

# “Valuation Adjustment Mechanism” in the Film Capitalization

## —A Case Study of the Movie “Lost in Russia”

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### Abstract

During the current investment boom, any Intellectual Property, especially of film, is one of the long-lasting destinations that capital pursues. As a result, the new model in the film capitalization, a high-priced bet agreement between the producer and the distributor, appeared in the capital market. This model exists some characteristics as high valuation and high risk, once encountered force majeure; they will make the whole film capital market vulnerable. This paper takes “Lost in Russia” as an example, through the analysis of VAM in the process of film capitalization, further explores the operability and risk of film capitalization.

### Keywords

Film Capitalization, Force Majeure, VAM

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## 1. Introduction

What is the definition of “VAM”? On November 14, 2019, the supreme people’s court officially issued the Understanding and application of “Minutes of the National Court Work Conference for Civil and Commercial Trials” (hereinafter referred to as the “minutes”), which exactly defined the “VAM”. The “VAM”, usually manifests as a bet agreement in the minutes, refers to the agreement designed by the investors and the financiers to adjust the valuation of the future target company, including equity repurchase, monetary compensation, etc. in order to solve the uncertainty of the future development of the target company, no piles of information and agency cost, and to balance the interests of investors, shareholders, creditors and companies in accordance with the law.

From the perspective of the main body of the conclusion of the “ a bet agree-

ment”, there is “bet” between the investor and the shareholders or the actual controller of the target company, “bet” between the investor and the target company, “bet” between the investor and the shareholders of the target company and the target company. In order to alleviate the financing difficulties of enterprises to a certain extent, the principle of capital maintenance should be implemented and the principle of protecting the legitimate rights and interests of creditors, and balance the interests of investors, corporate creditors and companies in accordance with the law.

The so-called “bet” with the target company, refers to the agreement signed by the investors and the target company, the target company financing from the investors, the investors become the target company’s shareholders, when the target company within the agreed period to achieve the target set by both sides, by the investors give the target company reward; instead, the target company shall repurchase the investor’s equity or/and undertake the obligation of monetary compensation to the investor in a pre-agreed manner (Supreme people’s court, *Understanding and application of “Minutes of the National Court Work Conference for Civil and Commercial Trials”*, 2019).

Moreover, what is “film capitalization”? When the film resources become a popular IP, the most common is that both parties sign a guaranteed issuance agreement. In the form of film resources, the producer sells its intellectual property rights (such as distribution rights and broadcasting rights) in exchange for a large capital inflow from the distributor to facilitate the completion of film production. On this basis, both two sides will achieve win-win results and mutual benefit.

Guaranteed issuance generally means that the distributor has an estimate of the market and sets a price that is acceptable to both parties. If the box office fails to reach the guaranteed price, the distributor will distribute the money to the producer according to this figure.

China’s net box office is divided between the upstream and downstream of the film industry. The upstream is dominated by producers and distributors, which together account for 43% of the net box office. The downstream of the industry is the theater chain and cinemas, which together account for 57% of the net box office.

Therefore, before the movie comes out, distributors always work hard. The cost the distributors paid was mainly the price of guaranteed issuance and various publicity costs, such as the patch advertisements’ and the billboard advertisements’ cost (Zhao, 2020).

## **2. The Application of VAM in the Film Capitalization**

### **2.1. The Road to the Film Capitalization: Xu Zheng and His “LOST” Series of Films**

From “Lost in Thailand” (2012) to “Lost in Hong Kong” (2015), as the director of the “Lost” series of road comedy films, Xu Zheng took advantage of his popu-

larity and initiated the crowdfunding as the financing promoter of the film project. He successfully directed two “Lost” series films and created a box office miracle, thus attracting the attention of numerous investors.

The so-called crowdfunded film refers to the crowdfunding of the project initiated by the film project promoter on the crowdfunding platform, and its success refers to reaching or exceeding the target amount within the preset time. For projects that do not meet the goals, the support money will be returned to all supporters in full. Upon completion of the fundraising project, the sponsor will receive a pre-committed reward from the sponsor. And the purchase of crowdfunding, to occupy the capital heights, refers to the seizure of high-quality film copyright resources, and then in the development of film copyright, as the originator of equity crowdfunding, to grasp the initiative to attract crowd funding. More importantly, the promoter masters the design right and interest distribution right of copyright development process.

In the film “Lost in Thailand,” Xu Zheng, both the director and lead actor, received only the director’s fee and salary, plus a 10% profit share from the company, which ultimately netted him around 50 million yuan. “Lost in Thailand” set a number of domestic box office records in that year and obtained a very high achievement.

During the filming time of “Lost in Hong Kong”, Xu had already been promoted to the management. He used 47.5% of net box office earnings to buy a stake in “21 Holdings”, a Hong Kong-listed company, in exchange for a 19% stake in the company, which made him become the second-largest shareholder. With “Lost in Hong Kong” as the turning point, the company transferred its main business from providing property agents to entertainment media, and renamed itself “Huanxi Media”. Xu’s final earnings are expected to be at least 2 billion yuan (Zhou, 2015).

At this time Xu had tasted the sweetness, he became Huanxi Media’s shareholders, mastered the initiative to negotiate with investors. He started taking the third step, filming “Lost in Russia”.

## 2.2. Film Capitalization of “Lost in Russia”

Because the bet agreement belongs to the investor and the financier, it has the confidentiality, so the bet agreement of the “Lost in Russia” cannot be known in the actual operation. At present, the author can only find the announcements published on the official website of Huanxi Media, which is about the guaranteed issuance agreement of “Lost in Russia”, namely the so-called the “bet agreement” in the film industry.

Huanxi Media is an investment holding company and a film investment company whose subsidiaries are mainly engaged in media and entertainment related businesses, including the production and investment of film and television series and the operation of streaming media platforms. Xu Zheng is one of its shareholders and directors. Huanhuan Xixi is a company incorporated under

Chinese law and indirectly wholly owned subsidiary of Huanxi Media, mainly engaged in investment in television and film rights, as well as the operation of streaming media platforms.

“Huanhuan Xixi”, as Huanxi Media’s wholly-owned subsidiary, signed the guaranteed issuance agreement for “Lost in Russia” with Hengdian Pictures on November 7<sup>th</sup>, 2019. Huanhuan Xixi was the producer, and the guaranteed party was Hengdian Pictures.

Hengdian Pictures is a subsidiary of HG Entertainment shareholder. Its main business is for the cinema distribution, film screening and related derivatives.

Under the agreement, Hengdian Pictures, as the guarantee party, may exclusively distribute the film offline in cities of China, Hong Kong, Macao and Taiwan for a period of 10 years, from the date of the agreement to the date of the first release of the film in the authorized territory. The parties agreed that the total box office of the guaranteed minimum is 2.4 billion yuan, and the guaranteed party shall pay the minimum issue price of 600 million yuan. If the actual gross box office of the film exceeds the guaranteed gross box office, in addition to the guaranteed release costs mentioned above, the portion of the box office that exceeds the guaranteed gross box office may be distributed by the parties in proportion to the net income of the film: 35% for Huanhuan Xixi and 65% for Hengdian Pictures.

In addition, as a part of the agreement, the guaranteed party shall bear the budgeted publicity and issue costs of 150 million yuan. Whether or not the actual gross box office of the film reaches the guaranteed gross box office, Huanhuan Xixi shall not bear the expenses of publicity and distribution, nor shall it bear the agency service fees of the guaranteed party for the distribution of the film. The movie is tentatively scheduled for release in Chinese cinemas in January 2020.

After the conclusion of the guaranteed distribution agreement, the group will continue to retain all other rights relating to the film, including all distribution rights of the film in other overseas cinemas and all profits generated from the rights of new media distribution worldwide.

However, in January 24<sup>th</sup>, Huanxi Media again issued two announcements. The first announcement said that since the film could not be released on the first day of the Chinese New Year in 2020 as agreed in the agreement, the group decided to terminate the agreement in accordance with it. But the announcement did not specify a solution.

Instead, the wholly owned subsidiary “Huanhuan Xixi” signed a cooperation agreement with ByteDance, which is stipulated that ByteDance has signed a minimum payment of 630 million yuan. By the way, ByteDance is an information technology company incorporated under Chinese law.

Huanhuanxixi and ByteDance will cooperate in the following areas in two phases:

The first phase of cooperation shall be 6 months from the date of signing of

the cooperation agreement. The main contents are as follows:

1) on the platform authorized by the group, certain new films and online dramas of the group can be simultaneously broadcast in the authorized area with the Huanxi premiere platform after the launch of the premiere platform of it; ByteDance shall pay RMB 630 million to use the licensed content according to the progress of the group's delivery of the licensed content; After deducting the channel cost of licensee's platform and the above mentioned price of RMB 630 million, the total revenue related to the broadcast of the licensed content obtained by licensee's platform shall be subject to a certain percentage of the revenue component in case of excess;

2) ByteDance set up an independent entrance for the Huanxi premiere platform to conduct the flow in toutiao, watermelon video and other platforms;

3) the platform of the authorized party shall provide publicity and promotion support for the group's film and television projects;

4) the group will open film and television project resources to provide ByteDance and its affiliated parties with embedded advertising, joint promotion, cooperation and other resources; and

5) the group shall provide ByteDance or its affiliates with the right of authorship of the co-producers of the films under its control.

The two sides will discuss the details of the second phase of cooperation and sign relevant agreements as soon as possible after the first phase begins.

The cooperation period of the second phase is from the expiration date of the first phase to December 31, 2022. The focus of the second phase is as follows:

1) the two sides jointly build the cinema channel and jointly build the "premiere" streaming media platform; and

2) both parties shall jointly contribute to the production and purchase of new media Copyrights for film and television content.

Upon the expiration of the second phase of cooperation, both parties shall have the priority to renew the contract (*The Announcements of "Lost in Russia", 2019-2020*).

Hereto, the agreement was terminated and the film was transferred from offline to online.

### **3. The Problems of VAM in the Film Capitalization**

#### **3.1. The Imputation after the Agreement Termination**

In early 2020, there was an outbreak of new coronavirus pneumonia (2019-nCoV) in Wuhan, China. Affected by the "2019-nCoV", in order to protect public health, all films during the Spring Festival were cancelled, and the Chinese government took corresponding measures to prevent and control the disease. On January 30<sup>th</sup>, 2020, the WHO identified the outbreak as a public health emergency of international concern. Definition of a public health emergency of international concern: Public health emergencies of international concern refer to unusual events identified under the provisions of the international health regula-

tions. Unusual events that pose a public health risk to other countries through the international spread of disease and may require a coordinated international response.

For both parties unable to perform the guaranteed issuance agreement, this event is a typical “force majeure” in the general provisions of the Civil Law.

Article 180 of “General Part of the Civil Code of the People’s Republic of China” provides that:

No Civil Liability is borne in case of failure to perform civil duties due to force majeure, unless otherwise provided by law.

Force majeure means unforeseeable, unavoidable and unconquerable objective situations.

Therefore, the disease itself will not cause any breach of the agreement between the film distributor and the cinema chain if the agreement is terminated. The film’s cancellation during the Spring Festival is unforeseeable, unavoidable and insurmountable, and the rights and obligations of both parties return to the origin. For the losses caused by the issuer after the termination of the agreement, both parties may negotiate compensation based on the actual losses (Zhao, 2020).

### **3.2. High Valuation & High Performance Commitment in VAM**

In the agreement of “Lost in Russia”, the two sides set a target of 2.4 billion yuan of guaranteed box office, indicating the high valuation and high performance behind the film.

The relevant data show that, Xu’s first two films, “Lost in Thailand” and “Lost in Hong Kong”, grossed just 2.88 billion yuan. Compared with his last film, “Dying to Survive”, the movie’s actual total box office is 3.1 billion yuan, with a score of 9.0 on douban.com (as of February 24<sup>th</sup>, 2020), while Lost in Russia’s score on douban.com is only 5.9 (as of February 24<sup>th</sup>, 2020). From the announcement, it can be seen that the producers’ expected valuation for “Lost in Russia” is too high. If the agreement were not terminated, the bet agreement will fail at a high rate.

In fact, the film IP is a hot object in the capital market, high valuation and high performance commitment can also stimulate the share price in the secondary market. Though there is a risk that the promise of high performance in such a hot area will not be fulfilled, it can stimulate the stock price to rise sharply. For example, the stock price of Huanxi Media surged 43.07% on January 24<sup>th</sup>, the biggest gain in recent days, after it announced that it would sell the distribution rights of lost mom to ByteDance for 630 million yuan. After the expiration of the commitment, the unrealized performance will affect the stock price, but as long as there is no extreme situation, such as earnings seriously lower than the performance commitment, it will not have a significant impact on the stock price, will not seriously affect the interests of investors. As mentioned above, financing after the performance commitment compensation, there is often a larger profit

space, so this situation, in fact, is a double win.

Therefore, the real risk of this kind of bet agreement is that in the security secondary market, a large number of mergers and acquisitions with high valuations will generate capital bubbles. If the bet fails, not only listed companies will suffer losses, but also small and medium-sized investors in the market will suffer serious losses. If the agreement continues to be implemented, whereas the box office fails to reach the standard, the bet fails, then the stock of Huanxi Media will fall, the small and medium investors will also be negatively affected (Li, 2017).

## 4. Conclusion

Through the three points above, it's no doubt that VAM can be used in the film capitalization through reasonable performance commitment and compensation to help investors obtain IP rights; meanwhile, the producer cashed in its uncertain future earnings ahead of schedule. However, for the better use of VAM in film capitalization, how to deal with the damage caused by force majeure to the high-priced bet agreement in a timely manner, China's relevant departments and film industry mechanism still need to be improved.

### 4.1. Cinema Investors Have a Poor Tolerance for Risk

In this case, there is a significant problem that the agreement mode of is too single. The parties agreed to distribute the films exclusively in cinemas, with no consideration for diversified distribution. When encountered force majeure, all the cinemas suffered a severe blow, and the investor could not recover the loss through the original way. The law does not explicitly stipulate that film must be released in cinemas. Compared with the tragic of Hengdian Pictures, the behavior that Huanhuan Xixi made the premiere of the film on ByteDance's online platform broke the industry rules and became a successful case to avoid the damage by the termination of the agreement.

### 4.2. Balance between Macro-Control and Protection

Given that the "2019-nCoV" is a public health emergency, it is too fast to control the situation and to look after the interests of all sides in a short time. All departments to the people's health as the premise, temporarily did not worry about the interests of the cinemas. As a result, there was no film released in 2020 in the Spring Festival season, which should have been already a good market. The whole film industry was weakened greatly. At this time, the macroscopically adjusting control of relevant branch appears very significant.

At this moment, this kind of high-priced bet agreement is apparently not a desirable outcome but a lose-lose situation. Relevant departments shall adopt offline policies to adjust the film schedule appropriately. It is urgent to protect the film culture industry timely and effectively.

To sum up, how to balance both of them are the key to the development of

film capital market.

### Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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