MEDIATIQUE

The Independent Production Sector

A Market Update

August 2009

Highlights in this report

- Independent production sector revenues exceeded £2bn in 2008, with more than half (£1.2bn) coming from primary TV commissions alone
- BBC spent the most on independent sector (£368m in 2008); Channel 4 was the next biggest spender (£331m in 2008); Channel 4 is biggest contributor to sector as proportion of channel revenues
- However, significant reductions in PSB budgets announced in recent months will have a dramatic effect in 2009 and 2010, with the independent sector facing as much as a 10% decline in broadcast revenues
- Profit margins sector wide will be affected; profit improvement in 2005-7 had already stalled in 2008
- Advertising continues to be very weak, further undermining the ability of commercial broadcasters to sustain content budgets; broadcast NAR is forecast by Mediatique to decline by 15% in 2009, and by a further 5% in 2010
- Content budgets at the key broadcasters are forecast to declined by c20% between now and 2012, based on announced plan cuts at ITV, Channel 4, five and the BBC
- The BBC, despite access to guaranteed licence free income, is seeking to reduce expenditure on programming in 2009 and in each of the next two years
- Revenue weakness among client broadcasters is likely to have the least impact on large, integrated indies, which have further strengthened their aggregated market share
- Sector consolidation has seen the top 10 company market share rise to 67% from 53% since 2005; 7 companies had revenues in excess of £100m in 2008
- The top 20 companies had 79% of total sector revenues in 2008; of 700 companies in the sector, top 100 were responsible for 97% of total revenues
- Seven of the leading 10 companies are now backed by venture capital investors; only two are listed on the Stock Exchange
- "New Media" and overseas revenues continued to climb in 2008; UK formats among most popular global programmes; economic slowdown will temper this
- Terms of trade are again up for discussion, as indies complain that broadcasters retain too great a share of the VOD market, the only segment where growth is likely to be significant, while broadcasters fear VOD may cannibalise their linear market shares

Mediatique has published two major reports on the independent sector, most recently in August 2008, and the present document is a summary update of the major trends affecting UK independent production since our last publication. It should be read in the context of the broader analysis contained in *All Grown Up: Cash, Creativity and the Independent Television Sector.*

Market update

The onset of recession from the summer of 2008 has been the defining feature of changes affecting the independent television sector, exacerbating the already quite significant impacts of underlying structural transformation particularly in broadcast media.

Following several years of reasonable growth in independent sector revenues (even as overall programming expenditure by client broadcasters was relatively stable) this trend is set to be reversed as continuing downward pressures on licence fees paid for programming and increased reliance by indies on external funding sources combine to put pressures on top line growth and – significantly – on margins.

Revenues in 2008 were roughly flat (sector-wide at £2.08bn) with margins slipping from 2007 levels (now at about 8% across the industry[1]). While the average masks a significant range across companies in the sector, the underlying trend is downward.

It is likely that sector-wide profits will decline further in 2009 and 2010, after slight improvements in 2006 and 2007, primarily reflecting the lower revenues achieved from primary commissions – still the most important source of revenue for the independent sector despite increases in the past decade in ancillary revenue generation from format, international and "new media" sales.

This is also likely to force further consolidation on the sector – but this time through company failure rather than through the mergers and acquisitions that marked the middle of the past decade.

The current climate will again put the spotlight on the terms of trade under which indies supply mainstream TV broadcasters, as the growth in on-demand programming risks rewarding broadcasters more than independent rights holders. ITV and five, in particular, are campaigning for revisions to the terms of trade on new media, which were put in place in 2006. There is a fear among independents that broadcasters will continue to benefit from income derived from new platforms such as VOD while the share taken by indies will decline.

The cyclical effect of the advertising downturn – NAR will be down at least 15% in 2009, perhaps with a further drop of 5% in 2010 – has been most obvious in the programming budgets of commercial broadcasters, in particular ITV, Channel 4 and five. All the PSBs have either announced cuts or their intention to make cuts (or to reallocate content budgets elsewhere), as we detail below.

[1] Source: PACT, Independent Production Sector Census, May 2009.

Content budget cuts by the PSBs…

BBC

The BBC, despite its claim to the licence fee, is seeking to reduce programming expenditure – by £200m over the next five years, in line with efficiency targets set as part of a lower-than-expected licence fee settlement. A small part is played, too, by the re-directing of resources away from programming *per se* and toward a range of investments aimed at underpinning the BBC's distribution strategy – including iPlayer, the proposed Canvas joint venture with ITV and BT, and Freesat.

ITV

ITV is aiming to cut c£250m from its budget for ITV1, taking it to £750m by 2011. The broadcaster explicitly targeted reductions in licence fees paid to third-party suppliers when it most recently confirmed the extent of the planned cuts at its results announcement in August 2009.

Channel 4

Channel 4 had already begun to cut its programming budget significantly in 2008, by £25m that year to c£600m. A planned further £25m cut in 2009 was revised upward in the summer of 2009, and the decline for the full year may be as much as £75m. In the case of Channel 4, it is likely that the reductions will fall disproportionately on the US acquisitions budget. The independent sector, on which C4 depends to produce all its originated UK programming, will not be immune however.

Five

Five, equally, has slashed its programming budget for 2009, by fully 25% year on year, taking it to £165m for 2009, compared to £220m in 2008.

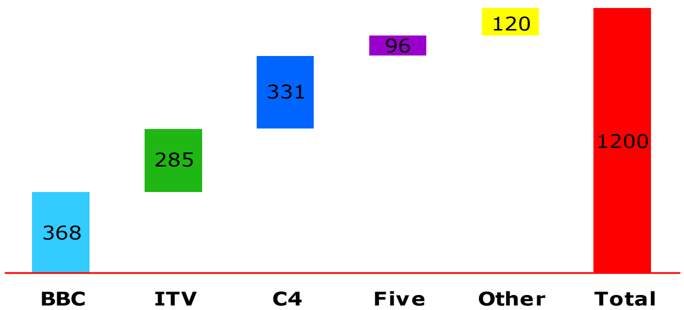
The significance for indies of the cuts at the major PSB broadcasters is rendered stark by the overwhelming dominance of these broadcasters in the primary commission sector. Including expenditure on their multi-channel extensions (e.g., ITV2, E4 and Fiver), the mainstream terrestrial broadcasters (including the BBC) account for c90% of all spending on non-sport, non film originated programming.

While budgets have been under pressure in real terms for the past five years, the effect on the independent sector has been limited, owing to a fundamental shift toward the use of third-party formats by mainstream broadcasters (where the independent sector has traditional skills) and to the BBC's Window of Creative Competition (WOCC), which has increased the amount of programming sourced from independent suppliers. In 2008, independents delivered more than 50% of originated hours of programming on the main networks.

Under the WOCC, for the BBC's 2008/09 financial year, comedy, children's and factual were heavily weighted in the favour of independents, entertainment was more evenly balanced, while Drama tipped substantially to in-house BBC. This was broadly similar to trends in previous years, and suggests that indies with strength in factual and comedy in particular are likely to out-perform the (admittedly under-performing) sector.

In 2008, this translated into c£1.2bn of revenues for the independent sector for primary commissions; this is broken down by major broadcaster below.

Programme spend with indie sector, by broadcaster (2008, £m, primary commissions)



Of PSB spend, Channel 4 and the BBC were again the biggest spenders in 2008, despite C4 reducing the number of independents it contracted with – to 300 from 312 in 2007.

The BBC spent £368m on qualifying external commissions in 2008, with C4 at £331m. ITV's total of £285m was roughly in line with 2007, while Five spent £96m. Non-PSB spend measured £120m

However, the depth of the cuts being pushed through this year, and the likelihood of further pressures on commercial broadcasters in 2010, have combined to have a material effect on independent sector revenues in the current year (2009) – particularly through the reductions of c5% on programme prices paid by commissioning broadcasters and a what may turn out to be the beginning of a major trend back toward internal production sourcing by the BBC and ITV (although subject in the case of the BBC to its targets under the WOCC). Coupled with weaker international markets, the result is likely to be a shortfall in indie sector revenues between 2009 and 2011 of as much as c£200m, or 10%, as the programme expenditure cuts work their way through. Indies report much longer lead times for commissioning, lower levels in the aggregate and declining prices paid for programming, requiring some larger, integrated indies to "deficit fund" from their own resources, thereby increasing their risk profile and deepening their reliance on the "back end" to generate margins.[2] Drama appears to be the hardest hit genre in this regard. Indies also report that commissioning broadcasters demonstrably prefer to deal with large suppliers with whom they have significant on-going relationships, making it harder for smaller indies to win commissions.

Access to "gap" funding to compensate for lower broadcaster licence fees, along with joint production revenues (primarily with European broadcasters and producers) will reduce the net effect for the sector as a whole; however, it is only the large, integrated indies, with distribution capability, that are able to tap these sources of funding.

Against this backdrop, there are also pressures on the independent sector's markets overseas (which have been an important source of ancillary revenues in the past decade), as the US and continental Europe are experiencing similar problems to the UK. While format sales remain a key revenue stream, supported by the reliance of leading broadcasters in the US and Europe on locally produced versions of global hits, overall programming budget declines in all major markets are inevitable as advertising revenues continue to suffer. This undermines the ability even of the largest indies to withstand lower licence fees in the UK by tapping international markets for funding and commissions. This is likely to be confirmed in the course of 2009 by international revenues declining from 2008's c£320m.

[2] In its most recent Census, published in May 2009, PACT estimates that such "gap funding" of UK production by the independent sector may be as much as £190m a year.

Meanwhile, ancillary revenues from online, mobile and VOD platforms are still a very small market even in gross revenue terms (i.e., before accounting for distribution costs), and the share eventually finding its way to those independents that have secured sufficient control of post-broadcast window rights is even smaller. Moreover, such revenues are only likely to be generated for the larger, integrated indies.

Market structure trends

The tri-partite structure of the independent sector identified in the past by Mediatique – the super indies, the "middle bulge" and the "long tail" – is still very much in evidence in the latest figures we have compiled. One effect of the consolidation of the period 2003-2007 was to reduce the size of the "middle bulge", accentuating the co-existence of two broad business models – integrated, big and diversified on the one hand and small and focussed on the other. The market power exerted by the very large companies increased further between 2007 and 2008, with the share of revenues represented by the top 10 indies now 67%, compared to 65% a year earlier.

2008		***2007***		***2006***		***2005***	
Name of indie	***% of sector***	***Name of indie***	***% of sector***	***Name of indie***	***% of sector***	***Name of indie***	***% of sector***
All3Media	11.1%	IMG	10.9%	IMG	11.0%	All3Media	9.0%
Shine	10.4%	All3Media	10.0%	Endemol UK	9.0%	Talkback Thames	8.3%
IMG	10.0%	Endemol UK	7.9%	All3Media	9.0%	Hit Entertainment	7.3%
Endemol UK	8.2%	Shine	7.2%	Hit Entertainment	8.7%	Endemol UK	6.9%
Talkback Thames	6.8%	Hit Entertainment	7.0%	Talkback Thames	7.6%	TWI (IMG)	6.5%
Hit Entertainment	6.6%	Talkback Thames	6.9%	RDF	5.2%	TV Corp (Tinopolis)	3.9%
RDF	5.8%	RDF	4.9%	Shine	5.2%	RDF	3.7%
Tinopolis	3.3%	Shed	3.5%	Tinopolis	2.5%	19 Entertainment	2.8%
Shed	3.0%	Entertainment Rights	3.4%	Aardman	2.3%	Ten Alps	2.6%
DCD Media	1.6%	Tinopolis	3.3%	Shed	2.3%	Tiger Aspect	2.5%
Total top 10	***66.6%***	***Total top 10***	***65.0%***	***Total top 10***	***62.8%***	***Total top 10***	***53.5%***

Moreover, since Mediatique's most recent detailed report was published last year, there have been significant movements in relation to the league table of independent producers in the UK. Most notably, All3Media, which had been in close contention for the top spot in 2007, moved comfortably into that position by 2008, securing more than 11% of sector revenues. Former number one IMG slipped to third place while Endemol dropped one position to number four. With the biggest rise in the top five, Shine finished 2008 in second position, with more than 10% of sector revenues.[3]

However, while the top 10 independent producers may have traded positions, the list has maintained a consistency since 2005, with virtually the same companies represented throughout the period. Their businesses have grown both organically and in some cases by acquisition. The mergers frenzy of the 2003-2007 period is effectively over – at least for now. There was only one deal in the sector of note in the period since our last report – the £61m acquisition by Shine of Metronome, the Scandinavian production group.

Detailed information on recent transactions in the independent production sector is set out in the following table, including a comparison of valuation metrics.

[3] Talkback Thames includes revenues from joint venture programming with Syco and 19 (e.g., *Britain's Got Talent*)

Date	Company	Acquiror	Consideration (£m)	Sales (£m)	EBITDA (£m)	EV/Sales (x)	EV/EBITDA (x)
Feb-07	The Mill	Carlyle Group	59.0	40.1	6.6	1.5	9.0
Jun-07	Maverick	All3Media	20.0	8.0	-	2.5	NA
Jul-07	West Park Pictures	DCD	3.0	1.1	-	2.7	NA
Jul-07	Prospect Pictures	DCD	7.1	7.5	1.2	0.9	5.7
Jul-07	September Holdings	DCD	9.1	7.3	0.7	1.2	12.8
Aug-07	Objective	All3Media	45.0	23.0	-	2.0	NA
Sep-07	Twenty Twenty	Shed	19.0	9.4	2.0	2.0	9.5
Nov-07	Wall to Wall	Shed	25.0	19.5	2.0	1.3	12.5
Dec-07	12 Yard	ITV plc	35.0	11.5	2.4	3.0	14.6
May-08	Tinopolis	MBO	44.7	66.0	3.6	0.7	12.4
Jun-08	2Waytraffic	Sony Pictures	114.3	-	22.3	NA	5.1
Aug-08	Carnival	NBC Universal	30.0	21.5	-	1.4	NA
Feb-09	RDF	MBO,Cyrte	52.0	120.6	9.5	0.4	5.5
Jan-09	Southern Star	Endemol	33.3	59.7	7.5	0.6	4.4
Jan-09	Carbon Media	ITV	1.1	1.3	0.2	0.8	6.0
Feb-09	Below the Radar	Ten Alps	0.8	0.3	-	2.5	NA
Apr-09	Metronome	Shine	61.0	88.1	6.0	0.7	10.9
					Average	**1.5x**	**9.0x**

The average EBITDA multiple for acquisitions in the 2007-2009 period is lower at 9.0x than the average between 2005-2008, which Mediatique calculated as 10.9x. The average multiple of deals completed since the economic slowdown was confirmed in summer 2008 is even lower at 6.4x (5.2x if the full price paid by Shine for Metronome is discounted) and this is probably more indicative of market valuations in the current market. Sales multiples are level, at 1.6x compared to 1.5x in that period. This indicates that while there had been a general, if modest, improvement in margins in 2006 and 2007, deals have been more keenly priced in recent years and have been affected by the general decline in asset values.[4]

The other chief trend in the past year was confirmation of the exit by quoted independent companies from the public market, with RDF and Tinopolis both de-listing, and with Shed management apparently still intent on taking the company private. If Shed is "privatised", there will be only two quoted companies in the top 20. Other than companies owned by larger entities – for example Freemantle and Talkback Thames – the most common form of external ownership in the sector is private equity.

Conclusions and future trends

This review of the sector underlines the pressures that are likely to continue to bear down on independents, with revenue declines and profit weakness both hallmarks of 2009 and 2010. Large, integrated firms, particularly those addressing global markets through format rights and secondary sales, will withstand the pressures best; small companies in the "long tail" may weather the economic climate owing to their modest requirements for only one or two commissions to stay afloat and their ability to target multi-channel

[4] Note that multiples normally relate to trailing year income, which does not fully capture superior growth. In addition, profit margins are often minimised to minimise tax and maximised in the lead up to corporate transactions to maximise headline figures.

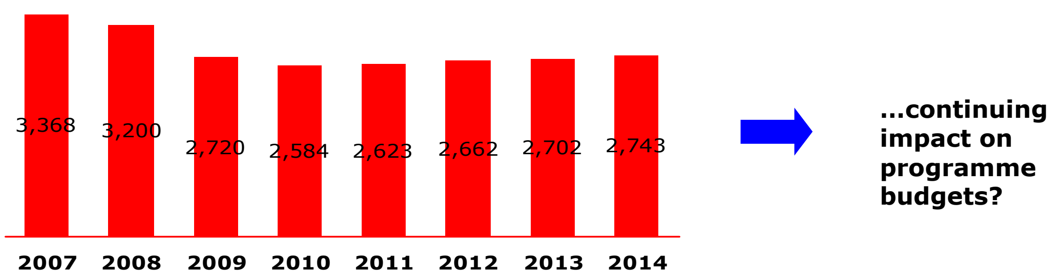
broadcasters for smaller commissions. Most at risk during the downturn are those in the middle bulge, where businesses have grown to a significant size but where marginal growth is crucial to profitability.

There is also likely to be a continued focus among major client-broadcasters on lowering costs, including programming expenditure, which will have an accelerating knock-on effect on the indie sector. Added to this will be a pre-occupation both at the BBC and ITV to concentrate on developing programmes internally, although subject in both cases to the independent sector quota and in the former case to the BBC's WOCC. While a secondary player in the market for commissioned programming, Five's sharp budget contraction will have at least a marginal effect in the course of the rest of 2009 and into 2010. While multi-channel budgets have risen in recent years, this has been driven principally by expenditure at the extension channels of the main networks, which are also subject to the programming cuts seen at the core channels.

Longer term, it is unlikely that advertising will recover to the levels of the mid-2000s, as the structural elements of the current malaise persist even after the cyclical effects have worked through. This suggests that there may be more severe cuts in programming, with further debilitating effects on the independent sector.

Mediatique's core NAR forecasts suggest that TV broadcast revenues will still be lower in real terms in 2014 than in 2007, the last year of year-on-year growth.

Total TV advertising revenues (£m)



Against this backdrop, and assuming that the chief (commercial) free-to-air broadcasters continue to rely nearly exclusively on advertising revenues to fund content, programming budgets are forecast to continue their downward path. While a move by ITV and Channel 4 to re-enter the subscription market cannot be discounted, there are currently no signs of an early move by these broadcasters to put some of their channels behind a pay wall.

Even the announced programming cuts for 2009-2012 are significant, and the pruning may well continue in the event that advertising growth remains modest. The BBC, ITV, Channel 4 and Five are expected to spend c£2.9bn in aggregate in 2009; planned cuts alone will see that figure declined to c£2.4bn by 2012. If the proportion of expenditure achieved in 2008 is maintained for external commissions over coming years, the independent sector could see its primary commission income decline by more than 20% by 2012.

Larger, integrated indies have access to co-production markets and gap funding to ensure they can continue to win commissions and – ideally – retain rights. However, the chief source of future ancillary revenue, VOD, remains a small market even if significant growth is forecast following likely upgrade of platforms to enable VOD functionality. The prospect for a more vibrant market for VOD will be enhanced by the launch of hybrid services such as Sky's IP-connected Sky Player service, delivering VOD to subscribers to Sky HD as well as the intended introduction from 2010 of hybrid Freeview VOD-enabled set-top boxes allowing Freeview homes to watch both standard and HD linear broadcasts and to request Video on Demand directly via the television set.

Mediatique forecasts that total VOD revenues in the UK, driven in large part by these platform upgrades, will reach c£500m by 2014 – a market that independent producers may be able to address directly or through sharing revenues with broadcasters. But might this come at the cost of having to forego revenues from the more certain linear broadcast market, where revenues are likely to be under threat?

This may be the key issue confronting the independent sector over the next 3-5 years: the degree to which they can benefit from the growth of VOD services. In recent years, the prospect of incremental revenues from mobile and fixed line VOD has helped fuel investor interest in the indie sector. It is true that, while broadcasters continue to lay claim to a significant share of these ancillary revenues in recognition of their control over the initial broadcast window, even the present terms of trade (and certainly any reformed terms that further promote the interests of rights holders) will ensure that indies with retained IP rights will benefit to some degree.

However in this context, the precise nature of any changes to the terms of trade will be a crucial factor in determining how broadcasters and producers divide the only pie that is likely to grow significantly in the medium term. And for indies, there may be a catch. If broadcasters find their traditional revenue streams are threatened as the growth in non-linear viewing reduces audiences and income derived from traditional broadcasting, they will be less able to fund content, and this jeopardises the most important source of income for indies – the primary commission. Even with a larger, protected claim to a greater share of VOD revenues, and despite excitement generated around the value of the VOD window, the net effect on the independent sector (and the broadcasters that largely fund them) may well be negative, certainly in the medium term.

Note on methodology and sources

Where necessary, we have relied on external secondary sources for the financial data contained in this report. We note, however, that the independent production sector has not been properly audited since the launch of Channel 4 in 1982. All figures included in this report are based on calculations by Mediatique and sourced from Televisual (1993-2002), Broadcast (2003-2009), PACT, Ofcom and Mediatique estimates. In addition, information has been sourced from the London Stock Exchange, company reports and brokers' estimates. The sector revenues (total) include all revenues generated by independent production companies (primary commission, secondary markets, programme sales, format sales, overseas, new media, agency, events management, etc.), The amount represented by primary commission is based on calculations by Mediatique, and is sourced from reported accounts of a range of companies and interviews with industry players.

These secondary sources have been backed up by primary research, including confidential interviews with key representatives from the independent production sector, broadcasters, trade bodies and regulators.

MEDIATIQUE

Contact information

Mediatique Limited

21 Little Portland Street

London W1W 8BT

United Kingdom

Telephone: +44 (0)20 7291 6900

Facsimile: +44 (0)20 7291 6901

www.mediatique.co.uk