EQUITY RESEARCH
ARSENAL HOLDINGS PLC (NEUTRAL)

COLLINS SARRI STATHAM
INVESTMENTS

Research Report
ADVISORY SERVICES

Report Date

5 May 2016

Analyst

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Collins Sarri Statham Investments Ltd

Stock Rating: NEUTRAL

Target Price................ NA
Share Price(Mid)...£15,715
Yr Hi/Low:......£16k/ £15k
Shares o/s....................62,217
Market Cap.............£977.7m
Avg Daily Vol..........2 shares
Dividend Yield...............0%
Fiscal Year......31May.2016
Website: www.arsenal.com

Key Risks

i) Very low free-float, ongoing corporate governance issues, weak cash generation

ii) Sensitive to inflationary trends in player costs and prices

iii) Asset risks; departure of key personnel and management.

Please note the risk warnings and disclaimers on the last page of this document.

Arsenal Holdings is a UK based football club. The club have won the most FA Cups of any English club since it was founded in 1886.

Arsenal is different…very different

*Arsenal Holdings (ISDX:AFC) reported weak interim results, with net loss of £3.4m. Partly this was attributable to negligible profits from player sales £0.3m v £26.7m (H1 2015). The board gave a cautious outlook mentioning the uplift in revenues from the Premier League broadcasting but higher costs in the form of inflationary wage pressures and transfer prices.

***<u>Due to the structural issues identified below, our view is Arsenal is not investable for the general public, the fact its ISDX quotation has survived is anomalous</u>.**

*Revenue growth to end May 2016 is seen as muted given no change in gate/ match day income and the drop off in property development/ player trading. Our forecast is for revenue growth of 2% in FY2016 to £351.5m.

*The heavy investment in players has already hit cash levels quite hard. We expect a £44.4m spend on player registrations over FY16. In our forecast for FY16 we anticipate a net profit of £3m.

*Arsenal has significant levels of cash but net levels are far lower limiting the club's spending – we estimate Arsenal has around £54m of cash that could be deployed on new players (assuming the board tap the £50m overdraft facility).

Structural issues….

"Spend more money on players" is an often heard criticism of Arsène Wenger and of the Arsenal board of directors who include Sir Chips Keswick and majority shareholder Stan Kroenke. Fans tend to have a short term focus, understandably.

Since Mr Wenger was appointed in 1996, Arsenal has been transformed from reliance on gate receipts to diverse income streams. Arsenal has rapidly grown broadcasting, commercial and retail revenues. Widely credited for cultivating talent internally rather than throwing money at the transfer market, Wenger has demonstrated a financial acumen lacking in the premier league. Numerous club rescues has amply demonstrated the pitfalls of the sector's profligacy. Since Mr Wenger's appointment the Arsenal share price has jumped a staggering 40 fold from £400 to £16000 per share. This is a highly commendable achievement.

Fan criticism tends to ignore the significant "structural issues" at Arsenal notably that it is essentially a controlled subsidiary. Stan Kroenke's KSE UK Limited holds 66.8% of Arsenals 62,217 shares whilst Alisher Usmanov holds 30.05% – the listed shares are a tiny minority interest. Relations between shareholders are reported to be limited. Mr Usmanov has left the board and KSE UK to their own devices. Shareholders are treated differently, KSE receives a £3m annual payment but shareholders receive zero dividend. Player spending decisions are in the hands of the board which include KSE representatives.

By remaining on the ISDX (ICAP Securities & Derivatives Exchange) Arsenal is subject to relaxed corporate governance standards. Kroenke is under no pressure to take full 100% control nor split Arsenal shares. He is required under takeover rules to buyout other holders if his stake hit 75%. This does not appear to be Kroenke's short term plan however especially as Mr Usmanov appears happy with the status quo. The quote as such is extremely illiquid and given the current ownership structure unlikely to change.

Arsenal working capital realities

The Arsenal balance sheet at the interims (2nd March 2016) suggests grounds for reticence on player spending. Broadly:-

a) **Working capital pressures**; Arsenal's cash (£159.4m) + receivables (£52.5m) = **£211.9m**; short term payables (payments < 12 months) = **£206m**. We have ignored £4m inventories and £11m development property in this determination due to realisation issues.

Of Arsenal's £159.3m total cash, this is comprised as cash (£75.3m) and cash equivalents (£84m) i.e. in short term reserve accounts. Due to Arsenal's cash collection being second half based (season ticket renewals in May/ April / higher player days, Champions payments) the cash levels should rise strongly by the 31 May 2016 year end. The Champions League payment of £20m was more uncertain this year than in previous years.

Cash flow from operations:-	£85.1m (the business operations)
Cash flow from investing activities:	-£73.4m (player / property spending)
Cash flow from financing;-	-£11.8m(mortgage/bond repayments)
Net change in cash:-	-£0.1m

Opening cash: (31 May 2015)	£228.1m
+/- Net change in cash	-£0.1m
Total cash y/e (31 May 2016)	£228m

- Mortgage/ Bond collateral requirement	£ 32m
- Short term payables (net of receivables)	£191.9m
+ Overdraft facility	£50m
= **Cash availability for players**	**£54.1m**

Working capital levels suggest £54m is available for player investment, possibly spread over 2 years**.**

b) **"Player churn" ie sale & purchase** activities was a heavy cash drain on Arsenal during H1.

Gross cash flows – player registrations (source: Arsenal Interims 2016)
Net proceeds from sales; £7.8m
Net payments for purchases: £47.2m
Hence Net cash outflow: £39.4m

Since the interims, the club has signed Mohd Elneny (c £5m) and prior to 31 May 2016 we expect three player contracts (3x £80k per week) to roll off contract. This reduces player expenses but does not increase player proceeds. Hence the 2016 year should show a net cash outflow approximating £44.4m. We note speculation of further short-term large ticket player purchases (Granit Xhaka - £35m). However the transfer window will open on 1st July ie post Arsenal's FY2016 year end.

c) **Player wage inflation**; Our forecast assumes £194m for FY 2016 given the board's warning at the interims, FY15 expense of £192.2m). Maybe this is a relatively generous estimate. It is possible player wage inflation will see expenses rise to nearer £200m though we would not expect more than a 5% adverse movement (i.e. £203.7m).

d) **Is Arsenal going to generate cash?** We expect closing cash of £228m. We do not think Arsenal can generate significant cash without player trading profits.

e) **Arsenal long term asset/debt position?** This is comfortable albeit with high average financing costs (5.9%). Arsenal has high 71% proportion of expensive fixed coupon/ fixed term debt it can do very little about, unless it draws down its £50m credit facility (this is unlikely) to fund a tender offer for the expensive high coupon bond. The fixed rate debt term at 13.5 years provides considerable flexibility for Arsenal. The problem with the capital structure is the mortgage terms cannot be flexed to the current very low rate environment.

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Income Statement forecast for FY2016

Based on the board's commitment to leave ticket/ gate prices alone, we have generated a forecast sales revenue and income statement for FY16 (ending 31 May 2016):-

Sales Revenues	**2014**	**2015**	**2016F**
Gate & Match Days	100,229.00	100,401.00	102,000.00
Broadcasting	120,762.00	124,844.00	131,086.20
Retail & Licensing	17,938.00	24,685.00	28,387.75
Commercial	59,216.00	78,602.00	86,462.20
Property Development	3,214.00	15,187.00	2,130.00
Player Trading	513.00	805.00	1,452.00
Total	301,872.00	344,524.00	351,518.15

Income Statement	**2014**	**2015**	**2016F**	**COMMENT**
Sales Revenue	301.87	344.52	351.52	2% revenue growth
Goodwill Amortisation	0.43	0.42	0.42	
Player Registration Amortisation	40.07	54.43	52	
Impairment of Player Registrations	0.00	0.93	0	
Depreciation	12.42	14.62	17	
Total Depreciation	**52.92**	**70.40**	**69.42**	
Staff Costs	166.40	192.20	194	1% expense inflation
Cost of Property Sales	2.70	2.04	0	
Other operating charges	69.79	72.11	72.11	
Operating expenses	**291.81**	**336.75**	**335.53**	
Operating profit	**10.07**	**7.78**	**15.99**	
Operating return on sales (%)	0.03	0.02	4.5%	
Share of profits from JV	0.71	0.76	0.76	
Profit from Player Registrations	6.90	28.94	0.3	Key assumption
Financial result	**7.61**	**29.70**	**1.06**	
Net finance charges	13.01	12.75	13	
Profit before tax	**4.67**	**24.73**	**4.05**	Lower net profits
Less: Income Tax	2.60	-4.67	-1.01	
Profit after tax	**7.27**	**20.06**	**3.04**	
EPS	116.82	322.48	48.86	
DPS	0	0	0	

Source; CSS Investments Ltd

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Forecast for FY2016 (cont)

Balance Sheet	2014	2015	2016
Non current assets	541.51	596.092	587.1
Intangibles	114.98	171.66	160.5
Tangible Fixed Asset	421.4	419.18	421.5
Goodwill	1.5	1.082	0.6
FS receivables	0	0	0
Investments	3.63	4.17	4.5
Current assets	293.15	323.27	325.42
Inventories- retail	4.93	4.53	4.2
Inventories- development	9.85	9.74	12.5
Short term receivables	65.64	74.175	75
Receivables post 1 year	4.861	6.66	5.66
Cash, cash equivalents	207.87	228.16	228.06
Total Assets	834.66	919.36	912.52
Equity	310.62	330.68	333.72
Share Capital	0.06	0.06	0.06
Share Premium	30.00	30.00	30.00
Merger Reserve	26.70	26.70	26.70
Profit & Loss Account	253.86	273.92	276.96
Non Current Liabilities	320.96	314.93	311.90
Fixed Rate Bonds	153.35	146.09	139
Floating Rate Bonds	52.57	52.42	47.902
Debenture	27.83	28.2	28
Other Creditors	15.866	32.92	47
Grants	3.795	3.7	3.6
Deferred Income	13.06	1	2.5
Provision for Liability	54.49	50.6	43.9
Current Liabilities	203.03	273.72	266.90
Foreign exchange derivative	0	0	0.4
Fixed Bonds	6.7	7.12	7.5
Trade Creditors	11.4	7.6	8
CorporationTax	1.155	5.05	1
Tax & NI	20.233	19.88	20
Other Creditors	30.977	60.8	60
Accruals & deferred Income	132.56	173.266	170
Total equity and liabilities	834.66	919.36	912.52

Source: CSS Investments Ltd

Balance Sheet forecasts & assumptions

*We envisage only a small change in cash balances over 2016FY

*Since the move to the Emirates Stadium in 2006 and the redevelopment of Highbury Arsenal has largely completed its period of significant property related activity.

*We do not expect any new equity issuance over FY16 due to the ownership structure remaining unchanged.

*A dividend is unlikely in 2016 due to the ownership structure remaining unchanged.

*Arsenal has reduced debt levels from over £400m in 2008 to far more manageable levels and this process continues in 2016.

*Arsenal has a high interest expense due to its capital structure containing a high proportion of high fixed coupon debt (c£13m pa).

Conclusion

Arsenal recent interims suggest the need for careful management. The deflationary environment dents future income growth from gate receipts/ retail income (we expect 2% revenue growth) whilst on the cost side player expenses/ payroll is 1% growth (hence only 1% "jaws"). Looking ahead we see limited reason for much change in revenues and the potential for higher costs.

Ever present player spending pressures and fan demands for more innovation on the pitch are clearly an issue for the board. In some respects this is to be expected. However we see limited actual cash available for this purpose, according to our calculations approximately £54m could be deployed for players.

Low and declining profitability due to Arsenal's weaker operating performance (due to a reliance on hit and miss player trading) leaves the problem of how to justify Arsenal's valuation of 3x net assets and 49x historic P/E based on FY2015.

It is not obvious how Arsenal's profits can recover in the absence of player trading profits. This is by nature unpredictable and hard to forecast. Arguably the player transfer market is worse than a zero sum game for Arsenal which as a larger club would be paying a premium to small clubs. Arsenal is taking significant balance sheet risks given the exposure to player assets (around 46% of net assets). Put it this way some of Arsenal's intangible assets might not always be marketable in the event of a reversal in player valuations.

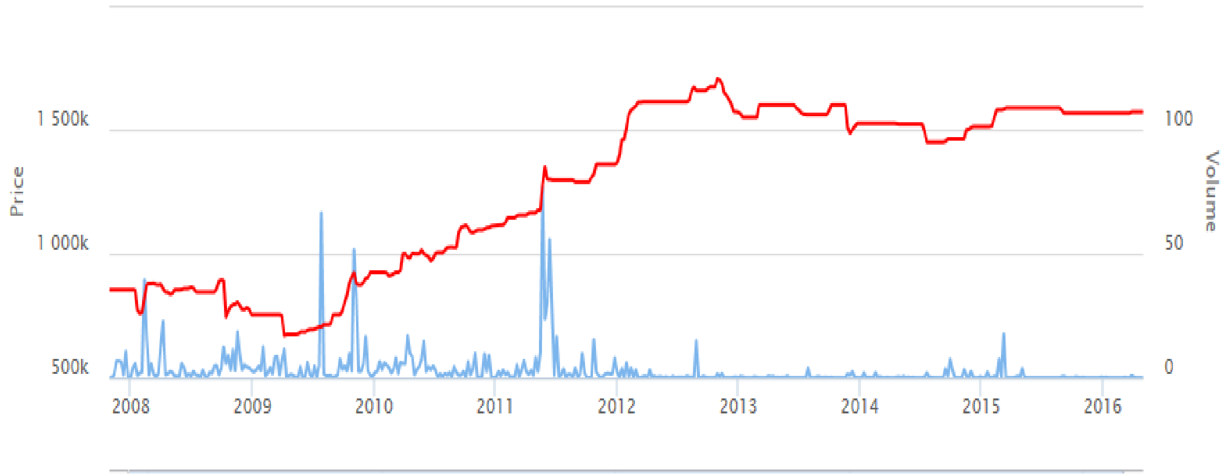
Clearly part of the valuation conundrum is based on Arsène Wenger's track record. The shares have jumped 40 fold under his tenure. In a sector full of last minute rescues, corporate failures, mountain bike levels of gearing, this is a laudable feat.

Can this continue? In our view the ownership structure is the main determinant of the valuation and there will come a time when KSE make a full acquisition. But this is not expected in the short term.

Notwithstanding the track record of returns over the 1996-2016 period we are not recommending Arsenal as a share investment because of its low marketability and valuation issues. **We are a neutral on Arsenal.**

NB. I would like to add, I am not a football fan myself, and have not looked at the football sector in depth before. This article is not written with any ill feeling towards Arsenal shareholders or supporters. From a football perspective I wish them the best and may the best team win.

Arsenal share price chart 2008-2016



Source; www.isdx.com

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2. Collins Sarri Statham Investments Ltd has clients who hold either shares or CFD positions in this security.

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