HollAnd Advisors

Holland Views – Price £25.67, MCap £4,425m

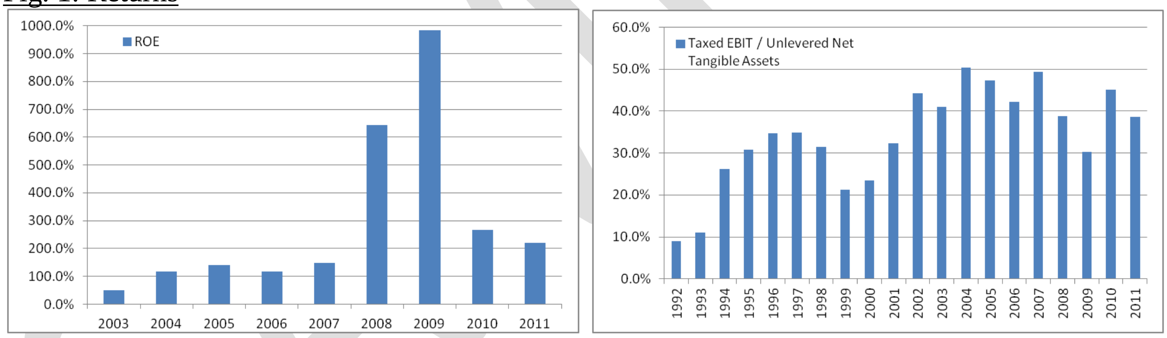
Phil Fisher right under our noses

We often tell our clients that we look at US markets a little more these days because there are so many more great investment franchises quoted there. Then we find one we have dismissed a little too quickly right under our noses. Whilst we have been aware of the attractive parts of the Next business model for a little while we have tended to dismiss it due to our continued caution on UK housing and consumption. In this note we try to give credit where it is due to Next and its managers who look to be 'innovating' and 'allocating' very well indeed.

Moved up, but still cheap vs. Returns

An impressive 25% appreciation of the groups share price so far in 2011 shows firstly how Next is bucking the all purveying gloom in the UK retail sector and also the error of us sitting on our hands in not looking at it more fully before now. That said the shares are still inexpensive for a business that we now observe is arguably doing all the right things. We are still being offered them at a PE of 10.8x company expected EPS to Jan 2012 or an 8.5x EV/EBIT to the same date.

Fig. 1: Returns



Source: Capital IQ / Holland Advisors

Financial excellence

- For a long while now we have insisted that great companies are defined by the level and quality of the returns they make on both assets and equity. As such when looked at on these two return metrics, Next looks in excellent shape.
- Next also demonstrates a number of traits we look for in many businesses, but specifically retail ones:
  - Goodwill is almost non-existent. It is currently less than 3% of total assets, demonstrating that the returns and growth the group reports have been organically achieved not bought.
  - Working capital, whilst not negative, is low. As a percentage of sales it averages 7%. This combined also with a large leasehold estate means the cost of growth for the group is very low. As a result marginal returns on capital are therefore very high. The cost of future growth could be lower still assuming it is likely to be directory / online orientated.

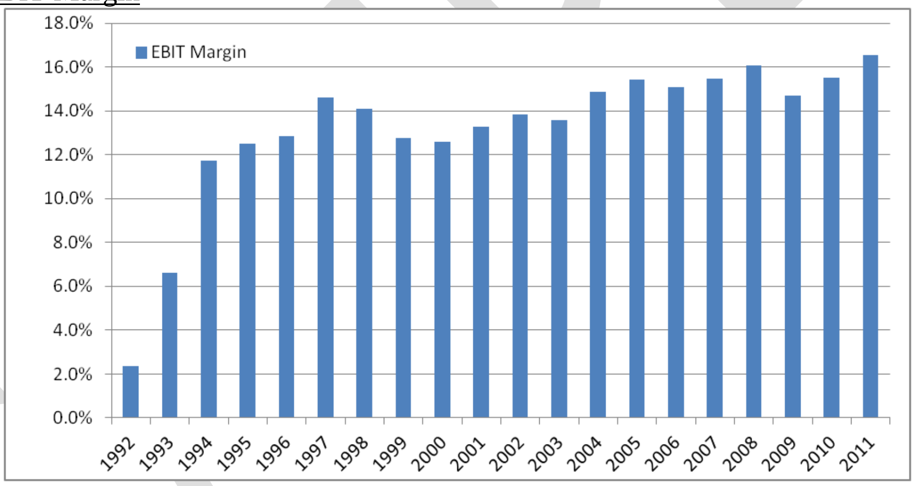
- The presence of mangers who act and think like owners.
- A low level of indebtedness.
- Constant innovation - An interesting point for Next which we will return to.
- A constant re-investment of scale that takes place for the customers benefit thereby securing future loyalty and likely growth - This is often visible in margins.

Margins

As with all our favourite retailers, stability of margin is something we look for as evidence of reinvestment in the customer offer/franchise. Whilst Next's margins are not the relentless and forecastable 6% we see every year from someone like Wal-Mart or Tesco, they do appear, over longer periods, to demonstrate similar stability. Watching the group's margin increase dramatically in the 1992-2002 decade, this author perhaps then assessed the group to be too keen to always keep the benefit of operational gearing for itself. Potentially therefore leaving itself one day more vulnerable.

A re-look at both gross and EBIT margins over the years since and a re-reading of the company's philosophy suggests this assessment was wrong. As such the group looks to have exactly the margin stability trait we seek in franchise retailers. Current margins could be assessed as a little high in comparison to recent years, but clearly the directory business largely explains this as we illustrate below.

Fig. 2: EBIT Margin



Source: Capital IQ / Holland Advisors

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

Disclaimer

This document does not consist of investment research as it has not been prepared in accordance with UK legal requirements designed to promote the independence of investment research. Therefore even if it contains a research recommendation it should be treated as a marketing communication and as such will be fair, clear and not misleading in line with Financial Services Authority (FSA) rules. Holland Advisors is authorised and regulated by the Financial Services Authority (FSA). This presentation is intended for institutional investors and high net worth experienced investors who understand the risks involved with the investment being promoted within this document. This communication should not be distributed to anyone other than the intended recipients and should not be relied upon by retail clients (as defined by FSA). This communication is being supplied to you solely for your information and may not be reproduced, re-distributed or passed to any other person or published in whole or in part for any purpose. This communication is provided for information purposes only and should not be regarded as an offer or solicitation to buy or sell any security or other financial instrument. Any opinions cited in this communication are subject to change without notice. This communication is not a personal recommendation to you. Holland Advisors takes all reasonable care to ensure that the information is accurate and complete; however no warranty, representation, or undertaking is given that it is free from inaccuracies or omissions. This communication is based on and contains current public information, data, opinions, estimates and projections obtained from sources we believe to be reliable. Past performance is not necessarily a guide to future performance. The content of this communication may have been disclosed to the issuer(s) prior to dissemination in order to verify its factual accuracy. Investments in general involve some degree of risk therefore Prospective Investors should be aware that the value of any investment may rise and fall and you may get back less than you invested. Value and income may be adversely affected by exchange rates, interest rates and other factors. The investment discussed in this communication may not be eligible for sale in some states or countries and may not be suitable for all investors. If you are unsure about the suitability of this investment given your financial objectives, resources and risk appetite, please contact your financial advisor before taking any further action. This document is for informational purposes only and should not be regarded as an offer or solicitation to buy the securities or other instruments mentioned in it. Holland Advisors and/or its officers, directors and employees may have or take positions in securities or derivatives mentioned in this document (or in any related investment) and may from time to time dispose of any such securities (or instrument). Holland Advisors manage conflicts of interest in regard to this communication internally via their compliance procedures.