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DHX.B.TO - Q1 2018 DHX Media Ltd Earnings Call

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CORPORATE PARTICIPANTS

Dana Landry *DHX Media Ltd. - CEO & Executive Director*

Keith Abriel *DHX Media Ltd. - CFO*

Michael Donovan *DHX Media Ltd. - Executive Chairman*

Nancy Chan-Palmateer *DHX Media Ltd. - Director of IR*

CONFERENCE CALL PARTICIPANTS

Adam Shine *National Bank Financial, Inc., Research Division - MD, Head of Montreal Research and Research Analyst*

Bentley Cross *TD Securities Equity Research - Associate*

Eric Wold *B. Riley & Co., LLC, Research Division - Senior Equity Analyst*

Jeffrey Fan *Scotiabank Global Banking and Markets, Research Division - Director, Telecommunication Services and Canadian and U.S. Telecom and Cable Equity Research Analyst*

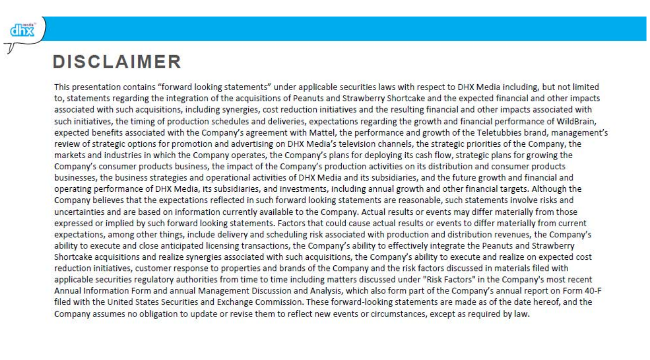
Robert Goff *Echelon Wealth Partners Inc., Research Division - MD, Head of Research, and Telecom Services & New Media Analyst*

Tim Casey *BMO Capital Markets Equity Research - Equity Research Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the DHX Media Fiscal 2018 First Quarter Webcast. (Operator Instructions) As a reminder, today's conference call is being recorded. I would now like to turn the conference over to Nancy Chan-Palmateer, Director, Investor Relations at DHX Media. You may begin your conference.



Nancy Chan-Palmateer - *DHX Media Ltd. - Director of IR*

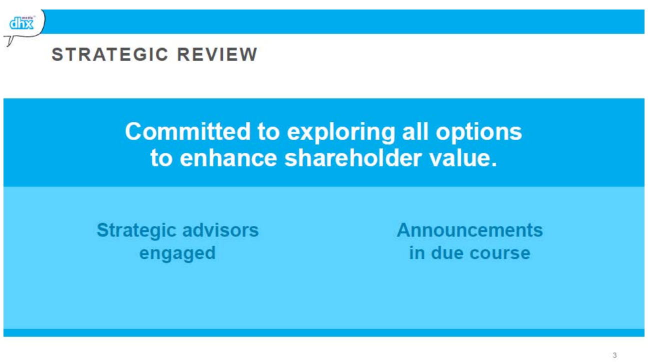
Thank you, operator, and thank you, everyone, for joining us today. Speaking on the call with us today are Michael Donovan, our Executive Chairman; Dana Landry, our Chief Executive Officer; and Keith Abriel, our Chief Financial Officer. Also, with us on the call and available during the question-and-answer session is David Regan, our Executive Vice President of Strategy and Corporate Development.

Turning to Slide 2 now. We have some standard cautionary statements. The matters discussed on this call include forward-looking statements under applicable securities laws with respect to DHX Media, including, but not limited to, statements regarding the company's ongoing strategic review, the integration of the acquisition of Peanuts and Strawberry Shortcake, and the expected financial and other impacts associated with such acquisitions, including synergies, cost-reduction initiatives and the resulting financial and other impacts associated with such initiatives, the strategic priorities of the company, the company's plans for deploying cash flow, the market and demand for kids content and the business strategies and operational activities of the company.

Such statements are based on information currently available and are subject to a number of risks and uncertainties. Actual results or events in the future could differ materially and adversely from those described in forward-looking statements as a result of various important factors, including the risk factors set out in the company's most recent MD&A and Annual Information Form.

For the question-and-answer session that will follow, we ask that each analyst keep to one question with one follow-up, so that everyone has a chance to ask a question. If you would like to ask an additional question, please rejoin the queue.

Turning to Slide 3. I will now hand the call over to our Executive Chairman, Michael Donovan.

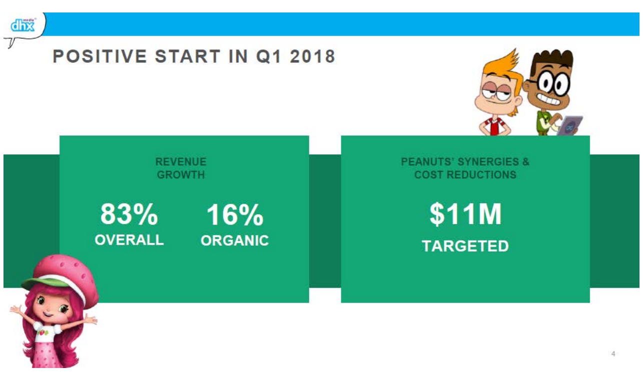


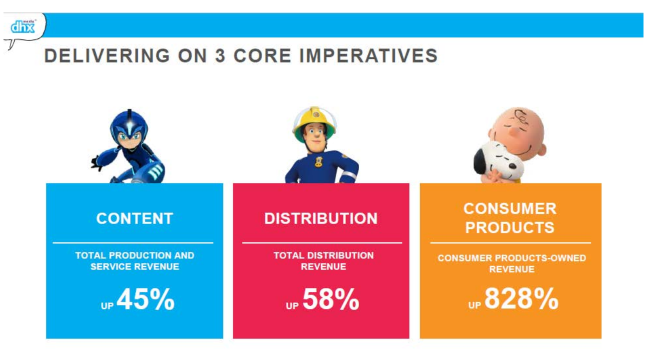
Michael Donovan - *DHX Media Ltd. - Executive Chairman*

Thank you, Nancy. I'm happy to report the company has resumed its growth track, and that our first quarter for 2018 is on plan. I'm also pleased to report that the integration of the recent Peanuts acquisition is also on track. And we are now positioned to execute on the unprecedented global demand we're experiencing for kids and family content.

As we announced on October 2, the Board of directors met, and on the recommendation of management, formed a special committee of the board. I'm pleased to report that special committee and its advisers have been working very hard since then. The mandate of the special committee is to review strategic options to enhance shareholder value. Bankers have been hired and have been actively assisting the special committee in this important work. We will update shareholders when the process is complete.

I'll now turn the call over to Dana.





Dana Landry - *DHX Media Ltd. - CEO*

Thank you, Michael, and thanks everyone for joining us on the call.

Management is encouraged by the growth in Q1 fiscal 2018. With the addition of Peanuts and Strawberry Shortcake, we are seeing evidence of the transformation of our business, which was the key strategic reason for the acquisition.

Revenues in the quarter were up 83% compared to Q1 last year. This increase reflected 16% organic growth and 67% acquisitive growth. We are also pleased with the progress being made on the integration of Peanuts. We are now implementing cost synergies, which put us on track to achieve our target this year of $5 million for Peanuts.

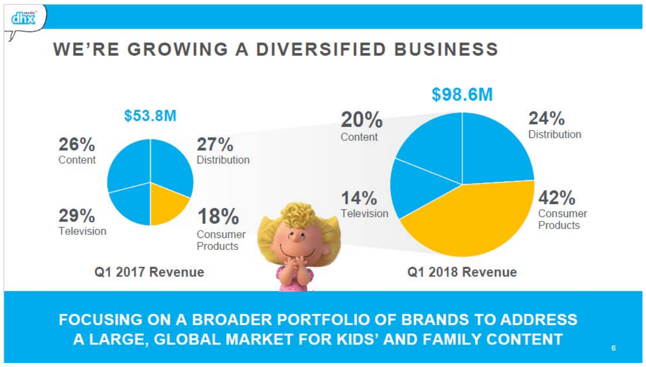
In addition, we have taken this opportunity to examine all aspects of the business to undertake company-wide SG&A cost cuts of $6 million. Overall, we anticipate these measures will deliver $11 million in annualized savings by the end of fiscal 2019.

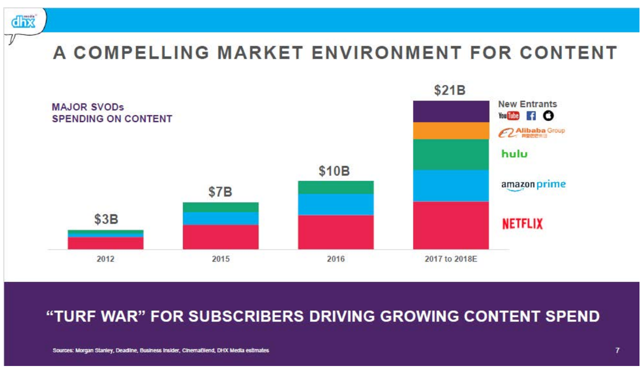
Turning to Slide 5 now, please. I'd like to remind everyone of what our 3-part mission is.

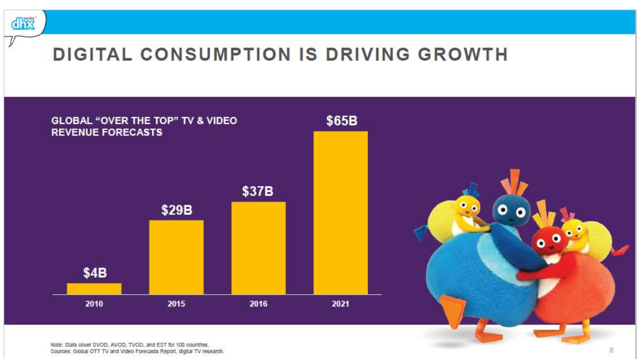
First, we continue to produce engaging and entertaining content for kids and families at our two animation studios and our live-action studio.

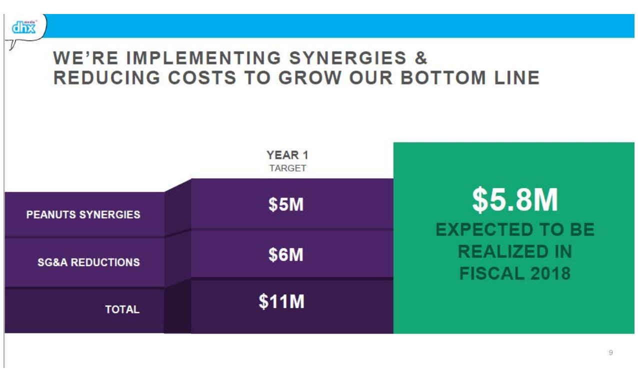
Secondly, we distribute shows from our leading independent content library to hundreds of broadcasters and streaming platforms worldwide.

And third, we license key brands from our library for consumer products opportunities globally. This has been our goal from day 1 and we remain committed to creating, distributing and licensing content and brands that inspire and entertain children and families worldwide.









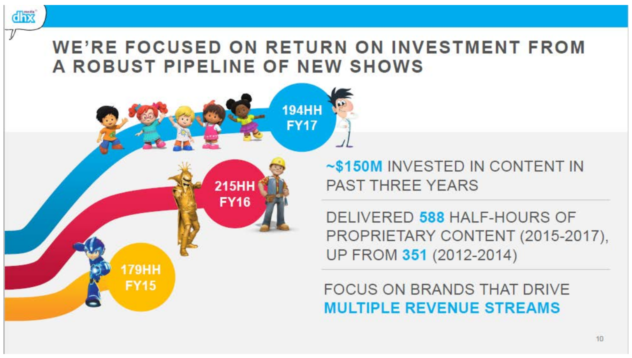
Dana Landry - *DHX Media Ltd. - CEO*

Turning now to Slide 6, please. With Peanuts now on board, our business model is more diversified, stable and growing. Over 40% of our revenues now come from licensing consumer products compared to 18% during the same period last year. We are capitalizing on the global market in content for kids and family and we have the brand to realize now on that opportunity. The plan is to leverage our expertise to grow our existing brands through new original content. This includes current brands like Peanuts, Strawberry Shortcake and the Teletubbies, and shows in the pipeline, such as Mega Man, Polly Pocket and Fireman Sam. This will allow us to add new categories and new territories in our consumer products portfolio.

Turning now to Slide 7, please. Content budgets from major video-on-demand services are expected to double from $10 billion in 2016, reaching USD 21 billion in 2018. These video on-demand platforms reflect our largest customers, and of course, potential customers.

Turning now to Slide 8, please. To understand what's driving this demand for content, we only need to look at kids in our own lives, whose consumption of content is transitioning massively to digital. We expect these digital trends to continue.

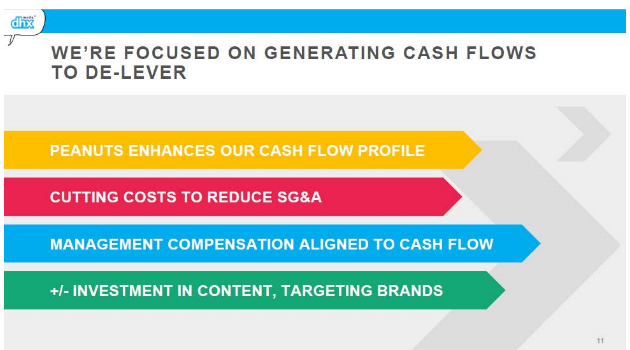
Turning now to Slide 9, please. As we capitalize on this expanding environment for content, management is also committed to improving the bottom line. We have already implemented cost synergies from the Peanuts acquisition that put us on track to achieve our $5 million in annualized synergies. Simultaneously, we are implementing further company-wide SG&A savings with a full year target of $6 million to grow our bottom line. As we said, we anticipate these measures will deliver $11 million in annualized savings by the end of fiscal 2019. In fiscal 2018, we expect to realize$5.8 million in savings.



Dana Landry - *DHX Media Ltd. - CEO*

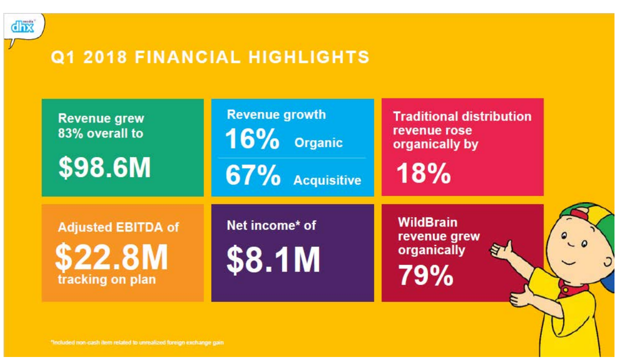
Turning now to Slide 10, please. Management is also focused on generating predictable free cash flow. We'll use this to de-lever the balance sheet, while continuing to selectively invest in new content for the long term. Given the strong demand for kids and family content, we've invested approximately $150 million over the past 3 years to build up our library.

We've now reached a steady state of production and we are starting to see returns on these investments, which will improve cash flows. Going forward, net content spending will naturally moderate as we focus production on key brands that will drive revenues across multiple streams.



Turning now to Slide 11, please. Positive free cash flow is a high priority for us. Management is committed to our free cash flow guidance for fiscal 2018. We'll use the cash flow to de-lever, while continuing to build the business for the long term. As we tighten our focus on cash generation and execute against our business plan, we have a range of levers at our disposal to achieve our targets over the next few years, some of which have already begun. These include, realizing cost synergies on the Peanuts acquisition, managing our investment in content and further cutting SG&A costs.

Turning to Slide 12 now, I'll hand the call to Keith for an overview of the Q1 numbers.



Keith Abriel - *DHX Media Ltd. - CFO*

Thank you, Dana. Q1 2018 was a good quarter and on plan. Historically, Q1 is a seasonally light quarter. We are on pace to achieve our EBITDA target. I'm also happy to report that Peanuts performed as management expected.

Now let me touch on some key metrics and highlights for the quarter. Revenues for Q1 2018 were $98.6 million, up 83% from $53.8 million for Q1 2017. On an organic basis, revenue grew 16% in the quarter, and on an acquisitive basis, revenue grew 67%.

Other highlights for the quarter included proprietary and production service revenues rose 45% organically compared to Q1 2017. Traditional distribution revenue was up 18% organically compared to Q1 2017, and WildBrain increased 79% organically compared to Q1 2017.

Now turning to gross margin. Total gross margin for Q1 2018 was $42.9 million, an increase in absolute dollars of $11.8 million compared to $31.2 million for Q1 2017. It's important to note that overall gross margin at 44% of revenue was on plan and as expected compared to 58% of revenue for Q1 2017. Gross margin for the quarter was impacted by, among other things, the acquisition of Peanuts, which carries a lower gross margin as a result of the talent fees paid to the estate of Charles M. Schulz; higher than normal third-party traditional distribution revenues for the quarter, which are expected to revert to historical norms for the remainder of the year; growth in WildBrain, which is being driven increasingly by third-party brands, and the blend of production service work currently being completed at our animation studios.

Keith Abriel - *DHX Media Ltd. - CFO*

Adjusted EBITDA is tracking on plan at $22.8 million, up $7.9 million or 54% over Q1 2017. Net income was $8.1 million for the quarter or $0.06 basic and diluted earnings per share compared to net income of $1.4 million or $0.01 basic and diluted earnings per share for Q1 2017.

Free cash flow for the quarter was a use of cash of $32 million, which was affected by 3 items. First, payment of $13.5 million in early redemption penalties related to the repayment of our senior unsecured notes on July 11, 2017. Second, payments of $5.1 million in debt issue costs and acquisition costs related to the Peanuts and Strawberry Shortcake transaction. And third, payments of $14.7 million related to our strategic partnership with Mattel. We are on track for our annual outlook for free cash flow.

For further specifics of our fiscal 2018 Q1 results and various other information, including a reconciliation of GAAP and non-GAAP financial measures, I would refer you to the company's fiscal 2018 Q1 MD&A, which was posted on SEDAR and EDGAR this morning.

I'll now hand it back to Dana.

Dana andry - *DHX Media Ltd. - CEO*

Thank you, Keith. Turning to Slide 13 now. Management is encouraged by the strong start to fiscal 2018. Going forward, we are focused on delivering growth; executing on Peanuts and implementing cost synergies; generating free cash flow; and de-leveraging our balance sheet.

Now, let's take some questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Rob Goff of Echelon.

Robert Goff - *Echelon Wealth Partners Inc., Research Division - MD, Head of Research, and Telecom Services & New Media Analyst*

My question would be on Teletubbies. Could you talk to the bit of the traction that you're seeing on Teletubbies in the U.S. when it comes from the AVOD side? And could you talk to how you might see the Teletubbies traction gaining from an M&L cycle?

Dana Landry - *DHX Media Ltd. - CEO*

Rob, second part of the question, was that related to the U.S. as well? Or was that a general question?

Robert Goff - *Echelon Wealth Partners Inc., Research Division - MD, Head of Research, and Telecom Services & New Media Analyst*

Probably, more in the U.S. as well, Dana.

Dana Landry - *DHX Media Ltd. - CEO*

Okay. So it's important to note that in the Teletubbies, right now, we're still executing on the traditional plan that we have, which is through Nickelodeon, and we're in conversations to contemplate our AdVOD strategy in the U.S. going forward. So we'll update listeners at that point in time. In terms of traction, we're sort of at the same place as we were at the end of the year. So no real update there, in terms of the U.S. But in Germany and in the U.K., for instance, the brand continues to perform above expectations. We're also getting quite excited about China going forward.

Robert Goff - *Echelon Wealth Partners Inc., Research Division - MD, Head of Research, and Telecom Services & New Media Analyst*

Okay. Could you perhaps expand on the Chinese outlook, then?

Dana Landry - *DHX Media Ltd. - CEO*

Yes, sure. So I mean, for China, you've probably noticed that we've announced a series of deals over the last year or so on a number of the platforms. And we're working on a strategy to roll-out consumer products in the near-term in China, in most categories. So stay-tuned.

Operator

And our next question comes from Adam Shine of National Bank.

Adam Shine - *National Bank Financial, Inc., Research Division - MD, Head of Montreal Research and Research Analyst*

When I look at the guidance disclosures, I guess, there's an extra sentence with respect to free cash flow, a bit of a qualifier saying adjusted or ex-$20 million, $25 million of costs related to the acquisition of Peanuts and Strawberry Shortcake. So maybe just elaborate in the context of Q1. In Q1, is the related spend that $5.1 million, which obviously further takes the free cash flow in Q1 to the minus $32 million context such that you haven't sort of made that adjustment that you'll adjust? Or we should simply adjust for 5x for effectively during the course of the year? Maybe just provide bit more color on that, because it's a new disclosure?

Dana Landry - *DHX Media Ltd. - CEO*

Yes. So the number in free cash flow essentially is a normalized number, is what we have for our guidance. We want to just make sure that we're clarifying that. And so in the quarter, as Keith said in his prepared remarks, there's two individual components that relate to the Peanuts acquisition,$13.5 million in early redemption penalties on the bond and $5.1 million of debt-issue and acquisition costs. So call it a total of about $18.6 million of about $25 million. So you'll see another $5 million to $7 million in the next quarter or so. And we obviously view those as sort of one-time costs related to the acquisition, which were all recorded in the previous fiscal year. And obviously, that's the working capital rolling out on that.

Adam Shine - *National Bank Financial, Inc., Research Division - MD, Head of Montreal Research and Research Analyst*

Okay. So now I understand how you're looking at it. So I appreciate that, Dana. Another point of clarification, I guess, just relates to costs and synergies. At the time of the Peanuts transaction, the expectation was sort of $5 million synergies per year times five years, right? And right now you're talking about $11 million sort of $5 million plus, call it, $5.8 million or $6 million by the end of 2019. So shouldn't we really be tracking towards a $16 million figure by the end of 2019? Maybe give some of the puts and takes on cost savings and synergies?

Dana Landry - *DHX Media Ltd. - CEO*

Yes, excellent. Happy to provide some clarity on that. So you're right. So when we originally announced we had two targets. $5 million Peanuts target and the $25 million Peanuts target over five years. So, so far, on that $25 million target, we've achieved -- we've got line of sight on $11 million. And$11 million on the cost side, which includes some SG&A cuts of about $6 million will be in full affect by end of 2019. The balance, let's call it, roughly$14 million will cascade over the next five years as individual agency contracts come off from the outside parties and into DHX's CPLG. And so it's not unfortunately a perfect $5 million per year, so that the cascading of the balance will come over that five-year period to get to the total of $25 million.

Operator

And the next question comes from Eric Wold of B. Riley.

Eric Christian Wold - *B. Riley & Co., LLC, Research Division - Senior Equity Analyst*

First question, I guess, give a sense of how much revenue, if anything, generated in the first quarter, was previously expected to be generated in fourth quarter kind of got pushed on the timing into Q1?

Dana Landry - *DHX Media Ltd. - CEO*

Maybe what I'll do, if you don't mind, is I'll ask Keith to have a look at that, and we'll come back to that. And maybe we'll queue back up. Nancy, can you make sure that we get back into that?

Nancy Chan-Palmateer - *DHX Media Ltd. - Director of IR*

Yes.

Dana Landry - *DHX Media Ltd. - CEO*

So maybe we'll ask you to maybe go onto the second question, while Keith looks in to that.

Eric Christian Wold - *B. Riley & Co., LLC, Research Division - Senior Equity Analyst*

Sure. And then just secondly, kind of larger picture, kind of with Peanuts and Strawberry Shortcake, where are you on negotiations with where we can just kind of other licenses, contracts to give more of an opportunity to kind of accelerate the move of Peanuts and Strawberry Shortcake into your WildBrain platform or new content development that doesn't infringe on contracts that were in place prior to the acquisition?

Dana Landry - *DHX Media Ltd. - CEO*

So just to be clear, your question was related to where are we with respect to the acceleration of content on WildBrain for Peanuts?

Eric Christian Wold - *B. Riley & Co., LLC, Research Division - Senior Equity Analyst*

Well, yes. (inaudible) some of the previous license part of the acquisition kind of had you -- restricted you from your new content development that you'd have free to kind of license to anyone else is kind of in someone else's hands or to pull the digital rights for Peanuts onto the AVOD platform given where currently it's held? I just want to get a sense of it.

Dana Landry - *DHX Media Ltd. - CEO*

I see. Okay. So yes, when we acquired Peanuts, there was -- we obviously stepped into the shoes of a number of various contracts. We've gone through all those and brought in-house as many as possible. And we were at the market in October licensing those out. So we've already started to do that on the, let's call it, the traditional side. And on the digital side, where rights were available in each territory, there we've already started to go through WildBrain and we're already starting to see some synergies come out of that. In terms of new content, we're obviously working with the family to come up with a plan for that and stay tuned.

Operator

(Operator Instructions) And our next question comes from Bentley Cross of TD Securities.

Bentley Cross - *TD Securities Equity Research - Associate*

First, I wanted to ask on Peanuts. Just -- can you give us a sense of the seasonality? Is it fair to assume that Peanuts is down year-on-year for this reported period?

Dana Landry - *DHX Media Ltd. - CEO*

No, it's exactly on plan. In terms of the -- obviously, there's seasonality with Peanuts as well. And the second, our second and third quarter, so the fourth quarter of calendar and the first quarter are the typically strongest quarters, because -- we're in the licensing business, and obviously, Christmas is a big, big, big factor in this. And so our quarter ended September will typically be a seasonally light quarter for Peanuts as well. It's exactly tracking to plan.

Bentley Cross - *TD Securities Equity Research - Associate*

Okay. Great. And then on the plan, there are a few major hurdles coming up. Maybe you could just talk about any progress you've made so far with the MetLife, and trying to replace those revenues?

Dana Landry - *DHX Media Ltd. - CEO*

So first of all, I want to make sure that everyone is aware that we normalized the MetLife contract out of our acquisition costs. So we didn't pay for that. That's important to point out, number one. Number two, we've got a series of individual discussions going on in each and every territory of the world that -- to try to replace that. There is timing issues with respect to when those would be able to come to be agreed to because the MetLife deal goes another couple of years or so. So we'll be able to update in the coming quarters and years on that progress. But we're very optimistic.

Operator

And our next question comes from Adam Shine of National Bank.

Dana Landry - *DHX Media Ltd. - CEO*

Yes, Adam, just give me one sec. I just want to go back to Eric's question -- sorry -- Was it Eric's question? About what the timing difference was. So the total was around $4 million to $6 million depending on how you want to look at it, call it, $5 million. About 75% of that related to distribution and the balance related to production. So sorry for that. Go ahead, Adam.

Adam Shine - *National Bank Financial, Inc., Research Division - MD, Head of Montreal Research and Research Analyst*

Let me just go back, also, to my question on the costs. Let's just use Table nine or Page nine of your deck. So again, we're thinking $25 million of synergies, obviously, subject to timing and not necessarily $5 million per year. And then over and above that, it's going to be the $6 million of SG&A reductions, which I think at the time of Q4 reporting was indicated to be tracking towards sort of $3 million out of the $6 million already realized. So I'm just wondering, should we just be thinking about the realization of actual Peanuts synergies, maybe taking a little bit longer and pushing out into 2019?Because, I think, we might be talking apples-to-oranges?

Dana Landry - *DHX Media Ltd. - CEO*

Yes. So in total -- so good question. So just for -- to be absolutely clear, the total target is $11 million, which includes $5 million from Peanuts, $6 million from SG&A. Of that $11 million, $5.8 million will be annualized synergies at the end for fiscal 2018. The full $11 million, you're right, will then be realized in 2019. The balance of the Peanuts' synergies will cascade through years two, three, four, five of the future.

Adam Shine - *National Bank Financial, Inc., Research Division - MD, Head of Montreal Research and Research Analyst*

Perfect. Okay. I just wanted to clarify that. And then maybe just one more on Mattel. I mean, a lot of noise around Mattel just in regards to its own company-specific issues, we won't touch on some of the rumors over the weekend regarding any Hasbro merger. But, I guess, as I read through the MD&A, its very much business as usual with you as it relates to the specific partnership you have with Mattel, right?

Dana Landry - *DHX Media Ltd. - CEO*

Yes, absolutely. We're seeing incredible engagement on their front. We're very, very encouraged by a number of the shows, in particularly, Polly Pocket and Fireman Sam. We're very excited about those. The others continue to perform. But certainly, no slowdown. In fact, I would say, as fast or even ahead of expectations.

Dana Landry - *DHX Media Ltd. - CEO*

Yes, absolutely. We're seeing incredible engagement on their front. We're very, very encouraged by a number of the shows, in particularly, Polly Pocket and Fireman Sam. We're very excited about those. The others continue to perform. But certainly, no slowdown. In fact, I would say, as fast or even ahead of expectations.

Operator

And our next question comes from Tim Casey of BMO.

Tim Casey - *BMO Capital Markets Equity Research - Equity Research Analyst*

I'm wondering if you could just provide a little color on the discussions you're having with the family with respect to content and some of the other longer-term initiatives. In the context that, I mean, you're also conducting a strategic review, where everything is on the table. And how willing are these partners or potential partners -- how willing are they to engage in long-term discussions when there's -- there's really some uncertainty as to what form the company will be in when these projects would come to the table? I'm just wondering if you could -- there seems to be a bit of a challenge there, I'm just wondering if you could talk to that?

Dana Landry - *DHX Media Ltd. - CEO*

I think I have all of your points here. So I think, what I'll do is I'll first turn to Michael, vis-à-vis the strategic review. And then maybe Michael, I can comment on content and the other aspects of the question.

Michael Donovan - *DHX Media Ltd. - Executive Chairman*

The special committee is conducting a thorough, deliberate, strategic review to explore all options at this point to enhance shareholder value. And this is in the context of this large transaction, which -- and it was on the recommendation of management that we review our strategy going forward in that context. And -- but Peanuts is a core product of our strategy. It's performing as expected. And we're tremendously excited about its growth going forward. Dana?

Dana Landry - *DHX Media Ltd. - CEO*

Thank you, Michael. So in respect of the content side, since the beginning, we've had extraordinarily positive conversations with the family and their advisers and the entire team over there. And it's very much business as usual. Our conversations are accelerating, in fact, we have a new content session happening within the next week or so, and making progress in a number of development initiatives. So we're very optimistic. We'll be able to have some new news on the content side going forward. With respect to the business as usual, what I'll say is, the company is very solid. We're off to a very good start in Q1. We're focused on executing on the business, and we're definitely excited about the positive market environment.

Operator

(Operator Instructions) And our next question comes from Jeff Fan of Scotiabank.

Jeffrey Fan - *Scotiabank Global Banking and Markets, Research Division - Director, Telecommunication Services and Canadian and U.S. Telecom and Cable Equity Research Analyst*

Just a quick one, actually, it's with respect to your balance sheet. Do you -- with the new debt that's coming in on the acquisition, you've got some countermeasures. I think there is 7.25 right now on net leverage. But they are stepping down by, I think, half a turn starting next year and then continue to step down after that. Just wondering based on your guidance, where do you expect to end up, I guess, either at the end of fiscal 2018 or September 2018? Can you just give us some sense of where you think you can end up in terms of leverage over the next 12 to 24 months?

Dana Landry - *DHX Media Ltd. - CEO*

So I think, what we have publicly stated and what we're going to stick to is that management is 100% aligned and committed to our target of 3.5x by fiscal 2019. Obviously, the definition -- our definition of 3.5x is total net debt to forward EBITDA at that moment, which is 2020. We're going to focus on both sides. Growing the EBITDA by cutting costs, continue to execute on our cost-reduction program, realizing our synergies on Peanuts and continuing to grow revenue through WildBrain and the new content that we have coming online. In terms of -- we won't be commenting on any targets over the next 12 months or so.

Operator

And our next question comes from Bentley Cross of TD Securities.

Bentley Cross - *TD Securities Equity Research - Associate*

I suspect, I know you answered this one, but I'm going to ask anyway. Michael, you said that you will give us some information when the process is complete on the strategic review. Any idea of when that might be? Or how long you expect the process to take?

Michael Donovan - *DHX Media Ltd. - Executive Chairman*

Okay. Yes. The special committee will take the time it takes to conduct a thorough review. And we will not discuss the details of the process other than to say that the special committee is conducting a thorough, and I believe, excellent process. And we're committed to exploring all options to enhance shareholder value. We'll update shareholders when the process is complete.

Operator

And our next question comes from Rob Goff of Echelon.

Robert Goff - *Echelon Wealth Partners Inc., Research Division - MD, Head of Research, and Telecom Services & New Media Analyst*

Dana, you had the comments with respect to production, where you said now at a steady state of production. And you also commented that your net content would naturally -- net content investment would naturally moderate. Could you address that within the context of your guidance of net investment in film and television programming of $20 million to $30 million? I would take it as a confirmation of that guidance.

Dana Landry - *DHX Media Ltd. - CEO*

Yes, that's exactly it, Rob. You'll recall over the last couple of years, we were in excess of net $50 million of investment. But we now have, we believe, the shows that we need, and so we've started to moderate that. As we said in our script, that back to a steady state of production. And we're looking forward to having increased returns on those investments in near quarters.

Operator

And I'm showing no further questions at this time. I'd like to turn the conference back over to Nancy Chan-Palmateer for any further remarks.

Nancy Chan-Palmateer - *DHX Media Ltd. - Director of IR*

Thank you very much, everyone, for joining us today. And we look forward to updating you at our next quarterly call. Thank you. Have a good day.

Dana Landry - *DHX Media Ltd. - CEO* Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone, have a great day.

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