SLATE FINANCING ARRANGEMENTS

INTRODUCTION

Slate financing has emerged in the film and television industry trades and industry-related literature as a term of art that refers to a financing arrangement which first appeared in 2004. In essence, the paradigmatic arrangement has an investment group providing capital in the nine- or ten-digit range (i.e., $100MM or more) to a major studio-distributor or one of its subsidiaries for the studio's production or distribution operations. Although every deal is unique, generally the studio is usually entitled to a distribution fee in the 10-15% range, and is allowed to recoup its marketing costs off the top before splitting profits with the slate investment group.

Slate financing arrangements (*SFA's)* differ from previous large investments in studio affiliated production or distribution operations, such as the Spyglass-Disney pact and the Village Roadshow-Warner Brothers arrangement in the late 90's. In most cases, under SFA's neither co-financier trades territorial distribution rights for the other's co-finance; instead, the studio retains worldwide rights, with a pre-negotiated distribution fee. Also, many of the large deals between big independents and major studios prior to the development of SFA's did not involve the studio making any investment (or not a substantial investment) of its own production capital. Most of the SFA arrangements today include the studio as a substantial co-financier, often supplying 50% of the production capital and all of the distribution capital. SFA's are also distinct from the large revolving credit arrangements in use by the major studios and big independents for several decades. Credit lines, of course, do not grant lenders an equity position or a participation in revenues, but create secured credit, and repayment obligations on the part of the borrower.

The slate equity funds are usually offered to investors in three different packages to appeal to the tastes and requirements of different investor classes: senior debt (or high-yield debt), mezzanine debt (or lower-yield debt), and equity.

Senior debt is long-term, high yield debt which appeals to banks and lending institutions. It consists of bond securities or other debt securities which have priority over the lower-yield debt sold by the issuer. It is called "senior," because it must be repaid before other creditors receive any payment. Mezzanine financing is a hybrid of debt and equity finance that is commonly provided quickly with a minimal of due diligence and collateral requirements. Usually it is debt capital that grants the lender the right to convert the debt to equity in the debt obligations are not fuflfilled timely. It is subordinate to the senior debt, and is sometimes called "lower-yield debt," although it is often aggressively priced with the lender seeking a return in the 20-30% range. Mezzanine financing is advantageous because it is treated like equity on the issuer's balance sheet, which helps in obtaining more traditional bank financing. Equity is stock or any other security representing an ownership interest such as limited partnership or limited liability company interest. Essentially, equity is ownership in any asset after all debts associated with that asset have been discharged. It is by its nature, subordinate to debt. Hedge funds, individual investors and some institutional investors usually prefer the higher-risk classes, mezzanine and equity, which have potentially higher returns than the senior debt.

Debt is repaid and returns on equity are distributed from the studio's gross receipts from the various media: theatrical film rentals, DVD revenues, pay-TV receipts, etc. The investment capital and the slate financier group is not limited to hedge funds; smaller funds may consist of a wealthy principal or an institutional investor that invests some cash and gathers a group of investors to complete the pool, often a combination of hedge funds, pension funds, insurance companies, private-equity firms and high net-worth individuals. An investment bank leading a slate deal gets mainly fees and interest. So-called senior debt, mezzanine and equity partners, in that order, take increasingly higher levels of risk for potentially higher returns.

The key characteristics that distinguish slate financing arrangements from other forms of outside investment are:

- The investment group participates in a slate films, usually a dozen or more, rather than a single film.
- The investment group has some participation in the selection of films prior to the closing of the transaction.
- The investment group participates in the full array of revenues from each film in the agreed-upon slate, not just specific media.
- The investment group participates in worldwide revenues from each film, not just specific territories.
- A major studio distributor, a subsidiary of a major studio distributor, or a large theatrical distribution company is a party to the arrangement and is committed to providing theatrical distribution.

In order to understand what is responsible for the slate financing trend, one needs a birds-eye view of the assortment of market and financial conditions, factors, and interests that gave rise to the slate finance capital influx beginning in 2004. There are at least six non-exclusive, contributing causes for the development of SFA's, the first of which involves private equity.

THE PRIVATE EQUITY EXPLOSION OF THE 00'S

A brief overview of the classes of funds that make investments of private equity is the natural starting point, since industry terms-of-art are often fuzzy in this area. At their most fundamental level, *hedge funds*, *private-equity funds* and *venture capital funds* are similar to *mutual funds*, which are professionally-managed collective investments that pool investment capital for investment in publicly traded securities. All of these vehicles rely on managed firms that accept money from many investors and reinvest it. The differences between the private equity vehicles involve the nature of the investors, the kind of governmental oversight or regulation in play, the qualities of the target companies, and the investment objectives.

• *Hedge funds.* A hedge fund is a privately-offered, managed pool of capital, with a minimum investment requirement of usually $1MM or more, that charges a performance fee and is typically open to only a limited range of qualified investors. As their name implies, hedge funds often seek to offset potential losses in the principal markets they invest in by hedging their investments using a variety of methods, most notably short selling. The descriptor *hedge* refers to the capacity for offseting potential losses in the principal markets with a variety of alternative investments tactics, such as short selling. However, in recent years the term *hedge fund* has come to refer to funds that do *not* actually hedge investment in principal markets: the term has even come to refer funds that use short selling and other techniques to *increase* risk, and therefore profits. Some analysts think the real advantage that hedge funds have over other investment vehicles rests in the capacity to soften damage in an economic downturn, rather than outperform the public markets.

There is no legal definition of *hedge fund* under U.S. securities laws, but they typically include any investment fund which, due to an exemption from regulations applicable to mutual funds, brokerage firms or investment advisers, can invest in higher risk or more complex investments. In the U.S., in order for an investment fund to be exempt from regulation, it must be offered only to accredited investors, and there are numerical limits on the investors in the fund. In general, hedge funds are less regulated than mutual funds and similar investment vehicles, and have the freedom to invest in a wider range of projects.

Basically, hedge funds have a general partner (or a managing member) and limited partners (or non-managing members). The general partner operates the fund and makes the investment and trading decisions; the limited partners provide the capital but don’t participate in the control or management of the business. Hedge-fund managers utilize a variety of strategies, alternative investments (i.e., alternative to investing in a mutual fund or trading stock in a public corporations) to generate returns, including buying futures or short selling. Due to their less conventional investment strategies, hedge funds usually don't move in tandem with the stock or bond markets, which gives them a diversification quality and allows them to cushion portfolios in a turbulent market. Management fees for hedge fund managers are quite lucrative, often having a 1.5% management fee plus a 20% incentive fee (or performance fee) which pays the managers 20% of the returns they generate.

A related entity is a *fund of hedge funds* (or *fund of funds*), an investment company that invests in hedge funds, rather than in individual securities. Some funds of hedge funds register their securities with the SEC, and all funds of hedge funds must provide investors with a prospectus and file reports with the SEC. Funds of hedge funds often have far lower investment minimums ($25-50,000) than hedge funds.

• *Private-equity funds*. Private equity (PE) funds are collective investment schemes, such as limited partnerships, that invest in (usually) publicly held companies or their business units with the intention of obtaining a controlling interest. Typically, the PE fund’s plans include restructuring the target’s reserve capital, management, and/or organizational infrastructure, and PE fund managers structure their financing packages to meet the needs of the targeted companies. Once the PE fund has achieved its goals, the the target may be delisted from public stock exchanges (if it was a public company), held privately, or restructured over a period of (usually) 3–7 years and later relisted. Restructuring techniques may be accomplished via leveraged buyouts, the use of venture capital or growth capital, angel investing, mezzanine debt, and other means. PE funds usually get returns for their investors by a sale or merger of the target, a recapitalization, or an initial public offering. Unlike hedge funds, private-equity funds usually have a stable of business managers and analysts who are inserted into the target’s management. PE is distinct from venture capital in that VC investments typically involve new or developing businesses, while private equity is more usually associated with companies have that more stability and predictable growth rates (frequently publicly held companies), and managed buy-outs/buy-ins. Investors in PE funds include pension funds, insurance companies, banks, endowment funds, companies and wealthy individuals.

• *Venture capital funds*. A venture capital fund is a collective investment scheme (usually a limited partnership) that invests the capital contributed by its limiter-partner investors. Target enterprises typically are young companies seeking growth capital, which are considered too risky for the standard capital markets and bank lending. VC funds make numerous, relatively small investments in upstarts, and rely on a few successful winners to offset the losses of the many. Venture capital investments typically include managerial and technical expertise, and the VC fund generally occupies a seat on the target's board and provides strategic direction and advice in an effort to increase the value of the target's shares. Most venture capital comes from individual investors, pension funds, investment banks and other financial institutions that pool such investments or partnerships. VC firms commonly charge investors an annual fee of 2% on committed capital, and 20% of any realized profits. VC firms seek a high rate of return over the medium term (usually 3-5 years) through capital appreciation, which is realised when the target is sold, does an IPO, or becomes listed on a Stock Exchange. Since VC funds rarely invest in entertainment companies, the remainder of this discussion focuses on the first two classes of investment funds.

All of the above are considered "alternative investments" because they operate differently than mutual funds that buy securities that trade on the major exchanges. But they are all similar insofar as they utilize specific investment strategies in given classes of investment scenarios, to achieve more or less distinctly defined objectives.

This decade has seen Wall Street deluged with private equity and hedge fund capital. The early 00's witnessed the formation of private equity mega-funds with $10 billion or more by firms such as Apollo Management, Blackstone Group, Texas Pacific Group, and Kohlberg Kravis Roberts & Co.[1] In addition to PE funds, hedge funds were taking in colossal amounts of capital and deploying much of it towards private equity investments. In recent years, hedge funds in the U.S. have acquired $1.7 trillion in investment capital. The deluge of capital into hedge funds and private equity funds which set the stage for the slate finance trend was triggered by a slow stockmarket, lagging returns on real estate, and low interest rates.

Resultingly, private equity fund and hedge fund managers found themselves sitting on billions of dollars which they needed to put to work safely and effectively. Nine-figure studio deals which came with the assurances inherent in the model developed by Isaac Palmer and later, Ryan Kavanaugh, fit the bill nicely. But there were additional factors and conditions that shared responsibility for the development for the SFA trend.

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[1] In June of 2006, Henry Kravis, founding chairman of the New York's Kohlberg Kravis Roberts & Co. (KKR) leveraged buy-out firm announced that KKR would raise a $15.5 billion PE fund, the largest PE fund ever raised. Other $10 billion (or greater) mega fund creators include Leon Black of Apollo Management, Stephen Schwartzman of Blackstone Group and David Bonderman of the Texas Pacific Group.

OTHER CONDITIONS EXPLAINING THE SFA TREND

Perhaps another factor driving Wall Street and private equity to the studios is the certitude about the value of owning a library, or more generally, content, in a rapidly developing, and thoroughly unpredictable technological era. The revenue base for motion picture content is expanding with new technologies. Interactive technologies, digital downloading, new formats for PDA's and handheld devices, videogames, and social networking applications all require content – past, present or future. Library owners can unlock value from digital entertainment content. The concentration of ownership of the valuable film libraries in five major studios makes owning content even more desirable, because fewer suppliers down the road will likely mean higher prices for those who control content.

Yet another factor driving money to Hollywood is the relatively recent centralization of power in only a few conglomerate-owned major studios, and the increasingly corporate character of the film industry that has resulted. In particular, seasoned corporate executives are now in charge at most studios, and all the majors (and most of the former big independents) belong to publicly traded corporations. Additionally – and as a result of the foregoing – studio accounting procedures now operate with degree of transparency heretofore unknown. These changes have made financial data about the performance of films worlwide and among all media more reliable and more accessible. There is a longer history of participation by outside investors, and more extensive and more useful data. Additionally, there are better advisors and intermediaries capable of more sophisticated financial analyses of film operations.

More reliable data, in conjunction with the slate aspect and the all-revenues quality, meant that financial managers and analysts could more safely assess and manage investment risks across a range of projects. SFA investments are inherently more like secured revolving credit arrangements, or stock ownership, than traditional single- or multi-film equity investments. As such, they have a higher degree of transferability because their value is less speculative. Underlying much of this analysis (and often an express selling point in selling the investment) is the notion that the law of large numbers (or law of averages) serves to reduce risk.[2]

An additional reason, which is common to other forms of studio finance and co-finance, involves studio accounting and investment concepts like earnings-per-share. Studios prefer to avoid having debt on their books, and would rather bring in equity capital to finance their films than take out loans or open credit facilities. The desirability of having off-balance-sheet financing was also one of the chief factors that underlay the development of discountable-contract finance.

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2 See UC Irvine Professor Dr. Art De Vany's *Trimming Hedges*, 7/16/06, for the countervailing mathematical arguments. He points out what may be fairly obvious: the law of large numbers does not apply to a slate of 20, or 50, or even 1000 films. Under this principle, with increasingly larger samples, averages should stabilize and the variance should fall; he argues that the law of large numbers does not apply to the film industry business there is no such thing as a true "average" box office, and variability of economic performance might be infinite. His analysis of roughly 2000 films shows, he says, that the increasing variance of the average with increasingly larger samples means that an average that is calculated from any given sample is a bad predictor of the average in the future. And, he says, the variance is equally unstable, growing with the number of films in the sample; it is unbounded and without a finite value. Essentially, the professor attributes the inadequacy of statistical principles like the law of large numbers to subjectivity of human behavior and aesthetics.

Finally, there is the simple explanation: *because the studios had no other choice*. Hollywood has for many decades become dependent on other people's money. Presale financing, German tax shelters, UK sale-leaseback, gap-insurance financing ceased to be the powerful sources of capital they once were; by 2004, it's fair to say that Wall Street and sophisticated private equity sources appeared the studio's only presently viable recourse, given the constraints placed upon them by their corporate parents and market forces generally.

Before scrutinizing individual deals and tracing the development of SFA's further, it is useful to set the stage by reviewing the salient events in film finance in the 1990's and early 00's: a period this author has in prior literature dubbed the *Post-Classic* period.

POST-CLASSIC FILM FINANCE

The 1990's was a tumultuous, explosive, and evolutionary period for film finance. Demand domestically and internationally for American films in all budget ranges increased dramatically. The U.S. box office increased 52% during the period 1990-2000, and the foreign markets underwent a breathtaking expansion in the early 1990's. By 1993, foreign theatrical revenues for major studio films exceeded the domestic take, due to new cinema construction, better marketing tools, and changing audience tastes.

As overseas revenues increased, a scandal that proved a profound but temporary setback for independent producers unfolded. Credit Lyonnais Bank Nederlands, one of the largest makers of single-picture production loans, abruptly discontinued its production lending entirely in 1991 in the wake of a massive acquisitions loan debacle that caused the bank's parent to revoke $358MM in credit extended in connection with Giancarlo Paretti's purchase of MGM/United Artists. While the CLBN/MGM/UN snafu played out, demand overseas for foreign television rights began surging among big distributors in Spain, German, France and other countries. Also, home video revenues began their march past theatrical revenues; a march that was accompanied by a global decline in the demand for direct-to-video or "B-movies" that mushroomed in the 1980's.

The major studios' reaction to the heightened demand for American product overseas was "bipolar." Initially, the studios chose to compete with the independents by distributing the same species of films that were selling tickets overseas: the arthouse or specialty film. In order acquire this kind of product, at first the studios scoured the film festivals. Later, the studios began to financially back outside productions by means of negative pickups, distribution guarantees, or presales arrangements (i.e., discountable contracts) rather than producing films in-house. By 1997, the critical acclaim and Oscar nominations showered on a spate of specialty films, and their ever-more-apparent potential for high profit margins, persuaded six studios to acquire their own arthouse/specialty units. At roughly the same time that specialty films distinguished themselves as critical and commercial winners, the studios were developing a vastly different production and marketing model, the tentpole picture. Before the tentpole model developed, however, the industry would experience a capital crisis that stemmed from market changes overseas.

The huge overseas appetite in the early 90's for quality, cast-driven film projects with A-list talent, and the swelling global TV and video markets demanded production capital. Yet, there was a profound shortfall of capital available for independent producers due to a variety of factors, including the CLBN fiasco, and the increased discountable-contract arrangements the studios were making, which depleted the limited supply of bank funding for films. Tempted by the increasing loan fees (due to a shortage of capital) banks could charge, and the prospect of acquiring new depositor clients, a number of American banks wet their feet in the water of production lending.

This surge in lender competition and heightened demand for capital led the banking and film industries to engage in some high-risk practices: expanding the safe gap limits to new levels, and utilizing loan insurers who guaranteed loan repayment, but inflated the costs of lending to extraordinary levels. So called "gap insurance financing" was not exclusively used by independents; the same principles were employed in insurance deals with the major studios. This new subspecies of discountable contract financing proved more or less disastrous for independent film finance, but not the studios, who could theatrically distribute even their losers, and thus guarantee some minimal level of performance overseas.

As the gap loan rush escalated, the markets in Asia took a turn for the worse. In 1997, the Asian Pacific regional economies were gripped by an economic crisis. Advertising revenues, especially TV advertising, plunged dramatically. Hardest hit were South Korea and Indonesia. The currency devaluations in those countries jeopardized the presale financings of many independent productions, destabilized dozens of small sales agencies awaiting guarantees or territorial revenues, and weakened many distribution companies that specialized in providing the action genre films which were devoured by the Asian territories. Naturally, the major studios felt the sting too, and it was estimated that the crisis took off 20% of their bottom-line profits for films released in that region.

In the late 90's, as the effects of the Asian economic crisis rippled through the industry, the many films financed during this "gap loan rush" revealed their true colors. A great many of these projects had not met the sales projections overseas, and many of them never obtained the precious domestic theatrical release which might have saved them. The confluence of these misfortunes spelled doom for the many insurance companies which had rushed into the gap loan boom to get a piece of the action. As the gap loan rush films fizzled at home and abroad, many banks and insurers who engaged in gap insurance financing retrenched or exited. Among the most notable tragedies were C.E. Heath's (a U.K. insurance broker) deal with L.A. based Phoenix Pictures, and the Axa Reinsurance (France)/AIG deal with Destination Films.

At roughly the same time as the Asian crisis and the gap loan bust, the studios became aware that their huge "event" films (e.g., *Titanic, Jurassic Park, Men In Black, Independence Day*) laden with special effects and star power could produce staggering revenues overseas, provided they reached a threshold level of box office performance in the States. Perhaps due to the growth of local-foreign productions, the "non-event" films (i.e., films with more generic elements or which are more character driven) ceased to enjoy the same level of success, even those films that had substantial star power. These factors drove the studios into a "tentpole" production and marketing strategy, by which they spent enormous sums of money producing and marketing their franchise-event-effects pictures. Negative costs for major studio films increased 72% between the period 1993 and 1999; marketing costs increased 74% over the same period. By 2000, every major studio had acquired or developed its own specialty or *classics* unit (collectively called "dependents," in later years), and the arthouse/specialty film had become the exclusive domain of the studio specialty units and the independents.

Among the consequences of the majors' enthusiastic charge into the overseas arena were that the foreign television market which was in large part responsible for the increased overseas demand that began in the early 90's, became saturated with product. Another effect was the drying up of precious prints and advertising capital for domestic distribution of independent product. It became virtually impossible for a small or even medium sized independent production company without a studio deal to obtain domestic theatrical distribution. In a recessed, oversaturated world market, with no theatrical distribution, only the large independents could thrive. Separate from the Asian crisis, the gap loan rush and the conquest of the foreign presale market by the majors, was a fourth major development in film finance, which was centered in Germany, and which also had its negative repercussions.

As gap loan financing in the U.S. was reaching its peak, the Germans responded to increasing domination of the major studios within Germany by developing a public market in tax shelter vehicles. The *Neuer Markt* allowed the German entertainment industry to raise huge sums of cash from wealthy private German investors by offering them large tax writeoffs in connection with film production costs. The large German film funds (e.g., Helkon, CP Medien, Advance Medien AG, and Kinowelt et al) used their capital to invest hundreds of millions of dollars with independent production companies like Franchise Pictures, New Line Cinema, Newmarket Group, Senator Entertainment, and many others, as well as the major studios. The types of deals they made with American producers and distributors included output deals, presale arrangements and co-production financing arrangements. Many of Hollywood's A-list producers entered arrangements with German film funds (e.g., Joe Roth, Mark Canton, and Francis Ford Coppola). The German film funds proliferated and their trading prices soared. By October of 2001, the *Neuer Markt* boiled over, and then collapsed. Virtually none of the production financing funds survived. Many that did survive ended up in legal disputes. All totaled, the *Neuer Markt* delivered $100MM in cash to Hollywood producers and distributors, and inked more than $1.0 billion in long-term production, distribution and rights commitments. When the funds dried up, the major studios and large independents were left to search for new production finance sources.

There was some good news during around this time, however. The plummeting cost of DVD players translated into huge sales of DVDs, quadrupling revenues between 1999 and 2001. DVD revenues would continue their climb for another five years, before leveling off.

The next addiction to other people's money was peddled by a new film industry entrepreneur, dubbed by the trades as the *financing producer*, a producer who brought partial production or distribution equity financing to the studio conference table. Much of this equity in fact was money that flowed through the German film funds, private investment raised on the *Neuer Markt*. The producers and companies who brought equity financing to the American studio-distributors included many established production companies and foreign sales organizations, as well as A-list producers and former studio executives who had the clout to secure an output, presale or co-production deal with a German fund or distributor. The *financing producer* trend ultimately did not evaporate the way that the *Neuer Markt* funds did, it morphed into a very different film finance vehicle which is the subject of this article. But some of these financing producers had another source of equity investment, wealthy American investors who had recently made fortunes in the stock market, the dot-com boom, real estate, or elsewhere.

The proliferation of the financing producers was in part precipitated by the mushrooming of private equity in the early 00's (see *THE PRIVATE EQUITY EXPLOSION OF THE 00'S*, below). In addition to the private equity and hedge fund surge in the early part of this decade, there were several other factors that enabled the studio's to satisfy their lust for outside capital. First, investment in the film industry became more mature science in recent years.

Second, the 1990's stock market boom produced numerous high net worth individuals, and many of them, predictably, became fascinated with the film industry. Third, numerous *high profile* investor-entrepreneurs outside the industry had entered the industry on way or another, including: Microsoft's Paul Allen; real estate magnate Bob Yari; eBay's Jeff Skoll; Qwest Communications' Philip Anschutz; Fed-Ex's Fred Smith; and Dallas Mavericks co-owner Mark Cuban. Yet another factor that contributed to the studios search for outside cash stemmed from the dual trends consolidation and globalization. The mid-90's tentpole model, which often called for a high-budget, major stars, a franchise-potential property, and stunning visual effects, survived into the 00's era of globalization and consolidation.

Consolidation in the film industry could be traced to Disney's merger with Capital Cities/ABC in 1996. By 2005, every major studio would become absorbed or controlled by a corporate conglomerate, and numerous other mergers, JVs, and acquisitions among telcos, cablers, ISP's had occurred, In the midst of this frenetic activity, the medium and lower budget films continued to be delegated to the studio specialty divisions or left to the independents. An economic slowdown that had begun in 2001 motivated the majors and their conglomerate parents to shirk risk and cut costs, without reducing profits. Cutting costs was not in the studio's tent-pole business model, which by its nature called for higher budgets for more spectacular looking films and supersizing marketing campaigns for maximum opening weekend impact.

The majors responded to the cost-reduction mandate in a number of ways. Co-financing high budget productions with other studios was one common attempt at lowering costs and reducing risk. Another tack was to slash overhead, development costs, producer deals, and talent deals. Also, outside parties such as talent agencies, were enlisted to build new sources of production capital. Some studios became more active in pre-selling foreign territories in order to lower their risks. And generally, studios became more dependent on their subsidiaries and affiliates and upon startup independents for bringing in co-financing sources, whom the studios perceived as having greater dexterity in dealing with and successfully acquiring soft money sources. In general, the corporatization of the studios made them more receptive to independent startups who could help them fill their production slates without draining their financial resources.

The combination of these factors drew more willing and able private investors to the table, and made it easier for the studios, distributors and producers to get their co-finance fix. According to some reports, by 2002 the major studios relied on outside equity investment to provide production financing on more than one-half of their product. In addition, by the same year the standard equation for financing an independent production had changed. In the 90's, presales could cover 80% or more of budget. In 2002 (and today), it is less than half. Two additional elements began to enter into the film finance equation for large and small productions, studio and independent films: private equity, and soft money arrangements. Neither of these elements were entirely new to film finance, but neither were strictly necessary until the 00's.

The last essential financial ingredient had been around in some form since the late 50's. Around 2002, *soft money* arrangements (i.e., tax shelters, tax breaks, labor or production credits, subsidies, co-production arrangements and currency valuation benefits) became an essential element in the finance mix for independently produced films. Among the most notable soft money phenomenon in recent years apart from the German film funds, was the U.K. sale-leaseback, was effectively gutted by the British Government in February 2004. Many other foreign territories developed or revamped their programs in the early 00's. 2002 was also the beginning of a fertile and dynamic period for soft money incentives in the United States. This was in part a reaction to the *runaway production* phenomenon, which referred to the many independently produced and studio-financed productions which located in Canada, Eastern Europe, the U.K., Germany and other countries. Shooting in some foreign locales enabled producers both to utilize powerful production incentives and obtain cheaper goods and services from (more or less) skilled industry technicians, crafterspersons, artists and other vendors. Powerful tax incentive programs installed in Louisiana and New Mexico (which had the potential to reduce negative cost by 15% or more) proved effective in diverting many of these productions, both studio and independent, to the local economies. Louisiana's transferable tax credit program increased local production by a factor of ten in less than two years, and created a tax brokerage industry that continues to exist. At least ten other states enacted or modified their incentive programs to compete with LA and NM. By the end of 2005, 37 states had film industry incentives of some kind, and legislation was pending or in the works in almost every other state. In 2004, the U.S. Government enacted § 181 of the Internal Revenue Code, which provided a substantial income deferral incentive for qualified films.

Over a twelve year period, the film industry experienced a surge in demand for product overseas, increasing costs, and profound shortages of capital. The industry as a whole radically changed its production and marketing models, saw virtually every major studio absorbed into a conglomerate, and shuddered under the weight of, and then recovered from four separate economic crises, each of which cut into the bottom line. The great majority of independents were folded into the major studios, paving the way for a new class of producers, distributors and sales companies who could deliver large pools of financing to the studios. And finally the nouveau riche from various walks of life, as they have done many times in the past, made their entrée. It was against this backdrop in 2003, that the earliest antecedent of the modern SFA developed.

DEVELOPMENT OF THE SLATE FINANCING MODEL

The first large financing that most closely resembles the SFA paradigm was the one for which a Paramount executive named Isaac Palmer[3] is sometimes credited. Sometime in 2003 he proposed a co-financing structure that made use of a common investment metric: *internal rate of return*. *Internal rate of return* is a widely accepted method of financial decision-making which uses a special discount that equates the present value of an expected cash outflow with the expected inflow.[4] When analysts speak of a corporation's internal rate of return, they are referring to a

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[3] Palmer's structured film finance experience at Paramount included overseeing $1.5 billion in public and private German film fund offerings that were used to finance Paramount's film operations. In addition, he also identified new business ventures for Paramount and served on the board of directors of Digital Cinema Initiatives, the studio consortium for digital exhibition. Before joining Paramount, Palmer was VP, business affairs, at Ogden Entertainment in Gotham.

[4] For example, assume a production company can make a film for $15MM, and expects revenues of $5MM per year for the next five years. The internal rate of return (IRR) is the discount rate that equates the present value of the expected cash outflows with the expected cash inflows. In this example, the internal rate of return is approximately 20%. In general, as between two competing investment opportunities, the one with the higher internal rate of return will be preferred. IRR can also be defined as the discount rate that yields a net present value (NPV) of

figure that reflects corporate earnings across all revenue streams, as opposed to a profit participation in a specific film or in a specific media. Even in a recent, poor performing year, Paramount's internal rate of return was said to be 15%. Palmer and his Paramount colleagues considered using the studio's accounting figures which reflected the internal rate of return as a way to persuade slate co-financiers. Palmer and Paramount's investment advisor, Merrill Lynch, set their sights on hedge funds, whose internal rate of return requirements typically were between 12-18%.

*Melrose Partners (*sometimes called *Melrose Investors,* or *Melrose Partners 1*). By July 2004, Paramount worked out a deal with Merrill Lynch through which the hedge funds would fund 18 percent of the cost of 26 consecutive Paramount movies in 2004 and 2005 (including *War of the Worlds*, *Mission Impossible II*) through a vehicle called Melrose Partners. In return, the investors would receive 18 percent of the revenue Paramount made from all 26 films.

Under the arrangement, The Paramount Motion Picture Group took a 10 percent-of-gross distribution fee, before calculating the split with the investor group, comprised of a mix of institutional investors. The fund ultimately raised $231 million, which it used to fund 20% of the production costs of each Paramount movie in the slate (which included *Mean Girls*, *War of the Worlds,* and *Mission: Impossible II*). The fund had a three-year term and was intended to cover 25 films. On the Merrill Lynch side, the deal was was put together by Michael Blum, head of its global structured-finance division, and a film finance veteran.

RYAN KAVANAUGH'S RELATIVITY MANAGEMENT/ MEDIA

Sometime in 2003 or 2004, a former venture capitalist who had prospered during the dot-com boom of the late 90's named Ryan Kavanaugh became associated with a number of trade industry-reported transactions. Kavanaugh was a principal in management firm Relativity Management, a company that housed lit, talent, production and music managers. It was described in 2004 as a talent management, production and finance organization with access to venture capital, and its clients included Mark Canton's Atmosphere Entertainment, George Clooney's Section Eight Prods., and Dean Zanuck.

Among Relativity Management's activities undertaken by Ryan Kavanaugh was the structure of a capital financing arrangement for Mark Canton's new entity, Atmosphere Entertainment, which was formed in 2003 with the assets of Artists Production Group and Canton Co., and financial resources (including capital) provided by Daedalus Media Fund. Daedalus was managed by an affiliate of entertainment finance advisor Mark Kimsey's New York-based K&Z Partners. Kavanaugh reportedly acted as advisor to Daedalus and was responsible for structuring the deal between Daedalus and Canton.

In October 2004, about three months after the Melrose Partners 1 fund was established, Relativity Management reported that it had entered into a $100 million joint venture arrangement that would create two funds: one for investing in preproduction for independent film, and the other for co-financing tentpole feature films. Kavanaugh said the deal would allow Relativity to finance overhead and development for producers like its client Exception Wild Bunch and also

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zero for a series of future cash flows. NPV is calculated with reference to an annualized cash flow by discounting all future amounts to the present.

would provide slate co-financing for its clients slates. Only two months prior, Relativity announced its acquisition of management/production firm Acronym Entertainment.

In March 2005, Canton's Atmosphere and Ryan Kavanaugh expanded their relationship by means of deals made by a different (or differently named) entity, Relativity Media. Relativity media was said to be film finance consultant formed in 2004,[5] and operated by principals Kavanaugh and a veteran film executive (formerly at Industry, MCA and Carolco) named Lynwood Spinks. Relativity assistedwith the financing of Canton's teen comedy *Full of It,* and in March, Atmosphere and Relativity Media formed Chiller Films, which planned to finance and produce several films per year with a $20MM budget cap in the horror genre. The new shingle's first film was the George Romero-directed *Land of the Dead.* Canton announced that Chiller was negotiating remake rights on several titles and was in discussions with with several studios on a first-look co-financing deal. Before the end of the year, Kavanaugh would succeed in creating Relativity's first large-scale SFA with a major studio. Before he did, three large co-finance deals similar to the Melrose Partners arrangement would be unveiled.

SFA'S IN 2005[6]

In April 2005, about three months after Canton and Kavanaugh formed Chiller Films, and almost one year after Melrose Partners 1 was announced, Merrill Lynch went back for seconds. This time, it was with comic book, merchandise and licensing company, Marvel Enterprises. Two more SFA's were announced before the end of the Summer (Legendary and Kindgom), and they were followed by the Relativity/Stark Investments SFA, Virtual Studios, in October. By the end of 2005, $1.93 billion in SFA funds would be committed.

Marvel Studios. In April 2005, shortly after entertainment entrepreneur, producer and talent manager Brad Grey took the helm of Paramount,[7] the studio announced it would distribute and market 10 films based on Marvel characters over a seven-year term. Underlying this deal was a seven-year, $525 million debt facility[8] arranged by Merrill Lynch and Pierce, Fenner & Smith. Later, the industry trades reported that Relativity Media played a role in structuring the financing as well.[9] The facility called for funds to be loaned to a Marvel subsidiary, MVL Film

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[5] Kavanaugh and Spinks later described their activities as working with large banks and hedge funds to invest in deals with major studios and independent production entities.

[6] NOTE: The majority of the remainder of this article consists of brief descriptions and histories of SFA's that have been identified in the industry trades and other literature, and selected because they have the defining characteristics set out on page 2. Many other large financings which have occurred since 2003 are excluded because they don't have the key characteristics provide above, or because there was insufficient public information to conclude they had those characteristics.

[7] In January 2005, Brad Grey was appointed Chairman/CEO of the Paramount Motion Picture Group.

[8] One press reportdescribed the Marvel deal as a $525 million revolving credit line, with Marvel characters as collateral. Daily Variety, *WB, Relativity order up a six-pack*, 10/5/05. Other reports indicate there is an equity component across a slate of films.

[9] One industry report said that "The Beverly Hills-based Relativity Media… was integral in putting together Marvel Enterprises' recent $500 million credit facility…." Hollywood Reporter, *Relativity, WB in co-finance deal*, 10/6/05. Another report said "Earlier this year (2005),

Finance, which was formed to protect the lenders' investment should Marvel ever declare bankruptcy. The agreements had Marvel pledge the theatrical film rights to 10 of its marquis characters as collateral for the debt facility.

The deal terms Marvel made with its lenders and Paramount, provided Marvel would fund the early development — including scriptwriting — of each film and then be reimbursed from the $525 million film-slate facility as each movie was greenlit by Marvel Studios. Paramount would deduct its marketing costs and distribution fees, including interest, and Marvel would take the profits from theatrical, homevideo, television, soundtrack and merchandising. Paramount would distribute worldwidewide, excluding Japan, Germany, Australia, New Zealand, Spain and France, where Marvel retained distribution rights.

Three years later (in May 2008), Marvel will release its first film, *Iron Man.* Today, Marvel Studios is still not a studio in the traditional sense, since it has less than forty employees, no studio lot, and no distribution system of its own. In February of ths year, Marvel informed its investors that, due to the writers strike, the studio was lagging in its planned development and production operations, and that investors should expect only one additional film to be released in 2009.

Legendary Pictures. In June 2005, Warner Bros. Pictures announced a $500MM co-financing, co-production arrangement with a venture named Legendary Pictures, headed by venture capitalist Thomas Tull, and backed by a group of private equity funds. The deal called for Legendary and Warners to be 50-50 co-financing partners on 25 films to be produced throughout the five-year term of the venture. The slate included films developed by Legendary as well as Warner Bros.[10] The studio would distribute all films, but its distribution fees and recoupment of expenses was not disclosed.

Tull reported that his financial plan was designed around private equity and returns, and he cited the DVD explosion and international boxoffice growth in recent years as the chief reasons that films were a more attractive asset class. Legendary's investors included ABRY Partners, AIG Direct Investments, Banc of America Capital Investors, Columbia Capital, Falcon Investment Advisors and M/C Venture Partners. San Francisco-based investment banking firm Perseus acted as financial adviser to Legendary Pictures in the transaction.

The Legendary deal seemed to draw special press scrutiny, perhaps because it was so large (twice as large as Melrose Partners) and/or because it had the appearance of a new financing paradigm (unlike Marvel Studios, which could have been viewed as an experiment by a publisher, an industry anomaly, and which was not publicly touted as a “slate financing”). Consequently, more of Legendary’s terms were discussed publicly. Two remarkable aspects of the SFA included:

Relativity structured a deal to provide Marvel Entertainment with a $525 million revolving line of credit from Merrill Lynch Commercial Finance Corp….” Daily Variety, *WB, Relativity order up a six-pack*, 10/5/05.

10 Legendary Studio’s president is now former TriStar production head Chris Lee; Larry Clark, former CFO of Creative Artists Agency, is Legendary's COO and CFO; marketing vet Scott Mednick is chief marketing officer; William Fay, previously president of Centropolis Entertainment, is Legendary’s president of physical production. Tull, most recently director of media and entertainment holding company the Convex Group, is Legendary's chair and CEO.

- The slate finance group was staffed like a separate production studio, with its own brass, marketing executive and even a physical production president because Legendary was a co-producer with production personnel who planned to actively participate in the production and marketing process.
- Unlike some of the later slate financings (e.g., Gun Hill Road 1 & 2, Kingdom et al), the Legendary slate finance investors did not participate in revenues from the entire slate of Warner Bros. movies, and the studio had substantial latitude in determining what films were placed in the slate. The terms called for Warners and Legendary to co-produce five films per year, over the five-year term. The pictures selected had to be "mutually agreed upon with the studio." Reportedly, the consequences of refusing to "mutually agree" a film selected by the studio was payment of the studio's $6MM annual overhead charge. Clearly, since Warner Bros. had the power to choose the films that Legendary would co-produce and co-participate in, Warner Bros. had a financial incentive to put less promising (and riskier) films into the fund, and keep its best prospects for itself.

The early Legendary co-productions included *Batman Begins* (which proved successful), and the less successful *Superman Returns*.

Kingdom Films. Credit Suisse First Boston announced in September 2005 that it successfully raised $135MM and created a $370MM credit line for Kingdom Films, a company that CSFB had set up in June 2005 to fund a slate slate of Walt Disney Co. movies. CSFB said the $370MM credit facility was securitized, and Kingdom acquired a a 40% stake in the production and distribution of 32 live-action films (including *Flight Plan,* but no animated films) to be released under the Walt Disney Pictures or Touchstone labels. Kingdom's stake in Disney revenues included theatrical, merchandising, DVD and TV rights.

Virtual Studios. Barely four months after Warner Bros. announced the Legendary deal, and one month on the heels of Kingdom Films, Relativity Media reported it had signed a multipicture co-financing deal with Warner Bros. Pictures, which the studio confirmed about two months later (in December 2005). The studio announcement named Benjamin Waisbren's[11] investment entity Virtual Studios[12] as the co-financier, and affirmed the previously announced investment commitment of $528MM over a 16 month period. At least five films in the pool, in

[11] Waisbren was a former bankruptcy litigator and veteran investment banker whose background included stints at Salomon Bros. and Stark Investments. Los Angeles-based Virtual Studios was also a joint venture partner with Initial Entertainment Group, a private equity investor and joint venture partner with France's Exception Wild Bunch, and operated VS Financial with Relativity Media for single picture financing for independent films.

[12] Virtual was described as a joint-venture company that invests equity capital in the production and distribution of major motion pictures as well as in the movie's operating companies. In addition to the Warners deal, Virtual was a joint-venture partner in the production and acquisition of films with Initial Entertainment Group, and a private equity investor and joint-venture partner in the acquisition and distribution of films with Paris-based Exception Wild Bunch. Through VS Financial, which was a joint venture with Relativity Media, Virtual provided single-picture financing and other forms of debt capital for the production of independent films.

varying stages of development at the studio, were disclosed: *The Good German, Blood Diamond, The Assassination of Jesse James, Poseidon,* and *V for Vendetta*.[13] Unlike the Legendary deal, Virtual would not co-produce. And unlike some of its subsequent SFA's, Relativity would have no creative involvement in any of the films but would carry a producer title, which it could keep or assign.

Perhaps most notable about the Virtual slate is the selling strategy that was reportedly used to persuade the investor group. Kavanaugh claimed to have a software program which could predict revenue performance of films based on their production and marketing characteristics.

The Virtual fund was a blend of bank loan money and equity capital raised from private investors, but neither the debt nor equity providers were disclosed. Reportedly, the companies negotiated the slate and deal points in two weeks, and closed the transaction 60 days later. By this time, Relativity reported it had structured and consummated more than $2 billion in production slate financings, including Canton's Atmosphere Entertainment and Exception Wild Bunch of France.[14]

2006 SFA'S

Dune Entertainment. In January 2005, Fox Filmed Entertainment (comprised of 20th Century Fox, Fox 2000, Fox Searchlight, Fox Atomic and 20th Century Fox Animation) announced that it had signed a a 28-film, $325MM slate financing deal with Dune Entertainment. Fox retained worldwide distribution rights to its slate. Debt financingwas provide by Dresdner Bank. Dune was a newly formed company which was said to be focused on the ownership of entertainment content, and it was an an affiliate of hedge-fund Dune Capital. Few other details were reported at the time.

In November of the same year, Dune and Fox said they were extending their co-financing partnership, and Dune would invest an additional $325MM for an additional 16 Fox releases. Dresdner Kleinwort, the investment bank of Dresdner Bank, provided debt financing to Dune in connection with the arrangement.

Gun Hill Road I.[15] In January 2006, Relativity Media was back on the scene, announcing it would invest $400MM in Sony Pictures Entertainment and $200MM in Universal Pictures. This was the first SFA that involved two major studios. Relativity raised the capital with the help of Deutsche Bank, which underwrote the senior debt.

The deal called for Relativity to invest 50% of the production budgets of seven of Universal's films over two years: *Nanny McPhee*, *The Inside Man*, *The Fast and the Furious: Tokyo Drift, The Kingdom, Smokin' Aces,* an untitled David O. Russell project (which was later abandoned,

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[13] The Canton-produced *300,* which grossed nearly one-half billion dollars at the global box office, was later said insome reports to be added to the slate retroactively to make up for the super-tanking *Poseidon.*

[14] Neither of these arrangements appeared to have the characteristics of an SFA, as described above, and hence are not discussed further, except in passing.

[15] *Gun Hill Road* was the site of a Revolutionary War battle in which the underdogs were victorious.

reducing the number to six), and the already-released *Doom*. Relativity would receive 50% of the films' profits. The studio retained creative control and worldwide marketing and distribution rights.

On the Sony side, Relativity would invest in production of 11 Columbia Pictures films scheduled for released over a fifteen-month period, more than 40% of its slate. The pictures in the slate were not disclosed. Sony would only say that certain pictures in their slate were offered to Relativity, and Relativity had a right to choose titles they were interested in financing. Most accounts said the Sony's lucrative *Spider-Man* franchise was excluded from the slate.

Sony and Universal were allowed to retain creative control as well as worldwide distribution rights of their films. In calculating each studio's share of the profits, the separate slates would not be cross-collateralized.

Gun Hill Road II. Only four months after the $600MM Gun Hill Road deal with Sony and Universal, Relativity raised another $740MM to co-finance 19 films at the same two studios. The deal was said to be structured almost identically to the first arrangement. Deutsche Bank again underwrote the senior debt for the arrangement. Sony and Universal again retained worldwide distribution rights and creative control, and the films in the slate were selected by Relativity from a group of projects that the studio offered up.

Neither studio identified the films in the slate, but the fund was said to finance films scheduled for release in the second half of 2007. Like the first fund, each studio's participation and accounting was independent of the other's slate, but Relativity's investors invested in a single pool. After deduction of capitalized interest, Sony expected to derive roughly $350MM for 11 films, and Universal would take $315MM for eight titles.

Kavanaugh claimed that the performance of the first Gun Hill Road slate (which included Sony's *RV* and Universal's *Nanny McPhee* and *Doom*) enabled him to raise the capital for the second venture, and said that the films in the first slate proved his investment model. He also said at the time of the announcement that Relativity was creating an even larger ($1 billion or more) SFA with Sony, and he was looking for a second studio participant.

Melrose Partners 2. Subsequent to both the Melrose Partners 1 SFA (July 2004) and the Marvel Studios SFA (June 2005), Paramount underwent two major changes. First, shortly after the first Melrose Partners, the Viacom board voted to carve out two companies, a move which gave Tom Freston and Leslie Moonves their own companies to run. Basically, the split un-did the CBS merger and separated the broadcast part (renamed CBS Corp.) of the conglomerate from the faster-growing cable and film side (renamed Viacom, Inc.). Second, in December 2005, Viacom Inc. closed a deal to purchase DreamWorks SKG for pay $1.6 billion.

It was the following October (in 2006), that Paramount announced it had made a $300MM, 30 film SFA with investment bank Dresdner Kleinwort, for production financing. The deal for its new Melrose Partners 2 fund was an increase of $75 million over its previous 2004 Melrose pact, which covered 25 pics. The films in the slate would include those released or produced by Paramount Pictures, DreamWorks, MTV Films and Nick Movies. Paramount Vantage and the Paramount Classics films were excluded from the package.

Films in the slate included *Mission: Impossible III, Nacho Libre, World Trade Center, Jackass Number Two, Freedom Writers, Norbit, Shooter, The Spiderwick Chronicles,* and the previously released *Failure to Launch.* Paramount said the fund followed the basic outline of the Melrose

Partners 1, which was arranged by Merrill Lynch, with Dresdner Kleinwort[16] serving as lead arranger for the senior notes. Capital was provided by a mix of institutional investors and hedge funds, and the arrangement called for the fund to provide about 20% of the production budgets for all films in the slate. Melrose Partners 2 reportedly added some features, such as revolving access to the fund rather than a one-time draw down and repay.

2007

2007 was a year of some pause for the SFA dealmakers. The sub-prime crisis in the U.S. and a global credit crunch threatened to derail the SFA trend. It was largely an empty threat, as it turns out; at least four SFA's closed during the year. The cumulative SFA capital for 2007 was $1.95 billion, down 15% from 2006's $2.35 billion.

Relativity Media Holdings. In January 2007, Relativity Media Holdings, a wholly owned subsidiary, announced it had signed a co-financing pact with Citigroup Corporate & Investment Banking to invest up to $1.1 billion in 80-100 studio films. Unlike any of Relativity's previous deals, this fund reportedly gave Relativity the discretion to choose films for investment. Like the Gun Hill Road deals, the five-year pact was intended to involve two major studios, one of which was said to be Sony. Sony declined to confirm the deal. Later reports said that Universal was the second studio.

Kavanaugh said that this arrangement was different because Relativity owned 100% of the equity, and there were no third-party hedge fund equity-holders. He added that Relativity would only enter into contracts with studios that were willing to share access to their film product at an early stage, and said there would be no studio cherry-picking of the most promising films for exclusion from the slate (such as the Sony/Spider-Man and Warner Bros./Harry Potter franchises). He further emphasized the future deals would require that virtually every film in the slate be vetted by Relativity. The deal provided that Relativity would not share in marketing costs, nor financially back studio development deals. And unlike other Relativity deals, Relativity would share in distribution fees.

New Line Cinema & RBS. Also in January (and one day after the Relativity Media Holdings SFA was announced), New Line Cinema reached a 20-film, $350MM, 2-year co-finance deal with the Royal Bank of Scotland, which included the 2007 releases *Hairspray, Rush Hour 3* and *The Golden Compass*. Spokespersons for the studio said the co-finance fund would serve as an additional source of production capital to the roughly $500MM annual allocation from Time Warner, which was intended to provide financing for 12-15 films with an average cost of $35-40MM. New Line added that the RBS co-finance pact would facilitate New Line's its shift towards more tentpole films.

The arrangement required RBS to invest equity and let it share in profits of the slate, which covered a wide range of genres and budgets (*Inkheart*, *Ghosts of Girlfriends Past*, and *Semi-Pro*). This was RBS's first SFA arrangement, although it had long been involved in entertainment lending, and had set up credit lines for New Line in the past. Alex Brown, Managing Director

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[16] Laura Fazio was managing director and head of media, global banking, at Dresdner Kleinwort during Melrose Partners 2. Headquartered in London and Frankfurt, Dresdner Kleinwort is the investment bank of Dresdner Bank AG and a member of the Allianz Group.

and head of Structured Asset Finance, Media & Entertainment at RBS, said RBS had two or three new co-finance deals in preparation.

Dune Entertainment. In August 2007, Dune Entertainment and FFE extended their co-financing partnership for a third time, this time committing to invest more than $500MM in a slate of films over the next three years. No titles were released, and the number in the slate was not disclosed. This time, the debt financing was reportedly provided by Societe Generale Corporate & Investment Banking and Dresdner Kleinwort.

In September 2007, Dune Capital Partners appointed Village Roadshow Pictures founder Greg Coote chairman and CEO of Dune Entertainment. Coote was formerly a managing director of Rupert Murdoch's TV interests in Australia. Larry Bernstein, who had been a financial consultant to Dune Entertainment since 2005, became CFO of Dune Entertainment.

United Artists. In August 2007, MGM-owned United Artists closed a $500MM SFA with Merrill Lynch. The deal was executed shortly after Goldman Sachs backed out of an underwriter proposal to commit $1 billion to MGM, which was regarded as a reaction to an increasing credit crunch worldwide. MGM CEO Harry Sloan said that the "MGM franchise film fund" would be offered at later date. The UA deal included financing for 15-18 films over five years, including two projects in production: *Lions for Lambs*, and *Valkyrie*.

MGM itself was a large investor in the deal (accounts varied between $50-$100MM), which had been in discussions for months. Reports said that the bulk of the financing was a revolving debt facility, provided by Merrill Lynch. Additional funds came from undisclosed hedge funds and more than 15 institutional investors based in the U.S., Europe, Asia and Africa. Paula Wagner and Tom Cruise became co-owners of UA in November 2006, and had begun raising money with the assistance of CAA almost immediately. By the time the UA/Merrill Lynch SFA closed, MGM was a 65% owner, and Cruise/Wagner owned the rest.

By November, it was clear that *Lions for Lambs*, a $35MM film, would be a disappointment, and was not expected to gross more than $60MM worldwide.

2008

Thus far (March 2008), only one SFA has been announced:

Relativity Capital. In late February 2008, Relativity and Universal entered a four-year co-finance arrangment said to provide an estimated $1 billion in equity for virtually the studio's entirely slate, according to Kavanaugh. It was the third time that Kavanaugh made an SFA with the studio. The slate included more than 40 films, for which Relativity would provide about 75% of the financing. Some reports said the fund was about $500MM, others said it would provide "billions" in financing. The revolving nature of the fund may explain the discrepancy; according to some insiders, Relativity might have $400-500MM invested at any given time, but the total invested over the term could exceed $1 billion. Relativity Capital was a subsidiary of Relativity Media formed in January with New York hedge fund Elliott Assoc., which was an investor in earlier funds such as Gun Hill Road 1.

The pact included all Universal producer and distributor subsidiaries and affiliates, including Working Title and Imagine Entertainment, but excluded Focus Features. In general, the fund functioned similarly to the Relativity Media Holdings deal signed in January 2007. Like that deal, Relativity had co-greenlight authority with the studio; Kavanaugh described it as a "true partnership." Sources inside said that Universal would present film projects to Relativity, who could choose to opt in or not. Other reports said that each side could opt out of a fixed number of projects. In particular, Universal had the option to retain full control over *The Mummy 3*. Still other reports confusingly said that unlike prior funds with Universal, this one was not built around pre-selected films.

Relativity would invest only in production, not distribution, and the studio would recoup its marketing costs off the top. Universal's distribution fee was not disclosed, and Relativity's participation in those fees (if any) was not indicated. Like many recent SFA's, Relativity would participate in every medium of revenue the studio had, in perpetuity. Relativity Capital reportedly was the underwriter of the capital structure, and no outside bank was used.

The prior month (January 2008), Relativity announced it had secured $1 billion-plus from Elliott Associates and launched the subsidiary, Relativity Capital. The announcements said Relativity Capital would acquire slates, single films, libraries, vidgames and TV and new-media assets, and would also sponsor or invest in transactions structured by Relativity Media. It further announced that Relativity Media had more than $4.5 billion in production slate financings on its resume.

The Relativity Capital SFA was the first deal where Relativity served as the principal and retained the mezzanine and equity levels of investment. Kavanaugh said that Relativity Capital now had buying power comparable to the biggest media congloms

Films in the slate have a wide budget range: $20 – 180MM. Disclosed projects included: *Leatherheads*, *The Wolf Man, Hellboy 2: The Golden Army,* and *The Fast and the Furious 4*.

FINAL REMARKS

This new wave of film finance is a portfolio approach to film production and in some cases, development and distibution, in which debt and equity investments are made in a slate of films. Having proven themselves over a five-six year period, and still increasing in number, slate financing arrangements ("SFA's") have a singular character that establishes them as a unique device in the realm of motion picture finance which has as much permanence as other long-standing vehicles for film finance such as discountable-contract finance, production-financing and distribution agreements, and single-picture private placements.

SFA's are transforming into near-partnership like arrangements, with the studio and lead investor acting as partners in selection of product, if not development, production and distribution. Many, if not most SFA's, do not require disproportional participations in the slate's upside to offset risk, a feature which distinguishes them from most low-budget investment deals and venture capital investments. That is, a 20%-of-budget investment earns 20% of profits (after deduction of distribution fees and expenses), a 50%-of-budget investment earns a 50% split of profits. Provisions that allow the studio to retain complete creative control, and unfettered discretion over which films go into the slate, have become anachronistic, due partly to the leveling off of DVD revenues in 2005 and 2006, partly to the well publicized failures like *Poseidon,* and party to the equally well publicized bearishness of some studios for their tentpole franchises like *Spiderman* and *Harry Potter.*

The history of the SFA development puts a number of questions for film finance professionals, producers, and distributors into the light. What will happen to this trend as the global credit crisis and the recession (or "economic downturn") in the U.S. continue to unfold?

What will the very successful promoters and lead investors like Relativity, Legendary and Dune transform into? How will new content delivery systems affect their transformation? Does the ascent of these outsiders – the SFA studio-cofinanciers – augur an expansion of membership among the elite major studios? And lastly, what are the ramifications of this wave of portfolio-style finance for the low-budget producer, or for any producer without a distribution pipeline?

If history is any indication of the future, entrepreneurs and film finance professionals will create ways to expand the effectiveness of SFA arrangements into the low-budget independent sector. The chief obstacle, perhaps, is that there are a limited number of studio distributors with limited theatrical distribution capacity. Additionally, there is a limited supply of studio co-finance capital. Perhaps there is an alternative strategy the independents will devise that offers an investor group the same assurances that a studio-distributor's internal rate of return offers. Their success may depend a great deal on how well some recent "non-SFA's" perform. Companies like Endgame, Wildflower and Spark Capital recently pooled huge sums of capital or obtained very substantial credit lines without a major studio slate-distribution commitment. If these entities fail, private equity and Wall Street advisors will be quick to point out that their flaw was to omit one essential ingredient: distribution. Maybe a new distribution medium will emerge as a suitable substitute for theatrical distribution, and a studio commitment will be unnecessary. Or maybe SFA's will remain a finance vehicle which belongs more or less exclusively to studios and the independents will simply have to paddle into position for the next wave.