Why Australian producers should think more like distributors

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Note: The views expressed in this paper are the author's and do not necessarily reflect those of AFTRS.
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Introduction

In 1996 three producers joined forces to form Porchlight Films. The company’s vision was to develop and produce bold and innovative Australian films and television for domestic and international audiences. Today, Porchlight has a firm reputation as a dynamic company at the forefront of the independent production sector.

In the same year, two partners joined forces to form Madman Entertainment. The company’s vision was to distribute bold and innovative Australian and global independent film, specialising in wholesale video and DVD distribution throughout Australasia. Today, Madman has a firm reputation as a dynamic company at the forefront of the independent distribution sector.

In April 2006, one of these companies was sold for $34.5 million dollars. Which one?

If the answer is an obvious one, it’s nonetheless worth asking why this is so. Why should a successful distribution company be worth so much more than a successful feature film production company? Is this the natural order of things, or are there environmental factors that could be changed in order to achieve a more equitable outcome for producers?

There are very good reasons to strive for such an outcome. Producers are at the heart of the film industry. They commission and/or generate the ideas that fuel the industry’s creative engine. But low levels of business sustainability mean that many producers exit the industry early, creating a constant flow of ideas, energy and experience out of the sector.

Why the imbalance?

There are many reasons why feature film distribution is more lucrative than production. Most obviously, there is the matter of scale. Companies with a larger volume of product are by nature more competitive because they can operate on lower margins for any one title. Distributors also rely on supply and demand for leverage. There are a relatively large number of local scripts available in Australia, so distributors can pick and choose. And if there is no local product up to standard, or if the local product does not have a clearly defined audience, then there is an endless supply of foreign product coming...
down the line. This foreign product often comes at a competitively low asking price and with ready-supplied and tested marketing campaigns.

There are other contributing factors more specific to the film industry. I will briefly outline two of these. First of all, in most industries, the entity that puts up the earliest, riskiest money is paid back first. But in the film industry, it is the reverse. Distributors, who have put in the least risky money on a feature film, and pay most of it only when the film is completed, are able to take first dollars from all income. They recoup their total exposure, their advances, print and advertising costs and their commissions, all before a single dollar is paid out to the producer and investors. True, producers usually earn a fee from the budget of the film, but this is often the first item to be slashed and/or deferred in a financing crunch. Beyond those modest fees, producers (and their investors) must wait until everyone else – distributors, exhibitors, video stores, TV stations, sales agents – has drunk from the income well, before they can step forward and take a drink too (assuming there’s anything left).

Distributors combine their privileged position in the income stream (last money in, first money out) with another devastating advantage – their privileged position in the flow of information. It is distributors who receive the daily and weekly reports of box office takings, video sales and TV ratings. They handle and count the cash as it comes in. They are in constant, frank communication with the retailers of content. And they go to all the markets, year in, year out. All of this combines to create an information advantage that neither producers, nor significantly, the funding agencies, are able to offset.

In the economic literature, situations like these are often characterised as giving rise to the ‘principal-agent problem’. The term refers to situations where one party (the principal) has engaged another (the agent) to take some action on its behalf. The problem arises when the agent knows more about the action than the principal. This happens quite a lot in business because agents who routinely perform a service become very expert at it, while the principals who routinely hire them slowly lose whatever expertise they may have had (or perhaps never develop the expertise). Furthermore, the principals cannot really monitor what their agents are doing on their behalf. They have to take it on trust. Economists call this an ‘information asymmetry’, and we have it in spades in the film industry. Distributors know
far more about the market than the ‘principal’s’ they serve – the producer, funding agencies, and investors – and that puts them in the box seat.

To make matters worse, some models of government support have actually exaggerated this natural advantage of distributors. An example was the Film Finance Corporation’s use of distributor commitments as a signal of marketplace support, or commerciality. Obviously, this policy decision gave distributors the edge in negotiations over money and terms. It’s hard to argue with someone whose support, however modest, is going to be the trigger for much larger investments. But there was another hidden cost in all of this.

The hidden cost was the excessive reliance the FFC was putting on these thin little market signals. Yes, a distributor’s commitment is a signal that the distributor believes it can recoup its exposure. But what more does it signal? That the film is going to be a hit? No. That the critics will applaud it? No. That investors will get their money back? No. Yet all of these things were riding on the FFC’s decisions.

To be clear: the problems I’m describing here are not with the distributors themselves – they are, after all, making rational business decisions. The problem is with the model. It remains to be seen whether the restructuring of Screen Australia and the new financing culture around the tax offset will contribute to a change in this situation.

So what are producers to do? In the main, our industry consists of a loose collection of ‘kitchen-table’ operators, poorly capitalised, going from one project to the next. This is an acute and revolving problem. Producers complete a project and are either so burnt-out or broke that they leave the industry or return to ancillary employment to recover financially (and emotionally) – even when the project is successful. In doing so, they lose the chance to capitalise on their success, to consolidate their market knowledge and to maintain momentum around their production slate. This is in stark contrast to the way distributors do business.

As producers, we cannot change the system overnight. What we can do, however, is understand how distributors operate and learn from what they do. They make good role models. By watching what they do, we can improve
our own business practices and perhaps achieve the holy grail of long-term sustainability.

The lessons I am about to outline here are the result of a lot of work and no small amount of painful experience. For many experienced producers, they are of course elementary knowledge. But I know for producers just entering the industry they are crucial. Better to learn them here than learn them the hard way.

So, what is it producers overlooked in their tendency to focus on one project at a time and to make projects at any cost?

**Running the numbers: what can producers learn from distributors?**

Distributors often say, ‘Let me run some numbers and get back to you’. This simply means, ‘Let me estimate what I can make out of your project then calculate a number that I am prepared to pay you where I am at little or no risk’.

To run the numbers the distributor needs to know the following variables:

- the value of each of the rights in a film;
- the marketing spend needed to achieve these values;
- the extent to which costs can be offset against revenues from all rights and territories, and
- the volume of titles through the company’s release schedule.

Every distributor has a sophisticated spreadsheet, tailored to their company’s structure, to calculate the minimum advance payment for any project on offer, whether completed or at script stage. In the competitive fury of a film market, experienced distributors can simply run the numbers in their head. But the higher the bids go, the more they need to return to the spreadsheet to assess how far they are prepared to go.

1. **Assess the value of the rights**

The first thing a distributor does is assess the value of each of the rights being offered to them. They know, as any producer should, the audience and market thoroughly. While producers often are biased by a belief that their project is pure genius and bloody commercial too, distributors are never
biased. For them, it’s not about taste or story or message, it’s about audience.

Using their endless market knowledge – which is being refreshed and updated daily as part of their constant engagement with the marketplace – distributors can estimate the gross income (money in the door) from each right available. The rights include:

- Theatrical
- Non-theatrical (airlines, ships, hotels and motels)
- Video/ DVD (rental and sell-through)
- Video on demand (VOD)
- Pay television/ pay-per-view (terrestrial, cable, satellite)
- Free television (terrestrial, cable, satellite)
- New technology/ online (linear formats)
- Educational (Screenrights)
- Soundtrack album
- Merchandise

Every film is different. Every film has a different ratio between all these values, influenced by genre, audience demographic, story, cast, market trends, marketing costs, rating etc. For example, the Porchlight film Jewboy had a great deal of value for educational purposes. This meant that we could achieve good results in terms of institutional DVD sales and Screenrights returns (Screenrights disburses payments to producers for the use of film and TV materials by educational institutions). On the other hand, Little Fish had value in theatrical and DVD but not Free TV or Screenrights. Jewboy has outperformed Little Fish on those two rights. Little Fish had a surprising value in soundtrack album rights and it will have a long tail (because of Ms Blanchett) for many years to come.

Essentially, it is about discussing audience and market at the same time. It is about not only knowing who the audience is but also where, when and how they will choose to view the film. This point is now more relevant than ever, given the emergence of new delivery platforms. When I apply this idea to any film in my development slate, I find that each has a very specific distribution of values across each of the rights areas.
With a proper understanding of these values, producers can begin to think strategically about the rights in a film. Cathy Schulman, the producer of *Crash*, retained control and ownership over the majority of the rights in the film, as few territories were sold off to finance it. She said, ‘the domestic (US) sale had to be an upside scenario. Therefore, we removed the US theatrical rights from the financing scenario’. This became a key part of the economic plan of her film. *Crash* had the budget covered by what it could achieve on foreign presales alone and the remaining gap from domestic video pre-sales.

Assessing the value of a film’s rights also requires an understanding of what I would call its critical element. Every film has one, possibly a set of them, yet Australian producers rarely acknowledge, discuss or even ask the question: what is the critical element of this project and if it is not in place how will you find it? In the case of *Crash*, the film on paper had up to $10 million of value, because the actors were so much bigger than the production. The high profile cast, in other words, was the film’s critical element. This was its greatest asset and finding a way to protect it as well as present it to investors was central to the film’s success. On the other hand, *Crash* also had a thematic focus on racism. This, according to Cathy, was the film’s ‘significant negative’. But the core critical element (the cast) was enough to offset this negative. Australian producers need to pay closer attention to critical elements and significant negatives in order to properly value the rights in their projects.

In the case of one of my recent productions, it was clear there was little international presale value. I received international sales estimates from a sales agent, and then divided these estimates by four to produce the conservative case scenario – a figure I could present to private investors and back up with hard facts. I then went systematically through each of the rights in the domestic market and assessed their value. I calculated gross domestic box office based on figures from other recent Australian films. I presented this to the private investors as approximately half the gross box office (GBO) of the producer and director’s last two films. GBO is still the strongest indicator of the overall value of a project. Many of the other rights are either directly or indirectly calculated from this. Put simply, if you do $10 million box office, you can charge a premium for airline rights, pay TV and so on.

When calculating projected video and DVD sales for a recent Porchlight title, I investigated five film titles from the past six years that achieved box office figures similar to my conservative GBO. I was not privy to the commercial

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terms on all but knew the units sold – and this is really all the information you need. Then using the deal terms I was seeking from a distributor, I could calculate the gross and net values. I followed a similar process for airline, pay per view and pay TV rights.

2. **Identify budget-to-market ratio**

The value of all the rights in a project, once calculated, should directly inform the structure and strategy for financing it. Unfortunately, the current Australian development culture has got it ‘arse backward’. Producers are often asked to get their script budgeted before investigating the marketplace, knowing the audience or assessing the value of the rights. These elements not only have to be considered – they have to be thoroughly examined, as a project with the wrong budget-to-market ratio will never work commercially.

It is not uncommon to hear overseas distributors, producers and sales agents comment that Australian feature film budgets are inordinately high when compared with the sale prices paid for them. What is the price range paid by distributors for North American rights? In the context of budget-to-market ratio, this is essential knowledge. Why don’t more Australian producers know this? Sales agents do.

With a firm grasp of the value of the rights, I can run the numbers, as any distributor would. This time, however, it is not to calculate the minimum guarantee; rather, it is to calculate the proper size of the budget. Identifying the market value of a film requires a clear picture of all the critical elements. What are they and what are the significant negatives? What is the value of the rights in the film? From this, you can begin to devise your budget-to-market ratio and your financing strategy.

American independent producers are much more accustomed to thinking in this way than their Australian counterparts. For example, *Half Nelson* was a low budget independent film produced by Paul Messey and starring Ryan Gosling. Its budget was approximately US$1 million but this excluded many of what we would call standard delivery items. Paul raised the budget using private equity investors only. He based the budget on the minimum returns the film could achieve in the domestic and foreign market place – what I am calling the *conservative case scenario*. In other words, if the film didn’t fully achieve its artistic ambitions, this was the minimum income possible across
all rights and from all territories. What Paul had done was to assess thoroughly the value of the rights, and then used this to determine an appropriate budget level. Paul thus created a balanced budget-to-market ratio to take to investors.

Like Cathy Schulman, Paul identified the film’s critical element in order to determine the value of the rights and, by extension, the budget level. In this case, the lead actor was the critical element: Paul declared that if Ryan Gosling was not in the film he would not have made it. In both of these examples, the producers:

- Identified the critical elements in their films and their value in the marketplace
- Identified the significant negatives and adjusted the market value of the project accordingly
- Matched the budget level to a conservative estimate of likely returns
- Retained maximum possible control over rights

In other words, unlike many Australian producers, they viewed all aspects of production and financing through the lens of distribution.

3. **Identify Net Present Value**

Australian producers will need to grapple with the mindset and methodology of private investors if they are to prosper in the new financial landscape. Developing a financing plan for my film *Prime Mover*, I worked closely with an investment banker to develop my knowledge of private equity investing. Firstly, I learned that investors, serious investors, don’t take risks unless they believe the rewards will be commensurate. I quickly discovered that I needed a minimum position of 120 per cent recoupment before any investor would look at the project.

In order to attract investors, a producer will need to provide clear evidence that this return can be achieved from the conservative case scenario. This will need to be presented in a language and a structure that they recognise – an after tax cash flow schedule with a net present value (NPV). The NPV of a project or investment is defined as the sum of the present values of the annual cash flows minus the initial investment. The annual cash flows are the net benefits (revenues minus costs) generated from the investment during its
lifetime. These cash flows are discounted or adjusted by incorporating the uncertainty and time value of money (running the numbers).

The modelling needed to calculate these figures is involved, and there is not space to go into it here. Needless to say, this should be essential knowledge for all Australian producers.

4. **Maximise vertical and horizontal integration**

To control risks and maximise returns you need *vertical integration*. That is, you need to control as many steps in the value chain as possible, from development down to distribution. This integration should also extend *horizontally* across rights and activities.

‘Crossing costs’ is another common term used in distribution. It simply means that the cost of marketing the theatrical release can be recouped from the income on DVD sales or airline sales and so on. This is why distributors are rarely interested in anything but acquiring ‘all rights’ in any project.

For producers, this approach has its limits. The challenge is to maximise vertical and horizontal integration while maintaining a focus on production itself. The success of Porchlight Films is a direct result of our commitment of time and resources to the activity of producing quality feature films: our core business. That said, Porchlight has had to embrace vertical integration as part of its business and the financing structure of individual films in order to survive, let alone grow and produce more commercially viable films. We set up Jetty Distribution in 2006 as a separate arm of Porchlight Films, to enable us to co-distribute, to hold back rights and earn first dollar income as well as to take fees for the things we actually do such as trailer production and DVD extras – things that distributors would normally take fees for even if the majority of the work is done by the producer.

Arena Films, headed by Robert Connolly and John Maynard, has a similar model – with a production and distribution company (Footprint) side by side. However, in contrast with Madman and Hopscotch, we are not interested in physically distributing the films. Jetty is a structural mechanism that allows Porchlight to manage and engage with the market place and in doing so take fees and earn first dollar income.
5. Match delivery and marketing activities to the project

Delivery requirements for film and video elements and marketing materials should be directly related to the financing and profitability of the project. But for the most part Australian films either over-deliver or completely under-deliver.

For low-budget films, it makes no sense to demand a complete set of delivery items until the market value of the project has been established. In the case of *Half Nelson*, there were little or no delivery items in the budget, based on the fact that there was no domestic distributor or delivery schedule at the production stage. The producer, Paul Messey, did this to keep his ‘initial investment’ low and to optimise costs of delivery. This meant that as the film demonstrated its worth in the market place, Paul could deliver the film territory-by-territory, item-by-item.

I believe this should be the model for very low budget films that do not have a distributor in place at the time of finance. Producers with production budgets of between $500,000 to $1,000,000 can take a film to fine cut, then be in a position to deliver only what the markets for the film require. This forces the producer to think about who the film is for and how they will see it, rather than aiming always for theatrical distribution.

For higher-budget films the delivery schedule should be much more comprehensive. Yet budgets for most mid-level Australian films include only about half the delivery items. Often there is a negotiation to remove these from the budget in a desperate effort to get the budget down. In many cases, the producer and director become directly responsible for generating marketing and delivery items. Meanwhile, distributors gladly soak up the cost of these materials, knowing they can add in a margin and recoup them in the first position.

There are two reasons this has come about. Traditionally, many of these items were considered marketing costs and therefore non-tax-deductible, so over the 25 years of 10BA they were moved out of the production budget to maximise private investors’ tax deductions. To my mind, if a film is being co-financed with a funding agency, then the funding agency equity should cover the non-deductibles. Yet the practice remains and is compounded by producers trying to get their budgets down. Meanwhile, marketing costs
(except those incurred during production) are still not included as Qualifying Australian Production Expenditure (QAPE) for the purposes of the new offset. This problem clearly deserves attention from Screen Australia, but it is also something that all producers should consider. Is your marketing spend commensurate with your film’s potential returns? Could you change your approach to better suit the realities of the distribution marketplace?

Towards sustainability

In the past year the whole government and private investment environment has changed dramatically for the Australian film industry. If independent producers are to survive in this new climate they are definitely going to need a firmer grasp of the mechanics and strategies of distribution. By applying the philosophies discussed here, Porchlight has been able to structure financing and recoupment in a way that benefits all parties. This has been our ongoing set of objectives:

For the producer – increased control
- Hold on to the rights
- Create a revenue stream from first dollar
- Increase and strengthen the overall earning position of private equity partners

For the private investor – money back and more
- Increase and strengthen relationship with the producer
- 120 per cent recoupment achievable from the conservative case scenario

For the distributor - net position no worse
- Zero impact on their commitment to release and market the film – possibly a more committed position
- Net position (fees and profit) no worse then if they paid a premium MG under previous model

For the government – net position no worse
- Total equity commitment lower than government agency average for film of this size
- Above average government agency recoupment for films that achieve same gross as conservative case scenario.
In other words, Porchlight has based its approach on a careful assessment of the value of rights across various markets, the needs of investors and distributors, and the financing and recoupment process. Yet many young producers do not understand the mechanics of distribution. Time after time, I have seen disempowered, broke and emotionally exhausted producers retreat from the industry, not really knowing what went wrong and therefore having no fuel, resources or power to take their next film to a higher level. Most often there is no next film.

Rethinking the financing and distribution strategies for low budget films is one solution to this problem. In cases where a film is only able to justify a release of 10 prints or fewer, the producer should be the co-distributor. Recent examples *The Bet* and *The Jammed* illustrate how this can work. This sort of approach is further enabled by new digital delivery systems, which allow producers to have a direct relationship with delivery providers (exhibitors of the future).

Meanwhile, the producer offset holds out the prospect of a business model in which producing is a viable activity. However, Australian producers should be under no illusions about this. The best financing models in the world cannot alter the fundamental imbalance in the system – an imbalance caused by a combination of natural advantage and systemic bias. For government, the need is to re-examine industry support models and ask whether they are exacerbating producers’ natural disadvantage in relation to distributors. The formation of Screen Australia holds out the possibility that these issues may be addressed soon.

At the same time, producers can’t simply assume that the rules will be changed to suit them. The success of distributors, based on a deep understanding of risk and return and a rigorous approach to business planning, offers us an excellent model for study. Producers need to grasp the fundamentals of this approach. Only then will they be able to take proper advantage of the opportunities offered by the new offset. Only then will Australia be on its way to creating a sustainable feature film production sector.