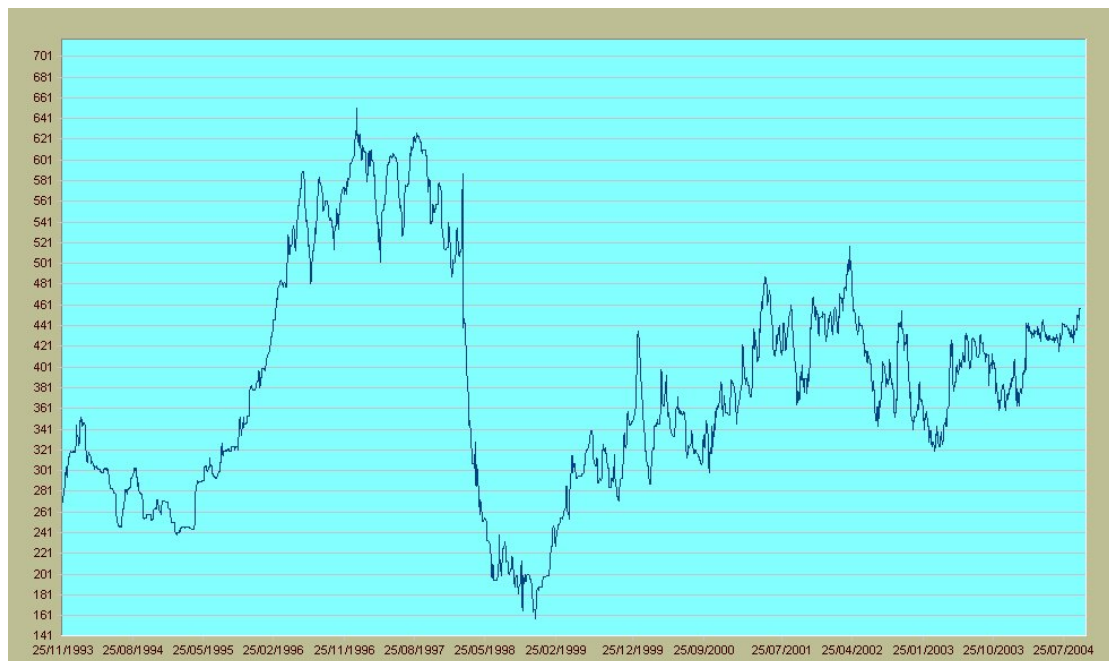


## Kirkham Has the Last Laugh, but It's an Omen for Things to Come

When Graham Kirkham brought DFS Furniture to the market in 1993, he celebrated by buying Gainsborough's "Peasants Going to Market". As in many successful retailing companies, Lord Kirkham was not just the founder, but the dominant personality in the company and Executive Chairman since then, although his family holdings had fallen to 10% by 2004. Ever the joker, the recent offer by Kirkham to buy out the business and take it private again was named "Full Circle", although the price offered did not amuse many long term holders of the stock such as the writer of this article.

I first purchased DFS in 1995 and it was one of my largest holdings, particularly after having bought more in 1998 when the price fell below 200p and in 2002 when it fell below 350p. It may not have been a smooth ride (see share price graph below) but the fundamentals of the business were enormously sound. As a result it has always paid a good dividend, and indeed has paid several "special dividends" in addition (one nice thing about furniture retailers is that they typically collect cash from customers before they have to pay suppliers so they are great cash generating machines).



DFS Furniture Share Price 1993-2004

DFS was also the classic "roll-out" story. They could add more stores, and gain economies of scale simply by finding more retail sites and using the same formula. In addition, DFS is partly vertically integrated, enabling them to maintain price levels and offer "interest free" deals to customers that none of their competitors could match.

But gloom has temporarily descended on the retailing market. Future prospects look gloomy for big ticket sellers, and the furniture sector seemed likely to suffer from increased competition from new entrants such as Marks & Spencer - at least this was the story promoted by Kirkham to justify his recent offer.

But most of the new competitors are making a hash of it. Even M&S admitted recently that its furniture offering was “too contemporary” and selling such large items from town centre stores is always going to be costly.

Was Kirkham’s final offer of 455p per share a fair one? The writer thinks not, because the property portfolio was undervalued, there was significant cash on the balance sheet, so even the offer of more to come from any “Primback” VAT claims doesn’t make it seem generous on an exit P/E of 14. But it was a significant premium to the price level before the bid. Although the bid offer was raised slightly, Kirkham suggested he couldn’t afford more and might even “have to sell a few pictures, or even his body” (for medical research he was thinking apparently). He also claimed he might “retire” although he is one of the best preserved 59 year olds you are likely to meet, or set up in competition if his offer was turned down.

In fact it seemed very likely that the offer would fail (it required a 75% majority as it was being done as a “scheme of arrangement”). But this was one of the first UK bids where hedge funds operating a “merger arbitrage” strategy seemed to have a major influence on the outcome. Many institutional holders that originally said they would vote against the bid, sold out when it looked like the bid would fail. Unlike in past circumstances, they could easily unload their large holdings to the arbitrageurs at a good premium, and avoid the risk of the share price falling back if the bid failed. One can’t really complain about their actions as it was probably right for their investors, and the writer did the same with most of his holding.

The final outcome was therefore close, but not as close as expected, and it went through with about 80% in favour on the 27<sup>th</sup> September 2004. It may be just as well, because if it had failed, the arbitrageurs would have been holding large amounts of the stock (and up to 50% has been suggested) when they had no long term interest in it. What a stock “overhang” that would have been.

The “Court” Meeting and Extraordinary General Meeting held in Doncaster was symptomatic of modern trends. There was only one shareholder who spoke at the meeting (the author).

The other interesting aspect of these events is that many of the large institutional holders publicly opposed the bid, yet took the arbitrageurs money, when they could have simply accepted the offer. In practice they have sacrificed some of their profit but offloaded the risk of the bid failing, because the market price was up to 5% below the offer price in the run up to the decision date (and investors also miss out on the Primback cash if it ever arrives).

Of course, there may also have been hedge fund operators who had gone short on the basis they thought the bid would fail. Perhaps this will be the way future bids will pan out, with long term holders selling out early and leaving the arbitrageurs and hedge fund gamblers to shoulder the risk, and determine the result.

Roger W. Lawson 30/9/2004

### **Postscript written 29/4/2006**

It seems that the business was not in quite such a bad way as Lord Kirkham tried to make out. In the year ending July 2005, turnover increased by 8.8% with like-for like sales increases accounting for half of that. Operating profits jumped 20% to £59.3 million. It seems the improved profits have been helped by the company slowing down its store expansion programme and stripping out some costs (or perhaps a cynic might suggest that not a lot of attention was paid to them before the offer for the company).