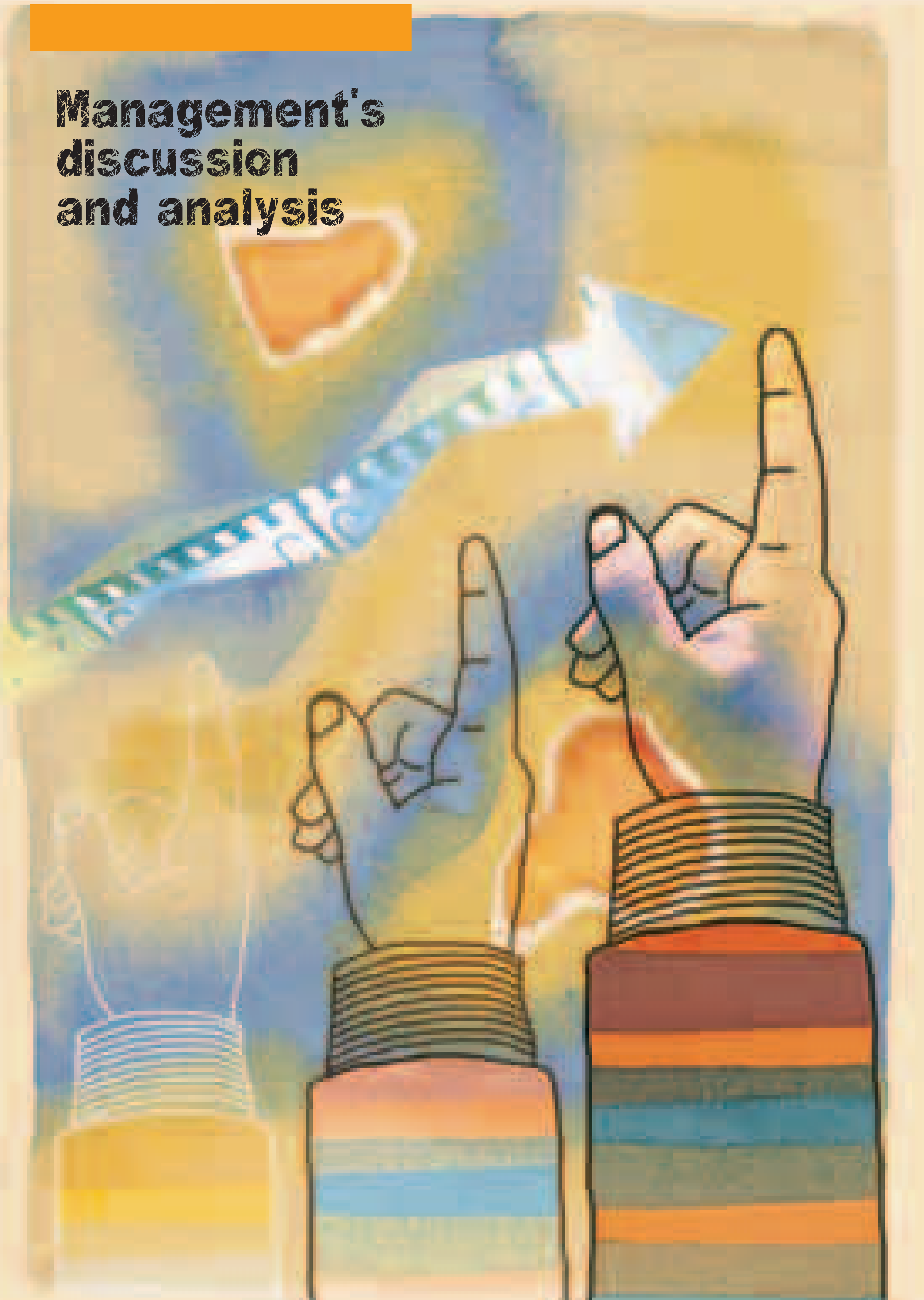
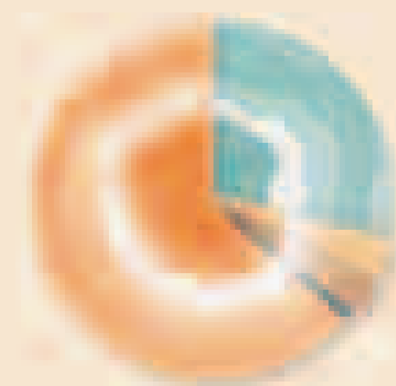
Management's discussion and analysis



Industry structure

The health of the Indian entertainment industry is largely influenced by the economic health of the nation. Given the robust growth of the Indian economy – GDP growth in excess of 8.4% in 2005-06 – the Indian entertainment industry grew in terms of volume (programming hours) and value (programming revenue) during the year under review. Though precise numbers are not available, the industry is currently estimated at INR 222 billion. Television is the Indian entertainment industry's fastest growing face, accounting for an estimated 62% of the industry's growth. Films contributed 27%, while segments like music, radio, live entertainment and interactive gaming accounted for the remaining 11%.

Indian entertainment industry, 2005 *(Rs. cr)*



Indian television industry

With total revenues of INR 139 billion, television is the goliath of the entertainment industry. A couple of important factors have driven its growth over the last decade – the privatisation of India's television industry, increase in the number of players (channels) and a corresponding growth in the number of entertainment software providers.

The result: From a zero presence at the start of the Nineties, the private operators (non-government) account for more than 60% of the industry's revenues today; there is a growing professionalism within the sector reflected in corporatisation across service providers.

As the television sector moves into a CAS (conditional access system) and DTH (direct to home) environment, the segment is expected to grow even faster to a projected INR 371 billion by 2010 (KPMG estimate).

Industry drivers

The growth of India's entertainment sector is driven by a number of factors, which have been discussed in detail in the following paragraphs:

Key drivers

Segment-wise composition of the entertainment industry *(INR billion)*

Segment-wise break-down	2003	2004	2005E	2006E	2007E	2008E	2009E	2010E
Television	122	139	164	189	228	266	325	371
Film	52	59	69	83	99	114	129	143
Music	10	10	10	11	11	11	12	13
Radio	2	2	3	4	5	6	7	8
Others (live entertainment, interactive games, etc.)	9	11	16	23	30	39	48	60
Gross unadjusted revenues	195	222	261	309	373	436	521	595
Less: overlap (sale of film broadcast and music rights) netted off	7	6	7	8	11	13	16	18
Add: overseas distributors' margin from sale of Indian films	8	8	8	7	8	9	10	11
Entertainment revenues at retail value	**196**	**222**	**262**	**309**	**371**	**432**	**515**	**588**

Note: The summation of the figures may not match due to rounding off
Source: KPMG Research

India's entertainment industry is expected to grow from Rs. 22,000 cr in 2006 to Rs. 45,000 cr by 2009.

Subscription revenues

What the viewer will pay in the form of subscriptions for the specific channels he wants to watch will influence the growth of India's television industry over the coming decade. In the short-term, subscription growth is being projected at 14%, primarily from growth in the number of cable and satellite households (expected to grow by 8%) and higher realisations. Thereafter, corrections in the regulatory mechanism are expected to pave the way for addressability in cable distribution and drive growth in digital distribution formats like DTH and other emerging platforms (IP-TV). As this trend matures, premium subscriptions for value-added services are expected to drive the growth in subscription revenues. This will also result in increased demand for content from these new media.

Declared revenues   Undeclared revenues

Source: KPMG Research

Consumerism

Over the last few years, disposable income has been rising like never before in India; it is estimated that between 1995 and 2002, nearly 100 million individuals joined India's rich and consuming classes and over the next five, 180 million individuals will enter this segment. On an average, annually 30 to 40 million individuals are joining India's middle-class – already the largest of its kind in the world by sheer numbers – translating into a huge spending on mobile phones, televisions, music systems and other similar products, following a consumption pattern typically associated with rising income.

This phenomenon is also accelerating the growth of India's entertainment sector. The growth of India's entertainment sector is being catalysed by the rural market comprising 128 million households, nearly three times that of urban India, the consuming class estimated at over 40% of India's middle-class and accounting for over 50% of the total disposable income. So far, this segment has remained largely untapped for accessibility and affordability reasons, but this is fast changing as a result of growing affluence, good monsoons and increased agricultural output.

Advertising growth

Advertising spending in India is directly linked to the growth in GDP. A reasonable estimate of its sensitivity to economic growth places it at least 500 basis points over the GDP growth across the foreseeable future. In view of the country's projected GDP growth, advertising spending is expected to grow 12-14% over the next five years to over Rs. 9,400 cr by 2009.

This increase in advertising spending is expected to strengthen broadcaster revenues and, in turn, content producers' revenues. Besides, the delivery of content over new wireless delivery formats is expected to open up a new avenue for advertising.

Pure advertising time for every hour of programming in India

Source: TAM Media Research

Technology

Technology will emerge as the entertainment industry driver into the next decade. In the emerging environment, boundaries are expected to blur between the entertainment, telecommunication and IT segments resulting in the emergence of value-added features for consumers and revenue for players.

The television industry will move towards digitisation, which in turn will influence viewership patterns. Success in animation and gaming will be driven by co-productions and securing rights over the produced content. This technology-intensive industry will migrate to being at par with global standards, not only in terms of technological advancements but also in terms of the creation of original content.

In the entertainment industry, content ownership will influence competitive edge; in such an environment, regulatory adaptations will facilitate the industry's growth.

Regulation

In India, most segments of the industry have grown to their present structure and size in a largely unregulated environment. However, in the media market, a consultative process has been used in influencing regulatory action. Such growth has resulted in the creation of last mile monopolies in cable television, established through informal agreement among the unorganised last mile operators.

However, a sustainable growth in the circumstances will be difficult without facilitating regulation. Such changes are being necessitated by the following realities:

- Dearth of consumer choice in several segments of the industry value chain, most notably in the last mile of cable distribution
- Piracy-related revenue and tax leakages across all segments of the entertainment industry
- Need to establish a level playing field for new distribution platforms like DTH, broadcasting and digital film

Pricing

India has the potential to become an attractive destination for international broadcasters and production houses - despite the low income per capita – on account of its large population. However, while prices are significantly lower in India than in other parts of the world, volumes have been historically restricted by the fragmentation in the distribution chain. Subscriber declaration by cable distributors to broadcasters in India has been low, resulting in an inequitable distribution of subscription revenues. According to independent research, the operator-broadcaster split of subscriber revenue in India

Niche genres are becoming increasingly popular and as a result, more entrants are expected in spaces like animation and business and lifestyle among others. Balaji is already proactively exploring a number of these niche areas.

reflects possibly the worst skew in the world. Low declarations have been attributed to a lack of transparency in the last mile distribution end of the business, controlled by 30,000-odd local and national cable operators.

Distribution of revenues *(in percentage)*

Market	Operator	Broadcaster
United States	60	40
United Kingdom	63	37
Australia	65	35
Japan	65	35
India	83	17

Source: Media Partners Asia

Content trends

The size of India's television software sector, which supplies programming content to broadcasters, is currently estimated at INR 28 billion. Its growth has been influenced by the following: an increasing number of programmes on prime time, a swell in the number of hour long weekly programmes, enhanced consumer interest in niche content and an increased global use of Indian content libraries.

It is expected that while mainstream entertainment programming will continue to be the bulwark of Indian television, genres like news, sports, children and special interests (religion, home and health, etc.) will account for an increasingly important proportion of the content pie.

Changes

Additional distribution platforms

The last mile of television distribution will see considerable action in the foreseeable future due to the entry of new direct to home (DTH) broadcasters, internet protocol-based television (IP-TV) and broadcasting services using digital subscriber line (DSL) technologies etc. These developments will also give broadcasters direct access to consumers, providing not just routine content but also customised value-added services (video on demand). Presently, the distribution of subscription revenues is skewed towards the cable operator due to lack of transparency in the declaration of subscribers by the local cable operator to the television broadcaster. The introduction of these new platforms and the consequent addressability will facilitate a more equitable distribution of revenues, which should strengthen broadcaster revenues and enhance income for content providers like Balaji.

More entrants in niche genres offering additional content variety to the viewer

Niche genres are becoming increasingly popular and as a result, more entrants are expected in spaces like animation and business and lifestyle among others. Balaji is already proactively exploring a number of these niche areas.

Liberalised regulatory intervention

A beginning has already been made in this direction through an amendment of the Telecom Regulatory Authority of India Act. This is expected to deliver addressability in the currently fragmented distribution market, thereby increasing the broadcaster's share of revenue and participation which should, in turn, strengthen revenues for a content provider like Balaji.

Outlook

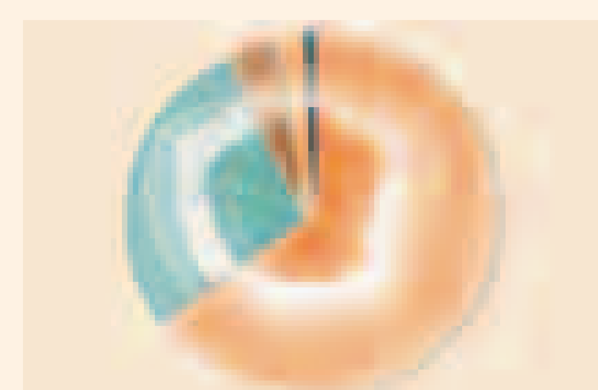
The future of the entertainment industry will be a function of the interplay of each of the above factors – namely consumerism, advertising spend, content, pricing,

The industry is expected to grow annually by 18% and breach the INR 500 billion barrier in five years. The trickle-down effect of this phenomenon is likely to enlarge the number of television channels, widening the market for a focused content provider like Balaji.

technology and regulation. A precise estimation of the industry size over the next 5-10 years will require a crystal ball, given the number of variables involved. However, based on current trends, the industry is expected to grow annually by 18% and breach the INR 500 billion barrier in five years. The trickle-down effect of this phenomenon is likely to enlarge the number of television channels, widening the market for a focused content provider like Balaji.

Importantly, the industry is entering its second phase of growth. This phase will be driven by technology and influenced by quality infrastructure and digital connectivity penetration. It is the industry's opinion that this phase will need to be supported by an enabling tax and regulatory infrastructure on the basis of its attractive long-term potential.

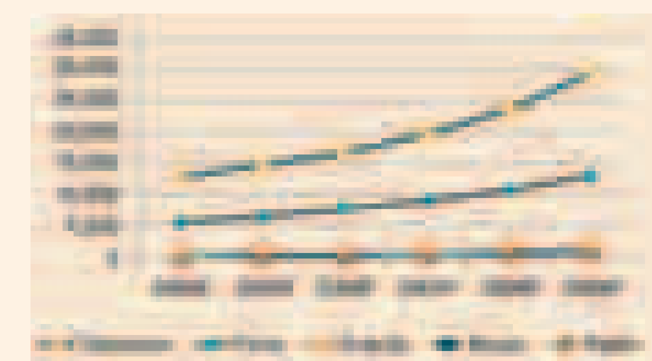
Projected growth - 2009 *(Rs. cr)*



Television 65% Films 28% Live Events 4% Music 2% Radio 1%

Source: Industry Estimates and PwC Analysis. Note: The figures taken above include only the legitimate sales in each segment. Revenues from the animation and gaming segments have not been included in the entertainment industry size as these have traditionally been included in the Indian IT and software revenues.

Projected growth in the Indian Entertainment Industry *(Rs. cr)*



Source: Industry Estimates & PwC Research

The proposed introduction of a number of channels augurs well for focused content creators like Balaji Telefilms:

- **Zee:** 24-hour comedy channel called Smile TV; spiritual channel called Jagran; now toying with the idea of launching children and women's channels
- **United Television:** Launched a children's channel called Hungama TV
- **Walt Disney:** In talks with Star, Sony and ESPN-Star Sports to distribute three of its channels (Playhouse, Toons and TDC) in 2006