put the whole industry on the chopping block with the claims that their deal model is identical to other German Funds. Betting the whole house and by that we mean the whole world, they claim in their defense that investor risk was mitigated by deal models created by "international financial and tax experts". German prosecutors need not look far to the UK, Australia and New Zealand to see that those wiring diagrams have a striking similarity. Germany has the potential to bring down the world and civil claims to recover cash as portended in many of our earlier articles could come back to haunt past deal promoters.

The only blessing is that current deals are not public offerings and searchable on the data base by Germans seeking recovery of their lost coin. Germany does have co-production treaties and the new tax laws do allow some projects to take advantage of the largesse in some of their treaty partner nation's tax laws. The ability to use tax shelter money to mix with the UK and other nations under the EU mantle and still do US films is now a distant memory.

SOFT MONEY │ GETS SMART

"I am going to be an entrepreneur in the true sixteenth century definition of the word, a real mover and shaker. I am going to shoot for the stars…."

Bud Fox │ WALL STREET

The changes in the world of soft money incentives over the last year have been breath taking. The demise of the tax shelter models in the UK, Germany and Australia has left only New Zealand, South Africa, Ireland and America out of the known players with the old technology. The UK scheme is plagued by the fact that the death of GAAP and EIS add on equity options, leave the money on offer a bit short.
The UK incentive is still attractive but the fine print in relation to income recognition has to be read carefully. The inability to use the co-production tricks of old to as much effect is a real handbrake on such co-production deal making.

The new Australian incentive is co-production friendly in either the minor or major partner mode. The level of incentive as far as direct tax credits/rebates are concerned is the best in the world and matched only by Puerto Rico. The exchange rate and SAG Global Rule One understandings provide a significant additional benefit in relation to residuals exposures. The post production hardware and skill levels are at Studio level as seen in the Matrix Trilogy, Star Wars, Happy Feet and Superman Returns. The international double tax treaty impacts on talent and profits assignable under permanent establishment doctrine to date have been user friendly. The tax shelter model is a dead letter and any attempts to combine it with the tax credit run the unacceptable risk of having the credit itself denied. Australia is by far the number one nation to do business in if the location is right at the time of writing.

The US after years of tax neutrality is striking back the combination of State soft money and incentives and Section 181 tax shelter nirvana is a heady mix. The ability to create and sustain tax shelter models based on wiring diagrams already found wanting in Australia, New Zealand, UK and Germany remains to be seen. Promoter's face a tough time as the VIP Media drama exposes much of what was hidden to public view. The guarantee structure at the heart of VIP investor vulnerability is a text book "at risk" issue and tax shelter abuse marker. Deals that look similar or create similar outcomes will not pass muster for long under the US tax shelter abuse code.

The Wall Street private equity deals provide a standard of commercial conduct which, if they are indeed economically viable, can be used to measure the commercial integrity of past, present and future tax shelter arrangements. The only silver lining may be found if such deals are in substance the same as those behind shelter arrangements, then at least the promoters may have the defense that they and their investors got screwed just like every other punter. The only problem is this hardly provides evidence of a "for profit" motive in the first place.

PRIVATE EQUITY │ PIRATE TREASURE

"There came Egypt a Pharaoh they did not know… it is prophecy… but the rich have been doing it to the poor since the beginning of time. The only difference between the pyramids and the Empire State building is that the Egyptians didn't have a union."

Mr. Fox Senior │WALL STREET

The amazing illusions presented at AFM 2006 by those lyrically selling the integrity of film investments left the knowing with only one question. When? When was it all going to turn pear shaped? In our last article we set the intellectual basis for why private equity investment in films on anything other than a risk mitigated single picture basis is always destined to fail.

Those reading the August 3rd 2007 edition of Screen International would if they believed the hyperbolic spin, that all was well in fact all was not as it seemed. The industry had raised $11 billion in private equity in the last 20 months. The optimistic projected another $15 billion in the next year with $10 billion coming from banks. The telling rationale for this forecast was given by one leading banker who sighted Hollywood hunger for constant finance as why lenders found the business so appealing.

The only moment of truth we have seen in this farce was this admission. The hunger for production money only exists because producers burn it and need more to replace it! The self indulgent logic proved our point if slate finance worked there would be no need for slate finance. It is the reasons behind why slate finance does not work that drives the hunger for new money.

Less than two weeks after the Screen International article, reality or at least a glimpse of it struck on August 15th 2007. A critical re-draw date for Hedge Fund investors sparked the current crisis in global credit. The Sub Prime Mortgage melt down had begun. The causally related liquidity crisis then shook the financial fabric of the world.

The world now saw risk for what was and now demanded that premiums for risk be re-evaluated. Ironically as many Hedge Funds melted either dying or reporting huge losses it was revealed the most vulnerable were Stat Arbitrage Funds. Statistical Arbitrage Funds also known as Quant's, remove common sense from investment choice basing decisions on math driven algorithmic model logic. PHD math genius devoid of real market knowledge was a preferred leader in such a game plan.

The irony we refer to is that in the August 3rd article almost all bankers and self anointed film finance experts referred to the Monte Carlo simulation math used to monitor their film slate investment. Monte Carlo simulations are risk assessment tools used to define the risk of a number of deal outcomes. The slate math was, like the Stat Arbitrage math

flawed as the model was structurally wrong for the equity player but perfect for the bankers.

Under this theory it was projected that cross collateralizing revenue over 25 films was a safer investment than doing it over 15. The reel mathematical analysis done by a real life Charlie Epps Professor, Art De Vany showed that spreading risk with wild random variables like films actual increases risk as you increase your bets. We presented these notions in our last article.

Films are wild random variables where most lose money and a wider portfolio does not increase the chance of one being a winner. In fact perversely in the film business if anything it ensures loss. In a wild and variable climate you may get lucky. It would also be just as likely that 25 out of 25 films are dogs as of 10 out of 25 being hits. The reason is with so few winners and many times that number of losers there is no confidence level one can rely on. Over any given range of slates some will in fact win but whose slate and when is only ever a guess.

In such a minefield the bell curve standard distribution model that drives the law of large numbers that creates mathematical prediction does not apply. Only raw luck rules and the more you bet the more vulnerable you become - this is math 101.

The law of large numbers is used to create life insurance and risk mitigation for many asset back security interests that do have non wild variables. Any experienced banker or player in the film game knows the truth. All cards are always wild. In such a game there is only one safer harbor play. Zero Risk single picture by picture mitigation of financial exposure done by those who know the game. The slate model as German Media Funds and before them Insurance Backed Bonds have proved will increase systemic risk.

The only players for who such systemic risk improves by bundling pictures on a slate basis are those at the top the industry revenue waterfalls. Those who fund pre-sales, tax incentives and who have first claim to distribution fees and receive income streams that are intrinsically non wild. This explains why bankers are so keen to lend senior debt into these deals. As always they are not at risk as it is only those below them that are the hit money.

The other math driven illusion doing the rounds is the much miss used notion of “Studio Ultimates”. This industry buzz word refers to the numbers the studios internally project in relation to a films economic performance in various release windows. The two key economic drivers being theatrical and DVD as success in these windows drives brand value into other long term windows.

Initially the term gained currency when DreamWorks used it as the glue to create a billion dollar credit line in 2004. The idea behind that syndication was that the security would come from the future library asset values of Dream Works films once released.

Once the Theatrical Release had actually taken place the Studio revenue estimates being "Studio Ultimates" could be used to assess library values for securitization purposes. This would be used again in their $750m library deal in 2006.

The idea and the term has since then been corrupted by those who seek to extend the dream. Studio projections once a film has been released have the stability of actual evidence of public acceptance. Such acceptance once known can then be used to predict the performance of other windows. The degree of accuracy improves markedly after the DVD release values are known. The remaining windows in nature are more stable and predictable apart from new kid VOD from cable and internet sources.

The private equity seekers of today used the notion to convey the same kind of economic accuracy to their projected slate performances. However there is a huge difference between projections once a film is released and those made before a film has even gone into pre-production.

The latter are just raw guesses dressed up as know how. "Studio Ultimate's" are a dangerous concept if the math is applied to assess economic value before production commences. Even data of acceptance from an opening box office week is not determinative as the work of Professor De Vany proved. Over a wide study two distinct opposite outcomes start to appear in Box Office data betweens weeks 4-6 of a run.

FOUR TYPES OF EQUITY | ONE FUNERAL

The private equity boom over 2006/2007 saw the film investment market split into four distinct types of equity:

- Studio slate
- Super rich one off investors
- Would-be leading independent producer equity raisings
- Independent single picture finance deals

Studio Slate | Private EQUITY

"Keeping track isn't easy… but card counters use certain techniques like assigning general values….this allows the card counter to keep a tally… the number count allows the player to make his choice favorably…"

Prof Epps | NUMBE3S

Since our last article the rate of fund raising and recapitalizing of existing deals continued unabated until the financial market crisis of August 2007.The crash of mid August saw its first casualty in Goldman Sachs withdrawing from a Billion Dollar deal with MGM. The deal has left the Hobbit and the next Bond move looking for cash. The Studio says it has not impacted production as the money was not ear marked for anything in the slate. Other deals such as $500m already raised to fund UA came in with the new shareholders Cruise/Wagner. This offering via Merrill Lynch had essentially closed at the time of the credit crash. The Goldman Sachs deal may proceed at a later date on a best efforts basis but no one is saying anything yet.

Goldman Sachs may have been saved by the bell as the first cracks were already appearing in the film industry private equity bubble.

Sony and Universal via two funding deals Gun Hill 1 and Gun Hill 2 raised $1.3 Billion through Relativity Media. In 2007 insider talk was that the first $600m dollar deal Gun Hill 1 spread over 18 pictures was going to be lucky to break even. Equity investors at the bottom of the structure looked unlikely to be made whole. The Universal Films had performed ok but the Sony package had not. Sony it is alleged kicked in some money to make life for their partners more palatable. The bottom equity portion of these deals in packages of $25m had been sold in relatively small junks to about dozen funds. Small change in the hedge fund games of such investors with losses of these amounts being unlikely to cause a public stink.

GUN Hill 2 was closed in May 2007 in the climate of these dark circumstances. The deal raised $385m for 11 Sony films and $315m for 9 Universal films. A prospective issue for investors in GUN Hill 2 will be what level of disclosure and assurance they actually received concerning GUN Hill 1 before investing in GUN Hill 2. Sony to be fair did the right thing the first time around but then perhaps they were obligated to anyway. The street talk was that the second fund had trouble closing its equity position money. Only time will tell.

Fact circumstances in Hollywood in relation to poor performance of an existing fund while raising a second fund factually morph what is happening in Germany now in relation to the VIP fund debacle. Getting your money back is not the same as getting the double digit return you were told was inevitable.

The gung ho predictions of the Gun Hill spin masters that movies are just like widgets may yet come back to the haunt them. Virtual Studios $265m Fund continued to sink under the weight of water from **Poseidon** and **V is for Vengeance** seeing one of its principals removed from power.

Legendary Pictures initial 26 picture deal with Warner Bros saw $500m invested into movies such as **Superman Returns** and **Lady in the Lake**. The Hedge Fund money came from ABRY Partners, AIG, Direct Investments and Bank of America. The deal had

done well on **Batman Begins** and **300** but took hits on **Ant Bully** and **Lady in the Water**. In June 2007 the deal was extended and an additional
$1 billion was raised to fund 45 films extending the initial deal through 2012. The capital injected this year was a mix of new equity, junior equity and debt. The junior equity portion also sees Columbus Nova investment management as a participant.

Dune Entertainment, an offshoot of Dune Capital Management backed another $325m deal with 20th Century Fox Studios for an additional 16 films announced in Nov 2006. This was in addition to the initial deal in Jan 2006 also for $325m in relation to 28 films. The latest Dune deal was presented by those close to it as like the first deal different because the fund takes a piece of everything Fox produces each year. The deal was accompanied by the same partner mutual back slapping seen at GUN Hill and Legendary.

In Jan 2007 Paramount backed by Morgan Stanley announced a $150m plan to fund movies made by Paramount Vantage by selling bonds. The fund Marathon LLC is perhaps emblematic of the ride investors may face. The fund will invest in 15 films including Babel and 10 to be released during 2007. The fund is to some extent retro active in that it includes some films already in release. It is the first time the specialty arm of a studio has done a slate financing deal. The deal is somewhat cleverer than those mentioned above as it appears have the characteristics of an existing library deal and pure production deal. The hybrid nature means a third of the fund is at least able to place some confidence on past release results in some windows. The bonds effective derive revenue from all the release windows across the release time line.

The Super Rich │Equity Player

Marvin “Did he see you?”
Bud “He saw right through me…”

Bud Courts Gekko│ WALL STREET

As much a phenomenon as the studio hedge fund plays are those of the super rich would-be kings of filmed entertainment.

MARK CUBAN / TODD WAGNER

Mark Cuban and Todd Wagner have already put a toe in the water with 2929 production endeavors. Success to date in pushing same day multiple release windows, theatre investment and a deal with a leading director have made them even bolder. In June 2007 they announced another innovative move by way of their investment in Content Partners LLC. The goal is to buy the profit participations of deals on movies and TV shows from actors, directors and producers. The company will buy out these entitlements for an upfront cash sum. Similar to the Bowie bond deals their plan is exchange future revenue streams for capital upfront. The deals are under their model buy out transactions are not loans as were seen in the Bowie Bonds. The idea is that talent gets paid now and does not

have to wait years to get income or wage war to get it. Sounds great but there is always more to it than appears on the surface with these two players. The rights being purchased may in the VOD cable and internet age exploding in front of us may be very, very valuable. Given the dot com know how of the partners this benefit is one they understand better than almost anyone in the game. The math here is a lot more solid than not yet released picture numbers as it pertains to existing revenue streams that have a performance history. Talk of buying out past tax shelter investor interest also would appear to be a silent gold mine if exploited properly.

JIM KOHLBERG

A billion dollar guy who controls one of the largest private equity firms in the world specializing in Leveraged Buy Out transactions. The quintessential corporate raider of 1987 and now in 2007 remains a leading force. He has formed Essential Entertainment to help finance smart independent pictures costing between 10m and $40m. He only wants to invest in films that make money and believes that it does not take hundreds of millions of dollars to make significant profits. He as executive produced **Forever Fabulous**, **Two Family House Runaway** and **Trumbo**.

BEN GOLDHIRSH

A wealthy young $100 million man whose Reason Pictures focusing on finance and development. He sees Hollywood as a way to effect change through its pervasive impact on the society, to date he had produced 2 films and has 4 in development.

STEVEN RALES

A billionaire industrialist highly regarded for his strategy and discipline. He is committed to financing and producing movies. Through Indian Paint Brush Pictures he fully financed **Nothing Is Private** and **The Fantastic Mr. Fox** and co-financed **The Darjeeling Limited**. The Super Rich players come with their own agenda and their own rules. Many appear in the industry from nowhere much like modern day reincarnations of the Count of Monte Cristo. The money is real, the purpose noble but what will be story at the end of Act 3 comedy, drama or tragedy.

Whether they stay or not depends on how they play the game. Hollywood has not historically been kind to the rich. In the past the well heeled have walked out of the town a dollar or few lighter than when they arrived. The new Section 181 write off may give many a natural tax hedge to buffer the rude awakening they are in for. Most have been falsely told they can make money at the movies. Few realize upfront that most people without an edge always lose. To the extent they finance product in a disciplined way by acting as private lenders to secure presale and soft money they may remain whole and of use. Our recent experience has been somewhat different as we have seen them more often than not the new dumb guy on the sharp end holding only the burn money pole position. A really dumb thing to do is to burn a billion dollar guy day one.

A new twist on this is also being played out in the Middle East where many industry players were recently seen trying to seduce petrol dollar Arab money into the film game. The money if it is civilian comes with consequences that may be more than one can ever handle. In a Global Market the new rich in less business aware nations are being targeted as the new coin Hollywood needs to replace the Hedge Fund cash. Right on cue just as the Hedge Funds replaced the Tax Shelter cash new international civilian investors are being tapped to replace the Wall Street Dream that is ending.

Leading Independent Producer │ EQUITY

"The card counter faces one obstacle to success, transparent betting patterns. In order to make money the card counter has to raise or lower his bets on the count. That is where the team comes in… "

Prof Epps │NUMBE3S

Cashing in on the spin so masterfully executed by the House many of the Hollywood elite spun their own web of private equity plays.

The Weinstein's hard work with Goldman Sachs created their own $253m Fund and put their hand up for coin in Asia most recently in Arab lands as well. The stated aim is to build a billion dollar business and become a Studio.

Summit Entertainment also joined the club with a $1 billion dollar fund through and association with Merrill Lynch. Summit through its significant sales agent status has a core edge that many players do not possess. The innate financial ability to lay off risk through pre-sales and later down sell through is own sales portal makes them a mini casino. Combine this with discipline, skill and good judgment and their chance of playing well is better than most.

Dark Castle Productions raised $240m through Bank of Ireland to finance 15 films over the next six years. This production house with significant artistic credit and studio ties will be an interesting bet.

Spyglass Entertainment also signed on to a $275m dollar deal with Dresner Klienwort to finance part of its upcoming slate. A clever company known for smart financial packaging always has an edge. This may well be a winner to watch.

Groundswell also raised $205m from a finance deal with global investment firm TPG-Axon Capital/Bank of Ireland under a non studio independent mantra. The theme being that instead of owning small parts of large Hollywood films in a slate one is better off with 50% to 100% interests in smaller budget films.

Ocean Media raised a $100m from American Strategic Capital on a similar independent film vibe.

Barbarian Film raised $50m aimed at financing independent films by financing split rights based production deals. The idea being that the global sale of split rights not box office is a safer business than a studio slate.

The story sounded different yet at its heart was identical to the studio pitch. In fact it was total nonsense to anyone in the industry with any wit about film finance. Pre Sales and rights values are falling. In an oversupplied market there is much more competition and players are waiting longer to see what it is you have actually released before shelling out big bucks.

While one may not rely on Box Office one does in any revenue window rely totally on public acceptance of the art. Bad art does not pay and the bottom money guy who thinks it does is in for a harsh lesson. The problem with all the independent producer equity play is that by natural consequence it creates burn money. Burn money investor profiles under a waterfall film revenue formula guarantee loss and on a slate basis, massive loss. The inability to tailor on a single picture basis zero risk capital exposure positions for all money contributions to a film ensure someone must always lose.

SINGLE PICTURES | MANY RESULTS

"What the hell is Cromwell doing giving lectures while losing $60m a quarter? He must be giving lectures on how to lose money... Jesus if this guy owned a funeral parlor no one would die. This rookie is brain dead…dilute the son of a bitch".

Gordon Gekko | WALL STREET

The single picture business approach struggled against the wave of slate driven product madness. Many bankers who used to finance single picture deals face the reality of a decline in demand. Equity driven slate deals create significant wide debt elements that originators then down sell by way of the magic asset backed securitization deals. Banks find these more attractive and less risk intensive than one off deals. Producers awash with money via equity already wrapped with debt elements do not need to go to traditional sources for now.

Single Picture finance is now the preserve of a few talented participants. The pre-sales, soft money and gap market for lending is still viable. The super gap market in a falling sales value high supply environment looks increasingly risky.

Israel Discount Bank is still a very committed player. One who shares our view of the film finance market. The ability to package and risk mitigate one film at a time is difficult, very difficult. The ability to package a slate of such film all at the same time is impossible.

This bank knows the business and has the intimate client relationships to know what is good and bad risk. Large slate lenders do not have their know-how or experience to make small loans. Slate loans are five to seven years whereas these single picture deals are normally 18mth to 24mth loans. Banks specializing in single picture finance need to turn over loans and are always looking for the next deal

Co America Bank is another such lender who makes single picture finance tick. This bank has a wide history of global pre-sale and soft money lending experience.

A number of new specialty lenders and investment firms have sprung up to fund single picture soft money tax incentives. In the UK Limelight and Aramid, in the USA Fallbrook Capital and AXIUM in Canada are only some the out fits. Soft money incentives from rebates and tax credits need funding. The cost of fees, the interest rate and the reserve and the safety margin off face value are all key deal factors. The ability to package and sell off by way of securitization such loans is only in its infancy. The stable nature and legal design of this revenue stream is such that it is an ideal candidate if properly administered for an ABS.

Hedge Funds should have invested solely in this type of film finance. It is effectively no risk classic arbitrage type financing that follows the law of large numbers in relation to actuarial risk assessment. The double digit returns and high safety margins required by some players reduce incentive values in the film finance plan of most producers. The Holy Grail then is to find an up front way to green light such deals by way of securing the funds only over the tax credit collateral alone, while also preserving as much of the face dollar value as possible.

Single Picture approach thinking has been and will be the only sane way to survive in the film business long term. The slate approach as seen in Germany and now in Wall Street can only lead to one outcome. The rationale that loss is inevitable because one is reckless as to taking the risk at inception is a self propelled result.

Single picture thinking demands that no film be financed unless its risk profile sees a zero risk outcome for each and every risk layer of money at stake. Losses can happen but in the face of such a mentality they are rare not the norm. The discipline of not making a film because its risk cannot be covered within its particular deal does not exist in the slate approach of today.

PRIVATE EQUITY│ ANALYSIS

"When the numbers start playing you instead of you playing the numbers it is time to take your money off the table."

Larry Fine Heart│NUMBE3S

The studio deals appear to have come to halt after the sub prime crash. The real tests are about to come as time and circumstance reveal the truth about the film revenue performance lottery.

The deals over the last 20 months have been for most part wrongly perceived as being equity investments. The telephone numbers on these private equity deals in the hundreds of millions are not pure equity plays.

The impression that they are, hides the reality of how they were packaged by the bankers and the studios as most had significant senior and mezzanine debt elements. In the waterfall of film revenues from pre-sales, certain territorial foreign right sales delayed till late in the production cycle and soft money tax incentives these elements are lower risks. Bankers never like to lose and in asset back securitized transactions they build in risk layers to favor themselves. Risk mitigation on the Lead Bankers part is further extended by on selling portions of each part of the debt element in each risk band to other banks.

The originating banks make huge fees and carry little on balance sheet risk unless a "repurchase on default provision" exists in the deal ink. The real equity that supports this tree is more or less the same as it was in the tax shelter game with the hit money at the bottom of the waterfall being the equity and junior equity deal position.

The bottom money is always the 20% to 50% of the negative cost to produce the picture that certain deal resources will never cover. In essence pre 2004 this was the tax shelter soft money that propped up the system. Now it does the same job but without the tax kicker to act as the underwriter of the deal.

Such deals were also required to keep unpleasant results off the books. Off Balance sheet is exactly that.

The studios still now as they did then, make 12%-15% distribution fees and profit from overhead in the deals. The intra window profits inside each window controlled by a vertically integrated global media company also adds significantly to profits. The degree of profits from books rights or values to the network TV or cable station they have an interest in never can be properly evaluated.

Merrill Lynch has proffered the notion that the slate approach accounts for losses because of the fat tails of the winners. The problem is all mathematical approaches are in essence

selectively related to the sample size and bias. Any UK sale and lease back slate or German Media Fund slate of the last 7 years is tangible evidence of the reality of the loss.

The private equity now sitting in the bottom tier of the Film Slate funding arrangements is identical to the tax shelter dollars in terms of rank. The promoters of the viability of these funds neglect to mention whether or not they enjoy any edge that was not part of the tax shelter game. Many allude to the fact that they share 100% in the DVD pie. Whether this true and how it is determined are still matters of great import.

The problem is that it is hard to see the house ever giving up its hand and its returns. The odd repayment of burn money without compensation for loss of the double digit earnings postulated is a cheap a deal if it ever comes to that. The slate in common sense does not work because if it did the studios would never need burn equity. All equity would be in the studio slate earning such returns.

The double digit returns promised to the hedge funds investors depends on these variables:

- The weighted average cost of the debt capital in the deal which is the so called blended fund rate of debt

- The amount of leverage in the deal of debt to bottom equity feeding into risk layers

- The blended rate cost of debt funds. The higher the leverage the higher the blended rate rises.

The art of the deal keeps the blended rate and risk exposure to debt down while still earning the required rate of return.

A 24% rate of return on a fund levered 1:3 at a blended debt rate of cost of funds of 8% would be attained if the fund earned 12% on its total investment. The margin on the debt on $3 of debt or 4% per dollar gives a 12% profit from the leverage. The profit on the debt dollars of 12% when added to the 12% return on one dollar of equity creates blended profit rate of 24%.

The portfolio in a slate or the investment profit in a single picture needs to account for these variables. Where there is a high degree of certainty pertaining to the collection of pre sales, co-financing and soft money revenues the senior debt elements face little economic risk. As uncertainty of revenue rises the amount of the debt packaged exposed requires risk mitigation and also reward.

The mezzanine portions of the debt package being at the upper levels of risk layers are the equal to gap and super gap positions in a single picture deal. Under a waterfall approach the gap portion is on a single picture basis, a fair bet. A slate approach to gap funding of this element from an investment banks view point does in fact comply with

the law of large numbers for the simple reason that the fail safe numbers for minimum revenues will exist whether it is not a dog film. The certainty of revenue is still a wild variable but some minimum safety margin money will come in.

The Super Gap portion of the slate debt package being the last risk layer of debt carries naked business risk. This debt band in the example given would with a 15% tax credit, pre-sales of 35% and gap of 10%, exist between 35% and 50% recovery of film production cost. A slate basis will mitigate risk but may in today's market still perform similar to the bottom equity in the deal.

Where an originator of loans carves up the debt elements and secures them in line with the waterfall, each deal element on sold to other lenders comes with a different risk curve and reward requirement. The immediate film finance past has seen most super gap lender elements lose their shirts in the independent film market. In the studio game the risk levels may or may not be lower. If the studio deals open up DVD and other window sharing beyond what is possible for independent producers to secure such lending risks, then they may to that extent be that much more secure and cheaper. The real issue is whether or not the blended cost of funds off balance sheet is significantly different from the costs on balance sheet. The German media fund trials may well be a telling factor in determining what is the reel standard of conduct that must be meet.

The flaw in many off the cuff math perceptions of the slate model lies in perception of loss and return related to risk. In a high debt levered Hedge Fund slate the drop dead number of loss of total equity once senior and mezzanine debt plus interest is accounted for, is another confounding variable. The break even point for debt plus interest in a levered deal may be over one hundred percent of negative production cost.

The waterfall punishes those at the bottom because at the beginning they start at the bottom with a strike price that includes interest. In the adverse event of poor revenue and slow work out time the rising interest costs put the risk position of the equity player further down the recovery tree. The slate math of loss has to account for the reality of the bottom equity. The average portfolio inability to recover negative cost is not an adequate risk perception tool. The reel insight is bottom equity faces in a loss environment, a deeper risk curve than in any other film deal. This is the rationale behind why it is always the burn money. The slate portfolio of similar risk layered interests has managed to create an overly bank friendly structure. No wonder bankers took the lead role in their creation.

For those with the courage to think about risk, one final issue adds yet another element to the risk profile. Many Hedge Funds placing equity in the bottom of the waterfall of a slate of films are themselves aggressively levered. It was this core fact that accelerated the sub prime debacles. Exotic high wire investments like film are often long term illiquid assets. Highly levered investors actual interest holding costs let alone opportunity costs makes true risk assessment of film deals a very delicate calculus. Getting a dollar of principal back in 5 years means an economic loss of more than 50 cents NPV today for a Hedge Fund. Most would be better selling their initial investments in film equity for 40 cents on the dollar now. The only problem is there is no buyer for a seat on the Titanic.

The likely outcome of the studio private equity slate deals is that without the creation of investment grade securities they will die a permanent death. Without credit enhancement of core revenue streams, equity participants in any film cannot protect their principal nor guarantee their capital.

Whether private equity comes from a Hedge Fund deal, rich guy, leading independent producer deal or single picture finance source the game remains the same. The challenge is constant only the essential facts on ground zero change.

Film size and slate size do not indicate anything about the math really in play. The math driven statements about big budget or low budget films as a class are as wrong as they are naive. A big budget film co-financed, risk mitigated may have a small equity risk delta. A low budget film may have a higher risk of loss due to a lack of risk mitigation deal potential. Nothing is generic in this game every film is different the general says nothing about the specific. In many cases it says the opposite.

In essence every slate is different as it comprises a unique grouping of slate film finance dynamics. The matrix of each slates reel collective break even point is a one off circumstance. The idea that 25 films of equal budget in two slates will create a basis for comparison is completely false. The real risk windows individual and collectively can be vastly different. Although we would submit the result for equity players will mostly tend toward loss.

Risk can be mitigated but only by solid certain deal chips such as presales and soft money. Sales estimates and studio ultimate number analysis helps but only to the smallest degree. The high art is to put together deal chips that not only finance the film 100% but also are risk mitigated to a high degree from inception. The use of pre-production release projections is merely a crap shoot.

The only fixed variable that the real math can account for is the zero value of unknown revenue outcomes. Working with this number means that one has to work the deal frames to create liquidation values for each deal participant. Work frames that recognize that zero values as the face of economic disaster is a minimum staring point. Each deal participant needs a risk profile that acceptably makes them at least whole.

The mad rabid gambler mentality that assumes loss as inevitable and that wins will cover losses must never be accepted by private equity. How many hard nosed private equity investors would ever consider financing false hope in any other industry than the movies?

On the plus side new approaches and deal models are starting to be created.
The clever use of statistically more stable data that projected pre-production revenues seen in the Dream Works Library finance model and the Content Partners talent participation purchase model, points toward a better way to securitize intellectual property based revenue streams.

In 2008/2009 the sub prime and private equity ABS CDO junk bond mess will hit full force. In such a climate, interest rates for exotically secured debt may rise dramatically. Worse the ability to obtain meaningful vanilla pre-sale financing may dry up. Gap and Soft money finance may also become impossible. The volume of studio product as funded by the private equity boom had darker purposes. One was to build a mountain of product prior to a strike, another to kill independent producer product.

The desperate race since last AFM for money by all sectors of the industry was not just a product of availability. It was also caused by the demise of the UK tax shelter business in early 2007. Some $3 billion in UK film tax shelter deals were initially amongst those hit and taken out of the game. Hollywood had to get back up fast and it did with the frenzy of deal making in 2007 we have commented on.

The Hedge Fund business and banking industry also face other problems. The first is the prospect of increased tax on private equity deals. At the moment the US funds have escaped with only a 15% top rate tax exposure. This must end but they have huge sub prime losses to soak it up.

The second relates to the passing of a new SEC rule relating to advisers and promoters of pool investments. This change applies to Hedge Funds and Private Placements Memorandums imposing steep obligations on advisors and promoters of these investments. The implication for those seeking equity under Section 181, from Hedge Funds or wealthy players anywhere is that care must be taken to explain the game. The VIP deals in Germany are being as we understand prosecuted under similar laws.

In response tinsel town has recently jumped the new looming jurisdictional walls and is going ARAB seeking petrol dollars from new bottom money in the Middle East. Money not only needed to fill holes left by the demise of Wall Street but needed yesterday to pay Wall Street back to avoid the prospect of prosecution. Much like the fictional Gordon Gecko and exactly like the all too real life Mike Milken, the intent today is only to pay ones way out. Only so one can perpetuate the game. Life it seems does imitate art. Just as Money Never Sleeps is due for release the real Wall STREET drama will be hitting headlines. Don't you just hate sequels!

Where did it all go wrong you ask? Numbe3s? Numbe3s never lie they are only ever used to tell them. The IILLUSIONISTS of the industry used the misdirection of the NUMBERS and THE PRESTIGE of the glitzy glamour to bait their WALL STREET trap. A viable capital market approach to film finance is more than possible as we shall illustrate. All that is needed is the wit and intent to perfect it properly.

"Let's raise the sperm count on the deal… We are in the kill zone … lock and load…. PAL! Lunch…… Lunch is for wimps!

Gordon Gekko │ WALL STREET

THE END

WALL STREET

NUMBE3S

THE ART OF FILM FINANCE

Money Never Sleeps PAL | Money Is Never Made Or Lost

Money Simply Transfers | One Perception To Another

WALL STREET 1987 | 2007

CONTRARIAN VISION | 2007
EDUCATIONAL | E. BOOKS

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