PRIVATE FILM FINANCING

Gains and losses in the Norwegian film sector

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Abstract

In a white paper to the parliament the Norwegian Ministry of Culture and Church Affairs in 2004 noted that while many of the recent national films could show a healthy return on its private capital of more than 50 percent there seemed to be a notable lack of participation from the traditional investment community in the financing of these films. This report explores the economic reasons for the lack of involvement applying a project financing perspective.

A financing and performance review of all the Norwegian films that were theatrically released in 2005 reveals that while these films collectively lost 20 percent of their private capital some showed very strong returns for their private investors and others produced severe losses. Generally, the distribution of performance outcomes did not converge to an average and extreme outcomes were common.

It is also demonstrated how positioning within a film's structured finance affects investment risk, and how the conditions to which public funding is offered affects conditions for private financing.

The findings indicate at least two possible reasons as to why the traditional investment community in Norway may be hesitant to participate in feature film financing: An overall negative return on private capital and extreme performance outcomes for the individual projects. However, the analysis also shows that the right application of layered finance may open for investment opportunities more attractive to risk-averse investors from outside the film industry.

Key words: Film financing, structured finance, cultural policy, public funding, film industry.

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Preface

The Norwegian film sector operates in both spheres of culture and commerce, and understanding its operation in light of one requires an understanding of its position in the other. For instance, the Norwegian Film Fund, which is its largest contributor of capital, does not invest on a commercial basis but to fulfill certain objectives in the government's cultural policy. This research report investigates private capital investments and the lack of participation from the traditional financial sector, and its perspective is thus primarily the one shared by most private investors, - the film sector as commerce. This perspective does not ignore its cultural significance, and I hope the findings presented herein will be informative for both perspectives.

I would like to thank The Norwegian Media Authority (RAM), the Norwegian Film Fund, as well as those in the industry who let themselves interview, for making this research project possible.

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Terje Gaustad

1. Introduction

It is sometimes said that the most creative work done in the film business is carried out far away from the lights and cameras by the people who finance the films. While in most cases this statement may be greatly exaggerated, it suggests that film financing is not always a straight forward transparent process accessible to any potential financier.

In a white paper to the parliament the Norwegian Ministry of Culture and Church Affairs in 2004 noted that while many of the recent national films could show a healthy return on its private capital of more than 50 percent there seemed to be a notable lack of participation from the traditional investment community in the financing of these films. And it went on to ask why it is so, since many of the film producers at the same time seemed to lack the capital base needed secure equity capital for their films (St. meld. Nr. 25, 2003-2004).

A brief review of the international film business trade papers will reveal that the problem is not exclusive to the Norwegian film business, but that it resounds internationally with various strength from territory to territory. Furthermore, European public funding bodies for the film sector seem to be increasingly concerned with how more private finance can be linked with their public finance[1].

This exploratory study will seek to identify and discuss some key factors that may explain why investors from the traditional financial community so often do not participate in film financing even when the potential return on investment seems healthy. Due to their lack of involvement these financiers may be defined as *outsiders* to the film business. Key questions then become *what challenges and opportunities these outside investors face if they are considering to enter into film financing* and *how the film business insiders better can attract the outsiders to participate*.

First, the study will review the financing of all Norwegian films released theatrically in 2005 to determine how the financing was typically composed. It will also map the market performance of these films to estimate earnings and return on investments. Based on this data the challenges and opportunities for outsider financiers will be analyzed and discussed.

[1] This was for example a central theme at the EU conference "New Horizons for Europe's Audiovisual Sector" (Utrecht, 25.-27.9.04).

The study is done within a framework of project financing[2] literature. The project financing literature offers reference to and experience from challenges in structuring financing for a wide variety of sectors and industries that are similar to those met in film financing.

1.1 Methodology

The empirical analysis is primarily based on documentation provided by the Norwegian Film Fund. This public funding organization was involved with all the national films released theatrically in 2005, and the set of documentation collected for their own evaluation and review process for each film thus represents a unique and somewhat standardized source of evidence. Included in the documentation on each film was the financing plan, which provided valuable information about financing structure, and the main distribution agreement, which typically includes provisions about the allocation of revenues. Furthermore, the producers are obligated to copy the Film Fund on their film's earnings statements. While these were not always complete, partly due to the fact that some of the films were not yet released in all media, they provided valuable evidence against which estimated revenues could be checked.

Understandably, some of the Film Fund's documentation had to be treated confidentially. So while this report can present exact average values and examples from actual deals, it cannot give a complete picture for each identifiable film. However, for the objective of the report this is also not necessary.

In addition to the Film Fund documentation, the study draws on interviews with the producers who were responsible for the financing of their respective film. The interviews complemented the film fund documentation, and did also offer information on details that were not necessarily included in the paperwork for every film. Producers for seven of the total nineteen films were interviewed.

[2] See Finnerty (1996) for an introduction and overview.

2. Film Financing

The financing of Norwegian theatrical feature films, most independent films internationally and to a large extend also the Hollywood studio films is best understood in terms of project financing[3]. Generally, project financing is used when a particular facility or a related set of assets is capable of functioning profitably as an independent economic unit (Finnerty, 1996). In the case of film financing the feature film itself constitute this set of assets. Project funds are used to create a film with supporting materials such as trailers and other marketing materials that when completed will be exploited to generate a cash flow from which the project finance can be serviced. While films are quite easily definable as independent economic units many have little or no prospects of showing any profits, but this is typically compensated by one or more public funding parties willing to take the economic loss and thereby providing the remaining financing parties with a real possibility of obtaining economic benefits.

The project financing literature typically focuses on other types of projects and on projects much larger than Norwegian feature films. Power plants, toll roads and pipe lines are more typical for the literature than feature films. Yet, as films are made on a project basis and meet the general requirements of project financing, the project financing literature provides a fruitful framework for understanding film financing.

2.1 Project Financing

Finnerty (1996) defines project financing as the raising of funds to finance an economically separable capital investment project in which the providers of the funds look primarily to the cash flow from the project as the source of funds to service their loans and provide the return of and return on their equity invested in the project.

A project will have one or more sponsors who initiate it. These project sponsors, other providers of funds, as well as the financially responsible parties providing credit support and security arrangements must agree to make available all funds necessary to complete the project. In the film financing case the sponsors are the producers who initiate the film projects. Together with the film's investors they must ensure that enough funds are available to finish the film before they commence production. Investors will

[3] Project financing is part of the broader defined area of structured finance (Davis, 2005).

often require various security arrangements such as cast and crew insurances and completion bonds. When contracted, the completion bond company is responsible for providing additional funds to see the film completed in case the production runs over budget due to various unforeseen events. It is thereby ensuring completion of the film to the other project parties (Rudman and Ephraim, 2004).

Furthermore, the parties have to agree and ensure that when project completion occurs and operations commence, the project will have available sufficient cash to enable it to meet its operating expenses and debt service requirements. Completion of the film project occurs when the film is delivered to its distributor with all supporting materials and paperwork. The distributor will then exploit the film in all possible media and markets and this exploitation represents the operation of the project. Typically the distributor will provide or otherwise be responsible for the funds necessary to carry out the exploitation (Cones, 1997). By contracting a distributor at such terms before commencement of production the producer may ensure that sufficient cashflow will be available for the exploitation of the film.

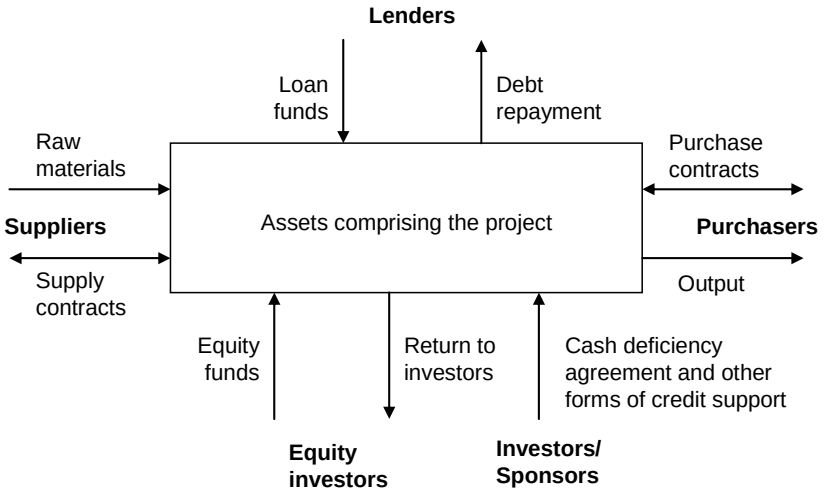
As in conventional direct financing the basic categories of project finance are debt and equity, but while direct financing investors will look to the firm's entire asset portfolio for security and servicing of the investments, project financiers may only look to the project related assets and cash flow. The critical distinguishing feature of project financing as opposed to direct financing is that the project is treated as a distinct legal entity. Project assets, project-related contracts, and project cash flow are segregated to a substantial degree from the sponsoring entity.

Figure 2.1 illustrates the basic elements of project financing, and figure 2.2 illustrates the same for a film project. At the center is a discrete asset or a related set of assets that has a specific purpose. In the film business this can be one single film project as observed in this study, but also a slate of film projects or finished films[4]. A project must include all the facilities that are necessary to constitute an economically independent, viable operating entity. In the case of film financing this means that the film project must include all elements necessary to complete delivery of the film to the distributors, which represent the project's purchasers. Purchase contracts take the form of distribution contracts and the project's output is the various distribution rights to the film.

[4] Raising project financing on a slate of films seems to be an increasingly popular financing tool used by the bigger Hollywood based film companies (Eisbruck, 2005)

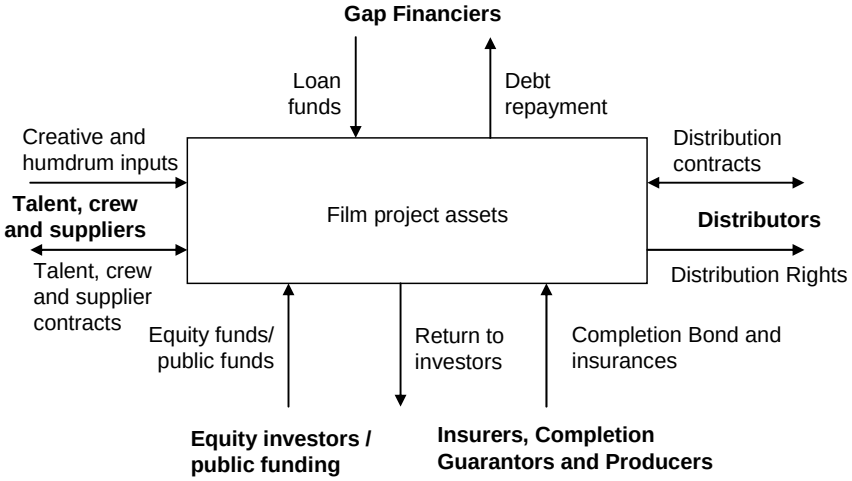
Suppliers are the wide range of creative and technical personnel as well as service providers and suppliers of raw materials ranging from film stock to set construction materials. These are contracted by the project entity to provide all input necessary to complete the film.

Figure 2.1 The basic elements of a project financing



Source: Finnerty, 1996

Figure 2.2 The basic elements of a film project financing



The project sponsors, or in the film business case the film producers, must reach financial closure[5] by securing sufficient funds – debt and equity – for production and operations. The debt and equity elements of the project financing are tailored to the characteristics of the project, and key factors are the nature of project cash flow and the collateral value of the project's assets. For film projects there will typically be a very high degree of uncertainty in predicting the level of cash flow generated from its exploitation. The demand for a specific feature film will always be uncertain up until the point where one can place the finished film in front of its buyers. It may be a commercial success generating revenues far exceeding its costs, but it may also flop finding very few buyers who place any positive value on it. Research carried out by DeVany and Walls (1999) shows that films are among the most risky of products as the probability distribution of their theatrical earnings or box-office has infinite variance. One may say that the film business is not a "normal" business because outcomes do not follow a normal probability distribution. The variance of box office revenue is infinite, so any cashflow projections will be highly uncertain and the level of risk generally taken when providing funding for a film project is thus high.

The collateral value of the film project's assets is affected by this uncertainty. Before the project is completed and the film released the collateral value will generally be low because nobody can guarantee that the film will not flop. In the cases where a film performs poorly in the market, the collateral value is furthermore affected in a negative direction due to the very high degree of *asset specificity* for most of the assets created in a film project. High asset specificity means that the assets cannot be redeployed outside the context of the project without sacrificing productive value (Williamson, 1985). Most of the assets are unique to the project. Footage shot for one film are seldom of any value whatsoever to other film projects, so the film it is shot for has to perform well for it to have any value.

Generally, the level of uncertainty associated with a project's ability to generate cash flow and the collateral value of its assets is reflected in its optimal debt-equity ratio. Typically, higher-risk projects take more equity to protect the interest of lenders, while lower-risk projects can accommodate more debt (Merna and Khu, 2003). Williamson (1988) links the debt-equity financing decision directly to asset specificity, arguing that equity financing is best suited where asset specificity is high. One would thus expect to find very high equity shares in film project financing compared to other types of projects offering less market uncertainty, lower asset specificity and thus

[5] Financial closure is the point at which the project participants reach a formal agreement on the fundamental business structure of the project and the project's financing plans (Merna and Khu, 2003).

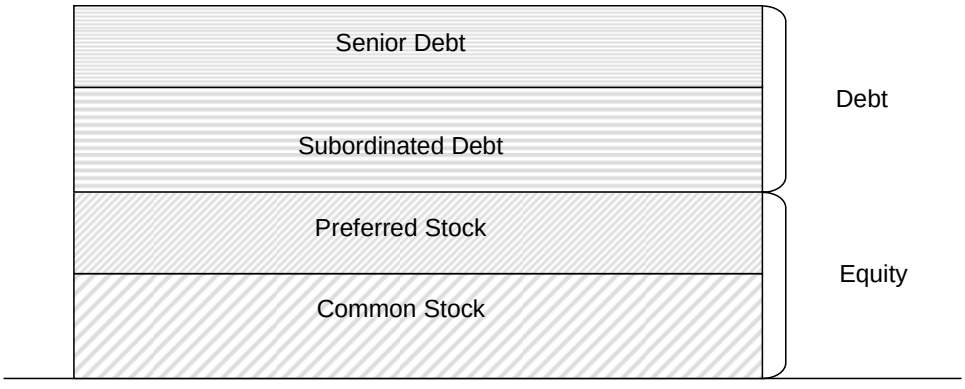
higher collateral value. While for example toll-road projects may see debt-equity ratios around 95-5 (Merna and Khu, 2003), independent feature films made for the international market seldom see more than 20-80 (Pendreigh, 2003).

2.2 Layered Finance

Achieving financial closure is always difficult, not only for film-projects, and all project financing thus require careful financial engineering to allocate the risks and rewards among the involved parties in a manner that is mutually acceptable. It is often necessary to find financing structures that offer more than the two basic layers of debt and equity. This allows the project sponsor to provide a larger group of different investors with instruments that match the risk/return characteristics best suited to their appetites and requirements. The increased pool of potential investors then available may allow the project sponsor both to close the financing and to reduce its cost of capital.

Layered financing can generally be applied to both debt and equity by adding one or more layers of subordinated debt and preferred stock (Parra and Kahn, 2001), see figure 2.3. When subordinated debt is used the senior lender agrees to lend to a project because, relative to the subordinated lender(s), the subordination provides it with priority rights to both debt servicing and security. In return for ceding these rights to the senior lender and assuming greater risk, the subordinated lender benefits from the higher yield.

Figure 2.3 Layered project financing



Parra and Kahn (2001) recognize three general categories of project partners that typically will be willing to take a subordinated position:

- First, *a project "insider"* may become a subordinated lender to substitute debt for required equity. Among such insiders are project sponsors, service providers and other parties whose primary motivation is to ensure the sale of its product or service to the project vehicle.
- Second, *an "investor"* not otherwise affiliated with a project or its sponsors but desiring to make an investment in the project because of its profit-making potential also may choose to become a subordinated lender to characterize its investment as debt rather than equity. Typically, these investors purchase project convertible (subordinated) debt and seek profits available from the conversion of their debt to equity if the project is successful.
- Third, *a project "catalyst"*, a party unaffiliated with a project or its sponsors or investors that desires to promote investment in a country or region, may choose to become a subordinated lender by providing subordinated loans in amounts sufficient to motivate commercial lenders to participate as senior lenders in a given project's funding.

In film finance, the first category is a common ingredient in a project's financing plan. Producers and key personnel as well as service providers often defer part of their fees to be recouped in a subordinated position. Furthermore, some investors, matching the second category, tend to accept lower priority in return for a larger share of the film's potential upside. And finally for the third category, public funding bodies, whose prime motivation may be either to see national films produced or to attract filmmaking activity to their region, provide subordinated funding to help producers close financing on films that coincide with these goals.

The line between debt and equity can sometimes seem blurry in film finance since equity investors do not necessarily obtain an ownership share in the special purpose company set up for the film, if any, or in the film's copyright. However, investors who acquire a share in the films potential profits is typically considered equity investors while those earning interest, either at an ongoing rate or defined as a fixed markup on the funds provided, are considered lenders.

2.3 Common Elements of Independent Film Finance

The different elements of layered debt and equity finance found in any film project will depend on the film's characteristics and qualities as well as on

the institutional environment within which it is produced. However, for so-called independent films[6] there is a set of elements that are commonly utilized. These are minimum guarantees, gap loans, equity and deferments, and for most European productions public funding may also be added as a fifth element.

Minimum guarantees (MGs) are advances paid by distributors against the producer's share of revenues generated by the distributor from exploiting the film. When distribution agreements are closed before start of production the MGs become part of the film finance and contributes to financial closure. If the finished film should perform worse than anticipated when the MG was agreed and paid out so that the producers share of revenues actually turns out to be lower than the MG-amount, the difference will not be repayable to the distributor – thus the term minimum *guarantee* (Cones 1997, 1992; Baumgarten et al 1992). The MG is thus in essence a limited recourse loan from the distributor to the producer where the distributor can only look to the revenues it generates from exploiting the film as security for its loan.

Gap loans are senior debt loans fully repayable from first revenues received by producer. If gap loans can be obtained and how much of the project financing they can cover, depends partly on the level of MGs. The higher the MGs, the more of the film's revenues will be retained by the distributors to cover the MGs. Accordingly, with a higher level of MGs utilized in the financing a gap lender will have to wait longer until the film generates enough cash flow to start repayment of its loan. The specific terms for different gap loans vary, but they are typically limited recourse loans secured in the producer's share of revenues, i.e. the cash flow generated by the film that is paid out from its distributors to the producer.

Equity includes all cash investments made in consideration for a share of the film's profit, if any. Sometimes an equity investment entitles the investor to a share ownership in the film's copyright or in the special purpose company that produces and owns the film, but often the "ownership" is limited to a contractual share of revenues from which the investor may see the return of and on the investment.

Deferments are all or portions of salaries or compensation for cast, crew and suppliers paid on a delayed basis out of the film's revenues. The payment is thus contingent upon the film earning enough to pay it. A film project may have more than one class of deferred compensations, where one class may be

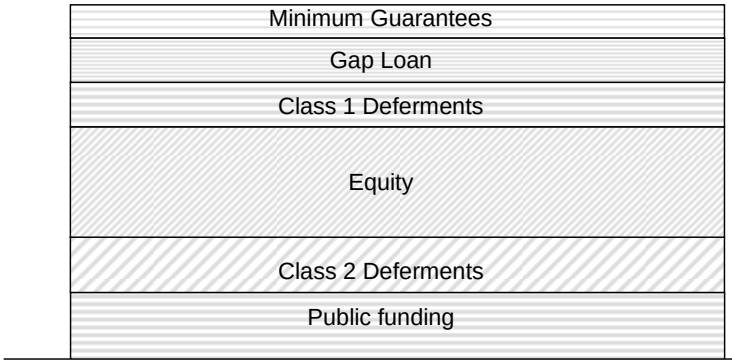
[6] An independent film is understood as a film made outside the control of a major integrated production-distribution company, such as the Hollywood studios.

subordinated to other deferments as well as other elements in the film financing.

Public funding provided by various public funding bodies through different public funding schemes is typically subordinated to all other financing elements, and in some cases the funding is non-recoupable. Public funding bodies will typically not require any share of profit or other form of ownership in return for the funding, so generally the public funding element of the financing is best described as deeply subordinated debt.

A possible layered financing structure of a film project containing these five common elements is illustrated in figure 2.4 below.

Figure 2.4 Layered film financing



2.4 Recoupment: Cash Flow and Waterfall

The gross income or cash flow generated from the operation of a project is allocated to cover its operational costs, servicing of the debt and eventually repayment of the debt. In the traditional corporate form of organization the management and board of directors decide how the cash flow is allocated, but when project financing is used the specific allocation of cash flow is governed in the project financing documents. This set of rules that prescribe how cash flow is allocated is known as the waterfall, and it must be agreed upon by all parties with an interest in the cash flow before financial closure can be reached (Finnerty, 1996; Bodington, 2004).

In what order and priority the cash flow is allocated vary from project to project, but typically the operating expenses are covered ahead of debt service and recoupment. What is left after operating expenses and lenders has been covered is referred to as free cash flow, and all free cash flow is usually distributed to the project's equity investors (Finnerty, 1996).

For a general project, a typical order of priority for the project cash waterfall may thus look like this (Parra and Khan, 2001):

1. Operating expenses
2. Senior debt service
3. Senior debt service reserve accounts
4. Subordinated debt service
5. Subordinated debt service reserve accounts
6. Restricted payments

Any free cash flow available when these elements are covered allows equity investors to recoup their investments and possibly earn a profit.

In a film project the cash waterfall is most often specified in the film's *net profit definition* or *net proceeds definition*. In addition to defining how the film's revenues will be allocated this document typically also incorporates the *gross receipts definition*, which states exactly what kind of revenues should be calculated into the cash flow being allocated. While the definition of the elements to be recouped from the gross receipts and their order vary from film to film, a typical but simplified order of priority for the film project cash waterfall may look like this (Cones, 1997; Baumgarten et al, 1992):

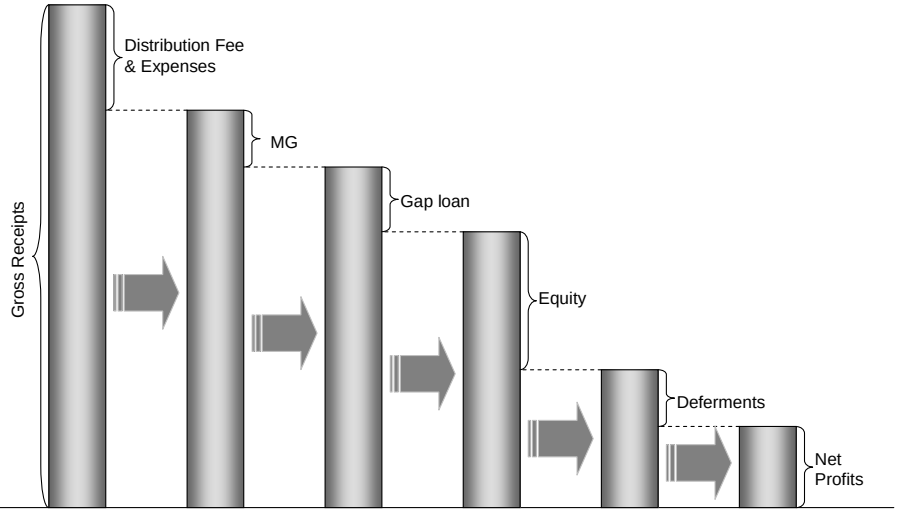
1. Distribution fees and expenses
2. Distributor's minimum guarantee
3. Gap loan[7]
4. Class 1 deferments
5. Equity
6. Class 2 deferments

After the operating expenses (distribution fee and expenses) are covered, the cash flow is allocated to recoup the financing elements in the priority order given by the film's layered financing structure illustrated in figure 2.4 above. In this case, the public funding is non-recoupable so no cash flow is allocated for it. Since the equity investors have already recouped their investments in fifth position any free cashflow available when these six elements are covered represents profit for the equity investors.

[7] An interest reserve account for the gap loan is often built into the production budget as a financing cost, but still it may also be added as a separate item in the cash waterfall in a position above the repayment of the loan.

The allocation of revenues as per a waterfall similar to the case above is illustrated in figure 2.5 below. The only difference here is that there are no class 1 deferments, but only one class which is subordinated to other debt as well as equity. From the total gross receipts represented by the first pillar the film's distribution fees and expenses are deducted off the top. From the remaining monies the distributor recoups its minimum guarantee, thereafter the gap loan is repaid, and so forth until all financing elements are recouped and free cash flow following operating expenses represents net profits.

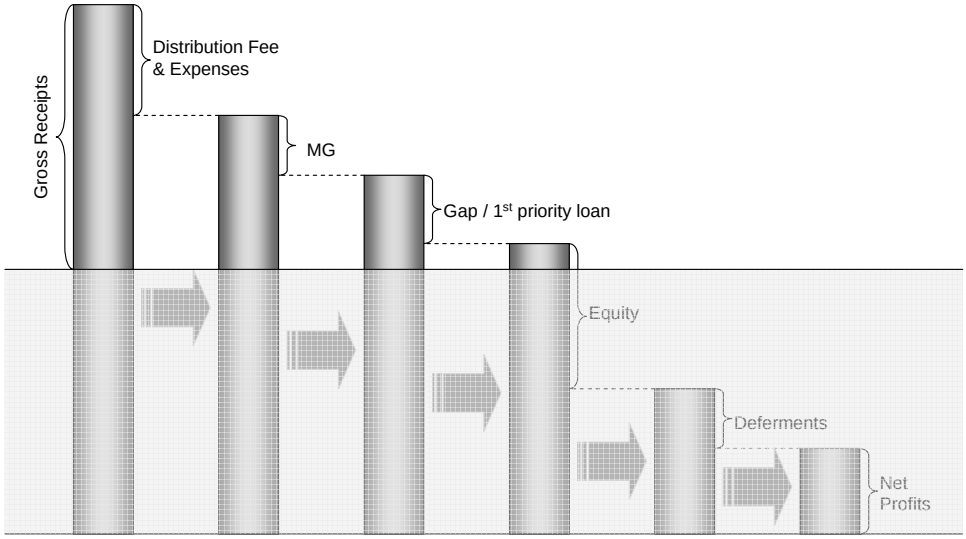
Figure 2.5 Waterfall recoupment



The allocation of economic risk between the film financing participants is easily illustrated by assuming that the film only earns half the revenues illustrated in figure 2.5 above. This is shown in figure 2.6 below where only the clear part of the first pillar above the new base line represents gross receipts earned by the film. Distribution fees and expenses will be covered as before and so will the distributor's MG and the gap financier's loan, but there will only be cash flow available to recoup a minor share of the equity investments. At this reduced revenues level no deferred payments can be made and the film will not earn any net profits. While the equity investors would have recouped their investment with a significant profit at the revenues level illustrated in figure 2.5, they would take a significant loss if gross receipts were reduced to half as illustrated in figure 2.6. However, the

distributor and gap financier providing debt finance carrying much lesser risk would not be affected by the shift in revenues.

Figure 2.6 Waterfall recoupment with reduced revenues



3. The 2005 Films: Finance

The total number of Norwegian feature films released theatrically in 2005 was 19, of which four were documentaries and fifteen fiction[8]. The budgets or required financing for these films ranged from NOK 2.9 million to NOK 22.8 million. The average budget was NOK 14.4 million, but this number is heavily influenced by a few very low budget films. The majority of films was budgeted at NOK 15 million or more, see table 3.1 and figure 3.1[9].

The total budgets include both production and so-called print & advertising (P&A) costs, and reaching financial closure thus required financing both production and P&A budgets. All the costs required to assemble the film up until it is ready for delivery to the distributor are defined as production costs, and these included development costs (screenplay, budgeting, etc.), cost of principal photography (actors, film stock, etc.) and post production costs (editing, music, etc.). P&A costs are the 'print and advertising' costs incurred to make the film available for the audience. As indicated by the term they include both duplication ('print') and marketing ('advertising') costs. On average NOK 11.9 million was spent on production while NOK 2.4 million was spent on P&A[10].

3.1 Public and Private Finance

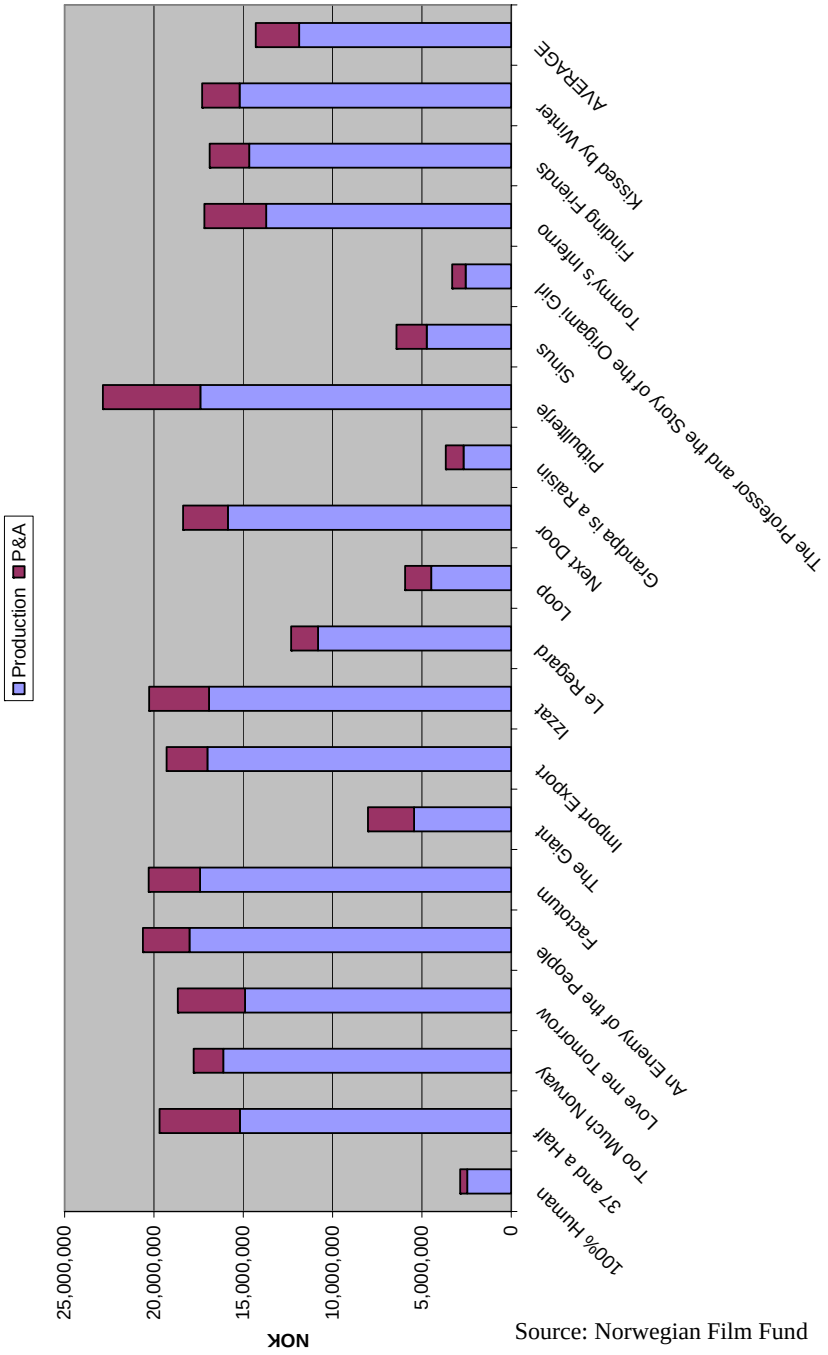
The financing of all the films included both public and private funds. The dominant source of public funding was the Norwegian Film Fund, which is the main body handling financial film support on behalf of the government. The fund's production financing support is mainly channeled through two systems: One where the review process and funding decision is handled by one of its film consultants, who assesses both the film's artistic and economic viability, and one where the funding decision is made primarily on the film's projected market potential. For both systems the fund expects part of the budget to be financed by private sources, but while the private share of the finance may be as low as 20-30 percent of the budget under the

[8] These include two films ("Grandpa is a Raisin" and "The Professor and the Story of the Origami Girl") with running time less than the 72 minutes minimum required in the Film Fund's feature definition, but the two films were still given independent theatrical releases and are thus of similar interest in terms of finance and market performance as the true features.

[9] All budget and financing figures are collected from the Norwegian Film Fund's files for each of the 2005 films.

[10] Foreign P&A is not included in the financing.

Figure 3.1 The 2005 Films: Budgets



Source: Norwegian Film Fund

consultant system the fund requires at least 50 percent private funding before it will consider a film under the market review system.

Table 3.1 The 2005 Films: Budgets

Title	Production	Distribution	Total
100% Human	2,460,318	404,000	2,864,318
37 and a Half	15,187,716	4,500,000	19,687,716
Too Much Norway	16,120,000	1,650,000	17,770,000
Love me Tomorrow	14,896,507	3,763,000	18,659,507
An Enemy of the People	18,000,000	2,615,940	20,615,940
Factotum	17,412,482	2,882,224	20,294,706
The Giant	5,436,365	2,582,600	8,018,965
Import Export	16,998,769	2,292,126	19,290,895
Izzat	16,910,233	3,353,500	20,263,733
Le Regard	10,824,811	1,500,000	12,324,811
Loop	4,482,016	1,462,000	5,944,016
Next Door	15,860,000	2,500,000	18,360,000
Grandpa is a Raisin	2,673,979	1,001,212	3,675,191
Pitbullterje	17,407,826	5,444,400	22,852,226
Sinus	4,734,684	1,700,370	6,435,054
The Professor and the Story of the Origami Girl	2,551,904	760,000	3,311,904
Tommy's Inferno	13,720,000	3,446,533	17,166,533
Finding Friends	14,671,146	2,200,000	16,871,146
Kissed by Winter	15,208,109	2,091,212	17,299,321
AVERAGE	**11,871,414**	**2,428,901**	**14,300,315**

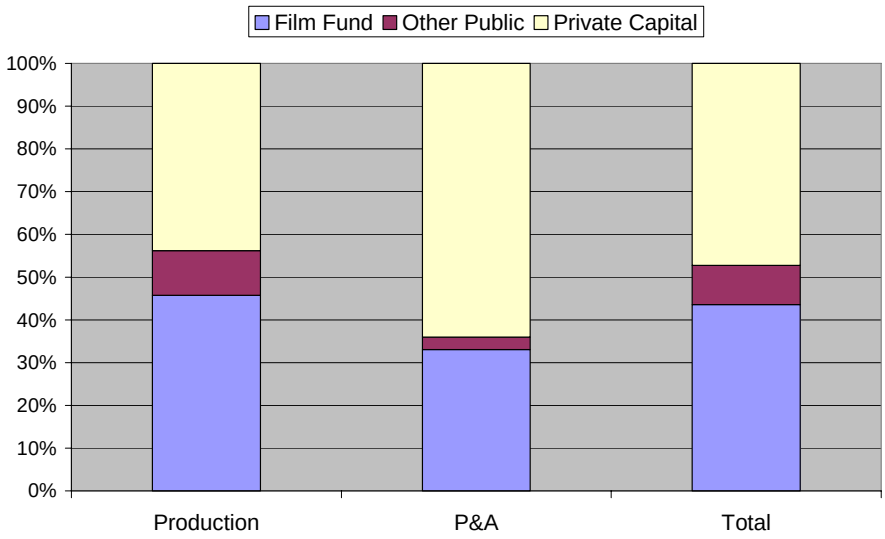
Source: Norwegian Film Fund

Other sources of public funding includes the Nordic Film and TV Fund, which provides production funds for films with theatrical distribution in at least two Nordic countries; Eurimages, which supports European co-

production; as well as smaller contributions from various other Norwegian public funding bodies.

For the average film 44 percent of the total budget was financed by the Film Fund and nine percent by other public funding sources. The balance 47 percent was financed from private sources (see figure 3.2 and table 3.2). In relative terms, the private capital financing was strongest for the P&A where it covered 64 percent of the funding. The combined public funding was strongest in both relative and absolute terms for the production where it covered 56 percent of the costs.

Figure 3.2 Average Film: Public and private finance



Source: Norwegian Film Fund

Table 3.2 Average Film: Public and private finance

Source	Production	P&A	Total
Film Fund	5,429,051	803,399	6,232,450
Other Public Funding	1,240,567	70,390	1,310,957
Private Capital	5,201,796	1,555,112	6,756,907
Total	**11,871,414**	**2,428,901**	**14,300,315**

Source: Norwegian Film Fund

The *catalyst* financing (Parra and Kahn, 2001) provided by public sources was thus very strong, covering more than half of the aggregate costs for all the 2005 films.

3.2 Sources of Private Finance

The structure of private financing varied significantly between the 19 films, but on average more than three quarters came from producer, distributor and the use of deferred payments. The *insider* element in the private financing was thus very strong.

The exact breakdown of the private funding was made into the following categories (see figure 3.3, table 3.3 and table 3.4):

Producer: This is the cash investment made by the film's production company or companies if more than one was involved, which typically takes the form of an equity investment. Of the average NOK 6.8 million total private capital the producer contributed NOK 1.2 million or 18 percent. Yet, the variance from film to film is significant. Lowest producer cash contribution was zero while the highest represented 57 percent of that film's private capital. The producer average investments cover almost equal shares of both the production and P&A budgets' private capital financing with 18 and 17 percent respectively. Note that the producer's contribution to the financing in some cases was bigger than reflected in these numbers since the producer sometimes also deferred a share of its budgeted fees.

Distributor: This is the cash investment made by the film's distribution company, and on average it represents the largest share of total private capital with NOK 2.6 million or 39 percent – more than twice the producer investment. It is divided between production and P&A with NOK 1.5 million and NOK 1.1 million representing 29 and 70 percent of the private capital, showing not surprisingly that the distributor is the dominant private P&A investor. Again the variance is significant, from zero to 82 percent of total private capital. These cash investments are typically made in the form of MGs, but some are also made as equity investments. Some distributors also contributed deferments towards the P&A budget in addition to their cash investment, so the average combined cash *and* deferred contribution is higher than 70 percent.

Deferments: These are budgeted production and P&A costs which are paid on a delayed basis out of the film's revenues rather than out of the budgets. In addition to producer and distributor deferments were made by production and post-production service companies, suppliers and key personnel such as

writers, directors and cinematographers. On average deferments covered NOK 1.4 million or 21 percent of the total private capital. Most deferments were made in the production budget where they represented 25 percent of the private capital. The variance from film to film was significant with some films avoiding the use of deferments completely while the highest deferment share of total private capital was 67 percent.

TV pre-sales: Some of the producers sold the television distribution rights before their film went into production and used the license fees to cover part of their private capital. Since many producers either chose not to do such pre-sales or were not able to, this source of private capital only represented three percent of the average total. The highest share was 24 percent, but this was for a lower budgeted film where a license fee at a typical level below the half million mark still can make up a quarter of the private capital. Funds from TV pre-sales were mostly allocated to cover production costs but in one case the entire pre-sale amount was included in the private P&A capital.

TV investment: Two of the films had direct equity investments into the production from television companies. In one case the investment was combined with a pre-sale splitting the television company's financial contribution into a pre-sale and an investment part. In the other case the full financial contribution was defined as an investment with no pre-sale recorded, but the TV company took co-producer status that likely secured television distribution rights. TV investments only made up for four percent of the average total and five percent of the average production investments, but for the two films that actually had such investments they made up an average 54 percent of the total private production finance indicating that TV companies may take an significant role in production financing.

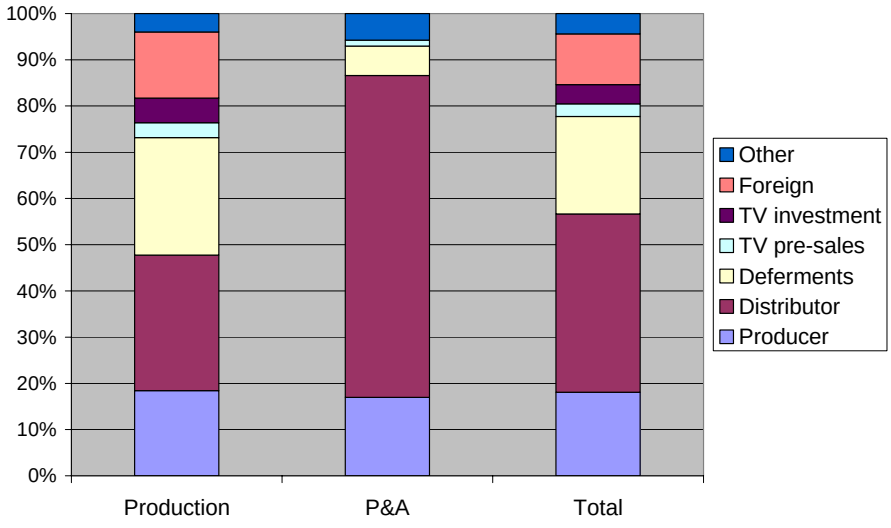
Foreign investment: These are investments made from a variety of foreign sources, but the primary sources were foreign co-producers and partners, distributors and television companies. The category thus largely represents the foreign equivalent to the producer, distributor and TV categories above. On average foreign investments represent 11 percent of the total private finance, but vary greatly dependent on the international character of each project from zero to 60 percent.

Table 3.3 Average Film: Sources of private capital

Source	Production	P&A	Total
Producer	957,666	264,004	1,221,670
Distributor	1,525,173	1,082,863	2,608,037
Deferments	1,322,089	99,339	1,421,427
TV pre-sales	166,842	19,222	186,064
TV investment	278,947	0	278,947
Foreign	743,327	0	743,327
Other	207,751	89,684	297,436
Total	**5,201,796**	**1,555,112**	**6,756,907**

Source: Norwegian Film Fund

Figure 3.3 Sources of private capital for the 2005 films



Source: Norwegian Film Fund

Table 3.4 Private capital spread for the 2005 films

Source	Low	High	Average
Producer	0%	57%	18%
Distributor	0%	82%	39%
Deferments	0%	67%	21%
TV pre-sales	0%	24%	3%
TV investment	0%	73%	4%
Foreign	0%	60%	11%
Other	0%	21%	4%

Source: Norwegian Film Fund

3.3 Layering

The financing structure of all the films had some element of layering, but varied from relatively simple structures to more sophisticated use of layering. However, the more advanced structures typically incorporated the basic elements of the simpler structures and one can thus see some overall common patterns.

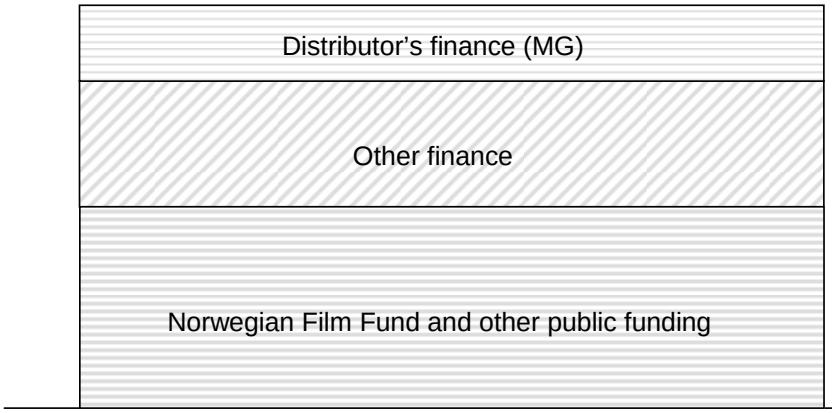
One common element was the finance provided by the Norwegian Film Fund. Repayment of monies provided by the fund for production and/or P&A costs were only due to start once the project had recouped an amount equal to 130 percent of its private capital, and at that point the share due to the fund equaled only 30 percent of its financing share. For instance, if the fund had financed 50 percent of a NOK 10 million film where the remaining share was covered by private capital, repayments to the fund would only start once the project had earned NOK 6.5 million and then only with 15 percent of the revenues received from then on going forward. The financing provided by the fund was thus deeply subordinated to other sources of finance, in line with its role as a project "catalyst" (Parra and Kahn, 2001).

Financing provided by distributors was another common element with relatively minor variance from project to project. The distributor's finance was typically provided in the form of an MG with full repayment due off-the-top in an exclusive first priority position ahead of any other financier. Furthermore, the distributor would typically be granted distribution rights to more than one media outlet or window (e.g. theatrical and home-video) with the right to cross-collaterise revenues so that ancillary market income would be fully allocated to recoup the MG should it not be covered by theatrical

revenues. Hence, in the project financing the distributor takes a position similar to that of a senior lender (Parra and Kahn, 2001).

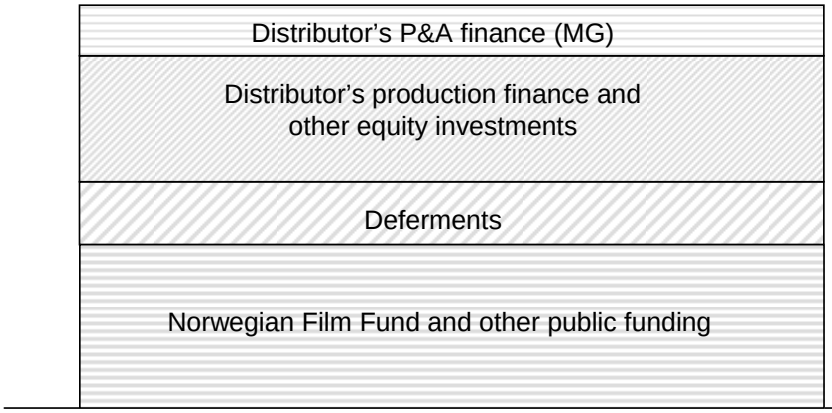
The Norwegian Film Fund and distributors thus generally defined a bottom and top layer in each film's financing as illustrated in figure 3.4.

Figure 3.4 Common layering for the 2005 films



In between these common upper and lower layers the variance seemed to be greater, and due to incomplete data also more difficult to map. The documentation available as well as interview data did suggest that equity investments in some cases took seniority over deferments and that deferments could be split in layers (with for instance producer's deferments being subordinated to suppliers' deferments), but also that various financing sources other than distributor's MG and public funding could be treated on a pro rata basis in one single layer. In one case the distributor's production finance was recouped on a pro rata basis with all other equity investments following the distributor's P&A finance, which was treated as an MG, and prior to the payment of deferred fees (figure 3.5).

Figure 3.5 Example of layering for a single film



Source: Norwegian Film Fund

4. The 2005 Films: Performance

The overall theatrical performance of Norwegian national films in 2005 was slightly weaker, but at the same level as the previous and following years. Of the total theatrical gross income the share held by national films was 12.5 percent, and of a total 230 films released that year 20 was Norwegian (including one reissued film excluded from this study) (Film & Kino, 2006). Yet, in line with the conclusions drawn by DeVany and Walls (1999) on motion picture market behavior, the performance varied dramatically from one film to another with some performing very well earning strong profits while others failed to find an audience and thus returned great losses to its investors.

4.1 Sources of income

The main sources of income for national films include both the usual sources of market revenues as well as public funding from the Norwegian Film Fund in the form of box office bonuses. The market revenues were split in two categories:

Theatrical revenues: The theatrical gross income from ticket sales (the box office) is split between cinema-owners and distributors, and the distributor's share (the film rental) is split between distributor and producer. The producer's share goes into the project pot that according to the film's waterfall first is used to service and recoup project lenders and investors and then, if sufficient, to earn a profit for the film's investors and other profit participants. The producer's theatrical revenues, which thus represent project cash flow, are calculated as 25 percent of the total box office gross[11].

Ancillary revenues: This category includes all project cash flow or revenues earned by the producer from exploitation of the film in all other markets, including home-video (DVD), pay and free TV, new media and foreign sales. In this report it is assumed that revenues from ancillary markets constitute 50 percent of producer's total market revenues, i.e. that ancillary revenues equal producer's theatrical revenues[12].

[11] This is the same share as used by the Norwegian Ministry of Culture and Church Affairs in their calculations for St. meld. nr. 25, 2003-2004.
[12] The Norwegian Film and Television Producers' Association has indicated that the ancillary share may be as high as 82 percent (St. meld. nr. 25, 2003-2004).

While all market earnings in this report are calculated based on reported revenues in only one market, the domestic theatrical market, the actual revenues reported to the film fund for eight of the films suggest that the calculated figures are quite accurate compared to actual figures. Total calculated revenues for these eight films were only 5.5 percent over the actual reported revenues.

The box office bonuses paid out by the Norwegian Film Fund to the producers equal 55 percent of the film's gross box office and are paid out up until the film's private capital plus overhead have been recouped from market revenues and box office bonuses. The actual bonus figures paid out to the 19 films were provided by the fund.

For the average film box office bonuses accounted for 53 percent of producer's total revenues or project cash flow generated while theatrical and ancillary markets accounted for 23.5 percent each (see table 4.1).

Table 4.1 Average Film: Sources of revenues

Producer's theatrical revenues	1,276,942	23.5%
Producer's ancillary revenues	1,276,942	23.5%
Film Fund Box Office Bonuses	2,873,705	52.9%
Total	**5,427,589**	**100.0%**

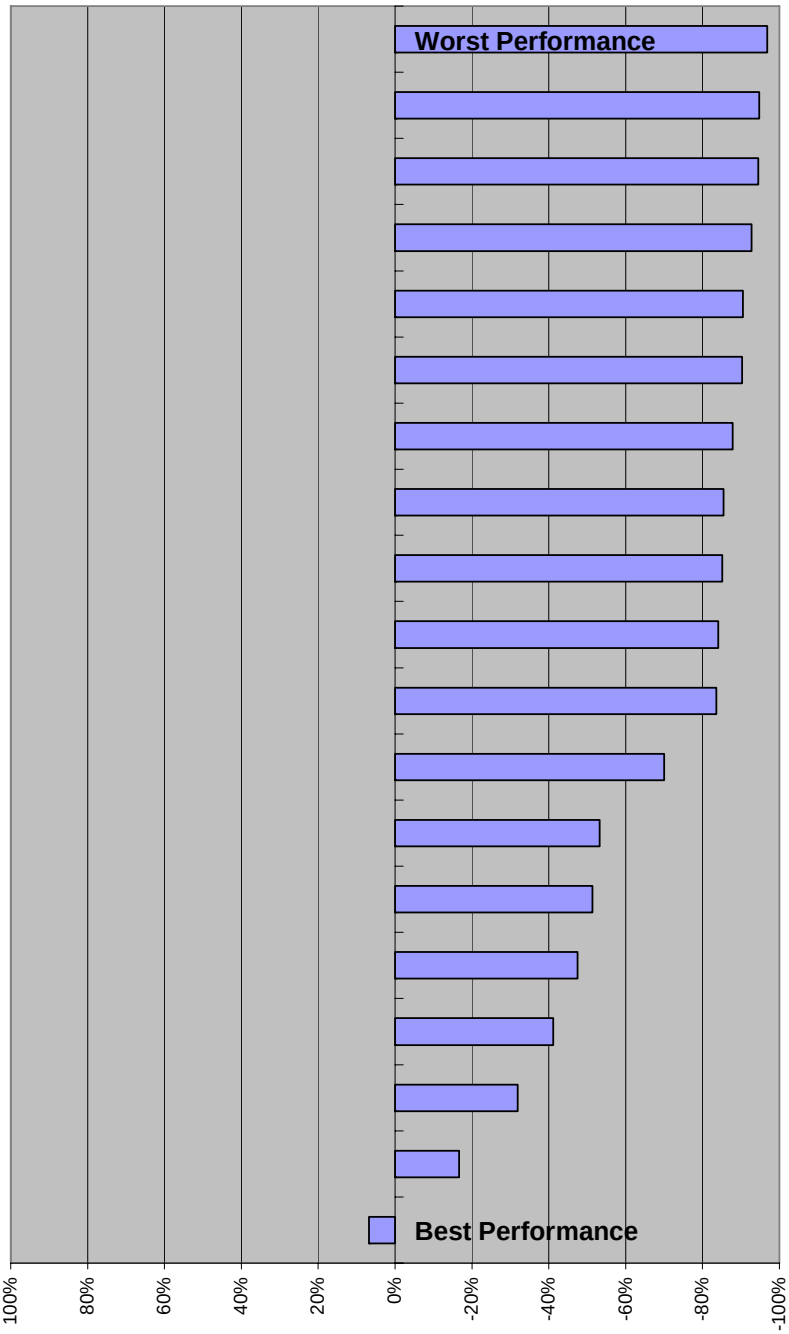
Source: Norwegian Film Fund

4.2 Return on capital

Generally one would not expect a positive return on capital for a Norwegian film. With the limited size of its home market and facing a significant cultural discount in foreign markets[13] it has proven very difficult for national films to generate revenues sufficient to cover their production and distribution costs. Positive returns would also undermine the argument for public funding which has played a major role in the Norwegian film business for decades. If the typical Norwegian film would produce a positive return on its capital, it would fulfill general requirements for project financing (Finnerty, 1996) and should be able to find the necessary financing without public support.

[13] For a discussion of cultural discount effects see e.g. Hoskins et al (1988)

Figure 4.1 Return on capital for the 2005 films



Source: Norwegian Film Fund

The simple measurement for return on capital used here is the ratio of money gained or lost relative to the money invested in each film project; where the money invested refers to the total budget. It is not annualized or in any other way adjusted to the time period the investment is held.

Aggregate figures for all 19 films show a loss of 62 percent, meaning that of the total NOK 272 million invested into the films by private and public parties NOK 169 million were left uncovered by aggregate revenues. The average film with a budget of NOK 14.3 million would incur a loss of NOK 8.9 million.

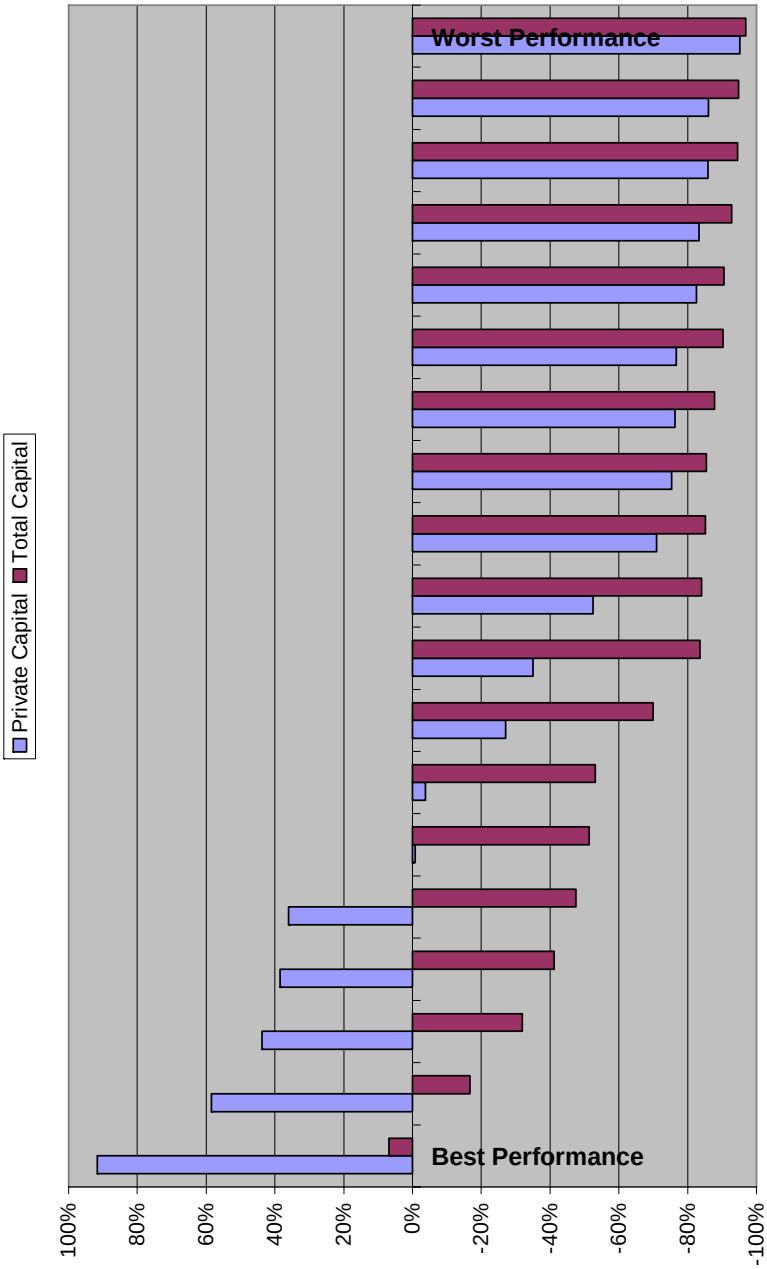
However, there is no typical or average film since box office revenue outcomes do not converge to an average (DeVany and Walls, 1999), and this is of course reflected in the return on capital figures. The significant spread in return on capital among the 19 films released in 2005 is shown in figure 4.1 above. The return is ranging from a seven percent gain to a 97 percent loss. The best performing film, which could show the seven percent gain, was the only film with a positive return on its total capital. All other showed losses. 14 films lost more than 50 percent and six films showed losses of more than 90 percent.

4.3 Return on private capital

A more relevant measure to examine why participation from the traditional investment community in film financing is absent is to look at the return on private capital. Of the aggregate figures private capital represents 47 percent of the total budgets or the total capital, with a range among the individual films from 25 to 89 percent. And it is the return on this capital which will be a decisive factor for a potential investor in the traditional investment community considering participation in a national film.

When calculating the return on private capital it is assumed that all private capital takes a priority position in the waterfall not only to the financing provided by the Norwegian Film Fund but also to all other public funding. It is furthermore assumed that the public funding is non-recoupable. Repayments are so minor and only affect the most successful films, so omitting such repayments here does not have any significant effect on the whole picture. Finally, it is assumed that all types of private capital are recoupable at 100 percent of the amount invested in the film. This latter assumption creates a simplified picture of the real world as some funding for instance may be recoupable with a fixed mark-up (e.g. 120 percent of the amount invested) and some contributions may not be recoupable but made in consideration for certain exploitation rights (e.g. TV pre-sales). Still, such

Figure 4.2 Return on total and private capital for the 2005 films



Source: Norwegian Film Fund

adjustments are relatively minor and primarily related to the division of cashflow among private capital providers, so the return on private capital calculations thus provide a fairly accurate measure of the overall gains and losses incurred for the private capital invested into the 19 films.

With the private capital taking a priority position to public funding the return is considerably better than for the total capital. Aggregate figures for all 19 films show a loss of 20 percent as opposed to the 62 percent loss for total capital. Of the NOK 128 million put into the 19 films as private capital NOK 25 million were lost.

Again, results for individual films were widely diverse. While the best performing film could return a strong 92 percent gain[14] to its private capital investors, the worst performing film produced a loss of 95 percent. Five of the 19 films had positive returns, all showing gains above 35 percent. The rest, however, lost money for its private capital investors. Ten lost 50 percent or more, and eight produced losses of 75 percent or more (see figure 4.2).

4.4 Layering and distribution of losses

The effects of layering on distribution of revenues and thus on distribution of gains and losses are already illustrated in the previous two sections. By taking a subordinated position to private capital public funding bodies greatly improves the return on capital for private investors. Hence, these public financiers are fulfilling a catalyst function in the project financing (Parra and Kahn, 2001). If private and public capital had not been layered but treated on an equal pro-rata basis, private investors in the best performing film would only have seen a modest return of seven percent instead of the very healthy 92 percent gain obtained when given priority. And it would only have been the private investors in this single film that would have seen any positive return on their investments, instead of all private investors in the five best performing films who saw positive returns with this simple layering (see figure 4.2).

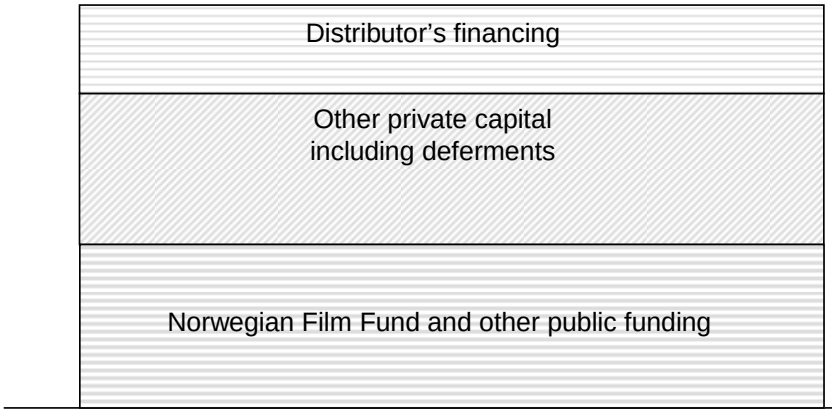
But as discussed in section 3.3 above, also the private capital is typically layered, so not all private investors are exposed to the same combinations of risks and rewards. Examining how layering of the private capital affects

[14] Incorporating repayment of public funding in line with film fund requirements at the time the return on private capital would have been 83 percent for this film. For the other four profitable films public funding repayment would have had a significantly lesser effect.

distribution of losses illustrates the relationship between risk and layering in film finance.

A film's distributor typically takes an exclusive first priority position for its investment. Assuming that all distributors of the 2005 films took such priority position for all their private capital contributions[15] a top layer of distribution investments may be separated from the private capital layer (figure 4.3).

Figure 4.3 Adding a priority layer for distributor's investments



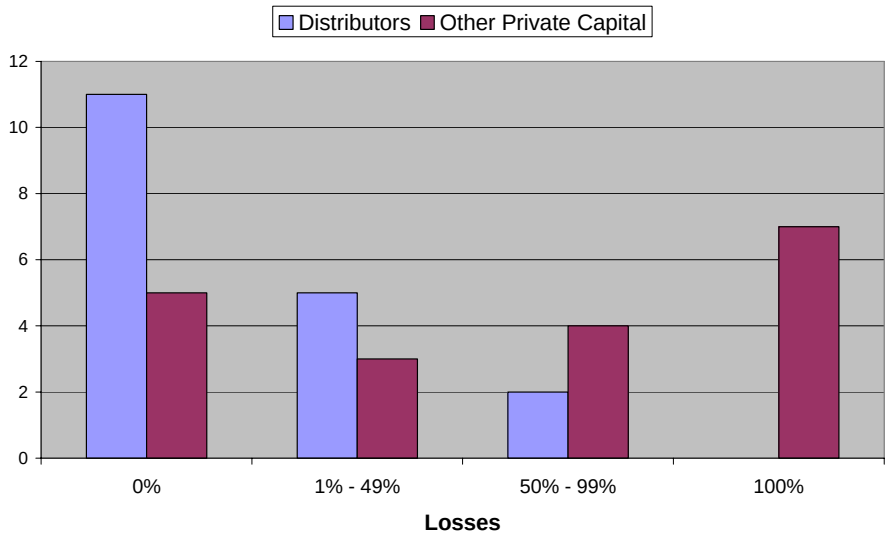
For the average film where the distributor contributes 39 percent of the private capital such priority layering would reduce its loss from 20 percent to zero. For all other providers of private capital, however, taking a subordinated position to the distributor would increase the loss from 20 to 32 percent.

Applying this layering, the distribution of losses among distributors and other private capital investors for the 19 films are shown in figure 4.4 below. Generally, losses are shifted from distributors onto other private investors. The distributors, which invested in 18 of the 19 films, would incur zero losses in 11 films. For five films the distributor would lose between one and 49 percent of its investment, and for two films the loss would be between 50 and 99 percent. For none of the films it would loose its full investment. Other private investors, however, would now only avoid losses for five

[15] At least one distributor accepted part of its investment in a second priority layer pro-rata with equity investors (see figure 3.5) so this assumption provides a slightly simplified picture of the actual layering of distributors finance.

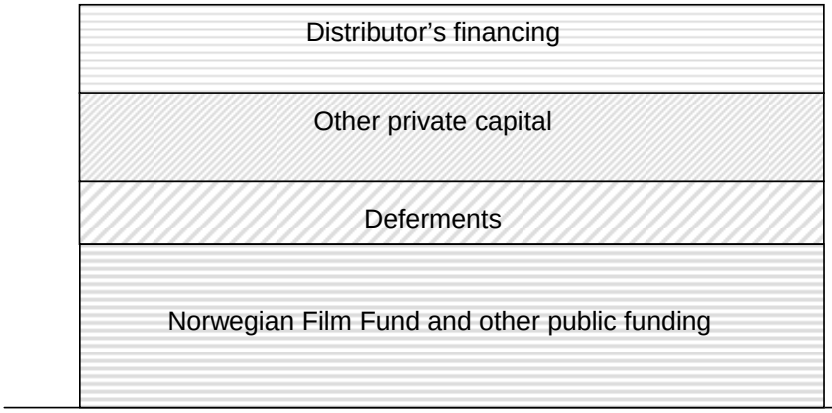
films, loose between one and 49 percent in three films, between 50 and 99 percent in four films, and for seven films their full investments would be lost. Without this layering no private investor would have lost their full investment.

Figure 4.4 Distribution of private capital losses



This shows how distributors, who are the largest contributor of private capital to Norwegian films, to a large extend avoid losses by insisting on a lower-risk first priority position for their investments. A significantly higher risk and a larger share of the losses are taken by other private investors, but they may of course compensate by demanding a larger share of potential gains, which would be typical for providers of subordinated project finance unless they are taking a catalyst role (Parra and Kahn, 2001).

Figure 4.5 Adding a subordinated layer for deferments



To further illustrate the effect of layering one may assume that all deferments took a subordinated position to all other private capital, thus creating a third layer of private capital (figure 4.5). It cannot be shown from the documentation obtained that this is a typical position for deferments even if it were used, so adding this layer is for illustrative and not descriptive purposes.

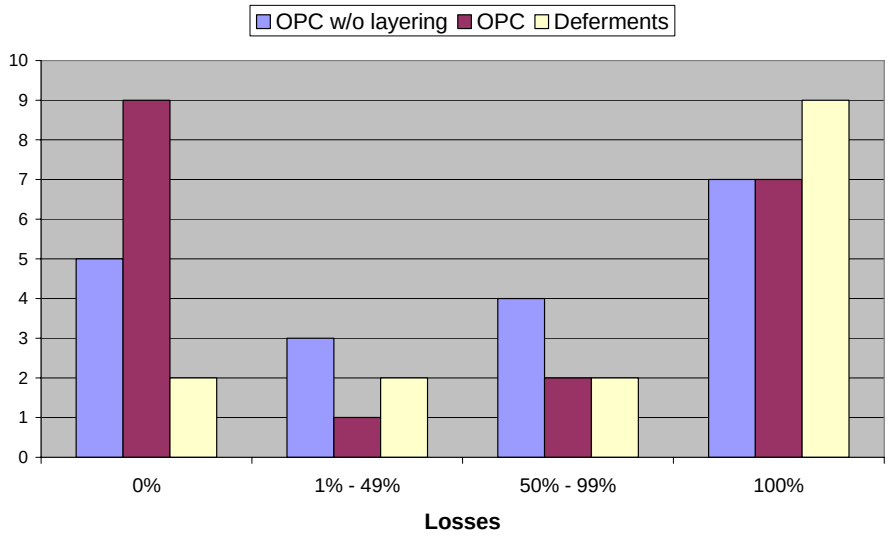
For the average film the addition of a deferment layer, which represents 21 percent of the private capital, would reduce the loss for other private capital investors from 32 percent to zero. The distributor would retain its priority position with zero losses, so the full loss of private capital investors would be carried by the deferrers who would loose 94 percent of their deferred amounts.

Box 4.1 The averaged film with three layers of private capital

Capital		
Total budget	14,300,315	
Private capital	6,756,907	
Distributor investment	2,608,037	39%
Deferments	1,421,427	21%
Other private capital	2,727,444	40%
Revenues		
Producer's theatrical reveneus	1,276,942	
Producer's anncillary revenues	1,276,942	
Film Fund box office bonuses	2,873,705	
Total	5,427,589	
Layered recoupment		
Distributor's investment	2,608,037	100%
Other private capital	2,727,444	100%
Deferments	92,109	6%
Total	5,427,589	80%

The distribution of losses with this three-layer private capital financing is shown in figure 4.6. The “other private capital” (OPC) category from figure 4.4, which included deferrers, is here split into a new “other private capital” category and a separate deferments category. The “other private capital” category including deferments from figure 4.4 is shown as the first column in figure 4.6 for comparison. The distributor’s situation would be unchanged from figure 4.4 and is thus not shown here.

Figure 4.6 Distribution of losses between 2nd and 3rd layer parties



The other private capital investors who incurred zero losses for five films while tied into the same layer as the deferrers would now enjoy zero losses for nine films. The number of films for which deferrers would incur zero losses would however fall from five to two. Losses between one and 49 percent would incur in one film for other private investors and two films for deferrers as opposed to in three films when they were tied in the same layer. Both would reduce the number of films with losses between 50 and 99 percent from four to two. The number of films in which all would be lost would remain seven for other private capital investors but increase to nine for the deferrers.

The effects of adding layers are summarized in table 4.4 below. Assuming up to three layers of private capital for distributors, deferrers and others the performance figures from the 2005 films show how these parties would face very different results depending on the structure chosen. Adding subordinated layers offer significant security to participants in priority layers while it adds risk to those recouping their funds in the new lower layers.

Table 4.4 Average return on private capital

	1 layer	2 layers	3 layers
Distributors	-20%	0%	0%
Other Private Capital	-20%	-32%	0%
Deferrers	-20%	-32%	-94%

5. Challenges and Opportunities

The Norwegian film sector faces a number of challenges when attempting to attract private capital from the traditional investment community. The findings presented in the previous two chapters indicate that a negative overall return on private capital and the uncertainty stemming from extreme performance outcomes may be among the most important. However, the analysis also suggests that the use of layered financing, which is already employed in Norwegian film financing, may be used to create lower-risk investment opportunities that may better fit the appetites of traditional investors.

5.1 Negative returns and uncertainty

The aggregate figures for all 2005 films show a negative return on private capital of 20 percent. Generally, capital is drawn to the investment opportunities offering the best return and it is thus likely that traditional investors pay more attention to other sectors of the economy which can offer better profitability.

Looking solely at this overall return-figure the question becomes less why investors from the traditional financial community stay out, but rather why industry insiders choose to invest. One reason may be that industry insiders also have nonpecuniary motives for their investment decision in addition to the expected financial return on investment. Suppliers as well as crew and cast may for instance accept partially deferred fees just to be able to participate in a project so that they can build reputation and network (Blair et al., 2003), and those who exercise any creative influence may also seek critical praise and the enjoyment that flows from artistic labor (Cowen and Tabarrok, 2000).

It may also be argued that 2005 perhaps was not a very good year for Norwegian films. While a slight dip in the national films' market share from both the previous and the following year[16] indicates that there may be some truth in such argument, it is not likely that it is sufficient to generally eliminate the problem of an overall weak return on private capital.

Adding to the challenges is a high level of uncertainty. Findings presented herein are in line with DeVany and Walls' (1999) conclusions; the

[16] National films' share of total box office: 13.7% in 2004; 12.5% in 2005; 15.3% in 2006. The number of national films released each year was 20, including reissues (Film&Kino, 2007)

distribution of performance outcomes among the films does not converge to an average and extreme outcomes are common. That some films may show healthy return on capital above 50 percent, as noted in the 2004 government white paper (St. meld. Nr. 25, 2003-2004), does not provide any strong indication of the general level of return under such conditions. This underlying uncertainty is creating a high level of investment risk, which is likely to discourage potential traditional investors.

The distribution out performance outcomes may, however, also explain why insiders do invest. Some films make healthy returns on their private capital, which means that some insiders make significant profits.

It is reasonable to assume that producers strive to maximize revenues from their films, and if the uneven distribution of performance outcomes is characteristic for the market, as DeVany and Walls (1999) claim, trying to alter this would be unrealistic. The question thus becomes how to best adapt.

5.2 Creating layered investment opportunities

Given the distribution of performance outcomes, appealing to the most risk-seeking investors should be relatively easy, but expanding the pool of potential investors to include also the more risk-averse requires structuring of the private financing. Layered finance mitigates risk for senior investors by adding layers of subordinated investors that are typically compensated by rights to potentially higher returns (Parra and Kahn, 1999).

The analysis of how layering affects distribution of revenues in section 4.4 above demonstrates to what degree risk may be reduced for priority-layer investors when adding subordinated layers. Average losses for the most senior investors, the distributors, which represent almost 40 percent of the private financing, are reduced from 20 percent to zero. This may also explain why these particular insiders do invest.

But it also demonstrates that by the use of layering one may find structures containing investment opportunities that fit the risk and return appetites of more risk-averse investors within the traditional financing community.

Offering relatively risk-averse outside investors priority positioning (gap financing deals or similar) requires willingness and ability to take higher risk among insiders currently holding those positions, - primarily distributors. Otherwise these would drop out and new outsiders would become substitutes to current insiders, and the objective of a higher aggregate level of private financing would not be met. The willingness and ability to assume risks

among various parties depend on the benefits each expect to derive, their financial strength and business objectives, and the perceived likelihood that those bearing risks will be compensated fully for doing so (Finnerty, 1996). Careful financial engineering that both exploit insiders' nonpecuniary incentives (Cowen and Tabarrok, 2000; Blair et al., 2003) and provide fair distribution of the potentially significant returns relative to risks taken would thus be required to structure the film financing in a way that fits all potential investors' requirements in a mutually acceptable manner.

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