24 November 2005

Germany
Entertainment

DEAG Deutsche Entertainment AG

Primary Exchange: Frankfurt
Prime Standard

Symbol: ERM
ISIN: DE0005513907

Rating: Buy
2005 Price Target: €4.30
Risk Rating: High

Reaction to Q3 Results

Company Profile

DEAG Deutsche Entertainment AG is one of the leading concert-organiser groups in Europe. The core business of DEAG consists of organising national and international concerts and tours and exclusive management of venues and variety theatres. It provides a full range of services for music tours including production, agency and promotion. The company is headquartered in Berlin and as of 30 September had 141 full time employees.

Key Points

- DEAG published its Q3/05 report on 11 November. Sales for the quarter were reported at €21.19m, 56% higher y-o-y than Q3/04's €13.61m. This increase can be largely attributed to the Zurich Hallenstadion reopening and the Joe Cocker world tour.
- In Q3, DEAG's CFO Wingolf Mielke resigned after fulfilling his contract with the company. On 1 September he was replaced by Dr. Ingo Stein, who was last employed as CFO of the film company Senator Entertainment AG, Berlin. Since his appointment, we have spoken with Ingo Stein several times and have been impressed with his grasp of the entertainment industry as a whole and DEAG in particular.
- DEAG's Q3/05 came in under our projections. The past two years' revenue growth has been hampered by the tight lending policy of German Banks. We are reducing our FY/05 revenue projection to €78.58m from €88.08m and our net income to €0.70m from €1.76m. We are also reducing our FY/06 revenue projections from €130.14m to €115.24m. This will result in the 2006 net income being reduced from €6.32m to €4.67m, with the diluted EPS estimate coming down from €0.42 to €0.24.

Recommendation

Although Q3/05 revenues grew by 56% y-o-y, they came in under our estimates. In reassessing our projections, we took a more conservative stance. Our current 2006 revenue estimates are closely linked to signed contracts and therefore involved little speculation. From our conservative standpoint, we expect a sharp rise in revenue growth of 47% in 2006. Furthermore, we believe the company will experience a significant "sea change", establishing an upward growth trend in 2006. We maintain our Buy recommendation on DEAG and reduce our 2005 price target from €5.75 to €4.30, with a high risk rating.

Risks

Risks to our price target include but are not limited to: cancellation of currently signed contracts or concert events.

Important disclosures are at the back of this report

Financial History & Projections

	2003A	2004A	2005E	2006E
Revenue €m	127.33	96.56	78.58	115.24
Yr/Yr Growth	-9%	-24%	-19%	47%
EBIT €m	-7.82*	4.65	2.22	9.76
Net Income €m	-14.68	2.88	0.70	4.67
EPS € basic	-1.54	0.21	0.05	0.31

*After deduction of Restructuring Expenditure (€12.13m)

Company Data (as of 30 September 2005 unless otherwise noted)

Market Capitalisation (23.11.05)	€36.91m
Shares Outstanding	15,125,050
Liquid Assets	€20.87m
Current Assets	€37.72m
Intangible Assets (incl. Goodwill)	€33.33m
Total Assets	€90.29m
Total Shareholders' Equity	€33.97m

Stock Overview

Source: Bloomberg & First Berlin

Closing Price (23.11.05)	€2.74
52-Week Range	€1.37 / 2.98
Free Float (Acc. to Deutsche Börse)	75.6%
Average Daily Share Volume (year)	120,569

Analyst Information

Stephen Love
stephenl@firstberlin.com

First Berlin
Equity Research Group
Schumannstr. 17
10117 Berlin

Tel. +49 (0)30 - 80 93 96 84
Fax +49 (0)30 - 80 93 96 87

Q3 & 9M/05 Results

DEAG published its Q3/05 report on 11 November. Sales for the quarter were reported at €21.19m, 56% higher y-o-y than Q3/04's €13.61m. This increase can be largely attributed to the Zurich Hallenstadion reopening and the Joe Cocker world tour. DEAG runs the Zurich Hallenstadion which consistently produces the highest margin of all the venues the company operates. The company segment Artists & Tours had revenues of €18.2m, well above Q3/04's €10.5m. The segments Urban Entertainment and Theatres were roughly in-line with Q3/04 numbers. The gross margin continued to improve in Q3/05 to 21.9%, compared to 15.4% in Q3/04.

Looking at the 9M/05 figures, revenues of €51.61m lagged behind 9M/04's €74.52m by 30.7%. The segment Artists & Tours at €41.4m was significantly below (35.7%) 2004's €64.4m. The Urban Entertainment and Theatres segments were in-line with last year. The 9M Artists & Tours comparison again points to the importance of both the Zurich Hallenstadion, and at least one major tour for DEAG's revenue continuity. 9M/04 revenues contained over seven months of Hallenstadion revenues; whereas 9M/05 received only a few weeks.

DEAG reported a 9M/05 net loss of €1.23m compared to the 9M/04 profit of €2.85m. However, it should be noted that the 2004 number is skewed by a one-time tax rebate of €2.59m for the period.

Although still negative, Operating Cash Flow improved strongly in the 9M/05 report to -€2.01m, compared to -€15.81m for FY/04. The 9M balance sheet was in-line with 31 December 2004. Liquid assets were reduced by €0.40m from €21.27m at the end of 2004 to €20.87m at the end of September 2005.

A new CFO

In Q3, DEAG's CFO Wingolf Mielke resigned after fulfilling his contract with the company. Mr. Mielke had come out of retirement to fill the position for a 12 month period and helped the company in contract negotiations and improving cooperation between its subsidiaries.

On 1 September he was replaced by Dr. Ingo Stein, who was last employed as CFO of the film company Senator Entertainment AG, Berlin. Since his appointment, we have spoken with Ingo Stein several times and have been impressed with his grasp of the entertainment industry as a whole and DEAG in particular.

Projections

DEAG's Q3/05 came in under our projections. The past two years' revenue growth has been hampered by the tight lending policy of German Banks. In Q3 revenues were further reduced by concert cancellations. Most notable, was the cancellation of the Eminem tour. Also, the Jahrhunderthalle expansion project, which has been awaiting a building permit for over a year, seems to be bound-up in political red tape in Frankfurt city hall. The interest payments on the loan associated with the deal have been a drag on earnings growth for the past several years.

As a result of the 9M performance, we are reducing our projections for both FY 2005 and 2006. Not all of the problems have been resolved, but the company has secured a line of credit to allow it to bid on international concert tours. With the Hallenstadion coming back online, even a very conservative estimate of 2006 growth would mean significant y-o-y growth for the company's P&L.

These factors considered, we are reducing our FY/05 revenue projection to €78.58m from €88.08m and our net income to €0.70m from €1.76m. We are also reducing our FY/06 revenue projections from €130.14m to €115.24m. This will result in the 2006 net income reducing from €6.32m to €4.67m, with the diluted EPS estimate coming down from €0.42 to €0.24.

Outlook

With the Zurich Hallenstadion back online since August, we can expect a good Q4/05. Indeed 2006 should give us the first FY numbers which will reflect the company running on "all cylinders" or subsidiaries again. In the paragraph above we reduced our projections for 2006. However, if those conservative projections are met, it will mean a 47% y-o-y revenue increase. In addition, there are rumours of new deals which could boost 2006 sales above our expectations. Looking forward, the indications are good.

DEAG's new Classic concert series was very successful in its first season. We expect above average growth in this new concert segment. In addition, these concerts have a higher margin than rock concerts.

2006 will also see additional income from the conversion of up to 4,583,350 convertible bonds up to the end of November. With a strike price of €2.33, it is reasonable to expect all conversions will be made.

Technical Analysis

Source: First Berlin & Bloomberg

After three failed attempts to break out above the €2.50 resistance this year, the rally in mid-September finally found the momentum to move the share price beyond this level. We have since seen some consolidation and new support has been confirmed at the old resistance of €2.50.

Given the current dynamics in the chart, we view the DEAG share as poised, for only the second time this year, to challenge the €3.00 mark. If it succeeds in breaking above this level, we see mid-to-long term resistance coming in at €3.50, the level which it fell from back in March 2004. Failing that, we see a short term trading range between €2.60 - 2.90, as the market digests these recent gains.

The company's improved fundamental situation (the reopening of the high margin Zurich Hallenstadion venue) has clearly had its impact on the markets' sentiment regarding DEAG. We view this as a positive development and would advise investors to buy at current levels, or on any minor corrections, to minimise downside risk.

Please note: While fundamentals serve as the basis for the overall trend in a stock, technical analysis measures emotional and psychological components. This is valuable in explaining price volatility while company fundamentals remain constant. We provide this simple technical overview to assist with investment timing.

Valuation Assumptions and Risks

We reduced our projections for 2005 and 2006 in this report. There is little speculation involved in our 2006 revenue projections because they are closely linked to currently signed contracts. The major risk to those estimates is a concert cancellation. Furthermore, with some deals for 2006 still in negotiation, there is considerable upside possibility.

Based on our 2006 projections and expectations for 2007, we consider DEAG is approaching the upswing of its turnaround. Our valuation of €4.30 is based on a P/E ratio of 18x our 2006 diluted EPS estimates, which is below the industry norm of 23x.

Recommendation

We published our first report on DEAG on 3 June 2004. The company divested the insolvent Stella Entertainment AG in 2003. DEAG entered 2004 with all debts associated with the Stella insolvency resolved. In comparison with the previous two years, we expected that DEAG was well situated to grow again.

However, DEAG's cash situation was tight. And due to a conservative loan policy by German banks, the company could not obtain loans to sign the few major rock concert tours being planned. For that reason, DEAG lost a major tour-group in Q1/04. We expected the funding problem would be solved, but had to reduce our projections several times since our first report. In addition, the Hallenstadion went into a 12 month major renovation in August of 2004.

Although Q3/05 revenues grew by 56% y-o-y, they came in under our estimates. In reassessing our projections, we took a more conservative stance. Our current 2006 revenue estimates are closely linked to signed contracts and therefore involved little speculation. From our conservative standpoint, we expect a sharp rise in revenue growth of 47% in 2006. Furthermore, we expect the company will experience a significant "sea change", establishing an upward growth trend in 2006.

We maintain our Buy recommendation on DEAG and reduce our 2005 price target from €5.75 to €4.30, with a High risk rating.

Income Statement Analysis

in t €	2002A TotalA	2003A TotalA	2004A TotalA	2005E TotalE	2006E TotalE
Revenue	**139991**	**127325**	**96557**	**78582**	**115243**
Cost of revenues	-104455	-100991	-76138	-62866	-91042
Gross profit	**35536**	**26334**	**20419**	**15716**	**24201**
Selling and marketing costs	-19863	-13214	-11407	-10216	-12319
General and administrative costs	-17199	-11688	-10452	-10905	-9845
Other operating income		27104	9061	9417	9522
Other operating expenses	9740	-21990	-2214	-1041	-1041
EBITDA	**-6313**	**6546**	**5407**	**2972**	**10518**
Scheduled depreciation		-684	-606	-601	-602
Amortization of goodwill		-13678	-150	-150	-150
EBIT	**-17739**	**-7816**	**4651**	**2221**	**9766**
Interest income and expenses	-2532	-4353	-2101	-1609	-2100
Result from investments and participations	5213	-1068	-50	395	195
Income/expenses from associated companies	44	7	-5		
Foreign currency exchange gains / losses	-213	-156	7	72	35
Other expenses and income	54	66	0		
Result before taxes (and minority interest)	**-15173**	**-13320**	**2502**	**1079**	**7896**
Income tax	4111	-287	231	-325	-2377
Result before minority interest	**-11062**	**-13607**	**2733**	**754**	**5519**
Minority interest	1930	-1071	146	-50	-850
Net income / loss	**-9132**	**-14678**	**2879**	**704**	**4669**
Earnings per share (basic)	**-1.08**	**-1.54**	**0.21**	**0.05**	**0.31**
Earnings per share (diluted)	**-1.08**	**-1.48**	**0.16**	**0.04**	**0.24**

Profitability analysis	2002A TotalA	2003A TotalA	2004A TotalA	2005E TotalE	2006E TotalE
Gross margin	25%	21%	21%	20%	21%
Operating margin	-5%	5%	6%	4%	9%
Net income margin	-7%	-12%	3%	1%	4%
Expenses as % of revenues					
Selling and marketing	14%	10%	12%	13%	11%
General and administrative	12%	9%	11%	14%	9%
Y-Y Growth					
Total revenues	-	-9%	-24%	-19%	47%
Operating income	-	204%	-17%	-45%	95%
Net income/ loss	-	-61%	120%	-76%	62%

First Berlin Recommendation & Price Target History

Report No:	Date of Publication	Previous Day Closing Price	Recommendation	Target Price	Interim High	% Change to High
1	3 June 2004	€2.80	Strong Buy	€3.75	€2.78	-0.7%
2	15 December 2004	€1.59	Strong Buy	€2.40	€2.51	57.9%
3	2 May 2005	€2.03	Strong Buy	UR	€2.42	19.2%
4	15 July 2005	€2.25	Buy	€5.75	€2.42	7.5%
5	15 August 2005	€2.11	Buy	€5.75	€2.98	41.2%
6	Today	€2.74	Buy	€4.30	-	-

Source: Bloomberg & First Berlin

First Berlin Policy

In an effort to assure the independence of First Berlin research neither analysts nor the company itself trade or own securities in subject companies. In addition, Analysts' compensation is not directly linked to specific financial transactions, trading revenue or asset management fees. Analysts are compensated on a broad range of benchmarks. Furthermore, First Berlin receives no compensation from subject companies in relation to the costs of producing this report.

Analyst Certification

I, Stephen Love, certify that the views expressed in this report accurately reflect my personal and professional views about the subject company; and I certify that my compensation is not directly linked to any specific financial transaction including trading revenue or asset management fees; neither is it directly or indirectly related to the specific recommendation or views contained in this research. In addition, I possess no shares in the subject company.

Investment Rating System

First Berlin's investment rating system includes an investment recommendation and a risk rating. Our recommendations, which are a function of our expectation of total return (forecast price appreciation and dividend yield) in the year specified, are as follows:

BUY: Expected return greater than 15%
HOLD: Expected return between 0% and 15%
SELL: Expected negative return

Our risk ratings are Low, Medium, High and Speculative and are determined by ten factors: corporate governance, quality of earnings, management strength, balance sheet and financing risk, competitive position, standard of financial disclosure, regulatory and political uncertainty, company size, free float and other company specific risks. These risk factors are incorporated into our valuation models and are therefore reflected in our price targets. Our models are available upon request to First Berlin clients.

Up until 30 June 2005, First Berlin's investment rating system was five tiered and was a function of our expectation of return (forecast price appreciation and dividend yield) over the specified year. Our investment ratings were as follows: STRONG BUY: expected return greater than 20%, BUY: expected return greater than 10%, HOLD: fairly valued, REDUCE: expected return between -10% and 0%, SELL: expected return to depreciate by more than 15%. In addition, we had a SPECULATIVE BUY recommendation for stocks which we projected had the potential to give a return of 50% or more but which we also expected to be exceptionally volatile (movement up or down of 50% or more). Our risk ratings were Low, Medium, High and Speculative and were a reflection of expected price volatility, the strength of the balance sheet and the predictability of earnings.

Additional Disclosures

This report is not constructed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer would be illegal. We are not soliciting any action based upon this material. This material is for the general information of clients of First Berlin. It does not take into account the particular investment objectives, financial situation or needs of individual clients. Before acting on any advice or recommendation in this material, a client should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should be relied upon as such. Opinions expressed are our current opinions as of the date appearing on this material only; such opinions are subject to change without notice.