Why Entertainment and Media companies should reassess asset valuation in the Digital Age

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At a glance

Intangible assets are often key components of entertainment and media (E&M) business value.

Many of the traditional intangible assets common to E&M businesses have evolved. The methods employed to value these assets—while still valid—may ultimately need to evolve in the interest of improved reporting in today's quickly changing new media world.

By refocusing acquisition accounting methods, E&M companies can better align the economics of their transactions with key value drivers in the Digital Age.

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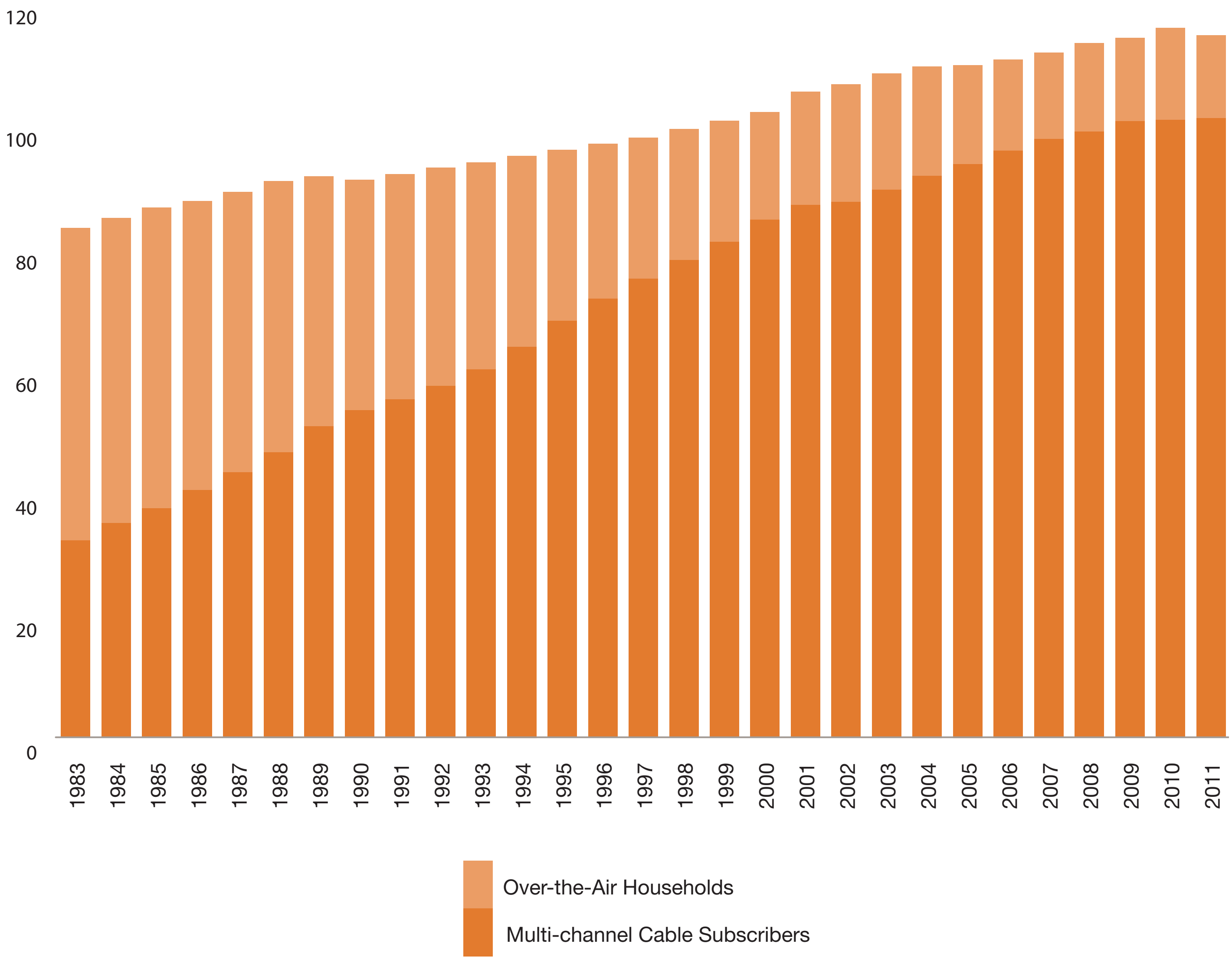
The behavior and expectations of consumers of Entertainment and Media (E&M) content are changing. What started with a shift in how consumers view television (see chart on next page) has evolved to audiences taking more control of their viewing experience—watching content anytime, anyplace, and on any device. As a result, E&M companies are being forced to adapt their business models and create new ways to connect to their target audiences.[1] Additionally, the value drivers behind many E&M mergers and acquisitions have changed as well.

Accounting rules (ASC 805) require companies to recognize intangible assets acquired in a business combination at fair value. Intangible assets—such as advertiser relationships and drivers of market share—are often key components of E&M business value.

However, many of the traditional intangible assets that exist in E&M businesses and the methods employed to value them may need to start evolving in this quickly changing environment. Traditional valuation techniques that have served the E&M industry well may eventually start giving way to alternative methods for calculating the value acquired in an M&A deal.

1 For additional information on evolving consumer trends, visit: pwc.com/consumerintelligenceseries

Changing US television viewership (millions)



Source: SNL Kagan

Overview: Three key valuation areas E&M companies should reassess

This publication explores how E&M consumer trends may start driving corresponding changes in asset valuation in three interrelated areas:

1. Valuing registered users

Television and movie audiences have always been valuable. But they have typically represented a mass of nameless consumers without any real ability to identify or contact them. Consequently, these viewers couldn't be valued or recognized as an asset for financial reporting purposes.

With the rise of digital distribution and social media, E&M companies place significant emphasis on identifying, retaining, and monetizing their audience. In turn, the ability to identify viewers/users creates challenges in valuing this relatively new asset.

2. Valuing advertiser relation-ships

In the not-so-distant past, advertisers had developed relationships with broadcasters, cable networks, and websites. Now, with potentially hundreds of channels and websites to choose from, advertisers are focused on viewer/user demographics and ratings more than developing ongoing relationships.

If a channel, program, or website can generate viewership in key/desirable demographics, advertisers won't be far behind. We've observed fewer M&A deals in the E&M industry where advertiser relationships are a significant value driver. At what point will the traditional approaches to valuing advertiser relationships need to change?

3. Valuing FCC licenses

The television broadcast landscape has changed drastically over the last 30 years. While there were only 32.2 million cable subscribers in the US in 1983, as of 2011, there were 101.2 million subscribers (including households subscribing to satellite and telecom-based television services). As of 2011, only 13.5 million households were viewing television only through over-the-air broadcast. Given this changing landscape, at what point do we need to revisit the traditional approaches to valuing FCC licenses?

The remainder of this publication explores these three key areas in greater detail.

In 2011, only 13.5 million households were viewing television only through over-the-air broadcast.

1. Nameless viewers to registered users

Expanding into digital distribution, social media, and online gaming has created opportunities for E&M companies to identify viewers/users by having them register for services. Once users register, their viewing habits, usage statistics, and other information can be used to tailor content and services. Not only does this raise much publicized privacy issues but it also has accounting and reporting implications in M&A deals.

In recent years, acquisitions of companies with the ability to identify, monitor and track visitors/users have increased. Due diligence has also started focusing more on this information. Acquirers are very interested in understanding how often users access various products/services, as well as their demographic statistics, attrition rates and other factors.

Websites and digital distribution companies may have many non-registered users for every registered user. However, these non-registered users are not likely to meet the definition of an asset for recognition separate from goodwill; they do not represent relationships that are contractual or separable. The registered users, however, are likely to meet the recognition criteria.

The difficult question becomes how these registered users should be valued. The answer may be different for each scenario, but cost-based or income-based methods are common approaches (see separate discussions of each highlighted on the next page).

Cost approach

In valuing users (as discussed on the previous page), the cost approach will likely be employed **to value the users of free-to-use services** (i.e. non-paying users). However, assessing the cost to recreate a group of registered users can be complex. Websites often track their costs for generating users but this data can come in different forms.

Some businesses track advertising spend and the number of new registered users every month to calculate an average "cost per new user". Looking at these data over an extended period may help develop a reasonable estimate of the average cost to acquire a registered user.

Other websites advertise on a "cost per click" basis, providing a more direct estimate of the cost of driving a potential user to the site. This, however, needs to be coupled with a "conversion rate"—or an estimate of what percentage of traffic actually registers and becomes a regular user of the web site or mobile app service.

An increasing number of services and websites are actually growing through word-of-mouth rather than paid advertising, especially in the social media space. In these circumstances a cost approach may be difficult to employ, as the true cost of the users historically was measured in time rather than dollars. A cost-based approach may become more theoretical for these businesses (i.e. if the business did grow through advertising, how much would it cost to replace the user base?).

Income approach

In valuing users (as discussed on the previous page), for **businesses with paying users**, a traditional excess earnings method may be more appropriate than using a cost approach to valuation. However, the user base of companies who grow through word of mouth may be also appropriately valued under an income approach through a lost-profits analysis.

Under a lost-profits analysis or a "with and without" method (see separate box on next page), values of the registered users are assessed by looking at the business' expected cash flows if one were hypothetically to remove the existing users. By comparing these cash flows in a hypothetical "without" scenario to the cash flows of the business "with" the users in place, one can calculate the value of those users. This method requires assessing the time required to reestablish a user base and the profits that would hypothetically be lost during this period.

For more established companies, developing the appropriate assumptions may be difficult. But for early-stage businesses that recently created their user base, the historical experience may be a reasonable basis for a lost profits analysis.

2. Are advertisers still a primary asset?

In the early days of television, most markets had a small selection of channels showing programming only during certain times. Relationships with advertisers (often local) were key to a broadcaster's ability to generate revenue.

Over time, the landscape slowly grew to include additional channels and expanded broadcast times. Today, there are hundreds (if not thousands) of channels or other distribution vehicles delivering content 24/7.

With audiences split between so many channels, companies increasingly look to place ads based on audience demographics rather than relationships with particular broadcasters. Advertiser who want to reach young men aged 18 to 24 may look beyond advertising loyalties to seek out channels or programs popular with that demographic.

The same can be said of internet advertising. In the past, a fairly small number of websites produced the majority of traffic and advertising dollars. Today advertising on the internet has become more targeted with visitors often presented with advertisements for specific items/topics based on their recent browsing history.

E&M companies have recognized this shift from relationship-based advertising to one based on audience share and demographics. As a result, much more emphasis is placed on content and carrier relationships than advertiser data during due diligence.

The shift in industry dynamics may require reassessing whether to value acquired advertiser relationships under an excess earnings method or a "with and without" method (see box below).

Valuing advertiser relationships: Using the "with and without" method

The "with and without" method is being used more frequently to value advertiser relationships. This recognizes the primary value of advertiser relationships in place immediately after an acquisition.

In the "without" scenario, we estimate the costs (both direct and opportunity costs) associated with negotiating with advertisers and the time the negotiating process takes.

Generally, if a company generates advertising revenue because of audience share or demographics rather than relationships, we would not expect significant costs or a long negotiation period. The value of advertiser relationships is typically reduced, as a result.

This conclusion seems reasonable for advertiser relationships that are easily replaceable. Why would a market participant assign significant value to an asset that could be replaced with little cost and effort?

If advertiser relationships aren't the "primary" asset, what is?

The primary intangible asset of any business is often the one that directly generates cash flow. This thinking has traditionally led to viewing the advertiser relationships as the primary asset by default (as this is the direct source of revenue).

Viewing advertising revenue as a by-product of the broadcaster's or web-site's ability to attract an audience and/or demographic requires identifying the assets attracting the audience. In most cases, the driver(s) are likely to one or all of the following:

- Content (library and pipeline)
- Brand/trademark
- Multichannel Video Programming Distributor (MVPD)
- Users/subscribers

There are no easy answers. The insights related to the time it takes to replace advertiser relationships can extend to MVPD relationships. Furthermore, up until recently MVPD relationships whereby the MVPD paid the channel for carriage primarily only existed for cable networks. With the growing demand and rising prices commanded for "retransmission" arrangements, broadcast networks and their underlying stations are increasingly entering into such arrangements.

For networks with significant clout in negotiating—or even demanding—carriage, an MVPD relationship may not be the primary asset, as it would be easily replaceable. However, in circumstances where negotiations around carriage were significant, valuing MVPD relationships with a traditional excess earnings method may be appropriate.

3. How important are FCC licenses today?

Before cable and satellite television became so prevalent in the US, a Federal Communications Commission (FCC) license was required to start any television station. Today, with a small percentage of households viewing television through over-the-air signals, broadcast licenses from the FCC have become less important. Even local television channels reach most of their viewership through cable and satellite networks. It may be overstating the case (and he may not be a noted authority on the topic), but it's interesting to note a recent Supreme Court discussion in which Justice Samuel A. Alito Jr. stated "Broadcast TV is living on borrowed time. It is not going to be long before it goes the way of vinyl records and eight-track tapes."

Historically, the *Greenfield Method* has been the most common way to value FCC licenses. This method estimates the value of a start-up station that owns only the FCC license and has to purchase, build, or rent all of the other assets needed to operate. The key assumptions when applying this approach relate to expected market share, margins, etc. and care must be taken not to "double count" the benefit from any network affiliations or other assets that exist. Given the subjectivity required in making these assessments and the fact that the E&M industry continues to evolve, we believe alternative ways to value FCC licenses should be considered.

Is the Market Approach the future?

In 2010, increased smartphone usage led the FCC to consider offering to repurchase licenses from broadcasters so the spectrum could be re-deployed for use by wireless carriers.

The FCC developed a National Broadband Plan which suggests allowing the FCC to conduct “Incentive Auctions” in which the current FCC license owners would receive a portion of the proceeds from the resale of their wireless spectrum. However, many industry participants are concerned that the auctions will not be voluntary.

If plans move forward with potential voluntary incentive auctions, this may provide good market evidence of FCC license values in the future. While the possible values of FCC licenses/spectrum at auction remains to be seen, it is certainly feasible that these licenses could have greater value at auction than ‘in use’ to television broadcasters.

Radio and international broadcast licenses

While television FCC licenses may have become less critical, many consumers continue to receive radio broadcasts over-the-air. The satellite and internet radio continues growing but has not approached cable and satellite television usage levels. As such, methodologies for valuing radio FCC licenses may not change for some time.

Similarly, in many international markets, over-the-air broadcast remains essential to operating a television or radio station. As cable networks are built out and satellite subscriptions increase, these international markets may follow a similar pattern to the US. Then, similar questions about the appropriate methods for valuing these licenses may arise.

Conclusion

Notwithstanding the variables outlined in this paper, consistency is a hallmark of quality valuation. However, the E&M industry is quickly evolving to take advantage of new media and distribution technologies. These trends may ultimately drive a fundamental shift in the way financial statement preparers and valuation advisors approach the industry.

The extent to which consumers have rewritten the rules for accessing content by exploiting a range of digital platforms warrants considering a fresh approach to valuing intangible assets. The most appropriate valuation approach will depend on individual circumstances and will continue evolving with the industry.

The industry should consider continually reassessing the status quo for accepted business value drivers. The need for transaction advisors to have industry expertise and understand how business drivers impact the valuation of intangible assets will also be increasingly important.

For assistance with your situation

PwC brings an integrated approach to acquisition accounting and provides teams of industry, accounting, due diligence, valuation, operational and tax experts to meet the needs of our clients.

Our Transaction Services practice has extensive experience with both the traditional E&M industry and the "New Media" areas that appear to be shaping the future of the industry. We can help our clients assess potential targets and the accounting impacts of acquisitions.

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