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Holland Views – Sports Direct – Price: 401p; MCap: £2,385m

Pile 'em high…with a smile

We have followed the Sports Direct business and management closely for many years. However its multi-year streak of profit growth and a share price that more than matched this rise kept our enthusiasm in check. A recent negative trading surprise fuelled the fires of those that love to hate Mike Ashley and its shares slumped. This is music to our ears. Sports Direct (SPD) is a high return business that dominates its industry, was built from scratch and still passionately run by a driven owner-manager. Its shares are now offered to us at c.7.4x EV EBIT, but notably, that EBIT is deemed to have significant growth potential by management. We also notice an interesting change underway at SPD – we think service and average prices are rising just a little in what looks to us a lot like a replay of Ryanair's highly profitable repositioning since 2012.

In this note, we look at three key issues:

1. How SPD defies convention (for the good of customers and all shareholders).
2. What is SPD's secret sauce that led it to capture 2/3 of the sports apparel market?
3. Could Ashley be following in Michael O'Leary's footsteps and upping customer services (and prices)? We sense that he is.

Finally we address the big concerns touted by many: namely whether weak LFL sales are structural (we think not) and supposedly dubious corporate governance and pay incentives.

We think SPD is a cheap franchise that might even be under-earning. Buy.

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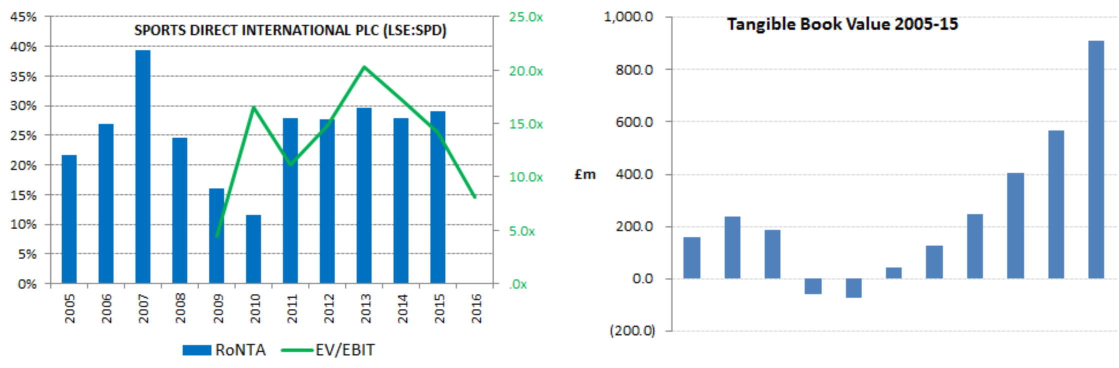
Fig.1: Unconventional management but excellent returns



Source: Capital IQ

Defying convention

Retail is a fairly conventional business activity. You buy stuff, stock your shelves and sell it with a sufficient margin to pay your costs and generate a profit. So how does one disrupt this well-worn path if you are not Amazon?

Here's the Sports Direct way: target a niche retail segment that is growing faster than GDP. Focus relentlessly on ultra-low operating costs and offering ultra-low prices to customers. Scale the business up. Ignore everyone's opinion except the customer and know what that customer really values. Become important enough to your suppliers to deserve above-average discounts and pass these on. Also bring some legacy brands in-house that allow lower prices but at higher margins.

Rinse and repeat. So far so boring, you might say – but what is important is the human skill and personality required to realise all this in the real world, resulting in a gain of close to 60% market share. To disrupt a market in this way (and this is disruption) requires thick skin, aggressive business practices and unwavering focus on the end game. It requires a maverick, someone often highly unlikely to be popular. Think Michael O'Leary, think Brian Souter, think Mike Ashley – all contentious business characters whose antics often triggered emotional, but not always rational, responses from the press and investors alike.

"Being rational is a moral imperative" – Charlie Munger

It is our contention that Ashley and his eponymous business Sports Direct (SPD) are misunderstood and underestimated by most. Looked at rationally, SPD commands up to two-thirds of the c.£4.5bn sports retail market in the UK – what is today essentially a duopoly market (and that is being generous to JD Sports). It has a very wide moat, enjoys a RoNTA of c.30% and has compounded its book value at 37% CAGR since listing in 2008! Any rational observer would surely agree that a 7.4x EV/EBIT price tag is far too cheap for such a business. Oh, and SPD's business we believe is starting to move just a little upmarket – so it would also be rational to expect an easing of price aggression causing a lift average selling prices and/or margins.

This is not a call on current trading at SPD – sales could deteriorate in the near term. Nor are we totally comfortable with rising gross margins in the face of falling LFL sales. What we are highlighting here is a great retail franchise that in our assessment is misunderstood and today undervalued by Mr Market.

> "*Conformity is the jailer of freedom and the enemy of growth"* – JFK
>
> *"Here's to the crazy ones. The misfits. The rebels. The troublemakers. The round pegs in the square holes. The ones who see things differently. They're not fond of rules. And they have no respect for the status quo. You can quote them, disagree with them, glorify or vilify them. About the only thing you can't do is ignore them. Because they change things"* – Apple, Think Different campaign, 1997

Unconventional behaviour always upsets the Status Quo

Watching unconventional behaviour makes most people uncomfortable and uneasy. It disturbs the status quo causing them to question their own way of doing things. Such new business approaches are almost always discredited until they later become accepted and ultimately lauded as being visionary! An example is the way we are now expected to book, check in and accept cattle-like treatment at airports. This change was hardly welcomed by the consumer but it became the norm as the benefit it brought was lower fares which we all wanted.

What these disruptive managers and businesses have in common is that they are not afraid to ruffle feathers in order to disrupt markets, displacing incumbents' and reinforcing their own position especially if it results in lower costs for them and cheaper products for their customers. Ryanair, IKEA, Costco, JD Wetherspoons, Lidl, Aldi and Sports Direct all do this[1]. Ten+ years ago many such businesses and their low cost models were underestimated, today nearly all of them have gained substantial share and are frequented by all and sundry.

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

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[1] We have seen excerpts from what looks at interesting book on this area – '*Different: Escaping the Competitive Herd'* by Youngme Moon e.g. IKEA's intentional differentiation is discussed in some detail. IKEA's founder, Ingvar Kamprad, was of course another maverick/eccentric businessman to say the least.

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