EDISON

Technicolor

Interim results

Robust demand with fulfilment issues

Media

Technicolor is on track to meet FY21 and FY22 management guidance (maintained at the Q3 results in November) on EBITDA and EBITA, despite supply constraints resulting from the pandemic, and our forecasts for these were unchanged. Demand in both Technicolor Creative Studios (TCS) and Connected Home remains robust, with financial performance constrained in the former by industry talent shortages and in the latter by continuing industry componentry supply issues. With planned cost savings tracking to plan, the shift is continuing back towards the equity, which now represents 35% of the enterprise value. We would expect that a return to focus on the operations should lead to a higher valuation.

Year end	Revenue (€m)	EBITDA (€m)	EBITA (€m)	PBT* (€m)	EPS* (€)	EV/EBITDA (x)
12/19	3,800	325	42	(73)	(4.92)	5.6
12/20	3,006	167	(56)	(43)	(0.38)	10.9
12/21e	2,760	270	60	(37)	0.17	6.8
12/22e	2,994	385	180	78	0.30	4.7

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Strong market positioning helps

Since the financial reconstruction of the group in late FY20, Technicolor's management has focused on driving the returns from the three distinct business segments and building sustainable operating models. The dynamics for each are different, but all are benefiting from their strong market positioning. For Connected Home, this means customers committing to FY22 volumes and agreeing to pass through contracts to ensure the supply of components. For TCS, it means having 75% of its FY22 pipeline for visual special effects (VFX) and animation already in place. The challenges of physical fulfilment for the former and of recruiting the talent to deliver the latter are significant, but, for both, are affecting the whole of both industries.

Financial strengthening

Management's achievement in negotiating and implementing a complex financial restructuring in FY20, during a global pandemic, is worthy of attention. If the outlined progression for FY21 and FY22 in EBITDA and EBITA can be achieved, then the prospects of more normalised cost of debt ahead of the FY24 expiry date improve. With good underlying demand and the group on track to deliver €325m of run rate cost savings by end FY22, the current delivery issues appear factored in.

Valuation: Underlying value likely higher

With a complex business structure and few genuinely comparable peers, any valuation of the group's equity is inevitably laden with assumptions. We have attempted a sum-of-the-parts based on compiling segmental FY22e earnings-based valuations, variously discounted, which derives a value equivalent to €4.49 per share. A group based DCF, using a WACC of 9.0% and terminal growth of 1%, gives a value of €3.77. Both are considerably higher than the current share price.

24 January 2022

Price	**€2.73**
Market cap	**€644m**
	US$1.14/€
Net debt (IFRS, including leases) at end September 2021 (€m)	1,183
Shares in issue	235.8m
Free float	90.6%
Code	TCH
Primary exchange	Euronext
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(0.1)	(2.9)	40.8
Rel (local)	(1.5)	(7.2)	14.3
52-week high/low		€3.6	€1.7

Business description

Technicolor is a worldwide technology leader operating in the media and entertainment industry. Its activities fall into three business segments: Technicolor Creative Studios, DVD Services and Connected Home.

Next events

FY21 results	February 2022

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Investment summary

From FY08 to FY18, Technicolor was reduced from a substantial portfolio of businesses to three, each of which is a leading player in its segment. In FY20, the group faced a significant challenge: renegotiating its debt financing while managing the severe disruptions to the business stemming from the COVID-19 pandemic. It is a considerable testament to the management team under Richard Moat (appointed in November 2019) that a way through this was found, bankruptcy was avoided, and the group was put on a more sustainable footing. The three business segments are:

- **Connected Home (53% of FY21e revenues, 35% of adjusted EBITDA):** the increased level of homeworking globally and the constant evolution in home entertainment have highlighted the importance of reliable broadband and wide bandwidth. New business wins and product launches are encouraging, but the global semiconductor and key component shortages are significant, although have recently eased a little. We think this will remain a challenging business but its relative and absolute scale advantages over most of its peers and leadership of growing segments (DOCSIS 3.1 and Android) should help mitigate some of these challenges. Concentration on key customers, a platform-based approach and the lower cost base should help protect margins and enable them to build as the component issues resolve.
- **TCS (22% of FY21e revenues, 43% of adjusted EBITDA):** activity levels are very strong as the entertainment industry rebuilds after the strictest lockdowns. The underlying trends for ever-more sophisticated VFX are helpful, while the division is also putting in a very strong performance in animation and games, with games a particular focus for effort. Over 75% of the FY22 pipeline is already in place in VFX and animation. The constraint here is capacity, with industry talent shortages. By working together more efficiently, increasingly on common platforms and in lower-cost geographies, as well as exploiting the group's well-established training programme, Technicolor should be better placed than most.
- **DVD Services (24% of FY21e revenues, 22% of adjusted EBITDA):** the physical home entertainment market is in ongoing decline, with geographic variations. Technicolor is a key provider of replication and distribution services to the major studios and has been renegotiating its contracts on more favourable terms as they come up for renewal. Along with efficiency measures, this is helping to drive improvement in margins. Better performance of back catalogue titles helped bridge the gap in the absence of new releases, which have now started to come through again.

Valuation: Equity building in the mix

As the group's future has looked increasingly secure, the share price has climbed, increasing by 55% over FY21, and equity now accounts for 35% of the enterprise value. Valuing the group on a sum-of-the-parts basis is an inexact science as there are no genuinely equivalent peers in any of the three segments. We have nevertheless attempted the exercise, deriving a value for the equity equivalent to €4.49/share. On a group basis, our DCF at a WACC of 9% and terminal growth of 1% indicates a value per share of €3.77, still well ahead of the current market value.

Financials: All in the mix

Management has guided to group adjusted EBITDA and adjusted EBITA from continuing business for FY21e and FY22e, as well as continuing free cash flow before financial results and tax (unchanged at Q321 from earlier guidance), and these figures are reflected in our modelling. This guidance was unchanged on the Q3 figures in November. The mix modelling is Edison's, and we expect meaningful FY22e top-line growth to be fuelled by TCS, with DVD Services declining around 6% and Connected Home revenues gaining 5% over the prior year. Adjusted EBITDA margins

should move ahead in all three, with the greater progress at TCS and Connected Home. Management has maintained its three-year cost savings target at a run rate of €325m by end FY22, with €115m set to come through in FY21. Restructuring costs were €31m for the first nine months of FY21. FY20's financial reconstruction put the group on a stable footing despite the weighting to debt in the enterprise value. Our forecast for FY21 year-end net debt to EBITDA is 3.8x, inside management's 4.0x target.

Sensitivities: Vary by business

The current key sensitivities are easily identified. For Connected Home the issue is centred on component shortages and supply chain issues, whereas for TCS, it is meeting strong demand when there are global talent shortages for artists and technicians. Both situations are being actively managed, and the group does not look to be losing its market positioning in either area. The refinancing has removed a core concern and the improving financial position should strengthen management's position into FY24, when the Term Notes and Loans expire.

Company description: Three businesses in one

Technicolor consists of three businesses, each a leader in its field. They are Connected Home (53% FY21e group revenue), DVD Services (24%) and TCS (22%), with a small balance from Corporate and Other.

- Connected Home offers a complete portfolio of broadband and video customer premise equipment (CPE) to pay-TV operators and network service providers (NSPs), including broadband modems and gateways, digital set top boxes, and Internet of Things (IoT) connected devices.
- TCS is a leading provider of VFX and animation to the global entertainment industry, and at the forefront of creative services and technologies
- DVD Services replicates, packages and distributes video, game and music CD, DVD and Blu-ray discs on behalf of the major studios and relevant publishers.

In the early 2000s, the group comprised a large number of disparate businesses. A new management team, installed in 2008, was charged with simplifying the business and strengthening the balance sheet ahead of debt approaching maturity. The strategy put in place prioritised for retention those business in the portfolio that had (or neared) market leadership, hence the current group composition.

The Technicolor group employed over 13,000 people in 25 countries at the end of FY20.

FY20 a turbulent year

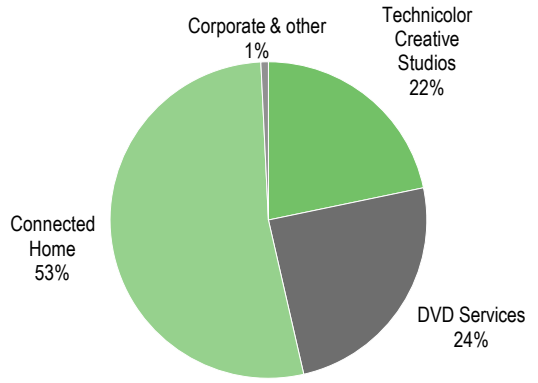
The scale of the turnround needed was substantial and the unhelpful economic and trading backdrop did not give enough time for the group's cash generation profile to be sufficiently improved ahead of the debt renegotiation, although significant opportunities for cost reductions had been identified across the three businesses and moves to release those savings initiated. A further management change was made in late FY19 with the appointment of Richard Moat as CEO, who had previously led the turnaround of Eir Limited, a leading telecoms operator in Ireland. His first priority was to oversee a financial reconstruction, and in February 2020, his plan was set out outlining €150m of cost savings (up from the €40m previously identified and with an implementation cost of €90m over three years), alongside a proposed rights issue to raise €300m. Successful completion of the rights was a prerequisite for the reconstruction of the debt. However, these plans were scuppered by the onset of the COVID-19 pandemic, which had a particularly negative impact on the key customers of TCS.

With the spread of the pandemic and the associated uncertainty, the ability of the group to conduct the rights issue in Q220 as originally envisaged was compromised and by late May the group's equity value of €58m compared to end March net debt of €1.6bn. Negotiations with the debt holders ran close to the wire, which undermined the group's credit rating further and put the group's future in sufficient doubt for the management to seek temporary protection from creditors via Chapter 15 in the United States. All was resolved through August and September of 2020 (and the various stages of the process were described in our reports through the year) with debt funding and a subsequent debt-to-equity swap, alongside a rights issue at €2.98, above the price at the time, which was taken up by 18.1% of equity holders.

Focus back on the underlying businesses

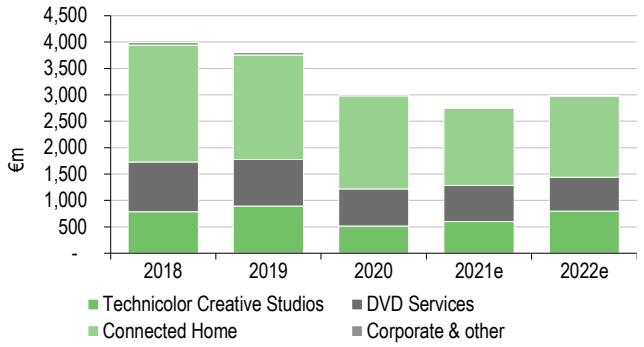
The resolution of the 2020 funding crisis meant that appraisal of the underlying businesses and their opportunities is again the primary driver of perceived valuation. The three segments (splits shown in Exhibits 1 through 4, below) have different attributes. Broadly, Connected Home is a scaled, global supplier of customer premises equipment for delivery of broadband and video services. While demand for video set-top boxes has peaked, the benefits of reliable, high-quality home broadband have become even more obvious with the growth of home working globally. So, prospects of combined top-line growth overall in the segment have improved, with the identification and implementation of substantial cost reductions improving the underlying profitability. The DVD Services segment is in a process of managed decline, with renegotiated contracts with its major customers lifting the operating margins and the attraction of good levels of cash generation.

Exhibit 1: FY21e revenue split



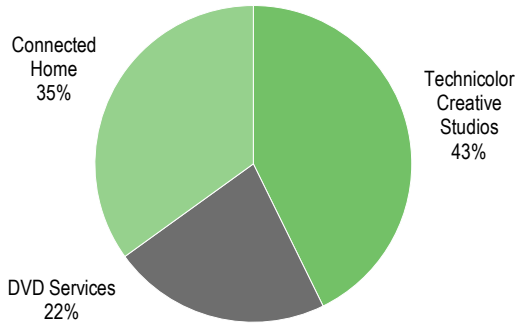
Source: Edison Investment Research

Exhibit 2: Segmental revenue FY18–22e



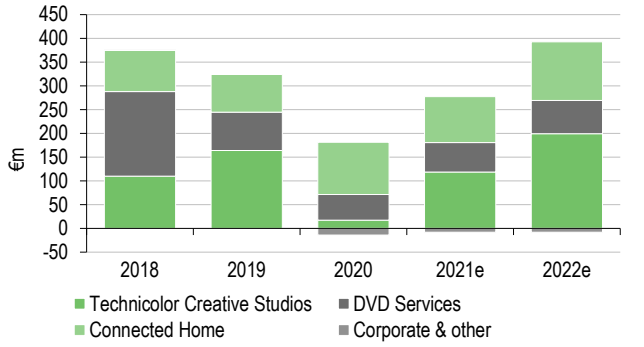
Source: Edison Investment Research

Exhibit 3: FY21e EBITDA split



Source: Edison Investment Research

Exhibit 4: Segmental EBITDA FY18–22e



Source: Edison Investment Research

This leaves TCS as the key engine of revenue growth for the group, with a premium quality offering in a growth industry and potential to expand in adjacent video-based content areas to its traditional film and TV remit. While the short-term impact on the industry stemming from the shutdowns in live

action filming had a major impact on the FY20 and FY21 financials, the release from lockdowns has unleashed demand from the studios and streamers with high levels of budgeted content spend, making the prospects for growth very encouraging. We look at the three segments in more detail below.

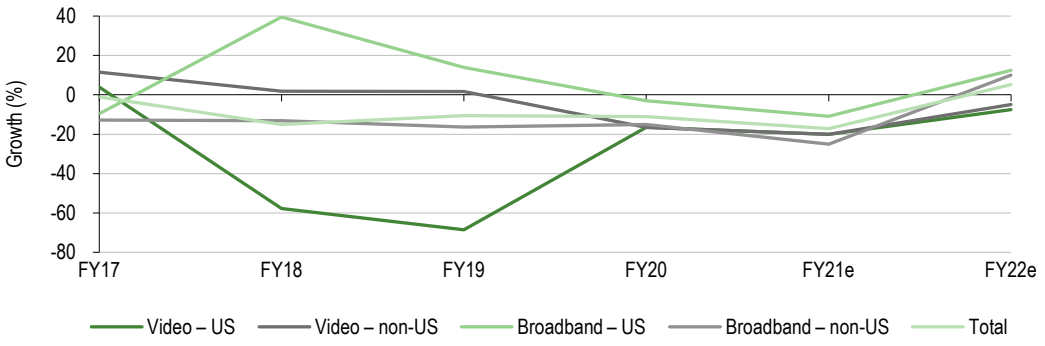
Connected Home (53% FY21e group revenue): Survive and prosper?

There is never a dull moment in Connected Home it seems. Over the last four years it has endured huge swings in commodity component prices, the steady shrinking of the video market, the pandemic (mostly a positive impact), the financial restructuring of its parent and now a squeeze on semiconductor availability and prices. Sales fell 33% (-10% CAGR) between FY16 and FY20 and were down 34% y-o-y on a reported basis in Q321. Despite all this, aggressive cost cutting in recent years has enabled it to grow margins, lifting EBITDA 39% in FY20 over the prior year, until the current component supply issues kicked in. EBITDA of €56m in H121 (a 7.3% margin) represented Connected Home's biggest first half profit since FY17, but Q321 EBITDA margin retrenched to 5.1%, reflecting the sales shortfall and higher component prices.

With all these external impacts, plus the impact of foreign exchange and huge quarter-by-quarter volatility, it is often difficult to appreciate the underlying demand trends. Mostly these look similar to those we highlighted in July 2020 (see Mapping a way through) and set out in our initiation note (see Entertainment enhancer), but the component shortfall and the continuing underperformance of Latin America add new layers of uncertainty. The performance of CommScope's Home segment, which saw revenues fall 28% y-o-y in Q1, pushing it into an adjusted EBITDA loss-making position, highlights that these trends are market wide rather than specific to Connected Home. Connected Home's key competitors in customer premise equipment are Commscope, Humax, Huawei, Arcadyan, Sagemcom and ZTE.

Even though a resolution to the semiconductor shortfalls or Latin America issues looks unlikely in the near term – and management has commented that they see issues persisting through FY22 and possibly into FY23 – stabilisation of the top line does still look possible. As Exhibit 5 highlights, while headline growth trends continue to look poor, adjusting for currency the pace of decline appears to be moderating. This does not reflect changes in the market trends but, as we highlighted previously, largely the impact of reduced exposure to set-top boxes. Stabilisation of the top line, or even sustaining the pace of decline to low single digits, would be a significant symbolic achievement.

Exhibit 5: Connected Home revenue growth trends by segment



Source: Technicolor, Edison Investment Research

Also significant for long-term prospects is Connected Home's relative scale advantage versus the rest of the industry. Previously we have emphasised its exposure to faster-growing platforms such as DOCSIS 3.1 (in Q321, the group launched a Wi-Fi 6 DOCSIS product with Vodafone, with built-

in Alexa). Its scale advantage over most of the industry is a key advantage that should enable it to weather this tough market; management believes it is faring at least as well as peers in this period of component shortage. Interestingly, in April CommScope announced it was intending to demerge its Home division (scheduled to complete by end Q222) to improve its overall growth prospects. We continue to believe that further consolidation in market, including a tie up between the two largest players, may make financial sense in the long term.

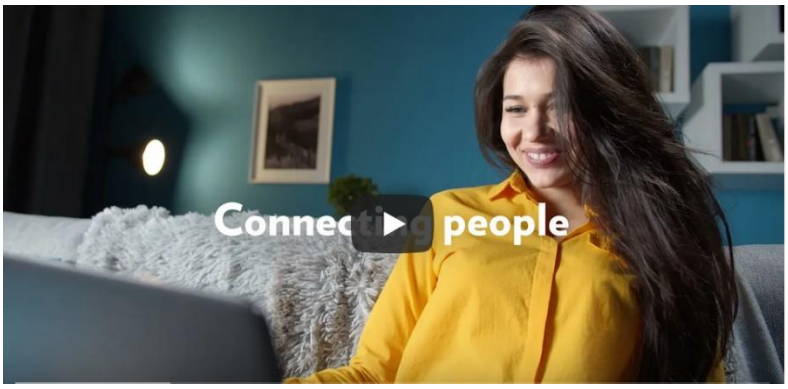
Management's Connected Home strategic objectives are to:

- **continue to pivot from video to broadband**, exploiting the global increases in home-working and domestic consumption of online entertainment. Domestic broadband is clearly set to maintain strong demand as it becomes a utility need around the globe. Consumer expectations on reliability, speed and bandwidth continue to step up and these attributes are key marketing points to the suppliers that comprise Technicolor's customer base.
- **exploit growth in Android TV**. The growing prevalence of smart TVs is unlikely to reverse as consumers become accustomed to the additional functionalities.
- **focus growth on scale customers using platform model**, ie increasing efficiency by upping the level of commonality and reducing the prevalence of bespoke products. This has involved a 'customer selectivity' plan, increasing product synergies and developing stronger partnerships with key suppliers and partners, which has undoubtedly helped build resilience in the operating model given the supply constraints.

TCS (22% of FY21e group revenue): Engine of group revenue growth

TCS is the new name for the group's Production Services segment, bringing back to the fore a brand name that is widely recognised well beyond the confines of its industry and tying it more closely to its underlying activities.

Exhibit 6: Technicolor showreel



Source: Technicolor

The group is now organised on a focused set of brands, addressing markets across film and episodic TV VFX, animation and games, and advertising. These are set out in the table below, along with the locations of the key operations. Technicolor Post Production, an activity that is more commoditised, was sold for $30m in H121 to Streamline Media.

TCS has operated under a number of brands and from multiple locations, which have recently been consolidated to improve clarity and efficiency, facilitated by a greater commonality of platform. The Mill and MPC Advertising have been brought together under The Mill Brand, to provide a leading global VFX offering for the advertising and brand experience sector.

The various brands serving the film and episodic industry are being consolidated under The Moving Picture Company umbrella – a well-recognised and highly respected brand.

Exhibit 7: TCS brand descriptions

Brand	Film & episodic VFX	Brand experience & advertising	Animation	Games	Primary focus area	Locations
Moving Picture Company (now includes MPC Film, MPC Episodic and Mr X	x				VFX for tentpole films, serving all major studios. Higher-end episodic projects and local market content. Smaller to mid-sized VFX projects for theatrical, episodic and streaming content.	London, Montreal, Vancouver, LA, Bangalore, Mumbai, Berlin, Paris, Liege, Toronto, Adelaide
The Mill (now including MPC Advertising)		x			VFX, production and delivery for agencies, production companies and brands	London, LA, NY, Chicago, Amsterdam, Paris, Shanghai, Mumbai, Bangalore, Berlin
Mikros		x	x		Feature animation; VFX/post-production services in France for film/TV and advertising	Paris, Montreal, Liege, Bangalore
Technicolor Games			x	x	High-end content and immersive experiences	LA, Bangalore

Source: Technicolor

Activity levels for the industries that TCS serves have recuperated very strongly as lockdowns have eased, particularly for film and episodic and animation as the production slates of the studios, streamers and other providers refill as they look to supply fresh content. There is obviously an element of catch-up for projects put on ice, but this is coupled with an underlying thirst for content that has been building as entertainment platforms have proliferated.

This very strong demand environment has highlighted the limited global supply of the artists and technicians skilled in VFX. TCS has invested over a number of years in offshore capability, building a substantial operation in Bangalore. Technicolor Bangalore is a primary hub for the creation of premium computer generated (CGI) animation for movies, television and the games industry, and is renowned for its global expertise in VFX, employing over 1,200 at end FY20.

Exhibit 8: Positioning of segmental activities

	Film & Episodic VFX	Advertising	Animation & Games
Market position	#1	#1	#2
Key customers	Major US studios	Global ad agencies	Major and independent animation studios
	Mini-majors and independent studios	Production companies	Key children's TV networks/other distributors
	TV production companies	Smaller agencies	Publishers and developers of AAA game titles
	OTT providers	Brands and advertisers	
		Consultancies	
Key competitors	Cinesite (PE/management)	Framestore	Animal Logic (private)
	Digital Domain (Sun Innovation/Reliance MediaWorks/Beijing Galloping Horse America)	Media.Monks (S4)	CGCG (Canadian VC, TJ Game Capital)
	DNEG (Prime Focus NV)	In-house production arms of global ad holding companies	Cinesite
	Framestore (Cultural Inv. Hdgs)	Local boutiques	DNEG
	ILM (Disney)		ICON Creative Studio (privately owned)
	Pixomondo (Mayfair Equity Partners)		Keywords Studios (LN: KWS)
	Rodeo FX (privately owned)		Reel FX (privately owned)
	Scanline VFX (bought by Netflix from private, November 2021, price undisclosed)		Sony Pictures Imageworks
	Weta Digital (recent bid from Unity for $1.63bn, excluding VFX)		The SPA Studios (privately owned)
			Virtuos (recent injection of £150m by Baring PE Asia)
Key data for Q321	>20 theatrical film and >35 streaming/episodic projects in production	c 660 commercials	c 1,060 minutes of animation delivered for film & TV

Source: Technicolor, Edison Investment Research

TCS has run The Technicolor Academy for a number of years, training artists and technicians, and this 'grow-your-own' concept has undoubtedly helped avoid the worst labour shortages, as has being a market leader with close attention paid to corporate culture (not always the case across the industry). It has scaled up the number of courses being run to address the situation. Nevertheless, talent shortages are currently a constraining factor on growth and there is some upward pressure on pay. Some projects are also suffering delays as they compete for VFX capacity.

This may be a contributory factor to an uptick on corporate activity in the segment, with recent transactions including a bid for Weta Digital (excluding VFX tools) from Unity Holdings, for a reported $1.625bn, and the recent acquisition of Scanline, a privately-owned Canada-based VFX specialist, by Netflix. The price of this transaction was not disclosed, although Netflix has indicated that post acquisition, Scanline will continue to handle third-party business.

TCS strategic objectives are set out by management as being:

- **exploit burgeoning demand for VFX content: secure volume**. This is clearly being tackled, as evidenced by the strong order book and pipeline into FY22, with around 75% of the budgeted pipeline for the year committed as of the time of the Q3 announcement.
- **agreements with key players and expand presence in the episodic and streaming market**. Technicolor has a broad client roster, with the Q3 statement highlighting project work for Disney, Paramount and Constantin in theatrical films, and including Disney+, Skydance/Apple TV+, MGM/Netflix, Amazon/Sony in episodic. Advertising clients are drawn from across the sector, with animation clients including DreamWorks, Disney, Nickelodeon and TF1.
- **optimise headcount allocation to individual projects**. Capacity management has always been an issue, managed through using a mix of retained and freelance artists and technicians. The group adapted efficiently to the experience of the pandemic, including some opportunities provided by the option of remote working. The recent reorganisation and brand consolidation should further help resource allocation.
- **standardise technology tools and where possible use across multiple business lines**. Having greater commonality of platform – as is already happening – will also allow for greater flexibility in rostering, alongside the increased resourcing in lower-cost locations such as Bangalore.
- **Advertising: improve margins/continue agency disintermediation**. This objective is more of a work in progress, dependent in part on factors outlined above.
- **Animation & Games: expand pipeline and explore opportunities in the gaming sector**. As mentioned above, the games arena is set for greater emphasis with the appointment of a new role of president of Technicolor Games.
- **maximise offshoring of Indian resources, consolidating delivery pipelines**.

DVD Services (24% of FY21e group revenue): In structural decline but improving margins and steady cash generation

Technicolor is an important partner to major studios in the physical distribution of DVD and Blu-Ray recordings to the consumer. Management estimates that its global market share is around 70%, with a 90% share of the key North American market. Its activities comprise mastering, replication, packaging and distribution of DVD, Blu-Ray and other discs.

While this is many ways a legacy business, the value derived by the studios from retail sales remains significant even as streaming dominates, while for consumers the quality of the viewing experience can be notably better. For the studios, this is a high-margin activity. Although the figures themselves are not separately reported, the investment in the product and IP has already been made and recouped so far as possible across theatrical release and/or streaming licensing.

The logistical element of getting physical product into consumers' hands via retail channels is complex and not within the sphere of expertise of the studios, giving the remaining providers of this service, such as Technicolor, a degree of leverage on pricing. Its key customers include major Hollywood Studios such as Warner Bros., The Walt Disney Company, Universal, Sony, Fox and Lionsgate, independent film studios, software and games publishers, and major music publishers. Most are covered by multi-year contracts, typically with volume exclusivity and/or time

commitments. Over the last couple of years, the focus has been on the renegotiation of studio contracts to reflect the continuing volume declines, with most now covered by updated terms. Satisfactory terms were not reached with Paramount on replication and mastering, which activity expired in mid-2021, but the group retains the distribution contract.

Technicolor's remaining key competitors in the DVD market include Sony and Arvato, both of which now have most of their activity concentrated in the European market.

Management's strategic objectives for DVD Services are:

- **Continue significant business transformation, reducing real estate footprint**. Two significant North American facilities were closed in H121 are part of the ongoing restructure. The original plan was accelerated because of the pandemic. Technicolor runs strategically positioned key manufacturing facilities in Guadalajara (Mexico) and Piaseczno (Poland), with services such as packaging and distribution in the United States (Tennessee and Alabama), Europe and Australia, supported by a multi-region/multi-site facility platform, with a further packaging and distribution facility near the US border in Mexico. Efficiency savings were ahead of plan at the half year.
- **Explore potential of adjacent businesses**. DVD services is actively diversifying, using its facilities to offer supply chain solutions, including transportation management and direct-to-consumer fulfilment services, for clients across a variety of segments to manage capacity more efficiently and utilise its expertise in complex logistics.
- **Maximise cash generation potential**. Acknowledging that DVD Services is unlikely to turn into an engine of group revenue growth does not mean that it is not useful. A highly efficient operation, it should be able to continue to generate good cash flow.

Balancing items (1% of FY21e group revenue)

The balancing segment is Corporate and Other. This includes:

- Trademark Licensing. This monetises brands owned by the group including RCA and Thomson, a legacy of the previous Consumer Electronics business
- Patent Licences. The remaining licences not sold to InterDigital, monetising post-disposal service operations and commitments related to former consumer electronics operations, mainly pension and legal costs.
- Unallocated Corporate functions, primarily head office and various centrally performed functions such as HR, IT, finance, marketing and communication, corporate legal operations and real estate management

Management

There were substantial changes to the group's board at the AGM in June 2019. A new chairperson, Anne Bouverot, was appointed. She is a senior adviser for TowerBrook Capital Partners. Other board appointments included senior individuals from (or with recent experience at) Eutelsat, AT Kearney, Fox Network and PwC, joining those from Microsoft and Group Telefonica. This gives the group broad experience across the relevant market sectors. In addition, there are two directors representing employees and two board observers. Of the 10 full board members, three are female, including the chairperson and vice-chairperson.

The appointment of Richard Moat as CEO was announced in November 2019. Richard's background is mostly within the telecoms sector, mostly recently as CEO of Eir (CFO from 2012, CEO 2014 to 2018), the largest telecom operator in Ireland, where he led a successful turnaround. Prior to Eir, he was deputy CEO and CFO of EE, the largest UK mobile telecoms company. Before that he spent 17 years at Orange, including as CEO of Orange Romania, CEO of Orange Denmark

and CEO of Orange Thailand. He spent the early weeks of his incumbency getting to know and understand the group's three businesses then working with the wider board and advisers to put together the revised group strategy and the financing plan, presented to the market in February 2020. This has now been adapted with revised refinancing proposals.

CFO Laurent Carozzi joined the group in March 2018, having previously been deputy CFO at Publicis from early 2017. Prior to this, he spent 12 years at Lagardère Group, where he was head of IR, then of head of group financial control. While at Lagardère, he led the turnaround of the Sports & Entertainment operation, as COO and CFO of the division.

Sensitivities

In terms of trading sensitivities, with three diverse business streams based in a variety of geographies, the group's risk factors are far from uniform.

Connected Home's hardware sales model offers investors little visibility. Customer deployment can drive rapid shipment growth in short periods but can fade just as quickly. The current component shortages and supply chain disruptions are self-evidently having a notable impact on revenues, while historical hikes in memory costs have demonstrated the sensitivity of its margins to component prices. In FY20, the top five customers accounted for 53% of the segment's revenue. While geographic diversity insulates Connected Home from the extreme swings in individual markets, the ongoing economic and geopolitical problems in Latin and South America have suppressed demand from those regions. Management has been proactive in reducing costs to preserve margins, but profits can nevertheless vary substantially from year to year. The greater exposure to broadband and concentration on a platform basis for a narrower base of customers should put Connected Home in greater control over its margins.

TCS' main issues surround the management of workflows, with often high-profile projects on tight timescales for clients with demanding expectations of technical and creative competence. Having the right staff in the right place is a key part of the package and the current global shortage of talent is a constraining factor. The greater use of cloud-based rendering allows additional flexibility. Confidentiality is also key for both physical and digital assets. The group needs to maintain its position at the forefront of technical innovation, including augmented reality, virtual reality and artificial intelligence. Where clients choose to place business can also depend on the availability of appropriate tax credits, which may limit the group's ability to transfer work between facilities.

DVD Services has inherently high customer concentration, with a limited pool of potential customers. In FY20, the top five clients accounted for 60% of revenues, up from 47% in the prior year. DVD Services has multi-year contracts, with varying terms and expiry dates and two were successfully renegotiated in FY20 on improved terms. The contract with Paramount is continuing solely on distribution as satisfactory terms could not be agreed. In terms of business risk, the operation needs to continue to deliver high-quality products on tight timescales, so competent management of raw materials and production facilities is crucial.

Other sensitivities include currency fluctuations, key individual exposure and the standard IT/cyber security issues. There is also outstanding litigation against the company and previous management regarding the liquidation of Quinta, an ongoing antitrust case in Europe that may be determined within the next couple of years and a historical toxic tort case in Taiwan against the company and General Electric. No provisions have been made in respect of these cases, where the quantum of any payments or their timing is not predictable.

Valuation

With three very different businesses within the group, all with different earnings dynamics and cash profiles, our preferred route to valuation would be on a sum-of-the-parts basis. However, the paucity of relevant comparable quoted peers in each of the three segments does make this approach potentially unreliable and we have also looked at valuation via a discounted cash flow (DCF) on a group basis. Ideally, it would be better to model DCFs for each of the three businesses, but the nesting of assumptions needed to do this risks compounding inaccuracies.

The group's valuation is also weighted to the value of the debt, which forms 65% of the group's enterprise value (EV) (end Q3 debt of €1,183m; current equity market capitalisation €644m), so deriving a value for the group simply based on its current and short-term earnings may also not give a reasonable valuation of the equity. If, as is envisaged by management, the group's revenue and earnings start to move ahead more strongly fuelled by the strong potential growth from TCS, the balance would swing more to the equity and this exercise would be more relevant.

Given these constraints, we would view this analysis as giving some context for valuation, rather than deriving a strict conclusion.

Peer valuation context

Exhibit 9: Peers for TCS

Company Name	Ccy	Price	Market Cap	LTM Perf	EV/sales			EV/EBITDA			EV/EBIT		
			(m)	(%)	FY0	FY1e	FY2e	FY0	FY1e	FY2e	FY0	FY1e	FY2e
Mondadori	EUR	2.1	535	36%	0.8	0.8	0.7	6.4	6.2	5.1	42.6	10.9	8.0
Cineworld	GBp	38.8	532	-39%	10.4	4.5	2.3	N/A	19.4	6.4	N/A	N/A	12.8
Criteo	USD	36.38	2,209	77%	2.1	1.9	1.7	6.9	5.4	4.8	9.8	7.5	6.4
ITV	GBp	118.8	4,781	11%	1.9	1.6	1.5	9.3	6.3	6.2	9.6	7.5	7.2
TF1	EUR	9.22	1,937	40%	1.0	0.9	0.8	4.3	4.0	4.0	17.6	7.0	7.1
JC Decaux	EUR	22.48	4,781	21%	4.4	3.9	3.1	10.5	31.7	17.1	N/A	N/A	44.7
Lagardere	EUR	24.34	3,405	19%	1.7	1.5	1.2	12.2	21.0	12.9	N/A	56.5	24.9
Mediaset	EUR	1.21	2,316	4%	1.3	1.2	1.2	4.1	5.3	5.1	12.6	7.5	7.1
Pearson	GBp	606.4	4,588	-11%	1.5	1.5	1.4	8.2	8.8	8.2	16.4	14.4	12.7
ProsiebenSat	EUR	14.61	3,302	6%	1.4	1.2	1.2	7.8	6.6	6.3	10.8	9.3	8.6
Keywords	GBp	2720	2,074	-5%	5.4	4.0	3.4	27.0	20.3	18.5	35.2	24.4	22.4
Prime Focus	INR	66.9	20,069	28%	2.2	N/A	N/A	9.7	N/A	N/A	33.7	N/A	N/A
PVR	INR	1546.25	94,302	17%	48.9	9.7	3.6	N/A	106.8	12.6	N/A	N/A	21.0
Zoo Digital	GBp	133	117	113%	3.0	2.2	1.9	26.6	23.5	17.4	74.8	96.3	39.5
Publicis	EUR	61.7	15,528	51%	1.9	1.7	1.7	8.6	7.9	7.6	18.8	11.0	10.2
Studio Dragon	KRW	86800	2,605bn	-6%	4.8	5.1	4.1	15.1	14.6	12.0	51.0	41.7	29.8
Avid	USD	31.5	1,417	98%	4.3	3.8	3.5	26.4	20.7	17.5	30.8	23.4	19.3
Mondo TV	EUR	1.3	57	-2%	2.4	2.1	1.9	3.3	2.4	2.2	7.4	6.8	5.6
Median				**18%**	**2.2**	**1.9**	**1.7**	**8.9**	**8.8**	**7.6**	**18.2**	**10.9**	**12.7**
Implied EV for TCS					1108	1126	**1345**	160	1049	**1517**		66	**886**

Source: Refinitiv. Note: Priced at 14 January 2022.

Firstly, for TCS, we have used a broad range of media and entertainment companies to represent the peer set, then calculated an implied EV at market median multiples for FY22e. Averaging across EV/sales, EV/EBITDA and EV/EBIT, to mitigate some of the variation of business model, derives a value of €1,249m. While we model a higher FY22e EBITDA margin for TCS than these companies (25% vs 21%), its forecast EBIT margin is lower (9% vs 15%) due to the nature of the business. The step-up in EBITDA margin reflects the better overhead recovery through higher volumes, greater commonality of platform and a higher proportion of work carried out in lower cost locations. The difference between EBITDA and EBIT margins is much higher in those businesses centred on content creation. Being within a larger group also points to a level of discount. Although

the quantum is arguable, we have applied a 20% discount, giving a value for the segment of €999m.

For Connected Home, the same exercise as for TCS derives a value for the business of €1,743m, but given the considerably lower growth rate (-7% vs +12%) and lower (albeit improving) margins than peers, we feel a larger discount is appropriate and have used 25% (although we note that this is somewhat arbitrary). This gives a segmental value of €1,307m.

Exhibit 10: Connected Home peers

Company name	Currency	Price	Market cap	LTM perf	EV/sales (x)			EV/EBITDA (x)			EV/EBIT (x)		
			(bn)	(%)	FY0	FY1e	FY2e	FY0	FY1e	FY2e	FY0	FY1e	FY2e
Netgear	US$	27.6	0.806	-13%	0.4	0.4	0.5	4.2	4.8	7.7	4.6	5.5	10.6
Qualcomm	US$	175.7	196.8	19%	9.5	6.2	5.2	28.1	15.4	13.0	30.3	15.7	14.1
Harmonic	US$	10.8	1.10	31%	3.1	2.4	2.0	49.8	22.3	16.1		33.5	19.7
Corning	US$	38.0	32.4	3%	3.4	2.7	2.6	12.3	9.7	9.0	21.9	15.5	14.0
Cisco	US$	54.7	230.58	27%	4.4	4.2	4.0	11.9	11.3	10.8	16.1	12.4	11.6
CommScope	US$	9.7	1.980	-28%	1.3	1.3	1.3	9.0	10.0	9.3	10.4	11.6	10.9
Median					**3.2**	**2.6**	**2.3**	**12.1**	**10.6**	**10.0**	**16.1**	**13.9**	**12.8**
Implied EV for Connected Home (€m)					5,715	3,718	**3,553**	1,327	1,034	**1,234**	273	480	**442**

Source: Refinitiv. Note: Prices as at 14 January 2022.

Peers for DVD Services are even more problematic to identify, so we have used three companies that also undertake complex distribution and logistics in consumer segments: Sysco, US Foods and McBride. Replicating the procedure for the other segments derives a value of €340m having applied a smaller 10% discount as margins, etc, are more comparable.

We then subtract the central/corporate and other at a market multiple of 13.5x, as shown in the exhibit below, to generate a per share value for the group.

Exhibit 11: Sum of the parts

	€m
TCS	999.4
Connected Home	1,307.3
DVD Services	340.0
Less Central costs	(405.0)
	2,241.7
Less debt	(1,183.0)
Group valuation	1,058.7
Valuation per share	**€4.49**

Source: Edison Investment Research

We have also looked at a DCF on a cross-group basis, as shown below, using varying WACCs and terminal growth rates. Selecting a WACC of 9% and a terminal growth rate of 1% (although the different segments would undoubtedly have different inputs) generates a value of €3.77 per share.

Exhibit 12: DCF at varying WACC and terminal growth rates

€/share		Terminal growth rate				
		0%	1%	2%	3%	4%
WACC	13%	0.85	1.02	1.23	1.47	1.76
	12%	1.31	1.53	1.78	2.10	2.50
	11%	1.85	2.13	2.47	2.89	3.44
	10%	2.49	2.86	3.32	3.90	4.68
	9%	3.28	**3.77**	4.40	5.24	6.42
	8%	4.26	4.94	5.85	7.12	9.02
	7%	5.52	6.50	7.86	9.91	13.33
	6%	7.20	8.67	10.88	14.56	21.92
	5%	9.55	11.93	15.90	23.83	47.63
	4%	13.07	17.35	25.91	51.59	N/A

Source: Edison Investment Research

More reliable estimates of value should be possible for TCS once the price for Netflix's purchase of Scanline is known (although this may not be until publication of the FY21 accounts) and for Connected Home once the Home division of CommScope is demerged as planned in Q222.

Financials

Earnings also a sum of the parts

As the dynamics of each segment are so different, we briefly summarise each below

Exhibit 13: TCS Q1–Q321

€m	Q321	Q320	% change (ccy)	Q1–321	Q1–320	% change (ccy)
Revenue	157	111	+37.9%	452	390	+17.9%
Adjusted EBITDA	33	(2)	N/A	74	0	N/A
Adjusted EBITDA margin	21.3%	(1.5%)		16.4%	0.1%	
Adjusted EBITA	16	(24)	N/A	22	(75)	N/A
Adjusted EBITA margin	10.1%	(21.1%)		4.8%	(19.2%)	

Source: Technicolor

The resurgence in demand after the lockdown period is clear to see in the rebound in revenues, which has strengthened in the fourth quarter. That improvement in activity levels has also lifted margins as capacity is more efficiently utilised. Our modelling shows this momentum continuing into FY22, as indicated by management outlining at the Q3 statement that 75% of budget was already in place for the year.

Prospects for margins are for further improvement, given the drive to increase the proportion of work delivered out of Bangalore and the greater efficiency from working on systems and platforms with a higher degree of commonality. Against this, there is the pressure on labour costs stemming from the high levels of demand across the industry, although, given that this is very much an industry issue, there are better prospects for this to be reflected in contract pricing.

Exhibit 14: Connected Home Q1–Q321

€m	Q321	Q320	% change (ccy)	Q1–321	Q1–320	% change (ccy)
Revenue	330	488	-33.9%	1,100	1,327	-13.1%
Adjusted EBITDA	17	31	-50.9%	73	85	-11.0%
Adjusted EBITDA margin	5.1%	6.3%		6.7%	6.4%	
Adjusted EBITA	1	15	N/A	31	35	-13.0%
Adjusted EBITA margin	0.4%	3.0%		2.8%	2.7%	

Source: Technicolor

Connected Home's financial performance shows the impact of the global component shortages and supply chain dislocation on revenues as the group has been unable to fulfil high levels of underlying demand. The impact on margin has been partially offset by the ongoing reductions in operating costs (see 2020 Outlook for details on Panorama 1 and 2 cost savings plans, which built on the earlier removal of €40m from segmental costs) and the switch to a platform-based approach, rather than the manufacture/assembly of bespoke products for each client.

Management expects the componentry supply issues to persist through FY22 and into H123, but without further deterioration, given that the situation stabilised somewhat in Q321. Customers have committed on volumes through to the end of FY22 and have agreed on a pass through of component prices changes to secure supply. Connected Home does not appear to be losing market share and we have modelled broadly stable revenues for FY22, with a slight tick-up in EBITDA margin from 6.3% to 6.6%.

Exhibit 15: DVD Services Q1–Q321

€m	Q321	Q320	% change (ccy)	Q1–321	Q1–320	% change (ccy)
Revenue	198	193	+3.6%	481	495	+1.2%
Adjusted EBITDA	29	27	+9.9%	39	29	+42.6%
Adjusted EBITDA margin	14.6%	14.1%		8.2%	5.8%	
Adjusted EBITA	18	15	+25.4%	8	(14)	N/A
Adjusted EBITA margin	9.0%	7.8%		1.6%	(2.9%)	

Source: Technicolor

Performance from the DVD Services segment picked up in Q321, with major releases starting to come through again, with the blockbusters favourable to Blu-Ray volumes and an increase in the quantity of non-disc goods being handled. Margin improvements reflect the better overhead recovery stemming from higher volumes plus the benefits of the ongoing cost reduction programme, including the closure of two sites in North America (associated restructuring cost of €15m). Our modelling suggests further improvement in EBITDA margin in FY22 to 10.8%, from the 9.0% we forecast for FY21.

We reviewed our revenue forecasts post publication of the Q321 report and made adjustments to the expected mix of revenues between the three segments. Although the resultant revenue figures are lower than we previously published (FY21e reduced from €2.93bn to €2.76bn, FY22e from €3.26m to €2.99m), the mix is more heavily weighted towards higher margin activities. At a group level, management has maintained its three-year cost savings target at a run rate of €325m by end FY22, with €115m set to come through in FY21. Combining the three segments gives the progression for the group shown below, which we have set to match the (unchanged) management guidance for the year and for FY22 for adjusted EBITDA and adjusted EBITDA as below:

Exhibit 16: Management guidance continuing operations

€m, post IFRS16	FY20	FY21e	FY22e
Adjusted EBITDA	167	270	385
Adjusted EBITA	(56)	60	180
Continuing FCF before financial results & tax	(124)	c 0	230

Source: Technicolor. Note: Continuing operations.

For FY22, the figures are stated post the disposal of the Post Production business from TCS in Q121, which means the removal of $40m of adjusted EBITDA and €23m of adjusted EBITA.

Exhibit 17: Segmental earnings progression

€m	2018	2019	2020	2021e	2022e
Revenue					
Technicolor Creative Studios	785	893	513	600	800
DVD Services	941	882	706	681	638
Connected Home	2,218	1,983	1,764	1,458	1,535
Corporate & other	44	43	23	21	22
Total	**3,988**	**3,801**	**3,006**	**2,760**	**2,994**
EBITDA					
Technicolor Creative Studios	110	164	18	119	200
DVD Services	178	81	54	62	70
Connected Home	87	79	110	97	123
Corporate & other	1	1	-14	-8	-8
Total	**376**	**325**	**168**	**270**	**385**
EBITDA margin					
Technicolor Creative Studios	14.0%	18.4%	3.5%	19.8%	25.0%
DVD services	18.9%	9.2%	7.6%	9.1%	10.9%
Connected Home	3.9%	4.0%	6.2%	6.7%	8.0%
Corporate & other	2.3%	2.3%	-59.7%	-37.4%	-37.2%
Total	**9.4%**	**8.6%**	**5.6%**	**9.8%**	**12.8%**
Adjusted EBITA	98	42	-56	60	180
Adjusted EBITA margin	2.5%	1.1%	-1.9%	2.2%	6.0%

Source: Technicolor accounts, Edison Investment Research

Improving cash flow

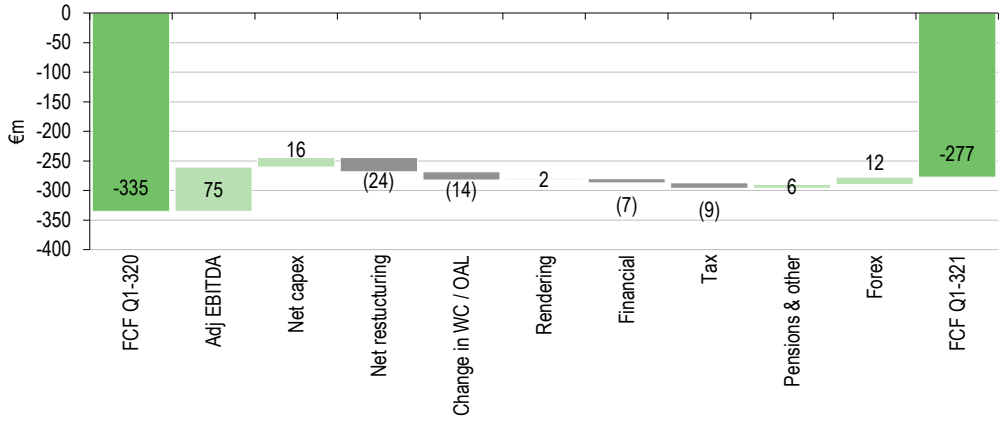
The general pattern for the group is one of cash absorption in the first half and cash generation in the second. The progress that the group has made from the tenuous financial position it held in FY20 ahead of the financial restructuring has led to a normalisation of the working capital position within Connected Home, which occurred during H121. The component shortage situation, though, presents a risk of inventory build-up as the normal throughputs are disrupted.

Overall free cash flow for the group improved from (€278m) in Q1–320 to (€206m) in the first nine months of FY21, mostly attributable to the improvement in trading and margins in TCS, combined with the reduced overhead across the group following the cost saving programme.

As indicated in Exhibit 16 above, management is guiding to a free cash flow (FCF) before financial results and tax of around break-even for FY21, improving to a positive FCF of €230m for FY22.

For the first nine-months of FY21, the free cash flow components are shown below (note that this runs from September 2020 to September 2021).

Exhibit 18: Free cash flow Q1 to Q321 versus Q1 to Q320



Source: Technicolor. Note: Continuing operations.

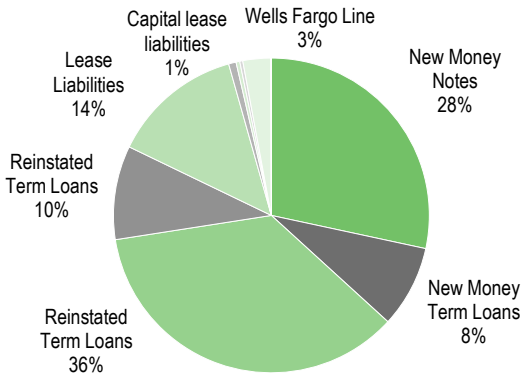
Stabilised balance sheet

The financial reconstruction completed in FY20 was complex, involving a debt refinancing and a debt-to-equity swap, alongside an equity rights issue (with bankruptcy protection put in place across the crucial renegotiation period). This process was described in detail in our reports at the time (July Outlook, updates in August and September 2020). The various elements of debt on the balance sheet are shown in the exhibit below, with the debt maturity profile. The new money notes and term loans repayable in June 2024 are at nominal rates of 12.00% and 12.15%, with the reinstated term loans at 6.0% and 5.9%, giving a weighted rate of 8.69%. Lease liabilities are payable at 8.2%, with the Wells Fargo line at 5.25%, giving an overall nominal rate across the gross debt of 8.46%.

With the debt set currently for repayment in FY24, there is a good likelihood that trading will have recovered sufficiently, and margins built following the cost reduction programme by that point, enabling any refinancing to be achieved on more favourable terms to the group.

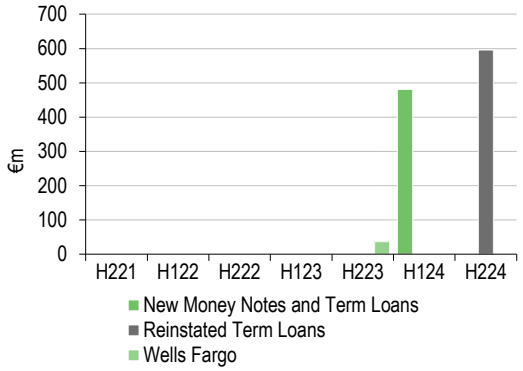
The implementation of this reconstruction has enabled a normalisation of credit arrangements, particularly important for the Connected Home operations.

Exhibit 19: Debt profile as at end Q321



Source: Technicolor

Exhibit 20: Debt maturity profile

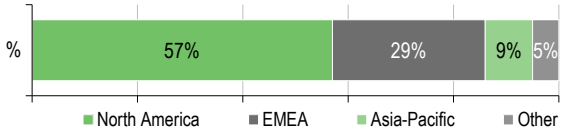


Source: Technicolor

Exhibit 21: Financial summary

€m	2019	2020	2021e	2022e
Year end 31 December	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT				
Revenue	3,800	3,006	2,760	2,994
Cost of Sales	(3,375)	(2,725)	(2,403)	(2,570)
Gross Profit	425	281	358	425
EBITDA	325	167	270	385
EBITA	42	(56)	60	180
Amortisation of acquired intangibles	(54)	(41)	(41)	(41)
Exceptionals	(79)	(151)	(20)	(10)
Reported operating profit	(121)	(264)	27	147
Net Interest	(84)	77	(125)	(120)
Joint ventures & associates (post tax)	(1)	0	0	0
Exceptionals	0	155	0	0
Profit Before Tax (norm)	(73)	(43)	(37)	78
Profit Before Tax (reported)	(206)	(188)	(98)	27
Reported tax	(3)	(5)	(5)	(5)
Profit After Tax (norm)	(75)	(48)	(42)	73
Profit After Tax (reported)	(208)	(193)	(103)	22
Minority interests	0	0	0	0
Discontinued operations	(22)	(15)	0	0
Net income (normalised)	(75)	(48)	(42)	74
Net income (reported)	(230)	(207)	(103)	22
Average Number of Shares Outstanding (m)	15	126	241	247
EPS - normalised (c)	(492.18)	(38.38)	(17.43)	29.81
EPS - normalised fully diluted (c)	(492.18)	(33.64)	(16.24)	27.81
Dividend per share (c)	0.00	0.00	0.00	0.00
Revenue growth (%)	(5)	(21)	(8)	8
Gross Margin (%)	11.2	9.4	13.0	14.2
EBITDA Margin (%)	8.6	5.6	9.8	12.8
EBITA Margin (%)	1.1	(1.9)	2.2	6.0
BALANCE SHEET				
Fixed Assets	2,082	1,674	1,649	1,576
Intangible Assets	1,483	1,251	1,271	1,233
Tangible Assets	476	288	243	208
Investments & other	40	62	62	62
Deferred tax and other	84	72	72	72
Current Assets	1,127	1,344	1,153	1,199
Stocks	243	195	206	201
Debtors	507	425	390	381
Cash & cash equivalents	64	330	162	223
Other	312	394	394	394
Current Liabilities	(1,542)	(1,379)	(1,293)	(1,350)
Creditors	(825)	(710)	(614)	(671)
Tax and social security	(41)	(21)	(33)	(33)
Short term borrowings	(95)	(72)	(104)	(104)
Other	(581)	(576)	(542)	(542)
Long Term Liabilities	(1,631)	(1,466)	(1,438)	(1,454)
Long term borrowings	(1,203)	(1,070)	(1,087)	(1,103)
Deferred tax	(27)	(15)	(19)	(19)
Other long term liabilities	(401)	(381)	(332)	(332)
Net Assets	37	172	70	(29)
Minority interests	0	0	0	0
Shareholders' equity	37	172	70	(29)
CASH FLOW				
Net profit	(208)	(193)	(103)	22
Depreciation and amortisation	322	263	203	213
Working capital	(69)	(101)	(72)	71
Tax and interest	(76)	(41)	(110)	(105)
Exceptional & other	101	(9)	0	0
Operating cash flow	70	(81)	(82)	200
Capex	(169)	(138)	(135)	(140)
Acquisitions/disposals	(2)	0	30	0
Equity financing	1	60	0	0
Dividends	0	0	0	0
Other	3	5	0	0
Net Cash Flow	(97)	(154)	(187)	60
Opening net debt/(cash)	733	1,234	812	1,029
FX		(16)	20	0
Discontinued	(35)	(23)	0	0
Other non-cash movements	(369)	615	(49)	(16)
Closing net debt/(cash)	1,234	812	1,029	984

Source: Company Universal Registration Document, Edison Investment Research

Contact details	FY20 revenue by geography
8-10 Rue Renard 75004 Paris France +33 (0) 1 88 23 30 00 www.techicolor.com	

Management team

CEO: Richard Moat	CFO: Laurent Carozzi
Richard joined Technicolor in November 2019. His career has mostly been in the telecoms sector. He was CEO of Eir (Eircom) (2014 to 2018), having previously been its CFO (2012 to 2014). Prior to Eir, Richard was deputy CEO and CFO of EE, having spent 17 years with Orange.	Mr Carozzi joined the group in March 2018, having previously been deputy to the CFO of Publicis from early 2017. Prior to this, he was at Lagadère for 12 years, where he was head of IR, then head of group financial control. From 2011, he focused on the turnaround of the Sports & Entertainment business unit as COO and CFO.
Chair: Anne Bouverot	
Anne was appointed to the board in June 2019 and is a senior adviser for TowerBrook Capital Partners.	

Principal shareholders	(%)
Credit Suisse Asset Management	12.1
Baring Asset Management	10.4
Bain Capital Credit	7.0
BNY Alcentra Group Holdings	6.6
Farallon Capital Management	6.2
Angelo, Gordon & Co	5.0
ELQ Investors Ltd	4.4
Bpi France Participations	4.4
Invesco	3.9

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