

## **Enterprise Inns (LN:ETI) Investment Thesis / Amir Dov**

### **Abstract**

Enterprise Inns is a UK PubCo currently facing uncertainties around the future of its core business model as well as around its ability to successfully execute an ambitious, recently announced, five-year strategic plan.

These uncertainties provide an opportunity to purchase the stock for ~40% of its tangible book value and at a 19% normalized FCF yield.

Sell-side analysts are noting that at a 10x EV/EBITDA, declining revenues and uncertainty regarding execution of new strategy - there's not a lot of upside (although most of them have price targets at least 40% higher than current price). However, what I'm seeing is a high-quality real-estate business trading for 19% normalized FCF yield, led by competent management team with the required experience and expertise to successfully implement a strategic shift (I also see revenues being practically flat in 2016-2017, while sell-side have them at -2% annual CAGR but we'll get to that later).

While upside may not be huge if management keeps allocating most FCF to debt reduction (I see a 70%-100% upside at current price), I view this as a very high floor / low risk opportunity, as the underlying value is backed by prime location real estate scattered around the UK.

### **Intro - Enterprise Inns**

Enterprise Inns is the largest pubs owner in the UK, with 5,060 pubs as of September 2015 (assumed to be approximately 10.5% of all UK pubs). Enterprise operates a leased and tenanted pub model in which the vast majority of its pubs are leased to the tenants under a tied lease.

Under the tied lease, the publican must buy all their drinks from Enterprise Inns, in addition to paying a fixed rent, which is lower than market rent for a similar property. The tied lease model is supposedly beneficial for both parties, as:

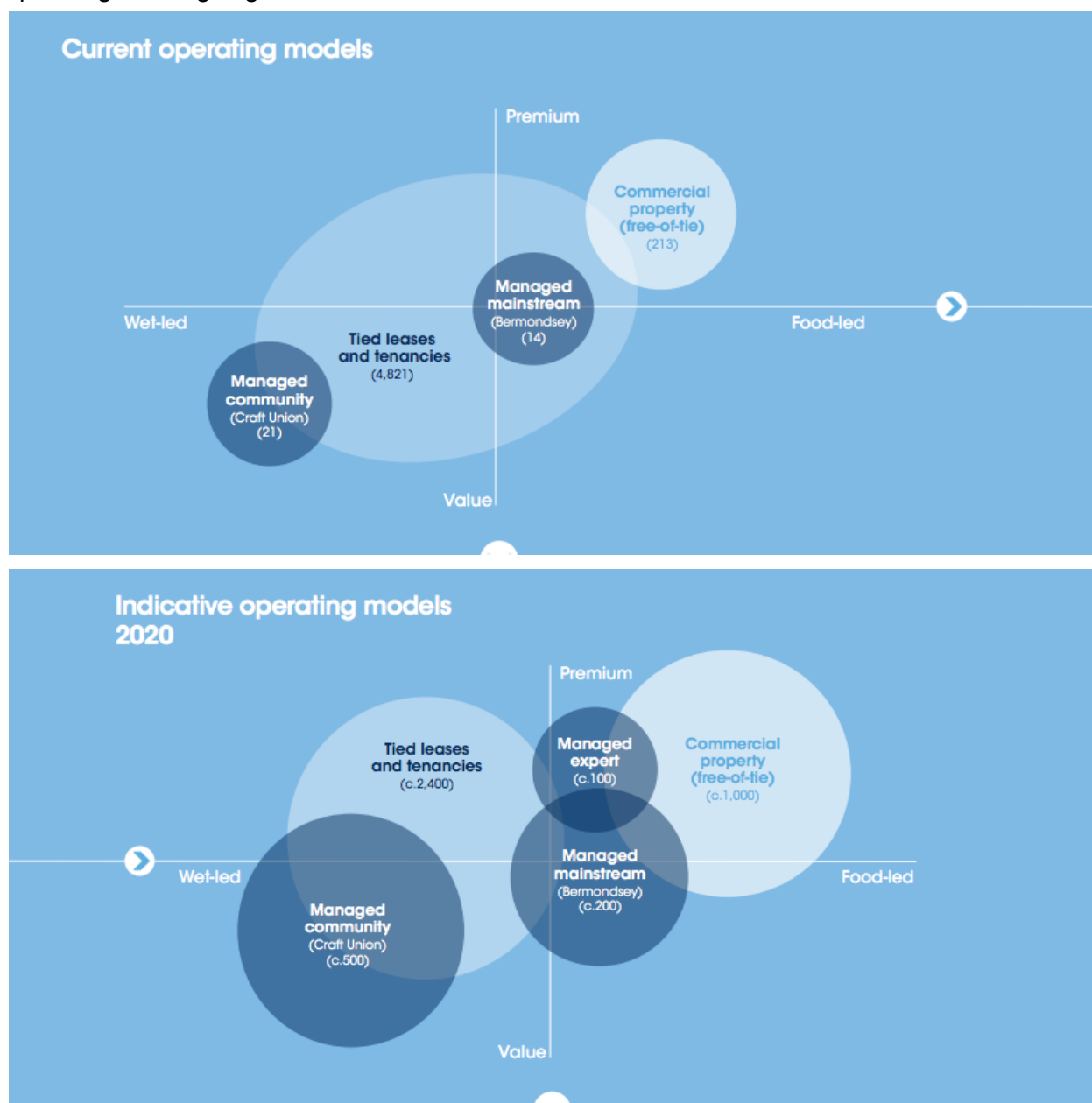
- Publicans gets the opportunity to own their own business with relatively low initial capital requirements, and the variable lease cost lets them share the risk with the PubCo.
- The PubCo (Enterprise in that case) benefits from scale advantages as a wholesaler of drinks and related services (satellite TV, WiFi, food supplies), and gets to share the publican's upside if a pub is indeed successful.

However attractive this model might sound, it has gained a lot of objection from publicans in the UK in recent years. So much that a recent regulation, which should kick-in in May this year, is about to force all PubCos to offer a Market Rent Only (MRO) option to publicans when rent review is due.

In preparation for the new regulation, Enterprise revealed a new strategic plan in May 2015, with plans to increase the number of free-of-tie pubs that are under normal commercial lease, as well as the managed pubs which will be fully owned and managed by the company (so basically the number of tied lease pubs is expected to shrink).

According to management's indicative plan for 2020, the estate as a whole should decrease from 5,060 pubs as of September 2015, to 4,200 owned pubs by 2020. The tied lease pubs will decrease from 4,821 today (~95% of estate) to 2,400 as of 2020 (~57% of estate).

The pictures below from the company's latest annual report show the expected changes in operating model going forward.



## How will a move from tied-lease to free-of-tie affect pubs value?

Part of the sell-side pessimism comes from the fear of many pubs switching from the tied lease to the less lucrative free-of-tie commercial lease. Analysts look at Enterprise's current portfolio of commercial properties, which has an average rent of £60k per annum, versus the average tied lease which averages a gross profit of £72k. They conclude that there's a material risk of 20% decline in income when switching between the models.

My view is that this is not the right way to look at it and that analysts are most likely wrong. First, Enterprise's current commercial properties aren't representative of the entire estate. Some of them don't even function as pubs and most of them ended up in a free-of-tie lease because they were the least quality assets in the estate.

Second and more importantly, signing a lower free-of-tie lease with an existing publican will really be a solution of last resort for Enterprise. If they are in a position of rent review with a tenant that wants out of the tied lease, they have the following options to explore before settling for a lower rent:

1. Set the fixed rent price at the former level of gross profit they were making from the pub.
2. Sell the property.
3. Evict the publican and operate the pub themselves.

The estate is supposed to decrease by about 800 pubs in the next five years, and ~800 more should be transformed to the managed pubs, so there are several options to deal with a rebellious tenant. My belief is that the vast majority of pubs will end up under one of these 3 solutions, while only a negligible fraction will actually be able to reduce their rent using the MRO option.

## Valuation - Basic NAV Outlook

So what's the best way to value a real estate company? First, a look at the Net Assets Value should give some perspective.

In Enterprise's case, I excluded all intangible assets and only took the PP&E value, trade receivables and cash, net of all liabilities. The result is below.

PP&E: £3,663

Assets held for sale: £33

Cash: £127

Receivables: £40

Total Assets: £3,863

Long-term financial debt: £2,373

Short-term financial debt: £74

Other liabilities: £413

Total Liabilities: £2,860

**Tangible NAV: £1,003**

**Tangible NAV per Share: £2.00**

Amir Dov / Huckleberry Value Fund, LP

So the simple NAV calculation reflects a 153% upside to today's share price of 79 pence. But this is still just balance sheet figures, and we all know the limitations of fair value accounting, and obviously the fact that some appraisal said these assets worth £3.6b isn't a good enough reason to buy in.

It's worth mentioning, however, that as of September 2015, 92% of the company's estate is valued by external appraisers (Colliers International & GVA Grimley), compared to 47% in previous years, so it should be a good proxy to the value. In any case my personal view is that the PP&E value is more right than wrong, but eventually the cash flows generated from these assets are the real drivers of value. which leads us to...

### **Valuation - FCF analysis**

I'm not a fan of DCFs, but when valuing real-estate it's a pretty useful tool.

As I mentioned earlier, sell-side analysts see revenues continue south in a linear trend, decreasing by 1.8% on average in 2016-2018 due to disposals of assets. I beg to differ. Taking into account organic like-for-like growth of 0.8% per annum and the additional revenue from the growing numbers of managed pubs, I see revenues decline by only 0.3% in 2016, completely flat in 2017, and growing 0.5% in 2018. I also see EBITDA margins declining less, going from 47.4% in 2015 to 46.0% in 2018. It's worth mentioning that in the trading update that was released last week, management reported like-for-like net income growth of 1.6% in the first 18 weeks of FY2016 (Enterprise's financial year starts at October 1). This is significantly higher than my assumed 0.8% like-for-like growth rate and might result in top-line growth as soon as FY16.

To come up with the 2016 normalized FCF yield, I used a £293m of EBITDA, subtracting £152m of interest cost, a 20.5% tax and £40m of maintenance CAPEX. This leaves us with FCF of £75m, a 19% yield on today's £396m market cap.

Going forward, due to the expected assets disposals, debt repayments and investment in growth CAPEX, things get a bit tricky and FCF varies a bit. However I see normalized FCF (calculated as EBITDA minus interest minus taxes minus maintenance CAPEX) increasing by a 3.2% CAGR between 2016 and 2020.

Using a 10% WACC and assuming capital allocation decisions aren't ideal (debt repayments instead of share buybacks), I see price target at £1.40 in a conservative scenario, or about 80% above current market price.

Better capital allocations decisions could have a big impact on shareholder returns in the next few years. I haven't seen management executing on any share buybacks yet (although they have an approved plan to buy back up to 15% of the float), so my base-case model sees only debt repayments according to the amortization schedule in the annual report.

However, even by using only the residual FCF after debt payments to buy-back some shares, the £1.40 price target turns to £1.79, implying 132% upside to current price (instead of 76%). An even more aggressive buy-back will provide additional upside, but seems unrealistic at this point.

I should also note that management could take the opposite way and use even more FCF to repay debt. If they do this and use 100% of FCF for debt repayments, target price could actually be lower and imply only 46% upside on current price.

Apparently another recent concern raised by Barclays' analysts involves a £350m debt refinance that is scheduled for 2018. Barclays just downgraded Enterprise Inns due to the credit tightening in the HY market and a concern regarding Enterprise's high debt levels.

I completely dismiss this concern and am surprised of the downgrade for the following reasons:

1. Thanks to the quality of the pubs portfolio, Enterprise's cash flows are very predictable and stable. With current EBITDA of £295m and interest payments lower than £160m, it hardly seems like there's any risk for the interest coverage.
2. LTV is currently 62%, and should be under 60% by the end of 2017. This doesn't strike me as high leverage for high quality real-estate assets. I'd argue that in the current environment, banks would actually fight for the privilege to finance commercial real estate assets with high-yield and predictable cash flows with 60% LTV (especially when we're talking about 6%-6.5% interest rate).

## **Conclusion**

I see this opportunity as a low-risk / high-yield play which can serve as a medium-to-large position in any value portfolio (it's the 5th-6th largest position for me). I think both regulatory and execution risk are overstated by analysts and investors, and the opportunity to buy prime UK real-estate at a ~50% discount is extremely compelling.

In my analysis I've focused on FCF, but it's also worth mentioning that the company is trading for a trailing P/E of 4.0x on an adjusted EPS basis (excluding non-cash cost of changes in properties value). I expect EPS to remain flat or slightly increased (by approximately 1%) in 2016.