Review

Edison investment research

12 March 2009

The Quarto Group, Inc.

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
12/07	100.1	7.7	24.4	7.2	3.0	9.9
12/08	112.7	7.7	26.5	7.2	2.7	9.9
12/09e	116.0	7.8	27.2	7.2	2.7	9.9
12/10e	118.0	8.3	29.3	7.2	2.5	9.9

Note: *PBT and EPS (fully diluted) are normalised, excluding goodwill amortisation and exceptional items.

Investment summary: Steady earnings progression

Quarto has delivered respectable figures which again illustrate the resilience of the business model in weaker consumer markets. The market remains fixated with debt and liquidity issues and is missing that the company has a strong record of cash conversion, a continuing pattern of progressive earnings and an understated balance sheet that exaggerates the apparent gearing. The shares are oversold.

Continuing investment in new titles

Much of Quarto's strength derives from the continuing monetisation of its backlist of previously-published titles. However, to rely on this alone would be to compromise the future earnings. In 2008, the group stepped up the publication programme of new titles, many of which were commissioned in the prior year. For Co-Edition, production only goes ahead once licenses have been sold across at least three markets, so investment in new titles does not increase the stock risk.

Understated balance sheet

Although the balance sheet reflects newer titles, the older backlists were not and are not capitalised. They nevertheless represent a significant value to the business as they continue to generate meaningful revenues. Edison calculates, on a conservative basis, that the unstated element represents another £1 per share of assets. Adding this back into the balance sheet reduces the nominal gearing to 145%, or 87% if the minorities are included. The group continues to operate within its banking covenants on facilities in place until beyond June 2012.

Valuation: Overly depressed

Within a highly-nervous market, Quarto's combination of consumer exposure, small market capitalisation, limited liquidity and apparently-stretched balance sheet are not natural box-tickers for investors. However, the current rating is at an unjustifiable discount both to the inherent value of the assets and to the quoted publishing peers.

Price	72.5p
Market Cap	£15m

Share price graph

Share details

Code	QRT
Listing	FULL
Sector	Media
Shares in issue	20.4m

Price

52 week	High	Low
	164.5p	52.5p

Balance Sheet as at 31 December 2008

Debt/Equity (%)	331
NAV per share (p)	78
Net borrowings (£m)	52.4

Business

Quarto is an international publisher of books produced under its own imprints and licensed to other publishers.

Valuation

	2008	2009e	2010e
P/E relative	20%	39%	28%
P/CF	0.2	0.7	0.7
EV/Sales	0.8	0.8	0.7
ROE	33%	21%	19%

Revenues by geography

UK	Europe	US	Other
15%	14%	49%	22%

Analyst

Fiona Orford-Williams 020 3077 5739

forford-williams@edisoninvestmentresearch.co.uk

The Quarto Group, Inc. is a research client of Edison Investment Research Limited

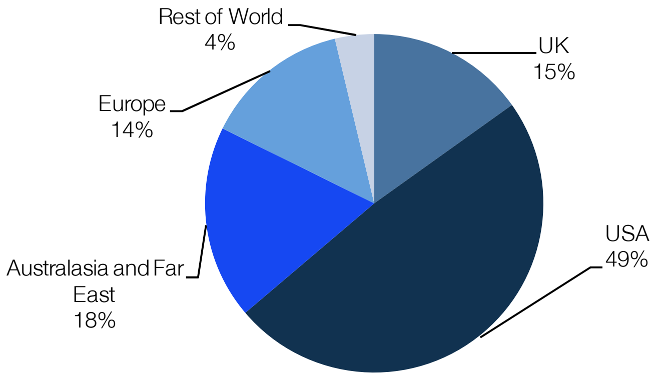
Investment summary: Steady earnings progression

Company description: International publisher

Quarto is a producer of books published both under its own imprints and in Co-Edition with other publishers worldwide. It specialises in illustrated non-fiction, making it far less susceptible to identifying 'hit' titles that drive the volatility of some of its peers. The books it produces are largely targeted at enthusiasts, hobbyists and specialists, covering a wide variety of topics of interest and are, in many cases, suitable for reprinting or updating over several years.

Around 60%-65% of revenues are invoiced in US dollars, with 49% being generated within the US, Quarto's most important market. Other key markets for group sales are the UK, Australia and New Zealand. The print broking operations are based out of Hong Kong and Singapore.

Exhibit 1: Geographic distribution of revenues 2008



Source: Quarto

Depressed valuation

With a small market capitalisation, a generally unfamiliar business model, limited liquidity and apparently high levels of debt, Quarto is struggling against the tide when it comes to achieving a reasonable market valuation. The last of these factors is particularly deceptive; we believe that the balance sheet is very conservatively stated, not reflecting the full value of the assets from which a high proportion of the revenues are derived, ie the backlists of previously published titles. As the debt is principally denominated in US$, the absolute amount has increased on translation as sterling has weakened. The current share price is indicating that the debt burden may be the group's undoing. We do not agree.

Sensitivities

Quarto relies upon people continuing to buy books. It concentrates on the less volatile non-fiction segments and produces high-quality, highly-illustrated volumes across a wide variety of subject matter. In previous harsher economic times, sales of books have proved resilient and that may well be the case again, but there are no guarantees. With such a high proportion of revenues (and costs) tied to the US$, the effects of currency movements can have considerable impact, especially concerning the presentation of the balance sheet, where year-end rates were $1.46, compared with $1.99 the prior year. The impact on earnings has been less dramatic in 2008, when the average rate was $1.86 ($2.00). With sterling weakness continuing over the year-to-date, the effect on the current year results could be even greater. The group has committed borrowing facilities in place of $165m until at least June 2012. The year-end net borrowing figure was $76.5m. Of the gross borrowing, $64m is hedged. The group is currently re-examining whether this continues to be the best strategy.

Financials

Quarto's management has carefully avoided giving indications for the current year, given the lack of visibility on sell-through. In our figures we have assumed that there will be a further softening of the market but that the effect on Quarto's figures will be mitigated by the continuing weakness of sterling, which will bolster the top line and would have a positive effect on net earnings. There is no longer any drain from the art print business, now discontinued. Our newly-published preliminary 2010 estimates for the following year assume little in the way of market recovery but benefit from the full-year effects of the actions taken to remove costs from the US infrastructure.

Exhibit 2: Forecast revisions

Note: Figures in £m except per share data

	EPS			PBT			EBITDA		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2008	26.5	26.5	N/A	7.7	7.7	N/A	22.0	22.0	N/A
2009e	26.6	27.2	+2	8.2	7.8	-5	23.7	23.6	u/c
2010e	-	29.3	N/A	-	8.3	N/A	-	23.9	N/A

Source: Edison

The earnings per share will benefit from a lower taxation charge than we had previously been expecting, more in line with the charge posted for 2008. The steady progression in earnings per share therefore looks set to continue, despite the weakening of the trading environment.

The business is fundamentally cash generative, with a strong record of turning operating profit into cash.

Respectable results

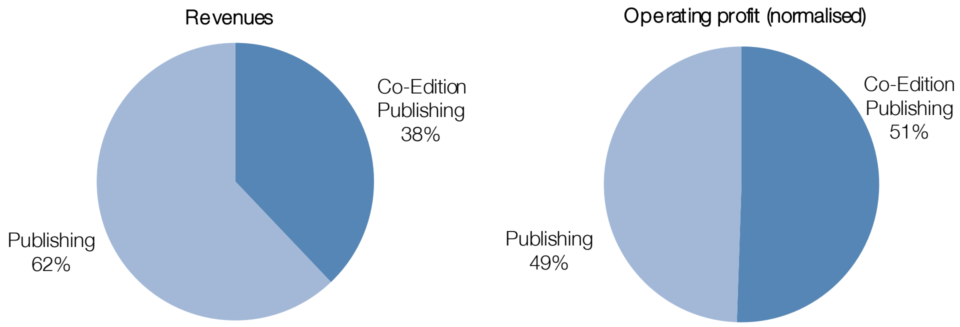
The fall in the share price over the last year might have been indicative of suspicions of difficulties with the underlying trading at Quarto. These results show that not to have been the case, although achieving maintained levels of profitability has obviously been more onerous. The important US market ended the year more strongly than looked likely during the dark days of November.

Co-Edition again takes the laurels

Quarto's Co-Edition Book Publishing has once again demonstrated the defensive nature of the business model, although the long lead times can build in a lag to the performance, with the 2008 results primarily reflecting titles initiated in 2007. As ever, the individual imprints varied in their fortunes, with some exceptionally strong performances such as that from QED, the UK-based children's educational publisher and with others, such as Marshall Editions, struggling.

The business model, whereby content ownership rests with Quarto but with the titles licensed out to third parties responsible for the distribution, marketing and inventory, means that the bulk of the risk of getting books to market vests with the licensee. Projects only get the go-ahead if those licenses have been sold to at least three markets with orders for over $100k and if the achievable margin averages over 10% after all direct third-party costs and in-house creative costs. For titles generated from the group's substantial backlists, gross margin is considerably higher.

Exhibit 3: Breakdown of revenues and operating profits 2008



Source: Quarto

Publishing nearer the heat

With greater pressure on the retail trade in Quarto's key markets of the US, UK and Australia, the group has done well to limit the reduction in operating margin from the division to 8.9%. Without the inclusion of a full year of MBI, bought in 2007, the scale of the impact would have been greater. The fortunes of the major US book retailers have been reasonably widely chronicled, but the distribution of the various imprints is far more widespread across the retail trade, encompassing the home improvement chains such as Home Depot and Lowes, art, craft and hobby specialists and the online distributors. The need to constrain levels of working capital led to considerable reductions in inventory levels within these channels, although from industry statistics it would seem that the level of actual sales has held up reasonably well.

As with the Co-Edition imprints, the backlist continues to provide an important impetus to sales, providing 59% of divisional sales, the same proportion as in both 2007 and 2008.

Withstanding margin pressure

Quarto had to deal with two main elements of margin pressure during the year; higher commodity and labour prices mid-year in South-East Asia (where the printing is carried out) compounded by the currency effect of weaker sterling for UK, and to a lesser extent, Eurozone, sales. As demand for product from the US retreated sharply towards the end of the year, print prices also fell with the overall effect that the group margins were very nearly on target.

Further restructuring to streamline fulfilment

At the interim stage, the company announced the discontinuance of the art print publishing operation, taking an exceptional charge of £2.6m to cover the relevant costs. The total charge for 2008 was £4.3m (of which cash represents £1.7m), the difference being the cost of reorganisation in the US post the acquisition of MBI. The subsequent consolidation of the infrastructure is involving the bringing together of accounting and back office functions as well as moving out the physical warehousing and fulfilment to a third-party contractor. The process, which began in 2008, will continue well into the current year. However, the benefits of improving efficiency should also start to come through.

Putting the debt into context

The medium- and long-term borrowings on the balance sheet have risen over the year from £58.2m to £80.2m, a rise of £22.0m, which, on the face of it, might appear worrying. However, the cash position is also a lot stronger than at the end of the prior year and the net debt figure is £52.4m against £43.4m. If this is then expressed in US$, the denomination of the debt itself, the end December 2008 number is $76.5m, compared to the end December 2007 total of $85.9m.

The group has borrowing facilities in place of $165m, consisting of a five-year $115m syndicated facility signed in June 2007 and a previous $50m eight-year private placement floating rate note. There are three principal covenants on these facilities, shown in Exhibit 4, below.

Exhibit 4: Debt covenants

	2007	2008	2009e	2010e
Net Debt < 3x EBITDA	2.03x	2.38x	2.28x	2.11x
Normalised operating profit > 3x net interest	3.63x	3.08x	3.11x	3.37x
Operating profit before amortisation > 1.5x net interest	3.76x	1.92x	3.11x	3.37x

Source: Forecasts based on Edison model

The weakness of sterling exaggerates the net interest charge, but this is offset in the current year (2009) by the reduced cost of borrowing.

Outlook

The trading background is particularly hard to judge currently and management have avoided any predictive statements. In any event, the last two months of 2008 were so different in outcome that extrapolation makes little sense. However, it is apparent that there has been extensive destocking particularly within key US retailers, which should ultimately improve visibility.

Assuming demand fairly resilient

Our forecasts are assuming that there is some further modest softening of demand, not that the market falls away dramatically. Historically, book sales have had an element of counter-cyclicality and intuitively it seems reasonable that a relatively low-ticket priced item that can translate to several hours of 'diversionary' activity will be recognised to be good value.

Spread of customers minimises credit risk

With the harshening conditions on the High Street, it would be surprising if Quarto's customers were not under pressure. However, they are very broadly spread and the risk from any one individual customer would not have a significant impact on group profitability. The level of receivables currently is broadly similar to the same period last year, with no meaningful uplift in the level of overdue payments. The reduction in the level of inventory held within the supply chain also reduces the risk of product returns, which are standing at around normal levels.

Currency effect

Whilst we have made certain assumptions on the effect of further currency movements within the income statement, at this point of the year there seems little merit in second guessing how the balance sheet will be calculated as at the translation date of 31 December 2009. In the notes to the 2007 Report & Accounts, the currency sensitivity analysis concluded that a 2% weakening of sterling would increase net profit and equity by £36k.

Sensitivities

Quarto's business model puts it at the lowest-risk end of the publishing spectrum. Nevertheless, we regard the following sensitivities as relevant to an evaluation of the group:

- Retail demand – particularly in the key markets of the US, Australasia and the UK. Historically, book sales have held up well during tougher economic markets due to the relatively low ticket prices and suitability for gifting. The evidence to support a repeat of this pattern in the current downturn so far is mixed.
- Currency – around 60%-65% of sales are US-dollar-denominated, with the dollar proportion of expenditure higher, as much of the printing is carried out in South-East Asia. Dollar receipts and expenditure are matched as far as is possible, but as the accounts are struck in sterling, there is inevitably a translational risk. Sterling weakness against the US$ inflates the top line (and vice versa). Further down the P&L, however, the effect is partially offset by the proportion of costs also in dollars. The nominal gearing figure is also inflated, as the debt is mostly US-dollar-denominated. The group is considering changing the accounting currency to US dollar to remove this element of uncertainty from the analysis of the figures.
- Interest rates – the group signed a $115m syndicated facility in June 2007, in addition to an existing $50m eight-year private placement facility. Borrowings of $64m were at fixed rates averaging 6.5%. The hedge through to 2012 is currently being re-examined.
- Balance of business risk – acquisitions have increased the proportion of the group's revenues derived from publishing its own imprints, rather than Co-Edition publishing. There is a higher financial risk in the former, due to the possibilities of unsold stock and returns. With Co-Edition publishing, orders are placed before production commences.
- Editorial sensitivity – despite the high proportion of revenues generated by the backlist, Quarto does have an ongoing editorial sensitivity. The popularity (or lack of it) of new titles is of fundamental importance.
- Credit risk – given the pressures on retailers, there is a strong possibility that there will be further casualties. Quarto has a very broad spread of customers and has no one title accounting for more than 1% of group sales. Nevertheless, problems in the customer base can lead to a drain on management resource to minimise consequential losses.

Valuation

With no direct comparators and a business model unfamiliar to many investors, the difficulty in placing Quarto into an easy 'box' has undermined its share valuation for some time. As the markets have become increasingly concerned with debt-free balance sheets and high levels of liquidity in stocks, Quarto's rating has been considerably undermined, which might indicate some concern over the trading performance. We argue that although markets are not easy, Quarto's conservative business model and accounting policies should partially insulate the worst effects.

Asset backing

The face of the balance sheet shows shareholders' funds at £15.9m, from £17.9m FY07, giving a net asset value per share of 78p, a 22% premium to the current share price. This does not include the net assets attributable to the minority shareholders, which increase the total to the equivalent of 103.5p per share.

This on its own should indicate the inherent value. However, Quarto is conservative in its accounting policies and only in recent years has it acknowledged that some value should be incorporated for the back list of titles that provide a meaningful proportion of the ongoing revenue stream; 65% of Co-Edition Publishing revenues and 59% of Publishing. The group capitalises its pre-publication costs and amortises them over three years, when much of the industry does so over a five year period.

As in previous years, Edison has made an attempt at valuing this unrecognised element, based on a cautious figure of £5k per title and working with an estimated catalogue of 9,000 titles. Some of this value is already recognised in the written down 'Other intangible non-current assets' of £3.2m. Within current assets there is £32.2m of further intangible assets of capitalised pre-publication costs less amortisation, but this will also include a sum in respect of work in progress that we have estimated to account for around one-third of the total. Stripping this away gives a de-facto backlist valuation of £3.2m + £21.5m = £24.7m, considerably below the £45m which Edison considers it to be worth.

Adding the difference to the published balance sheet gives an additional 100p per share of undisclosed assets.

Substantial discount to quoted peers

Exhibit 5: Valuations of quoted publishers

Note: priced as at 6 March 2009; Bloomsbury yet to publish preliminary results

	Price (p or c)	Mkt Cap (m)	P/E 08	P/E 09	P/CF	EV/ EBITDA	EV/ Sales
Quarto (£)	63	13	2.4	2.5	0.5	3.0	0.6
Bloomsbury Publishing (£)	144	106	14.4	15.7	4.4	3.4	0.4
Haynes Publishing (£)	122	20	-	-	4.0	2.6	0.6
Pearson (£)	646	5,228	11.2	11.4	8.2	7.7	1.4
Reed Elsevier (£)	477	5,258	10.7	10.3	5.2	5.8	2.1
John Wiley, Inc. ($)	28.40	1,664	11.4	11.9	7.6	9.3	1.5
Scholastic ($)	9.5	352	3.4	7.4	2.1	2.4	0.3

Source: Reuters, Digital Look, Edison Investment Research

The quoted publishing sector is far from homogenous, ranging far across media and subject matter. Bloomsbury is investing in its non-fiction imprints to reduce volatility and Haynes Publishing has recently agreed the sale of its printing unit. The market took Scholastic's Q2 figures very badly (high restructuring costs and bad debt provisioning) and the shares have been marked down heavily.

Quarto has actively avoided giving any guidance for the current year. Edison's forecasts assume a modest softening of a traditionally resilient market, offset by the benefits of a weaker currency conversion. The mark down in the share price implies that it expects earnings to be under far greater pressure than we currently feel likely.

Exhibit 6: Financials

Year end 31 December		2006	2007	2008	2009e	2010e
Accounting basis	£'000s	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		93,613	100,107	112,743	116,000	118,000
Cost of sales		(58,137)	(62,842)	(69,901)	(71,920)	(73,160)
Gross Profit		35,476	37,265	42,842	44,080	44,840
EBITDA		17,977	20,014	21,968	23,557	23,856
Operating Profit (before GW and except.)		17,018	18,976	20,879	22,500	22,800
Amortisation of intangibles		(1,387)	(1,312)	(1,830)	(1,850)	(1,850)
Exceptionals		(1,238)	370	(4,274)	0	0
Amortisation of pre-production costs		(7,461)	(8,416)	(9,529)	(11,000)	(11,000)
Operating Profit		6,932	9,618	5,246	9,650	9,950
Net Interest		(2,295)	(2,909)	(3,686)	(3,700)	(3,500)
Profit Before Tax (norm)		7,262	7,651	7,664	7,800	8,300
Profit Before Tax IFRS		4,637	6,709	1,560	5,950	6,450
Tax		(1,202)	(1,697)	(1,216)	(1,440)	(1,550)
Adjustment to tax for normalised earnings		(845)	(300)	(669)	(510)	(500)
Minority charge		(635)	(769)	(461)	(500)	(500)
Profit After Tax (norm)		4,580	4,885	5,318	5,367	5,767
Profit After Tax (FRS3)		2,800	4,243	(117)	4,027	4,417
Average Number of Shares Outstanding (m)		20.6	20.2	20.0	19.7	19.7
EPS - normalised fully diluted (p)		22.5	24.4	26.5	27.2	29.3
EPS - IFRS (p)		14.3	21.6	(0.6)	20.4	22.4
Dividend per share (p)		6.8	7.2	7.2	7.2	7.2
EBITDA Margin (%)		19%	20%	19%	20%	20%
Operating Margin (before GW and except.) (%)		18%	19%	19%	19%	19%
BALANCE SHEET						
Fixed Assets		20,396	31,641	35,358	35,022	35,022
Intangible Assets		12,697	23,116	26,622	26,622	26,622
Tangible Assets		7,699	8,525	8,736	8,400	8,400
Investment in associates		0	0	0	0	0
Current Assets		75,996	89,759	117,448	121,408	122,834
Intangible Assets: Pre-publication costs		20,919	24,946	32,222	38,000	41,000
Stocks		13,948	15,425	17,821	18,336	18,652
Debtors		27,200	31,811	38,484	39,596	40,278
Cash		13,929	17,577	28,180	25,476	22,904
Current Liabilities		(45,218)	(36,933)	(43,590)	(44,857)	(45,624)
Creditors		(27,418)	(34,173)	(43,257)	(44,507)	(45,274)
Short term borrowings		(17,800)	(2,760)	(333)	(350)	(350)
Long Term Liabilities		(31,546)	(62,602)	(88,102)	(81,000)	(76,000)
Long term borrowings		(27,121)	(58,190)	(80,234)	(75,000)	(70,000)
Other long term liabilities		(4,425)	(4,412)	(7,868)	(6,000)	(6,000)
Net Assets		19,628	21,865	21,114	30,573	36,232
CASH FLOW						
Operating Cash Flow		14,159	21,648	23,763	23,600	23,700
Net Interest		(2,499)	(2,819)	(3,870)	(4,160)	(4,150)
Tax		(611)	(798)	(1,093)	(1,272)	(1,468)
Capex		(9,308)	(11,169)	(14,109)	(14,000)	(14,000)
Acquisitions/disposals		844	(17,822)	(110)	0	0
Financing		56	56	1	0	0
Dividends		(1,535)	(1,581)	(1,655)	(1,655)	(1,655)
Other		583	89	(7,045)	0	0
Net Cash Flow		1,689	(12,396)	(4,118)	2,513	2,428
Opening net debt/(cash)		35,100	30,992	43,373	52,387	49,874
HP finance leases initiated		941	0	0	0	0
Loans acquired with acquisitions		0	0	0	0	0
Translation differences		1,478	15	(4,896)	0	0
Closing net debt/(cash)		30,992	43,373	52,387	49,874	47,446

Source: Edison Investment Research

EDISON INVESTMENT RESEARCH LIMITED
Edison is Europe's leading independent investment research company. With a team of 50 including over 30 analysts supported by a department of supervisory analysts, editors and assistants, Edison writes on more than 200 companies across every sector. Working directly with corporates, investment banks and fund managers, Edison's research is read by every major institutional investor in the UK, as well as by the private client broker and international investor communities. Edison was founded in 2003 and is authorised and regulated by the Financial Services Authority.