CINEWORLD/CITY SCREEN MERGER INQUIRY

Summary of hearing with Arts Alliance Advisors held on 23 May 2013

Background

1. Arts Alliance Advisors is a division of a financial advisory company, advising certain venture capital investors (the 'Arts Alliance' investors) with a focus on media businesses, particularly where there is industry disruption or where there are practices which are becoming inefficient or ineffective.

2. Arts Alliance investments typically range from £500,000 to £10 million and it works to typical venture capital return targets of 20 to 40 per cent. Arts Alliance does not have a policy on how long to remain involved in a company.

3. Arts Alliance initially invested in City Screen in 2002, with further investments being made between 2004 and 2006. It had been attracted to City Screen principally because of its potential for digital conversion and its customer focus, driven by its customer membership scheme. Arts Alliance Advisors noted that another one of its clients' investments, Arts Alliance Media, was the global leader in digital conversion services to the cinema industry. Arts Alliance had originally structured the relationship so that Arts Alliance Media was the shareholder in City Screen, but changed this after a couple of years.

Nature of the relationship

4. Arts Alliance Advisors had a reasonably active involvement in City Screen. Arts Alliance had appointed two representative directors from Arts Alliance Advisors who would be in weekly contact with City Screen directors. The relationship was more than monitoring but not an executive role.

5. The involvement of Albion Ventures in the City Screen group pre-dated that of Arts Alliance. Albion had taken a 50 per cent share in six Picturehouse cinemas (Brixton, Norwich, Greenwich, Exeter, Liverpool and Cambridge) with City Screen holding the other 50 per cent shareholding in each cinema. These six joint venture cinemas individually paid a management fee to City Screen Limited. In due course City Screen was able to fund new cinemas from its own operating cash flows and bank facilities. Since 2008, all of the new Picturehouse cinemas were 100 per cent owned by City Screen. Arts Alliance Advisors gave the opinion that Albion's interest was more in the nature of City Screen as a profitable physical property-backed investment, whereas Arts Alliance was more interested in the long-term growth potential of a different type of cinema

Rationale for the transaction

6. City Screen had a number of options open to it in 2012. It could pursue an aggressive expansion strategy; it could grow modestly each year and had the access to sufficient funding to add one or two sites a year for any number of years; or it could stop expanding and return cash to its shareholders. Arts Alliance was open to all three and all three were being actively considered when Cineworld approached City Screen in the middle of 2012.

7. While Arts Alliance was supportive of City Screen's development plans, it did not have access to the same level of resources as Cineworld and would not have been likely to fund in full the level of growth that City Screen was targeting. In addition, banks had not been lending with any kind of substance since 2008. Arts Alliance had not been looking to sell its assets in City Screen but Cineworld offered a price that Arts Alliance considered too good to turn down.

8. Cinema companies tended to be valued on a relatively straightforward EBITDA multiple basis so that there was a globally-recognized, ballpark valuation for a cinema chain. After negotiation, Cineworld offered a multiple that was extremely good, possibly because it had access to cheap debt.

9. Arts Alliance Advisors considered that no one else was in a position to offer a similar price to that offered by Cineworld. Arts Alliance Advisors did not see Odeon or Vue as likely purchasers and did not approach them. Nor did it approach any other possible bidders.

10. There were several reasons why Arts Alliance Advisors saw Cineworld as a good fit with City Screen. The two management teams had complementary skills and common views on the future of cinemas. The Cineworld team was very technologically aware, and was willing to bring in expertise from outside the company. In addition, their cinema portfolios were complementary: Cineworld did not have a particularly strong presence in London, while City Screen did. And even though there were some Cineworld cinemas reasonably close to a couple of City Screen cinemas, Arts Alliance Advisors had never really considered that City Screen was in competition with it.

11. Arts Alliance Advisors believed that the Cineworld management team had a great deal of respect for the achievements of the City Screen team and for the Picturehouse brand and made it clear that Cineworld expected and wanted the existing City Screen team to be central to the business in the future. Arts Alliance Advisors expected that some of the more upmarket and well-located Cineworld venues would be rebranded as Picturehouses and be run by the present City Screen management team in the future.

Alternatives to the transaction

12. The most likely alternative to the transaction was that City Screen would continue to grow at the rate of about one cinema a year, in due course becoming large enough to increase to two or more in a year. City Screen was a solidly profitable company. City Screen would either have gone ahead with slow and steady growth or possibly would have sought to access public markets with a listing. City Screen had in 2009 and again in 2011 considered the viability of seeking an AIM flotation and it was likely that it would have reconsidered this option. Such a flotation would have been with the dual aims of providing a partial exit for City Screen's investors while also providing fresh capital to fund future growth. City Screen was probably not far off being ready for that, but the markets were not sufficiently open at the point when Cineworld made its offer.

13. Scale was helpful for cinema chains in order to be able to attract the right calibre of middle and senior managers. At one extreme there were the large chains with 600+ screens and at the other there were the single independents. There were relatively few chains of the size that City Screen had become; perhaps just Everyman and the Curzon.

14. City Screen had explored a number of times the possibility of a merger between City Screen and Curzon or Everyman or all three but it had come to the realization that this would never happen for cultural reasons.

Benefits of the merger

15. Arts Alliance Advisors believed that there were synergies to be found on the distributor side and in the retail offerings, but these were small.

16. It believed that City Screen would be able to expand faster and more effectively within Cineworld than it could have done under its own steam. Its view was that the choice of locations for new cinemas would not change as a result of the merger. The process of opening a new City Screen cinema typically took five to seven years from the time a suitable location was identified. Finding distinctive buildings in the right geographic areas was an important part of the way that City Screen operated and would not change.

Evolution of the industry

17. Everyman pitched at a young, very wealthy demographic and would be unlikely to develop a cheaper format that would compete with City Screen's slightly broader appeal. Everyman had expanded in 2006/07 by buying seven cinemas. It had paid a high multiple to get those which would have affected its prospects of further expansion.

18. Curzon had set up its own programming team—having previously used City Screen's programming service—which would have added considerably to its overheads.

19. Although Odeon was experimenting with a couple of upmarket venues, it was unlikely that it would make serious attempts to compete with City Screen. Vue might be more interested in targeting City Screen customers, but was still working to integrate its purchases from the Apollo chain, which were the cinemas that might be the most suitable for a more upmarket offer.