

26 March 2010

## The Quarto Group, Inc.

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/08	113	7.7	26.5	7.2	3.5	7.8
12/09	107	6.9	26.0	7.2	3.5	7.8
12/10e	108	7.0	26.0	7.2	3.5	7.8
12/11e	110	7.3	27.0	7.2	3.4	7.8

Note: \*PBT and EPS are normalised, excluding goodwill amortisation and exceptional items

### Investment summary: Unloved

Quarto has delivered figures broadly in line with our previous forecasts and we have only slightly adjusted our current year forecast. Even given the dull market background, the rating has been unduly undermined. The market seems unable to see past the absolute level of the group's debt, although there are substantial sums undrawn under the facilities and covenants are now easing. The shares carry a considerable yield on a maintained and well-covered dividend.

### 2009 figures in line

The prelims are broadly in line with our forecasts. There are modest underlying divergences from our model, with difficult trading from the Far Eastern publishing services company offset by slightly better result from the publishing segment. Cash flow suffers a difficult comparison with a good year in 2008, but we expect a stronger performance in the current year. We have not dramatically adjusted our 2010 figures and are not incorporating any particular help from market improvements.

### Mixed market background

The group has a very broad spread of titles and customers, but trading conditions in US consumer markets are the most dominant influence, particularly on sentiment. Recent statements from major US retail chains appear to show some stabilisation, with at least a slower rate of decline in Q4 and guidance for revenue growth during 2010 being pushed tentatively ahead. The growth of new delivery media is less of a threat to Quarto than for more text-based publishers, but could also turn into an opportunity as products such as the Kindle and iPad are honed.

### Valuation: Unloved

The market seems unable to see past Quarto's apparently high level of debt. The rating is very low and at a considerable discount on traditional valuation metrics. The shares are also trading around par to the published net asset value, which we believe understates the true value of the back list of titles, which drive ongoing sales. Quarto carries a premium yield, based on a dividend comfortably covered by earnings.

Price 92p  
Market Cap £19m

#### Share price graph



#### Share details

Code QRT  
Listing FULL  
Sector Media  
Shares in issue 20.4m

#### Price

52 week High 118p Low 78.5p

#### Balance Sheet as at 31 December 2009

Debt/Equity (%) 284  
NAV per share (p) 86  
Net borrowings (£m) 50

#### Business

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

#### Valuation

	2009	2010e	2011e
P/E relative	24%	31%	36%
P/CF	1.1x	0.8x	0.8x
EV/Sales	0.8x	0.8x	0.7x
ROE	28%	24%	22%

#### Revenues by geography

UK	Europe	US	Other
13%	14%	49%	24%

#### Analyst

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## Investment summary: Results in line

### Company description: Illustrated non-fiction book publishing

Quarto is a publisher of illustrated non-fiction, predominantly 'how-to', instructional and informational in nature. The group has two divisions: international co-edition publishing and publishing. The former is a less familiar model, whereby concepts are created in-house and then pre-sold to licensing publishers globally. Titles are printed together in multi-publisher, multi-language co-editions and do not proceed until a sufficient range of licenses are in place to cover the costs of production, leaving negligible inventory risk. The publishing division is a conventional model, with inventory risk resting with the publisher. The risk/reward balance is therefore more pronounced than for the co-edition segment. Unlike many publishers, however, there is no dependence on producing 'hit' titles or need for substantial author advances, placing the company at the low risk end of the publishing spectrum.

### Valuation

Quarto continues to be very poorly rated by the market. There are comparatively few peers and it trades at a considerable discount to larger, more liquid stocks. It also trades at a large discount to the value of the underlying assets, which are not fully reflected on the published balance sheet. The absolute level of debt undoubtedly looks intimidating to the observer, but the group has substantial undrawn facilities and the headroom on the covenants is set to widen under our model.

### Sensitivities

The group's greatest sensitivities are to underlying levels of retail demand, with an element relating to the success of editorial decision making. With just under half of sales directly in the US (more in terms of US\$-based sales) and around two-thirds of costs also US\$ denominated, currency movements can have a notable impact on the financial results. The difficult retail climate means that the group carries a credit risk, but, unlike many fiction publishers, it has a broad customer base and is not dependent on creating a continuous stream of hit titles.

### Financials

The 2009 figures have broadly delivered the sterling result we expected. Constant currency revenues were 15% softer, reflecting the tough retail situation, particularly in the US. We have made modest adjustments to our forecast, as demonstrated below and are now giving our initial thoughts on 2011 figures. Growth will be hard to come by, but trading conditions do seem more stable.

#### Exhibit 1: New forecasts

Note: Figures in £m except per share data.

	EPS			PBT			EBITDA		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2009	26.0p	-	N/A	6.9	-	N/A	22.8	-	N/A
2010e	25.6p	26.0p	+2	7.2	7.0	-2	23.0	22.8	-1
2011e	-	27.0p	N/A	-	7.3	N/A	-	23.0	-

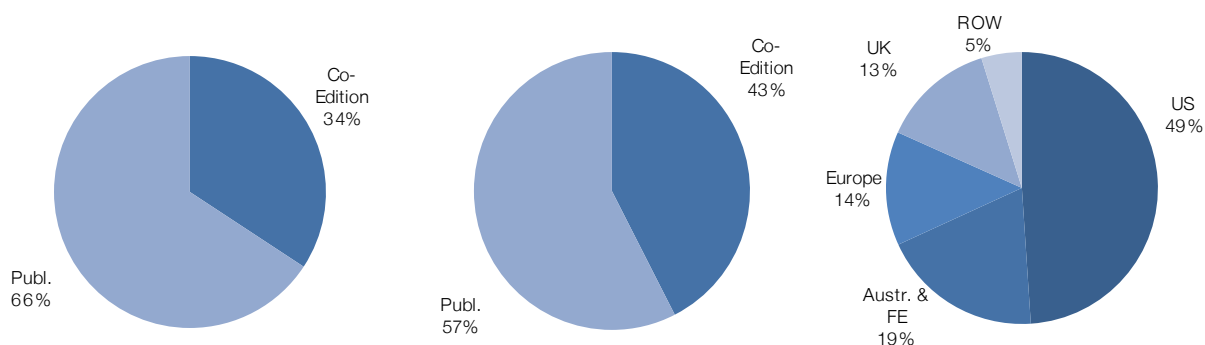
Source: Edison, Company

## Illustrated non-fiction publishing

### 2009 results broadly in line

The group's published statements go into a great deal of detail about the individual imprints' successes and shortcomings, and we do not intend to cover this in the same degree of depth. The figures came in broadly where we expected, with sales declining 15% in local currency terms, offset by movements in those currencies to net off at a reduction of 5% at the top line. The balance between publishing and co-edition has shifted by more than we anticipated, although the prime reason behind this is the inclusion in the co-edition figures of the Hong Kong-based publishing services business, Regent, which had a very tough year. This was as a result of retailers' reluctance to hold inventory and publishers' nervousness with regard to the market. The current level of activity within this operation has picked up and we have built an element of recovery into our estimates.

**Exhibit 2: Sales and operating profit by activity 2009; geographic sales breakdown 2009**



Source: Company

Restructuring charges of £1.6m have been taken with the 2009 prelims (£0.6m was identified at the interim stage). These predominantly relate to the integration and consolidation of the US warehouse and back office functions, together with some redundancy costs in the UK and Far East.

Cash generation was cast in a poor light by the exceptionally strong performance in 2008 and we expect a better performance in this respect in the current year. Our model shows cash flow sufficient to reduce net debt by £3m in both 2010 and 2011 (barring acquisitions).

The outlook statement is broad ranging, covering changes to delivery mechanisms and the emergence of new media. The key message, though, is that there remains a large degree of uncertainty in the market (particularly traditional book retailing), but that the illustrated non-fiction segment should prove more resilient than 'hit'-driven fiction markets.

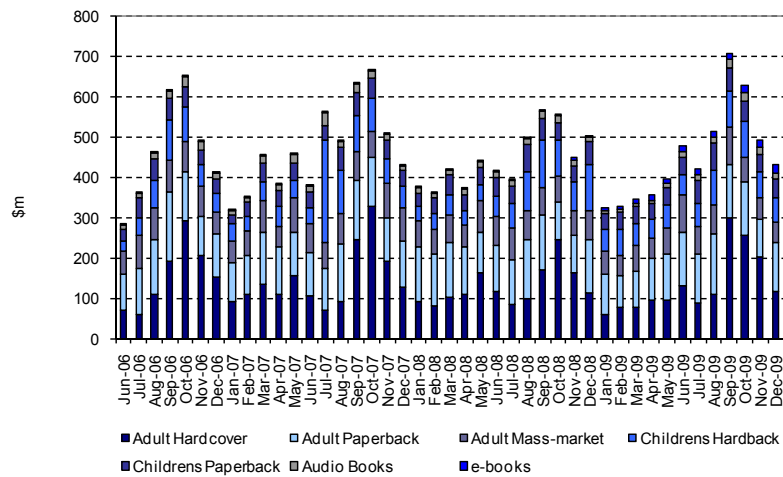
Our forecasts, including our first estimates for 2011, are predicated on only very modest top line growth, continued investment in new titles and the benefits of the US restructuring starting to flow through. We envisage a steady paying down of debt, unless and until an acquisition of a suitable publisher at a sensible price becomes available.

## Questions over routes to market

While the routes to market vary by territory, the US market is, by any measure, the key to the group's progress. However, it would be misleading to suggest that the vicissitudes of the US book retailing sector are the only factor, when so many of Quarto's various group imprints are distributed via specialist outlets, retail chains other than bookstores and, increasingly, online. Sentiment and confidence, though, can be difficult to see past.

## Overall US book sales marginally ahead

Exhibit 3: US consumer book sales



Source: AAP

Figures from the Association of American publishers indicate that over 2009 as a whole, book sales across all categories were ahead by 6%. However, growth in the educational, scholarly and religious categories was greater than for mainstream adult and children's publishing, where sales increased by 1% overall. The trading pattern between months has shown very high volatility, with substantial amounts of inventory being taken out of the supply chain, which has increased the publishers' nervousness. December 2009 sales in mainstream categories, for example, were 14.7% lower than the previous December.

## Book retailers hunkering down

The main US book retailing chains have had a rough ride, which may or may not be moderating. In its Q3 to end January, Barnes & Noble reported an improvement in sales over the prior quarter but down 7% year-on-year. Like-for-like store sales were off by 5.5%. Guidance for the fourth quarter is for further reductions of between 2% and 4%. One of Canada's largest independent book retailers, McNally Robinson, filed for bankruptcy just after Christmas, citing the recession, stagnant pricing, steep discounting on high volume titles and competition from online distribution channels. Harper Collins, Random House and Penguin are listed among the largest creditors. Borders traded poorly over the holiday season, with sales down by 13.7% over the 11 weeks to 16 January. However, there was less discounting, so gross margins improved. Industry rumours that the group was delaying payment to smaller publishers were strongly denied.

## Online channels continue to benefit

As we have commented on previous occasions, the large book retail chains have developed their business models on the premise of heavily promoted and discounted hit titles to drive footfall. This is increasingly threatened by the online distributors, in particular, Amazon, which does not have to cover the extensive overhead required by those on the high street or retail park. It has seemingly yet to identify and develop an alternative strategy. The emergence of e-books into a viable proposition now that the delivery is more elegant and less clunky plays further into the hands of the online retailer, with a customer base already very familiar with having their music requirements delivered in this way.

## Some recovery in US retail

The National Retail Federation is forecasting a 2.5% rise in US sales in 2010, after a 2.5% fall in 2009. In the home improvement sector, Home Depot has guided towards revenue growth of 2.5% for 2010, after reporting a greatly reduced rate of decline for the fourth quarter. A similar story is emerging at Lowe's, the home improvement retailer, where revenues are expected to increase by 1-3% in the first quarter of 2010 and by 4-6% for the year as a whole.

## Corporate activity back on the agenda

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**Meaningful organic growth will continue to be difficult to achieve in such a mature market. The restructuring in the back office and warehousing facilities in the US should deliver some improvement in returns over the next year or two, but the only way the top line is really going to be driven forward is through acquisition.**

## Vendor expectations moderated

Quarto's growth strategy has long been predicated on extending the portfolio through adding to the list of imprints and publishing companies. This remains more easily said than done, with vendor expectations on price accelerating in buoyant times and not necessarily moderating adequately when things turn down. Many potential acquisitions have issues with accounting or with the cultural adaptation of the individual publisher to working within the constraints of a different (or larger) organisation. The group's last purchase was MBI, in August 2007, although other approaches have been made since and have not come through to completion. Management's view is that corporate activity may now pick up. The investment and reorganisation in sales, marketing, warehousing and distribution, as well as in the IT systems will have changed the calculations on the achievable returns that can be driven from integrating new publishing companies onto the existing infrastructure.

## Headroom building in covenants

Obviously, with the share price where it is, it is unlikely that Quarto will be able to use its equity in any postulated purchase. However, it does have substantial banking facilities. These include a US\$115m syndicated bank facility, expiring on 12 June 2012, and a five-year private placement facility of \$50m that runs through to December 2014 (amortising from December 2012). These are subject to the covenants demonstrated below. Gross debt at the balance sheet was £74.4m (US\$120m at the prevailing rate of \$1.61=£1 on 31 December), with cash balances at the same

date of £24.1m. The tightest of the covenants is that of normalised (pre-exceptionals and goodwill amortisation) operating profit to net interest. The price that might be paid is obviously crucial to not breaching this covenant, which implies that dilutive acquisitions are not on the cards.

#### Exhibit 4: Debt covenants

	2008	2009	2010e	2011e
Net Debt < 3x EBITDA	2.38	2.21	2.07	1.93
Normalised operating profit > 3x net interest	3.08	3.06	3.15	3.30
Operating profit before amortisation > 1.5x net interest	1.92	2.57	3.15	3.30

Source: Forecasts based on Edison model

## Sensitivities

Quarto's business model puts it at the lowest-risk end of the publishing spectrum. Nevertheless, we regard some 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 that this pattern has been repeated is mixed, with destocking in the supply chain having muddied the waters.
- Currency** – around 60% 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. The nominal gearing figure is also affected, as debt is mostly US dollar-denominated.
- 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 are at fixed rates with a weighted average cost of 6.6%.
- Balance of business risk** – earlier acquisitions 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 starts.
- Editorial sensitivity** – despite the high proportion of revenues generated by the back list, 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

The stock undoubtedly looks undervalued on a conventional earnings basis, but there are a number of factors that the market is reluctant to overlook; the lack of familiarity with the co-edition business model; the paucity of true comparators; the US registration; the lack of liquidity in the

shares and, most of all, the apparent indebtedness. On this last point, the group has particularly conservative accounting policies that do not reflect the value of the revenue-generating assets.

## Asset backed

The balance sheet as stated shows shareholders' equity of £18.4m at the year-end, equivalent to 90p per share. Following the bounce in the share price on publication of the figures, the shares are therefore standing at par. The group has a substantial minority interest and, if this were to be included in the calculation, the NAV increases to 113p.

In Edison's view, this still masks the true value of the business. Until relatively recently, Quarto did not attribute any value in the balance sheet to the value of the backlist of titles, which are the source of a majority of the revenues in both co-edition and traditional publishing. Since 2006, though, the group has adopted standard industry practice in capitalising pre-publication costs, but over three years, rather than the commonly used five-year term.

As in previous notes, we have attempted to place a value on the unrecognised catalogue. On conservative assumptions of 9,000 titles and a value per title of £5k (less than the £6.7k paid in the last notable industry transaction for which figures are available), the backlist should be worth around £45m. The balance sheet item 'Other intangible assets' includes an element that reflects the written-down value attributable to the backlist; a maximum therefore of £1.4m. Pre-publication costs are included as intangibles within current assets and these, less amortisation, at 31 December totalled £31.9m. If around one-third of this sum reflects work in progress, then the value of the backlist currently formally recognised within the accounts is £21.3m, plus the other intangibles figure of £1.4m, ie £22.7m, or £2.5k per title. This is obviously some way short of our attribution, a shortfall of £22.3m, equivalent to another 109p per share.

## Well below peer group valuations

As we have described, with its roots in co-edition publishing and its specialisation in non-fiction, Quarto is not directly comparable to other quoted publishers, of whom anyway there are very few. It is nevertheless worth noting that its market valuation is way below its nearest peers on all standard measures bar EV/Sales, where it falls at the bottom of the range.

### Exhibit 5: Valuations of quoted publishers

Note: Prices as at 23 March 2010. Multiples annualised.

	Price	Market cap (m)	P/E 09	P/E 10	P/CF 09	EV/EBITDA 09	EV/Sales 09
<b>Quarto</b>	<b>90p</b>	<b>£18</b>	<b>3.5</b>	<b>3.5</b>	<b>1.0</b>	<b>3.0</b>	<b>0.6</b>
Bloomsbury Publishing	118p	£87	16.9	15.7	8.2	6.2	0.6
Haynes Publishing	247p	£40	8.3	8.4	-	4.4	1.2
Pearson	1006p	£8,162	15.4	14.8	11.1	9.4	1.6
Reed Elsevier	505p	£6,127	16.1	12.0	-	10.1	2.6
John Wiley, Inc.	\$42.60	\$2,550	19.8	16.5	7.3	9.8	2.0
Scholastic	\$29.90	\$1,087	84.7	12.9	5.8	6.5	0.7

Source: Reuters, Edison Investment Research

## Exhibit 6: Summary Financials

Year end 31 December	2007	2008	2009	2010e	2011e
Accounting basis	IFRS	IFRS	IFRS	IFRS	IFRS
£'000s					
<b>PROFIT &amp; LOSS</b>					
<b>Revenue</b>	<b>100,107</b>	<b>112,743</b>	<b>106,631</b>	<b>107,900</b>	<b>110,400</b>
<b>Cost of sales</b>	<b>(62,842)</b>	<b>(69,901)</b>	<b>(67,939)</b>	<b>(67,977)</b>	<b>(69,552)</b>
<b>Gross Profit</b>	<b>37,265</b>	<b>42,842</b>	<b>38,692</b>	<b>39,923</b>	<b>40,848</b>
<b>EBITDA</b>	<b>20,014</b>	<b>21,968</b>	<b>22,799</b>	<b>22,806</b>	<b>22,955</b>
<b>Operating Profit (before GW and except.)</b>	<b>18,976</b>	<b>20,879</b>	<b>21,750</b>	<b>21,750</b>	<b>21,900</b>
Amortisation of intangibles	(1,312)	(1,830)	(1,596)	(800)	(600)
Exceptionals	370	(4,274)	(1,625)	0	0
Amortisation of pre-production costs	(8,416)	(9,529)	(11,559)	(11,500)	(11,500)
Operating Profit	9,618	5,246	6,970	9,450	9,800
Net Interest	(2,909)	(3,686)	(3,332)	(3,250)	(3,150)
<b>Profit Before Tax (norm)</b>	<b>7,651</b>	<b>7,664</b>	<b>6,859</b>	<b>7,000</b>	<b>7,250</b>
<b>Profit Before Tax IFRS</b>	<b>6,709</b>	<b>1,560</b>	<b>3,638</b>	<b>6,200</b>	<b>6,650</b>
Tax	(1,697)	(1,216)	(881)	(1,350)	(1,400)
Adjustment to tax for normalised earnings	(300)	(669)	(672)	(230)	(240)
Minority charge	(769)	(461)	(190)	(300)	(300)
Profit After Tax (norm)	4,885	5,318	5,116	5,120	5,310
Profit After Tax (FRS3)	4,243	(117)	2,567	4,567	4,967
Average Number of Shares Outstanding (m)	20.2	20.0	19.7	19.7	19.7
<b>EPS - normalised fully diluted (p)</b>	<b>24.4</b>	<b>26.5</b>	<b>26.0</b>	<b>26.0</b>	<b>27.0</b>
<b>EPS - IFRS (p)</b>	<b>21.6</b>	<b>(0.6)</b>	<b>13.0</b>	<b>23.2</b>	<b>25.2</b>
Dividend per share (p)	7.2	7.2	7.2	7.2	7.2
EBITDA Margin (%)	20%	19%	21%	21%	21%
Operating Margin (before GW and except.) (%)	19%	19%	20%	20%	20%

**BALANCE SHEET**

<b>Fixed Assets</b>	<b>31,641</b>	<b>35,358</b>	<b>31,330</b>	<b>30,562</b>	<b>29,962</b>
Intangible Assets	23,116	26,622	24,012	23,212	22,612
Tangible Assets	8,525	8,736	7,318	7,350	7,350
Investment in associates	0	0	0	0	0
<b>Current Assets</b>	<b>89,759</b>	<b>117,448</b>	<b>105,534</b>	<b>105,172</b>	<b>106,597</b>
Intangible Assets: Pre-publication costs	24,946	32,222	31,941	32,000	32,000
Stocks	15,425	17,821	15,805	15,993	16,364
Debtors	31,811	38,484	33,696	34,097	34,887
Cash	17,577	28,180	24,092	23,082	23,346
<b>Current Liabilities</b>	<b>(36,933)</b>	<b>(43,590)</b>	<b>(33,140)</b>	<b>(33,631)</b>	<b>(34,402)</b>
Creditors	(34,173)	(43,257)	(32,890)	(33,281)	(34,053)
Short term borrowings	(2,760)	(333)	(250)	(350)	(349)
<b>Long Term Liabilities</b>	<b>(62,602)</b>	<b>(88,102)</b>	<b>(80,630)</b>	<b>(76,000)</b>	<b>(73,250)</b>
Long term borrowings	(58,190)	(80,234)	(74,176)	(70,000)	(67,250)
Other long term liabilities	(4,412)	(7,868)	(6,454)	(6,000)	(6,000)
<b>Net Assets</b>	<b>21,865</b>	<b>21,114</b>	<b>23,094</b>	<b>26,103</b>	<b>28,907</b>

**CASH FLOW**

<b>Operating Cash Flow</b>	<b>21,648</b>	<b>23,763</b>	<b>17,762</b>	<b>23,000</b>	<b>23,310</b>
Net Interest	(2,819)	(3,870)	(3,906)	(3,529)	(3,525)
Tax	(798)	(1,093)	(954)	(998)	(1,363)
Capex	(11,169)	(14,109)	(12,736)	(14,000)	(14,000)
Acquisitions/disposals	(17,822)	(110)	(414)	0	0
Financing	56	1	0	0	0
Dividends	(1,581)	(1,407)	(1,407)	(1,407)	(1,407)
Other	89	(7,293)	0	0	0
Net Cash Flow	(12,396)	(4,118)	(1,655)	3,066	3,016
<b>Opening net debt/(cash)</b>	<b>30,992</b>	<b>43,373</b>	<b>52,387</b>	<b>50,334</b>	<b>47,268</b>
HP finance leases initiated	0	0	0	0	0
Loans acquired with acquisitions	0	0	0	0	0
Translation differences	15	(4,896)	3,708	0	0
<b>Closing net debt/(cash)</b>	<b>43,373</b>	<b>52,387</b>	<b>50,334</b>	<b>47,268</b>	<b>44,253</b>

Source: Edison Investment Research, Company accounts

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