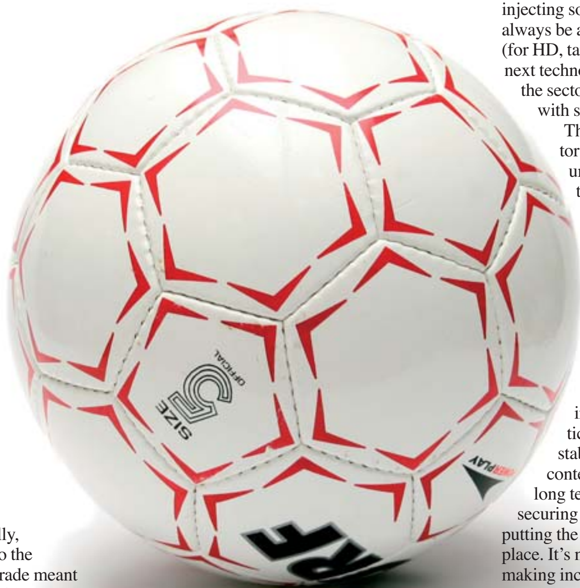
The investment game

As private equity activity continues apace in the industry, Alun Simpson looks at the league positions of different sectors and how they can gain the necessary backing from investors to climb to the top



ONE of the very few examples of investment banking humour is:
Q: How do you make a small fortune in TV?
A: Start with a large one.

In truth, the sector I've most often heard it applied to is football (if a banker goes through the unnatural pains of coming up with a joke, it'd better be reusable), but this old chestnut might just hold a lesson or two for both sectors.

Private equity investors are very explicit about what makes a good investment. In fact, click on any fund's website and you'll more than likely find a page labelled "investment criteria" or "investment approach". Ask a private equity manager to then rank their number one criterion and, almost without exception, they'll say management – probably followed by management and then management again.

This is, however, all about individual characteristics such as drive, entrepreneurialism and vision, and isn't terribly helpful when trying to rank the relative merits of parts of the media business. For that purpose, I've picked three other criteria that appear, if not as universally as management, at least on the majority of investors' wish lists. These are stability of earnings, cash conversion and market fragmentation.

All well and good, you may say, but what the hell do they mean? Let me illustrate with a recent example from the production sector.

Permira's £320m acquisition of All3Media in August represented a five times uplift in value on Bridgepoint's original investment. At the time of that deal in 2003, Bridgepoint had identified a sea change in the stability of the production sector. Specifically, changes to the terms of trade meant indies could generate new, more stable and recurring revenues from the likes of back catalogue sales and downloads, rather than being wholly dependent on the whims of the commissioners.

Bridgepoint will also have noted two points about how these revenues convert into cash. First, once the content is produced, the level of additional operational resources (opex) needed to generate these recurring revenues is pretty low (referred to by bankers as high operational leverage). Second, the production of this content does not require a significant level of investment in capital equipment (capex).

So, more stable revenues and pretty good cash conversion, but what about fragmentation of the market and why is this important? The more fragmented a market, the greater the chance to consolidate and gain the advantages of scale and a market-leading position. Such "buy and build" strategies are much loved by private equity and the fact it was Bridgepoint's game plan is clear because, in the three years it's owned the business, it grew All3Media from £90m to £160m revenues and to its current position as one of the largest UK indies.

At the risk of labouring the football theme, it's interesting to rank the different parts of the TV sector in terms of their counterparts in the Premier League.

Kit manufacturers come in pretty low – the Watford. Revenues, if not completely one-off, tend to be variable – and every additional piece of kit has an incremental material cost so there isn't great operational leverage. Then there's the drain on cash from the costs of investing in plant and R&D to keep up with technological change. Finally, the larger multinational players dominate the market so there's little scope to gain a dominant market position by consolidation.

Post-production is the Reading of the group – a chequered past but showing promise as a mid-table battler. Historically, the sector has suffered from poor visibility and stability of revenues, but the growing demand for services such as archiving and asset management is injecting some stability. Capex will always be a significant cash drain (for HD, tapeless, or whatever the next technology wave brings), but the sector remains fragmented with scope for consolidation.

The Spurs of my TV sector table – with great, but unfulfilled, potential – is the distribution market. There has been very little direct private equity investment in the sector – which is dominated by the offshoots of the broadcasters and production houses – but as a standalone business model, the distribution sector has very attractive investment characteristics. Revenues are pretty stable as long as rights and content deals are sufficiently long term. The key costs are securing these content rights and putting the sales infrastructure in place. It's not quite a case of then making incremental sales (across a burgeoning number of platforms) at zero cost, but certainly the operational leverage is very high and with minimal capex, a very large part of the revenue stream converts to cash. Again, it's a sector that has seen little private equity-led consolidation, but perhaps Ingenious Media's creation of Digital Rights Group shows that investors are beginning to spot the opportunities here.

Management, stability of earnings, cash conversion and fragmentation appear on investors' wish lists

When it comes to the high-profile TV production and broadcast TV sectors, I'd rank both somewhere in the middle of the table from an earnings stability and cash conversion perspective. In terms of market fragmentation, however, there's really very little more to be done in broadcast – at least on the terrestrial platforms – and the production sector, with the advent of the super-indies, is now a much more consolidated landscape than in 2003.

So what to make of these sectors – with deals such as All3Media and the abortive ITV bid – seeing some of the most significant recent private equity activity? Investors have often learnt the hard way the dangers of investing in sectors where others have established themselves and where the glamour can outshine the sector's economic shortcomings. If you're going to do it though, make sure you've got deep pockets and good management – just ask Chelsea.

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Post-production: showing promise as a mid-table battler

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