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PRIVATE MEDIA GROUP INC
Form 10-K
April 16, 2002

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended.....December 31, 2001
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.
(Name of Registrant as specified in its Charter)

Nevada 87-0365673
(State or other jurisdiction of (I.R.S. Employer Identification Number)
incorporation or organization)

Carretera de Rubi 22-26, 08190 Sant Cugat del Valles,
Barcelona, Spain
(Address of principal executive offices)

34-93-590-7070

(Issuer's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Exchange Act: None
Securities registered pursuant to Section 12(g) of the Exchange Act: Common
Stock, \$0.001 par value.

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 X No

Check if no disclosure of delinquent filers in response to Item 405 of
Regulation S-K is not contained herein, and no disclosure will be contained, to
the best of registrant's knowledge, in definitive proxy or information
statements incorporated by reference in Part III of this Form 10-K or any
amendment to this Form 10-K.

At April 12, 2002, the aggregate market value of the voting stock and
non-voting common equity held by non-affiliates of the registrant was
\$97,386,431. The aggregate market value has been computed by reference to the
last sales price of the common stock on April 12, 2002. On such date the
registrant had 28,426,152 shares of Common Stock outstanding.

PART I

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ITEM 1. DESCRIPTION OF BUSINESS

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

- . our business development, operating development and financial condition;
- . our expectations of growth in demand for our products and services;
- . our expansion and acquisition plans;
- . the impact of expansion on our revenue potential, cost basis and margins;
- . the effects of regulatory developments and legal proceedings on our business;
- . the impact of exchange rate fluctuations; and
- . our ability to obtain additional financing.

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

THE COMPANY

OVERVIEW

We are a leading international provider of high quality adult media content for a wide range of media platforms. We acquire still photography and motion pictures tailored to our specifications from independent directors and process these images into products suitable for popular media formats such as print publications, DVDs, videotapes and electronic media content for Internet distribution. We distribute our adult media content directly, and through a network of local affiliates and independent distributors, through multiple channels, including (1) newsstands and adult bookstores, (2) mail order catalogues, (3) cable, satellite and hotel television programming and (4) over the Internet via proprietary websites and evolving broadband delivery services. In addition to media content, we also market and distribute branded leisure and novelty products oriented to the adult entertainment lifestyle and generate additional sales through the licensing of our Private trademark to third parties. In the fiscal year ended December 31, 2001, we had net sales of SEK 360.6 million and net income of SEK 74.2 million.

Our business was founded in 1965 and achieved initial success through our flagship publication, Private, the first full color, hard-core sex publication in the world. Today, we produce four X-rated periodical magazines: Private, Pirate, Triple X and Private Sex, as well as several special feature publications each year. As of December 31, 2001, we had compiled a digital

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archive of more than two million photographs and all of our 337 print publications. We expect to add two additional issues and hundreds of photographs each month to this archive. Approximately 300,000 copies of our print publications are distributed each month at an average retail price of approximately Euro 11.50. We distribute our publications through a network of approximately 250,000 points of

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sale in more than 35 countries, with strong market positions in Europe, Latin America, Australia and Canada. We believe that our distribution network has the potential to reach nearly 500,000 points of sale in our existing markets.

Since 1992, we have also acquired, processed and distributed adult motion picture entertainment. We acquire motion pictures that meet our exacting standards for entertainment content and production value from independent directors, either under exclusive contracts or on a freelance basis. We then edit and process these motion pictures to ensure consistent image quality and prepare and customize them for distribution in several formats, including DVDs, videocassettes, broadcasting, which includes cable, satellite and hotel television programming, and the Internet. Our proprietary motion pictures and those produced by joint ventures in which we participate have received 61 industry awards since 1994, evidencing our success in setting high quality standards for our industry. As of December 31, 2001, our movie library contained 462 titles. We expect to add approximately 136 additional titles in 2002.

Since 1997, we have expanded our presence in emerging electronic markets for adult media content, such as the Internet, DVDs and broadcasting. We believe that these markets comprise the fastest growing segment of the adult entertainment industry. We launched our first Internet website, www.private.com, in 1997. In 1999, we launched two additional websites, www.privatecinema.com and www.privatelive.com. We also generate incremental sales by licensing our trademarks and proprietary adult media content for use on the websites of other companies.

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

In May 2001, we launched our www.privatespeed.com website to deliver our proprietary motion pictures to our customers using broadband connections over the Internet. This website utilizes advanced networking technology to furnish customers with instant access to our motion picture archive by buying blocks of viewing time. We are also preparing to distribute our adult media content through fixed and third generation mobile telecommunications technologies. While broadband and other high-speed Internet and telephonic connections are in their infancy, we believe that these technologies represent a substantial growth opportunity for us in the future.

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

Our principal executive office is located at Carretera de Rubi 22-226,

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08190 Sant Cugat del Valles, Barcelona, Spain, telephone 34-93-590-7070. In accordance with Nevada law we maintain a registered office at 3230 Flamingo Road, Suite 156, Las Vegas, Nevada.

Any reference in this Report to "we," "us" or "Private Media Group" refers to Private Media Group, Inc. and its consolidated subsidiaries. Milcap Media Group refers to Milcap Media Group SL (Spain) and Milcap Media Limited refers to Milcap Media Limited (Cyprus).

Private, Private Media, our Private logo, Pirate, Triple-X, Triple-X Files, Private Black Label, Private XXX, Gaia, Private Sex, Private Life, Private Style, www.privatespeed.com, Private Gold, Private Blue, www.private.com, www.prvt.com, www.privatecinema.com, www.privatelive.com, www.privategold.com, www.privatechannels.com, www.sexclub.sex.se, www.privateusa.com, www.private.com.ar, www.private.com.au, www.maxs.se, www.sex.se, www.clubx.com.au, and www.privategold.com are some of our trademarks and trade

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names. Other marks used in this Report are the property of their owners, which includes us in some instances. Information on these websites is not a part of this Report.

MARKET OPPORTUNITY

Demand for adult entertainment products has grown substantially in recent years. We believe that the total worldwide adult entertainment market exceeds \$56 billion annually. Of this market, we believe that our target market, including print publications, videocassettes, DVDs, broadcasting and the Internet, comprises more than \$40 billion. We believe that two principal factors are driving growth in our industry: the relaxation of social and legal restrictions on distribution of adult entertainment products and new technologies that facilitate the distribution of high quality adult media content to consumers in the privacy of their own homes. As a result of liberalized regulation of adult entertainment products, we now distribute our products in physical form in more than 35 countries worldwide with an aggregate current population of 1.1 billion, as compared to six European countries with a population of 144 million when the current management took over in 1991. We expect this liberalizing trend to continue, which should expand our potential markets further in the future.

The proliferation of easy to use electronic equipment, such as VCRs and DVD players, which allow consumers to view high quality video products in the privacy of their home, has boosted demand for adult media content compatible with these formats. For example, the installed base of DVD players in Western Europe and the United States doubled in 2001. Also, the evolution of the Internet as a channel of commerce and content distribution has stimulated additional demand for adult media content. In addition, advances in cable, satellite and hotel communications systems furnish another relatively new channel for the delivery of media content, including adult entertainment, into private homes, hotels and businesses.

We expect these regulatory and technological developments to fuel increasing demand worldwide for adult media content of all kinds, including demand for products in our market niche for explicit, unrated adult media content. In addition, we believe that market demand for content to fill new media outlets will lead mainstream media content providers to seek still more adult media content in the future. We expect that the high quality standards of the mainstream media, technological demands of multiple delivery formats and global marketing and distribution costs will increase capital requirements for

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providers of adult media content. While the adult entertainment industry is currently characterized by a large number of relatively small producers and distributors, we believe that the factors discussed above will cause smaller, thinly capitalized producers to seek partners or exit the adult entertainment business, leading to a consolidation of the adult entertainment industry.

OUR COMPETITIVE STRENGTHS

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

Extensive library of high quality adult media content

We have an extensive library of high quality adult media content. As of December 31, 2001, our library included still photographs developed for more than 300 back-issues of magazines and more than 400 motion pictures. We hold exclusive worldwide rights to this entire content archive. This has enabled us to enter into global distribution arrangements with a wide range of media content providers, including leading international companies. To facilitate electronic distribution of our products, we have converted our entire archive of print images into a digital format. We are currently digitizing our motion picture archive as well, and have now stored more than 50% of our existing motion pictures in digital form. We believe that this electronic archive constitutes one of the largest libraries of high quality adult media content in the world.

Recognized brand name

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We believe that our target customers associate the Private brand name with high quality adult entertainment products and services. This name recognition attracts leading producers of adult media content, as well as distributors and prospective joint venture partners interested in working with Private Media Group. We believe that the strength of our brand name leads to more favorable economic terms than we could otherwise obtain in our processing and distribution contracts, and enables us to negotiate favorable revenue sharing arrangements and joint ventures from which we derive significant licensing fees and royalty income. We have entered into joint venture and co-branding agreements with leading participants in our industry and other related industries, including Playboy and Penthouse. We seek to strengthen awareness of our brand name by consistently featuring the Private label prominently in our product packaging, cross-promoting our own products, selectively sponsoring athletes and distributing under the Private label complementary or ancillary non-media products that are consistent with an adult entertainment lifestyle. We believe that these activities engender a loyal customer base which, in turn, enables us to grow even with relatively modest external advertising and marketing expenditures.

Established market position and distribution network

We have a well-established worldwide distribution network which has been built up over the past 35 years, including some 250,000 points of sale in over 35 countries as of December 31, 2001. In many markets, we believe that our established presence hinders our competitors' ability to break into the market. In some cases, exclusive distribution agreements improve our market position further. This broad distribution network provides an effective channel to introduce new products and services and new formats for existing products and services. For example, we were able to utilize our existing video distribution channels to reach customers with our DVD-based products. In electronic media categories, we have entered into strategic alliances with a number of leading

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service providers, such as Terra/Lycos and T-Online, to facilitate widespread distribution. In addition, we have assembled an internal team of Internet specialists to maintain and improve our Internet infrastructure and electronic products and services. We believe that our broad, multi-format distribution network affords our customers convenient access to high quality adult media content in the format of their choice.

Flexible operating structure and access to substantial capital

We acquire adult media content from third-party directors on a project basis. This approach gives us substantial flexibility in terms of production volume and delivery time, significantly reduces our fixed production overhead and largely eliminates the risk to us of cost overruns in production. Because of our multiple product and service formats and broad distribution network, we can afford to hire top directors in the industry, which we believe results in a higher quality product for our customers. Similarly, we reduce our fixed processing costs by outsourcing editing and duplication functions for most of our products, although we retain oversight of the overall production process for cost and quality control purposes. As a public company with access to the capital markets and, in recent years, significant operating cash flow, we believe that we will have sufficient financial resources to increase our production and grow through acquisitions without sacrificing our high quality standards.

Experienced professional management

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

OUR STRATEGY

Our vision is to be the world's preferred content provider of adult entertainment to consumers anywhere, at any time and across all distribution platforms and devices. We have developed the strategies described below to

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increase sales and operating margins while maintaining the quality of our products and services and the integrity of our brand name.

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

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

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example, we have recently launched a streaming video, or video-on-demand, product that exploits broadband technology over our new privatespeed.com website to deliver high quality adult media content directly to customers via the Internet. We believe that this broadband technology, in particular, offers us a significant opportunity to increase our net sales and operating margins and simplify our distribution chain. In addition, we were one of the first adult entertainment companies to embrace the DVD format.

Increase market share through strategic acquisitions. The adult entertainment industry is currently fragmented and consolidating. We expect this trend to continue as small, privately owned companies seek to exit from the business. We plan to expand our market presence and increase our market share by acquiring local distributors in the markets in which we compete. In addition, we may seek to acquire existing business enterprises in other related businesses opportunistically. To finance future acquisitions, we expect to use a combination of cash flow generated by our operating activities and, in some instances, our common stock. As one of the few companies in our industry with publicly listed common stock, we believe that we will have a significant advantage over most of our competitors in financing such consolidating acquisitions.

To complete the digitalization of our entire movie and photograph library in order to prepare our library for distribution in new electronic media. We have developed an extensive library of motion pictures and other pictorial content. Until recently, this library was archived on a master print, which would allow duplication in traditional media. New forms of electronic distribution provide us with an opportunity to use this content by distributing it on new forms of media, such as DVD, Internet and broadband. To facilitate electronic distribution of our products, we have converted our entire archive of print images into a digital format. We are currently digitizing our motion picture archive as well, and have now stored over 50% of our existing motion pictures in digital form.

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

OUR PRINCIPAL PRODUCTS AND MARKETS

Magazine Publications

We are the publisher of Private, an international X-rated magazine. Private was founded 35 years ago, and was the first full color, hardcore sex publication in the world. Today, we produce four X-rated magazines which are released bi-monthly: Private, Pirate, Triple X and Private Sex. In addition, special editions are released monthly and a book, The Best of Private, is released annually. Our newest magazine, Private Life, which is produced by our

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licensees, is the first softcore magazine we have distributed. We distribute these magazines through newsstands and other retail outlets.

Movie Productions

Since 1992, we have acquired and distributed adult motion picture

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

We expect to produce approximately 100 X-rated and 36 R-rated movies in 2002, with distribution through a worldwide network that covers approximately 60,000 points of sale, including primarily videoshops and adult book stores. We believe we have the potential to reach more than 155,000 points of sale. Our first two monthly video labels were Private Film and Private Video Magazine. Both labels received critical acclaim in leading international magazines as well as numerous industry awards from industry associations and major adult entertainment movie festivals, including Adult Video News, Impulse d'Oro and Golden X. They were followed by the introduction of our monthly labels Triple X, Private Stories and Private Gold. In May 1997, we introduced Gaia, a bi-monthly label. In 1998, we introduced a bi-monthly new label, Private Black Label. In 1999, we introduced four new monthly labels Pirate Video Deluxe, Private XXX, The Matador Series and Peep Show Special. In 2000, in addition to several compilations, we introduced the label Private & Penthouse Video in conjunction with Penthouse.

As of December 31, 2001, our movie library contained 462 movie titles. By the end of 2002 we expect the total to increase to approximately 600 titles. All titles are available on videocassette and nearly 50% are available on DVD. These products are sold by distributors, primarily to retail stores and wholesalers worldwide. Several of our original motion picture programs have also been re-edited and licensed to cable, satellite and hotel television operators.

Internet

Our Internet team has combined the quality of our extensive media library with the newest technology to create what we believe to be one of the best adult websites, www.private.com. We believe that the rapid growth of the e-commerce market and increased access to the Internet by consumers has created an excellent opportunity for us to utilize our proprietary assets through marketing and distribution on the Internet. Private.com offers its more than 100,000 members access to high quality adult content, including over 200,000 pages of magazine pictures, photosets, stories, an interactive search categories gallery and access to video clips from more than 400 Private Media Group movies. Private.com members also get access to live, webcam, and contact/personals content. Private.com acquires customers primarily through advertising in DVDs, videos, magazines and broadcast programming with minimal incremental cost. It also acquires new customers by establishing partnerships with leading portals including Excite, Lycos, T-online, Prisacom and other e-commerce websites.

Due to Private.com's recognized brand name among adult site purveyors, we have many customers who have the confidence to make credit card payments to us. Current subscriptions prices are \$29.95 for a month's subscription and \$149.95 for an annual subscription. Consumers wishing to avoid credit card payments or not having a credit card can access Private.com content through so-called dialer access by dialing into a premium rate number and paying a per minute fee that varies depending on the country. Private Media Group also cross-sells its retail products through the Private.com shop. For example, Private.com is able to offer a consumer who views content on its website an opportunity to purchase that content, in a magazine, on DVD or video or in its on-line store. The Private.com website is currently generating traffic of approximately 2.5 million visits per month and more than 60 million pages are viewed per month. We currently maintain a staff of 36 full-time Internet employees.

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We have also developed a website called privatespeed.com, offering broadband customers access to Private Media Group's complete collection of movies and video content through video-on-demand. Privatespeed has a two pronged strategy for acquiring customers for its prepaid service: by partnering with broadband Internet service providers, or ISP's who host our content and distribute products to their installed customer bases and by targeting broadband customers directly, who view the content over the Internet. As of December 31, 2001, privatespeed.com has sold over 640,000 minutes directly to consumers since it launched in May 2001 with minimal marketing activity. We are currently negotiating agreements with leading broadband ISP's. We believe that with privatespeed.com we are well positioned among adult entertainment companies to take advantage of the transition to broadband content distribution.

In addition, we are licensing the right to use our trademarks and media library on the Internet to third parties with independent websites. This licensing activity generates significant royalty income. In addition, we market our products on the Internet through distributor sites and shopping sites.

OTHER MARKETS

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

HISTORY

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

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

On January 28, 2000, we acquired all of the outstanding shares of Extasy Video B.V. for total consideration of SEK 27.3 million. The consideration consisted of 208,464 shares of common stock and warrants to purchase 208,464 shares of common stock. The warrants are exercisable during the period January 28, 2001 to January 28, 2004 at an exercise price of \$9.63.

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

As of January 1, 2001, we acquired Coldfair Holdings Ltd., a company incorporated and organized under the laws of the Republic of Cyprus, for a total consideration of SEK 13.4 million payable in 248,889 shares of common stock. Coldfair Holdings is a company engaged in the marketing and sale of adult entertainment products and services.

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Effective April 1, 2001, we acquired the inventory and certain contracts of our U.S. distributor, Private USA, in exchange for SEK 9.1 million and the assumption of Private USA's obligations under some contracts.

On April 8, 2001, Peach Entertainment Distribution AB (Sweden), a subsidiary of Private Media Group, Inc., sold its interest in Private Circle, Inc., a company engaged in the design, production and marketing of trendy

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casual apparel, for an adjusted consideration of SEK 27.1 million as of May 2001.

INDUSTRY OVERVIEW

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

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

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

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

The production and distribution of adult media content is very competitive. Hundreds of companies are now producing and distributing movies to wholesalers and retailers, as well as directly to consumers. The low cost of high quality video cameras and equipment has significantly lowered the barrier to entry for production of adult media content. According to Adult Video News, approximately 10,000 new adult video titles were released in the United States

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in 1999, up from 8,950 in 1998 and 1,275 in 1990. The bulk of this production is represented by low quality, amateur productions, made for only a few thousand dollars, as opposed to the larger, professionally produced movies with high production values. Around 20 major producers, such as Private Media Group, Vivid, Video Company of America and Metro, release most high budget adult videos and DVDs. See "Business-Competition." In addition, because it costs as little as \$ 5,000 to establish an Internet presence, there is significant competition among distributors of adult media content over the Internet. The proliferation of websites distributing adult media content has itself fueled a greater and ongoing demand for the creation and licensing of new adult media content.

We believe that the global adult entertainment market exceeds \$ 56 billion annually. This covers memberships and subscriptions, escort services, magazines, sex clubs, telephone sex lines, cable and satellite pay-per-view programming, adult videos and toys and other related products and services. In 1998, Forrester Research estimated the U.S. adult entertainment market at \$ 10 billion annually. This compares to total U.S. cinema box office receipts for mainstream motion pictures of \$ 7.7 billion in 2000 (\$ 6.95 billion in 1998), indicating the size and importance of the adult market within the entertainment industry.

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VIDEO AND DVD SALES & RENTAL

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

Although DVDs will not replace videocassettes completely in the near term because of the ability of users to record on videocassettes as well as their current high level of market penetration, currently comprising approximately 93 million households in the United States, rentals and sales of DVDs are likely to increase significantly as more DVD players are sold. IDC Research anticipates that the number of household with DVD players in the United States will increase to 43.6 million in 2002 from 15.0 million in 2000. Similar growth is expected in Western Europe, with the number of households with DVD players increasing to 13.5 million in 2002 from 4.7 million in 2000, according to the International Recording Media Association.

In the U.S. market, total rental and retail spending on video and DVD titles in 2000 was over \$ 19 billion, a 10% increase over 1999, according to the Video Software Dealers Association. In 2000, total sales and rentals of adult videos in the United States were approximately \$ 4.0 billion according to Adult Video News estimates, including sales through general interest retailers and dedicated adult stores. In 2001, PR Week reported that the Free Speech Coalition estimated that 20% of all U.S. households with either cable or satellite television or a VCR watch adult movies.

The provision of in-room entertainment services by major hotel chains throughout the world also serves as a distribution channel for adult media content. In addition to a selection of mainstream movies, hotel guests often will have a choice of softcore, and frequently hardcore, adult videos available on a pay-per-view basis. In the United States, these services are provided by

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companies such as On Command and Lodgenet, which supply approximately 950,000 and 800,000 hotel rooms, respectively. Estimates by analysts cited to by the Los Angeles Times in 2001 suggest that adult movies generate approximately half of total hotel pay-per-view revenue in the United States, approximately \$ 250 million annually. Outside of the United States, excluding more restrictive countries such as the United Kingdom, hotel guests also have access to hardcore material on a pay-per-view basis.

BROADCASTING

Cable and satellite television have also brought adult media content into the privacy of the home. Technological developments, in particular the evolution of digital broadcasting, should not only increase the number of channels that can be delivered directly to the home, but should also lead to video on demand. The development of these services should benefit the adult entertainment industry by providing a greater number of special interest channels providing pay-per-view services. This should also increase the need for new adult media content.

In the United States, in addition to softcore channels such as Playboy TV, AdultTVision, Spice Channel and The Adam & Eve Channel, there are several hardcore video channels available, including Eurotica, Exotica, Exxtasy, True Blue, X!, Xxxcite and XXXplore, that offer uncensored hardcore material. In 2001, the Asian Wall Street Journal stated that, according to Kagan World Media, of a total pay-per-view revenue for satellite and cable television operators in the United States of \$ 1.73 billion, around 27%, or \$ 465.0 million, can be attributed to adult movies.

In 1999, Playboy and Spice Entertainment Companies, Inc. entered into an agreement resulting in the

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combination of the two companies. Playboy also acquired three television networks - the Hot Network, the Hot Zone and Vivid TV - in July 2001 which has altered Playboy's focus from softcore to hardcore programming.

At the end of 2000, according to Screen Digest, there were over 64 million subscribers to cable and satellite television in Western Europe. According to Forrester Research, in the United States there were approximately 83 million subscribers to satellite and cable television services at the end of 2000. The number of cable and satellite television subscribers is expected to continue to increase, as well as gradually shift from analog to digital services.

INTERNET

The adult entertainment industry was among the first to commercially exploit the Internet as a distribution channel, and among the few industries believed to generate a profit on the Internet. The Internet offers relative privacy for users, a seemingly endless selection of adult media content and can provide immediate delivery. Datamonitor research estimated that adult content accounted for 69% of paid content on the Internet in 1998.

Pay sites contain most of the adult media content on the Internet, but free sites are also common and are primarily supported by advertising from pay sites. Free sites get a few cents for each viewer who clicks on an advertising banner. The banner then transports these viewers to a site that tries to entice the user into paying for content using their credit cards. In 1999, Datamonitor estimated that there were well over 100,000 sexually-oriented sites, of which only about 14,000 generate revenues. Of the revenue-generating sites, only a

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handful of these account for the majority of overall revenues on the Internet for adult media content.

According to searchterms.com, 'sex' is the third largest category searched for on the Internet after 'autos' and 'travel', but above 'shopping', 'games' and 'MP3'. Of the 1.6 billion web pages indicated as available by the Google search engine, searching for 'sex' results in 15.9 million pages and 'porn' results in 3.3 million. In June 2001, Internet monitoring company NetValue estimated the following numbers of Internet users were visiting adult sites at least once per month: 5.3 million in Germany; 3.8 million in the United Kingdom; 2.7 million in France; 2.4 million in Italy and 1.5 million in Spain. In the United States, PR Week reported that Nielsen/Net and Media Metrix estimated that approximately 21 million Americans visit an adult content site at least once per month.

A number of well-established Internet businesses have recognized the revenue potential of adult media content and now provide those services. Freenet.com, Germany's second largest internet service provider has launched Fundorado.de offering hardcore movies, photographs and sex chat groups on a monthly subscription basis. In the United Kingdom, online retailer Lastminute.com has recently introduced a range of adult games and toys to its site. However, this development has also been subject to criticism, leading to withdrawals such as Yahoo!'s reversal of its decision to sell adult videos on its sites after receiving numerous complaints from consumers.

The use of the Internet for viewing adult media content is expected to increase significantly as home Internet access increases and broadband services become more widely available. IDC estimates that in 2005 the number of home Internet users will reach 194.1 million in the United States as compared to 100.8 million in 2000 and 196.4 million in Western Europe as compared to 80.3 million in 2000. Forrester Research estimates broadband services will reach 46.7 million households in the United States by 2005 as compared to 5.0 million in 2000 and 28.7 million in Western Europe as compared to 400,000 in 2000.

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

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MAGAZINE PUBLICATIONS

Our publishing operations include the publication of the adult magazines identified in the table below, special editions consisting of previously published material and occasional newsstand specials, calendars and paperback books. All of these magazines, together with local editions, are printed under various trade names and are distributed in over 35 countries. We publish several customized editions of our four principal magazines. Each edition contains the same editorial material but provides locally targeted content reflecting local governmental regulation regarding explicit adult publications. Most of our magazines feature pictures of men and women engaged in erotic and sexually explicit situations. We distribute approximately 300,000 copies of our print publications per month at an average retail price of approximately (Euro) 11.50. Our most popular publications are Private, Pirate, Private Sex and Triple X.

MAGAZINE LIBRARY

As of December 31,

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	2001	2000
Title	No of Issues	No of Issues
Private.....	168	162
Pirate.....	70	64
Triple-X.....	44	38
Private Sex.....	35	29
Special Editions.....	7	6
Best of Private (Book).....	13	12
Total.....	337	311

Quantities of Magazines Produced
(Printed, not sold)

Title	2001	2000
Private.....	642,200	697,500
Pirate.....	471,500	515,100
Triple-X.....	457,200	518,050
Private Sex.....	346,500	391,840
Special Editions.....	75,150	54,000
Best of Private (Book).....	58,200	109,550
Total.....	2,050,750	2,266,990

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

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

CIRCULATION

Our magazines have historically generated most of their revenues from firm sales distribution. However,

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

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

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

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

PRODUCTION, DISTRIBUTION AND FULFILLMENT

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

We print and ship all of our proprietary magazines from Barcelona, Spain with the exception of our U.K. licensee, who receives all our magazines in digital format and prepares its own layout and color separations before printing locally adapted softcore editions of all our magazine titles. We determine the amount of printed publications bi-monthly with input from each of our national distributors.

Most of our products are packaged and delivered directly by the printer or supplier, while Milcap Media Group provides warehousing, customer service and payment processing. Milcap Media Group employs a staff of 20 professionals to manage the production and to oversee the printing and distribution of our magazines.

LICENSED PUBLISHING

In 1999, we signed a licensing agreement with K-OS Publications (UK) Limited for the publication and distribution in Britain of two new softcore titles bearing the Private trademark. Private Life magazine was first published in the United Kingdom at the end of 1999, while Private Style magazine is set to launch in 2002.

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MOVIE PRODUCTIONS

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In 1992, we began releasing movies under the Private label.

Our adult movies are in genres similar to our magazines and books under the titles listed in the table below. Normally, we spend on average between \$ 25,000 and \$ 125,000 per movie. This amount excludes the computation of the post-production, master production, duplication and distribution costs. Generally, Milcap Media Group creates and designs all artwork for promotional items and packaging and contracts for printing services. Since 1997, independent laboratories have duplicated all of our videocassettes for us. Similarly, since 1999 all DVDs have been duplicated by independent laboratories as well. A number of our titles, including Private Film, Private Video Magazine, Triple X, Private Stories, Private Gold and The Matador Series are released on a monthly basis while others are released on a bimonthly or less frequent basis. As of December 31, 2001, our movie library contained 462 movie titles. By the end of 2002, we expect the total to increase to approximately 600 titles. All titles are available on videocassette and close to 50% are available on DVD. We sell approximately 75,000 videos and 80,000 DVDs per month. We continue to expand our video operations in international markets and presently market our video products in over 35 countries.

We finance all of our adult movies, and we contract with video and movie producers on a flat fee basis. All producers generally assume production costs and obligations, including among other things, the delivery of rights and model releases. Historically, we have principally financed new movies with the cash flow generated by previous productions. To date, we have not solicited any external financing for any of our acquisitions other than the \$ 4.0 million Note entered into with Commerzbank AG in December 2001.

	2001	2000
MOVIE LIBRARY	No of Titles	No of Titles
Private Video Magazine	26	26
Private Film	28	28
Triple-X Video	32	32
Private Video Stories	27	27
Private Gold	45	45
Gaia	6	6
Pirate Video	12	12
Triple-X Files	12	12
Casting-X	25	25
Best of Private	6	6
Private Black Label	16	16
Pirate Video Deluxe	12	12
Private XXX	12	12
Special Compilations	22	22
Amanda's Diary	5	5
Peep Show Special	12	12
Horny Housewives	9	9
The Matador Series	8	8
The Story	2	2
Private Movie	1	1
Private & Penthouse Video	5	5
Private Super F*****	7	7
Pirate Fetish Machine	2	0
The Private Life of	3	0
Private Reality Video	3	0

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Virtualia	5	0
Softcore Versions	70	46
	-----	-----
Total	376	290
	=====	=====

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

DISTRIBUTION

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

We have entered into distribution agreements in over 35 countries. Under these distribution agreements, our subsidiary Peach Entertainment Distribution or Milcap Media Group, agrees to provide a specific minimum number of new titles each month during the term of the agreement, and a licensee normally serves as the exclusive distributor throughout its own country or language territory. Under the various distribution agreements, licensees are normally required to purchase a minimum number of units for each monthly period during the term of the agreement.

In countries such as Germany, we have expanded our relationships with our national distributor by entering into exclusive multi-year, multi-product output agreements. In countries such as the United States, the Benelux countries, France and Spain, we have established local subsidiaries for the purpose of owning or controlling local distribution. In the near future, we intend to renegotiate some of our national distributorship agreements in order to vertically integrate Private Media Group into the chain of distribution. In general, we believe that national distribution agreements enable us to have an ongoing branded presence in international markets and to generate higher and more consistent revenues, than we could achieve selling directly to retailers.

In October 2001 we entered into an agreement with Quadriga Worldwide, a leading European hotel entertainment and service provider, to make a wide selection of our movies available to guests in hotels serviced by Quadriga. Quadriga presently provides 6,350 hotels in 30 countries with interactive entertainment and information services, covering 321,000 hotel rooms worldwide, with an estimated potential annual audience of 100 million hotel guests. Key customers of Quadriga include leading hotel chains such as Best Western International, Scandic Hotels, Choice Hotels, Starwood Hotels and Resorts, Six Continents Hotels, Accor Hotels, Carlson Hospitality Worldwide, Marriott Hotels, Thistle Hotels and Societe du Louvre.

VIDEO DUPLICATION/PRODUCTION TECHNIQUES

Masters are customized and duplicated by our subsidiary Peach Entertainment Distribution and from there they are sent to different distributors and VHS duplication centers. Some distributors receive a master

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directly and do their own duplication.

All artwork to print the video covers is created at Milcap Media Group. Most countries receive their own pre-printed covers from Spain and some countries print their own covers from CD-Roms when delivered.

THE DVD MARKET

Distribution of DVDs represents one of our fastest growing markets. We believe we set a high standard for DVDs in the adult entertainment industry, with each DVD released by us possessing five language options as well

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as four other subtitled languages. We believe that our multi-language DVD format provides a significant competitive advantage for us because it attracts consumers worldwide and expands our international marketing and sales potential. This global format allows us to reduce our overall unit production costs and increase profit margins. Currently, the majority of DVDs released by our competitors in the United States and worldwide are produced in only one language. As a result, they have to either license titles country-by-country or manufacture each title in separate languages, thus losing out on economies of scale. As the manufacture of each DVD master disc, prior to duplication, costs approximately \$ 10,000, this further drives down our competitors' profit margins.

Currently, mainstream movie titles are released on DVD in six Regional Codes or Zones. This is required primarily because producers often do not control the worldwide rights to their titles. Our DVDs are playable in any region, in every country in the world, because we own and control the global rights to everything we have produced.

Our DVDs are also "Internet Activated," which means that when a consumer plays the DVD in a personal computer, that person also gets a direct link to our websites, where they can view our content by purchasing a subscription or visit our extensive on-line shopping area. We also sometimes add `extras' to our DVDs, including alternative endings to movies, interviews with the stars, biographical data on the actors, their roles in other in-house productions and publications, and multiple-angle views.

BROADCASTING

In 2000, we signed an exclusive joint venture agreement with International Film Productions and Distributions, Ltd., IFPD, to create two new adult television channels to be broadcast worldwide. IFPD is a European-based television broadcasting company associated with major content providers that specializes in the distribution of cable and satellite television channels.

Under the terms of our joint venture agreement, IFPD has agreed to ensure the promotion and broadcasting of our new adult channels, Private Gold and Private Blue, to a worldwide audience and we have agreed to provide all adult media content and trademarks. The Private Gold channel will present hardcore material, while the Private Blue channel will broadcast softcore material. Under this agreement, we will receive 65% of the gross profits generated from the broadcast of, and advertising on, these channels. We also have an option to acquire up to 65% of the equity in IFPD at face value. In 2000, we also started broadcasting our Private Blue channel in the United Kingdom under an exclusive joint venture agreement with Zone Vision Enterprises, a UK-based television company, and IFPD. These channels operate on digital and analog platforms throughout continental Europe. We receive 35% of the net profit generated from those broadcasting and advertising revenues.

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Private Blue is available through the analog and digital satellite platforms of BSkyB and the Telewest cable network in the United Kingdom. In November 2001 we entered into a distribution agreement with NTL Network to make Private Blue available to over one million NTL digital cable subscribers in the United Kingdom on a pay-per-night basis. We also launched in Turkey on the DigiTurk platform, and in Hungary and Slovakia on the UPC networks, and in the Netherlands with MediaKabel. Currently available to over 6.6 million addressable subscribers in the UK alone, Private Blue has also secured an international satellite feed on the SIRIUS 2 satellite. This means that our Private Blue signal is available for further expansion to subscribers in all territories of Europe from 23.00 to 05.00 Central European time every day of the year.

Our Private Gold television channel, broadcasting under Dutch license, successfully launched in Hungary on the HCA Cable Association platform and in Hungary, Slovakia and the Czech Republic on cable systems and the UPC Direct satellite network in 2000. Private Gold also secured an international satellite feed on the AMOS 1 satellite. This will allow us to expand to subscribers in all territories in Europe from 24.00 to 04.00 Central European time, every day of the year. A second satellite feed, on the ASTRA satellite with Cryptoworks encryption, also became available in 2000. ASTRA is one of the leading satellite systems for direct-to-home transmission of television, radio and multimedia services in Europe. ASTRA currently has a fleet of nine satellites and transmits to 22 European countries.

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In 2001, we entered into an agreement with Canal Digital AS which provides for the distribution of the Private Gold television channel through Canal Digital in Sweden, Denmark and Finland as part of an exclusive joint venture agreement with IFPD. Canal Digital is jointly owned by the French company Canal+ and the Norwegian company Telenor. Canal Digital operates in the Nordic countries and is one of the leading suppliers of digital programs and services in the Nordic region. Canal Digital has more than 1.1 million card customers and over 700,000 subscribers to its services in the Nordic region.

In 2001, the Private Gold and Private Blue television channels were contracted for distribution throughout Latin America by Pramer S.C.A. Pramer is the largest company in Latin America dedicated to producing, distributing and commercializing content for cable and satellite television. Pramer will be responsible for the satellite distribution, advertising and commercialization of the Private Blue and Private Gold channels throughout Latin America. Both channel signals are transmitted on the NSS 806 satellite that covers the entire South American continent making the channels available to all of Latin America's 15 million satellite and cable subscribers.

In June 2001, we signed an agreement with Wizja TV to broadcast Private Gold in Poland. Wizja TV is one of the largest Direct to Home platforms in Poland with approximately 400,000 subscribers.

We believe that currently our Private Gold and Private Blue channels are available to approximately 28 million potential viewers worldwide.

In addition to the expansion of Private Gold and Private Blue, we signed other agreements concerning broadcasting of our content in 2000, including our agreement with media[netCom] AG.

In August, 2000 we entered into a two-year motion picture licensing agreement with Playboy, which calls for us to supply Playboy with motion picture content for Playboy's television networks throughout the Americas. Under the agreement, Playboy will receive the exclusive rights to broadcast our

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content on their networks over the term of the agreement for a fixed payment amount.

We also entered into agreements with Canal+ in 2000 to supply adult movie content for Canal+'s television networks throughout Europe. Canal+ receives the exclusive rights to broadcast 75 titles from our library on their networks. The territories included are France, French-speaking Belgium, the Netherlands, Luxembourg, Scandinavia, Spain and Italy. Canal+ is one of Europe's largest Pay-TV operators with approximately 15.5 million subscriptions to its different offerings and approximately 5.8 million digital subscribers as of December 31, 2001.

INTERNET SERVICES

Our Internet team has combined our extensive media library with the newest technology to create what we believe to be one of the best adult websites, www.private.com. We believe that the rapid growth of the e-commerce market and increased access to the Internet by consumers has created an opportunity for us to use our proprietary content assets through distribution over the Internet. During the first nine months of 2001, Private.com offered its more than 100,000 paying members access to high quality adult media content, including over 200,000 pages of magazine pictures, photosets, stories, interactive search galleries and access to video clips from more than 400 Private Media Group movies. Private.com members also get access to live, webcam, and contact/personals content. Private.com acquires customers primarily through advertising in DVDs, videos, magazines and broadcast programming with minimal incremental cost. It also acquires new customers by establishing partnerships with leading portals, including Excite, Lycos, T-online, Prisacom and other leading e-commerce websites. In November 2001 we entered into a non-exclusive online cooperation agreement with Lycos Spain, which calls for the establishment of an adult portal with links to our www.Private.com website. Initially the adult portal will be included on Lycos' Spanish site, www.lycos.es, and is expected to be expanded to other European sites.

Due to Private.com's recognized brand name among adult site purveyors, it has many customers who have

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the confidence to make credit card payments. Current subscriptions prices are \$ 29.95 for a month's subscription and \$ 149.95 for an annual subscription. Consumers wishing to avoid credit card payments or not having a credit card can access Private.com content through so-called dialer access by dialing into a premium rate number and paying a per minute fee that varies depending on the country. Private Media Group cross-sells its retail products such as videos and DVDs through the Private.com shop. For example, Private.com is able to offer a consumer who views content on the website an opportunity to purchase that content, in a magazine, on DVD or video, in our on-line store. The Private.com website is currently generating traffic of approximately 2.5 million visits per month and more than 60 million pages views served per month. In 2000, Private.com won the Award du X at the Erotic Trade Fair in Brussels, Belgium. We currently maintain a staff of 40 full-time Internet employees with more than 10 focusing on technology and the concentrating on website production, sales and marketing and customer support.

We have also developed a website called Privatespeed.com, offering broadband customers access to our complete collection of movies and video content through video-on-demand. Privatespeed has a two pronged strategy for acquiring customers to its prepaid service: by partnering with broadband ISP's who host its content and distribute products to their installed customer bases and by targeting broadband customers directly, who view the content over the

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Internet. Privatespeed.com has sold over 640,000 minutes directly to consumers since it launched in May 2001. We are currently negotiating agreements with leading broadband ISP's. We believe that with Privatespeed.com we are well positioned among adult entertainment companies to take advantage of the transition to broadband content distribution.

We market all of our products directly by e-mail, and had an e-mail list on December 31, 2001 of approximately 800,000 addresses. We also have direct links from our DVD and CD-Rom products to our Internet sites, where we can update such products quickly. We utilize a secure Web Pay application developed by Verisign which allows on-line processing of credit card payment transactions. We have in place a well-known protection program, Netnanny, Cyberpatrol, for minors which can be controlled by adults to limit access to our websites.

LICENSEES

We license the right to use our trademarks and our library of photographs and movies to third parties.

In December 1997, Milcap Media Limited entered into an Internet license agreement with Cyber Entertainment Network, which is in the business of developing and operating various adult websites. Under this agreement, we granted Cyber Entertainment use of the website Privategold.com. We provide this website with adult content and receive a percentage of the gross revenues from fees collected through the sale of memberships to the website. We received more than \$ 160,000 per month in the year 2000 under this arrangement, an increase of 100% over 1999. We understand that Privategold.com received, as of January 2001, 350,000 visits per day.

Our local German distributor VPS-Film Entertainment entered into a new agreement for the distribution of video-on-demand from our extensive video library on broadband Internet connections via the media[netCom] network in 2000. Media[netCom]'s customer distributes to local networks for further distribution to consumers. The 30-month agreement calls for our distributor to provide content for the entertainment service and for media[netCom] to market the service to its customer base of local networks.

Our reseller program implemented through our websites, www.privatecash.com and www.prvtshops.com, provides other websites with promotional material designed to sell our products. The reseller program aims to attract adult industry and non-adult industry website owners and potential website owners to sell our products by means of a 25% commission program. We then fulfill orders through our network of distributors.

TRADEMARK LICENSING

THE PRIVATE COLLECTION

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

On November 30, 1995, Milcap Media Limited entered into a license agreement with Private Collection and granted Private Collection worldwide

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rights to own, operate, distribute, subcontract, market, advertise and promote merchandise including, rubber goods, vibrating products, pumps, electric items, lotions, lubricants, potions, aphrodisiacs, realistic rubber and latex products, condoms, dolls, jelly products, massagers, playing cards and other items that fall into these product groups, except the rights to greeting and trading cards, leather and other apparels and lingerie which were licensed on a non-exclusive basis.

In 1999, the ownership of Private Collection was transferred to Doc Johnson Enterprises, a worldwide leader in the adult manufacturing and distribution business with more than 20 years of experience and a reputation for creative, innovative novelty products, and we renegotiated our 1995 agreement. Under the new five-year agreement, Doc Johnson Enterprises has the exclusive worldwide right to manufacture, distribute, sub-contract, market, advertise and promote a range of adult novelty products under the brand name The Private Collection. We, in turn, are entitled to receive royalty income on a quarterly basis, with a guaranteed minimum payment. We also have a right to purchase at a special rate an unlimited amount of products manufactured under the agreement for our own distribution through the Internet, television home shopping and other similar media.

Under the terms of the agreement, Doc Johnson Enterprises has agreed to maintain Private's high standards, to market The Private Collection with a pricing policy similar to that of comparable merchandise under the Doc Johnson brand name and to market the Private Collection in a manner similar to that used by Doc Johnson for its own brands. We have agreed to promote The Private Collection through our own products and services.

NUTRITIONAL SUPPLEMENTS, DRINKS AND OTHER SIMILAR PRODUCTS

In October 1997, we entered into a licensing agreement with RH-Patent & Original AB to expand the market for nutritional supplements such as Private Passion, Private Kick, Cold Relief, Metabolize 2000, Sleep Eeze, Maxi Charge, and personal care products such as Brazilian Bronze, Waistline Management, Cellulite Regulator Gel and Tight Factor.

RH-Patent & Original markets existing government approved products such as guarana-based energy drinks and aphrodisiacs, under labels such as Private, Private Passion and Private Kick, and distributes such products through its existing distribution network and in new markets. These products are also promoted for mail order and on the Internet.

In 1999, we signed an exclusive agreement with K-OS Distribution (UK) Limited for the distribution in Britain and Ireland of its Private Dynamite energy drink. Under the five-year agreement, K-OS can engage sub-distributors, licensees and selling agents within the specified territory to distribute, promote and sell the product. Private Dynamite is a premium-priced energy drink that can be consumed by itself or used as a mixer.

PROPRIETARY RIGHTS

GENERAL

We believe that our branded magazine titles and logos are valuable assets and are vital to the success and future growth of our businesses. We have filed trademark registration applications with respect to most of our trade names and logos. We believe that the name recognition and image that we have developed in each of our markets significantly enhance customer response to our sales promotions. We intend to aggressively defend our trademarks

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throughout the world, and we constantly monitor the marketplace for counterfeit products. We initiate legal proceedings from time to time to prevent unauthorized use of our trademarks.

PIRACY PROBLEMS

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

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

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

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

COMPETITION

GENERAL CONSIDERATIONS

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

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

Over the past few years, the adult entertainment industry has undergone significant change. Traditional producers of softcore content as well as mainstream providers of media content have shifted to producing hardcore content. As a result, we face greater competition to distribute hardcore content. This shift has also led to industry consolidation, creating fewer, more financially formidable competitors.

MAGAZINES

We meet with minimal direct competition from other publishers of hardcore adult magazines and paperback books. We believe that our print publications are dissimilar to other adult publications in style and format. The

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only similar business of which we are aware was represented by Rodox N.V., a Dutch/ Danish corporation, which recently decided to discontinue its publishing operation. We do not believe there is presently any significant competition in this segment of our business. Magazines such as Playboy and Penthouse and similar

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print publications do not compete directly with our publications, since we consider them to be softcore publications. There are several hardcore publications in each country where our magazines are sold. In general, these are printed in limited editions and are of lower quality than our publications.

VIDEO AND DVD

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

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

BROADCASTING

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

The strength of consumer demand for adult oriented cable programming is evidenced by the acquisition by Playboy of two hardcore U.S. cable channels from Vivid Film in July 2001. Until recently, Playboy's business has been largely confined to softcore adult entertainment and it has resisted entry into hardcore markets. Competition in this market has also been impacted by an increase in the number and availability of satellite direct-to-home transmission channels. Our cable and satellite television activities in the United States to date have been limited to licensing our content to channel operators, such as Playboy.

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

In the United States, cable companies such as Time Warner Cable, TeleCommunications, Inc., or TCI and Cablevision Systems offer softcore services like the Playboy Channel. Other cable companies like American Cable Entertainment, Comcast Corporation and Greater Media offer explicit adult

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programming, such as that available from Spice and Exxxstasy Networks.

The four largest cable providers are: TCI, Time Warner Cable, MediaOne and Comcast. TCI is the largest U.S. cable provider. In addition to softcore channels such as Playboy TV, AdultTVision, Spice Channel and The Adam & Eve Channel, there are seven hardcore video channels available in the U.S. exclusively on C-Band satellite television dishes, which are: Eurotica, Exotica, Exxxstasy, True Blue, X!, Xxxcite and XXXplore. Exotica, Exxxstasy and True Blue (offered by New Frontier Media, Inc.) offer uncensored hardcore material. Exxxstasy is the only U.S. hardcore adult channel being broadcast to Australia and the Pacific Rim.

We have only recently entered the hotel pay-per-view market, which is an extremely competitive market. This is due primarily to our unwillingness to enter into a typical hotel pay-per-view agreement, which requires a

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licensor such as Private Media Group to license the movies to a hotel provider on a fixed fee basis for each movie or video. We have recently entered into license agreements with a major hotel chain which provides for license fees based upon the number of rooms they service, and we are now intensifying our efforts to penetrate this segment of the market.

INTERNET

The Internet market for adult oriented content is expanding quickly. There are numerous adult media content websites competing with ours, most of which are free. Although consumer access to free websites may cause us to limit our ability to raise our prices, we see our chief competitors as adult pay websites that charge for their services and are operated by companies that possess global distribution, broadcasting and branding. Currently, there are few companies that fit this description, including Playboy.com, Penthouse.com and Vividvideo.com.

EMPLOYEES

As of December 31, 1999, 2000 and 2001 we employed 89, 118 and 142 people, respectively, on a full-time basis.

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

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

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

GOVERNMENT REGULATION

We operate in a highly regulated industry. This requires us to be

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

REGULATION OF THE ADULT ENTERTAINMENT INDUSTRY IN THE U.S.

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

The Classification and Rating Administration of the Motion Picture Association of America, MPAA, a motion picture industry trade association, assigns ratings for age group suitability for theatrical and home video distribution of motion pictures. Submission of a motion picture to the MPAA for rating is voluntary, and we do not submit our motion pictures to the MPAA for review. However, with the exception of several titles which have been

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re-edited for cable television, most of the movies distributed by us, if so rated, would most likely fall into the NC-17 - No Children Under 17 Admitted rating category because of their depiction of nudity and sexually explicit content.

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

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

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proceeds obtained from such offense; and (3) any property, real or personal, used or intended to be used to commit or to promote the commission of such offense, if the court in its discretion so determines, taking into consideration the nature, scope and proportionality of the use of the property in the offense.

With respect to the realm of potential penalties facing an organization such as ours, the forfeiture provisions detailed above apply to corporate assets falling under the statute. In addition, a fine may be imposed, the amount of which is tied to the pecuniary gain to the organization from the offense or determined by a fine table tied to the severity of the offense. Also factored into determining the amount of the fine are the number of individuals in the organization and whether an individual with substantial authority participated in, condoned, or was willfully ignorant of the offense; whether the organization had an effective program to prevent and detect violations of the law; and whether the organization cooperated in the investigation and accepted responsibility for its criminal conduct. In addition, the organization may be subject to a term of probation of up to five years.

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

We are engaged in the wholesale distribution of our products to U.S. wholesalers and/or retailers. We have taken steps to ensure compliance with all Federal, State and local regulations regulating the content of motion pictures and print products, by staying abreast of all legal developments in the areas in which motion pictures and print products are distributed and by specifically avoiding distribution of motion pictures and print products in

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areas where the local standards clearly or potentially prohibit these products. In light of our efforts to review, regulate and restrict the distribution of our materials, we believe that the distribution of our products does not violate any statutes or regulations.

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

In February 1996, the U.S. Congress passed the Telecommunications Act. Some provisions of the Telecommunications Act are directed exclusively at cable programming in general and adult cable programming in particular. In some cable systems, audio or momentary bits of video of premium or pay-per-view channels may accidentally become available to non-subscribing cable customers. This is called bleeding. The practical effect of Section 505 of the Telecommunications Act is to require many existing cable systems to employ additional blocking technology in every household in every cable system that offers adult programming, whether or not customers request it or need it, to prevent any

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possibility of bleeding, or to restrict the period during which the programming is transmitted from 10:00 p.m. to 6:00 a.m. Penalties for violation of the Telecommunications Act are significant and include fines and imprisonment. Surveying of cable operators and initial results indicate that most will choose to comply with Section 505 by restricting the hours of transmission. We believe that our revenues will be marginally adversely affected as a result of enforcement of Section 505. However, as digital technology (which is unaffected by Section 505) becomes more available, we believe that ultimately the impact will be insignificant.

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

Child Pornography and Non-Mainstream Content

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

Since 1990, the Free Speech Coalition has worked with the U.S. government to create a workable regulatory system designated to prevent minors from working in the adult industry. Child Protection Restoration and Penalties Enhancement Act of 1990 (18 U.S.C. section 2257) requires, in essence, that no one can work without having copies of their passport or driver's license, and a declaration under perjury of their age and true name, on file with a designated Custodian of Records, and available for inspection by law enforcement.

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

INTERNET REGULATION

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

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application to the Internet of other existing laws governing issues such as intellectual property ownership and infringement, pornography, obscenity, libel, employment and personal privacy is uncertain and developing.

Regulation of the Internet outside the United States

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

Regulation of the Internet Gaming Industry

We recently entered into a licensing and profit revenue sharing agreement with an online gaming company that offers sports betting and casino-style games online from facilities located outside the United States. In return for licensing our trade names and media content, we will receive a portion of the revenues derived from such gaming activities. Under this agreement, the online gaming company is responsible for compliance with all applicable laws and regulations governing its gaming services. We may nevertheless be deemed to be a principal in this venture and may be subject to the gaming related laws and regulations of each jurisdiction in which the online gaming company conducts its business. The application of these laws and regulations and the level of enforcement has been sporadic and the regulatory climate is uncertain. However, online sports and casino betting is unlawful in all states of the United States and very likely under any of several U.S. federal laws. Successful prosecutions have been brought at the state and federal level on both a corporate and individual basis. Accordingly, we risk possible prosecution as either a direct principal or on an aiding and abetting theory. Any prosecution in the United States or in other countries could have material adverse effect on our business, results or operations and financial condition.

Finally, to the extent that we fail to qualify to do business as a foreign corporation in any state or jurisdiction that requires such qualification due to the availability of our online gaming and other activities within that state or jurisdiction, we could be subjected to a variety of penalties including fines on a corporate and individual level, an inability to enforce contracts and, in several jurisdictions, imprisonment. Any such penalties could have a material adverse effect on our business, results of operation and financial condition.

SEASONALITY

Our businesses are generally not seasonal in nature. However, June, July and August are typically impacted by smaller orders from some European and U.S. distributors, due to the holiday season, while November and December sales are generally higher due to the printing of special issues such as The Best of Private.

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ITEM 2. DESCRIPTION OF PROPERTIES

PROPERTIES

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In 1997, we relocated our principal administrative and operating offices from Stockholm to Barcelona. The Barcelona facility houses our administrative, editorial and operational offices, the data center, customer service, and some of the warehouse and fulfillment facilities. With the acquisition of our French distributor at the end of 1997, we also inherited some office space in Paris, France. Currently, we lease office space in Barcelona, Spain, Knegsel, the Netherlands, and Paris, France.

Since May 27, 1997, Milcap Media Group is a lessee under an initial five-year term representing its operating corporate office. The lease was effective from the May 27, 1997. It is located at Carretera de Rubi 22-26, 08190 Sant Cugat del Valles, Barcelona, Spain. Average monthly base rental expense is approximately \$ 13,400. We recognize the rent expense on a straight-line basis over the extended term of the lease. Additionally, the lease requires us to pay our proportionate share of the building's real estate taxes and operating expenses. The majority of this space is used by all of our operating groups, primarily for post production.

Private Benelux is the lessee under a lease which terminates on July 31, 2006 and July 31, 2008 located in Knegsel. Average monthly base rental expense is approximately \$ 2,716. We recognize the rent expense on a straight-line basis over the extended term of the lease. Additionally, the lease requires us to pay our proportionate share of the building's real estate taxes and operating expenses. We use the majority of this space for operating our distribution in the Benelux countries.

Private France is the lessee under an expired term lease, which is now currently month-to-month, for approximately 50 square meters of corporate headquarters space located at 17, rue Charles de Gaulle -78680 Epone, France. Subsequent to the term of the lease, the average monthly base rental expense is approximately \$ 1,001. The rent expense is being charged to operations, on a monthly basis.

Private North America is the lessee under a lease effective April 1, 2001, with a term of five years, for a 21,500 square foot office and warehouse facility located in Sun Valley, California. Average monthly base rental expense is \$ 11,200, which amount increases by \$ 400 on an annual basis. The rent expense is being charged to operations on a monthly basis. Additionally, the lease requires us to pay our proportionate share of the building's real estate taxes and operating expenses. Private Media Group maintains an office in the United States at 3230 Flamingo Road, Suite 156, Las Vegas, Nevada 89121. Presently, no office space is rented and the above address is simply a mailing address.

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ITEM 3. LEGAL PROCEEDINGS

On June 7, 1999 the Swedish tax authority, Skattemyndigheten i Stockholm, instituted a proceeding against Milcap Media Limited, our wholly owned subsidiary, in the Administrative Court in Stockholm to seize assets as security in the event that the tax authority issues an assessment for corporate income tax against Milcap Media Limited. Although no tax assessment had been issued at that time, the Swedish tax authority alleged that Milcap Media Limited had a permanent establishment in Sweden and failed to withhold payroll tax, and therefore owed corporate income and payroll withholding taxes in Sweden for the income tax years 1995, 1996, 1997 and 1998. We believe that the opinion of the tax authority is without legal basis, as Milcap Media Limited conducts no operations in Sweden and has no permanent establishment in Sweden. Accordingly, we believe that the opinion of the tax authority is incorrect and that no tax will be due when the case is finally determined.

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For purposes of the seizure proceedings, the tax authority has filed a seizure request for an arbitrary amount of SEK 17.7 million, which is not based upon the actual financial results of Milcap Media Limited. As a consequence, the Swedish tax authority has filed and obtained an order from the Administrative Court in Stockholm, without prior notice to Milcap Media Limited, to seize assets of Milcap Media Limited having a value of up to SEK 17.7 million.

On December 20, 1999, Milcap Media Limited received an official notification from the tax authority with a statement that the tax authority had arbitrarily assessed Milcap Media Limited with income for the tax years mentioned above for a total amount of SEK 150 million, which is not based upon the actual financial results of Milcap Media Limited. The effective tax on the arbitrary income assessment would amount to around SEK 42 million plus fines of SEK 16.8 million. In addition, interest, which could be significant, is payable on those amounts. However, Milcap Media Limited is appealing the assessment to the Administrative Court in Stockholm. The final outcome of the appeal is expected to take several years and we have applied for a postponement of payment of the taxes and fees until the case is settled. No final decision has been given.

In March 2000, Milcap Media Group entered into an agreement with a construction contractor, ACOMO S.L., providing for the construction of a new office building and warehouse facility located in Barcelona, Spain. Under the terms of the agreement, Acomo was to construct the facility and transfer title to the land and building to Milcap Media Group for a total purchase price of approximately 2,705 million pesetas, approximately SEK 149.3 million. Subsequently, Milcap Media Group entered into an agreement with Viosland Trade S.L., a company deemed to be controlled by our principal shareholder, whereby Viosland agreed to acquire Milcap Media Group's interest in the project and to assume all financial obligations to Acomo. Milcap Media Group granted a guarantee to Acomo in the event of non-payment by Viosland. As of June 30, 2001, 972 million pesetas, approximately SEK 53.7 million, has been paid to Acomo in respect of construction in progress.

In July 2001, Acomo filed a civil action against Milcap Media Group and Viosland in Barcelona (Common Trial N. 298/2001) for approximately 479 million pesetas, approximately SEK 26,4 million, which Acomo claims is due for payment under the agreement, plus all future amounts which may fall due for payment over the course of the agreement. Milcap Media Group has filed an answer to this action, contending, among other things, that Acomo has not complied with some terms in the agreement and that accordingly no payment has fallen due. On December 21, 2001, an agreement before the judge was reached between Milcap Media Group and Acomo. On January 25, 2002 notification of the formal resolution issued by the judge ratifying the agreement was received. With this agreement Milcap Media Group recovers the rights over the construction from Viosland Trade S.L., and enables it to assign these rights to a third party. Accordingly, Milcap assigned the rights over the building to Ceresland SL, an affiliate of Berth Milton, on January 30, 2002. Finally, on March 21, 2002, the deed of purchase of the building was signed before the Public Notary between Acomo SL and Ceresland SL.

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

We are presently engaged in litigation, most of which is generally incidental to the normal conduct of our business and is immaterial in amount. We believe that our reserves are adequate and that no such action will have a

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material adverse impact on our financial condition. However, there can be no assurance that our ultimate liability will not exceed our reserves.

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

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PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

MARKET FOR PRIVATE MEDIA GROUP, INC. COMMON STOCK

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

	High	Low
	----	---
Fiscal 2001:		
First Quarter.....	\$8.88	\$4.94
Second Quarter.....	\$9.40	\$4.54
Third Quarter.....	\$9.84	\$6.46
Fourth Quarter.....	\$9.80	\$7.05
Fiscal 2000:		
First Quarter.....	\$13.00	\$5.82
Second Quarter.....	\$12.63	\$8.19
Third Quarter.....	\$10.13	\$5.38
Fourth Quarter.....	\$10.93	\$5.75
Fiscal 1999		
First Quarter (from February 1, 1999)....	\$4.83	\$3.43
Second Quarter.....	\$8.93	\$4.13
Third Quarter.....	\$6.93	\$3.93
Fourth Quarter.....	\$6.50	\$4.50

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On March 14, 2002, the last sales price reported on the Nasdaq National Market was \$6.44. On December 17, 2001, there were approximately 1,400 beneficial owners of our common stock.

DIVIDEND POLICY

We did not pay any cash dividends during our last fiscal year and we do not contemplate doing so in the near future. We currently intend to retain all earnings to finance the development and expansion of our operations, and do not anticipate paying cash dividends on our shares of common stock in the foreseeable future. Our future dividend policy will be determined by our Board

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of Directors on the basis of various factors, including results of operations, financial condition, business opportunities and capital requirements. The payment of dividends will also be subject to the requirements of Nevada Law, as well as restrictive financial covenants which may be required in credit agreements.

STOCK DIVIDEND

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

TRANSFER AGENT

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

MISCELLANEOUS

In July, 2000, our common stock was added to the Russell 2000 and 3000 Index.

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ITEM 6. SELECTED FINANCIAL DATA

The following table presents selected consolidated financial information for the five years ended December 31, 2001. The selected financial information has been derived from our consolidated financial statements which have been audited by Ernst & Young AB, independent auditors.

This selected consolidated financial information should be read along with our historical consolidated financial statements and related notes, and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in or appearing elsewhere in this Report.

	Years ended December			
	2001	2001	2000/(1)/	1999/(1)
	USD	SEK	SEK	SEK
	(in thousands, except per share)			
Statement of Income Data:				
Net sales	33,799	360,632	258,084	175,000
Cost of sales	11,990	127,928	98,770	84,000
Gross Profit	21,809	232,704	159,314	90,000
Selling, general and administrative expenses...	14,525	154,963	96,878	65,000
Offering expenses	731	7,801	--	--
Operating income	6,553	69,919	62,436	25,000
Sale of controlled entity	1,615	17,229	--	--
Interest expense	168	1,793	1,799	2,000
Interest income	132	1,407	3,077	--

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Income before income taxes	8,131	86,763	63,714	23,
Income taxes	1,180	12,589	10,705	3,
Net income	6,952	74,174	53,009	19,
Other Comprehensive Income:				
Unrealized loss on short-term investment.....	(116)	(1,238)		
Foreign currency translation adjustments.....	138	1,472	(818)	
Comprehensive income	6,974	74,408	52,191	19,
Income applicable to common shareholders.....	5,555	59,275	40,162	7,
Weighted average of shares outstanding:				
Basic	28,137,817	28,137,817	27,002,220	25,269,
Diluted	49,679,835	49,679,835	48,745,896	47,909,
Basic income per share	0.20	2.11	1.49	0
Fully diluted income per share	0.14	1.49	1.09	0
Dividends declared per common Share	--	--	--	

As per December 31,

	2001	2001	2000/(1)/	1999(
	USD	SEK	SEK	SEK
			(in thousands, except	
Balance Sheet Data:				
Cash and cash equivalents	5,657	60,357	14,381	7,
Working capital	19,738	210,609	140,510	98,
Total assets	50,225	535,890	388,063	256,
Total debt	4,193	44,738	5,356	6,
Total shareholders' Equity	37,154	396,439	302,423	211,

- (1) We have revised our previously reported basic earnings per share presentation for the twelve month periods ended December 31, 2000, 1999 and 1998, respectively, to properly reflect the issuance of common shares as dividends earned on our outstanding convertible preferred stock. This reduced our previously reported basic earnings per share by SEK 0.47, SEK 0.48 and SEK 0.24 per share for the twelve month periods ended December 31, 2000, 1999 and 1998, respectively. The restatement had no effect on previously reported diluted earnings per share for the twelve month periods ended December 31, 2000, 1999 and, 1998, respectively, except for the 1999 year for which there was a reduction of SEK 0.12 per share.
- (2) The 1997 and 1996 figures are from the historical combined financial statements of Milcap Media Limited and Cine Craft.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read this section together with the consolidated financial statements and the notes and the other financial data in this Report. The matters that we discuss in this section, with the exception of historical

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information, are forward-looking statements within the meaning of the Private Securities Reform Act of 1995. Such forward-looking statements are subject to risks, uncertainties and other factors which could cause our actual results to differ materially from those expressed or implied by such forward-looking statements. Potential risks and uncertainties relate to factors such as: (1) the timing of the introduction of new products and services and the extent of their acceptance in the market; (2) our expectations of growth in demand for our products and services; (3) our ability to successfully implement expansion and acquisition plans; (4) the impact of expansion on our revenue, cost basis and margins; (5) our ability to respond to changing technology and market conditions; (6) the effects of regulatory developments and legal proceedings with respect to our business; (7) the impact of exchange rate fluctuations; and (8) our ability to obtain additional financing.

Overview

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

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

We operate in a highly competitive, service-oriented market and are subject to changes in business, economic and competitive conditions. Nearly all of our products compete with other products and services that utilize adult leisure time and disposable income.

Due to the highly fragmented structure of the adult entertainment industry, we expect increasing consolidation. We believe that, as a public company with sufficient working capital and future financing capabilities, we are in a position to acquire several privately-held competitors.

We generate revenues primarily through:

- . sales of movies on DVD and videocassette formats;
- . sales of adult feature magazines;
- . Internet subscriptions and licensing;
- . broadcasting movies through cable, satellite and hotel television programming; and
- . brand name and trademark licensing.

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

Net sales by product group

Years ended December 31,

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	1999	2000	2001
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	SEK	SEK	SEK
		(in millions)	
Magazine and video.....	136.8	135.8	150.1
DVD's.....	8.4	50.2	109.8
Internet.....	16.6	50.7	71.6
Broadcasting.....	3.1	17.4	26.2
Other (1)			