Big deals keep on turning.

US *entertainment, media and communications deal insights*

Second quarter 2014 edition

August 2014

A publication from PwC's Deals practice

At a glance

*Deal volumes flat but **deal value** remains sky-high.*

*Number of **megadeals** outpace last year.*

***A return to our roots . . .Publishing** deals ramp up*

***Private equity** takes a greater share of EMC deals.*

Spotlight article:

*Thinking about buying a **young, high growth tech company?***

***Valuation tips** for the thoughtful dealmaker.*

Introduction

As we pushed through the second quarter of 2014, we continued to see EMC companies transforming themselves and shaking the foundations of their industry in the process. Businesses are employing new and innovative deal structures and pursuing strategic acquisitions that leverage their core strengths yet push the envelope to capture long term growth opportunities.

Shown below are some key data points from the second quarter. While the announced acquisition by AT&T of DIRECTV for $48B is by far the largest deal, there are four other billion+ dollar deals – or megadeals –that are poised to change the EMC landscape. The merger attempts (and failures) making the headlines now are equally as ambitious.

Staying relevant with today's M&A activity, the Spotlight article discusses valuing young, high growth technology companies: **How to think about valuing emerging technologies.** There is tremendous potential for deriving value from an early-stage technology company for thoughtful dealmakers who make the upfront investment in identifying key valuation drivers. This article is a nice primer when looking at companies whose valuations may be difficult to estimate.

As always, we are open to feedback from our valued readers so please contact me directly with your thoughts.

Best regards,

Bart Spiegel

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Partner, Entertainment, Media & Communications Deals, PwC

PwC Q2 2014 Deals: At a glance

Deals on wheels

$74B second quarter deal value in billions

By the numbers

▲ 50% increase in megadeals (>$1B) from last year

Talk of the town

48 purchase price in billions. AT&T's announced acquisition of DIRECTV is the largest deal this quarter

Leading the charge

Advertising & Marketing with 53 deals
Publishing with 42 deals
Internet with 40 deals

Dealmakers

21% US deals with a private equity purchaser — up from 17.1% last quarter

Looking overseas

100 deals by US acquirors of foreign targets — up from 79 last year

Spotlight article: How to value emerging technologies

There's tremendous value to be captured, if you pay the right price.

First quarter 2014 M&A trends

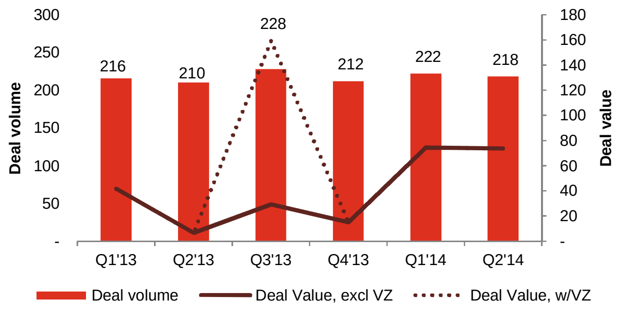
Announced deal volume remained strong in Q2 with deal values at $74 billion, up $67 billion over Q2 last year

Announced deal value was driven by yet another major consolidation in the Cable subsector with the announcement of a potential merger of AT&T and DIRECTV valued at $48 billion. This is the second transaction of this nature this year, following the announcement of Comcast's $46 billion acquisition of Time Warner Cable in Q1'14.

Deal volumes remained steady in Q2'14 at 218 deals, compared to the prior quarter of 222 deals. Volumes are up slightly compared to the same quarter prior year which had 210 announced deals (an increase of 8 deals or 4%).

Comcast/TWC deal spikes transaction value

US EMC announced deals



Source: Thomson Reuters

A year of the megadeal

After four announced "megadeals" (in excess of $1B) in Q1'14, an additional five megadeals were announced in Q2'14. Year over year, megadeals have increased by 50%, from 6 in 1H'13 to 9 in 1H'14. Q2'14 was led by:

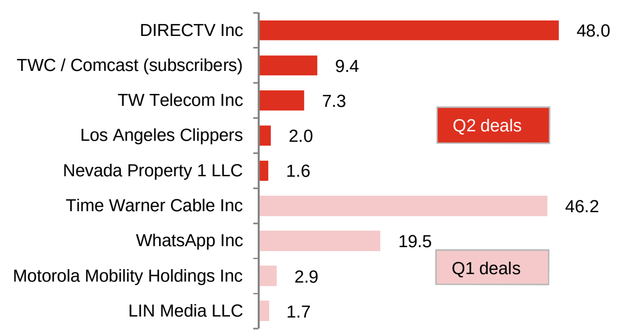
- AT&T/DIRECTV – allowing for a combined company competing in both the cable and communication subsectors. This transaction gives AT&T access to a broader domestic subscriber base to drive increases in bundled product offering revenue. [1]

- Divestiture of TWC/Comcast subscribers – approximately 1.4m TWC subscribers will be sold to Charter Communications and 1.6m of Comcast subscribers will be exchanged for Charter subscribers in certain markets, Additionally, 2.5m of Comcast subscribers will be spun off and listed as a separately traded public entity which Charter will manage and have a 33% ownership interest. Comcast shareholders will maintain majority control of the Company. [2]

- Level 3/TW Telecom – giving Level 3 a domestic position to broaden their Enterprise services, including internet access and online-based voice calling. [3]

Billion-dollar megadeals

YTD June 14 Megadeals (> $1B)



Source: Thomson Reuters

Quarter in review: Active sub-sectors

Advertising/Marketing and Publishing leads deal volumes

US EMC announced deals by sub-sector

	Deal Volume		Deal Value [3]	
$ in millions	Q1 Mar'14	Q2 Jun'14	Q1 Mar'14	Q2 Jun'14
Advertising & Marketing	52	53	633	741
Publishing	29	42	125	259
Internet Related / Information Services	46	40	20,711	94
Communications [1]	29	24	3,042	8,680
Recreation & Leisure	20	19	20	2,636
Broadcasting	12	16	1,890	710
Film / Content [2]	18	11	1,382	405
Casinos & Gaming	1	6	20	2,352
Cable	10	5	46,682	57,743
Music	4	2	10	2
Video Games	1	-		-
Total	**222**	**218**	**74,516**	**73,624**
Total Q2 Jun'13		210		6,583

[1] Classified as "Telecommunications" within the Thomson Reuters database.
[2] Classified as "Motion Picture/Audio Visual" within the Thomson Reuters database.
[3] Represents transaction value and not enterprise value

Source: Thomson Reuters.

Subsector commentary

1. *Digital media explosion*

Advertising & Marketing

Advertising and marketing remained the most active subsector in Q2'14 led by deals in the digital, online and mobile advertising arena which accounted for 20% of total advertising/marketing deals. Interest from foreign and private equity investors has also sparked deal activity in Q2'14, representing 38% of total advertising/marketing deals compared to only 25% of total deals in Q1'14. As more advertising dollars are channeled towards the internet and mobile, those advertising & marketing companies that have established a compelling value proposition and measured success will remain attractive targets. As described in our Global Entertainment and Media Outlook 2014 - 2018, Mobile and Internet based advertising spend are projected to increase at 22% and 16% CAGR respectively, from 2013-2018. These advertising channels are projected to rise to a combined spend of $25 billion by 2018 (16% of total advertising spend, up from 9% in 2013).

2. *The future of communications*

Telecommunications

a. Deal activity in Q2'14 was driven by the announcement of Level 3's acquisition of TW Telecom for $7.3 billion. Level 3's acquisition of TW Telecom (managed network services) allowing the company to provide service to the enterprise, government, and carrier markets – combining TW Telecom's local North America assets with Level 3's global assets[4]. Total deal value soared to $8.7 billion compared to only $3.0 billion in the prior quarter.

3. *The news on newspapers*

Publishing

Deal volumes in Q2’14 were driven primarily by the acquisition of newspaper, books and magazine publishing related assets. The sector has seen growth in the recent quarter in both newspaper/news and digital related publishing assets. The spurred interest can be seen most strongly in continued consolidation of regional newspaper assets (15 deals in the first half of 2014). Digital publishing assets are also likely to be attractive targets as companies look to establish and expand their presence in the digital value chain.

4. *Slam dunk*

Recreation & Leisure

Recreation & Leisure announced deal values increased significantly during Q2’14, dominated by recent NBA franchise transactions. The second quarter saw continued PE / high-net-worth individual interest in sports franchises with the purchase of the Milwaukee Bucks and LA Clippers for $0.6 billion and $2.0 billion respectively. The terms of the NBA’s next national television deal (beginning during the 2016-2017 season) will likely have a significant impact on overall franchise valuations going forward. [5]

5. *Giants combine*

Cable

Cable industry announced deal values during Q2 were driven by the landscape changing megadeals discussed above (AT&T’s purchase of DIRECTV for $48 billion in Q2 coming on the heels of Comcast’s purchase of Time Warner Cable for $46 billion in Q1). This transaction gives AT&T a significantly stronger presence in the Pay TV space and allows for the bundling of wireless voice/data service with satellite TV. From a content cost perspective, this transaction would also give the combined company additional bargaining leverage with respect to retransmission fees [6].

6. *Ante up*

Casinos & Gaming

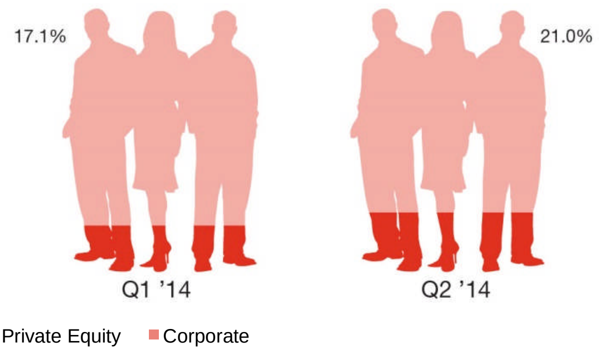
Casino & gaming deal value was significantly impacted by Blackstone’s $1.7 billion acquisition of the Cosmopolitan Resort in Las Vegas. The acquisition points to a recovery in the world’s second largest gambling market, and illustrates the attractiveness of Las Vegas properties which generate a large share of revenue from non-gaming amenities. [7]

Private equity's fast break

Private equity acquirers represented 21% of total US EMC deals in Q2'14, which is a significant step up from Q1'14 of only 17%. Private equity acquisitions were prevalent across a number of EMC subsectors, but were most active in the Advertising & Marketing, Publishing, and Recreation and Leisure.

Private equity picks up 4% more deals

US EMC deals: corporate vs. private equity mix



Source: Thomson Reuters

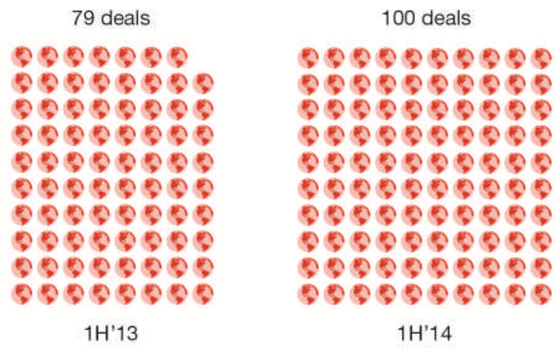
Outbound deals

The number of announced deals by US companies acquiring overseas targets ("outbound deals") remained consistent in Q2'14 when compared with Q1'14. On a year-to-date basis, 2014 is outpacing the prior year by 21 deals or 27%. Europe and Asia-Pacific regions dominate outbound deal activity, accounting for 80% of outbound deals in Q2'14.

- Advertising & Marketing and Internet Related/Information Services continue to be the two most active sectors for outbound deals, representing 60% of total outbound deals (versus 44% in Q1'14).
- Q2'14 saw a retreat of heavy outbound Communications deal activity from 13 deals in Q1'14 to only 3 in Q2'14.

Outbound deals continue grow by 27%

EMC cross-border deals by US acquirers



Source: Thomson Reuters

Spotlight: How to think about valuing emerging technologies

The EMC landscape is replete with examples of industry participants, both new and old, making interesting and unique investments to stay ahead of shifting industry dynamics. These changing dynamics are driving increasing levels of competition amongst legacy and new industry participants, which, in turn, is disrupting the distribution of industry profits. Although disruption poses challenges, it also often leads to opportunity, and many EMC companies are moving to take advantage by investing in differentiated assets. The EMC industry has experienced its share of large, transformational transactions, but several recent investments have been smaller in scale and pointed at emerging technologies (e.g., Comcast buying FreeWheel, Verizon buying Intel Media, and European broadcaster RTL Group making an investment in SpotXchange, a marketplace for digital video advertising). Making acquisitions of early-stage technology companies creates unique valuation challenges and heightens the need to maintain discipline throughout the M&A process. In this spotlight article, we highlight some of the critical valuation challenges that EMC dealmakers should manage in this environment.

Understanding the source of value creation

Before tackling specific inputs and valuation models, the starting point for any deal should be a qualitative assessment of a target's existing or emerging competitive advantages. Competitive advantages lead to excess returns on invested capital, the ultimate source of value creation. As buyers frequently pay for some or all excess returns expected to be generated by a target, failure to fully understand the competitive advantages driving the returns, and the sustainability of such advantages, can lead to critical valuation errors and value destruction for a buyer's shareholders. This is especially true for acquisitions centered on developing new, and perhaps unfamiliar, capabilities.

A key output on any potential transaction should be a specific analysis about competitive advantages. Such an analysis would identify the key drivers of a competitive advantage. For example, does a target have a first mover advantage, a technology that is protected by patents or difficult to replicate, or scale that creates a barrier to entry? This analysis should also assess the sustainability of a competitive advantage over time.

Beyond building the strategic rationale for doing a transaction, an analysis of competitive advantages also serves the purpose of helping to identify appropriate valuation methodologies for a given target and the data needed for those methodologies. For example, a competitive advantage that is relatively easy to replicate may suggest value is primarily a function of the costs to create the asset. In these cases, which are more commonplace for early stage companies, a buy versus build analysis often establishes the valuation framework. While conceptually simple to understand, this framework is not without its challenges. In build scenarios, certain relevant costs, both direct and indirect, are frequently overlooked, including opportunity costs such as profit lost (compared to a buy scenario) as a result of a long development cycle, or the development risks associated with creating the technology. On the buy side, the time, effort, and cost it will take to integrate the acquired technology with the buyer's existing service offering should be assessed.

A competitive advantage that is relatively difficult to replicate may suggest value is primarily a function of future cash flows because the advantage cannot be easily recreated. Here, income-based valuation methodologies are typically used to measure future excess return on capital. This approach pose unique challenges as well, especially for younger companies that do not have long histories of financial performance that may be considered when developing projections of future cash flows, which leads us to the second valuation challenge in valuing early-stage technology companies – projecting cash flow.

Upside, downside

In income-based methodologies, value is a function of future cash flow. More specifically, value is a function of *expected* future cash flow. Expected cash flows are not optimistic or pessimistic, aggressive or conservative, best or worst case. Instead, expected cash flows are a probability-weighted average of possible outcomes. Expected cash flows are unconditional; achieving the forecasts is not conditioned on a specific event. Thus, expected cash flows require a more robust and challenging forecasting process, but which ultimately enhances the understanding of the equation between price and value.

We frequently find that M&A practitioners do not spend sufficient time on relevant scenarios, and the probability of each occurring, in analyzing expected cash flows. Although somewhat less problematic for mature companies, insufficient scenario forecasting in early-stage and/or high-growth environments can result in significant valuation errors. In general, attention to commercial diligence is at the core of best practice in cash flow forecasting and is an excellent way to infuse dynamic assumptions into a valuation model. Overall, a deep focus on the source and sustainability of competitive advantages is a major step towards valuation best practices.

Some other factors to consider when deriving expected cash flow forecasts for technology companies include:

- *Strength of underlying technology/patents* – As noted earlier, a given technology may be difficult to replicate, which generates a significant competitive advantage. In cash flow modeling, this advantage translates into excess returns on capital. Attention should be given to how the target's technology compares to competing technologies, which will impact assumptions around revenue growth, gross profits, and R&D expenditures.

- *Variability in projected cash flows* – All companies have upside and downside scenarios, but the variability in cash flows for technology companies can be significant. At the extreme, a cash flow forecast may reflect a binary outcome – i.e., an in-development technology may fail and generate negative cash flows, or succeed and generate positive cash flows. "Framing" exercises help identify realistic scenarios to consider in a valuation.

- *Focus on the residual calculation* – In the valuation of many early-stage, high-growth technology companies, the value of cash flows expected to occur after a discrete forecast period (i.e., the "residual value") often exceeds 50 to 100 percent of total business value. As such, careful attention should be paid to embedded assumptions about value drivers in this calculation. The most significant concern is tied again to an understanding of competitive advantage. We frequently observe practitioners simply capitalizing expected performance in a final discrete period forecast into perpetuity. This assumes whatever excess returns on capital – i.e., whatever competitive advantage – exists in the final discrete period will continue forever. Yet in most industries, excess returns tend to revert to zero over time because of competition. Residual values should be assessed for reasonableness by disaggregating the calculations into implied assumptions about return on capital, growth, and the investments required to generate both.

Market multiples are not an escape hatch

Given the complexities of cash flow forecasting in early-stage environments, some would argue income-based methodologies should be abandoned in favor of market-based observations of value (e.g., market multiples of revenue). However, adopting this approach does not offer an escape from analyzing value drivers. Market multiples are outputs, not inputs. That is, multiples simply emerge from observed market values, which are driven by the same core value drivers of risk, growth, and return on capital. As such, when a multiple is applied to a valuation subject, it is assumed the subject shares capital returns, growth, and risk similar to the peer companies used to derive the multiple. That may be a reasonable assumption, but the only way to know is to analyze the expected cash flow of the valuation subject. This may be even more critical for an early-stage company because market multiples may *understate* value as public companies may be deeper into their operating life cycle and past their peek growth opportunities.

There is no such thing as intrinsic value

A major challenge for EMC companies pursuing technology companies is competition from buyers whose capabilities are better aligned with the targets', namely other technology companies as buyers. These buyers often have significant advantages in their capacity to realize value – for example, through synergies – from the transaction, and thus may be able and willing to pay more. As such, there is no such thing as intrinsic value – rather, there is a different value for different operators, which reflects each operator's unique operating strategies and potential synergies. A robust deal valuation model should consider these differing value perspectives to inform a negotiation strategy.

Conclusion

As industry trends continue to drive heightened competition amongst legacy and emerging competitors, we expect more traditional EMC companies to continue to seek M&A opportunities in non-traditional spaces, such as early-stage, high-growth technology companies. Given the valuation challenges highlighted above, deal makers will be well served by investing time and effort in valuation on the front end of transactions to avoid surprises on the back end. Robust valuation diligence that focuses on the source and sustainability of value creation and effectively considers the relationship between price and the value perspectives of different buyers, can improve the odds of maximizing shareholder value and return on investment for the buyer.

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About PwC's Deals practice

Smart deal makers are perceptive enough to see value others have missed, flexible enough to adjust for the unexpected, aggressive enough to win favorable terms in a competitive environment, and circumspect enough to envision the challenges they will face from the moment the contract is signed. But in a business environment where information can quickly overwhelm, the smartest deal makers look to experienced advisors to help them fashion a deal that works.

PwC's Deals group can advise Entertainment, Media & Communications (EMC) companies and EMC-focused private equity firms on key M&A decisions, from identifying acquisition or divestiture candidates and performing buy-side diligence, through developing strategies for capturing post-deal profits, to exiting a deal through a sale, carve-out, or IPO. With more than 9,800 deals professionals in 75 countries, we can deploy seasoned deals teams that combine deep entertainment, media & communications industry skills with local market knowledge virtually anywhere and everywhere your company operates or executes transactions.

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In short, we offer integrated solutions tailored to your particular deal situation and designed to help you complete and extract peak value within your risk profile. Whether your focus is deploying capital through an acquisition or joint venture, raising capital through an IPO or private placement, or harvesting an investment through the divesture process, we can help.

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About the data

Our analysis highlights the on-going changes in the EMC industry due to technology advances, the convergence of traditional and new media, and ever-shifting consumer preferences. For purposes of our publication, we have focused on the following sectors:

- Communications
- Recreation & Leisure
- Film/Content
- Cable
- Broadcasting
- Internet Related/Information Services
- Publishing
- Advertising & Marketing
- Casinos & Gaming
- Music
- Video Games

Our analysis was based primarily on individual EMC sectors as defined by ThomsonReuters, with the exception of Telecommunications and Internet Software & Services and E-Commerce, which we have renamed as Communications and Internet Related/Information Services, respectively, for the purpose of our analysis. In addition, all deal values disclosed, unless otherwise noted, were determined using transaction value. While in certain cases, enterprise value may exceed transaction value, it has not been considered in our analysis.

We define US EMC transaction activity as acquisitions, mergers, consolidation of minority interests, shareholder spin-offs, divestitures and restructurings. Acquisition targets are defined as US companies acquired by either domestic or foreign acquirers (both corporate and private equity). Cross-border deals in this publication have been limited to announced acquisitions of targets located outside of the United States by US acquirers. Deal value is transaction value as reported. Private equity transactions are defined as acquisitions of initial platform companies only. Subsequent add-on acquisitions by private-equity-controlled platform companies are herein classified as corporate transactions.

As has been the case over each of the past several years due to undisclosed deal activity, FY13 and FY14's disclosed deal volume was significantly lower than total EMC deal volume. Although transactions with disclosed deal values are indicative of overall EMC sector trends, the high volume of undisclosed deal activity is also indicative of growing middle-market deal activity in the space.

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