rthern leisure

ember 1997 edition of *Analyst*, we ran an advertisement: Growth Company Investment Analysts'. One of the many who to that advertisement was a young, self-taught private investor, Paton, who as he explained had *'been a subscriber to Analyst for s and within that period significantly developed my knowledge of picking techniques'.*

his is the piece of research that accompanied his application. Maynard will be writing more on some of his favourite growth companies in future editions. We'd like to publish more pieces like this from subscribers and turn them into a regular feature of the publication. Anyone game?

Analyst: Maynard Paton

Most *Analyst* subscribers will be familiar with *Company REFS* and how the various tables can be used as starting points in the search for undervalued growth companies. Keen followers of the SmallCap lowest PEG table will no doubt have noticed the appearance of Northern Leisure over recent months. With a reported PEG of 0.40, tremendous relative strength, terrific cash flow and directors recently purchasing shares, Northern Leisure could be interpreted by some as a 'sure fire winner'.

But before any hurried investment decision is made, potential investors must understand the operational characteristics and economic fundamentals of the business. An assessment must be made of Northern Leisure's ability to continue it's recent turnover and profits increases. Consideration must be given to the 'quality' of any future profits. In short, to determine whether Northern Leisure has the predictability, stability and visibility of future earnings to justify a purchase.

Business history, characteristics, attractions and disadvantages

The upward trend of turnover, profits and earnings per share over the last five years can be attributed to the 're-focusing' of the business. Back in 1992, Northern Leisure was a loss-making leisure conglomerate, composed of a mixture of 'leisure' businesses. Subsequently, underperforming divisions within the group were identified and sold.

Unencumbered, Northern Leisure now operates an estate of discotheques. Over the past three years, it has concentrated on increasing this estate and consolidating the highly fragmented and profitable discotheque industry. The consolidation being carried out by the company is rapid. Six new venues were bought in the year to August 1996 taking the total owned to twenty six, with fifteen bought in 1997. The company expects new acquisitions to continue at the rate of fifteen a year. Funding for the expansion has come from the aforementioned disposals, two share placings in the last twelve months and, not least, the benefits of cost-cutting in a highly cash generative business.

There are several aspects to Northern Leisure's operation that immediately appeal. It's a simple business with simple objectives. It purchases individual discotheques and, with improved venue management and an increasing advantage of scale, can reduce centralised costs. The savings are used to fund more acquisitions to continue the growth and consolidation. It has, albeit a quite short, track record of consistently achieving it's objectives. The company has been able to locate, purchase and integrate discotheques on a regular basis without any obvious problem.

There's plenty more growth to come as well. Although there are some larger competitors in the discotheque industry, hundreds of existing venues are operated by small or independent owners. The company has identified around 300 suitable towns for new locations. Discotheques generally enjoy big margins. Northern Leisure produces a 30% profit margin, indicating a pricing power over consumers and lack of direct competition. Local competition is no doubt reduced by the placing of licensing and planning restrictions upon potential new rival discotheques.

No investment proposition is without a downside though. The company is unlike, say, Yates Brothers or JD Wetherspoon, in that it has no overall 'roll-out formula'. It has no recognised 'brand' to fall back on

NORTHERN LEISURE

Price: 498p

Market Cap: £304m

52 week high/low: 500p/219p

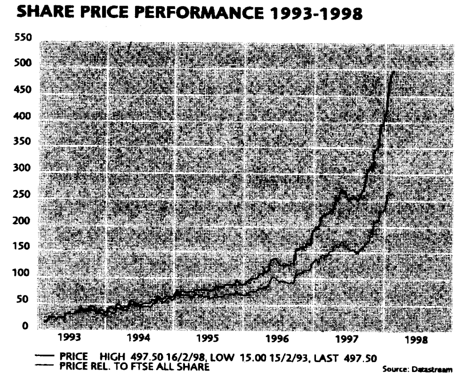
Financial year end: 31st August

Next announcement: 1998 Interim Results - March 1998

Sector: Leisure & Hotels

Address: 39 King Street, Cheapside, London, EC2V 2QD
Tel: 0171 600 0261

SHARE PRICE PERFORMANCE 1993-1998



if future trading conditions become difficult.

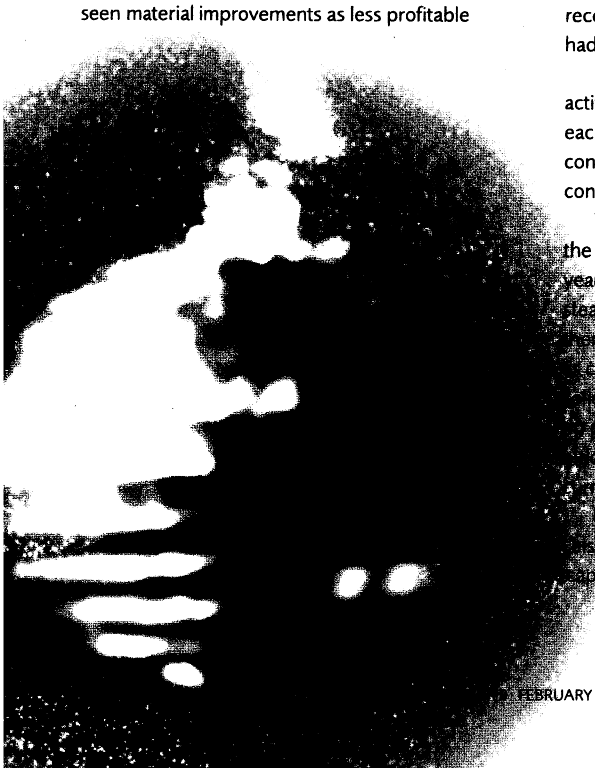
Northern Leisure's acquisitive nature gives an uneasy feeling as well, introducing all the extra uncertainties that go with purchasing any business. Acquired turnover may be fine in the short term, but long term investors want to see evidence of organic growth. A reliance on acquisition can become a dangerous game to play. Having been so visibly successful up to now, it can't be too long before others recognise the potential of acquiring and operating numerous discotheques. Competitors in any consolidation 'race' can easily raise the prices of possible new venues, leaving Northern Leisure nowhere to go if valuations become unreasonable. One such competitor, First Leisure, has recently, if somewhat belatedly, identified nightclubs as a future engine for growth.

On the financial side, Northern Leisure has made two successful share issues in the last twelve months to finance it's expansion. Investigations must reveal whether top line sales growth can be pursued without continued recourse to shareholders and lenders.

Financial analysis and interpretation

Turnover from Dancing has been increasing significantly since August 1994. The three financial years since have seen increases of 16%, 27%, and last year, 58%. The average turnover from the 'annualised' number of venues operated per year has marginally increased, around 3-4%, year-on-year. Stripping out acquired venues, turnover per continuing venue has remained static although reported like-for-like sales for the year to August 1997 were 5.1%. Either way, organic growth is minimal. Purchasing new venues is the sole driver for greater sales and the bigger the purchase, the better. The average annualised turnover of those venues acquired last year rose 12%, to £1.3m, with a 34% rise on the year before.

Gross margin and operating margins have all seen material improvements as less profitable businesses were sold. With operating margins now at around 30%, it's easy to understand why the decision was taken to focus entirely on discotheques. However, gross margins for the fifteen venues acquired in the last financial year matched those of the twenty six existing venues. This highlights the importance of cutting central costs in the future and taking advantage of the organisation's larger scale.



Employee and administration costs in relation to turnover have seen declines in the last four years. Half the employees are part time and the average employee pay (assuming part time staff are paid half as much as full time) has risen slightly to only £7,500 per annum. This very low figure indicates reliance on employing junior and (probably) inexperienced staff for most positions. Any legislation regarding the implementation of a minimum wage would certainly have an effect on margins.

The company enjoys the operating advantage of cash retailers, having little in the way of trade debtors and the ability to finance it's stock several times over from trade creditors. Short term liquidity measures, having remained reasonably steady over the last few years, should always be well under 1.

The key growth stock ratio, return on average equity, is unimpressive. It has averaged 13.6% over the last three years and hardly matches up to returns of 30% plus for some other *Analyst* cash retailers. Although it will take time to bring acquired businesses up to speed, it's disappointing to note a return of just 12.5% in 1997. Other factors for the low figures are that discotheques, by their nature, usually only appeal to the 18-30 age bracket and only open during the evening, with most trade at the weekends.

Gearing is a comfortable 40% at present with interest well covered at 6.3x. The company has a policy of limiting gearing to no more than 60% and has a maximum loan facility of £46m. Prior to the recent share placing and open offer, borrowings had reached over £40m.

Impressively, cash generated from operating activities has always exceeded operating profits in each of the last four years. This shows a tight control by management of working capital and is confirmed by the sales activity figures.

The prices Northern Leisure has had to pay for the acquisition of dancing venues over the last three years, using a price-to-sales calculation, has risen steadily. From 0.56x to 0.85x and to 1.32x last year, there is no doubt future increases can be expected as competitors realise the possible potential of consolidation within the discotheque industry and bid up prices. Although having highlighted this, the trading has a long way to go before it reaches the current 5x level Northern Leisure as a whole enjoys.

Unusually, over the last few years, Northern Leisure, when buying new venues, has built up a 'capital reserve' (or 'negative goodwill') by paying below the deemed 'fair value' of the tangible assets purchased. This was illustrated last year by the company purchasing tangible assets, the fair value of which was £41m, for only £27m. The capital reserve now amounts to £17m. It does seem odd, and somewhat suspicious, that new venues have been consistently purchased over the last three years at less than their 'fair' tangible value. Maybe within the industry annual turnover is more important than asset value for a selling price valuation, or some of the 'bargain' venues could be losing money.

The depreciation charge as a percentage of yearly fixed asset investment, fixtures and fittings and operating cash flow has steadily decreased over recent years. This can be expected as the company has lately adjusted depreciating fixtures and fittings from eighteen months to three years (thereby boosting short term profits) and has spent recently on refurbishments. These refurbishment costs have been highlighted by fixed asset investment increasing as a proportion of turnover and cash flow. The company has a similar capital expenditure rate to other expanding retailers, with fixed asset investment averaging 26% of operating profit over the last four years.

Another criticism that can be levelled at management's financial running of the company is the high dividend payout ratio. Retaining just 55% of after tax profits is a little wasteful. After considering recent share placings and open offers, large borrowings and the growth outlook of Northern Leisure, investors could be better served if the dividend payouts were lowered to help accelerate earnings.

In summary, none of the operating ratios have declined to any level of concern and most are at a consistent level. Significantly, margins have increased and working capital ratios have dramatically improved. However, the capital reserve, the change in the depreciation policy and the unduly high dividend payout ratio are 'question marks' in an otherwise sound financial history.

Recent trading, outlook, projections, and valuation

At the November AGM, the board was 'confident that the outcome for the current year will be very satisfactory'. Sales were reported to have increased by 91.3% in the nine weeks since 1st September 1997, like-for-like sales increasing by 3.8% and that trading continues to be 'strong'. This January, along with announcing a £20.6m placing and open offer, the board anticipated interim earnings of 8.8p (5.3p) and dividends of not less than 4p (2.5p). The company has purchased six new venues for a total of £14m since the August 1997 year end.

The beauty of companies whose expansion rests on a growing number of outlets, be it nightclubs, restaurants or superstores etc., is that future turnover and profits are, as forecasting goes, relatively straightforward to project. With a consistent financial history, various turnover per venue ratios and the company's expectation of acquiring fifteen new venues a year, profit forecasts can be projected.

Key assumptions for the forecast are that the average turnover per acquired venue increases by 6% (last year 12%) to August 1998 and 3% the year after. The price paid per £ of turnover of these acquisitions increases from 1.32x to 1.65x this year and 2.00x next. Like-for-like sales are to increase by 4% for both years.

The calculations produce profits of £12.3m and £17.4 for 1998 and 1999 respectively. Taking into account 5.4m extra shares from the January placing and 2m outstanding warrants, earnings per share are forecast at 21.1p and 28.1p. Using 1997 FRS3 earnings per share of 12.8p and a share price of 493p, the PEG is calculated to be 0.64.

In relation to a return on equity valuation, Northern Leisure appears expensive. For 1997, the average equity in the business was £49.9m, profits after 27% tax were £6.2m, giving a return on equity of 12.5%. With 1997 year end equity of £64.5m and assuming a dividend payout ratio of 40%, a projection five years forward would see earnings grow from £6.2m to £10.8m. If the company then sells at a multiple of 16.3, the 10 year risk free rate of return equivalent, it's market capitalisation would be around £176m, giving a valuation of £194m after accumulated dividends. Compared to today's £270m valuation, it can be clearly seen how important acquisitions are needed to boost equity and profits to justify the current rating. Taking into account the 1997 capital reserve increase and using a return of 14.5%, in line with historic and projected figures, the company's valuation of £235m still shows the shares to be overpriced.

Conclusions and recommendations

Northern Leisure is now an uncomplicated business and performs consistently well in purchasing 'bargain' dancing venues, cutting costs, squeezing working capital and using the cash generated to help fund more acquisitions. A low return on capital makes it necessary to borrow money and issue highly priced paper to continue expansion. No market growth and a lack of an identifiable 'competitive edge' (apart from the undoubted talents of the management) give an unpredictable feeling as and when serious competition arrives, possibly two or three years down the line. With a profit-enhancing depreciation policy change and a questionable capital reserve, the company cannot take its place as a core growth stock. Investors seeking long term investment 'fortresses' should pass and move on.

As the main driver of growth, any material slow down in suitable acquisitions would entail a large setback for the valuation of the company. ○

NORTHERN LEISURE – RATIO ANALYSIS

Year to 31st August	*1995*	*1996*	*1997*	*1998(f)*	*1999(f)*
Turnover	23,238	26,852	34,672	57,165	81,500
Staff costs	(5,244)	(5,618)	(6,218)	(9,718)	(13,448)
Depreciation	(1,490)	(1,183)	(1,382)	(1,601)	(2,357)
Cost of Sales (Total)	(15,674)	(17,423)	(21,088)	(33,156)	(46,455)
Gross profit	7,564	9,429	13,584	24,009	35,045
Administration Expense	(2,315)	(2,336)	(2,982)	(4,859)	(6,846)
Operating profit	5,249	7,093	10,602	19,150	28,199
Profit before taxation	**3,771**	**5,514**	**8,519**	**16,806**	**24,464**
Tax on profit	(300)	(785)	(2,278)	(4,538)	(7,095)
Profit for financial year	3,471	4,729	6,241	12,269	17,370
Dividends	(2,064)	(2,057)	(3,269)	(4,907)	(6,948)
Retained profit	1,407	2,672	2,972	7,361	10,422
Earnings per share (p)	**8.3**	**9.8**	**12.3**	**21.1**	**28.1**
Gross Margin (%)	*32.55*	*35.11*	*39.18*	*42.00*	*43.00*
Operating Margin (%)	*22.59*	*26.42*	*30.58*	*33.50*	*34.60*
Pre-tax Margin (%)	*16.23*	*20.53*	*24.57*	*29.40*	*30.02*
Staff Costs:Turnover (%)	*22.48*	*20.92*	*17.93*	*17.00*	*16.50*
Tax Charge (%)	*7.96*	*14.24*	*26.74*	*27.00*	*29.00*
Dividend Cover	1.68	2.30	1.91	2.50	2.50
Stocks	561	249	465	783	1,005
Trade Debtors	14	-	-	-	-
Cash	124	82	162	44	974
Current assets	2,783	2,805	2,367	2,623	3,874
Total short term debt	(750)	(1,000)	-	-	-
Trade Creditors	(610)	(936)	(2,477)	(4,023)	(6,164)
Current liabilities	(4,960)	(6,504)	(9,440)	(12,601)	(15,774)
Total assets less current liabilities	50,305	48,614	90,695	128,611	178,938
Medium/long term debt	(19,673)	(13,113)	(25,998)	(29,298)	(59,298)
Provisions for liabilities and charges	(119)	(266)	(184)	-	-
Net assets	30,513	35,235	64,513	99,313	119,640
Goodwill written off	736	736	736	736	736
Total Capital Employed (inc. G'will)	51,791	50,350	91,431	129,347	179,674
Capital Reserve	1,263	3,197	17,588	17,588	17,588
Staff employed	889	988	1,095	-	-
Current Ratio	0.56	0.43	0.25	0.21	0.25
Acid Ratio	0.45	0.39	0.20	0.15	0.18
Debt:Total Capital Employed (%)	*39.43*	*28.03*	*28.43*	*22.65*	*33.00*
Interest Cover (Gross)	2.7	4.5	6.3	8.2	7.6
Stock days	18.16	7.01	10.31	10.71	9.78
Trade Debtor days	0.22	0.00	0.00	0.00	0.00
Trade Creditor days	19.75	26.37	54.89	55.00	60.00
Turnover:Total Capital Employed	0.45	0.53	0.38	0.44	0.45
Turnover: Employees (£000)	26.14	27.18	31.66	-	-
Op. Profit: Employees (£000)	5.90	7.18	9.68	-	-
Post Tax Profit:Average Equity (%)	*14.00*	*14.39*	*12.51*	*14.98*	*15.87*
Op. Profit:Total Capital Employed (%)	*10.13*	*14.09*	*11.60*	*14.81*	*15.69*
Op. Profit:Total Capital Emp. (Ave %)	*10.92*	*13.89*	*14.96*	*17.35*	18.25
Operating Cash Flow	6,834	7,888	11,398	23,538	33,408
Purchase of tangible fixed assets	(2,271)	(588)	(4,182)	(7,277)	(10,716)
Depreciation:FAI (%)	*65.61*	*201.19*	*33.05*	*22.00*	*22.00*
Operating Cash Flow / Operating Profit	1.30	1.11	1.08	1.23	1.18

the character group

An upward trend in sales, high return on equity, tremendous relative strength and low PEG signal another potential growth stock. But, with a doubling of the share price in under a year, will the market continue to ignore the uncertainties?

Analyst: Maynard Paton

Business Overview

The Character Group ('Character'), formerly known as the Toy Options Group, describes itself as an "international distributor of a broad base of character related products". From its formation in 1991 until last year, the company had been a pure children's toy importer and distributor, serving the UK and the Republic of Ireland. After two acquisitions in 1997 and another made earlier this year, the group has widened its activities. The operation now includes the design, development and manufacture of a variety of media based 'character' products. Through acquisition, the company has enhanced its distribution network to over 50 countries.

The Character Group comprises four main businesses: the original core Toy Division and the recently acquired World Wide Licenses (WWL), Downpace Ltd and Prelude Worldwide Ltd.

The Toy Division acts as a 'middle-man' for foreign children's toy manufacturers wishing to sell their products in the UK and the Republic of Ireland. The division identifies and purchases branded or character licensed toys from the manufacturers and imports them, crucially, on an exclusive basis. The majority of the imports are based on American film and TV programmes, such as "RoboCop", "Star Wars" and "Power Rangers". The company then distributes and sells the products on to major toy retailers such as Toys'R'Us, Argos, Hamleys and Woolworths.

WWL, bought in March 1997 and based in Hong Kong, specialises in the design and manufacture of character related watches, clocks and stationery. The design processes are performed in house but the manufacture is carried out on a sub-contract basis in China. WWL has in place a network of distribution channels to supply its products to 56 countries worldwide.

Downpace, bought in May 1997 from Electronics Boutique plc, designs, manufactures and distributes character licensed 'giftware', such as mugs and keyrings. This new subsidiary has recently seen strong demand for its distributed 'Teletubbies' and 'Mr Bean' licensed giftware. Downpace has a separate customer base to that of the Toy Division, supplying the likes of Clinton Cards and WH Smith.

Prelude, bought from its receivers this January, designs, develops and distributes children's character related toiletries and accessories for sale in the UK and throughout Europe.

The reasons behind the acquisitions are straightforward. Downpace and Prelude will expand the licences and range of products distributed, thus reducing the inherent risks associated with solely supplying children's toys that could suddenly lose their appeal. Both Downpace and Prelude will benefit from the larger distribution operation of Character and gain the advantages of cheaper manufacturing costs through WWL. Also, WWL provides a ready made network of distribution channels to allow Downpace and Prelude to supply its products around the world.

Group history and flotation

Given that Character made two acquisitions in 1997 and a third this January, the group's history, as detailed in the flotation prospectus, makes for interesting reading. The current chairman and managing director of Character, Richard King, formed Fergabrook in 1974, a business that eventually evolved into a purchaser and distributor of children's toys. Fergabrook floated on the Unlisted Securities Market in 1984, and under Mr King's dual role as chairman and managing director (the same positions he holds now at Character), pursued a 'growth by acquisition' strategy venturing into distributing home improvement, hardware and duty-free goods. Difficulties were subsequently found at some of the new businesses and one in particular caused substantial losses. Eventually a reverse takeover rescued Fergabrook, renamed Clearmark, in 1988. Clearmark's diversified interests couldn't withstand the early 1990's recession and inevitably fell into receivership in 1991, owing creditors nearly £8m.

Mr King and three others left Clearmark to form Toy Options four months before the receivers moved in. During Clearmark's receivership, Toy Options agreed with Galoob Inc. (an American toy manufacturer) and the receivers to take on selected remaining Clearmark stock, and act as an exclusive distributor. This established a "close trading relationship" between Mr King and Galoob and laid the foundation for five subsequent years of significant growth at Toy Options.

Toy Options Group, floated in June 1995 with a placing price of 65p, raising around £2.7m. The company needed the flexibility of extra working capital that the proceeds would give and to reduce the dependency on costly and restrictive letters of credit and debt factoring. The proceeds would also finance continued growth and in-house product development within the group. The directors at the time of flotation were committed to maintaining organic growth and had no intention at the time of pursuing an acquisition strategy. It is somewhat surprising then, that three acquisitions have been made less than three years after listing, and a little unnerving given Mr King's previous acquisition experiences.

Financial analysis and interpretation

Turnover has risen from an annualised £5.2m in 1992 (the first full year of trading) to £41.3m in the year to August 1997, an astonishing compound rate of 51%. However, after considering the recent acquired turnover contribution of £4.2m, the rate of sales growth produced by the original Toy Division has seen a steady decline. From an 81% rise in 1994, down to 75%, 34% and 22% in 1997.

Gross margins dramatically improved during 1995 (the year of flotation), jumping from 32% to 42%, but have seen no subsequent improvement to date. There have been no improvements in operating costs either, with total staff costs, administration and distribution costs, in proportion to turnover, all remaining at higher levels compared to 1994. The one-off improvement in cost of sales during 1995 and changes in directors remuneration (detailed later), give the explanations behind operating margins lifting from 7.9% in 1994 to 12.2% for 1997. Excluding directors pay, operating margins are a constant 15%.

Character operates with little in the way of fixed assets or capital expenditure, going a long way to explain an impressive 33% return on. equity. During 1997, sales of £41m were generated from £1.5m of tangible assets. Tangible assets increased significantly last year, with the purchase of the freehold of the group's main premises, for £800,000, and over £200,000 spent on machinery. Prior to 1997, net capital expenditure averaged just £60,000 per annum.

Similar to margins, working capital performance ratios have remained static since flotation, with only stock turnover gradually reducing. Interestingly, Character has entered into agreements to 'factor' its trade debts. Thus, the group effectively 'sells' its debtors (and pays an additional charge for doing so) to a 'factor company'. The factor company immediately advances a payment for the majority of debts to Character on the sale. The factor company subsequently collects the amounts owed for itself, paying Character the balance as and when the remaining debts become settled. Factors can be made with or without recourse. Character factors the vast majority of its debts without recourse. That is, if the debtor fails to pay, the factor company, not Character, suffers the loss. The 'factor' effect on debtor days for Character is significant. Without factoring, the group could expect to wait over three months for payment, but assuming factor advances are paid immediately, the average collection period is just two weeks.

The importance of factoring becomes apparent when examining the group's history of stock turn performance, and the volume of trade debtors and creditors in relation to sales and cost of sales. Since 1995, the group has consistently paid for its supplied stock 60 days after receiving it and (with stock turn now around 100 days) usually sells it around 40 days later. Given that, after factoring, debtors take an average of 15 days to collect, there is a 55 day wait between cash being paid for 'inputs' (imported goods etc.) and cash being received for 'outputs' (goods sold on to retailers).

This unenviable working capital situation regularly forces overdraft facilities to be used and explains the odd ratios when comparing interest paid and received to net cash. The group had net cash of £2.0m at August 1996, £3.7m at February 1997 and again £3.7m at August 1997. Yet throughout the year, the group received interest of just £23,000. Interest paid, without any overdrafts or loans listed, was £54,000. Thus Character has the extra burden of paying its bankers net interest during the normal course of its working capital management.

From the above, it comes as no surprise to discover cash inflow from operating activities to be consistently lower than operating profits, averaging 0.54x over the last 6 years. **Operating cash flow has exceeded operating profits only once, in 1997.** However, these figures were somewhat flattered by the acquisition of Downpace, with its additional working capital being accounted for in the main cash flow statement, not the operating cash flow reconciliation.

THE CHARACTER GROUP

Price: 292.5p

Market Cap: £60m

52 week high/low: 304.5p/100.5p

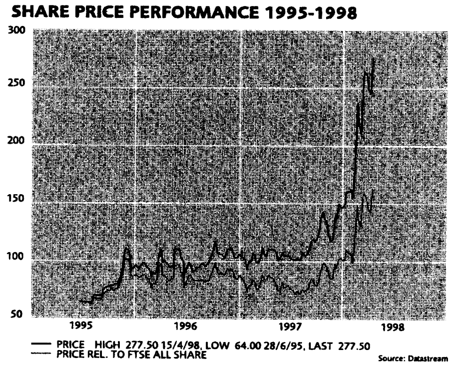
Financial year end: August

Next announcement: Interims, June 1998

Sector: Media

Address: 2nd Floor, 86-88 Coombe Road, New Malden, Surrey, KT3 4QS
Tel: 0181 949 5898 Fax: 0181 336 2585

SHARE PRICE PERFORMANCE 1995-1998



Acquisitions - Downpace and WWL

Character purchased both WWL and Downpace for cash, WWL for £1.2m and Downpace for £0.5m. Both purchases have an element of deferred payment, based on each subsidiary's post-tax profits over the next two to three years. The group's directors have estimated deferred payments of £1.6m for WWL (limited to US $8.4m) and £2.0m (limited to £4.0m) for Downpace. Both deferred payments can be satisfied in whole or in part by cash or an issue of ordinary shares, at Character's discretion.

The purchase of WWL has not been without its problems though. Character was soon embroiled in a legal dispute against a former owner and employee of the new subsidiary. The dispute, involving alleged copyright infringement, has incurred costs of £300,000 to date. WWL also underwent "a full reorganisation" after purchase and initially traded below original expectations.

The group's lack of information detailing contributions from WWL and Downpace causes concern. The two purchases brought additional sales of £4.2m and made operating profits totalling £517,000. Character reported WWL to have made a post tax profit of £42,000 to August 1997, but refuses to elaborate further on any figure for Downpace. Calculations to deduce a rough estimate for Downpace's contribution suggests an astonishing figure when compared against its prior financial history. Before Hong Kong profits tax, WWL made around £50,000. Subtracted from the overall acquisition operating profit leaves £467,000 for Downpace, say £300,000 post tax. This £300,000 three month contribution dwarfs the profits made by Downpace prior to purchase. Downpace, according to Character, made only £72,000 post tax in the four months leading up to acquisition and generated only £254,000 post-tax in the twelve months before that.

There are no obvious explanations to account for this extraordinary rise in profits, apart from a huge 'synergy' between the Toy Division and the new subsidiaries. Several plausible reasons, such as a large tax payment from WWL, a large interest bill for Downpace, or savings from massive Downpace redundancies, can all be discounted as an acceptable explanation for the phenomenal leap in profits. The chairman, through his statement in the 1997 annual report, rather understates the integration of the new subsidiaries by declaring that "anticipated trading benefits have already begun to materialise."

Comparisons of the price paid by Character in relation to rough estimates of annualised post-tax profits of the acquisitions suggest the group bought at 'bargain' prices. Character initially paid £1.7m for around £1.3m of annualised operating profit, say £0.8m after tax, producing a remarkably low p/e of just over 2. Even if Character had included the total deferred amounts it expects to pay, giving £5.3m, the p/e would still be a low 6.6, against Character's current 'rolling' p/e of 10.

Directors, shareholdings and performance targets

The board consists of four executive and two non-executive directors. The composition does not comply with the Cadbury Code, but the company considers the board appropriate for "the size and complexity" of the group's business. Each of the four executives has large holdings, totalling 50% of the share capital. Richard King, chairman and managing director, has interests in 4.8m shares, Kiran Shah, finance director, has 3.6m shares, Joe Kissane, sales director, has 1.1m and Jon Diver, marketing director, has 1.2m. The two non-executives have around 9,000 shares each. Three of the executive directors still have the same shareholding in the group as they did prior to flotation. The only director to have sold is Mr Kissane, disposing of 150,000 shares during 1997. Rather than reducing their shareholdings at flotation, the four executives awarded themselves large"additional remuneration entitlements", paid just a few weeks prior to the listing. Thus, in 1995, directors' emoluments equalled the group's pre-tax profit of £1.7m, and were double the cumulative directors' pay for the previous three years. Against the £2.7m net proceeds from the flotation, the additional entitlements looked excessive.

The non-executive remuneration committee amended in 1997, both the levels for capping director bonuses and, seemingly, the target to be achieved for the entitlement to any bonus. The cap, increased from one half salary to one times salary, was described as a "result of the impressive growth in shareholder value to date together with expected growth in the future". The bonus performance target for 1996 was for earnings per share to increase "by not less than 15%". The committee states for 1997 that the bonuses just require "increases" in earnings per share. The group won't comment on the new level, but if it has been lowered, it raises the question - did the board have doubts over the two acquisitions or the continuing toy distribution business?

The directors have authorised numerous share buy-backs, utilising surplus cash generated during 1997. Nearly 100,000 shares were bought for cancellation, at around 100p in financial 1997 and another 200,000 shares cancelled so far this year, between 118p and 155p. The share buy-backs come after a placing of 1m shares to raise additional capital, at 100p, in October 1996.

AGM, prospects and valuation

Mr King reported at the January AGM that like-for-like sales since August were up 42% on the previous year. Commenting on the group's divisions, Downpace had made "substantial progress", WWL was achieving "substantial growth" and the Toy Division was trading "in line with expectations". Overall, the board looked "forward to the future with extreme optimism". Brokers forecasts are for pre-tax profits to August 1998 of £6.7m, with eps of 21.1p, and pre-tax profits of £8.8m and eps of 26.7p, for 1999.

At a recent share price of 260p, the shares appear cheap with a PEG of 0.35. The return on average 1997 equity (including goodwill) was 33%. With a dividend payout ratio of 30%, and 1997 year end equity plus goodwill of £12.7m, a five year ROE projection gives post-tax profits of £9.5m and, on a p/e of 16.7, a market capitalisation of £170m, including £10m of dividends. With a current valuation of £55m, the shares again look cheap with an implied average annual compound rate of return of 24%. Looked at another way, to generate £9.5m post-tax profit five years out requires (with margins and tax at today's levels) turnover to increase by 20% per annum. Does the management have the ability to achieve this target and justify the large 'margin of safety' that seems to be apparent at the current price?

Conclusions and recommendation

Whenever investors thoughts turn to companies involved with children's toys, two immediate concerns spring to mind. Firstly, the unpredictability and relatively short term popularity that most toys have, imply a 'boom and bust' nature to toy manufacturers performance. This year's Christmas 'wonder-toy' could be next year's large, unwanted and overvalued stock pile. Secondly, the current toy retailing scene is not exactly a growth situation, with Toys'R'Us (maybe not in the UK, but certainly in the US), Hamleys and Argos hardly in any sparkling retail shape. These worries probably account for the low market rating of Character, sandwiched between the manufacturers and retailers, and the apparent attractiveness of the shares.

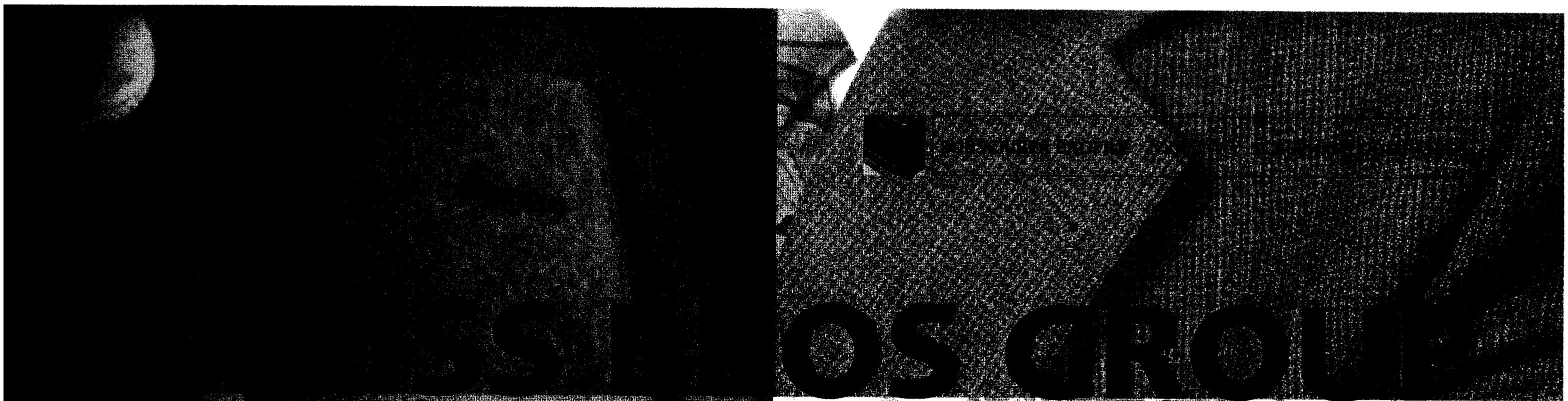
With the decision taken to broaden the group's product range and distribution network through acquisition, and reducing the dangers from being a pure toy distributor, Character has seen its share price double in less than a year. In terms of continuing the expansion of the group, the acquisitions were necessary. The growth of the core Toy Division operation is slowing. The chairman's description of trading conditions during Christmas 1996 and the first half of 1997 as "difficult", and a vague comment made this January, underpin the slowdown.

The trading nature of the business should put most investors off. With a history of an unfavourable working capital performance, the group appears to have little influence over trading terms with the toy manufacturers and retailers. It has needed overdrafts to keep itself going in its normal course of business. That's not unusual for a seasonal business, but when its noted that the group started to generate a cumulative free cash inflow only last year, then investors should be wary.

The biggest concerns cover the new subsidiaries. The chairman's previous history of making acquisitions doesn't inspire confidence, more so when it involved widening the range of products distributed, the situation at Character today. An uncertain trading performance from Downpace and initial difficulties at WWL, a combined "strategic change in direction", just strengthen the doubts.

In summary, Character throws up too many questions and uncertainties to justify any involvement, whatever the 'attractive' share price. The nature of the business, its historic lack of free cash generation, questionable acquisitions etc. give reason for investors to keep away. The only positives are the directors' large continuing shareholdings, their upbeat comments and recent share buybacks.

Not enough to outweigh the current doubts however, making Character Group one to avoid. ○



Moss Bros Group is one of the UK's best known menswear retailers. The group's stated aim is to become the 'leading menswear retail and hire company within the segments of the market that it chooses to operate'.

Since its formation at the turn of the century, the group has diversified from 'formalwear' hire and the retail of upmarket men's suits. Two relatively recent acquisitions have seen Moss Bros move into offering 'designer fashion' suits and casual clothing. Moss Bros has also developed a separate chain of mainstream menswear stores, stocking a wider variety of lower priced suits.

Business Description and Trading Divisions

After some boardroom changes and the emergence of the UK from the early nineties recession, the group embarked upon what has been, up to now, a successful expansion programme. Financed partially by the sale of its Covent Garden site for £20m in the late eighties, the total number of group outlets has grown from 100 during 1991 to 174 at January 1998.

Moss Bros divides its outlets into four markets: classic, fashion, mainstream and the original formalwear hire business.

The classic division trades through 57 outlets under the well established name of 'Savoy Taylors Guild'. Moss Bros describes this brand as appealing to the 'discerning customer who appreciates the quality and experience of the traditional tailor - without the price tag'.

The group's 1988 take-over of Cecil Gee plc created the fashion division. The 20 'Cecil Gee' branded outlets are summarised by Moss Bros to 'appeal to the independent, affluent man interested in fashion and prepared to spend money on his clothes'. As well as clothing sold under the Cecil Gee label, customers in these stores can expect the latest 'designer' offerings from the likes of Gianni Versace, Giorgio Armani and Dolce & Gabbana.

The Cecil Gee stores are complemented by the recent openings of four 'franchised brand' outlets. Having been a large customer of both Hugo Boss and Yves Saint Laurent products in the past, Moss Bros owns and operates 'boutiques' presenting just the collections from these two prestigious European fashion houses.

After Cecil Gee, the second acquisition to enhance the fashion division was to purchase 24 'Blazer' outlets in 1996, from Storehouse plc. Blazer's own branded product selection is described as 'stylish, understated and affordable' men's casualwear. Subject to acquiring the right locations, the Blazer brand was stated soon after acquisition to have the potential to double the number of stores from the 24 original sites.

Moss Bros developed the mainstream division in the eighties, and this trades under 'The Suit Company' brand. The division operates from 68 locations and directly competes with Marks and Spencer, the market leader, on the large but more competitive sub £300 segment of the men's suit market.

Moss Bros' original formalwear hire division operates from 107 departments, all located within larger classic, fashion or mainstream stores. The division, the UK market leader, offers a complete selection of suitable hire outfits for events such as weddings, university balls and Royal Ascot.

Through the expansion, Moss Bros has steadily increased its share of the £5bn menswear market to 3%. The group largely focuses on the menswear suit market with a current 12% share of this segment. The aim is to exceed 15% by 2000 and overtake Marks and Spencer.

Financial Analysis and Interpretation

Since the expansion programme began in earnest back in 1993, turnover has compounded at an average of 21.5% per annum. With only the one paper-based acquisition in that time, most of this growth has been captured at the turnover per share level, seeing an average 20.0% increase over the same period. Growth in sales hasn't just been achieved by increasing the number of outlets either, with sales per store witnessing a significant rise during the store expansion programme. Using year end outlet numbers, sales per store have risen 10% p.a. since 1993. This figure is somewhat distorted by the group having increased selling space by utilising basements and first floors at some stores. However, the sales per store performance is all the more creditable when taking into account the acquired 24 Blazer stores, whose sales per store after acquisition were at least 35% lower than Moss Bros' existing outlets. Probably a more accurate measure of store performance are increases in sales per square foot of selling space. Sales per square foot during financial 1993/4 were £338, compared to last year's £475, a compound rise of 7% p.a.

Gross margins have edged upwards slightly over the last few years to 50%, an enviable figure for any retailer. But the real improvement in margins has been seen at the operating level. Staff costs, selling costs and administration costs have all been reduced in proportion to sales over the years, thus lifting operating margins from a 1992 low of 1% to over 12% today. As with the sales-per-store ratios, Moss Bros has performed well with the integration of Blazer in terms of operating margins. Even though an operating margin of only 4.4% was reported for the 24 Blazer stores to January 1997, group margins still managed to rise slightly in the subsequent twelve months.

With sales increasing and an assault on operating costs, it is no surprise to find both sales per employee and operating profit per employee have consistently increased since 1993. At the bottom line, the progress has meant pre-tax profits and earnings per share compounding at an astonishing 50% plus p.a. over recent years.

Moss Bros operates with a very healthy, debt-free balance sheet. Working capital has remained at a consistent level, with stock days at a steady, but lengthy, 120 days. Trade creditor days are around the 57 day mark whereas trade debtors, as can be expected from a cash retailer, are negligible. At the end of January 1998, Moss Bros was sitting on a £20m cash pile, comprising one third of net assets. This large amount of cash is partly the legacy of the group's Covent Garden store disposal but mainly a result of a prodigious cash generation record.

The period 1992-1998 saw cash flow per share exceed earnings per share and operating cash flow exceed operating profits in all but one year. Another great sign is the internal funding of expansion. Although initially, Moss Bros did utilise the Covent Garden sale proceeds to start the expansion, all the recent growth (Blazer excepted - purchased through a £7.2m share placing) has been made without recourse to any outside financing. Over the last seven years, a cumulative total of £60m in cash has been generated after interest and tax, and before any capital expenditure. This compares to just £45m of accounting earnings. After £35m spent on store refurbishments, store openings and larger warehouse facilities, and £14m in dividends, Moss Bros still had an £11m surplus to add to its cash pile.

Return on average equity (adjusted for goodwill) has dramatically improved over the last five years to 21%, a respectable level for any retailer and above the 15% level managed by Marks and Spencer, Moss Bros' biggest competitor. (The comparison to this diversified retailer can be a little misleading though, as M&S is heavily involved in the low margin, low return food retailing business.) However, compared to current *Analyst* portfolio retailers, Moss Bros still falls a long way short of the 40% returns plus figures that JJB Sports, Carpetright, Topps Tiles etc. can regularly produce.

Compare again Moss Bros to its larger rival, M&S, and other *Analyst* retailers to determine how effectively retained profits are converted into subsequent earnings. Moss Bros, in the seven years to January 1998, increased EPS by 12.8p, whilst retaining 31.8p per share, giving a return of 40.2%. Marks and Spencer, on the other hand, increased EPS by 15.6p, whilst retaining 80.5p per share, producing a return of only 19.4%. Over slightly shorter periods, Carpetright produced a return of 66%, Blacks Leisure 63%, JJB Sports 50%, and Topps Tiles 40%. On this basis, Moss Bros yields a very respectable return.

Moss Bros' 21% return on average equity at only half the 40% return on retained earnings reflects the poor shareholder returns in the early nineties. With the mediocre return on equity prior to 1994 (around 5% at best), current equity returns do not fully reflect the recent re-investment achievements.

MOSS BROS GROUP - SUMMARY FINANCIAL RECORD

Year to 31st January (£'000 unless stated)	*1994*	*1995*	*1996*	*1997*	*1998*
Turnover	62,142	71,112	87,500	121,949	147,688
Cost of Sales	(31,319)	(34,452)	(42,313)	(59,554)	(73,177)
Gross Profit	30,823	36,660	45,187	62,395	74,511
Operating Expenses	(27,132)	(29,427)	(34,433)	(47,143)	(55,763)
Operating Profit	3,691	7,233	10,754	15,252	18,748
Profit Before Taxation	**4,082**	**7,395**	**11,305**	**15,916**	**19,600**
Taxation	(916)	(2,669)	(4,057)	(3,600)	(5,706)
Attributable Profit	3,166	4,726	7,248	12,316	13,894
Earnings per Share (p)	**3.77**	**5.67**	**8.51**	**14.09**	**15.62**
Dividend per Share (p)	1.40	2.40	3.60	4.80	6.00
Gross Margin (%)	*49.60*	*51.55*	*51.64*	*51.16*	*50.45*
Operating Margin (%)	*5.94*	*10.17*	*12.29*	*12.51*	*12.69*
Tax Charge (%)	*22.44*	*36.09*	*35.89*	*22.62*	*29.11*
Interest Cover (x)	1230.3	2411.0	5377.0	1525.2	6249.3
Dividend Pay-out Ratio (%)	*37.43*	*43.21*	*42.45*	*34.56*	*38.62*
Fixed Assets	18,849	19,339	23,701	29,953	39,355
Stocks	9,253	10,789	13,975	19,671	24,113
Trade Debtors	402	615	589	860	651
Cash	15,509	19,530	20,343	22,674	20,193
Current Assets	27,339	33,229	37,576	46,980	49,047
Short-term Debt	0	0	0	0	0
Trade Creditors	(4,952)	(5,564)	(6,600)	(9,830)	(10,534)
Current Liabilities	(10,511)	(13,942)	(18,437)	(24,962)	(26,241)
Medium and Long-term Debt	0	0	0	0	0
Provisions	(2,385)	(2,520)	(2,478)	(736)	(1,067)
Net Assets	33,292	36,106	40,362	51,235	61,094
Goodwill Written Off	6,311	6,311	6,311	10,096	10,096
Equity Shareholders' Funds	39,603	42,417	46,673	61,331	71,190
Capital Employed	41,988	44,937	49,151	62,067	72,257
Current Ratio	2.60	2.38	2.04	1.88	1.87
Acid Ratio	1.72	1.61	1.28	1.09	0.95
Stock Days	107.84	114.30	120.55	120.56	120.27
Trade Debtor Days	2.36	3.16	2.46	2.57	1.61
Trade Creditor Days	57.71	58.95	56.93	60.25	52.54
Turnover per Employee	79.98	85.99	97.87	106.23	111.04
Operating Profit per Employee	4.75	8.75	12.03	13.29	14.10
Staff Costs/Turnover (%)	*18.50*	*17.59*	*16.64*	*16.37*	*15.88%*
Return on Year End Equity (%)	*7.99*	*11.14*	*15.53*	*20.08*	*19.52*
Return on Average Equity (%)	*8.24*	*11.52*	*16.27*	*22.81*	*20.97*
Return on Average Capital (%)	*9.97*	*17.01*	*24.03*	*28.62*	*29.18*
Operating Cash Flow	3,590	9,444	11,883	17,692	19,140
Capital Expenditure	(2,425)	(3,135)	(6,824)	(8,861)	(12,576)
Capital Expenditure/Depreciation (x)	1.08	1.36	2.53	2.63	2.68
Free Cash Flow	1,665	5,376	3,061	5,859	1,913
Cash Flow/Earnings (x)	1.29	1.80	1.36	1.20	1.04
Year End Stores	102	111	129	164	174
Turnover per Year End Store	609.24	640.65	678.29	743.59	848.78

Directors, Shareholdings and Incentives

The acquisition of Cecil Gee brought the subsidiary's directors, the experienced Gee brothers, into the management team and a boardroom re-shuffle followed. Peter Moss had only a two month stint as managing director before Michael Gee took over the position in 1988. Michael Gee's tenure at the top lasted only six months, and ended when he handed the role to his brother Rowland, and became a non-executive. Rowland Gee has remained as managing director ever since. The third Gee, Nigel, joined the board in 1992. The Gee brothers currently have a total of 12m shares (13%) between them.

The Moss family, represented by Peter (now vice chairman) and David, together hold a total of 3.2m shares (3.5%). The other five directors hold under 300,00 shares in total, 160,000 of which are held by finance director Terry Donovan.

All the directors have shown remarkable restraint in the face of the sky-rocketing share price. With over a ten fold increase in the share price since the nadir of 1992, directors still hold 17% of the share capital, as opposed to 19% when the share price hit the bottom.

The Group doesn't reveal much when describing director performance incentives. Earnings per share have to achieve growth over a 'planned' figure for directors to earn up to a capped 30% bonus of salary. Options can be exercised three years after being granted subject to earnings per share increasing in excess of the RPI plus 2% per annum. Although an undemanding target, most of the relatively few options granted are insignificant compared to their owner's ordinary shareholdings.

Although part of an executive-favoured board (six executives, four non-executives), the five big shareholding directors with their strong family business backgrounds very much appear to be long term holders.

Outlook, Forecasts and Valuation

The original 'open 10 shops a year for 5 years' expansion plan has ended successfully. However, it remains unclear as to how further any subsequent store opening programme can progress. Unlike previous years, the 1997/8 annual report hasn't gone into any great detail about the year's store openings. Unusually, it also makes no comment about possible store openings for the year ahead either. Statements in the 1996/7 annual report such as the 'predicted 17% growth in the menswear market by 2000' and 'upward movements' in the suit market are noticeably absent in 1998.

Descriptions such as 'period of high property prices' and 'a highly competitive and demanding trading environment' go a long way to explain the lack of any short term positive growth outlook.

From normalised 1998 EPS of 14.9p, brokers forecast 16.7p for 1999 and 19.4p for 2000, giving a marked slowdown of EPS growth compared to years since 1993. At a recent share price of 260p, the PEG at 1.20 suggests little short term value. However, the current earnings yield (using a 'rolling' EPS of 15.7p to June 1998) of 6.0% does offer a better initial return than the current 5.7% gross yield on the 10-year benchmark government gilt.

Assuming Moss Bros can sustain its current return on equity, projecting the present return forward offers a worthwhile, but not satisfactory, margin of safety. Shareholders funds of £61.1m at January 1998, compounded at the current return of 21% per annum with a dividend payout at the current 40%, gives an equity base of £110m at January 2003. Projected earnings from that base would be £23.2m and on a multiple of 17.5 (the reciprocal of the 10 year benchmark gross yield and Moss Bros' average PER over the past five years) gives a market value of £407m. Add in cumulative taxed dividends of £20m, for a total valuation of £427m. From today's £236m valuation, a compound annual rate of return of 12.6% is projected.

Assuming Moss Bros could further its returns on equity to just 23%, say by investing the cash mountain in more profitable assets (i.e. extra stores), the expected five year compound return would exceed 15%.

MOSS BROS GROUP

Price: 251p

Market Cap: £228.4m

52 week high/low: 282.5p/217p

Financial year end: January

Next announcement: Interims, September 1998

Sector: Retailers, General

Address: 8 St Johns Hill, London, SW11 1SA
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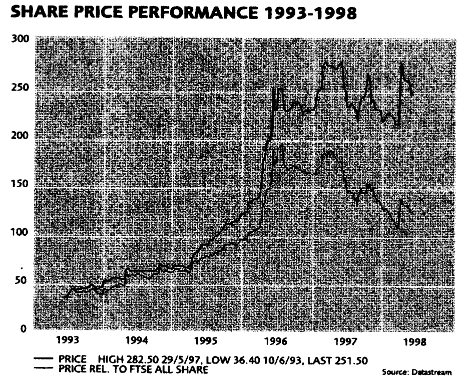
SHARE PRICE PERFORMANCE 1993-1998



Source: Datastream

Conclusions and Recommendation

The recent record of Moss Bros looks great. Impressive sales growth aided by like-for-like increases averaging 10% over the last five years gives a growth stock impression. However, there is a significant element of a 'turnaround' in Moss Bros, with both operating margins and return on equity rising substantially from the terrible pre-1994 figures. The management has done well in cutting operating costs, but with margins now above the sector average and the menswear market growing only at the rate of inflation, the scope for further margin improvement must be limited. Future growth will largely be driven by increasing the selling space available.

Moss Bros has developed a strong niche for upmarket and 'designer' menswear retailing, being the only sizeable retailer selling own brand labels alongside other designer branded clothing. The Savoy Taylors Guild, Cecil Gee, Hugo Boss and YSL stores, though very successful in the South East, are not really 'mass market' outlets. The scope for future expansion must be relatively small. Since 1992, with a background of rising consumer expenditure, the number of 'classic/fashion' stores (excluding Blazer) has doubled to 80. However, these stores are particularly sensitive to any deterioration in consumer spending. Sales from these stores decreased more than the overall menswear market during the last recession. So, thoughts must turn to the 'certainty factor' of the business. With a large exposure to upmarket stores, how will the group perform during the next economic downturn?

To reduce the risk associated with 'top of the range' menswear, and its inevitable cyclical link with consumer expenditure, the group has diversified. With the move into smart casualwear, via Blazer, Moss Bros have identified the growing importance of this type of menswear. Thus, the acquired Blazer range, combining with the Suit Company stores, projects a slightly more balanced trading future.

Moss Bros' tremendous cash flow record, the internal funding of the recent expansion and a resulting large liquid position are the hallmarks of any great retail growth stock. Without recourse to borrowings, Moss Bros has had an excellent financial and re-investment performance since 1993. If the current return on equity can be maintained at a slightly higher level than at present, the required margin of safety is there. But, without a proven record of consistently generating the required 23% return, why take the chance? With Moss Bros now giving a 'turned-around' or 'top-of-the-cycle' impression, investors looking at the General Retail sector should consider other options that consistently produce superior equity returns, are less exposed to the economic cycle and have intrinsic valuations offering a far greater margin of safety. ○