Merlin Entertainments

MERL

September 10, 2015 FAT-UK-602 | GBP3.88 | Core | MED | B

MERL Snapshot +

LEGO's growing attractions

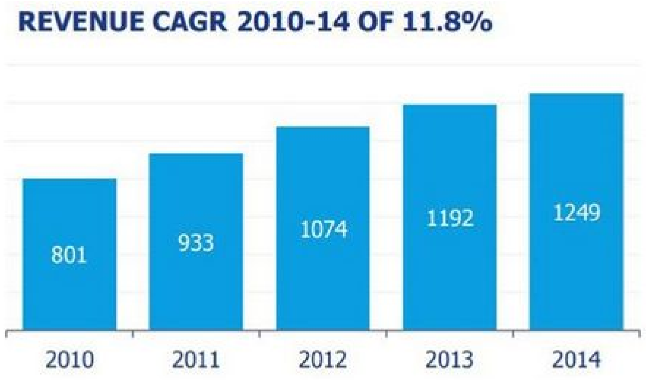
Merlin Entertainments has seen its share price weaken recently on account of an accident at Alton Towers. This is likely to only have a one to two year impact and the Resort Theme Parks division was only 27% of 2014 revenue. The growth prospects for LEGOLAND Parks and Midway attractions merit a buy rating.

In last week's special report we looked at four quality stocks that could be attractive given current equity market weakness. The companies were SAB Miller, the AA, Ryanair and Merlin Entertainments.

The idea was to not "try to be clever" but instead to look at companies we are familiar with due to special reports or traffic light articles. We have looked at the first three companies in special reports and profiled Merlin in a traffic light piece.

We looked at Merlin in June 2014 (FAT UK 547) but decided that Cineworld was a stronger candidate from the Travel & Leisure sector at the time. Both companies have done well since then with Cineworld up around 80% and Merlin up just over 10%.

Merlin Entertainments' divisions and financials



Source – Merlin Entertainments

Merlin Entertainments has recently seen its share price fall from a peak of £4.70 to the current level at just under £3.90. This reflects the accident at Alton Towers and the on-going equity market sell-off.

The Alton Towers accident happened on the Smiler ride on 2nd June and resulted in one victim losing a leg. This made the national media and resulted in the temporary closure of Alton towers and ride closures at two other UK theme parks.

This resulted in a profits warning for the second half of 2015 being issued towards the end of July. Looking ahead and a Q3 trading update is due on 17th September and a pre-close update on 1st December.

We may see a further deterioration in trading given the negative publicity and wet weather in August. However, Merlin Entertainments is well diversified and has attractive medium to long-term growth prospects.

In terms of the valuation and the weak trading anticipated this year puts the 2015 forecas P/E at a punchy 22.1X. This falls back to around 19X in 2016 and then steadily drops over time so that it is 13.4X by 2019.

The near-term valuation may not appear to be attractive but we view it as worthwhile to pay up for quality. The LEGOLAND Parks division has a particularly strong franchise in playful learning and family entertainment.

The share price continues to trend lower following the high of £4.74 that was reached in March. The slowdown in the downward momentum, and the rebound off the 78.6% Fibonacci retracement level, may though indicate an exhaustion of the decline. Therefore, with the 14-day RSI in oversold territory, we anticipate prices extending the recent consolidation, which should provide a base for upward momentum to return.

Merlin Profile – Three divisions and two products

Merlin Entertainments is the world's second largest visitor attraction operator after Disn
worldwide. It is the largest operator in Europe with a particularly strong position in the UK.

The company has two products with the first being Midway which offers indoor, city centre entertainment. The Eye Brand includes the London Eye while also in London is the recently opened SHREK's Adventure on the South Bank.

Midway brands

Source – Merlin Entertainments website

The second product is for outdoor attractions and includes the two divisions of LEGLOLAND Parks and Resort Theme Parks. Alton Towers is a leading Resort Theme Park in the UK while LEGOLAND Windsor is also extremely popular.

The owner of Lego has a 29.9% stake in Merlin Entertainments and as such the interest of both groups is aligned. The recent Lego movies have helped keep the brand strong and expand its popularity in emerging markets.

With an emphasis on playful learning the Lego brand doesn't look set to go out of fashion anytime soon. In the first half of 2015 sales at Lego increased by 23% to make it the world's biggest toymaker with Mattel pushed into second place.

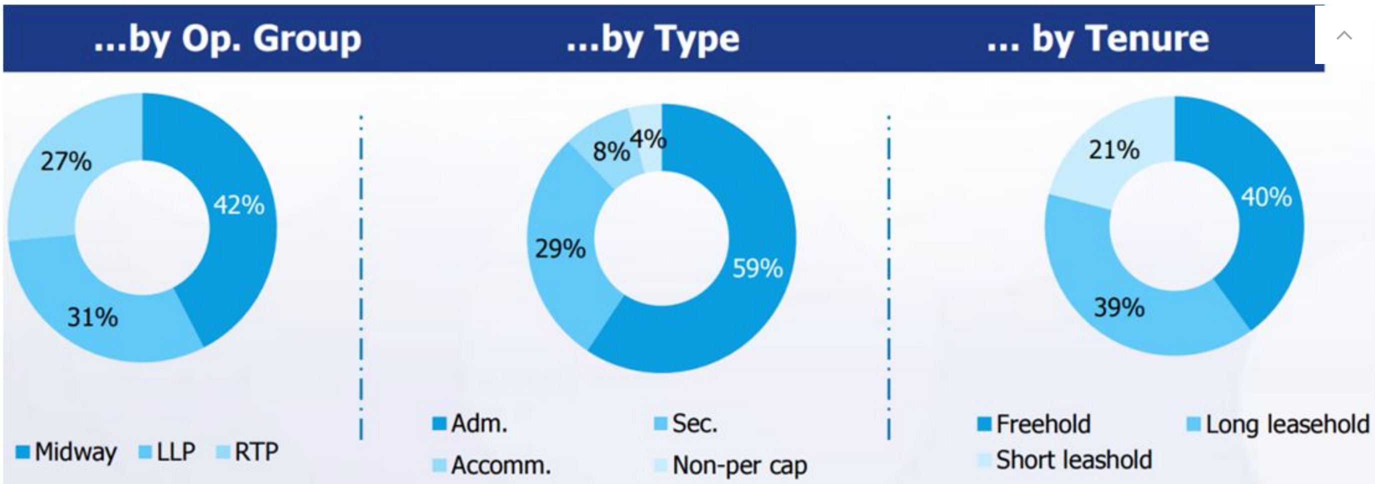
Theme Park's – LEGOLAND Parks and Resort Theme Parks

Source – Merlin Entertainments

The Theme parks are outdoor activities and generally involves a 1-2 day visit with sites increasingly having on-site accommodation. The indoor Midway attractions see up to a two hour visit and helps offset the effect of poor weather on the Theme Parks attendance during those periods.

In 2014 the Midway Attractions featured 92 sites and generated 42% of total revenue. LEGOLAND Parks featured 6 parks and make up 31% of revenue while Resort Theme Parks made up the remaining 27% of revenue from 6 parks.

Merlin's 2014 revenue generation



Source – Merlin investor presentation

Attraction Expansion

For Midway the group states that there is a significant roll-out opportunity with "100+ sites identified". The identified sites would double the size of Midway and the group is also introducing new brands like SHREK's Adventure.

2015 openings slated for Midway include SHREK'S Adventure, two LEGOLAND Discovery centre's, two SEALIFE attractions. In total seven openings are due for 2015 and a further seven in 2016 of which 3-4 will be in Asia.

Midway roll-out in 2015

Source – Merlin Entertainments presentation

In the case of LEGOLAND the group states that there is "substantial potential to develop new parks/markets". LEGOLAND Dubai is due to open in 2016, LEGOLAND Japan in 2017 and then LEGOLAND Korea is set to follow in 2018.

LEGOLAND expansion plans – A new park targeted every 2-3 years

Source – Merlin Entertainments presentation

LEGOLAND Korea is set to boost profits from 2018

Source – Merlin Entertainments

Turning to the Theme Park Resort division and there doesn't appear to be a plan to roll these out. Instead the emphasis is on investing in accommodation for both LEGOLAND Parks and the Theme Park Resort parks.

In 2015 the group opened a LEGOLAND hotel in Florida and at Alton Towers it hass opened a 120 room lodge and 5 tree houses. Accommodation on site helps make the resorts more attractive to families.

Merlin's six strategic growth drivers

The Midway and LEGOLAND park roll-outs are targeted to deliver a return on invested capital of over 20%. Transforming theme parks into short break destinations is expected to deliver a 15% return on invested capital.

Two other growth drivers are to invest in expanding the existing estate and targeting strategic synergies. Both are expected to deliver a 15% return on invested capital.

Strategic acquisitions are also targeted with a threshold for the synergized (i.e. after cost savings) return on invested capital at 20%. Given that takeovers are likely to be funded with debt they should boost earnings per share.

Merlin's six growth drivers

1	Existing estate growth via capex	Mid-single digit Like for Like EBITDA Growth + >15% ROIC on Accommodation
2	Strategic synergies	
3	Transformation of theme parks into short break destinations	
4	Midway roll out	>20% ROIC
5	Developing new LEGOLAND parks	
6	Strategic acquisitions	Synergised >20% ROIC

Source – Merlin Entertainments investor presentation

Financial performance in 2014

In 2014 the group saw a 4.9% increase in visitors and like-for-like revenue rose by an impressive 7.1%. Revenue rose by 9.6% on a constant currency basis and EBITDA rose by 11% on a constant currency basis to £411m.

The revenue split saw 39% come from the UK, 13% from Asia Pacific, 26% from Continental Europe and 22% from North America. Pre-booked and annual pass revenue was 49% of the total with the remaining 51% from same day revenue.

The adjusted earnings per share rose by 5% to 17.7p due to a higher share count followi the IPO. The group's return on capital improved to 10.6% from 10.2% the year before and an annual dividend of 6.2p was introduced.

Merlin 2014 financials

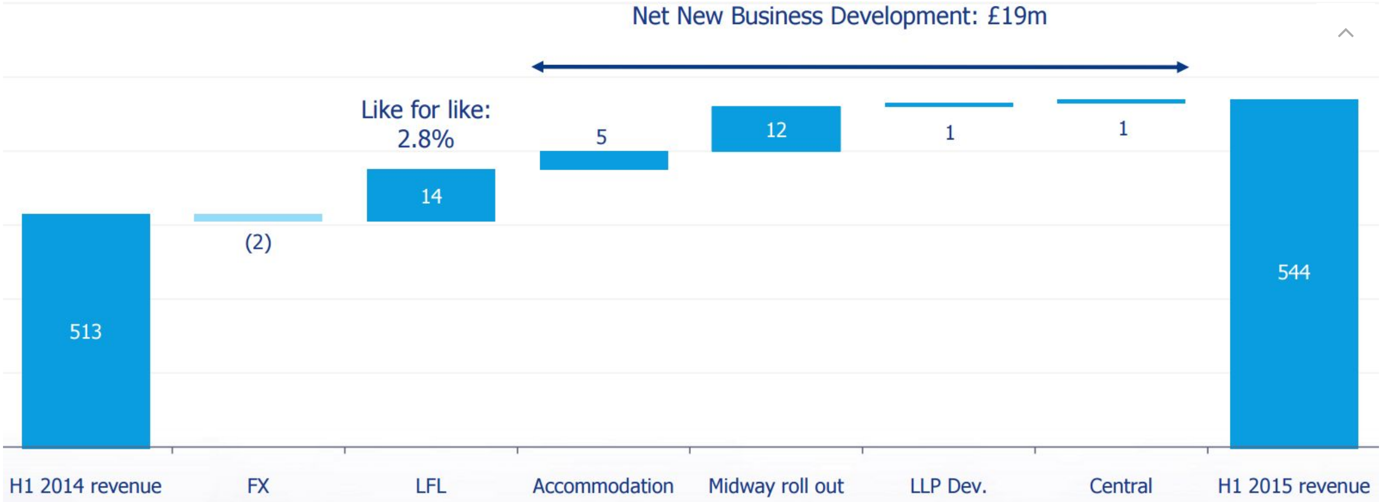
£ millions (unless stated)	2014	2013	Total growth at constant FX	Total growth at actual FX	Like for like growth
Revenue	1,249	1,192	9.6%	4.8%	7.1%
EBITDA	411	390	11.0%	5.3%	7.8%
Margin	32.9%	32.7%			
Operating Profit	311	290	13.3%	7.1%	
PBT	249	186		34.6%	
Underlying profit for the year	179	162		11.1%	
Adjusted EPS	17.7p	16.9p[1]		5.0%	
DPS	6.2p	-			
ROCE	10.6%	10.2%[2]			

Source – Merlin investor presentation

Financial performance in H1 2015

The picture for 2015 is not set to be as robust due to the incident at Alton Towers in June. However, first half like-for-like revenue did increase by 2.2% and new business development provided a £19m first half revenue boost.

Merlin revenue in H1 2015



Source – Merlin Entertainments investor presentation

First half revenue rose by £554m while if attractions that were opened in 2015 were excluded the revenue figure was £531m. Both represent an increase on the revenue in the first half of 2014 at £513m.

Looking at the drivers and visitor numbers were up by 0.9% to 27.7m in the first half of 2015. Resort Theme Parks suffered a 2% fall in like-for-like revenue due to the incident at Alton Towers.

First half revenue rose by 6.6% on a constant currency basis but EBITDA increased by only 0.3% as margins fell back. Financial costs fell due to the repayment of debt and lower financing rates and as such earnings per share rose by 24% to 3.4p.

Merlin first half 2015 financial results

£ millions, unless stated	H1 2015	H1 2014	Constant Currency	Reported Currency	Like fo like
Revenue	544	513	6.6%	6.1%	2.8%
EBITDA	123	120	0.3%	2.7%	
Margin	22.6%	23.3%			
Operating Profit	71	71	(3.6)%	1.2%	
PBT	49	40		23.9%	
Underlying profit for the period	35	29		24.0%	
Adjusted EPS	3.5p	2.8p		24.0%	
Dividend per Share	2.1p	2.0p		5.0%	

Source – Merlin Entertainments presentation

Turning to the balance sheet and bank loans and borrowings were £976m at June 2015 versus £1.16bn a year ago. This largely reflects the use of cash and cash equivalents to pay down debt as net debt rose over the period.

Merlin Entertainments balance sheet

£ millions, unless stated	June 2015	Dec 2014	June 2014
Bank loans and borrowings	976	1,136	1,161
Cash and cash equivalents	(68)	(285)	(268)
Net bank debt	908	851	893
Finance lease obligations	81	84	84
Net Debt	989	935	977

Source – Merlin investor presentation

Summary and valuation

Buying shares after a negative trading update is fraught with difficulty as it is often the case that a further negative surprise comes forward. This is clearly a possibility for Merlin with the next trading update on 17th September.

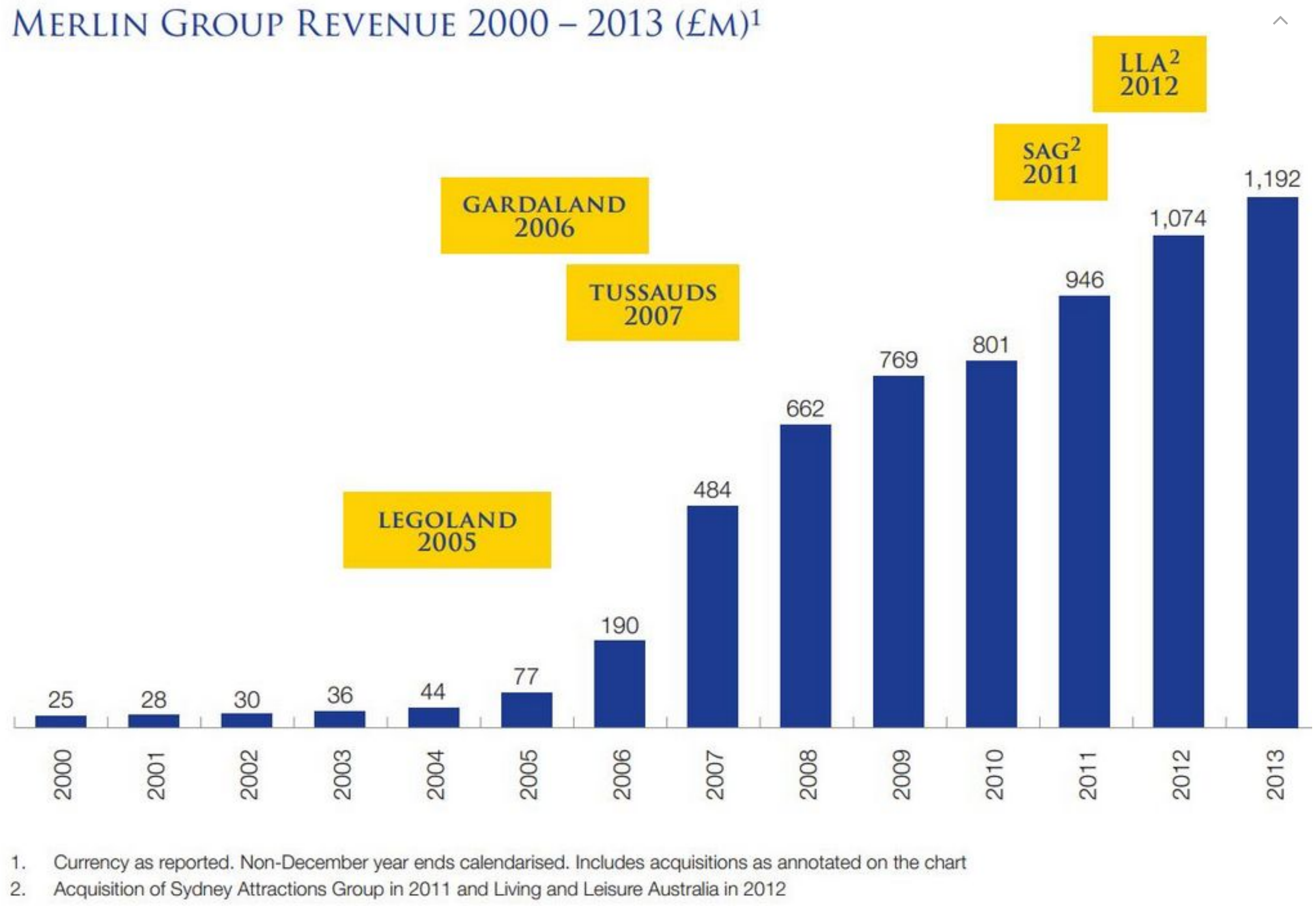
However, the Resort Theme Park division (which included Alton Towers) generated only 27% of revenue in 2014. As such the group will be able to offset the weakness to some extent and is benefiting from lower finance costs.

Merlin Entertainments doesn't look cheap relative to near-term fundamentals but offers a growth story that is, in our view, high quality in nature. LEGO only seems to be growing in popularity and supports the LEGOLAND Parks.

With the LEGO group a private entity probably the only way to buy into this success is through Merlin Entertainments. LEGOLAND Parks generated 31% of group revenue in 2014 and so is a key focus for growth.

There is clearly scope for acquisitions to boost the path of profits growth with Merlin having growth through takeovers. The company was previously owned by private equity and grew from £25m revenue in 2000 to £1.2bn in 2013.

Merlin's revenue growth and acquisition path



Source – Merlin Entertainments

As LEGOLAND Parks open in the coming years and the Midway attractions get rolled out the valuation starts to become appealing. By 2018 the forecast P/E is only 14.1X with a yield at 2.5% that is 2.8X covered by profits.

Accordingly, we recommend Merlin Entertainments as a buy to all members. Cautious members may look to buy over time with part of a holding bought after the upcoming trading update on 17th September.

subscribers. To the extent permitted by law, Fat Prophets and its employees, agents and authorised representatives exclude all liability for any loss or damage (including indirect, special or consequential loss or damage) arising from the use of, or reliance on, any information within the report whether not caused by any negligent act or omission. If the law prohibits the exclusion of such liability, Fat Prophets hereby limits its liability, to the extent permitted by law, to the resupply of the said information or the cost of the said resupply. As at the date at the top of this page, Directors and/or associates of the Fat Prophets Group of Companies currently hold positions in: ASX- Listed Australian stocks ABP, ADI, AMC, ANZ, APA, ARF, AVN, BHP, BOQ, BPT, BWP, CBA, CHC, CKF, CQE, DHG, ELD, EVN, FID, FMG, FPC, FPP, GMG, GOR, GPT, HUB, IGO, ILU, JHK, MAI, MCR, NAB, NCM, NEC, NUF, NXT, ORE, OSH, OVH, OZL, PAN, PPS, QBE, RIO, S32, SAR, SBM, SCG, SCP, SFR, SGP, SHL, SHV, SLR, SPK, SRV, STO, SUN, SYD, TLS, TPM, VCX, VOC, WBC, WES, WHC, WPL, WSA, International stocks: Alibaba, Alphabet, Alstria Office, American Homes 4 Rent, Apple, Ashford Hospitality Trust, Avalonbay Communications, Baidu, Braemar Hotel & Resorts, Brookfield Property Partners, Camden Property Trust, Castellum, Champion Real Estate Investment Trust, China Lodging Group , CNOOC, Coeur Mining, Columbia Property Trust, Cubesmart, Deutsche Wohnen, Entra ASA, Euronext, Extended Stay America, Extra Space Storage, FedEx, Frasers Hospitality Trust, Guangzhou Automotive, Heineken, Harmony Gold, Hufvudstaden, Icade, Industrial Logistics Properties Trust, Inmobiliaria Colonial Intu Properties, Japan Airport Terminal, Land Securities Group, Meituan Dianping, MGM China, Mitsui Fudosan Co, National Storage, Nintendo, Office properties income Trust, Prologis, Retail Value, Sands China, Segro, Seritage Growth Properties, Site centres Corp, SMC Corp, Sony, SPDR Gold Trust, Spirit Reality Capital, Sumitomo Mitsui Financial, Tanger Factory Trust, Taubman Centres, Tencent, Vail Resorts, VanEck Vectors Gold Miners ETF, VanEck Vectors Junior Gold Miners ETF, Vereit, Vodafone, Vonovia, Vornado Reality, Trust, Walt Disney, Wharf Real Estate Investment Co, Wynn Macau, Wynn Resorts, Zillow, ZOZO. These may change without notice and should not be taken as recommendations.