Re: Economics of Film Industry

The Advisory Committee on Film Finance

Report to the Secretary of State for National Heritage

July 1996

(Selected Extracts)

2: What are the obstacles to investment in the British film industry?

Introduction

2.1 The world market for film and film-related products is large and growing. Worldwide, the estimated revenues earned by films in 1995 were over $50 billion. With the increasing number of pay TV channels, the development of pay-per-view, the continuing popularity of video sell-through and rental and the emergence of new media capable of using film in exciting new ways, it is expected that this market will continue to enjoy rapid growth over the coming years. However, of that total turnover, just seven companies – the US major studios – account for around $20 billion.

2.2 Given this market structure, it is difficult for smaller countries to try to compete with the Americans. In many countries, the film industry has tended to turn inwards, concentrating on making small-budget films of cultural relevance to the domestic audience without too much consideration given to their wider international appeal. In the UK, despite our cultural differences, our shared language with the Americans leaves our market more open to their product. Conversely, producing films in the international language of the cinema gives British film-makers more opportunities to sell in overseas markets than many of their European counterparts.

2.3 In recent years, since the brief heyday of Goldcrest in the mid-eighties, the British industry has generally failed to compete effectively in the world market. Although more British films were made last year than in any of the previous 20, the level of investment, in real terms, was lower than in 1985. A large proportion were wholly or partly financed from overseas. The proportion of British films achieving widespread theatrical release also fell during the last ten years – from more than 50% in 1985 to 27% in 1994. Finally, the share of domestic Box Office enjoyed by UK-produced films remains at 8–10%, rising periodically as the result of a home-produced success, before returning to this level, while US-produced films continue to enjoy between 80% and 90% market share. This gives UK-produced films one of the lowest shares of domestic Box Office in Europe. A summary of key industry statistics is at Appendix A.

2.4 It is within this context that the periodic successes of the British film industry must be viewed. There is little doubt that Britain still produces some of the best creative and technical talent in the industry and boasts some of the best studio facilities in the world. British talent (including both cast and crew) has won around 30% of all Oscars awarded in the past 20 years as well as a whole host of other awards, including most recently Mike Leigh's Palme d'Or at Cannes for *Secrets and Lies*. Every few years a British film, such as *The Crying Game* or *Four Weddings and a Funeral*, is produced which becomes a major Box Office hit around the world.

2.5 Subsidy to British films per head of population is considerably lower than in any other comparable film making country outside the US. At around 50 pence per person per annum, the UK subsidy figure is 40% of that paid in France, a third of those paid in Australia, Canada and Germany, whilst in Ireland the cost in terms of gross tax revenues forgone last year was £12.20 per head (see details in Chapter 6).

2.6 Despite the inherent strengths of the UK film industry, and the occasional successes described above, the long-term prospects for the industry must be seen as poor unless the downward spiral of low investment and under-capitalisation can be broken. Whilst one cannot reasonably expect British companies to compete on equal terms with the US majors, the market is big enough that there is no reason why a well-run, properly capitalised film industry should not be able to increase its share of the domestic market and make inroads into global revenues.

2.7 The remit of this Committee was to look at the reasons for the lack of investment by British companies in the film sector and suggest ways of removing barriers to such investment. This chapter attempts to identify the structural, financial, and perceptual obstacles to investment, many of which have been derived from discussions with the investment community. Later chapters consider how these obstacles might be overcome.

Structural Obstacles

2.8 The Committee's terms of reference specifically referred to the structure of the film industry as a possible barrier to investment. Film production in the UK tends to take place in small units, many of which are only set up to produce a single film. According to evidence submitted by the British Film Institute, in the 1980s 454 feature films were produced in the UK by 342 different companies. Although there are advantages to this small-scale approach, particularly in terms of the technical quality of much of the output, it is a structure which allows for no cross-collateralisation between successful and unsuccessful projects and, hence, is unattractive to City investors wary of the risks inherent in the industry.

2.9 These small-scale production companies tend to have little or no capital. Films are financed on a project-by-project basis which, given the producer's desire to see the film made, can often lead to the company accepting finance on unfavourable terms. Furthermore, such companies generally have to sell the rights to their films in order to finance physical production, leading to a vicious circle of self-perpetuating under-capitalisation. Many larger production companies choose to make films through single project subsidiaries in order to protect themselves from creditors in the event of the film's failure. By so doing, however, they may be contributing to longer-term difficulties in raising production finance.

2.10 At a purely practical level the lack of an adequate financial structure can often mean that the production company simply cannot present potential investors with an adequate set of financial statements. A related issue is the lack of experienced managers and financial managers within the industry. Production companies are often headed by the creative brains behind the particular film project which means that decisions are often grounded in artistic ambition rather than taken on the basis of commercial logic. Whilst putting together a good film deal undoubtedly involves entrepreneurial skills and business acumen, it does not necessarily lead to satisfactory budgetary control and accounts.

2.11 Many consultees, from both the film and financial sectors, considered that investment would remain patchy until the industry developed some big players incorporated along the lines of the US studios with production, distribution and possibly exhibition all contained within the same companies. Effective exploitation via a captive distribution arm allows the Hollywood majors to maximise returns on the films they make, and the UK market is no exception to this rule. The role of distribution is returned to in greater detail in the next chapter.

Financial Obstacles

2.12 There is a strongly-held belief within the City that the film industry is too risky a business to become involved in. Over the years, most of the great success stories within the industry have fallen apart even more quickly than they have risen to prominence. Well documented cases include Goldcrest – which was seen as heralding the renaissance of the British film industry, before it ran into problems when three big-budget films, which absorbed most of the company's capital, failed to produce the expected financial returns, all at the same time – and Palace Pictures – which was responsible for *Mona Lisa* and *The Crying Game* but then went into liquidation owing money to a large number of creditors. These experiences are still remembered in the City whose attitude is that if well-established and apparently successful businesses like those could not survive, then there are likely to be even poorer prospects for smaller companies.

2.13 It is also well-known in the City that even the Hollywood majors are unlikely to achieve more than one or two successes from every ten films they produce. Hollywood studios can afford to take losses on films that do not make a return at the Box Office because they reap substantial benefits from those films that are successful (and make a good deal of money through the exploitation of the rights in their "non-profitable" films in other media). Backing individual films is not an attractive prospect for investors. Independent producers in the UK do not have the same opportunities for cross-collateralisation of winners and losers and regularly have to sell off their ancillary rights in order to finance production. In short, the risk:reward ratio for individual films is too unfavourable to tempt City investors.

2.14 Finally, a more specific barrier to film investment by some institutions is the lack of stock-exchange-listed companies operating in the industry. For example, investments that are not listed on a recognised stock exchange are disallowed for the purposes of calculating the solvency of insurance companies. Insurance companies also need access to daily valuations of the investments in their portfolios which, again, militates against investing in companies that cannot be readily valued by a stock market price. Although a number of large media companies are listed on the Stock Exchange, few of them are directly involved in financing film production on a significant scale (and

Conclusions

2.18 The Committee has identified a number of barriers to investment in the film industry, many of which are inter-related. The fundamental difficulty is that the structure of the industry is too fragmented, leading to under-capitalisation and poor financial performance, with no opportunities for investors to offset losses on some investments against gains made elsewhere. The City's perception of the industry as a high risk, low potential reward sector is understandable in the light of the production sector's performance, particularly over the last 20 years. By addressing the structural deficiencies in the industry, many of the other problems could also be resolved. The next chapter considers how the structure of the industry might be improved to make it more attractive to institutional investors.