Report on 2015-2016 Financial Statements of Tottenham Hotspur Limited ("THL")

Background

The latest financial statements cover the period 1st July 2015 to 30th June 2016, with the Income Statement and the Statement of Cash Flows showing the revenues/profits and the cash generated respectively by THL during that period and the Balance Sheet setting out the financial position of the club at the end of that period. This means that the figures are already quite historic as they neither capture the acceleration of the Northumberland Park Development ("NDP") project, nor the increased income from the new TV deal, nor the benefits of Champions League participation in 2016-17. It is certain that the next set of accounts will show substantial growth in all three elements of the financial statements.

Statements are provided for THL as a consolidated entity (the "Group") (i.e. including the activity of the numerous subsidiary companies owned by THL) and the sole accounts of THL (the "Company") (i.e. the activity of THL alone). For analysis purposes the consolidated accounts are the most important as they cover the entirety of the club's operations but comparison with the sole accounts has some interest as it sheds some light on the extent to which the NDP project is being implemented at a subsidiary rather than the THL level.

A minor note of interest is that the Group is audited according to IFRS (an international standard) while the Company is audited according to UK GAAP that applies just to the UK. There are some differences between the two (UK GAAP for instance treats goodwill more generously). I do not consider that any differences are material for the purposes of this analysis but my knowledge of accounting systems is not such that this can be relied upon with 100% confidence.

Formal Reports

Prior to the presentation of the financial statements there are a number of reports from the directors of the Company setting out a broad overview of the Group's performance during the year, policies of management and the responsibilities of the directors. The auditors, Deloitte, also report on the method by which they undertook their audit and give an opinion as to whether the accounts can be relied upon (they can).

The most interesting of these reports is the Strategic Report. Much of this is covered in detail in the financial statements and is therefore reviewed below however there are some additional nuggets:

- PL gate receipts were flat at £22.2m; the club is at the limit of its revenue-earning capacity for this income stream. This number can be expected to fall in 2016-17 due to the closure of the NE corner of WHL and reduced income resulting from the £30 away ticket cap.
- Europa League income was sharply up from £7.1m to £18.7m due to increased UEFA payments to incentivise prioritisation of the EL. This jump is not immaterial and suggests that UEFA might succeed in their aims.
- Domestic cup receipts almost halved to £2.4m due to indifferent performance in 2015-16.
- TV money was up by about 5% due to increased coverage as a result of the PL title challenge.
- Sponsorship and merchandising were both flat at £48.8m and £12.0m respectively. These numbers are well below the Group's target peer group and have been a source of weakness in the Group's recent performance. The ending of the Under Armour and AIA deals and the opportunities provided by the new stadium should give substantial room for improvement.
- Cumulative net spend on NDP is up from £59.0m to £115.3m which means that £56.3m was spent on the new stadium during the year (i.e. as much as in all previous years put together). Property, Plant and Equipment on the Balance Sheet amounts to £288m, which means that WHL plus all associated assets are valued at £173m.

- Daniel Levy's 29.41% interest in ENIC is equivalent to a 25.2% interest in THL given ENIC's 85% ownership of the latter. Joe Lewis presumably owns the remainder of ENIC, which is equivalent to a 48.0% ownership of THL. This is interesting as it means that Lewis does not have a majority interest in THL although he does have de facto control. Moreover Levy's stake is material; Lewis's wealth is well publicised but Levy's ability to fund his share of equity calls is less well known should equity calls be required to part-fund the NDP.

Consolidated Income Statement ("CIS")

Total revenues earned during the year were £209.8m, which is split into the different streams in Note 2 to the accounts. These incorporate the different revenue streams highlighted in the Strategy Report, albeit presented slightly differently. The total figure represents a 6.8% increase on the previous year's result, which is ahead of inflation but is mostly accounted for by the increased EL income.

The Group's operating costs, totalling £162.4m, are set out in Note 3. Salary costs totalled £100.0m, which is actually a very small reduction on 2014-15's figure and is, as pointed out in other commentary, a rarity in the PL world. The vast majority of this figure will be consumed by player's wages and, with the signing of new contracts by much of the squad, can be expected to rise significantly in 2016-17. There were also significant charges for letting people go, £6.5m in 2014-15 and £9.6m in 2015-16. No names are named but it is likely these relate to the release of Tim Sherwood and other coaching staff and Emmanuel Adebayor. There was also a £7.6m profit on property sales in the latest year, which is a substantial sum. One can speculate that more surrounding land was purchased than was needed for the NDP to be on the safe side and this is being released back on to the market while payments from Sainsbury's for the supermarket beneath Lilywhite House may also be a feature. Nevertheless, this helped plug a 10.7% increase in 'other operating costs'; these are not broken down but are likely to include the costs of third party suppliers e.g. the stadium caterers, maintenance of WHL and the training ground, police costs etc. It is not clear why such costs should have risen faster than the increase in revenues.

Subtracting these operating expenses from revenues results in an operating profit of £47.3m - up from £34.0m the year before. To get to the net profit further deductions need to be made, most pertinently from a fan perspective net transfer fees (or amortisation and impairment or profit on disposal of intangible fixed assets in accounting speak). It is important here to understand how transfer deals are reflected in the accounts. Transfers in are accounted for by amortising the fee over the life of the contract, so a £30m fee for a 5-year contract will result in £6m per year being charged to the CIS. Sales are booked at the point of sale with any surplus or deficit charged to the CIS e.g. if the same player above is sold after two years his book value is £18m (£30m – 2 x £6m). If he is sold for £20m a £2m profit is recorded; for £16m, a £2m loss. In fact, if at any time management reasonably determines that sale of a player is unlikely to recoup his book value (i.e. the outstanding portion of his transfer fee that hasn't yet been amortised) then the associated loss (technically an impairment) is immediately charged to the CIS.

The effect of this is that for any one year the 'Football Trading' line in the CIS reflects only that year's portion of the amortised cost of all transfer fees. This means that if the club were to splurge £80m on a player this summer only £16m of that would be charged to the CIS (assuming a 5-year contract). As a result the 'Football Trading' line is smoothed over a number of years but gives a medium term view of the Group's activities in the transfer market. In 2014-15 Football Trading resulted in a charge of £38.6m to the CIS but in 2015-16 this had fallen to £31.8m. This begs the question: to what extent this fall is the consequence of a deliberate policy to reduce net transfer spend (to free up cash for the new stadium) or is it evidence of successful player trading whereby profits have been booked through the sale of players at a cost greater than their book value?

There is strong evidence of the latter in the Strategic Report where it is reported that player sales generated a profit of £27.1m, up from £21.2m. This difference of nearly £6m is very close to the difference in the Football Trading result, suggesting that spending has been maintained at least in the two years presented in these accounts.

The numbers indicate the success of management in its transfer strategy of only signing players capable of re-sale during the course of their contracts. The effect of amortisation should be noted here: if a player signs for £10m on a 5-year contract and is subsequently sold two years later for the same amount a £4m profit is booked (through effectively recouping the 2 x £2m of the fee that has already been amortised). The converse applies: should a player's value need to be written down (as would have been the case if a transfer fee had been paid for Adebayor) this would have gone straight through to the bottom line. With the new stadium to be financed THL is not in the position of oligarch-bankrolled clubs to comfortably write off transfer fee mistakes.

One further financial indicator of note is the wage/income ratio where it is well known that THL has run a tight ship and performed better than most of its rivals. The ratio in 2014-15 was 51%; in 2015-16 this fell to 48%. This was down to increased income (EL prize money increase and extra PL live TV games) but will be subject to increased volatility from 2016-17 as contract extensions and increased TV money are factored in. Given the demands of financing the new stadium it is unlikely that this ratio will rise significantly in the near term but fans are justified in seeking reassurance that this ratio will be maintained at a level that will allow the club to attract players of a calibre to compete – and in time that cash flows in excess of debt service requirements are used to attract and/or retain the sort of world class players that in recent years it has lost to Real Madrid.

Consolidated Balance Sheet ("CBS")

The CBS sets out the assets of the Group and how those assets have been funded as at a specific date, 30th June 2016. Items of note are as follows:

- **Property, Plant and Equipment ("PPE")**
  PPE shows the fixed assets of the club, primarily the existing WHL stadium plus the work in progress on the new stadium and associated buildings (e.g. Lilywhite House). These have grown from £218m to £288m over the year to 30/06/16, reflecting the progress on the new stadium build. Note 9 splits this out with WHL given a book value of £109m and 'assets under construction' amounting to £167m. The Strategic Report however told us that cumulative spend on the NDP totalled £115m; this suggests that construction work valued at a not insignificant £52m has been invested on work that is not formally part of the NDP, as defined by the club. It is not clear whether this sum is included in the £800m publicised project cost and whether this will increase further. The club needs to provide greater clarity on what is included in the NDP and budgeted project costs for NDP and non-NDP investment.

- **Intangible Fixed Assets ("IFA")**
  This line reflects the book value of the players. In 2015 they were valued at £109m, falling to £98m in 2016 which is consistent with the profits from player sales shown in the CIS. As with the CIS, taken in isolation the reduction in player value is not necessarily a cause for concern in the knowledge that this largely represents the unwinding of the generally unsuccessful Bale splurge but further reductions could be a sign of failure to invest in the squad. It should also be noted that the book value of the squad is not the same as the market value; players such as Harry Kane and Dele Alli are only going to be a tiny part of the book value in the accounts given that they came through the development ranks and were signed for a modest fee respectively. Conversely note 9 also indicates that the value of two unidentified players are material to the accounts. These will be players signed for large transfer fees that would make a significant difference to the accounts if the book values of those players had to be impaired. One can surmise that the players concerned are Erik Lamela and Heung-Min Son.

- **Trade and Other Payables "TOP")**
  These have shown considerable movement and reflect sums that the Group is contracted to pay out in the future or, apparently, the value of contracts signed but where the services have not yet been provided. They are either current (£189m payable within one year) or non-current (£69m payable beyond one year). The element relating to stage payments for transfer fees paid is separately itemised (£20m current; £19m non-current) but the total amount of TOP comes to £257m and there is little clarity on the remainder. It is suggested that these comprise season ticket sales and the Group's commercial sponsorships. These are included in the Accruals and Deferred Income "ADI") lines in note 14 and 15. Note 14 puts the total amount of current ADI at £132m, up from £80m. If all season ticket sales are included in this figure our calculations show that even if every seat at WHL was sold as a season ticket, proceeds would not exceed around £40m, leaving £92m for commercial contracts. As a corresponding figure is by and large absent from the non-current ADI these contracts must be in their final year or were for one year only. The kit deal and shirt

sponsorship are obvious candidates, however as these contracts are approaching their end it does not explain why the overall amount would increase by £52m.

It is possible that part of the increase relates to the deal with Wembley to stage Champions League matches during 2016-17, which would fit with the one year timeframe of current ADI. Put simplistically this deal could have been structured in two ways. Firstly, the Group could have agreed to pay Wembley to rent the stadium and keep commercial income (tickets, catering receipts etc) for itself. If so, this wouldn't appear in ADI as the season ticket sales and commercial sponsorships that we know are included reflect monies that the Group has received for services to be provided in the future. As no such figure appears to be obviously reflected elsewhere in the accounts an alternative arrangement may apply. Wembley could have agreed to pay the Group to play CL matches at Wembley and retained ticket and other income for itself. Nevertheless such a contract would hardly seem able to account for the scale of the increase in ADI even if television income was also included in the deal.

In non-current TOP there is also a new accrual for £45m for which no explanation is given. Suggestions have been made that this could relate to the agreement with the NFL to stage two NFL games a year for ten years at the new stadium. Without knowing exactly what is included in that contract, at £2.25m per game this would appear credible but there is an added complication from looking at the sole balance sheet for THL (i.e. the Company). Its non-current liabilities include an accrual for £10m relating to a payment from an unnamed third party as a 'contribution towards future construction expenses related to the NDP'. The wording is curious as 'contribution' suggests something akin to a donation rather than an amount received in advance for a future service to be provided. Moreover, this £10m has to be included in the consolidated Group accounts somewhere and as the only non-current accrual is the £45m referred to above this amount has to include the £10m 'contribution'. If this is the NFL contract it would mean that NFL has paid out £45m upfront, comprising the £10m 'contribution', probably structured as some kind of fee for incorporating satisfactory NFL facilities into the new stadium, and then £1.75m per game.

- **Debt**

  As with TOP, loans and other debt are classified as either current liabilities or Short Term Debt ("STD"), due to be repaid within one year, and non-current liabilities or Long Term Debt ("LTD"), due to be repaid in more than one year. STD has fallen from £19.4m to a negligible £1.4m and has almost certainly been funded by new LTD that has been incurred. Moving STD to LTD is a sensible risk management policy as it allows more time to get the money together to ensure repayments are made on time. This STD appears to have been a £16m loan facility from Investec, a South African investment bank, which originally funded and was secured against the new training ground. Note 15 tells us that this was increased to £25m in August 2015 and repayment pushed out to 2022. This has therefore now become LTD. No detail is provided on repayment terms i.e. whether it is a 'bullet' repayable in full on the maturity date or 'amortising' repayable in instalments over the life of the loan. The distinction is important for debt service. A bullet repayment reduces debt service requirements to interest only over the life of the loan but presents a refinancing risk at loan maturity, while an amortising loan requires interest and principal repayments over the life of the loan (think of interest-only and repayment mortgages).

  The Investec loan is consequently now classified as LTD, which has increased to £123m from £12.0m, primarily due to a new loan provided by a consortium of three banks, HSBC, Goldman Sachs and Bank of America Merrill Lynch. The new loan is for £200m, of which £100m has been drawn, and is funding early construction of the new stadium. It is secured against WHL and future gate and corporate hospitality receipts. The maturity is December 2017 meaning that this is/was a 'bridge' facility meant to bridge the gap until a larger loan can be put in place. Bridges are considered riskier by banks due to the uncertain repayment sources and high construction risks and are therefore typically more expensive. Recent press reports have suggested that the bridge has now been completed through a new £350m loan arranged by the same three banks. No details are given in the accounts however it is reported that the loan has a 5-year tenor with a fixed interest rate. Fixing the rate is sensible, although typically comes at a higher cost, but the tenor is aggressive as it suggests that at least part will need to be refinanced. It indicates that a project finance structure (where loan repayments are typically expected to meet future cash flows) is not being considered and also management confidence in the future availability of debt and/or the ability to grow cash flows through increased TV money, CL participation etc.

The identity of two of the banks involved is of interest. Merrill Lynch and Goldman Sachs are not normally noted for their interest in balance sheet lending, that is to say they do not usually put their own money at risk for the simple return of the interest earned. Instead their strategy is to leverage any support they do provide with additional investment banking business, typically through arranging an equity or bond issue to take out any debt provided and earn a superior return through fee income from the new issue. This may suggest the current thinking on strategy for refinancing the debt.

At the start of the year, £18.3m of loan notes, issued in 2002/06, were also outstanding. These attracted a fixed rate of 7.29% and were secured against WHL and future gate and corporate hospitality receipts. They were repaid in December 2015, presumably from the proceeds of the new bank loan. No detail of who held the notes is given.

Finally it is also possible to estimate the cost of debt to the Group, which in turn gives an indication of the banks' assessment of the riskiness of the debt (the higher the interest rate the higher the implied risk). Assuming an average debt balance over the year of £77.6m (by adding the opening and closing balances together and dividing by two), interest of £3.7m implies an interest rate of 4.78%. We know however that the loan notes had a fixed rate of 7.29% giving interest charges for the six months until they were repaid of £1.35m. This leaves £2.36m in interest attributable to both the Investec and the HSBC/BAML/GS loans. £16m of the Investec facility was outstanding for the whole year, an additional £9m from Investec for 9 months and the HSBC/BAML/GS loan for six months. This implies an average amount outstanding on these facilities of £71.75m giving an interest rate of around 3.3%. In a low interest environment this looks neither cheap nor especially expensive but does suggest that the Group has refinanced the notes at a considerably cheaper rate.

- **Cash**
  The Group as at the accounting year-end had £172.6m in cash in its bank accounts. This is a very large balance. Despite drawing down £100m of the HSBC/BAML/GS loan it is apparent that at the CBS date little of this needed to be applied against the NDP spend.

- **Equity**
  The Group's equity position has continued to grow as annual profits are added to Retained Earnings and now totals £206m. Banks use a number of measures to assess a corporate borrower's creditworthiness, one of which is the debt/equity ratio. This measures whether shareholders have enough skin in the game relative to lenders. Although tolerance can vary depending on the industry, a conservative ratio would be in the order of 1:1, but up to 1.5:1 would not be unusual. As at the CBS date the Group's D/E ratio is 0.6:1, which is very comfortable, however add in the additional £250m of debt required for the financing and this reaches 3:1 which seems somewhat less comfortable. Moreover banks will often subtract intangible assets (in this case the players) from the equity as the value of these can diminish rapidly in the event of insolvency (see the transfer values of the Leeds and Portsmouth players when those clubs were bankrupted). It's not within the scope of this review to consider equivalent ratios for the Group's peer group but, given the scale of accumulated losses elsewhere, these may be much worse, while The Group's Retained Earnings will also presumably continue to grow. Nevertheless, in traditional terms a 3.0x ratio could be considered aggressive.

  One further point of note in the equity is the reduction in Preference Shares from £30m to £20m. These were issued to Macon Inc., a company understood to be owned by Joe Lewis. £10m of these shares were bought back by the Group in November. In short, these were a mechanism for Lewis to put money into the club, presumably to fund the early stages of the NDP and he has 'repaid' himself £10m of that amount. The timing is not coincidental. The bank loan was signed a month later and this will likely have restrictions on distributions to shareholders. In any event this transfer was almost certainly undertaken with the approval of both Investec and HSBC/BAML/GS but supporters could be forgiven for asking if financing is so tight whether withdrawing £10m in cash from the Group was appropriate at this stage.

Consolidated Statement of Cash Flows ("CSCF")

The CSCF shows the actual cash generated or spent by the Group as opposed to the profits booked in the CIS. The difference can arise through items such as an expense in the CIS which does not actually result in cash leaving the Group (e.g. depreciation) or through timing differences between income or an expense being booked and the associated cash being received or leaving the Group's bank account. The difference can be crucial. A large profit on the CIS may be a paper profit only and fails to make it through onto the CCSF while CIS expenses often result in an immediate cash outflow. If there is more cash leaving a company than there is coming in then a company may not be able to pay its creditors (suppliers, banks etc) as its obligations fall due resulting in insolvency. For banks looking to lend to a company the cash flow statement provides a strong indication of whether it will be able to keep up with future debt service requirements.

Firstly, a note of warning. The Group's CSCF, unlike its CIS and CBS has minimal explanatory notes, which means untangling the numbers becomes even more complicated. On the plus side, the Group's CSCF shows that it is at present strongly cash-generative.

The CSCF can be split into three sections showing the cash flows from operations ("CFO"), cash flows from investments ("CFI") and cash flows from financing activity ("CFF"). The CFO shows the cash generated from the ordinary operating activities of the Group. In the Group's CSCF this is derived by taking the operating profit in the CIS (essentially the difference between revenues and expenses plus the results of player trading as booked in the CIS) and then adding back non-cash items (e.g. depreciation and amortisation referred to above) and changes in working capital. The latter can often trip a company up – an increase in inventory or stock levels or paying your suppliers quicker than your customers are paying you can result in a drain on cash leaving insufficient to service debt or pay the taxman. The Group's working capital position shows a substantial change in payables, resulting in an £85.3m positive cash flow. The presentation of this item is confusing and is difficult to reconcile with the payables on the balance sheet (see TOP in the CBS above) but taken at face value this helped turn an operating profit of £42.6m into a net CFO or £124.0m (adding back net interest payments; I prefer to see these in CFF).

CFI shows the capital expenditure of the Group which is split between £74.3m on physical assets (primarily the NDP) and a £27.6m net cash benefit from the proceeds of player trading.

CFF shows the impact of debt service, new debt raised and any changes in equity. During the accounting period the Group also had a cash inflow from CFI due to the drawing of £100m from the new loan which more than matched the £10m outflow on redeeming preference shares (see Equity above) and £18.5m in repayment of the loan notes (see Debt above). Netting all the components of the CSCF off and adding to the previous cash balance of £10.7m gets us to the £172.6m cash balance seen in the CBS.

Potential lenders will be interested in seeing that CFO minus CFI exceeds the debt service (interest plus capital repayments in that period), otherwise known as the debt service cover ratio ("DSCR"). Of course the financial statements are historical so banks will look at each component to determine the risk of their changing substantially and calculate a forecast DSCR over the life of any new loan. In effect this means that the interests of lenders to the Group and supporters are broadly aligned – banks because they want to get their money back and supporters because they don't want the club to do a Portsmouth. Banks however will have extensively modelled the risks and, unlike supporters, they have access to the Group's projections. And supporters will be concerned that sale of key players are not part of the overall financing plan.

The key risks are likely to be:

	Item	Risk	Comment/Mitigants
CFO	Operating Profit	Revenues fall	Revenues will increase faster than costs due to increased capacity/increased TV money/naming rights/NFL.
CFI	Capex	Increased costs	Turnkey contract would mitigate but increased cost of stadium raises questions.
	Capex	Timing	Should be completed before debt service begins but do other project elements extend into debt service period?
	Player trading	Proceeds fall	• Successful squad development strategy to date will be supported by increased income; • Key player sales may negatively impact revenues through reduced ticket sales, non-CL participation, reduced TV money; • Club assurances; • Current market value of playing squad should comfortably exceed book value.
CFF	Cost of debt	Interest costs rise	£350m loan reported to be at a fixed rate. Base rates not expected to rise substantially in medium term and accounts suggest limited sensitivity to changes in rates.
	Repayment	Amortising loan	CFO will have to rise sufficiently to compensate (e.g. £350m repayable over 4 years will require £87.5m p.a.)
	Repayment	Bullet	Sufficient cash flows will have to have been accumulated by year 5 or the loan refinanced. Problems with the bank market (e.g. as seen in 2008) may limit availability of new debt.

Exchange Rates

Note 17 describes the Group's sensitivity to exchange rates with the principal exposure being to movements in the GBP/EUR exchange rate. The note suggests that a 10% fall in sterling would result in a £2m hit to profits. The recent increase in NDP costs was partly attributed to Brexit and the resultant fall in sterling but Note 17 would appear to contradict this. The sensitivity analysis however incorporated only current outstanding exposures and an explanation for the discrepancy could be that the commitments that resulted in the cost increase were not yet signed or otherwise active as at the date of the accounts. If this is the case, the construction contract would appear to have a more complicated structure than a standard turnkey contract.

Conclusion

As is generally acknowledged, THL is conservatively managed compared with its peers and generates strong cash flows. While this conservatism can be partly attributed to the character of management, it is also the case that it is being forced on THL by the circumstances of the NDP. The additional debt and its repayment structure will put strains on the balance sheet and supporters will need to be reassured that the additional revenue expected to be generated by the new stadium will be able to meet increased debt service demands without compromising first team competitiveness. There will be reasonable concerns over commercial sensitivity but greater clarity over the project structure should be able to accommodate these concerns while providing that reassurance.

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