



**AA plc (LSE:AA.)**

**BUY**

**One-Year Target Price: £5.40**

## **Executive Summary**

AA plc (LSE:AA.) is the leading player in the UK roadside assistance market, featuring EBITDA margins exceeding 40% and a highly cash generative business model with cash conversion over 90%. As a result of an unusually high but manageable amount of leverage, the market has significantly undervalued AA in light of its strong financial profile, dominant market position, and strategy of quickly deleveraging which will result in compounding EPS growth in the near term. As management continues repaying debt, the stock will receive a re-rating to 20.0x LTM P / E, in-line with other high-margin market leaders. Based on a FY2016 (January) estimated EPS of £0.27, AA shares will be worth £5.40 in one year, approximately 40% upside to the closing price on 24 February.

## **History**

Founded in 1905 by a group of motoring enthusiasts, AA has experienced varying ownership more recently. In 1999, members voted to demutualize and join Centrica plc. AA was subsequently acquired from Centrica in July 2004 by Permira and CVC Capital Partners for £1.75 billion. In June 2007, AA merged with Saga plc, a portfolio company of Charterhouse Capital Partners, with the three private equity firms owning the combined asset, called Acromas Holdings. AA was valued at £3.35 billion in the transaction.

In 2013, AA was spun off from Saga and its owners raised £3.2 billion in long-term debt to finance a special dividend of £2.6 billion. In June 2014, senior management partnered with several cornerstone institutional investors (Aviva, Lansdowne, Invesco, Capital Group, Black Rock) to acquire AA from Acromas and complete an accelerated IPO, which was oversubscribed. AA maintained high leverage (8.2x EBITDA) following the IPO, as opposed to using the proceeds to bring leverage down to more typical levels for a public company.

## **Industry Overview**

The £1.5 billion UK roadside assistance market covers approximately 31 million policies. This mature and concentrated industry is effectively a duopoly with AA the clear leader with 47% total share and RAC holding 28% share. The roadside assistance market is highly stable and resilient through economic cycles, as consumers tend to keep roadside assistance plans during downturns and instead reduce more discretionary expenses. AA also operates within the £11 billion UK motor insurance broking market, another highly stable industry.

## **Company Overview**

AA is a highly-trusted company that has provided motoring services, centered on breakdown cover, for over one hundred years. According to "Which?", AA has received the highest overall score of the major roadside assistance providers for the past seven years and was acknowledged as the UK's most trusted brand by Y&R in 2014. The business features significant economies of scale as a result of its large patrol force of 3,000 branded vehicles providing roadside cover services, and also enables AA to provide a high quality of service and achieve strong renewal rates. In addition to serving consumers, AA also provides services through B2B contracts with OEMs and car rental companies that typically last 3-5 years. In August 2014, AA signed a 4 year agreement to provide roadside cover for Volkswagen UK, through which one million new vehicles per year (20% of new UK car sales) will be

serviced. As a result, revenues for AA's roadside assistance business, which comprised 72% of the company's revenue in FY2014, are highly visible and predictable.

AA also benefits from strong network effects, and as a result is one of the largest insurance brokers in the UK. Given its relationship with drivers, AA has a low cost per acquisition to broker policies to its roadside customers, affording it high margins of approximately 60% for this business segment. Given improving underlying trends (i.e., total cars in operation) supporting growth in the automotive services sector, and significant cross-selling opportunities to a database of 18 million consumers, this segment will help AA continue its growth going forward, as well as increase its margins. AA's insurance services segment constituted 15% of total revenues during FY2014.

AA also operates a complementary driving services business segment (9% of FY2014 revenues) which trains 17% of newly licensed British drivers every year, and has an Ireland segment (4% of FY2014 revenue) that largely mirrors the UK business and possesses similar competitive positioning.

The company recorded £394 million in EBITDA on £982 million in revenue, and fully-diluted EPS of 21p during the twelve months ending 31 October 2014. For a business operating in a mature, stable industry, AA's strong management team has the strategy in place to achieve 5%+ p.a. top-line growth due to its insurance broking segment and the utilization of data and IT systems to better cross-sell motoring services to its customers and drive revenue growth. Furthermore, AA has minimal capital expenditure requirements (<£10 million p.a.) and positive working capital dynamics, resulting in a highly cash generative business model providing the company with the ability to quickly deleverage and significantly increase EPS.

## Valuation

AA shares have steadily increased in value since the IPO, and currently trade at 17.7x trailing earnings and 13.6x forward earnings. The company's total leverage of 7.8x continues to be a drag on earnings and suppresses valuation. While AA has no direct publicly traded comps, similar market-leading, high-margin companies typically trade in excess of 20.0x LTM earnings. As AA's leverage declines to become more in-line with public market expectations, the market should re-rate the stock to >20.0x. A valuation summary follows.

Valuation Summary		Key Valuation & Credit Metrics	
Share price (24 Feb 2015)	£3.80	LTM EV / EBITDA	12.5x
Fully-diluted shares outstanding	554.0	LTMP / E	17.7x
<b>Market capitalization</b>	<b>£2,104</b>		
Add: total debt	3,083	FY1 EV / EBITDA	11.4x
Less: cash	(273)	FY1 P / E	13.6x
<b>Enterprise Value</b>	<b>£4,913</b>		
		Total Debt / EBITDA	7.8x
Premium / (Discount) to 52-week High	0.0%	Net Debt / EBITDA	7.1x
Premium / (Discount) to 52-week Low	65.3%	EBITDA / Interest	1.6x

## Current Situation & Opportunity

AA's current situation affords investors an opportunity to take advantage of value creation and trading multiple expansion as the business quickly deleverages. AA has already repaid £175 million (50% of face value) of its 9.5% PIK notes and will likely repay the balance during 1H 2015, saving an aggregate of £33 million in pre-tax interest expense. The table below demonstrates that by achieving modest top-line and EBITDA growth expected in consensus estimates, EPS grows quickly as a result of deleveraging the business.

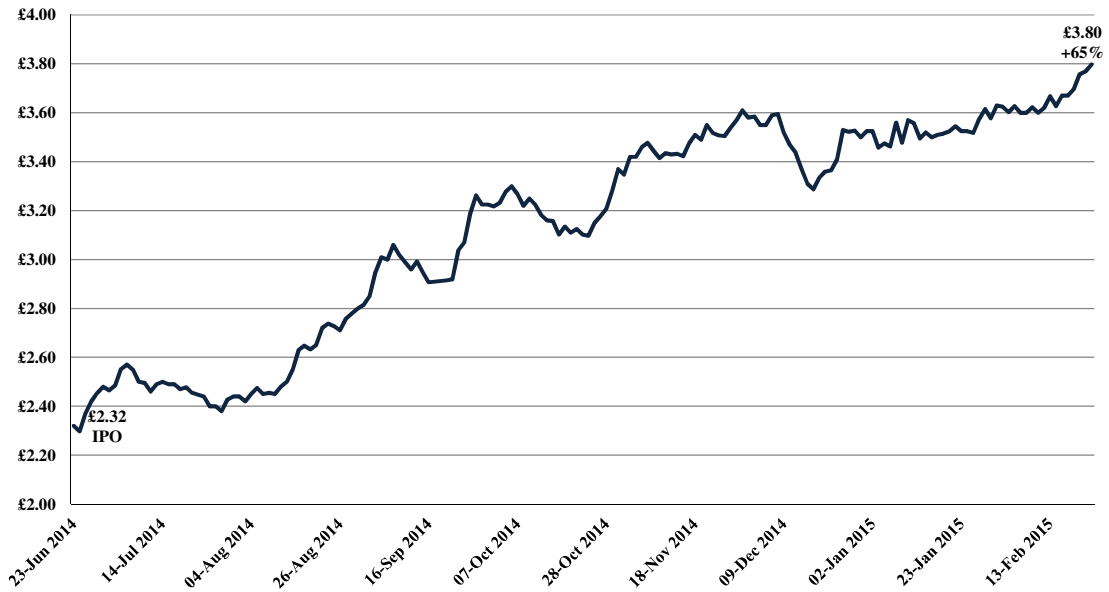
### Financial Projection Summary

*£ millions, except per share data*

<b>Fiscal Year Ending January</b>	<b>LTM Oct 14</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>CAGR</b>
<b>Revenue</b>	<b>£982</b>	<b>£994</b>	<b>£1,018</b>	<b>£1,055</b>	<b>£1,154</b>	<b>5.1%</b>
% Growth		2.1%	2.4%	3.6%	9.4%	
<b>EBITDA</b>	<b>£394</b>	<b>£431</b>	<b>£436</b>	<b>£460</b>	<b>£528</b>	<b>7.0%</b>
% Growth		1.8%	1.3%	5.4%	14.8%	
% Margin	40.2%	43.3%	42.8%	43.6%	45.8%	
<b>EPS</b>	<b>£0.21</b>	<b>£0.28</b>	<b>£0.27</b>	<b>£0.34</b>	<b>£0.45</b>	<b>17.1%</b>
Total Debt	3,083	2,908	2,483	2,233	1,968	
Total Debt / EBITDA	7.8x	6.8x	5.7x	4.9x	3.7x	

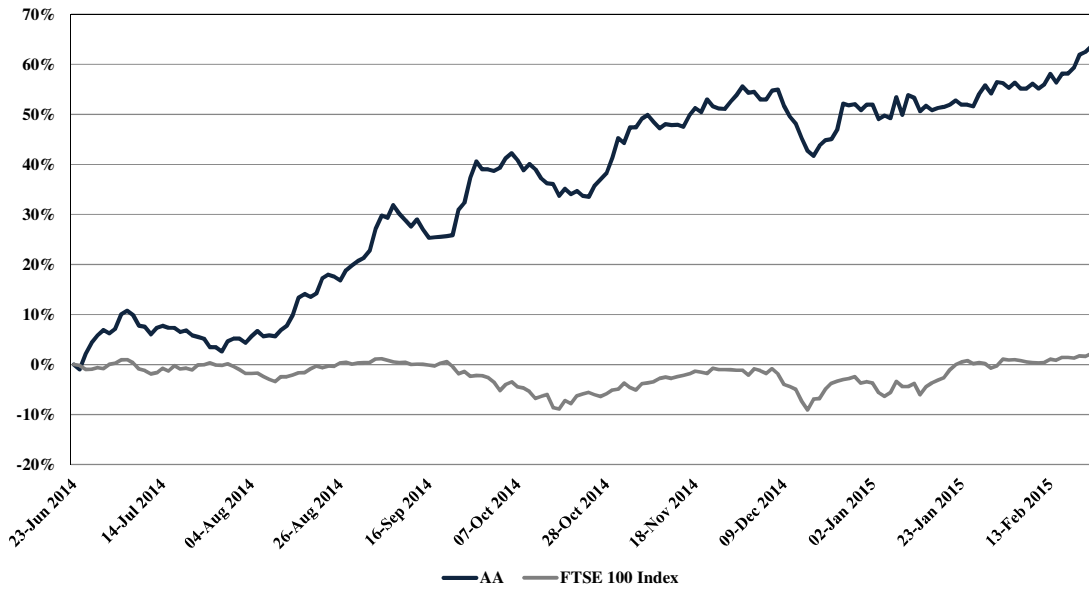
AA's strong market position provides it with a sustainable competitive advantage resulting in uncommon cash flow generation. It is currently priced at a discount due to temporarily high leverage, and as the company deploys cash to quickly deleverage, it will feature compounded earnings growth and should obtain P / E multiple expansion. With a very strong, stable business model and a catalyst in place to increase valuation, AA is a very attractive opportunity for a long-term value investment and ideal for the London Business School Student Investment Fund.

**Appendix 1 – Stock Price Chart (Since June 2014 Initial Public Offering)**



Source: Capital IQ

**Appendix 2 – AA Stock Performance vs. FTSE 100**



Source: Capital IQ

## Appendix 3 – Historical Financial Statements

### Income Statements

For the Fiscal Period Ending	LTM			
	12 months Jan-31-2012	12 months Jan-31-2013	12 months Jan-31-2014	12 months Oct-31-2014
<i>Currency (millions, except per share data)</i>	<i>GBP</i>	<i>GBP</i>	<i>GBP</i>	<i>GBP</i>
Revenue	973.9	968.0	973.9	981.8
Other Revenue	-	-	-	-
<b>Total Revenue</b>	<b>973.9</b>	<b>968.0</b>	<b>973.9</b>	<b>981.8</b>
Cost Of Goods Sold	377.8	349.4	343.6	344.7
<b>Gross Profit</b>	<b>596.1</b>	<b>618.6</b>	<b>630.3</b>	<b>637.1</b>
Selling General & Admin Exp.	280.6	276.5	251.6	270.8
R & D Exp.	-	-	-	-
Depreciation & Amort.	-	-	-	-
Other Operating Expense/(Income)	-	-	-	0.1
<b>Other Operating Exp., Total</b>	<b>280.6</b>	<b>276.5</b>	<b>251.6</b>	<b>270.9</b>
<b>Operating Income</b>	<b>315.5</b>	<b>342.1</b>	<b>378.7</b>	<b>366.2</b>
Interest Expense	(36.8)	(42.3)	(172.4)	(239.2)
Interest and Invest. Income	2.4	1.4	0.6	0.9
<b>Net Interest Exp.</b>	<b>(34.4)</b>	<b>(40.9)</b>	<b>(171.8)</b>	<b>(238.3)</b>
Income/(Loss) from Affiliates	0.4	0.7	0.4	1.3
Currency Exchange Gains (Loss)	0.2	0.3	(0.1)	(0.1)
Other Non-Operating Inc. (Exp.)	(0.8)	(0.3)	(0.2)	0
<b>EBT Excl. Unusual Items</b>	<b>280.9</b>	<b>301.9</b>	<b>207.0</b>	<b>129.1</b>
Restructuring Charges	(2.8)	(13.6)	(2.9)	(2.9)
Impairment of Goodwill	-	-	-	-
Gain (Loss) On Sale Of Invest.	0.6	3.1	0.4	(0.1)
Gain (Loss) On Sale Of Assets	-	-	-	3.4
Other Unusual Items	(13.9)	(16.4)	(11.7)	(20.8)
<b>EBT Incl. Unusual Items</b>	<b>264.8</b>	<b>275.0</b>	<b>192.8</b>	<b>108.7</b>
Income Tax Expense	66.8	67.6	39.4	(10.2)
<b>Earnings from Cont. Ops.</b>	<b>198.0</b>	<b>207.4</b>	<b>153.4</b>	<b>118.9</b>
Earnings of Discontinued Ops.	-	-	-	-
Extraord. Item & Account. Change	-	-	-	-
<b>Net Income to Company</b>	<b>198.0</b>	<b>207.4</b>	<b>153.4</b>	<b>118.9</b>
Minority Int. in Earnings	-	-	-	-
<b>Net Income</b>	<b>198.0</b>	<b>207.4</b>	<b>153.4</b>	<b>118.9</b>
Pref. Dividends and Other Adj.	-	-	-	-
<b>NI to Common Incl Extra Items</b>	<b>198.0</b>	<b>207.4</b>	<b>153.4</b>	<b>118.9</b>
<b>Per Share Items</b>				
Basic EPS	0.42	0.44	0.33	0.21
Weighted Avg. Basic Shares Out.	469.2	469.2	469.2	554.0
Diluted EPS	0.42	0.44	0.33	NA
Diluted EPS Excl. Extra Items	0.42	0.44	0.33	NA
Weighted Avg. Diluted Shares Out.	469.2	469.2	469.2	NA
Normalized Basic EPS	0.37	0.4	0.28	NA
Normalized Diluted EPS	0.37	0.4	0.28	NA

Source: Capital IQ

## Balance Sheets

Balance Sheet as of:

<i>Currency (millions)</i>	Jan-31-2012 <i>GBP</i>	Jan-31-2013 <i>GBP</i>	Jan-31-2014 <i>GBP</i>	Oct-31-2014 <i>GBP</i>
<b>ASSETS</b>				
Cash And Equivalents	29.1	31.9	203.2	273.0
<b>Total Cash &amp; ST Investments</b>	<b>29.1</b>	<b>31.9</b>	<b>203.2</b>	<b>273.0</b>
Accounts Receivable	271.5	269.8	134.9	155.5
Other Receivables	990.0	1,266.8	6.1	1,210.8
<b>Total Receivables</b>	<b>1,261.5</b>	<b>1,536.6</b>	<b>141.0</b>	<b>1,366.3</b>
Inventory	5.3	5.3	4.9	5.3
Prepaid Exp.	26.9	28.0	21.9	27.0
Other Current Assets	6.3	2.1	-	-
<b>Total Current Assets</b>	<b>1,329.1</b>	<b>1,603.9</b>	<b>371.0</b>	<b>1,671.6</b>
Gross Property, Plant & Equipment	198.2	198.7	204.6	240.1
Accumulated Depreciation	(100.0)	(112.2)	(127.3)	(132.3)
<b>Net Property, Plant &amp; Equipment</b>	<b>98.2</b>	<b>86.5</b>	<b>77.3</b>	<b>107.8</b>
Long-term Investments	2.9	3.4	4.9	6.5
Goodwill	1,196.9	1,197.8	1,198.5	1,197.8
Other Intangibles	34.0	39.5	47.2	52.8
Deferred Tax Assets, LT	47.0	48.0	36.4	60.4
Other Long-Term Assets	24.7	9.6	5.0	-
<b>Total Assets</b>	<b>2,732.8</b>	<b>2,988.7</b>	<b>1,740.3</b>	<b>3,096.9</b>
<b>LIABILITIES</b>				
Accounts Payable	182.0	235.7	115.1	119.6
Accrued Exp.	297.9	295.5	294.7	363.4
Short-term Borrowings	1,760.9	1,760.9	-	-
Curr. Port. of Cap. Leases	16.4	17.8	12.1	34.9
Curr. Income Taxes Payable	20.9	7.0	-	-
Other Current Liabilities	48.6	52.3	51.9	44.8
<b>Total Current Liabilities</b>	<b>2,326.7</b>	<b>2,369.2</b>	<b>473.8</b>	<b>562.7</b>
Long-Term Debt	227.8	265.5	3,351.4	3,034.0
Capital Leases	17.1	13.6	7.9	13.7
Pension & Other Post-Retire. Benefits	138.2	165.7	265.5	318.9
Other Non-Current Liabilities	68.0	29.9	19.9	17.6
<b>Total Liabilities</b>	<b>2,777.8</b>	<b>2,843.9</b>	<b>4,118.5</b>	<b>3,946.9</b>
Common Stock	0.2	0.2	0.2	20.0
Additional Paid In Capital	0.8	0.8	0.8	-
Retained Earnings	(45.9)	144.8	(2,371.9)	(856.3)
Treasury Stock	-	-	-	-
Comprehensive Inc. and Other	(0.1)	(1.0)	(7.3)	(13.7)
<b>Total Common Equity</b>	<b>(45.0)</b>	<b>144.8</b>	<b>(2,378.2)</b>	<b>(850.0)</b>
<b>Total Equity</b>	<b>(45.0)</b>	<b>144.8</b>	<b>(2,378.2)</b>	<b>(850.0)</b>
<b>Total Liabilities And Equity</b>	<b>2,732.8</b>	<b>2,988.7</b>	<b>1,740.3</b>	<b>3,096.9</b>

Source: Capital IQ

## Cash Flow Statements

For the Fiscal Period Ending	12 months		LTM	
	Jan-31-2012	Jan-31-2013	Jan-31-2014	Oct-31-2014
Currency (millions)	GBP	GBP	GBP	GBP
<b>Net Income</b>	<b>198.0</b>	<b>207.4</b>	<b>153.4</b>	<b>118.9</b>
Depreciation & Amort.	29.4	28.1	27.5	28.2
<b>Depreciation &amp; Amort., Total</b>	<b>29.4</b>	<b>28.1</b>	<b>27.5</b>	<b>28.2</b>
Other Amortization	7.3	9.8	41.4	56.3
(Gain) Loss From Sale Of Assets	-	-	-	(3.4)
(Gain) Loss On Sale Of Invest.	(0.6)	(3.1)	(0.4)	0.1
(Income) Loss on Equity Invest.	(0.4)	(0.7)	(0.4)	(1.3)
Other Operating Activities	47.9	58.8	180.8	204.0
Change in Acc. Receivable	(4.0)	2.4	36.9	(8.9)
Change In Inventories	0.5	-	0.4	(0.3)
Change in Acc. Payable	18.5	26.1	(11.4)	1.0
Change in Other Net Operating Assets	(26.1)	(32.2)	(40.8)	(35.1)
<b>Cash from Ops.</b>	<b>270.5</b>	<b>296.6</b>	<b>387.4</b>	<b>359.5</b>
Capital Expenditure	(13.5)	(6.6)	(9.7)	(9.2)
Cash Acquisitions	(3.3)	(8.1)	(0.6)	(0.6)
Divestitures	-	-	-	1.6
Sale (Purchase) of Intangible assets	(13.1)	(15.3)	(19.9)	(28.8)
Invest. in Marketable & Equity Secur.	0.3	3.1	0.4	0
Net (Inc.) Dec. in Loans Originated/Sold	-	-	-	-
Other Investing Activities	1.3	16.0	5.3	2.9
<b>Cash from Investing</b>	<b>(28.3)</b>	<b>(10.9)</b>	<b>(24.5)</b>	<b>(34.1)</b>
Short Term Debt Issued	-	-	-	-
Long-Term Debt Issued	-	-	4,266.4	-
<b>Total Debt Issued</b>	<b>-</b>	<b>-</b>	<b>4,266.4</b>	<b>1,763.1</b>
Short Term Debt Repaid	-	-	-	-
Long-Term Debt Repaid	(22.6)	(16.7)	(1,602.2)	-
<b>Total Debt Repaid</b>	<b>(22.6)</b>	<b>(16.7)</b>	<b>(1,602.2)</b>	<b>807.6</b>
Issuance of Common Stock	-	-	-	40.1
Repurchase of Common Stock	(248.9)	(270.9)	(82.2)	-
Common Dividends Paid	-	-	(2,571.9)	(2,571.9)
<b>Total Dividends Paid</b>	<b>-</b>	<b>-</b>	<b>(2,571.9)</b>	<b>(2,571.9)</b>
Special Dividend Paid	-	-	-	-
Other Financing Activities	-	-	(203.2)	(198.9)
<b>Cash from Financing</b>	<b>(271.5)</b>	<b>(287.6)</b>	<b>(193.1)</b>	<b>(160.0)</b>
Foreign Exchange Rate Adj.	(0.4)	0.5	(0.6)	(1.9)
<b>Net Change in Cash</b>	<b>(29.7)</b>	<b>(1.4)</b>	<b>169.2</b>	<b>163.5</b>

Source: Capital IQ