

PRIVATE MEDIA GROUP INC  
Form 10-Q  
August 15, 2011

# U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## Form 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2011

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from            to

Commission file number 000-25067

# PRIVATE MEDIA GROUP, INC.

(Exact Name of Registrant as Specified in its Charter)

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Nevada  
(State or other jurisdiction of

87-0365673  
(I.R.S. Employer

incorporation or organization)

Identification Number)

Calle de la Marina 16-18, Floor 18, Suite D, 08005 Barcelona, Spain

(Address of European principal executive offices)

34-93-620-8090

(Issuer's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined in Rule 12b-2 of the Act).

Large Accelerated Filer

Accelerated Filer

Non-accelerated filer

Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date

Class
Common Stock, par value \$.001

Outstanding at August 3, 2011
21,805,824

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

	December 31,	June 30,	
	2010 EUR	2011 EUR	2011 USD
	(in thousands)		
<b>ASSETS</b>			
Cash and cash equivalents	370	269	389
Trade accounts receivable	4,199	3,523	5,106
Inventories - net (Note 2)	1,790	1,730	2,507
Deferred income tax asset	5,014	5,014	7,267
Prepaid expenses and other current assets	618	596	864
<b>TOTAL CURRENT ASSETS</b>	<b>11,990</b>	<b>11,131</b>	<b>16,132</b>
Library of photographs and videos	8,345	6,538	9,475
Property, plant and equipment	4,397	3,534	5,121
Other intangible assets	4,847	4,790	6,942
Goodwill	9,204	9,204	13,339
Other assets	500	466	676
<b>TOTAL ASSETS</b>	<b>39,283</b>	<b>35,663</b>	<b>51,686</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
Short-term borrowings	2,689	2,325	3,369
Current portion of long-term borrowings	402	530	768
Accounts payable trade	6,146	4,467	6,474
Income taxes payable	1,059	985	1,428
Deferred income taxes	277	277	401
Accrued other liabilities	2,519	2,847	4,126
<b>TOTAL CURRENT LIABILITIES</b>	<b>13,093</b>	<b>11,430</b>	<b>16,565</b>
Contingent consideration payable	514	514	746
Long-term borrowings	1,905	1,557	2,256
Related party payable	30	7	10
<b>TOTAL LIABILITIES</b>	<b>15,542</b>	<b>13,508</b>	<b>19,577</b>
<b>SHAREHOLDERS' EQUITY</b>			
\$4.00 Series A Convertible Preferred Stock 10,000,000 shares authorized, none issued and outstanding at December 31, 2010 and June 30, 2011, respectively			
Common Stock, \$.001 par value, 100,000,000 shares authorized 20,815,824 and 20,815,824 issued and outstanding at December 31, 2010 and June 30, 2011, respectively	869	869	1,259
Additional paid-in capital	30,468	30,468	44,156
Retained earnings	(2,771)	(4,893)	(7,091)
Accumulated other comprehensive income	(4,824)	(4,289)	(6,216)

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TOTAL SHAREHOLDERS EQUITY	23,742	22,155	32,109
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	39,283	35,663	51,686

See accompanying notes to consolidated statements.

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## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF INCOME (LOSS)

## AND COMPREHENSIVE INCOME (LOSS)

	Three-months ended		Six-months ended		
	June 30,		June 30,		
	(unaudited)		(unaudited)		
	2010	2011	2010	2011	2011
	EUR	EUR	EUR	EUR	USD
	(in thousands)				
Net sales	6,037	4,705	12,400	10,075	14,601
Cost of sales	3,989	3,058	8,313	6,438	9,331
Gross profit	2,047	1,647	4,087	3,637	5,270
Selling, general and administrative expenses	3,362	2,671	6,490	5,557	8,054
Change in fair value of contingent consideration payable	2,352		2,352		
Operating income (loss)	1,037	(1,024)	(51)	(1,921)	(2,783)
Interest expense	102	78	198	189	275
Interest income		2		2	2
Income (loss) before income taxes	935	(1,101)	(249)	(2,108)	(3,055)
Income tax (benefit)	4	7	17	14	20
Net income (loss)	931	(1,108)	(266)	(2,122)	(3,075)
Other comprehensive income:					
Foreign currency translation adjustments	(757)	216	(1,386)	535	776
Comprehensive income	174	(891)	(1,652)	(1,587)	(2,299)
Net income (loss) per share:					
Basic	0.04	(0.05)	(0.01)	(0.10)	(0.14)
Diluted	0.04	(0.05)	(0.01)	(0.10)	(0.14)

See accompanying notes to consolidated statements.

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six-months ended		
	June 30,		
	(unaudited)		
	2010	2011	2011
	EUR	EUR	USD
	(in thousands)		
<b>Cash flows from operating activities:</b>			
Net income (loss)	(266)	(2,122)	(3,075)
<b>Adjustment to reconcile net income to net cash flows from operating activities:</b>			
Depreciation	387	284	412
Change in fair value of contingent consideration payable	(2,352)		
Stock based compensation	2		
Bad debt provision	21	207	300
Amortization of other intangible assets	62	58	84
Amortization of web pages	1,552	932	1,351
Amortization of photographs and videos	2,552	2,190	3,174
<b>Effects of changes in operating assets and liabilities:</b>			
Trade accounts receivable	64	469	680
Inventories	533	60	87
Prepaid expenses and other current assets	(159)	22	32
Accounts payable trade	235	(1,679)	(2,433)
Income taxes payable		(74)	(107)
Accrued other liabilities	393	327	474
Net cash provided by operating activities	3,024	675	978
<b>Cash flows used in investing activities:</b>			
Investment in library of photographs and videos	(1,115)	(383)	(556)
Capital expenditures	(1,093)	(354)	(513)
Investments in (sale of) other assets	168	34	49
Net cash (used in) investing activities	(2,041)	(704)	(1,020)
<b>Cash flows from financing activities:</b>			
Short-term borrowings repayments	(385)	(434)	(629)
Short-term borrowings additions	416	69	101
Long-term borrowings repayments	(149)	(243)	(352)
Long-term borrowings additions	304		
Net cash (used in) provided by financing activities	187	(608)	(881)
Foreign currency translation adjustment	(1,386)	535	776
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(216)</b>	<b>(101)</b>	<b>(147)</b>
<b>Cash and cash equivalents at beginning of the period</b>	<b>613</b>	<b>370</b>	<b>536</b>
<b>Cash and cash equivalents at end of the period</b>	<b>397</b>	<b>269</b>	<b>389</b>
Cash paid for interest	140	117	170
Cash paid for taxes		74	107

See accompanying notes to consolidated statements.



## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	Common stock		Additional paid-in capital EUR	Retained earnings EUR	Accumulated other comprehensive income EUR	Total shareholders equity EUR
	Shares	Amounts EUR				
Balance at January 1, 2010	20,704,934	869	30,466	1,564	(3,565)	29,334
Shares issued in reverse split	890					
Conversion of exchangeable shares	110,000					
Stock based compensation			2			2
Translation adjustment					(1,259)	(1,259)
Net loss				(4,335)		(4,335)
Balance at December 31, 2010	20,815,824	869	30,468	(2,771)	(4,824)	23,742
Translation adjustment					535	535
Net loss				(2,122)		(2,122)
Balance at June 30, 2011	20,815,824	869	30,468	(4,893)	(4,289)	22,155

See accompanying notes to consolidated statements.



## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

**1. Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles ( U.S. GAAP ) for interim financial information. Accordingly they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of financial position and results of operations have been included. Operating results for the six months period ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ended December 31, 2011. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on form 10-K for the year ended December 31, 2010.

Solely for the convenience of the reader, the accompanying consolidated financial statements as of June 30, 2011 and for the six months then ended have been translated into United States dollars ( USD ) at the rate of EUR 0.69 per USD 1.00 the interbank exchange rate on June 30, 2011. The translations should not be construed as a representation that the amounts shown could have been, or could be, converted into US dollars at that or any other rate.

**2. Inventories**

Inventories consist of the following:

	December 31, 2010 EUR	June 30, 2011 EUR
	(in thousands)	
Magazines for sale and resale	564	463
DVDs	1,152	1,204
Other	73	63
	1,790	1,730

**3. Fair value measurements**

The Company accounts for certain assets and liabilities at fair value. The hierarchy below lists the three levels of fair value based on the extent to which inputs used in measuring fair value are observable in the market. The Company categorizes each of its fair value measurements in one of these three levels based on the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

Level 1 inputs are based upon unadjusted quoted prices for identical instruments traded in active markets.

Level 2 inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques (such as a Black-Scholes or Lattice model) for which all significant inputs are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities.



## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

Level 3 inputs are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques, including option pricing models and discounted cash flow models.

*Assets and Liabilities Measured at Fair Value on a Recurring Basis*

As of June 30, 2011, the Company held certain liabilities that are required to be measured at fair value on a recurring basis. The fair value hierarchy requires the use of observable market data when available. In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement classification below has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Management's assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset or liability.

The fair values of liabilities measured on a recurring basis were determined using the following inputs:

	For the year ended December 31, 2010				
	Level 1 EUR	Level 2 EUR	Level 3 EUR	Net	Total
				Fair Value EUR	Gains (Losses) EUR
Contingent consideration payable (a)			514	514	4,189
<b>Total</b>			<b>514</b>	<b>514</b>	<b>4,189</b>

  

	For the six months ended June 30, 2011				
	Level 1 EUR	Level 2 EUR	Level 3 EUR	Net	Total
				Fair Value EUR	Gains (Losses) EUR
Contingent consideration payable (a)			514	514	
<b>Total</b>			<b>514</b>	<b>514</b>	

- (a) Under certain acquisition agreements, the Company has agreed to pay the sellers earnouts based on the performance of the businesses acquired. These earnout payments will be made in common stock of the Company. Contingent consideration payable is measured at its acquisition date fair value. Contingent consideration payable in the tables above represents the estimated fair value of additional future earn-outs payable for such acquisitions and is based on management's estimates and entity-specific assumptions, which are Level 3 inputs.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

The following table provides a reconciliation between the beginning and ending balances of items measured at fair value on a recurring basis that used significant unobservable inputs (Level 3).

	<b>Contingent Consideration Payable EUR (in thousands)</b>
Balance at January 1, 2010	4,703
Change in fair value recorded in earnings	(4,189)
Balance at December 31, 2010	514
Balance at June 30, 2011	514

**4. Earnings (loss) per share**

The following table sets forth the computation of basic and diluted earnings per share:

	<b>Three-months ended June 30,</b>		<b>Six-months ended June 30,</b>	
	<b>2010</b>	<b>2011</b>	<b>2010</b>	<b>2011</b>
<b>Numerator: (EUR in thousands)</b>				
Net income (loss)	931	(1,108)	(266)	(2,122)
<b>Denominator:</b>				
Denominator for basic earnings per share weighted average shares outstanding	22,005,816	22,005,824	22,005,423	22,005,824
<b>Effect of dilutive securities:</b>				
Common stock warrants, convertible notes, options and other dilutive securities			n/a	
Denominator for diluted earnings per share weighted average shares and assumed conversions	22,005,816		n/a	
<b>Earnings (loss) per share (in EUR)</b>				
Basic	0.04	(0.05)	(0.01)	(0.10)
Diluted	0.04	(0.05)	(0.01)	(0.10)

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For the six months ended June 30, 2010, diluted impact of potentially dilutive securities is anti-dilutive therefore diluted and basic loss per share are EUR 0.01. For the three and six months ended June 30, 2010 and 2011, basic earnings per share include exchangeable shares equivalent to 1,300,000 and 1,190,000 shares of common stock outstanding, respectively.

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**(UNAUDITED)**

**5. Stock-based compensation**

The Company has an expired Employee Stock Option Plan ( the 1999 Plan ) and a new Equity Incentive Plan (the 2009 EIP ) available as described below. The compensation cost charged against income for the six-month period ended June 30, 2010 was EUR 2 thousand, which is included in selling, general and administrative expense. The charge of compensation cost had no impact on tax since none of the option beneficiaries are taxable in the U.S. and tax rules are different in the beneficiaries' respective tax jurisdictions.

*The 1999 Plan*

The 1999 Plan, which was in effect until its expiration on March 1, 2009, allowed the Company to grant options to purchase common stock to designated employees, executive officers, directors, consultants, advisors and other corporate and divisional officers of Private Media Group. The 1999 Plan authorized the Company to grant stock options exercisable for up to an aggregate of 2,400,000 shares of common stock. No stock options may be granted under the 1999 Plan, following its expiration, on March 1, 2009.

Under the expired plan, the purchase price (exercise price) of option shares had to be at least equal to the fair market value of such shares on the date the stock option was granted. The stock option was exercisable for a period of ten years from the date of grant or such shorter period as was determined by the Company. Each stock option under the plan provided that it was exercisable in full or in cumulative or non-cumulative installments, and each stock option was exercisable from the date of grant or any later date specified in the option. Unless otherwise provided by the Company, an optionee could not exercise a stock option unless from the date of grant to the date of exercise the optionee remained continuously in the Company's employ. At June 30, 2011, options for 8,668 shares were still outstanding under the 1999 Plan.

*The 2009 EIP*

The 2009 EIP is shareholder approved and came into effect on December 16, 2009. It allows the Company to grant incentive stock options, non-statutory stock options, restricted stock, unrestricted stock and other equity-based awards, such as stock appreciation rights, phantom stock awards, and restricted stock units, which we refer to collectively as Awards. The Company may issue up to 2,066,667 shares of its common stock pursuant to Awards granted. Shares pursuant to Awards that have expired or are forfeited will be returned to the 2009 EIP.

The Company may grant Awards under the 2009 EIP to employees, directors and consultants of Private Media Group. No Awards may be granted after the 2009 EIP expires on December 15, 2019. The purchase price (exercise price) of option shares must be at least equal to the fair market value of such shares on the date the stock option is granted or such later date the Company may specify. Each Award may provide that it is exercisable in full or in cumulative or non-cumulative installments, and each Award is exercisable from the date of grant or any later date specified in the Award. Awards must expire within a period of ten years from the date of grant or such shorter period as is determined by the Company. Unless otherwise provided by the Company, an Award holder may not exercise an Award unless from the date of grant to the date of exercise the holder remains continuously in the Company's employ.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

At June 30, 2011, Awards for 2,065,667 shares were available for future grant under the 2009 EIP. Awards become exercisable on their respective vesting dates with vesting terms determined by management and approved by the Company's compensation committee.

A summary of stock option activity for the six month period ended June 30, 2011 is as follows:

	Number of Shares	Weighted- Average Exercise Price in USD	Weighted- Average Remaining Life in Years	Aggregate Intrinsic Value <sup>1</sup> in Thousands of USD
Outstanding January 1, 2011	9,668	6.42		
Granted				
Exercised				
Forfeited				
Outstanding June 30, 2011	9,668	6.42	1.0	
Exercisable June 30, 2011	9,668	6.42	1.0	

Stock-based compensation cost for stock awards is measured based on the closing fair market value of the Company's common stock on the date of grant.

Stock-based compensation cost for option awards is measured on the date of grant using the Black-Scholes option pricing model. The following general assumptions are used: a) expected volatility is based on historical volatility of our stock, b) expected life is determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior, c) risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and d) dividend yield is zero based on the Company's current dividend policy. During the six month periods ended June 30, 2010 and 2011 no grants were made.

As of June 30, 2011, there was no unrecognized compensation cost related to nonvested option granted under the Plan. The total fair value of all options vested and outstanding at June 30, 2010 and 2011, was USD 42 thousand and USD 22 thousand, respectively.

## 6. Income Taxes

The Company's subsidiaries file income tax returns in numerous tax jurisdictions, including the United States, several U.S. states and several non-U.S. jurisdictions, primarily in Europe. The statute of limitations varies by the various jurisdictions in which we operate. Because of the number of jurisdictions in which we file tax returns, in any given year the statute of limitations in certain jurisdictions may lapse without examination within the 12-month period from the balance sheet date. Other than the recurring effect of changes in unrecognized tax benefits due to the lapse of the statute of limitations, none of which are expected to be individually significant, management believe there are no other reasonably possible changes that will significantly impact the amount of tax benefits recognized in the Company's financial statements

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<sup>1</sup> The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of our common stock for the options that were in-the-money at June 30, 2011.

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**(UNAUDITED)**

within the 12-month period from the balance sheet date. The Company has substantially concluded all US Federal and State income tax matters for years up to and including 2004 and 2002 respectively, and all foreign income tax matters for years up to 2003.

The Company's practice is to recognize interest and penalties related to income tax matters in interest and other expenses respectively. Interest and penalties amounting to EUR 364 thousand were accrued as of June 30, 2011, of which EUR 20 thousand was recognized as interest expense during the six-month period then ended.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

You should read this section together with the consolidated financial statements and the notes and the other financial data in this Report. The matters that we discuss in this section, with the exception of historical information, are forward-looking statements within the meaning of the Private Securities Reform Act of 1995. Such forward-looking statements are subject to risks, uncertainties and other factors which could cause our actual results to differ materially from those expressed or implied by such forward-looking statements. Potential risks and uncertainties relate to factors such as: (1) the timing of the introduction of new products and services and the extent of their acceptance in the market; (2) our expectations of growth in demand for our products and services; (3) our ability to successfully implement expansion and acquisition plans; (4) the impact of expansion on our revenue, cost basis and margins; (5) our ability to respond to changing technology and market conditions; (6) the effects of regulatory developments and legal proceedings with respect to our business; (7) the impact on the Company and its investors from the outcome of legal proceedings referred to in *Part II Other Information - Item 1 Legal Proceedings*; (8) the impact of exchange rate fluctuations; and (9) our ability to obtain additional financing. The foregoing list of factors is not exhaustive. For a more complete list of factors that may cause results to differ materially from projections, please refer to the Risk Factors section of our Annual Report for 2010 filed on Form 10-K.

**Overview**

We are an international provider and distributor of adult media content. We acquire or license content from independent studios, producers and directors and process these images into products suitable for popular media formats such as digital media content for Broadcasting, Mobile and Internet distribution, and print publications and DVDs. In addition to media content, we also generate additional sales through the licensing of our Private trademark to third parties.

On January 20, 2009 we expanded our Internet operations through the acquisition of Game Link LLC and its affiliates, companies engaged in digital distribution of adult content over the Internet and eCommerce development. GameLink is a leading US adult entertainment VOD and eCommerce platform through its GameLink.com website. The site's installed user base represents over one million domestic and international customers and it serves over 100,000 users daily. Including 70,000 video titles, GameLink has one of the largest libraries of digital and physical adult media and novelties in the United States.

On October 29, 2009 we continued the ongoing expansion of our global digital media platform through the acquisition of Sureflex Digital Distribution and its affiliates, companies engaged in the business of digital distribution of premium gay adult content. Sureflex is a leading global supplier of adult programming. The company operates a vast network of more than 100 pay-per-view VOD websites and has a North American broadcast presence. It represents premium production studios in global television broadcast (cable, satellite), mobile, IPTV and Internet VOD markets. Sureflex has not only in-depth knowledge of adult programming, but also significant VOD technology and marketing expertise.

We operate in a highly competitive, service-oriented market and are subject to changes in business, economic and competitive conditions. Nearly all of our products compete with other products and services that utilize adult leisure time and disposable income. Although we believe our products are well-established in the adult entertainment industry, we compete with entities selling adult oriented products via any type of distribution network, including the Internet. Many of these products are similar to ours. Over the past few years, the adult entertainment industry has undergone significant change. Traditional producers of softcore content as well as mainstream providers of media content have shifted to producing hardcore content. As a result, we face greater competition to distribute hardcore content. This shift has also led to industry

consolidation, creating fewer, more financially formidable competitors. Recently, the introduction of a large number of free content Internet sites that allow users to access large libraries of content has created an even more challenging environment where both sales volume and margins are decreasing substantially. In addition, the recent recession has shown that the adult industry is not immune to economic cycles.

Despite serious challenges in the market for online content, we expect growth going forward. There are many reasons to be optimistic about our opportunities and our Internet group has been working hard to position itself to take advantage of these opportunities.

The primary source of growth is expected to come from a significant increase in traffic to our online properties coupled with improved conversion and retention rates and a much more sophisticated approach to traffic management. We have rebuilt our signature property, private.com, and restructured our affiliate programs in all properties to compete aggressively for affiliate traffic. In addition to our technical systems, we have restructured our departments with resources highly skilled in affiliate traffic development and shifted our emphasis from account management towards sales. We have also developed solutions for critical new markets: gay, international, and mobile. Finally, we have increased our efforts to defend against piracy of our content and the propagation of pirated content. The combination of the breadth of our premium assets and the scope of our market reach give us a unique and very defensible position.

During 2010, the DVD market has continued to shrink, with sales for our physical products declining by 18%. However, the DVD business is by no means dead even in this competitive landscape. The content providers that manage to survive the current clean out will control the DVD market going forward.

With respect to broadcasting, Private is a leading adult content provider in Europe and Latin America. Private content is currently continuously broadcasted via 194 platforms in 42 countries. In addition to this we are providing content to leading Pay-TV operators. Our strategic partnerships prove to be solid and strong revenue generators and will continue to perform well.

Private's mobile on portal revenues declined again in 2010. We are still the most distributed adult brand in the world and will monetize existing distribution as best as we can by going live with the few outstanding carriers and replacing non-performing content aggregators with new ones. During 2010 we have enabled smart phone users to browse, purchase and consume our library of content on all of our web properties and expect to generate substantial growth from this initiative going forward.

Through the acquisition of Gamelink and Sureflix, Private acquired a team of the most innovative and experienced developers in the adult industry who will lead a product development effort focused on a clear goal: increase qualified traffic to our web properties. There are three key strategies: opening our services to third parties to develop products on top of our platform; developing applications like Smart Phone & TV apps that give our content hooks into emerging markets and devices; and developing widgets that will merge the unique data analytics we have with our vast product offering and enable sites to easily leverage our catalog and transactional capabilities to their customers.

One Movie All Screens: the VOD landscape is an endless field of format proliferation. Consumers are forced to purchase the same movie in a variety of different formats at various price points in order to view it on different devices. Our goal is to provide our customers with the ability to watch any movie in our catalog on any screen available to them.

In addition to our online R&D efforts for traffic generation and improving conversion and retention rates, we will continue to explore the most effective way to enable customers to view our movies on all screens. The primary focus of our online R&D efforts will be on delivering content to the TV and enabling purchase and consumption on Smart Phones.

We generate revenues primarily through:

Internet e-commerce, subscriptions and licensing;

the broadcasting of movies through IPTV (Internet Protocol Television), cable, satellite and hotel television programming;

sales of DVDs and magazines;

sales of adult mobile content, B2B on-portal and B2C off-portal (wireless); and

content, brand name and trademark licensing.

Over time, we expect net sales from DVDs & magazines to continue to decline as a percentage of net sales in relation to total net sales from Internet, broadcasting and wireless. We expect net sales from Internet and wireless broadcasting to grow during the coming years.

We recognize net sales on delivery (for further information, see Critical Accounting Estimates).

Even though we recognize net sales upon delivery, we generally provide extended payment terms to our distributors of between 90 and 180 days. Although our extended payment terms increase our exposure to accounts receivable write-offs, we believe our risk is minimized by our generally long-term relationships with our distributors. In addition, we view our extended payment terms as an investment in our distribution channels which are important to the growth of our business.

Our primary expenses include:

web page development costs;

acquisition and licensing of content for our library of photographs and videos;

printing, processing and duplication costs; and

selling, general and administrative expenses.

We released 71, 72 and 87 proprietary video titles during 2010, 2009 and 2008, respectively. The releases include both new and archival material. We plan to release more than 50 proprietary video titles in 2011.

Over the years, our cost of sales has been fluctuating relative to net sales due to our use of new mediums for our products, such as the Internet, broadcasting and wireless. We also incur significant intangible expenses in connection with the amortization of our library of photographs and movies and capitalized development costs, which include the Internet. We amortize these tangible and intangible assets on a straight-line basis for periods of between three and five years.

*Restructuring*

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During 2009 and 2010 we have faced several organizational challenges as a result of the acquisitions and integration of the online businesses GameLink and Sureflix into the group. Parallel with

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the integration, we have rebuilt our signature property, private.com, and restructured our affiliate programs in all properties to compete aggressively for affiliate traffic. In addition, we have restructured our departments with resources highly skilled in affiliate traffic development and shifted our emphasis from account management towards sales. We have also developed solutions for critical new markets: gay, international and mobile. Furthermore, as a response to decreased margins in the adult entertainment industry, we have reviewed, analyzed and continued to restructure the operations of the non-online part of the business in order to become more cost effective. All the aforementioned processes have had impact both in terms of lost sales and additional selling, general and administrative expenses. However, as part of these processes, during 2010 we have reduced our workforce by 34% from 168 to 112 employees and we expect to continue this process as we become more efficient and enjoy economies of scale from the aforementioned acquisitions. During 2011, we expect to benefit from the continued restructuring and reduce costs and increase sales as we implement and launch new initiatives, such as fully combining our Internet assets, outsourcing major parts of our non-online operations and aggressively marketing our new Internet platforms.

### **Critical Accounting Estimates**

#### *General*

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities revenues and expenses. On an ongoing basis, we evaluate our estimates, including those related to impairment of the library of photographs and videos and other long lived assets, allowances for bad debt, income taxes and contingencies and litigation. Accounts receivable and sales related to certain products are, in accordance with industry practice, subject to distributors right of return to unsold items. We base our estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily available from other sources. Management periodically reviews such estimates. Actual results may differ from these estimates as a result of unexpected changes in trends.

We believe the following critical accounting policies are significantly affected by judgments and estimates used in the preparation of our consolidated financial statements.

#### *Recognition of Revenue*

The Company's primary sources of revenue are the sale of content delivered via Internet, broadcasting, DVD & magazines and mobile phones.

Internet video on-demand offerings are sold directly via the Company's online retail websites and are paid for almost exclusively by credit card. The Company recognizes revenue from video-on-demand when the service is rendered and collectability is reasonably assured, specifically, when the customer's credit card is charged, which is, in most cases, simultaneous with delivery of the on-demand video. Credit card payments accelerate cash flow and reduce the Company's collection risk, subject to the merchant bank's right to hold back cash pending settlement of the transactions. The Company also offers a prepaid video-on-demand service in which a customer purchases a number of minutes of on-demand video at a set rate per minute based on the number of minutes purchased. The rate per minute decreases as the number of prepaid minutes increases. The Company records revenue from pre-pay customers as deferred revenue prior to commencement of services and recognizes revenue as the services are rendered. Prepaid minutes purchased under this program do not expire.

The Company also offers a customer loyalty program under which each member's purchase of video on-demand, DVDs, movie downloads, books, novelties or other items earns the member one point for each dollar spent. After accumulating 150 points, a customer may redeem the points for a \$5 purchase. Points increase in value as they are accumulated and redeemed, with a maximum accumulation of 2,000 points, which may be redeemed for a \$200 purchase. All of a customer's points expire after 180 days of no purchase activity. Because the value of the award points is not significant in relation to the value of the services or products purchased by the customer, the Company records a liability for the estimated cost of the discounted services or products to be provided in the future.

Revenues from the sale of subscriptions to the Company's Internet website are deferred and recognized ratably over the subscription period.

IPTV (Internet Protocol Television), satellite & cable broadcasting revenues are recognized upon delivery when the following conditions have been met (i) license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale (ii) the arrangement fee is fixed or determinable and (iii) collection of the arrangement fee is reasonably assured. Such revenues may be generated by either a fixed license fee or as an agreed percentage of sales, based on sales reported each month by the Company's IPTV, cable and satellite affiliates. The affiliates do not report actual monthly sales for each of their systems to the Company until approximately 60 - 90 days after the month of service ends. This practice requires management to make monthly revenue estimates based on historical experience for each affiliated system. Revenue is subsequently adjusted to reflect the actual amount earned upon receipt. Adjustments made to adjust revenue from estimated to actual have historically been immaterial.

DVDs & Magazines (physical products) are sold both to wholesalers, on firm sale basis, and via national newsstand distributors, with the right to return. Our physical products are generally multi-lingual and the principal market is in Europe. Revenues from the sale of physical products where distributors are not granted rights-of-return are recognized upon transfer of title, which generally occurs upon delivery. Revenues from the sale of physical products under consignment agreements with distributors are recognized based upon reported sales by the Company's distributors. Revenues from the sale of physical products under agreements that grant distributors rights-of-return are recognized upon transfer of title, which generally occurs on delivery, net of an allowance for returned product. Distributors with the right to return are primarily national newsstand distributors. Most of our products are bi-monthly (six issues per year) and remain on sale at a newsstand for a period of two months. Normally, all unsolds are reported to us within a period of four to six months from delivery. There are normally two to four national newsstand distributors for all newspapers and periodicals operating in each country. A majority of our national newsstand distributors are members of Distripress, the international organization for publishers and distributors, and carry out the distribution of the largest national and international newspapers and periodicals, including: Financial Times, Herald Tribune, Time, Newsweek, Vogue, etc. The Company uses specific return percentages per title and distributor based on estimates and historical data. The percentages vary from 50-80%. Percentages are reviewed on an on-going basis. Magazines have an approximate retail price of EUR 11.50 (USD 15.95) per copy and are printed on glossy high-quality paper at a cost of EUR 1.25 (USD 1.75). They are often shrink-wrapped in order to comply with local regulation or guidance for the sale of adult publications. In view of the high retail price, the margin and the physical quality of the magazines and the fact that the content has a very long shelf-life since it is not particularly linked to time, trends, fashion or current events, the Company has always collected the returns from newsstands in order to make them available for sale again. The Company operates scheduled re-distribution of returned magazines, via

national newsstand distributors, together with DVDs as Magazine/DVD packs as a way of increasing DVD distribution. Since the national newsstand distributors have the right to return, the DVD packs are returned in order to be sold via an additional scheduled re-distribution. The retail price for products sold via re-distribution vary between EUR 14.95-19.95 (USD 20.75-27.70). Magazine returns not re-distributed as per above are sold on a firm sale basis to wholesalers as back numbers at a lower price than new issues. The Company has historically sold all returned copies at an average price higher than, or equal, to cost.

Revenues from mobile content (wireless) sales are recognized based on sales reported each month by mobile operators via aggregators. The aggregators do not report actual monthly sales for each of their operators to the Company until approximately 60 - 90 days after the month of service ends. This practice requires management to make monthly revenue estimates based on historical experience for each affiliated system. Revenue is subsequently adjusted to reflect the actual amount earned upon receipt. Adjustments made to adjust revenue from estimated to actual have historically been immaterial.

#### *Accounts receivable*

We are required to estimate the collectability of our trade receivables and notes receivable. A considerable amount of judgment is required in assessing the ultimate realization of these receivables including the current credit-worthiness of each customer. Significant changes in required reserves have been recorded in the past and may occur in the future due to the current market environment.

Management reviews the allowance for doubtful accounts on at least a quarterly basis and adjusts the balance based on their estimate of the collectability of specific accounts as well as a reserve for a portion of other accounts which have been outstanding for more than 180 days. This estimate is based on historical losses and information about specific customers. After collection attempts have failed, the Company writes off the specific account.

#### *Goodwill and Other Intangible Assets*

Goodwill represents the excess of the purchase price paid over the fair value of the net assets of businesses acquired.

Other Intangible Assets represents the value attributable to: a) Customer base, which was acquired from two of the Company's former distributors in the U.S. and in Canada in 2001 and 2003, respectively. The amortization expense is calculated on a straight-line basis over 10 years for each acquisition, b) Broadcasting asset, which was acquired from International Film Production and Distribution Limited in 2003. At the time of acquisition, the asset was deemed to have an indefinite life and is not subject to amortization, and c) Trade and Domain names, which were acquired from GameLink and Sureflex. At the time of acquisition, the assets were deemed to have an indefinite life and are not subject to amortization.

Goodwill and indefinite lived intangible assets are reviewed annually for impairment (or more frequently if indicators of impairment arise). Further separable intangible assets that are not deemed to have an indefinite life are amortized over their expected useful lives.

During 2008, 2009 and 2010, the we had impairment charges of EUR 293 thousand, EUR 884 thousand and EUR 1,562 thousand, respectively, and going forward additional impairment charges may occur.



*Impairment of Long-Lived Assets*

The Company evaluates the carrying value of its long-lived assets when events or circumstances indicate the carrying value may not be recoverable through the estimated undiscounted cash flows from the use of the asset. An impairment loss is then measured as the amount by which the carrying value of the asset exceeds its estimated fair value. In 2010, the Company had an impairment charge of EUR 548 thousand relating developed website technology. Going forward additional impairment charges may occur.

*Inventories*

Inventories are valued at the lower of cost or market, with cost principally determined on an average basis. Inventories principally consist of DVD s and magazines held for sale or resale. The inventory is written down to the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, write-downs may be required.

***Three months ended June 30, 2011 compared to the three months ended June 30, 2010***

*Net sales.* For the three months ended June 30, 2011, we had net sales of EUR 4.7 million compared to net sales of EUR 6.0, million for the three months ended June 30, 2010, a decrease of EUR 1.3 million, or 22%. Internet sales decreased EUR 0.6 million to EUR 3.1 million, which represents a decrease of 17% compared to the same period last year. The reduction in Internet sales was attributable to a decrease in sales from our North American websites as a result of foreign exchange rate changes and a reduction in sales from our Gay Content division. Broadcasting sales decreased EUR 0.3 million to EUR 0.8 million, which represents a decrease of 24% compared to the same period last year. The decrease was primarily the result of fewer newly released titles being broadcasted. Wireless sales decreased EUR 0.2 million to EUR 0.2 million, which represents a decrease of 53% compared to the same period last year. The decrease was primarily the result of migration from on-portal sales to off-portal sales from Smart Phone users which is included in Internet sales. DVD & Magazine sales decreased EUR 0.2 million, or 29%, to EUR 0.5 million. The reduction in DVD & Magazine sales was primarily attributable to an industry wide decrease in DVD sales (see discussion under *Outlook* below).

For the three months ended June 30, 2011 compared to the three months ended June 30, 2010, the average U.S. dollar exchange rate was 13% less which decreased all our sales, cost and expenses denominated in U.S. dollars by the same percentage. Fluctuations in exchange rates between the euro and the dollar can affect the comparability of our results from one period to another. We translate our consolidated subsidiaries whose functional currency is not the euro into the euro for reporting purposes. Income statement amounts are translated into euro using the average exchange rate for the period. The balance sheet is translated at the period-end exchange rate.

Going forward, we expect Internet, wireless and Broadcasting sales to increase (see discussion under *Outlook* below).

*Cost of Sales.* Our cost of sales was EUR 3.1 million for the three months ended June 30, 2011 compared to EUR 4.0 million for the three months ended June 30, 2010, a decrease of EUR 0.9 million, or 23%. Included in cost of sales is Internet, broadcasting and wireless. printing, processing and duplication

and amortization of library. Internet cost was EUR 1.8 million for the three months ended June 30, 2011 compared to EUR 2.4 million for the three months ended June 30, 2010. Internet cost as a percentage of related sales in the period was 57% compared to 63% in the same period last year. The decrease of EUR 0.6 million was primarily the result of reduced sales and reduced website amortization as a result of an old website which was decommissioned in May 2010. There was no broadcasting and wireless cost for the three months ended June 30, 2011 compared to EUR 0.1 million for the three months ended June 30, 2010. The reduction in cost was due to the reversal of provisions for expected cost. Printing, processing and duplication cost was EUR 0.2 million for the three months ended June 30, 2011 compared to EUR 0.3 million for the three months ended June 30, 2010, a decrease of EUR 0.1 million, or 38%. The decrease was primarily a reflection of the decrease in sales. Printing, processing and duplication cost as a percentage of DVD & Magazine sales was 34% for the three months ended June 30, 2011 compared to 38% in the same period last year. Amortization of library was EUR 1.1 million for the three months ended June 30, 2011 compared to EUR 1.2 million for the three months ended June 30, 2010. Amortization of library does not vary with sales since it reflects the amortization of our investments in content which has been available for sale for a period of three to five years.

*Gross Profit.* In the three months ended June 30, 2011, we realized a gross profit of EUR 1.6 million, or 35% of net sales compared to EUR 2.0 million, or 34% of net sales for the three months ended June 30, 2010. The increase in gross profit as a percentage of sales was primarily the result of reduced amortization of library and websites.

*Selling, general and administrative expenses.* Our selling, general and administrative expenses were EUR 2.7 million for the three months ended June 30, 2011 compared to EUR 3.4 million for the three months ended June 30, 2010, a decrease of EUR 0.7 million, or 21%. The decrease was primarily the result of reduced payroll and depreciation by EUR 0.7 million and EUR 0.1 million, respectively. The decrease was offset by increased bad debt provision.

*Operating profit/loss.* We reported an operating loss of EUR 1.0 million for the three months ended June 30, 2011 compared to an operating profit of EUR 1.0 million for the three months ended June 30, 2010. Discounting the effect of EUR 2.4 million in gain from change in fair value of contingent consideration payable in the three month period ended June 30, 2010, the operating result improved by EUR 0.3 million in the three month period ended June 30, 2011 as a result of reduced selling, general and administrative expenses offset by reduced gross profit.

*Interest expense.* We reported interest expense of EUR 0.1 million for the three months ended June 30, 2011, compared to EUR 0.1 million for the three months ended June 30, 2010.

*Income tax expense/benefit.* We reported no income tax expense or benefit for the three months ended June 30, 2011 and 2010.

*Net Income/loss.* We reported a net loss of EUR 1.1 million for the three months ended June 30, 2011, compared to net income of EUR 0.9 million for the three months ended June 30, 2010.

***Six months ended June 30, 2011 compared to the six months ended June 30, 2010***

*Net sales.* For the six months ended June 30, 2011, we had net sales of EUR 10.1 million compared to net sales of EUR 12.4, million for the six months ended June 30, 2010, a decrease of EUR 2.3 million, or

19%. Internet sales decreased EUR 1.0 million to EUR 6.7 million, which represents a decrease of 13% compared to the same period last year. The reduction in Internet sales was attributable to a decrease in sales from our North American websites as a result of foreign exchange rate changes and a reduction in sales from our Gay Content division. Broadcasting sales decreased EUR 0.3 million to EUR 1.7 million, which represents a decrease of 16% compared to the same period last year. The decrease was primarily the result of fewer newly released titles being broadcasted. Wireless sales decreased EUR 0.4 million to EUR 0.5 million, which represents a decrease of 44% compared to the same period last year. The decrease was primarily the result of migration from on-portal sales to off-portal sales from Smart Phone users which is included in Internet sales. DVD & Magazine sales decreased EUR 0.6 million, or 36%, to EUR 1.1 million. The reduction in DVD & Magazine sales was primarily attributable to an industry wide decrease in DVD sales (see discussion under *Outlook* below).

For the six months ended June 30, 2011 compared to the six months ended June 30, 2010, the average U.S. dollar exchange rate was 6% less which decreased all our sales, cost and expenses denominated in U.S. dollars by the same percentage. Fluctuations in exchange rates between the euro and the dollar can affect the comparability of our results from one period to another. We translate our consolidated subsidiaries whose functional currency is not the euro into the euro for reporting purposes. Income statement amounts are translated into euro using the average exchange rate for the period. The balance sheet is translated at the period-end exchange rate.

Going forward, we expect Internet, wireless and Broadcasting sales to increase (see discussion under *Outlook* below).

*Cost of Sales.* Our cost of sales was EUR 6.4 million for the six months ended June 30, 2011 compared to EUR 8.3 million for the six months ended June 30, 2010, a decrease of EUR 1.9 million, or 23%. Included in cost of sales is Internet, broadcasting and wireless. printing, processing and duplication and amortization of library. Internet cost was EUR 3.8 million for the six months ended June 30, 2011 compared to EUR 4.8 million for the six months ended June 30, 2010. Internet cost as a percentage of related sales in the period was 56% compared to 63% in the same period last year. The decrease of EUR 1.1 million was primarily the result of reduced sales and reduced website amortization as a result of an old website which was decommissioned in May 2010. There was no broadcasting and wireless cost for the six months ended June 30, 2011 compared to EUR 0.2 million for the six months ended June 30, 2010. The reduction in cost was due to the reversal of provisions for expected cost. Printing, processing and duplication cost was EUR 0.5 million for the six months ended June 30, 2011 compared to EUR 0.8 million for the six months ended June 30, 2010, a decrease of EUR 0.3 million, or 39%. The decrease was primarily a reflection of the decrease in sales. Printing, processing and duplication cost as a percentage of DVD & Magazine sales was 41% for the six months ended June 30, 2011 compared to 43% in the same period last year. Amortization of library was EUR 2.2 million for the six months ended June 30, 2011 compared to EUR 2.6 million for the six months ended June 30, 2010. Amortization of library does not vary with sales since it reflects the amortization of our investments in content which has been available for sale for a period of three to five years.

*Gross Profit.* In the six months ended June 30, 2011, we realized a gross profit of EUR 3.6 million, or 36% of net sales compared to EUR 4.1 million, or 33% of net sales for the six months ended June 30, 2010. The increase in gross profit as a percentage of sales was primarily the result of reduced amortization of library and websites.

*Selling, general and administrative expenses.* Our selling, general and administrative expenses were EUR 5.6 million for the six months ended June 30, 2011 compared to EUR 6.5 million for the six months ended June 30, 2010, a decrease of EUR 0.9 million, or 14%. The decrease was primarily the result of reduced payroll and depreciation by EUR 1.2 million and EUR 0.1 million, respectively. The decrease was offset by increased legal expenses and bad debt provision.

*Operating loss.* We reported an operating loss of EUR 1.9 million for the six months ended June 30, 2011 compared to EUR 0.1 million for the six months ended June 30, 2010. Discounting the effect of EUR 2.4 million in gain from change in fair value of contingent consideration payable in the six month period ended June 30, 2010, the operating result improved by EUR 0.5 million in the six month period ended June 30, 2011 as a result of reduced selling, general and administrative expenses offset by reduced gross profit.

*Interest expense.* We reported interest expense of EUR 0.2 million for the six months ended June 30, 2011, compared to EUR 0.2 million for the six months ended June 30, 2010.

*Income tax expense/benefit.* We reported no income tax expense or benefit for the six months ended June 30, 2011 and 2010.

*Net loss.* We reported a loss of EUR 2.1 million for the six months ended June 30, 2011, compared to EUR 0.3 million for the six months ended June 30, 2010.

### **Liquidity and Capital Resources**

We reported a working capital deficit of EUR 0.3 million at June 30, 2011, a decrease of EUR 0.8 million compared to the year ended December 31, 2010. The improvement in working capital is principally attributable to a decrease in current liabilities.

#### *Operating Activities*

Net cash provided by operating activities was EUR 0.7 million for the six months ended June 30, 2011, and was primarily the result of net income, as adjusted for non-cash transactions, offset by cash related to changes in operating assets and liabilities. The net loss of EUR 2.1 million was adjusted to reconcile net income to net cash flows from operating activities with bad debt provision of EUR 0.2 million, amortization of web pages of EUR 0.9 million, depreciation of EUR 0.3 million and amortization of photographs and videos of EUR 2.2 million making a total of EUR 1.5 million. The total of EUR 1.5 million was added to by changes in trade accounts receivable, inventories, prepaid expenses and other current assets, and accrued other liabilities totaling EUR 0.9 million offset by EUR 1.8 million from accounts payable trade and income taxes payable. Net cash provided by operating activities was EUR 3.0 million for the six months ended June 30, 2010. The decrease in net cash provided by operating activities of EUR 2.3 million for the six months ended June 30, 2011 compared to the same period last year was the result of net income, as adjusted for non-cash transactions, and cash related to changes in operating assets and liabilities.

### *Investing Activities*

Net cash used in investing activities for the six months ended June 30, 2011 was EUR 0.7 million. The investing activities were principally capital expenditure of EUR 0.4 million and investment in library of photographs and videos of EUR 0.4 million, which was carried out in order to maintain the 2011 release schedules. Net cash used in investing activities decreased EUR 1.3 million over the same period last year. The decrease is principally due to decreased investment in library of photographs and videos and decreased capital expenditure related to website activities.

### *Financing Activities*

Net cash used in financing activities for the six-month period ended June 30, 2011 was EUR 0.6 million. Net cash provided by financing activities for the six-month period ended June 30, 2010 was EUR 0.2 million. The change of EUR 0.8 million was primarily the result of repayments on borrowings.

### *Liquidity*

In each of the past three years we have experienced losses from operations. At December 31, 2010, we had cash and cash equivalents of EUR 370,000 and a working capital deficit of EUR 1,102,000. As a result, our independent registered public accounting firm has concluded that there is substantial doubt as to our ability to continue as a going concern, and has modified its report in the form of an explanatory paragraph describing the events that have given rise to this uncertainty. Our ability to continue as a going concern is based on our ability to generate or obtain sufficient cash to meet our obligations on a timely basis and ultimately to attain profitable operations. We currently expect future growth and to return to profitability provided we are successful with the following objectives:

the continued rollout and successful marketing of our Internet platforms, including: a) our newly built signature property and membership platform private.com, b) our cutting edge mobile platforms for Smart Phones and c) our multinational eCommerce VOD platform;

the successful marketing of our affiliate programs for all our properties to compete aggressively for, and attract, affiliate traffic;

continuing the rollout of our content on cable and IPTV video-on demand platforms;

completing the integration of businesses acquired in 2009;

consolidating and restructuring our operations into an efficient new media business;

outsourcing of non-cost effective parts of our operations; and

identifying and exploring new online business opportunities which are less dependent on content.

If we are not successful in implementing the above objectives, or if we otherwise do not successfully respond to changing conditions in the adult entertainment industry, we may continue to incur significant losses. There can be no assurance that we will be able to operate profitably in the future.

Although we expect that our available cash resources and cash generated from operations will be sufficient to meet our presently anticipated working capital and capital expenditure requirements for at least the next 12 months, we may need to raise additional funds to support more rapid growth or respond to unanticipated requirements. In this regard, we are presently engaged in litigation in New York state court with a third party lender regarding our obligations under a promissory note. An adverse outcome in this



dispute would likely have a material impact upon our liquidity if we are unable to obtain additional debt or equity financing to satisfy any resulting liability. In addition, this lender has recently filed an application with the New York court seeking an order attaching assets of the Company as security for the promissory note, which if granted may make it more difficult to obtain bank financing. For additional information regarding this litigation, see *Disputed Contractual Obligation below and Part I Item 3 Legal Proceedings* in our Form 10-K for the period ended December 31, 2010.

We currently have no additional availability under our existing credit facilities. The existence of a going concern exception by our auditors may make it more difficult to obtain additional bank financing if and when required. If additional funds are raised through the issuance of equity securities, our shareholders' percentage ownership will be reduced, they may experience additional dilution, or these newly issued equity securities may have rights, preferences, or privileges senior to those of our current shareholders. Additional financing may not be available when needed on terms favorable to us, or at all. In this regard, in the past most of our bank financing has included the guaranty of affiliated companies of our Chairman and principal shareholder, Berth Milton, and a pledge of shares of common stock owned by him or his affiliated companies. We cannot assure you that Mr. Milton or his affiliated companies will guaranty future debt financings or that such guaranties will be sufficient to obtain future debt financings. If adequate funds are not available or are not available on acceptable terms, we may be unable to develop or enhance our products and services, take advantage of future opportunities, maintain the scope of our operations or respond to competitive pressures or unanticipated requirements, which could harm our business.

#### *Disputed Contractual Obligation*

In December 2001 the group's holding company, Private Media Group, Inc., borrowed \$ 4.0 million from Commerzbank AG pursuant to a Note originally due on December 20, 2002. The Note bore interest at an annual rate of 7%, payable quarterly, with the entire principal amount and accrued interest originally due on December 20, 2002. The Note was guaranteed by Slingsby Enterprises Limited, an affiliate of Berth Milton, Private's Chairman, President and principal shareholder, and the guaranty was secured by 1,650,000 shares of Private Media Group, Inc. common stock. In December 2002 Commerzbank AG agreed to extend the maturity date of the Note to March 20, 2003. In April 2003 the Note was acquired by Consipio Holding b.v. from Commerzbank AG, and Consipio and Private reached an agreement-in-principle with Consipio to extend the maturity of the Note until April 2008. However, Consipio and Private were unable to reach final agreement on other terms and conditions relating to the restructured Note. Accordingly, in December 2003 Consipio notified Private and Slingsby Enterprises that Private was in default under the Note, and demanded \$3.4 million as payment in full of all outstanding principal and interest under the Note. The Company continued to make regular payments on the Note, including principal and accrued interest, through February 2008. In April 2008 Consipio requested Private to pay the remaining balance of the Note, without indicating the amount due. Private in turn requested that Consipio provide a statement of the amount due and the basis for its calculation. In response, Consipio demanded payment of \$3,194,000 as settlement in full of the Note, to be received by May 9, 2008. This calculation was made using an interest rate of 9.9%, as opposed to the 7% rate provided under the original terms of the Note. Consipio also advised that if payment was not received on such date it would institute litigation, in which event Consipio would claim that the amount due under the Note should be denominated in Euro, rather than U.S. dollars. In August 2008 Consipio notified Private that the Note was in default and that it intended to exercise its rights under the Note and the pledge of shares by Slingsby of Private common stock. Private believes that the amount due under the Note at May 9, 2008, including accrued interest, was no more than \$2.4 million, utilizing an interest rate of 7%. As of June 30, 2011, EUR 2.1 million (\$3.0 million), including accrued interest, was outstanding.

Consipio has filed a legal proceeding against the Company in New York to collect the amount due under the Note. An adverse outcome in this proceeding would likely have a material impact upon our liquidity if we are unable to obtain additional debt or equity financing to satisfy any resulting liability. In addition, this lender has recently filed an application with the New York court seeking an order attaching assets of the Company in the amount of \$6.7 million as security for the promissory note, which if granted may make it more difficult to obtain bank financing. For additional information regarding this litigation, see Part I, Item 3 Legal Proceedings, contained in the Company's Form 10-K for the period ending December 31, 2010.

## Outlook

During the past two years, we have developed Internet solutions for critical new markets: gay, international and mobile. Furthermore, as a response to decreased margins in the adult entertainment industry, we have reviewed, analyzed and continued to restructure the operations of the non-online part of the business in order to become more cost effective. The 2009 acquisitions of GameLink and Sureflex have also presented a challenge in terms of integration. All the aforementioned processes have had impact both in terms of lost sales and additional selling, general and administrative expenses. However, as part of these processes, during 2010 we reduced our workforce by 34% from 168 to 112 employees and we expect to continue this process as we become more efficient and enjoy economies of scale from the aforementioned acquisitions. In 2011, we are starting to benefit from the restructuring and will continue to reduce costs while increasing sales as we implement, launch and market new initiatives.

As part of our digital strategy, we have established that the combination of Private with major online retailers and accomplished platform developers is the approach to achieving our goals in the rapidly changing business landscape. The combined content assets of Private and core competencies of GameLink and Sureflex offer a compelling new business model. We will be expanding our joint Internet strategies globally with additional formats and applications to be launched in 2011. Currently we are reformatting and migrating all content on the GameLink VOD platform to a Content Delivery Network (CDN) and we expect this to enhance the user experience substantially and therefore improve both conversion and retention rates in general, but particularly in eastern North America and in Europe. This is a paramount initiative which is expected to increase sales significantly and also make it possible to expand our cooperation with affiliates worldwide. In addition, this initiative is crucial for the development and distribution of apps which will enable consumer access from the growing market of SMART TVs. The completion of the CDN initiative is expected to take place in the second half of 2011. In addition, during 2011 we will continue to aggressively market our recently launched cutting-edge Internet assets discussed below.

In May 2010, we launched our new private.com membership platform. The new platform features a number of proprietary sites and it is also available as a white label<sup>2</sup> version, which we expect will attract adult content providers and affiliates worldwide. In addition, the new platform has been built to be substantially less labor intensive to operate compared to the old one. The new platform also has improved conversion rates and attracts more traffic. During the six months ended June 30, 2011 the new membership pay-site attracted 8.1 million absolute unique visitors, which represents an increase of 70% compared to for the old site during the same period in 2010.

In April 2010, GameLink, launched a proprietary mobile solution enabling users to instantly stream over 15,000 movies. The platform is available to Smart Phones at the url: [www.gamelink.com](http://www.gamelink.com). The mobile

<sup>2</sup> A white label product or service is a product or service produced by one company that other companies rebrand to make it appear as if they made it.



Internet platform allows consumers to purchase and consume content instantly. All content is available for future viewing in the customer's virtual media center, stored in the company's Cloud. The platform has been optimized to work with Apple devices including the iPhone, iPod, the iPad as well as Android devices. Furthermore, in 2010, Apple's OS upgrade to iOS4.3 for iPhones, iPads and iPod touches made it possible to watch GameLink's mobile library on Apple TV by allowing users to redirect content streaming from those devices to their Apple TV. In addition to streaming, consumers can choose to download their movies or purchase DVDs and novelties from the globally accessible platform. A white label version of the mobile platform is available and is being marketed to adult studios and affiliates worldwide. Our objective is to become the main provider of an off-portal mobile platform solution to all major content providers in our industry. In contrast to Private's existing mobile content business, which is based on an on-portal model going through content aggregators and carriers, this new business is off-portal and provides substantially improved margins as content is sold directly by ourselves to the consumer. Our weekly sales for the GameLink VOD mobile solution has been steadily increasing since its launch and current weekly sales represents a USD 1.0 million twelve-month run rate. In August 2010, Sureflex introduced mobile VOD on its existing platform for its Maleflixxx network of hundreds of sites. The new mobile platform, Maleflixxx Mobile, allows consumers to view gay content on all mobile devices, including the iPad, iPod Touch, iPhone and Android handsets. Furthermore, in Q4, 2010, we released a number of Smart Phone apps with an end to increase traffic to our mobile assets. With the Smart Phone market growing rapidly<sup>3</sup>, we expect to generate substantial growth from our mobile VOD initiatives going forward.

With respect to broadcasting, we are continuing to implement our media growth strategy across all delivery systems, including: DTT, satellite, cable and IPTV. Private content is currently broadcasted via 194 platforms in 42 countries. While European broadband users are signing up for IPTV services in the hundreds of thousands each month, making Europe the biggest and fastest growing IPTV region in the world, we have successfully implemented part of our new media strategy and contracted for supplying content for VOD services to a total of 26 major platform operators in 18 countries in the region. During 2010 the European IPTV market grew by 25% to 20.7 million IPTV subscribers<sup>4</sup> and by the end of the year we had more than 75% market coverage. France remains the world champion IPTV country with 10.3 million subscribers and we cover 100% of this market. Furthermore, it is forecasted<sup>5</sup> that the number of global IPTV subscribers will grow from 44 million at the end of 2010 to 111.5 million in 2014, a compound annual growth rate of 26%. The forecast shows that Europe will be the regional leader, with 42% of the worldwide IPTV subscribers total in 2014. In relation to Private branded TV channels carrying our content in Europe and Latin America, our partners Playboy TV International and Playboy TV Latin America continue to improve distribution. In 2010, the Private Spice agreement with Playboy TV International was renewed for another five years. The channel is receivable in all of Europe and it currently has distribution in 22 countries via 101 cable, satellite, DTT and IPTV platforms. During the past twelve months, Playboy TV Latin America continued to increase the distribution of the Private Channel. The channel is receivable in all of Latin America and it currently has distribution in 19 countries via 63 cable, satellite and IPTV platforms and reaches 38 million platform subscribers. Going forward, we expect to grow our broadcasting distribution both on existing and additional platforms that are using any available technology.

During the six month period ending June 30, 2011, we have released fewer new titles compared to the same period 2010 and this has had an impact on both broadcasting and DVD & Magazine sales. As from the fourth quarter of 2011, we are increasing the number of new titles released.

Private's mobile on portal revenues declined in the first quarter of 2011 and the main reason for the decrease is that this business is migrating to off portal and is included in our Internet sales where these sales are increasing. We expect this trend to continue with the increased penetration of Smart Phones.

<sup>3</sup> According to Parks Associates report of March, 2010, "Smart Phone: King of Convergence": the number of Smart Phone users is expected to quadruple, exceeding 1 billion worldwide by 2014.

<sup>4</sup> According to Point Topic's report of March, 2011, "IPTV Q4 2010 Short Report".

<sup>5</sup> According to MRG's IPTV Global Forecast (December 2010).

Whether it is on or off portal, the growing use of Smart Phones, the introduction of Mobile VOD and TV, and the implementation of age verification systems offer additional growth potential for the combined markets in 2011 and beyond<sup>6</sup>.

During 2011, the DVD market has continued to shrink, with sales for our physical products declining by 36%. However, the DVD business is by no means dead even in this competitive landscape. The content providers that manage to survive the current clean out will control the DVD market going forward.

<sup>6</sup> Juniper Research estimates in its 2010 study *Mobile Adult Strategies: Downloads, Video Chat, Apps & Messaging 2010-2015* that global revenues from all mobile adult services will rise from \$1.7 billion in 2009 to \$2.8 billion by 2015.

#### **Item 4. Controls and Procedures**

##### *Evaluation of Disclosure Controls and Procedures*

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in reports filed under the Securities Exchange Act of 1934, is recorded, processed, summarized and reported within the specified time periods. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is accumulated and communicated to its management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. As of the end of the period covered by this report, the Company's management evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures. Based on the evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2011.

##### *Changes in Internal Control Over Financial Reporting*

There were no changes in the Company's internal control over financial reporting that occurred during the Company's fiscal quarter ended June 30, 2011, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

##### *Inherent Limitations in Internal Control Over Financial Reporting*

The Company does not expect that its disclosure controls and procedures will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company is a party to pending material legal proceedings. For information regarding these proceedings see Part I, Item 3 Legal Proceedings, contained in the Company's Form 10-K for the period ending December 31, 2010.

**Item 6. Exhibits**

- 31.1 Certifications pursuant to Rule 13a-14 under the Securities Exchange Act of 1934.
- 31.2 Certifications pursuant to Rule 13a-14 under the Securities Exchange Act of 1934.
- 32.1 Certification of CEO and CFO Pursuant to 18 U.S.C. § 1350, as Adopted Pursuant to § 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

PRIVATE MEDIA GROUP, INC.  
(Registrant)

Date: August 15, 2011

/s/ Johan Gillborg  
Johan Gillborg, Chief Financial Officer