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Hollywood's hedged bets; Studios share risks, and losses, with investors. But rules may change.

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CORRECTION: SEE CORRECTION APPENDED; Studio financing: An article in Section A on Feb. 16 about hedge-fund financing of Hollywood movies said studio projections for films in an investment pool known as Gun Hill Road I indicated that "Doom," "The Holiday" and "Stranger Than Fiction" might lose a combined $100 million over seven to 10 years. The projected losses for those three films are actually about $84 million.; Studio financing: An article in Section A on Feb. 16 about hedge-fund financing of Hollywood movies incorrectly identified Och-Ziff Capital Management as an investor in a slate of films known as Gun Hill Road I. Och-Ziff was not an investor in Gun Hill Road I.

On paper, "Evan Almighty" looked like a sure thing.

A spinoff of Jim Carrey's smash hit "Bruce Almighty," the film starred Morgan Freeman, reprising his role as God, and Steve Carell, one of Hollywood's hottest comedians.

But "Evan Almighty" turned out to be a dud, with an estimated $250 million in production and marketing costs and just $173 million in box office revenue.

The film's distributor, Universal Studios, is not the only one feeling the pain. A Milwaukee hedge fund put up millions of dollars to help bankroll the movie and more than a dozen others, according to investment bankers. Hedge funds have been a major source of capital for Hollywood studios over the last three years. Drawn by projections of double-digit returns with minimal risk, they pumped $13 billion into 150 major pictures. Typically, they helped finance "slates" consisting of as many as several dozen movies. Now, the glitter is gone. Many of those deals are likely to lose money for equity investors, according to investment bankers. The toll could reach hundreds of millions of dollars.

In some cases, studios have restructured deals to appease angry investors. Sony Pictures, whose investors backed such flops as "All the King's Men" and "Stranger Than Fiction," agreed last year to absorb some marketing costs originally charged to them, according to three people knowledgeable about the matter.

Sony agreed to swallow $20 million in marketing expenses, one of the sources said. Another said the figure could reach $45 million.

Bob Osher, Sony's chief operating officer, confirmed the restructuring but declined to discuss the financial terms. He said the renegotiation "was never related to any specific cost element of the pictures."

New deals will carry more stringent terms so that the studios can no longer profit if their backers end up in the red, investment bankers say.

"Many of the equity investors who have gotten into the industry in the last 24 months have woken up and smelled the coffee," said Eileen Burke, a managing director at investment firm D.B. Zwirn & Co. "They're either going to say, 'I don't want to invest anymore because I don't like the misalignment of interests' or they're going to insist on better alignment."

The drama has largely played out behind the closed doors of the famously secretive hedge funds, pools of private capital that almost never disclose profits or losses.

The most prominent intermediary between Hollywood and the hedge funds is Ryan Kavanaugh, a 33-year-old former dot-com deal maker. His West Hollywood investment firm, Relativity Media, put together some of the largest and most publicized financing packages, including the one that backed "Evan Almighty."

Kavanaugh sold hedge fund managers on the idea that investing in a dozen or more films at a time would reduce the risk that a single bomb would sink the portfolio. He also touted a computerized system he said he had developed to distinguish between potential hits and misses.

"He figured out how to create a financing formula that satisfied studios and investors and banks," former Columbia Pictures Chairman Mark Canton, a friend and business associate of Kavanaugh, said in an interview.

Kavanaugh declined to comment for this article. In the fall, he told the trade paper Variety that gains from one of his funds would approach 15% to 25%. Investment bankers, media analysts and Hollywood executives expressed skepticism.

"The industry overall is generating single-digit returns, so it would seem unusual that these slate deals could do better than that," said entertainment banker John W. Miller of JPMorgan Securities.

That limitation was not so apparent in late 2004, when hedge funds got involved in Hollywood in a big way. The funds were enjoying record inflows of capital and looking for new investments. The movie business was enjoying explosive profit gains stemming largely from sales and rentals of DVDs.

Studios were looking to mitigate the financial risks of producing movies. Traditionally, they had relied on bonds and bank loans that produced dependable profit for lenders. But the studios bore all the risks of failure.

When the idea emerged to offer backers a piece of the action, rather than merely fixed interest payments, it looked like a win-win proposition. Although the studios would have to share some of the profit from hit movies, they also would shed some of the risk of losses.

The investors would collect their returns once all the films in a slate had opened and started to generate DVD and television revenue, usually five to seven years after their theatrical openings.

At meetings in studio back lots and Wall Street skyscrapers, hedge fund managers heard investment banks and promoters project annual returns of 18% or better. They were so jazzed that they agreed to forgo some of the protections that bank lenders had imposed on film companies, such as limits on marketing budgets.

By the end of 2006, every major studio had lined up private equity backers for at least one package of films.

Paramount Pictures financed a slate with Merrill Lynch & Co. that included "Mission: Impossible II" and a second slate covering such films as "Flags of Our Fathers" with Dresdner Kleinwort & Co. Walt Disney Co. turned to Credit Suisse First Boston to find investors for a package that included the Jodie Foster thriller "Flightplan."

Kavanaugh's Relativity Media joined with Deutsche Bank to raise $620 million for the co-financing of movies at Sony Pictures and Universal Studios. The German investment bank also underwrote a $740-million follow-up fund.

Kavanaugh had a curious record for someone attempting to raise hundreds of millions of dollars from investors.

That record involved a Santa Monica venture capital business he operated during the dot-com boom of the late 1990s. A lawyer for Kavanaugh, Alan Harris, said in a letter to The Times that the business was "very successful."

Kavanaugh's own testimony and court filings suggest otherwise. He testified in civil court last month that as of 2002, the business was essentially worthless. Kavanaugh filed documents stating that shares in the start-up companies in which he concentrated his investors' money had no market value by the end of 2002. Kavanaugh testified that at that time he was "all but bankrupt."

Several of Kavanaugh's investors sued, accusing him of fraud, misrepresentation or other wrongdoing. He denied the accusations. At least two of the lawsuits were settled with payments to the plaintiffs and no admission of liability, according to court records and statements by Kavanaugh or his lawyers.

In a third case, an arbitrator ruled in 2002 that Kavanaugh had been "clearly negligent" in managing a $6.2-million investment by Los Angeles public relations executive Michael Sitrick. Kavanaugh was ordered to pay $7.7 million in damages. Sitrick is still trying to collect the judgment.

Kavanaugh's recent testimony about his venture-capital firm was tied to this case. He was trying to show that the business tanked, leaving him unable to pay Sitrick's judgment in 2002. To that end, Kavanaugh testified that he lost more than $730,000 of his own money in options trading after the dot-com crash -- much of it in a single day.

Under cross-examination, Kavanaugh also admitted that he never earned a bachelor's degree from UCLA, despite having claimed for several years that he was a graduate. That claim appeared on offering statements prepared for prospective investors.

Another lawyer for Kavanaugh, Martin D. Singer, said in a letter to The Times that his client mistakenly believed he had a UCLA degree and "found out later that several credits had not transferred over from UC Santa Barbara to UCLA and thus he had not officially 'graduated.' "

A few years after his setbacks as a venture capitalist, Kavanaugh emerged as a Hollywood deal maker.

By 2006, Details magazine's "Power 50" list of big shots under 42 lauded him for "saving Hollywood's ass, a couple billion dollars at a time." Vanity Fair listed him among a cadre of media up-and-comers under 40. A profile in the inaugural issue of Conde Nast's Portfolio in May called him "quick-witted and relentless."

One of the first movie transactions Kavanaugh helped broker was a $528-million fund called Virtual Studios, through which Stark Investments, the Milwaukee hedge fund, co-financed a slate of films at Warner Bros. beginning in 2005. The second picture in the package, the would-be blockbuster "Poseidon," bombed.

"Poseidon" cost more than $150 million, eating up a sizable portion of the fund's capital. As a result, the other films in the slate would have to do better than originally projected for the package as a whole to generate the desired returns.

Disappointments such as "Poseidon" prompted some slate investors to take a closer look at the structure of the deals. Some concluded that the terms tended to favor the studios at their expense.

The studios, for instance, typically were permitted to recoup their marketing costs up-front. They also collected distribution fees of as much as 15% of revenue before investors started to see any payback. These provisions reduced the incentive for the studios to control their costs.

The studios could also choose which films to put in the slates. They customarily gave the funds their most uncertain projects -- such as costly films lacking overseas appeal -- while keeping the surest blockbusters to themselves.

The slate funds were essentially "risk management vehicles," said entertainment industry analyst Harold L. Vogel of Vogel Capital Management in New York. "The studios are pushing the risk to the investors."

This came into focus as the tide ran out on the DVD boom. After years of 10% to 15% annual growth, sales and rentals flattened beginning in 2005. This sharply reduced the profitability of movies. Nevertheless, studio spending on production and marketing kept rising.

These twin trends put slate deals under pressure, including one of Relativity Media's vehicles, Gun Hill Road I, a package of 17 movies.

Late last year, after the release of the final film in the package, investors got a picture of how the slate had fared, based on box-office returns and authoritative studio estimates, known as "ultimates," of the probable earnings from DVDs and television over the next seven to 10 years.

The Times examined a financial analysis based on the studio projections. It showed that eight of the films are likely to lose money. Despite successes such as "The Pursuit of Happyness," "Talladega Nights" and "Inside Man," the slate as a whole is unlikely to break even, the analysis indicated.

Three films -- "Doom," based on the popular video game; "The Holiday," a comedy starring Cameron Diaz; and "Stranger Than Fiction," a Will Ferrell drama -- may lose $100 million combined, according to the projections.

The financial analysis did not include definitive figures for the final film in the slate, Universal's big-budget thriller "The Kingdom," which had not yet opened.

But already, investors were sufficiently concerned to demand the restructuring in which Sony agreed to absorb some marketing costs.

"The Kingdom," released in September, performed poorly, barely breaking $85 million in worldwide box-office receipts. That could translate into a loss of $30 million or more for the film, according to studio projections and industry executives.

Singer, the lawyer for Kavanaugh, said in a letter to The Times that Gun Hill Road I "is clearly profitable," echoing his client's assertion in Variety that the slate would generate returns of as much as 25%.

Hedge funds that helped finance the slate, including Chicago-based Citadel Investment Group and New York's Och-Ziff Capital Management, declined to comment or did not respond to inquiries.

Another Relativity Media fund, Gun Hill Road II, was launched in 2006. Among its first four films were "Evan Almighty" and "Marie Antoinette," both flops. More recently, "American Gangster" brought in $245 million worldwide in its first three months. But its profitability is uncertain, in part because of its high cost.

"When you're only partially through [a slate], it's premature to project performance," said Laura Fazio, a managing director at Deutsche Bank.

Some investors are not waiting for the final reckoning. Late last year, Deutsche Bank offered to sell stakes in Gun Hill Road II at a discount of as much as 30%, according to people who were approached by the bank's salespeople.

Investment bankers say the studios have started to see the need to appease investors in slate deals. They are beginning to sweeten the terms, sometimes under the threat that investors will demand to audit their spending or sue.

"There are a variety of strategies to improve investor returns by engaging the studios," said Stephen Prough, founder of Salem Partners, a Los Angeles investment bank. "You can get their attention."

Future deals are likely to more closely resemble Dune Capital Management's arrangement with 20th Century Fox. The deal provides production capital for all Fox films rather than a limited selection. That helps ensure that the hedge fund will share in the studio's hits as well as its failures.

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