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Salem Partners – Media & Entertainment Newsletter

2017 Kickoff: Recent Activity and a Look to the Future

Spring 2017

2017 is well underway, and Salem Partners is pleased to present our insights into several media and entertainment-related topics that are making headlines and shaping the industry landscape.

Below are several of the major topics and events that are impacting our industry:

- **ESPN Evolving:** ESPN has suffered high profile losses of subscribers over the last several years, due in part to the persistent trend of cord cutting. Trapped between potential long term subscriber and revenue declines and large fixed content obligations in the form of a slew of recently renewed and significantly more expensive sports rights deals, ESPN is reviewing its business from top to bottom, including cutting more costs and rolling out a consumer SVOD offering that may be the first small step to finally moving outside the bundle completely. *We review the state of play at ESPN in greater detail later in this newsletter.*

- **The End of Chinese Investment in Hollywood?**: We have covered the huge influx of capital from China in a prior newsletter, and while it seemed like the good times would never end, the delay and later termination of Wanda's deal to acquire Dick Clark Productions and speculation that Paramount's slate investors Shanghai Film Group and Huahua Media have failed to honor funding obligations has increasingly raised speculation that the Chinese government is shutting down deal flow entirely.

- **Sony Takes a Massive Writedown:** Sony Corporation wrote down nearly $1 billion in the film and television division in January 2017 and separately announced the departure of entertainment chief Michael Lynton. While the company indicated that the writedown was linked to continued declines in the physical media (DVD) segment of the business and goodwill related to the acquisition of Columbia Pictures in 1989, analysts were shocked by the magnitude of the reduction. Sony reiterated its commitment to the business and squashed rumors that the studio is for sale. CEO Kaz Hirai has established an office in Los Angeles to oversee the transition to new management.

- **Big Changes at Viacom:** After a long, public battle for control, culminating in the removal of CEO Phillippe Dauman in 2016, big changes are underway at Viacom. The rumored sale of a minority piece of Paramount and a potential merger with CBS have been nixed by Shari Redstone, Paramount CEO Brad Grey has departed and newly appointed CEO Bob Bakish has wasted no time putting his initiatives in place, with a focus on fixing Paramount and restructuring the cable networks portfolio. *We review the latest on Viacom and Paramount later in this newsletter.*

- **Pressure on the Theatrical Window:** Efforts to attack the theatrical window are a bogeyman that seems to show up once every year or two, most recently with Sean Parker's 2016 announcement of The Screening Room, a business model promising in-home viewing of movies in theaters for $50, which generated an uproar at Cinemacon and has been radio silent since. However, Warner Bros. head Kevin Tsujihara has continued to publicly push for early streaming as a necessity and has indicated progress in negotiations with exhibitors. Could a new windowing deal be a win-win for both studios and exhibitors, helping to maximize P&A dollars and providing an ancillary revenue stream for exhibitors?

- **Lionsgate's First Quarter After Starz Deal:** Lions Gate's merger with Starz in late 2016 was a complicated deal, with analysts struggling to reach consensus on how the pieces fit and the future for the combined companies. In February the company released its first post-merger earnings, which featured a slew of adjustments, add-backs and pro formas related to the deal and the partial quarter of combined financials. Reaction from analysts has been muted, with most keeping recommendations and long term projections stable.

ESPN Takes Big Steps to Adapt to an Uncertain Future

- ESPN has long been the crown jewel of the Disney empire, generating huge amounts of cash and garnering the highest affiliate fees of any network (by an order of magnitude) from domestic multichannel video programming distributors (MVPDs). With the largest lineup of must see live sports events and top rated sports shows like SportsCenter, viewers have treated the network as a necessity, and no MVPD sells even the most basic subscription without it.
- The high affiliate fees charged by ESPN have been compared to a "tax" on the households that do not watch sports, as all subscribers effectively bear the cost regardless of whether they watch the channel. With the rise of cord cutting or cord shaving and skinny bundles, subscribers are increasingly able to pay for what they want and not for what they don't use. While the ability to cobble together a perfect custom offering from SVOD, over the air, skinny cable bundles and other sources is still very difficult, the trends in media consumption are evolving in this direction, particularly for the youngest demographic.
- Despite Disney's very strong financial performance overall, nagging questions about weakness at ESPN have dogged the stock recently. Despite boosting affiliate fees from $5 per subscriber in 2013 to over $7 per subscriber today, the headwind of persistent subscriber losses, from the peak of over 100 million in 2011 to less than 90 million today have raised questions of whether the declines will continue or accelerate, or whether this is even indicative of a long term trend at all. The question is far from settled, as most analysts covering the stock have noted the data but have yet to raise serious concerns.
- However, concerns have been raised about the network's sky high sports rights fee obligations, such as the NFL, NBA, MLB and college football games, all of which were renewed from 2013-2016 at significant price increases. In particular, concerns about a toxic brew of long term, fixed fee rights deals and potential acceleration in profitability declines as revenue declines are seen as the worst case scenario.
- Perhaps in part as a reaction to the concerns about the business, Disney has not stood pat. In addition to recent cost cutting efforts at ESPN in 2015 and 2016 that were focused on trimming $100 million in costs in 2016 and $250 million in 2017, the company announced in March 2017 that it was looking to cut costs further, this time including content creators and on air talent.
- After years of rumors, ESPN has also moved aggressively to deliver on its promise of a consumer SVOD offering. Disney recently acquired a 33% stake (with an option to acquire control) in BAMTech, a streaming technology business spun off of MLB Advanced Media, for $1 billion. In February BAMTech also announced that Amazon VP of Digital Video Michael Paull had joined the company as CEO. While speculation is rampant regarding monthly subscription prices and content to be featured, Disney has given few specifics other than an early indication that content licensed to ESPN linear channels will not be available on SVOD, at least not initially. Disney has also indicated that it plans to use BAMTech throughout the Disney enterprise.

Big Changes Underway at Viacom as Redstone Asserts Control and Bakish Takes the Helm

- As we followed extensively in prior newsletters, 2016 featured a drawn out and messy battle for control of Viacom between former CEO Phillippe Dauman and the Redstone family, headed by heir Shari Redstone. While the battle raged on, the performance of Viacom under Dauman was in freefall, with the stock plunging from its 2014 highs in the mid-$80s to a range in the $30s and $40s in 2015 and 2016, and the company trading at a multiple consistent with a distressed business rather than a blue chip media enterprise.
- In 2016 investors dealt with several elements of uncertainty, including flagging performance at the networks, the heartburn from an increase in leverage to fund buybacks that ultimately resulted in credit rating agency downgrades and rumors swirling of a potential sale of Paramount to a Chinese investor.
- With Dauman finally out of the picture, COO Thomas Dooley was appointed interim CEO for a brief period before Bob Bakish, formerly head of Viacom's International Networks unit, was appointed interim CEO in October and fully confirmed as CEO in December. In keeping with the Redstone family's long held view, any talk of a sale of Paramount or a potential merger of Viacom and CBS was publicly scrapped, and Paramount CEO Brad Grey departed shortly after Bakish's tenure began.
- New CEO Bakish has moved quickly to put forward his vision of the future, and has included the following in his initiatives:
  - A revamping of Paramount, including an immediate search for a successor to departed CEO Brad Grey, with the frontrunner currently rumored to be Jim Gianopolus. With cooperation and synergy the order of the day, Bakish has focused on ways to integrate other Viacom IP into future Paramount film and release films branded with the cable networks.
  - A restructuring of the company's cable networks portfolio, with the focus shifting from 16 networks to an essential six – BET, Comedy Central, MTV, Nickelodeon, Nick Jr. and Spike (rebranding to Paramount Network in 2018). Smaller networks like CMT and TVland will get fewer resources and will look for partnerships and other ways to finance programming and operations.
- One concern of investors is the confusing news surrounding Paramount's slate deal with Shanghai Media Group and Huahua Media. Brokered by departed studio head Brad Grey and vice chairman Rob Moore in late 2016 and early 2017, the deal called for investments in 25% of the budgets of Paramount films for three years, with an option for a fourth. The deal, announced in January, called for substantial funds to be invested immediately, but press reports are that no funds have been received despite constant requests from Viacom, and that the Chinese investors may be concerned by the recent changes at the company. Given the public issues with other Chinese deals, there are concerns about the deal given the rocky start.

Highlighted Media & Entertainment Transactions

Termination of Wanda Acquisition of Dick Clark Productions

The $1 billion acquisition of Dick Clark Productions from Todd Boehly's (formerly of Guggenheim) Eldridge Industries by Wanda Group was announced in November 2016, but by early 2017 rumors began to swirl that the deal was in trouble. After news surfaced in February that the deal would be scrapped, opposing reports indicated that the deal had been slowed due to scrutiny from Chinese regulators, but would close within weeks. However, in March the deal was officially terminated by Eldridge Industries for nonperformance of contractual obligations and a motion was filed to release escrowed breakup fees of $25 million. Eldridge had already received $25 million released from escrow to extend the deal previously.

Content Partners Acquires Revolution Studios

In January 2017 it was announced that Revolution Studios, the independent studio founded by Joe Roth in 2000, was acquired by media investors Content Partners in a deal rumored to be valued at approximately $400 million. Revolution had been owned by hedge fund Fortress Investment Group since its acquisition in 2014 for approximately $250 million. During Fortress' time of ownership, Revolution added content with a series of acquisitions, including libraries of GK Films, Morgan Creek and Cold Spring Pictures. At the time of the sale, Revolution boasted a significant library of over 125 feature films and numerous television series.

Disney Acquires 33% Stake in BAMTech for $1 Billion

In August 2016, Disney acquired a 33% stake (with an option to later acquire control) in BAMTech, a video streaming company originally formed by Major League Baseball to broadcast streaming baseball games for the league's OTT offering. As part of the deal, BAMTech was spun off from the league's MLB Advanced Media business, which remains owned by each of the baseball teams. Disney plans to launch an OTT ESPN channel, and has indicated that it plans to integrate the technology into a number of its media businesses and franchises. In February BAMTech announced that Amazon VP of Digital Video Michael Paull had joined the company as CEO.

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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