8th March 2017

hardman&co

Merlin (One) plc

Series of Single Company EISs

Summary

The company's investment strategy is to invest in film and television projects using a mixture of specific cashflow financing and equity and recycling capital when available.

	Positives	Issues
Why Invest	**Strategy:** Invest into film and television projects, recycling returns into new projects as they are received.	**Complexity:** The structuring of the deals is not entirely straightforward and investors may wish to request further information.
The Directors	**Team:** The Directors bring broad experience of the media and tax industries.	**Track record:** Limited comfort can be taken from the previous Altus Media projects that adopted a similar structure.

Nuts & Bolts

- **Duration:** The tentative closing date will be 5th April 2017 with changes at the discretion of the directors.
- **Diversification**: The initial investment will be in one project, with 3-4 follow-ons.
- **Valuation:** Very prudent valuation with equity written off. Investors will receive regular updates on progress.

Specific Issues

- **Fees:** All charged directly to the company.
- **Performance fee:** Set at 25% of the investor share of the return above the return of the original subscription.

Scheme information	
Scheme assets	£0m
Scheme target	£4m
EIS assets	£0m
Total FUM	£0m
Launch date	2017

Risks

- **Target returns:** The target return is £1.00-£1.30 for each £1 invested, which suggests a lower risk strategy within the EIS area. Without the tax break the return may not compensate for the risk.
- **Strategy:** The initial investment will be split between funding specific cashflows and equity. Cash returns will be recycled into new investments that will also be matched against specific cashflows. While well established, it is not straightforward.

Analyst

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Factsheet

Merlin (One) plc	
Product name	Merlin (One) plc
Product manager	N/A
Media Advisor	Merlin Media Advisors LLP
Tax eligibility	EIS
Target return	£1.00-£1.30 for each £1 invested
Target income	None
Type of product	Single company EIS
Term	3-4 years
Sectors	Media
Diversification	
Number of companies	1
(Expected) Gini coefficient	1

Fees	Amount	Paid by
Initial fees	5.00% (plus VAT)	Company
Establishment costs	Not specified (see pg 10)	Company
Annual fees	1.0% (plus VAT)	Company
Company secretarial fee	£800 (plus VAT)	Company
Performance fee	25%	Investor share of proceeds over subscription

Advisor fee facilitation	Yes
Advisor fee amounts	As agreed with investor
Advance Assurance from HMRC	No
Reporting	6 monthly
Minimum investment	£25,000
Current funds raised	£0m
Fundraising target	£4m in current financial year
Initial closing date(s)	5th April 2017
Expected exit method	Share buyback, liquidation or sale

Source: Hardman & Co research

Fund Aims

Merlin (One) plc is a single company EIS which will invest in film and television production companies over the course of its lifespan. The target return is £1.00 - £1.30 for each £1 invested. Returns will be focussed on capital gains and investors are unlikely to receive any dividends. The fundraising is aimed at the current tax year.

There are two groups involved in the company:

- **Promoter**: Valkyrie Marketing Services LLP.
- **Project Advisor**: Merlin Media Advisors LLP.

Summary of Risk Areas

Note: There are generic risks from investing in EIS or unquoted companies in addition to the specific ones commented on below. Comments on relative risk refer to other EIS investments and not to wider investments.

Investments

Portfolio Risk

The company will invest serially into various film and television projects, with 70% funding of specific cash flows and 30% equity. Each company will provide little diversification in itself, though there will be sister companies.

The target return of £1.00-£1.30 for each £1 invested suggests lower risk and there is some downside protection through the revenue streams that are funded.

Sourcing and External Oversight

The Merlin team actively source projects through their industry network and direct approaches. With only 4-5 projects required over three years they should be able to source sufficient projects. The sister companies will also require sourcing, though there may be some co-investing.

The company directors will make all decisions on each investment. Significant investors may be invited to join the board.

Ongoing Support and Monitoring

The Board will be hands on in terms of monitoring each project that is invested in. The bookkeeping and accounting services will be supplied by Valhalla Private Client Services.

Exits

Investors will vote in the exit once the minimum hold period of three years is complete. It is expected that investors will take a capital return at that point through the most appropriate method.

Directors

Team

The Directors bring a combination of media and financial expertise. The media team have experience in film and television production, both of which are potential areas for investment.

Track Record

There have been fourteen previous projects in conjunction with Altus Media. None of these have exited and there are some special circumstances which mean that we cannot draw too much from the mean pre-tax return to date of -8%.

Regulation

Company

As a new company which has not started trading, Advance Assurance is not given by HMRC.

Related Entities

As a single company EIS, no regulation is required.

Valkyrie Marketing Services LLP is FCA registered. None of the other entities are regulated businesses.

Risk Analysis / Commentary

Although this is a new management combination, the Directors have experience both of the media and tax industries. The overall company structure that they use is well established.

The investment strategy used has some complexities to it and depends on knowledge both of the media industry and tax. The investments against part of the tax breaks and pre-sales will give significant downside protection, with a trade off that upside prospects may be more limited. Investors should be aware that this trade off will affect the prospective return, which may not compensate for the risk without the relevant tax breaks. Although the expectation is that budgets above Merlin's capacity will be met by soft money, projects may require additional borrowing.

As a single company EIS, diversification will be very limited though the company will invest serially into 4-5 projects. Investors may use the sister companies to diversify, though it is possible that some of these companies may invest in related projects.

Investment Process

Industry Overview

The process within the film and television industry, together with the corporate structure used around that is well established. Most films or television programmes are produced using a SPV dedicated to that project.

After some pre-production work, which usually takes around thirty to sixty days, the majority of the expense is in the filming of the production. Everyone who works on the project is hired on a temporary basis as required. Some of these, such as accountants, will work over most of the company's life, but the majority are employed for much shorter periods.

The production (filming) time is intensive, typically taking less than two months and the crew will peak at this time. Post-production work, such as editing and adding scores, takes longer, but the release version is usually ready between 10 and 15 months after the start of pre-production.

Many countries wish to have productions filmed in their countries and offer tax breaks to encourage this. In the UK these are 25% of up to 80% of the domestic production costs. Other countries can be lower or higher.

Film releases have a multi stage release period over which revenues are drawn from different sources:

- Cinematic release
- Priority distribution such as airlines
- DVD and online release
- Paid television and video-on-demand
- Free to air television
- Residual rights

Although the order of release to each channel may vary a little, overall these attract revenue over a period of up to two years. For television productions the timescale is usually shorter. Not only is there no cinema release period, but filming and post-production can take less time too.

Distributors may wish to have a pipeline of independent productions and offer a pre-sales guarantee, bringing the prospect of more certain revenue. There can be trade-offs though, with the distributor often getting a greater share of success.

Investors should know that there are several companies that hold residual rights to films and there is an active market to sell productions once the other sources have faded. This allows the SPV to be wound up in a 3-4 year timescale. Overall, it is almost impossible to predict whether a production will be successful, hence the emphasis by some on either downside protection or diversification.

It is worth noting that the dynamics of the industry are changing. The rise of the video-on-demand providers such as Netflix is leading to greater demand for TV content. Broadly there is usually more prefunding available for such productions, but also more limited upside potential, though this may not always be the case.

Deeper dig into process

Merlin (One) plc (henceforth Merlin) will initially invest into a single film or television project. Though the whole investment will most likely be used to fund the project, potential recovery will be split into two parts in a 70:30 ratio.

The larger part, the 70%, will be used to fund with recovery from three different parts of the revenue pool. Each of these are funded at a discount or fees, so recovery should bring an uplift on the amount invested:

- **Tax credits**: the first recovery will come from the tax credits that the production is eligible for. Management note that funding rates for tax credits have been under pressure and they expect to fund at a 10-15% discount to face value, lower than has been achieved in the past.
- **Pre-sales**: a prerequisite for any project that Merlin will be involved in is an agreement for a significant proportion of the budget to be covered by pre-sales. These are usually payable on delivery of the final print. Merlin will pre-fund these at a 15-20% discount to their value.
- **Gap financing**: This is unsecured lending akin to a mezzanine layer, and, when used, is to cover a smaller proportion of the budget, around 10-20%. Merlin's terms specify that this financing will be first in line for repayment after the tax credits and pre-sales have been satisfied. Revenues will still have to exceed the pre-sales for this funding to be recovered. As it is thus riskier than the other two lines, a higher discount of around 20-30% is charged. In order to reduce this risk Merlin will only fund gap finance where the lowest sales estimate received is 175% of the budget.

The smaller part, the 30%, will be primarily invested as equity in the project. Management note that access to the funding/revenue listed above is to a large extent dependent on the company's ability to supply equity. Most productions find it relatively easy to borrow against the secured elements, but equity is in shorter supply in the market.

The company may also finance some related projects, though we understand this will be very rare and only where Merlin controls the other elements. For example, it may do some development work such as funding the writing of a script, which management estimates will give about a 20% uplift. Although this is not secured directly, Merlin will only be involved when it is intending to fund the production. It may also do some bridging finance.

The expectation is that the total budgets for the productions that are being invested in will be in the £3-15m range. Merlin Directors see this as being the range that will allow quality productions. Merlin will be supplying £4m of this (less if the fundraise gives a lower amount). The first choice source for the additional funding is ** soft money, such as grants/subsidies or government backed support. There may be options for funding from Merlin's sister companies too.

In some cases the balance of the funding may be made up by loans from banks. This will be lending against tax credits and/or pre-sales – generally the banks will not fund equity. Investors should note that this means the equity proportion of the budget as a whole will be smaller, but may require a higher pre-sales figure to back all the funding.

Follow on investments

Productions will be able to reclaim the bulk of the tax credits once the principal filming stage is complete. This is roughly 4-6 months from the start of the project. The pre-sales commitment will be paid on delivery of the completed production, which is expected to be roughly 12-15 months from inception.

The intention is to redeploy this capital into new projects when it becomes available. These will follow similar criteria to those described above, though will mostly be funding tax credits and pre-sales, with equity only being invested in where the company can recycle from the initial equity allocation. Despite this they will still take ownership. As each recovery will be a portion of the company's original capital the subsequent projects may be significantly smaller than the initial project. Management expect that the company will participate in 4-5 projects over its lifespan.

The equity element will arise from the initial production. Usually this is first in line for recoveries from the revenues until the initial capital is recovered. Beyond that the upside is shared with other participants in the project, which is a common trade-off for getting priority on the earlier revenues. While arrangements cannot be guaranteed in advance, management suggest the investor share is likely to be in the 10-20% range. The production will have to be very successful for an investor to receive significant upside.

Overall this gives a reasonably clear return profile for investors. The security of the tax credits and pre-sales limits the downside on the 70% portion of their investment. The discounts on these elements and the recycling of the returns would, roughly, give a return of initial capital. There is an option on further gains through the equity element, though this is hard to value and investors should be cautious about making it a core part of their expectations. Management view the return of equity as being covered by the EIS tax relief.

Sourcing Deals

The company will source potential projects from three primary sources. In some cases they are approached because they are known to have funding. While most direct approaches are not good quality ideas, not all are bad and they may lead to some potential projects.

The Board of Directors is also pro-active about looking for potential projects, in particular using the film and television festivals which are the main industry gatherings. At the recent Berlin Film Festival they met with about 30 possibilities.

The final source is through the Directors personal networks. Two members of the board, Paul Brett and Martin Irusta, have a background in the industry and have a range of contacts. The two have diverse backgrounds, with the former having extensive knowledge of the film industry and the latter bringing wide experience of the television business.

Investors should note that the Directors will be looking to source projects for at least five similar companies, though each only needs a small number of productions over its life. It is possible that the companies could co-invest in a single project. The company has a reasonable slate of potential projects. Although there is competition to provide the funding, the Merlin management believe that by providing equity they have significant advantage over other funders.

Decision Making

There is a clear division of roles within the Directors in terms of the decision on whether to take on a project. In each case it will start with a review of the script by Martin Irusta and Paul Brett. If they are satisfied that the script is good then it is passed to the other Directors. The Directors are clear that they are aiming to fund good quality productions. This is effectively a pre-condition to get pre-sales. It does also mean that the budget has to be large enough to do that, hence the structure outlined above.

Once a script is deemed suitable, the finances of the project are then examined and a budget agreed. This is the focus of the other two Directors, and will also involve the producer of the project and agreements with the other funders.

Views from sales agents are taken, with selection appropriate for each project. The lowest sales estimate must at least equal 100% of the production's budget excluding the non-recoupable finance. We note that although the sales agents views are trusted, this re-emphasises that the equity portion is genuine risk capital.

There are various other criteria set out in the Information Memorandum. These are sensible, and investors should note the Completion Bond and insurances that will be put in place.

At this point contracts are drawn up and Merlin will acquire at least 90% of the production company.

As indicated above, exits are relatively straightforward. The funding of specific revenues will naturally, in the absence of a bad debt, return to cash when fulfilled. The residual rights can be sold, leaving a cash shell which can be liquidated. Alternatively, the entire company could be sold, leaving the purchaser to extract the cash assets.

Governance and Monitoring

In practice, Advance Assurance will not be available from HMRC as the company will not have commenced trading.

It is anticipated that cash will be held in the corporate bank account until invested. Shares will be issued by Mazars plc and will be directly held by investors i.e. there is no nominee arrangement. The Administrator for the company will be Valhalla Private Client Services who will also do the book-keeping.

Investors will receive reports every six months on the progress of the company. In addition they will also be notified when an investment is made and when the annual accounts are approved. Those who invest more than £100,000 may be invited to join the company board.

It is anticipated that post-investment the Directors will be very hands on with the project. As well as meeting monthly, they will oversee the production including going on set and support the producer where appropriate.

The Board also anticipate being involved in the subsequent exploitation of the productions, though the role of the distributors will be more important.

Track Record

These will be the first companies run under this management grouping. The Prescience MA directors have been involved in similar structures in recent years on conjunction with Altus Media. Fourteen companies in total have been set up in the last three years, though as a consequence none have exited yet. Most of them raised £4m, with one a little larger at £5.5m.

None of these have exited yet and management accounts prudently write off the value of the equity. The following values only include equity returns that management are confident of, so there may still be further returns if any productions have more success than currently expected. As is usual, we present these gross of tax and without any performance fees deducted. The data is as of the end of January 2017.

The mean return on investment to date is -8%, with a median of -7%. The range is from -23% to +6%.

Overall it is hard to draw much from the track record. A combination of immaturity and special circumstances make it hard for investors to place much reliability on the figures.

Fees

The fees for the Fund are set out in the table on page 3. These are straightforward, other than as noted below.

- **Establishment fees**: mainly the legal fees to set up the company and will be less than £15,000 (0.4% of a full fundraise). These may be shared with the sister companies, which could save on costs.
- **Company secretarial fee**: the fee of £800 plus VAT is 0.024% of a full fundraise.
- **Directors' fees**: are payable from the annual fees.
- **Performance fee**: this is calculated on the investors' share of profits above the original subscription. As a single company this will be based on the total return.

It is noted that, as is usual for film EIS, the costs of each production will be met from the budget for each.

Fundraising targets

The minimum size of the company will be £200,000, with an initial target fundraise of £4m by the financial year end. The closing date is 5th April 2017, which may be extended at the Director's discretion. Although funds are being raised in parallel with sister companies, the minimum applies to each individually.

The minimum subscription is £25,000.

Directors and advisors

People

Martin Irusta – Director, Merlin (One) plc

At Fox International for 13 years, he then led content strategy development at NBCU. Currently a Director at Crystal Clear Content and Scope Media Ltd, Group CEO at Merlin Pictures Group. IMDb gives production credits on four television series since 2011.

Paul Brett – Director, Merlin (One) plc

Has had senior roles at Miramax International and Connections Communications Centre, as well as other roles at, inter alia, Video Arts, The Movie Channel and Paramount Pictures. He founded Prescience, where he was involved in the Altus Media projects, and founded Hindsight Media where he is a Consultant. IMDb gives production credits on 26 films and television series since 2005.

Sara Macedo – Director, Merlin (One) plc

She is currently Managing Director at Konsensia, a professional services consultancy firm, holds the Group CFO position at Merlin Pictures Group, is a Director at Crystal Clear Content Ltd.

Peter Nichols – Director, Merlin (One) plc

Formerly a Tax Consultant at KPMG, Tax Partner at various firms and Senior Partner at Chancery (UK) LLP, he is currently Senior Partner at Valkyrie Marketing Services LLP, and Founding Partner at Prescience MA LLP. Peter will retire from Valkyrie at the end of March, becoming a consultant to the company.

This is a single company EIS. Martin Irusta and Sara Macedo have roles at Merlin Pictures Group. Paul Brett and Peter Nichols worked on the previous projects with Altus Media.

Appendix 1 – Due Diligence Summary

Summary of core due diligence questions		
Company		**Validated by**
Company	Merlin (One) plc	Hardman & Co
Founded	2016	Hardman & Co
Type	Public Limited Company	Hardman & Co
Ownership	Each Director owns 25% each	Hardman & Co
CRN	10465985	Hardman & Co
Solvency	NA	
EISA member	No	Hardman & Co
Administrator		
Company	Valhalla Private Client Services	Information Memorandum
Founded	2012	Hardman & Co
Type	Limited Liability Partnership	Hardman & Co
Ownership	Between the 5 Members	Hardman & Co
CRN	OC380193	Hardman & Co
Solvency	NA	
EISA Member	Yes	Hardman & Co

Source: Hardman & Co research

Regulation

Merlin (One) plc was incorporated as a public company on 7 November 2016, so there are no accounts available. Ownership is split evenly between the four Directors. There will be only one share class, 'Ordinary Shares'.

Merlin Media Advisers LLP is a limited liability partnership formed on 2 November 2016. Latest Companies House filings show that there are two corporate members. It is not FCA registered.

Valkyrie Marketing Services LLP is a limited liability company formed on 27 June 2016. The most recent records show that there are five members. It is FCA registered (number 646604) and is an appointed representative by Twigden Asset Management.

Valhalla Private Client Services LLP was incorporated on 14 November 2012. The most recent records show that there are five members. It is not FCA registered.

Appendix 2 – Example Fee Calculations

This calculates the estimated amounts payable both directly and indirectly under certain assumptions.

Basic Assumptions	
Term	4 years
Investor amount	£100,000
Company investment	£4,000,000
VAT is reclaimable by investee companies.	

Source: Hardman & Co research

Calculations

		Hardman Standard			Target
Gross Return		-50%	0%	50%	30%
Amount (pre tax relief)		£100,000	£100,000	£100,000	£100,000
Initial Fees	**Rate**				
Initial fee	5.0% (excl VAT)	£5,000	£5,000	£5,000	£5,000
Establishment costs	£15,000 pro rata	£375	£375	£375	£375
Total		£5,375	£5,375	£5,375	£5,375
Net investment		£100,000	£100,000	£100,000	£100,000
Annual Fees					
From company					
Management fee	1.00% pa (excl VAT)	£1,000	£3,250	£3,250	£3,250
Secretarial	£800 pa from year 2 (pro-forma)	£20	£20	£20	£20
Total		£4,060	£4,060	£4,060	£4,060
Gross value after investment return		£50,000	£100,000	£150,000	£130,000
Exit fees					
Performance	25%	£0	£0	£12,500	£7,500
Net amount to investor		£50,000	£100,000	£137,500	£122,500
Gain (pre tax relief)		-£50,000	£0	£37,500	£22,500
Gain (post tax relief)		-£20,000	£30,000	£67,500	£52,500
Total fees paid		£6,375	£6,376	£18,875	£13,875

Source: Hardman & Co research

Note: Merlin policy of funding cash that is contracted means a -50% return is highly unlikely, but we include it for consistency across products.

Notes

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