

Sunshine Holdings 3 Limited

Directors' report and financial statements

for the year ended 31 July 2008

Registered number: 05359848

Sunshine Holdings 3 Limited

Directors' report

For the year ended 31 July 2008

The directors present their report and the audited consolidated financial statements of the Company and its subsidiaries for the year ended 31 July 2008.

Principal activities and review of business

The principal activity of the Company and its subsidiaries (the 'Group') is the creation, production and exploitation of young children's properties across a wide range of outlets including television, video, publishing, licensing, merchandising and live events. This is likely to remain so for the foreseeable future.

The results for the Group show a pre-tax loss of \$16,138,000 (2007: \$41,809,000) after net interest payable of \$50,401,000 (2007: \$49,103,000). The Group's net debt of \$470,122,000 (2007: \$566,092,000) arose principally from the restructuring at the time of the acquisition of the Group by Sunshine Acquisition Limited, a subsidiary of the Company.

Business environment

The pre-school TV sector is competitive. There are a number of production companies operating in this space, and although the number of specialist kids' channels and demand for content is increasing, the key to launching and maintaining a successful long-term cross-media property such as those in which the Group specialises remains free-to-air (FTA) television. The rise of non-linear services, such as video on demand (VOD), offer potential alternative platforms, but remain fledgling in most markets and, as such, overall TV revenue remains modest.

The licensed consumer products market is a growth market as products with licensed characters sell better than unbranded products. As FTA broadcast of pre-school shows is a driver of retail placement of Consumer Products (CP), ancillary revenues are somewhat dependent on the Group's broadcast footprint in each territory. In terms of competition, although smaller than the Walt Disney Company and Viacom (which owns Nickelodeon), the Group is by far the largest and most international of the pre-school independents and in Thomas & Friends ('Thomas'), Bob the Builder ('Bob') and Barney owns three of the largest global pre-school properties.

The maturing home entertainment market has entered a softer period with the VHS format removed from retail. Looking forward, new formats, such as Blu-ray, are projected to support the packaged media side of the business. However, increased penetration of VOD, and new offerings such as digital downloading and PVR penetration all offer potential challenges to the traditional sell-through model on DVD.

Principal risks and uncertainties

As described above, broadcast is a driver of success for a business like the Group's and correspondingly loss of broadcast is a key risk. The Group owns three very strong global brands in Bob, Thomas and Barney which will achieve considerable recurring affiliation among successive generations of pre-schoolers driving continued television broadcast. The Group is also a partner in the US digital channel PBS Kids Sprout - the full benefit of this will be felt when Sprout reaches critical mass in terms of numbers of subscribers.

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The global CP market remains fragmented and competitive. There is a trend towards a few brands becoming dominant whilst others struggle to break through. The Group's position is strong in this regard, having three evergreen properties, but remains exposed to any of these becoming less successful. In addition, the Group has very strong positions in a number of geographic markets, including the US, so is not concentrated in one or two key markets. Much of the Group's CP business is in Toys.

A key risk in the CP business relates to licensed product quality and safety. The Group licenses its characters to various third party manufacturers across multiple CP categories. In the summer of 2007, the Thomas master toy licensee experienced a significant product recall wherein approximately 2 million units of certain Thomas train products were recalled after a sample of the products failed to meet safety standards. The recall negatively affected the Group's profits and, at least temporarily, damaged the Thomas brand. In June 2008, the Group reached a \$15 million cash settlement with the licensee in connection with the financial losses suffered as a result of the recall and also agreed an early termination of the license.

The principal risks and uncertainties for the home entertainment business include: a maturing market which puts pressure on growth and prices; any consolidation among the retail base; and new brands entering the pre-school video market. However, the Group's strong brands offer significant mitigation against this risk.

Strategy

The TV distribution strategy is multi-faceted and based on;

- * the continued development of guaranteed broadcast platforms internationally. In November 2007, the Group signed an agreement with Chello Zone, a Liberty Global company, to launch pre-school channels around the world.
- * international concentration on getting key brands on air in new markets on FTA television.
- * the pursuit of co-production and deals for the future production slate.

The objective for global CP is to maximise revenues in all CP segments, both territorially and within channel. The key areas of focus are: further building retail alliances; building a broader relationship with broadcasters; and creating new revenue streams from new media platforms as technologies develop. In addition, the Company is leveraging the strength of the current brands to improve licensee terms. The reach and scale of the Group's infrastructure make it an obvious partner for other pre-school brands and the Group is actively seeking out other characters and brands to add to the existing business.

Future outlook

As described above, the continued success of Thomas, Bob and Barney is key to the future of the Group. The main factors affecting that future are described above. The directors currently know of no further issues that would prevent the Group's continued success.

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Walker Report

On 20 November 2007 David Walker published his 'Guidelines for Disclosure and Transparency in Private equity' (the Walker Report) which recommends that portfolio companies of private equity firms, amongst other things, make certain enhanced disclosures in their financial statements.

HIT Entertainment is a portfolio company as defined by the Walker Report and the board has agreed to adopt all of the recommendations in the report. Funds advised and managed by Apax Partners have a controlling interest in HIT Entertainment. M Brockman, P Fitzsimons and J Reses are Directors of the company and exercise oversight on behalf of Apax Partners. Details on the composition of the board and the business and financial review are included in this Directors Report.

Directors and their interests

The directors of the Company during the year and to the date of signing the financial statements:

M Brockman

P Fitzsimons

G Dyke

J Reses

B Steinberg (resigned 6 March 2008)

J Weight

J Dunn

Employee Equity Scheme

An employee equity scheme exists within the Group wherein certain employees have invested in a limited partnership which owns ordinary shares in a holding company of the Group.

Results and dividends

The consolidated profit and loss account set out on page 9 shows a loss for the year of \$15,768,000 (2007: loss of \$31,170,000).

The directors do not propose a dividend for the year (2007: \$nil).

Share capital

As at the date of this report, 305,965,001 ordinary shares of £1 each are issued and fully paid.

Subsequent events

On 15 September 2008, HIT Entertainment sold its interest in Children's Radio (UK) Limited to Folder Media Limited.

The shares were sold for £1, the level to which the investment had been written down to in the year.

In October 2008, the Group announced a reorganisation which creates a focus on global brand management. To date, there has not been a significant amount of redundancies resulting from the recent reorganisation.

Bridgefilms Limited, in which Gullane Entertainment Limited owns a 50% share, was put into members' voluntary liquidation on 13 November 2008.

Research and development

The Group is involved with development activities in relation to its toy division. During the year ended 31 July 2008, \$4,723,000 (2007: \$4,612,000) was capitalised as development costs in the Group's accounts.

Related parties

Entities within the Group have related party transactions with entities outside the Group but who share the same ultimate parent company and with its joint ventures and associated undertakings. For further details regarding the transactions, see note 36.

Creditor payment policy

The Group does not have a standard code for dealing specifically with the payment of creditors. The Group is generally contracted to settle royalty accruals within 30-60 days of the royalty quarter dates. With respect to other creditors, the Group seeks to agree the terms of payment with the supplier and then pay in accordance with the agreed terms. Discounts offered by vendors are taken when, based on the time value of money, it is advantageous to the Group.

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Financial risk management

The Group is exposed to risks associated with foreign currencies, interest rates and credit exposure.

Foreign currency risk

The Group is exposed to foreign exchange risk in respect to its operations in the US, and to a lesser extent, net assets denominated in foreign currencies. See note 23 for a more detailed analysis.

Interest rate and liquidity risk

The Group manages its available funds through a revolving credit facility. The Group is exposed to interest rate fluctuations on its bank borrowings and finance lease creditors which incur floating interest rates based on appropriate LIBOR. A portion of the bank borrowings are hedged with interest rate swaps. Details of the revolving credit facility, the bank borrowings and the interest rate swaps can be found in notes 23 and 24.

Credit risk

The Group's policy is to provide for any trade or other creditor balance whose collection is deemed doubtful. The Group is exposed to credit risk of its trade and other debtors to the extent they are not specifically provided for as doubtful accounts.

Corporate responsibility

The Group is one of the leading owners and licensors of young children's entertainment properties in the world and its characters hold special positions in the minds of its young audience and their families. The Board recognises the responsibilities this brings and is keenly aware that, in the way it does business, the Group should uphold the virtues its properties display. The Board therefore pays close attention to social, environmental, and ethical ("SEE") matters and closely monitors all risks, including SEE risks, which may have an adverse impact on the Group's reputation and value. In this context, the principal issues for the Group are:

- * that the television programmes, home entertainment products, publishing titles and stage shows featuring the Group's properties continue to convey the highest entertainment and educational values to their target audiences;
- * that products produced directly or under licence are of a standard and safety commensurate with the Group's position as a supplier of quality children's entertainment and are produced in factories displaying appropriate labour, environmental and social practices;
- * to provide a safe and healthy working environment that is conducive to the recruitment and retention of the widest possible range of talented staff;
- * to improve its environmental performance so as to increase its operational efficiency and reduce its environmental impact;
- * to develop strong relationships in our chosen communities by using the Company's unique properties to benefit society.

Employees

The Group places considerable importance on informing employees of matters of concern to them and issues affecting the Group's operational and financial performance. The principal means of communication included all staff being regularly invited to briefings on the business from the Chief Executive Officer. Furthermore, an optional employee equity scheme was put in place in August 2006 which encourages the involvement of employees in the Group's performance. Employment of individuals within the Group is based on the position to be filled and the qualifications of the applicant, without regard to race, religion, sex, age, colour, marital status, national origin, handicap or any other characteristic. The aim is to ensure that the most capable job applicants are recruited and the most competent qualified candidate, including disabled persons, are considered for vacancies in the Group. Priority is given to the training of employees and the development of their skills and if individuals become disabled during employment and are unable to continue to perform their jobs, consideration is given to retraining for alternative jobs.

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Health and Safety

The Group takes all reasonable and practicable steps to safeguard the health, safety and welfare of its employees and recognises its responsibility for the health and safety of other people who may be affected by its activities. The health and safety policy is reviewed each year and is made available to employees and displayed at each of the Group's places of business. In addition, detailed health and safety plans have been prepared and are displayed at each of the Group's workplaces. Periodic ergonomic assessments are made of individual working environments to ensure persons using workstations, etc. are accommodated as comfortably and effectively as possible.

Environment

The Group does not operate in a business sector which causes significant pollution or other adverse environmental effects. The principal direct environmental impacts are the consumption of energy at its offices and studios, the production of waste, including packaging, and the consumption of water. Each office and studio has arrangements in place for the collection and recycling of waste paper. Used printer toner cartridges are donated to charities which arrange for them to be recycled and redundant information technology equipment is either donated to non-profit organisations such as schools or disposed of through specialist recycling companies.

Charity and community activities

The Group's commitment to both goodwill and outreach efforts is a natural product of its commitment to providing the highest quality, educational entertainment for the enrichment of young children. Companies in the Group are strong supporters of, and participants in, various charities and community efforts throughout the UK, US, and other territories in which the Group operates using its global brands Bob the Builder, Barney, Thomas the Tank Engine, Angelina Ballerina, and others to help raise funds for many charitable organisations. In addition, the Group gives value in kind through staff involvement and product donations to schools and other organisations. During the year the Group made \$52,000 (2007: \$89,000) in charitable cash donations to various children's charities. No political donations were made.

Ethical business conduct

The Group enjoys a worldwide reputation for quality, integrity and ethical conduct. Everyone employed by the Group is expected to do all they can to maintain this reputation and is required to act in accordance with the Group's Code of Business Conduct, which is issued to all employed and published on the Group's intranet, www.hitentertainment.net. Training in ethical standards and behaviour is provided to all employees who are then required to sign to confirm their understanding and acceptance of the Code.

Before the Group grants licences for the manufacture of products bearing any of its characters, the places and methods of manufacture are carefully reviewed to ensure that working conditions are satisfactory and no use is made of child labour. All products produced by licensees are extensively tested before being approved for sale and HIT will not grant licences for products which it does not consider to be in keeping with its aim of providing safe, entertaining and educational products for children. The Group is extremely careful in awarding licences to food manufacturers. In the UK, the Group has its own in-house guidelines forbidding the licensing of various foodstuffs such as certain fast-food products and confectionery; for example, the Group does not grant licences to crisp manufacturers. The Group works with the UK Food Standards Agency to ensure that Group-related food products contain safe quantities of sugar and salt. The Group's guidelines of foodstuffs are constantly under review and are currently being extended to cover the other territories in which the Group operates.

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Statement of directors' responsibilities

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). The financial statements are required by law to give a true and fair view of the state of affairs of the Company and Group and of the profit or loss of the Group for that period.

In preparing those financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements;
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business, in which case there should be supporting assumptions or qualifications as necessary.

The directors confirm that they have complied with the above requirements in preparing the financial statements.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and the Group and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the company and the group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

So far as the directors are aware, there is no relevant audit information of which the Company's auditors are unaware and the directors have taken all the steps that ought to have been taken as directors in order to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

On behalf of the board

J Weight
Chief Financial Officer

25 November 2008

Sunshine Holdings 3 Limited

Independent auditors' report to the members of Sunshine Holdings 3 Limited

We have audited the group and parent company financial statements (the "financial statements") of Sunshine Holdings 3 Limited for the year ended 31 July 2008, which comprise the Consolidated Profit and Loss Account, the Consolidated and Company Balance Sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Total Recognised Gains and Losses, and the related notes. These financial statements have been prepared under the accounting policies set out therein.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements.

In addition we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read the Directors' Report and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's and company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the group's and the parent company's affairs as at 31 July 2008 and of the group's loss and cash flows for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.

PricewaterhouseCoopers LLP

Chartered accountants and registered auditors

London

November 2008

		2008	2008	2008	2007	2007	2007
		\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
	Notes	Continuing Operations	Discontinued Operations	Total	Continuing Operations	Discontinued Operations	Total
Group turnover	2	238,403	35,386	273,789	231,164	32,207	263,371
Cost of sales		(102,229)	(13,643)	(115,872)	(94,409)	(13,018)	(107,427)
Gross profit		136,174	21,743	157,917	136,755	19,189	155,944
Selling, marketing and distribution costs		(22,154)	(3,247)	(25,401)	(20,077)	(3,376)	(23,453)
Administrative expenses							
Operating expenses		(74,978)	(4,250)	(79,228)	(58,987)	(6,579)	(65,566)
Amortisation of goodwill	13	(43,024)	(2,429)	(45,453)	(42,903)	(4,514)	(47,417)
Exceptional items	3	(12,285)	-	(12,285)	(2,935)	(649)	(3,584)
		(130,287)	(6,679)	(136,966)	(104,825)	(11,742)	(116,567)
Other operating income/(loss)							
Other operating income	5	13,575	-	13,575	2,893	-	2,893
Share of losses in joint ventures and associates	16	(4,516)	-	(4,516)	(11,523)	-	(11,523)
		9,059	-	9,059	(8,630)	-	(8,630)
Total operating (loss)/profit		(7,208)	11,817	4,609	3,223	4,071	7,294
Impairment of investments in joint ventures	16	(2,857)	-	(2,857)	-	-	-
Gain on sale of subsidiary	10	-	32,511	32,511	-	-	-
Interest receivable and similar income	7	436	8	444	2,287	7	2,294
Interest payable and similar charges	8	(50,845)	-	(50,845)	(51,397)	-	(51,397)
(Loss)/profit on ordinary activities before taxation	9	(60,474)	44,336	(16,138)	(45,887)	4,078	(41,809)
Taxation	11	411	(41)	370	11,062	(423)	10,639
(Loss)/profit for the financial year	29	(60,063)	44,295	(15,768)	(34,825)	3,655	(31,170)

There is no difference between the loss on ordinary activities before taxation and the loss for the year stated above and their historical cost equivalents.

Sunshine Holdings 3 Limited**Consolidated statement of total recognised gains and losses for the year ended 31 July 2008**

	Notes	2008 \$'000	2007 \$'000
Loss for the financial year		(15,768)	(31,170)
Currency translation differences on foreign currency net investments	30	1,389	3,124
Total recognised losses for the year		(14,379)	(28,046)

Sunshine Holdings 3 Limited
Consolidated balance sheet as at 31 July 2008

	Notes	2008 \$'000	2007 \$'000
Fixed assets			
Intangible assets			
Goodwill	13	721,715	845,173
Acquired rights	13	30,400	35,177
		<u>752,115</u>	<u>880,350</u>
Tangible assets			
Tangible assets	14	16,331	15,208
Development costs	15	8,097	6,220
Investment in joint ventures	16	1,537	2,127
Investment in associates	16	44,924	40,639
		<u>823,004</u>	<u>944,544</u>
Current assets			
Stock	18	12,833	19,813
Investment in programmes	19	100,770	87,967
Debtors	20	84,855	80,783
Deferred taxation	26	44,636	37,560
Cash at bank and in hand		33,706	29,721
		<u>276,800</u>	<u>255,844</u>
Creditors: amounts falling due within one year	21	<u>(134,454)</u>	<u>(122,948)</u>
Net current assets		<u>142,346</u>	<u>132,896</u>
Total assets less current liabilities		<u>965,350</u>	<u>1,077,440</u>
Creditors: amounts falling due after one year	22	<u>(499,047)</u>	<u>(600,894)</u>
Provisions for liabilities	25	<u>(6,134)</u>	<u>(1,998)</u>
		<u>460,169</u>	<u>474,548</u>
Capital and reserves			
Called-up share capital	28	570,196	570,196
Profit and loss account	29	(110,027)	(95,648)
Total shareholders' funds	30	<u>460,169</u>	<u>474,548</u>

The financial statements on pages 9 to 55 were approved by the board of directors on 25 November 2008 and signed on its behalf by:

J Weight
Chief Financial Officer

Sunshine Holdings 3 Limited
Company balance sheet as at 31 July 2008

	Notes	2008 \$'000	2007 \$'000
Fixed assets			
Investments	17	570,282	570,282
Creditors: amounts falling due within one year	21	<u>(83)</u>	<u>(57)</u>
Total assets less current liabilities		<u>570,199</u>	<u>570,225</u>
Creditors: amounts falling due after one year	22	<u>(252)</u>	<u>(252)</u>
		<u>569,947</u>	<u>569,973</u>
Capital and reserves			
Called-up share capital	28	570,196	570,196
Profit and loss account	29	<u>(249)</u>	<u>(223)</u>
Total shareholders' funds	30	<u>569,947</u>	<u>569,973</u>

The financial statements on pages 9 to 55 were approved by the board of directors on 25 November 2008 and signed on its behalf by:

J Weight
Chief Financial Officer

