EDISON

Smiths News

Predictable cash flows and growing dividends

Initiation of coverage

Industrial support services

Smiths News has successfully performed a turnaround of the business that has seen it return to a core newspaper and magazine distribution operation. While the print sector is declining, revenue is predictable and management has a clearly demonstrable cost-saving track record such that cash flow is strong and profits are broadly flat, post COVID-19. This means that debt is being paid down and dividends are likely to become an increasing feature. We value the business at 77p, twice the current price.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
08/19	1,303.5	38.0	12.0	1.0	3.1	2.7
08/20	1,164.5	28.2	10.4	0.0	3.6	0.0
08/21e	1,094.6	27.7	9.0	1.6	4.1	4.3
08/22e	1,050.8	27.5	9.1	2.3	4.1	6.2

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Restructuring leaves Smiths refocused on the core

The current management team has restructured Smiths News over the last three years as it has returned to its core distribution activity, having sold the loss-making logistics business, Tuffnells, in May 2020. The core business benefits from exclusive absolute territorial protection (ATP), long-term contracts with suppliers (publishers) and strong relationships with customers (retailers). This means that revenues are relatively predictable and managing the business becomes somewhat easier with fewer distractions.

Long-term cost-saving track record drives cash flow

While physical newspaper and magazine sales have consistently fallen, the rate of decline has been relatively constant and predictable. Cover price inflation partially offsets declining income, and management augments this with a long-term plan to more than match the declining profit contribution with cost savings. It has reduced costs by c £35m in the last six years and has earnt a track record of success. We anticipate that this process is likely to result in relatively flat profits and strong cash generation, which will see dividends and yield become an increasing feature.

Valuation: DCF calculation values the shares at 77p

We value Smiths News at 77.4p/share based on a discounted cash flow (DCF) model, more than twice the current share price. Given the predictable and consistent cash flow of the core business, we believe this is a reasonable methodology to adopt. The value is confirmed by our dividend discount model (DDM) valuation, which suggests a value of 76.6p/share. A DDM approach is also an appropriate way to value the stock considering the current strategy, which is to generate cash, pay down debt and return surplus cash to shareholders via dividends and 'special' payments. In absolute terms, Smiths News trades on a P/E of 4.1x in 2022e, with a yield of 6.2% and the prospect of 'special' dividends to bolster the yield as debt falls. In our experience, when 'safe' dividend yields exceed P/Es in absolute terms, it highlights a value opportunity.

18 October 2021

Price	**37p**
Market cap	**£92m**

Net debt (£m) at 31 Aug 2021E	60.0
Shares in issue	247.7m
Free float	100%
Code	SNWS
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(11.1)	(20.4)	37.6
Rel (local)	(12.9)	(22.7)	9.6
52-week high/low		45p	25p

Business description

Smiths News is the UK's largest newspaper and magazine distributor with a c 55% market share covering 24,000 retailers in England and Wales. It has a range of long-term exclusive distribution contracts with major publishers, supplying a mix of supermarkets and independent retailers.

Next events

Preliminary results	November 2021

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Edison profile page

Smiths News is a research client of Edison Investment Research Limited

Investment summary

Company description: No. 1 in newspaper & mags distribution

Smiths News is the UK's largest newspaper and magazine distributor with a c 55% market share covering 24,000 retailers in England and Wales. It has a range of long-term exclusive distribution contracts with major publishers, supplying a mix of major supermarkets, smaller multiples and independent retailers. Newspaper and magazine distribution accounts for c 98% of revenue and EBITDA, while two much smaller divisions account for the remaining 2%. These include DMD, a world leader in travel media and airside services, and InStore, which offers field marketing in the retail environment. Smiths News' key suppliers include publishers Associated Newspapers *(Daily Mail and Metro),* News UK (*The Sun* and *The Times*), Reach (*Daily Mirror*, *Daily Express*, *Daily Record*), and Frontline (Bauer Media Group), while its largest customers include Tesco Stores, Sainsbury's Supermarkets, WH Smith and the Co-operative.

Valuation: Valued at 77p and reinforced by our DDM

Based on our DCF calculation, we value Smiths News at 77.4p/share, more than twice the current share price. Given the business's predictable but strong cash flow, we believe this is a reasonable methodology to adopt. A sensitivity table for a range of terminal value growth rates and WACCs can be found in Exhibit 16. We estimate that Smiths News will generate an average free cash flow of c 10p/share pa over the next three years.

The value is reinforced by our DDM valuation, which suggests a value of 76.7p/share. A DDM approach is also an appropriate way to value the stock considering the current strategy, which is to generate cash, pay down debt and return surplus cash to shareholders via dividends and 'special' payments.

Financials: De-gearing to lead to 'special' dividends

The ongoing annual revenue decline is relatively easy to predict, as are the company's repeated cost-saving initiatives. Therefore, we believe that the profits of the business will be relatively stable and that the cash flows will be strong, although the corporate tax rate increase will affect EPS from FY23e. This cash flow in turn allows the company to pay down debt such that it will hit its 1x net debt/EBITDA target in 2023e, from 2x in FY20. It has already restarted paying dividends and, although restrictions exist until 2023, the yield of more than 6% in FY22e and the prospect, in our view, of paying higher dividends potentially offering yields of double figures if Smiths News was to move to a twice covered dividend. Furthermore, management has outlined an ambition to return surplus capital to shareholders via 'special' dividends.

Sensitivities: Predictable revenue and declining costs

Predicting future volumes of newspapers and magazines has been relatively simple for much of the last 20 years as up-to-the-minute news online has taken market share from physical news. In the 20 years from January 2000 to January 2020, the circulation of paid-for newspapers declined by 65%, an annual decline of 5.4% pa. More recently of course, volumes were affected by the pandemic, with Smiths News's newspaper and magazine volumes dropping by c 12% and 42% respectively in Q320 (March to May). This was clearly an unusual event and we expect that annual volumes will return to a more predictable glide path. Cover price inflation clearly helps offset declining volumes, but is insufficient to cover the volume decline, hence the ongoing cost-saving programme. The company has a strong track record of consistently reducing the cost base to offset margin erosion. This cost-saving activity puts Smiths News in a good place to deal with margin pressures that are building in the supply chain from well publicised labour availability and cost inflation issues. The outcome depends on how long the situation persists and potential remedies.

Company description: Reinvented as a cash cow

Over the last three years, Smiths News has reinvented itself by returning to its previous form it was before it tried to diversify away from its core newspaper and magazine distribution business. The last piece of the puzzle was the successful disposal of Tuffnells in 2020, despite the pandemic. As a result, we believe the company is now in a strong position to manage declining volumes and falling costs while cash is generated and initially used to primarily paydown debt, but also increasingly to return this value to shareholders in the form of dividends.

Management change at an end

There was extensive upheaval within the business over an extended period as Smiths News looked to diversify away from its core markets. Under the leadership of Jon Bunting and Tony Grace over the last three years, it has now returned to concentrating on newspaper and magazine distribution, which will present its own challenges. Towards the end of this disruptive period there has been management change, with the three senior positions changing within the last three years. The final change was the appointment of Paul Baker as chief financial officer with effect from 4 October, replacing Tony Grace who will retire from the company at the end of December.

The last major operational change was the disposal of the distribution business, Tuffnells, in May 2020. Since then, the company has reverted back to the Smiths News name, and has been able to concentrate on the recovery from the COVID-19 disruption and on running the core distribution business.

The existing executive board members are David Blackwood (chairman since May 2020), who was formerly finance director at Synthomer and has held senior roles at ICI; Jonathan Bunting (chief executive officer), who joined the company in 1994, but was appointed CEO in June 2020; and Paul Baker, who is the new chief financial officer. Prior to this he held finance director roles at Compass, Iglo Group/Birds Eye and Cadbury Schweppes.

Strategy to pay down debt and pay healthy dividends

Smiths News' strategy is focused on providing excellence in newspaper and magazine wholesaling, with its competitive advantage derived from a combination of service quality, scale efficiencies and value for customers. These 'three essentials' underpin its service offering to both publishers and retailers, and enable Smiths News to deliver sustainable and relatively predictable profit and cash flow for the foreseeable future.

After a long period of seeking to diversify away from its core distribution business, it has recently completed a 'reset' of the business and will in future largely focus on the distribution business. Although facing slow structural decline, the distribution business is profitable and cash generative and is likely to generate sufficient cash to pay down debt from 2x net debt to EBITDA, to 1x, and finance a healthy and attractive dividend. It may also offer the potential for the payment of 'special' dividends from time to time.

Market leader in newspaper and magazine distribution

Smiths News is the UK's largest newspaper and magazine distributor with a c 55% market share (private equity owned Menzies Distribution covers the other 45%) covering 24,000 retailers in England and Wales. It has a range of long-term exclusive distribution contracts with major publishers, supplying a mix of major supermarkets, smaller chains and independent retailers. Newspaper and magazine distribution accounts for c 98% of revenue and EBITDA, while two much smaller divisions account for the remaining 2%. These include DMD, a world leader in travel media and airside services, and InStore, which offers field marketing in the retail environment.

Smiths News's key suppliers include publishers Associated Newspapers *(Daily Mail* and *Metro),* News UK (*The Sun* and *The Times*), Reach (*Daily Mirror*, *Daily Express*, *Daily Record*) and Frontline (Bauer Media Group), while its largest customers include Tesco Stores, Sainsbury's Supermarkets, WH Smith and the Co-operative.

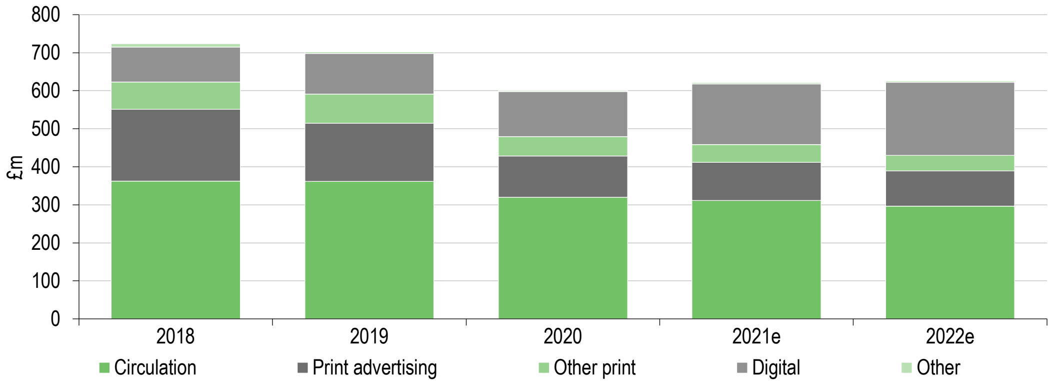
Managed decline of physical news media

The popularity of physical daily newspapers, magazines and periodicals has been in gradual decline, with first the growth in news consumption from television and radio and then, more recently, the internet becoming the primary source for up-to-the minute news. Figures from the Press Gazette, using ABC data, show a 65% reduction in circulation for paid-for newspapers (daily and weekly) from January 2000 to January 2020 (so pre-COVID-19), equating to an annual decline of 5.4%. There will have been some offset against this from rising cover prices.

The impact of the pandemic accelerated the trend to online news consumption, particularly in the strictest periods of lockdown, when access to retail outlets was limited. ONS data show a much less dramatic decline of 18% over the same 20-year period, but this data bundles together sales of books, newspapers and magazines, so is less representative.

The pattern of decline is clearly shown in the revenue splits from Reach, which publishes titles such as the *Daily Express*, *Daily Mirror* and *Daily Star*, plus their Sunday equivalents and a large number of regional titles. Reach titles accounted for around 25% of the ABC circulation figures for January 2020. Particularly worth noting is the decline in print advertising, as the return on advertisers' investment in online advertising improves with more tailored and accurate audience targeting.

Exhibit 1: Reach shift in revenues FY18–22e



Source: Reach (historical), Edison Investment Research (forecasts)

The latest Ofcom news consumption in the UK report (July 2021) shows that only 32% of over 16s now use newspapers as their source of news (and 0% do so exclusively). The habit of buying and reading a daily paper is most ingrained in an ageing demographic. The Ofcom data show around half of over 65s use physical newspapers, but only 16% of 16–24 year-olds do so.

Exhibit 2: Demographics of newspaper readers

	Total population	Male	Female	16–24	65+	ABC1	C2DE	Minority ethnic groups	White
Print Newspapers	32%	37%	27%	16%	50%	34%	29%	23%	33%

Source: Ofcom, July 2021

With these underlying characteristics, we would expect that UK newspaper circulation would continue to atrophy at a similar rate to the last 20 years, ie 5–6%, with some amelioration from inflation-plus increases in cover prices.

Smiths News delivers, 364 nights of the year

Although newspaper and magazine volumes are declining, there is still an important, very time-sensitive role to be played in their distribution. Smiths News plays the role that links the publishers with the retailers across 55% of the country, in the areas where it enjoys 'absolute territorial protection'. It does so under contracts, most of which run until 2025, giving the company good visibility of revenue. The predictability of revenue and the long duration of contracts give Smiths News the opportunity to manage declining income by offsetting it with cost savings from network management. Ultimately though, the business is cash generative and this offers the opportunity for attractive dividend payments, which are discussed later in the note.

Market characteristics

After many years of consolidation, the newspaper and magazine wholesale and distribution market has consolidated into a duopoly, with Smiths News enjoying 55% market share and Menzies having 45% (see map below). The region is divided into post coded territories with each wholesaler having 'absolute territorial protection' (ATP) awarded to them by the publishers. ATP in effect implies a regional monopoly that also minimises costs to the retailer.

Exhibit 3: Smiths News distribution territories

Source: Smiths News

Barriers to entry do exist in the form of fast delivery requirements (hard to replicate), exclusive publisher contractual relationships and complex product ranges, and the dispersed customer base. Menzies is likely to remain the key competitor, but this only becomes an issue when long-term contracts come up for renewal (95% of contracted revenue is contracted until at least 2024, and 80% until 2025). Churn of publishers at renewal has been minimal. The only other type of competition in physical distribution is small volumes of direct to customer deliveries in a very limited number of territories (Financial Times and News UK) though there is some evidence that News UK has reduced direct to retail delivery in recent periods.

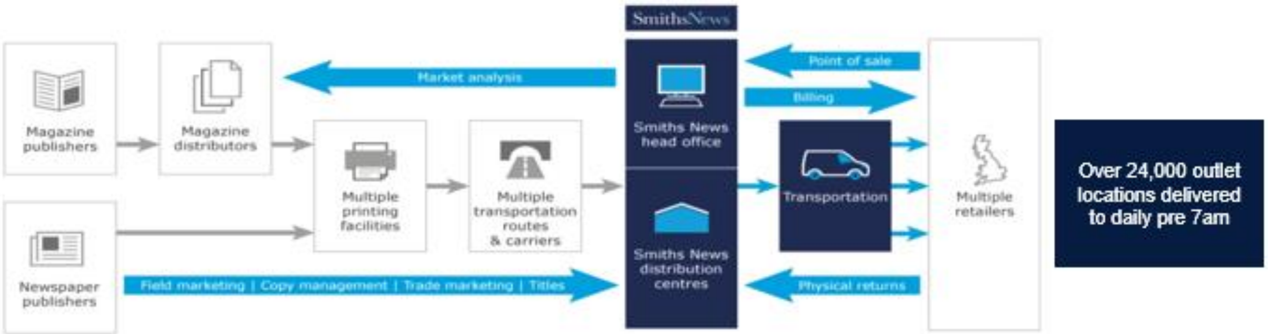
Other barriers exist in terms of the short nightly operating window (four to six hours overnight after news copy is written and printed), the cost of establishing a regional distribution hub and the necessity to reliably perform the task 364 nights per year.

Publishers are generally happy with the model because it is well established and reliable, and retailers are happy because the shared route to market, for newspaper and magazine delivery to individual premises, is the most economic and sustainable delivery model.

Operating model

As the graphic below shows, Smiths News sits between the relatively modest number of newspaper and magazine publishers and over 24,000 retail outlets that it has to service every day by 7am. It therefore operates one of the fastest moving distribution operations of its kind.

Exhibit 4: Smiths News operating model



Source: Smiths News

Smiths News operates automated systems from 32 newspaper and five magazine distribution centres within its region that monitors sales and refunds to ensure accurate and timely invoicing. In order to reach the c 24,000 retailers nightly, Smiths News utilises around 1,100 couriers, which implies that the average courier visits more than 21 retailers on a typical night, both delivering bundles of newspaper and magazines, and also collecting unsold volumes and arranging refunds to the retailer.

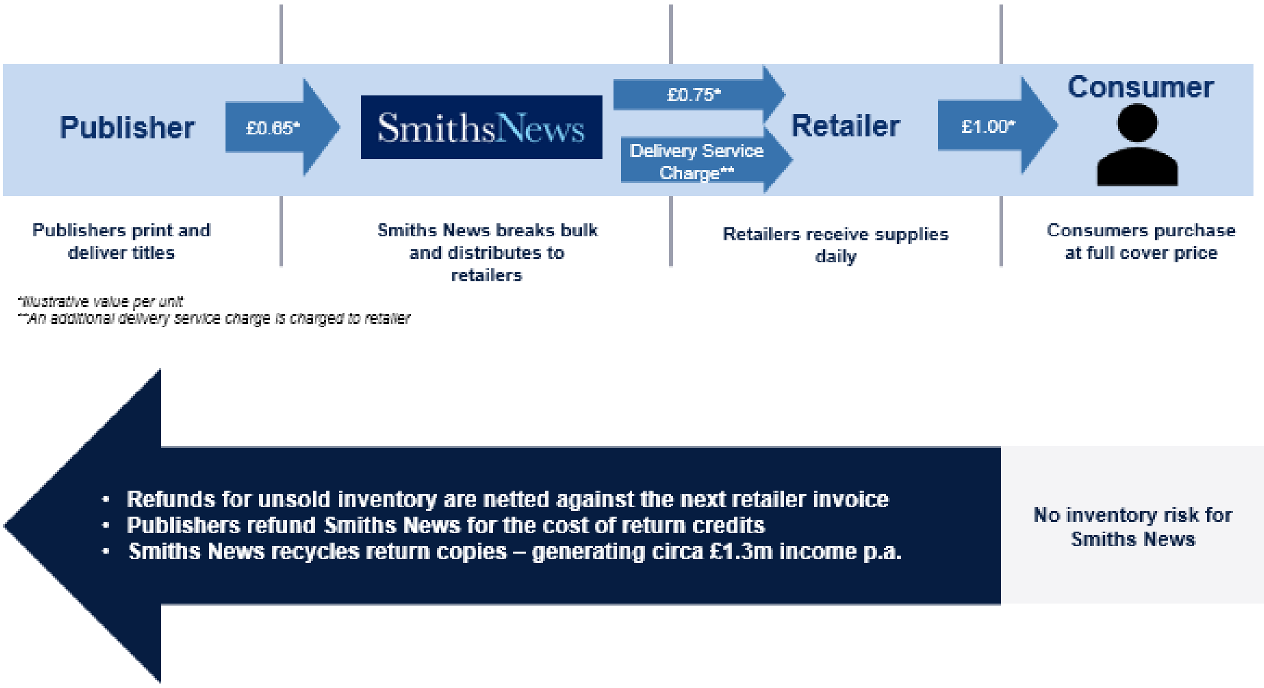
A short video illustrating Smiths News's overnight activities is available here.

Revenue model

Smith News' revenue model is relatively simple and predictable. In essence, the contracts will state a price at which Smith News will buy the titles from the publishers, say for 65p each (in the graphic below), and within hours sells them to the retailers for say 75p each, plus a delivery service charge. The agreed prices tend to move with the cover price, although some arrangements have an element of indexing within the agreement. Smiths News generates the vast majority of its net margin from the sales margin and the delivery service charge, with c 10% generated from ancillary revenue, which includes sales of 'part works' and stickers, and a very modest sum from waste paper revenue derived from recycling unsold product.

Refunds for unsold inventory are netted against the next retailer invoice, and Smiths News is in turn refunded via return credits from the publishers. This means that neither Smith News nor the retailer carries the risk of unsold stock. The publisher contracts also protect Smiths News against marketing activity where a publisher may engage in discounted promotions on certain titles for a period, as the margin received by Smiths News will be maintained at the % pre any marketing activity.

Exhibit 5: Smiths News revenue model



Source: Smiths News

Publisher/wholesaler: Typical contract terms

The contracts signed between the publishers and Smiths News, the wholesaler, typically have a duration of around five years and protect Smiths News from most risks, bar the expected slow volume decline that has been typical for the last 20 years. Smiths News would also benefit if headline copy prices rose or volumes increased, but when these things have happened in the past, they have proven to be temporary.

There are six key elements to a typical contract:

1. **Price promotion protection:** in the event of the introduction of a promotion price, ie a reduction in the cover price of a title, Smiths News can seek margin protection to ensure it receives a percentage of the pre-promotion price of a title.
2. **Sales floor mechanism:** some contracts allow additional margin to be paid to Smiths News to make up for lower than anticipated volumes, and therefore income, subject to a cap.
3. **Absolute territorial protection (ATP):** Smiths News has ATP over regional postcodes that ensure that retailers cannot source product from a third party.
4. **Right to renegotiate:** in certain specified situations, such as a change in the law, or the demise of a title or edition, Smiths News can initiate a renegotiation to better reflect the change in circumstances.
5. **Refund unsold volume:** all newspaper and magazine contracts allow for unsold volumes to be returned to the publisher for a refund. This ensures no obsolescence risk.
6. **Indemnity protection:** Smiths News's contracts give it full indemnity against a number of liability driven events, including (1) infringement of intellectual property rights, (2) product liability issues with any cover mounted gifts and (3) defamatory or unlawful material.

Exhibit 6: Publishers served by Smiths News

Source: Smiths News

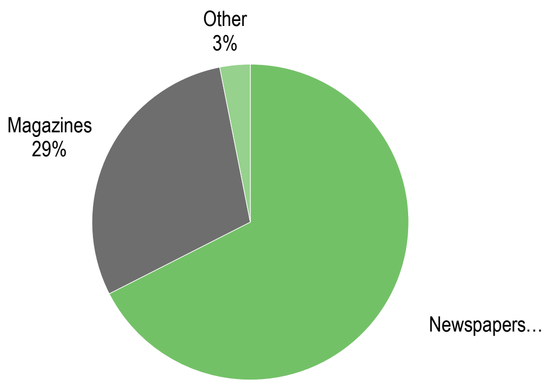
Further down the value chain, Smiths News takes no risk on the cost of distribution from petrol price fluctuations or wages costs as these services are tendered to it. There is little alternative work available overnight, either for drivers or for the delivery vehicles, so cost volatility tends to be very low.

Revenue by source and publisher

We estimate that Smiths News will generate c £1.1bn of revenue in FY21, two-thirds of which comes from the sale of newspapers and just under a third from magazines. The modest balance of c 3% comes from the less predictable revenue associated with 'one-shot' sales. These would include magazine and sticker collections often associated with sporting events like the European Championships or the Olympics, or perhaps blockbuster movie releases.

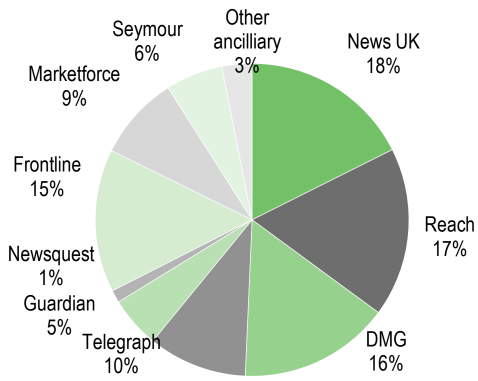
As a general rule, Smiths News generates a margin of c 6–7% on net newspaper sales, and a margin of c 10% on magazine sales. One-shot sales margin is similar to that of magazine sales.

Exhibit 7: Revenue by source (2020)



Source: Smiths News

Exhibit 8: Revenue by publisher (2020)

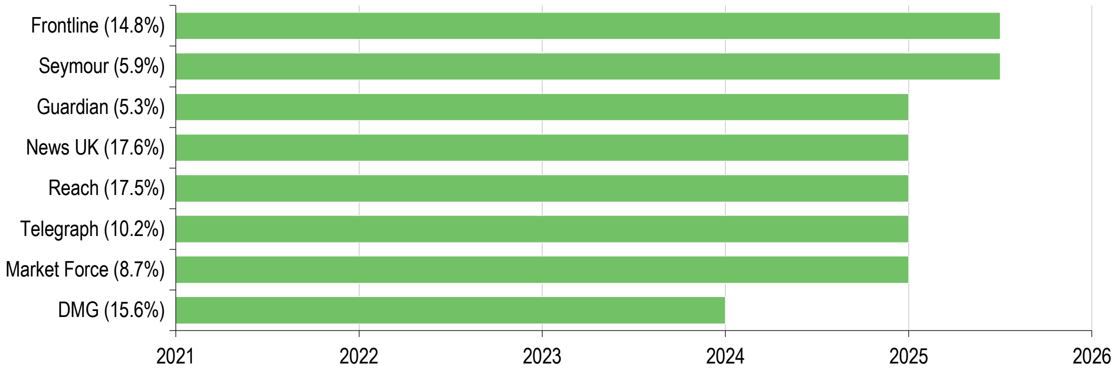


Source: Smiths News

Distribution contracts by expiry date and publisher

Smiths News is in a very comfortable position for the next four years as 95% of its revenue is the subject of contracts that run until at least 2024, with most running until at least 2025. The last major contract was a five-year deal with Associated Newspapers *(Daily Mail, The Mail in Sunday* and the *I newspaper)* announced in October 2020. This now allows management to concentrate on its extensive cost control programme to mitigate the anticipated volume and revenue declines.

Exhibit 9: Contracts by publisher and duration (percentage of FY20 revenue in brackets)



Source: Smiths News

Smiths customers are 'sticky' by nature

Smiths News has exclusive, long-term relationships with its customer base (ie the retailers), but it does not have any contracts with them. This is because of the exclusive postcode territories it has with its publishers, which effectively bans retailers from sourcing product from a third party. This ensures retailers remain 'sticky' customers of Smiths News. There is also a cost issue for the retailers in so far as they would need to pay a second delivery service charge if they took stock from another supplier, thus diminishing their own profitability.

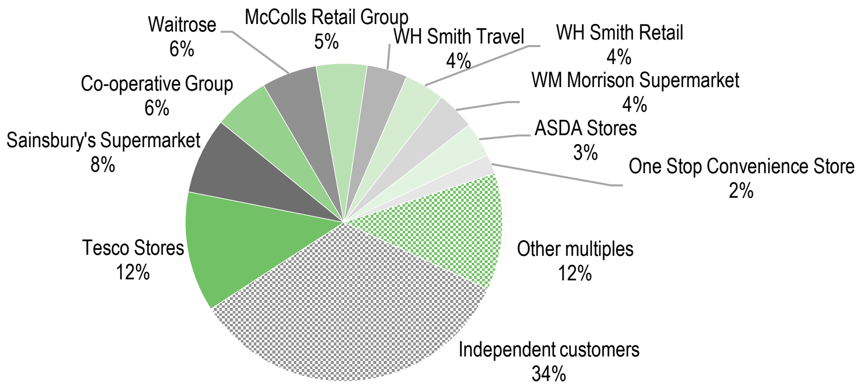
These arrangements create a high barrier to entry for third parties and for Smiths News's sole major rival, Menzies.

Smiths News's biggest clients are the large national retailers, with Tesco, Sainsbury's, WH Smith and the Co-op being the biggest and collectively accounting for around one-third of group revenue.

By contrast, the group of independent customers that accounts for 34% of revenue runs to several thousand customers, but obviously by definition most have only one location.

These retailers all pay a service charge for delivery of products that is based on a standard table pre-agreed with the Federation of Independent Retailers. This is in addition to the cost of the newspapers themselves.

Exhibit 10: Customers by revenue (2019)



Source: Smiths News

Sensitivities: Revenues and costs are fairly predictable

Predicting future volumes of newspapers and magazines has been relatively easy for much of the last 20 years, as up to the minute news from the internet has taken market share from physical news. As discussed earlier, in the 20 years from January 2000 to January 2020, the circulation of paid-for newspapers declined 65%, an annual decline of 5.4% pa. More recently of course, volumes were affected by the pandemic, with Smiths News's own newspaper and magazine volumes dropping c 12% and 42% respectively in Q320 (March to May). This was clearly an unusual event and of course it is hoped that it will not repeat and that annual volumes return to a more predictable glide path. In H121, newspaper revenue fell c 8.5% y-o-y and magazine revenue fell c 14%.

We would argue that Smiths News has, therefore, a fairly predictable revenue stream, albeit one that is in long-term structural decline, and a predictable cost base. With regards to revenue, it is further protected by around five-year contracts in place that give it territorial certainty over a vast majority of its revenue for the next four years. The only element of potentially material volatility could be the cover prices, which in the current inflationary environment could go up rather than down therefore earning Smith News modestly higher revenue.

On the cost side, the major elements are labour and property (37 depots) and again these are relatively controllable elements. It is worth mentioning that the cost of distribution from the depots to the thousands of retailers is met by the retailers, indirectly via Smiths News, and this is a low-competition marketplace as there are limited alternative uses for vans and drivers in the early hours of the morning. This tends to limit cost inflation in distribution, although pressures are building given the trickledown effect of cost inflation from the HGV driver shortages. The final mile distributors also carry the risk of fuel price volatility, thus protecting Smiths News from this risk too.

Other potential risks

There are other potential risks, but we believe these are relatively minor. They include:

- **Interest rate risks:** Smiths News signed a £120m debt facility in November 2020 that has interest costs of 5.5% and 6% over Libor, so there is potential risk here. It is worth noting that we expect Smiths News's gross debt to fall from £130m at the end of August 2020 to £110m at August 2021, and to fall further in future periods, thus reducing the interest rate risk.
- **Regulatory issues:** historically, the Competition and Markets Authority has periodically reviewed the nature of newspaper and magazine distribution in the UK. The last reviews were carried out in 2008 and 2009 and endorsed the lawfulness of the exclusive five-year territorial publisher contracts (ATP). Therefore, the threat of government intervention in the market is low, in our opinion.
- **Dividend risks:** one of the major attractions of investing in Smith News is its dividend paying potential. Although the absolute magnitude of the dividend is currently limited as part of the banking arrangements, there is clear upside to the payments in the longer term, and the potential for the declaration of special dividends. Total dividend payments are limited to £4m in FY21, and to £6m in FY22 and FY23.

Financials: Delaying the sunset; double-digit yields

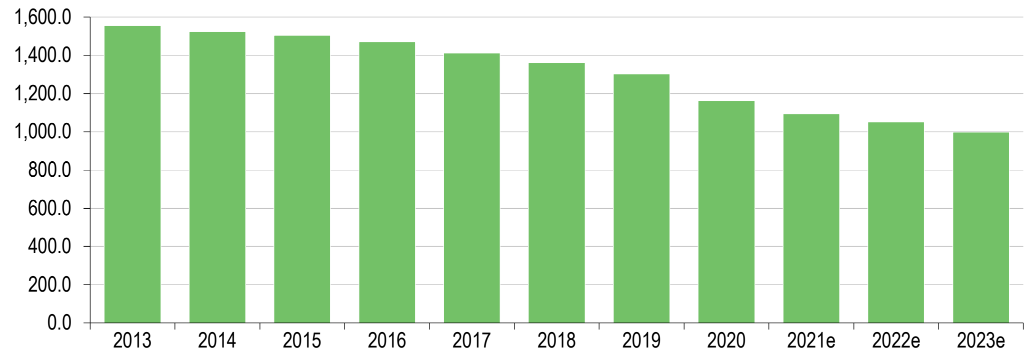
The ongoing annual revenue decline is relatively easy to predict, as are the repeated cost savings initiatives of the company. Therefore, we believe that the profits of the business will be relatively stable and that the cash flows will be strong. This cash flow in turn allows the company to pay down debt such that it should hit its 1x net debt/EBITDA target in FY23. It has already restarted paying dividends and although restrictions exist until 2023, the yield of over 6% next year and the prospect of higher dividends and 'special' dividends thereafter offer yields of double digits on the current share price, in our view.

Flat earnings after declining revenue and costs

On average, newspaper and magazine volumes have been declining at c 5% pa for a number of years. Obviously, 2020 was an unusual period due to COVID-19 disruption, which saw newspaper volumes fall c 12% in Smiths News's Q320 (March, April and May), and magazine volumes shrink c 44%. By Q221, year-on-year volume declines had returned to more predictable rates, even showing year-on-year growth as results lapped the poor Q320 volumes.

Smiths News's revenue tends to follow the direction of volumes, but to a lesser extent as it benefits from cover price inflation of c 3–4% pa, clearly not enough to offset the volume declines. It therefore needs to, and does, cut its cost base every year to offset the effect of declining revenue. In round terms, Smiths News aims to cut c £5m per year from the cost base and has very detailed plans to achieve this target in the short term. Over the longer term of three to 10 years the plans are more conceptual, but clearly the concept of continual cost cutting is at the forefront of management thinking.

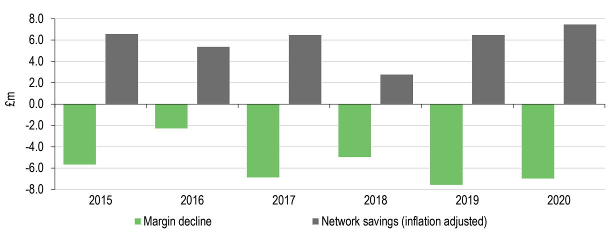
Exhibit 11: Revenue progression (£000)



Source: Smiths News, Edison Investment Research

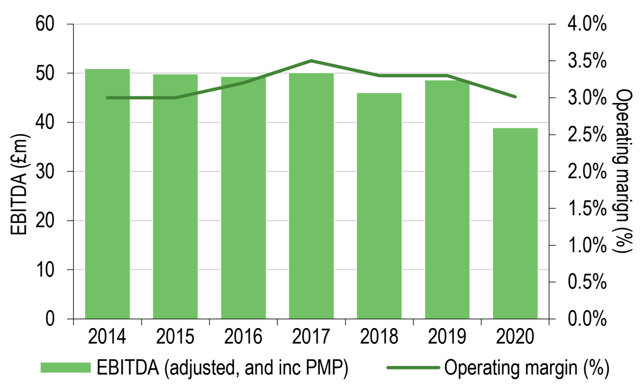
The exhibits below clearly show the impact of falling revenue and costs on the underlying profitability of Smiths News. Between 2015 and 2020, the gross impact on profitability of declining revenue saw profit contribution (margin decline) of £34.5m. However, Smiths News was able to make network savings of £35.3m, more than offsetting the margin decline.

Exhibit 12: Margin decline and network savings (£m)



Source: Smiths News

Exhibit 13: EBITDA (company adjusted and including discontinued PMP, £m) and operating margin (%)



Source: Smiths News

The net result has been an EBITDA contribution that has effectively been flat for seven years. The battle between declining revenue and cost cutting will continue and Smiths News is well prepared to continue to cut costs into the future. In fact, the company plans three years in advance to execute cost savings from the network. The network currently consists of 32 newspaper and five magazine depots and employs c 1,500 employees.

Cost savings are driven from three sources:

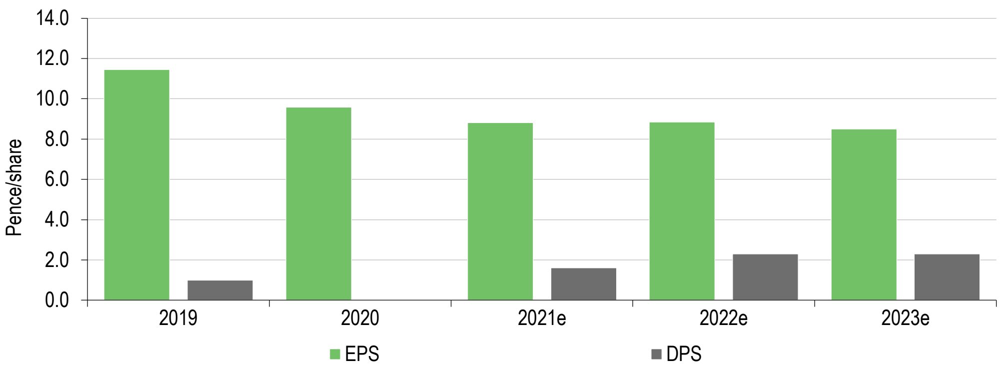
- The physical network, ie reducing the size of the network or relocating distribution to a better suited or better located centre.
- Efficiencies from working practices.
- Reductions in staff numbers. Staff numbers fell c 10% in 2020, and are expected to reduce further in 2021.

Predictable and flat EPS offers double-digit yield potential

We estimate that Smiths News will report EPS of 9.0p/share for the current year and that it is likely to generate earnings of a similar level in the next few years, although the corporate tax rate increase will have an impact from FY23e. Under 'normal' circumstances, this level of earnings would ordinarily lead to dividends 2x covered by EPS (ie c 4.5p). However, due to the current banking arrangements, Smiths News is restricted to a maximum dividend pay-out of £4m or c 1.6p/share in FY21e and £6m or c 2.3p/share in FY22e and FY23e.

Thereafter, Smiths News is targeting dividend cover of 2x, which implies dividends of c 4.5p/share and a yield of over 11%. It is also targeting a net debt to pre-IFRS 16 EBITDA of 1x at this point. This fits neatly with our DCF valuation of 77.4p (see below). A dividend of 4.5p/share at this price implies a yield of nearly 6% and a P/E of 8.8x. There is, however, the potential for special dividends, given the cash flow and the level of net debt, in our view.

Exhibit 14: Historical and forecast EPS and DPS



Source: Smiths News, Edison Investment Research

Cash flow lowers debt and offers 'special' dividend potential

Smith News is a very cash generative company, at least partly because it gets paid by its customers earlier in the month than it pays the publishers. We expect that in the three forecast years it will generate c £62m of free cash (ie c £20m pa). This cash will be partly used to pay down net debt, which stood at £79.7m at the end of August 2020, and now partly to pay dividends. We expect net debt to fall to c £60m as at August 2021, and to fall materially again in 2022 to £40.6m.

At this point, FY22e, net debt will be approaching the annual EBITDA of c £38m, which implies a ratio of 1.1x. In 2023, we expect that Smiths News will generate free cash, post dividends, of £15.2m, which would bring net debt down to £26.1m, a net debt to EBITDA ratio of 0.7x. This is below the 1x target, implying surplus cash that could be used to pay a special dividend to shareholders of c £5m. This could equate to a dividend per share of 2p, in addition to the ordinary of 2.3p.

Exhibit 15: Estimate of post dividend free cash flow and year-end net debt

£m	FY21e	FY22e	FY23e
EBITDA reported (ex IFRS 16)	**38.3**	**38.3**	**35.5**
Gross cash flow	28.1	34.2	31.1
Net capex	(4.2)	(4.2)	(4.2)
Repayment of lease liabilities	(6.0)	(6.0)	(6.0)
Free cash flow	17.9	24.0	20.9
Dividends	(1.2)	(3.9)	(5.7)
Estimated free cash flow, post dividends	16.7	20.1	15.2
Year-end net cash/(debt)	**(60.0)**	**(40.6)**	**(26.1)**

Source: Edison Investment Research

It is worth noting that Smiths News no longer has any pension obligations after transferring all assets and liabilities to L&G. There, is however, a conditional £16m pre-tax surplus available, which may result in some value being attributable to shareholders.

We value the shares at more than 2x the current price

We value the shares of Smiths News at 77.4p each, based on our DCF calculation, more than twice the current share price. Given the predictable but declining cash flow of the business, we believe this is a reasonable methodology to adopt. The value is confirmed by our DDM valuation, which suggests a value per share of 76.7p. A DDM approach is also an appropriate way to value the stock considering the current strategy, which is to generate cash, pay down debt and return surplus cash to shareholders via dividends and special payments. The cash-generative nature of the business was one of the key attractions that saw Menzies Distribution acquired by private equity in September 2018.

DCF valuation suggests a value of 77p/share

We have chosen to value Smiths News on a DCF basis. This is because the decline in revenue is relatively constant, and the reduction in the cost base is also factored into management action and it has a track record of delivering. Therefore, we believe that the profits and cash flow of the company are likely to be relatively robust and to decline only slowly over an extended period of time.

Our key assumptions include:

- **revenue declines of c 5% pa**, a combination of volume declines of 8–9%, and annual price rises of c 3–4%;
- **constant operating margins of 3.3%,** a reflection of cost base action;
- **a terminal growth rate of -5% pa**; and
- **a WACC of 6.5%**, cost of equity of 7.5% and cost of debt 6%, in line with current arrangements.

Plugging these assumptions into our DCF model gives a valuation of 77.4p.

The sensitivity table below describes how the valuation fluctuates with differing terminal value (TV) growth rates and WACCs. The current share price of c 37p is discounting a TV decline of 10%, and a WACC of 12.5%, both double the rates assumed in our base case scenario.

Exhibit 16: Smiths News DCF value per share (p)

		Terminal growth rate (%)				
		0.0%	-2.5%	-5.0%	-7.5%	-10.0%
WACC (%)	8.0%	83.4	71.9	64.8	60.0	56.5
	7.5%	90.2	76.7	68.6	63.2	59.3
	7.0%	97.8	81.9	72.7	66.6	62.3
	6.5%	106.6	87.8	**77.1**	70.3	65.5
	6.0%	116.8	94.3	82.0	74.3	69.0

Source: Edison Investment Research

DDM implies a value of 77p/share

Smiths News is unlikely to become an earnings growth story, but it is, in our opinion, likely to be an income story, especially as the dividend payment cap runs off. We can therefore value the stock on a DDM basis.

On this methodology, our key assumptions are as follows:

- a base dividend of 2.3p/share, in line with our FY22 dividend estimate;
- a cost of equity of 7.5%; and
- a dividend growth rate of 4.5% pa.

Using a simple DDM we arrive at a value per share of 76.7p.

Exhibit 17: Smiths News DDM valuation sensitivity (p/share)

		Dividend growth rate (%)				
		3.0%	3.5%	4.0%	4.5%	5.0%
Cost of equity	9.0%	38.3	41.8	46.0	51.1	57.5
	8.5%	41.8	46.0	51.1	57.5	65.7
	8.0%	46.0	51.1	57.5	65.7	76.7
	7.5%	51.1	57.5	65.7	**76.7**	92.0
	7.0%	57.5	65.7	76.7	92.0	115.0

Source: Edison Investment Research

It is possible to dispute the starting dividend value in our DDM. As stated, we have used 2.3p, which is the value in our model for FY22e, not 1.6p that we forecast for FY21e. It is also reflective of the dividend paying constraints imposed as part of the new banking arrangements. Smiths News has only just returned to paying dividends and the current value is not representative of future potential dividends, especially when considering that we are forecasting an average EPS of c 9p/share over the forecast period.

This level of earnings suggests that even 2.3p/share is likely to be too low considering that the company has historically declared a 2x covered dividend and this is management's current stated aim. A dividend cover of 2x and our average forecast EPS of 9p/share would imply a payment of c 4.5p/share. These inputs imply a value of c 60p/share. This is clearly below our DCF and DDM values of 77p, but gives no credit for the potential of 'special' dividends. It is also well in excess of the current share price.

The share price chart below highlights how far the shares have fallen. The business contained a loss making distribution business (Tuffnells) when the share price was four-times what it is today. We would argue that the current operation is significantly more attractive now than then, and that although the shares have recovered from a low of 11.5p in June 2020 to 37p now, our valuation suggests there is significant further upside.

Exhibit 18: Smiths News share price

Source: Bloomberg

Exhibit 19: Financial summary

£m	2019	2020	2021e	2022e	2023e
Year end 31 August	**IFRS**	**IFRS**	**IFRS**	**IFRS**	**IFRS**
INCOME STATEMENT					
Revenue	1,303.5	1,164.5	1,094.6	1,050.8	998.3
Cost of Sales	(1,217.5)	(1,091.4)	(1,025.0)	(982.7)	(933.5)
Gross Profit	86.0	73.1	69.7	68.2	64.8
EBITDA	60.1	40.4	39.2	39.2	36.4
Normalised operating profit	44.0	35.4	34.6	34.6	33.8
Amortisation of acquired intangibles	(0.1)	(0.2)	0.0	0.0	0.0
Exceptionals	(7.2)	(7.8)	(0.1)	0.0	0.0
Share-based payments	(0.4)	(0.3)	(0.3)	(0.3)	(0.3)
Impairment	0.0	(6.0)	0.0	0.0	0.0
Other	0.0	0.9	1.7	0.0	0.0
Reported operating profit	36.3	22.0	35.9	34.3	33.5
Net Interest	(6.0)	(7.2)	(6.9)	(7.1)	(6.2)
Profit Before Tax (normalised)	38.0	28.2	27.7	27.5	27.6
Profit Before Tax (reported)	30.3	14.8	29.0	27.2	27.3
Reported tax	(8.4)	(2.8)	(5.5)	(5.2)	(6.0)
Profit After Tax (norm)	29.6	25.4	22.2	22.3	21.6
Profit After Tax (reported)	21.9	12.0	23.5	22.0	21.3
Discontinued operations	(53.4)	(18.7)	(0.4)	0.0	0.0
Net income (normalised)	29.6	25.4	22.2	22.3	21.6
Net income (reported)	(31.5)	(6.7)	23.1	22.0	21.3
Basic average number of shares outstanding (m)	246	245	245	246	248
EPS - basic normalised (p)	12.01	10.39	9.04	9.07	8.72
EPS - diluted normalised (p)	11.98	10.28	8.94	8.97	8.62
EPS - basic reported (p)	(12.78)	(2.74)	9.40	8.94	8.60
Dividend (p)	1.00	0.00	1.60	2.30	2.30
Revenue growth (%)	N/A	(10.7)	(6.0)	(4.0)	(5.0)
Gross Margin (%)	6.6	6.3	6.4	6.5	6.5
EBITDA Margin (%)	4.6	3.5	3.6	3.7	3.6
Normalised Operating Margin	3.4	3.0	3.2	3.3	3.4
BALANCE SHEET					
Fixed Assets	31.5	66.5	57.5	48.7	43.9
Intangible Assets	10.1	4.0	0.0	(4.0)	(4.0)
Tangible Assets	10.9	9.4	10.4	11.6	12.8
Investments & other	10.5	53.1	47.1	41.1	35.1
Current Assets	181.2	165.9	159.0	152.5	147.4
Stocks	16.2	14.1	13.1	12.6	12.0
Debtors	124.2	101.2	95.2	89.3	84.9
Cash & cash equivalents	24.0	50.6	50.6	50.6	50.6
Other	16.8	0.0	0.0	0.0	0.0
Current Liabilities	(229.7)	(283.9)	(253.0)	(228.4)	(209.6)
Creditors	(173.7)	(139.5)	(131.4)	(126.1)	(121.8)
Tax and social security	0.0	(1.7)	(1.7)	(1.7)	(1.7)
Short term borrowings	(46.1)	(130.1)	(110.4)	(91.0)	(76.5)
Other	(9.9)	(12.6)	(9.6)	(9.6)	(9.6)
Long Term Liabilities	(57.3)	(30.1)	(24.1)	(18.1)	(12.1)
Long term borrowings	(49.3)	0.0	0.0	0.0	0.0
Other long term liabilities	(8.0)	(30.1)	(24.1)	(18.1)	(12.1)
Shareholders' equity	(74.3)	(81.6)	(60.7)	(45.3)	(30.3)
CASH FLOW					
Op Cash Flow before WC and tax	60.1	40.4	39.2	39.2	36.4
Working capital	(3.9)	(5.3)	(4.2)	1.2	0.8
Exceptional & other	(7.7)	(13.4)	1.3	(0.3)	(0.3)
Tax	(2.6)	0.0	(5.5)	(5.2)	(6.0)
Other	(22.9)	1.7	4.3	6.4	6.4
Net operating cash flow	23.0	23.4	35.0	41.3	37.3
Capex	(8.1)	5.3	(4.2)	(4.2)	(4.2)
Acquisitions/disposals	0.0	(3.7)	0.0	0.0	0.0
Net interest	(5.1)	(8.0)	(6.9)	(7.1)	(6.2)
Equity financing	0.0	(0.7)	(0.8)	(0.8)	(0.8)
Dividends	0.1	(2.2)	(1.1)	(3.8)	(5.6)
Other	(2.8)	(15.6)	(8.8)	(6.0)	(6.0)
Net Cash Flow	7.1	(1.5)	13.2	19.4	14.5
Opening net debt/(cash)	79.3	72.1	73.2	60.0	40.6
FX	0.1	(0.1)	0.0	0.0	0.0
Other non-cash movements	0.0	0.5	0.0	0.0	0.0
Closing net debt/(cash)	72.1	73.2	60.0	40.6	26.1

Source: Smiths News accounts, Edison Investment Research

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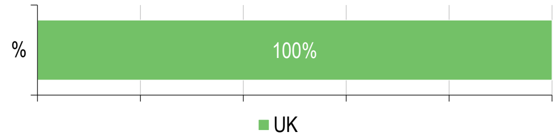
Revenue by geography



Management team

Chairman: David Blackwood

David was appointed chairman in 2020, having previously been a non-executive director at Dignity. He was formerly chief financial officer of Synthomer, where he was employed for seven years, stepping down in 2015, prior to which he held a number of senior roles at Imperial Chemical Industries. David is also a board member at Esken (formerly Stobart Group) and Scapa Group.

Chief executive officer: Jonathan Bunting

Jonathan joined WH Smith News in 1994. He held a variety of sales and marketing managerial roles before being promoted to the executive management team in 2001. In April 2014, Jonathan became managing director of the Connect News & Media division and, subsequently, chief operating officer in September 2017, a position that spanned wider group business interests held at the time, together with Smiths News. His appointment as interim chief executive officer in November 2019 was confirmed in June 2020.

Director: Tony Grace (retiring 31 December)

Tony was appointed finance director in 2018 and brought extensive, relevant finance and business transformation experience. He was most recently chief financial officer at Yodel Delivery Network and has previously held senior finance and operational roles at Virgin Media and Telewest. He was succeeded by Paul Baker WEF 4 October.

Chief financial officer: Paul Baker

Paul became chief financial officer on 4 October following the announcement that Tony Grace will retire on 31 December 2021. Most recently, Paul was integration director at Compass Group (2013–21). He has also held various regional and divisional finance director roles at Iglu Group/Birds Eye (2011–13) and Cadbury Schweppes (1997–2010).

Principal shareholders	(%)
Aberforth Partners	19.0
Forum Family Office	14.3
Fidelity International	10.0
Silchester International Investors	6.8
Jupiter Asset Management	5.0
Hargreaves Lansdown, stockbrokers (EO)	4.8
M&G Investments	4.3
Worsley Asset Management	4.0
Interactive Investor (EO)	3.4
Employee Share Scheme	2.9

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