



# COHEN INDEPENDENT RESEARCH GROUP

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## QUICK VIEW

July 8, 2008

### Seven Arts Pictures (SAPXF)

Recent Price: \$0.30  
Symbol: SAPXF  
Recommendation: BUY  
Industry: Motion Pictures

Seven Arts Pictures is an independent financier, producer and distributor of feature length films. We believe that the Company's business model is exciting because SAPXF does not have to rely on blockbuster receipts from first run theatrical release. Seven Arts' films derive their profitability from the worldwide distribution of DVD, PPV, as well as pay and free TV rights. The company also acquires the rights to films it has not produced to distribute through its established distribution network. Seven Arts maintains movie copyrights for future distribution and has a library of 35 movies. We believe that several new releases delivered in FY08, as well as a number of films in development, have strong revenue potential.

Stock Metrics	
Recent Price	\$0.30
52 Weeks Price Range	0.30-0.50
Shares Outstanding (mil.), FY08	23.82
Market Capitalization (mil.)	7.1
Avg Daily Volume (3 month)	1,454
Beta (estimated)	2.20

Balance Sheet		2008 E
Cash & Equivalents		605,007
Working Capital		-3,684,584
Total Assets		51,707,937
Long-Term Liabilities		23,115,170
Total Debt		28,594,760
Shareholders Equity		8,903,177

Key Ratios	2008 E	2009 E
SGA / Sales	8.8%	5.0%
Net Profit Margin	19.9%	24.5%
Interest Coverage	1.1	3.3
Return on Equity	38.1%	51.7%
Return on Assets	6.6%	11.4%

Price Ratios	
Price to Sales 2008E	0.6
Price to Sales 2009E	0.3
Price to Earnings 2008E	2.8
Price to Earnings 2009E	1.1
Price to Book 2008E	1.1



The Company's plan is to release four to seven in-house financed and produced new films per year, supplemented by several films distributed for other producers on an agency basis. We estimate gross investment in new films of \$35 million in FY:08, expanding to \$50 million in FY:09, and subsequently increasing by \$10 million per year. Seven Arts has approximately 12 films that are currently in various stages of production, or available for release. The Company has been very successful in utilizing tax credits and/or tax-advantaged investments (soft money) as well as pre-sales of distribution rights, against which it is able to acquire bank financing, in order to essentially fund 100% of its gross film costs. The Company's fiscal year end will change from March to June in 2008 to better balance the major film festivals within its fiscal year. These film markets typically generate the majority of the Company's rights sales. As a result, FY08, ending June 30, 2008 includes 15 months.

	<b>FY07A</b>	<b>FY08E</b>	<b>FY09E</b>	<b>FY10E</b>
Revenues	11,758,578	17,000,000	34,700,000	53,100,000
Net Income	1,934,260	3,391,233	8,493,283	10,924,798
Diluted EPS	0.05	0.08	0.26	0.34

We create three forecasts to describe the range of possible outcomes for the Company. The primary difference between the three scenarios is the revenue forecasts. Details of our forecasts are in the full report. The table below displays the Diluted EPS for each of our forecasts.

#### Diluted EPS Forecast

<b>All figures in \$</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Optimistic Case	\$0.08	\$0.40	\$0.52	\$0.69	\$0.85
Base Case	\$0.08	\$0.26	\$0.34	\$0.40	\$0.50
Pessimistic Case	\$0.08	\$0.11	\$0.12	\$0.13	\$0.13

We calculate a short-term and long-term price target based on PE multiples and our forecast for FY09 and FY10 diluted EPS. We note that the Base Case describes a 58.6% annual compound growth rate in diluted EPS for the forecast timeframe. Comparable companies trade at an average 31x trailing EPS. The following tables summarize our PE valuation analysis. Our single point short-term and long-term price targets are \$5.26 and \$6.76, respectively. Complete details of our financial forecast, valuation analyses and comparable companies are in the full report.

#### Short-Term Price Targets Based on PE Multiple to FY09 Diluted EPS

<b>PE Multiple</b>	<b>15</b>	<b>20</b>	<b>25</b>
Optimistic Case	5.99	7.98	9.98
Base Case	3.94	5.26	6.57
Pessimistic Case	1.59	2.13	2.66

#### Long-Term Price Targets Based on PE Multiple to FY10 Diluted EPS

<b>PE Multiple</b>	<b>15</b>	<b>20</b>	<b>25</b>
Optimistic Case	7.87	10.49	13.11
Base Case	5.07	6.76	8.46
Pessimistic Case	1.87	2.50	3.12



## Executive Summary

- Seven Arts Pictures is an independent motion picture financing, production and distribution company.
- The Company's core business strategy is to finance, produce, and distribute 4-7 films in-house annually with budgets of between \$5 and \$12 million each, and to finance these through a combination of tax credits and/or tax advantaged investments as well as loans from banks secured with presales of certain domestic and foreign rights. This business model generates a minimum 30-50% gross margin on each movie, even assuming a limited or no theatrical release. The Company also seeks to acquire films produced by others for distribution in post theatrical markets, as an agent, for a 15%-20% fee.
- Seven Arts plans to supplement its core strategy by producing a few higher cost films (\$20- \$50 million) that may have higher upside due to the increased likelihood of a wide theatrical release. Seven Arts may choose to partner with a major US distributor on certain of these movies in order to reduce its financial exposure and to secure a wide US theatrical release.
- The Company reduces its financial risk on each movie by pre-selling certain domestic and international rights to distributors before production commences. Such pre-sales typically amount to 40%-50% of the gross budget of each movie. Contracted pre-sales are then discounted with banks/finance companies to provide production financing. Each film is thus partially independently financed with such non-recourse senior debt, occasionally supplemented with a mezzanine tranche.
- Seven Arts Pictures takes advantage of tax motivated financing structures to fund film production. Certain states and municipalities subsidize film production in their jurisdictions by reimbursing a portion of the film's cost. In addition, the Company may receive cash from individual investors who receive tax credits and/or leveraged write-offs based on their investment in the film. The Company is not usually obligated to return the principal invested unless the picture is a blockbuster. Typically, such tax oriented financings provide 40% to 50% of a film's production budget. The company keeps current with changing tax laws in the US, Canada, UK, and Hungary and other countries to identify appropriate scripts and locate production in geographic regions that qualify for tax credit investments.
- The Company's business model focuses on distribution in the post-theatrical markets for its core "genre" movies. These include the domestic and international DVD markets, pay-per-view (PPV) and video-on-demand (VOD), and the domestic and international pay and free TV markets .
- Although the success of most of the Company's films is not dependent on a wide theatrical distribution, when it does occur, the advertising and marketing expenses associated with it will propel subsequent DVD, PPV, and TV distribution revenues, often by several multiples. Widely released films also provide the engine to pull smaller pictures along in subsequent library package sales. This helps explain the company's desire to produce and release a few larger budget movies that have "theatrical breakout" potential, while limiting the downside through pre-sales, tax shelters and, possibly, co-financings.
- Seven Arts Pictures has developed and maintains excellent relationships with several US theatrical distributors including MGM, Sony, Paramount, and Fox, as well as with international distributors such as Momentum (UK), Pathe (France), AMG (Japan), Soyuz (Russia) and Scanbox (Scandinavia). These relationships provide a majority of the Company's pre-sale agreements.



- Through a combination of releases and selected acquisitions, Seven Arts expects to increase its film library from 35 films to 125 films over the next five years. The Company expects that all of the cost of its in-house films will typically be amortized within three years of their release. The value of a film library is that it will continue to generate revenues in post-theatrical markets beyond that time, particularly if "pulled" by larger pictures, with little cost associated with those revenues.
- In FY 2008, two films produced by Seven Arts Pictures had a limited theatrical release. "Deal", starring Burt Reynolds, Bret Harrison and Shannon Elizabeth was distributed through MGM. "Noise", starring Tim Robbins and William Hurt was distributed through ThinkFilm. Both performed modestly, but are expected to meet profit targets based on the fact that half their production cost was provided through tax credits/investments and that pre-sales more than met the Company's goals.
- Several more films are in final post production or are ready for distribution. At least four will be available for distribution in the quarter and year ending June 30, 2008 such that certain pre-sale revenues will be booked at that time. They will all likely be released in the next several months either theatrically or post-theatrically. Certain of these, such as "American Summer" may enjoy a wide theatrical release.
- Seven Arts Pictures has secured the exclusive rights to create motion pictures based on a series of 11 novels by Boris Akunin, a Russian writer. The novels are adventure/thriller stories based in Czarist Russia and are very popular in Europe. We expect the first film of the series, "The Winter Queen", to be directed by Paul Verhoeven, will be released in FY10.
- The Company has several more high-profile films in development scheduled for production and release in 2009 through 2010 including "Catwalk", "Mortal Armor; The Legend of Galahad", "Romeo Spy" and "Neuromancer."
- Management has a wealth of experience in the film industry, including financing transactions, risk management, film production and distribution. Management has been directly involved in many successful feature films such as "Terminator 2", " Total Recall", " Rambo", " Rambo III", " Platoon", " The Big Easy", " Johnny Mnemonic" and "Showgirls".

### **Valuation Summary**

- We forecast three scenarios to value SAPXF common stock and to define a range of potential outcomes. Our Base Case scenario describes what we believe is easily achievable for the Company based on the number of estimated new film releases in 2008 and 2009, the films in development and the Company's disciplined business model. Our Base Case scenario identifies a compound annual growth for diluted EPS of 58.6%. Applying a 20x PE multiple (66% discount to our projected earnings growth) to FY09 diluted EPS, we calculate a single point price target of \$5.26. For our Optimistic case, our single point price target is \$7.98. We note that comparable companies trade at an average trailing 12-month PE of 31.5x, and a forecast PE of 16.5x.
- We forecast a long-term price target with our FY10 forecast. Our single point target price based on a 20x multiple to our FY10 is \$6.75 and \$10.49 for our Base Case and Optimistic scenarios, respectively. We note that our short-term and long-term price targets described by our Pessimistic case, \$2.13 and \$2.50, respectively, are significantly above the current stock price.



## Investment Thesis and Recommendation

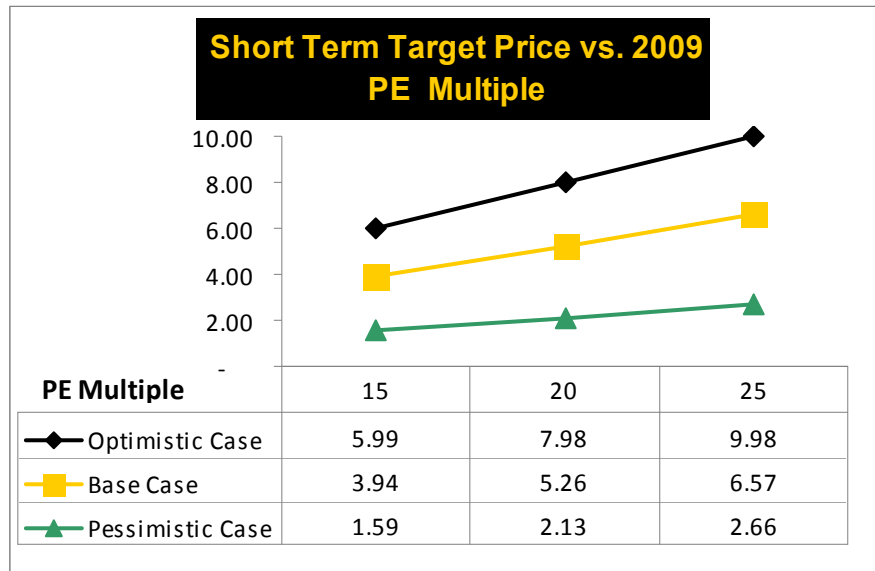
The motion picture industry is dominated by movie studios that rely on first run theatrical box office receipts to cover both high film budgets and marketing expenses as well as to maximize the value of the film's release for subsequent domestic and international markets. Major studios execute a business model that tends to inflate box office revenues with high marketing and advertising budgets at the expense of current gross margins and profitability. Seven Arts Pictures, on the other hand, focuses on producing films that are profitable in the post first run theatrical distribution market, and may not require a theatrical release. Growth of the post first run theatrical distribution market has been driven by the proliferation of DVD players worldwide, the availability of PPV to a large segment of the G-7 population, and growth of in-home high definition television and sound systems which closely replicate the cinema experience. Seven Arts Pictures takes advantage of these trends by producing moderately budgeted quality films that target the post theatrical distribution market and are highly sought after by the wholesale DVD and rental market. The Company reduces its financial risk by obtaining purchase commitments from distributors often before film production begins and by utilizing tax credits and/or tax advantaged financings that may cover up to 50% of the production budget, together with non-recourse bank loans that are secured with presales of certain rights to third party distributors. This enables Seven Arts to produce films with gross margins of 30 % to 50% even if revenue overages turn out to be minimal.

The company focuses on "genre" movies such as teen comedies, dramas, and horror movies. These films have strong appeal to a selected demographic audience and when combined with careful construction of the film's "elements" (the director, actors, producer, and writer), create a valuable long-term asset as a library title. Film libraries are the engines for long-term value creation in the movie business. Seven Arts Pictures plans to expand its movie library of 35 films to 125 titles within 5 years by producing four to seven films per year and by carefully acquiring additional titles.

Seven Arts has two movies, "Deal" and "Noise" that were recently released in a limited number of theaters and are about to be released in post-theatrical markets. Several more films are scheduled for release in the next several months, one of which ("American Summer") is believed to have wide theatrical potential which could make it the largest revenue producer in the Company's history. Several other films in development including "Catwalk", "The Winter Queen", "Mortal Armor; The Legend of Galahad", "Romeo Spy" and "Neuromancer" appear to be very promising.

We believe the Company's emphasis on protecting its downside risk through tax advantaged financings and presales, together with a slate of promising upcoming releases, creates significant upside to the current stock price and excellent long term value in the form of a film library.

At \$0.30 per share, with a valuation target of \$5.26, we recommend the purchase of SAPXF common stock for long-term growth investors.



At \$0.30 per share, we believe Seven Arts Pictures (SAPXF) is substantially undervalued even when compared to our most conservative forecast. Based on our valuation analyses, an investment in SAPXF has the potential for high returns over the next few years. We created three scenarios – Base Case, Optimistic Case and Pessimistic Case – while valuing the Company. The primary difference between the scenarios is the assumed revenues from new film releases. All three scenarios incorporate the same financial investments in films.

We expect the Company to release seven films per year in FY2009, and beyond. We believe our revenue forecasts in the Base Case and Optimistic scenarios are the most likely outcome for the Company. Details about new film releases and films in development are in the full report. Our revenue assumptions are defined in the Financial Forecast, and our valuation analyses is described in Valuation.

**Cohen Growth Drivers – Base Case**

<b>Cohen Growth Driver Analysis</b>	<b>FY-08E</b>	<b>FY-09E</b>	<b>FY-10E</b>	<b>FY-11E</b>	<b>FY-12E</b>
Revenues	17,000,000	34,700,000	53,100,000	68,240,000	82,040,000
Operating Margin	29.2%	30.2%	30.5%	31.2%	31.8%
Net Margin	19.9%	24.5%	20.6%	18.8%	19.7%
EPS - Diluted	0.08	0.26	0.34	0.40	0.50
Cash from Operations	13,108,259	26,732,783	36,318,748	44,997,818	55,209,818
Free Cash Flow	779,565	19,680,565	36,946,496	49,040,636	62,402,636
Cash	605,007	5,320,789	5,622,537	6,603,355	8,796,173
Working Capital	(3,684,584)	2,147,199	2,611,947	4,123,765	6,316,583
Long Term Debt	23,115,170	34,115,170	34,115,170	32,115,170	27,115,170
Total Debt	28,594,760	36,594,760	36,594,760	34,594,760	29,594,760
Total Assets	51,707,937	74,577,669	90,791,467	108,524,935	126,587,953

**Annual Percent Change in Revenues, Margins, Assets**

Revenues		104.1%	53.0%	28.5%	20.2%
Operating Margin		3.2%	1.1%	2.2%	2.0%
Net Margin		22.7%	-15.9%	-8.7%	5.1%
EPS - Diluted		233.5%	28.6%	17.4%	26.4%
Cash from Operations		103.9%	35.9%	23.9%	22.7%
Free Cash Flow		2424.6%	87.7%	32.7%	27.2%
Cash		779.5%	5.7%	17.4%	33.2%
Working Capital		-158.3%	21.6%	57.9%	53.2%
Long Term Debt		47.6%	0.0%	-5.9%	-15.6%
Total Debt		28.0%	0.0%	-5.5%	-14.5%
Total Assets		44.2%	21.7%	19.5%	16.6%

The growth story at SAPXF is exciting. Due to the change in the company's fiscal year from March to June, FY08 contains 15 months. We forecast FY08 revenues of \$17 million with operating profits of \$4.97 million, compared to FY07 revenue of \$11.8 million and gross profit of \$3.8 million. (Approximately \$2 million in revenues and profits recorded in FY07 were not film related but rather arose from a gain on exchange of financial instruments) FY07 was reported in the UK, thus, our FY07 data incorporates the conversion from British Sterling to \$US and conversion to GAAP, detailed in our Financial Forecast. Diluted EPS in FY08 is expected to be \$0.08 compared to \$0.05 in FY07. Revenue growth in FY08 is due to delivery of several films, most of which occurred in the last three months of FY08, or the 5<sup>th</sup> quarter. The company may report interim FY08 data for the year ending March 31, 2008 due to requirements from the PLUS market in London. Since the majority of revenues for the new FY08 are expected to be booked in the last three months of the fiscal year, we view any report for the year ending 3/31/08 as less than meaningful relative to our forecasts.

We expect revenue growth will accelerate in FY09 and FY10 due to the release of 11 new films in FY08 and FY09, and the release of five more films in FY10. Operating margins are expected to remain healthy throughout our forecast timeframe. The decline in net margin in FY10 and FY11 results from the increase in projected tax rate due to the expiration of net losses carried forwards. The compound annual growth rate in diluted EPS from FY07 through FY12 is 58.6%. Cash from operations and free cash flow, before reinvestment in new movies, are very strong throughout our forecast timeframe.



## Price and Volume



We believe the stock price is trading at a substantial large discount to the value of the business due to several factors:

1. No new films were released by the Company in the first half of FY08. This has changed significantly with the release of several films at the end of FY08.
2. The Company is changing its fiscal year end from March to June to better align financial reporting with the large film festivals, i.e. 2 major film markets in each half year.
3. The company's listing on the British PLUS MARKET has been disappointing due to poor visibility and liquidity.
4. SAPXF stock may have been perceived as having an overhang of convertibles which might have caused significant dilution and potential interest rate penalties. However, recent cash flows have paid off over \$8 million of debt that was technically in default, with no dilution.
5. SAPXF recently applied to be listed on the British AIM Stock Market, which is roughly equivalent to a US NASDAQ National Market Listing. This should increase the visibility and liquidity of the stock. Also, the company was just listed on the US Over the Counter market which will increase the exposure and visibility of SAPXF in the US.D



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Recommendations: BUY 98%, SELL 2%

