

PRIVATE MEDIA GROUP INC  
Form 10-Q  
May 15, 2009

**U.S. SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

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

For the quarterly period ended March 31, 2009

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

**87-0365673**  
(I.R.S. Employer Identification Number)

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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)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large Accelerated Filer  Accelerated Filer  Non-accelerated filer  Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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

| Class                          | Outstanding at May 11, 2009 |
|--------------------------------|-----------------------------|
| Common Stock, par value \$.001 | 62,114,803                  |

## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

|  | March 31,<br>(Unaudited)    |               |               |
|--|-----------------------------|---------------|---------------|
|  | December 31,<br>2008<br>EUR | 2009<br>EUR   | 2009<br>USD   |
| (in thousands)   |                             |               |               |
| <b>ASSETS</b>  |                             |               |               |
| Cash and cash equivalents  | 552                         | 470           | 626           |
| Trade accounts receivable  | 6,066                       | 5,532         | 7,376         |
| Related party receivable   | 7,038                       | 7,156         | 9,541         |
| Inventories - net (Note 3)   | 5,038                       | 5,117         | 6,822         |
| Deferred income tax asset  | 6,188                       | 6,188         | 8,251         |
| Prepaid expenses and other current assets  | 1,238                       | 1,168         | 1,557         |
| <b>TOTAL CURRENT ASSETS</b>  | <b>26,120</b>               | <b>25,631</b> | <b>34,174</b> |
| Library of photographs and videos  | 15,138                      | 14,363        | 19,150        |
| Property, plant and equipment  | 3,154                       | 6,219         | 8,292         |
| Other intangible assets  | 2,971                       | 4,471         | 5,961         |
| Goodwill (Note 2)  | 2,132                       | 10,582        | 14,109        |
| Other investments  | 1,022                       | 1,022         | 1,362         |
| Other assets   | 321                         | 319           | 425           |
| <b>TOTAL ASSETS</b>  | <b>50,859</b>               | <b>62,605</b> | <b>83,474</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                             |               |               |
| Short-term borrowings  | 4,401                       | 4,543         | 6,057         |
| Current portion of long-term borrowings  |                             | 146           | 195           |
| Accounts payable trade   | 3,816                       | 5,402         | 7,203         |
| Income taxes payable   | 1,087                       | 500           | 667           |
| Deferred income taxes  | 24                          | 24            | 32            |
| Accrued other liabilities  | 920                         | 1,789         | 2,386         |
| <b>TOTAL CURRENT LIABILITIES</b>   | <b>10,249</b>               | <b>12,405</b> | <b>16,540</b> |
| Contingent consideration payable (Note 2)  |                             | 3,575         | 4,767         |
| Related party payable  |                             | 224           | 299           |
| Other long-term liabilities  |                             | 202           | 269           |
| <b>TOTAL LIABILITIES</b>   | <b>10,249</b>               | <b>16,406</b> | <b>21,875</b> |
| <b>SHAREHOLDERS' EQUITY</b>  |                             |               |               |
| \$4.00 Series A Convertible Preferred Stock 10,000,000 shares authorized, none issued and outstanding at December 31, 2008 and March 31, 2009, respectively          |                             |               |               |
| Common Stock, \$.001 par value, 100,000,000 shares authorized 53,580,494 and 62,114,803 issued and outstanding at December 31, 2008 and March 31, 2009, respectively | 885                         | 892           | 1,189         |
| Additional paid-in capital   | 21,728                      | 28,365        | 37,820        |
| Retained earnings  | 22,074                      | 21,240        | 28,320        |
| Accumulated other comprehensive income   | (4,077)                     | (4,297)       | (5,730)       |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>  | <b>40,610</b>               | <b>46,199</b> | <b>61,599</b> |

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|   |        |        |        |
|---|--------|--------|--------|
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | 50,859 | 62,605 | 83,474 |
|---|--------|--------|--------|

See accompanying notes to consolidated statements.

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## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF INCOME (LOSS)

## AND COMPREHENSIVE INCOME (LOSS)

|  | Three-months ended |         |         |
|--|--------------------|---------|---------|
|  | March 31,          |         |         |
|  | (unaudited)        |         |         |
|  | 2008               | 2009    | 2009    |
|  | EUR                | EUR     | USD     |
|  | (in thousands)     |         |         |
| Net sales                                    | 5,251              | 5,804   | 7,739   |
| Cost of sales                                | 3,396              | 3,565   | 4,753   |
| Gross profit                                 | 1,855              | 2,239   | 2,986   |
| Selling, general and administrative expenses | 3,256              | 3,608   | 4,811   |
| Operating income (loss)                      | (1,401)            | (1,369) | (1,825) |
| Interest expense                             | 79                 | 98      | 130     |
| Interest income                              | 76                 | 56      | 75      |
| Income (loss) before income taxes            | (1,403)            | (1,410) | (1,881) |
| Income tax (benefit)                         | (563)              | (576)   | (767)   |
| Net income (loss)                            | (840)              | (835)   | (1,113) |
| Other comprehensive income:                  |                    |         |         |
| Foreign currency translation adjustments     | (760)              | (220)   | (294)   |
| Comprehensive income                         | (1,600)            | (1,055) | (1,407) |
| Net income (loss) per share:                 |                    |         |         |
| Basic  | (0.02)             | (0.01)  | (0.02)  |
| Diluted                                      | (0.02)             | (0.01)  | (0.02)  |

See accompanying notes to consolidated statements.

## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|  | Three-months ended |             |              |
|--|--------------------|-------------|--------------|
|  | March 31,          |             |              |
|  | (unaudited)        |             |              |
|  | 2008               | 2009        | 2009         |
|  | EUR                | EUR         | USD          |
|  | (in thousands)     |             |              |
| <b>Cash flows from operating activities:</b>                   |                    |             |              |
| Net income (loss)  | (840)              | (835)       | (1,113)      |
| <b>Adjustment to reconcile net income to net cash</b>          |                    |             |              |
| flows from operating activities:                               |                    |             |              |
| Depreciation   | 290                | 236         | 315          |
| Stock based compensation                                       | 4                  | 1           | 1            |
| Bad debt provision   | 22                 | 111         | 148          |
| Amortization of other intangible assets                        | 31                 | 36          | 48           |
| Amortization of web pages                                      |                    | 326         | 435          |
| Amortization of photographs and videos                         | 1,612              | 1,416       | 1,888        |
| <b>Effects of changes in operating assets and liabilities:</b> |                    |             |              |
| Trade accounts receivable                                      | 748                | 500         | 666          |
| Related party receivable                                       | (46)               |             |              |
| Inventories  | 185                | 138         | 183          |
| Prepaid expenses and other current assets                      | 904                | 116         | 155          |
| Accounts payable trade   | 197                | (477)       | (636)        |
| Income taxes payable   | (610)              | (587)       | (782)        |
| Accrued other liabilities                                      | (177)              | 35          | 47           |
| Net cash provided by operating activities                      | 2,320              | 1,016       | 1,354        |
| <b>Cash flows used in investing activities:</b>                |                    |             |              |
| Investment in library of photographs and videos                | (1,577)            | (640)       | (854)        |
| Capital expenditures   | (369)              | (127)       | (170)        |
| Cash received in acquisition                                   |                    | 35          | 47           |
| Investments in (sale of) other assets                          | 19                 | 3           | 4            |
| Net cash (used in) investing activities                        | (1,927)            | (729)       | (972)        |
| <b>Cash flows from financing activities:</b>                   |                    |             |              |
| Short-term borrowings repayments                               | (207)              | (125)       | (167)        |
| Long-term borrowings repayments                                | (111)              | (50)        | (67)         |
| Long-term borrowings additions                                 |                    | 27          | 36           |
| Net cash (used in) provided by financing activities            | (318)              | (148)       | (197)        |
| Foreign currency translation adjustment                        | (760)              | (220)       | (294)        |
| <b>Net (decrease) increase in cash and cash equivalents</b>    | <b>(685)</b>       | <b>(82)</b> | <b>(109)</b> |
| <b>Cash and cash equivalents at beginning of the period</b>    | <b>1,599</b>       | <b>552</b>  | <b>736</b>   |
| <b>Cash and cash equivalents at end of the period</b>          | <b>914</b>         | <b>470</b>  | <b>626</b>   |
| Cash paid for interest   | 58                 | 49          | 65           |
| Cash paid for taxes  |                    |             |              |

See accompanying notes to consolidated statements.



## PRIVATE MEDIA GROUP, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

|                                       | Common stock |                |   | Retained earnings<br>EUR | Accumulated other<br>comprehensive income<br>EUR | Total<br>shareholders<br>equity<br>EUR |
|---------------------------------------|--------------|----------------|---|--------------------------|--|--|
|                                       | Shares       | Amounts<br>EUR | Additional<br>paid-in<br>capital<br>EUR |                          |  |  |
| Balance at January 1, 2008            | 53,580,494   | 885            | 21,718                                  | 27,262                   | (3,118)  | 46,748                                 |
| Stock based compensation              |              |                | 9                                       |                          |  | 9                                      |
| Translation adjustment                |              |                |   |                          | (959)  | (959)                                  |
| Net income (loss)                     |              |                |   | (5,188)                  |  | (5,188)                                |
| Balance at December 31, 2008          | 53,580,494   | 885            | 21,727                                  | 22,074                   | (4,077)  | 40,610                                 |
| Shares issued in acquisition (Note 2) | 8,534,309    | 7              | 6,631                                   |                          |  | 6,637                                  |
| Stock based compensation              |              |                | 1                                       |                          |  | 1                                      |
| Translation adjustment                |              |                |   |                          | (220)  | (220)                                  |
| Net income (loss)                     |              |                |   | (835)                    |  | (835)                                  |
| Balance at March 31, 2009             | 62,114,803   | 892            | 28,365                                  | 21,239                   | (4,297)  | 46,199                                 |

See accompanying notes to consolidated statements.

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**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 March 31, 2009 are not necessarily indicative of the results that may be expected for the year ended December 31, 2009. 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, 2008.

Solely for the convenience of the reader, the accompanying consolidated financial statements as of March 31, 2009 and for the three months then ended have been translated into United States dollars ( USD ) at the rate of EUR 0.75 per USD 1.00 the interbank exchange rate on March 31, 2009. 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.

*Supplemental Accounting Policies*

The Company s revenue recognition policies are in accordance with Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition in Financial Statements. One of the Company s primary sources of revenue is sales of its video on-demand offerings, which are sold directly via its on-line retail website and paid for almost exclusively by credit card. The Company recognizes revenue from video on-demand when the service is rendered and collectibility 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. The Company follows the guidance in Emerging Issues Task Force No. 00-22 ( EITF 00-22 ), Accounting for Points and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future, Issue No. 2 in accounting for its loyalty program. 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.

**2. 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. As a result of the acquisition, Private is expecting to be a leading global digital distributor of adult content over the Internet.

The goodwill of EUR 8,451 thousand arising from the acquisition consists largely of the acquired know-how related to digital distribution of adult content over the Internet and online eCommerce development, economies of scale and synergies expected from combining the operations of Private and GameLink. None of the goodwill recognized is expected to be deductible for income tax purposes.

The following table summarizes the consideration paid for GameLink and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date:

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|   | <b>January, 20<br/>2009<br/>EUR<br/>(in thousands)</b> |
|---|--|
| <b>Consideration</b>  |  |
| Equity Instruments (8,534,309 common shares of Private)                   | 6,644  |
| Contingent consideration arrangement (4,595,397 common shares of Private) | 3,575  |
| <b>Fair value of total consideration transferred</b>                      | <b>10,219</b>  |

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## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

| <b>Recognized amounts of identifiable assets acquired and liabilities assumed</b> |         |
|---|---------|
| Financial assets  | 233     |
| Inventory   | 217     |
| Property, plant, and equipment  | 3,264   |
| Identifiable intangible assets  | 1,535   |
| Financial liabilities   | (3,480) |
| <br>  |         |
| Total identifiable net assets   | 1,769   |
| Goodwill  | 8,451   |
|   | <br>    |
|   | 10,219  |

The Company incurred EUR 122 thousand in acquisition-related costs, which are included in selling, general, and administrative expenses in Private's income statement for the three months ending March 31, 2009.

The acquisition was accomplished by the merger of two wholly-owned subsidiaries of Private into the two parent companies of the GameLink businesses, with the shareholders of those entities receiving 8,534,309 shares of Private Common Stock in exchange for 100% of their common stock. In addition, the former shareholders are entitled to receive up to an additional 4,595,397 shares of Private Common Stock if the combined EBITDA of the online digital media operations of Private and GameLink meet specified targets in 2009, 2010 and 2011. The total fair value of the acquisition, which assumes the EBITDA targets are met in 2009, 2010 and 2011, is EUR 10,219 thousand (USD 13,272 thousand).

Using an exchange rate of EUR 0.77 to 1.00 USD, the combined EBITDA targets of the online digital media operations of Private and GameLink which the contingent consideration arrangement stipulates for each of the years below are:

|      | <b>USD</b><br><b>(in thousands)</b> |
|------|-------------------------------------|
| 2009 | 5,188                               |
| 2010 | 7,988                               |
| 2011 | 9,301                               |
|      | <br>                                |
|      | 22,477                              |

The manner in which the contingent consideration is earned in relation to the combined EBITDA targets is as follows:

For each of the years ended December 31, 2009, 2010 and 2011 in which the actual EBITDA of the online digital media operations equals or exceeds the target EBITDA, the former owners of GameLink (the Former Owners) are entitled to receive 1,531,799 shares of Private Common Stock.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

## (UNAUDITED)

If there is a shortfall in the actual EBITDA compared to the target EBITDA in any year, instead of receiving 1,531,799 target shares for that year, the Former Owners are entitled to receive a pro rata portion of the target shares for that year, based upon the ratio between the actual EBITDA and the target EBITDA for that year. In such event, if the actual EBITDA required in the following year(s) exceeds the target EBITDA, in addition to the 1,531,799 target shares earned for the following year(s), the Former Owners are entitled to recover all or a portion of unearned target shares from the prior year(s) based upon the amount by which actual EBITDA exceeds the target EBITDA in the subsequent year.

The contingent consideration of EUR 3,575 thousand was valued at its acquisition date fair value using the lattice model. The Company believes that the target EBITDA will be reached by the end of the contingency period. The contingent consideration is classified as a liability under FAS 141R and will be re-measured at its current fair value each reporting period until the contingency is resolved.

The fair value of the acquired property, plant, and equipment of EUR 3,264 thousand is provisional pending receipt of the final valuation.

The fair value of the identifiable intangible assets of EUR 1,535 thousand, comprises domain names and customer relationships valued at EUR 1,339 thousand and EUR 196 thousand, respectively. The domain names have an indefinite estimated useful life and the customer relationships will be amortized over a period of 7 years. The fair value of these assets is provisional pending receipt of the final valuation.

The amounts of GameLink's revenue and earnings included in Private's consolidated income statement for the three months ended March 31, 2009, and the pro forma revenue and earnings of the combined entity had the acquisition date been January 1, 2008, are:

|   |                | Revenue<br>EUR | Earnings<br>EUR |
|---|----------------|----------------|-----------------|
|   |                | (in thousands) |                 |
| Actual from January 1, 2009                 | March 31, 2009 | 2,758          | (159)           |
| Supplemental pro forma from January 1, 2009 | March 31, 2009 | 6,410          | (903)           |
| Supplemental pro forma from January 1, 2008 | March 31, 2008 | 8,047          | (835)           |

**3. Inventories**

Inventories consist of the following:

|                               | December 31,<br>2008<br>EUR | March 31,<br>2009<br>EUR |
|-------------------------------|-----------------------------|--------------------------|
|                               | (in thousands)              |                          |
| Magazines for sale and resale | 2,394                       | 2,405                    |
| DVDs                          | 2,330                       | 2,383                    |
| Other                         | 314                         | 328                      |
|                               | 5,038                       | 5,117                    |

## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

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

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

|  | <b>Three-months ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2008</b>                             | <b>2009</b> |
| <b>Numerator: (EUR in thousands)</b>   |   |             |
| Net income (loss)  | (840)                                   | (835)       |
| <b>Denominator:</b>  |   |             |
| Denominator for basic earnings per share weighted average shares outstanding               | 53,590,147                              | 60,127,361  |
| <b>Effect of dilutive securities:</b>  |   |             |
| Common stock warrants, convertible notes, options and other dilutive securities            | n/a                                     |             |
| Denominator for diluted earnings per share weighted average shares and assumed conversions | n/a                                     |             |
| <b>Earnings (loss) per share (in EUR)</b>  |   |             |
| Basic  | (0.02)                                  | (0.01)      |
| Diluted  | (0.02)                                  | (0.01)      |

For the three months ended March 31, 2008 diluted impact of potentially dilutive securities is anti-dilutive therefore diluted and basic loss per share are EUR 0.02. The equivalent of 9,652 common shares derived from dilutive securities such as options, warrants and convertible notes are excluded from the diluted earnings per share at March 31, 2008 as they are anti-dilutive.

**5. Stock-based compensation**

The Company has had an Employee Stock Option Plan as described below. The compensation cost charged against income for the three-month periods ended March 31, 2008 and 2009 was EUR 4,000 and EUR 1,000, 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.

*Employee Stock Option Plan*

The 1999 Employee Stock Option Plan ( the 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 Plan authorized the Company 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, following its expiration, on March 1, 2009.

## PRIVATE MEDIA GROUP, INC.

## NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS

## (UNAUDITED)

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.

The Company calculated the fair value of each option award on the date of grant using the Black-Scholes option pricing model. The following general assumptions were used: a) expected volatility was based on historical volatility of our stock, b) expected life was 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 was based on the U.S. Treasury yield curve in effect at the time of grant and d) dividend yield was zero based on the Company's Dividend Policy. During the three month periods ended March 31, 2008 and 2009 no grants were made.

A summary of stock option activity for the three month period ended March 31, 2009 is as follows:

|                             | Number<br>of<br>Shares | Weighted-<br>Average<br>Exercise<br>Price<br>in USD | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term<br>in Years | Aggregate<br>Intrinsic<br>Value <sup>1</sup> in<br>Thousands<br>of USD |
|-----------------------------|------------------------|---|--|--|
| Outstanding January 1, 2009 | 1,888,920              | 4.99  |  |  |
| Granted                     |                        |   |  |  |
| Exercised                   |                        |   |  |  |
| Expired/Forfeited           | 1,256,920              | 5.09  |  |  |
| Outstanding March 31, 2009  | 632,000                | 4.79  | 0.6  |  |
| Exercisable March 31, 2009  | 619,000                | 4.87  | 0.5  |  |

During the three month periods ended March 31, 2008 and 2009, no options under our stock option plan were exercised.

As of March 31, 2009, there was USD 3,006 of total unrecognized compensation cost related to nonvested option granted under the Plan. That cost is expected to be recognized over a weighted-average period of 0.6 years. The total fair value of all shares vested and outstanding at March 31, 2008 and 2009, was USD 4.6 million and USD 0.5 million, respectively.

<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 March 31, 2009.

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**(UNAUDITED)**

**6. Income Taxes**

On January 1, 2007 the Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48).

The Company's subsidiaries file income tax returns in numerous tax jurisdictions, including the United States, several U.S. states and several non-U.S. jurisdictions, primarily in Europe. The statute of limitations varies by the various jurisdictions in which we operate. Because of the number of jurisdictions in which we file tax returns, in any given year the statute of limitations in certain jurisdictions may lapse without examination within the 12-month period from the balance sheet date. Other than the recurring effect of changes in unrecognized tax benefits due to the lapse of the statute of limitations, none of which are expected to be individually significant, management believe there are no other reasonably possible changes that will significantly impact the amount of tax benefits recognized in the Company's financial statements 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 2003 and 2001 respectively, and all foreign income tax matters for years up to 2002.

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 419 thousand were accrued as of March 31, 2009, of which EUR 14 thousand was recognized as interest expense during the 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.

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**PRIVATE MEDIA GROUP, INC.**

**NOTES TO THE CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**(UNAUDITED)**

**7. Recent Accounting Pronouncements**

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), Business Combinations ( FAS 141(R) ), to further enhance the accounting and financial reporting related to business combinations. FAS 141 (R) establishes principles and requirements for how the acquirer in a business combination (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. FAS 141 (R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Therefore, the effects of the adoption of FAS 141 (R) will depend upon the extent and magnitude of acquisitions after December 31, 2008. The GameLink acquisition, which took place on January 20, 2009, was accounted for under FAS 141 (R).

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements, ( FAS 157 ). This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FAS 157 applies to other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. The Statement does not require any new fair value measurements and was originally effective beginning January 1, 2008. In February 2008, the FASB issued FASB Staff Position ( FSP ) FAS 157-2. FSP FAS 157-2 defers the effective date of FAS 157 until January 1, 2009 for non-financial assets and non-financial liabilities except those items recognized or disclosed at fair value on an annual or more frequently recurring basis.

We adopted SFAS No. 157 effective January 1, 2008 for financial assets and liabilities measured on a recurring basis. The Company has no level 2 or level 3 assets as all of the cash and cash equivalents are considered to be level 1, therefore there was no impact for the partial adoption of SFAS No. 157 on our consolidated financial statements. The application of SFAS No. 157 to our non-financial assets and liabilities did not have any material effect on our consolidated financial statements. The fair value of the assets acquired and liabilities assumed from our GameLink acquisition was determined using FAS 157.

## 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 following discussion should be read in conjunction with the consolidated financial statements and related notes included elsewhere in this Report. References in this report to we, us, the Company and Private refer to Private Media Group, Inc., a Nevada corporation, including its consolidated subsidiaries.

### 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 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.

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 the largest library of digital and physical adult media and novelties in the United States

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:

- 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 (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, wireless 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 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.

With respect to proprietary video titles, we released 87 titles during 2008, 101 titles during 2007, and 110 titles during 2006, including both new and archival material. We plan to release approximately 50 titles in 2009.

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.

### **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 revenue recognition policies are in accordance with Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition in Financial Statements. One of the Company's primary sources of revenue is sales of its video on-demand offerings, which are sold directly via its on-line retail website and paid for almost exclusively by credit card. The Company recognizes revenue from video on demand when the service is rendered and collectibility 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. The Company follows the guidance in Emerging Issues Task Force No. 00-22 ( EITF 00-22 ), Accounting for Points and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future, Issue No. 2 in accounting for its loyalty program. 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 IPTV (Internet Protocol Television), satellite & cable broadcasting are recognized based on sales reported each month by its 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.

Revenues from mobile content sales (wireless) 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.

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 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%. 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 16.90) per copy and are printed on glossy high-quality paper at a cost of EUR 1.25 (USD 1.84). 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 21.99). 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 also 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 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 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.

*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).

The Company performs impairment tests of goodwill and indefinite lived intangible assets annually. The Company is required 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 has historically been no effect 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. 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 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.

#### *Website Development Costs*

The Company follows the guidance of Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use ( SOP 98-1 ) and Emerging Issues Task Force Issue No. 00-2, Accounting for Web Site Development Costs ( EITF 00-2 ). EITF 00-2 prescribes the accounting for website development costs based on the type of website development activity. In accordance with SOP 98-1 and the transition provisions of EITF 00-2, The Company has elected to apply this standard to costs incurred to develop its websites from January 1, 2000 forward. The Company capitalizes qualifying development costs which are incurred during the application development stage and in website enhancement activities, including graphics and related software. Capitalized website development costs for The Company's on-demand and retail services are amortized on a straight-line basis over periods of three to five years and are included in property and equipment in the accompanying consolidated balance sheets. Costs related to website maintenance are expensed as incurred.

#### *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**

##### ***Three months ended March 31, 2009 compared to the three months ended March 31, 2008***

*Net sales.* For the three months ended March 31, 2009, we had net sales of EUR 5.8 million compared to net sales of EUR 5.3 million for the three months ended March 31, 2008, an increase of EUR 0.6 million. The increase was the result of increased Internet sales offset by decreases in sales of DVD & Magazines, broadcasting and wireless.

Internet sales increased EUR 1.9 million to EUR 3.0 million, which represents an increase of 162% compared to the same period last year. The increase in Internet sales was the result of the acquisition of GameLink. DVD & Magazine sales decreased EUR 0.8 million, or 38%, to EUR 1.4 million. The reduction in DVD & Magazine sales was primarily attributable to an industry wide decrease in DVD sales (see discussion under *Outlook* below). Broadcasting sales decreased EUR 0.4 million, or 28%, to EUR 0.9 million primarily as a result of a decrease in title sales, offset by increases in TV-channel sales and video on demand sales via IPTV. Wireless sales decreased by EUR 0.1 million to EUR 0.5 million in the period.

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

*Cost of Sales.* Our cost of sales was EUR 3.6 million for the three months ended March 31, 2009 compared to EUR 3.4 million for the three months ended March 31, 2008, an increase of EUR 0.2 million, or 5%.

Included in cost of sales is Internet, broadcasting and wireless cost, printing, processing and duplication and amortization of library. Internet, broadcasting and wireless cost was EUR 1.5 million for the three months ended March 31, 2009 compared to EUR 0.5 million for the three months ended March 31, 2008. Internet, broadcasting and wireless cost as a percentage of related sales

in the period was 34% compared to 17% in the same period last year. The increase was primarily the result of an increase in Internet cost of EUR 1.3 million as a result of the acquisition of GameLink, offset by lower wireless and broadcasting cost as result of more cost efficient content delivery. Printing, processing and duplication cost was EUR 0.6 million for the three months ended March 31, 2009 compared to EUR 1.3 million for the three months ended March 31, 2008, a decrease of EUR 0.7 million, or 50%. Printing, processing and duplication cost as a percentage of DVD & Magazine sales was 45% for the three months ended March 31, 2009 compared to 56% in the same period last year. Amortization of library was EUR 1.4 million for the three months ended March 31, 2009 compared to EUR 1.6 million for the three months ended March 31, 2008, which represents a decrease of EUR 0.2 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 March 31, 2009, we realized a gross profit of EUR 2.2 million, or 39% of net sales compared to EUR 1.9 million, or 35% of net sales for the three months ended March 31, 2008. The increase in gross profit as a percentage of sales was primarily the result of reduced margins on DVD & Magazine sales.

*Selling, general and administrative expenses.* Our selling, general and administrative expenses were EUR 3.6 million for the three months ended March 31, 2009 compared to EUR 3.3 million for the three months ended March 31, 2008, an increase of EUR 0.3 million, or 11%. The acquisition of GameLink added EUR 1.0 million which was offset by EUR 0.8 million in reduced selling, general and administrative expenses in all other areas except bad debt provision, which increased by EUR 0.1 million.

*Operating loss.* We reported an operating loss of EUR 1.4 million for the three months ended March 31, 2009 compared to an operating loss of EUR 1.4 million for the three months ended March 31, 2008.

*Interest expense.* We reported interest expense of EUR 0.1 million for the three months ended March 31, 2009, compared to EUR 0.1 million for the three months ended March 31, 2008.

*Income tax benefit.* We reported income tax benefit of EUR 0.6 million for the three months ended March 31, 2009, compared to EUR 0.6 million for the three months ended March 31, 2008.

*Net loss.* We reported a loss of EUR 0.8 million for the three months ended March 31, 2009, compared to EUR 0.8 million for the three months ended March 31, 2008.

#### **Liquidity and Capital Resources**

We reported a working capital surplus of EUR 13.2 million at March 31, 2009, a decrease of EUR 2.6 million compared to the year ended December 31, 2008. The decrease is principally attributable to a increase in current liabilities as a result of the acquisition of GameLink.

*Operating Activities*

Net cash provided by operating activities was EUR 1.0 million for the three months ended March 31, 2009, 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 0.8 million was adjusted to reconcile net income to net cash flows from operating activities with bad debt provision of EUR 0.1 million, amortization of web pages of EUR 0.3 million depreciation of EUR 0.2 million and amortization of photographs and videos of EUR 1.4 million making a total of EUR 2.1 million, providing a net balance of EUR 1.3 million. The total of EUR 1.3 million was added to by changes in trade accounts receivable, inventories, and prepaid expenses and other current assets totaling EUR 0.8 million offset by EUR 1.1 million from related party receivable, income taxes payable, accounts payable trade and accrued other liabilities. Net cash provided by operating activities was EUR 2.3 million for the three months ended March 31, 2008. The decrease in net cash provided by operating activities of EUR 1.3 million for the three months ended March 31, 2009 compared to the same period last year was primarily the result of changes in operating assets and liabilities.

*Investing Activities*

Net cash used in investing activities for the three months ended March 31, 2009 was EUR 0.7 million. The investing activities were principally capital expenditure of EUR 0.1 million and investment in library of photographs and videos of EUR 0.6 million, which was carried out in order to maintain the 2009 release schedules. Net cash used in investing activities decreased EUR 1.2 million over the same period last year. The decrease is principally due to lower investment activity in library of photographs and videos as a result of a lower demand for new releases on new media platforms as opposed to traditional media which required a higher frequency.

*Financing Activities*

Net cash used in financing activities for the three-month period ended March 31, 2009 was EUR 0.1 million. Compared to the three-month 2008 period there was no material change.

**Contractual obligations**

During the three-month period ended March 31, 2009, we have not experienced any material changes in our contractual obligations compared to what was reported in our Form 10-K for the year ended December 31, 2008.

*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 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 until April 2008. However, Consipio and Private were unable to reach final agreement on other terms and conditions relating to the restructured Note. Accordingly, in December 2003 Consipio notified Private and Slingsby Enterprises that Private was in default under the Note, and demanded \$3.4 million as payment in

full of all outstanding principal and interest under the Note. The Company continued to make regular payments on the Note, including principal and accrued interest, through February 2008. In April 2008 Consipio requested Private to pay the remaining balance of the Note, without indicating the amount due. Private in turn requested that Consipio provide a statement of the amount due and the basis for its calculation. In response, Consipio demanded payment of \$3,194,000 as settlement in full of the Note, to be received by May 9, 2008. This calculation was made using an interest rate of 9.9%, as opposed to the 7% rate provided under the original terms of the Note. Consipio also advised that if payment was not received on such date it would institute litigation, in which event Consipio would claim that the amount due under the Note should be denominated in Euro, rather than U.S. dollars. In August 2008 Consipio notified Private that the Note was in default and that it intended to exercise its rights under the Note and the pledge of shares by Slingsby of Private Common Stock. Private believes that the amount due under the Note at May 9, 2008, including accrued interest, was no more than \$2.4 million, utilizing an interest rate of 7%. Private also believes it has valid claims and defenses against Consipio and its affiliates which may ultimately reduce all or a portion of its obligations relating to the Note. However, there are no assurances that either Private will be able to reach agreement with Consipio or that Private will ultimately prevail on its claims and defenses. In any event, the Company does not believe that the Note obligations will have a material adverse effect on the liquidity of 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 to the holder of the Note.

## Outlook

Going forward, we expect significant growth on our new media platforms, Internet, broadcasting and wireless. During the 2008, our new media platforms were responsible for 61% percent of our revenues. Following is a discussion highlighting some of the important factors of our business going forward.

### *Broadcasting*

We are successfully implementing our new media strategy for VOD via IPTV and to date we have contracted with 36 major platform operators in 18 countries in Europe. Currently we have gained 75% coverage of European IPTV market<sup>2</sup>. Going forward, we expect to increase our market coverage in this rapidly expanding market, which compared to traditional pay-TV generates substantially higher sales per subscriber at a considerably better margin.

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. In 2008, Playboy TV Latin America increased the distribution significantly in Brazil, Argentina and Central America.

During 2008, we have also noted a new emerging market for our content, the DTT (Digital Terrestrial Television) market. Faced with the imminent closure of analog TV services, a growing number of Western Europeans are opting for DTT as a replacement. Market analysis<sup>3</sup> forecasts DTT to be the primary TV Service in 44% of Western European Households by 2012. In July 2008, we made an agreement with Glamour Plus, the first nationwide adult pay-DTT channel in Italy and we expect to make additional deals across the EU on this new platform.

### *Wireless Adult Mobile Content*

With respect to mobile content, we believe this market is still in its infancy. During 2007 the distribution of Private content increased by 67% and by the end of the year it was available to 906 million handsets in 36 countries via 86 operators. In 2008, we have been optimizing our content delivery network of aggregators in order to secure a more aggressive long-term growth. This has created periods of gap in distribution with several operators during, but in the fall of 2008 this process was completed and consequently we expect sales to increase significantly during 2009. As of April, 2009, Private content was available to 1.2 billion handsets via 104 mobile network operators in 45 countries.

The markets of Asia and the Americas are still underexploited by us and therefore represent a significant growth potential. In addition, Mobile TV, increased penetration of 3G handsets and the implementation of age verification systems offer additional significant growth potential with both current and future operators in 2008 and beyond<sup>4</sup>.

<sup>2</sup> According to Global IPTV Forecasts made by MRG (Multimedia Research Group, Inc.), the number of global IPTV subscribers is estimated to grow from 13.5 million in 2007 to 92.8 million in 2012, a compound annual growth rate of 47 percent. Europe continues to be the biggest market for IPTV, with France significantly leading the growth projections through its principal telcos. The number of IPTV subscribers in Europe is forecasted to grow from approximately 6.4 million in 2007 to 36.4 million in 2012, a compound annual growth rate of 42 percent.

<sup>3</sup> According to the new research brief, *European DTT Services Snapshot* published by ABI Research, June 2008.

<sup>4</sup> Juniper Research estimates in its white paper *Adult Content in the Palm of Your Hand* (November 2007) that the global mobile adult content market will increase from US\$1.7 billion in 2007 to just over US\$4.6 billion by 2012.

*Internet*

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 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. For the year ended 2008 Gamelink and its affiliates reported net sales of USD 16.4 million.

The acquisition of GameLink is a significant development that will substantially contribute to our growth, while creating economies of scale. We have been establishing our digital strategy for the last year, and concluded that the combination of Private with a major online retailer and accomplished platform developer is the approach to achieving our goals in the rapidly changing business landscape. The combined content assets of Private and core competencies of GameLink offer a compelling new business model. We will be expanding our joint internet strategies globally with new formats and applications to be launched in 2009. 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. With this expanded digital strategic focus we will be announcing a variety of compelling new initiatives during 2009.

During the first half of 2009, we are launching 50 Internet niche sites aimed at diversifying our offering and increasing the proliferation of our content on the web alongside our flagship site, www.private.com. The niche sites form an important new network, delivering our content categorized according to genre and theme. The plan is to grow this network around three core sites to a total of over 100 niche sites in operation by the end of 2009. The sites are targeted to satisfy a variety of consumer interests with niche specific content sourced from our vast library and they are also offered to our affiliate network, www.privatecash.com. The niche site strategy is expected to generate significant incremental revenues and contribution to operating profit through substantially increasing shelf-space, traffic and conversion rates. In addition, it enables us to take advantage of additional up-selling and cross-selling opportunities. The new sites have been in development for over a year and are part of the ongoing evolution and growth of our global online diversification strategy.

*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.

### *Liquidity*

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 twelve 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.

### **Item 3. 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 equivalents 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 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 March 31, 2009.

*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 March 31, 2009, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

*Inherent Limitations in Internal Control Over Financial Reporting*

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

**PART II OTHER INFORMATION**

**Item 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: May 15, 2009

/s/ Johan Gillborg  
Johan Gillborg, Chief Financial Officer

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