kotak® Institutional Equities

Eros International Media (EROS)

Media & Entertainment

BUY

March 09, 2011

INITIATING COVERAGE

Sector view: Cautious

Price (Rs): 140

Target price (Rs): 200

BSE-30: 18,470

Strong storyline. BUY. Eros International Media (EROS) is a leading Indian film studio with promising prospects arising from (1) rising market share in the Hindi film industry post the economic downturn, (2) expansion into emerging butlucrative regional film markets, (3) strengthening theatrical and digital distribution network, (4) increasing competition on C&S TV for film content and (5) large and expanding film catalog/library. We initiate coverage with a BUY rating and 12-month forward fair value of Rs200, based on 8.5X FY2012E EV/EBIT.

12-month forward fair value of Rs200 offers 40% potential upside

We initiate coverage on EROS with a BUY rating at 12-month forward fair value of Rs200, based on 8.5X FY2012E EV/EBIT, ~30% discount to regional print and ~35% discount to broadcasting in India. Our relative valuation comparables capture early stage of development coupled with strong growth of the Indian media industry (emerging ancillary revenue streams including C&S TV licensing); the discount captures film business dynamics.

EROS: Leading Indian film 'studio' with increasing focus on content

Eros group is the leading Hindi film studio in overseas markets with the widest distribution network and strongest movie library (>2,000 films). Eros International Media (EROS) is the Indian subsidiary of the group, transforming into one of the leading Indian films studios within the last decade establishing an extensive domestic theatrical and ancillary distribution network. EROS aims to (1) strengthen the content focus of the group, (2) increase its market share in Hindi film market and (3) expand in emerging regional film markets. EROS' large, diverse and expanding film library is the key differentiator versus peers.

Financials: Larger new release film slate, expanding catalog key drivers

We model strong 32% CAGR in EBIT between FY2011E-13E led by 27% CAGR in revenues driven by (1) larger new film release slate (rising market share), (2) transformation of Indian film industry (multiplexes, emerging ancillary revenue streams) and (3) expanding catalog of films; (4) decline in cost of film production (profit share with talent) and (5) reduced print costs (digitization of box office) are likely to be key margin drivers.

Key risks: Execution, costs, Hollywood, piracy, capital, Eros Group dependence

The key risks to the Indian film industry include (1) 'hit or miss' nature of business, (2) limited availability of quality talent, (3) slowdown in theatre expansion, (4) rising clout of Hollywood and (5) continued problem of extensive piracy. The key risks to EROS include (1) hard-to-predict TV licensing income, (2) dependence on Eros Group, (3) sustained capital requirement given 'long-tail' of revenues and (4) execution risks in new business initiatives.

Company data and valuation summary

Company data
Rating: BUY
Current price (Rs)
140

Stock data	High	Low
52-week range (Rs)	218	128
Yield (%)		—
Priced at close of:	March 9, 2011	
Capitalization		
Market cap (Rs bn)		12.8
Net debt/(cash) (Rs mn)		(0.5)
Free float (%)		21.9
Shares outstanding (mn)		91.4

Price performance	1M	3M	12M
Absolute (%)	(8.4)	(10.1)	0.0
Rel. to BSE-30 (%)	(12.7)	(6.4)	0.0
Forecasts/valuation	**2011**	**2012E**	**2013E**
EPS (Rs)	14.1	16.7	20.9
P/E (X)	9.9	8.4	6.7
ROE (%)	17.8	17.1	18.6
EV/EBITDA (X)	7.8	5.8	4.5

Source: Company data, Kotak Institutional Equities estimates.

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Important disclosures appear at the back

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The prices in this report are based on the market close of March 9, 2011.

FALL IN LOVE WITH THE ICON OF INDIAN CINEMA

Exhibit 1: Financials and valuations of EROS, March fiscal year-ends, 2008-13E

Year-end	Revenues		EBITDA		EPS		P/E
March	(Rs mn)	Growth (%)	(Rs mn)	Growth (%)	(Rs/share)	Growth (%)	(X)
2008	4,747		551		4.5		30.8
2009	6,265	32	1,298	136	11.8	159	11.9
2010	6,409	2	1,110	(14)	10.1	(14)	13.8
2011E	7,011	9	1,608	45	14.1	39	9.9
2012E	8,927	27	2,138	33	16.7	18	8.4
2013E	11,234	26	2,799	31	20.9	25	6.7

Source: Company data, Kotak Institutional Equities estimates

Exhibit 2: Financial summary of EROS, March fiscal year-ends, 2008-13E (Rs mn)

	2008	2009	2010	2011E	2012E	2013E
Profit model (Rs mn)						
Net sales	4,747	6,265	6,409	7,011	8,927	11,234
EBIT	**551**	**1,298**	**1,110**	**1,608**	**2,138**	**2,799**
Other income	6	13	26	115	156	166
Interest expense	(28)	(61)	(90)	(87)	(87)	(87)
D&A expenses	(18)	(50)	(44)	(41)	(52)	(52)
Pretax profits	**511**	**1,200**	**1,002**	**1,595**	**2,155**	**2,826**
Extraordinaries	149	(160)	121	—	—	—
Tax incidence	(233)	(291)	(295)	(403)	(570)	(774)
Minority interest	(16)	(14)	(5)	(28)	(42)	(118)
Reported PAT	**411**	**734**	**823**	**1,165**	**1,544**	**1,934**
Adjusted PAT	**330**	**856**	**738**	**1,165**	**1,544**	**1,934**
EPS (Rs/share)	**4.5**	**11.8**	**10.1**	**14.1**	**16.7**	**20.9**
Balance sheet (Rs mn)						
Total equity	814	1,580	2,375	6,938	8,481	10,416
Deferred Tax	88	280	498	718	1,010	1,393
Minority interest	22	40	42	70	112	230
Total borrowings	1,239	2,118	2,175	2,175	2,175	2,175
Currrent liabilities	**5,887**	**7,189**	**4,962**	**4,267**	**4,777**	**5,667**
Total capital	**8,050**	**11,207**	**10,052**	**14,168**	**16,555**	**19,881**
Cash and equivalents	1,182	361	1,072	2,686	1,944	2,486
Loans and advances	**3,060**	**5,148**	**3,709**	**4,675**	**6,028**	**6,950**
Other current assets	2,329	3,423	2,469	2,930	3,755	4,369
Total fixed assets	**1,419**	**2,195**	**2,723**	**3,797**	**4,749**	**5,996**
Investments	60	80	80	80	80	80
Total assets	**8,050**	**11,207**	**10,052**	**14,168**	**16,555**	**19,881**
Free cash flow (Rs mn)						
Operating cash flow, excl. WC	2,619	3,027	3,082	3,829	4,875	6,173
Working capital	579	(1,844)	218	(2,123)	(1,667)	(646)
Capital expenditure	(2,736)	(2,702)	(2,554)	(3,118)	(3,970)	(5,013)
Free cash flow	**463**	**(1,519)**	**746**	**(1,413)**	**(761)**	**513**
Adjusted FCF	**(117)**	**326**	**528**	**711**	**905**	**1,160**

Source: Company data, Kotak Institutional Equities estimates

VALUATION: 12-MONTH FORWARD FAIR VALUE OF Rs200

We initiate coverage on Eros International (EROS) with a BUY rating and 12-month forward target price of Rs200 (40% potential upside) based on 8.5X FY2012E normalized EBIT estimates. Our relative valuation comparables (Indian regional print and broadcasting) capture (1) early stage of development of Indian media industry, (2) inherent transformation of the industry (box office led by digitization, emerging ancillary revenue streams) and (3) robust growth in free cash flows led by rising market share (new releases) and an expanding catalog/library of movies. The ~30% discount to regional print and ~35% discount to broadcasting is due to inherent nature of the business: (1) difficult to predict or forecast success of films and (2) high working capital/capex requirements (reduced normalized free cash flows).

BUY rating with 12-month forward target price of Rs200

Our BUY rating and 12-month forward target price of Rs200 (40% potential upside) is based on 8.5X FY2012E normalized EBIT estimates, at ~30% discount to Indian regional print and ~35% discount to Indian broadcasting companies. We believe our relative valuation comparables effectively capture (1) early stage of development of Indian media and film industry, (2) inherent transformation of the industry (box office led by digitization; emerging ancillary revenue streams) and (3) robust growth in free cash flows led by rising market share (new releases) and expanding film catalog. The discount captures film business dynamics notably (1) project nature and lack of predictability of films and (2) high working capital/ capex requirements (reduced normalized free cash flows).

Exhibit 3: Indian regional print and broadcasting valuation comparables, March fiscal year-ends, 2011E-13E

	Price	Market cap	EV	Sales	EV/EBITDA (X)			P/E (X)			Valuation		Discount
	9-Mar	(Rs bn)	(Rs bn)	(Rs bn)	2011E	2012E	2013E	2011E	2012E	2013E	TP (Rs)	EV/E (X)	(%)
Eros International	**140**	**13**	**12**	**7**	**7.8**	**5.8**	**4.5**	**9.9**	**8.4**	**6.7**	**196**	**8.5**	
Regional print													
Jagran Prakashan	117	35	33	11	9.6	8.7	7.2	16.8	14.8	12.5	150	11.2	24
DB Corp Limited	238	43	43	13	11.1	10.1	8.3	18.8	17.0	14.0	310	13.2	36
Average					**10.4**	**9.4**	**7.8**	**17.8**	**15.9**	**13.2**		**12.2**	**30**
Broadcasting													
Zee Entertainment	126	123	112	29	17.0	12.7	9.9	26.3	20.4	16.1	130	13.0	35
Sun TV Network	427	168	164	20	15.4	12.2	9.9	23.4	18.8	15.7	460	13.2	36
Average					**16.2**	**12.4**	**9.9**	**24.8**	**19.6**	**15.9**		**13.1**	**35**

Notes:
(a) For Eros International and Sun TV Network, EBITDA corresponds to EBIT as they account for film costs under amortization.

Source: Kotak Institutional Equities estimates

Indian/global film/content comparables may not be valid

We believe several factors preclude the use of Indian film/content companies as comparable benchmarks to value EROS notably—(1) limited number of listed comparables in the Indian film/content segment, (2) strength of EROS' movie catalog, which may not be comparable with other companies (number/quality of films in catalog, length of rights) and (3) lack of standardization in accounting rules for amortization of content cost, which impacts near-term earnings of companies in the segment. We also highlight that EROS receives strategic and financial support from its UK-based parent as enumerated in the arm's-length Relationship Agreement, with implications on valuations.

EROS aims to replicate the global studio model of film production and distribution but there exist several limitations to using global benchmarks for valuing Indian film companies notably—(1) film entertainment companies and movie studio in international markets (notably US) are in a mature phase, (2) rapid transformation of the Indian film industry driven by evolving business models on the revenue (theatrical, ancillary) and cost (profit sharing) side and (3) variations in accounting schedules for amortization of cost of movie production and acquisitions by various companies within the sector. Nonetheless, we present Indian and global film/content comparables in Exhibit 4.

Exhibit 4: Indian and global studio valuation comparables, calendar year-ends, 2010E-12E

	Year Ending	Price 9-Mar	Market cap (US$ mn)	EV (US$ mn)	Sales (US$ mn)	EV/EBIT 2010E	EV/EBIT 2011E	EV/EBIT 2012E	P/E (X) 2010E	P/E (X) 2011E	P/E (X) 2012E
India											
UTV Software Communications (Rs)	Mar	545	481	682	178	14.3	9.4	8.3	14.2	10.8	8.2
Balaji Telefilms Ltd (Rs)	Mar	34	49	48	35	—	12.1	—	—	13.2	—
Reliance Mediaworks Ltd (Rs)	Mar	149	150	546	189	—	—	—	—	—	—
Global											
Time Warner Inc (US$)	Dec	36	39,812	52,703	26,888	8.9	9.1	8.6	15.1	13.3	11.6
News Corp (US$)	Jun	17	45,361	51,001	33,082	10.2	9.7	8.1	17.8	15.3	13.1
The Walt Disney Co (US$)	Dec	43	82,040	93,698	39,040	11.2	10.4	9.2	20.9	16.3	14.2
Lions Gate Entertainment (US$)	Dec	6	841	1,589	1,669	32.6	14.9	22.9	—	63.6	22.8
Dreamworks Animation (US$)	Dec	26	2,237	2,073	785	13.6	9.8	8.9	15.4	14.8	13.1

Notes:
(a) For Indian companies, any year corresponds to next year ending March; for example, 2010E corresponds to fiscal year-end March 2011 or FY2011E.

Source: Bloomberg data, Kotak Institutional Equities

DCF-based valuation; catalog valuation may provide floor

Exhibit 5 presents our DCF-based valuation model for EROS; it also provides valuation sensitivity to different levels of WACC and growth in perpetuity. We use a WACC of 13.0% (12.5% for peers in regional print and broadcasting), which we deem appropriate given film business dynamics: (1) project nature and lack of predictability of films and (2) high working capital/capex requirements (reduced normalized free cash flows). Our DCF-based valuation results in 12X and 8.5X implied FY2012E EPS and EBIT.

We view DCF as an appropriate valuation methodology for EROS as it successfully captures (1) nascent stage of development of EROS and organized film industry in India, (2) 'long-tail' revenue effect (majority of the film costs are upfront but result in annuity revenue stream) and (3) robust growth in free cash flows led by rising market share (new releases) and expanding film catalog. Key risks include (1) subjectivity of forecasts beyond the near-term assumptions and (2) dependence of valuation on terminal cash flows.

Exhibit 5: DCF-based valuation of EROS, March fiscal year-ends, 2012E-13E (Rs/share)

	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E
Adjusted EBIT	2,138	2,799	3,141	3,463	3,135	4,357	5,455	6,045	6,459	6,782	7,121	7,477
Adjusted EBITDA	5,153	6,564	7,538	9,181	9,638	11,436	13,997	15,609	17,488	18,363	19,281	20,245
Tax expense paid	(552)	(753)	(900)	(1,028)	(935)	(1,316)	(1,645)	(1,825)	(1,952)			
Changes in NWC	(745)	1,218	(597)	(986)	2,353	(542)	790	479	-			
Cash flow from operations	**3,857**	**7,030**	**6,042**	**7,167**	**11,056**	**9,578**	**13,142**	**14,263**	**15,536**	**16,313**	**17,129**	**17,985**
Capital expenditure	(3,970)	(5,013)	(5,775)	(7,619)	(8,418)	(8,678)	(10,391)	(11,442)	(13,190)			
Free cash flow to the firm	**(112)**	**2,016**	**267**	**(453)**	**2,638**	**900**	**2,751**	**2,821**	**2,346**	**2,463**	**2,587**	**2,716**
Discounted cash flow-1 year forward		1,784	209	(314)	1,618	488	1,321	1,199	882	819	761	
Discounted cash flow-2 year forward			236	(354)	1,828	552	1,492	1,355	997	926	860	800

Discount rate (%)	**13.0**
Growth from 2020E to perpetuity (%)	**5.0**

	+ 1-year		+ 2-year	
Total PV of free cash flow (a)	**8,769**	**47%**	**8,693**	**45%**
FCF in terminal year	2,716		2,852	
Exit FCF multiple (X)	12.5		12.5	
Terminal value	33,949		35,646	
PV of terminal value (b)	**9,994**	**53%**	**10,494**	**55%**
EV (a) + (b)	**18,763**		**19,186**	
EV (US$ mn)	**417**		**426**	
Net debt/(cash)	(511)		232	
Equity value	**18,253**		**19,418**	
Implied share price (Rs)	**197**		**209**	
Exit EV/EBIT multiple (X)	5.0		5.0	

Value of EROS to different levels of WACC and growth rate (%)

Growth rate (%)	WACC rate (%) 12.0	12.5	13.0	13.5	14.0	14.5
3.0	192	180	170	160	152	144
3.5	200	187	176	165	156	148
4.0	208	194	182	171	161	152
4.5	218	202	189	177	166	157
5.0	228	212	**197**	184	172	162
5.5	241	222	206	191	179	168
6.0	256	234	216	200	186	174
6.5	273	249	228	210	195	181
7.0	294	265	242	222	204	189

Source: Kotak Institutional Equities estimates

Catalog valuation may provide a floor for the stock. Eros has a large movie library with significant associate audio-visual rights exploitable across a variety of platforms (home entertainment, digital platforms, broadcasting etc.) in India as well as overseas markets (through its Tamil film subsidiary, Ayngaran). The valuation of the high-margin annuity revenue stream and operating cash flows (production/acquisition cost of content is already sunk) derived from exploitation of the movie catalog may provide floor valuation for the stock, without giving credit to future value creation. We highlight that catalog constituted ~8% of EROS revenues in FY2010, which is almost entirely free cash flow given content cost is sunk and distribution/replication cost is marginal.

The overall valuation of the stock should reflect the underlying annuity value of the business and potential for future value creation through capital investments in new releases, which in turn can be derived from expected normalized returns ratios from a portfolio/slate of movies and corresponding enterprise value to invested capital benchmarks. However, the floor catalog valuation requires detailed knowledge of (1) movies in the catalog, (2) associated rights and (3) past monetization trends across platforms, which are unavailable currently. However, we expect improved disclosures (and not only related to catalog revenues) from the company in future, helping build such an understanding.

Key valuation drivers—content, distribution, catalog and capital

EROS valuation drivers—the studio model. EROS is aiming to replicate the global studio model of film production and distribution in India. We briefly highlight the key features of the studio model and thus, valuation drivers for EROS.

- **Production and/or acquisition of a portfolio of movies.** EROS' success is critically dependent on its ability to produce (or co-produce) and acquire a diverse portfolio of new movies (high-, mid- and small-budget). More important, EROS will need to manage content acquisition at competitive prices given the competition for talent and content. Eros' market share in new movies also has implications for distribution/monetization as it provides the company with negotiating power over retailers.

- **Well-developed content distribution network.** EROS already has an extensive network covering theatrical distribution, a music record label and a home entertainment division. EROS will need to further strengthen its distribution network adding further depth to its theatrical and digital network to reduce leakages and effectively monetize its slate of new releases and large and growing content catalog. EROS monetizes the overseas rights of its new movie slate through its parent, with an extensive global film distribution network, through an arm's-length Relationship Agreement.

- **Building a movie library/catalog.** EROS possesses one of the largest libraries of Hindi and regional language movies, comprising >1,000 Indian film titles. EROS needs to maintain and replenish its content library with continuous addition of new film releases and library acquisitions. EROS follows the 'bundle' model of distribution for TV licensing, home entertainment and digital new media, which implies that the company bundles different categories of films (as per the acquirer's requirement) including new releases and catalog films. As highlighted previously, effective monetization of the catalog is dependent on the company's market share (new releases) as well as negotiating power over retailers. The library also allows EROS to take advantage of technology developments and re-monetize the same across emerging formats.

- **Capital for investment in content (new release slate and scaling up the catalog) (notably regional markets).** As discussed previously, the 'long-tail' of revenues in the studio model implies large upfront capital investment even as revenue stream (except theatrical) is spread out and in the nature of an annuity. The capital requirement also increases with the need to scale up the content library and the new release slate as EROS expands beyond the Hindi and Tamil regional languages.

Given the volatile and unpredictable nature of the film business, EROS' strategic focus is on addressing its predictability, scalability, sustainability and profitability aspects on the lines of Hollywood film studios. However, the proof of the pudding is always in the eating; Exhibit 6 presents the operating and financial performance of EROS over the past few years, including the economic downturn (FY2009-10). EROS has successfully maintained robust profitability driven by (1) diversified film portfolio and (2) robust catalog revenues. We note that EROS' FY2009 financials include income from syndication of TV rights of FY2008 blockbuster '*Om Shanti Om*', resulting in high margins despite weak operating performance; nonetheless, core operating margins were yet robust at ~16%.

Exhibit 6: Operating and financial performance of EROS, March fiscal year-ends, 2008-11E

	2008		2009		2010		2011E	
New releases								
Blockbuster/Success								
	Om Shanti Om		Yuvraaj		Love Aaj Kal		Golmaal-3	
	Heyy Baby				De Dana Dan		Housefull	
	Partner				Kambakht Ishq			
	Cheeni Kum				Mee Shivaji Raje…			
Average								
	Provoked		U Me Aur Hum		Aladin		Anjaana Anjaani	
	Dus Kahaniyaan		Billu		Karthi Calling Karthik		Paathshaala	
	Sunday		Heroes		Tera Mera Ki Rishta		No Problem	
	One Two Three		Hashar… A Love Story		Heer Ranjha…		Haapus	
					Shikshancha Aicha Gho		Ideachi Kalpana	
Failure								
	Journey Bombay to Goa		Drona		Veer		Toonpur Kaa Superhero	
	Gandhi My Father		Mr Black Mr White		Vaada Raha…		Akrosh	
	Buddha Mar Gaya		Dhoom Dhadakka		Milenge Milenge		Pankh	
	Nanhe Jaisalmer		Money Hai Toh Honey Hai		Meri Life Main Uski Wife		The Great Indian Butterfly	
	No Smoking		Hi Jack		London Calling		Tere Ishq Nachiya	
	Bombay to Bangkok		Haal-E-Dil		Chintuji			
	Black & White		God Tussi Great Ho		Shree Siddhivinayak			
			Aa Dekhen Zara		Mitti			
Overseas								
	Bhool Bhulaiyaan		Sarkaar Raaj		Wanted		Dabangg	
	Aur Papu Pass Ho Gaya		Krazzy 4				Khatta Meetha	
	Jai Jagannath		Bhootnath				Benny and Babloo	
	Kaisey Kahein		Mehbooba				A Flat	
	Darling		Ek Vivaah Aisa Bhi				Khuda Kasam	
	Dahek		K Kompany					
	Speed		Kaash Mere Hote					
Digital prints (#)								
	Hey Baby	340	Yuvraaj	640	Kambakht Ishq	651	Housefull	878
					Love Aaj Kal	489	Anjaana Anjaani	654
Financial performance (Rs mn)								
Revenues		4,747		6,265		6,409		7,011
Catalog share (%)		**8**		**9**		**8**		**8**
Gross profit		1,086		2,045		1,940		2,566
Gross margin (%)		**23**		**33**		**30**		**37**
EBIT		551		1,298		1,110		1,608
Operating margin (%)		**12**		**21**		**17**		**23**

Source: Company data, Kotak Institutional Equities estimates

EROS has come a long way since and is capable of maintaining robust operating margins (>20%) even in a weak market and business scenario, in our view. We briefly discuss few additional characteristics of EROS business operations.

- Digitization of theatres, which results in reduced cost of distribution as well as improved revenues given wider distribution of a film (see Exhibit 6).

- Profit-sharing co-production deals with top talent in Indian film industry, which results in improved risk-reward and margins for film studios.

- Pre-sale of ancillary rights (music as well as C&S TV) associated with a film to reduce volatility and improve predictability. An intensely competitive C&S TV market ensures effective monetization even factoring-in pre-sale discounts.

EROS GROUP: THE LEADING BOLLYWOOD STUDIO OVERSEAS

From its humble beginnings as an exporter of Indian film content, Eros Group has come a long way to become the leading Bollywood studio in overseas markets with (1) content acquisitions driven by long-standing relationships with talent and first families of Indian film industry, (2) worldwide distribution network across theatrical, TV licensing, home entertainment and new media, (3) large and diverse catalog of Indian film content and last but not the least, (4) strong balance sheet to finance the acquisition of all-format film rights. The strong position and robust financial performance of Eros Group is important for Eros India (EROS) as defined in the Relationship Agreement between them.

The Eros Group—a historical perspective

The beginning and the middle hold important lessons for the end-game. Eros Group started with a modest vision—the opportunity to export Bollywood (the popular term used to describe the Hindi film industry) content to Indian Diaspora in overseas markets. The domestic market was riddled with problems notably (1) rampant piracy, (2) large number of single screens, (3) low ticket prices, (4) lack of well-developed ancillary revenue streams but more important, (5) the family-driven nature of the industry. The overseas opportunity was niche but lucrative given the relatively high per-capita income of overseas Indians (ability to pay) and well-developed film markets.

From its humble beginning as an exporter of Indian content, Eros Group (1) pioneered the development of the entirely new 'overseas' distribution territory for Indian cinema and in the process emerged as (2) a niche but integrated film studio with focus on Bollywood content. It assimilated features of a Hollywood studio—(1) long-term output deals for overseas rights, (2) >2,000 films strong movie catalog (all overseas rights), (3) extensive distribution network and (4) capital investments for scaling up its library of content as well as new release slate to ensure business visibility over time. Exhibit 7 highlights the dominant position of the Eros Group in overseas markets (Indian film content).

Exhibit 7: Overseas distribution of Eros International versus competition

Movie	Year	US theatrical (US$ mn)
Eros International		
Om Shanti Om	2007	3.6
Devdas	2002	2.7
Love Aaj Kal	2009	2.4
Lage Raho Munna Bhai	2006	2.2
Taal	1999	2.0
Hum Saath Saath Hain	1999	2.0
Salaam-E-Ishq	2007	1.9
Total	**119**	**63.6**
UTV Pictures		
Jodhaa Akbar	2008	3.4
Don	2006	2.2
Rang De Basanti	2006	2.2
Total	**44**	**28.8**

Movie	Year	US theatrical (US$ mn)
Yash Raj Films		
Kabhi Alvida Naa Kehna	2006	3.3
Veer Zaara	2004	2.9
Kabhi Khushi Kabhie Gham	2001	2.9
Dhoom 2	2006	2.6
Fanna	2006	2.1
Rab Ne Bana Di Jodi	2008	2.1
Kal Ho Na Ho	2003	2.0
Total	**33**	**34.6**
Big Pictures/Adlabs		
3 Idiots	2009	6.5
Ghajini	2008	2.4
Guru	2006	2.1
Total	**20**	**17.4**

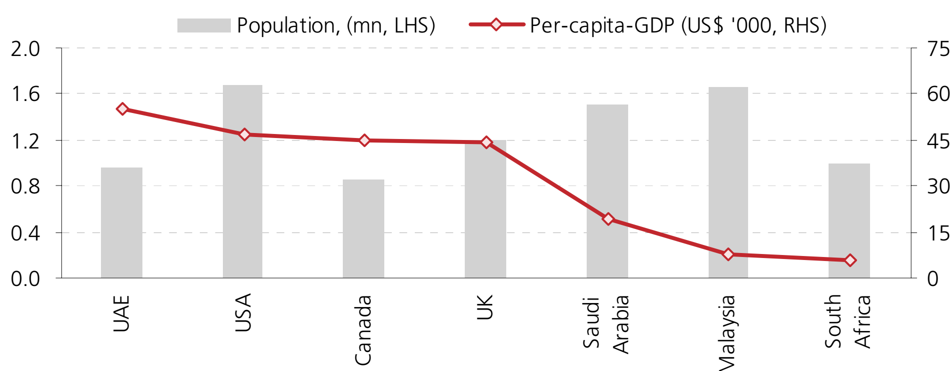
Source: www.boxofficemojo.com, Kotak Institutional Equities

The Eros Group typically acquired under-production Indian films by part-financing them in exchange for overseas rights, which were then exploited through theatrical and other distribution channels in overseas markets. Their were two notable features of overseas rights acquisition done by the Eros Group—(1) buying the rights to all overseas territories and not just the dominant markets (largely US and UK) and (2) buying all format rights to titles in overseas markets, including platforms that were not yet popular or even invented! This investment in the business resulted in (1) powerful and diverse catalog of titles and (2) ability to exploit emerging geographic markets and new media opportunities, helping transform the Eros Group into a niche Bollywood studio.

Overseas markets—the opportunity remains significant

Exhibit 8 presents the list of Indian Diaspora settled in various parts of the world; USA (North America), UK and Middle-East are the top-3 overseas markets for Indian films in terms of number of releases as well as revenues given the high per-capita income of the Indian Diaspora there. As the Indian population has increased substantially worldwide, so has the popularity of the Indian film industry as well as the value of overseas territory (rights). Additionally, there exists a huge migrant population from Pakistan, Sri Lanka and Bangladesh. Eros Group enjoys a robust first-mover advantage in overseas markets with extensive distribution network and robust relationships.

Exhibit 8: Estimated Indian Diaspora across key overseas markets (mn)

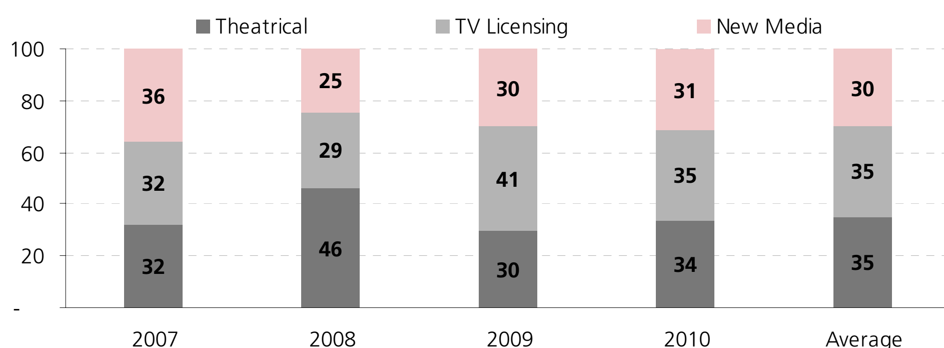


Source: Ministry of External Affairs, Kotak Institutional Equities

Overseas markets have been the savior of many an Indian film. Not long ago, the Indian film industry saw overseas markets as a marginal revenue source. The rise and expansion of the Eros Group and Yash Raj Films have altered this perception, led by 'DDLJ' in 1995 (YRF) followed by 'Dil Se' in 1998 (Eros Group), the first Indian film in the top-10 UK Box Office. Thereafter, Indian films have regularly featured in the top-10 US and UK Box Office. There are many examples of films that did average business in the domestic market but were successful overseas, highlighting the value of overseas territory.

Overseas ancillary revenue stream is bigger than box office. Exhibit 9 presents the revenue break-up of Eros Plc, the flagship company of Eros Group; home entertainment and TV licensing are bigger markets versus box office internationally. The organized retail channel as well as FTA broadcasting and pay-TV platforms are well developed networks. Internationally, the Eros Group is not constrained by release windows and can release a film simultaneously in theatres and other platforms.

Exhibit 9: Trends in revenues of Eros International Plc, March fiscal year-ends, 2007-10 (%)



Source: Company data, Kotak Institutional Equities

Eros Group—understanding the studio model

Eros Group—a 'niche' Bollywood studio. Eros Group's business strategy has always been modeled on major US film studios, to own complete IPRs of a large portfolio of new films as well as catalog/library and exploit them on a worldwide basis across different formats; the difference pertains to (1) scale of operations (niche) and (2) lack of extensive presence in the domestic market (India). Eros Group's rapid expansion in India aims to bridge the gap: (1) Vertical expansion (content) as well as (2) horizontal expansion (distribution). Eros Group has an extensive library of Indian films (>2,000 titles) built over time through acquisition of overseas/global rights of new as well as legacy films.

As highlighted previously, there are four key features of the studio model (see Exhibit 10). We briefly discuss the same as well as Eros Group's own version of 'niche' Bollywood studio model in overseas markets with its strengths and weaknesses.

Exhibit 10: Key features and dependences of a studio model

Film portfolio
Features
Not dependent on success of one film
Large market share, bargaining power
Dependence
Distribution - effective, efficient monetization
Capitalization - large working capital requirement

Distribution network
Features
Maximize revenues with wide release, windowing
Long-standing relationships with retailers
Dependence
Portfolio - bargaining power over retailers
Library - bundled, tailor-made content

Capitalization
Features
'Long-tail' of film revenues/windowing
Comfort to content/distribution partners
Dependence
Portfolio - reduced risk, low cost of capital
Library - assets with proven track record

Film library
Features
Sunk cost, high-margin steady revenue stream
Continous monetization on new formats/platforms
Dependence
Portfolio - new films enhance value of portfolio
Distribution - effective, efficient monetization

Source: Kotak Institutional Equities

- **Portfolio approach to production/acquisition of films/content.** Eros Group is one of the largest distributors of Indian film content in overseas markets, acquiring and distributing ~30 films annually. These include a mix of small-, mid- and high-budget films. Eros Group has always acquired a portfolio of films by part-financing them in exchange for overseas distribution rights (pre-buying from many small, independent producers), thus providing visibility of new release film slate and ensuring the business is not dependent on the success or failure of individual projects.

  However, we note that content production and acquisition has been an area of relative weakness for the group historically compared to its strength in distribution and catalog monetization. The lack of extensive presence in the domestic film market has prevented the group from penetrating deeper into the film value chain (production versus acquisition). This left the group open to (1) competition from local production companies with distribution experience (Yash Raj Films) and (2) rising prices of content given increasing competition for talent in the Indian film market. However, the group has progressively increased its production activities through EROS.

  Eros Group's relationships are a defining feature. The Indian film industry has traditionally been driven by talent and family-owned production houses, which consistently churn out 1-2 films annually. (1) Long-standing and deep-rooted relationships built over 30 years and (2) ability to showcase Indian films internationally has been the key driver of Eros Group's ability to source content at competitive prices despite rising competition for talent and content. Along with EROS (domestic distribution), the ability of Eros Group to release films worldwide and ensure global visibility for its partner talent has further strengthened these relationships.

- **Widespread distribution network.** The Eros Group has established a large network of offices and relationships worldwide to distribute/exploit its new release slate as well as catalog. As previously highlighted, Indian film content is a niche category in the international markets and Eros Group continues to enjoy a first-mover advantage in the global film distribution value chain further consolidating its position by (1) continuous addition to its large library and (2) continuous expansion of its extensive distribution network. We briefly discuss its distribution network across all formats.

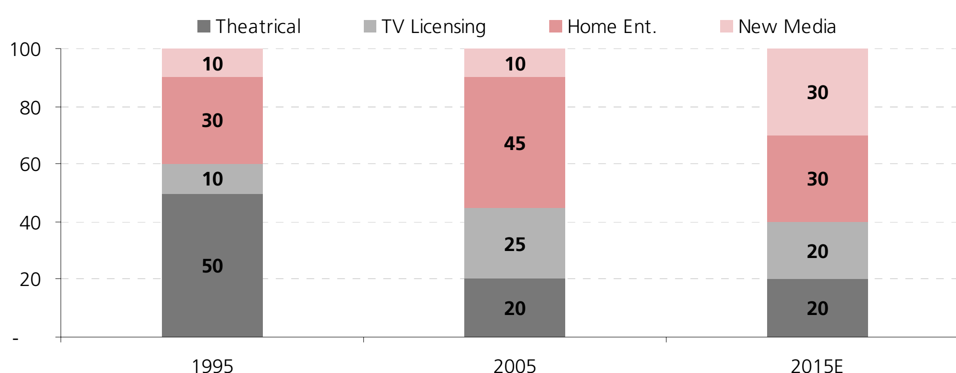
  - **Theatrical distribution.** Eros Group distributed its first film in UK cinemas in 1992 and expanded into US theatrical distribution in 1997. Eros Group has distribution offices in UK, US, Canada, South Africa, United Arab Emirates, Australia, Fiji etc. Eros group has strong tie-ups with exhibitors such as Cineworld and Vue in the UK, Regal in the US and Ster-Kinekor and Nu Metro in South Africa. Eros Plc is the member of the FDA (Film Distributors' Association) in the UK.

  - **TV rights licensing.** Eros Group has established a large network of international TV broadcasting clients with a reputation in the industry as a reliable and large supplier of high-quality Indian film content. Its clients include major global platforms such as BBC, Channel 4 etc., as well as overseas feeds of major Indian broadcasters such as Zee, Star, Sahara, B4U etc. The market is witnessing the entry of new players such as Imagine and Colors eyeing the lucrative overseas pay-TV market after having established themselves in the Indian C&S TV market.

    Finally, Eros Group has moved beyond offering pure Indian language content into dubbed and subtitled markets such as Germany, Russia and Indonesia; the markets are a small contributor to the overall revenues right now (not unlike the niche position of world cinema channels in India) but with robust growth potential of expanding the reach of Indian films to an international audience. This may also have a positive impact on the theatrical revenues in these markets.

  - **New Media.** Exhibit 11 presents the trends in global film revenues; we include home entertainment (VCD, DVD, now Blu-Ray) as well as Video-On-Demand (VOD, Pay-Per-View or PPV) in New Media. DVD home entertainment displaced video and theatrical to emerge as the platform of choice for movie-going population. 'New' New Media platforms like VOD, PPV, mobile and wireless are displacing DVD in the global film industry. The key is the presence of a large and diverse film catalog, which can be re-monetized across different formats as technologies advance over time; we briefly discuss Eros Group's experience with the same.

Exhibit 11: Trends in global film industry revenues, calendar year-ends, 1995-2015E (%)



Source: Western State University, Kotak Institutional Equities

Home Entertainment with DVDs, then Blu-Ray disks. Eros Group has built a large international dealer network for distribution of VCDs/DVDs. These include wholesalers with a wide presence in unorganized retail market, high-street retailers such as HMV, Tesco and Walmart as well as e-commerce portals such as Amazon. Eros has added new geographic markets such as Germany (Eurovideo/Bavaria Films) and intends to re-release its popular films in high-definition formats such as Blu-Ray.

Subscription-Video-On-Demand (SVOD) with Comcast. Traditionally, Eros Group has provided its Indian film catalog to cable operators such as Rogers Cable (Canada) on a Video-On-Demand (VOD) model where the subscriber pays a one-time fee for a film, which is shared between the operator and Eros. However, Eros Group's arrangement with Comcast gives them control of the Indian movie channel on the platform, which is provided to subscribers on a monthly rental based on assured new movie premiers, which also provides revenue visibility to Eros Group.

- **Valuable and expanding content library.** Eros Group owns intellectual property rights, generally across all media formats and for the overseas market, to a large and diverse film catalog of >2,000 films. The group continues to strengthen and enlarge its existing library through new release film rights as well as acquisition of catalog. The large catalog allows (1) 'bundling' of catalog films with new releases and (2) re-monetization of the catalog films to take advantage of technological developments and emergence of new platforms over time to generate annuity income.

  We believe the valuable and expanding catalog with the Eros Group is the primary driver of its strong financial performance (see Exhibit 12) and the generous terms offered to EROS as its exclusive agent for film production and acquisition in India. We highlight that catalog exploitation is a high-margin revenue stream since a substantial portion of the costs associated with the catalog has been written down (the majority of films with Eros Group are effectively present at zero cost). Eros Group generated FY2008 catalog revenues of US$23 mn, ~50% of its PBT of US$46 mn.

Exhibit 12: Consolidated income statement and balance sheet of Eros Plc, March fiscal year-ends, 2007-10 (US$ mn)

	2007	2008	2009	2010
Income statement				
Total revenues	**66**	**113**	**157**	**150**
Cost of sales	(27)	(50)	(85)	(82)
Admin. costs	(8)	(17)	(21)	(16)
Operating profit	**32**	**46**	**51**	**52**
Margin (%)	***48.0***	***41.1***	***32.5***	***34.6***
Net interest	(1)	(1)	(1)	(2)
Tax expense	(2)	(6)	(8)	(7)
Extraordinaries	-	-	(1)	-
Minority interest	-	(2)	(0)	(0)
Net income	**29**	**38**	**40**	**42**
Margin (%)	***44.0***	***33.5***	***25.8***	***28.2***

	2007	2008	2009	2010
Balance sheet				
Non-current assets	115	264	360	398
--Intangible assets (content)	**95**	**239**	**312**	**349**
Current assets	86	122	116	148
--Trade and other receiveables	37	31	56	55
--Cash and equivalents	46	88	56	88
Current liabilities	60	57	87	74
Total assets	**141**	**329**	**388**	**471**
Non-current liabilities	-	114	131	164
--Long-term borrowings	-	112	124	151
Total networth	**141**	**213**	**257**	**307**
Total liabilities	**141**	**329**	**388**	**471**

Source: Company data, Kotak Institutional Equities

- **Capital for investment in content (new release slate as well as catalog).** The 'long-tail' of revenues of films in the studio model implies continuous and significant upfront investment in content as revenues streams (except theatrical) such as New Media are spread out and in the nature of annuity income. Eros Group's total capital employed of about US$471mn (including direct content investments of US$349mn) by end-FY2010 (see Exhibit 11) would count among the largest in the Indian film industry. This also does not take into account the potential value of a significant portion of its content library, which is present in the Eros Group books at near-zero cost.

The Relationship Agreement—financial and strategic support

The Relationship Agreement. The Relationship Agreement defines and formalizes the terms of engagement between Eros Group (parent company) and EROS (subsidiary company). Previously, the rights (India and overseas) associated with a movie were monetized either by Eros Group or EROS given that the latter was wholly-owned subsidiary of the former. The Relationship Agreement has now formalized the separation of overseas rights (to be held by Eros Group) and India rights (to be held by EROS) as well as the position of EROS as the exclusive agent for production and acquisition of Indian film content of Eros Group. We briefly discuss the Relationship Agreement, which is an important source of strategic and financial support to EROS.

- **Exclusive mandate for Indian film production/acquisition.** EROS will have the exclusive mandate to produce, co-produce or acquire Indian film rights on behalf of Eros Group. Additionally, any film projects being negotiated by any Eros Group entity will first be offered to EROS for independent acquisition or participation. EROS will also have an exclusive mandate to source content (film financing or acquisition) solely for the purpose of overseas distribution on behalf of Eros Group at 30% commission on the cost of acquisition/financing. However, we note that Eros Group plans to buy largely worldwide rights to Indian film content in future.

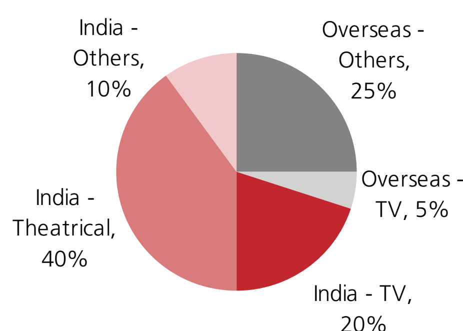
- **Assignment of film rights.** EROS will hold the rights of films for distribution in India, Nepal and Bhutan. Eros Group will acquire, absolutely and unconditionally, all distribution rights of films produced/acquired by EROS for the remaining/overseas markets for a specific fee, defined as 30% of the cost of production/acquisition of Indian film content at 30% commission (see Exhibits 13-14). Thus, the agreement provides significant financial support to EROS (39% cost of production realized upfront) as well as protection from success/failure of films in overseas markets. Additionally, Eros Group will advance these monies at the inception of the film project, a form of quasi-equity or quasi-finance given zero interest rate charged on these advances.

Exhibit 13: Revenue and cost sharing between Eros entities (Rs)

Cost attributable to EROS	
Cost of content acquisition by EROS	100
Share of Overseas rights (%)	30.0
Cost of overseas rights	**30**
Commission paid to EROS (@30%)	**9**
Cost attributable to Eros Group	39
Net revenue flow to EROS	**39**
Revenue overflow to EROS	
Revenue realized by Eros Group	**100**
Eros Group commission (@20%)	20
Cost of overseas acquisition	39
Cost of overseas distribution (@10%)	8
Net profits realized	**33**
Share of EROS (%)	30.0
Net profit overflow to EROS	**10**

Source: Company data, Kotak Institutional Equities estimates

Exhibit 14: Revenue stream of a Hindi film for Eros Group (%)



Source: Company data, Kotak Institutional Equities estimates

- **Other terms and termination.** EROS will be entitled to reimbursement from Eros Group for any distribution expenses incurred by it and pre-agreed by Eros Group at 30% commission. Additionally, Eros Group shall reimburse EROS for all other (not distribution related) pre-approved expenses incurred by the latter within the specified period. The Relationship Agreement may be reviewed on an annual basis, is valid for an initial period of five years, and automatically renewable (with any modification as may be necessary in annual review) for successive two-year terms.

EROS: AN INDIAN FILM 'STUDIO' WITH FOCUS ON CONTENT

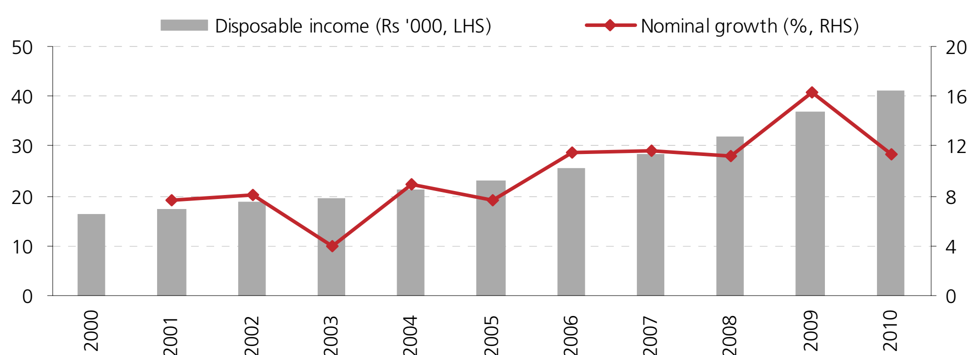
Eros Group's entry into India came about with the potential of the Indian film industry starting to turn into reality given (1) increased transparency and improved theatrical revenues, (2) robust growth in ancillary media platforms as well as (3) increasing corporatization with 'Industry' status for the Indian film market and entry of organized players. The focus of EROS would be on (1) better integration with the film industry value chain, notably content, (2) establishment of a robust domestic distribution network and (3) expansion of an already large library of films. The economic slowdown in India during FY2009-10 resulted in (1) reduced competition for content, (2) reduced new release visibility for weaker players and (3) new risk-reward sharing mechanisms with talent, which bodes well for serious players like EROS.

The risk-reward—unorganized but high growth potential Indian market

Indian film industry—an 'Industry' in the making. Eros Group did not evince much interest in the Indian film market for a long time despite the inherent potential (largest film market in the world in terms of released films and other volume metrics), natural affiliation with the market as well as its network and relationships. The reasons derived largely from the unorganized state of the Indian film market notably—(1) challenging theatrical distribution (widespread single screens), (2) low ATPs in single screen theatres, (3) rampant piracy and under-reporting, (4) cash collection issues, (5) under-developed ancillary revenue streams and (6) family-driven nature of the Indian film industry.

The recognition of 'Industry' status for the Indian film market was one harbinger of change, which made bank financing available for films at much cheaper rates of interest than previously. However, the transformation of the Indian economy was by far the overriding factor that led the Indian film industry to new heights. The growth rate of personal disposable income scaled a structural barrier (see Exhibit 15); the rise of the Indian middle class resulted in changing consumption patterns with increasing share of discretionary spends such as recreation. The movie-crazy Indian population with ability and willingness to pay and changing demographics (younger population) resulted in greater demand for quality content/entertainment and organized film retail.

Exhibit 15: Personal disposable income and growth in India, March fiscal year ends, 2000-10

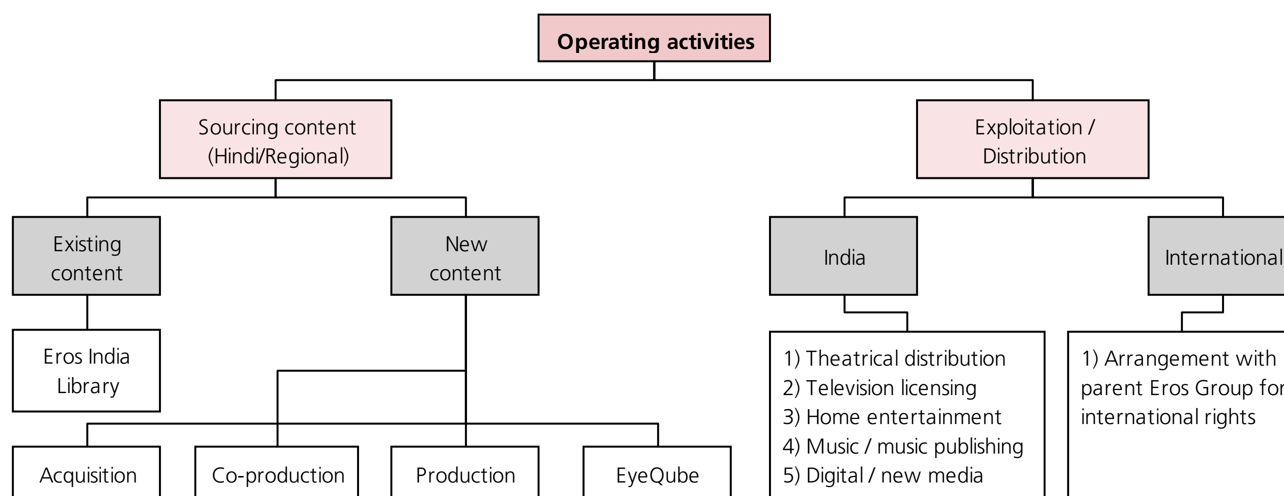


Source: Reserve Bank of India, Kotak Institutional Equities

The shift towards greater corporatization was led by rise of multiplexes in India, notably in the metro markets of Delhi and Mumbai. Pay-TV platforms also became a major source of revenue as consumers started demanding quality content from the comfort of their homes. The telecom market was opened up to private players with the auction of 2G licenses, which fueled demand for new media content. Eros Group, after sitting on the sidelines for over two decades, finally decided to take the plunge with the aim to consolidate the fragmented content and distribution markets in India. The rapid digitization of pay-TV platforms led by DTH may just prove to be the icing on the cake.

Exhibit 16 presents the principal operating activities of EROS. EROS aims to secure content through a combination of acquisitions, co-productions and productions. EROS will use its distribution network for exploitation of new film release slate as well as legacy films within its rapidly growing library. The focus will be on the Hindi and Tamil film markets, though Eros also plans to expand into other regional language film markets like Marathi, Punjabi, Telugu, Bengali etc. EROS has several new initiatives such as EyeQube, the visual effects (VFX) facility, which is both a standalone business opportunity (in the long term) and a key driver of EROS' content focus (in the near term).

Exhibit 16: Eros India's principal operating activities



Source: Company data, Kotak Instructional Equities

Evolution of business model—focus of content

Targeting the weak link in the Eros Group's business model. Eros Group's decision to enter the Indian film market and turn it into the cornerstone of its operations also helps complete the weakest link in its business model—content. Its robust overseas distribution network and large film library have traditionally been the key drivers for the group. However, its niche strategy has prevented it from exercising greater control over the entire film value chain, notably content. Eros Group's entry into the Indian film market through EROS aims to consolidate the highly fragmented Indian film industry across content and distribution, riding on the traditional strengths of the group.

- **Acquisitions.** These films are independently produced by the third-party producers with very little involvement of EROS (except at some well-defined boundaries). There are two forms of acquisitions—(1) the film is entirely financed and produced by the independent talent/production house and its rights are offered for sale or (2) the film is offered to EROS on a negotiated market price at a very early stage of its production. The model is working capital efficient since ~40% of the film's cost is payable only when the film is delivered by the producer, by when pre-sales have already begun. However, it leaves the studio open to a bidding war with competition (winner's curse).

  Typically, the acquisition model is employed for either large-budget (>Rs500mn) A+ movies or small-budget (<Rs50mn) C movies. In the former case, EROS is working with top talent (producers, directors and actors) with proven track record. The talent does not require financing or production support but wants to be associated with EROS given its distribution track record. EROS is not involved in the movie on a day-to-day basis but looks for progress at pre-defined intervals before releasing the next tranche of payments; the studio takes limited completion or cost overrun risk. The C movies are usually produced by independents and offered for sale on completion.

- **Co-productions.** The key difference between acquisitions and co-productions lies in the degree of control over the principal photography process. Typically, EROS is involved in the decision-making as regards the script, the cast, the director, the budget and all development activities along with the co-producer. However, the execution responsibility (principal photography) lies with the co-producer though the company nominates an executive producer for process management and financial control. The entire cost of the co-production is borne by EROS and the talent (co-producer) is entitled to a token fee and upside (20-50% of profit share) from the film.

  EROS prefers the co-production model. The co-production model allows EROS to simultaneously tap the services of key talent and scale up its new release film slate. Typically, EROS works with directors and producers that have extensive experience in the Indian film industry but either don't have the financial resources or are looking for a reliable distribution partner. Eros Group's legacy relationships within the Indian film community as well as capital commitment play an important role in attracting talent. EROS leaves the creative process largely in the hands of talent, which is best-suited to manage the same, with a policy of light touch control.

- **Productions.** EROS has had very limited film production slate in the past and most of its films are either acquisitions or co-production. The productions are driven by the creative team led by Mr. Ram Mirchandani, Chief Creative Officer, who also green-lights all the acquisitions and co-productions by EROS. The creative team is closely involved in the development activities and tries to match an available script with co-production partners. It is only in the exceptional cases where EROS likes the script but does not have a willing partner when it considers producing on its own. An execution team is brought on board on a project-by-project basis for the same.

Exhibit 17: Summary of various production models with advantages and disadvantages

Feature	Productions	Co-productions	Acquisitions
Movie format	For A or B movies	For A+, A or B movies	For A+ or C movies
Process control	Complete control	Moderate control	Minimal involvement
Financing	Complete 100% financing	Around 80-100% financing	Around 40-60% financing
Working capital	Required in various stages	Required in various stages	Majority payment at completion
Time overun	Escalation risk exists	From co-producer sweat equity	Final payment on completion
Cost overun	Escalation risk exists	From co-producer sweat equity	Competition risk exists
Scalability	Low given high involvement	Moderate given some involvement	High given low involvement

Source: Industry data, Kotak Institutional Equities estimates

Portfolio approach to films production/acquisition. EROS' new release slate includes a mix of high-, mid- and small-budget films working with the leading proven and high-profile talent as well as new and upcoming talent. Besides the Hindi film industry, EROS is active in Tamil and other regional markets. The portfolio approach to films is a well-known to reduce the risk of success (or failure) of an individual film. Additionally, the large and diverse new release film slate adds to the catalog. Well-made C movies can considerably add to the profitability given low cost of acquisition, low box office risk (limited release) and increasing value/demand from C&S TV and New Media platforms.

A brief summary of the film production process. The entire production process typically lasts between 12 and 18 months and consists of development activities, principal photography and post-production. The development activities include preparation of the script and the budget and commitments from director and star cast. The principal photography is the physical production, which requires the producer/director to manage the shoot on various locations with the star cast and within the specified budget. Thereafter, the film enters post-production that includes editing the raw shoot and adding dialogue or any special effects to the film. The film is now ready for marketing and distribution.

Excellence in distribution—extending to India

EROS' wide distribution network. EROS has established end-to-end distribution capability in India through a national theatrical distribution network (covering ~80% of the market), music distribution (Eros Music is the music record label) as well as a home entertainment division (associated relationships with large Indian wholesalers and organized retailers). EROS has its own distribution offices in Delhi, Mumbai, Kolkata and Chennai (through subsidiary Ayngaran) covering the major territories in India. This allows direct exploitation of new release slate with limited dependence on sub-distributors that demand high commission. EROS' music and home entertainment divisions allow for the exploitation of the existing film library as well as new films across all formats.

Monetization and exploitation is at the heart of EROS. Eros Group has a track record of excellence in distribution and monetization of content through innovation and relationships in the global film market. EROS benefits from Eros Group's learning and expertise in the global film market. The focus on building a diversified content portfolio and catalog is to ensure continuous refresh of the distribution pipeline. Eros Group has been at the forefront of taking advantage of technological developments (Blu-Ray in overseas markets) to expand the monetization potential of its new release slate and continually re-monetize its catalog. EROS may introduce new technological innovations (with 3G technology) and business model innovations such as SVOD services in India.

A brief summary of the film distribution process. As previously highlighted, the process of movie distribution begins from the inception of the film itself through pre-sales, which includes arranging initial financing (another well-known risk mitigation strategy) through commitments from third parties (sub-distributors in territories where EROS is not active) and TV as well as new media rights licensing. There is another pre-sales round at the post-production stage where interest parties are given another chance to buy some of the rights at an early stage, with the final shape of the movie in place (and share in the risk and reward of the success or failure of the movie). The film is now ready for its marketing activities (advertising and publicity) to begin in right earnest.

Windowing—maximum returns from sunk cost. Exhibit 18 presents the key distribution channels and timelines for exploitation of a new film. The process starts with the music release of the film as well as marketing across media platforms; music also forms an integral part of advertising and publicity, which begins simultaneously. The theatrical distribution in India contributes the majority of the revenues of the film (though ancillary revenue streams are growing in value) and thus, gets the exclusivity window for the first few weeks, followed by PPV platforms (DTH and digital cable). TV licensing and other new media (DVD et al) rights are the next in line for exploitation; the exclusive windows of operation ensure that the maximum revenue potential platforms capture the audiences first.

Exhibit 18: 'Windowing' of a new movie release across distribution channels

RM - 2	RM - 1	Release month (RM)	RM + 1	RM + 2	RM + 3	RM + 4	RM + 5	RM + 6	RM + 7	RM + 8	RM + 9
Music/Mobile release	Music/Mobile release										
		Theatrical release	Theatrical release								
			DTH/PPV release	DTH/PPV release							
				DVD/HE release	DVD/HE release						
						TV/C&S release	TV/C&S release	TV/C&S release			
						New Media (Mobile, Music, DVD et al) re-release	New Media (Mobile, Music, DVD et al) re-release	New Media (Mobile, Music, DVD et al) re-release	New Media (Mobile, Music, DVD et al) re-release	New Media (Mobile, Music, DVD et al) re-release	New Media (Mobile, Music, DVD et al) re-release

Source: Industry data, Kotak Institutional Equities estimates

Valuable and expanding content library in India. Exhibit 19 presents a summary of the legacy marquee films in the EROS catalog. EROS has one of the largest libraries of Hindi and regional language films in India, comprising >1,000 titles, constantly enriched by the addition of new releases as well as library acquisitions. The film library provides a high-margin annuity revenue stream (production costs associated with the library are already written off and variable costs of duplication and distribution are low), which helps diversify the revenues and reduce reliance on new film release. Additionally, the content library allows for bundled model of exploitation, large scale of operations (distribution network fixed costs) and improved negotiating power versus retailers.

Exhibit 19: Indicative list of catalog films/rights with EROS

Movie	Year	Theatrical (Rs mn)
Om Shanti Om	2007	1,089
Namastey London	2007	495
Cheeni Kum	2007	309
Lage Raho Munna Bhai	2006	947
Omkara	2006	379
Devdas	2002	471
Hum Dil De Chuke Sanam	1999	350
Rangeela	1995	245
Saajan	1991	150
Sholey	1975	NA
Mother India	1957	NA

Source: www.ibosnetwork.com, Kotak Institutional Equities estimates

Economic slowdown strengthens studio model

Wonder years but not for everyone. The period between FY2006 and FY2009 can be considered the wonder years of the Indian film industry with increasing corporatization led by entry of organized players, improving theatrical revenues led by multiplexes and digitization as well as strong growth of ancillary revenue streams. However, easy availability of financing, increased competition for talent as well as a general euphoria (opulent production values) resulted in production costs increasing by ~100%, much ahead of the growth in industry monetization potential. The weak financial performance of films subsequently threatened to make the Indian film industry an unviable proposition.

Much needed correction—separating the men from the boys. The economic slowdown was a period of intense pressure on the Indian film industry, forcing a reality check on the ambitious plans of production and corporate houses. A large number of independent producers (scaled down opulent film productions, which they were hoping to sell at a profit to distributors) and distributors (closed down operations post large losses in even successful movies due to inflated cost structure) were impacted. EROS and other organized, well-managed and well-capitalized studios, withstood the impact better (though not completely insulated from market dynamics). We briefly discuss the long-term benefits (and impact) of the slowdown for serious players like EROS.

- **Reduced content costs, competition.** The production costs of films, which had increased significantly between FY2006 and FY2009, corrected significantly and came down in line with the reality of monetization potential of films. More important, the competition for talent and content cooled down with all of the organized players getting out of the earlier mindset of bidding for content. The independent producers, having burned their hands at lavish spending on star cast and production values in the hope of profit but forced to sell at a loss with liquidity drying up, scaled down their operations. More important, they became more amenable to associating themselves with large studios, which only increases the corporatization in the industry.

- **Production ventures by talent and profit-sharing.** An important trend initiated was talent (notably actors) setting up their own production houses; EROS has supported the trend by concluding co-production deals with them. With the talent costs correcting, the industry is moving towards a risk-reward sharing model where talent is given a reduced/nominal upfront fee but shares in the upside potential of the movie by retaining 20-50% profit share. This is beneficial for EROS with (1) reduction in upfront cost of production, (2) improved average profitability (see Exhibit 20) and (3) greater effort by talent given their sweat equity in the co-production.

Exhibit 20: Impact of income-sharing agreements on studio profitability

	Blockbuster	Success	Average	Failure	Comments
Pre-income sharing agreements					
Cost of talent (Rs mn)	200	200	200	200	
Cost of production (Rs mn) (a)	600	600	600	600	
Cost of distribution (Rs mn) (b)	100	100	100	100	15-20% of production cost
Total cost of film (Rs mn)	700	700	700	700	(a) + (b)
Net movie revenues (Rs mn)	1,500	1,000	700	400	
Net movie income (Rs mn)	800	300	—	(300)	
Studio income (Rs mn)	**800**	**300**	**—**	**(300)**	**Movie income**
Talent income (Rs mn)	**200**	**200**	**200**	**200**	**Upfront income**
Studio revenue/investment (X)	**1.1**	**0.4**	**—**	**(0.4)**	**Working capital inefficient**
Post-income sharing aggrements					
Talent income share (%)	**50**	**50**	**50**	**50**	**50% of profits go to talent**
Cost of talent (Rs mn)	100	100	100	100	Reduction of Rs100mn
Cost of production (Rs mn) (a)	500	500	500	500	
Cost of distribution (Rs mn) (b)	100	100	100	100	15-20% of production cost
Total cost of film (Rs mn)	600	600	600	600	(a) + (b)
Net movie revenues (Rs mn)	1,500	1,000	700	400	
Studio commission (Rs mn)	**300**	**200**	**140**	**80**	**20% of revenues**
Net movie income (Rs mn)	600	200	(40)	(280)	
Studio income (Rs mn)	**600**	**300**	**100**	**(200)**	**Commission and 50% of profits**
Talent income (Rs mn)	**400**	**200**	**100**	**100**	**Upfront and 50% of profits**
Studio revenue/investment (X)	**1.0**	**0.5**	**0.2**	**(0.3)**	**Working capital efficient**

Source: Industry data, Kotak Institutional Equities estimates

- **Reduced new release slate, TV licensing income.** EROS was no exception to the industry dynamics and reduced its new film release slate during this period (~10 releases in FY2010-11E versus ~15 releases in FY2008-09) but is already on course for a strong comeback in FY2012E (see Exhibit 21). The scaling down of supply of content in line with declining prices and demand holds hope for improved revenue potential and margins for large studios from their new film release slate. The competition for growing (albeit relatively more slowly) multiplexes and digital screens reduced. The TV satellite rights market, impacted by the cyclical downturn in advertising, has also rebounded sharply in FY2011E driven by robust recovery in TV advertising market.

Exhibit 21: Indicative new release film slate of EROS in FY2012E

Movie	Talent	Production
RA.One	Shahrukh Khan, Kareena Kapoor	Red Chillies Entertainment
Rana	Rajnikanth, Deepika Padukone	Ocher Studios
Desi Boyz	Akshay Kumar, Deepika Padukone	Rohit Dhawan
Rockstar	Ranbir Kapoor	Imtiaz Ali
Zindagi Na Milegi Dobara	Hrithik Roshan, Katrina Kaif	Excel Entertainment
Mausam	Shahid Kapoor, Sonam Kapoor	Pankaj Kapur
Agent Vinod	Saif Ali Khan, Kareena Kapoor	Illuminati Films
Chalo Dilli	Lara Dutta, Vinay Pathak	Prashant Shah
Always Kabhi Kabhi	Zoa Morani	Roshan Abbas
Untitiled	Saif Ali Khan	Illuminati Films
Untitled	NA	Prabhu Deva

Source: Company data, Kotak Institutional Equities

THEATRICAL REVENUES: MULTIPLEXES AND DIGITIZATION

Domestic theatrical revenues are the mainstay of the Indian film industry despite the emergence of ancillary revenue streams. Box office collections will continue to exhibit robust growth in India led by (1) expansion in multiplex screens, (2) digitization legacy single screens (SS), (3) wider release of films given more capacity (multiplexes) and easier distribution (digital) and (4) higher average realizations from premium-quality theatres (multiplexes and digital SS). EROS' extensive distribution network covers ~80% of the monetizable markets in India, which allows for (1) greater transparency, (2) control and flexibility of release schedule as well as (3) improved margins (limited reliance on sub-distributors).

Box office—very valuable, growth continues

Exhibit 22 presents the breakdown of revenues of Indian film industry and film studios. The dependence on box office revenues/collections has come down over time with stronger growth in emerging ancillary revenue streams but the success or failure of a movie is still decided at the box office, which also has implications for the monetization of ancillary rights. The robust growth in average net box office collection (NBOC is box office collection less entertainment tax) of the top-10 films to Rs790 mn in 2010 from Rs237 mn in 2003 (see Exhibit 23) is a reflection of capacity expansion (multiplexes) as well as robust growth in average realizations (multiplexes and digital SS).

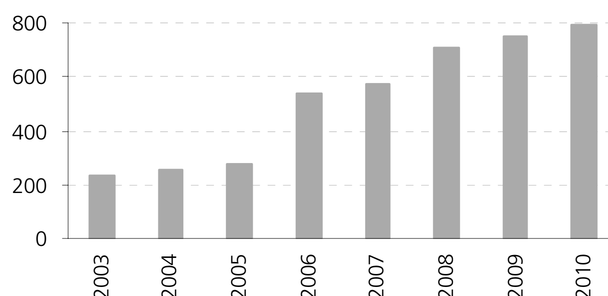
Exhibit 22: Revenue distribution of Indian film industry, 2010

	Industry		Studios (a)	
	(Rs bn)	(%)	(Rs bn)	(%)
Domestic theatrical	**72**	***72***	**23**	***45***
C&S rights	10	*10*	10	*20*
Ancillary	10	*10*	10	*20*
Overseas theatrical	8	*8*	8	*16*
Total	**100**	***100***	**51**	***100***

Notes:
(a) We assume 32% share of studios in theatrical revenues.

Source: Kotak Institutional Equities estimates

Exhibit 23: Average NBOCs of top 10 movies in India (Rs mn)



Source: www.ibosnetwork.com, Kotak Institutional Equities

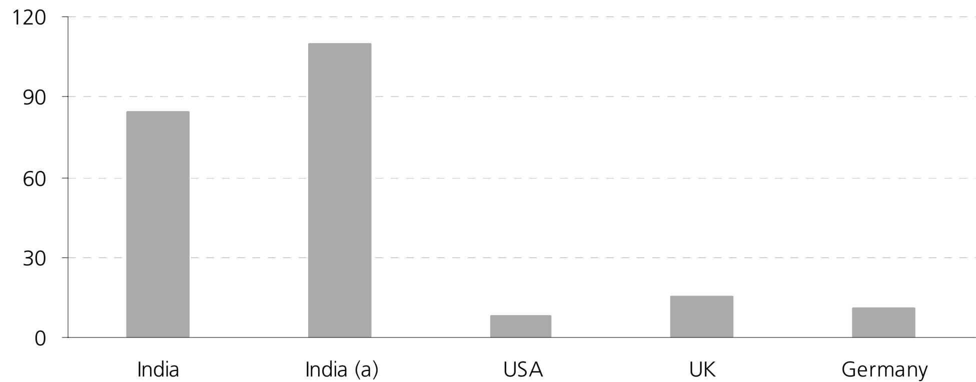
We discuss the key factors that will drive robust growth in theatrical revenues and more important, in film industry revenues in India.

- **Favorable demographics of Indian population.** The share of 'young' and 'earning' population (aged between 15 and 44 years) is ~50% of the total Indian population. The emerging demographic does not seek recreation and entertainment within the confines of the home only but is more outgoing in nature and willing to pay for the pleasure of watching movies on 'the big screen'. Movies and associated content (music, videos, celebrities etc.) are part of the staple diet of youth entertainment (also monetized by other media platforms such as print, radio and news channels).

- **Rising urbanization to support growth.** We expect the trend towards greater urbanization to continue in India with people moving to existing urban conglomerates (metros and rapidly growing surrounding regions) and emerging urban areas (mini-metros, state capitals) in search for better career opportunities; theatres, notably multiplexes, usually thrive in high population density areas. Multiplexes are entrenched in the metro markets with some cities likes Delhi and Mumbai already witness to a capacity glut. However, the multiplex rollouts has only begun in emerging mini-metros (Hyderabad, Pune, Chandigarh, Ahmadabad) and Tier-II towns (state capitals like Jaipur, Indore etc.); additionally, the digitization of legacy single screen theatres in Tier-II and III towns will drive more new releases and increasing footfalls.

- **Under-penetration of quality theatres in India.** India is film-crazy market with >3 bn annual admissions, much ahead of 1.5 bn admissions in the well-developed US market. Nonetheless, the singularly large population still implies that India is an under-screened market (see Exhibit 24). The lack of quality theatres is an even more acute problem for the Indian middle-class that has the ability to pay but multiplexes (limited to metros) and digital cinema is still a relatively recent phenomenon in India.

Exhibit 24: Population per screen across key markets, 2008 ('000)

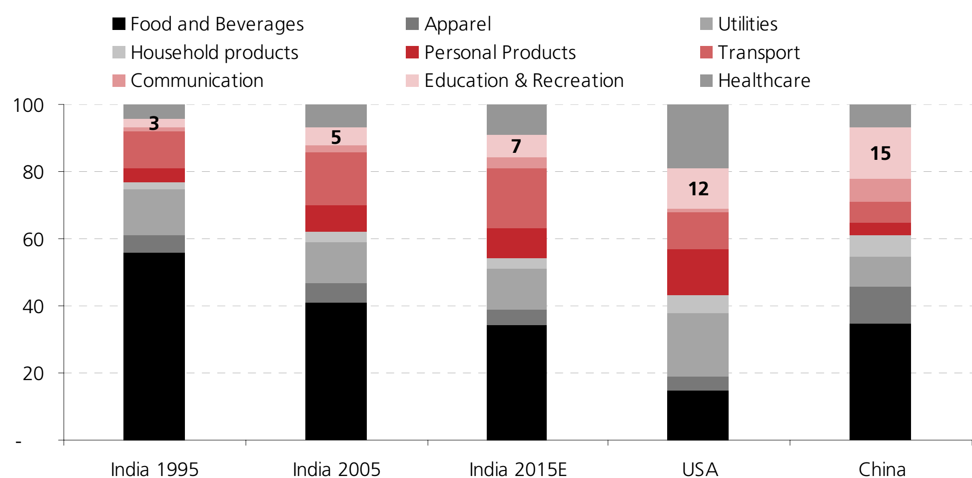


Notes:
(a) We assume multiplex/digital screens catering to urban population in India.

Source: Industry data, Kotak Institutional Equities estimates

- **Changing consumption patterns in India.** The strong GDP growth in India and rising per-capita income of Indian population has translated into higher discretionary spending, including on entertainment. The consumption patterns of the Indian population, notably the rapidly emerging middle-class are moving away from necessities such as food and utilities and towards recreational activities (see Exhibit 25). The media and entertainment industry in India will benefit directly (higher subscription/circulation/theatrical revenues) and indirectly (higher advertising/ancillary revenues).

Exhibit 25: Consumption pattern across key markets, 1995-2015E (%)



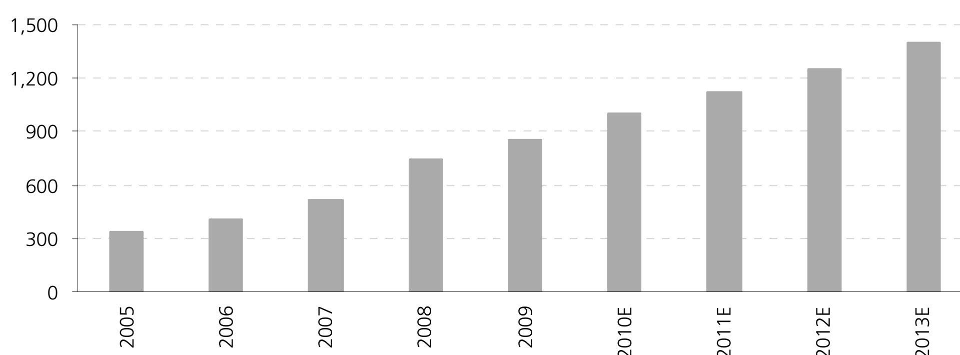
Source: BW Marketing Whitebook 2008, Kotak Institutional Equities

Riding the multiplex wave in India

Consumer demand for quality/choice driving multiplexes. The traditional dominance of single screen theatres set the lowest common denominator benchmark for movie watching experience in India. Additionally, the options in a single screen theatre was limited to one movie despite 2-4 Hindi movies (15-20 movies including regional) releasing every weekend. The emerging affluent and middle-class population in India was willing to pay for a better experience but for the lack of avenues.

The stage was set for the rise of multiplexes (see Exhibit 26) in India. Today, multiplexes account for ~10% total screens (~13,000) in India but more important, contribute ~50% of share of box office collections due to (1) higher ticket prices and (2) higher occupancy levels. (3) Their share of theatrical revenues of film studios is higher due to improved transparency versus under-reporting of revenues from unorganized single screen theatres (has been the case in the past but getting corrected due to digitization).

Exhibit 26: Trend in number of multiplex screens in India, calendar year-ends, 2005-13E (#)



Source: FICCI-KPMG 2009 report, Kotak Institutional Equities

- **Consumer demand is the key driver.** Multiplexes have redefined the quality of service for India's theatre-going population: (1) Superior quality of picture/sound, (2) improved ambience and (3) good-quality food and beverages complete the differentiation versus single screens. To be sure, the quality of service does come at a cost (high ticket prices, marked-up F&B prices) but rising income levels have resulted in a large multiplex audience in India. Also, the consumer gets a wide variety of movie choices (Hindi, English and regional; various genres) at one convenient location.

- **Growing popularity of 'niche' movies.** The introduction of multiplexes with limited capacity screens (~300 seats) and high ticket prices have made small-budget movies targeted at niche audiences viable again (see Exhibit 27). These 'niche' movies are produced keeping the multiplex audience in mind and may be less risky that big-budget mass movies (low investment requirement). Additionally, the portfolio approach of studios (mix of big-, medium- and small-budget movies) is particularly suited to multiplex movies, some of which have surprisingly become runaway hits.

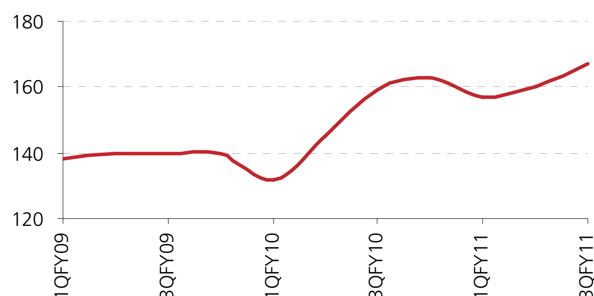
- **High ticket prices.** Multiplexes are able to charge higher ticket prices (~Rs150/ticket; see Exhibit 28) from patrons to recover the investment in quality theatrical infrastructure in prime locations of the city. A clear revenue sharing agreement between the studios and multiplex chains, which ensures 35-50% of the NBOCs are passed to the former, ensures that studios benefit from high ticket prices and complete transparency in multiplex chains. However, the scope for further increases may be limited given already high average ticket prices (ATPs) versus per capita incomes in the metros.

Exhibit 27: Contribution of PVR to box office collections

Movie	PVR (Rs mn)	NBOC (Rs mn)	Contribution (%)
Ghajini	88	932	9.4
Rab Ne Bana Di Jodi	75	694	10.8
Golmaal Returns	40	512	7.8
Dostana	58	491	11.8
Delhi 6	38	360	10.6
Fashion	**58**	**338**	**17.2**
Billu Barber	23	220	10.5
Dev D	**30**	**150**	**20.0**
Luck by Chance	15	120	12.5

Source: Company data, Kotak Institutional Equities

Exhibit 28: Trends in Average Ticket Prices (ATP) for PVR (Rs)



Source: Company data, Kotak Institutional Equities

- **E-tax exceptions has benefitted multiplexes, GST may benefit studios.** The levy of entertainment tax (E-tax) is a state subject in India and the various states have traditionally imposed very high rates on theatres. The trend is on the wane with E-tax rates declining but more important, E-tax exemptions (see Exhibit 29), which has greatly helped the spread of multiplexes given higher return on capital and faster recovery of investment. The studios have not benefitted directly since multiplex chains do not share E-tax exemptions with the studios. However, the introduction of goods and services tax (GST) may benefit both given lower effective tax rate (see Exhibit 30).

Exhibit 29: E-tax and exemption in key markets in India (%)

State	E-tax (%)	Exemption
Mumbai	**31**	**Yes**
Delhi	**17**	**No**
Maharashtra	30	Yes
Gujarat	20	Yes
Punjab	50	Yes
Haryana	30	No
Uttar Pradesh	40	Yes
West Bengal	30	Yes
Tamil Nadu	15	No
Andhra Pradesh	20	No
Karnataka	30	No

Source: Industry data, Kotak Institutional Equities

Exhibit 30: Impact of uniform GST on studio revenues (Rs)

	E-Tax	E-Tax	GST
Average ticket price	200	200	200
E-tax/GST (%)	**40**	**30**	**20**
Tax paid (a)	**80**	**60**	**40**
Net box office collection	**120**	**140**	**160**
Studio share of NBOC (%)	50	50	50
Studio realization	**60**	**70**	**80**
Net studio share (%)	**30**	**35**	**40**

Notes:
(a) E-tax exemption is completely realized by Multiplexes.

Source: Kotak Institutional Equities estimates

- **Spread of retail real estate in conjunction with organized retail.** The multiplex revolution in India has piggybacked on the expansion in retail real estate and organized retail segments in India, together translating into an emerging 'mall' culture. Organized retail chains and multiplex theatres benefit from the prime real estate locations of malls and in turn draw the crowds to the mall as anchor tenants. The competition among retailers and multiplexes resulted in significant increase in lease rentals previously, almost making the business unviable. The slowdown in the Indian economy has brought in the much-needed correction in lease rentals.

- **Digitization of multiplex screens.** Though digitization has been the dominant trend in single screens in India, multiplexes are joining the bandwagon given (1) reduced cost of operations (lower cost of digital prints), (2) improved and consistent quality of picture and sound over time and (3) easier distribution and control (centralized servers). Large multiplexes have gone for the D-Cinema (global) standard, which also allows for first-day global release of Hollywood movies in India.

Digitization—boon for single screen (SS) theatres

Single screens may yet have their place in the sun. The emergence of multiplexes have taken their toll on the dominance of single screens (SS) in India given their deficiencies such as (1) poor amenities, (2) reliance on mass movies given capacity (>500 seats), (3) lack of technology upgrades and (4) high taxation. Enter digitization to the rescue; additionally, conversion of single screen theatres into digital mini-plexes given their prime locations is another model being tested by some multiplex chains.

Digital Cinema—the basics and the benefits. Digital cinema is essentially a replacement of celluloid films and analog projectors with digital projection and storage. There are two version of the digital cinema—(1) D-Cinema refers to the digital specification provided by the Digital Cinema Initiative (DCI), a global norm, versus (2) E-Cinema, which is the poor cousin (low picture and sound quality though the difference is marginal) but has found ready acceptance in India. The two technologies differ largely in terms of investment requirement, and E-Cinema is more financially viable in India.

- **Savings in print cost**. The analog print cost born by a studio/distributor is ~10% of the cost of production of a big-budget movie (assuming 500 prints). Thus, in order to save on print cost, studios/distributors used to release limited analog prints starting with metro markets and then shift the same to smaller markets. The cost of digital print is much less than the cost of analog print; the economics of digitization is very favorable with a 3-year payback on E-Cinema (see Exhibit 31).

Exhibit 31: Payback period for D-cinema and E-cinema technologies (yrs)

	D-cinema	E-cinema	Comments
Analogue print copy cost (Rs)	60,000	60,000	
Average stay of movie per screen (weeks)	2.0	2.0	
Analogue print copy re-use across acreens	2.0	2.0	Re-use of prints in Tier-I towns, after screening in metros
Analogue print cost per screen (Rs mn/yr)	0.78	0.78	
Digitization cost per screen (Rs mn)	**4.5**	**1.8**	**US$100,000 for D-cinema, US$40,000 mn for E-cinema**
Digital print copy cost (Rs) (a)	6,000	6,000	Includes cost of digitalization and distribution of the movie
Average movie stay per screen (weeks)	2.0	2.0	
Digital print cost per screen (Rs mn/yr)	0.16	0.16	
Savings on print costs (Rs mn/yr)	**0.62**	**0.62**	
Simple payback period (yrs)	**7.2**	**2.9**	

Notes:
(a) We assume cost of digitalization of the movie is distributed across 500 digital copies.

Source: Industry data, Kotak Institutional Equities estimates

- **Wider release of film and reduced piracy**. The studios/distributors can flood the distribution network with large numbers of digital print, given the lost cost of replication and distribution, enhancing the revenue-generating ability of the movie. The exhibitors benefit from attracting more audiences from first-day release of a film and improved ATPs. The film studios benefit from greater control and reduced leakages from piracy (encryption in Digital Cinema), ability to create a wider buzz around the movie and improved revenues from smaller markets (single screens).

- **Unique lease rental business model in India**. The contentious issue in digitization pertains to large investment in digital equipment by theatres and benefits accruing largely to the studios/distributors (low cost of digital prints). A unique lease rental model has evolved in the Indian context where neither the exhibitors nor the studios/distributors make any upfront investments in digital equipment; a neutral technology provider make the investment and collect a nominal fee (~Rs250 per screening) from both the distributor and exhibitor. Technology players such as UFO Movies and Real Image are driving the digitization wave in India (>2,000 digital screens already).

Carpet bombing is the name of the distribution game

The rapid spread of multiplexes and Digital Cinema enable the studios to get a better bang for their buck (production cost is already sunk) by increasing prints given high marginal revenue potential (multiplexes) and low incremental cost (digital single screens). The wider release of a film helps further reduce the revenue leakages, even at the cost of higher P&A (print and advertising) cost, as it is sampled by a larger audience; the P&A cost in India is still ~20% of the cost of production versus ~100% in Hollywood. With the first week accounting for ~65% of NBOC and the first weekend ~75% of first-week NBOC, this also reduces revenue risk given weak response from critics.

Exhibit 32: Incremental profitability from increasing P&A expenses (Rs mn)

	Current	Multiplexes/Analog	Single screen/Digital
Cost structure			
Production cost	500	500	500
P&A expenses	100	106	106
Incremental cost		**6**	**6**
Revenue potential			
Cost per print (Rs)		60,000	6,000
Additional prints (#)		**100**	**1,000**
Occupancy (%)		25	10
Number of seats (#)		300	600
Average ticket price (Rs)		150	50
Length of the run on BO (weeks)		2	2
Gross BO collections		**63**	**168**
Entertainment tax (%)		40	40
Net BO collections		**38**	**101**
Producers' share (%)		50	30
Incremental revenue		**19**	**30**
Incremental income		**13**	**24**

Source: Industry data, Kotak Institutional Equities estimates

Revised revenue sharing with multiplexes boon for studios

The multiplexes and studios share a symbiotic relationship with the latter providing a steady content pipeline for the former and the former providing improved monetization to the latter. However, some key issues between the studios and multiplexes pertain to (1) studio's low and week-on-week declining share in NBOCs, (2) lack of sharing in E-tax exemption but most important, (3) last-minute haggling over revenue sharing terms when the studio had completed production and publicity of a film was in full swing. The resultant dispute between the two in April-May 2009 resulted in (1) standardized revenue sharing agreement giving (2) studios a larger share in NBOCs including (3) a performance incentive based on the success a film. The revised agreement results in an increase of 4-7% in studio's share of theatrical revenues for an average film and 7-13% for a successful film (defined as a film with first-week NBOC >Rs175 mn across the six national multiplex chains).

Exhibit 33: Revised studios' share of total multiplex NBOCs (%)

	Week1	Week2	Week3
Previous formula			
High-budget movie	**48.0**	**40.0**	**35.0**
Normal-budget movie	45.0	40.0	35.0
Revised formula			
Successful movie	52.5	45.0	37.5
Average movie	**50.0**	**42.5**	**37.5**
Increase in share (%)			
Successful big-budget movie	**9.4**	**12.5**	**7.1**
Average big-budget movie	**4.2**	**6.3**	**7.1**

Source: Industry data, Kotak Institutional Equities estimates

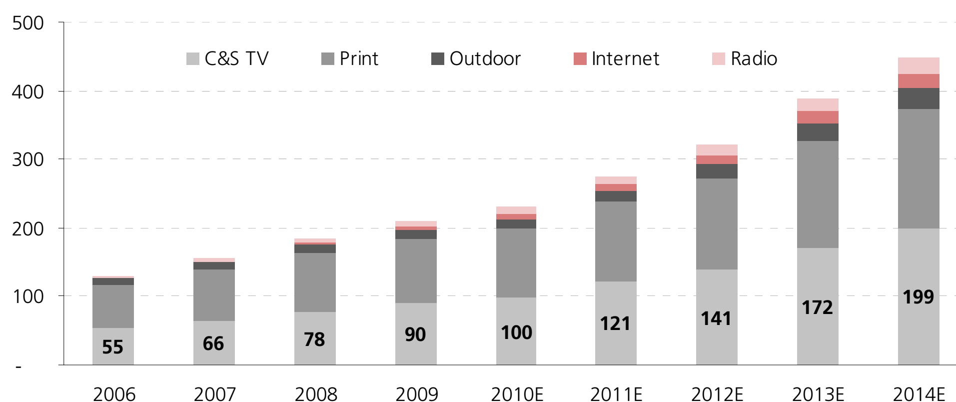
TV LICENSING: INDIA'S LARGEST MEDIA SEGMENT

We expect strong growth in Indian C&S TV advertising revenues led by (1) robust sustainable real GDP growth of ~8%, (2) rising disposable incomes and discretionary spending and (3) increasing advertisers on C&S TV along with strong growth in subscription/pay-TV revenues driven by (4) increasing C&S penetration driven by rapid spread of DTH notably in rural areas and (5) increasing digitization. EROS' strong new film release slate as well as diverse content library will find ready takers in large number of Indian broadcasters with rising demand for quality content. EROS's large film library will provide relatively steady revenues irrespective of syndication (sellers' market) or exclusive (buyers' market) licensing.

Broadcasting—India's largest media segment

We expect strong growth in Indian C&S broadcasting advertising revenues to sustain (see Exhibit 34) led by (1) robust sustainable nominal GDP growth (~14%), (2) increasing penetrations of media platforms notably C&S TV, (3) rising disposable incomes and discretionary spending as well as (4) increase in number of advertising categories on C&S TV (see Exhibit 35) driven by rising scale and greater organization in currently unorganized industries in India. We highlight that the current ad-spend-to-GDP ratio of ~0.5% in India is low given India being a consumption-driven economy with private consumption constituting >50% of GDP. Robust nominal GDP growth of ~14% and even a moderate increase in ad-spend-to-GDP ratio to 0.6% over the next decade will result in sustainable Indian media advertising revenue CAGR of >16%, led by C&S TV.

Exhibit 34: Advertising revenues across media platforms, March fiscal year-ends, 2006-14E (Rs bn)



Source: Kotak Institutional Equities estimates

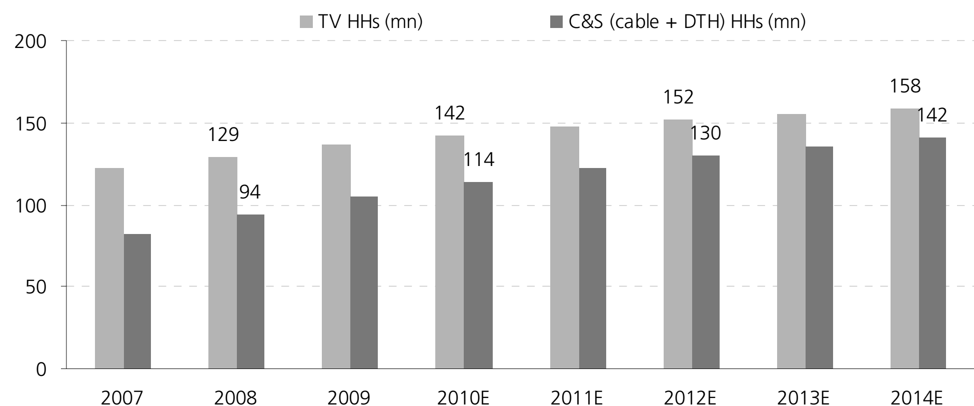
Exhibit 35: Trends in Indian C&S TV advertising, calendar year-ends, 2000-10

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
TV advertising volume											
Actuals (X=100)	133	167	245	352	452	591	781	1,021	1,306	1,711	2,121
Growth (%)	33	26	47	44	28	31	32	31	28	31	24
Avg. ads per day on a TV channel											
Actuals (X=100)	98	110	128	141	159	181	202	209	226	255	319
Growth (%)	(2)	12	16	10	13	14	12	3	8	13	25
TV advertisers											
Actuals (X=100)	100	95	112	152	180	183	188	206	189	202	238
Growth (%)	—	**(5)**	**18**	**36**	**18**	**2**	**3**	**10**	**(8)**	**7**	**18**
TV brands											
Actuals (X=100)	102	99	114	145	170	167	173	189	182	200	238
Growth (%)	**2**	**(3)**	**15**	**27**	**17**	**(2)**	**4**	**9**	**(4)**	**10**	**19**

Source: TAM Media Research, Kotak Institutional Equities

Exhibit 36 presents the robust growth Indian TV and C&S households (HHs) over the next several years driving advertising as well as subscription revenues of C&S TV broadcasters. The robust growth in C&S TV in India is driven by (1) rising income and consumption levels in Indian households resulting in (2) higher base of TV households and (3) greater penetration of pay-TV C&S households in India. The Indian consumer across semi-urban and rural markets in India is demanding content beyond the limited (albeit free-to-air) offerings of the national broadcaster. The demand for movie content is also rising as film telecasts as well as film-based content (music videos, celebrity shows) are immensely popular with viewers (and advertisers) on the C&S TV networks.

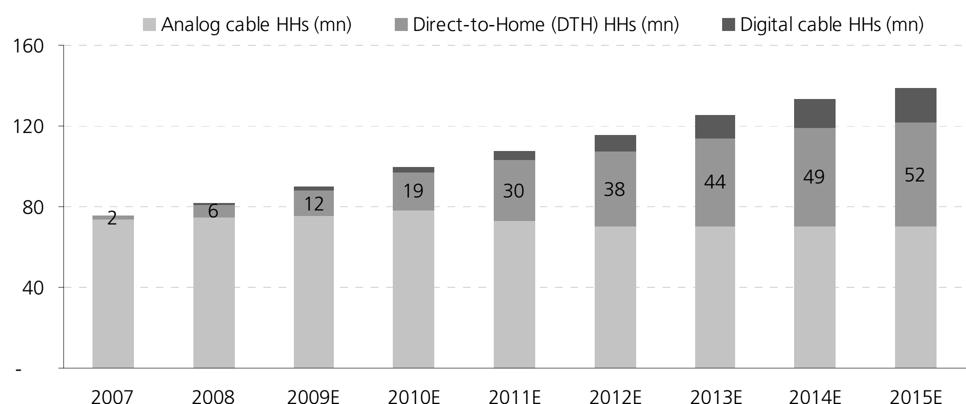
Exhibit 36: TV and C&S HHs in India, calendar year-ends, 2007-14E (mn)



Source: Media Partners Asia, Kotak Institutional Equities

Exhibit 37 presents the strong growth in DTH and digital cable households in India over the next several years. Traditionally, analog cable has been the dominant platform in India with DTH and digital cable emerging as viable options recently. The unorganized analog cable networks resulted in multiple problems for consumers and broadcasters alike notably (1) limited carriage capacity (maximum 100 channels) and (2) lack of addressability resulting in high 'leakage' of revenues, with LCOs sharing only a minuscule part of consumer pay-TV revenues with broadcasters (~15% versus ~40% in international markets). The rapid uptake of organized DTH services in India is (1) increasing broadcasters' share (~35%) of the pay-TV revenues and (2) providing more channel capacity.

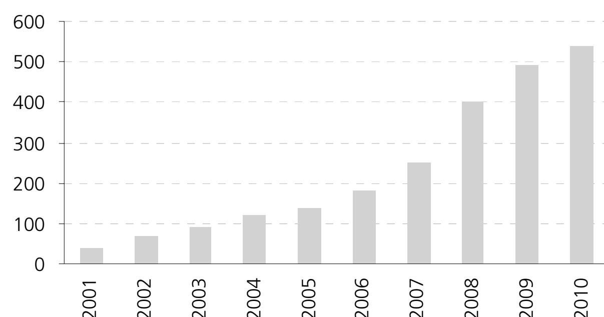
Exhibit 37: Cable (analog/digital) and DTH HHs in India, March fiscal year-ends, 2007-15E (mn)



Source: Kotak Institutional Equities estimates

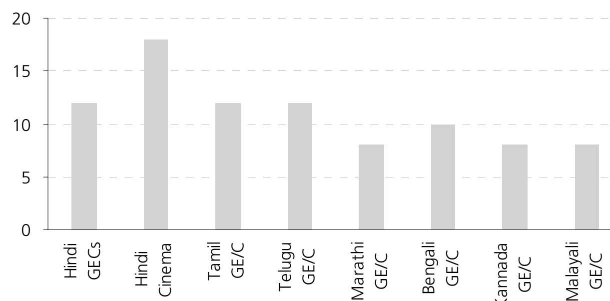
Exhibit 38 presents the trend in number of C&S channels in India. The strong growth in number of channels in India is driving demand for quality, diverse and differentiated content; we also note the diversity in languages and cultures in India resulting in large number of regional channels in India (see Exhibit 39), demanding popular movie content (more popular in case of regional channels versus Hindi channels). EROS caters to these large number of Hindi/regional channels of various genres (general entertainment, cinema, music and youth) with its new film release slate as well as large, diverse (including regional films) library and receives licensing income in lieu of its services.

Exhibit 38: Trend in C&S TV channels operational in India



Source: TRAI, Kotak Institutional Equities

Exhibit 39: Movie-oriented C&S TV channels operational in India



Source: Industry data, Kotak Institutional Equities

Competition for quality movie content has intensified. The entry of new channels in the market has intensified competition, increased fragmentation (declining trend in HH-Index) and eroded the bargaining power enjoyed by legacy leadership channels (see Exhibits 40-41). The success of new channels is a boon to content providers like EROS given (1) new channels have used movie content to attract audiences and get then to sample their channel (other content) and (2) the legacy movie catalog is also required to fill the gaps in programming hours given the high cost of original content.

Exhibit 40: Market share of key Hindi GE channels (%)

	2007	2008	2009	2010	2011E
Colors	-	-	14	24	21
Imagine TV	-	2	7	9	7
SAB	5	4	3	6	9
Sony TV	12	12	9	11	13
Star Plus	46	36	28	22	26
Zee TV	22	28	19	20	17
Others	15	18	20	10	7
HH-Index	**2,891**	**2,387**	**1,597**	**1,685**	**1,742**

Source: TAM Media Research, Kotak Institutional Equities

Exhibit 41: Market share of key Hindi cinema channels (%)

	2007	2008	2009	2010	2011E
FILMY	8	8	6	5	5
SET MAX	34	32	30	30	24
Star Gold	21	22	19	19	22
UTV Action	-	1	3	4	7
UTV Movies	-	0	6	8	8
Zee Cinema	31	30	29	28	25
Others	7	7	6	7	9
HH-Index	**2,574**	**2,463**	**2,229**	**2,126**	**1,860**

Source: TAM Media Research, Kotak Institutional Equities

There are two forms of film licensing: (1) Syndication—sale of non-exclusive rights across 3-5 broadcasters and (2) Exclusive—sale of exclusive rights to one broadcaster. The syndication model has higher revenue potential since sale of rights is across multiple broadcasters and rights revert to a film studio quickly, resulting in faster re-monetization. The slowdown in media market resulted in reduced demand and pricing of film licensing (exclusive model). However, sustained market fragmentation (permanent feature of Indian C&S TV) and recovery in advertising market has resulted in improved demand and pricing of film licensing. The market is trending towards the return of syndication model with the impending launch of Hindi cinema channels by IBN18/Colors and Reliance-ADAG.

EROS' strategy—'Share of Wallet' given large catalog/library

Exhibit 42 presents the movie content slate of Hindi movie channels during periods of special interest (Republic Day) and festivities (Valentine Day/New Year). Unlike Hindi GE channels, which acquire only the successful, blockbuster movies given their standing (in the broadcasters' network), movie channels require 24-hour movie content and are large important clientele for large film studios such as EROS. The movie channels require a large amount of legacy film content to fill the gaps in their programming. This is especially true for new channels that cannot afford to have all the best new movies (given capital constraints) but require quality content to attract audience.

Exhibit 42: Primetime content slate of key movie channels during special events

New Years - January 01			Republic Day - January 26		
Channel	**Movie**	**Genre**	**Channel**	**Movie**	**Genre**
Zee Cinema	Tarzan - 'Wonder Car'	Family	Zee Cinema	Mission Vande Matram	Patriotic
Zee Cinema	Phir Hera Pheri	Comedy	Zee Cinema	Ab Tumhare Hawale Watan	Patriotic
SET MAX	Namastey London	Romance	SET MAX	Main Azaad Hoon	Patriotic
SET MAX	Baghban	Family	SET MAX	Lage Raho Munnabhai	Nationalist
Star Gold	Welcome	Family	Star Gold	Hero - Love Story of a Spy	Nationalist
Star Gold	Kunwara	Comedy	Star Gold	Qayamat - City under Siege	Patriotic
FILMY	My Name is Anthony	Comedy	FILMY	Hindustani	Nationalist
UTV Movies	Home Delivery	Comedy	UTV Movies	I - Proud to be an Indian	Patriotic

Source: TAM Media research, Kotak Institutional Equities

The movie channels also cater to the diverse needs of the audience showcasing low-profile (dubbed English movies) and legacy-marquee (black-and-white-era movies) film content even as GECs cater to the mass audience in India (the lowest common denominator). However, the large broadcaster networks in India (Zee, Star, Sony, Sahara) have both Hindi GE and movie channels in their network and prefer bundled movie packages from large studios such as EROS instead of piecemeal acquisitions. The package also comes in handy when channels' want to provide packaged content to the users (movie festivals where movies from a genre or associated with a popular talent are telecast).

Large film library makes allows for both syndication and exclusive licensing. EROS' large library of Indian films allows for effective monetization in both the sellers' (Syndication) and buyers' (Exclusivity) markets. EROS pursued Syndication licensing during the upturn (FY2007-08) as new channels resulted in sharp increase in demand and consequently pricing of content; the catalog was monetized separately. The demand for content softened during the ensuing economic slowdown and EROS switched to Exclusive licensing with bundled catalog movies. EROS worked separately with each major broadcaster, packaging and licensing a bundle of movies (new releases as well as back catalog) keeping in mind its unique and differentiated requirements. EROS limited the impact on its telecast cast rights revenues (~20%) versus the significant correction in prices of telecast rights (~40% decline from peak levels) during the downturn (FY2009-10).

EROS' strategy is to capture higher 'Share of Wallet' of broadcasters' budget. EROS follows the portfolio strategy across its operations notably content acquisition as well as monetization. The management looks to exploit the entire bench-strength of its movie library during negotiations with large long-standing clients such as Star, Zee, Sony et al in garnering the maximum revenue potential from a broadcaster. EROS's large and diverse movie library allows it the flexibility to create a package of movies that fit the needs of a broadcaster network. The TV licensing revenue from back catalog is a high-margin annuity revenue stream exploited alongside the new release slate.

3DS OF NEW MEDIA: DVD, DTH AND DIGITAL

Robust growth in ancillary revenue streams such as home entertainment (DVDs) and new media (DTH, mobile) is critical for the growth of Indian film industry and EROS given (1) better engagement with the consumer and (2) reduced dependence on volatile box office. (1) Spread of organized retail, (2) greater penetration of high-end TV sets and 3G-enabled phones and (3) improved marketing efforts will drive new media platforms in India though piracy remains a persistent concern. The inflection point for new media revenues may still be sometime away given yet low platform penetration in India. We consider home entertainment (HE) within new media segment given emerging state of its development in India.

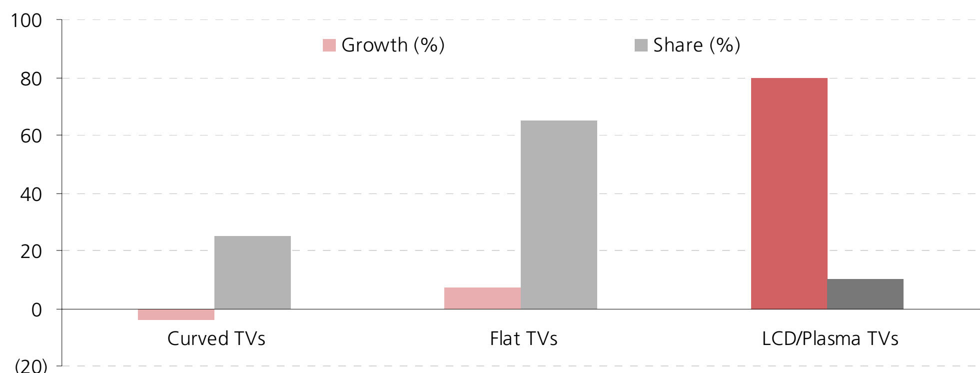
Home entertainment (HE)—organized retail, high-end TVs

Home entertainment (HE) is a constantly evolving market. The home entertainment (HE) market in India and globally has been constantly evolving starting with average quality VHS tapes to high quality VCDs/DVDs and further towards high-definition formats such as Blu-Ray. A strong catalog of films is at the heart of HE distribution since the rights to the catalog can be re-monetized time and again across different formats and technologies over time. EROS' large, diverse film catalog, which it continually refreshes with its new release slate, and its home entertainment distribution network covering retailers across India are the key drivers for the business, which is a modest contributor to the financials currently.

Piracy key roadblock; windowing for effective exploitation. The HE exploitation in India is plagued by piracy with the advantages of pirated content—(1) quick availability post release of movie and (2) low prices. However, there are certain disadvantages as well notably (1) the poor quality and (2) limited life-span of pirated HE formats. Thus, the branded HE players like EROS have started reducing the release window of HE formats, which are now available on the shelves within a few weeks of the films' theatrical release, and reduced the price premium over pirated HE to attract users. However, the protection accorded to intellectual property rights in India is not as effective as well-developed international film markets and needs considerable improvement.

Organized retail and high-end TVs may support HE growth. The rapid spread of organized retail in India has also supported branded HE. However, organized retail is an emerging industry in India with a modest ~10% share of the total retail market. We expect branded HE to witness robust growth alongside the organized retail market in India. Additionally, the rapid uptake of high-end TVs and home theatre TVs (see Exhibit 43) also favors the growth of branded HE in India. However, we note that high-end TV market is small currently and the inflection point may be some time away. Also, DTH and digital cable platforms may be better placed to capture the HE market, as is happening globally, given their rapid spread and large penetration in India.

Exhibit 43: Growth and share of various CTV types in India, March fiscal year-end, 2010 (%)



Source: Industry data, Kotak Institutional Equities

Value-Added-Services (VAS)—DTH and digital cable

Growing DTH penetration in India. Analog cable has traditionally been the dominant C&S platform in India and the entry of DTH has forced the shift to digital, as previously discussed, given the advantages—(1) significant improvement in picture quality and (2) significant increase in content capacity. Additionally, digital platforms allow for special interest content such as new film releases to be made available to consumers willing to pay for the same; digital platforms have opened up a new window and monetization opportunity between theatrical and C&S TV. EROS has PPV (Pay-Per-View)/ VOD (Video-On-Demand) deals with all major DTH operators in India for its new film release slate. Only a minority of digital cable networks in India are addressable currently and thus, EROS' deals with digital cable providers is more in the nature of TV licensing than revenue share.

Subscription VOD (SVOD)—evolution of VOD/PPV model. The PPV/VOD model allows consumer to watch special interest content such as a particular movie by making a one-time payment to the service provider (DTH or digital cable); the revenue generated is shared between the service provider and the content provider (EROS, in this case) usually on a 50:50 basis. The VOD model has evolved in the international markets with content and service providers starting to offer the subscription-oriented movie channels to the audience. Instead of a one-time payment for a particular movie, the consumers pay a recurring monthly fee for a pre-determined number of movies.

The content provider (EROS) is responsible for providing a minimum number of new releases/movies every month as well as refreshing the catalog movies on a monthly basis. The consumer benefits from a continuous stream of new movie content delivered at the same time it is released in theatres and is spared the hassle of making payments everyday. The content provider benefits from revenue visibility from its new film release slate as well as more effective monetization of its large, diverse library. EROS is looking to replicate Eros Group's international experience with SVOD deals with Comcast and Cablevision with digital cable and DTH platforms in India.

Large monetization potential given proper marketing. Exhibit 44 presents the revenues opportunity for SVOD services from digital platforms in the context of possible first-day release alongside theatrical release and ability to reach a much wider population; we highlight that there are >30mn digital set-top- boxes (>100mn individuals assuming 4 persons per household) in India currently, likely to more than double in the next few years. This compares with the maximum seating capacity of about ~5mn per show across all the theatres in India; the actual theatrical release in India is limited to ~10% of the total 13,000 theatres in India given the high cost of prints. However, the uptake of VOD services in India has been lukewarm so far; we believe greater marketing by service and content providers may be required to develop the consumer and the market. Nonetheless, the inflection point for S/VOD services may be some time away.

Exhibit 44: Revenue potential from VOD/SVOD movie services (Rs mn)

	VOD		SVOD	
VOD/SVOD penetration (%)	**3%**	**5%**	**1%**	**2%**
Number of households (mn)	30	30	30	30
Number of subscriber HHs (mn)	0.9	1.5	0.3	0.6
Average revenue per HH (Rs) (a)	50	50	600	600
EROS share of revenue (%)	50	50	50	50
Incremental revenues (Rs mn)	**23**	**38**	**90**	**180**

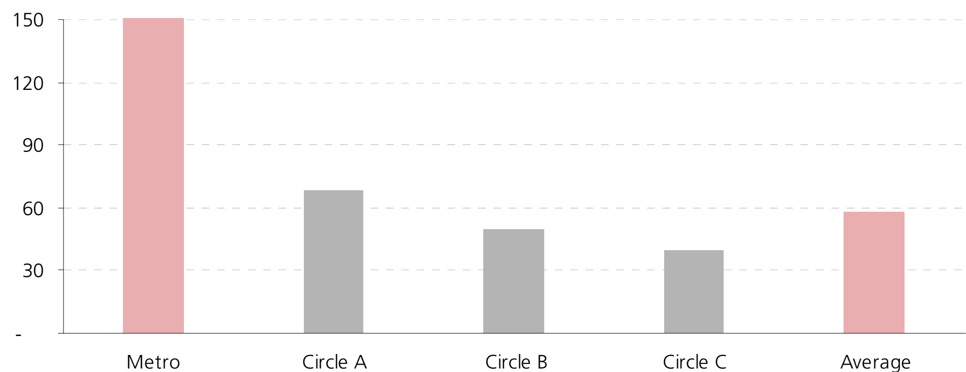
Notes:
(a) Rs50 per movie VOD and Rs50 per month (Rs600 per year) SVOD.

Source: Industry data, Kotak Institutional Equities estimates

Mobile-Value-Added-Services (MVAS)—the digital revolution

Mobile/Wireless telecom in India—a revolution indeed. The growth in mobile/wireless telecom market in India is indeed revolutionary with India becoming the largest telecom market in terms of volume (number of subscribers) and overall tele-density rising to >50% in 2010 from ~5% within the span of a decade. With falling tariffs and telecom operators penetrating deeper into rural areas, one can expect the mobile penetration levels to increase further in India. More important, the high-revenue-potential population in metros and towns of India is already covered (see Exhibit 45) though data services are still lagging behind; we expect the launch of 3G services in India to take care of the same, with operators pushing mobile VAS to counter declining commodity voice revenues.

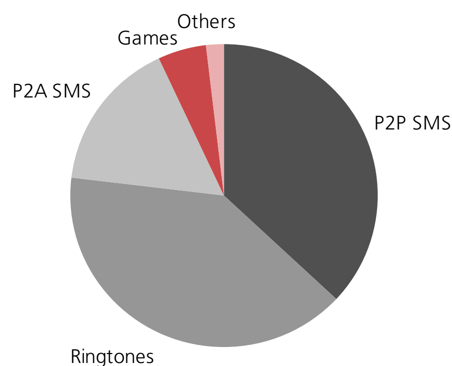
Exhibit 45: Penetration levels of wireless telecom in India across circles (%)



Source: Telecom Regulatory Authority of India, Kotak Institutional Equities

Entertainment is a key driver of MVAS in India. The MVAS market in India is around Rs117 bn (as of FY2010, as per IAMAI-IMRB 2010 report) of which ~40% is contributed by ringtone services driven by music (largely film entertainment; see Exhibit 46). The key differentiating factor of Entertainment MVAS such as film music has been the mass appeal that it generates, helping convert non-users as well as driving heavy volumes and usage of other services. New innovations in the form of Caller Ring Back Tones (CRBT) have led the growth of Entertainment MVAS in India, alongside greater penetration and usage of data services on GPRS and 3G-enabled handsets.

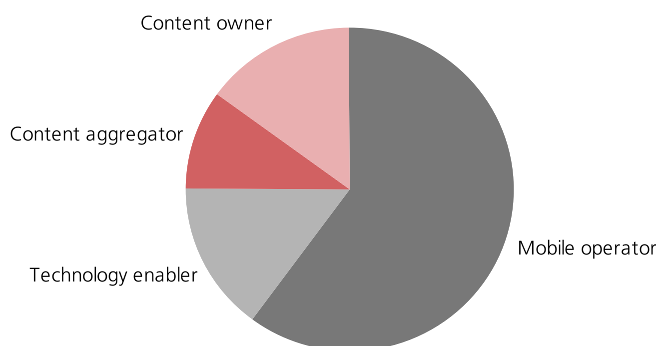
Exhibit 46: Contribution of various services to MVAS revenue in India (%)



Source: IAMAI-IMRB 2010 report, Kotak Institutional Equities

However, content is not the king of mobile. Exhibit 47 presents the distribution of revenues across the stakeholders in the Entertainment MVAS value chain; we highlight the heavy skew in favor of the mobile operators given their control of the last-mile (subscribers). (1) The large scale of telecom operators versus content owners, (2) vertical integration by mobile operators into the domain of technology enablers, (3) fragmentation at the content owner/aggregator level and (4) lack of effective regulation has resulted in mobile operators controlling the MVAS market in India. The content aggregators and owners are unable to even obtain authentic data on the number of unique users of their content and thus, most of the deals in this segment are done on an MG basis.

Exhibit 47: Share of various stakeholders in Entertainment MVAS (%)



Source: IAMAI-IMRB 2010 report, Kotak Institutional Equities

Changes in the mobile market may change the game. The mobile telecom market in India is currently undergoing a seas change notably at the level of (1) competition, where a large number of new mobile operators are going to enter the market, (2) technological change, with 3G licenses auctioned and operations taking-off, (3) declining voice ARPUs, driven by increasing competition in the market and making MVAS an integral part of an operators value-proposition and service as well as (4) vertical integration by content owners into the domain of content aggregators and technology enablers.

Increasing competition and increasing importance of MVAS, from a revenue as well as platform differentiation perspective, may force mobile operators to pay a premium for content that will help increase stickiness with users and create a differentiation for the operator/brand with the consumers. The introduction of 3G services will accelerate the trends towards increasing penetration and greater usage of data services, further increasing the importance of entertainment content such as music, videos etc. However, the content owners will have to focus their guns on consolidating the content market and building large content libraries to strengthen their bargaining power.

EROS proposes to do just that by (1) investing in expanding its catalog of film rights encompassing all audio-visual rights, (2) digitally archiving the film catalog into a readily searchable platform (DAM; Digital Asset Management platform) and (3) expand its distribution network further into the digital domain either organically or inorganically. The increasing competition among mobile operators and reduction in number of middlemen in the value chain may help EROS garner a higher share of the MVAS revenues and command a premium for its content. EROS may venture into the content aggregator domain itself to directly interact with mobile operators and monetize the digital rights associated with its new release slate as well as catalog films through DAM.

INDIAN FILM INDUSTRY: SHOW BUSINESS IS RISKY BUSINESS

We highlight the key risks for the Indian film industry in general—(1) the film business is essentially a 'hit or miss' business, (2) slower-than-expected expansion in multiplex screens and digitization, (3) competition for limited high-quality content and talent resulting in price escalations, (4) rising acceptance of Hollywood content in India and (5) continued problem of extensive piracy in India. We highlight the following key risks for EROS in specific—(1) hard-to-predict revenues and income from TV licensing deals and talent-specific profit sharing contracts, (2) dependence on support from Eros Group and (3) sustained capital requirement given the 'long-tail' of revenues and expanding film catalog.

Dependence on the box office for success or failure

The Indian film industry, compared to more developed international markets, is heavily dependent on the theatrical revenues derived from the box office. Indian domestic box office receipts tend also to be a predictive indicator of a film's expected success in other distribution channels. The ancillary revenue streams in India have been witnessing robust growth but there can be no assurance that industry revenues in future will be less dependent on the box office receipts than in the past, or that there will be less correlation between box office success and success in other distribution channels.

Slowdown in multiplex expansion and digitization

Continued growth of multiplexes in the large cities of India and digitization in existing single screen theatres is important for the growth of the Indian film industry given the heavy dependence on theatrical revenues. However, the expansion of multiplexes in India has happened in conjunction with the growth of organized retail and retail real estate in India; organized retail as well as real estate markets in India were significantly impacted by the economic slowdown, resulting in markedly slower growth. Similarly, digitization requires significant capital, which may or may not be timely available.

Competition for limited high-quality talent and content

The growth in the Indian film industry has resulted in the entry of many national and international players with deep pockets in the market. Intensified competition in recent years has increased demand for the limited pool of creative talent in India, which has in turn contributed to an increase in the cost of creative talent as a proportion of a film's overall budget. The competition for limited high-quality talent and content may result in significant price escalations in content acquisition, impacting the profitability and viability of the other stakeholders in the Indian film industry.

Rising acceptance of Hollywood content in India

The Indian film industry is substantially dependent on consumer tastes or preferences that are continuously changing. The Indian film industry creates content largely in local languages such as Hindi and other regional language. The Indian film industry is much smaller compared to international film markets such as US, which limits its ability to spend heavily on content. The large dual-language population in India has become a target for Hollywood film studios; the ability of the Indian film industry to compete against financially and technologically superior competition is less than certain.

Continued problem of piracy in India

The growth of the Indian film business is critically dependent on the ability to stakeholders to protect their intellectual property. The protection for intellectual property rights in India is not as effective as in most developed markets. Piracy of films and sales of counterfeit media, including DVDs and CDs, and continued or increased unauthorized use of intellectual property rights associated with films is a widespread problem in India. The continued menace of piracy and leakages of revenues from the value chain may limit the monetization potential of films and the growth of Indian film industry.

Governance practices of the industry need to improve

The Indian film industry has come a long way from being a largely family-driven unorganized business in the 1980s-90s to an increasingly corporatized approach led by film studios such as YRF Films, Eros and UTV in the 2000s. However, old habits die hard and cash transactions continue to be part of the industry, notably at the level of sub-distributors, single-screen theatres and producers. Further, disclosure levels at the industry and company level need to improve. The problem is further complicated by the contractual nature of the film industry; maintaining the sanctity of the contracts entered into by film studios with various parties necessitates improved disclosures and clear transaction trails.

Hard-to-predict TV licensing revenues and profit sharing

The revenues and profitability of film studios like EROS are critically dependent on its ability to continuously source content at competitive prices. The recent trend towards greater sharing of risk-reward between the various stakeholders, while positive from an operational perspective, makes it harder to predict revenues and profitability. Additionally, EROS books revenues from TV licensing and new media contracts on deal closing rather than amortizing the benefit over the term of the contract, further complicating predictability of revenues as well as raising flags over its quality of earnings. Nonetheless, we highlight that with EROS largely pre-selling TV rights, the risk is only on the timing and not on the quantum of cash flows, which are considerably de-risked.

Dependence on Eros Group and the Relationship Agreement

Eros Group provides financial and strategic support to EROS in the form of large loans and advances (at zero interest cost) from group companies to EROS and its subsidiaries, which is then used to fund the film production and acquisition activities of the group in India. Additionally, the transactions between the Eros Group and EROS are governed by the terms of the Relationship Agreement, which provides for pre-defined commission for EROS. However, the financing arrangements and the Relationship Agreement with the Eros Group are subject to revisions in the future. Nonetheless, we highlight that the need for capital and support from Eros Group has gone down considerably post the IPO, with the EROS having an under-leveraged balance sheet currently.

Sustained capital requirement to scale the business

EROS is focused on expanding its new release slate through acquisitions and co-productions as well as its library of films through catalog acquisitions, which may require significant capital. The film business is a capital intensive business wherein the costs are incurred upfront but the revenue streams (with the exception of theatrical) are ‘long-tail’ in nature, which requires sustained capital infusion till such time that annuity revenue stream from film catalog becomes large enough to support recurring capital investment. EROS as well as the Indian film industry is at a nascent stage in their development curve, which may require EROS to continually tap the capital markets.

Success in new business initiatives is not guaranteed

EROS has expanded into new business segments such as regional films and special effects (EyeQube) in the recent past. The success in new business initiatives is not guaranteed given EROS’ limited experience and emerging nature of these new businesses. We highlight the risk through the example of EyeQube, which handles the VFX business for the group. The VFX ability of Indian studios is small given limited capital and large technological gap versus the developed film markets. Thus, the risk lies in EROS allocating capital to EyeQube and VFX projects that may not match the expectations of the audience given their exposure to technological advanced Hollywood films.

FINANCIALS: MARKET SHARE GAINS, CATALOG TO DRIVE EARNINGS

We model strong 32% CAGR in EROS' EBIT over FY2011E-13E led by (1) robust market share gains in new release film slate (Hindi and regional), (2) large, expanding catalog of films and (3) transformation of Indian film industry (box office led by digitization, emerging ancillary revenue streams). However, free cash flows will likely be subdued during the growth phase (FY2012E-13E) with (1) rising investments in new film release slate and (2) shift towards co-productions (12-18 months lead time) versus acquisition resulting in increase in working capital investments (advances for film production). Nonetheless, we expect improved return ratios between FY2012E and FY2013E and beyond as transformation of Indian film industry (on revenue as well as cost side) will likely lead the renewed investment cycle.

Strong EBIT growth led by expanding new release slate, catalog

Exhibit 48 presents our profit model of EROS. EROS reported strong EBIT growth during FY2007-09 as it evolved from being an Eros Group outpost in charge of acquisition and export of Indian content overseas to becoming a significant player in the Indian film industry (film production as well as distribution). However, FY2010 was a challenging year for the film industry due to reduced revenues (economic downturn) but also due to high cost of film content commissioned for production (12-18 months of lead time).

We model strong 32% CAGR in EROS' EBIT over FY2011E-13E led by (1) robust increase in new release film slate (Hindi as well as regional), (2) large, expanding catalog of films (new releases and acquisitions), (3) transformation of Indian film industry (box office led by digitization, emerging ancillary revenue streams) and (4) correction in cost of production of film content post the economic downturn.

Exhibit 48: Profit model of EROS, March fiscal year-ends, 2008-13E (Rs mn)

	2008	2009	2010	2011E	2012E	2013E
Total revenues	**4,747**	**6,265**	**6,409**	**7,011**	**8,927**	**11,234**
Total expenditure	**(4,196)**	**(4,967)**	**(5,299)**	**(5,403)**	**(6,789)**	**(8,435)**
Operating expenses	(3,662)	(4,220)	(4,468)	(4,445)	(5,567)	(6,959)
--Amortization of film rights	(2,099)	(2,051)	(1,940)	(2,403)	(3,015)	(3,765)
--Purchase of film rights	(1,135)	(1,592)	(2,068)	(1,447)	(1,806)	(2,287)
--Other operating expenses	(428)	(577)	(461)	(595)	(747)	(907)
Personal expenses	(85)	(155)	(197)	(250)	(300)	(345)
SG&A expenditure	(449)	(592)	(633)	(709)	(922)	(1,131)
EBIT	**551**	**1,298**	**1,110**	**1,608**	**2,138**	**2,799**
Other income	6	13	26	115	156	166
Interest expense	(28)	(61)	(90)	(87)	(87)	(87)
D&A expenses	(18)	(50)	(44)	(41)	(52)	(52)
Pretax profits	**511**	**1,200**	**1,002**	**1,595**	**2,155**	**2,826**
Extraordinaries	149	(160)	121	—	—	—
Tax-current	(130)	(99)	(77)	(182)	(279)	(391)
Tax-deferred	(103)	(193)	(218)	(220)	(291)	(383)
Minority interest	(16)	(14)	(5)	(28)	(42)	(118)
Reported net income	**411**	**734**	**823**	**1,165**	**1,544**	**1,934**
Adjusted net income	**330**	**856**	**738**	**1,165**	**1,544**	**1,934**
EPS (Rs/share)						
Year-end	4.5	11.8	10.1	12.6	16.7	20.9
Primary	**4.5**	**11.8**	**10.1**	**14.1**	**16.7**	**20.9**
Growth (%)						
Net income		159	(14)	58	33	25
Primary EPS		**159**	**(14)**	**39**	**18**	**25**
Ratios (%)						
EBIT margin	**11.6**	**20.7**	**17.3**	**22.9**	**24.0**	**24.9**
Tax rate-current	25.4	8.2	7.7	11.4	12.9	13.8
Tax rate-effective	**45.5**	**24.3**	**29.4**	**25.2**	**26.4**	**27.4**

Source: Company data, Kotak Institutional Equities

We briefly discuss our key financial and operating assumptions of EROS below.

- **Revenues**. EROS reported strong revenue growth in FY2007-09 as it transformed into an Indian film studio with focus on (1) production/acquisition of Indian film content (worldwide all-format rights) and (2) distribution/exploitation of rights across platforms. The new release film slate increased to 15 in FY2009 from 4 in FY2007. Additionally, EROS acquired 51% stake in Ayngaran (Tamil films) and started EyeQube (VFX) in FY2008. The relative slowdown in revenues in FY2010-11E resulted from (1) dispute between film studios and national multiplex chains and (2) reduced new release film slate due to the economic slowdown and weakened monetization.

  We model strong 27% CAGR in EROS' revenues in FY2011E-13E led by (1) larger new release film slate post the economic recovery supported by (2) robust growth in Indian box office revenues (increased spread of multiplexes and digitization of single screens) as well as (3) strong growth in ancillary revenue streams (satellite rights including VoD and mobile networks including 3G) also driven by expanding catalog of films/rights. EROS has two of the most-widely-awaited movies in its FY2012E-13E slate: RA.One with Shah Rukh Khan and Ranaa with Rajnikanth. We highlight the structural change in satellite rights market given rising competition among broadcasters.

- **Relationship Agreement and operating expenses.** Pursuant to the Relationship Agreement between Eros Group and EROS, India rights will be controlled and exploited by EROS while all overseas rights will be sold to Eros Group. EROS will directly expense out 30% of content cost attributed to overseas rights sold to Eros Group at a 30% markup; the remaining 70% cost attributed to India rights will be amortized, 60% in the first year and remaining 40% spread equally across remaining period of rights or 9 years, whichever is shorter. Given the catalog rights present in EROS balance sheet as net block, amortized cost would be ~80% of capex initially.

- **EBIT margins**. A significant part of a film studio's costs are direct expenses: (1) Content costs (production or acquisition of film content) and (2) P&A costs (print and advertising) associated with theatrical distribution and initial marketing of a film. However, fixed costs exist on account of employees, overheads and startup costs associated with establishing the distribution network. EROS reported rising EBIT margins in FY2007-09 on account of (1) increased scale of operations in the core business, (2) robust revenue environment led by ancillary revenue streams and (3) improved contribution from Ayngaran and EyeQube. FY2010 was a challenging year due to the economic downturn but more important, high cost of content commissioned for production in FY2009.

  FY2011E is also likely to be a unique year given robust revenue environment and reduced cost of content commissioned for production in FY2010 (bottom of economic cycle) resulting in high EBIT margins (24% in 9MFY11). Thereafter, we model strong 32% CAGR in EROS' EBIT over FY2011E-13E (sustained ~25% margins) led by (1) larger new release film slate (Hindi/regional), (2) expanding catalog of films (new releases and acquisitions) and (3) robust revenue environment (multiplex growth, emerging ancillary revenue streams) supported by (4) co-production deals with talent (profit-sharing) as well as (5) digitization of theatres (reduced print and distribution costs).

- **Others.** EROS is susceptible to currency fluctuations given (1) export of overseas rights of film to Eros Group, (2) production of Indian films undertaken overseas and (3) US$-denominated working capital debt. EROS' low effective tax rate (25% in 9MFY11) is due to its overseas subsidiaries (Copsale, owner of legacy high-margin catalog rights, and Ayngaran Tamil business). EROS' cash tax rate is even lower due to differences in book amortization versus income tax amortization of content costs/film rights; the income tax laws in India allow 90% of content cost/films rights to be amortized in the first year (year of release) and remaining 10% in the next year.

Renewed investment cycle in growth phase (FY2012E-13E)

Exhibit 49 presents our cash flow model of EROS. EROS reported robust growth in adjusted operating cash flows (excl. working capital) in FY2007-09 led by the revamp of its business model and core operations. After a brief pause in FY2010, We expect renewed growth led by (1) strong revenue growth (increased new release slate, robust revenue environment) as well as (2) high EBIT margins (expanding catalog and reduced content costs). However, working capital requirements would increase in FY2011E-13E led by (1) rising scale of operations (to finance expanded future new release film slate) and (2) greater focus on co-productions (12-18 month lead time) versus acquisitions (working capital efficient as majority of payment is made on delivery of film).

The capital expenditure for EROS is largely content cost (production or acquisition of films). EROS' current slate of 10-12 films in any year has scope for expansion as it represents only ~5% share of the Hindi film industry. The robust growth in capital expenditure due to increased scale of operations (rising new release film slate) will be matched by corresponding increase in revenues. However, the 'long-tail' in film revenues (ancillary streams) may result in <100% cost-recovery in the first year (year of release). Nonetheless, we model continued robust growth in adjusted free cash flows (excl. working capital) due to (1) rising catalog revenues (legacy investments), (2) reduced content costs and (3) structural changes in satellite revenue market. Free cash flows will remain negative given renewed (working capital) investment cycle in growth phase (FY2012E-13E).

Exhibit 49: Cash-flow model of EROS, March fiscal year-ends, 2008-13E (Rs mn)

	2008	2009	2010	2011E	2012E	2013E
Operating						
Net profits before tax	660	1,039	1,123	1,595	2,155	2,826
D&A expenses	2,117	2,102	1,984	2,444	3,067	3,817
Taxes paid	(207)	(139)	(142)	(182)	(279)	(391)
Other Income	(21)	(69)	(37)	(115)	(156)	(166)
Interest expenses	49	131	127	87	87	87
Extraordinary items	21	(36)	27	—	—	—
Working capital changes (a)	**579**	**(1,844)**	**218**	**(2,123)**	**(1,667)**	**(646)**
Total operating (b)	**3,198**	**1,183**	**3,300**	**1,705**	**3,208**	**5,527**
Investing						
Capital expenditure (c)	(2,736)	(2,702)	(2,554)	(3,118)	(3,970)	(5,013)
(Purchase)/Sale of assets	(114)	(84)	(10)	(400)	(50)	(50)
(Purchase)/Sale of investments	(20)	(20)	—	—	—	—
Total investing	**(2,870)**	**(2,805)**	**(2,564)**	**(3,518)**	**(4,020)**	**(5,063)**
Financing						
Proceeds from equity	—	—	—	3,398	—	—
Proceeds from borrowings	552	867	68	—	—	—
Interest paid	(49)	(131)	(127)	(87)	(87)	(87)
Interest income	19	65	35	115	156	166
Total financing	**523**	**801**	**(25)**	**3,426**	**69**	**79**
Year-end						
Net increase in cash	**851**	**(821)**	**711**	**1,613**	**(742)**	**542**
Beginning cash	331	1,182	361	1,072	2,686	1,944
Ending cash	**1,182**	**361**	**1,072**	**2,686**	**1,944**	**2,486**
Ratios						
Depreciation/capex (%)	**77.4**	**77.8**	**77.7**	**78.4**	**77.3**	**76.1**
Adj. operating CF (b) - (a)	2,619	3,027	3,082	3,829	4,875	6,173
FCF (b) + (c)	**463**	**(1,519)**	**746**	**(1,413)**	**(761)**	**513**
Adj. FCF (b) + (c) - (a)	**(117)**	**326**	**528**	**711**	**905**	**1,160**

Source: Company data, Kotak Institutional Equities

Robust balance sheet post IPO to support investments

Exhibit 50 presents our balance sheet model of EROS. EROS' balance sheet provides a glimpse of the weak cash flow model of a film studio in general (during the initial years as new release slate and catalog are scaling up). As previously highlighted, the studio model requires significant upfront investments but revenues have a long tail; EROS' transformation into an emerging Indian film studio resulted in >2X increase in net block in FY2008-10. The large capital investments in current (net block) and future (working capital) film releases is a unique feature of the film studio model. Nonetheless, EROS' balance sheet has been strengthened post the IPO to support renewed investments.

EROS' historical return ratios look exemplary largely on account of an under-capitalized balance sheet; EROS had scaled up its operations in India largely using debt and interest-free advances from Eros group in the past, being a wholly-owned subsidiary (overseas advances within current liabilities). With a well-capitalized balance sheet and reduced financial support from Eros Group post IPO, return ratios have normalized to more sustainable levels; we expect EROS to report RoACE of ~18% in FY2011E-13E, despite renewed investments. We highlight that a significant majority of the capital is employed/locked up in future film releases, which are not income-generating assets currently.

Exhibit 50: Balance sheet model of EROS, March fiscal year-ends, 2008-13E (Rs mn)

	2008	2009	2010	2011E	2012E	2013E
Equity						
Share capital	51	51	727	927	927	927
Reserves/surplus	763	1,529	1,647	6,010	7,554	9,488
Total equity	**814**	**1,580**	**2,375**	**6,938**	**8,481**	**10,416**
Deferred Tax	88	280	498	718	1,010	1,393
Minority interest	22	40	42	70	112	230
Liabilities						
Total borrowings	1,239	2,118	2,175	2,175	2,175	2,175
Overseas advances	**4,373**	**5,398**	**3,213**	**2,338**	**2,411**	**2,780**
Liabilities & provisions	1,514	1,791	1,750	1,929	2,366	2,887
Total capital	**8,050**	**11,207**	**10,052**	**14,168**	**16,555**	**19,881**
Assets						
Gross block	4,663	7,723	10,050	13,568	17,587	22,650
(Accumulated depreciation)	(3,245)	(5,529)	(7,327)	(9,771)	(12,838)	(16,655)
Net block	1,419	2,195	2,723	3,797	4,749	5,996
Total fixed assets	**1,419**	**2,195**	**2,723**	**3,797**	**4,749**	**5,996**
Cash and equivalents	1,182	361	1,072	2,686	1,944	2,486
Loans and advances	**3,060**	**5,148**	**3,709**	**4,675**	**6,028**	**6,950**
Other current assets	2,329	3,423	2,469	2,930	3,755	4,369
Investments	60	80	80	80	80	80
Total assets	**8,050**	**11,207**	**10,052**	**14,168**	**16,555**	**19,881**
Ratios (%)						
Net debt/equity	**7.0**	**111.2**	**46.4**	**(7.4)**	**2.7**	**(3.0)**
Net debt/capital	**2.8**	**47.5**	**24.2**	**(5.6)**	**2.2**	**(2.5)**
RoAE	**37.3**	**53.8**	**30.9**	**16.8**	**18.2**	**18.6**
RoACE	**36.7**	**26.5**	**22.5**	**17.8**	**17.1**	**18.6**

Source: Company data, Kotak Institutional Equities

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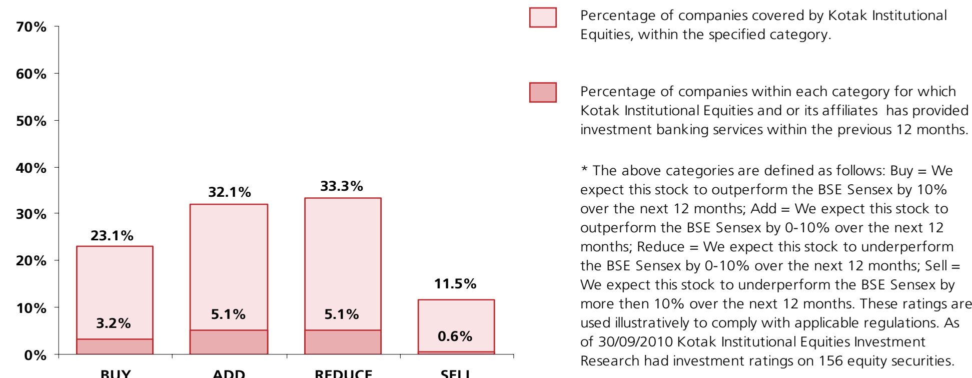

Source: Kotak Institutional Equities | As of September 30, 2010

Eros International Media (EROS.BO)

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Source: Kotak Institutional Equities Research for ratings and price targets, Bloomberg for daily closing prices.

Rating
Price target
X Price target removal
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