

Photo-Me International 36.5p
Good Numbers – Upgrade

9 July 2010

Share Price: 36.5p



12m High: 45.5p

12m Low: 17.25p

Market Cap: £131m

Shares in Issue: 361m (368m inc. shares held in Treasury)

NAV/Share: 21p inc. intangibles but excluding goodwill

Gearing: nil, £8.1m net cash

Interest Cover: n.a. for current year

EPIC Code: PHTM

Sector: Leisure Goods

Market: London Full List

Broker: JPMorganCazenove/Evolution Securities

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Website: www.photo-me.co.uk

Description: Photo-Me operates photobooths and other vending equipment throughout Europe and Japan. It also manufactures printing kiosks, photo album machines, minilabs and other photo processing equipment.

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Full year profits were slightly ahead of our expectations. The company had issued a positive and unexpected Trading Statement in mid-June in order to prepare the market for good news. The key differences between the published numbers and our forecasts were a higher adjusted profit, a lower tax charge than we had predicted (leading to eps 12% ahead of our forecast) and a surprisingly generous dividend.

Key points from last year's trading were:

- An improvement in margins in the dominant Operations Division, which was driven by Photo Booths.
- A turn-round back into profit by the Sales & Servicing Division, where sales revenues were higher than we expected. Partly this seems to have been because of encouraging sales of the new Photobook Maker, which now has an installed base of 500 units.
- The company finished the year with net cash of £8.1m. Cash generated from operating activities was £47.7m. EBITDA was £44.0m.
- The year was currency aided, but even in constant currency terms profits were well up.

For the current year the following issues will be important:

- Currencies will be working against Photo-Me. The Pound has moved up 7% against the Euro compared to last year's average rate.
- Capital spending will be higher as a new generation of Photobooths is rolled out onto the estate. Cash generation will still be strongly positive however.
- Margins will continue to improve because Photo-Me is paying much more attention to the siting of its machines, and on keeping down costs.
- Expansion in China holds considerable promise.

The shares have risen since our last research note, and in a falling market. They still only trade on 2.7X EV/EBITDA, while its trading range is 2.5 – 3.5X. We don't expect fireworks in 2010/11 because of the adverse effect of currency movements, but even so profits should once again be higher.

Y/E	Group Sales	Adjusted EBITDA*	Adjusted Pre-tax Profit*	Adjusted EPS*	EV/EBITDA	P/E ratio	Divi	Yield
April	£m	£m	£m	p.			p.	%
2009A	210.5	38.6	1.6	0.2	3.2	182.0	-	-
2010A	222.5	44.0	14.0	2.7	2.8	13.5	1.25	3.4
2011E	212.9	44.8	16.0	3.1	2.7	12.2	1.50	4.1
2012E	No	Forecast						

* Before exceptional items

The Full Year Results

The results for the year to end-April 2010 were close to our estimates, as indeed they should have been because Photo-Me issued a guidance statement less than a month before the day of the announcement.

- Sales Revenues were £222.5m, compared to our forecast of £226.8m. Sales were up on the previous year's £210.5m, but almost entirely because of favourable currency movements. In constant currency terms sales revenues rose by only 0.4%.
- Gross Margins were up from 10.7% to 14.5%. This has been the big success story at Photo-Me over the past year. The margin improvement has been partly driven by a major efficiency drive introduced by Deputy Chairman and CEO Serge Crasnianski. Underperforming country heads and section heads have been replaced, supply contracts have been renegotiated, surplus labour shed and trading performance improved at each of the two Divisions.
- The Operations Division increased its operating margin for the second consecutive year, from 7.3% to 9.6%, and we believe margins will rise again in the current year. The photobooths are the driver in this business, they account for only half of the 43,850 sites in the Operations Division, but, we estimate, around 80% of the profit. Photo-Me has become very much more professional about getting profit out of each site, and is also paying much more attention than in the past to expanding the number of sites, particularly for its most profitable models.
- The Sales and Servicing Division is back in profit after two years of losses. The new Photobook appears to be a success, with c. 500 installed units now.
- EBITDA was £44.0m, precisely as we forecast, and a considerable improvement upon the previous year's £38.6m.
- The Pre-tax Profit was £14.0m. We had forecast £12.9m. On the other hand Exceptional Items (redundancy and reorganisation costs etc) were a little higher than we thought.
- The tax charge was lower than we expected at 28%. This is a very favourable tax rate for Photo-Me, because the corporation tax rates in France and Japan, two of its biggest country contributors, are high. We look for 30% tax charge in the current financial year.
- The dividend payment is very much higher than we thought likely, at 1.25p for the year. Shareholders had previously been two years without a dividend.

The Current Year

There are three key factors that are certain to influence the current year, and three more that might have a significant bearing on the outcome.

- Last year's average exchange rate was 1.13 Euros to each UK Pound. The exchange rate is currently 1.20 Euros to each UK Pound. Photo-Me will have to increase its French sales revenues and earnings by c. 7% just in order to produce the same result in terms of UK Pounds.
- Chinese expansion could be very important. We believe that China is already profitable even though Photo-Me has only 200 machines there at present. We look for this to be increased very significantly.
- The efficiency drive will have its full benefits in the current financial year.

Other factors that may be important include:

- A hike in capital spending will be seen, from £15m to £20m, possibly more. Photo-Me has a number of interesting new machines under development that it hopes can continue pushing margins upwards. These include a 3D photobooth.

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- The surplus Grenoble property may be a source of future capital for the business. Its lease has been renewed by the French industrial giant EDF for a further 9 years. This is producing £1.1m a year in rent (and appears in the line 'other income' in the accounts). Now the lease has been extended, Photo-Me may decide to sell it, or monetise the future rental stream in some other way, in order to increase its cash pile. We estimate the value of this property, on a sale in the open market to a financial institution, would be €13 – 15m. Having a 9 year lease to a tenant with a top grade covenant makes the building all the more attractive to an investor.
- Negotiations are under way in the Sales & Servicing Division for major Photobook contracts. As well as direct sales, OEM contracts are being discussed with major international organisations for Photobook Makers. The Photobook Maker has potential, and has some unique qualities. There is a clear demand for it in the market, this much has been demonstrated by the sales made in the short time since its launch. Also, management appears determined to obtain sensible margins on these deals. Negotiations of this kind often take a very long time to turn into firm orders, however, and we have not included any contribution for major contracts in our estimates.

Conclusion

Photo-Me is a transformed animal from the wounded beast of two years ago. The resumption of the CEO's role by the largest single shareholder, Serge Crasnianski, is in our opinion the main reason for this. In terms of profits and EPS, the shares are very much in line with the market. But the depreciation charge at £29m is twice as high as the profit, and because of that EV/EBITDA is the best way of valuing this company. Photo-Me is trading at 2.7X EV/EBITDA, which is towards the bottom of its trading range, and it is still throwing off huge quantities of cash, and making a very good return on capital employed.

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£m	2005/6A IFRS	2006/7A* IFRS	2007/8A IFRS	2008/9A IFRS	2009/10A IFRS	2010/11E IFRS
<i>Turnover</i>						
Operations	146.4	142.9	148.8	166.1	172.4	160.3
Sales & Servicing	83.6	69.9	44.7	44.4	50.1	52.6
Total Turnover	230.0	212.8	193.5	210.5	222.5	212.9
Change in Turnover						
Operations	4.6%	-2.4%	4.1%	11.6%	3.8%	-7.0%
Sales & Servicing	-14.2%	-16.4%	-36.1%	-0.7%	12.8%	5.0%
Total Turnover	-3.1%	-7.5%	-9.1%	8.8%	5.7%	-4.3%
Operating Margin						
Operations**	12.6%	10.6%	6.1%	7.3%	9.6%	10.0%
Sales & Servicing	12.2%	7.4%	-15.9%	-11.5%	5.6%	7.0%
Group	10.5%	7.4%	-1.3%	2.4%	6.7%	7.4%
Operating Profit						
Operations	18.5	15.1	9.1	12.1	16.5	16.1
Sales and Servicing	10.2	5.2	-7.1	-5.1	2.8	3.7
Group Overheads	-4.8	-4.5	-4.6	-2.0	-4.5	-4.0
Associates	0.2	0.0	0.0	0.0	0.0	0.0
(Discontinued item not included for 05/6)						
Operating Profit	24.1	15.8	-2.6	5.0	14.8	15.8
Non-Operating Profit (Ins Recovery)	5.4	0.0	0.0	2.1	0.3	0.0
Net Finance Costs	-1.7	-1.9	-3.6	-3.4	-1.1	0.2
Group Pre-Tax Profit	27.9	13.9	-6.3	1.6***	14.0	16.0

* Restated to exclude US Vending, since sola

***rounding

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£m	2005/6A IFRS Full Year	2006/7A* IFRS Full Year	2007/8A IFRS Full Year Restated	2008/9A IFRS Full Year	2009/10A IFRS Full Year	2010/11E IFRS Full Year
Gross Profit	47.4	37.6	16.5	22.5	32.3	33.5
Gross Margin %	20.6%	17.7%	8.5%	10.7%	14.5%	15.8%
Administrative Expenses	24.8	22.9	20.2	18.9	18.8	19.3
Change in Admin Expenses	-3.7%	-7.8%	-11.8%	-6.5%	-0.4%	2.5%
Other	1.3	1.1	1.1	1.4	1.6	1.5
Profit on Insurance Recovery	3.3	0.0	0.0	0.0	0.0	0.0
Joint Venture/Associates	0.2	0.0	0.0	0.0	0.0	0.0
Operating Profit	27.4	15.8	-2.6	5.0	15.1	15.8
Asset Impairment Charge	0.0	0.0	-7.8	-5.5	-1.2	0.0
Disposals/Exceptionals/JVs/l	2.3	1.8	-6.8	-1.2	-3.6	0.0
Interest Charge(-) or Credit (-)	-1.7	-1.9	-3.6	-3.4	-1.1	0.2
Interest Cover X	15.8	8.3	n.a.	1.5	13.7	
Declared Pre-tax Profit	27.9	15.7	-20.9	-5.1	9.2	16.0
Adjusted Profit	25.7	13.9	-6.3	1.6	14.0	16.0
Tax Charge on Declared Pro	26.5%	33.2%	0.0%	-99.4%	28.6%	30.0%
Tax Charge (- = credit) £m	7.4	5.2	0.2	-1.6	4.0	4.8
After Tax Profit	20.5	10.5	-21.1	-3.5	5.2	11.2
Discontinued Operations	0.4	-3.1	0.0	0.0	3.0	0.0
Minority Interests	-0.8	0.4	-0.2	0.0	0.0	0.0
For Ordinary Shareholders	20.1	7.8	-21.3	-3.5	8.2	11.2
Declared EPS p.	5.5	2.1	-5.9	-1.0	2.3	3.1
Cost of Dividend	4.4	8.8	0.0	0.0	4.5	5.4
Retained Earnings	15.7	-1.1	-21.3	-4.3	3.7	5.7
Adjusted EPS #	4.7	2.1	-5.1	0.2	2.7	3.1
Divi p.	1.20	2.40	0.00	0.00	1.25	1.50
Avg No Shares m.	368.2	367.9	359.3	359.3	361.9	361.9

* Loss from US Vending in 'Discontinued Operations'

Adjusted pre-tax profit, actual tax charge. Excludes discontinued operations

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Management	Major Shareholders
<p>Chairman: John Lewis</p> <p>Deputy Chairman and CEO: Serge Crasnianski</p> <p>Group Finance Director: Françoise Coutaz-Replan</p>	<p>Serge Crasnianski: 22.2%</p> <p>Western Management Overseas Ltd: 18.3%. Beneficial ownership: Philippe Wahl.</p> <p>Schroder Investment Management: 14.5%</p> <p>Dan David: 13.2%</p> <p>Artemis Investment Management: 5.0%</p> <p>Legal & General Group PLC: 3.0%</p>
Key Dates	Key Milestones
<p>Annual Meeting: November 2010, usually includes a Trading Update.</p> <p>Interim Results: December 2010 or January 2011.</p>	<p>2007: Disagreement between directors and certain shareholders. Several directors resign.</p> <p>2008: Re-living of fixed assets. Announcement of new strategy. End of rift between certain shareholders and the company.</p> <p>2009: Sale of Imaging Solutions (wholesale lab manufacturing).</p>

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