

BKN INTERNATIONAL AG

GERMANY / MEDIA & ENTERTAINMENT

Primary Exchange: Frankfurt / General Standard
Secondary Exchange: London
Symbol: BKQ ISIN: DE0005290704

RATING: Buy

PRICE TARGET: €3.75

RISK RATING: High

GEARING UP FOR 2007

COMPANY PROFILE

BKN and its subsidiaries are engaged in the production, distribution and marketing of children's animation television programmes and the merchandising and licensing of the rights to those programmes. The parent company is located in Cologne, Germany with offices in New York, London and Barcelona.

KEY POINTS

BKN published FY05/06 results on 28 November. Full-year consolidated revenues increased 16.1% y-o-y to €13.89m from €11.97m. Although this was below both our forecast of €15.08m and company guidance, the results still confirm the impressive growth in sales and earnings the company has experienced since 2003.

EBIT of €4.74m came in above our forecast of €4.08m, increasing 48.4% y-o-y from €3.20m. This strong performance was primarily due to a significant reduction in depreciation charges to €1.43m from €2.68m.

After a solid 2005/06, BKN management provided a positive outlook for the current year. They provided guidance for a revenue increase of 20 - 30%, which is in-line with our revenue estimate of €17.37m. We are expecting a FY06/07 EBIT margin of 35.7%.

RECOMMENDATION

Our valuation of BKN is based on a peer-group comparison and earnings forecasts to 2007/08. On current levels, our peer group trades at an average FY06/07 P/E multiple of 16.0x, or 16.1x at median levels. At 12.5x, we regard BKN as undervalued, especially due to its strong line-up of new products. Furthermore, our projected FY06/07 EBIT margin of 35.7% should outpace the industry average of 23.2%.

Our FY06/07 P/E target of 14.5x for BKN represents a 9.4% discount to the average, which we see as justified due to the company's inability to compete on the same terms as its larger peers. Applying 14.5x to our annualised FY06/07 EPS forecast of €0.26 we derive a fair value of €3.76 per share.

Our fair value translates to a new price target of €3.75 (previously €4.80). Our price target equates to P/E multiples of 14.5x 2006/07 and 12.3x 2007/08 annualised diluted earnings. We reiterate our Buy rating on BKN.

RISKS

Risks to our price target include but are not limited to delays in animated series development, decreases in TV programming spending, delays in client acquisitions, non-renewals of existing contracts and changing consumer interests.

TRADING DATA

Market Capitalisation (18.12.06)	€50.77m
Shares Outstanding	15.72m
Closing Price (18.12.06)	€3.23
52-Week Range	€2.37 / 4.18
Free Float (According to Company)	63%
Average Daily Share Volume (year)	25,892

STOCK OVERVIEW



Source: Bloomberg & First Berlin

FINANCIAL HISTORY & PROJECTIONS

	2004/ 05A	2005/ 06A	2006/ 07E	2007/ 08E
Revenue €m	11.97	13.89	17.37	21.19
Yr/Yr Growth	44.4%	16.1%	25.0%	22.0%
Operating Profit €m	3.20	4.74	6.20	7.31
Operating margin	26.7%	34.1%	35.7%	34.5%
Net income €m	4.29	3.74	4.70	5.71
EPS €(diluted)	0.27	0.20	0.25	0.30
P/E	12.0	16.2	12.9	10.8

COMPANY DATA (as of 30 September 2006 unless noted)

Liquid Assets	€1.65m
Current Assets	€3.93m
Intangible Assets	€6.59m
Total Assets	€43.82m
Current Liabilities	€2.13m
Total Shareholders' Equity	€28.64m

ANALYST INFORMATION

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2006 FINANCIAL RESULTS

BKN published positive full-year 2005/06 results on 28 November. The results confirmed the impressive growth in sales and earnings the company has experienced since 2003. Revenues, operating income and net income all hit record levels for the company. We see this growth as sustainable until 2008/09 based on a dynamic slate of new productions scheduled for delivery in 2007. Positive developments in the market for children's animation should support this growth. Shows such as *Zorro – Generation Z* and *Dork Hunters from Outer Space* see the company extending both its international appeal and its programme style. *Zorro* will mark BKN's largest excursion into Spanish-speaking markets, while *Dork Hunters* is the highest profile comedy series in the company's history. Interest in these shows has been lively, particularly since they were presented at October's MipCom audiovisual trade fair. As a result, we expect BKN to announce significant TV broadcast deals in H1 06/07.

INCOME STATEMENT

Consolidated revenues increased 16.1% y-o-y to €13.89m from €11.97m. This was below our prediction of €15.08m and below company guidance from earlier this year. Approximately €0.30m in sales was lost due to the late delivery of products scheduled for Q4 05/06. The products are scheduled for delivery during the company's Q1 06/07. The €0.30m will carry forward to revenues for H1 06/07.

Operating income of €4.74m came in above our forecast of €4.08m, increasing 48.4% y-o-y from €3.20m. The operating margin improved to 34.1% compared to 26.7% in 2004/05. This strong performance was due primarily to a significant reduction in depreciation charges to €1.43m from €2.68m. The reduction in depreciation was due to a decline in the production of new properties in 2004 and 2005. According to the business model, 70% of a property's book value is depreciated over the first three years of sales. This meant that by 2006 the value of the company's product portfolio was lower than in previous years. Furthermore, the company altered the book value of its portfolio in light of an independent valuation carried out in H2 05/06. Without these effects, EBIT would have been lower due to a sharp rise in operating and salary costs. These increased by a total of 70.7% y-o-y to €3.98m from €2.33m.

In our view, this rise in costs is not a major concern, since the company spent H2 05/06 investing in new products and building up the DVD distribution network for the Home Entertainment division founded in February 2006. We expect these investments to impact revenues positively from 2006/07 onwards. For example, the Home Entertainment division began releasing its slate of animated feature films in November at the rate of one a month, which will start to show up in revenues from H1 06/07 onwards. FY05/06 earnings, before deferred tax gains, increased 38.6% to €4.12m compared to €2.97m in 2004/05. This result was significantly higher than our FY05/06 net income target of €3.23m. Underlying basic EPS for 2005/06, before deferred tax gains, increased at a similar level y-o-y to €0.26 from €0.19.



A CLOSER LOOK

BKN reports its revenues by segment, region and significant property. The main driver of 2005/06 sales in both the television and consumer brands segments was the company's back catalogue. Television sales increased by 4.7% y-o-y to €5.74m from €5.48m. Consumer brand sales increased by 22.3% y-o-y to €6.87m from €5.62m. Production and other revenues increased by 47.6% y-o-y to €1.28m from €0.87. This rise reflects the investment in new properties *Zorro* and *Dork Hunters* in 2005/06.

Europe and the US continued to form the core markets for BKN in 2005/06, accounting for 39% and 36% of sales, respectively. Increases in European sales were particularly strong, from €3.47m in 2004/05 to €5.42m in 2005/06. US sales increased 16.1% y-o-y to €5.0m from €4.31m.

BKN increased its product portfolio in 2005/06 to include more revenue-driving properties outside of its back catalogue. *Legend of the Dragon* accounted for €3.71m or 31% of FY 04/05 revenues. *Kong* accounted for €1.32m (11%) and *Ali Baba* for €0.60m (5%). Back catalogue sales were worth €6.34m (53%). In 2005/06, *Legend of the Dragon* accounted for €2.64m of turnover (19%), *Kong* for €2.08m (15%), *Dork Hunters* for €1.11m (8%), *Ali Baba* and the new Classic Collection for €0.42m each (a total of 6%) and the back catalogue for €7.22m (52%).

BALANCE SHEET & FINANCIAL POSITION

As of the 30 September reporting date, BKN had cash and cash equivalents of €1.65m, compared to €0.38m in the prior year. The company had current assets of €3.93m and total assets of €43.82m of which €36.59m were intangible assets. Current liabilities totalled €2.13m, whereas the company had long-term liabilities of €3.06m and shareholders' equity of €28.64m. BKN's working capital position declined to €0.16m versus €2.16m in the previous year, excluding cash.

BKN generated cash flow from operations of €5.49m in FY05/06 compared to €5.64m in the prior year. The 2.7% decrease is a reflection of the 26.7% increase in operating costs for the year. CAPEX of -€0.11m was above the previous year's levels of -€0.02m, whereas cash flow from investing activities totalled -€4.48m. Cash flow from financing activities amounted to €8.88m.



OUTLOOK

After a solid 2005/06, BKN management have provided a positive outlook for the current year. They offer guidance for a 20-30% increase in revenues and earnings based on organic growth, which is in-line with our revenue estimate of €17.37m. We are expecting an operating margin of 35.7% for the year based on the assumption revenue growth will outpace operational costs.

We expect medium-term growth to stem from three major sources. First, monthly sales from BKN's back catalogue now amount to approximately €0.70m per month against operating costs of approximately €0.50m per month. The back catalogue is likely to remain the backbone of company sales.

Second, the company invested some €14.37m in 2005/06 (2004/05: €10.21m) in expanding its portfolio of new properties. The second season of *Legend of the Dragon* was delivered in H2 05/06 and will continue to drive sales in 2006/07. New properties *Dork Hunters* and *Zorro* will be delivered in 2007 and should have a positive impact on revenues from 2007 through to 2008/09.

Third, the company has invested heavily in its new Home Entertainment/DVD division. Launched in February 2006, the division released its first title in November 2006. This new division should help diversify the company's revenue streams from H1 06/07.

Competition in the children's TV market is fierce, leading to pricing pressures on the sale of animation properties. Across the world, however, the number of dedicated children's channels continues to multiply with increasing demand for content. At the same time, several existing channels are in the market for new content due to the expiration of contracts for broadcasting rights. The German market is a good example of this increased demand. The launch of Nickelodeon Germany in 2005 has increased competition between the German channels. Now four channels are purchasing new properties: Nickelodeon Germany, SuperRTL, RTL II and Kika. As a result of both new channels and demand for new content from existing channels, the potential for increased volume sales bodes well for BKN.



EARNINGS ANALYSIS

For BKN, we forecast revenue growth of 25% to €17.37m for FY06/07. We project net profit to increase to €4.70m for the period. After 2005/06, we project net income rising in the double digits in the medium term. In 2007/08, we expect net income of €5.71m. We expect medium-term sales growth to remain above 20%. BKN should continue to secure more DVD market share with its Home Entertainment division, while increasing sales to broadcasters based on its new properties. Europe and the US are likely to remain the most important markets for the company until 2008/09. BKN expects its fastest regional sales growth in Latin America due to the potential popularity of its *Zorro* series.

We expect EBIT margins to remain above 34% over the medium term, going from a high of 35.7% in 2006/07 down to 34.5% in 2007/08. This reflects continued investment in new properties and DVD distribution networks. However, we foresee expenses as a percentage of sales declining slowly as sales growth outpace growth in costs. We believe the highest operational expense – G&A costs – will amount to 22% of revenues in 2006/07 and 20% of revenues in 2007/08. We expect salary expenses to amount to 20.5% of revenues in 2006/07 and 19% of revenues in 2007/08. We see scheduled depreciation increasing from 10.3% of revenues in 2005/06 to 18.8% in FY06/07 and 23% in FY07/08.

Based on these assumptions, our operating income target for FY06/07 is €6.19m. We forecast pre-tax income of €5.17m and net income of €4.70m. This equates to a diluted EPS of €0.25. For FY07/08, we modelled for revenues of €21.19m, operating profit of €7.31m and pre-tax income of €6.28m. Our net income estimate of €5.71m corresponds to a diluted EPS of €0.30.



VALUATION

Our valuation of BKN is based on a peer group comparison and earnings forecasts to 2007/08. The peer group includes Germany-based TV Loonland and Your Family Entertainment as well as UK company Entertainment Rights and US-based 4kids Entertainment. BKN's peers are trading at an average expected FY07 P/E of 16.0x and a slightly stronger median valuation of 16.1x. We have excluded EM.TV from our peer group comparison because the company's business operations are dominated by sports broadcasting (84.9% of FY05 revenues).

We believe BKN is currently undervalued at an annualised P/E ratio of 12.5x, especially as the company's FY06/07 expected EBIT margin of 35.7% outperforms its competitors' average of 23.2%. Closest competitor TV-Loonland, for example, is forecast to achieve a 27.1% EBIT margin. BKN showed its largest ever line-up of new properties at this year's MipCom in October. In addition, the company is skilled at both merchandising and selling properties in its back catalogue. BKN has consistently met its financial performance targets over the last three years. Furthermore, we expect the top-line to grow more dynamically due to the number of new products scheduled for 2006/07 from both the home entertainment and television divisions. This combination of factors places BKN up to 12 months ahead of rival animators such as TV-Loonland.

Industry Peer	Price as @		Enterprise Val.	Share Price as % of 52w High	Multiples												
	18/12/2006	Equity Val.			EV/Sales			EV/EBITDA			EV/EBIT			P/E			
					06E	07E	08E	06E	07E	08E	06E	07E	08E	06E	07E	08E	
European Entertainment - Family Entertainment																	
4kids Entertainment	18.00	240.72	124.46	91.6%	1.63x	1.54x	n.a.	4.7x	3.4x	n.a.	n.a.	24.3x	n.a.	n.a.	26.2x	n.a.	
Entertainment Rights	30.25	124.96	145.77	71.9%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18.6x	16.1x	n.a.
TV Loonland	1.59	15.74	33.88	68.8%	2.26x	1.76x	1.26x	14.0x	4.5x	3.1x	n.a.	6.5x	4.1x	n.a.	5.6x	3.4x	
Your Family Entertainment	1.80	11.75	11.28	58.1%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Average				72.6%	1.95x	1.65x	1.26x	9.4x	3.9x	3.1x	n.a.	15.4x	4.1x	18.6x	16.0x	3.4x	
Median				70.4%	1.95x	1.65x	1.26x	9.4x	3.9x	3.1x	n.a.	15.4x	4.1x	18.6x	16.1x	3.4x	
Average (incl. EM.TV)				72.6%	1.61x	1.41x	1.09x	8.6x	4.6x	4.3x	21.8x	15.7x	8.7x	18.6x	22.1x	15.9x	
BKN (at current market prices)	3.23	61.83	68.90	76.5%	4.67x	3.76x	3.17x	9.8x	6.8x	5.6x	13.5x	10.6x	9.2x	15.5x	12.5x	10.6x	
BKN (at target price)	3.76	71.99	79.06	89.1%	5.36x	4.31x	3.64x	11.3x	7.8x	6.4x	15.5x	12.2x	10.6x	18.1x	14.5x	12.3x	

The average P/E multiple of 16.0x for FY07 is driven by 4kids Entertainment and Entertainment Rights as the largest companies in the peer group. Our FY06/07 P/E target of 14.5x for BKN represents a 9.4% discount to the average, which we see as justified due to the company's inability to compete on the same terms as its larger and financially stronger peers. Applying our 14.5x FY06/07 P/E multiple to our annualised EPS forecast of €0.26, we derive a fair value of €3.76 per share for BKN. Compared to the present trading level of the company this translates into a Buy recommendation.



RISKS AND CONCERNS

The main risk to BKN's share price is a recent history of consistent selling in the stock. While the selling seems to have stopped over the last two weeks, the identity of the sellers and their motive for selling remains a mystery. Consequently, the selling could resume once the stock hits more attractive levels. The second largest risk to the price is the diluting effect of the convertible bond the company issued in August, which we see as likely to hold the stock at or below the €3.75 level.

Risks to the company's future revenues include possible delays in animated series development, decreases in TV programming spending, delays in client acquisitions, non-renewals of existing contracts and changing consumer interests.



RECOMMENDATION

We believe BKN is set to continue its growth trend this year. We have revised our revenue estimates slightly downwards and our EBIT and net income forecasts upwards. We based our forecasts for more than 20% annual revenue increases for FY06/07 and FY07/08 on continued organic growth, as we do not see any acquisitions on the horizon. We anticipate this growth to stem from opening European media markets in need of more content and a popular slate of properties. US growth should continue to be healthy, while we anticipate a steep increase in sales in Spain and Latin American markets due to the new *Zorro* property. *Zorro* is due to be delivered to the company in H2 06/07.

Looking ahead, we believe the greatest challenge for the company is to diversify its revenue streams. We are confident that the Home Entertainment division has the potential for fast sales growth but await news on success in 2006/07 before looking ahead to 2008/09 and beyond. As an intellectual property company that owns all worldwide rights to its properties across all media, BKN will have the opportunity to exploit new internet-based opportunities for downloading episodes and video streaming services. The company's current strategy is to delay entering this market until it has matured and the value of property rights sold via the internet is likely to increase. Thus we do not expect increasing internet-based sales to start impacting the top line of the P&L until 2008/09 at the earliest.

Based on our earnings forecasts and our peer group comparison we have determined a new price target of €3.75 (previously €4.80). Our price target equates to P/E multiples of 14.5x 2006/07 and 12.3x 2007/08 annualised diluted earnings. We reiterate our Buy rating on BKN.



INCOME STATEMENT ANALYSIS AND FORECAST

in t €	2004/05A	2005/06A	2006/07E	2007/08E
	Total	Total	Total	Total
Television	5,481	5,740	7,815	9,958
Consumer brands	5,617	6,870	8,162	9,746
Other Revenues / Capitalized Costs (04)	869	1,283	1,389	1,483
Total Revenues	11,967	13,893	17,366	21,187
Producer Fees & other direct operating costs	-232	-985	-521	-742
Salaries & Employee Benefits	-2,099	-2,993	-3,560	-4,025
General & Administrative	-3,761	-3,742	-3,821	-4,237
Provisions for bad debt	0	0	0	0
EBITDA	5,875	6,173	9,465	12,182
Scheduled depreciation	-2,679	-1,430	-3,270	-4,875
Amortization of goodwill	0	0	0	0
EBIT	3,196	4,743	6,195	7,307
Net Interest	-225	-625	-695	-695
Convertible Bond (23.8.06 @ 10.25%)	0	0	-328	-328
Other Expenses & Extraordinary income / (expenses)	0	0	0	0
Result before taxes (and minority interest)	2,971	4,118	5,172	6,285
Income tax	1,318	-377	-473	-575
Result before minority interest	4,289	3,741	4,698	5,709
Result (after tax) from discontinued operations	0	0	0	0
Minority interest	0	0	0	0
Net income / loss	4,289	3,741	4,698	5,709
Earnings per share (basic)	0.28	0.24	0.30	0.36
Earnings per share (diluted)	0.27	0.20	0.25	0.30
Weighted average shares outstanding (basic, millions)	15.25	15.72	15.72	15.72
Weighted average shares outstanding (diluted, millions)	16.18	19.14	19.14	19.14

Profitability analysis	2004/05A	2005/06A	2006/07E	2007/08E
	Total	Total	Total	Total
EBITDA margin	49.1%	44.4%	54.5%	57.5%
Operating margin	26.7%	34.1%	35.7%	34.5%
Net income margin	35.8%	26.9%	27.1%	26.9%
Expenses as % of revenues				
Salaries & Employee Benefits	17.5%	21.5%	20.5%	19.0%
General & Administrative	31.4%	26.9%	22.0%	20.0%
Y-Y Growth				
Television - Catalogue	35.8%	26.0%	36.1%	27.4%
Consumer brands - Catalogue	71.8%	22.3%	18.8%	19.4%
Total revenues	44.4%	16.1%	25.0%	22.0%
Operating income	72.8%	48.4%	30.6%	18.0%
Net income/ loss	153.8%	-12.8%	25.6%	21.5%



FIRST BERLIN RECOMMENDATION & PRICE TARGET HISTORY

Report No.:	Date of Publication	Previous Day Closing Price	Recommendation	Target Price	Interim High	% Change to High
Initial Report	3 February 2006	€1.87	Strong Buy	€2.75	-	-
2...6	↓	↓	↓	↓	↓	↓
7	21 November 2005	€4.05	Buy	€0.00	€4.18	3.21%
8	26 April 2006	€3.23	Buy	€5.50	€3.77	16.72%
9	24 August 2006	€2.90	Buy	€4.80	€3.21	10.69%
10	Today	€3.23	Buy	€3.75	-	-

Source: Bloomberg & First Berlin

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

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

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

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

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