Zacks Small-Cap Research

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Seven Arts Pictures (SAPX-NASDAQ)

SAPX: Focus shifts Toward Larger Films and Improving the Balance Sheet - Neutral

Current Recommendation	**Neutral**
Prior Recommendation	Outperform
Date of Last Change	02/23/2012
Current Price (05/21/12)	$0.06
Target Price	**$1.00**

OUTLOOK

Seven Arts Entertainment Inc. is an independent motion picture production and distribution company which develops, finances, produces and licenses theatrical motion pictures, with budgets generally ranging from $2 million to $15 million, for exhibition in domestic (United States and Canada) and foreign theatrical markets. Seven Arts strategy is to build their film library up from 33 titles today, to 50 to 75 titles over the next 5 years. While earnings will be up and down and generally difficult to predict the firm should be valued on the monetization of its film library. As distribution changes at a swift pace firms that can continue to monetize creatively will benefit.

SUMMARY DATA

52-Week High	**$5.75**
52-Week Low	**$0.05**
One-Year Return (%)	**-92.95**
Beta	**-0.62**
Average Daily Volume (sh)	**2,008,579**
Shares Outstanding (mil)	**31**
Market Capitalization ($mil)	**$2**
Short Interest Ratio (days)	**0.29**
Institutional Ownership (%)	**1**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2013 Estimate	**0.2**
Zacks Rank	**3**

Risk Level	**High**
Type of Stock	**Small-Value**
Industry	**Movie/Tv Pr&Dis**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2010					6.42 A
2011					3.33 A
2012	$0.59 A	$0.21 A	$0.19 A	$0.50 E	1.49 E
2013	$0.75 E	$1.00 E	$3.00 E	$5.21 E	10.0 E

Earnings per Share
(EPS is operating earnings before non recurring items)

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2010					-$0.34 A
2011					$0.66 A
2012	-$0.14 A	-$0.07 A	-$0.05 A	-$0.02 E	-$0.28 E
2013	-$0.08 A	$0.03 E	$0.05 E	$0.07 E	$0.07 E

Prior to FY 2012, SAPX traded as a PLC and did not release quarterly results.

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WHATS NEW

Seven Arts Shifts focus to Larger films and improves the Balance Sheet

On May 21, 2012, Seven Arts Entertainment Inc., reported results from operations for its third quarter and nine months, ended March 31, 2012. While third quarter results were weak, Seven Arts continued its trend of debt reduction and growth of stockholder equity.

The Company's year over year revenues fell from $272,703 for the third quarter ended March 31, 2011 down to $187,793 during the third quarter fiscal 2012.

While the majority of revenue for the third quarter of fiscal 2012 was from the films "The Pool Boys" and "Nine Miles Down", the drop in revenues was primarily due to there being no new releases in the 2012 period.

Seven Arts' reported a net loss of $1.585 million for the three months ended March 31, 2012 compared to a net loss of $973,034 for the comparable quarter of 2011.

Included in the quarter ended March 31, 2012, is $278,529 of startup costs for Seven Arts Music Inc.

However, the increase in net loss was primarily a result of a year over year jump in net interest expense from $40,446 to $744,469 during the three months ended March 31, 2012, primarily due to interest on the loans with Palm Finance.

Gross margin was negative for the three months ended March 31, 2012, due to the Company amortizing 100% of revenue achieved and utilizing certain media credits for the first time for the release of "The Pool Boys".

Still, based on a weighted average number of basic and diluted common shares of 30.421 million, basic and diluted net loss per share resulted in $0.05 loss per share during the third quarter fiscal 2012. Compared to a diluted net loss per share of $0.57 on a weighted average number of basic and diluted shares of 1.717 million during the quarter ended March 31, 2011.

It should be noted that the increase in weighted shares outstanding was in part a result of the issuance of unregistered shares to Seven Arts Pictures Plc., the Company's NASDAQ listing predecessor. Likewise, Seven Arts issued 19.300 million shares in the March 2012 quarter that retired $2.200 of debt and $1.100 million of other liabilities and raised $600,000 of equity investments (restricted stock).

For the nine months ended March 31, 2012, year over year revenues decreased to $987,220 from $1.510 million for the nine months ended March 31, 2011.

Net loss for the nine months increased to a net loss of $3.664 million. This compares to a net loss of $1.183 million for the nine months ended March 31, 2011. The increase in year over year net loss was primarily a result of negative gross margins in fiscal 2012 as well as an increase in year over year total operating expenses.

However, based on a weighted average number of basic and diluted shares of 17.665 million, basic and diluted net loss per share resulted in a net loss of $0.21 per diluted share during the nine months ended March 31, 2012. This compared to a net loss per basic and diluted share of $0.69 on a weighted average number of basic and diluted shares of 1.717 million during the nine months ended March 31, 2011.

Here again, the increase in weighted shares outstanding was in part a result of the issuance of unregistered shares to Seven Arts Pictures Plc., the Company's NASDAQ listing predecessor as well as 19.300 million shares issued in the March 2012 quarter that retired $2.200 of debt and $1.100 million of other liabilities and raised $600,000 of equity investments (restricted stock).

The Company continued its progress of improving its balance sheet. As of March 31, 2012, the Company reported $41.269 in assets, up sequentially from $28.729 million in assets as of December 31, 2011.

However, Seven Arts' working capital deficit increased to $8.692 million for the period ended March 31, 2012, up sequentially from a working capital deficit of $7.815 million during the second quarter ended December 31, 2011.

It should be noted that the large negative balances are mainly a result of film loans having to be treated as current debt. Additionally, as a result of its continued efforts to reduce indebtedness and increase net shareholder equity, Seven Arts made progress during the quarter in reducing its debt and increasing stockholder equity.

The Company reduced film and production loans by $6 million to under $5 million and reduced other liabilities (accounts payable, accruals, participations and other loans) by a net $2.2 million to under $6.6 million from the amounts at Seven Arts' last year end.

Furthermore, $1.200 million of existing Other Loans were paid or converted to equity since June 30, 2011 and production debt decreased from $15.876 million at December 31, 2010 and $10.890 million at June 30, 2011 to $4.921 million at March 31, 2012.

However, it should be noted that $1.500 million of new convertible loans were taken out in the March 2012 quarter as the Company began gearing up for the production of "Neuromancer" and "Winter Queen" and the launch of Seven Arts' new music company.

Still, the Company increased net shareholders' equity from $7.958 million as of June 30, 2011 and $15.250 million as of December 31, 2011 to its current level of $24.978 million (excluding the positive effect of an additional $1.3 million of debt conversions post quarter-end).

With domestic theatrical box office sales of all films reaching $10.6 billion and worldwide box office reaching as much as $29.9 billion in 2009, many successful independent motion picture companies and major studios have been reducing the number of pictures that they finance and distribute.

Consequently, these large studios and independent motion picture companies have concentrated on a limited number of higher budget films with budgets in the range of $10 million to $100 million or more.

As a result, Seven Art's business model has more recently turned its primary focus to the distribution in the post-theatrical markets for lower-cost, "genre" motion pictures.

The Company's strategy is to produce and distribute two to four $2 million to $15 million motion pictures in house per year.

Recently, Seven Arts has completed production and is anticipating the release for the theatrical showing of Radio Free Albemuth (United States) and Men Don't Lie (United Kingdom).

The Company has six motion pictures (Catwalk, Waxwork, Mortal Armor: The Legend of Galahad, Romeo Spy, The Winter Queen and Neuromancer) in development that are expected to be released within the next two to three years.

Likewise, the Company anticipates the release of 'Drunkboat' and 'Nine Miles Down' early next fiscal year.

Similarly, Seven Arts completed the formation of Seven Arts Music Inc. and released multi-platinum artist DMX's single "I Don't Dance" and DMX's music video on "I Don't Dance."

Digital sales of the single exceeded expectations at this early stage and the Company expects a major jump in digital sales with radio airplay building significant rotation daily.

More recently, since March 31, 2012 to May 10, 2012 the Company issued approximately 26 million new shares of common stock as part of its program of reducing debt and increasing stockholders' equity.

Aggregate production loans are now only $4 million while other debt has been reduced by $0.3 million and $0.5 million of the music company's overhead has been cleared.

Seven Arts expect its first releases from its new record subsidiary to be in the Fourth Quarter fiscal 2012.In January the Company announced it executed a definitive agreement to acquire music industry veteran, David Michery's music assets.

Upon completion of the acquisition, David Michery will be appointed Chief Executive Officer of the Company's new music division, Seven Arts Music, which will comprise of Big Jake music and other stars including DMX.

Last, it should be reiterated that during the past fiscal year the Company received initial funding for two films that will be produced by Dark Arts, a division of Seven Arts' affiliate, Esplanade Pictures LLC.

INVESTMENT THESIS

- Distribution of movies and programs is changing dramatically. Video on demand and video over the internet is the new reality of the space.
- The Company has seven motion pictures (Catwalk, The Winter Queen, Mortal Armor: The Legend of Galahad, Romeo Spy, Voodoo Museum, The White Lily and Neuromancer) in development that are expected to be released within the next two to three years.
- Seven Arts controls copyright interests for 21 completed motion pictures and a film library of 14 films, which it anticipates increasing to as many as 50 to 75 pictures over the next five years.
- The number of films produced is shrinking and major studious have cut back on distributing smaller budget pictures and have focused on large budget pictures and franchises.
- Seizing on the opportunity of fewer films produced, Neuromancer could provide significant revenues beyond what is typical of Seven Arts films.

OVERVIEW

Seven Arts Entertainment Inc. is an independent motion picture production and distribution company based out of London, the United Kingdom. The Company develops, finances, produces and licenses theatrical motion pictures, with budgets generally ranging from $2 million to $15 million, for exhibition in domestic

(United States and Canada) and foreign theatrical markets.

Seven Arts further provides post theatrical motion picture releases in the media forms of DVD, home video, pay-per-view and free television. Along the same lines, the Company controls copyright interests for 21 completed motion pictures and a film library of 14 films, which it anticipates increasing to as many as 50 to 75 pictures over the next five years.

The Company has recently released the domestic theatrical motion pictures Deal (April 2008), Noise (May 2008), Autopsy (January 2009), The Pool Boys (current release) and Nine Miles Down (current release).

While all of these releases have thus far received limited U.S. theatrical releases (50-300 theaters in the United States) Seven Arts has completed production and is anticipating the release for the theatrical showing of Radio Free Albemuth (United States) and Men Don't Lie (United Kingdom).

The Company has seven motion pictures (Catwalk, The Winter Queen, Mortal Armor: The Legend of Galahad, Romeo Spy, Voodoo Museum, The White Lily and Neuromancer) in development that are expected to be released within the next two to three years.

Additionally, it should be mentioned that in addition to the domestic titles, Seven Arts also released Knife Edge (October 2009) as a United Kingdom DVD premiere and Night of the Demons (September 2010) in the United Kingdom theatrically.

With domestic theatrical box office sales of all films reaching $10.6 billion and worldwide box office reaching as much as $29.9 billion in 2009, many successful independent motion picture companies and major studios have been reducing the number of pictures that they finance and distribute. Consequently, these large studios and independent motion picture companies have concentrated on a limited number of higher budget films with budgets in the range of $10 million to $100 million or more.

Full-Year Box-office & Attendance Since 1999

Year	Avg. Ticket Price	Total Box-office Gross	Percent change vs. previous year	Tickets Sold	
2009	**$7.46**	**$10,600,000,000**	10.07%	1,420,911,528	5.94%
2008	$7.18	$9,630,000,000	-0.52%	1,341,225,627	-4.67%
2007	$6.88	$9,680,000,000	4.09%	1,406,976,744	-0.91%
2006	$6.55	$9,300,000,000	3.79%	1,419,847,328	1.58%
2005	$6.41	$8,960,000,000	-5.19%	1,397,815,913	-8.14%
2004	$6.21	$9,450,000,000	1.61%	1,521,739,130	-1.33%
2003	$6.03	$9,300,000,000	-0.21%	1,542,288,557	-4.02%
2002	$5.80	$9,320,000,000	11.35%	**1,606,896,552**	8.47%
2001	$5.65	$8,370,000,000	8.00%	1,481,415,929	3.22%
2000	$5.40	$7,750,000,000	3.33%	1,435,185,185	-2.79%
1999	$5.08	$7,500,000,000	7.91%	1,476,377,953	-0.37%

Source: Deadline Hollywood

As a result, Seven Art's business model has turned its primary focus to the distribution in the post-theatrical

markets for lower-cost, "genre" motion pictures. The Company's strategy is to produce and distribute two to four $2 million to $15 million motion pictures in house per year.

Seven Arts, also intends to supplement this business strategy by occasionally producing higher cost motion pictures with production budgets in the range of $30 million to $50 million.

Furthermore, each year the Company intends to acquire opportunistic distribution rights to an additional two to five motion pictures that are produced by others. These motion pictures would be distributed by Seven Arts as an agent for a 15 percent to 20 percent fee into the theatrical, video and television markets.

The Changing Landscape of Cinema **(partial source filmmaking.net)**
Just as VHS and DVD once looked threatening to the movie industry, the internet threatens to change distribution once again. The industry is seeing P2P/IP TV as the new TV, download-to-own as the new DVD, and worldwide-synchronous online releases as the new cinema. In the past when the industry viewed new technology as a threat, that very threat ended up increasing sales.

The internet does not only represent a threat (piracy) but rather an opportunity to reach bigger audiences with more product, more quickly for far less cost. Think of the cost benefit of taking DVD's out of the supply chain. Several insiders also point to built-in marketing tools like peer-review and recommendations, and brand new methods for taking advantage of old revenue sources such as advertising.

Desire for Cinema and programs have not changed - just how we choose to access it. And we now have plenty of choices. Download services are re-populating our distribution landscape, giving rise to many exciting new opportunities. The early pioneers in content delivery are iTunes, Netflix, Amazon.com, Sony Playstation, and Microsoft Xbox.

Universal's Gamble
What Universal is planning is three weeks after its cinema release of Tower Heist, to release the film over a video on demand service. This is a limited trial, with the film being made available over Comcast's VOD service in a limited number of locations (Portland, Oregon, Georgia and Atlanta).

It'll also attract a premium price, costing viewers $60 if they want to see the film this way, this soon. Seems pricey at 5 times what it would sell for normally, but it's a bit like buying a brand new rental copy of a VHS/DVD in the past can be 2 or 3 times more expensive.

In Production

Title	Event	Production
Catwalk	- Principal photography to begin Summer 2011	Summer 2011
Waxworks	- Casting Complete. - Principal photography to begin Fall 2011	Summer 2011
The Winter Queen	- Signed Director Fyodor Bondarchuk (The 9th Company, The Inhabited Island) Milla Jovovich (Resident Evil, The 5th Element) - Production slated for June 2011	June 2011
Mortal Armor: The Legend of Galahad	- Signed Director Jon Amiel (Entrapment, Copycat) - Signed Producer Gale Anne Hurd (Terminator 2, Armageddon) - Currently casting lead	Winter 2011
Romeo Spy	-Signed Director Bronwen Hughes (Harriet the Spy, Stander) -Currently casting lead	Winter 2011
Neuromancer	-Signed Director Vincenzo Natali (Splice, Cube) -Currently rewriting screenplay with William Gibson	Summer 2011

Big Jake

On October 6, 2011 Seven Arts announced its subsidiary has executed a Distribution Services Agreement for digital and physical sound recordings with Entertainment One Distribution, the leading and fastest growing independent record company in the United States. Under the agreement Big Jake Music, will be releasing Seven Arts film soundtracks, along with proprietary recording artists on a national and global basis. The initial soundtrack releases shall be for the Seven Arts films "Night of the Demons" and "The Pool Boys."

Entertainment One Distribution shall receive fees based upon sales generated, and Big Jake Music shall be responsible for production and marketing costs associated with these releases. One Distribution, the largest independent music and video distributor in North America, holds the highest market share of any independent distributor. Through its facilities in New York and Toronto, eOne Distribution manages physical distribution of CD, Blu-ray and DVD inventories and is a leading Internet fulfillment wholesaler of entertainment products through partnerships with the world's largest online retailers. eOne is a leader in digital distribution, aggregating content for multiple partners including iTunes, Netflix, Amazon.com, Sony Playstation, Xbox, eMusic, and Rhapsody.

On August 23, 2011 the firm announced it has executed an agreement for the acquisition of all of the capital stock of Big Jake Music a newly formed record and multi-media entertainment company, for $5,000,000 of convertible preferred stock, convertible into common stock at a premium to the market price at closing, and which is not subject to conversion for agreed periods of time.

Big Jake Music currently owns $5,000,000 in net value of media credits from News USA, a national media, marketing and publicity firm. Seven Arts expects to be using these media credits to promote its motion pictures.

A typical Deal

Seven Arts receives between 50 and 100 submissions of potential film projects or completed films every year, which generally include a "package" of a screenplay and certain talent elements (such as producer, director and cast). In certain limited cases, Seven Arts will arrange for the creation of a screenplay and the "packaging" of creative elements. Seven Arts commissions independent production budgets of certain projects to evaluate the project's suitability for production or distribution. The pictures produced are selected according to several key criteria formulated to maximize the profit potential of its films, including the potential

to license the worldwide distribution rights to the film for an amount greater than the projected production budget (minimum profit margin of at least 20%),

Seven Arts creates a separate finance plan for each motion picture it produces. The sources of the funds for production of each motion picture vary according to each finance plan and is based on state and foreign country tax credits (e.g. Louisiana, United Kingdom and Hungary) and direct subsidies), "mezzanine" or "gap" funds, which are senior to its equity, and senior secured financing with commercial banks or private lenders, together in certain cases with a limited investment from SAPX, which is customarily less than 10% of the production budget.

In 2007, Seven Arts Pictures Louisiana LLC, a subsidiary of SAP Inc., acquired real property in New Orleans, Louisiana, which they are in the process of developing as a production and post production facility for motion pictures in Louisiana. Over the past five years, Louisiana has become a popular destination for the production of motion pictures due to very favorable tax incentives. Since 2005, the Company has produced five motion pictures under the Louisiana Motion Picture Incentive Act (Louisiana Incentives), which provides substantial transferable tax credits for film production activities in Louisiana accredited to a firm whether it produces or acquires a motion picture. The Louisiana Incentives provide generally that the producer will receive both a 25% (increased to 30%) transferable investment tax credit on all film expenditures on Louisiana vendors and a 10% (decreased to 5%) transferable labor tax credit on all expenditures for labor performed in Louisiana by Louisiana residents.

The Company licenses distribution rights for its motion pictures in the United States and in most foreign territories prior to and during the production or upon the acquisition of rights to distribute a picture. The firm shares in the commissions generated by the sales of the pictures. Sale of a license to distribute a motion picture prior to its delivery is termed a “pre-sale” and may occur at any time during the development and production process. In a typical license agreement, the company would license a picture to a distributor before it is produced or completed for an advance from the licensee. This advance is recoverable by the distributor from its share of the revenues generated by the distribution of the picture in the licensee’s territory, after deduction of the distributor’s expenses and distributor fee. The advance usually is in the form of a cash deposit plus a letter of credit or “bank letter” for the balance payable 10-20% on execution and the balance on delivery. The license grants the distributor the right to the post-theatrical release of the picture in all or certain media in their territory for a predetermined time period. After this time, the distribution rights revert back to the Company and they are then free to re-license the picture.

The Film Library

The film library includes 33 films. Twelve films are controlled by Arrowhead Target Fund until the firm recoups its loan. The strategy is to grow the library of films to 50-75 over the next 5 years.

Title	Director	Cast	Production Cost	Title	Director	Cast	Production Cost
Asylum	David MacKenzie	Natasha Richardson	$20,000,000	**Shattered Image**	Raul Ruiz	William Baldwin Anne Parillaud	$7,250,000
Stander	Bronwen Hughes	Thomas Jane Deborah Unger	$14,000,000	**The Hustle**	Stuart Cooper	Bobbie Phillips Robert Wagner	$5,000,000
No Good Deed	Bob Rafelson	Samuel L. Jackson Milla Jovovich	$17,000,000	**Pool Hall Prophets**	Keoni Waxman	Freddie Prinze, Jr. Ving Rhames	$6,000,000
I'll Sleep When I'm Dead	Mike Hodges	Clive Owen Malcolm McDowell	$8,000,000	**Boo**	Anthony C. Ferrante	Trish Cohen Happy Mahaney	$1,000,000
Supercross	Steve Boyum	Sophia Bush Steve Howey	$5,000,000	**Cemetery Gates**	Roy Knyrim	Reggie Bannister	$1,000,000
A Shot At Glory	Michael Corrente	Robert Duvall Michael Keaton	$12,000,000	**Popstar**	Richard Gabai	Aaron Carter Alana Austin	$5,000,000
Johnny Mnemonic	Robert Longo	Keanu Reeves Dolph Lundgren	$24,500,000	**Red Riding Hood**	Randall Kleiser	Lanie Kazan Morgan Thompson	$5,000,000
Never Talk To Strangers	Peter Hall	Antonio Banderas Rebecca DeMornay	$11,700,000	**Back In The Day**	James Hunter	Ving Rhames Ja Rule	$5,000,000

Effective monetization of the film library is critical as technology changes. Seven Arts must continue to find new ways to monetize these assets in order to grow the library with new films.

Title	Director	Cast	Production Cost	Title	Director	Cast	Production Cost
Captivity	Roland Joffe	Elisha Cuthbert	$17,500,000	**Noise aka**	Henry Bean	Tim Robbins William Hurt	$9,000,000
Mirror Wars	Vasily Chiginsky	Armand Assante Malcolm McDowell	$8,000,000	**American Summer**	J.B. Rogers	Matthew Lillard	$15,000,000
Getting' It	Nick Gaitatjis	Jessica Canseco Patrick Censoplano	$2,500,000	**Autopsy**	Adam Gierasch	Robert Patrick	$9,000,000
The Wedding Chest	Nurbek Egen	Natasha Regnier Bolot Tentimyshov	$1,500,000	**Knife Edge**	Anthony Hickox	Joan Plowright Natalie Press	$8,000,000
The Mesmerist	Gil Cates, Jr.	Neil Patrick Harris Jessica Capshaw	$1,000,000	**Nine Miles Down**	Anthony Waller	Adrian Paul Kate Nauta	$17,400,000
A Broken Life	Neil Coombs	Tom Sizemore Ving Rhames	$2,000,000	**Hades**	Gabriel Bologna	Robert Patrick Danielle Harris	$2,500,000
Drunkboat	Bob Meyer	John Malkovich John Goodman	$3,500,000	**Night of the Demons**	Adam Gierasch	Shannon Elizabeth Edward Furlong	$9,000,000
Deal	Gil Cates, Jr.	Burt Reynolds Bret Harrison	$9,000,000				

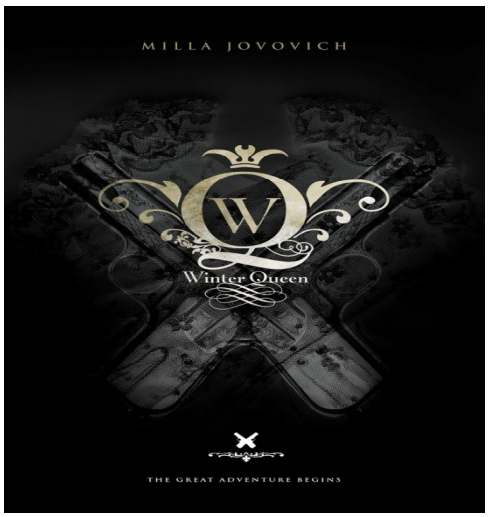
Neuromancer
Poised to take advantage of falling new release films, Neuromancer is the currently in production and projects to have a budget of $60 Million. Beyond the obvious larger potential take at the box office, The opportunity remains for a wider than normal theatrical release along with gaming and franchising rights.

The science fiction film which is based on William Gibson's best selling novel has directors and producers attached. Fees are expected in 2012 followed by a stronger 2013.

The revenue generated could be 3-5 times what the firm usually sees in its smaller budget releases.



Winter Queen is another of the potential bigger revenue films. Set in 1876 the plot surrounds a young investigator with the Moscow police who sets out to solve the apparent suicide of a university student, but soon lands in the middle of a far-reaching international conspiracy. Recognizable talent includes Milla Jovovich (*Resident Evil*, *The Fifth Element*), and Fyodor Bondarchuk (dir.) (*The Inhabited Island*, *The 9th Company*)



Potential Breakdown of Winter Queen

Production Budget	Tax Credits	P & A Spend	Total Cost
$15,000,000	($7,500,000)	$7,000,000	$14,500,000
$15,000,000	($7,500,000)	$10,000,000	$17,500,000
$15,000,000	($7,500,000)	$12,000,000	$19,500,000

Foreign Pre-Sales	US B.O.	U.S. Video, Pay TV, TV	Foreign Overages	Total Revenues
$11,000,000	**$7,000,000**	**$7,000,000**	**0**	**$4,500,000**
$12,000,000	**$15,000,000**	**$10,000,000**	**$2,500,000**	**$12,500,000**
$12,000,000	**$30,000,000**	**$12,500,000**	**$5,000,000**	**$25,000,000**

INDUSTRY OUTLOOK

Media companies suffer from audience fragmentation and limited near-term reinvestment opportunities. Consumers have access to an unprecedented selection of independent media outlets resulting in audience dilution for most traditional media services. An example can be seen in the steep decline in network television ratings largely attributed to audience migration to cable and the Internet. To retain share, large media companies are forced to reinvest in additional media outlets. However, growth is limited by government regulations on media ownership. The changing distribution on films and programs are likely to ignite a new round of industry consolidation. Attractive reinvestment opportunities, nevertheless, remain a challenge. Valuations of attractive acquisition targets have risen in anticipation of further industry consolidation.

Technology remains a wildcard for the industry. It has been both a boon and a bust for media companies. The rapid consumer adoption of DVDs has greatly enhanced returns in the filmed entertainment industry. In direct contrast, rampant file sharing of digital music has significantly impacted sales of recorded music. Personal video recorders (PVRs) represent the most recent emerging technology to affect the media industry. While ad-based media outlets are threatened by the devices' ability to skip commercials, cable and satellite operators stand to benefit from offering the new "time-shifting" devices to attract subscribers and earn incremental revenue from video-on-demand services.

INDUSTRY POSITION

The firm competes against medium and large well capitalized media companies. The number of films produced is shrinking. In 2009 558 films were released compared to 633 the previous year. Major studious have cut back on distributing smaller budget pictures and have focused on large budget pictures and franchises. Several specialty shops have closed such as New Line, Picturehouse and Paramount Vantage all the while sales at the box office have been increasing. This gives Seven Arts a unique opportunity as those who are left in the space have better access to talent and projects.

VALUATION

Seven Arts is poised to capture a bigger piece of the entertainment dollar as technology and distribution change. Neuromancer and Winter Queen have the potential to produce three to five times higher revenue than the average Seven Arts picture as well as franchising opportunities.

Through a combination of debt forgiveness, paying down debt, and equity deals Seven Arts reduced its total loans payable The Company reduced film and production loans by $6 million to under $5 million and reduced other liabilities (accounts payable, accruals, participations and other loans) by a net $2.2 million to under $6.6 million from the amounts at Seven Arts' last year end. Furthermore, $1.2 million of existing Other Loans were paid or converted to equity since June 30, 2011 and production debt decreased from $15.9 million at December 31, 2010 and $10.9 million at June 30, 2011 to $4.9 million at March 31, 2012. The equity deals add the effect of dilution and investors should be aware of the drag on the shares when lock up periods expire. Over the long-term a film library of 50 to 75 films could produce revenues of between $20-100 million. The firm is nowhere near that yet so we suggest investors look at book value.

The incentive to makes films in Louisiana is significant. The Louisiana Incentives provide generally that the producer will receive both a 25% (increased to 30%) transferable investment tax credit on all film expenditures on Louisiana vendors and a 10% (decreased to 5%) transferable labor tax credit on all expenditures for labor performed in Louisiana by Louisiana residents.

The firm looks undervalued when looking at the price to book and the price to sales metric.

Price to book value a ratio used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share. The book value of equity is the difference between the book value of assets (original price – allowable depreciation) and the book value of liabilities. The market value of an asset in contrast to its book value reflects its earnings power and expected cash flows.

$$P/B\,Ratio = \frac{Stock\ Price}{Total\ Assets - Intangible\ Assets\ and\ Liabilities}$$

Metric	Seven Arts	Industry Average
Price/Book Value	0.07	1.91

While not as popular as Price/Earnings or Price/BV, Price/Sales is not influenced by accounting decisions in depreciation, inventory and extraordinary charges. P/S multiples are much less volatile than P/E multiples. However if the problem with the firm lies in cost control the P/S ratio will not reflect this flaw.

Metric	Seven Arts	Industry Average
Price/Sales	0.05	1.25

According to the Price/Book Value and the Price/Sales models the firm appears undervalued compared to the industry.

We see the book value of the stock at approximately $0.75 per share today and feel the intrinsic value of the stock could trade at $1.00 as revenue ramps, further debt is paid down, and the balance sheet is strengthened. Keep in mind our price target is based on the company shifting to larger films and increasing revenues substantially. The payoff on the stock could look like that of a call option. The reason for our neutral rating is a lack of short-term catalysts until larger titles take over and the firm issuing a heavy dose of new equity.

RISKS

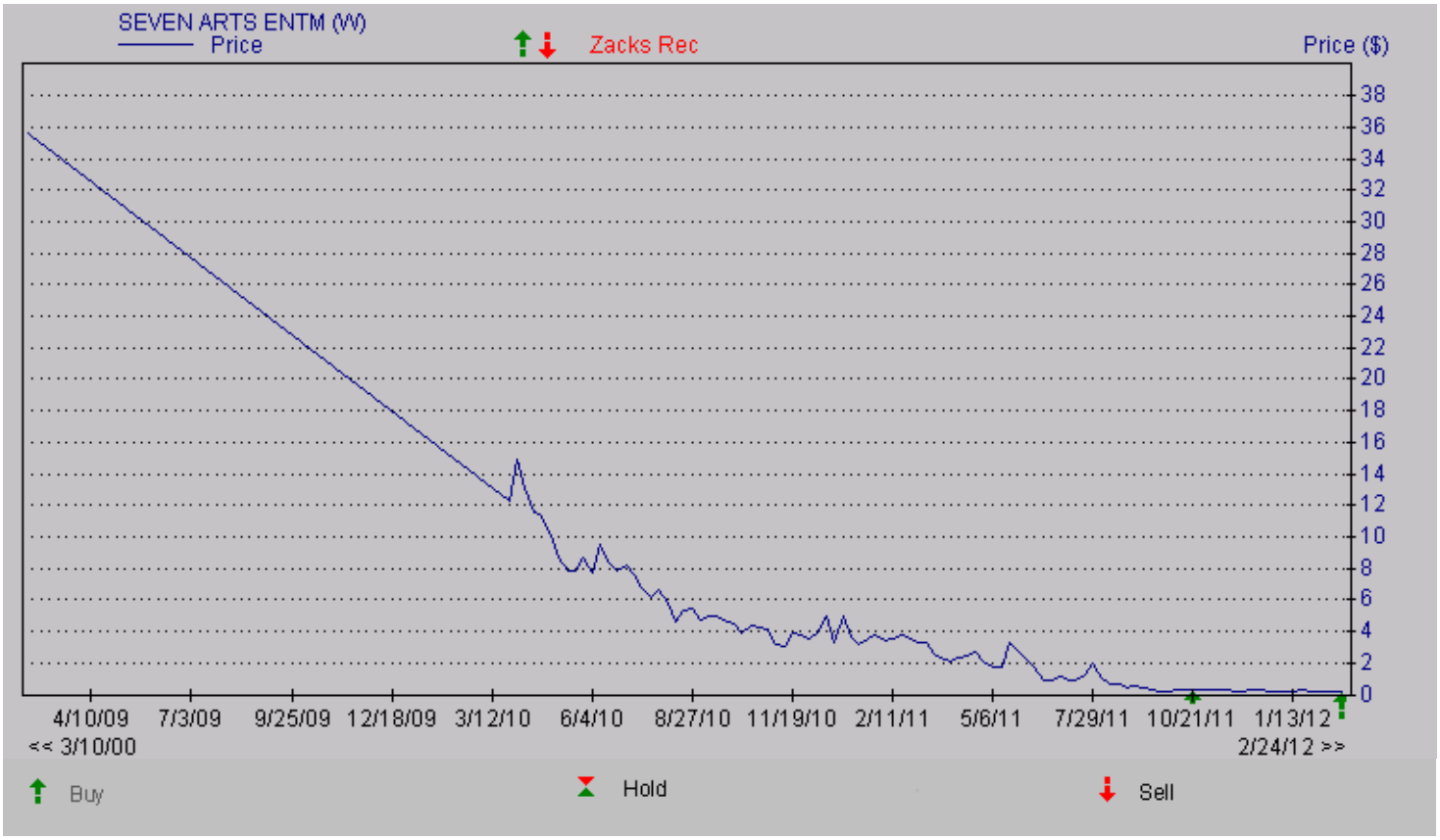
- The production, acquisition and distribution of motion pictures require a significant amount of capital.
- Given the pace of technology, the costs of producing and marketing feature films have steadily increased and may further increase in the future, making it more difficult for a film to generate a profit.
- Seven Arts business model requires the firm be efficient in the production of motion pictures. Actual motion picture production costs often exceed their budgets, sometimes significantly.
- Seven Arts remains highly leveraged and will likely continue to finance its business through dilutive equity deals.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Mil)	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012 E	FY 2013 E
REVENUE						
Film Revenues	**3.265**	**4.22**	**1.97**	**2.76**	**1.49**	**7.00**
Fee Related Revenues	**-**	**6.01**	**4.44**	**0.57**	**-**	**3.00**
Total Revenue	**3.27**	**10.23**	**6.42**	**3.33**	**1.49**	**10.00**
Sequential Growth						
OPERATING EXPENSES						
Cost of Revenues	4.09	4.66	2.40	3.45	2.00	7.00
% of Revenue						
Gross Profit -	**(0.82)**	**5.57**	**4.02**	**(0.12)**	**(0.51)**	**3.00**
Proforma Gross Margin	-25.2%	54.4%	62.6%	-3.6%	-34.2%	30.0%
Selling General and Administrative	4.0	3.6	2.6	1.9	1.5	2.0
% of Revenue		59.6%	59.0%			
Corp Overhead	-	-	-			
% of Revenue		0.0%	0.0%			
GW Amort, Restructuring, other	-	0.5	0.3	0.2	0.2	0.2
% of Revenue						
Total Operating Expenses	4.02	4.12	2.94	2.09	1.73	2.23
% of Revenue		68.6%	66.1%	366.1%	116.4%	74.5%
Operating Income -	**(4.84)**	**1.44**	**1.08**	**(2.21)**	**(2.24)**	**0.77**
Operating Margin		24%	24%			
NON-OPERATING ITEMS						
Non operating Income/Expense	-0.2	3.3	(1.56)	3.67	(1.50)	1.50
% of Revenue		54.76%	-35.02%	643.46%	#DIV/0!	50.00%
Tax Provision	-0.49	0.00	0.00	0.00	0.00	0.00
Effective Tax Rate	10%	0%	0%	0%	0%	0%
Net Income -	**(4.56)**	**4.74**	**(0.48)**	**1.46**	**(3.74)**	**2.27**
Net Income Margin		78.8%	-10.7%	256.4%		75.5%
EARNINGS PER SHARE						
EPS - Basic	-$0.97	$0.78	-$0.07	$0.77	-$0.28	$0.07
EPS - Diluted	-$0.97	$0.58	-$0.07	$0.66	-$0.28	$0.07

Ken Nagy, CFA Zacks Investment Research

HISTORICAL ZACKS RECOMMENDATIONS



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The current distribution of Zacks Ratings is as follows on the 1025 companies covered: Buy/Outperform- 17.2%, Hold/Neutral- 75.7%, Sell/Underperform – 6.1%. Data is as of midnight on the business day immediately prior to this publication.