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the money men

After the gold rush

Mick Pilsworth



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After the gold rush
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Mick Pilsworth | Chairman,
Motive Television PLC

The year 2005 was marked by the dash to the Stock Exchange of several high-profile independent production companies, the so-called 'super indies', Shed and RDF among them. The sky-high valuations put on these companies by City investors staggered many in the television business and made overnight millionaires of the independent producers who had founded and built them. Why did these companies decide to float on the stock market and what will they do now? Will investors continue to back them and what will be the effect of this development on the television industry?

The City has always had a love/hate relationship with the entertainment industry, and especially with the independent television production sector. Most investors and fund managers regarded it as a lifestyle business, where the assets, the creative talent, left the building every day at six o'clock and were both difficult to manage and also unpredictable. They looked at the fragmented market - 900 plus members of the Producers' Alliance for Cinema and Television (Pact), at the low entry-barriers (a commissioned idea on a piece of A4 paper is how most companies start trading), the lack of working capital, the over-dominant monopoly buying behaviour of the broadcasters, and they took fright.

They hated what they perceived to be low margins, where the average return on turnover was three per cent. They hated the vicissitudes of the production sector where good programmes could be cancelled on a whim or a change of a commissioning editor, and where onscreen talent could, and did, ask for huge pay rises when they became successful, often eroding margins for the producer in the process. And most of all they hated the fact that most of those companies which had floated had underperformed. Companies such as Sleepy Kids, Circle Communications and Alibi had created great excitement on launch, but their fortunes had waned and their investors cannot have been amused.

And one of the biggest criticisms of the sector was that the independent production companies did not create assets with long-term value. They were seen as tied suppliers, 'guns for hire', whose share of the secondary value of the programmes (merchandising, video and DVD rights, overseas sales and re-runs on satellite channels) which they created was controlled by the broadcasters, who took the lion's share of the gains and who sat on wasting programme assets which they could not be bothered to exploit.

But in 2004, all this changed when the new Terms of Trade between the UK broadcasters and the independent sector were agreed and put into effect. Many will recall the genuine passion and commitment of Shed's Eileen Gallagher and RDF's David Frank when, throughout the past six years, they used their leadership of Pact to try to secure fairer Terms of Trade

for the independent television production sector. In what must be regarded by even the most dispassionate observer as one of the most sophisticated lobbying campaigns ever fought in this country, Pact, under John McVay and assisted by expert evidence gathered by industry consultant David Graham's DGA, clearly demonstrated that broadcasters were using their dominant market power to distort the programme supply market to their own commercial advantage and in the process were shackling the potential of the independent sector.

The campaigners were hugely assisted by a spat between the Labour government and the independent-minded Labour peer, Lord Puttnam, over the government's desire to allow American broadcasters to buy into British television networks. Desperate to assuage Puttnam, who is a highly skilled and well-connected lobbyist and who was close to wrecking the government's massive Communications Bill, they asked him if there was anything else they could offer him to guarantee the Bill's passage with most of the liberalisation measures relating to US involvement intact. When he suggested the modification of the independent production Terms of Trade the government nearly took his arm off in their haste to agree, not least because Secretary of State Patricia Hewitt, was impressed with the indie sector's case.

So the Terms of Trade were changed. Ofcom would police the implementation, so there was nowhere for the broadcasters to hide. The producers found themselves in a transformed landscape: they could keep the rights of the programmes they had created. This would mean that in addition to earning a production fee or profit margin and charging recoveries of fixed costs to budgets, producers would control the exploitation of their catalogues and would start to earn money on all of the income streams accruing to their programmes, not just from global exploitation but also from secondary exploitation of re-runs in the UK on the burgeoning digital and satellite channels.

It did not take long for the City investment experts and professionals involved in the sector to notice this sea change. The first was the stockbroker Durlacher's veteran television industry analyst, Nick Ward, whose expert research note 'UK Indie PLC' fired the starting gun on the race to float the big indies. The brokers, nominated advisers ('NOMADS'), lawyers and accountants who specialise in smaller companies and in media, began courting the bigger indies (even the biggest indie is small in City terms). Their motivation was straightforward: there are handsome advisory fees and commissions to be made for floating companies on the Stock Exchange. Typically a stockbroker will charge an annual flat fee plus 3-4 per cent commission on the funds raised from its clients; lawyers' and accountants' fees on the smallest floats can routinely run to hundreds of thousands of pounds for the 'due diligence' (a painstaking and highly detailed examination of every aspect

of a company's affairs) which has to be performed on a target company; and corporate advisers to the sellers of companies can charge 5-7 per cent of the price achieved for their services.

With the markets in the early part of 2005 surging and with City fund managers awash with cash for the first time in five years the race was on to identify the companies that had the potential to float successfully on the London Stock Exchange's junior market, the Alternative Investment Market (known as AIM). AIM's listing requirements are less onerous than the main market's and the annual costs of being on AIM are much less, so it is attractive for smaller growth companies.

But what can the owners of the target companies hope to get out of floating their companies' shares on the market, aside from the obvious cash which they could take out for themselves?

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Essentially the advantages to listing are fourfold: first, access to capital (in that money for developing the business or for buying other businesses can be raised by issuing more shares to new and existing investors); second, liquidity for shareholders in the business (in that the founder owners of the business have the ability to sell shares in the market at certain times of the year in order to raise personal cash); third, incentivisation schemes (publicly listed shares can be offered to the staff of the floated business to incentivise them, in the form of share options or gifted shares); and, fourth, the shares can be offered to the owners of businesses which the floated business wishes to acquire in order to expand.

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announcement the company makes will be analysed by the City and may affect the share price; and any surprises or setbacks can have a devastating effect on the company's share price.

And this can create a further chronic problem. Floated companies tend to operate in a deal-driven environment. Activity is essential and those companies which do not grow rapidly through deal-making are penalised through a low rating (the price/earnings ratio, or p/e, which is the ratio of the share price to the company's earnings per share). But to be able to do deals effectively the growing floated company has to try to effectively arbitrage, or exploit the difference between its own highly rated shares (or 'paper') and the lower-rated shares of a target company. For example, if the market values independent television production companies on 12 times earnings before interest, tax, depreciation and amortisation ('ebitda', which equates to operating cash flow, or the cash being generated by the business each year) and a floated company can acquire additional privately owned production companies for eight times their ebitda, the shares of the acquiring company should rise, because its earnings will be flattered by each new deal it does. In simple terms, it is buying shares in private television companies more cheaply than it is selling its own public shares to investors.

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This process creates a virtuous circle, because as more earnings-enhancing deals are completed the floated company's share price should keep rising. However, if something goes wrong, a vicious circle is created; if the floated company's shares fall in value below the value placed on the privately owned shares of target companies, then the deals become more and more expensive for the floated company and may become earnings-dilutive. At this point the floated company becomes enmired and is unable to extricate itself from its predicament except through managing itself better and trying to solve its problems without doing deals. This can be a long, tortuous and slow process.

But what of the companies such as RDF and Shed which have successfully floated this year? RDF benefited greatly from having a venture capital investor (or a 'private equity' investor as they is now know), on board at an early stage in its development.

The presence of venture capital fund Sagitta Investments on RDF's board and the injection of cash which they provided in the early years of the company's development created an environment in which programmes would only go into development if they had secondary income streams (for example, format sales) attached to them which could increase the financial return to RDF.

And Shed had the terrific advantage of having a former director of Scottish Television, Granada and MD of LWT, Eileen Gallagher, as one of its founders. Again the company was run as a commercial enterprise, making programmes only for ITV, (at the time the only broadcaster which had terms of trade under which independents could retain all rights outside of the primary UK broadcast licence for two or three runs) and specialising in low-cost precinct drama of returnable series (*Bad Girls* and *Footballers' Wives*) that worked well and were cost-effective for ITV.

Both companies generated high levels of profit and had demonstrated that they were well run and stable, with long-running series and high levels of ancillary income accruing from format sales, programme sales and spin-offs such as DVDs. And the market treated them well on their launch putting the shares on a multiple of 10-12 times ebitda, thus providing them with sufficient firepower to generate a deal flow should they wish to acquire other companies in the sector. Their founders became multi-millionaires overnight, and whilst they still hold most of their new fortunes in paper, they were allowed to cash in shares sufficient to have a life-changing impact.

Which is where the troubles usually begin.

When the founder of a private company floats it on the Stock Exchange and takes out a few million pounds several things happen.

First, they are approached by experts in wealth planning, or private bankers, eager to help them deal with all of the many problems associated with a windfall capital gain. Obviously a certain amount of prudent estate planning goes on: people pay off mortgages and set up inheritance tax planning arrangements.

Second, and understandably, they may acquire new assets. New homes, second homes, boats, cars, wives, husbands. For their lives have been altered forever and this takes some getting used to. Their lives become more complex and all these new assets take time to acquire and then become time-consuming themselves.

Third, they will be approached by many owners of private companies in the sector eager to do deals.

Lastly, they have a whole new raft of problems to deal with: the City needs to be managed. The list of new jobs for the CEO to handle is daunting: investor relations, fund manager presentations, road shows, constant internal financial monitoring, tighter controls, forecast, reforecasts, meetings with NOMADS, brokers' analysts, results presentations, City PR, legal issues, managing the new Board with its non-executive directors asking difficult questions; it can seem like a full-time job at times, especially if things go wrong.

The end result is that their eyes may come off the ball, just a little. And of course, the troops who deliver the programmes week in, week out, will have been watching all of this wealth creation and wealth management and will start to become just a little more restive. Key people who feel left out of the enrichment process may leave or become difficult to manage. Commissioners who have built up relationships with the newly wealthy suppliers may feel aggrieved and may be tempted to shift their allegiances to younger, weaker suppliers.

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So just at the very point that the owner-manager of a floated business needs to pay more attention than ever to the core business, the distractions that come from sudden wealth, managing the City's expectations, and increased status and leverage within the sector can become damaging.

And there is a further, deep-seated problem facing the newly floated TV company. The history of the independent sector shows clearly that independent television production companies tend to have a relatively short lifespan. Those companies that were ‘hot’ in the early days of the sector, many of which were acquired by bigger groups, have now disappeared or become far less successful. Action Time and Planet 24 were acquired by Carlton television at the height of their success, and neither can have fulfilled their new owner's expectations. SelecTV acquired the hugely successful Alomo, Witzend and Clement La Frenais Productions in the early 1990s, all since closed down by their new owner, Fremantle. Red Rooster, acquired by Chrysalis in 1994, is no more despite having enormous success in drama in the 1990s. Blue Heaven and Cinema Verite, despite huge success with hit drama series and comedies over the years simply closed down when their fortunes changed.

If you look at the lists of the top ten companies in the independent television production sector in the last two decades or in the 20th century, most of those listed no longer exist. It seems as though there is a natural life-cycle to an indie: eight to ten years is about as long as one, or sometimes two, founding owner-managers can stay in the job, not just because it is incredibly demanding, but also because suppliers may age, but commissioning editors stay forever young (and seem to be getting even younger).

It becomes more and more difficult for ageing suppliers to sell face to face to young commissioners, not least because it is often the case that the mature suppliers feel they have a lot more experience than the buyers and find it difficult to accept criticism from them. Of course there are exceptions, but there is a general issue here for the more successful companies as they grow older.

And then there is the green-eyed monster. Commissioning editors on salaries are unlikely to be unmoved when they see the enormous valuations being placed on companies whose owners are being enriched by the proceeds of the commissions they have awarded them. And many, such as Lorraine Heggsey, the former Controller of BBC One and now an independent producer at Fremantle, must make the switch from the commissioning role to the supplier role partly at least because the financial rewards are likely to be much greater.

Equally, sometimes those who have been enriched by selling or floating their business decide that they have had enough, and simply walk away. Peter Fincham made millions from the sale of his company, Talkback, to Fremantle and had decided to give it all up, at least for a while, until his enthusiasm for the television business was revived by the offer of the controllership of BBC One. There are some things that money just cannot buy, clearly. Fincham will now be in the somewhat unusual position of commissioning programmes from one of his former buyers, Lorraine Heggsey, now head of talkbackTHAMES.

Despite all of these looming problems, though, floated independent television production companies will prosper. They will become bigger and when they reach a certain size, with a market capitalisation of £20 million or greater, they will be able to attract blue-chip pension funds as investors and then there will be a free and liquid market in their shares. The benefits of size are sometimes difficult to gauge, but they include economies of scale for central support services such as accounting, audit, business affairs, rights-exploitation, distribution and real estate.

Possibly the biggest benefit of scale in this sector is in the area of development funding. As broadcasters adjust to the new Terms of Trade they will turn off the development funding that they have been

supplying and the sector will have to come up with its own. As competition for the newly-acquired distribution rights increases programme distributors will offer development funding in exchange for distribution rights, but there is no doubt that the bigger, better-funded companies will be able to add to this from their own funds and cash flow. RDF has shown that a huge investment in highly-targeted investment reaps dividends in commissions and in the exploitation of programmes that have secondary income streams attached to them. Endemol now has the firepower to invest in whole new genres.

In the middle of all of this excitement about the City and AIM, one company, All3Media, has shown that the traditional route of raising private equity for expansion is still open for those who have the ambition and the guts to race for growth. With turnover approaching £200 million a year, its own distribution company and operations in the UK, the Netherlands and New Zealand, All3Media, backed by Bridgepoint Capital (the only private equity group to have invested heavily in the sector) is well on its way to becoming the dominant force in the sector. The key difference between the private equity route and the public equity route is that private equity investors typically build in a huge amount of debt into the business (in the case of All3Media, the bank debt was supplied by RBS). This has to be serviced (interest has to be paid), and on top of this the private equity investor will typically look for a return of not less than 40 per cent within 3-5 years, with the exit being provided by a trade sale to a bigger corporate acquirer, or by a flotation.

And if the market conditions remain as they are today, not only could All3Media float with a valuation of around £150 million, it could even float on the main market rather than AIM. It would be not just a super-indie, but an uber-indie, and would be bigger than many digital broadcasters in the UK.

The growth of super-indies is not just inevitable; it is arguably good for the sector and will eventually provide the kind of stability that is good for creativity. There will however always be room for new, small companies to come into being. The low barriers to entry in the sector mean that people with good ideas who want to work independently of broadcasters will always be able to do so. The only difference is that they can now be rewarded for their creative achievements, either by selling their rights, or ultimately by selling their businesses. The days of indies closing down on retirement are well and truly over.

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changing how you do business**

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 nothing will change.

Conrad Withey | Managing Director,
 The Rights Company (UK) Ltd

The 2003 Communications Act delivered seismic changes to the UK's independent production industry. Suddenly one of the world's leading creative talent bases was handed back the real value in the programmes that it creates, ensuring that the very people who come up with the ideas and make the end product are able to share in the success they deliver. Broadcasters instantly became service providers - there to platform content and deliver it to a viewing audience through the media they know - but not to be rights owners in sectors spinning off from that.

Better than that though, the arrival of the legislation coincided with a number of other significant positive market dynamics for content creators. First, British TV shows, made by indies, were reaching unprecedented levels of popularity and performance around the world. Programming as varied as *Who Wants To Be A Millionaire?*, *Bob The Builder*, *Midsomer Murders*, *Pop Idol*, *Survivor* and *Wife Swap* were delivering huge audiences in the US and beyond. The UK was building on its reputation in the all-important US market as a creative hothouse that could deliver hits - and even better than that, returning hit series.

'You need specialists, and you need one in every area of ancillary rights exploitation.'

Second, there was the arrival of the most successful new media format of all time. DVD really hit the big time in 2001 and the impact was a force for good for all producers, driving a value back to intellectual property owners not seen since the arrival of the CD format in the music industry. Not only could you make money - big money - out of new hit shows but there was suddenly also the opportunity to re-purpose old content and re-launch it to both a whole new audience and those replacing their existing VHS libraries.

Third, the rush in the UK to embrace digital television and the resulting creation of hundreds of generalist and specialist channels offered new commissioning opportunities to those same producers. While the budgets aren't going to be huge in the digital world, the need to fill the schedules of the fledgling channels that could deliver a real point of difference to an ever-splintering audience drove orders of content that kept more independent production businesses going and encouraged other talented individuals to set up on their own.

These beneficial dynamics mixed with legislative change have sent the value of independent production companies sky high and the City, traditionally wary of the sector, has suddenly got all excited. Its enthusiasm has encouraged the rolling up of producers in companies

like All3Media, the flotation on AIM of the larger players and a renewed interest in investment generally in more than 800 businesses treading water in the programme-making business.

How exciting. But then you know all that. That's probably why you've got time to read this book. Things are now so good for producers that all you've got to do is sit back and consider the future in this rosy world.

Of course it just isn't that easy. The truth is very little will change for independent production outfits unless the individuals who run those companies are willing to change the way they do business. While there is now a legislative framework that can and will mean that the value of businesses in this sector is going to grow significantly, unless producers set themselves up to exploit the opportunity then nothing will change.

'It's just not acceptable any more to be a business about making programmes for TV. Producers now need to think of themselves as entertainment brand creators and ensure that right from the start they are thinking about how that brand needs to be adapted for other areas of exploitation.'

It isn't in fact the legal framework that makes you money; it is the way you operate within it. Consider, for example, the fact that long before 2003 there were already independent companies out there building very healthy businesses from the programmes they produced. They were hanging on to rights and making money from them before any legislation was in place to help them. Familiar names such as 19, Endemol, Talkback, Hit Entertainment, Tiger Aspect, Chorion, Hat Trick, Avalon and Entertainment Rights had already delivered business models that could make money from their programmes in ancillary areas of exploitation. And they didn't do it because they had any special, preferred position in the market or some magic formula. They did it because they had the balls and belief that giving rights away was not a particularly great idea.

When shows were commissioned from these producers they either flatly refused to give up the ancillary rights or put themselves in a funding position where they didn't have to. Whether it was driven by having key presenting or acting talent locked up or a range of funding routes that did not rely on one broadcaster, the end result was that they hung on to their rights and when the hits came they were able to exploit the ancillary products. And they were able to do that because they had developed relationships with specialist partners who were

prepared to pay advances for the ancillary rights and knew full well how to exploit them in their own particular markets to maximise the potential.

These producers were effectively working their brands in the publishing, home video, international broadcast and other merchandising areas years before the government recognised a need to support the independent sector. They prospered in short because they thought and acted differently from everyone else. Not only that but they created a business network to back up the heartfelt belief that what they were doing was special and deserved specialist treatment.

What *has* changed now is that there is a significant backing for this point of view, enshrined in law. What hasn't changed is that unless these laws are exploited with drive and knowledge they won't make a jot of difference. The broadcasters who have built extensive exploitation businesses off the back of the ancillary rights they were once handed on a plate aren't going to suddenly sit back and let them go. BBC Worldwide, C4I and the like are going to fight tooth and nail to keep their operations viable and you can be damn sure that unless you know what you are doing in dealing with them you will probably not be a great deal better off.

The challenge that faces all producers of TV programming in the UK now is to get up to speed fast on the potential of what they have and to build a working network of relationships to exploit it. And that doesn't mean suddenly hiring a vast team of lawyers or consultants to advise on the right steps forward. But it does mean producers getting smarter about how they do what they do and empowering themselves with market knowledge.

It's all very well, I hear you cry, but what are small independent producers to do next to change the way they work in the new world order. Well here are the top five tips I'd suggest to anyone out there trying to pick their way forward to producing and exploiting The Next Big Thing. They don't provide all the answers, but I do believe they offer a solid base for any independent production business that wants its future to be not only more stable but also significantly more profitable.

Learn what sells (and more importantly what doesn't!)

The truth is, I am afraid, that 80 per cent of everything that is produced just doesn't have a value beyond the TV. The irony of the huge success of reality TV formats such as *Wife Swap*, *Brat Camp* and *I'm A Celebrity*, *Get Me Out Of Here* is that however popular they are to viewers at the time, there is no brand loyalty and no real interest in spending hard-earned cash on anything spinning off from the show. Sure, voting brings in cash but that's your lot. Consider the eight million

viewers of *I'm A Celebrity* to the two million viewers of *Bo Selecta* and then compare the former's 10,000 units of DVDs to the latter's 500,000 and you see what I mean. To make money you need to make what people want to buy, and viewers are not always the key factor in this.

Make new friends

Learning what works and what sells takes years of experience and you just aren't going to get that overnight, but you can start by making friends in the other worlds of publishing, retailing, DVD distribution, licensing and merchandising. And that won't be one friend to cover all, it will be a wide network. Each of those sectors has its own quirks and characteristics and what works for one isn't what will work for another. They are also going to provide fantastic advice, early on, on which projects to back with all your resources and which to park in the 'nice TV but forget the rest' box. The worst thing in the world is chasing hard on a programme brand that has no ancillary potential. As they say, a quick no is better than wasting a lot of time unnecessarily. Of course the other thing about having friends in the right places is that when you need it it's valuable advice - free of charge. Excepting the odd lunch of course.

Get an agent

No small to medium independent production business can justify the overhead of a specialist rights management team. The unpredictable nature of the commissioning process just doesn't lend itself to covering the significant costs involved in this kind of recruitment.

But who to appoint to look after your content is not a simple decision of bringing in your enthusiastic media lawyer or an old school distributor. They might tell you that they can handle your rights but experience says that although they are great at what they do, when it comes to non-core business for them it's generally all talk. You need specialists, and you need one in every area of ancillary rights exploitation. You wouldn't ask a plumber to do the electrics in your house, so don't ask a publishing agent to handle your interactive rights. Get a team you like and trust and who are leaders in their own areas of expertise. And then bring them into your business and let them see what you are up to and what's coming through next. Granted you'll give up an element of the revenues earned, but that will be far exceeded by the value added in having the right person looking after your rights.

Find out where the money lies

Despite the insistence of Pact and Ofcom that broadcasters cannot reduce budgets for new commissions in the light of losing ancillary rights, there's a general feeling in the camp that bit by bit this is happening anyway. Whether it is or not is irrelevant, as it's in the

interest of every independent producer to explore all the possible areas where funding can be found for the programmes they want to make.

The ability of a business to secure advances up front from a combination of broadcasters, co-producers, international distributors, DVD distributors, book publishers and mobile operators defines the extent to which they can turn the production process itself into a profitable experience and the chances of back-end revenues improve significantly. Perhaps more importantly, though, by spreading the sources of funding you retain a strength in negotiation that will help to deliver the right deals to make your programmes work better for you.

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Make and develop programmes differently

Finally, it's time to work completely differently in the process of production. It's just not acceptable any more to be a business about making programmes for TV. Producers now need to think of themselves as entertainment brand creators and ensure that right from the start they are thinking about how that brand needs to be adapted for other areas of exploitation. Don't wait for someone else to come along and suggest how your might re-purpose content for them - get on with it on your own. From simple matters like clearing music and talent for other uses, to actually editing different versions of the programme that suit on-line, mobile or DVD exploitation, it's important to be planning for and covering all the bases.

The point is that The Next Big Thing isn't just the matter of finding new hits. The Next Big Thing is changing your business to suit the changing market in which you now produce content. Rest assured if you don't, there are plenty of others out there who will and they'll be the ones at the top of the pile in two or three years.

This is a phenomenally exciting time to be an independent TV producer in the UK and there is no doubting the fact that commercially the future offers far more now than it ever has. The framework is there to make independent TV production businesses into exciting, rights-owning, media profit centres but don't fall into the trap of thinking that you are owed anything.