CANADA MEDIA FUND

Working Group

Date: October 7, 2011 **Presenter: S. Cardin**

FOR INFORMATION

SUBJECT: Investments and Recoupment

INTRODUCTION AND MANDATE PRINCIPLES:

This memo discusses CMF policies around investments and recoupment in both the Convergent and Experimental Streams. These policies will be considered in light of the CMF's mandate, with a focus on two principles in particular: 1) Simplification and; 2) Improving the CMF's return on investment.

These two principles are not always aligned. The best way to increase the CMF's ROI may also increase complexity; meaningful simplification measures may also adversely affect recoupment. Nevertheless, the CMF is considering a mix of options in pursuit of simplification, increase ROI, or both. In addition to these issues, the CMF will also need to take into account impacts on other financial partners, as well as the recent Terms of Trade Agreement, to ensure that the CMF does not conflict with them.

The following is a brief summary of the CMF's simplification and ROI mandates.

Simplification

Simplification was discussed in a separate Working Group on September 7, 2011. As was stated at that time, simplification is an objective that will guide all CMF program and policy discussions for the next year. For context, the following brief excerpts are from the briefing note provided for the September 7 Working Group meeting:

> In October, 2010, the CMF's Board of Directors held a Planning Session to consider high level, long term strategic objectives and priorities for the CMF. The CMF Board settled on two specific strategic objectives to be pursued in the 2011-2012 and 2012-2013 CMF fiscal years: 1) Simplification; and 2) Rewarding Success. This memo discusses the former objective
> …
> Simplification as a goal is born of the recognition that the CMF has become complex. There are a variety of causes of complexity at the CMF. Some are attributable to the CMF's due diligence requirements, to ensure transparency and accuracy of reporting to its funders and stakeholders. Others are attributable to specific policy directives and result in rules which seek to ensure that the CMF's mandate is carried out effectively. Others still—particularly various rules within the several funding programs in the Convergent Stream—result from calls for various sectors of the industry to address their particular challenges.
> …
> Some complexity is inevitable in a complex industry, and the CMF Board of Directors did not state that "simplification" should be pursued as a goal in itself or without regard to other priorities. There are two goals of simplification, namely to:
>
> 1) Provide better client service (e.g. better understanding of the Program Guidelines, streamlined application requirements, reduced processing times, increased consistency); and

2) Reduce the cost of program management.

ROI

In the March 9, 2009 announcement by the Department of Canadian Heritage regarding the creation of the CMF, it was stated that:

> The realigned fund will favour projects…that have achieved and demonstrated the most potential to achieve success, in terms of audience and return on investment.

In subsequent discussions with the Department, the CMF was informed that its mandate for return on investment was to be defined in terms of financial return to the CMF itself as a result of investments made in funded projects.

Accordingly, the CMF began in the Fall of 2010 to consult with stakeholders on measures that could be implemented to increase its ROI. This Working Group follows up on those discussions.

BACKGROUND & DISCUSSION:

Convergent Stream

Current CMF Policy

The CMF makes equity investments in its production funding for Television Components as per the following from the 2011-2012 Performance Envelope Program Guidelines:

> **2.2 NATURE OF FUNDING CONTRIBUTION**
>
> The Performance Envelope Program may provide: to the Television Component, a mix of licence fee top-ups and equity investments according to a set formula; and to the Digital Media Component, a non-repayable contribution.
>
> A licence fee top-up supplements a successful Applicant's Canadian broadcaster cash licence fees. As such, this type of contribution forms part of the broadcaster's licence fee for the Television Component and is non-recoupable. An equity investment is a cash investment in the project, which results in the CMF acquiring an undivided copyright ownership interest in all versions of the project. Equity investments are recoupable, and subject to a standard and non-negotiable recoupment schedule (as described and subject to any exceptions set out in the CMF Standard Recoupment Policy, see Appendix B).
>
> The first CMF contribution to the Television Component will be in the form of a licence fee top-up to a maximum of 20% of the component's Eligible Costs unless otherwise specified (see section 2.4). Amounts in excess of this maximum will be in the form of an equity investment up to a maximum of 49% of Eligible Costs, licence fee top-up and equity investment combined. However, the CMF considers any eligible equity investment request of less than $10,000 to be too small for equity participation. Accordingly, any such requested amount shall be automatically converted into a licence fee top-up.

Policy Options

The following policy options are available to the CMF, and are presented in an order that ranges from options that focus on simplification, to those that focus on increasing ROI:

1. Eliminate Equity Investments

The CMF could eliminate equity investments as form of production financing in the Convergent Stream. This option would entail converting all production funding to licence fee top-up, with no recoupable production funding taking place in this Stream.

The chief benefits of this proposal are simplification and the impact on the "grind" for federal tax credits. CMF equity investments currently count as "assistance" that reduces the amount of federal tax credits available to Canadian productions. Eliminating equity investments would eliminate the grind. The following chart shows the impact of the grind in 2007-2008 and 2008-2009, the most recent years for which CMF has a critical mass of recoupment revenue:

CMF Equity Investments vs. Potential Tax Credits

$M

	Total Can. Television Budgets	CMF Total Television Commitments	CMF Television Equity Investments	15% of CMF Equity inv. = Estimated potential lost tax credits	Potential lost tax credits as % of Budgets	Recoupment from equity inv.	Difference btw. lost TC and recoupment
2007-2008	868.7	242.4	72.4	**10.9**	1%	3.1	7.7
2008-2009	943.2	275.2	86.8	**13.0**	1%	2.3	10.7

As mentioned, this proposal would also significantly simplify policies and processes at the CMF by eliminating top-up/equity split calculations, the Standard Recoupment Policy, and the need for recoupment reporting and administration. However, it would also eliminate the CMF's ROI. See the line graph in Appendix "A" - page 1 - showing CMF revenues from 1996-97 to 2010-11..

2. Limit the projects in which the CMF makes equity investments by type or genre

Currently, the CMF applies the funding formula described above in section 2.2 to all Convergent projects, regardless of genre, language, or any other criteria. The CMF could take a more targeted approach, exempting certain genres or other types of programming from equity investment. It has been suggested that certain genres, such as documentary or variety & performing arts, have historically recouped less than others, and that the CMF should focus its investment on the more historically "profitable" genres. It has also been suggested that the English market typically generates more recoupment for the CMF and therefore projects from the French market should not be subject to equity investment. See the bar graph in Appendix "A" - page 2 - showing CMF revenues by languages and genres from 1996-97 to 2010-11.

In addition, international format buys have limited exploitation potential because the Canadian producer is acquiring rights for a limited territory and has little or no non-Canadian revenue potential. Finally, it has been argued that in the case of minority official treaty co-productions, the minority Canadian producer(s) have little or no leverage to require that the co-production adhere to CMF distribution-related recoupment rules. As such, it has been suggested that minority co-productions should not be subject to the Standard Recoupment Policy and/or should not receive equity investments.

This measure could achieve some degree of simplification, at least for those applicants who would receive a licence fee top-up only and therefore would not be subject to the reporting and accounting requirements of recoupment on equity investments. However, the measure would likely result in less equity investments being made by the CMF, and somewhat lower recoupment, and therefore a reduction in its ROI. The measure, if applied in the first iteration outlined above, also raises an issue of fairness, as producers of English-language drama and children's & youth programs particularly are likely to consider they are being held to a different standard than their counterparts in other genre/language categories.

However, a one-size-fits all distribution policy presents many challenges, such as:

- For smaller projects: administrative burden for projects with limited sales potential and thus small recoupment potential (distribution agreement amendments, high number of projects which have to submit exploitation reports).
- For projects where CMF equity is <10% of the TV Component budget: limited negotiation leverage in particular for international co-productions.
- For projects with no international sales potential: e.g. international format-buys, variety projects or French language projects tailored to the Quebec marketplace

As such, the CMF could implement the following approaches depending on the size and type of project:

1. Where the CMF contribution to the Television Component is less than $100,000, the CMF could provide funding in the form of licence fee top-up only. See the following information:

Equity Working Group - Small-budget projects

Projects with CMF below $100K

	2010-2011	2009-2010	2008-2009
# of projects	98	87	107
# of projects w/ no EIP	62	60	64
% of projects w/out EIP	63%	69%	60%
Total EIP $	1,340,881	733,580	1,196,062
Total CMF $	5,356,367	4,663,534	6,056,573
EIP %	25%	16%	20%

2. The CMF could provide funding in the form of licence fee top-up only for international format buys.

3. Limit the CMF's participation in profits

Currently, the CMF recoups its initial equity investment from revenues generated by exploitation of a project and then participates in profits (albeit at a lower, 50% rate) thereafter. The CMF could cease its share in revenues after recouping its initial investment, and no longer participate in profits.

This measure would simplify, for both applicants and the CMF, the accounting and reporting requirements associated with CMF participation in exploitation revenues after initial repayment. Applicants would not have to provide exploitation reports after full recoupment and the CMF would not have to monitor and administer the process. However, the CMF would forgo revenue and thereby reduce its ROI.

4. Limit the time frame during which the CMF requires recoupment

Currently, the CMF requires that it recoup on any revenue generated by the project on an indefinite basis, and that the CMF receive distribution reports for at least 10 years, even if no revenue is generated. The CMF TV Financing Agreement states these requirements as follows:

> The Applicant shall provide or cause all Distributors of the TV Component to provide the CMF with a complete exploitation report on all aspects of the Distribution of the TV Component, including copies of such Distributors' reports, on the first day of February and August, in each year for the periods ending on the last day of December and June, for the first thirty-six (36) months following the date of disbursement of the Phase II Payment, and thereafter annually on the first day of February for the year ending on the last day of December for 10 years, whether or

not Production Revenue is generated by the TV Component and for any additional year in which Production Revenue is generated by the TV Component.

The CMF could simplify these requirements in a number of ways. The CMF could shorten the 10-year non-revenue-generating reporting period, and/or shorten its overall recoupment period, so that after, for example, 7 years the CMF ceases to require that reports be submitted and revenues remitted to the CMF. See the charts attached to this memo. See the line graphs in Appendix "A" – pages 3 and 4 - showing CMF revenue over 10 years.

These measures could achieve some degree of simplification, however, the measure would likely result in lower recoupment from projects overall, and therefore a reduction in its ROI.

5. Remove preferential treatment of provincial tax credits

Currently the CMF's Standard Recoupment Policy permits provincial tax credits to be recouped in a preferential position relative to other recoupable financing. The CMF could remove this preferential treatment, so that provincial tax credits are recouped the same as other financing.

The impacts of this change include delaying the producer's recoupment of these tax credits in comparison to their current treatment, but would speed recoupment by all other investments, including the CMF's equity.

6. Change the funding formula related to licence fee top-up versus equity investment to increase the latter

As noted above, section 2.2 of the production guidelines states that the first CMF contribution to the Television Component will generally be in the form of a licence fee top-up to a maximum of 20% of the component's Eligible Costs, while amounts in excess of 20% will be in the form of an equity investment.

The CMF could increase its equity stake in productions by adjusting this formula. The CMF could decrease the equity threshold from 20% to 15%, 10%, or some other number, so that CMF equity investment is triggered sooner and, presumably, in more projects at a higher amount. The CMF could reduce the threshold all the way to 0%—i.e. provide financing only in the form of equity investment. Alternatively, the CMF could reverse the formula, so that the first CMF contribution is in the form of an equity investment up to 20% (or some other number), after which the contribution is top-up.

In terms of simplification, an all-licence fee top-up approach would be the simplest option, since no projects would receive equity in the Convergent Stream and therefore the CMF could eliminate all policies and procedures related to recoupment. Contrariwise, an all-equity approach would be the most complex since the CMF would have to administer recoupment for all production projects. In addition, since CMF equity "grinds" the federal tax credit, an all-equity approach would increase the grind and a no-equity approach would eliminate it.

7. Producer Performance Envelopes

The Canadian Media Production Association (CMPA) has proposed that the CMF adopt a Producer Performance Envelope program (PPE), whereby certain producers receive envelope allocations similarly to how broadcasters currently do under the Performance Envelope Program.

The goal of such an incentive would be to reward producers who achieve success in international markets. The Performance Envelope system currently rewards broadcasters for their success with audiences in the Canadian market, so there is an argument that producers should be rewarded for similar success internationally as they (or the distributors/sales agents they employ) are responsible for making these sales happen. The underlying rationale is that such an incentive would result in more revenues being generated overall for producers (and, therefore for the CMF) as producers will be encouraged, by the perspective of obtaining an envelope, to better develop and deploy their international marketing strategy.

Experimental Stream

When the Government of Canada announced the creation of the Canada Media Fund on March 9, 2009, the Fund was asked to put in place the Experimental Stream. The CMF understood from discussions with the Department that recoupable forms of financing would be preferred. The CMF also understood that the Fund should place a renewed focus on generating a financial return on its investments and seek to foster, to the extent possible, a self-sustaining industry. This policy direction was set out in the Guiding Principles contained in the 2010-2011 Contribution Agreement.

Based largely on this understanding, the CMF chose investments as the form of funding to be provided to eligible production projects in the Experimental Stream[1]. The CMF does not currently take a copyright ownership interest in projects in the Experimental Stream.

The CMF then needed to develop an approach to recoupment which reflected its overall objectives. The main challenge faced by the CMF with the current recoupment structure in the Experimental Stream is the wide variety of projects that can be funded through the Stream. The current, one-size-fits-all approach may need to be reviewed.

The following options are available for adjusting equity investment in the Experimental Stream. Eliminating equity entirely is not proposed, as it is in the Convergent Stream, given the great potential for return on investments as compared with the historical position of television production. These proposals are based on comments received from industry stakeholders—the CMF has not yet obtained full or complete revenue reporting with regards to the projects it has funded so far in this stream.

1. Adopt different equity approaches depending on the type of project

As noted above, the Experimental Stream currently funds different types of projects utilizing different business models. Videogames may be exploited similarly to film/television properties, in that they are released on a certain date, generate the bulk of their revenue shortly thereafter and, unless they achieve "classic" status, eventually slow down and cease making money before effectively disappearing from the market. This type of project would not change much from its initial form throughout its exploitation cycle. Web properties, on the other hand, are not "one-off" propositions, but rather are ongoing projects that exist and iterate over a longer time frame. A social networking site, for example, may launch on a certain date, but is intended to exist indefinitely, and changes are made during its lifetime to add features, expand services, or even to morph into something else. In this case, it can be harder to identify the "original project" as it develops over time, so separating out the CMF's investment for recoupment purposes can be a challenge.

Currently the CMF's Experimental Stream Recoupment Policy assumes a one-size-fits-all approach. The CMF could tailor this policy to the different types of projects funded in the Experimental Stream. In particular, the CMF has identified two primary revenue models: 1) "Finished Products"; and 2) "Live Exploitation Products". Finished Products are more-or-less discrete, one-off, self-contained projects such as console videogames, while Live Exploitation Products include social networking websites or game engines.

For Finished Products, the CMF could recoup as per the current Recoupment Policy until it reaches full recoupment and then at a certain percentage of the CMF's initial investment for a period of 5 years,[2] after which the CMF would receive no revenues from the project. As part of this approach:

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[1] Projects supported at the development stage are funded through recoupable advances and projects supported at the marketing stage are funded through non interest bearing loans.

[2] Such a cap on profits could also be applied to the Convergent Stream, though such an approach would be largely theoretical given the virtual absence of profit in that Stream.

- Producers would have to submit business plans and simulations demonstrating how they're going to generate the necessary revenues to pay back the CMF and provide the expected ROI in the given period of time.
- There would be simplification of negotiation and reporting processes.
- Producers would know when CMF's participation ends: once the CMF has obtained a certain percentage of profits or after 5 years, whichever comes first.

Examples of Finished Products include: mobile apps; console games; downloadable games; websites with non-evolving content; software or applications made for specific tasks.

For Live Exploitation Products, the CMF could recoup as normally until it reaches full recoupment and then at a certain percentage of the CMF's initial investment if the IP is sold. As part of this approach:

- After recoupment, it leaves all the exploitation revenues untouched so the producers can continue to reinvest to operate the project.
- The CMF participates in the value-creation of the company and the CMF benefits if the IP is sold or the company is sold.

Examples of Live Exploitation products include: online multiplayer games; ARG; evolving websites; social platforms; software packages.

The CMF could establish two different recoupment structures based on these two revenue models. One of the challenges with such an approach may be the emergence of a "third" model which is not contemplated within either of the two above-identified models. Another challenge could be projects that effectively utilize both models within the same "project". For example, a game developer that creates both a videogame and an engine within the same project might release the finished game as a "Finished Product" and then licence the engine to other developers on an "Live Exploitation" basis. In such a case, provided that the CMF's investment was for both, the Fund might have to distinguish between the revenues from both types of exploitation and apply each recoupment strategy to each component.

2. Adjust the CMF's percentage of recoupment in a project

The current recoupment policy states that:

> The CMF will recoup its investment from revenue generated by exploitation of the project in a manner no less favourable than pro rata and pari passu with other financial participants who are providing recoupable financing to the project, to a maximum of 50%.

The CMF could keep, reduce, or increase its percentage of recoupment in a project. Some stakeholders have expressed their view that the current cap is too high, and that it is not sustainable for a producer to forgo 50% of their revenues to the CMF, since it prevents further development of projects. The CMF could lower its recoupment cap.

3. Limit recoupment by time and/or return

Currently the CMF seeks to recoup its investment and participate in profits according to its formula indefinitely. The CMF could limit is profit participation. This could be done in reference to time—for example, for only 5 years following start of exploitation of the project. Or it could be done in reference to the CMF's investment—for example, once the CMF has recouped twice its initial investment.

4. Better define a CMF buy-out

Currently the CMF says:

> The CMF may consider proposals by the applicant(s) to be “bought out” of its investment in CMF-funded projects on a case-by-case basis.
>
> The CMF will not consider proposals to buy out the CMF’s investment where the buy-out is primarily intended to extinguish the CMF’s right to recoupment or profit participation from revenues generated by the project. As such, the CMF will expect to receive buy-out proposals in which the amount paid to the CMF for the buy-out would be materially higher than the amount of the CMF’s investment in the project. The CMF expects that buy-out proposals will typically come where a sale of the project, either alone or as an asset in the sale of the applicant company/companies, (or similar transaction) by the applicant(s) to a party unrelated to the applicant has been made.
>
> Buy-out proposals must involve payment to the CMF in cash or in instruments easily convertible to cash. Where a sale of the project (or similar transaction) results in an ongoing revenue stream to the applicant(s), the CMF will expect to also participate in those revenues in a proportion consistent with the level of recoupment and profit participation described below.

The CMF has received feedback on its current buy-out provisions to the extent that they are vague and/or ill-suited to current market realities. As such, the CMF could establish a standard buy-out formula applicable either to all projects in the Experimental Stream, or based on the two revenue models discussed under Option “1” above. This could be based on a certain return on the CMF’s investment—for example, full recoupment of the CMF’s initial investment plus a certain percentage of its investment over and above that. This option benefits from being simple, but could significantly under-reward the CMF in the event that it funds a highly successful project. The buy-out formula could also be based on revenues generated by the project, though this becomes more complicated to negotiate and implement. It could also result in inconsistent application and, finally, poses challenges in terms of valuation of the project. One potential solution to the latter problem is for the CMF and the producer to hire an independent valuation expert when a buy-out proposal is submitted.

5. For marketing support, provide funding in the form of a recoupable contribution

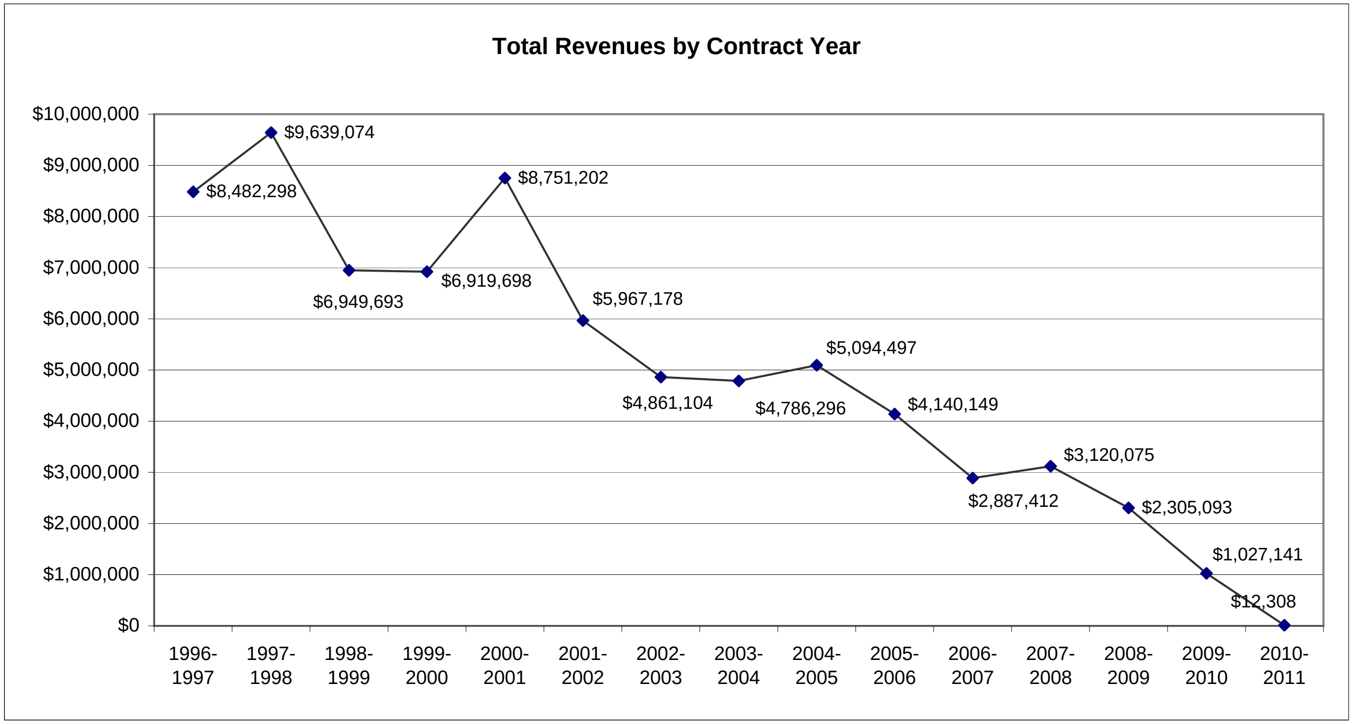
The CMF has received feedback on its approach to funding marketing projects in the Experimental stream to the effect that the current form of financing—a loan repayable within 6 months following commencement of commercialization of the project—is inappropriate in most cases. Marketing costs, it has been argued, have some risk attached to them in that they may not realize a return, and the absolute requirement for repayment so soon after commercialization means that there may be no money from which to repay.

As such, the CMF could change the form of financing into a contribution that would be repayable from revenues generated from exploitation of the project, similar to production funding.

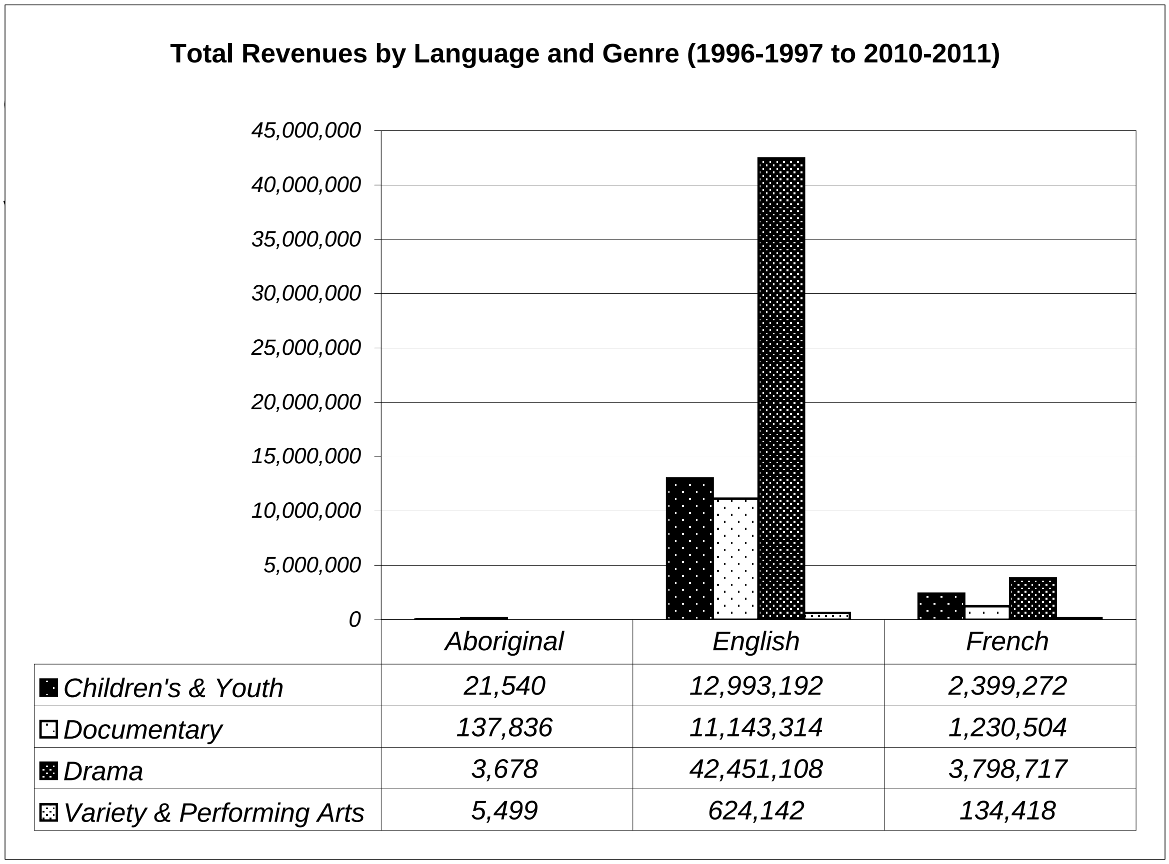
COMMENTS:

Appendix A

Sum of Revenue	
Signature Year	Total
1996-1997	$8,482,298
1997-1998	$9,639,074
1998-1999	$6,949,693
1999-2000	$6,919,698
2000-2001	$8,751,202
2001-2002	$5,967,178
2002-2003	$4,861,104
2003-2004	$4,786,296
2004-2005	$5,094,497
2005-2006	$4,140,149
2006-2007	$2,887,412
2007-2008	$3,120,075
2008-2009	$2,305,093
2009-2010	$1,027,141
2010-2011	$12,308
2011-2012	$0
Grand Total	$74,943,219

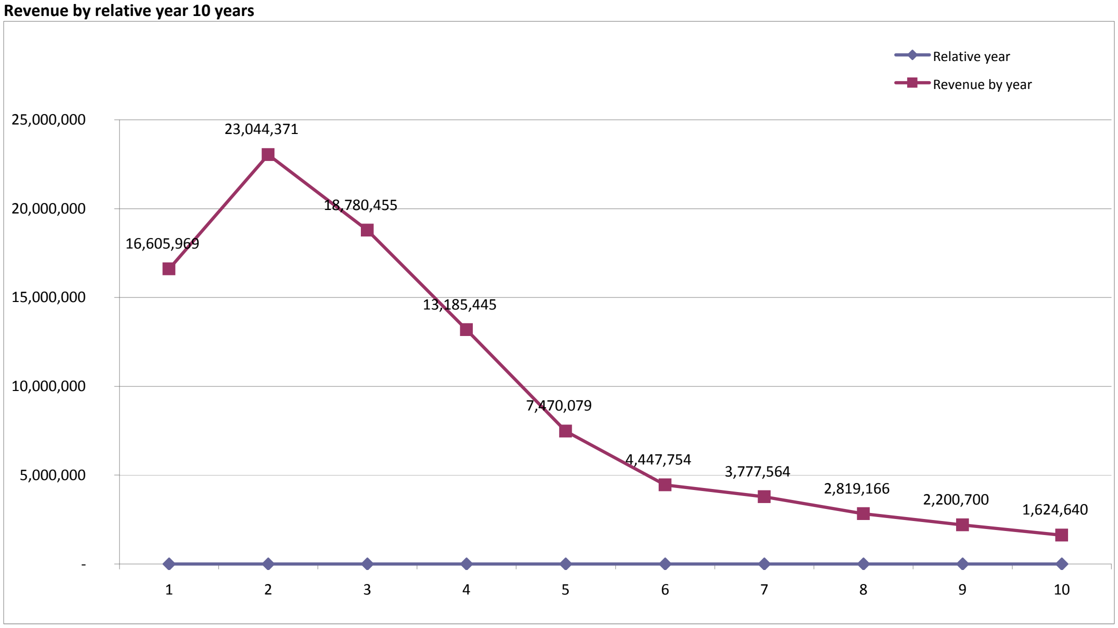


Sum of Revenue	Language			
Genre	Aboriginal	English	French	Grand Total
Children's & Youth	21,540	12,993,192	2,399,272	15,414,004
Documentary	137,836	11,143,314	1,230,504	12,511,653
Drama	3,678	42,451,108	3,798,717	46,253,502
Variety & Performing Arts	5,499	624,142	134,418	764,059
Grand Total	168,552	67,211,756	7,562,911	74,943,219

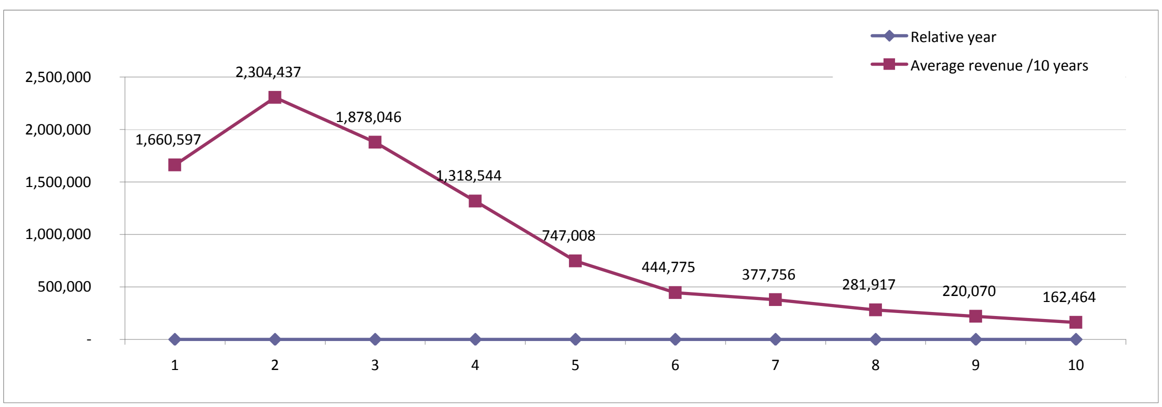


Analysis of revenue reported by relative year - based on 10 years
Population includes titles financed from 1996 -1997 to 2008-2009 with EIP participation (French & English language)
Year 1 correspond to the year following the completion of the production
Analysis demonstrates a significant decrease of the revenue from the 5th year, however all the projects included in the date do not represent 10 years of reporting
Significant difference between the revenue reported from English titles versus French titles (See graph by language below)
Analysis of the revenue by genre demonstrates that the revenue comes in majority from the Drama category. (See graph by genre)
Performing Art and Variety category were not included in the analysis since the revenue is not significant.

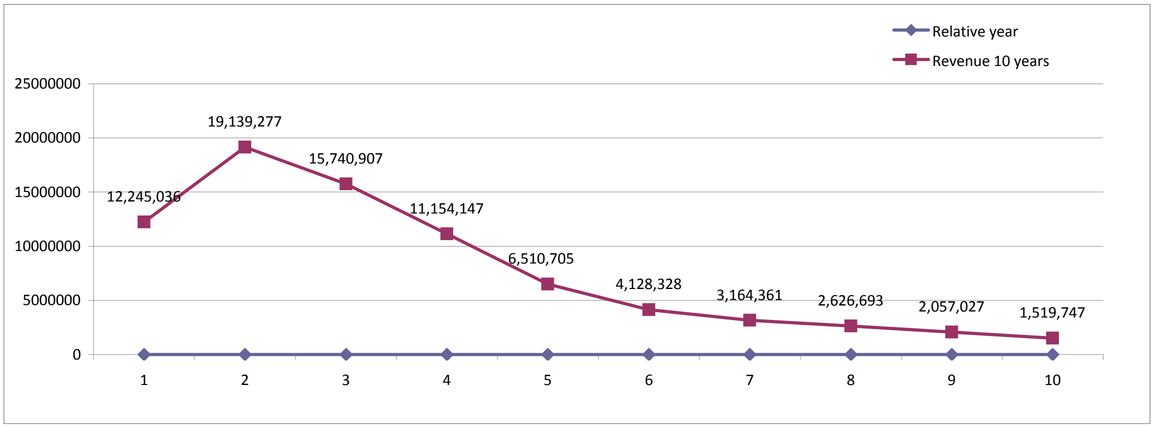
Revenue by relative year 10 years



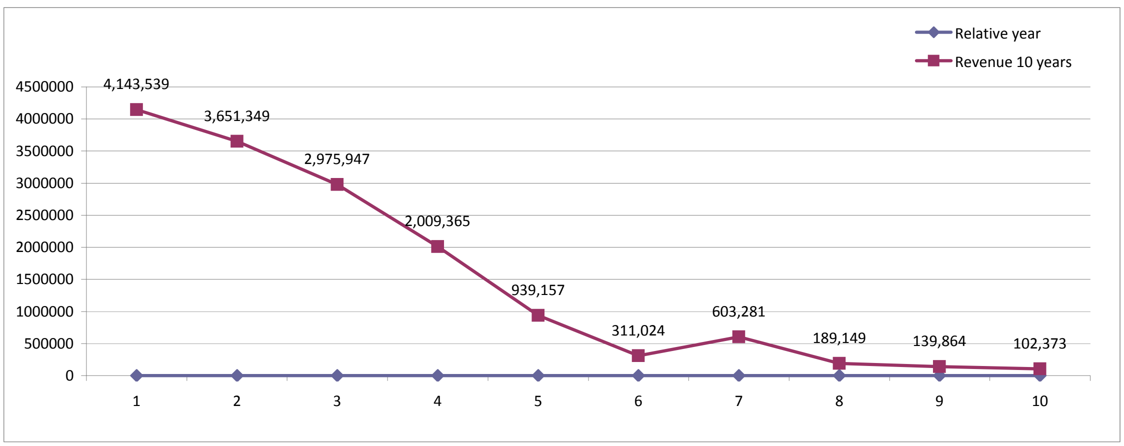
Average revenue by year / 10 years



Revenue by relative year, English language



Revenue by relative year, French language



Revenue by genre- by relative year/ 10 years