

PRIVATE MEDIA GROUP INC  
Form 10-Q  
August 23, 2010

# U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## Form 10-Q

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

For the quarterly period ended June 30, 2010

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-25067

# PRIVATE MEDIA GROUP, INC.

(Exact Name of Registrant as Specified in its Charter)

Nevada  
(State or other jurisdiction of

incorporation or organization)

537 Stevenson Street, San Francisco, California 94103

(Address of U.S. principal executive offices)

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

(Address of European principal executive offices)

U.S. (415) 575-9700, Europe 34-93-620-8090

(Issuer's telephone number, including area code)

87-0365673  
(I.R.S. Employer

Identification Number)

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

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

Large Accelerated Filer  Accelerated Filer   
Non-accelerated filer  Smaller Reporting Company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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

Class	Outstanding at August 19, 2010
Common Stock, par value \$.001	20,705,822

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

	December 31, 2009 EUR	June 30, (Unaudited) 2010 EUR      USD	
	(in thousands)		
<b>ASSETS</b>			
Cash and cash equivalents	613	397	490
Trade accounts receivable	5,382	5,297	6,540
Inventories - net (Note 3)	2,439	1,907	2,354
Deferred income tax asset	4,478	4,478	5,528
Prepaid expenses and other current assets	866	1,025	1,266
<b>TOTAL CURRENT ASSETS</b>	<b>13,779</b>	<b>13,104</b>	<b>16,178</b>
Library of photographs and videos	11,635	10,197	12,589
Property, plant and equipment	6,685	5,841	7,211
Other intangible assets	5,212	5,151	6,359
Goodwill	10,524	10,524	12,993
Other assets	675	507	626
<b>TOTAL ASSETS</b>	<b>48,510</b>	<b>45,324</b>	<b>55,956</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
Short-term borrowings	3,080	3,113	3,843
Current portion of long-term borrowings	222	305	376
Accounts payable trade	6,207	6,442	7,953
Income taxes payable	1,089	1,089	1,344
Deferred income taxes	24	24	30
Accrued other liabilities	1,884	2,277	2,811
<b>TOTAL CURRENT LIABILITIES</b>	<b>12,506</b>	<b>13,249</b>	<b>16,356</b>
Contingent consideration payable	4,703	2,351	2,903
Long-term borrowings	1,898	1,984	2,450
Related party payable	69	57	70
<b>TOTAL LIABILITIES</b>	<b>19,176</b>	<b>17,641</b>	<b>21,779</b>
<b>SHAREHOLDERS' EQUITY</b>			
\$4.00 Series A Convertible Preferred Stock 10,000,000 shares authorized, none issued and outstanding at December 31, 2009 and June 30, 2010, respectively			
Common Stock, \$.001 par value, 100,000,000 shares authorized 20,704,934 and 20,705,822 issued and outstanding at December 31, 2009 and June 30, 2010, respectively	869	869	1,073
Additional paid-in capital	30,466	30,468	37,615
Retained earnings	1,564	1,297	1,601
Accumulated other comprehensive income	(3,565)	(4,951)	(6,112)

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TOTAL SHAREHOLDERS EQUITY	29,334	27,683	34,177
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	48,510	45,325	55,956

See accompanying notes to consolidated statements.

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF INCOME (LOSS)

## AND COMPREHENSIVE INCOME (LOSS)

	Three-months ended		Six-months ended		
	June 30, (unaudited)		June 30, (unaudited)		
	2009	2010	2009	2010	2010
	EUR	EUR	EUR	EUR	USD
	(in thousands)				
Net sales	6,175	6,037	11,979	12,400	15,308
Cost of sales	4,030	3,989	7,595	8,313	10,263
Gross profit	2,145	2,047	4,384	4,087	5,045
Selling, general and administrative expenses	4,371	3,362	7,979	6,490	8,012
Change in fair value of contingent consideration payable		2,352		2,352	2,903
Operating income (loss)	(2,226)	1,037	(3,595)	(51)	(63)
Interest expense	94	102	191	198	244
Interest income	54		110		
Income (loss) before income taxes	(2,266)	935	(3,677)	(249)	(307)
Income tax (benefit)	(713)	4	(1,288)	17	21
Net income (loss)	(1,553)	931	(2,388)	(266)	(329)
Other comprehensive income:					
Foreign currency translation adjustments	34	(757)	(186)	(1,386)	(1,711)
Comprehensive income	(1,519)	174	(2,575)	(1,652)	(2,040)
Net income (loss) per share:					
Basic	(0.03)	0.04	(0.04)	(0.01)	(0.01)
Diluted	(0.03)	0.04	(0.04)	(0.01)	(0.01)

See accompanying notes to consolidated statements.

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six-months ended		
	June 30,		
	(unaudited)		
	2009	2010	2010
	EUR	EUR	USD
	(in thousands)		
<b>Cash flows from operating activities:</b>			
Net income (loss)	(2,388)	(266)	(329)
<b>Adjustment to reconcile net income to net cash flows from operating activities:</b>			
Depreciation	457	387	478
Change in fair value of contingent consideration payable		(2,352)	(2,904)
Stock based compensation	2	2	2
Bad debt provision	222	21	26
Amortization of other intangible assets	62	62	77
Amortization of web pages	809	1,552	1,917
Amortization of photographs and videos	2,979	2,552	3,151
<b>Effects of changes in operating assets and liabilities:</b>			
Trade accounts receivable	420	64	79
Related party receivable	(192)		
Inventories	861	533	658
Prepaid expenses and other current assets	481	(159)	(197)
Accounts payable trade	(54)	235	290
Income taxes payable	(1,087)		
Accrued other liabilities	48	393	485
Net cash provided by operating activities	2,620	3,024	3,733
<b>Cash flows used in investing activities:</b>			
Investment in library of photographs and videos	(1,380)	(1,115)	(1,377)
Capital expenditures	(956)	(1,093)	(1,350)
Cash received in acquisition	35		
Investments in (sale of) other assets	15	168	207
Net cash (used in) investing activities	(2,286)	(2,041)	(2,519)
<b>Cash flows from financing activities:</b>			
Short-term borrowings repayments	(294)	(385)	(475)
Short-term borrowings additions	66	416	514
Long-term borrowings repayments	(17)	(149)	(184)
Long-term borrowings additions	29	304	375
Net cash (used in) provided by financing activities	(216)	187	230
Foreign currency translation adjustment	(186)	(1,386)	(1,711)
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(69)</b>	<b>(216)</b>	<b>(267)</b>
<b>Cash and cash equivalents at beginning of the period</b>	<b>552</b>	<b>613</b>	<b>757</b>
<b>Cash and cash equivalents at end of the period</b>	<b>484</b>	<b>397</b>	<b>490</b>
Cash paid for interest	88	140	173
Cash paid for taxes			

See accompanying notes to consolidated statements.



## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	Common stock		Additional	Retained	Accumulated	Total
	Shares	Amounts	paid-in	earnings	other	shareholders
		EUR	capital	EUR	comprehensive	equity
			EUR	EUR	income	EUR
					EUR	
Balance at January 1, 2009	17,860,165	867	21,727	22,074	(4,077)	40,610
Shares issued in acquisition	2,844,770	2	6,642			6,644
Exchangeable shares issued in acquisition			2,095			2,095
Stock based compensation			3			3
Translation adjustment					512	512
Net loss				(20,150)		(20,150)
Balance at December 31, 2009	20,704,934	869	30,466	1,564	(3,565)	29,334
Shares issued in reverse split	888					
Stock based compensation			2			2
Translation adjustment					(1,386)	(1,386)
Net loss				(266)		(266)
Balance at June 30, 2010	20,705,822	869	30,468	1,298	(4,951)	27,684

See accompanying notes to consolidated statements.



## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

**1. Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles ( U.S. GAAP ) for interim financial information. Accordingly they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of financial position and results of operations have been included. Operating results for the three months period ended June 30, 2010 are not necessarily indicative of the results that may be expected for the year ended December 31, 2010. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on form 10-K for the year ended December 31, 2009.

Solely for the convenience of the reader, the accompanying consolidated financial statements as of June 30, 2010 and for the six months then ended have been translated into United States dollars ( USD ) at the rate of EUR 0.81 per USD 1.00 the interbank exchange rate on June 30, 2010. 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. Acquisition***GameLink Acquisition*

On January 20, 2009, Private Media Group, Inc. ( Private ) completed the acquisition of 100% of the business of Game Link LLC and its affiliate, eLine, LLC collectively ( GameLink ). The GameLink companies are engaged in the business of digital distribution of adult content over the Internet and online eCommerce development.

The amounts of GameLink s revenue and earnings included in Private s consolidated income statement for the three and six months ended June 30, 2009, and the pro forma revenue and earnings of the combined entity had the acquisition date been January 1, 2009, are:

		Revenue EUR	Earnings EUR
		(in thousands)	
Actual from January 20, 2009	June 30, 2009	4,771	(187)
Actual from April 1, 2009	June 30, 2009	2,618	(95)
Supplemental pro forma from January 1, 2009	June 30, 2009	12,569	(2,454)

*Sureflix Acquisition*

On October 29, 2009, Private Media Group, Inc. ( Private ) completed the acquisition of 100% of the business of Entruphema Inc. and Sureflix Digital Distribution Inc.,( Sureflix ). The Sureflix companies are engaged in the business of digital distribution of premium gay adult content over the Internet and online eCommerce development.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

The pro forma revenue and earnings of the combined entity had the acquisition date been January 1, 2009, are:

		Revenue EUR (in thousands)	Earnings EUR (in thousands)
Supplemental pro forma from January 1, 2009	June 30, 2009	14,482	(2,296)
Supplemental pro forma from April 1, 2009	June 30, 2009	7,476	(1,505)

**3. Inventories**

Inventories consist of the following:

	December 31, 2009 EUR (in thousands)	June 30, 2010 EUR (in thousands)
Magazines for sale and resale	805	577
DVDs	1,417	1,208
Other	217	120
	2,439	1,906

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

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

	Three-months ended June 30,		Six-months ended June 30,	
	2009	2010	2009	2010
<b>Numerator: (EUR in thousands)</b>				
Net income (loss)	(1,553)	931	(2,388)	(266)
<b>Denominator:</b>				
Denominator for basic earnings per share	weighted average shares outstanding			
	20,704,935	22,005,816	20,369,797	22,005,423
<b>Effect of dilutive securities:</b>				
Common stock warrants, convertible notes, options and other dilutive securities				n/a
Denominator for diluted earnings per share	and assumed conversions			
		22,005,816		n/a

**Earnings (loss) per share (in EUR)**

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Basic	(0.08)	0.04	(0.12)	(0.01)
Diluted	(0.08)	0.04	(0.12)	(0.01)

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

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PRIVATE MEDIA GROUP, INC.

NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

**5. Stock-based compensation**

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

*The 1999 Plan*

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

Under the expired plan, the purchase price (exercise price) of option shares had to be at least equal to the fair market value of such shares on the date the stock option was granted. The stock option was exercisable for a period of ten years from the date of grant or such shorter period as was determined by the Company. Each stock option under the plan provided that it was exercisable in full or in cumulative or non-cumulative installments, and each stock option was exercisable from the date of grant or any later date specified in the option. Unless otherwise provided by the Company, an optionee could not exercise a stock option unless from the date of grant to the date of exercise the optionee remained continuously in the Company's employ. At June 30, 2010, options for 13,002 shares were still outstanding under the 1999 Plan.

*The 2009 EIP*

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

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

## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

At June 30, 2010, Awards for 2,062,333 shares were available for future grant under the 2009 EIP. Awards become exercisable on their respective vesting dates with vesting terms determined by management and approved by the Company's compensation committee.

A summary of stock option activity for the six month period ended June 30, 2010 is as follows:

	Number of Shares	Weighted- Average Exercise Price in USD	Weighted- Average Remaining Life in Years	Aggregate Intrinsic Value <sup>1</sup> in Thousands of USD
Outstanding January 1, 2010	17,336	6.77		
Granted				
Exercised				
Forfeited				
Outstanding June 30, 2010	17,336	6.77	1.82	
Exercisable June 30, 2010				

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

Stock-based compensation cost for option awards is measured on the date of grant using the Black-Scholes option pricing model. The following general assumptions are used: a) expected volatility is based on historical volatility of our stock, b) expected life is determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior, c) risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and d) dividend yield is zero based on the Company's current dividend policy. During the six month periods ended June 30, 2009 and 2010 no grants were made.

As of June 30, 2010, there was USD 1 thousand of total unrecognized compensation cost related to nonvested option granted under the Plan. The cost is expected to be recognized over a weighted-average period of 0.3 years. The total fair value of all options vested and outstanding at June 30, 2009 and 2010, was USD 0.4 million and USD 42 thousand, respectively.

## 6. Income Taxes

The Company's subsidiaries file income tax returns in numerous tax jurisdictions, including the United States, several U.S. states and several non-U.S. jurisdictions, primarily in Europe. The statute of limitations varies by the various jurisdictions in which we operate. Because of the number of jurisdictions in which we file tax returns, in any given year the statute of limitations in certain jurisdictions may lapse without examination within the 12-month period from the balance sheet date. Other than the recurring effect of changes in unrecognized tax benefits due to the lapse of the statute of limitations, none of which are

<sup>1</sup> The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of our common stock for the options that were in-the-money at June 30, 2010.



**PRIVATE MEDIA GROUP, INC.**

**NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**(UNAUDITED)**

expected to be individually significant, management believe there are no other reasonably possible changes that will significantly impact the amount of tax benefits recognized in the Company's financial statements within the 12-month period from the balance sheet date. The Company has substantially concluded all US Federal and State income tax matters for years up to and including 2004 and 2002 respectively, and all foreign income tax matters for years up to 2003.

The Company's practice is to recognize interest and penalties related to income tax matters in interest and other expenses respectively. Interest and penalties amounting to EUR 524 thousand were accrued as of June 30, 2010, of which EUR 52 thousand was recognized as interest expense during the six-month period then ended.

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 Company is of the view that no permanent establishment is at hand in Sweden. However, the Administrative Court of Appeal has finally decided that a permanent establishment is at hand. The litigation is, however, still going on and the purpose is to finally decide the amounts to be attributed to the permanent establishment and thus being taxed in Sweden. In February 2009, the County Administrative Court reduced the assessment for the tax years 1995-1998 to a total amount of SEK 12,600,000 (approx. EUR 1.1 million) plus fines amounting to SEK 5,040,000 (approx. EUR 0.5 million) plus interest. However, as a matter of fact the tax claim on the Company has been extinguished according to Administrative Law. Only the claim related to the tax fine amounting to SEK 5,040,000 (approx. EUR 0.5 million) plus interest is valid, should the Administrative Court's decision prevail. The Company has appealed the decision to the Administrative Court of Appeal. The final outcome of this litigation will not be known for several years. Due to the fact that the final outcome of this matter is still uncertain, and the relatively minor claim now at stake, no amounts have been provided in the Company's financial statements for this dispute.

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

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

**Overview**

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

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

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

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



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

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

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

During 2009, the DVD market has continued to shrink, with sales for our physical products declining by 50%. However, the DVD business is by no means dead even in this competitive landscape. The content providers that manage to survive the current clean out will control the DVD market going forward.

With respect to broadcasting, Private is a leading adult content provider in Europe currently partnering with 38 IPTV operators. In addition to this we are providing content to leading Pay-TV operators. Our strategic partnerships prove to be solid and strong revenue generators and will continue to perform well.

Private's mobile on portal revenues declined again in 2009 after years of strong growth. We are still the most distributed adult brand in the world and will monetize existing distribution as best as we can by going live with the few outstanding carriers and replacing non-performing content aggregators with new ones. Throughout 2008 and 2009 there has been a huge increase in off-portal traffic. According to research firm Nielsen, the mobile Internet market has seen a 74% increase between February 2007 and February 2009. We are in the process of enabling smart phone users to browse, purchase and consume our library of content on all of our web properties and expect to generate substantial growth from this initiative in the second half of 2010.

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

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

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

We generate revenues primarily through:

Internet e-commerce, subscriptions and licensing;

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

sales of DVDs and magazines;

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

content, brand name and trademark licensing.

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

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

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

Our primary expenses include:

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

web page development costs;

printing, processing and duplication costs; and

selling, general and administrative expenses.

We released 72, 87 and 101 proprietary video titles during 2009, 2008 and 2007, respectively. The releases include both new and archival material. We plan to release approximately 72 proprietary video titles in 2010.

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 broadcasting and wireless. We also incur significant intangible expenses in connection with the amortization of our library of photographs and movies and capitalized development costs, which include the Internet. We amortize these tangible and intangible assets on a straight-line basis for periods of between three and five years.

#### *Restructuring*

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We have faced several organizational challenges during 2009 and 2010 as a result of the acquisitions and integration of the online businesses GameLink and Sureflex into the group. Parallel with the integration, we have been rebuilding our signature property, private.com, and are restructuring our affiliate programs in all properties to compete aggressively for affiliate traffic. In addition, we have

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restructured our departments with resources highly skilled in affiliate traffic development and shifted our emphasis from account management towards sales. We have also developed solutions for critical new markets: gay, international and mobile. Furthermore, as a response to decreased margins in the adult entertainment industry, we have reviewed, analyzed and continued to restructure the operations of the non-online part of the business in order to become more cost effective. All the aforementioned processes have had impact both in terms of lost sales and additional selling, general and administrative expenses. During 2010, we expect to benefit from the restructuring and reduce costs and increase sales as we implement and launch new initiatives, such as fully combining our Internet assets, outsourcing major parts of our non-online operations and launching our new Internet platforms.

### **Critical Accounting Estimates**

#### *General*

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

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

#### *Recognition of Revenue*

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

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

The Company also offers a customer loyalty program under which each member's purchase of video on-demand, DVDs, movie downloads, books, novelties or other items earns the member one point for each dollar spent. After accumulating 150 points, a customer may redeem the points for a \$5 purchase.

Points increase in value as they are accumulated and redeemed, with a maximum accumulation of 2,000 points, which may be redeemed for a \$200 purchase. All of a customer's points expire after 180 days of no purchase activity. Because the value of the award points is not significant in relation to the value of the services or products purchased by the customer, the Company records a liability for the estimated cost of the discounted services or products to be provided in the future.

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

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

DVDs & Magazines (physical products) are sold both to wholesalers, on firm sale basis, and via national newsstand distributors, with the right to return. Our physical products are generally multi-lingual and the principal market is in Europe. Revenues from the sale of physical products where distributors are not granted rights-of-return are recognized upon transfer of title, which generally occurs upon delivery. Revenues from the sale of physical products under consignment agreements with distributors are recognized based upon reported sales by the Company's distributors. Revenues from the sale of physical products under agreements that grant distributors rights-of-return are recognized upon transfer of title, which generally occurs on delivery, net of an allowance for returned product. Distributors with the right to return are primarily national newsstand distributors. Most of our products are bi-monthly (six issues per year) and remain on sale at a newsstand for a period of two months. Normally, all unsolds are reported to us within a period of four to six months from delivery. There are normally two to four national newsstand distributors for all newspapers and periodicals operating in each country. A majority of our national newsstand distributors are members of Distripress, the international organization for publishers and distributors, and carry out the distribution of the largest national and international newspapers and periodicals, including: Financial Times, Herald Tribune, Time, Newsweek, Vogue, etc. The Company uses specific return percentages per title and distributor based on estimates and historical data. The percentages vary from 50-80%. Percentages are reviewed on an on-going basis. Magazines have an approximate retail price of EUR 11.50 (USD 15.95) per copy and are printed on glossy high-quality paper at a cost of EUR 1.25 (USD 1.75). They are often shrink-wrapped in order to comply with local regulation or guidance for the sale of adult publications. In view of the high retail price, the margin and the physical quality of the magazines and the fact that the content has a very long shelf-life since it is not particularly linked to time, trends, fashion or current events, the Company has always collected the returns from newsstands in order to make them available for sale again. The Company operates scheduled re-distribution of returned magazines, via national newsstand distributors, together with DVDs as Magazine/DVD packs as a way of increasing DVD distribution. Since the national newsstand distributors have the right to return, the DVD packs are returned and the magazines are broken out in order to be sold via an additional scheduled re-distribution as Megapacks and Superpacks (three different copies per pack). Returns from the sale of Megapacks and Superpacks are destroyed. The retail price for products sold via re-distribution vary between EUR 14.95-19.95 (USD 20.75-27.70). Magazine returns not re-distributed as per above are sold on a firm sale basis to wholesalers as back numbers at a lower price than new issues. The Company has historically sold all returned copies at an average price higher than, or equal, to cost.

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

#### *Accounts receivable*

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

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

#### *Goodwill and Other Intangible Assets*

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

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

#### *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 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 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

### *Three months ended June 30, 2010 compared to the three months ended June 30, 2009*

*Net sales.* For the three months ended June 30, 2010, we had net sales of EUR 6.0 million compared to net sales of EUR 6.2 million for the three months ended June 30, 2009, a decrease of EUR 0.2 million. The decrease was the result of decreases in sales of DVD & Magazines and Wireless offset by increased Internet sales. Internet sales increased EUR 0.4 million to EUR 3.8 million, which represents an increase of 11% compared to the same period last year. The increase in Internet sales was the result of our acquisitions last year. Discounting EUR 1.0 million in impact from acquisitions, Internet Sales decreased EUR 0.6 million. DVD & Magazine sales decreased EUR 0.5 million, or 39%, to EUR 0.8 million. The reduction in DVD & Magazine sales was primarily attributable to an industry wide decrease in DVD sales (see discussion under *Outlook* below). Wireless sales decreased EUR 0.1 million, or 12%, to EUR 0.4 million. Broadcasting stayed flat at EUR 1.1 million.

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

*Cost of Sales.* Our cost of sales was EUR 4.0 million for the three months ended June 30, 2010 compared to EUR 4.0 million for the three months ended June 30, 2009. Included in cost of sales is Internet, broadcasting and wireless, printing, processing and duplication and amortization of library. Internet cost was EUR 2.4 million for the three months ended June 30, 2010 compared to EUR 1.8 million for the three months ended June 30, 2009. Internet cost as a percentage of related sales in the period was 63% compared to 54% in the same period last year. The increase of EUR 0.6 million was primarily the result of the acquisition of Sureflex. In addition, we are rebuilding our private.com membership site and as a result of this we have incurred increased costs, including accelerated amortization of the old site which was decommissioned in May 2010. Broadcasting and wireless cost was EUR 0.1 million for the three months ended June 30, 2010 compared to EUR 0.1 million for the three months ended June 30, 2009. Broadcasting and wireless cost as a percentage of related sales in the period was 5% compared to 5% in the same period last year. Printing, processing and duplication cost was EUR 0.3 million for the three months ended June 30, 2010 compared to EUR 0.5 million for the three months ended June 30, 2009, a decrease of EUR 0.2 million, or 47%. The decrease was primarily a reflection of the decrease in sales. Printing, processing and duplication cost as a percentage of DVD & Magazine sales was 38% for the three months ended June 30, 2010 compared to 45% in the same period last year. Amortization of library was EUR 1.2 million for the three months ended June 30, 2010 compared to EUR 1.6 million for the three months ended June 30, 2009, which represents a decrease of EUR 0.4 million. Amortization of library does not vary with sales since it reflects the amortization of our investments in content which has been available for sale for a period of three to five years.

*Gross Profit.* In the three months ended June 30, 2010, we realized a gross profit of EUR 2.0 million, or 34% of net sales compared to EUR 2.1 million, or 35% of net sales for the three months ended June 30, 2009. The decrease in gross profit both in money and as a percentage of sales was primarily the result of the accelerated amortization of our old private.com membership site which was replaced in May 2010 and reduced DVD & Magazine sales offset by reduced amortization of library.

*Selling, general and administrative expenses/benefits.* Our selling, general and administrative benefits were EUR 3.4 million for the three months ended June 30, 2010 compared to EUR 4.4 million for the three months ended June 30, 2009, a decrease of EUR 1.0 million, or 23%. Discounting EUR 0.5 million in impact from our acquisitions last year, the company reduced selling, general and administrative expenses by EUR 1.5 million.

*Change in fair value of contingent consideration payable.* During the three months ended June 30, 2010, we recorded a EUR 2.4 million gain from change in fair value of contingent consideration payable as a result of the performance of GameLink and Sureflix. The two recently acquired companies have not reached the earnout targets set for 2009 and expectations for reaching future earnout targets have been adjusted accordingly.

*Operating profit/loss.* We reported an operating profit of EUR 1.0 million for the three months ended June 30, 2010 compared to an operating loss of EUR 2.2 million for the three months ended June 30, 2009. The EUR 3.2 million improvement was the result of change in fair value of contingent consideration payable and reduced selling, general and administrative expenses offset by reduced gross profit.

*Interest expense.* We reported interest expense of EUR 0.1 million for the three months ended June 30, 2010, compared to EUR 0.1 million for the three months ended June 30, 2009.

*Income tax expense/benefit.* We reported no income tax expense or benefit for the three months ended June 30, 2010, compared to EUR 0.7 million in income tax benefit for the three months ended June 30, 2009.

*Net income/loss.* We reported net income of EUR 0.9 million for the three months ended June 30, 2010, compared to a net loss of EUR 1.6 million for the three months ended June 30, 2009.

***Six months ended June 30, 2009 compared to the six months ended June 30, 2008***

*Net sales.* For the six months ended June 30, 2010, we had net sales of EUR 12.4 million compared to net sales of EUR 12.0 million for the six months ended June 30, 2009, an increase of EUR 0.4 million. The increase was the result of increases Internet sales and Broadcasting offset by decreases in sales of DVD & Magazines and Wireless. Internet sales increased EUR 1.3 million to EUR 7.7 million, which represents an increase of 20% compared to the same period last year. The increase in Internet sales was the result of our acquisitions last year. Discounting EUR 2.6 million in impact from acquisitions, Internet Sales decreased EUR 1.3 million. Broadcasting sales increased EUR 0.1 million to EUR 2.1 million. Wireless sales decreased EUR 0.1 million, or 8%, to EUR 0.9 million. DVD & Magazine sales decreased EUR 0.8 million, or 32%, to EUR 1.8 million. The reduction in DVD & Magazine sales was primarily attributable to an industry wide decrease in DVD sales (see discussion under *Outlook* below).

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

*Cost of Sales.* Our cost of sales was EUR 8.3 million for the six months ended June 30, 2010 compared to EUR 7.6 million for the six months ended June 30, 2009. Included in cost of sales is Internet, broadcasting and wireless. printing, processing and duplication and amortization of library. Internet cost



was EUR 4.8 million for the six months ended June 30, 2010 compared to EUR 3.2 million for the six months ended June 30, 2009. Internet cost as a percentage of related sales in the period was 63% compared to 51% in the same period last year. The increase of EUR 1.6 million was primarily the result of the acquisition of GameLink and Sureflix. In addition, we are rebuilding our private.com membership site and as a result of this we have incurred increased costs, including accelerated amortization of the old site which was decommissioned in May 2010.

Broadcasting and wireless cost was EUR 0.2 million for the six months ended June 30, 2010 compared to EUR 0.2 million for the six months ended June 30, 2009. Broadcasting and wireless cost as a percentage of related sales in the period was 6% compared to 6% in the same period last year. Printing, processing and duplication cost was EUR 0.8 million for the six months ended June 30, 2010 compared to EUR 1.2 million for the six months ended June 30, 2009, a decrease of EUR 0.4 million, or 35%. The decrease was primarily a reflection of the decrease in sales. Printing, processing and duplication cost as a percentage of DVD & Magazine sales was 43% for the six months ended June 30, 2010 compared to 45% in the same period last year. Amortization of library was EUR 2.6 million for the six months ended June 30, 2010 compared to EUR 3.0 million for the six months ended June 30, 2009, which represents a decrease of EUR 0.4 million. 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 six to five years.

*Gross Profit.* In the six months ended June 30, 2010, we realized a gross profit of EUR 4.1 million, or 33% of net sales compared to EUR 4.4 million, or 37% of net sales for the six months ended June 30, 2009. The decrease in gross profit both in money and as a percentage of sales was primarily the result of the accelerated amortization of our old private.com membership site which was replaced in May 2010 and reduced DVD & Magazine sales offset by reduced amortization of library.

*Selling, general and administrative expenses.* Our selling, general and administrative expenses were EUR 6.5 million for the six months ended June 30, 2010 compared to EUR 8.0 million for the six months ended June 30, 2009, a decrease of EUR 1.5 million, or 19%. Discounting the EUR 1.3 million in impact from our acquisitions last year, the company reduced selling, general and administrative expenses by EUR 2.8 million.

*Change in fair value of contingent consideration payable.* During the six months ended June 30, 2010, we recorded a EUR 2.4 million gain from change in fair value of contingent consideration payable as a result of the performance of GameLink and Sureflix. The two recently acquired companies have not reached the earnout targets set for 2009 and expectations for reaching future earnout targets have been adjusted accordingly.

*Operating loss.* We reported an operating loss of EUR 0.1 million for the six months ended June 30, 2010 compared to an operating loss of EUR 3.6 million for the six months ended June 30, 2009. The EUR 3.5 million reduction in operating loss was the result of change in fair value of contingent consideration payable and reduced selling, general and administrative expenses, offset by reduced gross profit.

*Interest expense.* We reported interest expense of EUR 0.2 million for the six months ended June 30, 2010, compared to EUR 0.2 million for the six months ended June 30, 2009.

*Income tax expense/benefit.* We reported no income tax expense or benefit for the six months ended June 30, 2010, compared to EUR 1.3 million in income tax benefit for the six months ended June 30, 2009.

*Net loss.* We reported a loss of EUR 0.3 million for the six months ended June 30, 2010, compared to EUR 2.4 million for the six months ended June 30, 2009.

### **Liquidity and Capital Resources**

We reported a working capital deficit of EUR 0.1 million at June 30, 2010, a decrease of EUR 1.4 million compared to the year ended December 31, 2009. The decrease is principally attributable to a decrease in current assets and an increase in current liabilities.

#### *Operating Activities*

Net cash provided by operating activities was EUR 3.0 million for the six months ended June 30, 2010, and was primarily the result of net income, as adjusted for non-cash transactions, and cash related to changes in operating assets and liabilities. The net loss of EUR 0.3 million was adjusted to reconcile net income to net cash flows from operating activities with depreciation of EUR 0.4 million, amortization of other intangible assets of EUR 0.1 million, amortization of web pages of EUR 1.6 million and amortization of photographs and videos of EUR 2.6 million, offset by EUR 2.4 million from change in fair value of contingent consideration payable, making a total of EUR 2.2 million, providing a net balance of EUR 2.0 million. The total of EUR 2.0 million was added to by changes in trade accounts receivable, inventories, accounts payable trade and accrued other liabilities totaling EUR 1.2 million offset by prepaid expenses and other current assets of EUR 0.2 million from. Net cash provided by operating activities was EUR 2.6 million for the six months ended June 30, 2009. The increase in net cash provided by operating activities of EUR 0.4 million for the six months ended June 30, 2010 compared to the same period last year was primarily the result of net income, as adjusted for non-cash transactions, and cash related to changes in operating assets and liabilities.

#### *Investing Activities*

Net cash used in investing activities for the six months ended June 30, 2010 was EUR 2.0 million. The investing activities were principally capital expenditure of EUR 1.1 million and investment in library of photographs and videos of EUR 1.1 million, which was carried out in order to maintain the 2010 release schedules. Net cash used in investing activities decreased EUR 0.3 million over the same period last year. The decrease is principally due to reduced investment in library of photographs and videos as a result of a lower cost per title for acquisitions of videos.

#### *Financing Activities*

Net cash provided by financing activities for the six-month period ended June 30, 2010 was EUR 0.2 million. For the six-month 2009 period EUR 0.2 million was used in financing activities.

#### *Liquidity*

In each of the past three years we have experienced losses from operations. As a result of our operating losses our independent registered public accounting firm has concluded that there is substantial doubt as to our ability to continue as a going concern, and have modified their report for the financial year ending December 31, 2009 in the form of an explanatory paragraph describing the events that have given

rise to this uncertainty. Our ability to continue as a going concern is based on our ability to generate or obtain sufficient cash to meet our obligations on a timely basis and ultimately to attain profitable operations. We currently expect future growth and to return to profitability provided we are successful with the following objectives:

rolling out our Internet platforms, including: a) our newly built signature property and membership platform private.com, b) our cutting edge mobile platform for Smartphones and c) our multinational eCommerce VOD platform;

restructuring our affiliate programs on all properties to compete aggressively for, and attract, affiliate traffic;

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

completing the integration of businesses acquired in 2009;

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

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

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

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

Although we expect that our available cash resources and cash generated from operations will be sufficient to meet our presently anticipated working capital and capital expenditure requirements for at least the next 12 months, we may need to raise additional funds to support more rapid growth or respond to unanticipated requirements. In this regard, we are presently engaged in litigation with a third party lender, Consipio Holding BV, regarding our obligations under a promissory note. An adverse outcome in this dispute would likely have a material impact upon our liquidity if we are unable to obtain additional debt or equity financing to satisfy any resulting liability. See *Disputed Contractual Obligation* below and *Part II, Item I Legal Proceedings* for further information regarding this litigation.

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

*Disputed Contractual Obligation*

In December 2001 the group's holding company, Private Media Group, Inc., borrowed \$ 4.0 million from Commerzbank AG pursuant to a Note originally due on December 20, 2002. The Note bore interest at an annual rate of 7%, payable quarterly, with the entire principal amount and accrued interest originally due on December 20, 2002. The Note is guaranteed by Slingsby Enterprises Limited, an affiliate of Private's Chairman and principal shareholder, and the guaranty is secured by 1,650,000 shares of Private Media Group, Inc. Common Stock under a Pledge Agreement. In December 2002 Commerzbank AG agreed to extend the maturity date of the Note to March 20, 2003. In April 2003 the Note was acquired by Consipio Holding B.V. from Commerzbank AG, and Consipio and Private reached an agreement-in-principle with Consipio to extend the maturity of the Note until April 2008. However, Consipio and Private were unable to reach final agreement on other terms and conditions relating to the restructured Note. Accordingly, in December 2003 Consipio notified Private and Slingsby Enterprises that Private was in default under the Note, and demanded \$3.4 million as payment in full of all outstanding principal and interest under the Note. The Company continued to make regular payments on the Note, including principal and accrued interest, through February 2008. In April 2008 Consipio requested Private to pay the remaining balance of the Note, without indicating the amount due. Private in turn requested that Consipio provide a statement of the amount due and the basis for its calculation. In response, Consipio demanded payment of \$3,194,000 as settlement in full of the Note, to be received by May 9, 2008. This calculation was made using an interest rate of 9.9%, as opposed to the 7% rate provided under the original terms of the Note. Consipio also advised that if payment was not received on such date it would institute litigation, in which event Consipio would claim that the amount due under the Note should be denominated in Euro, rather than U.S. dollars. Private believes that the amount due under the Note at May 9, 2008, including accrued interest, was no more than \$2.4 million, utilizing an interest rate of 7%. In August 2008 Consipio notified Private that the Note was in default and that it intended to exercise its rights under the Note and the pledge of shares by Slingsby of Private Common Stock under the Pledge Agreement. No payments have been made under the Note since February 2008, and the Note provides for interest to accrue on the unpaid principal amount of the Note until paid in full. Private believes that the amount due under the Note at June 30, 2010, including accrued interest, was no more than \$2.8 million (EUR 2.2 million), utilizing an interest rate of 7%.

On May 1, 2009, Consipio Holding BV filed a lawsuit against the Company and Slingsby asserting a claim for unspecified damages under the Note and the guaranty. The Company and Slingsby filed their Answer and asserted several affirmative defenses. On March 26, 2010, the Court dismissed the lawsuit, finding that U.S. federal courts did not have jurisdiction over the subject matter of the lawsuit.

On July 9, 2010, the Company received a notice from Consipio advising it that the Company continues to be in default under the Note and requesting Slingsby to deliver an additional 3,950,000 shares of common stock as collateral to Consipio under the terms of the Pledge Agreement. In addition, pursuant to such notice Consipio purported to exercise the right as pledgee to vote all of the collateral shares, including the 1,650,000 shares of common stock previously pledged as collateral, so long as an event of default has occurred and is continuing under the Note.

On August 12, 2010, the Company received notice that Consipio had refiled a Complaint against the Company and Slingsby to enforce the Note and guaranty in New York State Court, entitled Consipio Holding BV v. Private Media Group, Inc. and Slingsby Enterprises Limited (Case No. 650462/10). The new Complaint contained allegations and sought relief similar to the allegations and relief sought in the case previously filed on May 1, 2009, in U.S. federal court. Both the Company and Slingsby intend to vigorously defend against these claims.

## Outlook

We have been transitioning our business model from linear to digital content production and distribution over the past two years and this has affected our margins. As DVD and magazines sales have rapidly declined, we have made substantial progress moving to a digital business model with significant new media distribution deals and the monetization of our expansive library of content. We are now a leading adult content provider on the Internet and on all major digital platforms in Europe, and as we continue to build out and get larger, we project significant growth in both sales and net income. Specifically, we project the biggest gains to be achieved through: Internet, broadcasting and wireless. In 2009, these platforms were responsible for 83% percent of our sales compared to 61% for 2008 and 57% in 2007. Following is a discussion highlighting some of the important factors of our business going forward.

### *Internet*

In January 2009, we expanded our Internet operations through the acquisition of Game Link LLC and its affiliates, companies engaged in digital distribution of adult content over the Internet and eCommerce development. GameLink is a leading US adult entertainment VOD and eCommerce platform through its GameLink.com website. The site's installed user base represents over one million domestic and international customers and it serves over 100,000 users daily. Including 70,000 video titles, GameLink has the largest library of digital and physical adult media and novelties in the United States. The Company offers VOD in multiple media formats including streaming and downloads to computers and iPhones. GameLink's infrastructure is the most robust in the industry and is highly flexible, customizable and scalable designed to support multiple retail strategies and products simultaneously. Additionally, through its related companies, GameLink offers third-party and white-label ecommerce solutions and development.

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

The acquisitions of GameLink and Sureflix are a significant development that will substantially contribute to our growth, while creating economies of scale. As part of our digital strategy, we have established that the combination of Private with major online retailers and accomplished platform developers is the approach to achieving our goals in the rapidly changing business landscape. The combined content assets of Private and core competencies of GameLink and Sureflix offer a compelling new business model. We will be expanding our joint Internet strategies globally with new formats and applications to be launched in 2010. In May this year we launched our new private.com membership platform which we have been building since mid 2009. The new platform features a number of proprietary sites and it is also available as a white label version which we expect will attract adult content providers affiliate worldwide. The new platform is forecasted to improve conversion rates and receive considerably times more traffic compared to our previous membership platform. In addition, the new platform has been built to be substantially less labor intensive to operate compared to the existing one. Following the rollout of the new membership platform, we are launching a new video-on-demand platform following the same concept. Both of the new platforms will be available in localized versions with respect to language and payment options.

Additionally, we will be developing improved interactive functionality for new media platforms such as IPTV and mobile, and maximizing our content monetization with the existing vast Private library as

well as aggregation of select international studios offering a wide range of content and genres for all platform needs. In April this year, GameLink, launched a proprietary mobile solution enabling users to instantly stream over 15,000 movies. The platform is initially available on Smartphones such as the iPhone and Android phones at the url: [www.gamelink.com](http://www.gamelink.com). The mobile Internet platform is an extension of GameLink's leading Video-on-Demand e-commerce platform, allowing consumers to purchase and consume content instantly. All content is available for future viewing in the customer's virtual media center, stored in the company's cloud. The platform has been optimized to work with Apple devices including the iPhone, iPod, the iPad as well as Android devices. In addition to streaming, consumers can choose to download their movies or purchase DVDs and novelties from the globally accessible platform. A white label version of the mobile platform is available and is being marketed to adult studios and affiliates worldwide. Our objective is to become the main provider of an off-portal mobile platform solution to all major content providers in our industry. In contrast to Private's existing mobile content business, which is based on an on-portal model going through content aggregators and carriers, this new business is off-portal and provides substantially improved margins as content is sold directly by Private to the consumer.

#### *Broadcasting*

We are continuing to implement our new media strategy for growth of VOD (Video-on-Demand) via IPTV and to date we have contracted with 38 major platform operators in 24 countries in Europe, as the leading supplier of adult content. Currently we have gained more than 75% coverage of the European IPTV market and across all platforms. Going forward, we expect to increase our market coverage in this expanding market.

Furthermore, the introduction of IPTV in Europe has challenged the Cable-TV industry and subsequently cable operators are rapidly upgrading their systems to provide the same functionality as IPTV. In 2009 we have contracted with two leading cable operators in Western Europe and going forward we expect to add further Cable/VOD platforms to our portfolio.

In relation to Private branded TV channels carrying our content in Europe and Latin America our partners Playboy TV Latin America and Playboy TV International continue to improve distribution. During the 2009, Playboy TV Latin America increased the distribution significantly in Brazil, Argentina and Central America and we expect to see positive impact from this going forward.

#### *Wireless Adult Mobile Content*

Private's mobile on-portal revenues declined again in 2009 after years of strong growth. We are still the most distributed adult brand in the world and will monetize existing distribution as best as we can by going live with the few outstanding carriers and replacing non-performing content aggregators with new ones. Throughout 2008 and 2009 there has been a huge increase in mobile off-portal traffic and currently 5% of all searches on Google are made from mobile phones. With the Smartphone market growing rapidly<sup>3</sup>, we are in the process of enabling Smartphone users to browse, purchase and consume our library of content on all of our web properties and expect to generate substantial growth from this initiative already in the second half of 2010.

<sup>2</sup> Private content is available to 1.2 billion handsets via 104 mobile network operators in 45 countries.

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

*DVDs & Magazines*

As we further transition into global digital content delivery, DVD pricing and volume is being affected considerably and as a result the industry in general is experiencing a severe downturn in DVD sales. In view of the aforementioned, we continue to re-strategize our distribution of DVDs and Magazines to reduce any further negative impact of this downward DVD trend.

**Item 4T. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in reports filed under the Securities Exchange Act of 1934, is recorded, processed, summarized and reported within the specified time periods. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is accumulated and communicated to its management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. As of the end of the period covered by this report, the Company's management evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures. Based on the evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2010.

*Changes in Internal Control Over Financial Reporting*

There were no changes in the Company's internal control over financial reporting that occurred during the Company's fiscal quarter ended June 30, 2010, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

*Inherent Limitations in Internal Control Over Financial Reporting*

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

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

*Termination of Ilan Bunimovitz as CEO and Subsequent Litigation*

On July 19, 2010, Ilan Bunimovitz was terminated as Chief Executive Officer of Private Media Group, Inc. Mr. Bunimovitz was employed as CEO since 2009 pursuant to a written employment agreement, which agreement was terminated by the Company under provisions allowing it to terminate the agreement for cause (as defined in such agreement). Conduct of Mr. Bunimovitz constituting cause included breach of fiduciary duty, conflict of interest, material acts of dishonesty and violations of the Company's Code of Ethics. Mr. Bunimovitz's termination for cause was unanimously approved by all three independent directors and a majority of the disinterested directors. Mr. Bunimovitz continues to serve as a director of the Company for the remainder of his term, which expires at the Company's 2010 Annual Meeting of Shareholders.

Immediately following Bunimovitz's termination, he instituted two legal proceedings against the Company, both of which are without merit and are being contested vigorously by the Company. These legal proceedings are described below under Employment Arbitration and Nevada State Court Action.

*Employment Arbitration*

On July 23, 2010, Mr. Bunimovitz filed a Demand for Arbitration and related Statement of Claim against the Company with JAMS (Case No. 1100063395), a private arbitration service, pursuant to the dispute resolution provisions of his Employment Agreement, contesting his termination as CEO. In the Statement of Claim, Mr. Bunimovitz alleges that (1) his termination on July 19, 2010, was without cause under his written Employment Agreement; (2) the termination was taken in retaliation for Mr. Bunimovitz demanding an independent investigation of Berth Milton's alleged self-dealing transactions and was taken in an effort to silence him; and (3) the termination of employment was not properly authorized by the Board of Directors, and is therefore invalid. Mr. Bunimovitz seeks declaratory relief that the termination was without legal effect and unspecified compensatory and punitive damages. On August 6, 2010, the Company filed an Answer, denying Mr. Bunimovitz's allegations in all material respects. The Company and GameLink, a wholly owned subsidiary, have also filed a Cross-Claim against Mr. Bunimovitz for breach of contract and conversion, based upon his failure to return property belonging to Private which Bunimovitz had wrongfully refused to turn over to the Company at the time of his termination.

Although Bunimovitz claims that he was terminated in retaliation for demanding an independent investigation of self-dealing transactions on June 8, 2010, in fact both Mr. Bunimovitz and his personal legal counsel were aware of the request made by the Chairman to the Board of Directors to terminate Bunimovitz for cause since at least May 5, 2010. The alleged self-dealing transactions of which Mr. Bunimovitz complains include payment of rent for the Chairman's personal offices, the failure of the Chairman to repay a multi-million dollar loan from the Company and unauthorized cash payments that the Chairman be directed to himself, transactions which were under review by the independent directors since January 2010 and disclosed in the Company's SEC reports, to the extent required by SEC rules. In particular, Form 8-K filed with the SEC on March 11, 2010, addressed in detail payments made to Mr. Milton in 2009, and their approval by the Board of Directors. In addition, Item 13 in the Company's ANNUAL REPORT on Form 10-K filed with the SEC on May 25, 2010, addressed in detail the status of the loan transaction. Mr. Bunimovitz signed this ANNUAL REPORT on Form 10-K as CEO and director and personally certified the accuracy and completeness of this filing pursuant to the provisions of the



Sarbanes-Oxley Act of 2002. As required by Nasdaq corporate governance rules, all related party transactions involving directors and officers continue to remain under the ongoing review of the Audit Committee, comprised solely of three independent directors, to ensure fairness of these transactions to the shareholders.

*Nevada State Court Action*

On August 11, 2010, Mr. Bunimovitz, together with Consipio Holding BV and Tisbury Services Inc., filed a Complaint against Private Media Group, Inc. in Nevada County Court, Clark County, Nevada (Case No. A-10-622802-B) alleging mismanagement of the Company's business by the Company's three independent directors, Johan G. Carlberg, Peter Dixinger and Bo Rodebrandt, and Berth Milton, the Company's Chairman and CEO, and seeking to have Mr. Bunimovitz and another non-independent director, Eric Johnson, appointed as receivers to run the business and affairs of Private, to the exclusion of the other directors. The Complaint also seeks an injunction which, if granted, would prevent Private from issuing any stock, borrowing any money or taking any other action outside the ordinary course of business. The Complaint does not name any defendant other than the Company. The matter has been set by the Court for a Preliminary Hearing on September 3, 2010, to determine whether the Plaintiffs are entitled to any of the requested relief.

On August 13, 2010, the Plaintiffs also requested the Court to grant a temporary injunction, to remain in effect until the Preliminary Hearing on September 3, which, if granted, would have prohibited the Company from engaging in any transaction outside the ordinary course of business. The Court denied the Plaintiffs' requested temporary relief, but issued a temporary order, with the consent of Private, requiring Private to seek permission of the Court to hold any special Board meeting prior to September 3. The temporary order does not prohibit Private from holding regularly scheduled Board meetings or otherwise in any way restrict the conduct of Private's business.

The Company believes that the allegations are without merit and are an improper attempt to circumvent valid and lawful actions of the disinterested majority of the Board of Directors, including all three independent directors, and to instead place control of the Company in the hands of a disgruntled former employee (Bunimovitz), his former subordinate employee (Eric Johnson) and a creditor (Consipio Holding BV) with whom the Company has been in a protracted and heavily litigated dispute reported in SEC filings since 2003. Consipio, in addition to being a creditor, is also an affiliate of a competitor of Private, Beate Uhse, AG, an adult entertainment company listed on the Frankfurt Stock Exchange. For further information regarding the other litigation with Consipio see *Part I Item 2. - Management's Discussion and Analysis of Financial Condition and Results of Operations - Disputed Contractual Obligation* appearing elsewhere in this Report, and *Consipio Holding BV vs. Private Media Group, Inc. and Slingsby Enterprises Limited, New York State Supreme Court, County of New York, Case No. 650462/10*, which appears in this Item 1 below.

The Company also believes that the actions of Mr. Bunimovitz as a director since he was terminated as CEO, including pursuing a lawsuit with a creditor with whom the Company is in protracted litigation, are a clear and serious breach of his fiduciary duties, and have been taken in bad faith to advance the personal interests of Mr. Bunimovitz. Accordingly, the Company intends to file counterclaims against Bunimovitz in this proceeding, seeking monetary damages and other appropriate relief.

*Consipio Holding BV vs. Private Media Group, Inc. and Slingsby Enterprises Limited, New York State Supreme Court, County of New York, Case No. 650462/10*

On May 1, 2009, Consipio Holding BV filed a lawsuit against the Company asserting a claim for unspecified damages under a Note dated December 21, 2001 in the original principal amount of \$4,000,000, which was guaranteed by Slingsby Enterprises Limited, an affiliate of the Company's Chairman and principal shareholder. The guarantee is secured by 1,650,000 shares of the Company's common stock. The Company filed its Answer and asserted several affirmative defenses. On March 26, 2010, the Court dismissed the lawsuit, finding that U.S. federal courts did not have jurisdiction over the subject matter of the lawsuit.

On August 12, 2010, the Company received notice that Consipio had refiled a Complaint against the Company and Slingsby to enforce the Note and guaranty in New York State Court, entitled Consipio Holding BV v. Private Media Group, Inc. and Slingsby Enterprises Limited (Case No. 650462/10). The new Complaint contained allegations and sought relief similar to the allegations and relief sought in the case previously filed on May 1, 2009, in U.S. federal court. Both the Company and Slingsby intend to vigorously defend against these claims. For additional information relating to this litigation see *Part I Item 2. - Management's Discussion and Analysis of Financial Condition and Results of Operations - Disputed Contractual Obligation* appearing elsewhere in this Report.

**Item 6. Exhibits**

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

**SIGNATURES**

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

PRIVATE MEDIA GROUP, INC.  
(Registrant)

Date: August 23, 2010

/s/ Johan Gillborg  
Johan Gillborg, Chief Financial Officer

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