Merlin Entertainments

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July 4, 2019 FAT-UK-788 | GBP4.487 | Core | MED | SH

MERL Snapshot +

Fat Prophets take some Profits

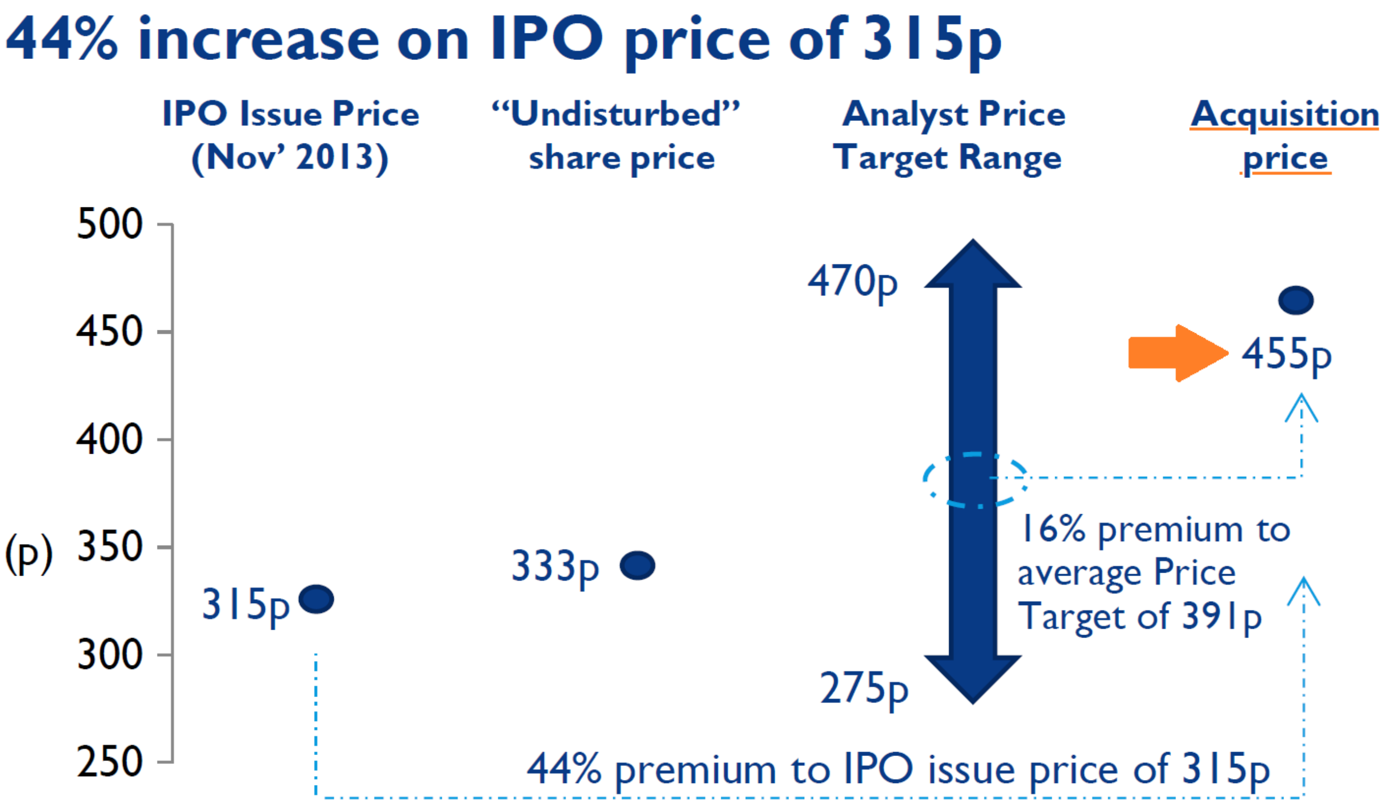
Merlin Entertainments (LSE.MERL) has received a takeover offer from one of its largest shareholders, along with other partners. This has already unlocked some value in the company for shareholders. There are still some hurdles for the transaction to finalise and in the meantime, we recommend Members sell half their holding to take some profits off the table.

What's new?

In our previous note on the group back in June (FAT-UK-786), we covered the company's latest update pipeline and its steady expansion, but more importantly the letter issued to the Board by the hedge fund ValueAct Capital. With that company proposing Merlin Entertainments be taken into private hands to unlock its value, with an estimate of a fair value for the group pegged at £4.50/share.

The valueAct proposal is turning into a reality in just a couple of weeks, as a consortium of investors covering **KIRKBI** (the holding company of the Danish billionaire family that owns the toymaker Lego), private equity group **Blackstone** and **Canada Pension Plan Investment Board** (**CPPIB**) move to privatise. The consortium has extended a Tender Offer to take Merlin private following the letter from ValueAct.

The consortium, as at 28 June, **offered to buy out Merlin Entertainments for £4.766 billi or £4.55 on a per share basis**, which marks a substantial increase of 31% over its 6-month average price at the time, and slightly ahead of ValueAct's £4.50/share 'fair value' estimate, or according to the company's filing, 16% higher than the median consensus estimate. The substantial premium much makes it one Europe's largest buy-out offers in recent times.



Source: Merlin Entertainments Website

Looking closely at the consortium's rationale for the offer, they believe it worthwhile to align the economics of a Theme Park business that can take years to build-up and even longer for it to become profitable (such features are unpalatable to public shareholders who tend to hold shares for a shorter time), to the joint interest of the consortium. Further, if Merlin Entertainments is taking private, it would make for more time and breathing space to invest in its asset base and allow future slower grow without angry shareholders breathing down management's neck.

A positive is that the consortium looks to be a friendly acquirer, which is not often the case with other Private Equity deals. Private owners tend to load the new business with substantial debt (ala leveraged buyout) and squeeze it for every single penny. The consortium would not opt for short-term efforts to milk the business, at the expense of its reputation.

This is mainly due to the fact that Merlin will be bought by the same former owners (pre-Merlins IPO), in KIRKBI and Blackrock.

From the current base, KIRKBI has owned a 29.58% stake in Merlin since 2005, when it sold the rights to the Legoland resorts. The other members of the consortium are also well aligned, as Blackstone will place its stake in Merlin Entertainments into its long-term fund, which seeks to hold companies for a decade or so – better aligned for theme parks with long business cycles – while CPPIB has a long-term investment mandate due to it being a pension fund.

This offer, in our view, is highly likely to proceed, given that it is quite generous compared with recent share price levels. In fact, this is currently the best opportunity to unlock the value in the group, as the shares have been in the doldrums and even hit a low of £3/share at the end of last year. This was a direct consequence of a number of headwinds from concerns around UK tourism owing to Brexit, the 2017 London terror attacks as well as an accident with one of its rollercoasters at Merlin's Alton Towers park.

The long-term chart below perfectly illustrates what a rollercoaster ride it was:

It's also notable that the shares have been lacklustre, despite the fact that since its IPO 6 years ago, revenues have increased at a compound annual rate of 7.4%, while visitor numbers have increased 24% to over 67 million. It seems that the consortium was right about the mismatch between short-term oriented public shareholders and Merlin Entertainments business cycles.

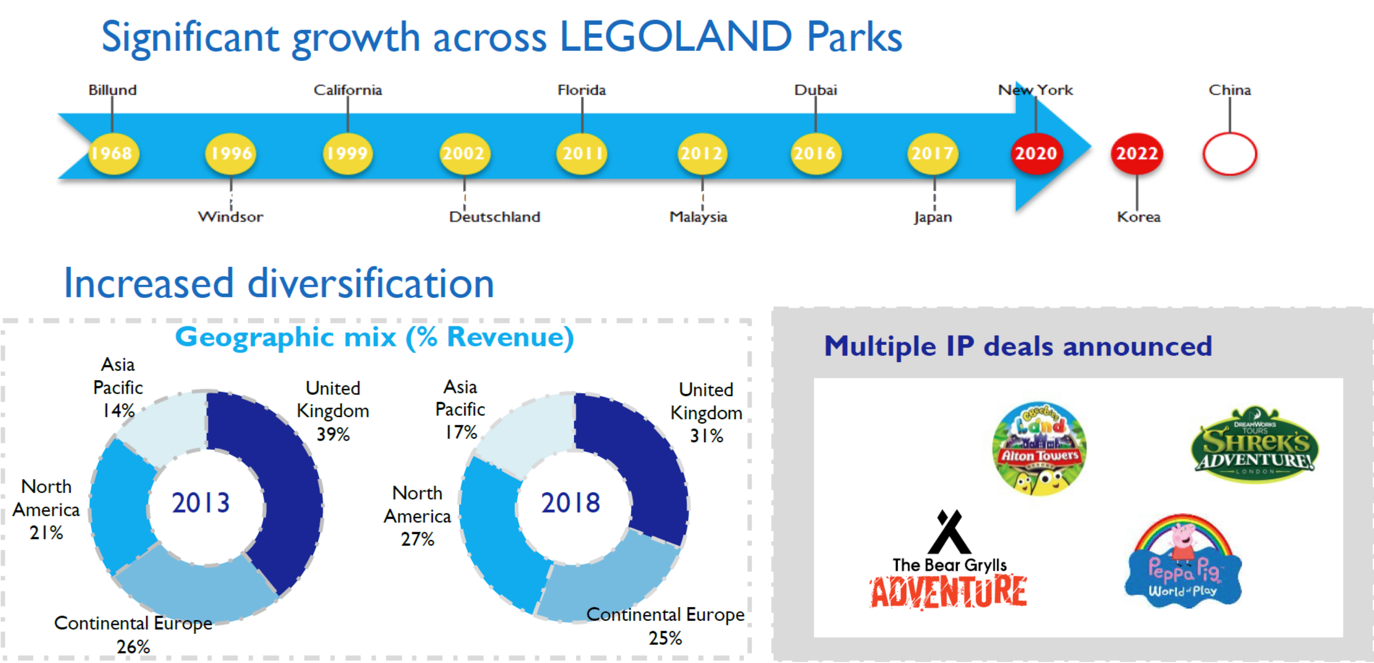
That said, aside from KIRKBI's near-30% stake, the consortium has also received irrevocable commitments from other shareholders. ValueAct is probably onboard and is likely to vote in favour of the deal and represents 14.2% of Merlin shares. **This amounts to a sizeable backing of 43.78%.** Should this deal pull through, KIRKBI will own 50% of the company while the remainder will be split between Blackrock and CPPIB.

The Chairman of the Board, Sir John Sunderland, has also provided his backing, along with the rest of the Board who voted unanimously, and said that "*the Board believes this offer represents an opportunity for Merlin Shareholders to realise value for their investment in cash at an attractive valuation. **We are therefore unanimously recommending it to our shareholders.***"

We concur, with the offer being highly attractive, as has the market in pushing the shares higher in response. **We recommend Members take some profits off the table by selling half their holding now.** The premium difference between the market price and the offer price isn't substantial (~1.2%).

This is because the deal still has two hurdles to clear, shareholder approval (which we outlined as highly likely) as well as the customary regulatory approval. Provided there are no hiccups, the deal is expected to clear by the 4Q19.

Our decision to retain half is based on the off chance that the deal falls through (perhaps by regulatory or not meeting other conditions), so Members should still retain a position in a company with longer-term potential. In fact, the company still has substantial value on offer, especially with an attractive expansion pipeline in New York, Korea and China, as reflected in the graphic below:



Source: Merlin Entertainments Website

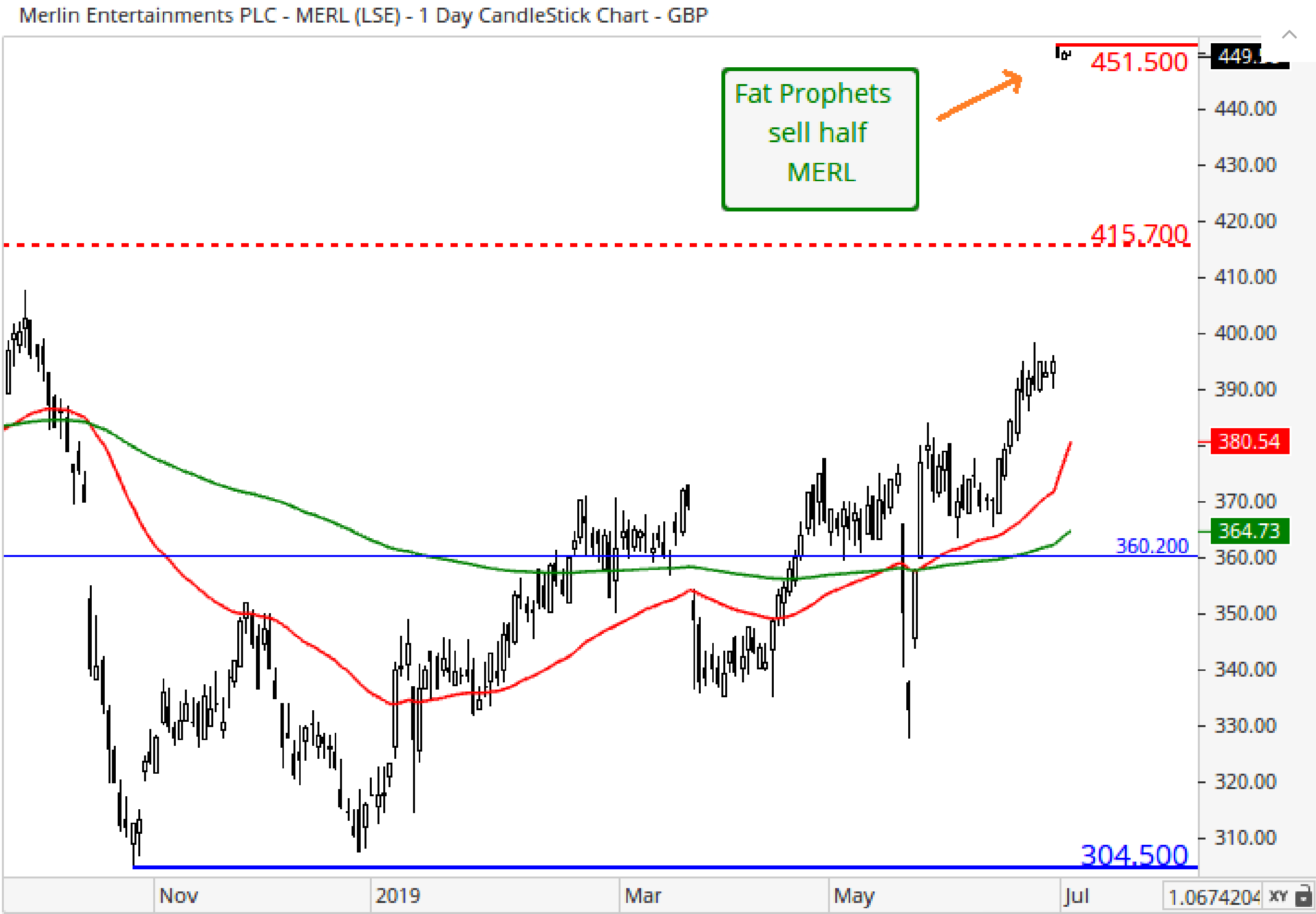
The closest one is the theme park in New York – the company's largest to date – which Merlin Entertainments has invested circa £350 million. It has also diversified out some geographic risks such as working with BBC to create CBeebies Land and with Sony on a Ghostbusters ride in Germany. The company also has multiple IP deals that would further broaden its offerings.

There is also another long-term driver, the secular shift towards the ‘experience economy with a greater number of consumers looking to visit more theme parks while also increasing spending. This is supported by data from Morgan Stanley which noted that Annual Visitor Numbers across the world’s Ten Largest Theme Parks increased 5.4% last year while average spend per head rose 4.5%.

To capture more of the market, Merlin Entertainments has announced plans to spend £470 million this year and aims to open an average of 200 hotel rooms, pods or glamping tents every year going forward to take advantage of the growing demand.

Summary

Previously, we noted that the letter to the Board from ValueAct could act as a catalyst and that has proven true, with a consortium of investors comprising its largest shareholder, along with other long-term investors proposing a tender offer at an attractive premium to the then share price. The proposal still has a couple of hurdles to pass (shareholders & regulators), although we expect these to be surmounted easily enough. In the meantime, we recommend Member sell half their holding to lock in some profits.



According, we issue a SELL HALF rating on Merlin Entertainments (LSE.MERL).