Review

Edison investment research

11 October 2010

Arsenal Holdings plc

Year End	Revenue (£m)	PBT* (£m)	EPS* (£)	DPS (p)	P/E (x)	Yield (%)
05/08	223.0	36.7	413.49	0.0	26.8	N/A
05/09	313.3	45.5	566.24	0.0	19.5	N/A
05/10	379.9	56.0	980.31	0.0	11.3	N/A

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items.

Investment summary: Easy on the eye

Despite justifiable satisfaction with the FY10 results, the very success of Arsenal's "non-recurrent" property and player trading risks showing up the more prosaic core football business, whose profit declined. Encouragingly, management is firmly on the case, intent on stepping up relatively undeveloped commercial activities, and the newly-revitalised balance sheet is in tune with a market subject to increasing financial regulation. Meanwhile, a good start to FY11 and a boost from new TV contracts is tempered by likely lower property and transfer gains and a hike in wage costs.

Impressive performance

In the year to May bumper contributions from property development and player trading delivered a record pre-tax profit and a striking reduction in net debt, which is now long-term and fixed-rate and barely 50% of shareholders' funds. Given straitened times, fewer home games and sustained wage pressure, football proved less buoyant, albeit resilient (EBITDA down by just 9%). Higher finance costs despite reducing debt largely reflected lower interest receivable owing to depressed rates. Since 2007 the Club has been a net seller in the transfer market.

Mixed outlook

The current year may be one of mixed fortunes as healthy season ticket subscriptions, higher broadcasting income from new Premier League contracts and (hitherto) on-field strength are offset by "significantly" increased wage costs owing to squad investment, likely lower player disposal profits after a quiet summer in the transfer market and an inevitable fall in property gains as the stadium project completes. Retail and commercial activities face consumer spending pressures while low interest rates will not reward cash generated by residual property completions.

Valuation

An uncertain profit outlook suggests that the investment case may continue to be driven by takeover considerations, however specious. There has been no material change in major shareholdings (over 10%) since May 2009.

Price	£11,050
Market Cap	£687m

Share price graph

Share details

Code	AFC
Listing	PLUS
Sector	Leisure, Entertainment & Hotels
Shares in issue	62,217

Price

High	Low
£11,050	£9,000

Balance Sheet as at 31 May 2010

Debt/Equity (%)	53
NAV per share (£)	4,103.73
Net borrowings (£m)	135.6
Gross borrowings (£m)	263.2

Business

Arsenal Holdings plc operates a professional football club, Arsenal, with related commercial activities, and carries out property development, associated with its move to the Emirates Stadium.

Revenues by geography

UK	Europe	US	Other
100%	0%	0%	0%

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This report has been commissioned by the Arsenal Supporters' Trust

Investment summary: Easy on the eye

Arsenal Holdings plc operates a professional football club, Arsenal, with related commercial activities, and carries out property development, associated with its move to the Emirates Stadium from Highbury. The Emirates Stadium, which opened in July 2006 at a cost of £440m, has capacity for 60,000 spectators and 150 executive boxes (48 at Highbury). Arsenal has won 13 League Championships and 10 FA Cups, including three League and FA Cup ‘doubles’, as well as qualification for the UEFA Champions League for the past 13 years.

World class

As European football becomes more polarised (the leading 20 clubs account for 25% of the market), Arsenal is more readily viewed against its fellow international majors than the confines of the Premier League (apart from Arsenal, only Liverpool, Manchester United and the three newly-promoted clubs were profitable at the operating level in 2008/09).

Exhibit 1: Leading football clubs by football-related revenue (season 2008/09)

Note: * Converted at €1.17/£ (30 June 2009).

	£m *	Year-on-year change (constant currency)
Real Madrid	342	+10%
FC Barcelona	312	+18%
Manchester United	278	+8%
Bayern Munich	247	-2%
Arsenal	222	+7%
Chelsea	206	-3%
Liverpool	185	+10%
Juventus	173	+21%
Internazionale	167	+13%
AC Milan	167	-6%

Source: Deloitte Football Money League (March 2010)

Arsenal is confident that it can comply with new UEFA regulations (“Financial Fair Play”) aimed at restoring stability to European football club finances. After a phased implementation, a “break-even requirement” will apply to 2012 financial statements, obliging clubs to spend no more than they generate over a rolling three-year period. In addition, no “overdues” (eg on transfers) will be payable during the season and disclosure and communication of financial information will be enhanced.

Notwithstanding a prudent and strikingly successful record in the transfer market (since 2007 a net seller at considerable gain without detriment to playing performance), the Club is reassuringly aware of the need to build up its core football activity, notably through development of commercial revenues (barely 15% of income, which is low relative to its peers), since recent wholesale debt reduction has been driven by “non-recurrent” property and player trading.

Management is similarly restrained in respect of wage costs despite continued pressures. Its wage/revenue ratio of 46% in FY09 (up to 50% last season) compared with 75% in Italy’s Serie A and 67% in the Premier League, where inflation was fuelled by clubs looking to secure Champions League qualification or avoid relegation.

Sterling performance in FY10

Exhibit 2: Revenue and profit analysis

Note: * Fees from player loans.

Y/E May (£m)	2008	H109	H209	FY09	H110	H210	FY10
Turnover							
Gate + other match day	94.6	44.4	55.7	100.1	41.4	52.5	93.9
Change	+4%	+8%	+4%	+6%	-7%	-6%	-6%
Broadcasting	68.4	28.9	44.3	73.2	35.4	49.2	84.6
Retail	13.0	8.0	5.9	13.9	7.4	5.2	12.6
Commercial	31.2	16.3	18.0	34.3	15.9	15.5	31.4
Football	207.2	97.6	123.9	221.5	100.1	122.4	222.5
Change	+12%	+10%	+5%	+7%	+2%	-1%	flat
Property development	15.3	58.4	29.9	88.3	96.6	60.3	156.9
Player trading	0.5	0.8	2.8	3.6	0.1	0.4	0.5
Total	223.0	156.8	156.5	313.3	196.8	183.1	379.9
Change	+11%	+62%	+24%	+40%	+25%	+17%	+21%
EBITDA							
Football	59.6	23.5	39.2	62.7	18.0	38.8	56.8
Change	+41%	+7%	+4%	+5%	-23%	-1%	-9%
Property development	-	6.3	1.5	7.8	11.3	3.9	15.2
Sub-total	59.6	29.8	40.7	70.5	29.3	42.7	72.0
Change	+16%	+22%	+16%	+18%	-2%	+5%	+2%
Player trading	5.2	8.0	(5.1)	2.9	20.8	(7.2)	13.6
Turnover *	0.5	0.8	2.8	3.6	0.1	0.4	0.5
Amortisation of player registrations	(21.8)	(11.4)	(12.5)	(23.9)	(13.2)	(11.8)	(25.0)
Gain on disposal of player registrations	26.5	18.6	4.6	23.2	33.9	4.2	38.1
Total	64.8	37.8	35.6	73.4	50.1	35.5	85.6
Depreciation	(11.6)	(5.8)	(5.9)	(11.7)	(6.0)	(5.9)	(11.9)
Trading profit	53.2	31.9	29.8	61.7	44.1	29.6	73.7
Joint venture	0.5	0.4	neg.	0.4	0.3	0.2	0.5
Net interest	(17.0)	(7.8)	(8.8)	(16.6)	(9.2)	(9.0)	(18.2)
Pre-Tax Profit	36.7	24.5	21.0	45.5	35.2	20.8	56.0
EBITDA Margin (%):							
Football	28.8	24.1	31.6	28.3	18.0	31.7	25.5
Total pre-player trading	26.7	19.0	26.0	22.5	14.9	23.3	18.9

Source: Arsenal Holdings plc accounts

Football

As per the above table (Exhibit 2), the half to May followed the pattern of H1 in terms of activity, if not profitability. Match day revenue suffered from four fewer home games (-1 in H1) rather than from a fall in average paid attendance, which was up marginally for the full year. The reduction in home fixtures also duly affected retail, whose revenue was down by 9% (-7% in H1), compounded by the difficult consumer climate. By contrast, broadcasting revenue was again well ahead (+15% in FY10), boosted by a revised UEFA contract, which widened income distribution to the play-off round in the Champions League, as well as by greater domestic TV coverage. Total segment revenue was thus broadly flat in H2, as in H1, which is impressive in such circumstances.

However, EBITDA for the full year was down by 9%, principally because of a hike in wage costs in line with management's policy of re-signing key players (17) to long-term contracts. Encouragingly, implementation has served not only to protect material Club assets but did not breach management's (undisclosed) target range for the wage/revenue ratio despite rising from 46% to 50% in the period (49% in FY08 and 51% the year earlier). Non-wage expenses held steady at c £55m as lower direct costs associated with fewer home games were matched by increased stadium maintenance and tax administration costs.

Property development

During the year the Club sold 81% of 447 apartments at Highbury Square unsold at May 2009. This justifies management's description of segment progress in the year as "remarkable." EBITDA from these sales all but doubled to £19m, reflecting higher unit profitability despite lower average selling prices (c £370,000 against c £420,000 in FY09). Moreover, sale proceeds eliminated the related bank loan (£5m net cash by May 2010), such that remaining completions (85 at the start of the year – 52 at late September) can produce cash (we estimate c £30m, ie 85 sales x £370,000, the average price achieved in FY10) for re-investment in the team and Club infrastructure. NB this does not include c 20 units from an in-fill project on the Highbury site, which are due for completion this year.

The group's other material property asset is its site with planning permission for 375 market-priced apartments at Queensland Road (the social housing element there was sold during the year). Sale completion is not expected in the near term.

Player trading

A record profit (up by 64% on FY09) from the sale of player registrations, principally those of Adebayor and Toure to Manchester City, contributed to a substantial gain in EBITDA in spite of much higher amortisation in the wake of a 50% rise in spend on new players and contract extensions in the previous year.

Cash flow

Exhibit 3: Cash flow analysis

Year-end May (£m)	2008	2009	2010
Trading profit (before gain on disposal of player registrations)	26.7	38.5	35.5
Depreciation	11.5	11.7	11.9
Amortisation of player registrations	21.8	23.9	25.0
Working capital	(81.0)	(11.8)	104.2
Operating cash flow	(21.0)	62.3	176.6
Net interest	(19.6)	(17.7)	(17.6)
Taxation	(4.2)	(7.6)	(6.3)
Capital expenditure	(6.9)	(2.9)	(5.3)
Player registrations	4.0	(12.3)	15.9
Other movements	(2.2)	(1.4)	(1.2)
Net debt change	(49.9)	20.4	162.1
Net (debt) cash	(318.1)	(297.7)	(135.6)
Retained profit	25.7	35.2	61.0
Shares issued	-	-	-
Currency effects	-	-	-
Closing shareholders' funds	159.1	194.3	255.3
Gearing	200%	153%	53%

Source: Arsenal Holdings plc accounts

FY10 saw a step-change in the group's finances as full repayment of £130m property bank loans, courtesy of the successful apartment sales programme, drove a reduction in year-end net debt from £298m to £136m. As shown in Exhibit 3 above, the active sale of development properties (stock) ensured a strongly positive movement in working capital (negative in the previous two years), while net cash from transfers (player registrations) of £16m mirrored a net outflow of £12m last year. Trading cash flow was otherwise broadly neutral during the period, compared with estimated c £50m negative in FY09 on a like-for-like basis, ie excluding property sale proceeds and transfers.

Group debt is now effectively long-term and fixed-rate, comprising £237m stadium finance bonds (over 21 years and at 5.3%) and £26m debenture loans (roughly half over 132 years and interest-free, the remainder over 18 years and at 2.75%). Cash rose by £28m to £128m (c 25% held on deposit as security against future debt and interest payments) because of stronger season ticket renewals at the period end and a policy of accumulation now that short-term borrowings have been eliminated, ie the stadium bonds are to be repaid according to their fixed long-term schedule (currently c £6m pa), hence no anticipated material cut in c £260m gross debt in the medium term.

As a counter, the balance sheet at May 2010 showed a carrying value of £434m in respect of fixed assets and £60m for players NB this is after amortisation, so does not reflect the players' current market value, which the directors consider to be "significantly higher," and does not include players developed through the Club's youth system.

Sensitivities

- The Group's income is significantly affected by the performance and popularity of the Club's first team and by its ability to retain and attract the highest quality playing and coaching staff. As insurance of members of the first team squad may not be enough to cover all financial loss, so employment contracts with key personnel cannot guarantee retention in a highly competitive domestic and European market, which may require the Club to follow trends in market rates for wages and transfers in order to maintain the strength of its squad, albeit mitigated by recruitment through the Academy.
- The Club is subject to external governing bodies such as the FA, Premier League, UEFA and FIFA. There could be material impact from any change in regulations relating, for example, to the format of competitions, the division of broadcasting income, the eligibility of players and the operation of the transfer market. The Club is dependent on the Premier League brand.
- Significant revenue is derived from sponsorship and other commercial relationships. Risk is moderated by the Group's aim for long-term arrangements with key partners, eg naming rights and shirt sponsorship contracts with Emirates Airline, which expire in 2021 and 2014 respectively.
- There is no direct influence on broadcasting contracts negotiated centrally between the Premier League and UEFA. The current Premier League TV contract runs until the end of the 2012/13 season.
- There is foreign exchange exposure, mainly through the Club's participation in European competition and player transfers.
- Income from the sale of property development assets may be affected by conditions in the mortgage lending sector and the supply and pricing of local properties.

Valuation

An uncertain profit outlook suggests that the investment case may continue to be driven by takeover considerations, however specious. Major shareholdings (over 10%) are Stan Kroenke 29.98%, Red and White Securities (co-owned by Alisher Usmanov, co-owner of Metalloinvest) 26.83%, D D Fiszman 16.11% and Lady Nina Bracewell-Smith 15.90%. There has been no material change since May 2009.

Exhibit 4: Financials

£'000s	2008	2009	2010
Year end 31 May	IFRS	IFRS	IFRS
PROFIT & LOSS			
Revenue	222,970	313,399	326,800
EBITDA	64,744	73,372	85,603
Operating Profit (before GW and except.)	53,191	61,690	73,688
Exceptional Items	0	0	0
Amortisation of Acquired Intangibles	0	0	0
Associates/JVs	469	455	463
Operating Profit	53,660	62,145	74,151
Net Interest	(16,992)	(16,633)	(18,183)
Profit Before Tax (norm)	36,668	45,512	55,968
Profit Before Tax (FRS 3)	36,668	45,512	55,968
Tax	(10,942)	(10,282)	5,024
Adjustment to tax for normalised earnings	0	0	0
Profit After Tax (norm)	25,726	35,230	60,992
Profit After Tax (FRS 3)	25,726	35,230	60,992
Minority charge	0	0	0
Average Number of Shares Outstanding (m)	0.1	0.1	0.1
EPS - normalised (£)	413	566	980
EPS - normalised fully diluted (£)	413	566	980
EPS - FRS 3 (£)	413	566	980
Dividend per share (p)	0.0	0.0	0.0
EBITDA Margin (%)	29.0	23.4	26.2
Operating Margin (before GW and except.) (%)	23.9	19.7	22.5
BALANCE SHEET			
Fixed Assets	505,588	509,545	496,208
Intangible Assets	55,665	68,446	60,661
Tangible Assets	449,517	440,369	434,494
Investments	406	730	1,053
Current Assets	328,725	323,864	240,466
Stocks	189,182	168,758	47,642
Debtors	46,279	55,489	65,217
Cash	93,264	99,617	127,607
Current Liabilities	(334,252)	(314,096)	(154,835)
Creditors	(191,417)	(179,994)	(149,587)
Short term borrowings	(142,835)	(134,102)	(5,248)
Long Term Liabilities	(340,961)	(324,983)	(326,517)
Long term borrowings	(268,502)	(263,195)	(257,998)
Other long term liabilities	(72,459)	(61,788)	(68,519)
Net Assets	159,100	194,330	255,322
CASH FLOW			
Operating Cash Flow	(21,013)	62,305	176,560
Net Interest	(19,655)	(17,689)	(17,649)
Tax	(4,177)	(7,622)	(6,294)
Capex	(6,944)	(2,950)	(5,342)
Acquisitions/disposals	4,010	(12,335)	15,903
Financing	0	0	0
Dividends	0	0	0
Other	(2,097)	(1,316)	(1,137)
Net Cash Flow	(49,876)	20,393	162,041
Opening net debt/(cash)	268,197	318,073	297,680
HP finance leases initiated	0	0	0
Other	0	0	0
Closing net debt/(cash)	318,073	297,680	135,639

Source: Arsenal Holdings plc accounts

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