

SECTOR ANALYSIS

"Old" Media Charms Private Equity Investors

Recent Trends In Private Equity Investments

- Seeking ever-bigger targets, P.E. funds increasingly form ad hoc consortia to make joint bids in what is called "clubbing." For example, Alpinvest Partners of the Netherlands, Blackstone Group, Carlyle Group, Hellman & Friedman, Kohlberg Kravis Roberts & Co. and Thomas H. Lee Partners have a \$9 bil. deal pending to buy media giant VNU.
- P.E. increasingly teams with strategic partners that later will take out P.E., thus providing an assured exit strategy. For example, Providence Equity Partners, Texas Pacific Group and DLJ Merchant Banking joined two media outfits to buy MGM for \$5 bil. in 2005.
- P.E. investors sell properties to other P.E. investors, a new trend that leaves bystanders wondering who made the better deal. For example, Madison Dearborn Partners led a \$1.5 bil. recapitalization in 2004 of big U.S. cinema chain Cinemark in which investor Cypress Group exited.

Private Equity Targets Univision

One P.E. group eyeing Univision encompasses Bain Capital Partners, Blackstone Mgmt. Assoc. V, Carlyle Investment Mgmt., Bill Gates' Cascade Investment and Kohlberg Kravis Roberts. Another group includes Providence Equity Partners, Madison Dearborn Partners, Thomas H. Lee Ptns. and Texas Pacific Group.

Monday Media Market Cap Analysis (Mkt. Cap Of Public Media Companies)

Date	Companies	Mkt. Cap (bil.)	\$ Chg. (bil.)	% Chg.
12/30/05	482	\$5,165.9		
5/1/06	469	5,357.2	\$191.3	3.7%
5/8/06	468	5,443.4	86.2	1.6
YTD			277.5	5.4

© 2006 Kagan Research, LLC, a division of Jupiter-Kagan, Inc., from industry data. All rights reserved.

Private equity (P.E.) financiers—those sophisticated investors making big acquisitions—are covering the movie business from every angle in deals of all shapes and sizes. It's an interesting wrinkle in P.E.'s growing love affair with old media as film is now added to longtime favorites broadcasting and cable TV.

Private equity first engulfed movie exhibition, buying the top three U.S. theater circuits this decade—Regal (Philip Anschutz, Oaktree Capital), AMC Loews (five P.E. investors) and Cinemark (Madison Dearborn Partners). More recently, a P.E. consortium joined Sony Pictures and cable giant Comcast in buying Metro-Goldwyn-Mayer last year for \$5 bil. (including debt assumption).

In November, Rizvi Traverse Mgmt. (joined by Merrill Lynch Global Asset Based Finance Group) invested \$100 mil. to recapitalize Hollywood talent agency International Creative Management. A *Los Angeles Times* story in March suggests ICM wants to acquire other agencies to pursue a rollup strategy.

Last month, Soros Fund Management paid \$900 mil. to buy the 59-title DreamWorks live-action film library from Viacom's Paramount Pictures, getting film rights without any company infrastructure. Titles include Oscar winners *Gladiator* and *American Beauty*, but no animated features.

Perhaps the most daring P.E. film investors are seven outfits that parked more than \$3 bil. in the film slates of major studios, which historically have been less than generous to equity players. These include Legendary Pictures (Warner Bros.), Virtual Studios (Warner Bros.) and Kingdom Films (Disney).

Deals vary but typically involve putting up 20%-50% of the cost of a group of films, and then splitting revenue with the studio partner on each film after the studio recoups specified costs and takes a distribution fee off the top.

Studios look at film co-investing as off-balance-sheet financing and help in carrying CapEx weight on big-budget films, such as Warner's underperforming \$160 mil. production of *Poseidon*, co-financed by Virtual Studios.

While P.E. is often called "smart money," the timing of these forays into film does not look ideal. U.S. ticket sales have slid since 2002, although this is somewhat offset by ticket-price hikes. The global video business abruptly plateaued, ending a streak of revenue growth since DVD bowed in the U.S. in 1997. Virtual Studios chief Benjamin Waisbren exited the company as *Poseidon* opened poorly.

The arrival of next-generation high-definition DVD, however, is expected to lift home video's fortunes again, and new media, while a potential source of piracy, will be a voracious buyer of filmed entertainment if harnessed.

About \$140 bil. was raised last year for P.E. investment in all industries as deep-pocketed investors augmented their equity with debt to make acquisitions or to buy sizeable stakes in companies. The broadcast, cable and movie sectors offer relatively stable cash flows and sport robust profit margins of 15%-40%, better than most other industries. Further, media has moderate to low capital expenditure requirements compared to most other sectors.

Because P.E. flocks to media sectors despite relatively high asset valuations in private market transactions, investors find few bargains when acquiring old-media assets. A popular exit strategy is IPOs—yet Wall Street places low values on old media stocks, making it hard to command high prices in public offerings.

P.E. investors are leading bidders in the open auction for Spanish-language broadcaster Univision, expected to fetch \$12+ bil. Potential strategic bidders—industry insiders such as Time Warner, Walt Disney and News Corp.—aren't expected to have the stomach to outbid the private equity players.

(CONTINUED ON NEXT PAGE)

Traditional Media A Safe Bet For Attractive ROI (CONTINUED FROM P. 2)

P.E. is solely motivated by profit, unlike strategic investors expanding in their own or allied industries for synergies. P.E. investors also buy into revenue-generating assets, as opposed to venture capital investors, which focus on speculative startups such as new or embryonic technology enterprises.

Private equity investors buy assets outright or, if 100% ownership is not feasible, take sizeable stakes, typically no less than 20%. If P.E. does not own a majority, it typically insists on a hand in oversight via one or more board seats.

The endgame is usually to sell in an intermediate time frame, typically three to five years. Private equity is particularly attracted by downtrodden assets, which have turnaround potential that means outsized profits. Being purely financial, P.E. always has an exit strategy. In cable TV, P.E. investors sometimes buy small and medium systems adjacent to large, acquisition-minded cable operators that will make logical buyers when the P.E. players seek to sell.

The Private Equity Investment Model

P.E. investment is usually grouped in special-purpose funds with specific life cycles, typically five to 10 years, managed by a general partner that sizes up investment targets, serves as executive management and is the fund's public face.

P.E. solicits deep-pocketed investors who buy in large increments—from \$25,000 to \$1 mil. per unit. Investors are high-net-worth individuals and institutions, such as pension funds.

For example, Harvard University has deployed about \$3.4 bil. in P.E. investments—about 13% of its huge endowment.

Once a fund is assembled, it invests in a series of separate deals. The silo structure means if one deal goes sour, it won't impact a fund's successful investments.

In recent history, private equity investors bought media assets based on internal projections of annual returns on equity in the low 20% range. But with increasingly bigger pots of money chasing deals, it's difficult to realistically expect an annual return rate in the low 20s these days. P.E. investors usually are happy with an annual return in the high teens. (For traditional stock market investments, a 5%-8% annual return is normal over the long haul.)

In this climate, old media is a safe bet even if it doesn't always offer outsized returns—and money keeps pouring in thanks to some startling successes.

At the high end, Kohlberg Kravis Roberts' currently-deployed \$6 bil. Millennium Fund reportedly achieved a 55% annual gain (including values of assets yet to be sold). Using that as a springboard, KKR raised \$5 bil. in an initial public stock offering on Amsterdam's Euronext exchange earlier this month for a public-traded fund, while virtually all other P.E. vehicles are closely held. The Euronext exchange was attractive because of skimpy disclosure requirements.

While the big funds with large institutional investors are best known, small P.E. players are also part of the mix and particularly active in radio stations.

Gary Lawrence, pres. and vice chmn. of private-equity-financed First Broadcasting Investment Partners, told the 23rd Annual Kagan Radio/TV Values & Finance Summit in March that about 80% of the investors buying "stick" radio stations from 2003-'05 were P.E.

(A stick is a broadcast station with a construction permit or new format, which means negative or developing cash flow, so it doesn't sell at a c.f. multiple.)

P.E. stepped up as mainstream radio groups, which are logical buyers of stick stations, backed away from acquisitions because of falling radio values in public markets. P.E. outfits build up their stick radio stations with the goal to sell to buyers that typically want to install religious or ethnic formats.

The funds borrow typically 70 cents out of every dollar they invest. Thus, despite the name, debt is a big component of P.E. transactions.

The low debt interest rates since the 1990s are another driver of P.E. transactions, because debt leverage is cheap and has been plentiful.

The debt component magnifies returns for foundation equity capital in successful transactions or else quickly wipes out core equity if things go bad.

Managers of funds typically charge fees of up to 1%-2% of the total amount under management and get a small fee on each asset acquisition and a 20% cut of profits, typically after investors recoup.

Robert Marich