ARSENAL HOLDINGS PLC

Commentary on INTERIM ACCOUNTS for the six months ending 30 November 2008

by Nigel Phillips

"Ready to survive the Recession?"

The financial results for the six months to 30 November 2008 confirm what we knew already: a sold out stadium and significant broadcast income can sustain a £100 million wage bill and service the new stadium debt – just! The Chairman comments that these results "have been achieved against a background of what is clearly a very difficult economic climate" but in reality they were achieved before the recession hit as expenditure for this period was committed months or even years previously. The figures also provide a revealing insight into the increasingly difficult property development ventures of Highbury Square and Queensland Road. More of that later.

The Arsenal Football Business – ***Football turnover*** increased by 10% to £98.4m from £89.3m for several reasons, including more games, higher TV distributions, the 2008/09 season ticket price increase and the € / £ exchange rate effect on Champions League money. The ***football operating profit (before debt service costs)***, excluding player sales and the cost of writing down the squad (basically depreciation of intangible assets – a non-cash cost) was £23.5m (£21.9m).

Arsenal's football income comprised four separately identified revenue streams:

Match day	£44.4m (£41.1m)	45%	(46%) of football revenue
Broadcasting	£28.9m (£24.3m)	30%	(27%) of football revenue
Commercial	£16.3m (£15.7m)	17%	(18%) of football revenue
Retail	£8.0m (£7.8m)	8%	(9%) of football revenue

Football costs rose to £74.1m (£67.1m), mainly due to wage increases and extra stadium operating costs. On an annualised basis this £150m is broadly split between wages (£100m) and "other costs" (£50m) and must be compared to "cash" football revenues, ie money received when earned and not in advance. "Other costs" include stadium operating costs (£20m?), costs related to revenue sources such as merchandising, and team travel and training expenses. It is unclear what, if any, downward flexibility there is in the cost base. It should be noted that the often quoted ***wages to football turnover*** ratio is likely to be close to a respectable 50% – comfortably within any potential UEFA guidelines or regulations for good governance.

The cash balances were £75.7m (£69.1m), which included £22.6m (£23.1m) held in specific debt service reserve accounts related to the new stadium financing. This account acts as security for lenders that future interest and principal payments can be made on due dates. Of the remaining £53m (£46m) it is estimated that £35m is held to finance the completion of the Highbury Square development.

The ***new stadium debt*** is falling in line with expectations, and was £242.1m (£246.8m). Interest costs on this loan are either fixed contractually or by interest rate swaps and are about £15m pa. Arsenal pay about £1.5m pa to an insurer (Ambac Assurance) to provide additional protection for the lenders / investors in case Arsenal default on the debt service of this loan. Due to the downgrading of Ambac the worth of this insurance has been reduced. The £25.9m (£25.6m) of supporter held debentures (the A, B, C and D bonds) increased by the amount of the rolled up interest on the C and D bonds.

"Accruals and deferred income" (revenue received in advance of the accounting period to which it relates – essentially Club, box and commercial monies) remain high but fell to £151m (£162m).

Player trading again proved a very profitable activity generating a surplus of £18.5m (£19.6m) with gains on the sales of Hleb, Hoyte and the on-sale of Bentley. Expect some Diarra on-sale money in the next reporting period. Wenger has been criticised for making a profit from player trading, but this is a useful revenue stream and could be part of a broader strategy when reviewing the composition of the squad and likely distribution of wages. Money payable in the future on players fell to £23.5m (£30.7m) of which £10.9m (£20.1m) is described as "probable" based on the expected future number of first team appearances.

The Arsenal Property Business – The club have provided significantly more detail than previously on the Highbury Square development, as the collapse in the mortgage market and falling property prices take an inevitable toll on this project. ***The good news*** is that all future building costs at Highbury Square (£35m?) were fully funded (money received and held on deposit), meaning each new sales completion goes to reducing the outstanding ***property development loan***. At the period end this loan totalled £140m (£104m), of which £135m related to Highbury Square. This loan is due for final repayment by April 2010. The club is negotiating with the three banks to extend the terms of this loan, as it has become clear that apartment completion delays mean the original anticipated repayment schedule can not be met.

Of the 680 apartments (655 now built and marketed), 85 are unsold and are held by a separate Arsenal company, 186 had reached financial completion, and the remaining 409 were subject to pre-sale agreements. ***To fully repay the loan it is estimated that a further 340 of the units subject to pre-sales need to be completed.*** Only at this stage will Arsenal be "in the money" on this development. Whilst correct from an accounting point of view to record a profit on property development in these figures (£6.3m vs £2.5m), the reality is that many more completions are needed before a real profit will be seen. The inability of many purchasers to obtain mortgages on their apartments is a concern, as is the story that Fraser and Neave Limited, a quoted Singapore based packaging and property company, is "seeking assistance" to complete on its purchase of 125 units in the North Bank Stand.

There is a £5m loan against the ***Queensland Road*** site, which recently received planning permission, and details are awaited on the plans for developing this 700-apartment (350 affordable housing / 350 market priced units) plus sports centre project.

Arsenal has reiterated that all Group property development activities are totally ***ring-fenced and separate*** from the football club. It will be interesting to see how this impacts on decision making while the day when the club can finally exit the property business moves further away. Generating surplus cash for the football club seems a distant prospect now, and compares with the Chairman's statement at this time last year that property activities would gross the club £350m in the next two years, implying a £70m-£100m surplus.

Summary Football, like the world in general, is facing a period of unprecedented economic uncertainty. The Arsenal business objective of ***self sustainability and paying its own way*** works well in a sold out stadium. However with premium seats (Club Level, executive boxes and Diamond Club) generating c£35m pa and my estimate of a ***55,000 break even paid attendance***, the club can ill afford any appreciable fall in revenues. Season ticket waiting lists are about to be put to the test. The recent 5% increase for the next three year (2010/11-2012/13) domestic TV deal is positive for the Premier League clubs. However, it is clear why Champions League qualification for 2009/10 is variously described as somewhere between important and vital. Non-qualification (after 11 consecutive seasons of qualification) could cost the club about £40m in lost revenue (£20m UEFA distribution and £20m gate receipts), which would only be partially mitigated by entry into the UEFA Cup / Europa League. It is not clear if wages are linked to Champions League qualification in any way. This would be prudent but unattractive to the players.

Football costs (wages and other) are high and need a full-ish stadium at all levels (premium and general admission) to be self sustaining. Loaning out players is a short term measure to reduce costs (and develop the players) and the 13 players currently out on loan (25% of playing staff!) could reduce the wage bill by about £5m for a full year.

Those who ask about ***squad investment*** and the extra revenue generated by the new stadium need to keep in mind the following: the wage bill now is 50% higher than when we last won a trophy (with Henry, Pires, Vieira, Bergkamp, Campbell, Ljungberg, etc) and is spread across a smaller number of players (54 vs 61). This reflects the significant wage inflation throughout top level football.

The ***long term commercial deals*** with Emirates (shirts expiring 2014/15 and stadium naming rights 2020/21) and Nike (2010/11) are secure but generate progressively less cash value due to the stadium-induced front loading of these contracts. The annual cash forgone is now about £7.5m. The contribution from commercial revenues is small in comparison to other clubs.

The property is a concern and the extension of the loan will be expensive and will further eat into any future profitability of the project, though the unsold properties could be let out by the club in the years to come. One hopes that most of the remaining 400 units under contract but yet to complete do so, but this is unlikely without some negotiation on the payment terms. It remains to be seen if, as the football business needs more executive input to steer it through these uncertain times, the club is prepared to pass the property hot potato onto a willing (and opportunistic?) property developer or even allow the lending banks to assume full responsibility for seeing this project to its conclusion. Hold on tight!

As an Arsenal Supporters' Trust member, if you have any comments on the financial accounts please get in contact with us at info@arsenaltrust.org or on 07775 671345

These observations and comments seek to be objective but are a personal commentary by the author and do not represent an official statement from the Arsenal Supporters' Trust.