FINAL REPORT

UK Radio
Impact of regulatory relaxations

5th May 2009

Several data points and information identifying individuals and companies have been excluded from this version of the report due to confidentiality reasons

The aim of this project is to provide Ofcom with a view of the impact of utilising regulatory levers it has as its disposal

Project context

- **The UK radio industry is currently experiencing a period of considerable change**
  - **structural changes:** the industry has been witness to several large mergers and changes to overall structure (Global and Bauer stations now account for a majority of the market by revenues)
  - **changes in advertising spend:** a redistribution of advertising spending is taking place, characterised by larger budgets dedicated to channels like online and interactive
  - **cyclical changes:** the radio industry is also undergoing significant stress due to the overall industry-wide advertising downturn (-6% 08 vs. 07, plus acceleration in Q109)
- **In its submission to Digital Britain, Ofcom has identified several regulatory options to alleviate some of the pressures facing the industry**
  - Ofcom has identified several regulatory levers it could utilise to reduce the level of commercial stress currently being experienced by the radio industry including:
    - **reorganising geographical areas** based on DAB licenses, historical ILRs and larger population sizes with the aim of providing larger, more sustainable geographic regions to support local radio services
    - **allowing stations to access options like co-location and full mergers** within the geographical areas to realise potential cost savings and increase chances of surviving in the current financial atmosphere
  - Ofcom had conducted **some preliminary analysis** on the benefits from co-location for approx. 30 radio stations.
  - Ofcom would like to **understand, test and verify** the **impacts of co-locations and mergers** on the profitability of an additional 28 stations (separate from the 30 stations examined earlier) and the **segments of the industry** where they may be most needed

Project objectives

- **Identify the fixed and variable cost components** of the 28 stations (organised in 14 pairs/groups) identified by Ofcom and conduct a sensitivity analysis to understand the **impact of the advertising downturn** on PBIT margins
- **Estimate the potential impacts** of the regulatory levers identified by Ofcom (namely – co-location and full-merger) on the margins of the stations
- Provide a view on the segments within the industry where these **regulatory relaxations are likely to have the greatest benefit**

Note: The analysis in this report is based on a set of **14 pairs/groups of stations identified by Ofcom** which could potentially access the option to either co-locate or fully merge. The results of this analysis are relevant to the stations in the sample only and is **not representative** for the entire industry

Source: Zenith, RAB, Value Partners model analysis

Chapter 2 – Approach and results

Essentially, the project has been organised into 4 main work steps…

Project work steps	Key questions addressed
1 **Analysis of station accounts and allocation of fixed and variable costs**	• What portion of the identified stations' cost bases are fixed as compared to variable (i.e. likely to vary with revenues) • What are the current EBIT margins of the stations? • What cost buckets can operating costs be allocated to in order to identify potential benefits from the regulatory relaxations?
2 **Understanding the Impact of the advertising downturn on station margins**	• How is the advertising downturn likely to affect the profitability of the stations identified? • How many stations are likely to become unprofitable due to the downturn? • What is the impact on the industry if the downturn is more severe?
3 **Estimating the potential benefits from regulatory relaxations**	• What are the potential benefits from a set of two/three stations undergoing a co-location of premises or a full merger? • What is the impact of these benefits on the EBIT margins of the identified stations? • How many stations are the relaxations likely to benefit?
4 **Identifying industry segments where the impact of relaxations is most beneficial**	• Which stations are currently in greatest need for the identified regulatory relaxations?

Source: Value Partners

… and is centered around the estimation of potential benefits to radio stations from co-location and full mergers

High level descriptions of the options potentially available to radio stations

Potential options available to radio stations after regulatory relaxation

Co-location

- Two or more radio stations could exercise the option of co-locating premises which would allow them function as two separate entities out of one premises, allowing cost savings from facility-related costs (rents, utilities), some general and administrative (G&A) costs

Full merger

- In addition to the benefits from co-location described above, a full merger of two or more stations creates the potential to realise cost savings in several other areas like programming staff costs, sales staff costs, station marketing costs, transportation and additional G&A costs

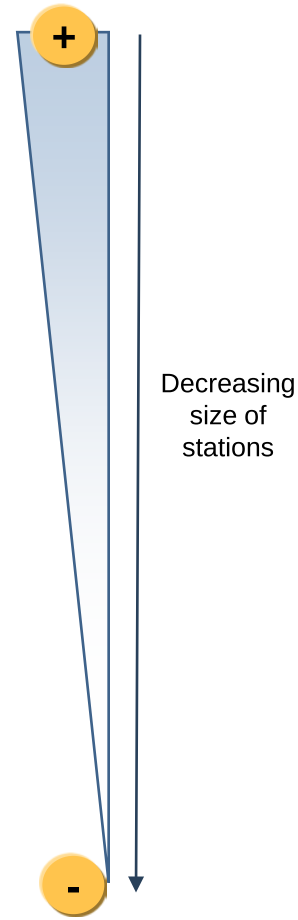
Source: Value Partners

14 pairs of stations of varying sizes have been analysed

Note: the chosen sample comprises of stations which may access the option of co-locating/merging. It is not a representative sample of the radio industry in the UK

MCA (000s)	Category allocated
• <= 300k	• Small stations
• >300k and <=750k	• Mid sized stations
• >750k	• Large stations

Pair[1]	Station	Station category
• 1A	• 1A – Station 1	• Large
	• 1A – Station 2	• Large
• 1B	• 1B – Station 1	• Mid sized
	• 1B – Station 2	• Mid sized
	• 1B – Station 3	• Mid sized
• 2A	• 2A – Station 1	• Mid sized
	• 2A – Station 2	• Small
• 2B	• 2B – Station 1	• Mid sized
	• 2B – Station 2	• Mid sized
• 2C	• 2C – Station 1	• Mid sized
	• 2C – Station 2	• Mid sized
• 3A	• 3A – Station 1	• Small
	• 3A – Station 2	• Small
• 3B	• 3B – Station 1	• Small
	• 3B – Station 2	• Small
• 3C	• 3C – Station 1	• Mid sized
	• 3C – Station 2	• Small



Note: (1) This pairing convention has been adopted in order to remain consistent with Ofcom's convention. As a high level guide, the size of the stations co-locating or merging decreases as the number of the pair increases (i.e. pairs 3A, 3B and 3C comprise of smaller stations compared to pairs 1A and 1B)

Source: Value Partners analysis, Ofcom

14 pairs of stations of varying sizes have been analysed (cont'd)

Note: the chosen sample comprises of stations which may access the option of co-locating/merging. It is not a representative sample of the radio industry in the UK

MCA (000s)	Category
• <= 300k	• Small stations
• >300k and <=750k	• Mid sized stations
• >750k	• Large stations

Pair[1]	Station	Station category
• 4A	• 4A – Station 1	• Small
	• 4A – Station 2	• Small
• 4B	• 4B – Station 1	• Small
	• 4B – Station 2	• Small
• 4C	• 4C – Station 1	• Small
	• 4C – Station 2	• Small
• 5A	• 5A – Station 1	• Small
	• 5A – Station 2	• Small
	• 5A – Station 3	• Small
• 5B	• 5B – Station 1	• Small
	• 5B – Station 2	• Small

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Decreasing size of stations *(continued from previous page)*

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Note: (1) This pairing convention has been adopted in order to remain consistent with Ofcom's convention. As a high level guide, the size of the stations co-locating or merging decreases as the number of the pair increases (i.e. pairs 3A, 3B and 3C comprise of smaller stations compared to pairs 1A and 1B)

Source: Value Partners analysis, Ofcom

Radio stations typically have a relatively large fixed cost base

Breakdown of cost base into fixed and variable components

Largely fixed costs

Cost category	Constituent costs	Value £m	% of total	Key driver
Sales and marketing	**External commission**	5.2	1%	• Commissions paid to external sales houses
	In-house sales costs	78.1	15%	• Commissions, bonuses and salaries for in house sales staff
	Station marketing costs	31.2	6%	• Display advertising, marketing at events, etc
Trans-mission	**Transmission**	60.6	12%	• Transmission costs based on platform
Production	**Programming**	74.6	15%	• High quality studio talent and journalistic staff
	Commercials production	22.9	4%	• High quality studio talent and additional fees for voiceover artists
Rights	**Rights**	46.0	9%	• Rights fee structure dictated by rights collection agencies, high base fees for stations existing on multiple platforms
G&A	**G&A**	189.9	37%	• Management salaries, utilities, insurance, transportation, memberships, research,
Total		**508.6**	**100%**	

- Significant costs incurred by the radio industry are of a highly inflexible nature
- Costs like transmission and programming are largely fixed
  - programming costs, spent mainly on bringing on board high quality talent are extremely important to maintain the listener base of the station
- The category of G&A, other costs comprises of management fees, general administration expenses, insurance, etc and is a fixed cost category to a large extent as well

- **Most stations are already running extremely lean and there are few opportunities to reduce costs. The impact of lower revenues could be severe on stations which are either loss making or currently operating with low margins**

Source: Previous Value Partners model analysis for Ofcom

We have separated fixed and variable costs into appropriate cost buckets and calculated PBIT margins for all stations sampled

Analysis of management accounts

ILLUSTRATIVE

Individual line items have been allocated to appropriate revenue and cost buckets

		Variable costs		Fixed costs				
	Revenues	Royalties	Other variable costs (sales commissions, commercial production, etc)	Programming costs	Transmission and technical costs	Occupancy costs	G&A, other costs	Central recharges
Line items								
…								
…								
Totals	Total revenues	Total royalty costs	Total other variable costs	Total programming costs	Total transmission & technical costs	Total occupancy costs	Total G&A, other costs	Total central recharges

Calculating PBIT

Total revenues - { **Total variable costs** + **Total fixed costs** } = **Operating PBIT**

- Line items in each station's management accounts were allocated to the revenue and costs buckets shown and PBIT was calculated
- The cost buckets were chosen in order to:
  - accurately allocate fixed and variable costs
  - isolate costs for areas (e.g. occupancy, programming costs, G&A, etc) where costs synergies can be derived when stations co-locate/merge

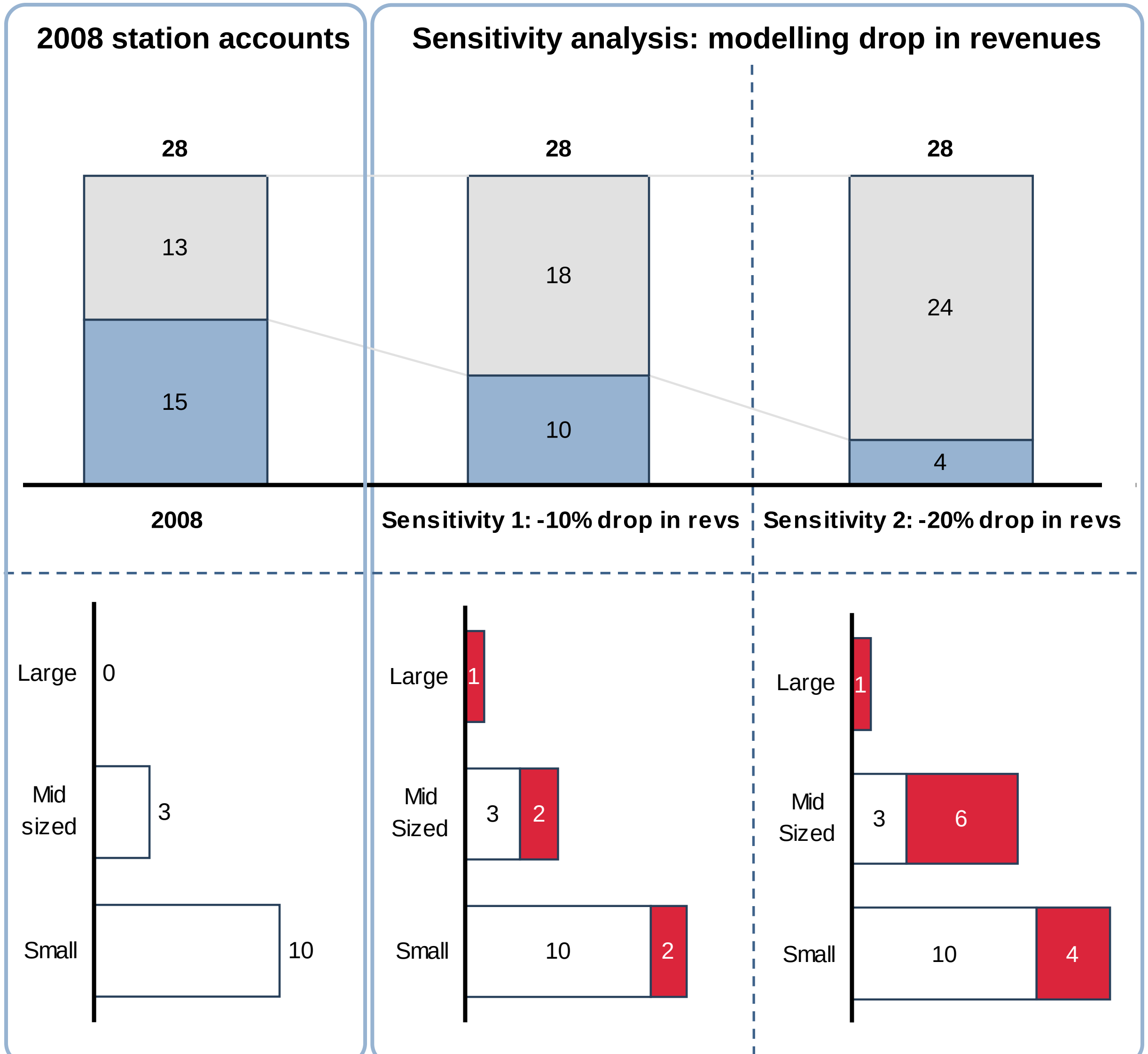
Source: Value Partners model analysis

Stress testing the stations' margins showed that smaller stations are already suffering significantly from the downturn

Profitable stations
Unprofitable stations
Additional stations that become unprofitable due to drops in revs

Variation of profitable vs. unprofitable stations due to the advertising downturn

Classification of unprofitable stations by size



- The 2008 accounts reveal that almost **50% of stations sampled** were **already unprofitable** and a **majority of these stations were small stations** with MCA < 300k
- The sensitivity analysis showed that:
  - at a **10% drop in revs**, it is estimated that **5 stations** are likely to become unprofitable
  - at a more extreme, **20% drop in revs**, **11 stations** are likely to become unprofitable
  - at a **20% drop in revs**, **80% of small stations** and **100% of mid sized stations** sampled **will become unprofitable**
- This demonstrates that the current downturn has **affected the profitability** of **mainly smaller stations** but if revenues continue to drop, **medium and some large size** stations are likely to become commercially unviable as well

VALUE PARTNERS

Source: Value Partners model analysis

We estimate that on average, stations can realise savings of c.150k from co-locating and c.450k from full mergers

Approach used to determine benefits from identified possible regulatory relaxations

Cost areas summed to estimate co-location benefits

Cost savings from the smaller station

Premises costs of the smaller station(s) **-100%** + G&A/other costs of the smaller station(s) **-50%**

Cost areas summed to estimate full merger benefits

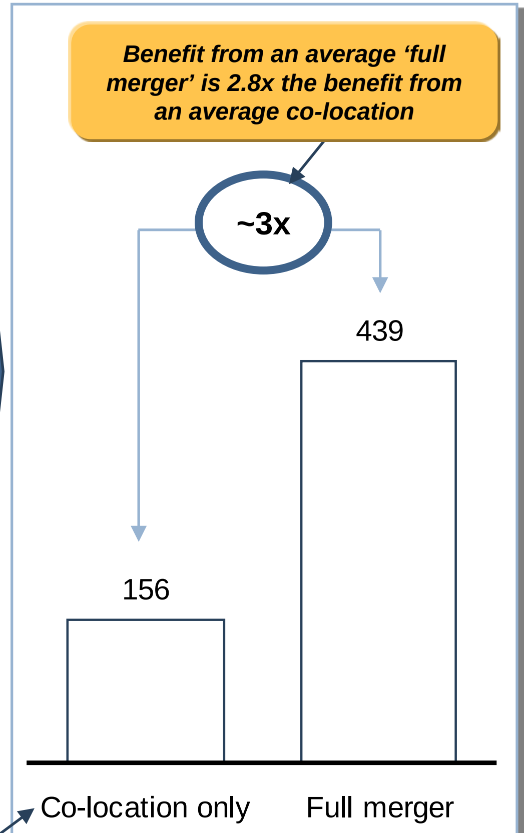
Cost savings from the smaller station(s)

Co-location benefits
+
Programming staff costs: **-100%**
+
Sales, admin staff costs: **-% varies by station**
+
Transport, operation, G&A: **-% varies by station**
+
Station marketing costs: **-% varies by station**
+
Central recharges: **-% varies by station**

Cost increases at the larger station

Programming staff costs: **+20-30%, varies by station**
+
Sales staff costs: **+% varies by station**
+
Occupancy costs: **+% varies by station**
+
Marketing, G&A costs: **+% varies by station**

Average benefits per station (£000s)



Note: benefit from co-location of 156k per station is skewed by the disproportionately high benefit for Group 1A. If group 1A is excluded, the average benefit per station scales down to £124k

Co-location:

- Cost savings were assumed to come from a reduction in the cost of premises and a 50% reduction G&A/other costs of the smaller station

Full merger:

- Cost savings were derived from cost reductions in the smaller stations offset by some cost increases in the larger station.
- These have been calculated on a station by station basis to account for the wide range of station sizes
- Cost reductions were driven mainly by programming staff costs, central recharges, marketing, transport and other G&A cost savings
- Cost increases were allocated to realistically model the costs at the larger station that were likely to increase. These include programming staff costs, occupancy (in some cases), etc

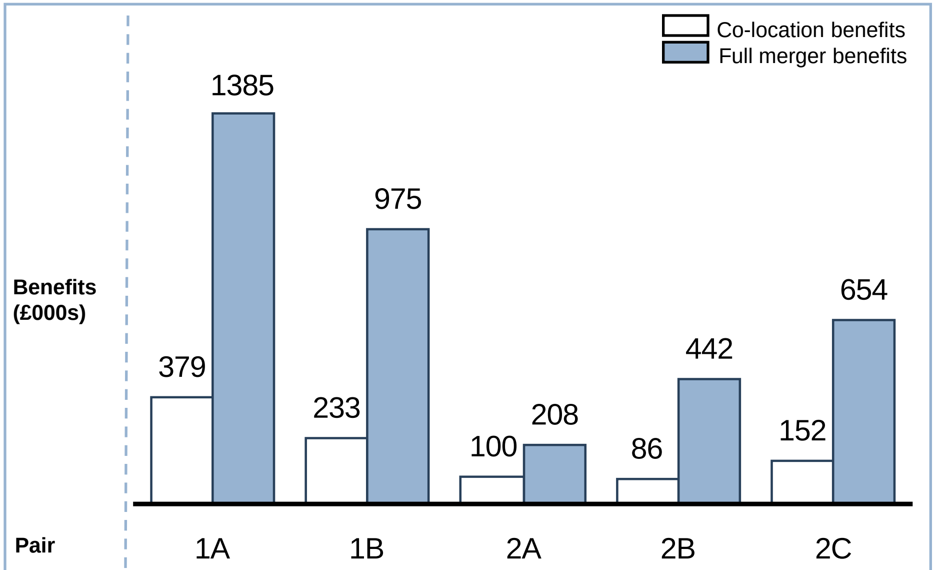
Source: Value Partners model analysis, inputs from Ofcom

In general, larger stations in the sample stand to gain significant cost benefits from both co-locations and full mergers

Description of benefits

- The values of the benefits from co-location and full merger were significantly large for larger stations with combined MCAs of over 1 million
- The key driver for these high benefit values were large cost savings made on areas like facilities costs, programming, significant savings on G&A and other costs
- Central recharges were generally found to be large costs on station management accounts
- The impact of central recharges on potential benefits was found to be a sensitive lever:
  - we have assumed that a percentage of central recharges for the smaller station(s) (varying between 30-50% based on size of station, level of cost information provided) would be achieved as benefits from the merger

Benefits from co-locations and mergers (£000s)

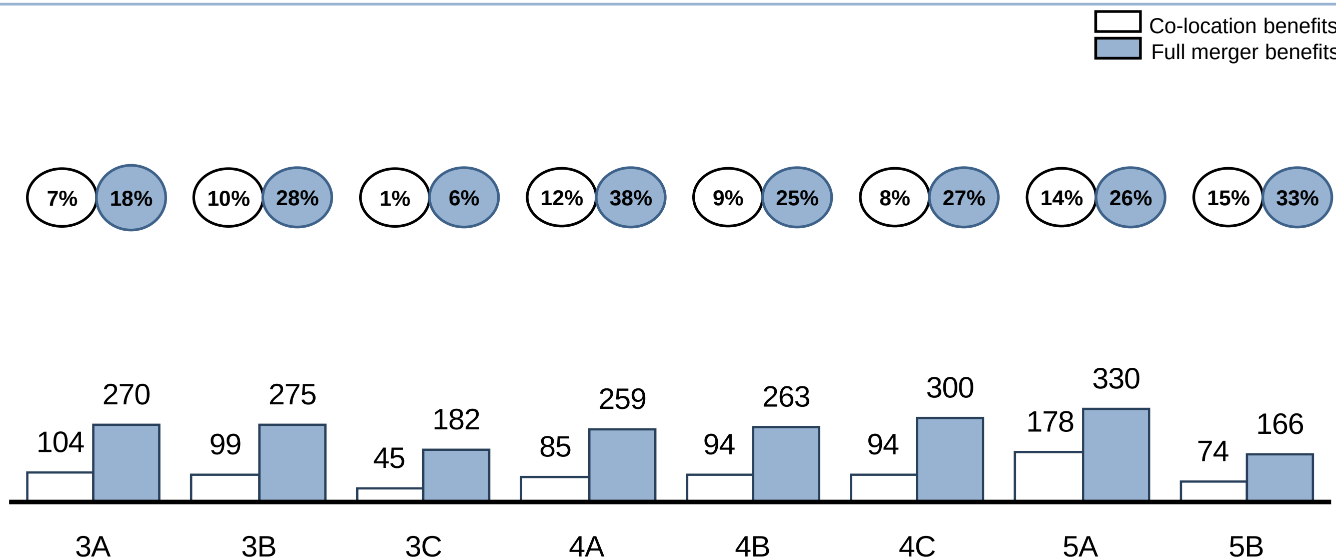


	1A	1B	2A	2B	2C
Stations	1A – Station 1 1A – Station 2	1B – Station 1 1B – Station 2 1B – Station 3	2A – Station 1 2A – Station 2	2B – Station 1 2B – Station 2	2C – Station 1 2C – Station 2
Size	Large	Mid size	Mid size	Mid size	Mid size

Note: Where detailed breakdowns of management accounts were not available, assumptions were made around the potential benefits from reduced central recharges
Source: Value Partners model analysis, Ofcom

Smaller stations are likely to make significant cost savings as well

Benefits from co-locations and mergers (£000s)



	3A	3B	3C	4A	4B	4C	5A	5B
Benefits as a % of total revenues (Co-location / Full merger)	7% / 18%	10% / 28%	1% / 6%	12% / 38%	9% / 25%	8% / 27%	14% / 26%	15% / 33%
Benefits (£000s) (Co-location / Full merger)	104 / 270	99 / 275	45 / 182	85 / 259	94 / 263	94 / 300	178 / 330	74 / 166
Stations	3A – Station 1 3A – Station 2	3B – Station 1 3B – Station 2	3C – Station 1 3C – Station 2	4A – Station 1 4A – Station 2	4B – Station 1 4B – Station 2	4C – Station 1 4C – Station 2	5A – Station 1 5A – Station 2	5B – Station 1 5B – Station 2
Size	Small	Small	Mid size	Small	Small	Small	Small	Small

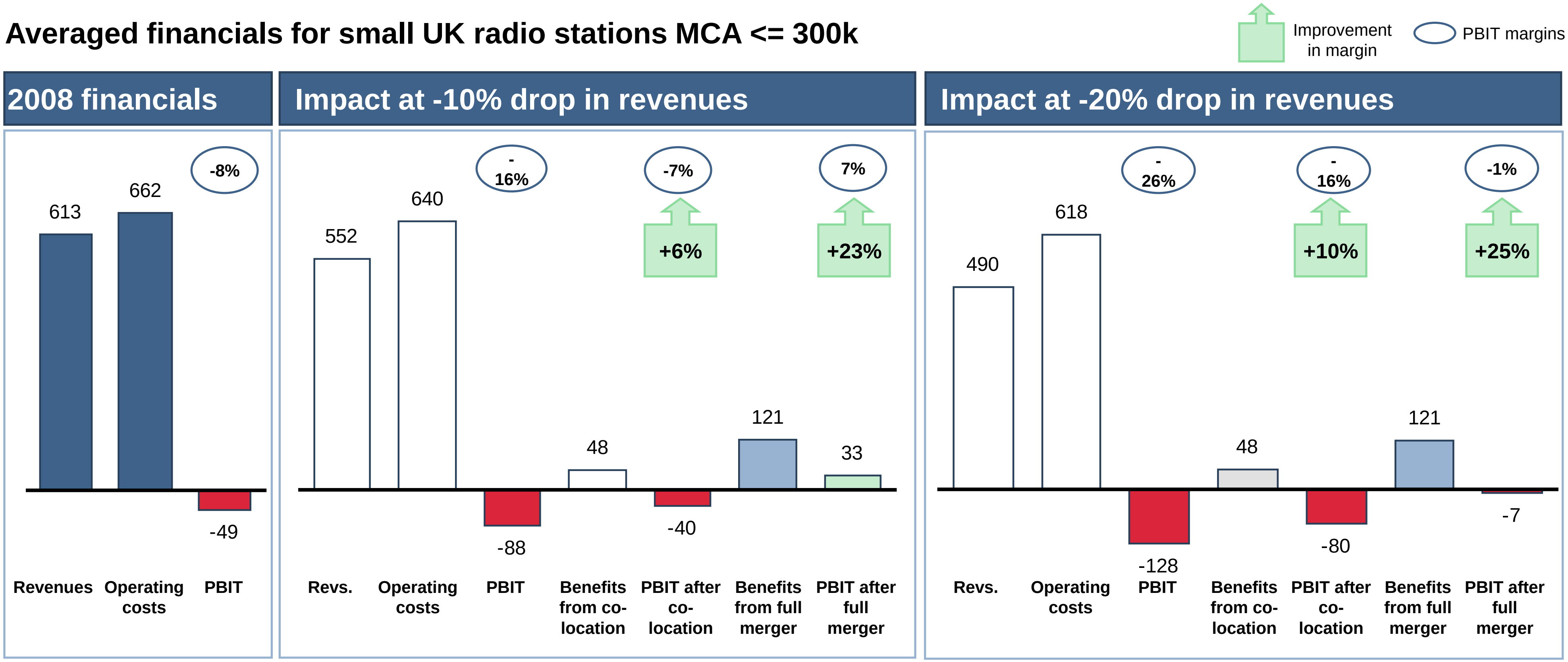
Description of benefits

- The value of benefits possible from co-locations and full mergers for smaller stations are significantly smaller when compared to those made by the larger groups from similar ventures
- However, based on the size of the revenues of these stations, the benefits represent a substantial cost saving

Source: Value Partners model analysis, Ofcom

With a weak current financial position and the potential to be severely impacted by the downturn, smaller stations are in greatest need of the identified regulatory relaxations

Averaged financials for small UK radio stations MCA <= 300k

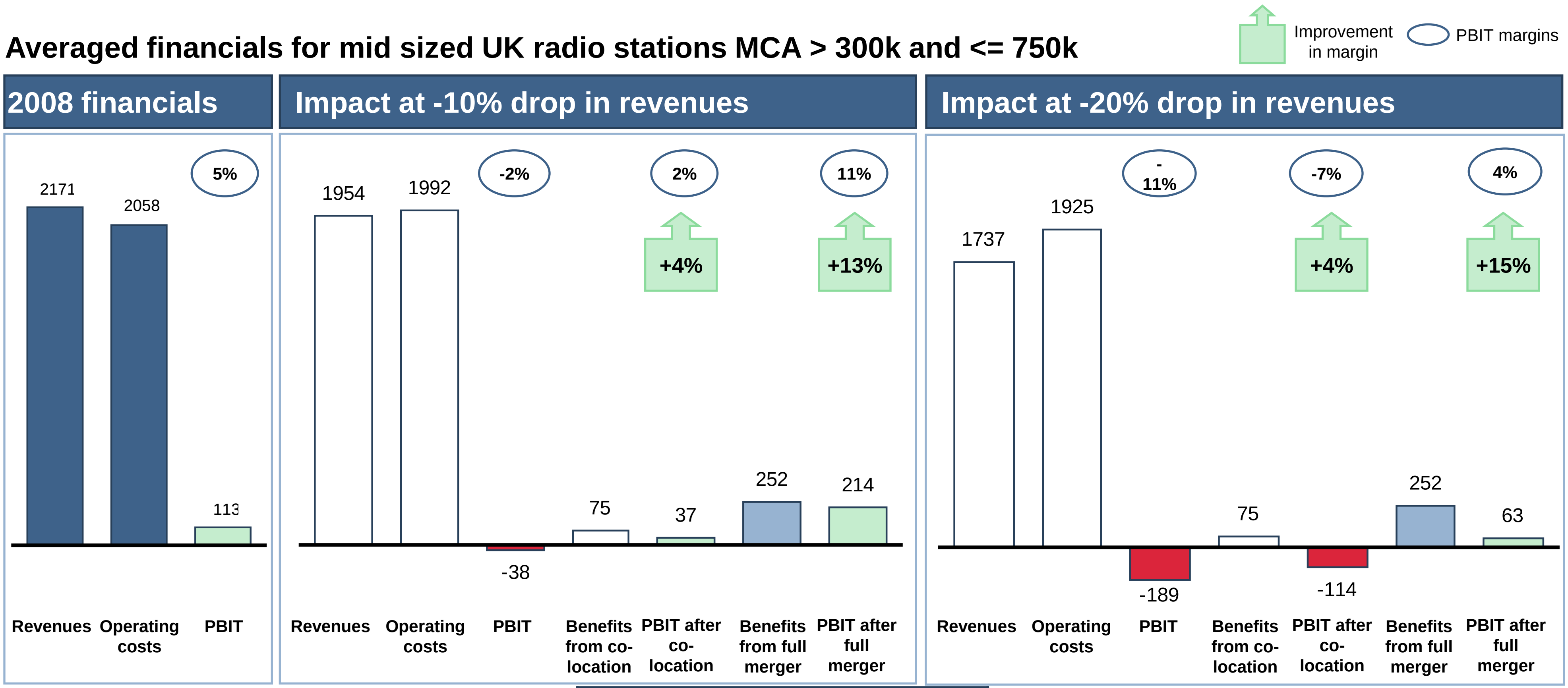


- The current financials of smaller stations demonstrates the stress being felt due to the advertising downturn. Given the high fixed cost base, the opportunities to significantly reduce costs are limited. The already negative margins are anticipated to worsen significantly with a drop in advertising revenues
- The option for stations of this size to co-locate or fully merge creates the opportunity to realise considerable savings (co-location savings: c.10% of revs, full merger savings: c.20-25% of revs). These stations have the greatest need for regulatory support.

Source: Value Partners model analysis, Ofcom

With small positive margins, mid sized stations are comparatively healthier, but are still likely to require regulatory support

Averaged financials for mid sized UK radio stations MCA > 300k and <= 750k

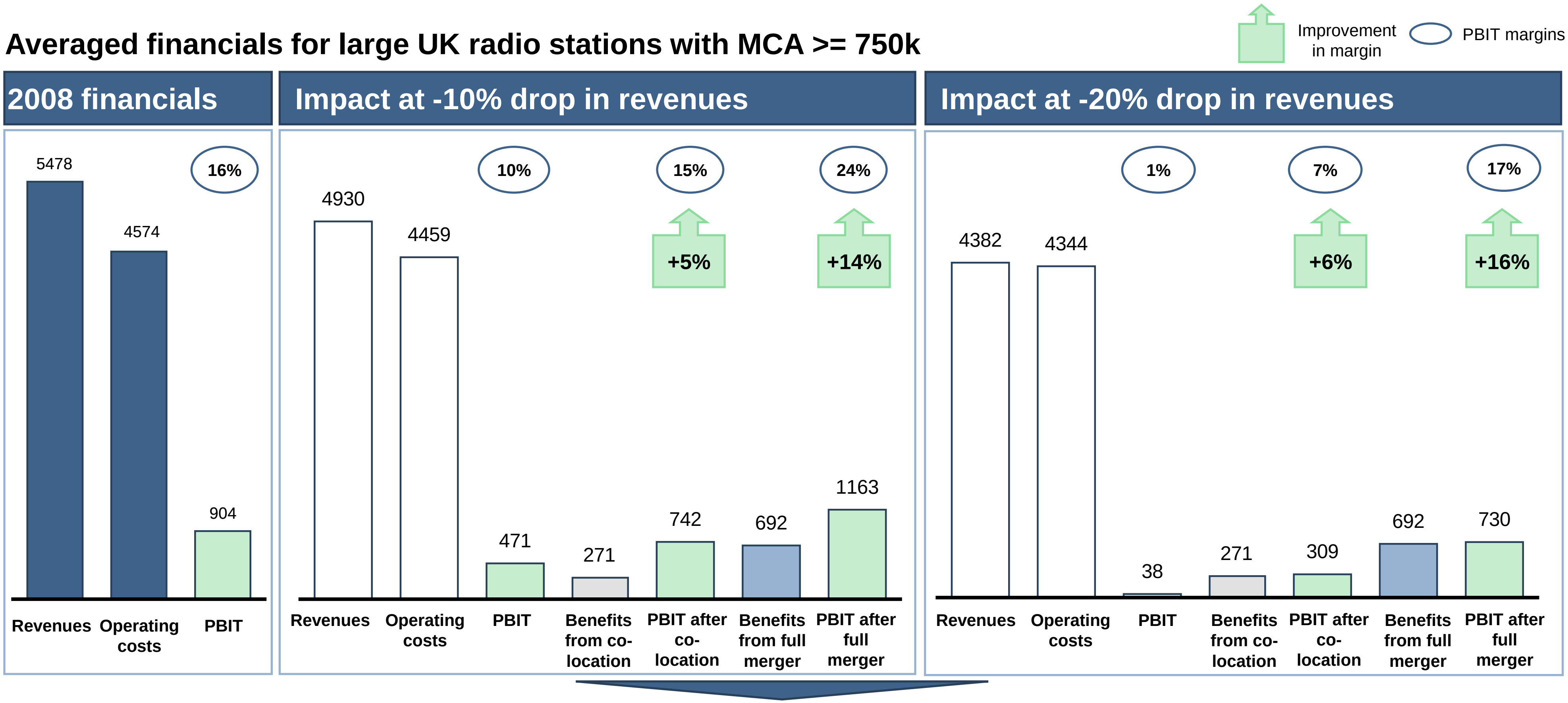


- The mid sized radio stations sampled show the improvement in margins with growing scale. However, their margins have been impacted by the current downturn as well and on average, a mid size station is likely to have just broken even at the end of 2008
- When a reduction in revs. is applied, a number of these stations are expected to become unprofitable. Co-location is able to provide some relief in a 10% downturn however, if the drop in revenues is greater (-20%) a merger between stations may be the only option
- Based on the sample set considered, there appears to be a need for regulatory relaxation to enable smaller stations to achieve larger scale

Source: Value Partners model analysis, Ofcom

With strong financials and the lesser impact of even a steep downturn, the larger stations are in a stronger position

Averaged financials for large UK radio stations with MCA >= 750k



- The accounts of the large radio stations from the sample demonstrate a strong financial position, driven by their scales and access to a larger share of national advertising (which typically has higher margins)
- These stations are likely to remain commercially viable going forward, even in the case of a very steep downturn
- Based on the above, it can be concluded that in the first instance, smaller stations require the additional benefits provided by the identified regulatory relaxations

Source: Value Partners model analysis, Ofcom

On average, the regulatory relaxations are likely to have the greatest effect on the financials of the small stations

		-10% drop in revenues					-20% drop in revenues				
	'08 PBIT %	PBIT %	PBIT % after co-location		PBIT % after full merger		PBIT %	PBIT % after co-location		PBIT % after full merger	
Small stations (MCA <= 300k)	-8%	-16%	-7%	+6%	7%	+23%	-26%	-16%	+10%	-1%	+25%
Mid size stations (MCA > 300k, <=750k)	5%	-2%	2%	+4%	11%	+13%	-11%	-7%	+4%	4%	+15%
Large stations (MCA > 750k)	16%	10%	15%	+5%	24%	+14%	1%	7%	+6%	17%	+16%

Whilst the magnitude of the benefits from co-locations and mergers may be smaller, their impact (especially from full mergers) is the most significant for smaller stations

Source: Value Partners model analysis, Ofcom

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