Rating Methodology for Media Industry (Film Production, Distribution and Exhibition)

This rating methodology provides a reference tool for investors and issuers to understand ICRA’s approach in assessing the business and financial risk profiles of companies in the media industry focused on the Film Production, Distribution and Exhibition segment and system integrators. Film Production relates to the financing, direction and actual creation of the film, making it ready for screening in the theatres. Once the film is ready for screening, the same is replicated into several prints (either analogue or digital), marketed and distributed to the theatres, referred to as Film Distribution, which often involves part-financing of the film as well. The last link in the film industry value chain is Film Exhibition which is the most important medium for delivery of films to the viewers.

The methodology broadly highlights the quantitative and qualitative risk factors that are likely to influence the rating outcomes of companies in this industry and include the following:

- Industry Risk
- Business Profile
- Scale and Market Position
- Regulatory Risk
- Financial Profile
- Management and Accounting Quality

Industry Risk

**Film Production and Distribution:** The vast and diverse nature of the film media business has resulted in a highly fragmented industry structure marked by the presence of a number of film producers (individual as well as production houses) and several small (local) and big (national) film distributors.

Notwithstanding the fragmentation, the industry is marked by high entry barriers due to the high capital investment requirements as well as consistent investments towards content creation, building content library and innovation in the film production business.

The ratings also factor in the industry inherent risks and the ability of the players to mitigate the same. The key risk in the film media space pertains to the performance of the movie at the box-office which is highly dependent on audience preferences and beyond the control of the producers and distributors. Thus, in addition to understanding the movie slate (i.e. diversity in terms of budgets, genres, languages/ regions), it is imperative to take into consideration the ability of the producer and distributor to monetize content through various alternative platforms to reduce dependence of revenues on the box-office performance. Diversified revenue streams facilitating monetization of IPRs across various platforms and a strong content library helps minimize revenue volatility and thus supports the rating.

**Film Exhibition:** The Indian film exhibition industry is also largely fragmented with presence of a large number of unorganized players operating single screen theatres and only a handful of large multiplex chains. The occupancy level driven film exhibition business is also exposed to the risks associated with the box-office performance of the movie and threat of piracy. While rising urbanization and disposable incomes are driving increased investments in the exhibition space, film exhibitors are exposed to additional industry risks such as increasing competitive intensity in line with aggressive capacity expansion by exhibitors and delay or failure in handover of properties by developers and slowdown in organized retail and sluggish real estate activity. Being a predominantly weekend business, the film exhibition business also remains exposed to seasonality risks (occupancy levels drops during Feb-Mar and September) and event risks (terrorist attacks, endemic health scares, etc.).
Business Profile

Film Production and Distribution: The business model of producers comprises content creation/aggregation and content monetization. Content aggregation can either be done through acquisition, co-production or own production. The business model followed by the producer becomes a key rating factor to ascertain the quantum and timing of cash outflows expected in the near term with respect to the content acquired by the producer. It also helps understand the IPR held by the producer (either independently or as a co-producer) and the first position recoupment of investment rights held by the producer. Adoption of a studio model by production houses in recent times is a credit positive as it allows diversification of content across genres, languages and budgets thereby mitigating the risk of losses due to poor box-office performance of some of the movies.

The revenue profile of film producers and distributors primarily comprises the monetization of content by way of sale of music rights, domestic theatrical distribution, DVD and home entertainment distribution, satellite rights and new media distribution avenues such as mobiles; in-film advertising/merchandising and trading and exporting of international distribution rights. Focus on pre-sales and the ability of a company to monetize content through available channels thereby reducing the dependence on box-office success of a movie remains a key rating factor. Additionally, ability to invest continuously in content as well as catalogue for the producers and distributors create barrier to entry for other players, thereby enhancing the competitive position of the company.

Film distributors ideally operate on two business models- revenue share and minimum guarantee based or outright purchase model. The revenue share model is relatively risk free where a fixed percentage of revenues (box-office collections) is kept as a commission for distribution of movies while the remaining is upstreamed to the producer, thereby limiting the downside risks for distributors.

In case of minimum guarantee and outright purchase of rights by the distributor, significant amount of risk of the performance of the movie is borne by the distributor, since he provides a lump sum amount to the producer for the distribution rights. Box-office collections, above the minimum level, may be shared with the producers; however, any deficit is borne entirely by the distributor. Thus, the acquisition of film rights does expose the distributor to box-office performance risks, though it is partially offset by sale of satellite rights in case the movie fails to live up to expectations, as they own the entire distribution rights for the film.

The revenue model of system integrators comprises rentals from exhibitors, virtual print fee from distributors, advertisement income – shared with exhibitors and digitization income. While business scalability remains restricted to the growth in the screens and theaters, the revenue profile of system integrators also remains vulnerable to the changes in technology, their applications and acceptance.

Film Exhibition: In the film exhibition business, revenue streams primarily comprise sale of movie tickets, sale of food & beverage and advertising revenue. The revenue profile of exhibitors remains highly vulnerable to the occupancy levels of cinema properties which in turn depends on box office performance of the films screened.

While analyzing the business model, it is important to understand the level of business integration the company enjoys or its relations with channel partners across the production, distribution and exhibition segment and its ability to monetize the same. Ideally, large media conglomerates with presence across the film industry value chain including production, distribution and exhibition not only enjoy diverse revenue streams and higher bargaining power but are also able to monetize content investment across platforms as compared to small scale producers and distributors.

Scale and Market Position

We look at the market position and scale of operations to understand the level of business integration of the company and the ability to make incremental investments in content acquisition. The scale of operations also reflects the susceptibility of the company to business cycles and inherent volatility in the film business.

With substantial scale of operations, a company is better positioned to make incremental investments in attractive content and latest technology and own a significant number of IP Rights coupled with the ability
to monetize the same over multiple distribution platforms including new technology initiatives. Moreover, a large revenue base also leads to economies of scale in terms of cost efficiencies in the production, distribution, purchasing and administrative functions.

A company with a strong market position aided by tie-ups, strategic joint ventures and license agreements with global brands and studios enjoys higher bargaining power along the value chain and is better positioned to acquire and retain the best talent to sustain its leadership position. Healthy global brand recognition coupled with large scale of operations and substantial level of vertical integration also pose entry barriers for new players in the industry. While the above factors are a credit positive from the business risk point of view, the impact of a healthy market share and position is also reflected in the stability in operating margins of the company.

Regulatory Risk
The Indian film media space remains sensitive to the government policies and regulations. While there is no regulatory body governing the Indian film industry, each of the participants is expected to follow certain rules – producers have to comply with the guidelines laid down by the Central Board of Film Certification, while exhibitors need to abide by the entertainment tax laws in various states.

The industry is regulated by the Central and State Governments on several aspects, such as, corporate holding structure and FDI in the film production, distribution and exhibition space and indirect taxation levied by the Central and State Government. With a liberal FDI policy, 100 percent FDI is allowed in the film production, distribution and exhibition segment including related services and products. FDI in the sector is permitted under the ‘Automatic Route’ with no entry level conditions. However, post filing, requirements with respect to notifying RBI and filing of other documents within 30 days of receipt of inward remittance or allotment of shares remains mandatory.

In terms of indirect taxation, the media and entertainment industry is subject to central excise duties, custom duties and service taxes payable to the Central Government and Value Added Tax (VAT) and entertainment tax payable to the State Government. High and uneven entertainment tax structure across States (ranging from 0-55%) has been a major impediment to the growth of Indian film exhibition industry, in addition to regulatory hurdles in obtaining a theatre operating license which can take as long as six months in certain cases.

While regulations generally pose an entry barrier for competition, the quantum of favourable or unfavourable impact of the same on the business and financial profile of existing players remains a key rating sensitivity.

Financial Profile
ICRA’s assessment of the financial risk profile of the company is based upon the ability of a company to generate healthy cash flows to reinvest in the business as well as meet the debt servicing obligations. The financial policies- past as well as future, are a key rating factor to ascertain the risk appetite of the management and the impact of the same on the financial performance of the company.

- Profitability
  
  Film Production: For a film production, the cost structure varies based on the budget and star cast, wherein, the fees of the star cast form a major component of a film’s budget for most large productions. Further, in recent times, the marketing and promotion budget of films has also witnessed an increasing trend, adding to the overall cost of a film. With high fixed cost nature of the production business and escalating production costs, the profit margins of producers remain susceptible to the box office collections of the movie (though the risks can be moderated through pre-launch monetization of music, satellite rights etc.) thereby resulting in volatile profit margins. While a substantial scale of operations mitigates the volatility to a certain extent, the financial profile of the film producers, distributors and exhibitors remains highly dependent on the flow and quality of content being released.

  Film Distribution: For the film distributors, in addition to minimum guarantee offered to the film producer/ share of box-office collections to be upstreamed to the film producer, the major cost is the cost of replicating the prints, which however has been significantly reduced on the back of digitization, thereby
making it affordable for a distributor to release a greater number of prints for a film at the same time and also prevent piracy.

**Film Exhibition:** For the film exhibitors, the major cost is distributor expenses, i.e. sharing of revenues from sale of tickets with the distributors followed by lease rentals and service tax on the same. Slow development of malls in the country has been constraining the supply of theatres. In addition, high entertainment tax, which is an additional cost for the exhibitors, gets passed on to the public in the form of increased ticket prices, affecting footfall. While digitization of theaters has supported the profitability of exhibitors with reduced print costs and wide simultaneous release of movies; lower print costs have also benefit distributors facilitating a faster break-even. For system integrators, however, capital investments remain high with returns spread over a long period of time.

Amortization policy on intangibles or inventory with respect to content produced or procured from outside can differ significantly across entities in the industry. While rating, ICRA takes cognisance of such differences and makes necessary adjustments on such amortization, wherever necessary, to bring in comparability across entities in the industry.

**Leverage and Cash flows**
The film production space is capital intensive requiring consistent reinvestments in intellectual property to build a strong content slate and catalogue that can be further monetised through various existing, new and emerging platforms by producers. Hence, access to stable sources of funding – either internal or external – remains crucial for producers to maintain a competitive advantage. Moreover, timely monetization of the content created also remains critical for maintaining the credit profile of the company.

The exhibition space also entails high capital investments towards growing the cinema network geographically to ensure a healthy market share. With majority of the revenues from sale of tickets and food and beverage being collected in cash, the working capital requirements for exhibitors however remain low.

ICRA takes into consideration the funding mix of the company towards such investments and its ability to maintain a healthy liquidity profile in a volatile operating environment. Leverage ratios are an indicator of the degree of financial flexibility a company enjoys in terms of its ability to raise funds from alternate sources in times of financial distress. Such flexibility is reflected in a company’s gearing, Total Debt-to-EBIDTA multiple and Free Cash Flows-to-Debt multiple. A low gearing ratio indicates adequate cushion available in terms of raising funds primarily from external sources (debt borrowings) for meeting funding requirements and is a credit positive. However, the extent to which a company can leverage its balance sheet is subjective and is determined primarily by the philosophy of the management.

Strong free cash flows indicate the ability of a company to fund investments, organic and inorganic growth opportunities and debt repayments. A strong Total Debt-to-EBIDTA and Free Cash Flows-to-Debt multiple is a credit positive as it reiterates the ability of the company to service its debt obligations; fund growth opportunities and improve its competitive position without being overly reliant on external sources.

In addition to long-term financial flexibility the liquidity profile of the company is equally important to understand the ability of the company to meet short term financing requirements. A key indicator of the same is the monthly working capital utilization of the company and the available drawing power. A company maintaining buffer in the drawing down back finance consistently would score well given the flexibility imparted to meet any short term mismatches in a cyclical industry.

**Foreign Currency Risks**
The foreign currency risks for the film media space primarily arise out of foreign currency denominated liabilities (for instance foreign currency denominated debt). While taking into consideration the hedging policy of the company towards mitigating foreign currency risks, ICRA also focuses on the impact of adverse movement in foreign exchange rates which may have an impact on the profits or result in incremental cash outflows for such companies. The revenue from international markets, which now accounts for ~10-15% of total collection for large movies, can also be impacted by currency fluctuations.
- **Tenure Mismatches, and Risks Relating to Interest Rates and Refinancing**
  Large dependence on short-term borrowings to fund long-term investments can expose a company to significant re-financing risks, especially during periods of tight liquidity. The ratings factor in the existence of adequate buffers of liquid assets/bank lines to meet short-term obligations and the extent to which the company could be impacted by interest rate movements on such borrowed funds.

- **Debt Servicing Track Record**
  The debt servicing track record of the company forms an important rating consideration. Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the company’s future debt servicing capability. ICRA also factors in the ability of the company to honour its debt obligations during period of cyclical stress.

- **Contingent Liabilities/Off-Balance Sheet Exposures**
  ICRA also looks at the quality of accounting practices followed by a company based on interactions with the Statutory Auditors as well as studying the Auditors’ Report and other Notes to Accounts disclosed by a company in its Annual Report. Some of the key factors looked at include: auditor qualifications with respect to internal control systems, debt servicing and asset-liability mismatch; contingent liabilities and other off balance sheet items and the method of revenue recognition and depreciation/amortization policy of a company in comparison with industry peers.

- **Consolidated Financial Analysis**
  The film media industry in India continues to be dominated by large media conglomerates with presence across the production, distribution and exhibition value chain, primarily through various subsidiaries. While evaluating the financial risk profiles of such companies, ICRA draws comfort from consolidated/group level financial indicators in terms of capital structure, debt coverage indicators and future funding requirements.

- **Adequacy of Future Cash Flows**
  Since the prime objective of the rating exercise is to assess the debt servicing capability of a company; ICRA draws up projections on the likely financial position of the company based on the expected movements in operating performance factoring in capital expenditure and investment requirements as well as upcoming debt obligations to study the impact on revenue growth and profitability, cash flows, leverage as well as debt protection indicators. We also look at the funding requirements of a company and the funding options available to it.

**Management and Accounting Quality**
In addition to the business and financial risk analysis, ICRA also factors in the management profile of the company while assigning the ratings. An interaction with the management not only provides a better insight into the operations of a company (as well as other entities belonging to the same promoter group) and track record but also helps understand the management’s commitment to the business and strategies, growth plans as well as risk appetite which may have an impact on the future performance of the company. The other factors assessed are management policies on leveraging, interest risks and currency risks and ability and willingness of the promoter group to support the issuer for growth plans as well as during stress. Periodic interactions with the management also help ICRA estimate the probability of the management’s tendency to deviate from its business philosophy in times of stress.

In addition to the factors mentioned above, ICRA also looks at other indicators which are common to all industries including, ownership, management, governance and liquidity.

**Conclusion**
The rating methodology broadly highlights ICRA’s approach in assessing the business and financial risk profiles of companies in the film media industry. It should not be treated as an exhaustive discussion of all the factors considered while assigning a credit rating but a broad framework to help stakeholders understand the approach to the same.
Rating Methodology

Media Industry (Films)

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