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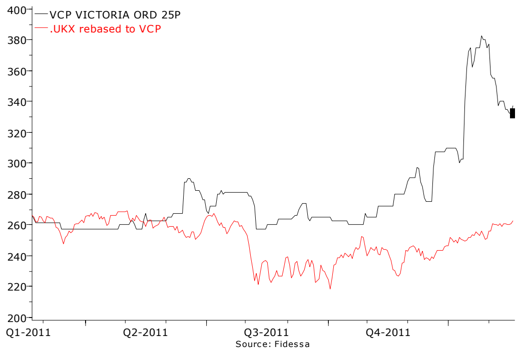
Victoria 320p

Battle For Control – The Tufts Are Flying

24 February 2012



12m High:382.5 p

12m Low: 257.5 p

Market Cap: £22m

Shares in Issue: 6.94m

NAV/Share: 565p (October 2011)

Net Debt: £8.0m (October 2011)

EPIC Code: VCP

Sector: Household Goods

Market: London Full List

Brokers: Arden Partners

PR: Citigate Dewe Rogerson Birmingham

Website: www.victoriaplc.com

Description: Vertically integrated carpet manufacturer in Australia and the UK.

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The shareholder proxy battle at London Full List quoted carpet manufacturer Victoria PLC has turned nasty. Insults, accusations and counter-accusations are flying, and in this short research note we attempt to take an objective view of some of the key issues involved before the Extraordinary Meeting* that has been convened for Tuesday March 6.

Voting is hugely important. Abstention is not an option, because the group of shareholders that has demanded the meeting controls 46% of the vote. This means that if only 9% of the uncommitted shareholders forget to vote, abstain, or inconveniently die without leaving legally watertight voting instructions, the dissidents will gain control of the company. That is unless the Board's arguments manage to split the Dissident Consortium.

It may be, of course, that after examining both sides of the argument, that change is what the majority of shareholders want.

We have no axe to grind, no interest in Victoria shares, no contract or understanding with either party. But after researching the fortunes of the UK carpet industry for 15 years, we feel we have something to add to the debate.

** 2pm on Tuesday March 6 at the offices of Wragge & Co LLP, 55 Colmore Row, Birmingham B3 2AS.*

Y/E	Group Sales	Declared Profit	Adjusted Profit	Adjusted EPS	P/E ratio	Divi	Yield
April	£m	£m	£m	p.		p.	%
2010A	63.0	1.1	1.1	7.9	40.5	8.0	2.5
2011A	70.5	1.9	1.9	15.8	20.2	9.0	2.8
2012E	No	estimate					
2013E	No	estimate					

"Other carpet manufacturers' returns on equity are as high as 18%"

The group proposing changes at Victoria has claimed 18% ROE can be seen in the carpet industry, but it hasn't actually named the comparisons, and our emails requesting information about these comparatives have not been answered. We think we have found an unquoted company that fits the bill. It is one that we regard as "best of breed" in the UK market.

It is the privately owned **Abingdon Flooring**. This is arguably the only sizeable UK carpet manufacturer that is comparable to Victoria PLC and also has a "clean" record as far as shareholders are concerned. Abingdon Flooring claims to be "the UK's largest privately owned manufacturer of quality carpets". Its sales revenues for the year to March 2011 were £67m, which is more than twice the UK sales revenue of Victoria plc and almost as large as the £70m that Victoria plc recorded as a group. Abingdon made a pre-tax profit of £0.94m on shareholders' funds of £5.30m, which is a ROE of 17.8% on the year's closing capital. Taking the traditional accountancy methodology of averaging starting and closing capital, the ROE for the year rises to 18.8%.

We rate Abingdon Flooring. It has been increasing market share in a declining market, has moved with gusto into the "smooth flooring" sector and has made waves in the industry by offering a lifetime stain-free guarantee. But on the downside, it is heavily geared. Its £5.3m of shareholders' funds is supporting £7.6m of invoice discounting and £2.4m of other debt, giving gearing of 200%. Before the Victoria shareholders get too carried away with this comparison, they should ask themselves whether they would be happy for their own company to carry this level of leverage.

The return on capital at Abingdon Carpets last year was 7.9%. This compares with the return on capital at Victoria plc of 5.2%. So Abingdon Carpets is doing better, but in practice there is not a huge difference between the two companies.

It is also interesting to note that Abingdon's pre-tax return on sales is, at 1.4%, lower than Victoria's 2.7%. Victoria's UK return on assets (a slightly different measure) is 1.2%.

Of course, Abingdon operates entirely in the UK, unlike Victoria, which is over 50% in Australia and makes c. 90% of its profit from there. Most of Abingdon's business is in a different segment, lower market synthetics rather than mid – high end wools. Abingdon has a big advantage in that it appears to have totally ignored Ireland, which lost money heavily for Victoria last year. But even stripping out Ireland, Victoria's return on capital is still less than that of Abingdon.

So, yes, the dissident shareholders are correct to quote this number, but as far as we can gather it only applies to very highly geared operations. And also to very exceptional operations, as well. Abingdon, like Victoria, is one of the very few survivors of a British carpet industry that has been driven almost to extinction by huge imports, primarily from Belgium and the Netherlands. Imports currently take 80% of the British carpet market.

We are not aware of any European carpet manufacturer that earns 18% in terms of return on capital. On the contrary, most other UK based carpet manufacturers have, even if continuing to trade currently, been through the Administration process during this recession, therefore effectively eliminating all value for their ordinary shareholders.

Brintons, the largest manufacturer in Victoria's home town of Kidderminster, went into Administration in 2011, and while it was bought out of administration by a private equity firm, since then has had one round of redundancies under its new owners, with workforce consultation currently in progress for a further 150 possible job cuts.

Carpets of Kidderminster, which claimed to be "the UK's largest specialist woven carpet manufacturer" and been established for 70 years, entered Administration in August 2010.

Among retailers, **Floors-2-Go** has collapsed twice, the first time in 2008 and again recently in 2011. **Allied Carpets**, of course, entered administration in 2009.

Going back before the latest recession, but since the time we began researching Victoria, other quoted companies such as **Gaskell** (March 2005), **Stoddard** (March 2005) and **Carpets International** (August 2003) have entered receivership. The only remaining quoted UK carpet manufacturer apart from Victoria is **Low & Bonar**. This produced a return on capital of 16.8% in its last financial year. However, only a very small part Low & Bonar's business is manufacture of carpet tiles and carpet tile backing.

The current directors are survivors. In the UK carpet industry, that is a rare talent, give them credit for it.

Replacing Two Directors with Four

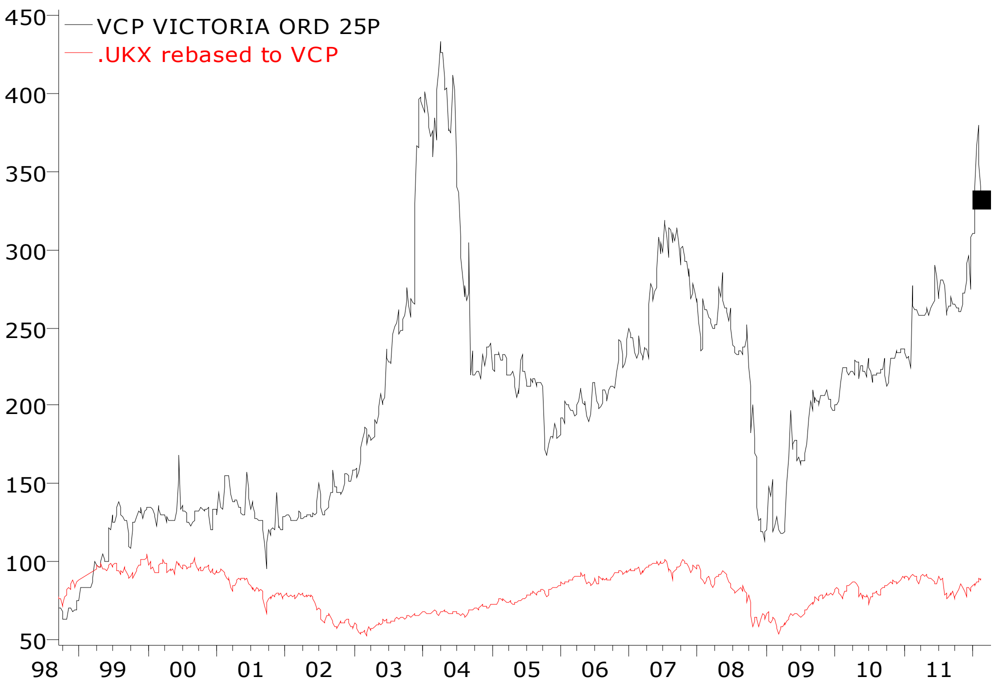
There are five directors on the Victoria plc board. Two of these, Nikki Beckett (the chair) and Peter Jensen, are non-executive directors. The dissident group wants to replace the two NEDs with four NEDs of its own. This will, if successful, give it four members of a seven member board and therefore board control.

This is the element of the dissident shareholder proposal that we like least.

If the two NEDs, one of which is also chairman, have done such a bad job, then get rid of them by all means. But why not suggest replacing them with two new NEDs, why totally change the composition of the board?

Criticism of Victoria's Track Record

As far as the share price is concerned, Victoria is beyond criticism. More than that, it is one of the great investment stars of the era. We published our first research note on the company on 19 October 1998, when the shares were 63p and the FTSE100 Index was 5133. On the day before the dissident shareholder approach became public, Victoria shares were 275p and the FTSE100 Index was 5419. Throughout this period, Victoria has paid a consistently higher dividend so the comparison on a total return basis is even greater. It has also paid a 'Special Dividend' of 15p/share on asset sales.



Criticism of Victoria's Strategy

First, Victoria's strategy over the past ten years must have been good, or it would have gone bust like the most of the rest of the British carpet industry.

With hindsight, Victoria would be in better shape today if:

- It had not got involved in Ireland, and in particular not made its Irish acquisitions.
- It had moved earlier into other floor coverings, such as 'luxury vinyl tiles' which it only entered in the UK in 2011, and wood flooring.
- It had moved earlier into carpet tiles, a market it ignored until very recently. Low & Bonar paid 20X earnings for a carpet tile company in 2007.

But hindsight is a wonderful thing.

"Too Much Money Tied Up In Working Capital"

This is an interesting claim by the dissidents. It has some justification, Victoria's inventory in its last published accounts was running at 17 weeks' sales, and in the more recent interim accounts appeared to be rising even from this.

Victoria is a vertically integrated business. It operates yarn spinning for its carpet business, both in the UK and in Australia. Therefore it is carrying the inventory for what are in effect two businesses in its consolidated accounts. Abingdon Flooring is a vertically integrated business as well, and manages an 8 week stock turn, but its vertical integration is with vertical yarn extrusion, not the spinning of wool which is the case with Victoria.

Dig into the notes to the accounts of both companies, and the differences can be seen. On relatively similar annual sales figures, Abingdon is carrying £1.4m of raw materials, and Victoria £6.7m. We put the high Victoria figure down to its policy of buying and carrying large stocks of raw wool, and (in Australia) bulk sourcing SDN (Source Dyed Nylon) from overseas. It may be that the Dissident Consortium wants to examine the benefits of this capital intensive raw materials policy.

In terms of work in progress, the two companies are almost identical.

In terms of finished stock, Victoria carries almost twice as much as Abingdon. But it needs to be remembered that Victoria primarily services the small independent retailers, who order stock in pre-cut lengths rather than entire rolls – and Victoria gets additional margin for providing this extra service. The small independent retailer appears to be a smaller proportion of Abingdon's business. Additionally, Victoria is heavily tied into warehousing and servicing for its largest single customer, John Lewis. Several years ago, in fact, it totally redesigned its storage facilities in order to take a good part of this work out of John Lewis's hands.

The dissidents have a point, but if inventory were squeezed too far, there would be an adverse impact either on the small retailer, or on the John Lewis relationship, and these are the core pillars round which the Victoria business has been built.

Otherwise, finished goods inventory could be cut by a range reduction, a colour reduction, or allowing a greater proportion of "out of stock" lines in the product portfolio at any one time. We don't think that would necessarily be good news either.

"Putting The Company Up For Sale In A Rushed And Unplanned Way Is Irresponsible"

We would have more sympathy for this comment from the dissident shareholders if they had opted to have just two directors on the board, rather than a majority of four. As it is, the hands of the directors have been forced in this matter. For the dissidents to appoint four directors on a board of seven amounts to a change of control. If that is to happen, the shareholders backing the current directors will want to know what could be obtained from other forms of change of control, i.e. a total sale, or from a partial sale, for example of either the UK or the Australian parts of the business.

If we were shareholders, we would want to know the full range of alternatives.

Sale of Non-Core Assets

The dissidents “note that the current board have agreed to adopt one of our proposals”. The planned sale of these assets was discussed in our October 1998 research document, and unless the dissidents know of non-core assets that have escaped our attention, the board has cleared out pretty well most of the potential since then. There two remaining non-core assets that we know of. The first is the cricket pitch in the centre of Kidderminster, value probably c. £1m. The second is some unzoned on which, many years ago, Victoria hoped to build a new factory that is probably worth a tenth of that.

Who Are The Members of the Dissident Consortium?

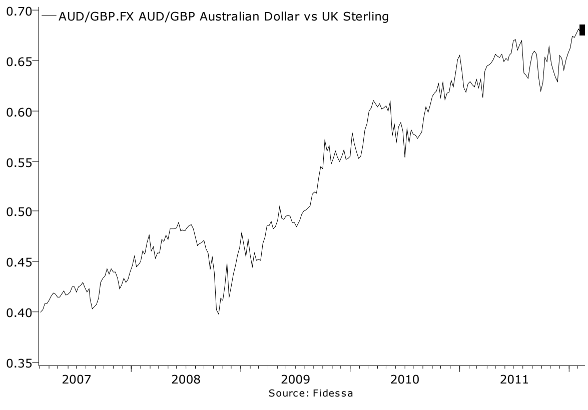
This question has been raised by the incumbent directors. It is a valid point. Two have been declared, Alexander Anton (an ex director) and Fortress Finance (an institution). They appear to account for less than half the claimed 46% of the shares.

“The current board members take more from Victoria in salaries and fees than the shareholders receive in dividends”

This is completely true. Last year £583,000 was paid out in shareholder dividends, while directors’ total remuneration, including benefits in kind was up 28% at £797,000.

This is not just a cheap debating point on the part of the dissidents. There are a number of quoted companies where directors rip off their shareholders. However, this is not one of them. We think this for the following reasons.

This is a five person board, three of whom are executive directors. One director takes 40% of this – Barry Poynter, with a total package of £340,000. Poynter runs the Australian operation, which has been the best performing part of the business for years. The Australian Dollar has risen by more than 50% against the UK£ in the last three years, which makes his package expressed in UK£ somewhat difficult to control. The dissident group has not asked for Poynter’s removal. Apart from Poynter, the salaries do not appear unusual.



The answer is to raise the dividend, 1.9X covered last year with substantially more cover available for the current year as the profits in H1 were up strongly. Whichever party does that, we shall be happy.

What Would The Dissidents Do?

After almost two months we still don't have a totally clear picture of what the Consortium would do if it gained board control. But we have an increasingly clear idea of what it would not do, and in ruling out so many options, the Consortium has almost by default committed itself to being conventional, even though it says "no strategic opportunity is being ruled in or out".

Their key points appear to be:

- Growing the company, both in the UK and Australia. So, the UK won't be shut down and sold off for its assets (though industrial property in Kidderminster currently and liquidation of carpet stocks probably wouldn't raise asset value).
- Particularly, growth in Australia. "High growth opportunities . . . where Victoria is missing out". Does this mean Australian acquisitions?
- Reducing working capital.
- Minimising debt.
- Presumably, in view of the objection to putting the company up for sale, not looking for a takeover.

There is over a week to go yet. It should be an interesting time. But the key message is, whatever you think, make sure you vote.

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