

# **Report on UK Film Finance Summit October 2004**

**“Making sense of Britain’s New Financial Climate”**

**Prepared**

**by**

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## 1. Introduction

Screen International's Film Finance Summit brings together the top players from the UK Film Industry and beyond to provide a open forum to encourage some 'blue sky' thinking on the way forward for getting films made in the UK and further strengthening the industry at home and internationally. The industry is on a precipice, new tax breaks on the horizon, UK co-productions treaties and EU conventions under review, new models are being sought to bring distribution to the fore as a way of increasing the success of UK films and realising that the cost of making films in the UK is higher than ever there is continuing pressure to find more economical ways of making films in the UK.

### Key questions of the Summit

- Can the UK film finance sector maintain its pre-eminent position after 2005?
- Will the son of Section 48 (new tax break) deliver the good?
- What will be the future role of fund managers and sales agents?
- What kind of funds will be launched in the future?
- What will be the impact of changing EU conventions and UK treaties on co-production?
- Which countries are in the best position to financially interface with the UK film industry and how will they do it?

## 2. Keynote Address

John Woodward, CEO UK Film Council – 2005: A watershed year.

John began by quoting from a government report which described the film industry in the UK as fragmented, with no stability where there is acrimony between certain sections of the industry, where too many extravagant under-performing films are being produced, in a climate where distributors are taking too much for too little. With a murmur of quiet acknowledgement rippling through the delegates he then revealed that that report had in fact been published in 1952, begging the question 'What has changed?'

Although the quote painted the picture of a bleeding industry and many would agree that little has changed, John's assertion was that the industry should regard its position as being more positive than negative, 'the glass is half full'. The UK film sector remains the 3<sup>rd</sup> biggest market outside the USA and provides the biggest volume and most diverse financial packages outside Los Angeles. It is perceived to be the 'coolest', still sells more films than it buys and is perceived around the world as dynamic and entrepreneurial - the industry is on a roll at present!

Always perceived to be economically inefficient and easily abused, the withdrawal of the Section 48 tax break for film production in April of last year promoted the industry and government to find a more efficient tax break that would really achieve the result that public fiscal support is supposed to, i.e. encourage and support a sustainable film industry in the UK. The recent replacement of Section 48, currently being referred to as 'son of Section 48' is a permanent tax credit initiative, the details of which will be worked out over the next three to four months. The credit will not be transferable as had been hoped but will be available to the actually entity producing the film. The credit will be available to films with a budget up to £20m and current provision under Section 42 will remain for budgets in excess of £20m. John strongly advised the industry, for it's own sake, to look on this new provision as a privilege and not a right and warned against seeking ways of manipulating or abusing it. The success of the new tax relief provisions should not be measured purely by any increase in production it may bring but by how many more UK films get in front of audiences. To this effect that DCMS wants to see stronger links between the distribution and productions sectors and the UK Film Council is working on a number of initiatives in this area.

As well as continuing its support for distribution with the P&A fund and the roll out of digital screens across the UK, the UK Film Council will increase the pressure on PBS broadcasters to increase their support for UK films and will continue to lobby for greater fiscal incentives to support distribution. It is only increased distribution that will give UK films the greatest chance of increasing their financial return and therefore support a sustainable industry. It is worth noting that the top 10 UK films have a combined revenue of over £2billion.

One other potentially inhibiting factor to the sustainability and growth of the film industry in the UK is the growing problem of piracy, with DVD reproduction methods becoming easier and cheaper the scale of the problem is escalating. Over 2 million pirate copies of UK films have been recovered in the past year and that is reckoned to be only the tip of the iceberg. The UK Film Council is currently completing a report on piracy which will be delivered to the Government next month.

In conclusion, while the balance sheet of the UK Film Industry is healthy and there is greater cohesion of public policy, if the disparate facets of the industry can be brought together in a climate where there remains strong support from the Government then we will have the beginnings of a sustainable industry.

### **3. The Son of Section 48 – new tax relief for film**

This panel discussion looked at the new tax relief on offer, examined the details of the new provision and considered the real benefits available to productions and producers.

In his budget of 2004, the Chancellor of the Exchequer announced that "Section 48 relief" for low budget British films will be replaced when it expires in July 2005 by a new relief to be given directly to the film producer. It is thought that the new relief will typically fund around 20% of production costs, compared with 15% for Section 48. Production companies will be entitled to a deduction of 150% of a film's production budget which can be offset against income when computing its business profits. The company will be able to surrender losses, up to a limit of 100% of production expenditure, to the Inland Revenue for a cash payment equal to 20% of the amount of the loss surrendered. The current Section 48 relief will be extended to apply to production or acquisition expenditure on films where the first day of principal photography is before 2 July 2005; and the completion date is not later than 5 April 2006.

There was considerable uncertainty regarding how the new relief will work and what the actual percentage benefit will be to a production. There is no fixed percentage and it will vary depending on the financing structure and how the producer chooses to apply the relief. Paul Candler, Head of Film at the DCMS stated that there was genuine desire from the Government for this new relief to work for and support producers of low budget films but warned that it must be cost effective for the treasury in achieving its aim of creating a sustainable film industry in the UK. Opportunities for tax avoidance, as was perceived with the previous provision, must be avoided and there will be greater monitoring of how the relief is being applied. The relief will be extended to P&A cost and UK distribution will be a condition of the credit.

Peter Watson, Chief Executive of Recorded Picture Company, contends that a lot of producers perceive the relief to be a straight benefit of 20% of production budget, that may be the case if 100% of expenditure is surrendered, whereas in practice he suspects most producers will find themselves surrendering 50%, providing a 10% benefit. There may be a danger in surrendering 100% of expenditure because if the producer recoups more than 50% of the budget there would be a tax liability further down the line.

There was further uncertainty over when the cash benefit from the credit will be available to producers leading to questions over whether banks will be willing to cashflow the benefit at the time of production or will producers have to rely on high wealth entities or individuals to cashflow the benefit in return for a cash benefit.

It was felt that bank will be wary of providing cashflow of the new tax relief as it is reliant on certification as a British film. This certification can not be applied for until the production is complete and there is no guarantee, except in the case of a film being wholly developed, shot and post produced in UK, that certification will be forthcoming. As a result of this uncertainty it is thought that a species of middle man will evolve who will broker the cashflow of the tax relief in return for a cash benefit.

Paul Candler accepted that previously the certification procedure had been oblique and slow and the DCMS are responding to industry requests to review the procedure and make it more transparent, easier and, most importantly, quicker.

There was a general feeling that the new relief will take a year or two to bed down, as seen with the previous provision, and similarly, over time, we will see an increase in the net benefit available to producers as market forces come into play.

There was general agreement between the producers on the panel that the transitional arrangements could prove difficult and that the deadline of 5 July 2005 for start of principal for Section 48 relief be lifted but retain the completion date cut off at 5 April 2006. This would mean that producers will be better able to plan the financing of their productions during the transitional period.

There was a strong desire to see the new relief being used to support and encourage commercial success. To this end the benefit received as a result of the credit should be treated as producer's equity. This will be suited more to companies that are the producer and exploiter of their films but in any case the producers 'contribution' should stand shoulder to shoulder with other equity investments in a film. As the credit needn't be applied to a particular film but can be used to offset the profits of the production company then why should the it not be regarded as equity investment from the Producer?

As the technical details of the new relief are worked out over the coming months the key issues will be insuring this process itself happens speedily; that the DCMS know and understand the complexities of 'patchwork' financing of UK films; that the process of certification of a British film is reviewed and improved considerably; that the industry ensure that the new relief is, as intended, focussed on film makers and producers and that pressure is brought to bear to convince the treasury to remove the July 2005 deadline for the current Section 48 relief.

#### **4. A new model for production costs – how low is low?**

Recognising that film production costs in the UK continue to rise, this session focussed on the development of lower cost production models as a way of insuring UK films remain competitive.

Simon Relph, author of the Relph Report into low cost film making in the UK, informed the summit that a working group has been formed to look into the report and make recommendations which will be published early next year. The report maintains that it is films with a production budget in the range of £3-5m that have the greatest difficulty in closing financing. It is hoped that distributors can be enticed back into investing in the production industry and therefore assist film in this budget range.

Alan Niblo from Vertigo films outlined his company's approach to low budget film production stating that there is a strong focus on the potential market of a film from script stage. Films are budgeted in the £0.5-1m range and financing does not rely on subsidy or TV sales. Financing is sought from high wealth individuals or entities who make a direct equity investment, coupled with tax relief provisions such as sale and leaseback. The films are produced using a set 3-tier crew deal – starting at £1k per week for HoD's, £750 for lower ranked technicians, and a lowest weekly rate of £500. The copyright in the films is retained by the company, who also handle the distribution. This ensures that the a greater percentage of the revenue from each film is returned to the company.

Vertigo concentrate on films with first time directors and works hard to maintain the relationship with these directors as their careers advance.

There will be further investment in very low budget, or 'micro' budget, films from Film London, in order to support the development of new talent.

The volume and success of lower cost British films may be increased if there is a move away from borrowing against overseas sales potential to fund films and more work is put into developing lower budgeted films that are particular to the UK market. New development models, such as a group of creatives working with a set low budget make a decision on what films should be produced, and the investigation of different distribution models would all increase the chance of low budget films being financed and finding a way to their intended market. There may also be scope for lowering production costs by creating a corridor on revenues which can be used to reward producers, cast and crew that accept lower fees at the production stage.

## **5. What kind of middle men do we want?**

One of the intended outcomes of the change in the tax relief provision for UK Films was the removal from the finance loop of the companies that emerged as a result of the need for private film partnerships to be formed, to allow producers to access the benefit available through the previous tax breaks. The blame for the perceived abuse of the previous system fell squarely on the shoulders of these, so called, middle men. This session explored the evolving role of the middle men.

Michael Ryan, Chairman of IAC and IFTA, started by asserting that the new tax relief provision will not, as intended, remove the need for middle men when accessing the benefit. As discussed in an earlier session, there is uncertainty as to how the benefit will be cashflowed during production and this will lead to a need for some form of brokerage.

It may be a mistake to believe that the middle men were completely to blame for the abuses of the previous tax provisions and it must be recognised that these very entities brought a considerable amount of new equity into the film sector, a sector that had always had an uneasy relationship with investors. Private investors feel more comfortable when dealing with the middle men.

Most producers accept the need for middle men and are most interested in the relationships that will allow them to close the financing on their films with as little manoeuvring for leverage as possible. Most problems arise when a producer is trying to get gap financing from a bank, this is usually the point where other parties to the financing agreement can become difficult, with distributors being single out as potentially the most difficult at this time.

It seems that sales agents will become even more of a force in the market as a result of the changing financial landscape. As it stands sales agents, and their involvement in providing sales estimates with the required coverage, are a crucial part of the finance loop. Except in exceptional circumstances there will be no pre-sales or advances on most films and banks are asking for increasingly higher degrees of coverage from sales estimates when agreeing gap finance. This has led to a greater focus on how much films will cost, what is the realistic potential of the film in the market and, therefore, should it be made?

There is even a suggestion that they could manoeuvre into a position where they become principal financiers, investing in production or cashflowing the benefit of the new tax credit, in return for greater participation in revenues from exploitation of a film. This of course will give them greater control over what films are made and why. There is mixed feeling over whether this would be a good move or not but it is accepted that the strengthened position of sales agents in the financial loop is inevitable.

Mo Yousef, CEO of Invicta Ltd, remains unconvinced that there will be enough of an incentive for middle men to remain involved with financing through the new tax relief, although they will still be involved in Equity Investment Schemes and Venture Capital Trusts. Excluding the middle men from the roll out of the new tax relief he perceives as an 'own goal' for the industry. With the uncertainty surrounding the new relief and the technical details of its implementation still to be ironed out, the lack of involvement of these experienced financial brokers could prove to be a great loss.

So rather than ask what kind of middle men do we want, it may be better to ask what kind of middle men are we going to need and more importantly what kind of middle men are we going to get regardless? There is already evidence that some middle men are becoming producers, the Priority Pictures venture involving Marion Pilowsky and Colin Leventhal being one example, and we are left with the suggestion that more and more will follow with possibly even greater involvement in development, production and distribution. It is clear that the middle man will not disappear but will evolve as the industry evolves.

## **6. Future perfect – what kind of funds are on their way.**

Looking back at investment over the past tax year 03/04 it is clear that the majority of investment into the industry was in Deferral Benefit tax schemes such as Sale and Leaseback. With the change in tax relief this will undoubtedly change, will we now see a transferral of the funds invested in deferral schemes into other initiatives such as Equity Investment Schemes or the new Venture Capital Trusts?

In a recent article in the Times, Imelda Staunton, star of Mike Leigh's award winning *Vera Drake*, bemoans the lack of risk taking investors in British film. But as we are reminded by Keith Evans of Baker Street Media, private investors don't like, and never have liked, investing in film. It is still seen as far too risky an investment, even when dealing with a known property or talent such as Mike Leigh. The huge gross investment in British film we've seen since 1997 is as a result of the tax deferral schemes, low risk investment, that allows investors to protect profits from their other activities and defer tax on these with very little risk investment that actually relies on a film's success at the box office. These investors are very unlikely to change their minds and start taking the kind of risks that would be required to keep the level of cash investment we have seen recently.

On the issue of the banks view on the new tax credit, Rob Sherr, Head of Media at Bank Leumi (UK) plc, disagrees with the widely held view that banks will be unwilling to cashflow the benefit received from the new tax credit although he does suggest that the benefit, and the amount banks will be willing to lend against, is more likely to be between 10% and 12.5% of anticipated allowable expenditure of a film. There are still challenges facing bank in taking on the role of cashflowing the benefit and what is not clear yet is how the banks will mitigate all the identifiable risks, although as matters stand none of the problems appear insurmountable. It is hoped though that as they banks obtain greater clarity and experience the percentage of expenditure that will be available to the producer will increase. In order to avoid the treasury coming back and changing the way in which the credit is used, therefore causing problems for a continuing and positive position from banks, the DCMS, the UK Film Council and the industry must work together to ensure the new credit works properly and any abuse is not sanctioned.

The uncertainty over the change in the tax relief will possibly be off-putting to international co-production financiers and partners in the first instance. EIS schemes should remain unaffected as the benefits from them are not affected by the new tax relief provision. What we might see though is EIS companies investing in a number of films rather than in individual projects.

Paul Brett, Director of Prescience Film Finance, advises producers and production companies that the best way in attracting and retaining investment in their films and companies is to 'think global and act local', in other words be outward looking in your in terms of your product and your ability to market that product but remain committed to local trusted talent and seek investors that understand and appreciate that view.

The biggest barrier to real equity investment in UK films remains the difficulty a investor has in identifying the profits to be made. It is not a simple as looking at a films budget and comparing it with the box office revenues. The complexity of film financing, marketing and distribution make certainty almost impossible and the perceived risk too great.

Section 42 relief still remains for films budgeted over £20m but this is a small market in the UK as very few films have a budget level that high and most of the ones that have are backed by studios or mini-majors. The benefit of Section 42 to investors through EIS or Venture Capital Trusts is as yet unproven.

Distribution is an area where we may see more investment in the future, producers may take advantage of this by following the Vertigo Films model, where the producer retains copyright and handles their own distribution. In any event to encourage future investment producers need to have a international outlook to their businesses. The industry in the UK as a whole will have to accept that to stay competitive there will need to be a move towards making fewer, more commercially attractive films.

## **7. My Euro-vision**

Mathew Justice, Producer with Lunar Films gave a personal view on the changing landscape for European co-productions. With the current review of the bi-lateral and European Convention treaties and the increase in the required UK spend to 40% of budget, more films made under the treaties will have to look at shooting more in the UK, although this remain difficult because of the prohibitive costs of shooting here. There needs to be more of a focus on films that benefit creatively from co-production rather than just looking at the financial benefits, he sights Ken Loache's work as an example of where this works effectively. He is currently working on the 65-35% Anglo-French co-production of *Russian Dolls*.

There also needs to be a more streamlined procedure for UK certification and the paperwork for co-productions under the treaties also needs to be streamlined. UK producers need to ensure they get a return on the benefit being provided through the new tax relief and reiterated the view that this credit should be seen and used as producer equity.

## **8. Mixed marriage: are co-productions a success story or the latest funding abuse?**

Steve Norris – UK Film Commissioner, currently leading the review of the co-production treaties, indicated why the review is crucial now and what is expected to come from them. To begin with the treaties are out of date, they no longer reflects the way the industry works both here in UK or in the international market. There are grave operational concerns about these treaties, the system appears to be overloaded. The UK need to remain attractive a co-production partner but something must be done to address the feeling of defensiveness towards films made under the treaties as there remain too many where the UK producer is the minority partner. The treasury and the industry need to identify what is it that we want out of these treaties. There must be an balanced economic and cultural benefit to the UK and UK Procurers must be seen to be gaining experience and knowledge through them.

Although there is no, or at least no strong, suggestion of abuse with co-productions it is still recognised that the benefit received under these treaties is soft money and will always be attractive to producers in financing their films. It is recognised that in order to ensure a greater transparency and to avoid suggestion of abuse then more co-production will have to shoot in the UK with majority UK partners. Of course this remains difficult because of the high cost involved in shooting in this country.

It seems for most producers of low budget films in the UK that it is no longer possible to 100% fund in the UK and that co-productions are an absolute necessity to get their films made.

What is needed to ensure that the UK remains competitive in the co-production market and to ensure that UK Producers can reap the benefits is certainty from the Treasury, the DCMS and the UK Film Council over the use of the new tax relief provision and qualifying criteria for co-production, a more streamlined system for certification, with responsibility for this possibly moving to UK Film Council, along with a greater contribution to UK films from PBS broadcasters.

## **9. Come fly with me: exploring which nations make the best production partners.**

This session presented the summit with 3 emerging markets in terms of co-production.

Marc Noyons, Marmont Film Financing, explained the reasoning behind the start up of Marmont and the beneficial climate from co-production with Belgium. The tax sheltering provisions in Belgium cover 50% of the budget of a film where 40% of that can be in loan form and 60% in equity with an obligation placed that 90% of the equity invested must be spent in Belgium. The incentives from a producer's point of view in co-producing with Belgium is the high creative qualities in music, design, sound and special effects, a profusion of excellent locations (although there are few shooting stages), excellent post production facilities at competitive prices and high quality production support. For investors the benefits included a simple transparent tax scheme that offers a 51% immediate tax break, there is limited risk and interesting yields for equity investors and the films have the high chance of reaching target groups. The estimated volume of co-productions in Belgium as a result of the present climate in 25m Euro in 2004 rising to 50m Euro in 2005.

Eddie Mballo, CEO of the national Film and Video Foundation of South Africa (NFVF), presented a comprehensive overview of the cultural, economic and trade imperatives in progressing the film industry in South Africa and the important part that UK co-productions can play in this arena. There is an obvious need to address a historical imbalance in the opportunities for ordinary South Africans to bear influence in the expression of their own images and thereby deepen democracy and create prosperity. The Government, through the formation of bodies such as the NFVF and their considerable investment in infrastructure and facilities, are committed to creating an environment that develops and promotes the South African film industry domestically and internationally. The South African Film Incentive provides a rebate for film and television production which is readily available to UK productions which are compatible with South African locations, culture and co-productions. Currently, co-production between SA and UK occur through other intermediary treaties such as Canada. This brings about many hurdles and costs which ultimately compromises the flow and volume of SA/UK co-productions. Therefore the finalisation of the UK/South African co-production treaty is a matter of top priority.

Thomas Leong, President of International Pacific Artists, briefly outlined the market conditions in China. There are 200-250 films made in mainland China each year. Most are in the \$1-3m range with up to 10 budgeted at \$10m and 3-5 films per year with budgets in excess of \$10m. China is a protected market, a indigenous producer receives over 30% of gross revenue from a film whereas the producer of an imported film can only receive 10% of gross. Chinese investors usually make up between 10 and 50% of a film's budget.

## 10. Summary – Jonathan Olsberg of Olsberg/SPI

In overview the film financing landscape in the UK is complex and unpredictable, it changes regularly and when it does the effects of that change are unclear.

Echoing John Woodford's 'glass half full' view of the industry, Jonathan listed the healthy and unhealthy aspects of the industry at present.

The Unhealthy half of the glass:

- Producers – the engines of the industry are weak and have little or no leverage, can they really be called independent when they are so heavily reliant on everyone else?
- Legislation – the new tax legislation is unclear and perceived to be of less benefit than what went before.
- Broadcasters are not pulling their weight in supporting British Film
- Talk is centred around financing individual projects rather than looking at ways of developing sustainable companies.

The Healthy half of the glass:

- UK's creative talent is strong and the envy of other countries.
- The much maligned middle men are actually a major resource for the industry and the UK has an abundance of credible and talented film banks and lawyers.
- The Government remains very positive towards encouraging and supporting the industry, with representations to the Treasury better than ever.
- More than even is being spent on training for the industry.
- UK has huge range of companies and productions in the market from micros to majors (companies like Vertigo Films, productions like Troy)
- UK has great international contacts.

From here on:

- The new tax credit must be made to work and must be counted as Producer's Equity, perhaps the recoupment could be held in escrow for the Producer or companies next production.
- We need a 5% corridor on recoupment for producers.
- Middle men must ensure that EIS and VCS work.
- We must make sure there is public support given to new directors.
- In the future we need to focus on fewer films with a greater chance of distribution.
- Production, finance and distribution must be brought closer together, perhaps EIS and VCT schemes could play a greater part in this.
- Co-production treaties and their administration must be improved.
- There should be a line in budgets for UK P&A expenditure.