HollAnd
Advisors

Holland Views – J D Wetherspoon: Price 1216p; MCap £1,280m

Low Risk Compounding + Red Herrings

We have written a lot on JDW over the years and we are proud of this work. In the summer we claimed something that no-one else seems to believe possible in this company; i.e. that one day its seemingly long-lost operational gearing will return. Over the last few weeks we have spent time with Tim and many of those in his team. As such we reflect on this and other ideas.

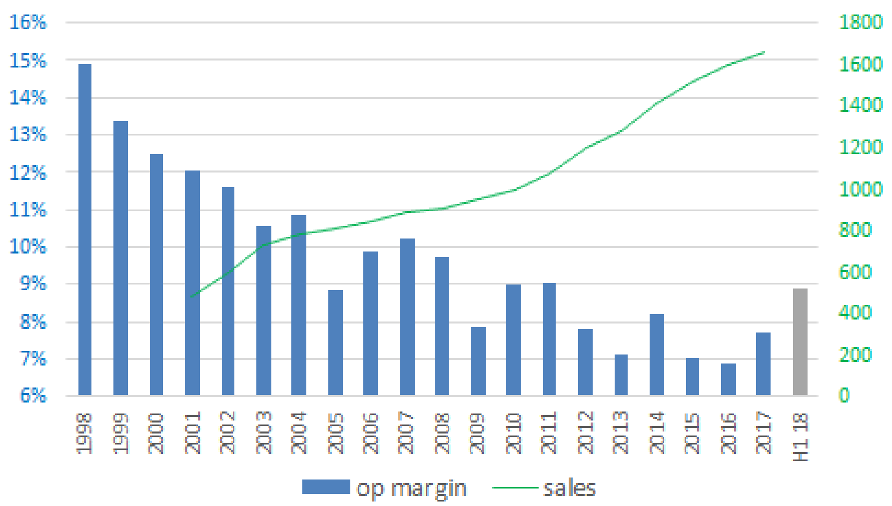
In a recent trading statement, the company commented that they thought full year 2019 profits would be flat as cost increases will not be passed on in higher prices to the customer – the shares reacted falling 10%. As statements go, we think this is the perfect red herring. Post recent meetings with JDW we add a few points to our thesis on the company.

The Red Herring

Almost every other company who is putting wage rises through is passing these on in routine smaller price increases (NB: Next did exactly that post Sterling's Brexit fall).

- But JDW is not like any other company – Tim Martin has many strong beliefs (in case you have not noticed!) and keeping prices very low to win over customers year after year is one of them.
- During 2018 while the company has had a 5% increase in like for like sales its LFL profit per pub only grew 1.2%. The main reason being strong rises in staff costs (up 9%). However pretty much all of that 5% sales increase was volume not price.
- Had JDW increased prices a little in this period (say 2%) to pass on cost increases we doubt its LFL sales would have been impacted that much, but profits would have been higher (much).
- When we seek to find companies with "pricing power" surely this is what we are after; Companies that 'could' rise prices. Whether they chose to or not is a different issue.

Fig.1: No-one, it seems, expects margins to *ever* buck the long downward trend (except us!)



Source: Bloomberg

A great employer

- JDW is now a great place to work:
  - Prior to the November 18 pay rise for all staff JDW were paying 20-30p a hour above the minimum wage across all bands. Post this month's rises it will be 45-50p above. In some areas the pay gap is much higher.
  - In addition, there is an annual bonus of c.5% of pay.
  - Managers are now on maximum 40 hour weeks with far better terms for accommodation and other allowances.

"We have now got quite a big buffer in wages" John Hutson, CEO Sept 2018

An investment phase

- The company has been on a strong investment phase for the last few years – investing heavily in its pubs and its people. Arguably quite soon they might run of out of things to spend the money (that rising volumes generate) on.
- Notably the group is far more careful about new pub expansion these days. Interestingly this is not due to a lack of ambition or lack of demand (huge swathes of London are crying out for a 'Spoons) but due to the company's careful consideration of the return on capital they want to ensure each new pub will make.
- During this phase JDW have also largely completed the closure of less profitable sites that they have admitted were a function of past over expansion in some towns

Pricing gap only increasing

Due to Tim's and his teams desire to keep prices low wherever they can:

- The groups like for like sales continue to grow at industry beating rates. It should be noted that there are some operators who have similarly good LFL sales data as JDW (Youngs, Fullers + Marston's are examples) but these companies have put up prices consistently in recent years. In volume LFL growth we think JDW is streets ahead.
- The JDW team keep a close eye on the pubs they are closest to make sure that they are always 20-25% cheaper across the range of drinks/food offered against their local peers. However, with the industry raising prices and JDW not following suit this gap is widening.
- Furthermore, we believe JDW has a deflationary effect on prices around its pubs as competitors have to respond to offer better value to compete. The result is JDW now admits they are likely now far more than 20-25% cheaper if compared to a broader basket of pub sites in the industry. (Our own experiences easily backs up this point).

Investor reflection

We would ask readers at this moment to stop and reflect on how many companies they can find that:

a) Have a strong customer centric culture and one of continuing improvement
b) Where the price offering is so much lower than peers for the same product
c) Where as a result there is arguably significant untapped pricing power
d) Where EBIT margins are at a record low despite the companies growing scale

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