CREDO WEALTH

Flexing to grow

As Equity Investors, we are a step away from where decisions are made and implemented. Shareholders own a slice of the business, but the business is run on our behalf. Ideally, we get a great management team, who build up a track record of reacting well to whatever complexity, uncertainty, and ambiguity gets thrown their way. In that way, when evaluating a business, we are able to look at what 'normal earnings' are. Then, when there are challenging periods, and short-term investors make their decisions based on the next few quarters, buying opportunities present themselves.

Merlin Entertainments is the second largest theme park operator in the world (only Disney has higher visitor numbers). It runs 124 attractions in 25 countries across 4 continents. In 1998, Nick Varney (still the CEO) led a private equity backed management buyout to start the firm. The strategy is to provide unique and memorable experiences in family entertainment through rolling out brands as well as expanding the accommodation on existing sites. Their portfolio includes theme parks like LEGOLAND and Alton Towers, and attractions like Madame Tussauds, The Eye Brand (e.g. London and Blackpool), Sea Life (the world's biggest aquarium brand), and others.

Money is fungible. It can be used for many things. Investors want good management to either put capital to good use or to return it. To act as custodians of that capital. Although following a capital-intensive strategy, the management of Merlin has shown themselves to be good at what they do, operating in a family environment where trust is essential. As opportunities have expanded, the disciplined management has continued a process of capital deployment looking for Returns of Invested Capital (ROIC) of over 20%. 2 new LEGOLAND theme parks are planned for completion by 2018 in Asia. It also has plans to continue the roll out of the smaller attractions such as Madame Tussauds and Sea Life.

More recently, one of the two levers of growth (new parks/attractions and more visitors to existing sites) has faced some challenges. Like-for-like growth in visits to existing sites has been challenged in recent years. Management believes this decrease has been caused by the recent terrorist attacks in 2015, 2016 and 2017. They have also been impacted by hurricanes in America which caused the closure of resorts in Florida and Orlando. Management has decided to "flex the strategy" and increase the roll out of new business initiatives. A profit warning has led to a decrease in the multiple investors are prepared to pay for earnings.

Even if existing attractions stop being a strong growth lever (growing in line with inflation instead), new attractions have the potential to make up the difference. Merlin has recently added Bear Grylls Adventures (which lets visitors try their hand at extreme adventuring) and Peppa Pig World (offering, amongst other things, muddy puddles for little adventurers). Perhaps the biggest opportunity comes from the opening of a LEGOLAND in New York, which has 23 million people in its primary catchment area. Trends of expanding leisure time and paid entertainment for children are expected to continue. They should be able to fund most of this capital investment with cash generated from the existing businesses, with limited borrowing.

Earnings are at the low end of normal. On top of that, the multiple we are asked to pay for these earnings is the lowest since the company became publicly traded. Expanding existing operations obviously offers shorter cycle return on capital. New developments are offering higher, but longer cycle returns. Shifting capital from shorter to longer cycle projects may provide less short-term earnings visibility, but it is simply responsible capital budgeting. Those able to look beyond medium-term consensus earnings should have their patience rewarded.

As these new initiatives start bearing fruit, there is the possibility of a recovery in investor confidence. That recovery would provide pleasing returns for those willing to buy in during tougher times. In the meantime, we get a solidly run company, doing what they do well.

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