

Broadcaster at crossroads in E. Europe, with competition a threat for the first time

Company description

Central European Media Enterprises operates the leading group of terrestrial and cable TV stations in Central and Eastern Europe. CME and its partners operate 13 TV networks in six countries: Croatia, Romania, Slovakia, Slovenia, Ukraine and the Czech Republic.

Central European Media Enterprises

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Ronald Lauder: nonexecutive chairman
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Dan Penn: general counsel and company secretary

UPON FIRST glance, the past year for Central European Media Enterprises (CME) was somewhat quiet compared with a rollercoaster 2005. That year was a real turning point for the company: In 2005, it finally gained control of by far its most important asset – the Czech Republic’s No. 1 commercial network, TV Nova – after an arduous legal battle with the channel’s former chief.

But Michael Garin, CME’s ever ebullient chief executive, said 2006 was just as important to the company. “The past 12 months have been probably the most transformational for us,” he said. “At the start of the year, we said we wanted to evolve from being a holding company for a collection of assets ... into a more sophisticated operating company. We have absolutely done that.”

The future TV picture looks bright for CME. It owns more assets in Central and Eastern Europe – the world’s fastest-growing TV market – than any other major media group. “We will double our revenues within five years, and we will do this growth by expanding margins,” Garin said. “That does not even include M&A activity.”

CME finds itself at a crossroads, with any number of developments

possible, ranging from acquisitions in new markets, such as Poland, to becoming a takeover target itself for the likes of RTL Group or News Corp.

A clear picture?

But CME’s future TV picture is not entirely without fuzz. Other majors want a piece of the Eastern European TV action, and that means CME will soon face some pretty stern rivals. News Corp. is beginning to build a portfolio of free-to-air broadcasters in the region by deploying Fox-branded stations in Poland, Bulgaria, Turkey, Serbia, Georgia, Israel, Latvia and Lithuania (*TVI*, 2 Mar, 2007).

News Corp. will undoubtedly reach major-player status in the region, but Garin doesn’t appear overly concerned about it. According to local sources, News’ entrance into Turkey hasn’t been smooth sailing, with TGRT having seen its ratings slip since being rebranded Fox Turkey in February. “There is no apparent strategic benefit to this move in the region for News Corp.,” Garin said. “Perhaps Rupert wants to plant the flag in these markets like Turkey, take a short-term loss, and wait for the long term. Maybe these are all loss leaders. We can do this type of foot-in-the-door thing in small markets, but we do not have the kind of resources to do this in big markets. If we enter a market, the opportunity has to be in reach.”

Another threat is posed by the private-equity owners of Germany’s ProSiebenSat1 and SBS Broadcasting, which view CEE as a vital expansion outlet. Meanwhile, RTL Group and MTG need to expand in the region because Western Europe’s TV advertising market is expected to grow just 1% in the coming years.

Aside from external threats, the company has several internal problems to contend with. CME does not directly control its Ukrainian affiliate, the Studio 1+1 group. That means it is limited in its ability to implement strategies or make programming decisions. In addition,

the 70% ownership interest in Studio 1+1 held by CME partner Alexander Rodnyansky has been the subject of litigation in Ukraine. Although that problem has been resolved, the uncertainty has given it limited room to maneuver in such a key market.

In addition, the company has found the going tough in Croatia. Its Croatian network, Nova TV, remains unprofitable. But it is well on the path to a turnaround, most likely making a profit by late 2008. Revenues grew 63.5% in 4Q06 compared with 4Q05.

No deal pressure

Garin says CME is not under pressure to buy new stations. “M&A is probably five on our list of priorities,” he said, noting that the forecast doubling of group revenues will come from organic growth alone. “We will do this growth by expanding margins. That does not even include M&A activity.”

But what’s on the deal radar? “We like Hungary, Poland, Romania and Serbia right now,” Garin said. Russia is one of the world’s fastest-growing markets, and CME would ideally like to be there, but Garin is against investing in that market just now. “Russia is very interesting to us, but some of the deals coming up in Russia are for minority stakes, and we only do deals where we have a clear path to control,” he said. “And at the moment, until the elections in Russia deliver a clear outlook on the future, investment is not likely.”

Although Garin does not feel pressure to buy, he notes that the company is on the starting blocks should a deal come up that looks viable. Private-equity giant Apax is now on board – having bought roughly half of the Ronald Lauder entity that controls CME – and Garin says Apax’s presence gives CME extra fiscal firepower and extra deal-making clout. “Apax’s involvement in CME on a day-to-day level has been largely passive [Apax owns only an 8% indirect CME stake],”

CME EBITDA by market (US\$ mil.)

	2006	2005	2004
Croatia	-14.41	-15.87	-3.76
Czech Republic	100.49	71.54	n/a
Romania	65.86	43.80	25.20
Slovakia	20.81	17.24	18.98
Slovenia	19.84	19.34	19.08
Ukraine	29.97	21.80	14.73

Source: CME 4Q06 financial report

he said. "But for us they provide much needed manpower when looking at deals. They can help put deals together for us. And they are in the capital markets a lot more than us, so they can help us to maximize our capital structure. We are very under-leveraged at the moment, so there is a lot of scope for us to do deals."

A likely target is Poland. Its advertising market is forecast by Zenith Optimedia to grow at least 5% a year through 2012, from US\$1.8 billion last year to about US\$3 billion five years from now. Polsat is the commercial market leader, and although owner Zygmunt Solorz-Zak sold a chunk to Germany's Axel Springer, Polsat TV is set for an IPO, and CME could look to make a move. Meanwhile, Poland's TVN has been wooing investors with its performance, and parent ITI might look to cash out at some point.

Garin says CME is interested in Poland but won't jump into anything there. "Poland is a great market, but remember a lot of this is driven by the sheer size of the country," he said. "We would love to be there, but we will wait for the right deal rather than enter at all costs."

A move into Hungary is also highly likely. By moving into that nation, CME could take advantage of subregional synergies with its Romanian operations, thanks to the large Hungarian community in Romania and the 1 million or so Roma-

nians living in Hungary. Arguably less eye-catching, but equally likely, are more moves into the former Yugoslavia. With assets in place in Croatia and Slovenia, TV assets would likely be on the block for relatively inexpensive amounts in Serbia and Macedonia.

Digital options

Beyond acquiring analog free-to-air stations, CME is likely to expand its multichannel presence. Although multichannel penetration is relatively high in the Czech Republic and Romania – according to TVI publisher Informa Telecoms & Media, the figures are 29% and 59%, respectively – digital-TV take-up is below 5% in most CME markets. DTT is not expected to begin until 2009 at the earliest in the Czech Republic, meaning analog cable channels are the most likely expansion route for now. It operates eight thematic channels in the region and operates an expatriate version of Ukrainian net Studio 1+1 in the U.S. via DirecTV.

"We continue to pursue as aggressively as we can a multichannel strategy, which we have done very well in markets such as Romania," Garin said. "We now have four channels in Romania, and revenues have rocketed as a result." CME's Romanian revenues were up about US\$15 million last year.

Garin is confident that CME, as

the biggest TV player in the region, has the clout to succeed in the multichannel arena. "With multichannel, you need scale to do this, and we have that," he said. "Library channels work well, but without local content they will simply struggle. But we have both library and local content."

Although slightly less developed, CME's new-media strategy is rapidly finding favor with investors. The company has aggressive plans to expand its new-media businesses in all six countries in 2007. Given lower disposable income and broadband take-up in the company's geographic markets compared with Western Europe and North America, CME says it has a better opportunity to capitalize on new media than the local competition does. The company plans to invest US\$10 million this year in new media.

"We find that broadband is now growing finally," Garin said. "Conditions are now good. New media is like any prime real estate. We want to own that real estate. The goal for the next two years is to invest and establish a leadership position without having to acquire an existing online asset."

Investment bank Morgan Joseph recently wrote: "Given the opportunity to invest in Internet ahead of other entrants, we believe the additional investments are prudent and will support further company-wide growth over the long-term."

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Digital switchover

Unlike its peers in Western Europe – where the take-up of digital TV is high – CME has yet to see its audiences fragment. Digital-TV take-up in Central and Eastern Europe stands at just 6%.

With many countries in the region now full-fledged members of the European Union, the pressure for them to switch terrestrial signals to digital is growing. The move from a three- or four-channel analog terrestrial environment to a multichannel world would change everything for CME. The company wants to play a role in the rollout of digital terrestrial but has grave concerns about DTT's viability in the region.

"None of the DTT models that I've seen take into account the realities of our business," said CME's chief execu-

tive, Michael Garin. "I don't understand how a regulator can promote a technology without explaining to consumers how it's going to be paid for. It makes very little sense to me."

In the case of the Czech Republic's DTT plans, Garin is downbeat. "If you look at the Czech Republic, it has 3 million households, and let's assume that [a DTT network] is very successful and gets a third or a 50% penetration," he said. "And let's assume that half of those are watching, say 750,000, and that network for a given program gets a 5% audience share. So that's 37,000 households. It's a lot cheaper to gather them up on buses and put them in a football stadium with the programs on a truck. I don't think this has been very well thought through. And I haven't seen any model

that says to me that DTT networks in small countries have any possibility of succeeding."

In the Czech Republic, CME applied for licenses to operate four DTT channels, but its bid was denied, with all DTT licenses going to a variety of local players, none of which had operated TV stations previously. CME complained to the local courts, and the regulator, RRTV, must now issue a new tender for the licenses.

"I told the regulator, 'You are going to end up with a bunch of networks that are bankrupt in a few years,'" Garin said. "Our view towards DTT and switchover strategy is to support everyone. We were the first network in the Czech Republic to be ready for DTT. But my view is that regulators need to be realistic."

Chronology

1990 Ronald Lauder and Mark Pramer form Central European Development

1992 Lauder and Pramer team up with Vladimir Zelezny to create CET 21

1994 Central European Media Enterprises formed to operate TV Nova. CME listed on the Nasdaq exchange later that year

1995 CME launches Pro TV in Romania and Pop TV in Slovenia

1996 Launches Markiza TV in Slovakia, Studio 1+1 in Ukraine and Puls in Germany

1997 Launches TVN in Poland and TV3 in Hungary. Closes Puls in Germany

1998 Sells TVN back to SBS

1999 Fires Zelezny, and he appropriates TV Nova license, sparking legal dispute

2000 Acquires Kanal A in Slovenia

2001 Stockholm court rules in favor of Lauder

2002 CME receives US\$27.1 million in cash from Zelezny

2003 CME awarded US\$358.6 million from Czech authorities

2005 Acquires Galaxie Sport, a cable sports channel serving the Czech Republic and Slovakia. CME begins trading on the Prague stock exchange

2006 Apax Partners acquires indirect stake in CME from Ronald Lauder for US\$190 million. Launches international version of Ukraine net Studio 1+1 in the U.S. via DirecTV. Slovakian net TV Markiza gets 12-year license extension