Financial Review, 2006-07

By Joe Beardwood

What's the real issue at Everton?

People buy shares for either to make money (value of the shares increase or dividends) or to take a more active interest in the running of the company. Good corporate governance encourages ALL shareholders to hold the board to account and most effective boards contain non-executive directors to check and balance how the executive team run the business. Unless when a company is 100% owned by the acting directors (your classic owner managed business), the directors have a duty to report to the shareholders.

When the company is a football club and its shareholders are also its fans and key customers…the duty to report should become an absolute.

I didn't become a shareholder at Everton to make money. I doubt any of the small private shareholders did for any other reason than to participate in the 'people's club'.

Football today is business. Well run businesses generate cash and cash buys players.

Players wages, huge transfer fees, new stadia and state of the art academies are a necessity for success at the top level. Therefore business performance comes FIRST as it generates the funds to buy things.

Everton's business performance since 2000 (8 years)

	1998/99 £'000	*1999/2000 £'000*	*2000/01 £'000*	*2001/02 £'000*	*2002/03 £'000*	*2003/04 £'000*	*2004/05 £'000*	*2005/06 £'000*
Total Income	25,643	28,397	33,067	38,440	46,942	44,672	59,953	58,123
Total Expenditure	(26,781)	(28,908)	(36,252)	(39,839)	(41,367)	(47,330)	(49,567)	(55,072)
Trading Profit / (Loss)	(1,138)	(511)	(3,185)	(1,399)	5,575	(2,658)	10,386	3,051
Interest & Similar Charges	(1,034)	(1,271)	(1,604)	(2,112)	(2,624)	(2,967)	(2,674)	(2,186)
Profit on Sale of assets	2,070	(991)	10,741	13,979	(1,151)	1,592	26,177	(238)
Amortisation Player Reg.	(10,666)	(8,396)	(9,605)	(8,913)	(14,780)	(11,343)	(10,380)	(11,421)
Net Profit / (Loss)	(10,768)	(11,169)	(3,653)	1,555	(12,980)	(15,376)	23,509	(10,794)

The club has lost £39.6m over the last 8 seasons despite the sales of Rooney(£25m) (2005), Jeffers (£8m) and Ball (£6m) (2002) generating the near £40m profit shown on the sale of assets line which has proved crucial.

As a business however, expenditure has climbed year after year; from £26m (1999/00) up to £55m (20005/06).

Everton has no benefactor to pump cash in without a return. The chances of any benefactor being attracted to this business (basic numbers) are low.

This history lesson is important, because when management pursue a strategy of operating the business at a loss each year to gamble against success on the pitch, then the only way of funding this is by increasing the level of debt.

The Debt

The debt has climbed from £20m with the Coop Bank in 2000 to a combined £45m with Barclays and Bear Sterns.

For this year’s accounts however, the effect of raising funds in 2006 will have a negative effect:

- Finch Farm (the new academy) was sold last year “on the basis of a sale and leaseback in order to raise the necessary finance in order to enable completion of the works”.
- The sale of the Megastore and Netherton sites for £2.2m in 2005 on sale and leaseback schemes (source: Report & Accounts, 2006)

The net effect is that the club don’t own the Megastore, Netherton or the new academy – increasing operating costs with the burden of higher rents. These transactions followed the sale of the Eileen Craven Car Park for £2.8m the year before.

The Need for Business Expertise

Bill Kenwright is (in his own words) an emotional Evertonian. Therefore the appointment of a shrewd businessman to look after the books was essential. The appointment of an able, experienced business professional to bring financial stability, manage the organisation and drive revenue streams. Therefore, the appointment of a Chief Executive in November 2004 with a seat on the board was a move to applaud.

Three years on, the Chief Executive has had the time to make his changes and start to deliver in the only way it matters – financial performance.

The 2006/07 accounts are perhaps the most important set in the last 9 years. For many reasons, the club has to show real progress this year;

- The bank has already increased overdraft facilities to fund players last season and will want to see that sound financial systems are in place
- Funding for a new stadium (even simple architect plans) will be required from the club even if Tesco pay for the build – this money has to be raised
- Money needs to be generated to pay for player wages and squad additions

The financial year ending May 31st 2007 ended over 7 weeks ago so by now the numbers will be drafted for board approval. Second guessing the performance is a worthwhile exercise as it gives pointers as to what might be happening at the club at the moment.

SCENARIO 1: BREAK EVEN ACHIEVED

This is the expected result based on the comments and promises made by Management. Management have made it clear that the sponsorship and corporate performance of the previous regime fell well short and that they were going to be able to introduce proper merchandising, marketing and promotion systems. In 3 years, expect a big impact on ‘other income’ and increases in TV (due to 6th) and match income.

As staff costs increased by a huge £7m last season, then we would expect at a minimum this line to be held flat. Other expenditure, which peaked at £18.7m in 05, needs to also have been drastically reduced.

Break even will demonstrate to Tesco, Knowsley, investors and the bank that the club is now well run and under control. This is not a complex business.

	2004/05 £'000	***2005/06 £'000***	***Prediction?***	***2006/07 £'000***

TV Income	29,504	26,349	6th place prize fund	26,750
Match Income	18,711	18,128	Up 10%	19,941
Other Income	11,738	13,646	Increased sponsorship & advertising (+30%)	17,740
Total Income	**59,953**	**58,123**		**64,431**
Staff Costs	**(30,840)**	**(36,966)**	Held flat	**(36,966)**
Expenditure	**(18,727)**	**(18,106)**	Reduced 20% - outsourcing & technology?	**(14,485)**
Total Expenditure	**(49,567)**	**(55,072)**	***Crucial this line is reduced***	**(51,451)**
Trading Profit / (Loss)	**10,386**	**3,051**	Profits 25% up on 2005 - year KW took charge	**12,980**
Interest & Similar Charges	**(2,674)**	**(2,186)**	***Downward trend continues***	**(2,000)**
Profit on Sale of assets	**26,177**	**(238)**	Youth policy yields profit	**441**
Amortisation Player Reg.	**(10,380)**	**(11,421)**	Transfer policy in place	**(11,421)**
Net Profit / (Loss)	**23,509**	**(10,794)**		**(0)**

SCENARIO 2: THINGS REMAIN THE SAME

This scenario assumes that match income is up slightly, other income is up 20%, staff costs have increased by 5% and expenditure has only reduced by 10%. The effect of this would be to increase trading profit (although not to the level of 2005); but due to the player purchases outweighing sales for the last two years, then the P&L will still show a loss of around £7m.

In these circumstances one could imagine a summer of little transfer activity (as there is no money), lengthy conversations with the bank and a need to spin hard to ensure that the fans discuss anything other than underlying business performance. Examples of this might include a ballot on a new stadium and chasing star names at reported fees in excess of £5m. It was interesting that the 2006 AGM was dominated by discussions about a new stadium and that shareholders raised no issues or dissatisfaction with the way the business is performing.

	2004/05 £'000	***2005/06 £'000***	***Prediction?***	***2006/07 £'000***
TV Income	29,504	26,349	Thank heaven for 6th!	26,750
Match Income	18,711	18,128	Better corporate sales	18,500
Other Income	11,738	13,646	Increased sponsorship & advertising (+20%)	16,375
Total Income	**59,953**	**58,123**		**61,625**
Staff Costs	**(30,840)**	**(36,966)**	Held to 5% increase?	**(38,814)**
Expenditure	**(18,727)**	**(18,106)**	Reduced by 10%?	**(16,295)**
Total Expenditure	**(49,567)**	**(55,072)**	Crucial this line is reduced	**(55,110)**
Trading Profit / (Loss)	**10,386**	**3,051**	Measures how well the business is run; expect improvement this year (min £3m up)	**6,515**
Interest & Similar Charges	**(2,674)**	**(2,186)**		**(2,000)**
Profit on Sale of assets	**26,177**	**(238)**		**(238)**

Amortisation player Reg.	(10,380)	(11,421)		(11,421)
Net Profit / (Loss)	**23,509**	**(10,794)**		**(7,144)**

This type of result would worry any bank considering advancing a loan or extending overdraft facilities.

SCENARIO 3: The business continues to underperform

In this scenario, match income is down slightly (attendances were around 60,000 down overall year on year) as season ticket prices are held and corporate seats decline and 'other income' shows no increase. The result is that turnover is slightly ahead of the prior year thanks to the 6th place finish.

Let's then imagine that with the onset of a new TV deal management begin renegotiating contracts resulting in a 10% increase in staff costs. At the same time, the projected savings from outsourcing and IT don't come in as fast as predicted and therefore expenditure declines by only 5%.

This results in an unthinkable situation of only breaking even at a trading level – in other words without paying back all the interest on the loans and writing off player amortisation.

Overall, the result is a £13.2m loss. This would be a real problem at a time when the club needs to spin off cash. Cash will fund the planning of a new stadium; cash buys players and cash funds wages.

In this scenario, Management should create as many distractions as possible to make sure nobody focuses on the real underlying root cause of all the frustration – business performance.

	2004/05 £'000	*2005/06 £'000*	*Prediction?*	*2006/07 £'000*
TV Income	29,504	26,349	Thank heaven for 6th!	26,750
Match Income	18,711	18,128	attendances down	18,000
Other Income	11,738	13,646	Worst case would be no growth!	13,646
Total Income	59,953	58,123		58,396
Staff Costs	(30,840)	(36,966)	New player contracts in lieu of a new TV deal - management team salaries (+10%)	(40,663)
Expenditure	(18,727)	(18,106)	Rents included for Megastore, Academy etc	(18,337)
Total Expenditure	(49,567)	(55,072)	Nightmare scenario - expenditure up	(59,000)
Trading Profit / (Loss)	10,386	3,051	Small Trading Loss	(604)
Interest & Similar Charges	(2,674)	(2,186)	High charges on bank overdraft - low income received as balance low all year	(2,396)
Profit on Sale of assets	26,177	(238)	Nothing left to sell	0
Amortisation player Reg.	(10,380)	(11,421)	Johnson, Lescott drive up	(12,000)
Net Profit / (Loss)	**23,509**	**(10,794)**		**(15,000)**

Play the Game – You are BK!

So what do you think? Break even, £7m loss or £15m loss? Or profit?

Every supporter can do their own forecasting on this year's financial result based on the trends of the last 2 years; we all have a view about who's been signed and sold, what we see at the club when we go each Saturday and our experience as a customer when buying tickets, visiting the shop or flying to UEFA Cup ties.

The statements coming from the club with regard to the manager's transfer kitty and a new stadium suggest we have money in the bank and confidence in extending our bank loan. Therefore scenario 1 must be the most likely result?

I refuse to believe that the proposed move to Kirkby and the debate generated is another Fortress Fund (a distraction from the real issue).

If scenario 2 or 3 happens then I'd be very worried; as a fan and as a shareholder.

Anything worse than scenario 3 would be unimaginable.

The report and accounts are due out in October – they will be, as ever, a very interesting read.

Joe Beardwood