

PRIVATE MEDIA GROUP INC  
Form 10-K  
March 31, 2005

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**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 10-K**

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

For the fiscal year ended December 31, 2004

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

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**PRIVATE MEDIA GROUP, INC.**

(Name of Registrant as specified in its Charter)

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Nevada

87-0365673

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(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification Number)

3230 Flamingo Road, Suite 156, Las Vegas, Nevada 89121

(Registered office)

Carretera de Rubí 22-26, 08190 Sant Cugat del Vallès, Barcelona, Spain

(European headquarters and address of principal executive offices)

34-93-590-7070

(Issuer's telephone number, including area code)

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Securities registered pursuant to Section 12(b) of the Exchange Act: None

Securities registered pursuant to Section 12(g) of the Exchange Act: Common Stock, \$0.001 par value.

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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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 1b-2 of the Act). Yes  No

At June 30, 2004, the aggregate market value of the voting stock and non-voting common equity held by non-affiliates of the registrant was \$44,278,393. The aggregate market value has been computed by reference to the last sales price of the common stock on June 30, 2004.

On March 18, 2005 the registrant had 50,159,312 shares of Common Stock outstanding.



**PART I**

**ITEM 1. DESCRIPTION OF BUSINESS**

*This Report includes forward-looking statements. Statements other than statements of historical fact included in this Report, including the statements under the headings Management's Discussion and Analysis of Financial Condition and Results of Operations, Business and elsewhere in this Report regarding future events or prospects, are forward-looking statements. The words may, will, expect, anticipate, believe, estimate, plan, intend, should or variations of these words, as well as other statements regarding matters that are not historical fact, constitute forward-looking statements. We have based these forward-looking statements on our current view with respect to future events and financial performance. These views involve a number of risks and uncertainties which could cause actual results to differ materially from those we predict in our forward-looking statements and from our past performance. Although we believe that the estimates and projections reflected in our forward-looking statements are reasonable, they may prove incorrect, and our actual results may differ, as a result of the following uncertainties and assumptions:*

*our business development, operating development and financial condition;*

*our expectations of growth in demand for our products and services;*

*our expansion and acquisition plans;*

*the impact of expansion on our revenue potential, cost basis and margins;*

*the effects of regulatory developments and legal proceedings on our business;*

*the impact of exchange rate fluctuations; and*

*our ability to obtain additional financing.*

*We do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise except to the extent required by law. You should interpret all subsequent written or oral forward-looking statements attributable to us or persons acting on our behalf as being expressly qualified by the cautionary statements in this Report. As a result, you should not place undue reliance on these forward-looking statements.*

**THE COMPANY**

**OVERVIEW**

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Private Media Group, Inc., a US incorporated company, and its subsidiaries (together referred to hereinafter as Private Media Group, we or us) is a leading international provider of high quality adult media content for a wide range of media platforms. Any references in this report to Milcap Media Group refers to Milcap Media Group S.L. (Spain), and Milcap Media Limited refers to Milcap Media Limited (Cyprus).

Private Media Group, Inc. is incorporated in the State of Nevada. In accordance with Nevada law we maintain a registered office at 3230 Flamingo Road, Suite 156, Las Vegas, Nevada. Our European headquarters are located at the offices of one of our principal operating subsidiaries, Milcap Media Group, S.L., whose address is Carretera de Rubí 22-26, 08190 Sant Cugat del Vallès, Barcelona, Spain, telephone +34-93-590-7070.

We acquire worldwide rights to still photography and motion pictures tailored to our specifications from independent directors and process these images into products suitable for popular media formats such as print publications, videotapes, DVDs and electronic media content for Internet distribution. We distribute our adult media content directly, and through a network of local affiliates and independent distributors, through multiple channels, including (1) newsstands, video rental stores, travel retail and adult bookstores, (2) mail order catalogues, (3) cable, satellite and hotel television programming, (4) over the Internet via proprietary websites and broadband delivery services and (5) wireless telephony. In addition to media content, we also market and distribute branded leisure and novelty products oriented to the adult entertainment lifestyle and generate additional sales through the licensing of our *Private* trademark to third parties. In the fiscal year ended December 31, 2004, we had net sales of EUR 35.6 million and net income of EUR 0.2 million.

Our business was founded in 1965 and achieved initial success through our flagship publication, *Private*, the first full color, hard-core sex publication in the world. Today, we produce four X-rated periodical magazines: *Private*, *Pirate*, *Triple X* and *Private Sex*, as well as several special feature publications each year. As of December 31, 2004, we had compiled a digital archive of more than two million photographs and all of our 432 print publications. We expect to add two additional issues and hundreds of photographs each month to this archive. Approximately 300,000 copies of our print publications are distributed each month at an average retail price of approximately Euro 11.50. We distribute our publications through a network of approximately 250,000 points of sale in more than 40 countries, with strong market positions in Europe, Latin America, Australia and Canada. We believe that our distribution network has the potential to reach nearly 500,000 points of sale in our existing markets.

Since 1992, we have also acquired, processed and distributed adult motion picture entertainment. We acquire worldwide rights to motion pictures that meet our exacting standards for entertainment content and production value from independent directors, either under exclusive contracts or on a freelance basis. We then edit and process these motion pictures to ensure consistent image quality and prepare and customize them for distribution in several formats, including DVDs, videocassettes, broadcasting, which includes cable, satellite, broadband and hotel television programming, and the Internet. Our proprietary motion pictures and those produced by joint ventures in which we participate have received more than 100 industry awards since 1994, evidencing our success in setting high quality standards for our industry. As of December 31, 2004, our movie library contained close to 800 titles. We expect to add more than 100 titles in 2005.

We launched our first Internet website, [www.private.com](http://www.private.com), in 1997. We now own a number of sites directed at specific customer bases, including [www.privatespeed.com](http://www.privatespeed.com) and [www.private.com/shop](http://www.private.com/shop). We also generate incremental sales by licensing our trademarks and proprietary adult media content for use on the websites of other companies.

Since 1997, we have expanded our presence in emerging electronic markets for adult media content, such as the Internet, broadcasting and are currently in the process of launching products developed for use on hand-held devices including both mobile phones and Personal Digital Assistants. We believe that these technologies represent a substantial growth opportunity for us in the future.

In addition, we license our content to cable and satellite television operators as well as to hotels. We have also launched three television channels, *Private Gold*, *Private Blue* and *Private Fantasy*, that broadcast our content. Consumers pay for these products either on a pay-per-view basis or by subscription.

We operate in a highly regulated industry. This requires us to be socially aware and sensitive to government strictures, including laws and regulations designed to protect minors and to prohibit the distribution of obscene material. We take great care to comply with all applicable governmental laws and regulations in each jurisdiction where we conduct business. Moreover, we do not knowingly engage the services of any business or individual that does not adhere to the same standards. Since 1965, we have never been held to have violated any laws or regulations regarding obscenity or the protection of minors.

*Private*, *Private Media*, our *Private* logo, *Pirate*, *Triple-X*, *Triple-X Files*, *Private Black Label*, *Private XXX*, *Gaia*, *Private Sex*, *Private Life*, *Private Style*, [www.privatespeed.com](http://www.privatespeed.com), *Private Gold*, *Private Blue*, [www.private.com](http://www.private.com), [www.prvt.com](http://www.prvt.com), [www.privatelive.com](http://www.privatelive.com), [www.privatechannels.com](http://www.privatechannels.com), [www.sex.se](http://www.sex.se), [www.privatepda.com](http://www.privatepda.com), [www.privatenightclub.com](http://www.privatenightclub.com), [www.privateathome.com](http://www.privateathome.com), [www.privatestars.com](http://www.privatestars.com), [www.private.com/shop](http://www.private.com/shop), and [www.privategold.com](http://www.privategold.com) are some of our trademarks and trade names. Other marks used in this Report are the property of their owners, which includes us in some instances. Information on these websites is not a part of this Report.

## Market Opportunity

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Demand for adult entertainment products has grown substantially in recent years. We believe that the total worldwide adult entertainment market exceeds \$56 billion annually. Of this market, we believe that our target market, including print publications, videocassettes, DVDs, broadcasting and the Internet, comprises more than \$40 billion. We believe that two principal factors are driving growth in our industry: the relaxation of social and legal restrictions on distribution of adult entertainment products and new technologies that facilitate the distribution of high quality adult media content to consumers in the privacy of their own homes. As a result of liberalized regulation of adult entertainment products, we now distribute our products in physical form in more than 40 countries worldwide with an aggregate current population of 1.1 billion, as compared to six European countries with a population of 144 million when the current management took over in 1991. We expect this liberalizing trend to continue, which should expand our potential markets further in the future.

The proliferation of easy to use electronic equipment, such as VCRs and DVD players, which allow consumers to view high quality video products in the privacy of their home, has boosted demand for adult media content compatible with these formats. For example, DVD players have been adopted by consumers faster than any other electronic device ever, including the cell phone and personal computer.

Also, the evolution of the Internet as a channel of commerce and content distribution has stimulated additional demand for adult media content. In addition, advances in cable, satellite and hotel communications systems furnish another relatively new channel for the delivery of media content, including adult entertainment, into private homes, hotels and businesses.

More recently, the telecommunications industry has shown considerable interest in the use of adult content on hand-held devices such as mobile telephones, PDAs and other wireless activated devices. This provides an additional and exciting new source of potential revenues for us as one of the principal providers of adult content.

We expect these regulatory and technological developments to fuel increasing demand worldwide for adult media content, including demand for our products. In addition, we believe that market demand for content to fill new media outlets will lead mainstream media content providers to seek still more adult media content in the future. We expect that the high quality standards of the mainstream media, technological demands of multiple delivery formats and global marketing and distribution costs will increase capital requirements for providers of adult media content. While the adult entertainment industry is currently characterized by a large number of relatively small producers and distributors, we believe that the factors discussed above will cause smaller, thinly capitalized producers to seek partners or exit the adult entertainment business, leading to a consolidation of the adult entertainment industry.

### **Our Competitive Strengths**

We believe the following strengths, among others, will enable us to exploit the growing global market for adult entertainment:

#### *Extensive library of high quality adult media content*

We have an extensive library of high quality adult media content. As of December 31, 2004, our library included still photographs developed for more than 400 back-issues of magazines and close to 800 movies. We hold exclusive worldwide rights to this entire content archive. This has enabled us to enter into global distribution arrangements with a wide range of media content providers, including leading international companies. To facilitate electronic distribution of our products, we have converted our entire archive of print images into a digital format. We are currently digitizing our motion picture archive as well, and have now stored most of our existing motion pictures in digital form. We believe that this electronic archive constitutes one of the largest libraries of high quality adult media content in the world.

#### *Recognized brand name*

We believe that our target customers associate the *Private* brand name with high quality adult entertainment products and services. This name recognition attracts leading producers of adult media content, as well as distributors and prospective joint venture partners interested in working with Private Media Group. We believe that the strength of our brand name leads to more favorable economic terms than we could otherwise obtain in our processing and distribution contracts, and enables us to negotiate favorable revenue sharing arrangements and joint ventures from which we derive significant licensing fees and royalty income. We have entered into joint venture and co-branding agreements with leading



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participants in our industry and other related industries, including Playboy and Penthouse. We seek to strengthen awareness of our brand name by consistently featuring the *Private* label prominently in our product packaging, cross-promoting our own products, selectively sponsoring athletes and distributing under the *Private* label complementary or ancillary non-media products that are consistent with an adult entertainment lifestyle. We believe that these activities engender a loyal customer base which, in turn, enables us to grow even with relatively modest external advertising and marketing expenditures.

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*Established market position and distribution network*

We have a well-established worldwide distribution network which has been built up over the past 40 years, including some 250,000 points of sale in over 40 countries as of December 31, 2004. In many markets, we believe that our established presence hinders our competitors' ability to break into the market. In some cases, exclusive distribution agreements improve our market position further. This broad distribution network provides an effective channel to introduce new products and services and new formats for existing products and services. For example, we were able to utilize our existing video distribution channels to reach customers with our DVD-based products. In electronic media categories, we have entered into strategic alliances with a number of leading international service providers. In addition, we have assembled an internal team of Internet specialists to maintain and improve our Internet infrastructure and electronic products and services. We believe that our broad, multi-format distribution network affords our customers convenient access to high quality adult media content in the format of their choice.

*Flexible operating structure and access to substantial capital*

We acquire adult media content from third-party directors on a project basis. This approach gives us substantial flexibility in terms of production volume and delivery time, significantly reduces our fixed production overhead and largely eliminates the risk to us of cost overruns in production. Because of our multiple product and service formats and broad distribution network, we can afford to hire top directors in the industry, which we believe results in a higher quality product for our customers. Similarly, we reduce our fixed processing costs by outsourcing editing and duplication functions for most of our products, although we retain oversight of the overall production process for cost and quality control purposes. As a public company with access to the capital markets we believe that we will have sufficient financial resources to increase our production and grow through acquisitions without sacrificing our high quality standards. However, we cannot guarantee that funds will be available from the capital markets when needed.

*Experienced professional management*

Our management team has extensive experience in the production and distribution of adult media content and in general business administration. Berth H. Milton, our Chairman of the Board and Chief Executive Officer, has extensive knowledge of our industry and has successfully founded and developed other profitable businesses. Other members of our management team have broad expertise in content production, sales and marketing, technology and finance, and have contributed to our record of growth in our core business and in acquiring and integrating companies in related businesses.

**Our Strategy**

Our vision is to be the world's preferred content provider of adult entertainment to consumers anywhere, at any time and across all distribution platforms and devices. We have developed the strategies described below to increase sales and operating margins while maintaining the quality of our products and services and the integrity of our brand name.

*Develop strategic alliances and joint ventures with businesses outside of the adult entertainment industry to broaden our distribution channels.* We are entering into strategic alliances and joint ventures with leading media companies outside of the adult entertainment industry to distribute our adult media content for use on popular and newly developing media formats, including revenue sharing relationships with cable and satellite television operators and Internet service providers with significant market positions. We expect these initiatives to widen the scope of our distribution network, enabling us to reach new customers while supplying our partners and licensees with content.

*To be at the forefront of the adult entertainment industry in adapting new technology and distribution channels such as broadband distribution of our motion pictures.* By actively seeking out and utilizing advanced technologies to distribute our content such as, broadband, Internet ,cable and satellite television and wireless devices we expect to increase revenues with minimal incremental cost.

*Increase market share through strategic acquisitions.* The adult entertainment industry is currently fragmented and consolidating. We expect this trend to continue as small, privately owned companies seek to exit from the business. We plan to

expand our market presence and increase our market share by acquiring local distributors in the markets in which we compete. In addition, we may seek to acquire existing business enterprises in other related businesses opportunistically. To finance future acquisitions, we expect to use a combination of debt and equity. As one of the few companies in our industry with publicly listed common stock, we believe that we will have a significant advantage over most of our competitors in financing such consolidating acquisitions.

*To complete the digitalization of our entire movie and photograph library in order to prepare our library for distribution in new electronic media.* We have developed an extensive library of motion pictures and other pictorial content. Until recently, this library was archived on a master print, which would allow duplication in traditional media. New forms of electronic distribution provide us with an opportunity to use this content by distributing it through new forms of media, such as, Internet ,broadband and wireless devices. To facilitate electronic distribution of our products, we have converted our entire archive of print images into a digital format. We are currently digitizing our motion picture archive as well, and have now stored most of our existing motion pictures in digital form.

*Continue to increase and strengthen brand awareness.* We have developed strong brand awareness within each of our magazines and videos targeted markets. We own the worldwide rights to all of our content. We seek to strengthen awareness of our brand name by consistently featuring the *Private* label prominently in our product packaging, cross-promoting our own products, selectively sponsoring sports and distributing under the *Private* label complementary or ancillary non-media products that are consistent with an adult entertainment lifestyle.

## **Our Principal Products and Markets**

### *Magazine Publications*

We are the publisher of *Private*, an international X-rated magazine. *Private* was founded in 1965, and was the first full color, hardcore sex publication in the world. Today, we produce four X-rated magazines which are released bi-monthly: *Private*, *Pirate*, *Triple X* and *Private Sex*. In addition, special editions are released monthly and a book, *The Best of Private*, is released annually. We distribute these magazines through newsstands and other retail outlets.

### *Movie Productions*

Since 1992, we have acquired and distributed adult motion picture entertainment. These productions generally feature men and women in a variety of erotic and sexual situations, generally in both hardcore and softcore versions. We distribute these movies primarily on videocassettes, DVDs, through cable, satellite and hotel television programming and over the Internet. We maintain the ownership and copyrights of every movie we finance and produce.

We expect to produce approximately 80 X-rated and 36 R-rated movies in 2005, with distribution through a worldwide network that covers approximately 60,000 points of sale, including primarily video shops and adult book stores. We believe we have the potential to reach more than 155,000 points of sale. We have also worked together on creating labels with other recognized brands, including, in 2000 the introduction of a the *Private Penthouse Video* label in conjunction with Penthouse.

As of December 31, 2004, our movie library contained close to 800 movie titles. All titles are available on videocassette and DVD. These products are sold by distributors, primarily to retail stores and wholesalers worldwide. Many of our original motion picture programs have also

been re-edited and licensed to cable, satellite and hotel television operators.

*Internet*

We launched our first Internet website, *private.com*, in 1997. We now own a number of sites directed at specific customer bases, including *privatespeed.com* and *private.com/shop*. We also generate incremental sales by licensing our trademarks and proprietary adult media content for use on the websites of other companies.

The Internet team has combined Private Media Group's extensive media library with the most advanced technology to take advantage of the growth of Internet access and new distribution methods. Private has developed several key product offerings which include a subscription based service, broadband video on demand site, live sex chat service, adult personals, DVD rental service, and e-commerce shop.

In 2003, Private took the decision to outsource the Internet operations in order to lower operational expenses and increase its profit margin. This move will allow Private to focus solely on its strategic marketing and sales plan for the future growth of its catalogue of online products.

### **Other Markets**

In April 1996, we launched our Private Collection International, Inc. line of adult pleasure products. We also license the Private name in connection with various lines of clothes, nutritional supplements, and energy soft drinks. Channels of distribution for licensed products include conventional distribution channels, e-commerce and television home shopping.

### **History**

The parent company, Private Media Group, Inc., was originally incorporated in 1980 as a Utah corporation under the name Glacier Investment Company, Inc. for the purpose of acquiring or merging with an established company. In 1991, we changed our domicile to the State of Nevada. The parent company had no material business activity prior to its acquisition of Milcap Media Limited and Cine Craft Limited in June 1998.

On December 19, 1997 Private Media Group, Inc. entered into acquisition agreements with Milcap Media Limited and Cine Craft Limited to acquire all of their outstanding capital stock in exchange for 22,500,000 shares of Common Stock, 7,000,000 shares of the \$4.00 Series A Preferred Stock, and 2,625,000 common stock purchase warrants. Private Media Group, Inc. completed these acquisitions on June 12, 1998. In connection with these acquisitions, in December 1997 the parent company changed its corporate name to Private Media Group, Inc. and declared a one for five reverse split of its Common Stock.

On January 28, 2000, we acquired all of the outstanding shares of Extasy Video B.V. for total consideration of Euro 3.2 million. The consideration consisted of 208,464 shares of common stock and warrants to purchase 208,464 shares of common stock. The warrants were exercisable during the period January 28, 2001 to January 28, 2004 at an exercise price of \$9.63.

In May 2000, we authorized a three-for-one stock dividend on our common stock, which was distributed to holders of record of common stock on May 30, 2000.

As of January 1, 2001, we acquired Coldfair Holdings Ltd., a company incorporated and organized under the laws of the Republic of Cyprus, for a total consideration of Euro 1.5 million payable in 248,889 shares of common stock. Coldfair Holdings is a company engaged in the marketing and sale of adult entertainment products and services.

Effective April 1, 2001, we acquired the inventory and certain contracts of our U.S. distributor, Private USA, in exchange for Euro 1.0 million and the assumption of Private USA's obligations under some contracts.

On April 8, 2001, Peach Entertainment Distribution AB (Sweden), a subsidiary of Private Media Group, Inc., sold its interest in Private Circle, Inc., a company engaged in the design, production and marketing of trendy casual apparel, for an adjusted consideration of Euro 2.9 million as

of May 2001.

On December 31, 2002, we acquired all of the outstanding shares of Barbuda B.V., a company owning a building, for total consideration of Euro 10.0 million. The consideration consisted of cash and a note payable in the amount of Euro 6.6 million. The purpose of this transaction was to acquire this property as its European headquarters. Since the acquisition, the Company has been reevaluating its need for additional space and as of February 2005, the Company no longer owns this property, see Note 22 subsequent events in the consolidated financial statements.

On May 30, 2003 the Company acquired certain assets, including governmental film board approvals and distribution rights from its former Canadian distributor, Software Entertainment Ltd. In exchange for Euro 0.7 million.

On November 26, 2003 the Company entered into an Asset Purchase Agreement to acquire certain intangible assets from International Film Production and Distribution Limited, including certain rights and distribution and licensing agreements. The transaction closed on November 28, 2003. The consideration for the transaction was Euro 2.5 million.

## INDUSTRY OVERVIEW

The adult entertainment industry has evolved rapidly in recent years. In spite of often intense political campaigning, there has been a general trend towards wider acceptance of adult entertainment content among the general public and mainstream media channels. New technologies have lowered costs and changed the way in which adult content is produced, distributed and viewed. Lower costs, in particular, have lowered barriers to entry and increased competition in the adult entertainment industry. The trend toward wider acceptance of sexually-explicit material and ongoing technological developments has created a large and growing global market for adult content.

Historically, the adult entertainment industry has attracted a considerable level of government and regulatory attention primarily due to obscenity, which has led to limitations on either the explicitness of content or the availability. Traditionally, to view adult material, consumers were required to purchase movies in a public environment or to go to an adult movie theatre or peepshow.

Through a process of evolution rather than revolution the adult entertainment industry has become more acceptable over time, with a relaxation of the regulations and guidelines governing the industry. For example, in the United Kingdom, one of Europe's more restrictive countries with respect to adult entertainment, there has been a gradual relaxation of what is suitable for public viewing. The British Board of Film Classification, BBFC, has introduced the 'R18' category, allowing distribution of hardcore adult videos through licensed sex shops for the first time. The approval from the BBFC, and subsequent theatrical release of movies such as *The Idiots* and *Intimacy* have also broadened what is regarded as acceptable adult content.

New technologies have helped to legitimize the industry and increase the size of the market. During the 1980s, the introduction of adult movies on videocassette and through broadcasting on cable and satellite television increased acceptance of adult media content by confining it to the privacy of the consumer's home. More recently, the Internet has become a primary distribution platform for both suppliers and consumers of adult media content providing low-cost delivery and increased privacy. Although currently under-exploited, third generation mobile and handheld devices are likely to increase the market even further in the future, making adult media content viewing mobile.

The production and distribution of adult media content is very competitive. Hundreds of companies are now producing and distributing movies to wholesalers and retailers, as well as directly to consumers. The low cost of high quality video cameras and equipment has significantly lowered the barrier to entry for production of adult media content. According to Adult Video News, annual worldwide release of movie titles peaked at 25,000 and is currently at 11,000 of which 4000 in US alone vs. 500 in Hollywood. The bulk of this production is represented by low quality, amateur productions, made for only a few thousand dollars, as opposed to the larger, professionally produced movies with high production values. Around 20 major producers, such as Private Media Group, Vivid, Video Company of America and Metro, release most high budget adult videos and DVDs. See Business-Competition. In addition, because it costs as little as \$5,000 to establish an Internet presence, there is significant competition among distributors of adult media content over the Internet. The proliferation of websites distributing adult media content has itself fueled a greater and ongoing demand for the creation and licensing of new adult media content.

We believe that the global adult entertainment market exceeds \$56 billion annually. This covers memberships and subscriptions, escort services, magazines, sex clubs, telephone sex lines, cable and satellite pay-per-view programming, adult videos and toys and other related products and services. In 1998, Forrester Research estimated the U.S. adult entertainment market at \$10 billion annually. This compares to total U.S. cinema domestic box office receipts for mainstream motion pictures of over \$9.3 billion in 2004, indicating the size and importance of the adult market within the entertainment industry.



**Video and DVD Sales & Rental**

Bringing adult movies into the privacy of the home through the introduction of videocassettes along with cable and

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satellite services all but eliminated the adult theatre business. The introduction of the DVD and its rapid acceptance by the public is gradually shifting the balance of home viewing from videos to DVDs. DVDs offer better picture and sound quality than videos, worldwide compatibility and other add-ons. The DVD format also benefits suppliers and retailers. Several languages can be combined onto one DVD, so only the DVD cover needs to be changed for different territories. Also, back catalogue sales should initially increase as consumers look to replace their videocassette library with the new format.

DVD players have been adopted by consumers faster than any other electronic device, including the cell phone and personal computer. 37 million DVD players were sold in the United States in 2004 and the installed base of DVD players reached 70 million households. The Digital Entertainment Group (US) estimates that more than 80% of US households will have at least one DVD player by the end of 2005. Consumers spent a record \$21.2 billion renting and buying DVDs in 2004. DVD retail sales grew to \$15.5 billion in 2004, an increase of 33 percent over last year.

In 2000, total sales and rentals of adult videos and DVDs in the United States were approximately \$ 4.0 billion according to Adult Video News estimates, including sales through general interest retailers and dedicated adult stores. In 2001, PR Week reported that the Free Speech Coalition estimated that 20% of all U.S. households with either cable or satellite television or a VCR watch adult movies.

### **Broadcasting**

Cable and satellite television has brought adult media content into the privacy of the home. Technological developments, in particular the evolution of digital broadcasting, has not only increased the number of channels that can be delivered directly to the home via satellite (DTH or DBS) and cable, but has also led to the development of on-demand technologies such as Video On Demand (VOD) and Near Video On Demand (NVOD). The development of these services is benefiting the adult entertainment industry by providing a greater number of special interest channels allowing platform providers to target niche audience and also provide premium tier, Pay-Per-View (PPV) and subscription services.

General growth in the PPV market in the US and Western Europe is expected to result in part from cable system digitization upgrades utilizing fiber-optic, digital compression technologies or other bandwidth expansion methods that provide cable operators additional channel capacity. Cable operators have begun the shift from analog to digital technology in order to upgrade their cable systems and to respond to competition from DBS (Digital Broadcast Satellite) providers who offer programming in a 100% digital environment. When implemented, digital compression technology increases channel capacity, improves audio and video quality, provides fully secure scrambled signals, allows advanced set-top boxes for increased interactivity, and provides for integrated electronic programming guides ( EPG ). Cable operators are also using their upgraded plants to provide their digital customers with VOD (Video-On-Demand) services. For the most part, the appeal of VOD to adult video consumers is no different than it is to consumers of other genres: VOD gives subscribers the opportunity to purchase movies impulsively, and the ability to watch movies exactly when, where and as often as they want. However, the ability to pause, rewind and fast-forward a VOD program - essentially mimicking the functionality of a DVD - may hold even more appeal for adult video consumers.

Adult services will serve as an important driver to cable systems in their efforts to convert analogue subscribers to digital services. Private Media Group expects that all of its future cable launches will be on a digital platform.

### *United States*

According to the National Cable and Telecommunications Association ( NCTA ), Cable MSOs deliver service to approximately 72 million basic households in the United States as of September 2004 and approximately 24.3 million received digital cable service. The NCTA estimates that

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by 2006 there will be 48.6 million digital cable subscribers. NCTA reported in its 2004 Year-End Industry Overview that there were a total of 24 million DBS households as of September 2004 (DirecTV provides services to 13.5 million households and EchoStar Communications Corporation's DISH Network (DISH) provides services to 10.5 million households). During 2004, DirecTV and DISH gained 3 million net new subscribers. Kagan estimates that DBS will grow to 26 million subscribers by the year 2006. Based on the above sources, we estimate the number of digital cable and satellite subscribers for 2006 to be approximately 75 million households, a growth of 54%.

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Turning to the adult entertainment segment, content distribution has evolved over the past twenty-five years from home video platforms (video cassette) to cable television systems and DBS providers via PPV, and more recently to VOD. In the early 1980 s, cable television operators began offering subscription and PPV adult programming from network providers such as Playboy Enterprises, Inc. Kagan estimates that adult PPV revenue generated by cable systems and DBS providers in 2002 was \$609 million, representing an increase of 15% from revenues of \$529 million generated by the category in 2001. Kagan projects revenues from the adult category to grow to \$917 million by the year 2006.

VOD availability is becoming increasingly widespread and is now on its way to becoming a mainstream content-delivery platform. Kagan research (*Video-On-Demand 2005: A Strategic and Economic Analysis*) indicates that nearly 20 mil. homes had VOD by the end of 2004, a number that is on track to nearly double to 39.2 mil. by the end of 2008. Kagan estimate that VOD revenue and cable VOD revenue from movies and TV series more than doubled from \$157 mil. in 2003 to \$318 mil. in 2004. By 2006, VOD revenue will comprise the majority of the PPV/VOD revenue sector. In 2007, Kagan estimates that cable VOD revenue (from all sources, including adult and SVOD) will cross the \$2 billion mark on its way to \$6 billion in 2013.

### *Europe*

According to a March 2005 report from Strategy Analytics, Inc. (*Digital TV in Western Europe: Market Outlook & Analysis*), approximately 25 million households received digital satellite service and 7.6 million households received digital cable service. The report estimates that by 2010 there will be 49.1 million digital satellite subscribers and 28.9 million digital cable subscribers. Based on the report, the total estimated number of digital cable and satellite subscribers in Europe for 2010 is approximately 78 million households, a growth of 139%.

### **Internet**

The adult entertainment industry was among the first to commercially exploit the Internet as a distribution channel and is, together with gambling and online games, among the few industries which generate profit on the Internet. The Internet offers relative privacy for users, a seemingly endless selection of adult media content and can provide immediate delivery.

Pay sites contain most of the adult media content on the Internet, but free sites are also common and are primarily supported by advertising from pay sites. Free sites get a few cents for each viewer who clicks on an advertising banner. The banner then transports these viewers to a site that tries to entice the user into paying for content using their credit cards. However, the bulk of revenues comes from pay sites.

As of March 2005 the number of Internet users in the European Union and United States was 206 million and 201 million, respectively, which represent a growth over the past five years of 121% and 111%, respectively. The total number of Internet users in the world as of March 2005 was 889 million. Based on information from RHK Inc. the Company estimates global adult entertainment Internet revenues to have grown from nothing to more than US\$3 billion in 2004, in less than ten years. Furthermore, RHK Inc. estimates global adult entertainment Internet revenues, exclusive of revenues from online Video-on-Demand (VOD), to grow to more than US\$5 billion by 2007.

The use of the Internet for viewing adult media content is expected to increase significantly. Broadband Internet access is transforming the way that millions of consumers use and pay for news, entertainment, music and other media. Consumers will use their Internet high-speed, always-on broadband connections to access and pay for entertainment content, including adult content, and services. According to analysis and forecasts, global broadband subscriptions were estimated to have grown by 50% to 150 million<sup>1</sup> during 2004 and by 2009 the number of broadband subscribers is expected to grow to more than 287 million<sup>2</sup>. Although VOD online is still in its absolute infancy and VOD via cable is the default delivery pipe at the moment, it is interesting to note that forecasts<sup>2</sup> see global VOD online consumer spend going from US\$ 70 million in 2003

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to US\$ 2.34 billion in 2007, representing a CAGR of 142%.

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- 1 Point Topic Ltd's (UK) World broadband market analysis of 16 December 2004.
  - 2 Forecasted by RHK, Inc (USA)

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The increased availability of adult media content on the Internet has attracted considerable attention. Concerns have arisen with respect to child protection and the distribution of illegal material. In response to the issue of child protection, a number of software packages have become available that control the content that can be accessed from a personal computer. Products such as Surfcontrol, NetNanny, Websense and others can be employed to filter sites for inappropriate material, blocking access for unauthorized users.

#### **In-Room Entertainment**

The provision of in-room entertainment services by major hotel chains throughout the world also serves as a distribution channel for adult media content. In addition to a selection of mainstream movies, hotel guests often will have a choice of softcore, and frequently hardcore, adult videos available on a pay-per-view basis. In the United States, these services are provided by companies such as On Command and Lodgenet, which supply approximately 750,000 and 810,000 hotel rooms, respectively. Estimates by analysts cited to by the Los Angeles Times in 2001 suggest that adult movies generate approximately half of total hotel pay-per-view revenue in the United States, approximately \$ 250 million annually. Outside of the United States, excluding more restrictive countries such as the United Kingdom, hotel guests also have access to hardcore material on a pay-per-view basis.

**MAGAZINE PUBLICATIONS**

Our publishing operations include the publication of the adult magazines identified in the table below, special editions consisting of previously published material and occasional newsstand specials, calendars and paperback books. All of these magazines, together with local editions, are printed under various trade names and are distributed in over 40 countries. We publish several customized editions of our four principal magazines. Each edition contains the same editorial material but provides locally targeted content reflecting local governmental regulation regarding explicit adult publications. Most of our magazines feature pictures of men and women engaged in erotic and sexually explicit situations. We distribute approximately 200,000 copies of our print publications per month at an average retail price of approximately (Euro) 11.50. Our most popular publications are *Private*, *Pirate*, *Private Sex* and *Triple X*.

**MAGAZINE LIBRARY**

| <u>Title</u>            | <u>As of December 31,</u> |                     |
|-------------------------|---------------------------|---------------------|
|                         | <u>2004</u>               | <u>2003</u>         |
|                         | <u>N° of Issues</u>       | <u>N° of Issues</u> |
| Private                 | 186                       | 180                 |
| Pirate                  | 88                        | 82                  |
| Triple-X                | 62                        | 56                  |
| Private Sex             | 53                        | 47                  |
| Private Man             | 4                         | 4                   |
| Mansize                 | 4                         | 4                   |
| Special Editions        | 19                        | 14                  |
| Best of Private (Book)  | 15                        | 14                  |
| Special Editions (Book) | 1                         | 1                   |
| <b>Total</b>            | <b>432</b>                | <b>402</b>          |

| <u>Title</u>           | <u>Quantities of Magazines</u> |                  |
|------------------------|--------------------------------|------------------|
|                        | <u>Produced</u>                |                  |
|                        | <u>(Printed, not sold)</u>     |                  |
|                        | <u>2004</u>                    | <u>2003</u>      |
| Private                | 512,761                        | 530,660          |
| Pirate                 | 390,531                        | 380,905          |
| Triple-X               | 340,901                        | 365,465          |
| Private Sex            | 298,221                        | 318,825          |
| Private Man            |                                | 80,100           |
| Mansize                |                                | 154,125          |
| Special Editions       | 317,451                        | 309,190          |
| Best of Private (Book) | 42,420                         |                  |
| <b>Total</b>           | <b>1,902,285</b>               | <b>2,139,270</b> |

Our publications offer a variety of features and have gained a loyal customer base. We believe we have earned a reputation for excellence by providing a high standard of quality to the adult entertainment industry, while we maintain circulation leadership as the leading hardcore magazine publisher. All of our publications have long been known for their graphic excellence and features, and publish the work of top artists and photographers in the field. They are also renowned for their pictorials of beautiful people. Our magazines command some of the highest prices in the industry.

All of our publications are printed by independent third parties. We have a longstanding relationship with several printers in Spain We believe that generally there is an adequate supply of printing services available to us at competitive prices, should the need for an alternative printer arise. All of our production and printing activities are coordinated through our operating facility maintained by our wholly owned subsidiary, Milcap Media Group.



## **Circulation**

Our magazines have historically generated most of their revenues from firm sales distribution. However, now distributors with rights to return represent approximately 50% of our production. Single copy retail sales normally occur in adult book stores and similar establishments. Newsstand retail sales are permitted in most European countries, including France, Italy, Spain, Germany, Denmark, Sweden, Finland the Benelux countries and Portugal.

Our magazines are distributed to newsstands and other public retail outlets through a network of national distributors, who maintain a local network of several wholesale distributors and licensors. We have entered into national distribution agreements covering over 35 countries and generally deal with a magazine distributor for local distribution of our publications. We ship copies of each issue in bulk to our wholesalers, who distribute on to local retailers.

Independent distributors who distribute our magazines do so under individual distribution agreements. These agreements are normally subject to automatic yearly extensions unless either party terminates the arrangement.

For the past few years, we have sought to expand the use of our magazines' content and other assets across different media formats. Our primary focus in recent years has been the re-editing and digitizing of every Private magazine for use on our websites. This content was initially available on our websites in May 1998, and we completed the digitization of our still photo archive in 2000.

## **Production, Distribution and Fulfillment**

Four independent printers in Spain currently print most of our magazines, books, brochures and video and DVD covers. Printing costs vary based upon the price of component raw materials. The principal raw materials necessary for publication of our magazines are coated and uncoated paper. Paper prices are affected by a variety of factors, including demand, capacity, pulp supply and by general economic conditions. Our printers have a number of paper supply arrangements and we believe that those arrangements provide an adequate supply of paper for our needs. In any event, we believe that alternative sources are available at competitive prices. With respect to color separation, pre-press and related services, we currently use our own scanning facilities and have the support of two independent suppliers for color separations. We are also using the latest technologies in this field, such as digital imposition and computer-to-plate process technology, or CTP. CTP eliminates the need for the production of film/color separations during the pre-printing process, saving time and money while improving quality. In simple terms, CTP allows printers to receive computer disks containing electronic files (both text and graphics) and output those files directly to a plate. The result is a top quality image which takes minutes instead of hours to produce.

We print and ship all of our proprietary magazines from Barcelona, Spain. We determine the amount of printed publications bi-monthly with input from each of our national distributors. Most of our products are packaged and delivered directly by the printer or supplier, while Milcap Media Group provides warehousing, customer service and payment processing.

Our full-time editorial and post-production staff consists of an editor-in-chief, six executive editors and approximately seven editors, associate editors and assistant editors who oversee the quality and consistency of the artwork and editorial copy and manage the production schedule of each issue. The production of each issue requires the editors to coordinate the activities of a writer, a pencil artist, an inker, a colorist and a printer over a two-month period. The majority of this work is performed on our premises in Barcelona, Spain. We have entered into agreements with some photographers and writers under which such people have agreed to provide their services to us on an exclusive basis, generally for a period of one to three years.

**MOVIE PRODUCTIONS**

In 1992, we began releasing movies under the *Private* label. Our adult movies are in genres similar to our magazines and books under the titles listed in the table below. Normally, we spend on average between \$ 50,000 and \$ 125,000 per movie. This amount excludes the computation of the post-production, master production, duplication and distribution costs. Generally, Milcap Media Group creates and designs all artwork for promotional items and packaging and contracts for printing services. Since 1997,

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independent laboratories have duplicated all of our videocassettes for us. Similarly, since 1999 all DVDs have been duplicated by independent laboratories as well. A number of our labels, including *Private Gold*, *Private Black Label*, *Private Movies*, *The Private Life of* and *Private Reality Video* are released on a monthly basis while others are released on a bimonthly or less frequent basis. As of December 31, 2004, our movie library contained close to 800 movie titles. By the end of 2005, we expect the total to increase to more than 900 titles. All titles are available on both videocassette and DVD. We sell approximately 270,000 DVDs per month. We continue to expand our video operations in international markets and presently market our video products in over 40 countries.

**MOVIE LIBRARY**

| <b>Label</b>           | <b>As of December 31,</b> |                     |
|------------------------|---------------------------|---------------------|
|                        | <b>2004</b>               | <b>2003</b>         |
|                        | <b>N° of Titles</b>       | <b>N° of Titles</b> |
| Amanda s Private Diary | 5                         | 5                   |
| Best - End of Year     | 9                         | 9                   |
| Gaia                   | 6                         | 6                   |
| H**** Housewives       | 9                         | 9                   |
| Mansize                | 2                         | 2                   |
| Peepshow Special       | 12                        | 12                  |
| Pirate Fetish Machine  | 16                        | 13                  |
| Pirate Video           | 12                        | 12                  |
| Pirate Video de Luxe   | 16                        | 16                  |
| Private Black Label    | 35                        | 33                  |
| Private Castings       | 50                        | 50                  |
| Private Fantasies      | 5                         | 5                   |
| Private Films          | 28                        | 28                  |
| Private Gold           | 68                        | 62                  |
| Private Interactive    | 1                         | 1                   |
| Private Lust Treasures | 9                         | 9                   |
| Private Man            | 6                         | 6                   |
| Private Movies         | 12                        | 10                  |
| Private Reality Video  | 26                        | 22                  |
| Private Sports         | 6                         | 5                   |
| Private Stories        | 27                        | 27                  |
| Private Superf****ers  | 12                        | 12                  |
| Private Tropical       | 14                        | 9                   |
| Private Video Magazine | 26                        | 26                  |
| Private X-Treme        | 16                        | 10                  |
| Private XXX            | 16                        | 15                  |

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|                          |                          |                          |
|--------------------------|--------------------------|--------------------------|
| Private-Ninn             | 4                        | 4                        |
| Private-Penthouse Movies | 12                       | 12                       |
| The Best by Private      | 63                       | 52                       |
| The Matador Series       | 15                       | 15                       |
| The Private Life of      | 22                       | 17                       |
| The Private Story of     | 3                        |                          |
| Triple X Files           | 12                       | 12                       |
| Triple X Video           | 32                       | 32                       |
| Virtualia                | 6                        | 6                        |
| When Pornstars Play      | 2                        | 1                        |
| Erotica (soft titles)    | 164                      | 137                      |
|                          | <u>          </u>        | <u>          </u>        |
| <b>Total</b>             | <b>779</b>               | <b>702</b>               |
|                          | <b><u>          </u></b> | <b><u>          </u></b> |

We finance all of our adult movies, and we contract with movie producers on a flat fee basis. We have entered into agreements with some movie directors under which they have agreed to provide their services to us on an exclusive basis, generally for a period of one to three years. All producers generally assume production costs and obligations, including among other things, the delivery of rights and model releases.

### **Video Duplication/Production Techniques**

Masters are customized and duplicated by our subsidiary Peach Entertainment Distribution and from there they are sent to different distributors and DVD duplication centers. Some distributors receive a master directly and do their own duplication. All artwork to print the video covers is created at Milcap Media Group. Most countries receive their own pre-printed covers from Spain and some countries print their own covers from artwork provided in digital format.

### **Distribution**

We distribute our productions worldwide via masters, videocassettes and DVD s that are sold or rented in video stores, sex shops, newsstands and other retail outlets, and where permitted, through direct mail. Our website has contributed to increasing video and DVD sales, and we expect this new medium to become a significant distribution channel in the future.

We have entered into distribution agreements in over 40 countries. Under these distribution agreements, and according to the territory, one of our subsidiaries, Peach Entertainment Distribution or Milcap Media Group, agrees to provide a specific minimum number of new titles each month during the term of the agreement, and a licensee normally serves as the exclusive distributor throughout its own country or language territory. Under the various distribution agreements, licensees are normally required to purchase a minimum number of units for each monthly period during the term of the agreement. In countries such as Germany, we have expanded our relationships with our national distributor by entering into exclusive multi-year, multi-product output agreements. In countries such as the United States, the Benelux countries, France and Spain, we have established local subsidiaries for the purpose of owning or controlling local distribution. In general, however, we believe that national distribution agreements enable us to have an ongoing branded presence in international markets and to generate higher and more consistent revenues, than we could achieve selling directly to retailers.

We have licensed many of our original programs to cable television networks and adult pay-per-view television channels. These licenses generally grant the television channel owner a specific right of transmission and we retain the intellectual property rights of every production. We edit many of our new feature movie releases into several versions depending on the media through which they are to be distributed. In general, versions edited for cable, satellite and hotel television programming are less sexually explicit than the versions edited for home video distribution.

### **The DVD Market**

Distribution of DVDs represents one of our fastest growing markets. We believe we set a high standard for DVDs in the adult entertainment industry, with each DVD released by us possessing five language options as well as four other subtitled languages. We believe that our multi-language DVD format provides a significant competitive advantage for us because it attracts consumers worldwide and expands our international marketing and sales potential. This global format allows us to reduce our overall unit production costs and increase profit margins. Currently, the majority of DVDs released by our competitors in the United States and worldwide are produced in only one language since they either license titles country-by-country or manufacture each title in separate languages, thus losing out on economies of scale, which further drives down our competitors' profit margins.

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Currently, mainstream movie titles are released on DVD in six Regional Codes or Zones. This is required primarily because producers often do not control the worldwide rights to their titles. Our DVDs are playable in any region, in every country in the world, because we own and control the global rights to everything we have produced. Our DVDs are also Internet Activated, which means that when a consumer plays the DVD in a personal computer, that person also gets a direct link to our websites, where they can view our content by purchasing a subscription or visit our extensive on-line shopping area. We also sometimes add `extras` to our DVDs, including alternative endings to movies, interviews with the stars, biographical data on the actors, their roles in other in-house productions and publications.

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## Broadcasting Satellite & Cable

Since launching the broadcasting business in 2000, we have rapidly expanded in Eastern and Western Europe, Latin America and the United States. The broadcasting business was launched through an exclusive joint venture agreement with International Film Productions and Distributions, Ltd., ( IFPD ). IFPD is a European-based television broadcasting company associated with major content providers that specializes in the distribution of adult cable and satellite television channels. Under the joint venture agreement, IFPD was responsible for promoting and broadcasting PRVT's two adult channels, namely Private Gold (hardcore) and Private Blue (soft core), globally. The agreement provided PRVT with 65% of the gross profits generated from the broadcast of, and advertising on, these channels. Recently, the joint venture was dissolved and PRVT acquired the channel names Private Gold and Private Blue and is currently licensing them to affiliated companies of IFPD under a two-year agreement with a minimum guarantee. The license is worldwide excluding North and Latin America. In August 2003, we announced the launch of The Private Fantasy Channel.

### *The Private Blue & Private Gold Channels*

The Private Blue channel was launched in United Kingdom, under an exclusive joint venture agreement with Zone Vision Enterprises ( ZV ), a UK-based television company, and IFPD. As mentioned above, PRVT acquired the channel name Private Blue, and is currently licensing it to an affiliate company of IFPD for a fixed fee. Private Blue is available through the analog and digital satellite platforms of BSkyB and the Telewest cable network in the United Kingdom. Private Blue is also available in Turkey on the DigiTurk platform, and in Hungary and Slovakia on the UPC networks, and in the Netherlands with MediaKabel. Private Blue also has an international satellite feed on the SIRIUS 2 satellite, which gives it access to subscribers in all territories of Europe from 23.00 to 05.00 Central European time every day of the year.

The Private Gold television channel is broadcasted under Dutch license, and is available on the HCA Cable Association platform in Hungary, Slovakia and the Czech Republic, and on the UPC Direct satellite network. Private Gold has an international satellite feed on the AMOS 1 satellite, which gives it access to subscribers in all territories in Europe from 24.00 to 04.00 Central European time, every day of the year. Private Gold has a second satellite feed, on the ASTRA satellite with Cryptoworks Encryption. ASTRA is one of the leading satellite systems for direct-to-home transmission of television, radio and multimedia services in Europe, and currently has a fleet of nine satellites and transmits to 22 European countries. The Private Gold channel were launched in Western Europe in 2001, under a joint venture agreement with Canal Digital AS and IFPD. Canal Digital distributes Private Gold in Sweden, Denmark and Finland. Canal Digital is jointly owned by Canal+ and Telenor. In 2001, Canal Digital had more than 1.1 million card customers and over 700,000 subscribers in the Nordic region.

Both Private Gold and Private Blue television channels were launched in Latin America in 2001, via the joint venture agreement with IFPD, and under a distribution agreement with Pramer S.C.A. Presently, PRVT holds this agreement directly with Pramer. Pramer is one of the largest companies in Latin America responsible for producing, distributing and commercializing content for cable and satellite television. Both channels are transmitted on the NSS 806 satellite that covers the entire South American continent, and reaches 15 million satellite and cable subscribers in the region.

In June 2004, we entered into an agreement with Comcast Cable Communications, LLC, (Comcast), to make the Spanish language version of the pay per view channel Private Blue available to Spanish speaking cable TV customers in the U.S. Comcast services over 21 million US cable TV customers.

In October 2004, the Private Gold television channel was launched on the Noos platform in France. Noos is the largest cable television operator in France, Following an agreement with Private Blue and Gold Broadcasting BV, a Private Media Group Licensee, the Private Gold channel will be offered to Noos subscribers on a monthly subscription basis. The adult entertainment channel will be broadcast from midnight to 5 am seven days a week. Noos distributes to more than 1.7 million subscribers.

We believe that currently the *Private Gold* and *Private Blue* channels are available in over 40 territories to approximately 43 million potential viewers worldwide.



*The Private Fantasy Channel*

Private Fantasy Channel (PFC) is distributed as a Pay-Per-View (PPV) service using PPV technology which enables cable television operators or satellite providers to sell a block of programming, an individual movie, or an event for a set fee. PPV technology also permits cable television operators or satellite providers to sell our programming on a monthly, quarterly, semiannual and annual basis. PPV programming is delivered through any number of delivery methods, including: (a) cable television; (b) DTH (Direct To Home) to households with large satellite dishes receiving a low-power analog or digital signal (C-Band) or DBS (Digital Broadcast Satellite services such as those currently offered in the US by EchoStar Communications Corporation and DirecTV); (c) wireless cable systems; and (d) low speed (dial-up) or broadband Internet connections (i.e., streaming video). The Company is not limited to use any of the described methods of delivery in the future. In order to produce and deliver the channel we have agreements with several subcontractors. The management, programming and output of an encrypted signal is currently carried out in Europe. The encrypted signal is thereafter delivered via cable or satellite to the distributor.

In August 2003, we entered into an agreement with EchoStar Satellite LLC to make the pay per view channel available to more than 9 million DISH Network satellite TV customers in the U.S. On February 4, 2004, the Private Fantasy channel became available to DISH Network satellite TV customers. During 2004 the DISH Network increased its subscription base to 10.5 million U.S. households.

*Broadcasting Growth Potential*

General growth in the PPV market in the US and Western Europe is expected to result in part from cable system digitization upgrades utilizing fiber-optic, digital compression technologies or other bandwidth expansion methods that provide cable operators additional channel capacity. Cable operators have begun the shift from analog to digital technology in order to upgrade their cable systems and to respond to competition from DBS (Digital Broadcast Satellite) providers who offer programming in a 100% digital environment. When implemented, digital compression technology increases channel capacity, improves audio and video quality, provides fully secure scrambled signals, allows advanced set-top boxes for increased interactivity, and provides for integrated electronic programming guides ( EPG ). Cable operators are also using their upgraded plants to provide their digital customers with VOD (Video-On-Demand) services. For the most part, the appeal of VOD to adult video consumers is no different than it is to consumers of other genres: VOD gives subscribers the opportunity to purchase movies impulsively, and the ability to watch movies exactly when, where and as often as they want. However, the ability to pause, rewind and fast-forward a VOD program essentially mimicking the functionality of a DVD may hold even more appeal for adult video consumers. We believe adult services will serve as an important driver to cable systems in their efforts to convert analogue subscribers to digital services. We expect all of our future launches to be on a digital platform.

*Digital Cable and Satellite Development in the United States*

According to the National Cable and Telecommunications Association ( NCTA ), Cable MSOs (multiple-systems-operators) deliver service to approximately 72 million basic households in the United States as of September 2004 and approximately 24.3 million received digital cable service. The NCTA estimates that by 2006 there will be 48.6 million digital cable subscribers. NCTA reported in its 2004 Year-End Industry Overview that there were a total of 24 million DBS households as of September 2004 (DirecTV provides services to 13.5 million households and EchoStar Communications Corporation's DISH Network ( DISH ) provides services to 10.5 million households). During 2004, DirecTV and DISH gained 3 million net new subscribers. Kagan estimates that DBS will grow to 26 million subscribers by the year 2006. Based on the above sources, the total estimated number of digital cable and satellite subscribers for 2006 is approximately 75 million households, a growth of 54%.

*Video-On-Demand Development in the United States*

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VOD availability via cable is becoming increasingly widespread and is now on its way to becoming a mainstream content-delivery platform. Kagan research (*Video-On-Demand 2005: A Strategic and Economic Analysis*) indicates that nearly 20 mil. homes had VOD by the end of 2004, a number that is on track to nearly double to 39.2 mil. by the end of 2008. Kagan estimate that VOD revenue and cable VOD revenue from movies and TV series more than doubled from \$157 mil. in 2003 to \$318 mil. in 2004. By 2006, VOD revenue will comprise the majority of the PPV/VOD revenue sector. In 2007, Kagan estimates that cable VOD revenue (from all sources, including adult and SVOD) will cross the \$2 billion mark on its way to \$6 billion in 2013.

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### *Digital Cable and Satellite Development in Europe*

According to a March 2005 report from Strategy Analytics, Inc. (*Digital TV in Western Europe: Market Outlook & Analysis*), approximately 25 million households received digital satellite service and 7.6 million households received digital cable service. The report estimates that by 2010 there will be 49.1 million digital satellite subscribers and 28.9 million digital cable subscribers. Based on the report, the total estimated number of digital cable and satellite subscribers in Europe for 2010 is approximately 78 million households, a growth of 139%.

### **Broadcasting    Broadband**

Internet access is transforming the way that millions of consumers use and pay for news, entertainment, music and other media. Consumers are increasingly using their Internet high-speed, always-on broadband connections to access and pay for entertainment content, including adult content, and services. The Company is engaged in VOD broadcasting of its content over broadband via its proprietary websites and third party revenue share or licensing arrangements with VOD online aggregators and in 2004 the Company has experienced growth in this area.

According to analysis and forecasts, global broadband subscriptions were estimated to have grown by 50% to 150 million<sup>3</sup> during 2004 and by 2009 the number of broadband subscribers is expected to grow to more than 287 million<sup>4</sup>. Although VOD (Video on Demand) online is still in its absolute infancy and VOD via cable is the default delivery pipe at the moment, it is interesting to note that forecasts<sup>5</sup> see global VOD online consumer spend going from US\$ 70 million in 2003 to US\$ 2.34 billion in 2007, representing a CAGR (compound annual growth rate) of 142%.

### **Mobile Entertainment**

The Company is engaged in licensing its content and trademarks for mobile entertainment services. Currently this is done together with third parties who manipulate the content to make it suitable for distribution via mobile telephone operators to consumers. The Company's content is currently distributed via more than twenty national and multinational mobile telephone operators, and available in thirteen countries in Europe and Asia. The market currently consist of SMS, games and rich-media mobile downloads including; MMS, wallpapers, screensavers, video clips and videostreaming. Juniper Research estimates in its white paper *Adult to Mobile: Personal Services - Second Edition (February 2005)* that the global mobile adult content market will more than triple over the next five years, to nearly US\$2.1 billion by 2009.

### **In-Room Entertainment**

In October 2001 we entered into an agreement with Quadriga Worldwide, a leading European hotel entertainment and service provider, to make a wide selection of our movies available to guests in hotels serviced. Quadriga presently provides hotels in 30 countries with interactive entertainment and information services, covering 489,000 hotel rooms worldwide, with an annual audience of 100 million hotel guests. Key customers of Quadriga include leading hotel chains such as: Hilton, Marriott, Intercontinental, Le Meridien, Sofitel, Novotel, Mercure, Sol Melia and Thistle Hotels. In addition to Quadriga we have agreements with other hotel entertainment and service providers.

### **Broadcasting - Licensing**

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Private licenses the right to use its content to broadcasters for a limited time period on a per title and territory basis.

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- 3 Point Topic Ltd's (UK) World broadband market analysis of 16 December 2004.
  - 4 Forecasted by RHK, Inc (USA)
  - 5 Forecasted by RHK, Inc (USA)

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## INTERNET SERVICES

### Overview

Private Media Group's Internet team has combined its extensive media library with the most advanced technology to take advantage of the growth of Internet access and new distribution methods. Private has developed several key product offerings which include a subscription based service, broadband video on demand sites, live sex chat service, adult personals, DVD rental service, and e-commerce shop.

In 2003, Private took the decision to outsource the Internet operations in order to lower operational expenses and increase its profit margin. This move will allow Private to focus solely on its strategic marketing and sales plan for the future growth of its catalogue of online products.

### Key Products

*Private.com* ([www.private.com](http://www.private.com)) is the flagship site of Private Media Group's Internet offerings. The site offers access to high-quality adult content that includes over 70 full-length Private movies, photosets, sex-stories, a full library of Private magazines in image and downloadable PDF format, and third-party content. In addition, subscribers receive access to live webcam, live sex shows performed by couples, and a adult personals. Premium content is also accessible through Private.com in a variety of different formats. The ability to purchase full-length DVD quality movies on a rental basis is available through Divx technology at a discounted rate for subscribers. One on one live chat is also accessible to members at a discounted rate. The site offers various payment methods to suit the ever-changing demands of the end-users that include credit card subscriptions, pay-per-minute diallers, debit cards, online cheques, and SMS payments. All payments are made through a secured system and verification process that are in-line with the International and local e-commerce regulations. Our websites are currently generating traffic of approximately 1.5 million visits per month and more than 25 million pages are viewed per month. The Private.com website features the most advance technology to enable Private to protect its digital assets from theft and file sharing through usage of Microsoft digital rights encryption and protection. Private also goes the extra step to protect its library by digitally watermarking all images. Private.com acquires customers primarily through advertising in DVDs, videos, magazines and broadcast programming with minimal incremental cost. It also acquires new customers by establishing partnerships with leading international portals. In 2004, Private.com sold over 72,000 memberships and had approx.10,000 active members at any time.

*Private Shop* ([www.private.com/shop](http://www.private.com/shop)) offers a complete catalogue of Private products including Private DVDs and video titles, magazines, and adult toys available for purchase online. The site provides free pictures and free video clips to those who register with the shop. The site is built upon an extensive technical platform that utilizes real-time, secure transaction processing. In addition, the Shop is available in multi-lingual format and currency options based on a users locale. In 2004, the average order value was US\$100.

*PrivateSpeed* ([www.privatespeed.com](http://www.privatespeed.com)) is the broadband video on demand channel for Private. PrivateSpeed features an extensive collection of Private movies in both streaming and downloadable formats for rental online. Users of PrivateSpeed are offered a free membership to view trailers of movies and other premium content through a simple sign up process that collects their email address. In 2003, Private licensed the technology of Go Internet for the backend platform for PrivateSpeed. The complete site was redone to include a new design that features a simplified user interface, new streaming, advance account management, and searchable information. Through the partnership with Go Internet, Private has been able to significantly lower costs on it streaming and hosting solution. Since it's relaunch in June of 2003, PrivateSpeed growth has been significant with 58% growth in 2004 compared to 2003.

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*Private At Home* ([www.privateathome.com](http://www.privateathome.com)) is an online DVD rental service that launched in May 2003 in the UK. The site allows users to subscribe to a service of renting either 2-3 Private DVDs at any one time, which are then shipped directly to the privacy of their homes. The site offers payment methods especially geared for the UK market including all major credit and debit cards and billing is in local currency. All payments are processed through a recognized and established third party processor.

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*Licensing.* Private licenses the right to use their trademarks and their library of photographs and movies to third parties.

## **TRADEMARK LICENSING**

### **Private Collection**

Together with several licensees, we have developed a program to market and distribute high quality branded merchandise over our websites and the websites of those licensees. Our licensed product lines include clothing, novelties, accessories, fragrances, leather goods, eyewear, nutritional supplements, aphrodisiacs and condoms. These products have been marketed principally through mail-order and retail outlets, including department and specialty stores.

### **Private Centers**

The carefully developed Private Center concept for retailers has taken the adult industry to new levels. Through its Licensing Division, Private is offering a unique opportunity for adult specialist and other retailers to buy into the Private brand through licensing agreements to either upgrade their existing retail points of sale or develop new outlets in order to satisfy the increasingly sophisticated and broad demands of adult consumers. Licensees are required to follow guidelines set by Private and the product range on offer will span from traditional adult products such as sex toys, magazines and DVDs to lifestyle Private-branded products, ranging from streetwear to lingerie. The Private brand, valued by consumers and retailers alike thanks to its enduring focus on quality and innovation, thereby continues to meet new consumer demands, in both niche markets and broader sectors, such as the ever increasing number of female customers.

### **Private Energy**

In 2001 we signed a five-year worldwide distribution agreement with Travel Retail Sales Limited to sell an energy drink called Private Energy. Under this agreement the licensee is responsible for all production, marketing, sales and distribution of the product and guarantees incremental minimum sales each year on which royalties are payable to us.

## **PROPRIETARY RIGHTS**

### **General**

We believe that our branded magazine titles and logos are valuable assets and are vital to the success and future growth of our businesses. We have filed trademark registration applications with respect to most of our trade names and logos. We believe that the name recognition and image that we have developed in each of our markets significantly enhance customer response to our sales promotions. We intend to aggressively defend our trademarks throughout the world, and we constantly monitor the marketplace for counterfeit products. We initiate legal proceedings from time to time to prevent unauthorized use of our trademarks.

### **Piracy Problems**

According to figures from the Motion Picture Association of America, annual losses from video piracy are an estimated \$ 250 million a year in the United States alone, and close to \$ 3.0 billion a year worldwide. Adult Video News estimated that approximately 20% of the U.S. video market (both rental and sales in 2000) was attributable to adult videos.

Piracy involving adult entertainment products and services is most prevalent in markets where pornography is illegal and in developing countries, including Eastern European countries, such as Russia, Poland and Romania. We believe that piracy is so prevalent in many of these countries that we cannot distribute our products there, as piracy undercuts our price structure and eliminates profit margins. It is very difficult to enforce our proprietary rights in these markets.

Another piracy problem concerns the Internet. We are currently unable to confirm that all mail order sites selling Private products actually sell our original products and not pirated copies. The problem stems from distribution procedures, which in the case of Internet, is straight from the Internet provider's order page to the consumer. Also, video streaming over the Internet renders it difficult for us to control the origin of what is shown.

Our legal counsel handles most piracy problems and attempts to resolve these matters or litigate them on a case-by-case basis.



## COMPETITION

### General Considerations

Our products compete with other products and services that utilize leisure time or disposable income of adult consumers. The businesses in which we compete are highly competitive and service-oriented. We have few long-term or exclusive service agreements with our customers. Business generation is based primarily on customer satisfaction with key factors in a purchase decision, including reliability, timeliness, quality and price. We believe that our extensive and longstanding international operations, our brand name, image and reputation, as well as the quality of our content and our distributors, provide a significant competitive advantage over many of our competitors.

Although we believe our magazines and videos are well-established in the adult entertainment industry, we compete with entities selling adult oriented products in retail stores, as well as through direct marketing. 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.

### Magazines

We meet with minimal direct competition from other publishers of hardcore adult magazines and paperback books. We believe that our print publications are dissimilar to other adult publications in style and format. The only similar business of which we are aware was represented by Rodox N.V., a Dutch/ Danish corporation, which has discontinued its publishing operation. We do not believe there is presently any significant competition in this segment of our business. Magazines such as Playboy and Penthouse and similar print publications do not compete directly with our publications, since we consider them to be softcore publications. There are several hardcore publications in each country where our magazines are sold. In general, these are printed in limited editions and are of lower quality than our publications.

### Video and DVD

The distribution of adult entertainment videocassettes and DVDs is a highly competitive business. Each format competes with the other as well as with other forms of entertainment. Revenue generation for motion picture entertainment products depends, in part, upon general economic conditions, but the competitive position of a producer or distributor is still greatly affected by the quality of, and public response to, the entertainment product it makes available to the marketplace. Competition arises from established adult video producers and from independent companies distributing low-quality material.

Our primary competitors in the movie industry are adult motion picture studios, with in-house production and post-production capabilities. These include U.S. producers such as Video Company of America, Hustler, Vivid Film, Wicked Pictures, Evil Angel Productions and Metro Global Media Inc. Some competitors are smaller, but locally or regionally they are capable of quickly identifying niche markets that could compete for our customers. In addition, we also compete with other forms of media, including broadcast, cable and satellite television, direct marketing, electronic media and adult entertainment websites.

**Broadcasting**

The distribution of adult movies on cable and satellite television systems and hotel pay-per-view systems is highly competitive. Competition in this area is increasing in line with increasing consumer demand for hardcore adult entertainment generally. Our strongest geographical market position for cable and television and distribution is in Europe and United States and Latin America, with our adult channels, *Private Fantasy*, *Private Gold* and *Private Blue*, and licensing arrangements with established European television networks, such as Canal+.

The strength of consumer demand for adult oriented cable programming is evidenced by the acquisition by Playboy of two hardcore U.S. cable channels from Vivid Film in July 2001. Until then, Playboy's business had been largely confined to softcore adult entertainment and it had resisted entry into hardcore markets. Competition in this market has also been impacted by an increase in the number and availability of satellite direct-to-home transmission channels. Our cable and satellite television activities in the United States has historically been limited to licensing our content to channel operators, such as Playboy, however, in 2004 we started broadcasting the Private Fantasy pay-per-view channel over Echo Star's distribution platform.

In licensing, we experience competition from our video and DVD competitors. Our position in U.S. markets is not well established, and competition in this market is strong.

We have only recently entered the hotel pay-per-view market, which is an extremely competitive market. This is due primarily to our unwillingness to enter into a typical hotel pay-per-view agreement, which requires a licensor such as Private Media Group to license the movies to a hotel provider on a fixed fee basis for each movie or video. We have recently entered into license agreements with a major hotel chain which provides for license fees based upon the number of rooms they service, and we are now intensifying our efforts to penetrate this segment of the market.

#### **Internet**

The Internet market for adult oriented content has expanded dramatically over the past years. There are numerous adult media content websites competing with ours, operated by companies that possess global distribution, broadcasting and branding.

#### **EMPLOYEES**

As of December 31, 2002, 2003 and 2004 we employed 177, 163 and 141 people, respectively, on a full-time basis.

Our full-time editorial and post-production staff consists of an editor-in-chief, six executive editors and approximately seven editors, associate editors and assistant editors who oversee the quality and consistency of the artwork and editorial copy and manage the production schedule of each issue. The production of each issue requires the editors to coordinate the activities of a writer, a pencil artist, an inker, a colorist and a printer over a two-month period. The majority of this work is performed on our premises in Barcelona, Spain.

The photographers and directors consist of freelancers who generally receive a flat fee. We have entered into agreements with some photographers, movie directors and writers under which such people have agreed to provide their services to us on an exclusive basis, generally for a period of one to three years.

We believe that we have a good relationship with our employees. Currently, none of our employees is represented by a labor union.

## GOVERNMENT REGULATION

We operate in a highly regulated industry. This requires us to be socially aware and sensitive to government strictures, including laws and regulations designed to protect minors or which prohibit the distribution of obscene material. We take great care to comply with all applicable governmental laws and regulations in each jurisdiction where we conduct business. Moreover, we do not knowingly engage the services of any business or individual that does not adhere to the same standards. Since 1965, we have never been held to have violated any laws or regulations regarding obscenity or the protection of minors.

### Regulation of the Adult Entertainment Industry in the U.S.

The following is a description of some of the laws and regulations in the United States which impact the adult entertainment industry. It is not an exhaustive description of all such laws. Moreover, we conduct business in over 35 countries around the world, each of which has its own regulatory framework. This regulatory environment is constantly changing in the geographical areas in which we conduct business, and in some instances laws which are enacted are subsequently determined by the courts to be unconstitutional.

The Classification and Rating Administration of the Motion Picture Association of America, MPAA, a motion picture industry trade association, assigns ratings for age group suitability for theatrical and home video distribution of motion pictures. Submission of a motion picture to the MPAA for rating is voluntary, and we do not submit our motion pictures to the MPAA for review. However, with the exception of several titles which have been re-edited for cable television, most of the movies distributed by us, if so rated, would most likely fall into the NC - 17 - No Children Under 17 Admitted rating category because of their depiction of nudity and sexually explicit content.

The right to distribute adult videocassettes, magazines and DVD products in the United States is protected by the First and Fourteenth Amendments to the United States Constitution, which prohibits Congress or the several States from passing any law abridging the freedom of speech.

The First and Fourteenth Amendments, however, do not protect the dissemination of obscene material, and several states and communities in which our products are distributed have enacted laws regulating the distribution of obscene material, with some offenses designated as misdemeanors and others as felonies, depending on numerous factors. The consequences for violating these state statutes are as varied as the number of states enacting them. Similarly, specific U.S. federal regulations prohibit the dissemination of obscene material. The potential penalties for individuals (including directors, officers and employees) violating the Federal obscenity laws include fines, community service, probation, forfeiture of assets and incarceration. The range of possible sentences requires calculations under the Federal Sentencing Guidelines, and the amount of the fine and the length of the period of the incarceration under those guidelines are calculated based upon the retail value of the unprotected materials. Also taken into account in determining the amount of the fine, length of incarceration or other possible penalty are whether the person accepts responsibility for his or her actions, whether the person was a minimal or minor participant in the criminal activity, whether the person was an organizer, leader, manager or supervisor, whether multiple counts were involved, whether the person provided substantial assistance to the government, and whether the person has a prior criminal history. In addition Federal law provides for the forfeiture of: (1) any obscene material produced, transported, mailed, shipped or received in violation of the obscenity laws; (2) any property, real or personal, constituting or traceable to gross profits or other proceeds obtained from such offense; and (3) any property, real or personal, used or intended to be used to commit or to promote the commission of such offense, if the court in its discretion so determines, taking into consideration the nature, scope and proportionality of the use of the property in the offense.

With respect to the realm of potential penalties facing an organization such as ours, the forfeiture provisions detailed above apply to corporate assets falling under the statute. In addition, a fine may be imposed, the amount of which is tied to the pecuniary gain to the organization from the offense or determined by a fine table tied to the severity of the offense. Also factored into determining the amount of the fine are the number of

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individuals in the organization and whether an individual with substantial authority participated in, condoned, or was willfully ignorant of the offense; whether the organization had an effective program to prevent and detect violations of the law; and whether the organization cooperated in the investigation and accepted responsibility for its criminal conduct. In addition, the organization may be subject to a term of probation of up to five years.

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Federal and state obscenity laws define the legality or illegality of materials by reference to the U.S. Supreme Court's three-prong test set forth in *Miller v. California*, 413 U.S. 1593 (1973). This test is used to evaluate whether materials are obscene and therefore subject to regulation. *Miller* provides that the following must be considered: (a) whether the average person, applying contemporary community standards would find that the work, taken as a whole, appeals to the prurient interest; (b) whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law; and (c) whether the work, taken as a whole, lacks serious literary, artistic, political or scientific value. The Supreme Court has clarified the *Miller* test in recent years, advising that the prurient interest prong and patent offensiveness prong must be measured against the standards of an average person, applying contemporary community standards, while the value prong of the test is to be judged according to a reasonable person standard.

We are engaged in the wholesale distribution of our products to U.S. wholesalers and/or retailers. We have taken steps to ensure compliance with all Federal, State and local regulations regulating the content of motion pictures and print products, by staying abreast of all legal developments in the areas in which motion pictures and print products are distributed and by specifically avoiding distribution of motion pictures and print products in areas where the local standards clearly or potentially prohibit these products. In light of our efforts to review, regulate and restrict the distribution of our materials, we believe that the distribution of our products does not violate any statutes or regulations.

Many of the communities in the areas in which we offer or intend to offer products or franchises, have enacted zoning ordinances restricting the retail sale of adult entertainment products. We supply products only in locations where the retail sale of adult entertainment products is permitted.

In February 1996, the U.S. Congress passed the Telecommunications Act. Some provisions of the Telecommunications Act are directed exclusively at cable programming in general and adult cable programming in particular. In some cable systems, audio or momentary bits of video of premium or pay-per-view channels may accidentally become available to non-subscribing cable customers. This is called bleeding. The practical effect of Section 505 of the Telecommunications Act is to require many existing cable systems to employ additional blocking technology in every household in every cable system that offers adult programming, whether or not customers request it or need it, to prevent any possibility of bleeding, or to restrict the period during which the programming is transmitted from 10:00 p.m. to 6:00 a.m. Penalties for violation of the Telecommunications Act are significant and include fines and imprisonment. Surveying of cable operators and initial results indicate that most will choose to comply with Section 505 by restricting the hours of transmission. We believe that our revenues will be marginally adversely affected as a result of enforcement of Section 505. However, as digital technology (which is unaffected by Section 505) becomes more available, we believe that ultimately the impact will be insignificant.

As discussed above, federal and state government officials have targeted sin industries, such as tobacco, alcohol, and adult entertainment for special tax treatment and legislation. In 1996, U.S. Congress passed the Communications Decency Act of 1996, or the CDA. Recently, the U.S. Supreme Court, in *ACLU v. Reno*, held certain substantive provisions of the CDA unconstitutional. Businesses in the adult entertainment and programming industries expended millions of dollars in legal and other fees in overturning the CDA. Investors should understand that the adult entertainment industry may continue to be a target for legislation. In the event we must defend ourselves and/or join with other companies in the adult programming business to protect our rights, we may incur significant expenses that could have a material adverse effect on our business and operating results.

#### *Child Pornography and Non-Mainstream Content*

We believe that roughly 90% of the adult material produced and distributed over the past 15 years contains mainstream sexual acts between consenting adults. The rest could be classified as specialty material which does not contain explicit sex, but which still involves consenting adults (i.e. fetish, bondage, etc.). Mainstream sex acts means intercourse, oral sex, anal sex, group sex, etc. Our adult movies do not contain any depictions, let alone actual performances of rape, sex with coercion, animals, urination, defecation, violence, incest or child pornography.

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Since 1990, the Free Speech Coalition has worked with the U.S. government to create a workable regulatory system designated to prevent minors from working in the adult industry. Child Protection Restoration and Penalties Enhancement Act of

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1990 (18 U.S.C. section 2257) requires, in essence, that no one can work without having copies of their passport or driver's license, and a declaration under perjury of their age and true name, on file with a designated Custodian of Records, and available for inspection by law enforcement.

As indicated above, all of our products are all in compliance with 18 U.S.C. Section 2257 and all models performing in our productions are 18 years of age or older.

### **Internet Regulation**

Government regulation of the Internet is a rapidly developing area and, therefore, adds additional uncertainty to our business. New laws or regulations relating to the Internet, or more aggressive application of existing laws, could decrease the growth of our websites, prevent us from making our content available in various jurisdictions or otherwise have a material adverse effect on our business, financial condition and operating results. These new laws or regulations could relate to liability for information retrieved from or transmitted over the Internet, taxation, user privacy and other matters relating to our products and services. For example, the U.S. government has recently enacted laws regarding website privacy, copyrights and taxation. Moreover, the application to the Internet of other existing laws governing issues such as intellectual property ownership and infringement, pornography, obscenity, libel, employment and personal privacy is uncertain and developing.

### *Regulation of the Internet outside the United States*

We may also be subject to claims based upon the content that is available on our websites through links to other sites and in jurisdictions that we have not previously distributed content in. For example, a recent French ruling banning the sale of Nazi memorabilia in France suggests that website operators may be forced to undertake expensive security measures to block certain users or face significant fines. Implementing such security measures to reduce our exposure to this liability may require us to take steps that would substantially limit the attractiveness of our websites and/or their availability in various geographic areas, which could negatively impact their ability to generate revenue.

### **SEASONALITY**

Our businesses are generally not seasonal in nature. However, June, July and August are typically impacted by smaller orders from some European and U.S. distributors, due to the holiday season.



## ITEM 2. DESCRIPTION OF PROPERTIES

### PROPERTIES

Private Media Group maintains an office in the United States at 3230 Flamingo Road, Suite 156, Las Vegas, Nevada 89121.

In January 2002 Milcap Media Group renewed the lease for the building it currently occupies, located at Carretera de Rubi 22-26, 08190 Sant Cugat del Valles, Barcelona, Spain, for a further term of five years. Average monthly base rental expense is approximately \$ 27,000. The building is currently used by all of our operating departments, primarily for marketing, administration and post production. In addition, the building serves as the European headquarters of Private Media Group, Inc. In addition, Milcap Media Group leases warehouse space also located on Carretera de Rubi. The lease expires in 2007 and the average monthly base rental expense is approximately \$ 20,300. We recognize the rent expense on a straight-line basis over the term of the leases. Additionally, the leases requires us to pay our proportionate share of the building's real estate taxes and operating expenses.

Effective December 31, 2002, Fraserside Holdings Limited ( Purchaser ) a wholly-owned subsidiary of Private Media Group, Inc. completed the purchase of all of the outstanding stock of Barbuda B.V., from Luthares Investments N.V. and Stichting de Oude Waag, companies indirectly beneficially owned by the Company's principal shareholder. The principal asset of Barbuda B.V. is an approximately 6.300 square meter office facility and additional parking, located in Barcelona, Spain. The purpose of this transaction was to acquire this property as its European headquarters. Since the acquisition, the Company has been reevaluating its need for additional space and as of February 2005, the Company no longer owns this property.

Currently, in addition to Barcelona, Spain, the group's subsidiaries lease office and warehouse space in Sweden; Stockholm, Knegsel, the Netherlands; Paris, France and Montreal, Canada.

## ITEM 3. LEGAL PROCEEDINGS

In December 1999 the Company received final notification from the Swedish Tax Authority assessing its subsidiary in Cyprus for the tax years 1995-1998 for a total amount of SEK 42,000,000 (approx. EUR 4.5 million) plus fines amounting to SEK 16,800,000 (approx. EUR 1.8 million) plus interest. The Swedish Tax Authority has taken the position that the subsidiary carried on business in Sweden from a permanent establishment during the period in question and should therefore be taxed on the income attributable to the permanent establishment. The case is under litigation and the Company believes the circumstances supporting the Tax Authority's claim are without merit. However, the County Court has decided that a permanent establishment is at hand. The Court has only made a principle statement and the question how to calculate any eventual profit that can be allocated to the permanent establishment is not decided by the Court at this stage. The Company has appealed against the decision. The final outcome of this litigation will not be known for several years. Due to the early stages of this matter and the uncertainty regarding the ultimate decision, no amounts have been provided in the Company's financial statements for this dispute.

We are from time to time a defendant in suits for defamation and violation of rights of privacy, many of which allege substantial or unspecified damages, which we vigorously defend.

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We are presently engaged in litigation, most of which is generally incidental to the normal conduct of our business and is immaterial in amount. We believe that our reserves are adequate and that no such action will have a material adverse impact on our financial condition. However, there can be no assurance that our ultimate liability will not exceed our reserves.

Except as disclosed above, neither Private Media Group, Inc. nor its subsidiaries is or has been, during the last two fiscal years, involved in any other litigation or arbitration proceedings which have had or might have a material influence on our financial condition or results of operations.

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**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Our 2004 Annual Meeting of Shareholders was held on December 20, 2004. At the Annual Meeting each of our five nominees was elected to serve as a director until the next Annual Meeting of Shareholders. The election results were as follows:

**Election of Five Directors:**

| <u>Name</u>       | <u>For</u> | <u>Withheld</u> |
|-------------------|------------|-----------------|
| Berth H. Milton   | 40,115,290 | 5,167           |
| Bo Rodebrant      | 40,176,773 | 5,167           |
| Ferran Mirapeix   | 40,176,663 | 5,167           |
| Johan G. Carlberg | 40,170,273 | 5,167           |
| Daniel Sánchez    | 40,177,263 | 5,167           |

No other matter was submitted to a vote at the 2004 Annual Meeting.

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**PART II**
**ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS****Market for Private Media Group, Inc. Common Stock**

The common stock of Private Media Group, Inc. has traded on the Nasdaq National Market since February 1, 1999 under the symbol PRVT . Previously, our common stock traded on the NASD, Inc. OTC Bulletin Board since March 29, 1996. The following table sets forth the range of representative high and low bid prices for the common stock for the periods indicated, as reported by the Nasdaq National Market. Quotations represent inter-dealer prices, do not include retail markups, markdowns or commissions and may not represent actual transactions.

|                     | <u>High</u> | <u>Low</u> |
|---------------------|-------------|------------|
| <i>Fiscal 2004:</i> |             |            |
| First Quarter       | \$ 3.69     | \$ 1.97    |
| Second Quarter      | \$ 2.68     | \$ 1.94    |
| Third Quarter       | \$ 2.80     | \$ 2.19    |
| Fourth Quarter      | \$ 4.95     | \$ 2.42    |
| <i>Fiscal 2003:</i> |             |            |
| First Quarter       | \$ 3.31     | \$ 1.16    |
| Second Quarter      | \$ 2.48     | \$ 1.07    |
| Third Quarter       | \$ 2.85     | \$ 1.88    |
| Fourth Quarter      | \$ 2.24     | \$ 1.30    |

On March 17, 2005, the last sales price reported on the Nasdaq National Market was \$ 4.60. On October 30, 2004, there were 187 shareholders of record and approximately 1,400 beneficial owners of our common stock.

**Sale of Unregistered Securities in the Fourth Quarter of 2004**

During the three months ended December 31, 2004, we sold unregistered securities in the following transactions.

In the fall of 2003 we sold convertible notes to four accredited institutional investors in the aggregate principal amount of \$2.25 million. Interest on the convertible notes accrues at the rate of 7%, and is payable quarterly in cash or common stock, at the election of the Company, based upon a weighted average market price during the 15 trading days preceding payment. The notes are convertible at the option of the holder at a fixed conversion price of \$2.00. In fourth quarter of 2004 we issued an aggregate of 13,037 shares of common stock in payment of \$34,032 of accrued interest under the outstanding notes. The issuance of the common stock is deemed to be exempt from the registration requirement of the Securities Act of 1933, as amended, in reliance on Section 4(2) of the Securities Act and Regulation D promulgated thereunder, as it was sold to institutional investors believed to be accredited investors and was made without general solicitation or advertising.

**Equity Compensation Plan Information**

On March 1, 1999 the Company adopted the 1999 Employee Stock Option Plan. In February 2003 the Plan was amended to provide for the issuance of up to 7,200,000 shares of the Company's common stock to employees, consultants and advisors of the company, and was approved by the shareholders.

Full details of the Plan are included in note 2 and 19 to the financial statements and are summarized below as of December 31, 2004:

|       |  |           |
|-------|--|-----------|
| ( a ) | Number of securities to be issued upon exercise of outstanding options, warrants and rights  | 4,661,561 |
| ( b ) | Weighted-average exercise price of outstanding options, warrants and rights  | \$ 3.47   |
| ( c ) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in row (a) above) | 2,233,153 |

**Dividend Policy**

We did not pay any cash dividends during our last two fiscal years and we do not contemplate doing so in the near future. We currently intend to retain all earnings to finance the development and expansion of our operations, and do not anticipate paying cash dividends on our shares of common stock in the foreseeable future. Our future dividend policy will be determined by our Board of Directors on the basis of various factors, including results of operations, financial condition, business opportunities and capital requirements. The payment of dividends will also be subject to the requirements of Nevada Law, as well as restrictive financial covenants which may be required in credit agreements.

**Stock Dividend**

We implemented a 3:1 stock dividend whereby each holder of record of our common stock on May 30, 2000, received two additional shares of common stock for each share owned on the record date. Corresponding adjustments have been made to the warrants and options outstanding on the record date as well as the Series A Preferred Stock to reflect adjusted conversion and dividend terms. Accordingly, all share and per share values reflected have been adjusted to give effect to the stock dividend.

**Transfer Agent**

The transfer agent and registrar for our common stock is InterWest Transfer Co., Inc., 1981 East 4800 South, Suite 100, Salt Lake City, Utah 84117.

**ITEM 6. SELECTED FINANCIAL DATA**

The following table presents selected consolidated financial information for the five years ended December 31, 2004. The selected financial information has been derived from our audited consolidated financial statements. This selected consolidated financial information should be read along with our historical consolidated financial statements and related notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in or appearing elsewhere in this Report.

|   | Years ended December 31, |            |            |            |            |            |
|---|--------------------------|------------|------------|------------|------------|------------|
|   | 2004                     | 2004       | 2003       | 2002       | 2001       | 2000       |
|   | USD                      | EUR        | EUR        | EUR        | EUR        | EUR        |
| (in thousands, except per share data)           |                          |            |            |            |            |            |
| <b>Statement of Income Data:</b>                |                          |            |            |            |            |            |
| Net sales                                       | 48,784                   | 35,612     | 38,491     | 39,410     | 38,979     | 30,553     |
| Cost of sales                                   | 24,766                   | 18,080     | 19,081     | 17,031     | 13,827     | 11,693     |
| Gross Profit                                    | 24,017                   | 17,533     | 19,411     | 22,379     | 25,152     | 18,860     |
| Selling, general and administrative expenses    | 24,624                   | 17,976     | 19,871     | 20,562     | 16,751     | 11,469     |
| Offering expenses                               |                          |            |            | 1,569      | 843        |            |
| Operating income (loss)                         | (607)                    | (443)      | (461)      | 249        | 7,557      | 7,391      |
| Sale of controlled entity                       |                          |            |            |            | 1,862      |            |
| Interest expense                                | 1,052                    | 768        | 761        | 366        | 194        | 213        |
| Interest income                                 | 225                      | 165        | 147        | 327        | 152        | 364        |
| Income (loss) before income taxes               | (1,434)                  | (1,046)    | (1,075)    | 210        | 9,378      | 7,543      |
| Income taxes (benefit)                          | (1,760)                  | (1,284)    | (504)      | (130)      | 1,361      | 1,267      |
| Net income (loss)                               | 326                      | 238        | (570)      | 340        | 8,017      | 6,275      |
| <b>Other Comprehensive Income:</b>              |                          |            |            |            |            |            |
| Unrealized loss on short-term investment        |                          |            |            | (67)       | (134)      |            |
| Foreign currency translation adjustments        | (435)                    | (318)      | 642        | 666        | (1,978)    | (1,305)    |
| Comprehensive income                            | (109)                    | (80)       | 72         | 939        | 5,905      | 4,970      |
| Income (loss) applicable to common shareholders | 326                      | 238        | (718)      | (1,107)    | 6,428      | 4,769      |
| <b>Weighted average of shares outstanding:</b>  |                          |            |            |            |            |            |
| Basic   | 50,136,203               | 50,136,203 | 43,493,163 | 28,626,327 | 28,137,817 | 27,002,220 |
| Diluted   | 52,377,163               | 52,377,163 | N/A        | N/A        | 49,679,835 | 48,745,896 |
| Basic income (loss) per share                   | 0.01                     | 0.00       | (0.02)     | (0.04)     | 0.23       | 0.18       |
| Fully diluted income (loss) per share           | 0.01                     | 0.00       | (0.02)     | (0.04)     | 0.16       | 0.13       |
| Dividends declared per common Share             |                          |            |            |            |            |            |

As per December 31,

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|                            | 2004   | 2004   | 2003   | 2002   | 2001   | 2000   |
|----------------------------|--------|--------|--------|--------|--------|--------|
|                            | USD    | EUR    | EUR    | EUR    | EUR    | EUR    |
| (in thousands)             |        |        |        |        |        |        |
| <b>Balance Sheet Data:</b> |        |        |        |        |        |        |
| Cash and cash equivalents  | 4,467  | 3,261  | 856    | 1,694  | 6,408  | 1,624  |
| Working capital            | 24,988 | 18,241 | 13,293 | 15,287 | 22,360 | 15,864 |
| Total assets               | 86,686 | 63,281 | 68,149 | 68,989 | 57,086 | 43,864 |
| Total debt                 | 13,365 | 9,756  | 13,732 | 16,486 | 4,750  | 605    |
| Total shareholders Equity  | 63,281 | 46,026 | 44,157 | 43,451 | 42,280 | 34,195 |

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## ITEM 7. 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 of exchange rate fluctuations; and (8) our ability to obtain additional financing.

### Overview

We are an international provider of adult media content. We acquire still photography and motion pictures from independent directors and process these images into products suitable for popular media formats such as print publications, DVDs, video cassettes and digital media content for Broadcasting, Broadband and Internet distribution. In addition to media content, we also market and distribute branded leisure and novelty products oriented to the adult entertainment lifestyle and generate additional sales through the licensing of our *Private* trademark to third parties.

In June 1998, we acquired Milcap Media Limited, its subsidiaries and Cine Craft. Prior to these acquisitions, we were a holding company. Milcap Media Limited, its subsidiaries and Cine Craft were the acquirees, but for accounting purposes they were deemed to be the acquirors. We became a U.S. reporting company following the 1998 acquisitions.

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.

We generate revenues primarily through:

sales of movies on DVD and videocassette formats;

sales of adult feature magazines;

Internet subscriptions and licensing;

broadcasting movies through cable, satellite and hotel television programming; and

content, brand name and trademark licensing.

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The following table illustrates our net sales by product group for the periods indicated.

|                                   | Years ended December 31, |               |               |
|-----------------------------------|--------------------------|---------------|---------------|
|                                   | 2002                     | 2003          | 2004          |
|                                   | EUR                      | EUR           | EUR           |
| <i>Net sales by product group</i> |                          |               |               |
| Magazine                          | 5,777                    | 5,316         | 5,121         |
| Video                             | 7,986                    | 7,206         | 2,130         |
| DVD s                             | 15,482                   | 18,309        | 19,488        |
| Internet                          | 6,059                    | 4,819         | 4,859         |
| Broadcasting                      | 4,106                    | 2,841         | 4,014         |
| <b>Total</b>                      | <b>39,410</b>            | <b>38,491</b> | <b>35,612</b> |

Over time, we expect net sales from magazines and videocassettes to continue to decline as a percentage of net sales in relation to total net sales from DVDs, the Internet and broadcasting. We expect net sales from DVDs, the Internet and 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:

acquisition of content for our library of photographs and videos;

printing, processing and duplication costs; and

selling, general and administrative expenses.

Our magazines and DVD and videocassette covers are printed by independent third-party printers in Spain. We introduced DVDs as a motion picture medium in 1999. The production of each DVD master disc, prior to duplication, costs approximately \$10,000. DVDs have a relatively low cost of duplication, inclusive of box and packaging, of approximately \$2.00 per unit. Our DVDs are duplicated on an all region format, playable on both NTSC and PAL with multiple languages and sub-titles.

We released 104 titles on DVD during 2004, 111 titles during 2003 and 120 titles during 2002, including both new and archival material. We plan to release approximately 120 proprietary titles on DVDs in 2005. In addition, in 2004 we signed an exclusive three year Agreement with US-based Pure Play Media, Inc. for content distribution in Europe. Under the agreement, we will distribute approximately six to ten newly produced movie titles per month in Europe, our main market for DVDs. The content controlled by Pure Play Media features top US producers and directors such as Michael Ninn, Seymore Butts, and Cousin Stevie. The arrangement is based on a split of gross profit and does not require any up-front or future investment in content by Private. We will start releasing titles on DVD under the agreement in the second quarter of 2005.

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, DVD and broadcasting. Internet and broadcasting sales has historically not carried any cost of sales and variations in these areas affect the overall cost of sales percentage in relation to sales. These new media provide us with additional sales of our existing content

In December 2003, a group-wide review of operations initiated. The objective of the review was to restructure our operations to focus on our core business and reduce or abandon spending on, and investments in, activities not generating sufficient gross profits and/or operating profits. The review resulted in reduced selling, general and administrative expenses in the areas targeted and had a positive impact on the results of operations in 2004.

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The group-wide review initiated in 2003 also resulted in the restructuring of our US operations and our US subsidiary outsourced its distribution of physical products, inclusive of Internet shop fulfillment. The restructuring started September 30, 2004 and the impact has initially been a temporary loss of revenues from the US during the fourth quarter transition period. The loss of revenues had a significant impact on gross profit. However, during the first quarter of 2005 distribution resumed and we expect the impact of the restructuring to increase gross profit and reduce selling, general and administrative expenses in 2005 compared to 2004.

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.

## 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*

Revenues from the sale of magazines, videocassettes, DVD s and other related products where distributors are not granted rights-of-return are recognized upon transfer of title, which generally occurs upon delivery.

The Company sells magazines to wholesalers on firm sale basis and via national newsstand distributors with the right to return. Our magazines are multi-lingual and the principal magazine market is in Europe.

Revenues from the sale of magazines 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 magazines. Distributors with the right to return are primarily national newsstand distributors. Most of our magazines 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 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%. Higher percentages generally reflect newer markets and/or products. Percentages are reviewed on an on-going basis.

The magazines have an approximate retail price of EUR 11.50 (USD 15.00) per copy and are printed on glossy high-quality paper at a cost of EUR 1.25 (USD 1.60). 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

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make them available for sale again.

The company has scheduled re-distribution of the returned magazines, via national newsstand distributors, as Megapacks or Superpacks (three different copies per pack) where the retail price is EUR 14.95 (USD 19.50). As the national newsstand distributors have the right to return, the packs come back to us and are then broken up in individual copies in order to be sent out in DVD packs, see below, or sold on firm sale basis to wholesalers as back numbers at a lower price than new issues.

The company recently started 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 and the magazines are broken out in order to be sold on firm sale basis to wholesalers as back numbers at a lower price than new issues. The company has historically sold all copies printed at an average price higher than, or equal, to cost.

Revenues from the sale of videocassette and DVD products under consignment agreements with distributors are recognized based upon reported sales by the Company's distributors. Revenues from the sale of subscriptions to the Company's internet website are deferred and recognized ratably over the subscription period. Revenues from licensing of broadcasting rights to the Company's video and film library 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. Revenues from satellite & cable broadcasting are recognized based on sales reported each month by its cable and satellite affiliates. The affiliates do not report actual monthly sales for each of their systems to the Pay TV Group 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 collectibility 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 collectibility 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*

On January 1, 2002 the Company adopted Financial Accounting Standards Board Statement (SFAS) No. 142, Goodwill and Other Intangible Assets. Under SFAS 142, goodwill and indefinite lived intangible assets will no longer be amortized but will be reviewed annually for impairment (or more frequently if indicators of impairment arise).

During 2002, the Company performed an initial impairment test of goodwill and indefinite lived intangible assets as of January 1, 2002. This generally required us to assess these assets for recoverability when events or circumstances indicate a potential impairment by estimating the undiscounted cash flows to be generated from the use of these assets. There was no effect of on the earnings and financial position of the Company as a result of the impairment testing.

Other Intangible Assets represents the value attributable to certain acquisitions (see Note 3 and 8). Amortization expense is calculated on a straight-line basis over 10 years.

#### *Impairment of Long-Lived Assets*

The Company periodically evaluates the carrying value of long-lived assets including its library of photographs and videos for potential impairment. Upon indication of impairment, the company will record a loss on its long-lived assets if the undiscounted cash flows that are

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estimated to be generated by those assets are less than the related carrying value of the assets. An impairment loss is then measured as the amount by which the carrying value of the asset exceeds the estimated discounted future cash flows. Management's estimated future revenues are based upon assumptions about future demand and market conditions and additional write downs may be required if actual conditions are less favorable than those assumed.

### *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, videocassettes 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, additional write-downs may be required.



## Results of Operations

### *2004 compared to 2003*

*Net sales.* Our net sales in 2004 were EUR 35.6 million compared to EUR 38.5 million in 2003, a decrease of EUR 2.9 million, or 7%. The drop in net sales is primarily the result of the Company's reorganization of its US distribution, *see previous discussion under Overview in this Item 7*, and a decrease in Video sales. The decrease in Video sales of 70% to EUR 2.1 million, was primarily the result of a combination of a general industry decrease in Video sales and 40% less titles being released by the Company as a result of fewer new movie productions available for sale on Video in 2004 compared to 2003. DVD sales, which increased 6%, to EUR 19.5 million, was also affected by the US reorganization and the reduction in new movie productions available for sale. However, the Company managed to offset part of the negative effect from fewer new titles on DVD sales by opening additional distribution channels, thereby increasing sales on a per release basis. Magazine sales decreased 4% to EUR 5.1 million, while Internet sales increased 1% to EUR 4.9 million. Broadcasting sales increased 41% to EUR 4.0 million primarily as a result of the broadcasting launch of our own TV channel in the United States in February 2004.

In 2003 and the first half of 2004, investment in new movie productions was cut back due to reduced cash-flow as a result of overspending in 2002 and 2003. Improvements in cash-flow during 2004 has allowed the Company to increase its investment activity in new movie productions and the impact on sales is expected to show in the first half of 2005, see also *Liquidity and Capital Resources - Investing Activities*.

Net sales in general were affected by unfavorable changes in exchange rates. During the period the dollar weakened against the euro and since our sales in the United States are translated into euro this had a negative effect. Fluctuations in exchange rates between the euro and the dollar can affect the comparability of our results from year to year. We translate our consolidated subsidiaries whose functional currency is not the euro into the euro for reporting purposes. Income statement amounts are translated into euros using the average exchange rate for the fiscal year. The change in average exchange rate for the fiscal year 2004 compared to 2003 was a decrease of 9%. The balance sheet is translated at the year-end exchange rate. Due to the significance of the results reported in dollars the impact of the euro/dollar exchange rate on our major categories of revenue and expense can be material.

*Cost of Sales.* Our cost of sales was EUR 18.1 million for 2004 compared to EUR 19.1 million for 2003, a decrease of EUR 1.0 million, or 5%. The decrease was the result of reduced sales. Cost of sales as a percentage of sales was 51% for 2004, an increase of 1% compared to 2003. The increase in cost of sales as a percentage of sales was primarily the result of the impairment of the value of video cassettes in inventory as of December 31, 2004 made to reflect the change in market conditions for video cassettes.

Included in cost of sales is printing, processing and duplication, amortization of library and broadcasting costs. Printing, processing and duplication cost was EUR 10.9 million for 2004 compared to EUR 11.8 million for 2003, a decrease of EUR 0.9 million, or 7%. The decrease was the result of reduced sales. Printing, processing and duplication cost as a percentage of sales was 31% for 2004, which represents no change compared to 2003. As a result of changing market conditions, we wrote off video cassette inventory to a value of EUR 1.5 million during the fourth quarter, which increased printing, processing and duplication cost with the same amount. Amortization of library was EUR 6.6 million for 2004 compared to EUR 7.1 million for 2003, a decrease of EUR 0.5 million, or 7%. 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. The decrease was the result of lower amounts invested in content released during the period subject to amortization in 2004 compared to 2003. Broadcasting cost was EUR 0.6 million for 2004 compared to EUR 0.2 million for 2003, an increase of EUR 0.4 million. Broadcasting cost represents programming and transmission cost and the increase relates to the start-up of the Private Fantasy Channel in the United States.

*Gross Profit.* Our gross profit for 2004 was EUR 17.5 million, or 49% of net sales, compared to EUR 19.4 million, or 50% of net sales for 2003. This represented a decrease of EUR 1.9 million, or 10%, compared to 2003. The decrease was the result of lower sales. Gross profit as a

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percentage of sales was down 1% for 2004 compared to 2003. The decrease in gross profit as a percentage of sales was the result of the impairment of the value of video cassettes in inventory as of December 31, 2004 made to reflect the change in market conditions for video cassettes.

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*Selling, general and administrative expenses.* Our selling, general and administrative expenses were EUR 18.0 million for 2004 compared to EUR 19.9 million for 2003. Despite increases in bad debt provision and depreciation of EUR 0.9 million and EUR 0.9 million, respectively, selling, general and administrative expenses decreased by EUR 1.9 million, or 10%. The increased bad debt provision in 2004 related primarily to one specific receivable which was written off completely as collection attempts failed. We attribute the decrease in selling, general and administrative expenses to an overall program started in 2003 where the objective is to review and reduce all controllable selling, general and administrative expenses in low or non-profitable areas. We expect lower bad debt provisions and reduced depreciation in 2005. We also expect selling, general and administrative expenses in low or non-profitable areas to continue to decrease in 2005.

*Operating profit/loss.* We reported an operating loss of EUR 0.4 million for 2004 compared to an operating loss of EUR 0.5 million for 2003, a decrease of EUR 1.0 million. The decrease in loss was primarily the result of reduced selling, general and administrative expenses.

*Interest expense.* Our interest expense was EUR 0.8 million for 2004, compared to EUR 0.8 million for 2003.

*Income tax expense/benefit.* Our income tax benefit was EUR 1.3 million for 2004, compared to 0.5 million for 2003.

*Net income/loss.* Our net income was EUR 0.2 million for 2004, compared to a net loss of EUR 0.6 million for 2003. We attribute this increase in net income in 2004 of EUR 0.8 million primarily to increased income tax benefit.

#### *2003 compared to 2002*

*Net sales.* Our net sales in 2003 were EUR 38.5 million compared to EUR 39.4 million in 2002, a decrease of EUR 0.9 million, or 2%. We attribute this change to a decrease in Video and Magazine, Internet and Broadcasting sales. Video and Magazine sales decreased 9% to EUR 12.5 million, primarily as a result of DVD taking over from video in the marketplace. Internet sales decreased 20% to EUR 4.8 million as a result of a weaker US dollar and lower license sales. Broadcasting sales decreased 31% to EUR 2.8 million as a result of a decrease in license sales. The reduction in Broadcasting license sales is a result of the Company's strategy to start operating its own TV channels in the United States. The launch of the channels requires the Company to refrain from selling its broadcast rights to third parties for the period leading up to the launch. The decrease in Video and Magazine, Internet and Broadcasting sales was offset by a increase in DVD sales of 18% to EUR 18.3 million. We attribute the growth in sales of DVDs to the increasing number of DVD players being sold in all of our markets. We believe that the growth in DVD sales will continue through the remainder of 2004.

Net sales in general were affected by unfavorable changes in exchange rates. During the period the dollar weakened against the euro and since our sales in the United States are translated into euro this had a negative effect. Fluctuations in exchange rates between the euro and the dollar can affect the comparability of our results from year to year. We translate our consolidated subsidiaries whose functional currency is not the euro into the euro for reporting purposes. Income statement amounts are translated into euros using the average exchange rate for the fiscal year. The change in average exchange rate for the fiscal year 2003 compared to 2002 was a decrease of 17%. The balance sheet is translated at the year-end exchange rate. Due to the significance of the results reported in dollars the impact of the euro/dollar exchange rate on our major categories of revenue and expense can be material.

*Cost of Sales.* Our cost of sales was EUR 19.1 million for 2003 compared to EUR 17.0 million for 2002, an increase of EUR 2.0 million, or 12%. The increase was the result of a combination of an increase in sales volume in areas generating cost of sales and unfavorable exchange rate changes. Cost of sales as a percentage of sales was 50% for 2003, an increase of 7% compared to 2002. The increase in cost of sales as a percentage of sales was primarily the result of sales mix, see *Gross Profit*.

*Gross Profit.* Our gross profit for 2003 was EUR 19.4 million, or 50% of net sales, compared to EUR 22.4 million, or 57% of net sales for 2002. This represented a decrease of EUR 3.0 million, or 13%, compared to 2002. Gross profit as a percentage of sales was down 7% for 2003 compared to 2002. The decrease in gross profit was primarily the result of sales mix, with higher sales volume in products generating cost of sales, such as Videos, Magazines and DVDs combined, and lower sales in products not generating cost of sales, such as Internet and Broadcasting sales.

*Selling, general and administrative expenses.* Our selling, general and administrative expenses were EUR 19.7 million for 2003 compared to EUR 20.6 million for 2002, a decrease of EUR 0.9 million, or 4%. We attribute the decrease to an overall program started in 2003 where the objective is to review and reduce all controllable selling, general and administrative expenses in low or non-profitable areas, offset by our expansion in Canada through our new subsidiary Private Media Group Canada which became fully operational during the second half of the year. We expect selling, general and administrative expenses in low or non-profitable areas to continue to decrease in 2004.

*Operating profit/loss.* We reported an operating loss of EUR 0.5 million for 2003 compared to an operating profit of EUR 0.2 million for 2002, a decrease of EUR 0.7 million. Discounting non-recurring charges of EUR 1.6 million in offering expenses made in 2002, the decrease was EUR 2.4 million. The decrease was primarily the result of lower gross profit.

*Interest expense.* Our interest expense was EUR 0.8 million for 2003, compared to EUR 0.4 million for 2002.

*Income tax expense/benefit.* Our income tax benefit was EUR 0.5 million for 2003, compared to 0.1 million for 2002. The increase of EUR 0.4 million is primarily attributable to more of the Company's losses being recorded in tax jurisdictions where there is a higher corporate tax than compared to other tax jurisdictions.

*Net income/loss.* Our net loss was EUR 0.6 million for 2003, compared to a net income of EUR 0.3 million for 2002. We attribute this change in net income in 2003 of EUR 0.9 million to decreased operating profit.

## **Liquidity and Capital Resources**

We generate cash from our operating activities, borrowings from third parties, the exercise of warrants and private sales of our equity securities. Our principal uses of cash typically include, building our library of photographs and movies.

We reported a working capital surplus of EUR 18.2 million at December 31, 2004, an increase of EUR 4.9 million compared to the year ended December 31, 2003. The increase is principally attributable to increases in cash and cash equivalents and prepaid expenses and other current assets and decreases in borrowings and accrued other liabilities.

We reported a working capital surplus of EUR 13.3 million at December 31, 2003, a decrease of EUR 2.0 million compared to the year ended December 31, 2002.

### *Operating Activities*

Net cash provided by our operating activities was EUR 8.3 million for 2004 compared to EUR 10.3 million for 2003, and was primarily the result of net income and adjustments to reconcile net income to net cash flows from operating activities. We adjusted our net income of EUR 0.2 million to reconcile it to net cash flows from operating activities. Adjustments included (1) depreciation of EUR 2.1 million, (2) convertible note adjustment of EUR 0.1 million, (3) bad debt provision of EUR 1.6 million, (4) amortization of goodwill and other intangible assets of EUR 0.1

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million and (5) amortization of photographs and videos of EUR 6.6 million making a total of EUR 10.8 million which was offset by EUR 0.7 million from deferred income taxes, providing a net balance of EUR 10.1 million. Changes in operating assets and liabilities reduced the net balance by EUR 1.8 million through trade accounts receivable, related party receivable, accounts payable trade, income taxes payable and accrued other liabilities totaling EUR 3.1 million, offset by EUR 1.3 million from inventories and prepaid expenses and other current assets.

Net cash provided by our operating activities was EUR 10.3 million for 2003 compared to EUR 4.3 million for 2002, and was primarily the result of net income and adjustments to reconcile net income to net cash flows from operating activities. We adjusted our net income of EUR 0.6 million to reconcile it to net cash flows from operating activities. Adjustments included (1) depreciation of EUR 1.2 million, (2) convertible note adjustment of EUR 0.1 million, (3) bad debt provision of EUR 0.8 million, (4) amortization of goodwill and other intangible assets of EUR 0.1 million and (5) amortization of photographs and videos of EUR 7.1 million making a total of EUR 8.7 million which was offset by EUR 1.2 million from deferred income taxes, providing a net balance of EUR 7.5 million. Changes in operating assets and liabilities added a total of EUR 2.8 million through trade accounts receivable, prepaid expenses and other current assets, accounts payable trade, accrued other liabilities and income taxes payable totaling EUR 4.7 million, offset by EUR 1.9 million from inventories.

Net cash provided by our operating activities was EUR 4.3 million for 2002 compared to EUR 7.5 million for 2001, and was primarily the result of net income and adjustments to reconcile net income to net cash flows from operating activities. We adjusted our net income of EUR 0.3 million to reconcile it to net cash flows from operating activities. Adjustments included (1) depreciation of EUR 1.0 million and (2) amortization of photographs and videos of EUR 5.8 million offset by (3) deferred income taxes of EUR 0.2 million, providing a total of EUR 6.9 million. We reduced the total of EUR 6.9 million by the increases in related party receivable, inventories, prepaid expenses and other current assets and income taxes payable totaling EUR 6.7 million, and we offset this reduction with EUR 4.2 million from trade accounts receivable accounts payable trade and accrued other liabilities.

#### *Investing Activities*

Net cash used in investing activities for the fiscal year ended December 31, 2004 was EUR 5.1 million. The investing activities were investment in library of photographs and videos of EUR 4.9 million, which were carried out in order to maintain the 2003 and 2004 release schedules for magazines, videos, DVDs and broadcasting. In addition to investment in library of photographs and videos, EUR 3.3 million was invested in capital expenditures, which was principally related to the completion of our building, and EUR 1.3 million was invested in a note receivable which was acquired in connection with our US subsidiary's restructuring of its US distribution. The total cash used in investing activities was offset by EUR 4.4 million from sale of part of the building. The decrease over the comparable twelve-month 2003 period is principally due to decreases in investment in library of photographs and videos and building related activities included in capital expenditures and sale of part of building, offset by the net effect of note receivable and the absence of investment in other intangible assets and sale of short-term investment. In 2003 and the first half of 2004, investment in new movie productions was temporarily cut back due to cash-flow restrictions as a result of overspending in 2002 and 2003, which in turn has affected the release frequency of new productions on both Video and DVD. During the latter half of 2004 cash-flow improved and we increased the acquisition of movie productions and the Company expects to attain optimum release frequency of new movie productions during the first half of 2005.

Net cash used in investing activities for the fiscal year ended December 31, 2003 was EUR 9.6 million. The investing activities were investment in library of photographs and videos of EUR 7.0 million, which were carried out in order to maintain the 2003 and 2004 release schedules for magazines, videos, DVDs and broadcasting. In addition to investment in library of photographs and videos, EUR 3.3 million was invested in other intangible assets and EUR 2.0 million was invested in capital expenditures. The total cash used in investing activities was offset by EUR 2.7 million from sale of short-term investment, which was used to reduce the related party note payable. The decrease over the comparable twelve-month 2002 period is principally due to the absence of investments in a building included in capital expenditures in 2002.

Net cash used in investing activities for the fiscal year ended December 31, 2002 was EUR 21.6 million. The investing activities were investment in library of photographs and videos of EUR 8.5 million, which were carried out in order to maintain the 2002 and 2003 release schedules for magazines, videos, DVDs and broadband. In addition to investment in library of photographs and videos, EUR 13.1 million was invested in capital expenditures. The increase over the comparable twelve-month 2001 period is principally due to investments in a building included in capital expenditures primarily financed by related party note payable.

#### *Financing Activities*

Net cash used in financing activities for the fiscal year ended December 31, 2004 was EUR 0.5 million, represented primarily by EUR 4.8 million in repayments on short- and long-term borrowings offset by EUR 2.6 million in cash provided by short- and long-term borrowings and EUR 1.8 million in cash received for conversion of warrants. The main movements resulting in a net decrease of EUR 2.3 million in borrowings during the twelve-month period ended December 31, 2004 are described as follows:

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The \$2.0 million and \$3.0 million loans from Beate Uhse AG were reduced by EUR 2.2 million, inclusive of exchange rate changes. As of December 31, 2004 the \$2.0 million was repaid and the remaining balance on the \$3.0 million loan was EUR 0.7 million. The \$4.0 million Note held by Consipio Holding b.v. was reduced by EUR 0.4 million inclusive of exchange rate changes. As of December 31, 2004 the remaining balance on the Note was EUR 2.2 million.

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In May 2003 Euro 1.65 million of the related party note payable to Luthares was re-financed by an institutional lender at the same interest rate as on the note payable, EURIBOR + 1%. The loan is repayable in equal monthly installments over a four year period starting June 29, 2004. During the twelve months ended December 31, 2004, the Company repaid Euro 0.3 million and subsequently the remaining balance was Euro 1.4 million.

In March 2003, the Company was granted a loan from an institutional lender in the principal amount of EUR 4.2 million of which EUR 1.75 million was received. The loan bears interest at the rate of EURIBOR + 1.5%, repayable over 12 years, including an initial period of 18 months during which only interest is payable. The loan was obtained for the purpose of financing the construction of an office building and is secured by a mortgage on the building. In 2004 an additional EUR 2.45 million was received in order to pay for the completion of the construction of the building. In connection with the sale of part of the property in 2004 EUR 1.9 million was repaid and as of December 31, 2004 the remaining balance on the loan was EUR 2.3 million.

Net cash used in financing activities for the fiscal year ended December 31, 2003 was EUR 2.2 million, represented primarily by EUR 7.7 million in repayments on short- and long-term borrowings and related party note payable offset by EUR 5.5 million in cash received provided by short- and long-term borrowings and convertible notes. We attribute the change over the comparable twelve-month 2002 period to the following:

The \$2.0 million and \$3.0 million loans from Beate Uhse AG were reduced by EUR 2.0 million, inclusive of exchange rate changes. As of December 31, 2003 the remaining balance on the Loans was EUR 2.9 million. The \$4.0 million Note held by Consipio Holding b.v. was reduced by EUR 1.2 million inclusive of exchange rate changes. As of December 31, 2003 the remaining balance on the Note was EUR 2.6 million.

In May 2003 Euro 1.65 million of the related party note payable to Luthares was re-financed by an institutional lender at the same interest rate as on the note payable, EURIBOR + 1%. The loan is repayable in equal monthly installments over a four year period starting June 29, 2004. In December 2003 the Company sold its short-term investment and paid Euro 2.7 million on the related party note payable. The note was originally payable at December 31, 2004, but has been re-negotiated and matures December 31, 2008. The note carries interest payable annually at EURIBOR + 1%. As of December 31, 2003, the balance outstanding on the note was EUR 2.2 million.

Effective September 2003, pursuant to securities purchase agreements entered into separately with four accredited institutional investors, we agreed to issue and sell to each of these investors convertible notes in the aggregate principal amount of \$2.25 million (see Note 11 to the financial statements). Pursuant to the conditions of the agreements, the financing was completed October 27, 2003 and an aggregate net cash amount of EUR 1.9 million was received.

In March 2003, the Company was granted a loan from an institutional lender in the principal amount of EUR 4.2 million of which EUR 1.75 million was received. The loan bears interest at the rate of EURIBOR + 1.5%, repayable over 12 years, including an initial period of 18 months during which only interest is payable. The loan was obtained for the purposes of financing the construction of an office building and is secured by a mortgage on the building. The balance of the loan will be paid out over the remaining period of construction of the building, which is expected to be completed in May 2004.

Net cash provided by our financing activities for the fiscal year ended December 31, 2002 was EUR 12.0 million, represented primarily by related party note payable, short-term borrowings and conversion of warrants during the year offset by repayments of long-term borrowings. We attribute the increase over the comparable twelve-month 2001 period to related party note payable and short-term borrowings which result from loans provided by Beate Uhse in November and December 2002.

*Non-Cash Transaction*

The Company has a note payable to an entity controlled by the Company's principal shareholder. The amount payable at December 31, 2004 was EUR 0.7 million. In September 2004, the amount payable under the note was reduced by EUR 1.5 million as a result of certain adjustments provided for under the December 2002 Share Purchase Agreement for the outstanding stock of Barbuda BV for which the note payable relates to.

**Contractual obligations**

The table below describes the Company's future contractual obligations, including items not included in the consolidated balance sheet, as of December 31, 2004:

|  | Amounts due in |              |              |              | Total         |
|--|----------------|--------------|--------------|--------------|---------------|
|  | Less than      | One to       | Three to     | More than    |               |
|  | one year       | three years  | five years   | five years   |               |
|  | EUR            | EUR          | EUR          | EUR          |               |
| (in thousands)                           |                |              |              |              |               |
| Long-term debt:                          |                |              |              |              |               |
| Banks <sup>(1)</sup>                     | 701            | 1,378        | 743          | 1,413        | 4,236         |
| Non-institutional debt <sup>(1)</sup>    | 3,081          | 46           | 751          |              | 3,879         |
| Convertible Note <sup>(2)(3)</sup>       | 100            | 1,523        |              |              | 1,623         |
| <b>Total long-term debt</b>              | <b>3,883</b>   | <b>2,948</b> | <b>1,494</b> | <b>1,413</b> | <b>9,738</b>  |
| Operating leases <sup>(4)(5)</sup>       | 525            | 1,037        | 103          |              | 1,664         |
| Capital lease obligations <sup>(5)</sup> | 47             | 28           |              |              | 74            |
|  | <b>4,455</b>   | <b>4,012</b> | <b>1,597</b> | <b>1,413</b> | <b>11,476</b> |

The pro-forma table below has been adjusted to show the effects of matters discussed in subsequent events, see Note 22 to the financial statements, and describes the Company's future contractual obligations, including items not included in the consolidated balance sheet, as of December 31, 2004:

|  | Amounts due in |              |            |            | Total        |
|--|----------------|--------------|------------|------------|--------------|
|  | Less than      | One to       | Three to   | More than  |              |
|  | one year       | three years  | five years | five years |              |
|  | EUR            | EUR          | EUR        | EUR        |              |
| (in thousands)                           |                |              |            |            |              |
| Long-term debt:                          |                |              |            |            |              |
| Banks <sup>(1)</sup>                     | 2,800          | 839          | 205        |            | 3,844        |
| Non-institutional debt <sup>(1)</sup>    | 3,786          |              |            |            | 3,786        |
| Convertible Note <sup>(2)(3)</sup>       | 100            | 1,523        |            |            | 1,623        |
| <b>Total long-term debt</b>              | <b>6,686</b>   | <b>2,362</b> | <b>205</b> |            | <b>9,253</b> |
| Operating leases <sup>(4)(5)</sup>       | 525            | 1,037        | 103        |            | 1,664        |
| Capital lease obligations <sup>(5)</sup> | 47             | 28           |            |            | 74           |

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|  |              |              |            |               |
|--|--------------|--------------|------------|---------------|
|  | <u>7,258</u> | <u>3,426</u> | <u>308</u> | <u>10,992</u> |
|--|--------------|--------------|------------|---------------|

- (1) Interest included. Debt with variable interest rate linked to EURIBOR has been calculated at the current rate since EURIBOR has been reasonably stable during the past years.
- (2) Non-cash interest payments included. As provided by the agreement, the Company has declared to pay all future interest in common stock until further notice.
- (3) The amount repayable has been adjusted for a conversion of \$300,000 of the Note into common stock made in January 2004. Should any further conversions take place, the amount payable will be less.
- (4) Includes rent for the Company's offices and warehouses.
- (5) Amounts included in Note 17 in the financial statements.

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**Description of long-term debt:**

*Banks*

In March 2003, the Company was granted a loan from an institutional lender in the principal amount of EUR 4.2 million of which EUR 1.75 million and EUR 2.45 million was received in 2003 and 2004 respectively. The loan bears interest at the rate of EURIBOR + 1.5%, repayable over 12 years, including an initial period of 18 months during which only interest is payable. The loan was obtained for the purposes of financing the construction of an office building and is secured by a mortgage on the building. In 2004 the Company sold part of the property and repaid EUR 1.9 million. The balance outstanding on the loan as of December 31, 2004 was EUR 2.3 million.

In May 2003 Euro 1.65 million of the related party note payable was re-financed by an institutional lender at the same interest rate as on the note payable, EURIBOR + 1%. The loan is repayable in equal monthly installments over a four year period starting June 29, 2004. The loan is guaranteed by the Company's principal shareholder and affiliates of the Company's principal shareholder. The balance outstanding on the loan as of December 31, 2004 was EUR 1.4 million.

The Company's Spanish subsidiary has an existing bank line of credit agreement under which this subsidiary may borrow up to EUR 1.2 million. Borrowings under the line of credit during 2003 were charged interest at EURIBOR+1%. At December 31, 2003 and 2004 the borrowings outstanding under this agreement amounted to EUR 0.8 million and EUR 1.2 million, respectively.

At December 31, 2004 the Company's Swedish subsidiary had an outstanding bank loan totaling EUR 39 thousand. Interest on the loan at December 31, 2004 was 8% which was equal to the Swedish banks' official interest rate at that time. The loan requires principal repayments of EUR 5 thousand quarterly plus accrued interest and the loan matures on September 30, 2006. The loan has been guaranteed by the Company's principal shareholder.

*Non-institutional debt*

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 is guaranteed by Slingsby Enterprises Limited, an affiliate of Berth Milton, Private's Chairman, Chief Executive Officer and principal shareholder, and the guaranty is secured by 4,950,000 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 for five years, with interest on the Note being increased to 9.9% per annum, and to refinance a \$ 3.0 million loan from Beate Uhse AG, discussed below (the \$ 3.0 Million Beate Uhse Loan), which had a maturity date of December 13, 2003. However, Consipio and Private have been unable to reach final agreement on other terms and conditions relating to the restructured Note or refinancing of the \$ 3 Million Beate Uhse Loan. Accordingly, in December 2003 Consipio notified Private and Slingsby Enterprises that Private was in default under the Note, and demanded immediate payment of the outstanding principal under the Note. The Company continues to make all regularly scheduled interest payments on the Note and believes that it has valid defenses to the demand for immediate repayment of the Note, should Consipio seek to enforce immediate repayment. In any event, the Company does not believe that the acceleration of the Note by Consipio, if not rescinded, will have a material adverse effect on the Company, as the Note is fully collateralized by 4,950,000 shares of Private Media Group, Inc. Common Stock pursuant to the guaranty agreement from Slingsby Enterprises Limited. As of December 31, 2004 the outstanding principal under the Note was EUR 2.2 million and is classified as a current liability.

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On December 13, 2002, the group's holding company, Private Media Group, Inc., borrowed \$ 3.0 million from Beate Uhse AG under a Loan Agreement (the \$ 3 Million Beate Uhse Loan). Interest accrues at the rate of 5%, payable quarterly, with the entire principal plus accrued interest due at maturity, December 13, 2003. In December 2003, Beate Uhse AG notified Private Media Group, Inc. that the full loan amount was due and payable and offered to extend the loan maturity, subject to receipt of adequate collateral. Subsequently, Beate Uhse AG proposed an agreement whereby, so long as Private and Beate Uhse continued to maintain a business relationship, no action would be taken to enforce repayment of the \$ 3 Million Beate Uhse Loan, and that loan payments would be made from credits based upon orders by specified Beate Uhse companies to specified Private Media Group companies, as was done with the \$ 2 million Beate Uhse loan. Beate Uhse offered that this arrangement would be

acceptable until December 31, 2005 and that any outstanding balance on the loan would have to be paid by then. In September 2004, a formal agreement reflecting the aforementioned was reached with Beate Uhse AG regarding the restructuring of the \$ 3 Million Beate Uhse Loan. As of December 31, 2004, the balance outstanding on the loan was EUR 0.7 million.

On November 15, 2002, the group's holding company, Private Media Group, Inc., borrowed \$ 2.0 million from Beate Uhse AG under a Loan Agreement. Interest accrues at the rate of 5% per annum, payable quarterly, with the entire principal plus accrued interest due at maturity, November 14, 2003. In November 2003 Beate Uhse agreed to that loan payments would be made from credits based upon orders by specified Beate Uhse companies to specified Private Media Group companies and that the loan would expire when it had been repaid. As of December 31, 2003 the outstanding balance under the Loan Agreement was EUR 389 thousand and as of February, 2004, the loan was repaid in its entirety.

At December 31, 2004, the Company's Spanish subsidiary had a total debt of EUR 74 thousand under certain long term leasing agreements under which the subsidiary has acquired certain equipment, machinery and fixtures. The leasing arrangements carry an average EURIBOR+1.5% rate of interest and cover 36-60 month periods. Payments under these lease agreements are made monthly in an approximate aggregate amount of EUR 5 thousand.

#### *Convertible notes*

Effective September 2003, pursuant to securities purchase agreements entered into separately with four accredited institutional investors, we agreed to issue and sell to each of these investors convertible notes in the aggregate principal amount of \$2.25 million, Series A Warrants exercisable for an aggregate of 337,500 shares of our common stock, and Series B Warrants exercisable for an aggregate of 225,000 shares of our common stock. The securities purchase agreements each provided for the sale of one-half of the convertible notes (\$1.125 million aggregate principal amount) and the issuance of all of the Series A and B Warrants as of the first closing, September 19, 2003, and obligated each of the investors to purchase, and for us to sell and issue to these investors, the remaining convertible notes (\$1.125 million aggregate principal amount) immediately following the registration with the SEC of the common stock issuable under the convertible notes and the warrants (the second closing), which financing was completed effective October 27, 2003. Effective as of the first closing we received aggregate gross cash proceeds of \$1,125,000, and we received an additional \$1,125,000 of aggregate proceeds at the second closing, in each case before deduction of selling expenses. Effective January 2004, one investor converted \$0.3 million (EUR 0.2 million) of principal into common stock. As of December 31, 2004, the amount recorded under long term borrowings, after charging debt discount of EUR 0.6 million to additional paid in capital in 2003, was EUR 1.2 million.

Interest on the notes is payable quarterly, and interest accrues at the rate of 7% per annum from their respective issue dates of September 19, 2003 and October 27, 2003. The outstanding principal balance is due and payable on August 31, 2006, subject to acceleration upon the occurrence of specified events of default. Pursuant to the terms of the notes, the note holders may elect to convert their notes, at any time prior to maturity, into shares of our common stock at a fixed conversion price of \$2.00 per share. In addition to anti-dilution provisions providing for proportionate adjustments in the event of stock splits, stock dividends, reverse stock splits and similar events, this conversion price is subject to downward adjustment upon the issuance by us of common stock or securities convertible into common stock at a price per share of less than \$2.00 per share. We may elect, with limited exceptions, to pay the interest due under the notes through the issuance of shares of common stock at a conversion price equal to the arithmetic average of the five lowest daily volume-weighted average prices of our common stock during the 15 consecutive trading days immediately preceding payment. *For additional information on the convertible notes, see Note 11 to the Financial Statements.*

#### **Outlook**

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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. However, we may need to raise additional funds to support more rapid expansion or respond to unanticipated requirements.

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. 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 or respond to competitive pressures or unanticipated requirements, which could harm our business.



### **Euro Conversion**

Historically, a significant portion of our revenues and operating expenditures have been in Swedish Kronor. Over time, due to internal growth, new business developments and acquisitions, our business activities are being increasingly conducted in countries of the European Union who have adopted the euro as their currency. As a result, for all fiscal periods beginning after December 31, 2001, we are submitting our accounting reports using the euro as our primary reporting currency. The transitional period for the introduction of the euro ended on January 1, 2002 when the euro replaced all local currencies in eleven of the member states. Although the euro conversion may affect cross-competition by creating cross-border price transparency, we believe that this development is unlikely to affect our business due to the low per item cost of our magazines, movies and other products.

### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We do not use derivative financial instruments for trading purposes and were never a party to any derivative, swap or option contracts. We do not hedge our interest rate or foreign currency exchange rate exposures.

As our cash and cash equivalent and short-term investments consist principally of money market securities and investments in short-term debt or equity securities and our borrowings are primarily at fixed rates of interest our market risk related to fluctuations in interest rates is limited. Accordingly, a one percentage change in market interest rates would not have a material impact on our results of operations.

We transact our business in various currencies, principally the Euro and the U.S dollar and certain other European Union currencies. We generally attempt to limit exposure to currency rate fluctuations by matching transaction currencies (revenues/expenses) to the functional currency of its operating subsidiaries. Our exposure to market risk for fluctuations in foreign currency exchange rates relates primarily to fluctuations in the Euro versus the U.S dollar. We translate our consolidated subsidiaries whose functional currency is not the euro into the euro for reporting purposes. Income statement amounts are translated into euros using the average exchange rate for the fiscal year. The balance sheet is translated at the year-end exchange rate. Due to the significance of the results reported in dollars the impact of the euro/dollar exchange rate on our major categories of revenue and expense can be material.

### **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Our audited consolidated financial statements and related notes appear at the end of this Report.

**ITEM 9A. 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, as amended, is recorded, processed, summarized and reported within the specified time periods. As of the end of the period covered by this report, the Company's Chief Executive Officer and Chief Financial Officer evaluated, with the participation of the Company's management, the effectiveness of the Company's disclosure controls and procedures. Based on the evaluation, which disclosed no significant deficiencies or material weaknesses, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective. There were no changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART III**
**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS****Identification of Directors, Executive Officers and Key Employees**

The following table sets forth all of the current directors, executive officers and key employees of Private Media Group, Inc., their age and the office they hold with Private Media Group. Executive officers and employees serve at the discretion of the Board of Directors. All directors hold office until the next annual meeting of shareholders and until their successors have been duly elected and qualified.

| Name  | Age | Position With the Company or Subsidiary   |
|---|-----|---|
| <b>Directors</b>                                  |     |   |
| Berth H. Milton                                   | 49  | President, Chief Executive Officer, Chairman of the Board and Director  |
| Bo Rodebrant                                      | 52  | Director  |
| Ferran Mirapeix                                   | 47  | Director  |
| Johan G. Carlberg                                 | 45  | Director  |
| Daniel Sánchez                                    | 35  | Director  |
| <b>Other Executive Officers and Key Employees</b> |     |   |
| Claes Henrik Mårten Kull                          | 39  | Chief Marketing Officer, Private Media Group, Inc.; Marketing Manager, Milcap Media Group   |
| Javier Sánchez                                    | 43  | Chief Operating Officer, Private Media Group, Inc.;   |
| Johan Gillborg                                    | 42  | Secretary and Chief Financial Officer, Private Media Group, Inc.; Chairman, Private France S.A.; Chairman, Private Benelux; Administrator, Milcap Media Group |
| Philip Christmas                                  | 43  | Vice President, Private Media Group, Inc.; Chief Financial Officer, Milcap Media Group  |

The following sets forth certain information with respect to the persons who are members of the Board of Directors, executive officers or key employees of Private Media Group, Inc.:

**Berth H. Milton** was appointed to the Board of Directors of the Company in February 1998 and was the Corporate Secretary from June 1998 until February 1999. In February 1999 Mr. Milton was appointed Chairman of the Board and Chief Executive Officer of Private, and served as Chief Executive Officer until May 2002. In November 2003 Mr. Milton was reappointed President and Chief Executive Officer of the Company. Mr. Milton was Administrator of Milcap Media Group from its inception until June 2000 and has been acting as an advisor to the Milcap Group since 1991. Mr. Milton is also active in several international industry and real estate projects and developments.

**Bo Rodebrant** was appointed as a Director of Private Media Group, Inc. in August 1998. Mr. Rodebrant has operated his own accountancy and management consulting services, R&S Ekonomiservice, since 1986. Prior to that time he co-founded an ice cream business, Hemglass, which was the largest of its kind in Stockholm, Sweden. The business was sold by Mr. Rodebrant in 1986. Mr. Rodebrant holds a degree in

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construction engineering which he received in 1974.

**Ferran Mirapeix** was appointed to the Board of Directors in December 2001. Mr. Mirapeix joined the Meriden Group, a private holding company, in 1990 and has been its President since 1996. Between 1985 and 1990, he lived in Spain and worked as Director of Marketing and Director of New Business Development for a large consumer goods company. Prior to 1985, he worked for a management consulting firm in the United States for two years. Mr. Mirapeix holds a Law Degree from the University of Barcelona, a Diploma in Economics from the London School of Economics and a Master in Business Administration from Northwestern University.

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**Johan G. Carlberg** was appointed to the Board of Directors in October 2004. Mr. Carlberg has operated his own import, trading and consulting business in the textile and fashion industry since the seventies. Mr. Carlberg holds a Degree in Business from the Stockholm Institute of Business.

**Daniel Sánchez** was appointed to the Board of Directors in October 2004. Since January 2004, Mr. Sanchez has been promoting, as a founding partner, the launching of a new private venture capital firm. Prior to entering the venture capital field, he held the position as Deputy Managing Director at Electrodomésticos Taurus, a consumer electronics company, from 2002 to 2004. Between 1995 and 2002 he worked as a Manager in the field of mergers and acquisitions at Alpha Corporate, a well known international consultancy firm. Mr. Sanchez holds a Master's Degree in Business Administration from the University of Chicago.

**Claes Henrik Mårten Kull** joined the Milcap Media Group in 1992 as a sales manager, and has been Milcap Media Group's Marketing Manager since 1993, and was appointed Chief Marketing Officer of Private Media Group in August 1998, with his main responsibilities being to identify and open up new markets and negotiate with distributors. Since he began working for the Private Media Group, Inc. in 1992, it has commenced distribution in approximately 25 new countries. From 1991 to 1992 he operated his own business (his business partner was Johan Gillborg) which acted as a sub-contracted sales force for Securitas Direct of Sweden. From 1988 to 1991 he managed a private import and trading corporation, which became the start of his career as an entrepreneur and sales professional.

**Javier Sánchez** was appointed as the Chief Operating Officer of Private Media Group, Inc. in August 1998, and has been the General Manager of Milcap Media Group, member of the Board of Milcap Media Group and Private France, and minority shareholder of Milcap Media Group since its incorporation in 1991. He has been a member of the Board of Milcap Publishing Group AB since its incorporation in 1994 until 1997. From 1988 to 1991 he was the Operations Director of a mid-size printing company near Barcelona. From 1984 to 1987 he was the Production Manager of a major printing company in Barcelona.

**Johan Gillborg** was appointed as Chief Financial Officer of Private Media Group, Inc. in August 1998 and has been the Chairman and Managing Director of Milcap Publishing Group AB from 1994 until January 2000. Mr. Gillborg joined the group in 1992 as Marketing Consultant. From 1991 to 1992 he operated his own business which acted as sub-contracting sales force for Securitas Direct of Sweden (together with Mr. Kull). From 1988 to 1990, Mr. Gillborg served as a general manager in the hotel business in the United Kingdom and Portugal. Mr. Gillborg holds a Bachelor's Degree in Business Administration from Schiller International University in London.

**Philip Christmas** was appointed Vice President, in August 2001. Prior to this time Mr. Christmas was employed by PricewaterhouseCoopers and its predecessor firm, Coopers & Lybrand, since 1988. While employed by PricewaterhouseCoopers he was responsible for carrying out audits of multinational and local companies and, more recently, he has provided transaction services to clients acquiring businesses in Spain. Mr. Christmas is a member of the Institute of Chartered Accountants of England and Wales and of ROAC (Official Register of Auditors) in Spain.

No director or executive officer serves pursuant to any arrangement or understanding between him or her and any other person.

#### **Meetings and Committees of the Board of Directors**

The Board of Directors currently has three committees: (i) an Audit Committee, (ii) a Compensation Committee, and (iii) an Executive Committee. The Board of Directors does not have a formal nominating committee, and all decisions regarding director nominations are addressed by the entire Board of Directors.

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Under applicable Nasdaq listing rules the Company is a controlled company as Berth Milton beneficially owns more than 50% of the Company's Common Stock. Therefore, the Company is exempt from Nasdaq rules which require that (i) compensation of executive officers be determined by either a majority of the independent directors or a compensation committee comprised solely of independent directors, and (ii) nomination of directors be made by either a majority of independent directors or a committee comprised solely of independent directors.

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The Company's Board of Directors met five times during 2004 (including actions by unanimous written consent). No director attended less than 75% of the aggregate of all meetings of the Board of Directors and all Committees on which he served during the 2004 fiscal year.

All of the members of the Board of Directors are independent as defined in Nasdaq Stock Market Rule 4200 other than Berth Milton, who is the Company's Chief Executive Officer.

The Audit Committee is currently comprised of Ferran Mirapeix, Johan Carlberg and Daniel Sánchez. All of the members of the Audit Committee are independent as defined in applicable Nasdaq listing requirements and SEC regulations, and each of them is able to read and understand fundamental financial statements. The Board has determined that Ferran Mirapeix is an audit committee financial expert as defined under applicable SEC regulations. The Audit Committee reviews and recommends to the Board, as it deems necessary, the internal accounting and financial controls for the Company and the accounting principles and auditing practices and procedures to be employed in preparation and review of financial statements of the Company. The Audit Committee makes recommendations to the Board concerning the engagement of independent public accountants and the scope of the audit to be undertaken by such accountants. The Audit Committee has adopted a written Audit Committee Charter. The Audit Committee met four times during 2004.

The Compensation Committee is currently comprised of Messrs. Milton and Javier Sánchez. The Compensation Committee reviews and, as it deems appropriate, recommends to the Board policies, practices and procedures relating to the compensation of the officers and other managerial employees and the establishment and administration of employee benefit plans. It exercises all authority under any employee stock option plans of the Company as the Committee therein specified, subject to the review and approval of the Board of Directors, and advises and consults with the officers of the Company as may be requested regarding managerial personnel policies. The Compensation Committee also has such additional powers as may be conferred upon it from time to time by the Board. The Compensation Committee met twice during 2004.

The Executive Committee is comprised of Messrs. Milton, Kull and Javier Sánchez. The Executive Committee is authorized, subject to certain limitations, to exercise all of the powers of the Board of Directors during periods between Board meetings. The Executive Committee met five times during 2004.

The Board has not established a formal nominating committee, nor has the Board adopted a nominating committee charter. Therefore, decisions relating to the nomination of directors are addressed by the entire Board of Directors. The Board has not established any specific minimum qualifications that must be met for recommendation for a position on the Board. Instead, in considering candidates for director, the Board will generally consider all relevant factors, including among others the candidate's applicable expertise and demonstrated excellence in his or her field, the usefulness of such expertise to the Company, the availability of the candidate to devote sufficient time and attention to the affairs of the Company, the candidate's reputation for personal integrity and ethics and the candidate's ability to exercise sound business judgment. Other relevant factors, including diversity, age and skills, will also be considered. Candidates for director are reviewed in the context of the existing membership of the Board (including the qualities and skills of the existing directors), the operating requirements of the Company and the long-term interests of its shareholders. The Board uses its network of contacts when compiling a list of potential director candidates and may also engage outside consultants (such as professional search firms). At this time, the Board does not consider director candidates recommended by shareholders. The Board believes that it is in the best position to identify, review, evaluate and select qualified candidates for Board membership. All of the Company's nominees for director at the 2004 Annual Meeting were approved by the entire Board of Directors.

### **Compensation of Directors**

Our Board of Directors may, at its discretion, compensate directors for attending Board and Committee meetings and reimburse the directors for out-of-pocket expenses incurred in connection with attending such meetings.

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Effective May 2002, we have agreed to pay to Berth Milton a director fee of \$215,000 per year plus out-of-pocket

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expenses for serving as Chairman of the Board. In 1999 we adopted the 1999 Employee Stock Option Plan which authorizes stock options to be issued to directors. On April 3, 2003 Mr. Milton received 2,000,000 options exercisable \$1.20 under the plan for serving as Director and Chairman of the Board. The Company has agreed to pay each of Daniel Sánchez and Johan Carlberg a fee of EUR 2,000 and EUR 1,000, respectively, for each Board and Committee meeting attended. In addition, Messrs. Sánchez and Carlberg have each been granted options to acquire 10,000 and 3,000 shares, respectively, of the Company's Common Stock at an exercise price of \$2.53 per share, which options vest in October 2005 and expire in October 2008.

#### **Code of Ethics**

We have adopted a code of ethics that applies to our principal executive officer, principal financial officer, principal accounting officer and persons performing similar functions. Our code of ethics is filed as Exhibit 14.1 to this Annual Report on Form 10-K. We intend to satisfy the disclosure requirements under Item 10 of Form 8-K, regarding an amendment to or waiver from our code of ethics, by posting the required information on our corporate Internet website at [www.prvt.com](http://www.prvt.com) or as otherwise permitted under applicable law.

#### **Section 16(a) Beneficial Ownership Reporting Compliance**

Based solely upon a review of Forms 3, 4 and 5 furnished to Private Media Group covering its 2004 fiscal year filed under Section 16(a) of the Securities Exchange Act of 1934, Daniel Sánchez and Johan Carlberg did not file Form 3 and Javier Sánchez did not file Form 5.

**ITEM 11. EXECUTIVE COMPENSATION**

The following table summarizes all compensation paid to our Chief Executive Officer serving during 2004 and to our other most highly compensated executive officers other than the Chief Executive Officers whose total annual salary and bonus exceeded \$100,000 (the Named Executive Officers ), for services rendered in all capacities to Private Media Group during the fiscal years ended December 31, 2004, 2003, and 2002. No other executive officer earned compensation in excess of \$100,000 in each of these periods.

**Summary Compensation Table**

| Name and Principal Position During Fiscal 2003  | Fiscal Year | Annual Compensation<br>Salary (\$) | Long-Term  |
|---|-------------|------------------------------------|--|
|   |             |                                    | Compensation/<br>Securities<br>Underlying<br>Options/SAR |
| Berth H. Milton, President and CEO (1)<br>Director, Chairman of the Board   | 2004        | 455,000                            |  |
|   | 2003        | 393,000                            | 2,000,000  |
|   | 2002        | 215,000                            |  |
| Javier Sánchez<br>Chief Operating Officer, Private Media Group, Inc.<br>General Manager, Milcap Media Group   | 2004        | 207,000                            | 500,000  |
|   | 2003        | 188,000                            | 50,000   |
|   | 2002        | 155,000                            |  |
| Mårten Kull<br>Chief Marketing Officer, Private Media Group, Inc.;<br>Marketing Manager, Milcap Media Group   | 2004        | 177,000                            |  |
|   | 2003        | 148,000                            | 50,000   |
|   | 2002        | 98,000                             |  |
| Johan Gillborg<br>Secretary and Chief Financial Officer, Private Media<br>Group, Inc.; Chairman, Private France S.A.; Chairman,<br>Private Benelux; Administrator, Milcap Media Group | 2004        | 165,000                            |  |
|   | 2003        | 137,000                            | 50,000   |
|   | 2002        | 96,000                             |  |
| Phil Christmas<br>Vice President, Private Media Group, Inc.;<br>Chief Financial Officer, Milcap Media Group   | 2004        | 119,000                            |  |
|   | 2003        | 108,000                            | 15,000   |
|   | 2002        | 92,000                             |  |

- (1) Mr. Milton was appointed as the President and CEO of PrivateMedia Group, Inc. in February 1999 and served in such capacity until May 2002. For 2002 compensation reflects base salary as CEO through May 2002 and director fee for 2002. Mr. Milton was reappointed as the President and CEO of PrivateMedia Group, Inc. in November 2003.

**Compensation Committee Interlocks and Insider Participation**

Our Compensation Committee is currently comprised of Messrs. Milton and Sánchez, who are our Chief Executive Officer and Chief Operating Officer, respectively, and served in these capacities during the 2004 fiscal year. During the last fiscal year, none of our executive officers served on our Board of Directors or Compensation Committee of any other entity whose officers served either on our Board of Directors or Compensation Committee.



### Employee Stock Option Plan

The 1999 Employee Stock Option Plan was adopted by the Board of Directors and shareholders of Private Media Group, Inc. in 1999 and was amended effective December 31, 2002. The Plan allows us 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 Plan authorizes us to grant stock options exercisable for up to an aggregate of 7,200,000 shares of common stock. No stock options may be granted under the Plan, after the Plan expires, on March 1, 2009. If a stock option expires, terminates or is cancelled for any reason without having been exercised in full, the shares of common stock not purchased under the Plan are available for future grants.

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 we may specify. The stock option is exercisable for a period of ten years from the date of grant or such shorter period as is determined by us. Each stock option may provide that it is exercisable in full or in cumulative or non-cumulative installments, and each stock option is exercisable from the date of grant or any later date specified in the option. The Board of Directors has the authority under the Plan to take certain actions, including the authority to accelerate vesting schedules and to otherwise waive or adjust restrictions applicable to the exercise of stock options.

Unless otherwise provided by us, an optionee may not exercise a stock option unless from the date of grant to the date of exercise the optionee remains continuously in our employ. If the employment of the optionee terminates for any reason other than death, disability or retirement at or after the age of 65, (1) the stock options then currently exercisable will remain exercisable for a period of 90 days after that termination of employment (except that the 90 day period is extended to 12 months if the optionee dies during such 90 day period), unless those stock options expire prior to the expiration of 90 days, and (2) the stock options then not exercisable will terminate as of the date of termination of employment.

The Board of Directors may at any time suspend, amend or terminate the Plan. Shareholder approval is required, however, to (1) materially increase the benefits accruing to optionees, (2) materially increase the number of securities which may be issued (except for adjustments under anti-dilution clauses), or (3) materially modify the requirements as to eligibility for participation. The Plan authorizes us to include in stock options provisions which permit the acceleration of vesting in the event of a change in control of Private Media Group, Inc. as defined under the Plan.

As of December 31, 2004, 4,661,561 options were outstanding under the Plan with an average exercise price of \$3.47. Options for 2,233,153 shares of common stock remained available for grant as of such date. Future grants under the Plan will be made at our discretion.

**Option Grants in the Last Fiscal Year**

The following table sets forth certain information at December 31, 2004, and for the year then ended, with respect to stock options granted to the individuals named in the Summary Compensation Table above. No options have been granted at an option price below the fair market value of the Common Stock on the date of grant.

**OPTION/SAR GRANTS IN LAST FISCAL YEAR**

| Name            | Number of Securities Underlying Options/SARs Granted(#) | % of Total Options/SARs Granted to Employees In Fiscal Year | Exercise or Base Price(\$/ Sh) | Expiration Date | Potential Realized Value at Assumed Annual Rates of Stock Price Appreciation for Option Term at 5% and 10% Respectively |         |
|-----------------|---|---|--------------------------------|-----------------|---|---------|
|                 |   |   |                                |                 | 345,352   | 763,138 |
| Berth H. Milton |   |   |                                |                 |   |         |
| Javier Sánchez  | 500,000   | 100   | 5.00                           | Oct 7, 2009     | 345,352   | 763,138 |
| Mårten Kull     |   |   |                                |                 |   |         |
| Johan Gillborg  |   |   |                                |                 |   |         |
| Phil Christmas  |   |   |                                |                 |   |         |

The following table summarizes certain information regarding the number and value of all options to purchase Common Stock of Private Media Group, Inc. held by the individuals named in the Summary Compensation Table.

**AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR  
AND FISCAL YEAR-END OPTION VALUES**

| Name | Shares Acquired On Exercise | Value Realized (\$) | Number of Securities Underlying Unexercised Options/SARs At Fiscal Year End Exercisable/Unexercisable |   | Value of Unexercised In-the-Money Options/SARs At Fiscal Year End(\$)* Exercisable/Unexercisable |
|------|-----------------------------|---------------------|---|---|--|
|      |                             |                     | SARs At Fiscal Year End Exercisable/Unexercisable   | At Fiscal Year End(\$)* Exercisable/Unexercisable |  |
|      |                             |                     |   |   |  |

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|                 |           |         |           |
|-----------------|-----------|---------|-----------|
| Berth H. Milton | 2,180,000 | 0       | 6,160,925 |
| Javier Sánchez  | 180,000   | 550,000 | 60,925    |
| Mårten Kull     | 172,500   | 50,000  | 60,300    |
| Johan Gillborg  | 172,500   | 50,000  | 60,300    |
| Phil Christmas  | 0         | 15,000  |           |

(\*) Based on the closing price of our common stock on the last trading day of the fiscal year ended December 31, 2004.

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**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The following table presents certain information as of March 17, 2005, regarding the beneficial ownership of our common stock by (i) each of our directors and executive officers individually, (ii) all persons known by us to be beneficial owners of five percent or more of our common stock, and (iii) all of our directors and executive officers as a group. Unless otherwise noted, the persons listed below have sole voting and investment power and beneficial ownership with respect to such shares.

| <u>Name and Address (1)</u>   | <u>Number of<br/>Shares<br/>Beneficially<br/>Owned (1)</u> | <u>Percent<br/>Beneficially<br/>Owned</u> |
|---|--|---|
| Berth H. Milton (2)<br>Senate Limited (3)                                   | 27,282,985   | 52.2%                                     |
| 3 Bell Lane, Gibraltar<br>Chiss Limited (4)                                 | 5,025,000  | 10.0%                                     |
| 3 Bell Lane, Gibraltar<br>Fidelity Investments International (UK) Ltd. (11) | 4,200,000  | 8.4%                                      |
| 25 Canon Street, London, UK<br>Mårten Kull (5)                              | 4,671,616  | 9.3%                                      |
| Johan Gillborg (6)  | 231,500  | *   |
| Javier Sánchez (7)  | 277,500  | *   |
| Bo Rodebrant (8)  | 210,000  | *   |
| Ferran Mirapeix (9)   | 72,000   | *   |
| Phil Christmas  | 50,000   | *   |
| Johan G. Carlberg<br>Daniel Sánchez   |  |   |
| All Executive Officers and Directors as a group (9 people) (10)             | 28,123,985   | 53.1%                                     |

\* Denotes less than 1%

- (1) Beneficial ownership is determined in accordance with rules of the U.S. Securities and Exchange Commission, and includes generally voting power and/or investment power with respect to securities. Shares of Common Stock which may be acquired by a beneficial owner upon exercise or conversion of warrants, options or Preferred Stock which are currently exercisable or exercisable within 60 days of March 17, 2005, are included in the Table as shares beneficially owned and are deemed outstanding for purposes of computing the beneficial ownership percentage of the person holding such securities but are not deemed outstanding for computing the beneficial ownership percentage of any other person. Except as indicated by footnote, to the knowledge of the Company, the persons named in the table above have the sole voting and investment power with respect to all shares of Common Stock shown as beneficially owned by them.
- (2) Includes 22,296,909 shares of Common Stock owned by Slingsby Enterprises Limited, of which Mr. Milton is the sole shareholder. 4,950,000 of these shares are pledged to a third party to secure payment of a loan from the third party to the Company. See Management - Related Transactions. Also includes (i) 2,785,076 shares of Common Stock owned by Bajari Properties Limited, of which Mr. Milton is the sole shareholder, and (ii) 180,000 shares issuable upon exercise of Options issued under the Employee Stock Option Plan. His address is c/o the Company, Carretera de Rubí 22-26, 08190 Sant Cugat del Vallès, Barcelona, Spain.
- (3) Kate Bentley is the sole shareholder of Senate Limited and, therefore, may be deemed to be the beneficial owner of these shares.
- (4) Marina Magid is the sole shareholder of Chiss Limited and, therefore, may be deemed to be the beneficial owner of these shares.

- (5) Includes 172,500 shares issuable upon exercise of Options issued under the Employee Stock Option Plan owned by Mr. Kull. His address is c/o the Company, Carretera de Rubi 22-26, 08190 Sant Cugat del Vallès, Barcelona, Spain.
- (6) Includes 172,500 shares issuable upon exercise of Options issued under the Employee Stock Option Plan owned by Mr. Gillborg. His address is c/o the Company, Carretera de Rubi 22-26, 08190 Sant Cugat del Vallès, Barcelona, Spain.
- (7) Includes 180,000 shares issuable upon exercise of Options issued under the Employee Stock Option Plan owned by Mr. Sánchez. His address is c/o the Company, Carretera de Rubi 22-26, 08190 Sant Cugat del Vallès, Barcelona, Spain.
- (8) Includes 72,000 shares issuable upon exercise of Options issued under the Employee Stock Option Plan owned by Mr. Rodebrant. His address is c/o the Company, Carretera de Rubi 22-26, 08190 Sant Cugat del Vallès, Barcelona, Spain.
- (9) Includes 50,000 shares issuable upon exercise of Options issued under the Employee Stock Option Plan owned by Mr. Mirapeix. His address is c/o the Company, Carretera de Rubi 22-26, 08190 Sant Cugat del Vallès, Barcelona, Spain.
- (10) Includes 2,827,000 shares issuable upon exercise of outstanding Options under the Employee Stock Option Plan.
- (11) Based upon information reported by the Nasdaq Stock Market as of March 18, 2004. Includes 304,700, 174,200 and 32,216 shares of Common Stock owned by Fidelity Management & Research Co., Fidelity Investments Japan Ltd. and Fidelity Investments SA, respectively, which companies are believed to be affiliates of Fidelity Investments International (UK) Ltd.



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## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

### Certain Relationships

No Director or executive officer of Private Media Group is related to any other Director or executive officer. None of our officers or Directors hold any directorships in any other public entity. There are currently four outside directors on our Board of Directors.

### Related Transactions

We have short-term loans to an entity controlled by Mr. Milton in the amount of EUR 4.2 million and 4.2 million at December 31, 2003 and 2004, respectively. The loans bear interest at the rate of EURIBOR+1% per annum and have no maturity date. During 2003 and 2004 the highest amounts outstanding were EUR 4.5 million and EUR 4.2 million, respectively. Advances and repayments since June 30, 2002 are related to the property that we have acquired from an entity controlled by Mr. Milton, which transaction is discussed below. As of March 18, 2005, EUR 4.3 million remained outstanding on these loans including interest.

In December 2001 we borrowed \$4.0 million from Commerzbank AG pursuant to a Note originally due December 20, 2002 in order to expand our product portfolio. Subsequently the maturity of the Note was extended to March 2003. The Note bears interest at an annual rate of 7%, payable quarterly, with the entire principal amount and accrued interest due on maturity. The Note is prepayable in full upon the sale of equity by us. Upon the Note becoming prepayable, we are required to repay the entire principal amount of the Note together with the greater of (1) accrued interest payable on the Note or (2) a prepayment premium equal to \$200,000. The Note is secured by a guaranty from Slingsby Enterprises and a pledge by Slingsby Enterprises of 5,600,000 shares of our Series A Preferred Stock. The lender and Slingsby Enterprises have also agreed that if the Note remains unpaid at maturity, Commerzbank may elect to exchange the Note for Series A Preferred Stock or common stock owned by Slingsby Enterprises to the value of \$5.0 million. 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 for five years, with interest on the Note being increased to 9.9% per annum. However, Consipio and Private have been 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 immediate payment of the outstanding principal under the Note. The Company continues to make all regularly scheduled interest payments on the Note and believes that it has valid defenses to the demand for immediate repayment of the Note, should Consipio seek to enforce immediate repayment. As of December 31, 2004 the outstanding principal under the Note was \$ 3.1 million (or EUR 2.2 million). In any event, the Company does not believe that the acceleration of the Note by Consipio, if not rescinded, will have a material adverse effect on the Company, as the Note is fully collateralized by 4,950,000 shares of Private Media Group, Inc. Common Stock pursuant to the guaranty agreement from Slingsby. Slingsby Enterprises is beneficially owned by Berth H. Milton, Chairman of the Board of Directors.

Effective December 31, 2002, we completed the purchase of all of the outstanding stock of Barbuda B.V., from companies indirectly beneficially owned by Berth Milton. The principal asset of Barbuda B.V. was an approximately 6,300 square meter office facility and additional parking, located in Barcelona, Spain, under construction. Construction was completed in 2004. The purpose of this transaction was to acquire this property as its European headquarters. Since the acquisition, the Company has been reevaluating its need for additional space and as of February 2005, the Company no longer owns this property, see Note 22 subsequent events in the consolidated financial statements.

The consideration paid by our subsidiary to the seller for the stock was EUR 9,956,950. The consideration consisted of EUR 3,387,581 cash paid in December 2002 and a note payable in the amount of EUR 6,569,369. The note bears interest at a rate of EURIBOR+1% payable annually and was originally due and payable on December 31, 2004. The fair market value of the principal asset, the real estate, is based upon independent appraisals. The amount payable on the Note at December 31, 2004 was EUR 0.7 million. The note has been re-negotiated and expires December

31, 2008.

In May 2003 Euro 1.65 million of the related party note payable was re-financed by an institutional lender at the same interest rate as on the Note Payable, EURIBOR + 1%. The loan is repayable in equal monthly installments over a four year period starting June 29, 2004. The loan is guaranteed by the Company's principal shareholder and affiliates of the Company's principal shareholder.

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The foregoing transactions were approved by a majority of our disinterested directors and are believed to be on terms no less favorable to us than could be obtained from unaffiliated third parties on an arms-length basis.

#### **ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

##### **Fees Paid to BDO Audiberia**

Following is information regarding fees billed by BDO Audiberia for services rendered to the Company in 2003 and 2004.

*Audit Fees.* The aggregate fees billed to the Company by the Company's principal accountant, BDO Audiberia, for the audit of the Company's annual financial statements and for the review of the financial statements included in the Company's quarterly reports on Form 10-Q totaled \$84,000 and \$145,000 in 2003 and 2004, respectively. Audit fees consist of fees for the audit and review of the Company's financial statements, statutory audits, consents and assistance with and review of documents filed with the SEC.

*Audit-Related Fees.* BDO Audiberia did not provide any assurance or related services which are not included under "Audit Fees" in 2003 and 2004, respectively.

*Tax Fees.* BDO Audiberia did not provide any tax compliance, tax advice, or tax planning services in 2003 and 2004, respectively.

##### **Policy on Audit Committee Pre-Approval of Audit and Permissible Non-Audit Services of Independent Auditors**

The Audit Committee pre-approves all audit and permissible non-audit services provided by the Company's independent auditors. These services may include audit services, audit-related services, tax and other services. Pre-approval is generally provided for up to one year, and any pre-approval is detailed as to the particular service or category of services and is generally subject to a specific budget. The independent auditors and management are required to periodically report to the Audit Committee regarding the extent of services provided by the independent auditors in accordance with this pre-approval, and the fees for the services performed to date. The Audit Committee may also pre-approve particular services on a case-by-case basis. During 2003 and 2004, all services provided by BDO Audiberia were pre-approved by the Audit Committee in accordance with this policy.

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K**

**(a) Documents filed as part of this Form 10-K:**

**1. Financial Statements.**

See Consolidated Financial Statements.

**2. Financial Statement Schedules.**

See schedule II.

**3. Exhibits.**

See Exhibit Index.

**(b) Reports on Form 8-K:**

On November 4, 2004, the Registrant filed a Report on Form 8-K to announce the appointment of Johan G. Carlberg and Daniel Sánchez as directors to fill two vacancies on the Registrant's Board of Directors.

**INDEX TO EXHIBITS****Exhibit**

| <b>No.</b> | <b>Description of Document</b>   |
|------------|--|
| ***3.1     | Restated Articles of Incorporation   |
| ***3.2     | Articles of Amendment to the Articles of Incorporation   |
| (1)3.3     | Amended and Restated Bylaws  |
| *4.1       | Specimen Common Stock Certificate.   |
| *4.3       | Certificate of Designation re Preferred Stock.   |
| ++4.4      | Form of Securities Purchase Agreements dated as of September 10, 2003, entered into by the Company with each of Omicron Master Trust, Cranshire Capital L.P., and Solomon Strategic Holdings, Inc., including as exhibits thereto:<br>(a) Exhibit A - Form of Convertible Note.<br>(b) Exhibit B - Form of Series A Warrant.<br>(c) Exhibit C - Form of Series B Warrant.<br>(d) Exhibit D - Form of Registration Rights Agreement dated as of September 10, 2003.<br>(e) Exhibit E - Form of Legal Opinion. |
| ++4.5      | Form of Securities Purchase Agreement dated as of September 10, 2003, entered into by the Company with CD Investment Partners, Ltd., including as exhibits thereto:<br>(a) Exhibit A - Form of Convertible Note.<br>(b) Exhibit B - Form of Series A Warrant.<br>(c) Exhibit C - Form of Series B Warrant.<br>(c) Exhibit D - Form of Registration Rights Agreement dated as of September 10, 2003.<br>(e) Exhibit E - Form of Legal Opinion.  |
| ++4.6      | Letter Agreement dated October 9, 2003, by and between the and CD Investment Partners, Ltd.  |
| *10.1      | Milcap Acquisition Agreement dated December 19, 1997   |
| *10.2      | Cinecraft Acquisition Agreement dated December 19, 1997  |
| *10.3      | Distribution Agreement between Sundance Associates and the Registrant  |
| *10.4      | License Agreement between PCI, Inc. and Milcap Media Ltd.  |
| *10.5      | Letter of Intent dated May 5, 1998, by and between Max s Film AB and Milcap Media Limited as amended on August 20, 1998, and October 12, 1998  |
| *10.7      | Agreement dated March 31, 1998, by and between Milcap Media Ltd. and certain shareholders of Viladalt, S.L.  |
| *10.8      | Agreement dated March 31, 1998, by and between Zebra Forvaltnings, AB and certain shareholders of Viladalt, S.L.   |
| *10.9      | Agreement dated March 31, 1998, by and between Milcap Media Ltd. and certain shareholders of Viladalt, S.L.  |
| *10.10     | Agreement dated March 31, 1998, by and between Milcap Media Ltd. and certain shareholders of Viladalt, S.L.  |
| +++10.11   | Amended and Restated 1999 Employee Stock Option Plan.  |
| **10.12    | Production Agreement dated as of March 29, 1999, by and between Milcap Media Ltd. And Pierre Woodman.  |
| **10.13    | Final Agreement dated as of March 22, 1999, by and among Private Media Group, Inc., Danny Cook and Qamilla Carlsson.   |
| ***10.14   | 7% Note Due 2002 from the Registrant to Commerzbank AK.  |

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- +++10.15 Amendment No.1 to the 7% Note Due 2002
- +10.16 Share Purchase Agreement dated as of December 9, 2002, by and among Fraserside Holdings Limited, Luthares Investments N.V. and Stichting de Oude Waag.

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|         |  |
|---------|--|
| (1)14.1 | Code of Ethics   |
| 21      | Subsidiaries.  |
| 23.1    | Consent of BDO Audiberia   |
| 23.2    | Consent of Bruce E. Waldman, C.P.A.  |
| 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. |

- 
- \* Incorporated by reference from the registrant's Registration Statement on Form SB-2 (SEC File No. 333-62075).
  - \*\* Incorporated by reference from the registrant's Annual Report on Form 10-KSB for the year ended December 31, 1998.
  - \*\*\* Incorporated by reference from the registrant's Registration Statement on Form S-1 (SEC File No. 333-69654).
  - + Incorporated by reference from the registrant's Form 8-K dated January 14, 2003.
  - ++ Incorporated by reference from the Company's Registration Statement on Form S-3 (SEC File No. 333-109607) as filed with the U.S. Securities and Exchange Commission on October 10, 2003.
  - +++ Incorporated by reference from the registrant's Annual Report on Form 10-K for the year ended December 31, 2002.
  - (1) Incorporated by reference from the registrant's Annual Report on Form 10-K for the year ended December 31, 2003.

**SIGNATURES**

In accordance with the requirements of Section 13 or 15(d) of the Exchange Act, the registrant has caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: March 30, 2005

**PRIVATE MEDIA GROUP, INC.**

By: /s/ Berth H. Milton

\_\_\_\_\_  
Berth H. Milton,

Chief Executive Officer

In accordance with the requirements of the Exchange Act, the Report has been signed below by the following persons on behalf of the registrant in the capacities and on the dates indicated.

| <u>Name</u>                                       | <u>Title</u>   | <u>Date</u>    |
|---|--|----------------|
| <u>/s/ Berth H. Milton</u><br>Berth H. Milton     | Chairman of the Board and<br>Chief Executive Officer, Director | March 30, 2005 |
| <u>/s/ Johan Gillborg</u><br>Johan Gillborg       | Chief Financial Officer,<br>Chief Accounting Officer           | March 30, 2005 |
| <u>/s/ Bo Rodebrant</u><br>Bo Rodebrant           | Director   | March 30, 2005 |
| <u>/s/ Ferran Mirapeix</u><br>Ferran Mirapeix     | Director   | March 30, 2005 |
| <u>/s/ Johan G. Carlberg</u><br>Johan G. Carlberg | Director   | March 30, 2005 |
| <u>/s/ Daniel Sánchez</u><br>Daniel Sánchez       | Director   | March 30, 2005 |



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**REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS**

**To the Board of Directors and**

**Shareholders of Private Media Group, Inc.**

1. We have audited the accompanying consolidated balance sheet of Private Media Group, Inc. as of December 31, 2003 and 2004 and the related consolidated statements of income and comprehensive income, shareholders' equity, and cash flows for the three years in the period ended December 31, 2004. We have also audited the schedule listed in the accompanying index. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits. We did not audit the financial statements of Private North America Inc. a wholly-owned subsidiary, which statements reflect total assets constituting 5% and 2% and total revenues constituting 17%, 14% and 14% of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to data included for Private North America Inc, is based solely on the report of those auditors.
2. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal controls over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
3. In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Private Media Group, Inc. at December 31, 2003 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.
4. Also, in our opinion, the schedule presents fairly, in all material responses, the information set forth therein.

/s/ BDO Audiberia Auditores

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**BDO AUDIBERIA AUDITORES**

Barcelona, Spain

March 29, 2005

**To the Board of Directors and**

**Shareholders of Private North America Ltd.**

I have audited the accompanying balance sheets of Private North America Ltd. as of December 31, 2003 and 2004 and the related statements of income and retained earnings and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. I believe that my audit provides a reasonable basis for my opinion.

In my opinion, based on my audit, the financial statements referred to above present fairly, in all material respects, the financial position of Private North America Ltd. at December 31, 2003 and 2004 and the results of its operations and its cash flows for each of the three years ended December 31, 2004, in conformity with generally accepted accounting principles in the United States of America.

/s/ Bruce E. Waldman

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Bruce E. Waldman,  
Certified Public Accountant

Sherman Oaks, California

March 21, 2005

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

|  | December 31,   |               |               |
|--|----------------|---------------|---------------|
|  | 2003           | 2004          | 2004          |
|  | EUR            | EUR           | USD           |
|  | (in thousands) |               |               |
| <b>ASSETS</b>  |                |               |               |
| Cash and cash equivalents  | 856            | 3,261         | 4,467         |
| Trade accounts receivable net (Note 4)   | 9,768          | 8,397         | 11,503        |
| Related party receivable (Note 14)   | 4,187          | 4,220         | 5,781         |
| Inventories - net (Note 5)   | 10,733         | 9,978         | 13,669        |
| Deferred income tax asset (Note 13)  | 1,608          | 2,350         | 3,219         |
| Prepaid expenses and other current assets (Note 10)  | 2,110          | 2,288         | 3,134         |
| <b>TOTAL CURRENT ASSETS</b>  | <b>29,262</b>  | <b>30,494</b> | <b>41,773</b> |
| Library of photographs and videos - net (Note 6)   | 16,807         | 15,146        | 20,748        |
| Property, plant and equipment - net (Note 7)   | 15,792         | 10,910        | 14,945        |
| Other intangible assets (Note 3 and 8)   | 3,590          | 3,467         | 4,750         |
| Goodwill (Note 9)  | 2,425          | 2,425         | 3,322         |
| Note Receivable (Note 10)  |                | 541           | 741           |
| Other assets   | 273            | 297           | 407           |
| <b>TOTAL ASSETS</b>  | <b>68,149</b>  | <b>63,281</b> | <b>86,686</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                |               |               |
| Short-term borrowings (Note 11)  | 4,094          | 3,442         | 4,716         |
| Current portion of long-term borrowings (Note 11)  | 1,614          | 1,313         | 1,798         |
| Accounts payable trade   | 7,486          | 6,099         | 8,355         |
| Income taxes payable (Note 13)   | 981            | 265           | 363           |
| Deferred income taxes (Note 13)  | 2              | 65            | 90            |
| Accrued other liabilities (Note 12)  | 1,791          | 1,068         | 1,463         |
| <b>TOTAL CURRENT LIABILITIES</b>   | <b>15,969</b>  | <b>12,253</b> | <b>16,785</b> |
| Long-term borrowing (Note 11)  | 4,451          | 3,109         | 4,259         |
| Related party payable (Note 14)  | 2,237          | 728           | 997           |
| Convertible notes (Note 11)  | 1,336          | 1,164         | 1,595         |
| <b>TOTAL LIABILITIES</b>   | <b>23,993</b>  | <b>17,254</b> | <b>23,636</b> |
| <b>SHAREHOLDERS EQUITY (Note 15)</b>   |                |               |               |
| Common Stock, \$.001 par value, 100,000,000 shares authorized 49,955,057 and 50,162,176 issued and outstanding at December 31, 2003 and 2004, respectively | 883            | 883           | 1,210         |
| Additional paid-in capital   | 17,124         | 17,321        | 23,728        |
| Common stock to be issued  |                | 1,752         | 2,400         |
| Retained earnings  | 27,976         | 28,213        | 38,648        |
| Accumulated other comprehensive income   | (1,826)        | (2,143)       | (2,936)       |
| <b>TOTAL SHAREHOLDERS EQUITY</b>   | <b>44,157</b>  | <b>46,026</b> | <b>63,050</b> |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>   | <b>68,149</b>  | <b>63,281</b> | <b>86,686</b> |



See accompanying notes to consolidated financial statements.

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**PRIVATE MEDIA GROUP, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**AND COMPREHENSIVE INCOME**

|  | Years ended December 31, |         |         |         |
|--|--------------------------|---------|---------|---------|
|  | 2002                     | 2003    | 2004    | 2004    |
|  | EUR                      | EUR     | EUR     | USD     |
|  | (in thousands)           |         |         |         |
| Net sales                                    | 39,410                   | 38,491  | 35,612  | 48,784  |
| Cost of sales                                | 17,031                   | 19,081  | 18,080  | 24,766  |
| Gross profit                                 | 22,379                   | 19,411  | 17,533  | 24,017  |
| Selling, general and administrative expenses | 20,562                   | 19,871  | 17,976  | 24,624  |
| Offering expenses                            | 1,569                    |         |         |         |
| Operating income (loss)                      | 249                      | (461)   | (443)   | (607)   |
| Interest expense                             | 366                      | 761     | 768     | 1,052   |
| Interest income                              | 327                      | 147     | 165     | 225     |
| Income (loss) before income taxes            | 210                      | (1,075) | (1,046) | (1,434) |
| Income tax (benefit)                         | (130)                    | (504)   | (1,284) | (1,760) |
| Net income (loss)                            | 340                      | (570)   | 238     | 326     |
| Other comprehensive income:                  |                          |         |         |         |
| Unrealized loss on short-term investment     | (67)                     |         |         |         |
| Foreign currency translation adjustments     | 666                      | 642     | (318)   | (435)   |
| Comprehensive income                         | 939                      | 71      | (80)    | (109)   |
| Income (loss) applicable to common shares    | (1,107)                  | (718)   | 238     | 326     |
| Net income (loss) per share:                 |                          |         |         |         |
| Basic  | (0.04)                   | (0.02)  | 0.00    | 0.01    |
| Diluted                                      | (0.04)                   | (0.02)  | 0.00    | 0.01    |

See accompanying notes to consolidated financial statements.

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

|  | Common stock |         | Preferred stock |         | Additional<br>paid-in<br>capital | Common<br>stock<br>to be<br>issued | Stock<br>dividends<br>to be<br>distributed | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income | Total<br>shareholders<br>equity |
|--|--------------|---------|-----------------|---------|----------------------------------|------------------------------------|--|----------------------|---|---------------------------------|
|  | Shares       | Amounts | Shares          | Amounts |                                  |                                    |  |                      |   |                                 |
|  |              | EUR     |                 | EUR     |                                  |                                    |  |                      |   |                                 |
| Balance at January 1, 2002   | 28,370,857   | 863     | 7,000,000       |         | 14,285                           | 396                                | 396  | 29,802               | (3,066)   | 42,280                          |
| Translation Adjustment   |              |         |                 |         |                                  |                                    |  |                      | 666   | 666                             |
| Unrealized loss on short-term investment   |              |         |                 |         |                                  |                                    |  |                      | (67)  | (67)                            |
| Conversion of warrants and options   | 55,295       |         |                 |         | 232                              |                                    |  |                      |   | 232                             |
| Stock dividends  | 182,457      |         |                 |         | 1,150                            |                                    | (1,150)                                    |                      |   |                                 |
| Stock dividends to be distributed  |              |         |                 |         |                                  |                                    | 1,446                                      | (1,446)              |   |                                 |
| Net income   |              |         |                 |         |                                  |                                    |  | 340                  |   | 340                             |
| Balance at December 31, 2002   | 28,608,609   | 863     | 7,000,000       |         | 15,668                           |                                    | 692  | 28,695               | (2,467)   | 43,450                          |
| Issuance of warrants with and beneficial conversion feature for convertible debt |              |         |                 |         | 617                              |                                    |  |                      |   | 617                             |
| Translation Adjustment   |              |         |                 |         |                                  |                                    |  |                      | 642   | 642                             |
| Conversion of preferred stock to common stock                                    | 21,000,000   | 20      | (7,000,000)     |         |                                  |                                    |  |                      |   | 20                              |
| Stock dividends  | 346,448      |         |                 |         | 840                              |                                    | (840)                                      |                      |   |                                 |
| Stock dividends to be distributed  |              |         |                 |         |                                  |                                    | 148  | (148)                |   |                                 |
| Net income (loss)  |              |         |                 |         |                                  |                                    |  | (570)                |   | (570)                           |
| Balance at December 31, 2003   | 49,955,057   | 883     |                 |         | 17,124                           |                                    |  | 27,976               | (1,826)   | 44,157                          |
| Repurchase of common stock   | (116,051)    |         |                 |         | (253)                            |                                    |  |                      |   | (253)                           |
| Conversion of bond principal into common stock                                   | 153,438      |         |                 |         | 236                              |                                    |  |                      |   | 236                             |
| Conversion of bond interest into   | 66,245       |         |                 |         | 124                              |                                    |  |                      |   | 124                             |

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|  |            |     |  |        |       |  |        |         |        |
|--|------------|-----|--|--------|-------|--|--------|---------|--------|
| common stock                             |            |     |  |        |       |  |        |         |        |
| Cash received for conversion of options  |            |     |  | 1,752  |       |  |        | 1,752   |        |
| Conversion of options                    | 19,500     |     |  | 23     |       |  |        | 23      |        |
| Conversion of series A warrants          | 45,000     |     |  | 67     |       |  |        | 67      |        |
| Cashless Conversion of series A warrants | 38,987     |     |  |        |       |  |        |         |        |
| Translation adjustment                   |            |     |  |        |       |  | (319)  | (319)   |        |
| Net income (loss)                        |            |     |  |        |       |  | 238    | 238     |        |
| Balance at December 31, 2004             | 50,162,176 | 883 |  | 17,321 | 1,752 |  | 28,213 | (2,145) | 46,024 |

See accompanying notes to consolidated financial statements.

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|   | Years ended December 31, |                |              |               |
|---|--------------------------|----------------|--------------|---------------|
|   | 2002                     | 2003           | 2004         | 2004          |
|   | EUR                      | EUR            | EUR          | USD           |
|   | (in thousands)           |                |              |               |
| <b>Cash flows from operating activities:</b>  |                          |                |              |               |
| Net income  | 340                      | (570)          | 238          | 326           |
| <b>Adjustment to reconcile net income to net cash flows provided by operating activities:</b> |                          |                |              |               |
| Deferred income taxes   | (237)                    | (1,241)        | (679)        | (930)         |
| Depreciation  | 1,021                    | 1,237          | 2,133        | 2,923         |
| Convertible note adjustment   |                          | 80             | 64           | 88            |
| Bad debt provision  | (39)                     | 776            | 1,649        | 2,259         |
| Amortization of other intangible assets   | 41                       | 94             | 124          | 170           |
| Amortization of photographs and videos  | 5,784                    | 7,091          | 6,568        | 8,998         |
| <b>Changes in operating assets and liabilities:</b>   |                          |                |              |               |
| Trade accounts receivable   | 3,497                    | 1,928          | (279)        | (382)         |
| Related party receivable  | (2,665)                  | 41             | (33)         | (45)          |
| Inventories   | (557)                    | (1,924)        | 754          | 1,033         |
| Prepaid expenses and other current assets   | (1,846)                  | 1,520          | 544          | 745           |
| Accounts payable trade  | 61                       | 557            | (1,386)      | (1,899)       |
| Income taxes payable  | (1,678)                  | 228            | (716)        | (981)         |
| Accrued other liabilities   | 611                      | 452            | (723)        | (991)         |
| <b>Net cash provided by operating activities</b>  | <b>4,334</b>             | <b>10,267</b>  | <b>8,260</b> | <b>11,315</b> |
| <b>Cash flows used in investing activities:</b>   |                          |                |              |               |
| Sale of short-term investments  |                          | (2,670)        |              |               |
| Investment in library of photographs and videos   | 8,471                    | 6,969          | 4,907        | 6,722         |
| Capital expenditures  | 13,125                   | 1,975          | 3,278        | 4,490         |
| Sale of part of building  |                          |                | (4,387)      | (6,010)       |
| Investments in other intangible assets  |                          | 3,259          |              |               |
| Investment in (cash from sale of) other assets  | 20                       | 33             | 24           | 33            |
| Note receivable   |                          |                | 1,262        | 1,728         |
| <b>Net cash used in investing activities</b>  | <b>21,617</b>            | <b>9,566</b>   | <b>5,084</b> | <b>6,964</b>  |
| <b>Cash flow provided by financing activities:</b>  |                          |                |              |               |
| Conversion of stock options and warrants  | 232                      |                | 1,842        | 2,523         |
| Short-term borrowings - repayments  |                          | (3,275)        | (752)        | (1,030)       |
| Long-term borrowings - repayments   | (42)                     | (53)           | (4,093)      | (5,607)       |
| Related party note payable  | 6,569                    | (4,332)        |              |               |
| Convertible note  |                          | 1,910          |              |               |
| Long-term borrowings - additions  |                          | 3,451          | 2,450        | 3,356         |
| Short-term borrowings - additions   | 5,209                    | 119            | 100          | 137           |
| <b>Net cash (used in) provided by financing activities</b>                                    | <b>11,969</b>            | <b>(2,181)</b> | <b>(453)</b> | <b>(621)</b>  |
| Foreign currency translation adjustment   | 599                      | 642            | (318)        | (435)         |
| <b>Net increase in cash and cash equivalent</b>   | <b>(4,715)</b>           | <b>(838)</b>   | <b>2,405</b> | <b>3,294</b>  |
| <b>Cash and cash equivalents at beginning of the year</b>                                     | <b>6,408</b>             | <b>1,694</b>   | <b>856</b>   | <b>1,172</b>  |



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|   |                   |                   |                   |                   |
|---|-------------------|-------------------|-------------------|-------------------|
| <b>Cash and cash equivalents at end of the year</b> | 1,694             | 856               | 3,261             | 4,467             |
|   | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Cash paid for interest                              | 329               | 533               | 637               | 873               |
|   | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Cash paid for taxes                                 | 1,548             | 276               |                   |                   |
|   | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Repurchase of common stock (non-cash transaction)   |                   |                   | 253               | 347               |
|   | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

See accompanying notes to consolidated financial statements.

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. The company and basis of presentation**

Private Media Group, Inc. ( the Company ) was originally incorporated on September 23, 1980 as Glacier Investment Company, Inc. under the laws of the State of Utah and, effective November 24, 1997, after a series of interim name changes, changed its name to Private Media Group Inc. Effective June 12, 1998 the Company acquired Cine Craft Limited ( Cine Craft ), a Gibraltar corporation and Milcap Media Limited ( Milcap ), a Republic of Cyprus corporation. Prior to the acquisitions the Company was a holding company with no operations. Milcap and its subsidiaries and Cine Craft operate under common control and are engaged in the acquisition, refinement and distribution of video and photo rights for adult feature magazines and movies (videocassettes and DVD s) through distributors and via the Internet. The acquisition was accounted for as a reverse acquisition whereby the Company was considered to be the acquiror even though legally it is the acquiror. Accordingly, the accompanying financial statements present the historical combined financial statements of Cine Craft and Milcap from January 1, 1998 through the acquisition date of June 12, 1998 and the consolidated financial statements of the Company, Cine Craft and Milcap since that date. Since the fair value of the net assets of the Company were equal to their net book values on June 12, 1998, the assets and liabilities of the Company remained at their historical cost following the acquisition. During the year ended December 31, 2000, the Company established two new wholly owned subsidiaries, one in Sweden (Peach Entertainment Distribution AB, Peach ) and one in the Republic of Cyprus (Fraserside Holdings Ltd., Fraserside ). These subsidiaries were formed to carry on the business of Milcap Publishing Group AB (Sweden) and Milcap (Cyprus), respectively.

Effective January 1, 2002, the Company changed its reporting currency from the Swedish Krona (SEK) to the euro ( EUR ). On that date, the euro became the principal currency in which Private Media Group generates its cash flows. The assets and operations of the Company s US based operations are currently not significant. The accompanying financial statements have been recast for all periods presented using methodology consistent with Statement of Financial Accounting Standards No. 52, *Foreign Currency Translation* (SFAS 52).

Solely for the convenience of the reader, the accompanying consolidated financial statements as of December 31, 2004 and for the twelve months then ended have been translated into United States dollars ( USD ) at the rate of EUR 0.73 per USD 1.00 the Exchange Rate of the European Central Bank on December 31, 2004. 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. Summary of significant accounting policies**

*Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and all wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

*Foreign Currency*

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The financial statements of the Company's operations based outside of the euro area have been translated into euro in accordance with SFAS 52. Management has determined that the functional currency for each of the Company's foreign operations is its applicable local currency. When translating functional currency financial statements into euro, year-end exchange rates are applied to the balance sheet accounts, while average annual rates are applied to income statement accounts. Translation gains and losses are recorded in other comprehensive income as a component of shareholders' equity.

Transactions involving foreign currencies are translated into euro or functional currencies using exchange rates in effect at the time of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated at period end exchange rates and the resulting gain or loss is charged to income in the period.

Should the Company choose to pay dividends, although the Company's current intention is to re-invest the un-remitted earnings of its foreign subsidiaries, dividends would be declared and paid in euro.

The aggregate exchange gain/(loss) included in determining net income amounted to EUR (1,297) thousand, EUR 265 thousand and EUR 374 thousand for the years ended December 31, 2002, 2003 and 2004, respectively

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*Recognition of Revenue*

The Company's revenue recognition policies are in accordance with Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition in Financial Statements. Revenues from the sale of magazines, videocassettes, DVD's and other related products where distributors are not granted rights-of-return are recognized upon transfer of title, which generally occurs upon delivery.

The Company sells magazines to wholesalers on firm sale basis and via national newsstand distributors with the right to return. Our magazines are multi-lingual and the principal magazine market is in Europe.

Revenues from the sale of magazines 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 magazines. Distributors with the right to return are primarily national newsstand distributors. Most of our magazines 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 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%. Higher percentages generally reflect newer markets and/or products. Percentages are reviewed on an on-going basis.

The magazines have an approximate retail price of EUR 11.50 (USD 15.00) per copy and are printed on glossy high-quality paper at a cost of EUR 1.25 (USD 1.60). 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 has scheduled re-distribution of the returned magazines, via national newsstand distributors, as Megapacks or Superpacks (three different copies per pack) where the retail price is EUR 14.95 (USD 19.50). As the national newsstand distributors have the right to return, the packs come back to us and are then broken up in individual copies in order to be sent out in DVD packs, see below, or sold on firm sale basis to wholesalers as back numbers at a lower price than new issues.

The company recently started 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 and the magazines are broken out in order to be sold on firm sale basis to wholesalers as back numbers at a lower price than new issues. The company has historically sold all copies printed at an average price higher than, or equal, to cost.

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Revenues from the sale of videocassette and DVD products under consignment agreements with distributors are recognized based upon reported sales by the Company's distributors. Revenues from the sale of subscriptions to the Company's internet website are deferred and recognized ratably over the subscription period. Revenues from licensing of broadcasting rights to the Company's video and film library 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. Revenues from satellite & cable broadcasting are recognized based on sales reported each month by its cable and satellite affiliates. The affiliates do not report actual monthly sales for each of their systems to the Pay TV Group 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.

### *Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*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, videocassettes and magazines held for sale or resale.

*Library of Photographs & Videos*

The items in the library comprise our content used for distribution on various formats. Currently these are principally DVD and video cassettes, cable & satellite television and broadband (for films) and magazines and internet narrowband (for photos). All our content is sold or licensed repeatedly, unlike inventory items which are sold only once. Furthermore the content is not only sold on one particular release, or issue, but is also re-edited and included for sale on compilations such as Best of.. titles and publications.

The film library is sold or licensed on various formats such as video cassettes, DVDs, television, and Internet, in different markets and territories. The current rate of technological advance means that we are continually finding new distribution platforms for our content. Recent examples of this would be broadband and broadcasting via digital cable and satellite television with pay-per-view (PPV) and video-on-demand (VOD) abilities. The film library includes: a) films, which represent the content, i.e., the edited movie including soundtrack. b) translations, sound dubbing, & sub-titles, which are required to customize each movie in terms of language for all territories, and c) Digital Manipulation for DVD Masters, which is required to digitize the movie and create menus and language options in order to produce a master to be used to duplicate DVDs from.

The photo library comprises purchased photographic material used for print and internet publications. Our photographic material is used initially in one issue of our four principal magazine titles. However it will normally subsequently be used in later special editions. The print publications are typically printed once and thereafter they are sold over a period of several years, as discussed later. Internet publications are sold via membership fees charged at the Company s websites. Photos are also licensed to other internet and print publishers.

The library of photographs and videos, including rights for photographs and videos as well as translation and dubbing of video material, is reflected at the lower of amortized cost or net realizable value. The cost is amortized on a straight-line basis over 3-5 years representing the estimated useful life of the asset, except for photos which are amortized on a sliding-scale basis over three years. Estimated future revenues are periodically reviewed and, revisions may be made to amortization rates or write-downs made to the asset s net realizable value as a result of significant changes in future revenue estimates. Net realizable value is the estimated selling price in the ordinary course of business, less estimated costs to complete and exploit in a manner consistent with realization of that income.

*Property, Plant and Equipment*

Property, plant and equipment are carried at cost and are generally depreciated using the straight-line method over the estimated useful lives of the assets. The useful lives range from 3-5 years with exception of the building which has an estimated useful life of 50 years.

In March 2000 the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board reached a consensus on Issue 00-2, *Accounting for Web Site Development Costs* ( EITF 00-2 ). In accordance with the transition provisions of EITF 00-2, the Company has elected to apply this standard to website development costs incurred from January 1, 2000 forward. Capitalized website development costs including graphics and related software are being amortized on a straight-line basis over 5 years and are included in property, plant and equipment in the accompanying balance sheet (see Note 7).

*Goodwill and Other Intangible Assets*

Goodwill represents the excess of the purchase price paid over the fair value of the net assets of the businesses acquired, (see Note 9) .

**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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, (see Note 3 and 8). The amortization expense is calculated on a straight-line basis over 10 years for each acquisition, and b) Broadcasting asset, which was acquired from International Film Production and Distribution Limited in 2003 (see Note 3 and 8). At the time of acquisition, the asset was deemed to have an indefinite life and is not subject to amortization.

In July 2001 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 142 Goodwill and Other Intangible Assets (SFAS 142). SFAS 142 was required to be adopted by the company as of January 1, 2002. Under SFAS 142, goodwill and indefinite lived intangible assets are no longer amortized but 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 will continue to be amortized over their expected useful lives with no maximum life specified; whereas under prior rules a maximum life of 40 years was required.

During 2002, the Company performed the required initial impairment test of goodwill and indefinite lived intangible assets as of January 1, 2002. There was no effect on the earnings and financial position of the Company as a result of the impairment testing. The company performs periodic impairment reviews in order to ensure that its accounting treatment is in compliance with SFAS 142 Goodwill and Other Intangible Assets.

*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.

*Advertising Costs*

Advertising costs are charged to income as incurred. The total advertising costs were EUR 2,609 thousand, EUR 2,291 thousand and EUR 2,146 thousand for the years ended December 31, 2002, 2003 and 2004, respectively.

*Shipping and Handling Costs*

Shipping and handling costs related to the Company's products are recognized in cost of sales.

*Income Taxes*



The Company accounts for certain income and expense items differently for financial reporting purposes than for tax purposes. Provision for deferred taxes are made in recognition of such temporary differences, following the requirements of Financial Accounting Standards Board Statement No. 109 *Accounting for Income Taxes*. The Company assesses the recoverability of deferred tax assets and records a valuation allowance when it believes it is not more likely than not that they will be recovered.

*Cash Equivalents*

All highly liquid investments purchased with an original maturity of three months or less at the time of acquisition are considered to be cash equivalents.

*Concentration of Credit Risk*

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents and trade accounts receivable. The Company does not require collateral on these financial instruments.

Cash and cash equivalents are maintained principally with major financial institutions in Spain and Sweden that have high credit standings and the Company's policy is to limit exposure to any one institution. Management attempts to limit credit risk on trade receivables mainly through establishment and monitoring of credit controls.

**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*Basic and Diluted Earnings Per Share*

Basic and diluted earnings per share is calculated in accordance with Financial Accounting Standards Board Statement No. 128, *Earnings per Share* (Note 16).

*Fair Value of Financial Instruments.*

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments. The estimates presented herein are not necessarily indicative of the amounts that the Company could realize in a current market exchange.

Cash and cash equivalents: The carrying amount reported in the balance sheet for cash and cash equivalents approximates its fair value.

Accounts receivable and accounts payable: The carrying amounts reported in the balance sheet for accounts receivable and accounts payable approximate their fair values.

Long-and short-term debt: The carrying amounts of the Company's borrowings under its short-term credit arrangements approximate their fair value. The fair value of the Company's long-term debt and leasing contracts are estimated to be equivalent to their carrying values as the rates of interest in these contract represents rates available to the Company for similar types of arrangements.

*Stock-Based Compensation*

As permitted by Statement of Financial Accounting Standards No. 123 ( SFAS No. 123 ), *Accounting for Stock-Based Compensation*, the Company has elected to continue following Accounting Principles Board Opinion No. 25 ( APB 25 ), *Accounting for Stock Issued to Employees*, and related Interpretations for measurement and recognition of stock-based transactions with employees and adopted the disclosure-only provisions of SFAS No. 123. Under APB 25, generally no compensation expense is recognized since at the date of grant, the exercise price of stock options is set: a) at, or above, current price at closing of market or, b) at the price at closing of market on a pre-determined future date.

Had compensation cost for the Company's stock based compensation issued to employees been determined based upon the fair value at the grant date consistent with the methodology prescribed under SFAS 123, the Company's pro forma net income (loss) for 2002, 2003 and 2004 would have been as per the following table:

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|  | Years ended December 31, |        |       |
|--|--------------------------|--------|-------|
|  | 2002                     | 2003   | 2004  |
|  | EUR                      | EUR    | EUR   |
|  | (in thousands)           |        |       |
| Net income, as reported  | 340                      | (570)  | 238   |
| Deduct: Total stock based employee compensation expense determined under fair value based method for all awards net of related tax effects | (2,406)                  | 82     | (151) |
| Pro forma net income   | (2,066)                  | (448)  | 87    |
| Net income applicable to common shares, as reported  | (1,107)                  | (718)  | 238   |
| Deduct: Total stock based employee compensation expense determined under fair value based method for all awards net of related tax effects | (2,406)                  | 82     | (151) |
| Pro forma net income applicable to common shares   | (3,513)                  | (636)  | 87    |
| Earnings per share:  |                          |        |       |
| Basic as reported  | (0.04)                   | (0.02) | 0.00  |
| Basic pro forma  | (0.12)                   | (0.01) | 0.00  |
| Diluted as reported  | (0.04)                   | (0.02) | 0.00  |
| Diluted pro forma  | (0.12)                   | (0.01) | 0.00  |

**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The weighted average fair value of options granted during 2004 was estimated at \$0.75 per share, based upon the Black-Scholes option-price model with the following weighted average assumptions: 0% dividend yield, expected volatility of 70%, risk-free interest rate of 4.00% and expected life of 2.71 years.

The weighted average fair value of options granted during 2003 was estimated at \$0.57 per share, based upon the Black-Scholes option-price model with the following weighted average assumptions: 0% dividend yield, expected volatility of 70%, risk-free interest rate of 3.82% and expected life of 2.74 years.

The weighted average fair value of options granted during 2002 was estimated at \$3.69 per share, based upon the Black-Scholes option-price model with the following weighted average assumptions: 0% dividend yield, expected volatility of 71% to 90%, risk-free interest rate of 2.60% to 5.29% and expected life of 3-12 years.

**3. Transactions**

*Software Entertainment Ltd*

On May 30, 2003 the Company entered into an Asset Purchase Agreement to acquire certain assets, including governmental film board approvals and distribution rights from its former Canadian distributor, Software Entertainment Ltd. As a result of the acquisition, the Company is starting up its own subsidiary in Canada in an effort to increase sales in the Canadian market. The transaction closed on May 30, 2003. The consideration for the transaction was EUR 734,091. The transaction has been accounted for as the acquisition of an intangible asset and the full value has been assigned to customer base and is being amortized on a straight line basis over 10 years.

*International Film Production and Distribution Limited*

On November 26, 2003 the Company entered into an Asset Purchase Agreement to acquire certain assets from International Film Production and Distribution Limited. As a result of the acquisition, the Company is entering into the global broadcasting market with its proprietary pay-per-view cable & satellite television channels. The entry into the broadcasting market is part of the Company's strategy to distribute its content on all available platforms.

The assets acquired include:

- i) all rights pertaining to the name and concept of the television channels Private Blue and Private Gold,

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- ii) the launch, management and sales representation of the pay-per-view satellite and cable television channels Private Blue Latino and Private Fantasy in North America, inclusive of a five year distribution agreement with Echostar Communication Corporation,
- iii) the management and sales representation of the pay-per-view satellite and cable television channels Private Blue and Private Gold in Latin America, inclusive of a distribution agreement with Pramer, S.C.A. for a majority of the territories in: South America, Central America and the Caribbean and
- iv) two content licensing agreements in Western Europe.

The transaction closed on November 28, 2003. The consideration for the transaction was EUR 2,525,014 and the transaction has been accounted for as the acquisition of an intangible asset. The full value of the transaction has been assigned to broadcasting asset and was deemed not to be subject to amortization.

### *Barbuda BV.*

On December 9, 2002 the Company entered into a Share Purchase Agreement with an entity controlled by the company's principal shareholder to acquire all of the outstanding shares of Barbuda BV. ( Barbuda ) for total consideration of EUR 9,956,950. The consideration consisted of cash EUR 3,387,581 paid in December 2002 and a note payable in the amount of EUR 6,569,369. The note bears interest at a rate of EURIBOR+1% payable annually. The note is payable at December 31, 2004. The transaction was effectively closed on December 31, 2002.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The allocation of the purchase price is as follows:

|                       | <b>EUR</b>       |
|-----------------------|------------------|
| Current assets        | 1,206,962        |
| Building              | 13,194,142       |
| Current liabilities   | (2,189,507)      |
| Long-term liabilities | (2,254,646)      |
|                       | <b>9,956,950</b> |

Prior to its acquisition by the Company, the activity of Barbuda BV entailed the construction of an office building. The Company intends to use this building as its corporate headquarters upon completion. Barbuda BV did not have any other material operations and therefore the pro forma impact on the results of operations is immaterial.

#### 4. Trade accounts receivable

Trade accounts receivable consist of the following:

|                                      | <b>December 31,</b>   |              |
|--------------------------------------|-----------------------|--------------|
|                                      | <b>2003</b>           | <b>2004</b>  |
|                                      | <b>EUR</b>            | <b>EUR</b>   |
|                                      | <b>(in thousands)</b> |              |
| Trade accounts receivable            | 11,792                | 9,328        |
| Allowance for doubtful accounts      | (2,024)               | (930)        |
| Total trade accounts receivable, net | <b>9,768</b>          | <b>8,397</b> |

Management reviews the allowance for doubtful accounts on at least a quarterly basis and adjusts the balance based on their estimate of the collectibility 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.

**5. Inventories**

Inventories consist of the following:

|                               | <b>December 31,</b>   |              |
|-------------------------------|-----------------------|--------------|
|                               | <b>2003</b>           | <b>2004</b>  |
|                               | <b>EUR</b>            | <b>EUR</b>   |
|                               | <b>(in thousands)</b> |              |
| Magazines for sale and resale | 3,257                 | 3,955        |
| Video cassettes               | 2,838                 | 733          |
| DVDs                          | 4,515                 | 5,049        |
| Other                         | 123                   | 241          |
|                               | <b>10,733</b>         | <b>9,978</b> |

## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 6. Library of photographs &amp; videos

Library of photographs & videos consist of the following:

|  | December 31,   |               |
|--|----------------|---------------|
|  | 2003           | 2004          |
|  | EUR            | EUR           |
|  | (in thousands) |               |
| <b>Gross:</b>                              |                |               |
| Photographs                                | 6,042          | 6,707         |
| Videos                                     | 30,926         | 33,204        |
| Translations, Sound Dubbing, & Sub-Titles  | 7,280          | 8,002         |
| Digital Manipulation for DVD Masters       | 4,785          | 6,025         |
| Digital Manipulation for Broadband Masters | 561            | 561           |
|  | <u>49,593</u>  | <u>54,500</u> |
| <b>Less accumulated depreciation:</b>      |                |               |
| Photographs                                | 4,894          | 5,469         |
| Videos                                     | 19,412         | 23,004        |
| Translations, Sound Dubbing, & Sub-Titles  | 5,228          | 6,293         |
| Digital Manipulation for DVD Masters       | 2,949          | 4,175         |
| Digital Manipulation for Broadband Masters | 302            | 414           |
|  | <u>32,786</u>  | <u>39,354</u> |
| <b>Net:</b>                                |                |               |
| Photographs                                | 1,147          | 1,239         |
| Videos                                     | 11,513         | 10,200        |
| Translations, Sound Dubbing, & Sub-Titles  | 2,052          | 1,709         |
| Digital Manipulation for DVD Masters       | 1,835          | 1,851         |
| Digital Manipulation for Broadband Masters | 260            | 148           |
|  | <u>16,807</u>  | <u>15,146</u> |

## 7. Property, Plant and Equipment

Property, plant and equipment consist of the following:



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|   | December 31,   |               |
|---|----------------|---------------|
|   | 2003           | 2004          |
|   | EUR            | EUR           |
|   | (in thousands) |               |
| Building  | 11,663         | 8,202         |
| Equipment & Furniture                           | 7,186          | 7,854         |
| Website Development                             | 1,148          | 1,323         |
| E-commerce software system                      | 462            | 471           |
| Translation difference                          | 131            | (9)           |
| Accumulated depreciation                        | (4,798)        | (6,932)       |
| <b>Total Property, Plant and Equipment, net</b> | <b>15,792</b>  | <b>10,910</b> |

Included under property, plant and equipment in building is the value of our real estate property located in Barcelona, Spain. During 2004 the construction of the property was completed.

In April 2004, the Company signed an agreement for the sale of part of the building. Under the agreement, the Company sold the ground floor of its new office building, which represents approximately 14% of the sellable floor space. The

**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

consideration under the agreement was 1.8 million euro. A 10% down-payment was received upon signature and the balance of the consideration was received upon delivery of the property in August 2004. In June 2004, the Company signed an agreement for the sale of part of the Company's building in Barcelona, Spain. Under the agreement, the Company sold the first floor of the building, which represents approximately 23% of the sellable floor space. The consideration under the agreement was 2.8 million euro. A 10% down-payment was received upon signature and 2.3 million euro was received upon delivery of a substantial part of the property in August 2004. The balance of the consideration will be received upon delivery of the remaining part of the property, which is expected to take place during 2005. Through the aforementioned agreements, the Company sold 37% of the sellable floor space for a total of 4.6 million euro.

The Company has a note payable related to the acquisition of the building. In September 2004, the amount payable under the note was reduced by EUR 1.5 million as a result of certain adjustments provided for under the December 2002 Share Purchase Agreement for the outstanding stock of Barbuda BV. The amount has been applied as a reduction to the value of the property.

As of December 31, 2004 the building had not been used and management was reviewing the future use of the remaining part of the property, but had no intention of selling at that time. In January 2005 the Company received an offer for the rest of the building and in February it was accepted, see subsequent events Note 22 for further discussion.

In March 2000 the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board reached a consensus on Issue 00-2, *Accounting for Web Site Development Costs* ( EITF 00-2 ). EITF 00-2 requires that all costs incurred in the website planning stage should be expensed as incurred.

The EITF also concluded that costs incurred in the website application and infrastructure development stage (including the initial graphics) and costs relating to software used to operate a website are to be accounted for in accordance with Statement of Position No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* ( SOP 98-1 ) unless a plan exists or is being developed to market the website software externally.

The EITF further concluded that costs incurred to operate an existing website including training, administration, maintenance, and other costs should be expensed as incurred. However, costs incurred in the operation stage that involve providing additional functions or features to the website should be accounted for as, in effect, new software and the costs of upgrades and enhancements that add functionality being expensed or capitalized based on the guidance in SOP 98-1.

In accordance with the transition provisions of EITF 00-2, the Company has elected to apply this standard to website development costs incurred from January 1, 2000 forward and accordingly in the years ended December 31, 2003 and 2004 the Company has capitalized EUR 175 thousand and EUR 175 thousand respectively of costs related to the development of its website including graphics and related software.

**8. Other Intangible Assets**

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Other intangible assets consist of the following:

|                               | Years ended December 31, |       |               |       |       |       |
|-------------------------------|--------------------------|-------|---------------|-------|-------|-------|
|                               | 2003                     | 2004  | 2003          | 2004  | 2003  | 2004  |
|                               | Broadcasting asset       |       | Customer Base |       | Total |       |
|                               | EUR                      | EUR   | EUR           | EUR   | EUR   | EUR   |
|                               | (in thousands)           |       |               |       |       |       |
| Beginning of year             |                          | 2,525 | 506           | 1,240 | 506   | 3,765 |
| Acquisition value (cost)      | 2,525                    |       | 734           |       | 3,259 |       |
| End of year                   | 2,525                    | 2,525 | 1,240         | 1,240 | 3,765 | 3,765 |
| Accumulated amortization, beg |                          |       | (80)          | (174) | (80)  | (174) |
| Amortization                  |                          |       | (94)          | (124) | (94)  | (124) |
| Accumulated amortization, end |                          |       | (174)         | (298) | (174) | (298) |
| Net book value                | 2,525                    | 2,525 | 1,066         | 942   | 3,591 | 3,467 |

## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Broadcasting asset is deemed to have an indefinite life and is not subject to amortization. The estimated amortization expense for customer base for the five years ended December 31, 2005 to 2009 is EUR 124 thousand per year.

**9. Goodwill**

|                                     | Years ended December 31, |       |
|-------------------------------------|--------------------------|-------|
|                                     | 2003                     | 2004  |
|                                     | EUR                      | EUR   |
|                                     | (in thousands)           |       |
| Beginning of year                   | 2,900                    | 2,900 |
| Acquisition value (cost)            |                          |       |
| End of year                         | 2,900                    | 2,900 |
| Accumulated amortization, beginning | (475)                    | (475) |
| Amortization                        |                          |       |
| Accumulated amortization, ending    | (475)                    | (475) |
| Net book value                      | 2,425                    | 2,425 |

**10. Note Receivable**

In September the Company's US subsidiary received a Promissory Note issued by Pure Play Media, Inc., a California corporation, as payment for DVDs and Videos purchased. The amount payable to the Company under the Note is \$ 1,728,000 (EUR 1.3 million) together with interest on the principal sum outstanding at the rate of 3.5% per annum. Starting January 1, 2005, principal together with interest is payable in equal monthly installments of \$81,682. The Note is secured by a lien under a Security Agreement and expires on October 1, 2006. The current portion of the Note is included in prepaid expenses and other current assets.

**11. Borrowings**

Short- and long-term borrowings are comprised of the following:

December 31,

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|   | 2003           | 2004         |
|---|----------------|--------------|
|   | EUR            | EUR          |
|   | (in thousands) |              |
| <i>Short-term borrowings:</i>                   |                |              |
| Banks   | 1,100          | 1,200        |
| Non-institutional debt                          | 2,994          | 2,242        |
|   | <u>4,094</u>   | <u>3,442</u> |
| <i>Current portion of long-term borrowings:</i> |                |              |
| Banks   | 314            | 648          |
| Non-institutional debt                          | 1,300          | 665          |
|   | <u>1,614</u>   | <u>1,313</u> |
| <i>Long-term borrowings:</i>                    |                |              |
| Banks   | 3,148          | 3,049        |
| Non-institutional debt                          | 1,303          | 60           |
|   | <u>4,451</u>   | <u>3,109</u> |

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**PRIVATE MEDIA GROUP, INC.**

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*Banks*

In March 2003, the Company was granted a loan from an institutional lender in the principal amount of EUR 4.2 million of which EUR 1.75 million and EUR 2.45 million was received in 2003 and 2004 respectively. The loan bears interest at the rate of EURIBOR + 1.5%, repayable over 12 years, including an initial period of 18 months during which only interest is payable. The loan was obtained for the purposes of financing the construction of an office building and is secured by a mortgage on the building. In 2004 the Company sold part of the property and repaid EUR 1.9 million. The balance outstanding on the loan as of December 31, 2004 was EUR 2.3 million.

In May 2003 Euro 1.65 million of the related party note payable was re-financed by an institutional lender at the same interest rate as on the note payable, EURIBOR + 1%. The loan is repayable in equal monthly installments over a four year period starting June 29, 2004. The loan is guaranteed by the Company's principal shareholder and affiliates of the Company's principal shareholder. The balance outstanding on the loan as of December 31, 2004 was EUR 1.4 million.

The Company's Spanish subsidiary has an existing bank line of credit agreement under which this subsidiary may borrow up to EUR 1.2 million. Borrowings under the line of credit during 2003 were charged interest at EURIBOR+1%. At December 31, 2003 and 2004 the borrowings outstanding under this agreement amounted to EUR 0.8 million and EUR 1.2 million, respectively.

At December 31, 2004 the Company's Swedish subsidiary had an outstanding bank loan totaling EUR 39 thousand. Interest on the loan at December 31, 2004 was 8% which was equal to the Swedish banks' official interest rate at that time. The loan requires principal repayments of EUR 5 thousand quarterly plus accrued interest and the loan matures on September 30, 2006. The loan has been guaranteed by the Company's principal shareholder.

*Non-institutional debt*

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 is guaranteed by Slingsby Enterprises Limited, an affiliate of Berth Milton, Private's Chairman, Chief Executive Officer and principal shareholder, and the guaranty is secured by 4,950,000 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 for five years, with interest on the Note being increased to 9.9% per annum, and to refinance a \$ 3.0 million loan from Beate Uhse AG, discussed below (the \$ 3.0 Million Beate Uhse Loan), which had a maturity date of December 13, 2003. However, Consipio and Private have been unable to reach final agreement on other terms and conditions relating to the restructured Note or refinancing of the \$ 3 Million Beate Uhse Loan. Accordingly, in December 2003 Consipio notified Private and Slingsby Enterprises that Private was in default under the Note, and demanded immediate payment of the outstanding principal under the Note. The Company continues to make all regularly scheduled interest payments on the Note and believes that it has valid defenses to the demand for immediate repayment of the Note, should Consipio seek to enforce immediate repayment. In any event, the Company does not believe that the acceleration of the Note by Consipio, if not rescinded, will have a material adverse effect on the Company, as the Note is fully collateralized by 4,950,000 shares of Private Media Group, Inc. Common Stock pursuant to the guaranty agreement from Slingsby Enterprises Limited. As of December 31, 2004 the outstanding principal under the Note was EUR 2.2 million.

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On December 13, 2002, the group's holding company, Private Media Group, Inc., borrowed \$ 3.0 million from Beate Uhse AG under a Loan Agreement (the \$ 3 Million Beate Uhse Loan). Interest accrues at the rate of 5%, payable quarterly, with the entire principal plus accrued interest due at maturity, December 13, 2003. In December 2003, Beate Uhse AG notified Private Media Group, Inc. that the full loan amount was due and payable and offered to extend the loan maturity, subject to receipt of adequate collateral. Subsequently, Beate Uhse AG proposed an agreement whereby, so long as Private and Beate Uhse continued to maintain a business relationship, no action would be taken to enforce repayment of the \$ 3 Million Beate Uhse Loan, and that loan payments would be made from credits based upon orders by specified Beate Uhse companies to specified Private Media Group companies, as was done with the \$ 2 million Beate Uhse loan. Beate Uhse offered that this arrangement would be

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

acceptable until December 31, 2005 and that any outstanding balance on the loan would have to be paid by then. In September, a formal agreement reflecting the aforementioned was reached with Beate Uhse AG regarding the restructuring of the \$ 3 Million Beate Uhse Loan. As of December 31, 2004, the balance outstanding on the loan was EUR 0.7 million.

On November 15, 2002, the group's holding company, Private Media Group, Inc., borrowed \$ 2.0 million from Beate Uhse AG under a Loan Agreement. Interest accrues at the rate of 5% per annum, payable quarterly, with the entire principal plus accrued interest due at maturity, November 14, 2003. In November 2003 Beate Uhse agreed to that loan payments would be made from credits based upon orders by specified Beate Uhse companies to specified Private Media Group companies and that the loan would expire when it had been repaid. As of December 31, 2003 the outstanding balance under the Loan Agreement was EUR 389 thousand and as of February, 2004, the loan was repaid in its entirety.

At December 31, 2004, the Company's Spanish subsidiary had a total debt of EUR 74 thousand under certain long term leasing agreements under which the subsidiary has acquired certain equipment, machinery and fixtures. The leasing arrangements carry an average EURIBOR+1.5% rate of interest and cover 36-60 month periods. Payments under these lease agreements are made monthly in an approximate aggregate amount of EUR 5 thousand.

*Convertible notes*

Effective September 2003, pursuant to securities purchase agreements entered into separately with four accredited institutional investors, we agreed to issue and sell to each of these investors convertible notes in the aggregate principal amount of \$2.25 million, Series A Warrants exercisable for an aggregate of 337,500 shares of our common stock, and Series B Warrants exercisable for an aggregate of 225,000 shares of our common stock. The securities purchase agreements each provided for the sale of one-half of the convertible notes (\$1.125 million aggregate principal amount) and the issuance of all of the Series A and B Warrants as of the first closing, September 19, 2003, and obligated each of the investors to purchase, and for us to sell and issue to these investors, the remaining convertible notes (\$1.125 million aggregate principal amount) immediately following the registration with the SEC of the common stock issuable under the convertible notes and the warrants (the second closing), which financing was completed effective October 27, 2003. Effective as of the first closing we received aggregate gross cash proceeds of \$1,125,000, and we received an additional \$1,125,000 of aggregate proceeds at the second closing, in each case before deduction of selling expenses. Effective January 2004, one investor converted \$0.3 million (EUR 0.2 million) of principal into common stock. As of December 31, 2004, the amount recorded under long term borrowings, after charging debt discount of EUR 0.6 million to additional paid in capital in 2003, was EUR 1.2 million.

Interest on the notes is payable quarterly, and interest accrues at the rate of 7% per annum from their respective issue dates of September 19, 2003 and October 27, 2003. The outstanding principal balance is due and payable on August 31, 2006, subject to acceleration upon the occurrence of specified events of default. Pursuant to the terms of the notes, the note holders may elect to convert their notes, at any time prior to maturity, into shares of our common stock at a fixed conversion price of \$2.00 per share. In addition to anti-dilution provisions providing for proportionate adjustments in the event of stock splits, stock dividends, reverse stock splits and similar events, this conversion price is subject to downward adjustment upon the issuance by us of common stock or securities convertible into common stock at a price per share of less than \$2.00 per share. We may elect, with limited exceptions, to pay the interest due under the notes through the issuance of shares of common stock at a conversion price equal to the arithmetic average of the five lowest daily volume-weighted average prices of our common stock during the 15 consecutive trading days immediately preceding payment.



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The Series A Warrants have an exercise price of \$2.00 per share, and are exercisable at any time from September 19, 2003, through September 19, 2008. The Series B Warrants have an exercise price of \$1.00 per share, are exercisable only upon the occurrence of specified events, and expire on September 19, 2004. Events which entitle the holders of the Series B Warrants to exercise the warrants include the following: (i) a material adverse change in our business, as defined in the securities purchase agreements; or (ii) the market price of our common stock on March 19, 2004, is less than \$2.37, with the market price being defined as the arithmetic average of the five lowest daily volume-weighted average prices of our common stock during the 15 consecutive trading days immediately preceding March 19, 2004. On March 19, 2004 the Market Price was greater than \$2.37. In addition to anti-dilution provisions providing for proportionate adjustments in the event of stock splits, stock dividends, reverse stock splits and similar events, the exercise price of the warrants is subject to downward adjustment upon the issuance by us of common stock or securities convertible into common stock at a price per share of less than the then current exercise price.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Payment of the exercise price of the warrants may be made, at the option of the warrant holder, either in cash or by a cashless exercise. Upon a cashless exercise, in lieu of paying the exercise price in cash, the warrant holder would receive shares of common stock with a value equal to the difference between the market price (the average of the closing prices of the common stock for the five trading days immediately preceding the exercise date) at the time of exercise and the then current exercise price multiplied by the number of shares so exercised. During 2004 the equivalent of 145,000 Series A warrants were exercised, of which 100,000 were converted into 38,987 shares of common stock through a cashless conversion.

**12. Accrued other liabilities**

Accrued other liabilities are comprised of the following:

|                           | December 31,   |              |
|---------------------------|----------------|--------------|
|                           | 2003           | 2004         |
|                           | EUR            | EUR          |
|                           | (in thousands) |              |
| Accrued expenses          | 494            | 122          |
| Deferred income           | 906            | 462          |
| Taxes and social security | 321            | 352          |
| Other                     | 70             | 131          |
|                           | <u>1,791</u>   | <u>1,068</u> |

**13. Income taxes**

Following is a summary of income before income taxes of U.S. and international operations:

|               | Years ended December 31, |         |         |
|---------------|--------------------------|---------|---------|
|               | 2002                     | 2003    | 2004    |
|               | EUR                      | EUR     | EUR     |
|               | (in thousands)           |         |         |
| USA           | (3,167)                  | (1,474) | (2,329) |
| International | 3,377                    | 399     | 1,282   |

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The provision for income taxes consisted of the following in the years ended December 31, 2002, 2003, and 2004:

|                                       | <b>Years ended December 31,</b> |                |                |
|---------------------------------------|---------------------------------|----------------|----------------|
|                                       | <b>2002</b>                     | <b>2003</b>    | <b>2004</b>    |
|                                       | <b>EUR</b>                      | <b>EUR</b>     | <b>EUR</b>     |
|                                       | <b>(in thousands)</b>           |                |                |
| <i>Current</i>                        |                                 |                |                |
| Federal                               | (601)                           |                |                |
| State                                 | 1                               | 17             | 1              |
| Foreign                               | 719                             | 721            | (607)          |
| <b>Current tax expense</b>            | <b>118</b>                      | <b>738</b>     | <b>606</b>     |
| <i>Deferred</i>                       |                                 |                |                |
| Federal                               | (296)                           | (473)          | (595)          |
| State                                 | (49)                            | 42             | (98)           |
| Foreign                               | 97                              | (810)          | 14             |
| <b>Deferred tax expense/(benefit)</b> | <b>(248)</b>                    | <b>(1,241)</b> | <b>(679)</b>   |
| <b>Income tax expense/(benefit)</b>   | <b>(130)</b>                    | <b>(504)</b>   | <b>(1,284)</b> |

## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A reconciliation of income taxes determined using the United States corporate statutory rate of 35% to actual income taxes provided is as follows:

|                                       | Years ended December 31, |               |                |
|---------------------------------------|--------------------------|---------------|----------------|
|                                       | 2002                     | 2003          | 2004           |
| US federal statutory income tax rate  | 35.00%                   | 35.00%        | 35.00%         |
| Aggregate effect of foreign tax rates | (41.16)%                 | 28.65%        | 96.30%         |
| Permanent differences                 |                          |               |                |
| Items not deductible for tax purposes | 11.61%                   | (0.12)%       | 8.08%          |
| Prior period adjustments              | (38.65)%                 | 6.28%         | 289.77%        |
| Other                                 | 2.97%                    | (11.09)%      | (75.40)%       |
| Movement in valuation allowances      | 4.83%                    | (11.85)%      | (231.05)%      |
| <b>Total tax provision</b>            | <b>(25.39)%</b>          | <b>46.88%</b> | <b>122.70%</b> |

In 2004, a deferred tax asset was recognized for the Subpart F income that has been previously taxed at the US federal and state levels and not included in the US parent company's financial income. However, the deferred tax impact of this amount was offset in large part by the recognition of a valuation allowance.

While on a consolidated basis the Company was in a US GAAP financial statement loss position in 2003, significant current tax expense was recorded in Spain and The Netherlands. In addition, losses incurred in various jurisdictions around the world, significant temporary book-tax differences in Spain, as well as adjustments between US GAAP and local accounting rules generated a deferred tax benefit in 2003 that led to the relatively high effective tax rate.

The tax charge for 2002 includes the effect of a benefit arising from the reversal of an overprovision of taxes recorded in prior years. This principally reflects the release to income of amounts accrued during 2000 in connection with the Company's estimated liability for income taxes on certain foreign source income accruing since the date of the acquisition of certain subsidiaries in 1998. During 2002, the Company completed amended return filings in connection with these taxes for applicable tax years and released amounts originally provided and not required as of December 31, 2002.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Deferred tax assets and liabilities reflect the future tax consequences of events that have already been recognized in the consolidated financial statements or income tax returns. At December 31, deferred tax assets and liabilities consisted of the following:

|                                  | December 31,   |              |
|----------------------------------|----------------|--------------|
|                                  | 2003           | 2004         |
|                                  | EUR            | EUR          |
|                                  | (in thousands) |              |
| <i>Deferred Tax Assets:</i>      |                |              |
| Provisions for sales returns     | 515            | 164          |
| Provision for bad debts          | 43             | 52           |
| Differences in fixed assets      | 34             | 97           |
| Deferred expenses/revenues       | 112            | 108          |
| NOL carryforwards                | 889            | 2,103        |
| Investment in subsidiaries       |                | 2,169        |
| Other                            | 123            | 114          |
|                                  | <u>1,716</u>   | <u>4,807</u> |
| Less: Valuation allowance        | (108)          | (2,457)      |
|                                  | <u>1,608</u>   | <u>2,350</u> |
| <i>Deferred Tax Liabilities:</i> |                |              |
| Deferred expenses/revenues       | 49             |              |
| Spanish leasing benefits         | (8)            | (11)         |
| Investment Incentives            | (7)            | (8)          |
| Swedish Tax Reserves             | (36)           | (45)         |
|                                  | <u>1,606</u>   | <u>2,285</u> |

## Net Operating Loss Carryforward

The company's operating loss carry-forwards are described in the table below:

|        | Year ended<br>December 31,<br>2004 |
|--------|------------------------------------|
|        | EUR<br>(in thousands)              |
| USA    | 3,483                              |
| Sweden | 10                                 |
| Cyprus | 1,551                              |

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|        |       |
|--------|-------|
| Spain  | 1,405 |
| Canada | 225   |
|        | <hr/> |
|        | 6,674 |
|        | <hr/> |

Cyprus, the United States, and Spain are the jurisdictions in which nearly all of the NOLs have been generated. NOLs in Cyprus post-2000 may be carried forward indefinitely. The NOLs in the United States may be carried back 2 years and carried forward for 20 years, while the NOLs in Spain may only be carried forward for 15 years.

No provision has been made for United States federal and state taxes or foreign taxes that may result from future remittances of undistributed earnings of the Company's foreign subsidiaries because it is expected that all such earnings will be permanently reinvested in these foreign operations.

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**14. Related party transactions**

The Company has short-term loans receivable from entities controlled by the Company's principal shareholder of EUR 4,187 thousand and EUR 4,220 thousand at December 31, 2003 and 2004 respectively. The loans bear interest at a rate of EURIBOR+1% payable annually. The balance of these loans at December 31, 2004 totaled EUR 4,220 thousand which includes accrued interest.

The Company has a note payable to an entity controlled by the Company's principal shareholder. The amount payable at December 31, 2003 and 2004 was EUR 2,237 thousand and EUR 728 thousand, respectively. The note bears interest at a rate of EURIBOR+1% payable annually. The note was originally payable at December 31, 2004, but has been re-negotiated and expires December 31, 2008.

In May 2003 Euro 1.65 million of the related party note payable was re-financed by an institutional lender at the same interest rate as on the Note Payable, EURIBOR + 1%. The loan is repayable in equal monthly installments over a four year period starting June 29, 2004. The loan is guaranteed by the Company's principal shareholder and affiliates of the Company's principal shareholder.

In December 2001 we borrowed \$4.0 million from Commerzbank AG pursuant to a Note originally due December 20, 2002 in order to expand our product portfolio. Subsequently the maturity of the Note was extended to March 2003. The Note bears interest at an annual rate of 7%, payable quarterly, with the entire principal amount and accrued interest due on maturity. The Note is prepayable in full upon the sale of equity by us. Upon the Note becoming prepayable, we are required to repay the entire principal amount of the Note together with the greater of (1) accrued interest payable on the Note or (2) a prepayment premium equal to \$200,000. The Note is secured by a guaranty from Slingsby Enterprises and a pledge by Slingsby Enterprises of 5,600,000 shares of our Series A Preferred Stock. The lender and Slingsby Enterprises have also agreed that if the Note remains unpaid at maturity, Commerzbank may elect to exchange the Note for Series A Preferred Stock or common stock owned by Slingsby Enterprises to the value of \$5.0 million. 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 for five years, with interest on the Note being increased to 9.9% per annum. However, Consipio and Private have been 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 immediate payment of the outstanding principal under the Note. The Company continues to make all regularly scheduled interest payments on the Note and believes that it has valid defenses to the demand for immediate repayment of the Note, should Consipio seek to enforce immediate repayment. As of December 31, 2004 the outstanding principal under the Note was \$ 3.1 million (or EUR 2.2 million). In any event, the Company does not believe that the acceleration of the Note by Consipio, if not rescinded, will have a material adverse effect on the Company, as the Note is fully collateralized by 4,950,000 shares of Private Media Group, Inc. Common Stock pursuant to the guaranty agreement from Slingsby. Slingsby Enterprises is beneficially owned by Berth H. Milton, Chairman of the Board of Directors.

**15. Shareholders' equity**

*Retained Earnings*

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The Company is a holding company with no significant operations of its own. Accordingly, the retained earnings of the Company represent the accumulated earnings of its foreign subsidiaries, principally Cine Craft Ltd, Milcap Media Ltd. and Fraserside Holdings Ltd. The ability of the Company to pay dividends is dependent on the transfer of accumulated earnings from these subsidiaries. The Company is not currently aware of any significant restrictions that would inhibit its ability to pay dividends should it choose to do so, although the Company's current intention is to re-invest the unremitted earnings of its foreign subsidiaries. In addition the Company is restricted from payment of dividends under the terms of its short-term note agreement (Note 11).

### *Common Stock*

The Company is authorized to issue 100,000,000 shares of common stock. Holders of common stock are entitled to one vote per share. The common stock is not redeemable and has no conversion or pre-emptive rights.



**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In June, 2000, the Company's shareholders and board of directors approved an increase in the Company's authorized capital stock, consisting of an increase in the number of authorized common shares from 50,000,000 to 100,000,000. This increase was effected in August 2001 upon the filing of a Certificate of Amendment of the Company's articles of incorporation with the Nevada Secretary of State.

During 2000 the Company's Board of Directors authorized the repurchase of up to 10% of the Company's outstanding common shares. Such purchases may be made from time to time in the open market for an indefinite period of time. As of December 31, 2003 no shares had been repurchased.

*Stock Dividend*

The Company implemented a 3:1 stock dividend whereby each holder of record of Common Stock on May 30, 2000, received two additional shares of Common Stock for each share owned. Corresponding adjustments have been made to the Warrants and Options outstanding on the record date as well as the Series A Preferred Stock to reflect the dividend. Accordingly, all share and per share values reflected in the accompanying consolidated financial statements have been adjusted to give effect to the stock dividend.

*Preferred Stock*

The Company is authorized to issue 10,000,000 shares of preferred stock with relative rights, preferences and limitations determined at the time of issuance. The Company has issued 7,000,000 shares of \$4.00 Series A convertible preferred stock. The Series A convertible preferred stock is non-voting and provides for a 5% annual stock dividend beginning in 1998 to be paid quarterly in common stock at the average closing price of the Company's common stock for the twenty consecutive days prior to the quarterly record date. Each preferred share is convertible at any time into common shares on a one-for-three basis (post-split). Additionally, at any time the common stock of the Company has a closing price of less than \$1.33 per share for twenty consecutive days the preferred stock may be converted at the option of the holder thereof into common stock at a 20% discount to the five day average closing price prior to the date of conversion. In accordance with the terms of the Series A Preferred Stock Agreement, 346,448 shares of common stock were issued in 2003 with respect to dividends on preferred shares relating to 2002 and 2003. On March 18, 2003 and August 8, 2003, Slingsby Enterprises Limited converted 5,350,000 and 1,650,000 shares of \$4.00 Series A convertible preferred stock into 16,050,000 and 4,950,000 shares of common stock, respectively. Accordingly, as of August 8, 2003, no shares of Series A Preferred Stock remained outstanding.

*Common Stock Warrants*

During 2004 the equivalent of 145,000 Series A warrants were exercised of which 100,000 were converted into 38,987 shares of common stock through a cashless conversion. *For more information on Series A Warrants, see convertible notes below.*

*Convertible notes*

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Effective September 2003, pursuant to securities purchase agreements entered into separately with four accredited institutional investors, we agreed to issue and sell to each of these investors convertible notes in the aggregate principal amount of \$2.25 million, Series A Warrants exercisable for an aggregate of 337,500 shares of our common stock, and Series B Warrants exercisable for an aggregate of 225,000 shares of our common stock. The securities purchase agreements each provided for the sale of one-half of the convertible notes (\$1.125 million aggregate principal amount) and the issuance of all of the Series A and B Warrants as of the first closing, September 19, 2003, and obligated each of the investors to purchase, and for us to sell and issue to these investors, the remaining convertible notes (\$1.125 million aggregate principal amount) immediately following the registration with the SEC of the common stock issuable under the convertible notes and the warrants (the second closing), which financing was completed effective October 27, 2003.

Interest on the notes is payable quarterly, and interest accrues at the rate of 7% per annum from their respective issue dates of September 19, 2003 and October 27, 2003. The outstanding principal balance is due and payable on August 31, 2006, subject to acceleration upon the occurrence of specified events of default. Pursuant to the terms of the notes, the note holders may elect to convert their notes, at any time prior to maturity, into shares of our common stock at a fixed conversion price of \$2.00 per

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

share. In addition to anti-dilution provisions providing for proportionate adjustments in the event of stock splits, stock dividends, reverse stock splits and similar events, this conversion price is subject to downward adjustment upon the issuance by us of common stock or securities convertible into common stock at a price per share of less than \$2.00 per share. We may elect, with limited exceptions, to pay the interest due under the notes through the issuance of shares of common stock at a conversion price equal to the arithmetic average of the five lowest daily volume-weighted average prices of our common stock during the 15 consecutive trading days immediately preceding payment.

In connection with the sale of the convertible notes, effective as of September 19, 2003 we issued to the four investors Series A Warrants exercisable for an aggregate of 337,500 shares of our common stock, and Series B Warrants exercisable for an aggregate of 225,000 shares of our common stock. The Series A Warrants have an exercise price of \$2.00 per share, and are exercisable at any time from September 19, 2003, through September 19, 2008. The Series B Warrants have an exercise price of \$1.00 per share, are exercisable only upon the occurrence of specified events, and expire on September 19, 2004. Events which entitle the holders of the Series B Warrants to exercise the warrants include the following: (i) a material adverse change in our business, as defined in the securities purchase agreements; or (ii) the market price of our common stock on March 19, 2004, is less than \$2.37, with the market price being defined as the arithmetic average of the five lowest daily volume-weighted average prices of our common stock during the 15 consecutive trading days immediately preceding March 19, 2004. On March 19, 2004 the Market Price was greater than \$2.37. In addition to anti-dilution provisions providing for proportionate adjustments in the event of stock splits, stock dividends, reverse stock splits and similar events, the exercise price of the warrants is subject to downward adjustment upon the issuance by us of common stock or securities convertible into common stock at a price per share of less than the then current exercise price. Payment of the exercise price of the warrants may be made, at the option of the warrant holder, either in cash or by a cashless exercise. Upon a cashless exercise, in lieu of paying the exercise price in cash, the warrant holder would receive shares of common stock with a value equal to the difference between the market price (the average of the closing prices of the common stock for the five trading days immediately preceding the exercise date) at the time of exercise and the then current exercise price multiplied by the number of shares so exercised. During 2004 the equivalent of 145,000 Series A warrants were exercised of which 100,000 were converted into 38,987 shares of common stock through a cashless conversion.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 16. Earnings per share

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

|  | Years ended December 31, |            |            |
|--|--------------------------|------------|------------|
|  | 2002                     | 2003       | 2004       |
| <b>Numerator: (EUR in thousands)</b>   |                          |            |            |
| Net income (numerator diluted EPS)   | 340                      | (570)      | 238        |
| Less: Dividends on preferred stock   | 1,446                    | 148        |            |
| Income applicable to common shares (numerator basic EPS)                                   | (1,107)                  | (718)      | 238        |
| <b>Denominator:</b>  |                          |            |            |
| Denominator for basic earnings per share weighted average shares outstanding               | 28,626,327               | 43,493,163 | 50,136,203 |
| Effect of dilutive securities:   |                          |            |            |
| Preferred stock  | n/a                      | n/a        |            |
| Common stock warrants, options and other dilutive securities                               | n/a                      | n/a        | 2,240,959  |
| Denominator for diluted earnings per share weighted average shares and assumed conversions | n/a                      | n/a        | 52,377,163 |
| <b>Earnings per share (in EUR)</b>   |                          |            |            |
| Basic  | (0.04)                   | (0.02)     | 0.00       |
| Diluted  | (0.04)                   | (0.02)     | 0.00       |

For 2002 and 2003 diluted impact of potentially dilutive securities is anti-dilutive therefore diluted and basic loss per share are EUR 0.04 and EUR 0.02, respectively. The equivalent of 21,085,904 and 7,230,440 common shares derived from dilutive securities such as options, warrants, convertible notes and convertible preferred shares are excluded from the diluted earnings per share for 2002 and 2003, respectively, as they are anti-dilutive.

## 17. Commitments and contingent liabilities

The Company leases certain property and equipment under non-cancelable operating leases. Certain of these leases contain renewal options. Rental payments under these leases are charged to operations on a straight-line basis with any differential recognized as deferred rent in the balance sheet. The rental payments under these leases are charged to operations as incurred. Rental expense for the years ended December 31,

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2002, 2003 and 2004 amounted to EUR 849 thousand, EUR 931 thousand and EUR 967 thousand, respectively.

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## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Future minimum payments under non-cancelable leases as of December 31, 2004 are as follows:

| Year | EUR<br>(in thousands) |
|------|-----------------------|
| 2005 | 572                   |
| 2006 | 534                   |
| 2007 | 530                   |
| 2008 | 51                    |
| 2009 | 51                    |
|      | 1,739                 |

In December 1999 the Company received final notification from the Swedish Tax Authority assessing its subsidiary in Cyprus for the tax years 1995-1998 for a total amount of SEK 42,000,000 (approx. EUR 4.5 million) plus fines amounting to SEK 16,800,000 (approx. EUR 1.8 million) plus interest. The Swedish Tax Authority has taken the position that the subsidiary carried on business in Sweden from a permanent establishment during the period in question and should therefore be taxed on the income attributable to the permanent establishment. The case is under litigation and the Company believes the circumstances supporting the Tax Authority's claim are without merit. However, the County Court has decided that a permanent establishment is at hand. The Court has only made a principle statement and the question how to calculate any eventual profit that can be allocated to the permanent establishment is not decided by the Court at this stage. The Company has appealed against the decision. The final outcome of this litigation will not be known for several years. Due to the early stages of this matter and the uncertainty regarding the ultimate decision, no amounts have been provided in the Company's financial statements for this dispute.

### 18. Operations by geographical area

The Company operates in one business segment, which is the acquisition, refinement and distribution of video and photo rights for adult feature magazines, movies and the Internet.

Information concerning net sales from the Company's geographic locations is summarized as follows:

|                  | Years ended December 31, |                |      |
|------------------|--------------------------|----------------|------|
|                  | 2002                     | 2003           | 2004 |
|                  | EUR                      | EUR            | EUR  |
| <i>Net Sales</i> |                          | (in thousands) |      |

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|              |                   |                   |                   |
|--------------|-------------------|-------------------|-------------------|
| USA          | 7,472             | 5,527             | 5,486             |
| Gibraltar    | 1,437             | 975               | 1,276             |
| Cyprus       | 14,367            | 9,985             | 13,614            |
| Sweden       | 25,362            | 25,668            | 23,690            |
| Spain        | 28,698            | 32,035            | 26,763            |
| France       | 1,793             | 1,595             | 1,698             |
| Benelux      | 3,629             | 3,212             | 3,072             |
| Canada       |                   | 546               | 1,206             |
|              | <u>          </u> | <u>          </u> | <u>          </u> |
| Eliminations | (43,347)          | (41,051)          | (41,193)          |
|              | <u>          </u> | <u>          </u> | <u>          </u> |
| Total        | 39,410            | 38,491            | 35,612            |
|              | <u>          </u> | <u>          </u> | <u>          </u> |

Eliminations principally relates to inter-group revenue arising from trademark, license and distribution agreements between the Company's subsidiaries in USA, Gibraltar, Cyprus, France, Sweden, Spain and the Netherlands.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

|                          | December 31,   |               |
|--------------------------|----------------|---------------|
|                          | 2003           | 2004          |
|                          | EUR            | EUR           |
|                          | (in thousands) |               |
| <i>Long-lived assets</i> |                |               |
| USA                      | 559            | 921           |
| Cyprus                   | 19,542         | 17,328        |
| Sweden                   | 4,399          | 4,166         |
| Spain                    | 13,328         | 9,483         |
| France                   | 28             | 21            |
| Benelux                  | 292            | 247           |
| Canada                   | 740            | 620           |
| <b>Total</b>             | <b>38,887</b>  | <b>32,787</b> |

One customer accounted for 11 %, 9% and 9% of consolidated revenues for the years ended December 31, 2002, 2003 and 2004, respectively.

The following table illustrates our net sales by product group for the periods indicated.

|                                   | Years ended December 31, |               |               |
|-----------------------------------|--------------------------|---------------|---------------|
|                                   | 2002                     | 2003          | 2004          |
|                                   | EUR                      | EUR           | EUR           |
|                                   | (in thousands)           |               |               |
| <i>Net sales by product group</i> |                          |               |               |
| Magazine                          | 5,777                    | 5,316         | 5,121         |
| Video                             | 7,986                    | 7,206         | 2,130         |
| DVD s                             | 15,482                   | 18,309        | 19,488        |
| Internet                          | 6,059                    | 4,819         | 4,859         |
| Broadcasting                      | 4,106                    | 2,841         | 4,014         |
| <b>Total</b>                      | <b>39,410</b>            | <b>38,491</b> | <b>35,612</b> |

### 19. Stock-based compensation

On March 1, 1999 the Company adopted the 1999 Employee Stock Option Plan ( the Plan ). The Plan was amended in February 2003 and provides for the issuance of up to 7,200,000 shares of the Company s common stock to employees, consultants and advisors of the company.



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At December 31, 2004, stock options to purchase an aggregate of 4,661,561 shares of the Company's common stock were outstanding under the Plan and these options have a weighted average contractual remaining life of approximately 3.79 years. Options for 3,858,561 shares were exercisable with exercise prices ranging from \$1.19 to \$11.71 per share and the weighted average exercise price of vested options equals \$3.16 as of December 31, 2004. Vested options for 2,405,000 shares have exercise prices ranging from \$1.19 to \$3.25 per share and a weighted average exercise price of \$1.39 per share as of December 31, 2004. Vested options for 942,936 shares have exercise prices ranging from \$4.17 to \$6.00 per share and a weighted average exercise price of \$4.57 per share as of December 31, 2004. Vested options for 510,625 shares have exercise prices ranging from \$7.16 to \$11.71 per share and a weighted average exercise price of \$8.92 per share as of December 31, 2004.

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## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Options for 603,000 shares were granted during 2004 at a weighted average exercise price of \$4.65 per share. The weighted average time period from December 31, 2004 until the options granted in 2004 become exercisable is 0.64 years.

At December 31, 2004, options for 2,233,153 shares were available for future grant under the Plan. Share options become exercisable on their respective vesting dates with vesting terms determined by management and approved by the Company's compensation committee. Options granted under the Plan generally expire 5-10 years following the date of grant, certain options grants may have shorter lives.

A summary of stock option activity for the years ended December 31, 2002, 2003 and 2004 is as follows:

|                               | Number of<br>Shares | Weighted<br>average<br>exercise<br>price<br>in USD |
|-------------------------------|---------------------|--|
| Granted                       | 1,690,000           | 6.02   |
| Exercised                     | 32,795              | 3.89   |
| Forfeited                     | 365,178             | 6.04 <sup>(1)</sup>                                |
|                               | <hr/>               |  |
| Outstanding December 31, 2002 | 3,671,395           | 5.73 <sup>(1)</sup>                                |
| Granted                       | 2,150,000           | 1.53   |
| Exercised                     |                     |  |
| Forfeited <sup>(2)</sup>      | 1,711,142           | 6.13 <sup>(1)</sup>                                |
|                               | <hr/>               |  |
| Outstanding December 31, 2003 | 4,110,253           | 3.30 <sup>(1)</sup>                                |
| Granted                       | 603,000             | 4.94   |
| Exercised                     | 19,500              | 1.16   |
| Forfeited                     | 32,192              | 6.10   |
|                               | <hr/>               |  |
| Outstanding December 31, 2004 | 4,661,561           | 3.16 <sup>(1)</sup>                                |

(1) Weighted average information relates only to options vested and priced through each period.

(2) 1,500,000 forfeited options relates to options that had previously been awarded to the former CEO who left the Company in November 2003.

The Company applies APB 25, and related interpretations in accounting for its stock based compensation to employees. Accordingly, no compensation expense has been recognized for stock based compensation issued to employees.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 20. Selected quarterly financial data (unaudited)

Selected quarterly financial data for the years ended December 31, 2004 and 2003 is summarized as follows:

|                                      | For the year 2004                     |                   |                  |                   |            |
|--------------------------------------|---------------------------------------|-------------------|------------------|-------------------|------------|
|                                      | First<br>Quarter                      | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Total      |
|                                      | EUR                                   | EUR               | EUR              | EUR               | EUR        |
|                                      | (in thousands, except per share data) |                   |                  |                   |            |
| Net sales                            | 9,951                                 | 9,267             | 10,579           | 5,814             | 35,612     |
| Gross profit                         | 5,275                                 | 5,611             | 5,111            | 1,536             | 17,533     |
| Net income (loss)                    | 784                                   | 1,159             | 700              | (3,101)           | 238        |
| Net income (loss) per share:         |                                       |                   |                  |                   |            |
| Basic                                | 0.02                                  | 0.02              | 0.01             | (0.05)            | 0.00       |
| Diluted                              | 0.01                                  | 0.02              | 0.01             | (0.04)            | 0.00       |
| Weighted average shares outstanding: |                                       |                   |                  |                   |            |
| Basic                                | 50,084,407                            | 50,163,938        | 50,130,762       | 50,140,526        | 50,136,203 |
| Diluted                              | 52,388,120                            | 52,153,695        | 52,283,523       | 52,586,425        | 52,377,163 |
|                                      | For the year 2003                     |                   |                  |                   |            |
|                                      | First<br>Quarter                      | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | Total      |
|                                      | EUR                                   | EUR               | EUR              | EUR               | EUR        |
|                                      | (in thousands, except per share data) |                   |                  |                   |            |
| Net sales                            | 9,591                                 | 10,078            | 9,437            | 9,385             | 38,491     |
| Gross profit                         | 5,292                                 | 5,198             | 3,509            | 5,411             | 19,411     |
| Net income (loss)                    | 256                                   | 279               | (968)            | (137)             | (570)      |
| Net income (loss) per share:         |                                       |                   |                  |                   |            |
| Basic                                | 0.00                                  | 0.00              | (0.02)           | 0.00              | (0.02)     |
| Diluted                              | 0.00                                  | 0.00              | (0.02)           | 0.00              | (0.02)     |
| Weighted average shares outstanding: |                                       |                   |                  |                   |            |
| Basic                                | 31,154,305                            | 44,983,761        | 47,920,057       | 49,955,057        | 43,493,163 |

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|         |     |     |     |     |     |
|---------|-----|-----|-----|-----|-----|
| Diluted | N/A | N/A | N/A | N/A | N/A |
|---------|-----|-----|-----|-----|-----|

- 
- (i) On September 30, 2004 the Company's US subsidiary outsourced its distribution and the impact has initially been a temporary loss of revenues from the US during the fourth quarter transition period. The loss of revenues had a significant impact on gross profit. However, during the first quarter of 2005 distribution resumed and we expect the impact of the restructuring to increase gross profit and reduce selling, general and administrative expenses in 2005 compared to 2004.
  - (ii) During the fourth quarter of 2004, the Company wrote off video cassette inventory to a value of EUR 1.5 million and consequently gross profit was impacted by the same amount.
  - (iii) In connection with the preparation of the 2003 year end provision for income taxes the Company revised its previously estimated effective tax rate and in 2004 the Company determined it to be more appropriate to reverse these adjustments. The reversal of the adjustment had no impact on net loss for for the twelve month period.

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**21. Recent accounting pronouncements**

On December 16, 2004, the Financial Accounting Standards Board issued SFAS No. 123 (revised 2004), ( SFAS 123(R) ), which is a revision of SFAS 123. SFAS 123(R) supersedes APB 25, and amends SFAS No. 95, Statement of Cash Flows . Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. SFAS 123(R) must be adopted no later than July 1, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. The Company expects to adopt SFAS 123(R) on July 1, 2005, using the modified-prospective method as proscribed in SFAS 123(R).

As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using APB 25 's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Accordingly, the adoption of SFAS 123(R) 's fair value method will have an impact on the Company 's results of operations, although it will have no impact on its overall financial position. While the Company cannot estimate the level of share-based payments to be issued in the future, based on the stock options that are currently outstanding, the Company expects that the adoption of SFAS 123(R) will not result in any significant charges to operations in the second half of 2005.

**22. Subsequent events**

In January 2005, the Company presented a claim to the previous owner of our real estate property located in Barcelona, Spain. Under the claim the Company was awarded EUR 2.2 million which has been applied as a reduction to the value of the property.

On February 4, 2005, we entered into an agreement with Local i Serveis Sant Cugat, S.L. to sell the remaining part of our real estate property located in Barcelona, Spain. The consideration under the agreement is 6.9 million euro, of which a 10% down payment was received upon signature. The balance of the consideration will be received in two installments which are expected to be received no later than June and November of 2005, with the first installment to be not less than 2.85 million euro. Part of the proceeds from the sale will be used to repay the outstanding balance on the loan related to the building, see Note 11. As a result of this sale and previously reported sale transactions entered into in April 2004 and June 2004, we will have sold the entire office building for a total of 11.5 million euro. The Company is not expecting any loss related to the sale of the building and will not pay any sales commission related to the sale.

**PRIVATE MEDIA GROUP, INC.**  
**VALUATION AND QUALIFYING ACCOUNTS**

(in thousands)

| <b>Description</b>  | <b>Additions charged to</b> |                               |                        |                           | <b>Ending<br/>balance</b> |
|---|-----------------------------|-------------------------------|------------------------|---------------------------|---------------------------|
|   | <b>Opening<br/>balance</b>  | <b>Costs and<br/>expenses</b> | <b>Revenue<br/>(a)</b> | <b>Deductions<br/>(b)</b> |                           |
|   | EUR                         | EUR                           | EUR                    | EUR                       | EUR                       |
| Allowance deducted in the balance sheet from the asset to which it applies: |                             |                               |                        |                           |                           |
| Year ended December 31, 2004:   |                             |                               |                        |                           |                           |
| Allowance for magazine returns  | 2,191                       |                               | 6,229                  | (6,762)                   | 1,658                     |
| Allowance for doubtful accounts   | 2,024                       | 1,649                         |                        | (2,743)                   | 930                       |
| Year ended December 31, 2003:   |                             |                               |                        |                           |                           |
| Allowance for magazine returns  | 1,907                       |                               | 5,147                  | (4,863)                   | 2,191                     |
| Allowance for doubtful accounts   | 1,264                       | 776                           |                        | (16)                      | 2,024                     |
| Year ended December 31, 2002:   |                             |                               |                        |                           |                           |
| Allowance for magazine returns  | 1,564                       |                               | 3,774                  | (3,432)                   | 1,907                     |
| Allowance for doubtful accounts   | 1303                        | 489                           |                        | (528)                     | 1,264                     |

Notes:

- (a) Represents provisions for expected returns of magazines from national distribution networks which are charged to net revenues.
- (b) Represents settlements on returns provisions previously recorded, and write-offs less recoveries on doubtful accounts. The write-off in 2004 relates primarily to one specific receivable from an Internet billing service provider provided for in 2003 and 2004, which has been written off completely after collection attempts failed.