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Financing the Audiovisual Industry

Abstract: *This chapter describes the main financial techniques adopted by financial intermediaries to finance audiovisual productions – such as the slate financing structure and the ticked linked bond – and the use of innovative instruments – such as securitization of rights, crowdfunding and microcredit. These techniques follow the logic of contract discounting rather than gap financing. In this latter case, intermediaries usually prefer to act as lenders, rather than to act as equity investors. The reason is to be found precisely in the logic of risk management. In this perspective, the chapter outlines a taxonomy of financial risks associated with financing the industry and the role of guarantee funds in managing the credit risk exposure.*

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8.1 Introduction

The main difference between public and private funding lies in the objectives that motivate investors. Public funding bodies will support the development of the audiovisual market as a component of cultural industry, while private investors will look for profits. This implies a different evaluation of the project or the production company to be financially supported.

It is worth noting that, in general terms, financial intermediaries active in the audiovisual industry follow the logic of *contract discounting*. *Gap financing*, or in other words financing a part of the budget relying on future revenue, is a less common practice, even though in recent years some financiers have developed specific financing techniques to cover the gap. These techniques favour the approach of *project financing*, aimed at funding a single project or a portfolio of projects. The approach of corporate finance, namely, financing a company as a whole, happens very rarely. Intermediaries usually prefer to act as lenders providing funds to cover debts deriving from specified projects, rather than to act as equity investors. The reason is to be found precisely in the logic of risk management. Reduced size of audiovisual companies, low capitalization, short lifespan, often linked to the production of individual projects, are all factors that do not fit corporate finance or equity investments. When possible, however, in the case of more structured companies, corporate financing is applied with the same techniques used for the financing of portfolios of audiovisual projects, but using the company's library as collateral. The choice of equity investment is limited to very few examples.

The purpose of this chapter, therefore, is to outline a preliminary taxonomy of financial risks associated with financing the audiovisual industry and to describe some of the main financial techniques adopted in the credit market and the capital market. It will also be demonstrated why different forms of financing must be based on an analysis of the value of audiovisual products, in particular of their sale price. At this stage, the theory of value and the pricing models outlined in Chapters 5 and 6 become of utmost importance. Without them the finance of the audiovisual industry does not exist.

8.2 Access to finance for the audiovisual industry

Production of audiovisual products is based on high capital-intensity processes that require, in early development stages, high liquidity. In

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financial terms, it means the need to obtain funding in accordance with the budget and in line with the cash flow needed to support the production development.

Financial models of the audiovisual industry actually expose audiovisual firms to a double risk. On one hand, the trend is that soft money is getting harder; constraints on public expenditures have reduced the amount of government subsidies devoted to the audiovisual industry, while the assignment criteria are increasingly oriented towards the assessing of the efficiency of the applying companies. On the other hand, the effect of the financial crisis has shortened the resources deriving from the exploitation of rights, which are strongly dependent on the economic cycle. In these conditions, opening the audiovisual industry to private financing is unavoidable.

The essential requirement for private funding to take place is to verify the sustainability of a project. Investors need to assess the potential return on investment. Revenues determined by the pre-sales mechanism and future revenues estimated on the basis of the possible transfer of the unexploited rights must be considered before determining the rate of return on investment.

In the case of the audiovisual industry, sustainability takes on peculiar features. Firstly, the assessment of future revenues is conditioned by a variable that is difficult to estimate, and that is the success with the audience. It is easy to perceive the difference between estimating the revenues in the case of new products and for sequels or remakes, as well as, for example, estimating future revenues from a film before and after it is released in cinemas; in the latter case, the *box office* can be indicative for estimations of revenues from other exploitation markets.

Secondly, the analysis of the audiovisual industry financial model clearly shows how the above-mentioned considerations should not only refer to the potential revenue sources, but must also take into account commercial and financial relations among the different players of the market. For example, a bank which decides to finance a film project cannot do it without a careful analysis of the distribution deal and the recoupment agreement agreed on between the producer and the distributor. As regards the revenues generated by the film, in fact, the amount the producer will have at its disposal in order to cover the debt depends on the provisions of the distribution deal. The exact understanding of the mechanisms of allocating revenues defined in the distribution agreement becomes for the lending bank the key point of the lending process.

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8.3 Financial risks in financing the audiovisual industry

Financial intermediaries entering the audiovisual industry need to be fully aware of all the risks and of the financial chain of every single project they decide to finance.

Risk management in the audiovisual industry is no different from any risk management in other industrial sectors. The risk is due to the uncertainty regarding future events and their effects in terms of revenues generated by a given project. The risk, therefore, can produce positive or negative effects by increasing or decreasing future revenues. A rational investor will try to measure *ex ante* the level of risk of a given investment, in order to assess whether to invest or not and at what price. Therefore, the risk has two dimensions: the "expected component", that the rational investor expects and incorporates in its decision, and the "unexpected component", that cannot be forecasted. Risk management is responsible for identifying, measuring, managing and controlling risk determinants and all their components.

Financing the audiovisual industry brings with it peculiar risk determinants that make even more complex the risk management process. This is largely due to the nature of "prototype good" of audiovisual products: on the one hand, the production process is difficult to standardize in all is phases, and is often subject to variation due to internal and external circumstances; on the other, the final quality of the product can be largely de-correlated by the quality of the production factors. For these reasons, a taxonomy of the risks associated with financing audiovisual products is needed. In the taxonomy proposed below, each single risk is related to a specific category of traditional financial risks (Figure 8.1).

Audiovisual productions are associated with *business risks*, *operational risks* and *financial risks*. These types of risk impact, directly or indirectly, the ability of the debtor to cover its obligations with revenues and, therefore, affect the return on investment made by the investor who financed the project or company.

Business risks

Firstly, financing audiovisual products exposes the intermediary to a *specific business risk*, a risk that is directly linked to the given project or to the company (*project risk* or *company risk*). Regarding this type of

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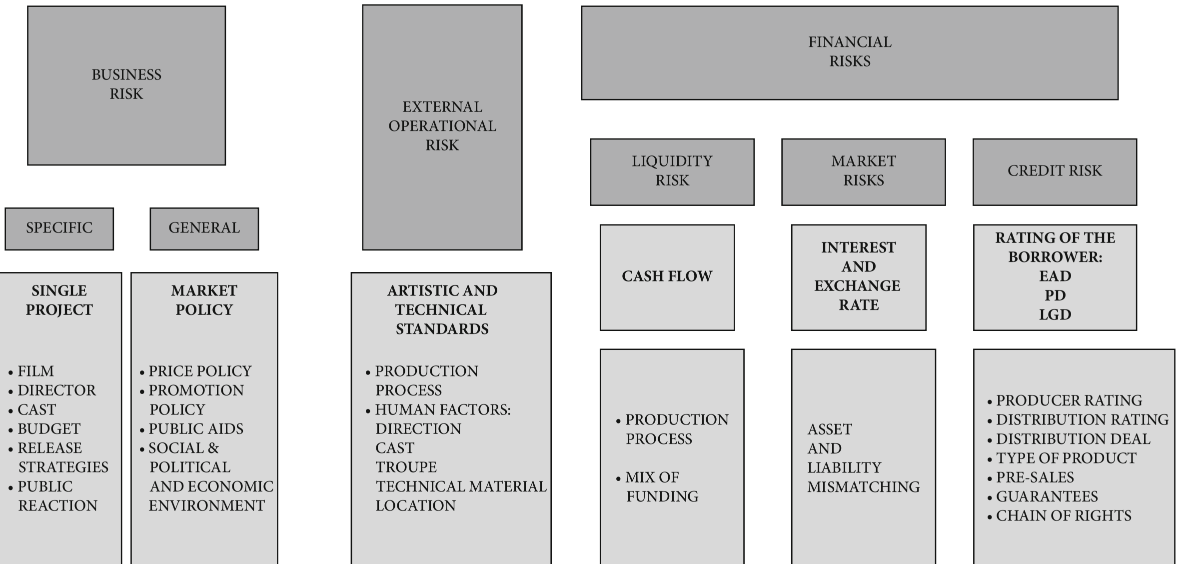

FIGURE 8.1 *Risks and determinants in financing the audiovisual industry*

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risk, it is important to underline how the positive or negative performance of the financed product – or basket of products – is determined by elements that are hard to estimate. The response of the audience remains an unpredictable variable, and such situation makes it difficult to assess the probability of default related to the financed project. The analysis of financing techniques demonstrates how, in order to limit the specific business risk, the lending intermediary requires that the production must respect some covenants based on projections of the available historical data, ensuring a minimum level of revenue predictability. The perfect examples are those projects where famous directors and actors are engaged: the track records of the director and of the main actors allow, in fact, a more precise evaluation of the performance of the audiovisual product. Similarly, sequel projects that reproduce technical, artistic and commercial elements which have already been tested on the public lead to a lower business risk level.

Another important component of business risk is the *general business risk* (or *industry risk*). This category includes a variety of market factors that are independent from a single production and are uncontrollable for the company; for example, the performance of a film can be influenced by market dynamics, including wrong industrial policies (as in the case of too high ticket price), inadequate cultural and education policies, or, indirectly, by economic-political recession.

External operational risk

Every audiovisual company is aware that there is the possibility that the technical and artistic quality of production may result distant from the expected one, or that the production may suffer variations in the schedule or, even worse, that it may not be completed at all. Such risk is part of the *external operational risk*. The occurrence of such events can be due to inadequate processes and systems within the production, as well as to human factors and external or environmental circumstances. The external operational risk in the audiovisual business presents two types of effects: a monetary one and an economic one. The first type is determined by not following the working plan and may imply a financial stress, as the use of financial resources does not follow the timing that had been programmed. The latter type occurs when expenses exceed the budgeted amount, or when the lower quality of the final product results in lower revenues (or, if the project is not completed,

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no revenues at all) and, therefore, no possibility of return for the intermediary.

The transfer of risk to another intermediary is the only possible form of risk management when dealing with external operational risk. Banks active in the audiovisual industry usually manage the operational risk by transferring the risks to specialized intermediaries, such as completion bonders that have the know-how to deal with the completion and delivery risks of the product.

A *completion bond* is a form of contract that guarantees that the product will be completed and delivered as it includes: (a) the agreed production schedule and (b) the levels of the budget established as appropriate. The majority of banks will request a *completion bond* as collateral, but it can also be required by broadcasters, private investors, public bodies or by distributors who have already paid the *minimum guarantee* during the development of the project, or by co-producers. Regardless of the institution that requires the completion bond, the purpose is to hedge against the risk of non-completion of the work resulting in the inability to recover the funds already spent. Among the obligations of the *completion guarantor* are the following:

1) the *completion guarantor* ensures that the producer will complete and deliver the work in accordance with a set of criteria previously approved by the investor regarding the script, schedule and budget;
2) the *completion guarantor* undertakes to ensure financial resources in excess of the approved budget which may become necessary;
3) in case the producer is unable to finish the production, the *completion guarantor* will assume the task of completing it by replacing the producer and the director, if necessary[1], or alternatively, will fully repay to the lender all amounts invested in the production of the work up to that time.

In order to undertake a contractual commitment of this kind, the *completion guarantor* must necessarily examine all the factors affecting the production, such as the story and screenplay, the budget, cash flow, the shooting schedule, the cast and technical crew, locations, insurance policies[2], as well as the financial structure and the individual involvement of each investor. The guarantor may also require an increase in the budget, if it is deemed inconsistent or insufficient. As regards timing, the *completion bond* is signed in conjunction with the request for funding, and certainly before the start of the shooting. In return for the assumed

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risk, the *completion guarantor* is entitled, in addition to receiving a fee, to exercise certain rights, such as being constantly informed on the production and having access to accurate reports related to the budget, cash flow and schedule, as well as the right to exercise a constant monitoring of the locations by engaging, where necessary, technicians and experts on the shooting set. If the monitoring and control reveal constant levels of overspending, the *completion guarantor* has the right to make changes to the cast and crew, and in some extreme cases, the right to substitute the producer and director and to take over their place in the completion of the film. It is in the interest of banks and lenders to make sure that the company providing a *completion bond* has a good reputation and a brilliant track record. But above all, it is important to verify whether the guarantor's financial solidity is enough to fulfil its commitments. To this end, the *completion guarantor* often transfers part of the risks taken against the bank and the producer to an insurance company by entering into a re-insurance called "*cut-through*" that gives the bank the right to take action against the insurer in the event that the *completion guarantor* is unable to meet its contractual obligations. The cost attributable to the *completion bond* varies depending strongly on the intrinsic characteristics of each production, the track record of the producer making the request and the general conditions on the *completion bond* market at the time of signing[3]. Should it be necessary for the *completion guarantor* to anticipate some money in order to complete the film, it will have the priority, over all other investors excluding the bank, to recover the sum from revenues generated by the film.

Financial risks

Financial risks in the audiovisual financing are attributable to the typical liquidity, market and credit risks.

Liquidity risk is due to the possibility that the inflows may not be able to cover the outflows. Film productions are characterized by strong financial stress which is concentrated, in particular, in the early stages of production and are determined by a mismatching between inflows and outflows. The gap between the timing and the amounts of incoming and outgoing cash flows is a natural condition of audiovisual productions and may affect the debtor's ability to pay its debt.

Therefore, the loan should be aimed at favouring the debtor's monetary equilibrium, allowing it to avoid financial stress likely to affect

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its solvency. In this regard, three conditions are relevant: the timing of financing, forms of use and the amortization schedule. It is crucial that the debtor is able to use the granted funds according to the financial needs dictated by the production cycle. Financial crisis of the debtor, in fact, could adversely affect its ability to repay the loan.

Market risks are determined by changes in interest rates and exchange rates affecting the income or the value of the assets of an audiovisual company or of a single project. Changing interest or exchange rates may have a possible impact on the overall capacity of the borrower to pay its debt. The company's exposure to market risks, including in relation to individual projects, will be the subject of risk management policies implemented by the company itself; the efficacy of risk management policies will affect the credit rating expressed by a bank or any other potential lender. The risk of interest rates is relevant when the production or audiovisual company is heavily indebted. In such a case, a change in interest rates can have a negative impact on the ability to repay the financial obligations.

The exchange rate risk assumes significance in the case of international productions within which the budget is expressed in a foreign currency.

Market risks are a critical variable of audiovisual productions as, in most cases, production companies do not have the internal expertise to manage them. The techniques of asset and liability management at the base of the management of market risks, in fact, require a specific know-how and an *ad hoc* organizational structure. In practice, therefore, production companies resort to external companies – in some cases, the lending banks themselves – to assist the companies in managing risks with advice and financial products suitable for their specific needs.

The *credit risk* contextualized in the audiovisual industry leads to its most significant manifestation, that is, insolvency. The *insolvency loss effect* is, in fact, the most common outcome of credit risk.[4]

The credit risk assessment finds a crucial variable in evaluating the borrower's rating. The evaluation of the *counterpart credit risk* refers to the typical determinants of credit risk and in particular to the probability of default (PD) of the borrower and to the loss given default (LGD).[5] The estimation of the PD implies an initial difficulty in the exact identification of the counterpart that shall be evaluated. This is particularly true for the film industry. The analysis of the distribution deal has clarified how the agreements between producer and distributor influence the sharing of the revenue flows between production and distribution. The producer's

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chances of receiving its shares, as well as the level of coverage of production costs, shall not only depend on the market performance of the film, but also on the recoupment agreements stated in the distribution deal and on the exploiting skills of the distributor on those markets that follow the theatrical one. This shall be confirmed in the case that the distribution deal slows down the recovery of the producer's shares, as it happens in the *net deal* contract. Therefore, for a lender that needs to estimate the rate of return of his investment, it is essential to globally evaluate the counterparts that are involved in the project and the agreements with such counterparts. Another difficulty in measuring counterpart credit risk is represented by the typology of guarantees that are required by the intermediary in order to reduce the LGD. On a market such as the audiovisual industry, where borrowers and lenders generally don't know each other, real assets guarantees are normally required. However, audiovisual firms – including companies that work on an established basis and not on specifically designed structures for single projects – do not generally invest much in property. Hence, collaterals made of real assets are distant from the nature of the production cycle of this industry and, consequently, are hardly applied. Nevertheless, typical assets of the audiovisual companies are represented by the exploitation rights to their library of products. These rights represent – together with pre-sales contracts – the most natural form of guarantee. The identification of the rights of the borrower, and their evaluation, require, however, time and the know-how that could not be compatible with the urgent financial needs of the borrower and with the expertise of lenders. Consequently, the availability in the credit market of institutions and professionals able to carry out – at affordable costs and in reasonable time – an evaluation of the library is of paramount importance. The unavailability of such players would limit the credit guarantee to the agreed pre-sales contracts, while the full use of the rights concerning the company's library would be possible only for few financial transactions.

For the financial intermediaries, the exposure to credit risk is of utmost importance in the credit policies. Supervisory authorities, in fact, require intermediaries to set aside regulatory capital in relation to the risk levels of loans granted.[6] The higher the risk, the more capital must be set aside. According to the rules of prudential regulation, financing audiovisual companies is placed within the higher levels of risk, both because of the lack of capitalization of the companies and because of the intangible nature of the exploitation rights that are not considered high-quality guarantees. This fact translates into a higher cost for

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intermediaries – measurable in terms of regulatory capital absorbed by the single credit exposure.

For intermediaries active in the audiovisual industry, the best policy to manage credit risks is to adopt a portfolio approach allowing for diversification strategies. A "pool of projects approach" – applied to different projects of the same company or to single projects that are promoted by various companies provides, through diversification, a lower exposure not only to credit risk and financial risks in general, but also to business risk and operational risk.

Finally, considering the general business risk, the intermediary has to avoid the concentration risk; this would derive from building up a loan portfolio with a high percentage of loans granted to the audiovisual industry. In this perspective, it is useful to carry out an adequate evaluation of the audiovisual business share on total loans.

In addition to management policies, in practice, intermediaries resort to specific financial schemes limiting their risk exposure. Many of the financial structures, for example, include the use of a special purpose vehicle (SPV). Its purpose is to isolate the financed project from the producer's budget, limiting the intermediary's exposure to the counterparty credit risk. In this way, the PD is attributable to a single project only and the LGD is not influenced by the production and distribution companies. Similar structures are particularly useful in financing co-productions for which estimates of the creditworthiness of various productions involved can be particularly difficult and laborious.

8.4 How to finance the audiovisual industry: products and markets

Intermediaries financing film productions can intervene in two different ways: *contract discounting and gap financing*, differing in the degree of involvement on the part of the intermediary, in terms of both risks and expected return, as well as in terms of requested requirements and collaterals[7].

Contract discounting

Following the discount approach, banks and financial intermediaries discount the future revenues deriving from pre-sale contracts already

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signed and that the producer has entered into with other parties before addressing the intermediary. In this case, banks do not provide additional financial resources for the production but merely act as a liquidity provider. In other words, banks make available financial resources that would only be liquidated at a later time. The ability to get a discount to existing agreements, which provide for payments but only in conjunction with the completion of the audiovisual product and its subsequent release on exploitation markets, enables the producer to find resources that can be used to cover the costs related to the production phase, generally associated to a certain degree of financial stress. Existing agreements are usually valuated below their paper value. From the banks' point of view, if properly implemented, discount contracts are considered not too risky, and at the same time, rewarding transactions. Usually, the discount rate is determined on the basis of a benchmark market rate[8] and by adding a commonly agreed spread that may vary depending on the levels of risk taken, the quality of the guarantees provided and the track record of the producer. In addition, banks will charge the producer with a lump sum commission (fee), organizational and managerial costs incurred and the costs of legal expenses required for the discount.

Gap financing

In this second scenario, intermediaries are exposed to a greater degree of credit risk, as they undertake to provide the missing financial resources for the project counting on future revenues deriving from future contracts. Intermediaries, in this case, lend the amounts primarily based on sales estimates of the exploitation rights to the product on different territories. The term "gap" refers to the fact that banks and intermediaries provide financial coverage for any difference (shortfall) between the funding already found and the amount necessary for the production, thereby providing the missing funds for the final coverage of the budget, providing the so-called "missing financing". The gap is calculated as[9]:

$$\text{GAP} = [\text{Total Budget Requirements} - \text{Already Received Financing}] \quad 8.1$$

In these cases, banks will accept higher levels of risk, taking into account also the estimates made by independent sales agents on the value of product rights on those territories and exploitation markets where the product has not been sold yet. In general terms, based on the elements such as cast, director, genre, production and budget, sales agents prepare

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estimates for the different territories. Banks will grant the necessary funding only if convinced by the feasibility of these estimates, favouring the agents of well-established reputation in the industry that will commit themselves to sell the product in the countries considered in their predictions. In such a context, the possibility of using gap financing works well for those titles which have clear potential sales and business opportunities on a wide range of markets, also internationally. Usually, intermediaries will require that the values indicating the revenues from the sale of film rights in multiple territories, and on different markets in the same region, indicate the existence of significant margins that would provide for the repayment of the loan[10].

Also in gap financing banks and financial intermediaries require the priority on the waterfall of revenues from the product funded. But, intermediaries may also accept a "parallel" recovery to other lenders, such as in the case of a product funded by the State or other public institutions. We should keep in mind that it is a rather costly and challenging form of financing, given the high costs the intermediaries apply in the form of commissions (fees), reimbursement of expenses and, more importantly, in terms of interest rates negotiated for the loan granted that are higher than those applied in the contract discounting and established on a case-by-case basis. In the Anglo-Saxon financial context, the intermediaries may require the presence of an additional independent party, a sort of *super partes* risk manager which, given a contractually established commission[11], will express a judgment on the adequacy of sales estimates made by the sales agents and will certify the quality and commercial viability of the project, exerting also a function of monitoring and control over the making of the product, as well as on subsequent modes of economic exploitation from which the revenues to cover the loan come.

In practice, the banks and financial intermediaries financing audiovisual productions often use a combination of the two approaches described. They provide liquidity through the discount of existing contracts and possibly integrate it with the provision of gap financing for an amount that should not exceed 20–30% of the budget, thus giving rise to structures of "hybrid" debt financing.

Bank lending structures

While in the United States and in the UK financial intermediaries have been actively supporting the audiovisual business for quite a long time, in continental Europe relationships between banks, financial

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intermediaries, institutional investors and film industry have been seriously taken into consideration only recently. Financial innovation has produced new products used to fill the financial gap of a project.

Some typical financial structures adopted by international banks to finance films and television products – mainly fiction – will be described below. These structures are adaptable, with proper precautions, also for the purposes of other television products and those web products that generate enough revenues to cover the cost of the loan.

In order to deal with the most incisive peculiarities of audiovisual productions, namely, the unpredictable future incomes, financial intermediaries have designed some financial tools and techniques that help achieve two objectives:

- to separate the financed assets from the debtor's balance sheet, thus segregating the individual assets and rights on which to rely for the repayment of the financing provided;
- to break down and redistribute risks according to risk sharing models that allow to assign the risks to the most appropriate types of investors.

Segregation of assets on one hand and risk diversification on the other seem to be the drivers of the debt financing products primarily used by banks.

In particular, in this paragraph, the following financial products will be taken into consideration:

- single film project financing,
- revenues discounting credit facility and portfolio project financing, and
- leasing and microcredit.

Single film financing

Single film financing (Figure 8.2) consists in financing the production of a single project and can be issued in a pre-production phase, as well as during production.[12]

The amount of the loan is defined according to the value of the rights that are sold in advance and, in the case of a film project, is independent from *box office* results. If compared to a traditional credit line, single project financing includes some important differences. The structure uses a special purpose vehicle (SPV) which has two functions: (a) it acquires from the producer the ownership of the cash

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flow generated by the negotiated rights on which the amount of the financing depends; (b) it provides the servicing of the financial flow of the transaction. Actually, first the bank acquires the cash flow rights, then provides a loan for the SPV, which uses it to pay the producer for the transfer. Subsequently, the SPV receives from distributors the cash flow deriving from the acquired rights and transfers them to the bank in order to pay back the loan.

This structure allows the financing institution to identify financial risks according to two main variables: (a) the counterpart credit risk regarding the distributors involved in the transaction – since the financial flow that is earmarked to pay back the loan depends on the ability of the distributor to exploit the rights and to comply with the transfer of money to the SPV; (b) the risk of non-completion of the work: the essential condition for the distributor to fulfil its commitments set out in the distribution deal – leading to the ability of the financial intermediary to be refunded is the actual completion of the film – is the creation of a master copy allowing for the economic exploitation of the product.

This type of structure allows controlling and limiting some of the typical risks of film financing. First of all, the transfer to SPV of the contractual rights allows separating the specific project from the producer's

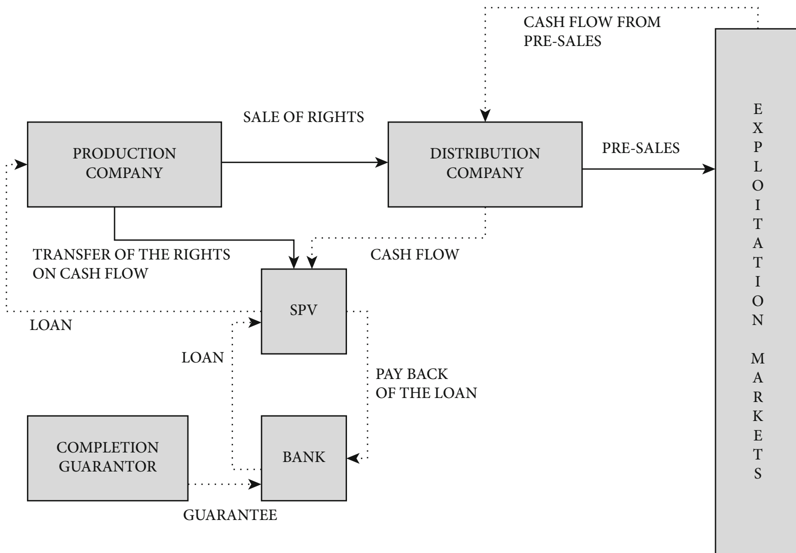

FIGURE 8.2 *Single film financing*

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balance sheet, so that the financing institution can focus its activity on a single project, rather than on the credit rating of the company. Moreover, segregation of the assets that represent the collateral of the transaction provides a more transparent cash flow and facilitates risk sharing with third counterparts. Usually, such structure provides, in collaboration with a bank, the presence of an intermediary – normally an insurance company – that offers a completion guarantee for the risks related to the completion of the project. By doing so, the financing bank can be sure that any technical or artistic problems occurring during the production shall not prejudice the payback of the loan. The completion guarantor, upon the payment of a predetermined fee, agrees to finish the film in case budgets and deadlines are not met during the original production.

A systemic approach – which is quite common among the most dynamic intermediaries operating in the industry – suggests the use of portfolio project financing, oriented towards the support of a large number of projects proposed by the same company, as well as of projects of different companies.

Revenue discounting credit facility and film slate financing

In the case of portfolio approach, many financial techniques can be used; however, for taxonomic simplicity, it is possible to identify two options: the *revenue discounting credit facility* and the *film slate financing* (Figures 8.3 and 8.4)[13]. Both structures provide a company with a revolving credit line that is guaranteed by the rights of a basket of movies during pre-production and production.

The contract sets out a maximum available amount and a maximum number of products that can be financed in a certain period. Each product belonging to the initial pool – as well as to the revolving one – is subject to the approval of the financing institution. The borrowing company can withdraw in order to finance the projects that are included in the pool, following payback schedules and procedures as stated. As for single film financing, also in this case a completion guarantor is present in order to provide the lending intermediary with insurance on the completion and delivery risks of the projects.

In the revenue discount facility scheme, the relationship between producer and financing institution is direct: the producer transfers to the financial intermediary the rights concerning the pre-sales-based cash flow. In slate film financing the same function found in single film financing is carried out by a SPV. Therefore, only in the first case banks have the possibility to take a direct legal action against the producer.

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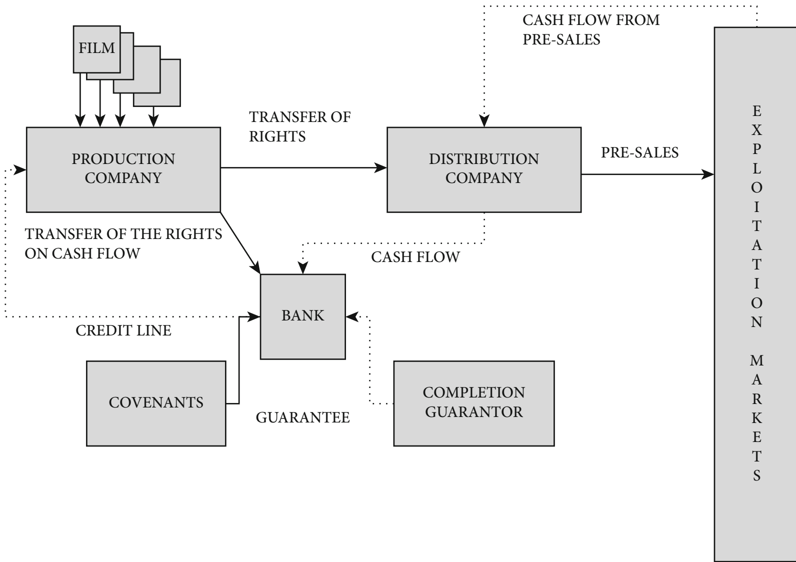

FIGURE 8.3 *Revenue discount facility*

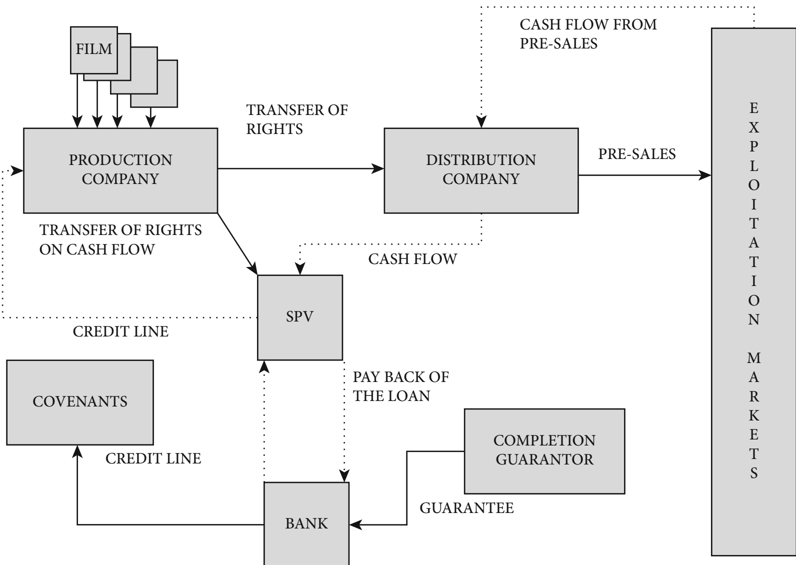

FIGURE 8.4 *Film slate financing*

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Destining funds to a portfolio of films, rather than to single projects, on one hand allows the financing institution to perform a risk diversification among different typologies of products, but on the other hand, it imposes a higher monitoring level of the project management carried out by the borrowing company. For this reason, portfolio financing schemes always include some covenants that the borrowing company must follow. Among the most common covenants required, it is possible to find a minimum level of equity invested by the producer, a minimum number of printed copies for each product included in the portfolio and the adequacy of the distribution network that is used for selling the rights.

Portfolio financing is mainly designed for those production companies that can guarantee a significant number of products and satisfying levels of equity. However, besides its application on a well-defined target, the portfolio approach can be considered as a valuable model also for supporting smaller companies or single projects. Careful consideration of the managerial attitude of the borrower and the application of a set of covenants should represent the essential elements of any audiovisual project financing.

Leasing

In particular cases, banks have used a leasing agreement to finance the production of audiovisual works, mostly films.[14] In general terms, through a lease agreement one party (Lessor) agrees to purchase and contemporarily to lease an asset acquired from a supplier to a third party (the Lessee), which at the end of the contract, has the right (option) to buy it at a predetermined price.[15] Technically, the general structure of a leasing transaction provides for the existence of two separate yet connected contracts:

1) the purchase by which the leasing company buys a certain asset;
2) the Lease itself, through which the same company leases the asset to the user (lessee) against the payment of monthly or yearly fees.

The transaction usually requires a structure involving three parties: the supplier, the Lessor and the lessee. However, in the case of audiovisual works, the actors are only two (the owner and Lessor), since the good is not purchased by a third party, but is directly produced by the user itself that, in this case, coincides with the producer (direct lease or sale and leaseback, Figure 8.5). In this way, the producer immediately

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obtains the cash needed from the proceeds of the sale and, at the same time, preserves the rights to the asset (the work produced) thanks to the leasing relationship allowing the producer to repurchase the asset by paying the fees and by exercising the option upon the termination of the contract. The contract stipulates that at the agreed time, the user/producer can regain ownership of the asset sold by the intermediary (the movie), pursuant to a purchase option included in the contract. Lease transactions on an audiovisual product essentially involve:

- a production company that transfers the ownership of an audiovisual product in exchange for an immediate cash benefit and is required to make escalating periodical rental payments to the Lessor; the producer benefits by receiving the purchase price, whilst being able to, at the same time, exploit the film commercially;
- a Lessor that is a specialized financial intermediary, purchaser of master negatives/tapes of a completed audiovisual work that, immediately after buying the work from the producer, leases it back to the same producer and receives a fee;
- in some cases, a bank or a specialized intermediary engaged by the leasing company for the medium-/long-term financing. In most cases, the rental payments must be secured by way of a bank guarantee or a standby letter of credit.

Usually, in an international context, and in more financially developed cases, the transfer takes place through a special purpose vehicle (SPV) that acquires ownership rights from the producer on behalf of the intermediary and, at the same time, pays the monetary value to the producer, which in turn agrees to pay a fee periodically to the lessor. It is normally the producer who chooses the moment to sign a leasing contract, in relation to a given product, the contractual duration of the transaction (which on average varies from 36 to 48, up to a maximum of 60 months) and the frequency of payments.[16] However, a prerequisite for such a contract to be signed is that the work is finished, or at least a large part of the footage is in postproduction. The main advantage for the producer is the liberation of financial resources, the payment of which is not strongly correlated and dependent on the *box office* results, and if exploited consistently, enables the company to start new investments and to finance new projects. It is due to the fact that the economic benefit arising from the immediate financial resources that the leasing transaction frees for the producer does not manifest itself

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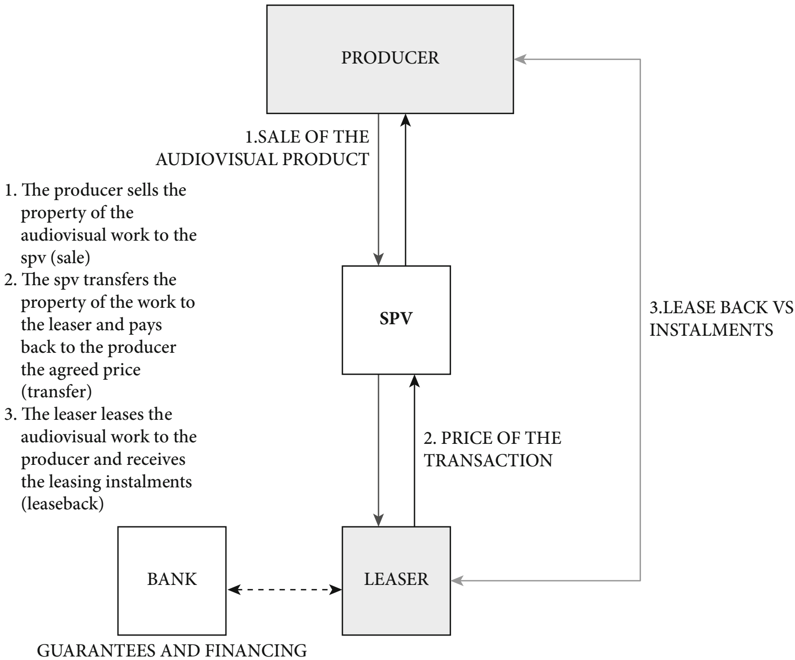

FIGURE 8.5 *Leasing of audiovisual products*

on the financial structure of the film involved in the lease (which must already be completed in order to access the transaction[17]), but presumably the liquidity that is made available from the transaction will benefit the funding of future projects in progress, or in other words, the resources freed up by the leasing contract will form the financial structure of other films. And therefore, this method of financing is only useful for companies that regularly devote themselves to film productions and portfolios investing in a long-term perspective, and not the firms established with the aim of producing a single movie and whose existence is conditioned upon completion of a single project. On the other hand, intermediaries specializing in lease agreements will evaluate the costs, fees and fairness of the transaction not only based on the characteristics of the film being object of the lease term, or its expected *box office* returns, but also on a function of the economic and financial solidity of the production company and the value of the library in its possession. In other words, the overall risk of a lease, from the point of view of the lessor, is evaluated by weighting the risk relative to the production company with the one related to the product.

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Microcredit

In general terms, microcredit is a small loan granted to individuals – or a group of individuals – excluded from the traditional financial system, to finance a micro-entrepreneurial activity.[18] Traditional guarantees are absent and often substituted by guarantee funds, usually provided by States. The traditional microcredit market derives from the microcredit initiatives carried out in developing countries to help the so called "poorest of the poor". In such a context of financial exclusion, microcredit represents a valid tool of inclusive credit policies, because it is capable of overcoming the traditional logic of customer selection utilized by banks and financial intermediaries. The lending methodology in microcredit widely differs from that of traditional finance, and the creditworthiness analysis of the borrowers focuses mainly on qualitative factors.

With this in mind, microcredit may result a useful financial instrument for all those young authors and independent small audiovisual firms that are not able to access the traditional banking market and to provide traditional guarantees.

In the audiovisual industry, the traditional microcredit structure can be adapted to meet the needs of small productions. Microcredit programmes can be financed both by governmental bodies and private investors. Funds can be channelled through microfinance institutions – where the legislation provides for this type of intermediary – or traditional banks, while capacity building institutions may carry out the qualitative analysis of the borrowers, also providing technical assistance to borrowers during the whole process.

Several industrial countries have implemented specific microcredit regulations in order to foster the microcredit market: in Europe this is the case, among others, for France, Italy and Romania. In these countries, microcredit may result as a valid alternative to traditional credit, especially to finance web audiovisual products, or even the start-up of young production and distribution companies. It is worth noting, anyway, that microcredit is a credit product suitable only for those firms or projects that are able to generate enough revenues to repay the financial costs of the debt.

The development of a microcredit market for the audiovisual industry is largely dependent on the promotion of guarantee funds and the implementation of specific legislation which would allow for microfinance institutions to enter the market.

Access to capital market

In countries with "well-established" financial systems, the capital market, even for companies active in the audiovisual sector, is one of the most important financing channels, and placement of debt securities and shares to the public is the most common way to recover capital.

The importance of the stock market for audiovisual firms seems to be finally established in the United States and in most Anglo-Saxon countries, where several companies are listed on the Stock Exchange and raise capital on the equity market.

The access to capital markets is still at a very early stage in continental Europe, where very few firms are listed on the Stock Exchange and only few companies regularly issue debt securities. Among the reasons that most are frequently discouraged from entering the Stock Exchange are the costs and the fear of a new governance model. Shareholders who control the company fear having to suffer the possible interference from third parties. For audiovisual firms, still experiencing a bank-oriented market, the direct access to the stock market seems to be premature while it could be a useful alternative strategy in the future.

Nevertheless, in recent years, a number of new financial instruments have been developed by financial intermediaries to help audiovisual firms to attract funds on capital markets from institutional investors and from private and retail investors. The use of these new financial techniques have been stimulated by the securitization process experienced by financial markets, which provides, for the financial needs of the borrower, the issue and placement of negotiable securities. In such perspective, financial instruments for the audiovisual industry can be divided in two typologies: *theatrical performance instruments*, which guarantee a return rate that depends on the theatrical revenue, and *full rights performance instruments*, where the revenue depends on a wider exploitation of the film rights. As a consequence, the first type of financing is restricted to film financing.

The list of most commonly used financial products to raise funds on capital markets for audiovisual productions includes: ticket linked bonds, asset-backed securitization (ABS), investment funds and crowdfunding.

Ticket-linked bonds

The first category, the instrument that has been experimented also on the markets of continental Europe, is the so called *ticket-linked bond*

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(Figure 8.6). This short-term film bond is issued in order to support film production, and it has a yield that depends on the *box office* revenue of the film obtained in a defined market, and for a determined period, which corresponds to the maturity of the bond.[19] In its basic structure, the ticket-linked bond is issued as a zero coupon bond. The potential yield on maturity of the bond consists in the capital and in the interest paid to investors; both capital and interest are calculated as percentage of the number of sold tickets. In fact, for each ticket sold, a defined percentage of the revenue is transferred to the investors of the bond. The amount that the investor will receive on maturity will be equal to:

$$CS = n^\circ\, Bv\, (\%Pb) \qquad 8.1$$

where:

CS = capital and interest on maturity

n° Bv = Number of sold tickets

%Pb = percentage of the price of the ticket transferred to the investors.

Film bonds – generally placed among institutional investors – can be issued at the early stage of the film production, as well as during the advanced production phase. The maturity of the bond depends on the time of issue and on the corresponding production phase of the film and shall be as long as the distance in time between the issue of the bond and the movie's *premiere*. The amount of the issue depends on the film budget and on the resulting financial gap to be covered. The ticket-linked bond can be used to finance a single project or a portfolio of projects. It can be issued to support the production or the distribution. Since the revenue is linked to the theatrical collection, this instrument adapts particularly to the financing of projects that can guarantee a minimum level of predictability of the theatrical return. Therefore, the ticket-linked bond finds its best application in supporting films with important cast and director or sequel projects.

For the arranger, the ticket-linked bond represents an instrument which facilitates the diversification of the risk, since it is transferred and redistributed between the investors of the bond; at same time, the arranger diversifies its revenues which, in the case of this specific transaction, consist of commissions related to the packaging of the programme.

For investors, the bond represents an alternative investment with an average maturity of about 18 months and with no correlation with traditional investments.

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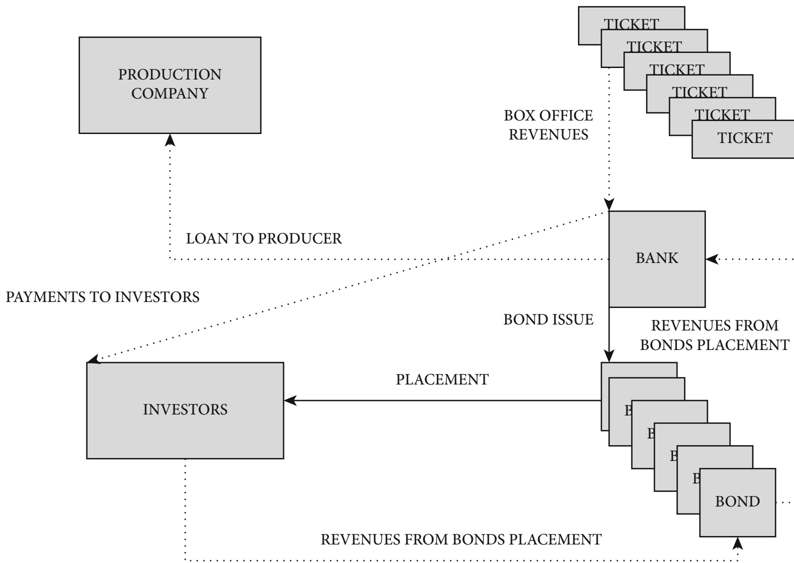

FIGURE 8.6 *Ticket-linked bonds*

For film companies, the ticket-linked bond represents a valid alternative financial instrument for those projects that have good revenue predictability.

Asset-backed securitization

The *asset-backed securitization* (ABS) represents one of the most sophisticated forms of financing available for the audiovisual sector. The ABS is a technique that allows a company (originator) to transfer a pool of assets to a Special Purpose Vehicle (SPV), which finances the transfer by issuing and placing negotiable financial instruments on the capital market.[20] For companies operating in the audiovisual business, the assets involve audiovisual rights stored in their balance sheets, or that shall derive from future productions. For such reason, ABS is a financial technique that can be used by production companies, as well as by distribution firms.

In its most traditional structure, audiovisual rights securitization considers as the originator a production company that transfers a portfolio of rights to an SPV (Figure 8.7). The SPV then issues an amount of asset-backed securities (ABSs) which equals the price of the rights' transfer and places such securities on the market, generally to institutional

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investors. Throughout the duration of the transaction, the revenues that are generated by the exploitation of rights are used to pay the investors.

ABS represents a useful financial technique for those companies – or consortiums of companies – operating in the audiovisual industry, which have a library value that is high enough to justify the costs of implementing an ABS programme. For the production and distribution companies, asset securitization allows cash conversion of the balance sheet assets, and it generates liquidity that can be used for the financing of the production cycle, as well as for the reduction of the financial debt. Such liquidity has a funding cost which may result lower than the borrowing rate of the originator. Asset segregation, in fact, ensures a funding cost that is proportional to the quality of the assets and to the guarantees included in the specific ABS structure, and does not take into account the standing of the originator.

It is useful to point out that, in order to carry out a successful ABS programme, it is necessary to follow certain rules that cannot be disregarded. First of all, every ABS projected for the audiovisual market

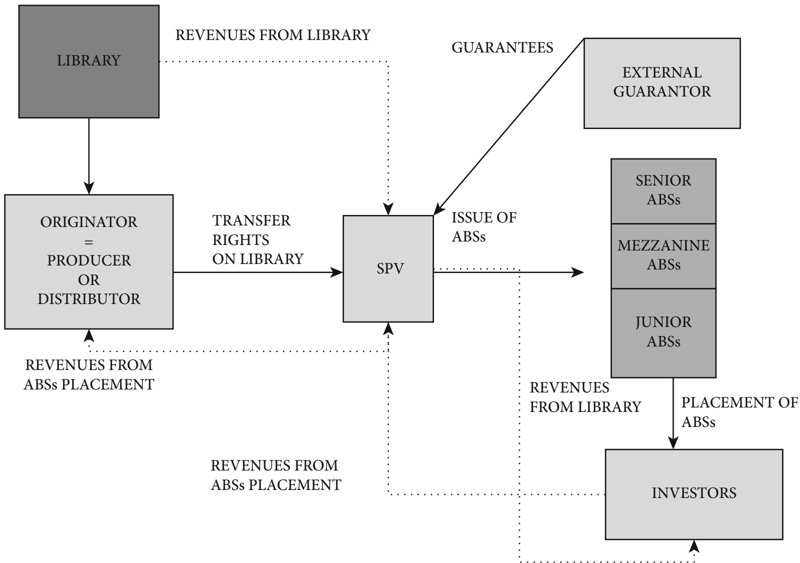

FIGURE 8.7 *Securitization of audiovisual rights*

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must guarantee the certainty of the chain of rights – which means that its object must consist in a package of rights on which the ownership is undoubtedly held by the originator. Secondly, a balanced and truthful evaluation must be carried out on the portfolio of rights.

Finally, it is necessary that the structure of the transaction can guarantee certainty on how the exploitation of the underlying rights will be performed in order to guarantee the expected performance and the regularity of the payback flows of the securitization.

Investment funds

Investment funds represent a way of raising financial resources that allow audiovisual companies to finance their needs; at the same time, individuals and institutional investors may invest their savings into a basket of projects, taking advantage of any existing tax benefits.

Investors are willing to channel their resources towards a dual objective:

a) the search for a profitable investment that would not be correlated to the performance of other traditional industries;
b) the opportunity to take advantage of tax benefits, usually associated with the investment.

The fund is divided into shares, pertaining to a plurality of investors and managed without customized treatment, by a management company. Investors buy shares of the fund, and their money is used to cover the budget of a pool of audiovisual products. It should be clarified that investment funds also adopt an approach of gap financing, under which funding does not cover the entire production budget but serves only to cover a certain percentage of it.

The fund invests in a pool of products, appropriately selected, with various characteristics, so as to minimize the probability of failure and maximize high returns. Once these products are completed, marketed and begin to generate revenue, investors recover the amount initially paid plus a return that can be equal to a percentage of the proceeds, or can be calculated as percentage of the paid-up capital, depending on the extent of the funding and the structure of the fund. In addition to participating directly in the revenue generated by the products financed, usually the Fund has also a share in the ownership of the products.

Each fund must also define an exit strategy as having a duration it needs to emerge definitively from their investments before deadline.

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This requires being able to resell one's shares of the property to producers, or to third-party investors, rather than resorting to a securitization of rights.

For an investor, the attractiveness of a fund lies in the seriousness and competence with which the pool of projects to be funded are analysed and which should be chosen so as to allow a minimization of the risk of commercial failure and burdens. Naturally, tax benefits, usually associated with this kind of funds, represent a protective cushion from any losses or leverage of future revenues.

To summarize, the potential of any investment fund may be reduced to five variables:

- *track record* of the management of the fund, and the production companies who routinely work with the fund;
- *instruments and hedging policies*, which can generally take the form of completion bonds, insurance on the cast and director, pre-sales, estimates of an independent sales agent, careful preparation of the waterfall of repayments and hedging against currency risk;
- *artistic quality and commercial potential* of the products financed;
- the *degree of diversification* of the product portfolio;
- the presence of *tax benefits* associated with the investment.

In the audiovisual industry, there are different examples of private equity firms that have taken the form of a closed-ended investment fund, whose shares are subscribed at an early stage of the fundraising. Once the amount of resources set as an objective of the fund is reached, the management company closes the collection and the investment begins.

In the light of the changes that have taken place in public policies supporting the audiovisual industry, the possibility of creating a fund of mixed private and public capital seems an interesting opportunity. In such a scheme, the public body, or the State directly, may subscribe junior shares and work as "lender of last resort" for private investors; moreover, it would have the advantage of participating in an initiative with the perspective of profit, with possible economic return; besides, this kind of investment could generate a leverage effect greater than that derived from traditional public grants.

Finally, if well planned, investment funds for the audiovisual industry are also appealing to a vast range of retail investors, as they can attract not only those motivated by purely economic purposes, but also individuals driven

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by a strong passion for the audiovisual market, as they believe it to be socially relevant to invest in an industry that produces "cultural" products.

Crowdfunding platforms

Crowdfunding – as the combination of words *crowd* and *funding* suggests – is a process of financing from the bottom. The innovative element of *crowdfunding* is the means by which it is made: the *web*. In essence, the *web* becomes the place where every person in need of money to finance their business idea, or to fulfil personal needs, can appeal to investors and lenders around the world willing to trust them. The meeting between borrowers and lenders is possible through web platforms. *Crowdfunding* is based on a belief that on financial markets there are resources available which are not channelled through traditional financial intermediaries.

Crowdfunding platforms can work in different ways (Figure 8.8).

Accordingly to their objectives, it is possible to identify four types of *crowdfunding*:[21]

1. *donation model*: is generally adopted by non-profit organizations to fund projects from which contributors do not seek revenues;
2. *reward-based model*: requires that investors receive a reward in the form of benefits or gadgets;
3. *social lending model*: investors receive back capital plus interests. Investors and beneficiaries are regarded, to all intents and purposes, as lender and borrower;
4. *equity-based model*: the investor does neither a donation nor a loan, but buys shares of a company: a real investment in venture capital.

As regards the audiovisual industry, the most feasible models of *crowdfunding* are mainly the donation and the reward-based model. These two types, in fact, are able to attract those investors who are inspired by the desire to feel part of the production process of an audiovisual work and do not require additional return. In order to realize the emotional aspiration, these investors are satisfied even if they do not receive any remuneration, or if they simply get gadgets and benefits related to the product. Different experiences of audiovisual crowdfunding have already been tested on different markets and are characterized by a spirit of non-profit donors. Given the nature of this financial support, *crowdfunding* falls into a category of audiovisual financing tools for *art house* products that are promoted by independent producers, often at the first experience. And therefore, it is used for products such as short films and web-native products. There are, however, rare but

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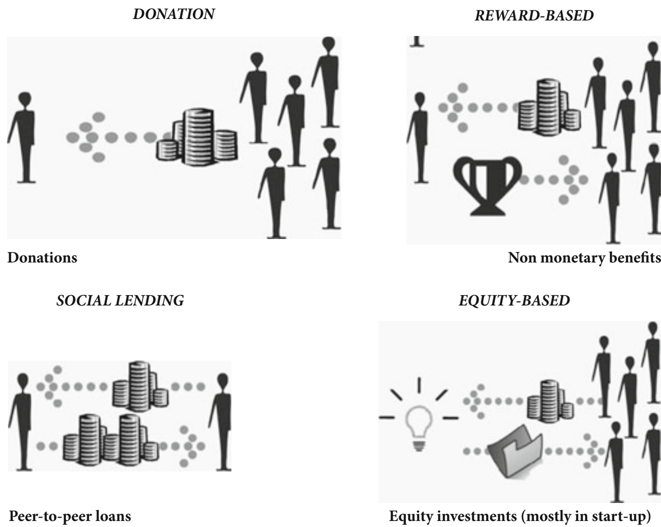

FIGURE 8.8 *Crowdfunding models*

high-profile examples of established authors resorting to *crowdfunding* that have also enjoyed significant success.

Crowdfunding, in the form of social lending and equity, can be seen as one complementary source of funding for medium-high budget products and as a significant funding strategy for *art house* and web audiovisual products. In the future, the recourse to web platforms could be used also by banks and financial intermediaries in combination with more traditional financial structures of bank lending, microcredit, as well as investment funds, especially for those projects with significant potential of future revenues.

The role of guarantee funds and fiscal incentives

Guarantee funds are a necessary tool for the provision of credit to businesses that have a low credit rating, and that do not have real or personal collaterals, as for audiovisual firms. According to this, for audiovisual firms, guarantee funds can be considered a *conditio sine qua non* for access to finance.

For a guarantee fund to work, some essential parameters need to be established. In particular: the *coverage ratio*, the *leverage* rate and the *percentage of provision* to the fund.

The *coverage ratio* of a loan is the loan ratio covered by the guarantee; it never reaches 100% of the nominal value of the loan itself, and represents

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a policy choice of the promoters of the fund. This choice has an impact on the maximum number of payable guarantees. The higher the percentage of coverage, the lower the number of loans guaranteed. The *leverage ratio* of a fund represents its multiplier effect – or how much of the total volume of loans guaranteed may exceed the nominal amount of the fund. This leverage is justified by the fact that it assumes a default rate of less than 100%. The higher the leverage ratio, the wider the maximum expansion of the fund – that is the number and volume of loans warrantable by the fund. Finally, the sustainability of the fund requires that it be fed as the guarantees are being paid. A portion of the guarantee provided must be set aside to ensure the availability of resources in the event of borrower's default.

The example below assumes a guarantee fund with resources amounting to €100 (Table 8.1).

Suppose that the maximum amount of a single loan is fixed at €10, and that the coverage ratio is 80%, while the leverage ratio is equal to 3, and the percentage of provision to the fund is fixed at 20% of the guarantee (option 1). The fund would finance guarantees for €8 on each loan (10 x 0.8). Given the amount of the fund, it can be deduced that the maximum number of loans warrantable would be equal to 37.5 [(100 x 3)/(10 x 0.8)] for a maximum amount of loans secured by €375 (10 x 37.5) and an accounting provision equal to 60 [(10 x 0.8 x 37.5) x 0.2]. If the leverage was lower or equal to 2 (option 2), the number and volume of guaranteed loans would be lower, and would be equal to 25 and 250, and the provision would equal to 40.

If, in contrast, the coverage ratio was lower, suppose equal to 50% (option 3), the fund would finance guarantees of €5 for each loan. In this case, the number and maximum volume of loans warrantable would increase significantly and would be equal to 60 and 600, while the provision would always be equal to 60.

TABLE 8.1 *The functioning of a guarantee fund*

ASSUMPTIONS	OPTION 1	OPTION 2	OPTION 3
AMOUNT OF THE FUND	100	100	100
LOAN AMOUNT	10	10	10
GUARANTEE COVERAGE RATIO	0.8	0.8	0.5
LEVERAGE	3	2	3
ACCOUNTING PROVISION	60	40	60
NUMBER OF LOANS GUARANTEED	37.5	25	60
VOLUME OF LOANS GUARANTEED	375	250	600

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The financial crisis has accentuated the importance of guarantee funds to increase access to credit for businesses. Banks and financial intermediaries will be more inclined to provide financing knowing that, in case of default, part of its risk will be covered by the guarantee fund. In Europe, there are several countries offering guarantee schemes devoted to the audiovisual industry; of some relevance are the guarantee funds established in France and Spain – based on public-private partnership – and in Germany where each federal State has a public guarantee bank aimed at facilitating lending to SMEs.[22]

For banks and regulated intermediaries, there is one more reason to take advantage of the guarantee funds: the prudential supervision rules they comply with, known as "Basel rules". They require the intermediaries to set aside regulatory capital in relation to the riskiness of the assets they have in their balance sheet. The more risky are the assets, the more capital is required. Banking and financial intermediaries, therefore, are reluctant to provide very risky loans as they demand greater volume of capital. When the loans are covered by collaterals, the percentage of covered loan shall not be reckoned on the purposes of capital absorption. To this end, however, it is important that the guarantee fund is Basel compliant. The Basel rules, in fact, lay down in detail the types of guarantees that are valid for the purposes of capital relief and modes of operation that the guarantee fund must comply with.

A greater involvement of financial intermediaries in the audiovisual market, therefore, necessarily requires the establishment of Basel compliant guarantee funds that can protect intermediaries from excessive exposure to credit risk. These guarantee funds are regarded as useful tools to compensate the lack, on the part of the audiovisual companies, of real guarantees eligible for the purposes of prudential supervision and capital absorption, allowing an easier access to credit for such companies and an easier risk management for financial intermediaries. It was the reason for the establishment of a guarantee fund promoted by the European Commission under the Creative Europe Programme and managed by the EIF, in favour of all the cultural industries. Such a Fund may be used in conjunction with national funds and adapted to the different financing structures used by financial intermediaries in the industry. An increased use of guarantee funds from the national authorities not only favours the leverage of public resources but would be a key lever to stimulate greater involvement of private investors in the audiovisual industry.

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This is also the case of tax incentives, which may be seen as an efficient tool to attract funds on capital markets. In Europe, several countries have introduced fiscal incentives for the audiovisual industry; most of them are intended for producers and distributors, but there are few also devoted to external investors.[23] When dedicated to private investors, fiscal benefits may act as a leverage tool for corporations and financial intermediaries willing to invest in the industry; investment funds may make use of fiscal advantage to promote private funding, while banks are encouraged to combine credit facilities with direct investments.

Any form of fiscal benefit, as well as any public guarantee scheme, has to respect state aid rules; within this legal framework, European countries should promote the implementation of guarantee funds and tax relief measures also aiming at a stronger complementarity with the traditional and incoming financial supports offered by the European Union.

Notes

1 The completion guarantor may also *take over* the film production.
2 For example, insurance on the main cast and the director; or insurance on the certainty of legal rights of a movie script.
3 On average, a completion bond contract requires from the producer a financial commitment of about 5–6% of the total budget of the production.
4 Other two effects of credit risk are the *opportunity cost effect* and the *sale loss effect*, but they do not assume great importance in the audiovisual industry, given the lack of a secondary market for loans.
5 The PD is defined as the mean value of loss distribution for a specific loan category; the LGD is the effective loss and it is calculated as the expected loss rate in percentage of the recovery rate (1-recovery rate).
6 This is particularly true for those intermediaries subject to Basel II and Basel III capital requirements.
7 Examples of banks active in Baujard et al. (2009).
8 For example the LIBOR (London Interbank Offered Rate).
9 The gap financed is usually 10–15% of the budget; the so called "super gap" is around 30% of the total budget: see Baujard et al. (2009).
10 The margin usually acceptable for the banks is of about 200–300% of the amount that is supposed to be granted.
11 Such a *fee* may amount up to 10% of the budget.
12 The average amount of a typical single film financing is around $3–5 million with an average duration of two years (Société Générale 2006).

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13 The average amount of a typical discounting credit facility is around $15–20 million with an average duration of five years. The average amount of a typical film slate financing is around $35 million with an average duration of 18–60 months (Société Générale 2006).
14 In Italy, BNP Paribas offers a special "leasing movie product" through its leasing firm Locafit.
15 Among others, Leone (2006).
16 Usually, the first instalment is much higher than others (paid on a monthly basis) and amounts to 10% of the overall value of the leasing.
17 And so it must have been already funded with other resources.
18 (La Torre M. 2006)
19 The ticked linked bond has an average maturity of 12–18 months (Société Générale 2006).
20 See La Torre M., Mango F., 2011
21 See La Torre (2013).
22 In France the IFCIC (Institute for Financing Cinema and Cultural Industries) is 49% owned by the State and 51% by several commercial banks; in Spain the Audiovisual Mutual Guarantee Society was founded by the Ministry of Culture and the Audiovisual Producers' Rights Management Association (EGEDA). For more details, see: Baujard et al. (2009), http://www.ifcic.eu; http://www.egeda-us.com/Egeda_AudiovisualSGR.asp.
23 Among others, the UK and Italy.

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