CREDO WEALTH

The right type of ownership

It can be argued that one of the downsides of being a publicly listed company is the relentless earnings reporting cycle which encourages a short-term approach by both company management and shareholders. The need to continually meet and beat expectations for growth can result in management taking decisions that are not in the long-term best interests of the company. Analysts can end up focusing on the next quarterly report and subsequently, companies can find themselves being penalised for investing in long-term projects when there is a short-term negative impact on earnings or cashflow.

Often, this can create opportunities for shareholders who are willing to look past the temporary impact and understand the growth opportunities that are being created. Merlin Entertainments was precisely one of these opportunities when we originally invested in it.

Merlin is the second largest theme park operator in the world, running over 125 different attractions across 4 continents. Attractions range from smaller city centre operations, like Madame Tussauds and Sea Life Centres to sprawling LEGOLAND resorts and theme parks, such as Alton Towers. After a period of disappointing top-line growth, the stock sold off significantly, which provided our entry point in early 2018. A series of terror attacks across Europe had impacted visitor numbers to city centre sites and adverse weather conditions in America and Europe temporarily closed some resorts. Analysts were worried about stagnating profit growth, declining reported returns and the increased investment going into the business. Despite these difficulties, management were pressing ahead with building new attractions which included one of the largest opportunities for several years, LEGOLAND New York.

Although clearly suffering temporary setbacks in visitor growth, we did not believe that Merlin's business model was broken. We considered that the decline in reported returns could be mostly explained by the temporary challenges facing the existing business, alongside the increased investment going into projects which were not yet generating any income. LEGOLAND New York is due to open in 2020 but many analysts simply do not forecast earnings that far in advance and so the company was being penalised for investing in its future.

We had faith that the strength of Merlin's brands and the underlying industry trends would result in a return to growth for the existing business. Moreover, we believed that it was the right decision to continue investing in future growth. Merlin could fund the capital required through cash flow generated from the current attractions. Prior to the recent challenges, management had a stellar track record and Merlin remains uniquely placed to partner with brands in developing entertainment experiences. We estimated that the income generated from these new projects would represent an attractive return for shareholders and we believed that, once this income began to be realised, the market would revalue the business. As long-term investors, we felt able to ride the short-term volatility, in the expectation of being rewarded for our patience once market optimism returned.

Recently, the activist investor ValueAct published an open letter to management reasoning that Merlin should consider a "public to private transaction". They argued that by undervaluing the company, the market was disincentivising management to make the right long-term decisions. Instead, private ownership would provide a more stable capital base, allowing focus on strategic vision rather than short-term earnings.

As shareholders we want management to “have skin in the game”. We want their incentives aligned to ours, for good decisions to benefit everyone and for them to feel the pain of poor choices just as acutely. Investments generally work best when the objectives of management, the board of directors and shareholders are all aligned. However, when good management decisions are not rewarded by the market, the system works for no-one.

On 28th June 2019, Merlin announced that it had received a bid from a consortium of investors, including KIRKBI, Blackstone Equity Advisors and Canada Pension Plan Investment Board. Management intend to recommend the proposal to shareholders. KIRKBI is the Kirk Kristiansen family’s private holding company which founded The LEGO Group and still owns 75% of it. KIRKBI has also maintained a significant strategic shareholding in Merlin since the sale of the LEGOLAND parks to the company in 2005. At the time of the offer, the family’s holding was around 30% of Merlin’s shares. KIRKBI and Blackstone together controlled Merlin in the 8 years prior to the company’s public listing in 2013. This consortium of investors has shown a willingness to invest for the long term, which should allow management the space they need to make the best decisions for the future of the company.

We continue to believe in the long-term potential of Merlin and trust that under the new ownership structure, the business will thrive. That being said, we must always balance the risk-reward of a holding. The share price reaction to the news of the bid was extremely positive and therefore the remaining upside was limited. Although we view it as likely that the bid goes through, we were also cognisant that there could be significant downside should it not. Considering this, we took the opportunity to realise our gains and sell our position. Over the 18 months that we held the stock, the total return (including dividends) was just over 30%.

Important notice