

Marchpole 13p

Swedish financing opens the way for DKNY

19 September 2008

Share Price: 13p



Source – Reuters

12m High: 125p

12m Low: 10p

Market Cap: £5m fully diluted

Shares in Issue: 39.1m fully diluted

NAV/Share: 20p inc. intangibles, nil ex intangibles

Gearing: 196% inc. intangibles

Interest Cover: N/A

EPIC Code: MPH

Sector: Retailing

Market: London Full List

Broker: Shore Capital

PR: Bell Pottinger

Website: www.marchpole.com

Description: Marchpole is a fashion group that is responsible for major brands selling into UK, and increasingly overseas, retailers. Brands include Paul Boateng, JCC and, from the current Autumn collection, DKNY for men.

Analysts: Roger Hardman/Yvette Riachi

Tel: +44(0)20 7929 3399

Email: roger@hardmanandco.com

Shareholders at fashion group Marchpole have approved a £2.5m financing that will allow the group to build inventory ahead of its critical new deal, the right to represent DKNY menswear worldwide from the coming 2008 winter season. The financing was announced with full year results for the twelve months to March 2008 that were broadly in line with our expectations once allowance was made for some one-off items, the most important of which will be clawed back in the current financial year.

The Marchpole of 2009 and 2010 will be a much improved company on the one investors had in front of them in 2006 and 2007. Flamboyant fashion guru Michael Morris has only 20% of the fully diluted equity, and is now second largest shareholder to Atlas Design AB, the Swedish fashion house that will be the new 30% shareholder if it fully converts all its loan notes. There is an executive chairman, Chris Phillips, to provide some balance in the boardroom, and one of the Swedish non-executive directors brings a great deal of industry expertise to the boardroom table.

The March 2008 balance sheet showed that Marchpole had done a satisfactory job in restoring its finances, but before the Atlas transaction there was little headroom to invest working capital for the new DKNY business. Now there is. We look for a further loss in the first half of the current year, followed by good profits from H2 onwards. The £6m fully diluted market capitalisation is for a business with sales revenues of possibly £30m-£35m in the current year, £50m in y/e March 2010.

Y/E	Group Sales	Declared Profit	Adjusted Profit	Adjusted EPS	P/E ratio	Divi	Yield
March	£m	£m	£m	p.		p.	%
2007A	90.5	6.2	6.2	15.3	0.8	3.75	28.8%
2008A	44.7	-6.1	-6.1	-19.9	-	1.1	8.4%
2009E	30.0	0	0	0	-	0.5	3.8%
2010E	45.0	No	Forecast			0.8	6.1%

Background

Marchpole has for a number of years been one of the UK's leading fashion groups. It operates brands that are sold into mid and high end boutiques and high street shops primarily in the UK, but also in the USA and, increasingly, other countries. Fashion is very much a personality driven business, and the key figure on the Marchpole board is Michael Morris, a 63 year-old clothing entrepreneur with a history in the industry that goes back to the early days of Carnaby Street. With the exception of an unhappy three years of dispute between 2000 and 2003 he has been the *de facto* chief executive throughout that time.

After over 30 years operating the rights to the YSL brand name for men worldwide outside the USA, Marchpole lost the franchise with effect from December 2006. This had the effect of inflating both sales and profits for the financial year to March 2007. Marchpole took maximum benefit from the remaining months of the agreement and cleared its outstanding inventory. Marchpole made immediate efforts to replace YSL, which included buying the own-label footwear supplier Greenmark, but the loss of the YSL agreement removed over half the group's turnover. For some months in mid-2008 the group operated with a highly stretched balance sheet. It declared a trading loss for the year to March 2008.

The trading was undertaken amidst appalling conditions for the retail fashion industry worldwide, with at least six major UK fashion retailers going into administration and almost every company in the industry worldwide reporting a major drop in profits.

An agreement to represent the DKNY brand for men worldwide except in Japan and India was reached earlier this year. This is a hugely important deal. The DKNY women's brand sells US\$3.5 billion a year, and Marchpole has won the opportunity to try and replicate this for men. This contract will not contribute to sales or profits until the closing months of the current financial year. It is inevitable that Marchpole will post another loss in H1 of the current financial year, and the best shareholders can hope for is enough profit in H2 to pull the group up to modestly above breakeven for the full twelve months. A profit is likely thereafter.

In order to fund the DKNY deal Marchpole has accepted a 30% dilution of its equity, by issuing subordinated convertible loan notes to Atlas AB, a Swedish corporation. The loan notes convert at 11.5p/share, and dilute Michael Morris down from 30% to 20% of the equity. Atlas AB will become the largest single shareholder. Marchpole shareholders voted in favour at an Extraordinary Meeting at end-August.

Marchpole has appointed two Atlas directors to its board. These are Peter Wahlberg and Allan Ladow. They take the number of directors on the Marchpole board to 10. A new finance director is in the process of being recruited.

Atlas Design AB

Atlas Design AB is a Swedish based company formed in 1943 by the grandparents of the current chief executive, Allan Ladow. It specialises in men's and women's shirts (its biggest seller), accessories and underwear. It sells throughout Scandinavia, and also in Germany, Italy and the UK; its UK office is in Berners Street, in the same building as the Head Office of Marchpole. It is largely family owned, but the Sixth National Swedish Pension Fund, which is a Government operated organisation, has recently taken a 24.5% share stake.

The turnover of Atlas Design AB in its last financial year was UK£30m, so while it is smaller than Marchpole it is still a very substantial organisation. Its head office is in Gothenburg, and in addition to the London office in Berners Street it has offices in Germany and Norway. Its main brand is Guthrie & Valentine. It also has the licence for the brand Tiger of Sweden, where its range includes underwear (for men and women), scarves ties and socks, Bugatti, Joop (No.2 to Hugo Boss in Germany and The US Polo Assn). It produces and markets products under three cartoon character brands, Snoopy, The World of Smiley and Hello Kitty.

Marchpole

19 September 2008

Private label business in the UK includes Austin Reed, Burton, John Lewis, Moss Bros, Tie Rack and Harrods.

We have met Allan Ladow and other members of his team, and it is clear that they have entered into the Marchpole transaction with a great deal of enthusiasm and commitment. Allan Ladow plans to devote a significant amount of time to the relationship with Marchpole. We expect Marchpole to be able to use Atlas's strong connections in Germany and Scandinavia to expand its presence there. In return Marchpole should be able to assist Atlas in Italy and the USA. We expect to see good volumes of cross trading between the two companies within the next twelve months.

The Atlas Deal

Atlas has provided £2.5m of additional finance to Marchpole, consisting of 1.36m new shares at a price of 11.5p a share and £2.34m of Loan Notes that convert into new shares, also at a price of 11.5p. The Loan Notes are subordinate to the existing bank debt. They carry a coupon of 7% p.a., which we view as an exceptionally favourable rate for a subordinate loan to a company of Marchpole's size and financial condition that is operating in the fashion industry. A proportion of the Loan Notes automatically converts into equity. The remaining loan notes, if not converted, are due for repayment in 2011. Full conversion will give Atlas 29.9% of the Marchpole equity.

This transaction is highly unlikely to be followed by a full takeover.

We understand that the deal was actively brokered by the Marchpole executive directors, without any involvement (until the legal stages) from the City corporate finance community. Morris has enthusiastically supported the deal in a letter to shareholders.

Impact On Management

The Atlas transaction has diluted deputy chairman Michael Morris down from approximately 30% of the equity to 20% (on full exercise of the conversion rights), and makes him the second largest shareholder rather than the largest. This will hopefully create more balance in the management team. In our view one of the problems at Marchpole has been the way Michael Morris's forceful, extrovert personality has, combined with his large shareholding, resulted in him dominating the company.

Marchpole has been aware of this for some time. It is one of the reasons why Chris Phillips, the ex Colliers CRE director, was moved from non-executive chairman to executive chairman in February 2008. The board is also seeking to recruit a new finance director with industry experience.

As Atlas is a fashion company rather than a finance house, its presence, and that of its two directors, will also alter the tone of the company. We expect the Atlas NEDs to do a great deal more than represent the interests of the Swedes. Because of their fashion expertise they should make a positive contribution to Marchpole's trading. Allan Ladow appears already to be working well with Michael Morris. This could also give Marchpole an option in terms of eventual management succession (Michael Morris is 63 but his pace of work is if anything becoming more dynamic each year and he has given no indication whatsoever of wanting to retire).

The 2007/8 Results

The final results for the year to March 2008 showed turnover and gross profit very much in line with our expectations, and a pre-tax loss worse than we expected, part of which was due to non-cash one-off factors. We have included the March 2007 results for comparison, but care needs to be taken because March 2007 included a full year of YSL, while the March 2008 results included no contribution from YSL.

Marchpole

19 September 2008

Y/e	2008	2007
March	£m	£m
Revenue	44.8	90.5
Gross Profit	10.4	63.5
Gross Margin	23.2%	70.1%
Distribution costs	2.6	4.2
Administration Costs	12.5	14.8
Operating (loss)/profit	-4.7	8.0
Finance costs	1.4	1.7
Pre-tax (Loss)/Profit	-6.1	6.3
(Loss)/Profit per Share	-19.9p	15.3p
Dividend per Share	1.1p	3.75p

Revenue. This reflects both the loss of YSL and a full year of the shoe acquisition Greenmark. We estimate that Greenmark provided broadly half of group turnover for the year; this shows how very dependent the group has been on YSL in the recent past. This revenue figure was slightly higher than we had thought likely.

Gross Margin. The 70% gross margin produced in the year to March 2007 was clearly unsustainable. It arose from the group making the very most of the use of the YSL name in the final months of the contract, and also reflects an element of fixed cost overheads within the Cost of Sales. The 2008 gross margin was also flattened because the auditors insisted that £1.4m of late payments from one client be treated as a bad debt. The payment has since been received in full and will be credited to the H1 2009 results.

Administration Costs. These have remained stubbornly high in view of the dramatic reduction in revenue, reflecting a significant element of fixed costs. We had expected these to be lower than they are, and part of the reason they have changed so little has been the determination of management to replace the YSL contract rather than downsize the company. Other factors are an amortisation charge following a sale and leaseback of property (a £0.5m non-cash item that should not repeat), and a prior year adjustment. Even so, administration costs to revenue of 28% are clearly unsupportable and we expect action to be taken to reduce these.

Finance Costs. The March 2007 finance costs included £0.8m of 'arrangement fees' for new facilities that have not been repeated this year, and the underlying interest charge is actually up, rather than down as the table would suggest.

Dividend. There is no final dividend. The 1.1p/share total for the year was declared and paid at the time of the interim results.

Y/e	2008	2007
March	£m	£m
Total Debt	10.8	7.0
Trade Creditors	10.0	8.9
Trade Debtors	7.5	11.5
Inventory	6.2	3.8
Shareholders' Equity	5.5	12.5
Shareholders' Equity ex Intangibles	-4.9	2.3

Marchpole

19 September 2008

Debt. The key item in the Balance Sheet, and arguably in the whole Preliminary Statement, is total debt. This has been very much reduced from its peak at the time of the Interim Statement. It is also sufficiently within the group's total borrowing facility to give some comfort to investors who last year were concerned about the group's financial position.

Trade Creditors. These are higher. We view the previous year's figure as abnormally low. Marchpole has been taking longer to pay its suppliers. It is not hugely out of line with the company's turnover however.

Trade Debtors are lower, reflecting the fall in turnover. Part of the reason it is down so significantly is the insistence of the auditors that one important late payer be written off as a bad debt. During the second half Marchpole also ceased trading with one important US customer and two major UK retailers (one in sportswear, the other in shoes) that had been late payers and/or impossible to insure. Marchpole has a policy of insuring substantially all its trade debt.

Inventory. This is higher, reflecting the fact that Marchpole ran its YSL inventory down to zero at the end of the March 2007 financial year. We view the fact that inventory is only £6.2m as an indication that H1 current year turnover will be substantially lower once more.

Shareholders' Equity. This is lower because it reflects the losses made during the year. Excluding goodwill and other intangibles, shareholders' equity is now negative. Marchpole has never been an asset situation however.

The Current Year

The DKNY contract will only benefit Marchpole in the final quarter. Marchpole will represent DKNY for one of the two seasons' collections, and we anticipate sales in the region of £12 - £15m, rather than the £30m+ that the DKNY work should produce in years two and three of this three year contract.

Following the decision to cease supplying a retailer for whom credit insurance proved impossible to obtain, we expect Greenmark sales to halve. However, Greenmark, as an own label shoe supplier, has low margins compared to the rest of the group, so the impact on profits will be limited.

Licence revenue will be slightly higher than last year. This is important, because licensing is high margin business, and also a higher quality earnings stream.

Other brands, such as JCC, Ungaro, Homebody and Paul Boateng, are likely to be stable.

Overall, therefore, we expect sales revenues of £30 – 35m in the current year, split £10m in H1, and £20 - £25m in H2. Sales revenues in the year to March 2010 will probably be in the region of £45 – 50m.

We expect a loss in H1 of the current year of possibly £3m. This will be an understatement of the true position, because the £1.4 bad debt provision insisted upon by the auditors will be written back during this half. For the full twelve months, we expect a pre-tax position of between breakeven and £3m profit. We shall provide a fuller analysis, and spreadsheets, once the Annual Report is available.

Marchpole

19 September 2008

Management	Major Shareholders						
<p>Chairman: Chris Phillips</p> <p>Deputy Chairman: Michael Morris</p> <p>CFO: Vacant</p> <p>Non-executive Directors: Ronald Stirling, Harvey Shulman, Allan Ladow, Peter Wahlberg</p>	<table> <tr> <td data-bbox="783 434 1177 490">Atlas Design AB <i>(on conversion of loan notes)</i></td> <td data-bbox="1187 434 1259 456">29.9%</td> </tr> <tr> <td data-bbox="783 517 943 539">Michael Morris</td> <td data-bbox="1187 517 1259 539">20.0%</td> </tr> <tr> <td data-bbox="783 573 1027 629">Equity funds managed by Barclays Bank</td> <td data-bbox="1187 600 1259 622">8.0%</td> </tr> </table>	Atlas Design AB <i>(on conversion of loan notes)</i>	29.9%	Michael Morris	20.0%	Equity funds managed by Barclays Bank	8.0%
Atlas Design AB <i>(on conversion of loan notes)</i>	29.9%						
Michael Morris	20.0%						
Equity funds managed by Barclays Bank	8.0%						
Key Dates	Key Milestones						
<p>AGM: No date yet released</p> <p>Ex-Dividend Date: None – No Final Dividend</p> <p>Dividend Payment: No Final Dividend</p> <p>Next Interim Results: January 2009</p> <p>Next Full Year Results: July 2009</p>	<p>1973 Formation of company and agreement to distribute YSL brand.</p> <p>2000 Michael Morris resigns from board and takes legal action against the company.</p> <p>2002 Poor results. Bankers require sale of Head Office. Board disagreement with a majority of shareholders leads to resignation of entire board and the auditors.</p> <p>2003 Michael Morris reinstated as executive deputy chairman.</p> <p>2007 Loses rights to YSL (December)</p> <p>2008 Obtains rights to DKNY menswear worldwide</p>						

Disclaimer

The conclusions and opinions expressed in the investment research accurately reflect the views of the first named analyst. Hardman & Co provides professional independent research services and the companies researched pay a set fee in order for this research to be made available. While the information in the research is believed to be correct, this cannot be guaranteed. There are no other conflicts of interest.

Neither Hardman & Co nor the analysts responsible for this research own shares in the companies analysed in this research note. Neither do they hold any other securities or derivatives (including options and warrants) in the companies concerned. Hardman & Co does not transact corporate finance and therefore does not earn corporate finance fees. It does not buy or sell shares, and does not undertake investment business either in the UK or elsewhere.

Hardman & Co does not make recommendations. Accordingly we do not publish records of our past recommendations. Where a Fair Value price is given in a research note this is the theoretical result of a study of a range of possible outcomes, and not a forecast of a likely share price.

Our research is issued in good faith but without legal responsibility and is subject to change or withdrawal without notice. Members of the professional investment community are encouraged to contact the analyst concerned.

This research is provided for the use of the professional investment community, market counterparties and sophisticated and high net worth investors as defined in the rules of the regulatory bodies. It is not intended to be made available to unsophisticated individuals. In the UK, any such individual who comes into possession of this research should consult their properly authorized professional adviser, or undertake one of the 'self certified' sophisticated investor tests that are available.

This research is not an offer to buy or sell any security.

Past performance is not necessarily a guide to the future and the price of shares, and the income derived from them, may fall as well as rise and the amount realised may be less than the original sum invested. For AIM and PLUS shares, it is the opinion of the regulator that risks are higher. Furthermore the marketability of these shares is often restricted.

This document must not be accessed or used in any way that would be illegal in any jurisdiction.

In some cases research is only issued electronically and in some cases printed research will be received by those on our distribution lists later than those receiving research electronically.

The report may be reproduced either whole or in part on condition that attribution is given to Hardman & Co, and on condition that Hardman & Co accepts no liability whatsoever for the actions of third parties in this respect.

Hardman & Co is not regulated by the Financial Services Authority (FSA).

© Hardman & Co.

Hardman & Co

4-5 Castle Court
London
EC3V 9DL
United Kingdom

Tel: +44(0)20 7929 3399
Fax: +44(0)20 7929 3377

www.hardmanandco.com

