EQUITY RESEARCH
SAGA PLC – IPO- BUY

COLLINS SARRI STATHAM
INVESTMENTS

Research Report
ADVISORY SERVICES

Report Date

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Analyst

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Collins Sarri Statham Investments Ltd

Stock Rating: BUY

Target Price................ 260p
Offer Price.........185p-245p
Yr Hi/Low:.....................NA
Shares o/s.................1.067bn
Market Cap...............£2.61bn
Avg Daily Vol.....................NA
Dividend Yield..............NA
Fiscal Year......31Jan.2015
Website: www.saga.co.uk

Key Risks to Price Target

Saga is exposed to underwriting risks, and risks relating to the adequacy of reserves to cover claims.

Changes to EU rules on General Data Protection Regulation could impact Saga

IPO investors are likely to see their applications scaled back and the Board have retained considerable flexibility on the IPO price.

Saga is a diversified conglomerate offering holidays, healthcare insurance and financial and legal services primarily targeting middle aged/ elderly demographic groups.

Strong IPO subscription expected

Saga's extensive marketing efforts, alongside a strong IPO market have led to 700k retail investors declaring an interest in its IPO. This significant private investor interest suggests aggressive pricing at the high end of the indicated range of 185p-245p. Our expectation is the IPO will be priced between 240p-245p per share.

The rather long timeframe for dividends (June 2015 40%-50% payout ratio target but "no guarantees will pay a dividend") means Saga customers are being offered the incentive of one free Saga share for every 20 still held on the one year IPO anniversary. This non-cash dividend appears also an attempt to build a loyal private client shareholder base. The short term effect of this policy could make it harder for institutions to acquire a sufficient weighting ahead of FTSE 250 entry.

Grey market indications, which are highly variable; www.ig-com.uk suggest a debut price of 252p (242p/262p) we would suggest an opening 6% premium is possible. There will be a heavy scaleback of applications. In our view the minimum investment of £1,000 is likely to be heavily scaled back – at least by 50% in our view.

A brief reminder of the IPO timetable:-
Latest time for receipt of applications; 20th May 2014
Announcement of IPO pricing: 23rd May 2014
Admission to Official List: 29th May 2014

The Offer is structured as an i) institutional offer in the UK and overseas ii) a retail offer to a)eligible customers b) non customers c) an Intermediaries offer d) Saga employee offer. In the case of oversubscription, preference will be given to the applications in the Saga customer offer and Saga employee offer.

The selling owner Acromas Bidco is disposing of 18% of its interest its post IPO holding is subject to a 180 day lock up period.

Exposure to the ageing demographic

Much is made of Saga's focus on the 50+ age group in its literature. Saga's exposure to the trend towards accelerating wealth inequality due to the elderly's high property wealth is its key USP. According to Savills c.£1trn of housing equity is in the hands of over 65s; by contrast under 35s own one tenth of that exposure. According to the long form prospectus, Saga's "target demographic" of over 50s 22.8m individuals in 2013 is forecast to grow by 30% to 29.1m by 2033 (Office of National Statistics) with a 29% growth in the 65 to 75 age group. However Saga's key operating areas, tour operations, financial services/ insurance/ healthcare are highly competitive regardless of client particulars. We would caution against extrapolating corporate success primarily due to client's age demographic largely due to the speed of technological change and inherent underwriting risks.

High operational gearing valuation

Saga's high operational sensitivity means revenue growth will be amply rewarded with profit growth. The table below demonstrates 2014's sensitivity i.e a £200m revenue increase (15.8%) would lead to 46.3% net profit growth. Saga's revenues have gyrated in recent years (2012: £1.175bn 2013 £1.314bn 2014 £1.257bn).

FY2014 Net Profit Sensitivity Analysis							SAGA
						Taxation	26.50%
Sales (£m)	MGN (bps)			Profit After Tax (£m)			
	0	-50	-100	-150	-200	-250	-300
£1,260	108	107	105	103	102	100	99
£1,310	121	119	117	115	113	112	110
£1,360	133	131	129	127	125	123	121
£1,410	145	143	141	139	137	134	132
£1,460	158	155	153	151	148	146	143
£1,510	170	167	165	162	160	157	155
£1,560	182	179	177	174	171	169	166
£1,610	195	192	189	186	183	180	177
£1,660	207	204	201	198	194	191	188
£1,710	219	216	213	209	206	203	200
£1,760	231	228	225	221	218	214	211
£1,810	244	240	236	233	229	226	222
£1,860	256	252	248	245	241	237	233
£1,910	268	264	260	256	252	248	244
£1,960	281	277	272	268	264	260	256
£2,010	293	289	284	280	276	271	267

Source; CSS Investments Ltd

Assuming revenue gains of £150m this equates to EPS in the range of 12.4p-13.6p for FY2015.

EPS FY15	MGN (bps)						SAGA
						O/S Shares	1067.35
Sales				EPS (p)			
	0	-50	-100	-150	-200	-250	-300
£1,252	10.2	10.0	9.8	9.7	9.5	9.4	9.2
£1,302	11.3	11.1	11.0	10.8	10.6	10.5	10.3
£1,352	12.5	12.3	12.1	11.9	11.7	11.5	11.3
£1,402	13.6	13.4	13.2	13.0	12.8	12.6	12.4
£1,452	14.8	14.5	14.3	14.1	13.9	13.7	13.4
£1,502	15.9	15.7	15.4	15.2	15.0	14.7	14.5
£1,552	17.1	16.8	16.6	16.3	16.1	15.8	15.5
£1,602	18.2	18.0	17.7	17.4	17.1	16.9	16.6
£1,652	19.4	19.1	18.8	18.5	18.2	17.9	17.6
£1,702	20.5	20.2	19.9	19.6	19.3	19.0	18.7
£1,752	21.7	21.4	21.0	20.7	20.4	20.1	19.7
£1,802	22.8	22.5	22.2	21.8	21.5	21.1	20.8
£1,852	24.0	23.6	23.3	22.9	22.6	22.2	21.8
£1,902	25.1	24.8	24.4	24.0	23.6	23.3	22.9
£1,952	26.3	25.9	25.5	25.1	24.7	24.3	23.9
£2,002	27.5	27.0	26.6	26.2	25.8	25.4	25.0

Source: CSS Investments Ltd

Premium valuation, but what does IPO achieve?

We assume for valuation purposes a "worst case" £2.61bn valuation (ie. 245p IPO) hence the IPO historic P/E of c 23.8x a significant premium to FTSE 100 (13.8x) FTSE 250 (19.26x) and the FTSE Travel & Leisure sector at 20.85x.

Saga's earnings multiple imply it is a high profit growth business achieving to the order of 20%+ annual profit growth. In fact Saga net profits have grown from £108.2m in 2012 to £109.6m in 2014 coming off a hiatus of £113.3m in 2013. This very stagnant level of profit growth (sub 1% pa) now faces a new major headwind in the form of listed company costs.

Another problem is the lack of precise listed comparable companies i.e. one with a similar mix of high end holidays/ personal finance/ insurance/ media targeting the elderly. It is not difficult to see forecasting problems due to the many moving parts within the Saga structure, divisions operating in different business cycles.

A further qualm we have is this. Saga will raise £550m before expenses (£37.6m) from the Offer which will also monetise the Acromas shareholding giving the owner a partial exit. But what precise benefit does the IPO deliver for Saga? The key positives listed are, according to Saga a) increased publicity for Saga that will strengthen the brand b) the Retail offer will add additional contactable names for the Marketing Database and c) repay £512.4m debt "the senior facilities agreement". Saga has current financial indebtedness of net £645.7m but this will shrink to under £150m post IPO hence save £8.5m in interest expense – (gain 0.8p EPS) but we expect half of this will be lost by listing costs.

But it seems an opportunity is being lost to make acquisitions where revenue growth has been slow in recent years specifically in Travel, Financial services (growth c2%). How and when will top line growth revive?

The material risk factors point out data protection and new EU rules "EU General Data Protection Regulation" on the transferability and use of consumer data. Saga Group Marketing Database ("over 1bn lines of data for 10.4m contactable names") is a key factor in the cross sell business model but to what extent is that database at risk?

Conclusion

There is an element of opportunism about all IPOs and Saga is no exception. Certain categories of IPO subscriber are being treated more favourably than others. New shareholders will have to contend post IPO with Acromas holding at least 41% post IPO - a controlling interest. This raises the governance point, but as a newly listed co shareholders have no governance track record to look at.

Overall Saga should benefit from strong UK GDP growth/ UK property prices in 2014. Saga's high operational gearing should work in its favour and deliver revenue gains if the IPO brings onboard new marketing opportunities. Our expectations would be pro-forma EPS of c. 13p for FY15.

We expect technical factors and high retail oversubscription to provide key share price drivers in the short-term. We would be more cautious for longer term investors – and expect the valuation to start reflecting Saga's revenue challenges before long.

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