HollAnd Advisors

Holland Views: Games Workshop – Price: £30; MCap: £976m

Niches, Money Trees and Margins of Safety

We have spent some time looking at the unusual company that is Games Workshop (GAW). We conclude to like much about it from both its exceptional financial metrics (high margins and high returns) and the tailwind that we conclude will likely drive its online profits and IP monetisation in the future. The problem (if there is one) is the Margin of Safety we are offered – or lack of it. Normally we like to find companies that are under-priced and under-earning at the time of purchase. A cursory glance at the profits and share price charts of GAW suggests this is perhaps not the case for this investment. However, two factors stood out in our work that we thought worthy of investor attention. These are:

- The huge boost to margins that is taking place by retail sales becoming online sales
- The fact that the group's Intellectual Property looks substantially under monetised

Never has the word 'niche' been so apt

Late last year we visited Games Workshop at their Head Office and Manufacturing facility in Nottingham (Thank you Client X for kindly organising this). It is a company that for a few years we have been recommended to meet and we only wish we had heeded that advice earlier! From this trip and a studious look at the company's past accounts we have learnt a great deal. Below we offer a few observations.

This is a company with a wonderful global niche product sold to a widespread but dedicated fan base. Games Workshop is a 'miniature wargaming manufacturing company' that is, it sells figurines of mythical characters, fantasy storylines. Its bestselling series being Warhammer.

Suffice to say that it is an unusual product to understand unless you are immersed in that niche (which we doubt many readers of this research will be – but see section later for help). What is striking however is the widespread global following of the product and that it has just grown almost by worth of mouth, but done so consistently over the last 30 years. Indeed, when asking the company about why it may open a store in a particular city and the data/research behind such a decision it is clear there is surprisingly little. They just look for geographic areas where they think there night be demand in and crucially try to find store manager for that local business that are/will be passionate about the product. On this point (i.e. the recruitment of the right people) however they are very clear in what they seek. This all suggests long term growth has been disciplined, but perhaps not very dynamic, especially in the online world that we now all live in. We will return to this point.

Financial metrics to die for

The output of this quirky company making games characters and shipping them globally from Nottingham, are some simple financial metrics e.g.

- RONTA (Return on Net Tangible assets) = 150%,
- Gross margin 70%
- EBIT Margin 33%

In addition, the company has longstanding managers who communicate a great understanding of Intellectual Property protection, innovation and economic value creation. The company also has an excellent record of capital allocation with no acquisitions and a pay-out ratio that ranges from 70%-170% in the last 10 years. They also appear prudent. On our trip we were shown character moulds that the company created 10 years ago that occasionally are re-used for repeat product runs. We note that in the accounts however all moulds are characterised as development costs and are written off at a declining balance rate of 50% over 4 years (so 75% in first 24 months).

The business is also still growing. Store rollouts globally are adding c.+5% pa to the existing estate and most recent sales grew at 14% in 1H 2019 over the same period last year – which had itself seen very strong growth as our Appendix shows. With the shares of the company changing hands for c.17x earnings (and the Balance Sheet sitting on net cash) they appear to be reasonably priced vs. the Rare Bird characteristics that we conclude the company seemingly demonstrates.

If there is a catch, we will come to it shortly, but first we point out the two factors at GAW that excite us even more than the impressive numbers we outlined above.

They are:

1. Online sales increase will be a huge driver for profitability

The table below extracted from the group R+A shows the company's sales and profits by different channels. In our model in the Appendix we have laid this and more past period data out to show the remarkable growth that has occurred at this company in recent years. But leaving such growth aside for a moment, another startling point we think can be seen. <u>This being the stark difference in margins it makes between its different routes to market</u>

Sales
Sales by segment

	53 weeks to 3 June 2018 Constant currency	52 weeks to 28 May 2017 Constant currency	**53 weeks to 3 June 2018 Actual rates**	52 weeks to 28 May 2017 Actual rates	**2018 % of total Sales**	2017 % of total sales
Trade	**£96.2m**	£61.3m	**£94.3m**	£61.3m	**43%**	39%
Retail	**£82.5m**	£64.8m	**£82.0m**	£64.8m	**37%**	41%
Online	**£43.9m**	£32.0m	**£43.6m**	£32.0m	**20%**	20%
Total sales	**£222.6m**	£158.1m	**£219.9m**	£158.1m		

Reported sales grew by 39% to £219.9 million for the year. On a constant currency basis, sales were up by 41% from £158.1 million to £222.6 million.

Operating profit
Operating profit by segment

	53 weeks to 3 June 2018 Constant currency	52 weeks to 28 May 2017 Constant currency	**53 weeks to 3 June 2018 Actual rates**	52 weeks to 28 May 2017 Actual rates
Trade	**£33.3m**	£18.0m	**£32.9m**	£18.0m
Retail	**£6.7m**	£0.5m	**£7.2m**	£0.5m
Online	**£27.9m**	£18.8m	**£27.9m**	£18.8m
Product and supply	**£25.1m**	£16.3m	**£23.9m**	£16.3m
Royalties (net of costs)	**£9.4m**	£6.9m	**£9.1m**	£6.9m
Other costs	**£(26.3)m**	£(22.2)m	**£(26.4)m**	£(22.2)m
Total operating profit	**£76.1m**	£38.3m	**£74.6m**	£38.3m

Source:
Games Workshop Annual Report 2018

What is not stated above but can easily be derived is the EBIT Margin each distribution channel generates. These can be easily calculated in the year to June 2018 as:

- 'Retail' (i.e. own stores) 8%
- Trade (i.e. wholesale) 34%
- Online 64%

A visit to the company's factory shows clearly why this is the case. Production of small, but intricate plastic modelled characters if done in scale is a very high margin activity (Ref# the companies sustained high gross margin of 71%. It has never been below 65%).

As these plastic components are sold for high prices, but are small and light, so shipping costs are low. However, to sell these in store requires a store workforce and store running costs. Those familiar with the company's history will know that this issue, i.e. store manning and its cost structure have been the key issue for the company in the last 10 years. Whilst we are new (late?) to this company and as such we must be careful of our inexperience in its markets. That said maybe we bring a fresh pair of eyes to this long running Opex cost issue? Some years ago, we were stuck by a brilliant quote from Charlie Munger:

> *"you have to work out when Technology is going to kill you and when it is going to help you*." Charlie Munger

On many occasions he has used this reference to explain the tailwind that helped certain companies (the Video Recorder for **Disney** and Refrigeration for **Coke**). In today's investment world there are many old economy business models that technology has helped kill. This quote immediately came to mind when we both listened to the GAW management talk about their business and noticed the dramatic difference in distribution channel margins for selling **the exact same product.**

Money tree?

We could now go off on a tangent showing a great number of companies with the exact opposite metrics, however we hope our readership has the necessary experience to agree with the following conclusion. This being that for the vast majority of retail-facing companies we meet, making money online today is a lot harder than it had been in store years before. In many cases due to the increased distribution costs or because they have lost a once dominant position due to new online competitors. There are some exceptions. A few that have been built from scale (Next like to bundle Directory purchases to enable it to make better margins than in store) and for others a higher Average Selling Price helps cover distribution costs (Ted Baker make this point stating that its online margin are as good as their best store).

However we have yet to see a company (until now) with a Store EBIT margin that has bumped around breakeven (0-10%) for 20 years only to see online sales generate 65% EBIT Margins!

Currently GAW online sales are only £44m vs. £83m in store and £94m in wholesale, but in profit terms the company makes a whopping £28m EBIT online and only £7m in store. As more and more sales may move online responding to the group's investment in this channel, we see a continued and natural boost to margins. We also observe that:

- A proportion (undisclosed) of the group's wholesale sales are online also
- Like other Intellectual Property companies (Ref our Disney and WWE work) as it spreads the word of it products/brand better internal online sales will generate higher margin that external ones (which currently lose the wholesale mark-up)

Changing guard – Changing attitudes

The company's seemingly long-held belief (given by the ex-CEO) that the way for the business to promote itself was via its own stores. Via this channel its games characters and worlds can be explained by a local expert it has claimed. Again, we may find our lack of experience comes to bite us here, but we observe that not only do we feel that this modus operandi for the spread of the brand is outdated, it is also perhaps unnecessary.

Whilst not a perfect example one of your authors and his family are big fans of Star Wars and Lord of the Rings. Whilst these are not games, but films, importantly we have not required anyone to explain the backstories or worlds they inhabit to us. This was a process we enjoyed finding out for ourselves. However, under the previous CEO of the company (much admired we might add) a belief seemed to take hold that it was only really by a trip to the stores where a customer would find out about the storylines and game products the company possessed.

Crucially on visiting GAW this was something that we feel has been a real change of culture in the organisation on the last 1-2 years. A new CEO has welcomed more ideas from the organisation below him and these have often come in the form of 'let's tell our stories to the world in whatever medium we can, or whatever way they want to hear it in' (The favourite channel being making far greater use of the company's own website). We see this as pushing on an open door.

Having observed the staff at head office talk about 'significant changes under the new CEO', we looked at how long he had been there. The answer being that he was CEO since Jan 2015, so not that new we concluded? But also COO from 2011-2015. Strange we thought that such changes are seemingly heralded by staff in 2018. We conclude that this new attitude is less about the abilities of the new CEO and more about the freedom that he and his staff have found since the departure of long-standing Chairman/CEO and then Chairman again, charismatic and we guess domineering, Tom Kirby. Whilst we have enjoyed reading Mr Kirby's past letters as much as any other shareholder and think he likely brought great financial discipline to the company with a cash and ROIC focus we think it right to conclude that when he finally left the Board completely in September 2017 it freed up those around him to develop this company to its full potential.

Pushing on an open door

For years Mr Kirby outlined the groups four key elements, they remained largely unchanged whilst he was CEO or Chair. We paraphrase below:

1. *Make high quality miniatures*
2. *That are based in our imaginary worlds*
3. *Global nature of our business*
4. *We are focused on making money (cash) doing* it

Indeed, there is nothing wrong with these building blocks for they explain the group well to outsiders like ourselves. However, we noticed some additions in the 2018 annual report. Mr Rountree and team, we suggest are opening their shoulders somewhat. Two new drivers of this business were highlighted:

> *"The third element is that we are customer focused. <u>We talk to our customers. We aim to communicate in an open, fun way. Whoever and wherever our customers are, and in whichever way they want to engage with Warhammer,</u> we will do our utmost to support them."*
>
> *"We believe our IP to be among the best in the world."*
>
> *"The Warhammer settings are incredibly rich and evocative backdrops. They're populated by more than three decades of fantastical characters and comprise of thousands of exciting narratives. <u>Going forward, we want to make it easier than ever for people to engage with and immerse themselves in our IP. To that end, I have a small, senior team to help me find new partners to help us bring the worlds of Warhammer to life like never before</u>. Together, we'll explore animation, live action and more, while ensuring we do not harm our core miniatures business."*

CEO statement 2018 Report and Accounts

The above comments by us on Management and its somewhat changed focus in recent months are not to try and suggest there were problems that needed solving. They are only to try and assess the group's potential in the two key areas that we think are crucial for its future financial success. These are its future online communication with its fan base and the sales via that profitable channel that could result and the monetisation of its IP.

Just a word on typecasting

When perhaps seeking out to typecast (an unfair activity which we apologise for, but a useful short cut maybe for investors unfamiliar with the business) a standard Games Workshop customer we are minded to think of The Big Bang Theory*. The intelligent but nerdy characters portrayed in the series are often engaged in two pastimes: 1. Playing fantasy games such as those made by GAW, and 2. Spending time online. Hence our conclusion above that the company is pushing on an open door with its new online communication with its fan base. If this were a retirement home company hoping to only explain itself by a teenage mobile app – well, take up might be hard! But this is a company that until recently chose to explain its product to perhaps the most connected social set of people on the planet, by making them go to a store…and one that just might be a long way away!

***Very good/ funny if you have never seen it and on its 12th and last season (for perspective Friends has 10 seasons!).**

2. The group has enormous Intellectual Property – yet to be monetised

The second area of huge potential for this business we feel is its Intellectual Property. This is a company that has fantasy worlds and story lines galore. It is developing them all the time with new characters and new story lines and it has done so for 30 years. It also owns and controls all of its IP. How are they being played out in this digital world…? Almost solely by board games and the hobby miniatures they sell! This to us smacks of under-monetisation and post our trip to Nottingham we were delighted to hear numerous members of staff make that point themselves. They also stated that this was a point of resistance for the previous CEO, but one that the current CEO and his team are embracing more fully. The above quote from the current CEO in his 2018 letter on IP makes this clear. It is in contrast to Tom Kirby's chairman letter of 2016 which we extract below:

Games Workshop – the IP play

Over the years we have been exhorted by some to develop our revenue stream by 'leveraging' our IP. Using our great imagery we could do all sorts of lucrative and exciting value-enhancing (i.e. take private and re-float) deals. Actually, what they really mean is: do a movie!

We have never NOT done licensing deals, as you can see from the steady stream of royalties we earn; it's just that we believe we must do them on our terms and not prostitute the business to any and every deal that comes along. If we do a movie (along with the concomitant abandonment of the toy rights) it will be on terms that do not compromise our business. It isn't likely.*

Long term owners will notice a big increase in royalty income this year. Have we sold out at last? No, it's just that working closely with the myriad app developers, and being more precise with the terms we offer, we have increased the number of 'computer' games in the market.

**Anyone doubting this aspect of movies needs to read how Marvel prevented an Iron Man movie having a female as the main baddie because it would hurt the toy sales.*

Extract from 2106 Chairman Letter – Tom Kirby

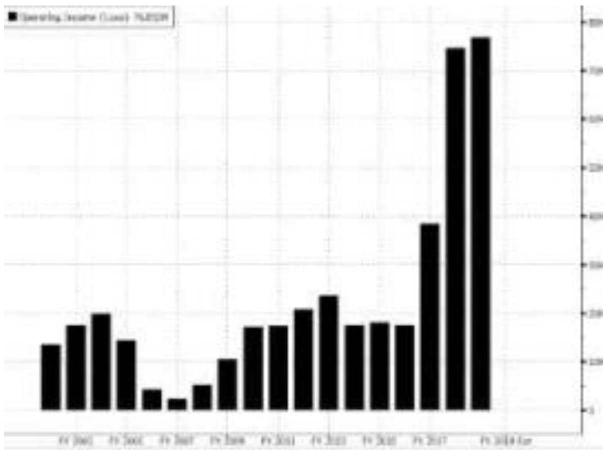
Whilst we admire this company's determination, both past and present to defend its IP. We conclude that Mr Kirby was maybe somewhat stuck in the past. Also, that whilst scepticism of all new ideas emanating from the city is always wise, unchecked scepticism can become cynicism.

Time spent studying Disney's development of the many brands within it we think is illustrative. A new modern iteration of a brand, if well-constructed can bring its values and enjoyment to many more customers. We offer for reference the new Mary Poppins movie, or Rogue One from Star Wars. We must be clear, we are not saying "Do a Movie" we are saying modernise your IP, whilst protecting it and communicating with your current and new customers in ways they want in todays world. Thankfully we do not think that this a message Mr Rountree needs to hear from us. He and his passionate staff concluded as such some time ago it seems.

The big caveat – has the business been over-earning?

So what holds us back from shouting from the rooftop that this share is a buy? Only the recent trajectory of profits and the lack of Margin of Safety an investor may get from buying at the top of the hockey stick. The chart below shows the enormous leaps in profit this company has achieved in recent years. Unsurprisingly the share price has mirrored this, jumping from £5 in 2015 to £30 today.

Fig.1: Operating Income



Source: Bloomberg

A longer term perspective also shows that the company has had reductions in sales levels before, i.e. this has not been a linear growth story of just more players spending a little more gradually over time.

As a result, this is the analytical challenge/question we are looking at. We need to better understand whether this company has been overearning in recent years. This is not meant as a criticism, or to suggest the results have been artificially boosted in anyway. Only that with different product releases at different times, depending on the scale of customer take up could have seen a period of very strong sales growth that is then followed by a quieter period. Buying into the shares at say a reasonable valuation for such franchise (16x unlevered) is all well and good but if this is based on a level of profits that are latterly observed to have been elevated an investor may have either over paid for the Franchise or at the very least seen his Margin of Safety evaporate. The group disclosed that in 2018, 38% of its sales were 'new products'.

Whilst this is an impressive Phil Fisher esq. stat, it does pose the question of whether the group has overtraded for a period selling strong new products into an exciting customer base that might re-trench for a while…? Or have they reached a new much wider number of customers. On that point we currently do not have enough information to judge either way. That said we thought the most recent new chairman's statement was of interest:

> *This is my first statement as non-executive chairman of Games Workshop Group PLC: .....Your board believes that the Company has achieved a new order of magnitude, driven by the strategy devised and implemented by our CEO, Kevin Rountree.*
>
> **Chairman's Letter 2018**

Whilst we have work to do to try to better understand this company's current and near future earning power, the Board it seems believes that Mr Rowntree has built something that is sustainably bigger and will grow further.

We pause – for now

For now, we will leave our observations there. We very much like this company's:

- Great financials characteristics
- Global niche
- The tailwind that more online sales with bring to EBIT margin upside
- That its fully controls and owns all its IP, but has yet to fully monetise its full potential
- That is has a management team seeming focused on these opportunities

We are looking at the Margin of Safety (i.e. peak profitability or not) actively and would happily share/learn from those that know the company a little better than us newbies.

Kind regards

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Appendix

Fig.2: Holland Summary Model

Games Workshop
Sales and Margin progession 2015-2018

		May-15	May-16	May-17	May-18	% over May-16
Revenue		119,132	118,069	158,114	219,868	
Trade acc numbers		3,700	3,800			
Trade	UK/CE	15,656	15,504	25,442	39,068	152%
	NA	17,740	17,944	27,207	41,805	133%
	Aust/NZ	2,000	1,658	2,472	4,340	162%
	Asia	584	741	2,257	3,857	421%
	Other	8,497	8,675	3,876	5,224	
Total trade		44,477	44,522	61,254	94,294	112%
store numbers			451			
Retail	UK	16,959	16,074	22,474	27,250	70%
	CE	13,879	12,878	16,859	21,303	65%
	NA	9,806	10,417	16,759	22,243	114%
	Aust/NZ	5,619	5,133	7,471	8,977	75%
	Asia	317	417	1,285	2,198	427%
	Other	2,480	3,495			
Total retail		49,060	48,414	64,848	81,971	69%
Mail Order/Online		25,595	25,133	32,012	43,603	73%
		119,132	118,069	158,114	219,868	
EBIT		**16,709**	**17,053**	41,892	79,603	367%
		14%	**14%**	**26%**	**36%**	
Trade		11,508	10,625	17,956	32,888	210%
		26%	**24%**	**29%**	**35%**	
Retail		- 1,510	- 3,410	461	7,185	
		-3%	**-7%**	**1%**	**9%**	
Mail Order/Online		14,432	13,747	18,788	27,880	103%
		56%	**55%**	**59%**	**64%**	
Royalties		1069	5329	6949	9125	71%
Product and supply		8606	7093	16286	23887	237%
Costs		-17520	-16436	-22117	-26370	60%
		-15%	-14%	-14%	-12%	
	Total EBIT	**16,585**	**16,948**	**38,323**	**74,595**	

Source: Holland Advisors, Company Reports

Disclaimer