2016 Midyear Review: A Look Back at Major Topics of Interest

FALL 2016

Summer is over and as we move into the tail end of 2016, Salem Partners is pleased to present our insights into several media and entertainment-related topics that are making headlines and shaping the industry landscape.

It's hard to believe, but we are already well into the second half of 2016, and it has been an active year thus far to say the least. Below are several of the major topics and events of the first half that are impacting our industry:

- **Chinese Capital Spigot is Wide Open:** From a trickle, now to a flood, Chinese buyers are scouring the media marketplace looking for strategic opportunities, including all major sectors such as theatrical exhibition, feature film, television production and distribution. Hollywood, always hungry for fresh capital, has welcomed the new financiers with open arms. We review these recent deals in more detail further in this newsletter.

- **Summertime Blues for Domestic Box Office**: The summer box office is in the rearview mirror, and it has been a season of few hits and many expensive misses in another year of sequels and tentpole franchises. Winners like *The Secret Life of Pets*, *Finding Dory* and *Captain America: Civil War* have prospered, while the next tier below has been lucky to settle for a fraction of the box office of the winners, with several high profile, expensive misses such as *Star Trek: Beyond*, *The Legend of Tarzan*, *Teenage Mutant Ninja Turtles: Out of the Shadows*, *Alice Through the Looking Glass*, *Ice Age Collision Course, Ghostbusters, Independence Day: Resurgence* and *The BFG* (among many others). Normally reliable tentpoles and sequels have struggled mightily, leading many to question whether the public is tiring of this tried and true formula, or whether worsening underlying trends are at work.

- **China Box Office Continues to Grow in Importance:** One of the brightest spots in the entire feature film business has been the strength of the Chinese box office, which continues to grow by leaps and bounds. Films are generating eye-popping grosses and some domestic films have been able to find their greatest success there, including otherwise poor performers *Terminator Genisys*, *Warcraft* and others. The local production market is also booming, with grosses for local language films eclipsing all but the largest domestic imports. Titles unknown to American audiences are generating huge box office numbers, such as *The Mermaid* (over $525 million in Chinese box office), *The Monkey King 2* ($185 million), *From Vegas to Macau 3* ($172 million) and *Ip Man 3* ($124 million). The question now is whether Chinese-made films will remain a local phenomenon, or eventually find a global audience.

- **Film Studio Deals:** M&A has been the order of the day for entertainment studios for the first time in a decade. Major deals include Comcast's acquisition of DreamWorks Animation for $3.8 billion, the acquisition of Starz by Lions Gate for $4.4 billion and the rumored deal for a 49% minority stake in Paramount Pictures for $4-5 billion. These deals have provided a fresh view of the financial and strategic value of owning a US-based studio. While valuation metrics have remained relatively consistent, perceived "trophy value" as well as strategic and operational synergies have been a key factor in bridging the gap between current performance and multiples paid in deals. We review these deals in more detail further in this newsletter.

2016 Midyear Review: A Look Back at Major Topics of Interest (Continued)

- **The Saga at Viacom Ends:** The long-running battle between Viacom's controlling shareholder National Amusements (Shari and Sumner Redstone) and management has concluded with Phillippe Dauman taking a golden parachute to exit the company and former COO Tom Dooley acting as interim CEO, while a search for new management begins. Some cleanup of ancillary disputes remains, but the uncertainty hanging over the company has started to fade.
- **Netflix Stumbles Badly:** Q2 earnings by the darling of media investors included a miss to subscriber numbers, as well as a reduction in future subscriber expectations, both domestically and internationally. The market reaction after hours was violently negative, falling from nearly $100 a share into the mid-$80s. While the stock has recovered essentially all of the lost ground, analysts have reassessed their views on the streaming giant and its prospects for the future. As the oldest and most established platform, changes to the projections for Netflix have an impact on views of the digital and overall media business worldwide. We review Netflix's recent performance and changes in research consensus views further in this newsletter.
- **Time Warner Investment in Hulu:** Time Warner announced in August that it had acquired a 10% stake in Hulu for $583 million in cash, valuing the streaming platform at $5.8 billion. The transaction is highly structured, and includes the addition of Time Warner networks CNN, TBS, CNN, Cartoon Network and TCN, both live and on-demand on Hulu's linear streaming offering, expected to debut in 2017. Unlike other strategic investors, current seasons of Time Warner shows will not be made available on Hulu's existing platform offering and will be retained by Time Warner. Hulu is expected to pay carriage fees to Time Warner to offer the media company's channels on its linear streaming offering.
- **Regional Sports Network Tipping Point?:** The standoff continues between RSNs and cable and satellite platforms over the price of carriage. RSNs demand steep affiliate fees and inclusion on the basic subscriber tier, essentially requiring the platforms to pass the cost along to all subscribers or eat the cost themselves. With ambitious recent entrants Pac-12 Network and LA SportsNet (Dodgers) failing to secure full distribution after several years, the question remains whether the business model is a viable one. We review the latest on the RSN business further in this newsletter.

Studios in Play: DreamWorks Animation Sold, Lions Gate Acquiring Starz and Paramount On the Block

Comcast's Acquisition of DreamWorks Animation

- As a public company, DreamWorks Animation had long struggled with inconsistent earnings and lumpy financial results, some of which are inherent in financial reporting for a feature film studio with a limited slate of releases. After its initial distribution agreement with Paramount Pictures expired, the company turned to Fox to distribute its films from 2012 through 2017. With the company's strength in high budget animated features, it has long made sense to sell to a larger owner with the resources and deep pockets required to ride out rough patches. The company has been rumored to be in talks with larger partners several times over the years, including most recently with Softbank and later Hasbro. The company had a very deep portfolio of intellectual property assets, including the blockbuster *Shrek*, *Kung Fu Panda* and *Madagascar* franchises as well as the Classic Media portfolio, acquired in 2012.
- The deal was announced on April 28, 2016 with an equity value of $3.8 billion in cash. Analysts viewed the transaction as a strong strategic fit for Comcast, with significant operational cost cutting synergies available and a large and high quality library of IP, which can be leveraged by Comcast subsidiary NBC Universal. With 2017 EBITDA for DWA estimated at $185-200 million, an implied forward EBITDA transaction multiple of over 20x was significantly reduced to under 10x with estimated cost synergies in the range of $225-250 million. These cost savings synergies represent a reduction in existing DWA overhead in the neighborhood of 75%.

Lions Gate's Acquisition of Starz

- Lions Gate, long viewed as a "mini major", or the largest domestic independent studio, has expanded its profile over the last several years with the release of the *Hunger Games* franchise and a major expansion into television production with hits such as *Mad Men*. As the company has grown, it has become clear that a deal or partnership that can expand the company's footprint will be critical to the company's success in a very competitive business.
- Lions Gate announced the acquisition of Starz on June 30, 2016 for $4.4 billion in cash and stock. Starz, which was spun off from John Malone's Liberty Media in 2013, includes the pay cable network Starz, as well as distribution business Anchor Bay. The purchase price of $32.70 per share of STRZA represented a modest premium to the pre-deal stock price and a discount to the company's 52-week high stock price of over $40.
- Analysts have been supportive of the transaction, with the major drivers of value being the increased scale of the combined business, significant cost and tax synergies of $125-150 million and the opportunity to deleverage through the sale of non-core assets, potentially including EPIX, Defy Media and other assets.

Studios in Play: DreamWorks Animation Sold, Lions Gate Acquiring Starz and Paramount On the Block (Continued)

Potential sale of a Minority Interest in Paramount Pictures

- The acquisition of Paramount Pictures by Viacom in 1994 was as one of the signature deals in Sumner Redstone's career. Once one of most prolific major studios, Paramount has gradually reduced the number of films released each year, for a time relying on a series of slate co-financing partners and distribution deals with DreamWorks Animation and Marvel to generate release volume. As those deals have expired and slate co-financiers have not materialized, the Company's slate has dwindled to a handful of wide releases.
- Viacom announced its intent to sell a 49% minority stake in Paramount in early 2016, a move that was widely seen as an effort to generate positive news around current management and also an opportunity to deleverage the company's balance sheet. With press at the time quoting analysts as valuing Paramount at $4 billion (and several valuing it at far less), rumors swirled of a valuation of up to $10 billion in a sale to a Chinese buyer. Rumored bidders included Dalian Wanda, Reliance, Alibaba Pictures and DMG Entertainment.
- While any sale of a stake in Paramount Pictures appears to be on hold as part of the recently-ended battle between National Amusements and then-current Viacom management for control, analysts have been highly supportive of the transaction, in part as they view current financial performance of Paramount to be poor and Viacom's balance sheet to be stretched. Consensus among analysts is that the now rumored valuation range of $8-10 billion is attractive for the seller in part as it is unjustified by purely financial metrics, and implies a significant "trophy asset" premium.

Netflix Stumbles in Q2, But Analyst Reaction is Muted

- Netflix reported Q2 2016 earnings on July 18, and the stock immediately sold off after hours as analysts and investors dissected the disappointing details of the report. Of particular focus was the miss on subscriber figures, both domestically and internationally, as well as a reduction of future forecasts by the Company.
- The reaction in the market was swift, with the stock dropping approximately 13% after hours from the closing price of $99 to $86 per share, and opening the next day at $85. While the stock has recovered significant ground since then and now trades in the high-$90s, analysts and investors reassessed their views on the near and longer term growth prospects for the company.
- Key takeaways from the Q2 earnings release include:
  - Q2 revenues came in slightly below estimates, while operating income and EPS came in well above estimates on lower than expected content and other expenses.
  - Q2 domestic net subscriber additions of 162,000 came in well below prior management guidance of 500,000 and consensus estimates of 532,000, and international net subscriber additions of 1.9 million came in below prior management guidance of 2.0 million and consensus expectations of 2.1 million.
  - The Company is "un-grandfathering" subscribers at $7.99 and $8.99 per month tier up to the current $9.99 per month pricing. The company indicated its belief that this change in pricing was responsible for the increased churn in the quarter, but interestingly noted that churn of the subscribers subject to the "un-grandfathering" was lower than that of other subscribers. The company also noted that gross subscriber additions were inline with their expectations, with the miss driven by the elevated churn.
  - Company guidance for Q3 net subscriber additions was reduced below prior expectations to 300,000 domestic (vs. analyst consensus estimates of 774,000) and 2.0 million for international (vs. analyst consensus estimates of 2.9 million), and has indicated that elevated levels of churn are persisting thus far in Q3.
- Netflix is one of the most heavily covered stocks in the market, with over 30 analysts publishing research on the company. Reactions from the analyst community were diverse, but several analysts expressed similar reactions to elements of the Q2 earnings report:
  - Q2 and projected future net subscriber additions were materially below expectations and were cause for concern. While some analysts took the bear case, many made only modest reductions to long term subscriber forecasts.
  - Financial performance for the quarter was better than expected and has tempered analyst reductions in future results. Margins in particular have paced ahead of expectations, and international is seen as a major contributor in 2017.
  - Some other strategic positives continue, including slate of original content and localized content in some international territories. Overall, many analysts looked past the near term miss to stay bullish and several advised clients to buy on this weakness.

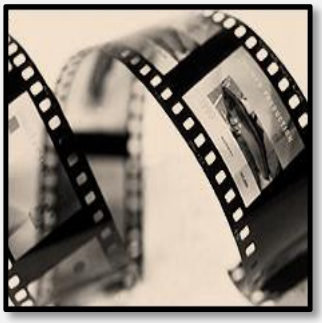
Hollywood's New Partner: China

- Hollywood has a new financial partner: China. Over the last several years, large Chinese media companies and institutional investors have turned their focus to the west in their search for investment and acquisition opportunities.
- Since 2012, Chinese institutional investors and media companies have completed a number of high profile transactions, with the pace quickening in 2015 and 2016. Key deals include:
  - Dalian Wanda Group's acquisition of AMC Theaters in 2012 for $2.6 billion and acquisition of Legendary Entertainment in 2016 for $3.5 billion.
  - Tang Media Partners' acquisition of IM Global in 2016.
  - Citic Guoan Group's $150 million investment in Dick Cook Studios in 2015, and Film Carnival's subsequent $500 million film fund financing in 2016.
  - Perfect World's 2015 co-financing commitment of $500 million to Universal to fund motion picture production.
  - Bona Film Group's 2015 co-financing commitment of $235 million to Fox to fund motion picture production.
  - Hunan TV's 2015 commitment of $375 million to Lionsgate to fund both motion picture and television production.
  - STX Entertainment's initial capital raise in 2014, which included an investment from Chinese private equity firm Hony Capital, 2015 commitment by Huayi Brothers Media's to finance 12 to 15 films per year, and 2016 investment of up to $700 million by Tencent and PCCW.
  - Fosun Capital's 2014 commitment of $200 million in production capital to Studio 8, run by former Warner Bros. studio head Jeff Robinov.
  - Alibaba Pictures Group's investment in various feature films and launch of a $300 million fund with Wuhu Gopher in 2016 to invest in Chinese and US Productions.
  - Bison Capital's 2014 investment in Jeff Berg's short-lived startup talent agency Resolution.
  - Warner Bros. 2015 joint venture with China Media Capital to produce Chinese local language feature films for worldwide distribution.
  - IMAX's 2015 deal with Dalian Wanda for 150 IMAX theaters in China.
  - The rumored sale of a minority stake in Paramount Pictures to Dalian Wanda, DMG Entertainment or others.
- Before the credit crisis, the last wave of capital invested into Hollywood was largely driven by hedge funds seeking financial returns, with the vast majority of the funds flowing into the acquisition of MGM and numerous major studio slate financings.
- In sharp contrast, Chinese investors have shown a much greater focus on the long term strategic benefits of their deals rather than pure financial return. While the local Chinese media business is booming, with Chinese box office for locally produced Chinese language films in some cases eclipsing that of US major studio blockbusters, Chinese media firms are looking ahead to the larger global market with a goal of one day exporting their own films to the world.

Regional Sports Networks: Where is the Tipping Point?

- In a newsletter last year, we touched on some of the very public battles between cable channels and the multichannel video programming distributors (MVPDs) over carriage fees, which in many cases led to very public clashes and rhetoric between various parties. While there have been a seemingly unending series of blackouts and carriage fights for a number of channels, nowhere has the issue of carriage fees been more problematic than with the regional sports networks (RSNs). RSNs are local networks focused on specific sports teams, such as the YES Network in New York or the Big Ten Network.
- In general, MVPDs across the country remain unconvinced that the high carriage fees demanded by RSNs are worth the price, as only a small percentage of their subscribers actually watch the sports networks. More vocal critics of these RSNs have labeled them a "tax" on all cable subscribers, many of whom have no interest in watching these networks, but are forced to pay for them every month regardless.
- The most visible battle has been DirecTV's refusal for several years to accept the fee structure proposed by SportsNet LA (managed and partially owned by Time Warner Cable) to see Dodgers games in the Los Angeles market. This has resulted in only 30% total subscriber distribution in the Los Angeles MSA and an erosion of the Dodgers' (and Time Warner's) brand. In 2013, Dodgers ownership negotiated a very large long-term licensing fee ($8.35 billion over 25 years) from SportsNet LA to carry Dodgers games, but this fee has also in turn forced SportsNet LA to demand a large carriage fee from local MVPDs. DirecTV has refused to carry the network on its basic tier due to the large fees, but likely as well out of a desire to thwart rival Time Warner Cable. As a condition of the later terminated merger of Comcast and Time Warner Cable, Time Warner Cable agreed to write down the value of SportsNet LA by approximately $1 billion over the life of the 25 year deal, valuing it at $3 per subscriber rather than the previous $5 per subscriber.
- A "worst case scenario" situation for an overpriced RSN is what occurred in Houston, whereby the local RSN, started by the Houston Rockets and Astros in partnership with Comcast, filed for bankruptcy and had to reorganize due to persistent similar distribution and fee disputes.
- Similarly, there have been long-running issues between MVPDs and both the Pac-12 Network (in the LA market) and the Longhorn Network in Texas with lack of broad MVPD distribution. As more upper tier baseball rights (and in some cases basketball) come up for renewal, many RSNs will need to think long and hard about the consequences of agreeing to those rights fees in the context of their overall distribution deals with MVPDs (which typically renew ever 3 to 5 years vs. sports rights deals which can last 20 to 25 years).

Ivar Combrinck Joins Salem Partners Media and Entertainment Team



Salem Partners is pleased to announce Ivar Combrinck as a new member of the Media and Entertainment team. Ivar joins the firm with more than 15 years of experience as a senior executive in the entertainment industry. He was previously part of the start-up and growth of media financing company Screen Capital International, which was involved in the finance and launch of Stuart Ford's IM Global, had a stake in Sierra/Affinity, participated in various slate financing arrangements, and collaborated with William Morris Agency on launching Incentive Filmed Entertainment.

Ivar was also a lead executive on more than $7 billion in cutting-edge, cross-border financing transactions for production, marketing and distribution, and library acquisitions with counterparties including Walt Disney, Marvel Studios, Warner Bros., New Line, The Weinstein Company, Constantin Film, New Regency, and Universal Studios. His track record includes successful transactions on more than 100 films, including *Pirates of the Caribbean 2* and *3, Harry Potter 2, National Treasure 2, Oblivion, Blood Diamond, Rush Hour 3, Team America, Hugo, Where the Wild Things Are, Enchanted, The Reader, Charlie Wilson's War, Iron Man 2, Thor, The Bourne Ultimatum* and *Jurassic World*.

Ivar will continue to serve as the US advisor for Freeway Entertainment, the premier collection account management and intermediary licensing services provider for more than 3,500 individual film and TV projects.

About Salem's Media and Entertainment Practice

Founded in 1997, Salem Partners is a boutique investment bank and wealth management firm based in Los Angeles, California. It is firmly dedicated to servicing clients in the media and entertainment industry. We provide our clients with a full suite of investment banking and valuation services, including buy and sell-side mergers and acquisitions, capital raising advisory and financial and valuation opinions.

Salem Partners' industry experience and domain expertise provides us with a deep understanding of the values, risks and financing possibilities connected with the media and entertainment industry. We are constantly in contact with key industry participants, including media companies and strategic and financial investors, and have detailed current knowledge of how buyers and sellers view assets and businesses within the industry. We have a comprehensive knowledge base on the key trends in the media and entertainment industry, including the economics of development, production and distribution of filmed content on all media, the changes occurring with distribution strategies and platforms (theatrical, television, home video and digital media), industry dynamics in various countries and territories around the world, and the current state of the market for investment in filmed entertainment content.

Since the firm's inception, Salem Partners has completed hundreds of financial and strategic advisory assignments in the media and entertainment space, including advising on more than 35 mergers and acquisitions and financing transactions. Salem Partners also provides valuation services to clients in the media and entertainment industry, including media companies, banks, financial and strategic investors and others. Our valuation work is used for a wide variety of purposes, including transaction due diligence, credit facilities, tax, estate planning and support for portfolio valuations.

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