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Leisure: Punch Taverns (PUB): 73p
De-merger update, analysts' meeting

Following the group's update this morning on the proposed demerger of its Spirit business, Punch Taverns presented (at some length) and hosted a meeting for analysts at which we believe the main points to emerge were as follows. Questions are highlighted with a Q:

- **THE STRATEGIC REVIEW SUMMARY:**
  - The status quo was not maintainable
  - Managed requires investment and leased needs repositioning
  - Limited synergies make a demerger workable
  - This will provide choice & liquidity to shareholders
  - Both businesses will have greater flexibility and Spirit should pay a dividend
- **TRADING:**
  - Managed LfL sales have been sharply higher in last two quarters
  - Leased is moving back towards zero % is -3% with the core in growth
- **DEMERGER PROCESS:**
  - Circular etc. to be posted later today. EGM on 26 July and new shares expected to begin trading on 1 August
  - Group has filled in most of the gaps on the boards, though more changes may come at Punch
  - Allocation of cash is £113m Spirit and £92m to Punch; the payment to Punch is necessary to prevent default and buys the group time. Q – Cash was £270m at end FY, £242m at end H1 and just below that now; what cost the support to A & B? There will be some up-streaming post year-end, c£20m net – this will be added to Punch's c£92m just after year end.
  - De-facto separation (separate IT systems, offices etc.) took place on 4 July. This included renegotiating beer supply contracts.
  - A (max nine month) TMS (temporary management service agreement) is in place – effectively to deal with Spirit's leased pubs
  - Q – Bondholder discussions? No need for this at present; clear strategy. Will come up to factors (such as selling more than 25% of pubs) that will need bondholder approval and will deal with that as and when.
- **SPIRIT:**
  - Strong trading momentum, 80% of estate will have been refurbished by summer 2012.
  - Some leased units, perhaps 100 of 550, will be moved to managed. Will sell the 'rump' of the estate but intend to improve its performance first. Q – What characterizes the 100 v the 450? They are all being viewed individually on a case-by-case basis. Where are the units located? Are they big enough, what other units does Spirit have in the location etc. 'There is no rush'.
  - Q – Head office costs? These will rise in the short term but 'it is a really insignificant number'.
  - Pro forma data was given and further details can be found on Punch's website. We would highlight:
  - Spirit generated a pro-forma £41m of PBT in the last 12 months.
  - LfL managed pub profit was up by 15% in H1.
  - Leased profits are running at £97k per pub, proof that the group's leased units are of a high quality.
  - Cashflow was c£51m in the lasts 12 months; capex will remain relatively high but disposals should compensate. Debt is 5.6x EBITDA.
  - Q – Up streaming? This should be allowed from next year at some point.

- Q – What about the cash that is going into Spirit? Has to be viewed in the round & there's no compulsion to spend it.
- The first dividend should be paid post the March 2012 H1 numbers. Q – Is this not a little optimistic? Capex is at above-normal levels; longer term, the dividend is supportable. Group is 'entirely comfortable'.
- Q – Will the payout be 1/3 of income post onerous leases? Group says it will be 'one third of net income'.
- Q – Are assumptions too bullish? Co denies this as EBITDAR margin is 500bps < Mitchells & Butlers & headline sales can move further.
- Q – Cash cost of onerous leases was £15m to £20m; what progress? Have invested in some. Tend to judge at the EBITDAR level (pre-rent).

- **PUNCH TAVERNS:**
  - Performance is improving, particularly at the average (but also at the LfL) level.
  - Target of 3,000 pubs increasing EBITDA by 2% to 3% per annum. Aim to sell around 500 non-core units per annum.
  - Expect to commence discussions with bond holders.
  - A and B are profitable pre debt amortization.
  - Pro forma data can be found in more detail on the group's website. We would highlight:
  - Punch's estate is predominantly (94%) freehold.
  - Core units are down 2% LfL in 40w to May. This should move to +2% over time. Non-core was down by 14.5% in the first 40w.
  - Core units are valued at £702k (9.3x) and non-core are valued at £278k (8.1x).
  - Cashflow will be utilized in the core estate. Cash tax will remain low.
  - Punch has 8.6x debt to EBITDA. Securitised debt has an effective interest rate of 6.9%.
  - Q – Board? Could be subject to further change.

Langcap view: No real surprises but the meeting did run over once again the rationale for a demerger and it reassured on trading, at least on the managed side.

LfL managed sales are still strongly ahead but, though tenanted LfLs are moving towards zero, they are still in decline. True, the core estate is in growth but disposing of 2,000 non-core pubs (and more in managed) is not going to be achieved overnight.

And the group ran into some questioning on its dividend policy re Spirit as capex is likely to remain relatively high on the managed side for some time. Overall, we remain of the view that a great deal of execution risk remains and that the outlook for Punch is too uncertain to make it a potential core investment for non-holders.

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