Langton Capital Limited

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MITCHELLS & BUTLERS (MAB): 407p
Group acquires bulk of Orchid estate:

Group says purchase 'will accelerate M&B's growth and present significant opportunities for value creation…'

Year to end-Sep	PBT (£m)	EPS (p)	PER (x)	DPS (p)	Yield (%)
2013 (A)	150.0	34.9	11.7	Nil	Nil
2014 (E)	190.0	36.0	11.3	1.6	0.4
2015 (E)	209.0	39.4	10.3	6.0	1.5

Source: *Company & Broker Estimates*

Group announces purchase of Orchid pubs:

Mitchells & Butlers has this morning announced that it has reached agreement to purchase the majority of the assets of Orchid and our comments are set out below:

The Deal:

- After weeks of speculation, Mitchells & Butlers has confirmed that it has reached agreement to purchase 173 'predominantly freehold' pubs from Orchid Group for £266m
- The purchase price is to be paid wholly in cash
- Some 158 of the pubs are either freehold or long leasehold, the purchase is 'in line with (M&B's) stated strategy'
- Some 96 of the units will be converted to M&B's existing brands over the next two years
- The group is forecasting cost savings of £6m 'available from rationalisation of support functions and combination of purchasing'
- As a condition of the deal, M&B is taking over the Orchid head office – and suggesting that it will be responsible for restructuring costs going forward – a figure of £10m is mentioned
- The group will provide HO functions for the leasehold pubs being retained by Orchid
- The group says there will be immediate EPS benefits (for a cash deal, there should be) and M&B expects a 'double digit earnings enhancement with returns well ahead of cost of capital'

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Market Cap: £1.7bn
12m range 358p 490p

Mark.brumby@langtoncapital.co.uk
Suite 415, No1 Alie Street, London, E1 8DE
020 7702 3389

- CEO Alistair Darby says the deal 'will accelerate M&B's growth and present significant opportunities for value creation'

Funding:

- Despite not having had the cash to pay a dividend since the credit crunch, M&B says it has 'funded the substantial majority of the consideration using existing cash resources'
- The group says it has put in place additional unsecured debt facilities of £150m

Comment:

- M&B says the deal expands its market share. It does but, last year, M&B said that the industry was expected to grow over the short or medium term.
- Over the slightly longer term, it maintains this morning that the market should expand by a relatively anaemic 6% by 2018
- Brand conversion should bring some benefits. The revenues for the acquired estate comprise £15k per week compared with nearly £23m across the existing M&B estate
- There is no update on trading which, last seen, was sluggish. Recent trends are shown below:
- **Tab.1. Mitchells & Butlers LfL Sales Trends:**

Period	LfL sales (%)
FY 08/09	+1.6
FY 09/10	+2.8
FY 10/11	+2.6
H1 11/12	+2.7
FY 11/12	+2.1
H1 12/13	+0.3
FY 12/13	+0.4
First 8w of 13/14	+0.1
Implied next 7w of 13/14	+4.7
First 17w of 13/14	+2.0
H1	+1.1

Source: Company Reports

- This is CEO Alistair Darby's first deal and M&B has outbid Greene King amongst other operators in order to secure this purchase
- The competition to purchase the best of Orchid's units does suggest that the price is likely to be relatively full
- That said, M&B does have a strong stable of brands into which it will be able to slot a number of Orchid's units and some additional revenues should be forthcoming

Langton Comment: M&B is the largest contributor to the Peach Tracker survey and its recent performance has been somewhat lacklustre. The purchase of Orchid, it is to be hoped, has not been a distraction. It didn't appear to be for under-bidder Greene King but the price, whilst likely full, has to leave a little in it for synergy benefits

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Mitchells & Butlers already has assets to die for. However, whilst some observers have suggested that the group should have remained focused on improving the performance of what it already has. Perhaps, if it had this money to hand, it should even have paid a dividend.

That said, there is little doubt that some of Orchid's pubs are extremely attractive. The acquisition will be immediately earnings enhancing and there will be some upgrades to existing numbers. On unchanged forecasts, the group is trading on only 10.3x next year's earnings. It is cheap on that basis but growth has been elusive and it must deliver on the integration of today's acquisition. In addition, the group's share register remains an issue. Value may not come out in the same way or as quickly as it perhaps could in other circumstances.

Whilst acknowledging the latent strength of M&B's business and accepting that it trades on a relatively lowly rating, we would still be tempted to look for value elsewhere.

Contact – Mark Brumby - +44(0)20 7702 3389

mark.brumby@langtoncapital.co.uk

Mark.brumby@langtoncapital.co.uk
Suite 415, No1 Alie Street, London, E1 8DE
020 7702 3389