Renaissance Studio, Ltd. vs Legendary Entertainment Comparison

Overview

Concerns are expressed about equity investment in Renaissance Studio, Ltd. ("RSL") because it is a start up that has not established a filmmaking and earnings track record. The implication is that RSL is much more risky than investments in established movie producers or studios regardless of any other considerations. This summary addresses this issue by comparing RSL to the recent acquisition of Legendary Entertainment by Dalian Wanda in 2016.

Legendary Entertainment

Current annual net income	**$122 million**	See income calculation note below
Current operating cash flow (Est.)	$150 million	Multiplied by 10 Years = **$1.5 billion debt capacity**
Total Legendary purchase price	**$3.0 billion**	
Plus: Operating capital	$ .5 billion	This amount needed for existing operations only
Less: Debt capacity	($1.5 billion)	
Net equity invested estimate	**$2.0 billion**	
Total capital at risk	**$3.5 billion**	**Before adding operating growth capital**

Assumptions:

- The $3.5 billion price included $.5 billion of operating capital. **This may not have been the case.**
- All the current operating income and cash flow goes to debt service.
- The **annual** ROE expectation from operations on any equity investment should be a minimum of 15%. Therefore Legendary must increase its earnings from $122 million to **$300 million annually to achieve this goal on its $2 billion equity investment.**
- The current annual income assumption is from the article at link below. $5.36 billion divided by 32 multiplied by 73% = **$122 million**.

http://www.wsj.com/articles/wanda-group-seeks-1-5-billion-for-piece-of-movie-business-1456313951

This means that the after tax income of Legendary must increase **2.5x** from current levels just to achieve a 15% annual ROE from operations. There are several important questions and issues:

- Presumably, operating capital will have to increase proportionately by 2.5x from $.5 billion to $1.25 billion to support the earnings growth to deliver a 15% annual ROE from operations. Additional earnings will be required to offset the additional cost of this capital.
- Did the income estimate of $122 million from 2015 include the extraordinary profit from "Jurassic World"? If so, can those exceptional earnings be repeated?
- With a few unsuccessful exceptions, Legendary does not write, develop, produce and distribute its own movie projects. **Therefore, where will the additional big budget "Tentpole" movie content come from to rapidly increase Legendary's movie output and distribution by 2.5x???**
- Was it rational for Dalian Wanda to pay a 29x P/E multiple for Legendary? Would anyone else pay such a high P/E multiple? Are Wanda and the other new shareholders not at exceptional risk for the $2.28 billion difference between the 29x P/E multiple and a more rational 10x P/E multiple?

Given all of the above, is it rational to expect Legendary to deliver an annual ROE of 15% from operations to Wanda and the other investors, especially after the costs of the additional up to $1.75 billion of debt capital are deducted from the assumptions above?

Renaissance Studio, Ltd.

RSL is a start up with no earnings track record so the Legendary analysis format above does not fully apply. Therefore, we will compare the key elements of investments in Legendary versus RSL:

Description (Estimates)	Legendary	RSL
Primary Equity Investment	$1,500 million	$ 5 million
Operating Equity Investment	$ 500 million	$ 45 million
Primary Debt Investment	$1,500 million	$100 million
Total Primary Capital Invested	**$3,500 million**	**$150 million**
Growth Capital Estimate to Reach 15% ROE	$ 750 million	$ 0 million
Total Capital At Risk	**$4,250 million**	**$150 million**
Acquisition P/E ratio	28.69x	Infinite
Projected Annual Income – Year 4	$ 300 million	$200 million *
Total Capital Divided by Year 4 Income	14.17x	0.75x
Year 5 Market Valuation at 28.69x	$8.607 million	$5,738 million
Year 5 Market Value Less Total Capital Invested	**$4,357 million**	**$5,588 million**
5 Year Return on Total Capital Invested	**103%**	**3,725%**
5 Year Return on Total Equity Invested	**218%**	**11,176%**

- **NOTE:** The RSL year 4 income amount assumes that the RSL films will average $193 million which is 45% of the genre average box office /DVD revenues of $429 million. RSL earnings will be much higher than Legendary because:
  - RSL will have much lower production costs because it will self originate all its movie content and produce its own movies rather than rely on other studios or producers as Legendary does.
  - RSL will have much lower corporate overhead.
  - RSL will produce modest budget movies in high revenue ceiling genres rather than very high budget movies in high revenue ceiling genres.
  - RSL will achieve major cost advantages by self-producing high concept, triumph of the human spirit stories with multidimensional characters who are immersed in a much broader variety of compelling but much lower cost resonance elements.
  - Unlike Legendary, RSL will not invest in very high cost perpetual action sequences or computer generated effects extravaganzas.
  - RSL does not have to share profits with studios or producers who originate and produce the projects.
  - RSL will have much lower debt service costs because its budget requirements are much lower than Legendary.

- RSL will self-fund $24 million of P&A expenses per film to insure broad domestic distribution, international market interest and control of advertising and marketing expenditures to insure strong net revenue performance.

The bottom line is that:

- The huge capital investment in the Legendary acquisition severely limits the ROE potential of the investment Wanda investment.
- Investing of 3.5% of the total capital that was/will be invested in Legendary in RSL can deliver exponentially greater ROEs.
- **In effect, Wanda is investing an additional <u>$4.1 billion</u> to guard against the start up risk of RSL and to possibly earn 50% more income in year 4 if Legendary can find the content to increase earnings by 2.5x over the first 4 years.**

Risk Comparison

Conventional wisdom would assert that the additional $4.1 billion investment in Legendary is justified because RSL is a start up with no filmmaking or earnings track record. An objective and rational comparison of the actual risks may result in the opposite conclusion.

Description	RSL	Advantage	Legendary
Track record	Start up	Legendary	Active since 2005
Industry network & credibility	Start up but will hire team with strong networks & credibility	Legendary	Well established
Management	Start up but will hire top executives with capital in place	Legendary	In place
Year 4 earnings estimate	$200 million	Legendary	$300 million
Capital recovery	2.5 years	RSL	14 years
Capital at risk	$150 million	RSL	$4.25 billion
5 year return on capital est.	3,725%	RSL	103%
5 year return on equity est.	11,176%	RSL	218%
Project level IRR profiles	Mid budget films in high revenue ceiling genres	RSL	High budget films in high revenue ceiling genres
Project income sharing	RSL only	RSL	Share with studios/producers
Sourcing movie content risk	RSL originates	RSL	Others originate
Typical project Concept scope	High concept	RSL	Low concept
Budget control risk	RSL controls	RSL	Others control

Description (cont'd)	RSL	Advantage	Legendary
Marketing effectiveness	RSL controls	RSL	Others control
Costs of production	Low – RSL controls	RSL	High – Others control
Corporate G&A costs	Very low	RSL	High
Project concentration risk	Average $30 million budgets	RSL	Average $109 million budgets
Debt service costs	Very low on $100 million going to zero in year 3	RSL	Very high on $2,250 million going to zero in year 14
Market acceptance risk	Targets very broad demographics	RSL	Targets narrow demographics
Story resonance elements	Broad diversity	RSL	Action, violence, depravity, CGI
Character complexity	Multidimensional	RSL	Generally one dimensional
Distribution risk	Wanda credibility & network solve this issue	=	Wanda credibility & network solve this issue
Active franchise profiles	10	RSL	5
Content evaluation metrics & green light standards	Advanced	RSL	Better than industry standard but still green light "dead on arrival" projects
Screenwriting methodologies	Advanced & proprietary	RSL	Rely on industry sources
Capital loss risk	Moderate because of low capital cost requirements and early recovery	RSL	High because of the very high P/E multiples that were paid for Legendary and the long recovery period

Summary

Legendary has some advantages because it is well established but these attributes are far more than offset by many other factors that are greatly in favor of RSL. RSL asserts that:

- The risk adjusted ROE potential of RSL is exponentially higher than Legendary.
- RSL will be a stronger company than Legendary because it will not rely on others for content creation and production.
- Filmmaking is a mercenary contracting business and it is much more cost, capital and ROE effective to create a new entity and hire seasoned professionals with strong networks than to pay 30x+ price/earnings multiples for corporate entities.

Full due diligence will confirm that RSL represents the most exceptional **risk adjusted** ROE opportunity in the motion picture industry.