HollAnd Advisors

Holland Views – Next plc – Price: 5198p, MCap: £7,260m

Observations on a retail innovator

The premise of our first research note on Next plc way back in 2011– prompted by Phil Fisher (Fig.1) – centred on Next's excellence as an innovator, its growth prospects and capital stewardship. Seven years later and for all the headwinds that it since faced, Next still stands-out as a diamond in the rough – a UK retailer that seems likely to endure. Under Simon Wolfson, Next enjoys a managerial pragmatism and honesty[1] that is very unique in the UK market.

Fig.1: Phil Fisher's original checklist – still useful 61 years later

PHIL FISHER'S 15 QUESTIONS

- Does the company have products or services with sufficient market potential to make possible a sizable increase in sales for at least several years?
- Does the management have a determination to continue to develop products or processes that will still further increase total sales potentials when the growth potentials of currently attractive product lines have largely been exploited?
- How effective are the company's research-and-development efforts in relation to its size?
- Does the company have an above-average sales organization?
- Does the company have a worthwhile profit margin?
- What is the company doing to maintain or improve profit margins?
- Does the company have outstanding labor and personnel relations?
- Does the company have outstanding executive relations?
- Does the company have depth to its management?
- How good are the company's cost analysis and accounting controls?
- Are there other aspects of the business, somewhat peculiar to the industry involved, which will give the investor important clues as to how outstanding the company may be in relation to its competition?
- Does the company have a short-range or long-range outlook in regard to profits?
- In the foreseeable future will the growth of the company require sufficient equity financing so that the larger number of shares then outstanding will largely cancel the existing stockholders' benefit from this anticipated growth?
- Does management talk freely to investors about its affairs when things are going well but "clam up" when troubles and disappointments occur?
- Does the company have a management of unquestionable integrity?

Source: 'Common Stocks and Uncommon Profits', Phil fisher (1957)

What follows are some further observations from a recent group meeting we participated-in with Simon Wolfson. We were taken with Wolfson's candid appraisal of the myriad of challenges facing Next in the UK high street (especially, the negative operating leverage) but came away realising that there are many potentially material offsets to that within Next's armoury. Offsets such as; the aforementioned and much-underrated managerial innovation, the capitulation of UK landlords and the now-impressive scale of online. We also post a left-field[2] but plausible (to us) theory that Next might be a very rare (and thus attractive) asset for a certain US retail behemoth to consider buying.

[1] Holland Views – Next – Radical Truth – April 2018

[2] First we suggest Royal Mail as a take-out target, now Next too – no we are not losing our marbles! Perhaps it reflects the stage of the market cycle we are in but, like Wolfson, at Holland too, we are trying to be honest and transparent in our thinking – even if such thinking is unconventional!

Valuation discipline is key with Next and market uncertainty (and thus volatility) is creating opportunity for patient investors with some regularity. A 12x PE is interesting, but not as compelling (given the headwinds) as the last capitulation to 8.5x PE reached last year.

That said, if we ran a UK-only portfolio, we'd own this stock. Global fund managers fish in a bigger pond. All investors ought to keep Next on their watch list.

Healthy scepticism and discipline

We might be accused of being infatuated with Next – it is indeed one of the most frequently written-on stocks here at Holland. But we are unapologetic – this is a top-class business and one that every UK investor ought to know well (and in our defence, the stock *has* doubled since 2011!). That said, we try hard to be unemotional and distinguish its attractions as great company from its attractiveness as an investment.

In other words, for all of our admiration for Wolfson's management of this company we have always tried to be disciplined in our approach to the price we are willing to pay for its shares. Even we, as enthusiastic followers of the business, could see that the 17x multiple (£70 share price circa 2015) was simply way too high. What is more, the group then experienced something that is easy to do in the fast-moving world of fashion – it stumbled. The result, we felt, was that the price pendulum over-shot in the other direction (at £40-45) under-pricing an innovative management team who were highly likely to evolve, innovate and care for shareholder capital.

Today with the shares at £52 and now rated at 12x earnings (reflecting c.16.5% operating margins) the shares are *perhaps* closer to fair value at first glance. Or so we thought before we went to meet Lord Wolfson last week!

A trio of levers

We see three major levers working for and against Next at the moment:

1. Operating leverage (in reverse)
2. Lease renewals
3. Next's Online scale

Lever #1 – a negative – operating leverage

UK retailing, across the board, is a proper test of managerial ability these days as managements are forced to deal with the symmetrical nature of operating leverage. Declining stores sales – lost (or indeed cannibalised to an online alternative) obviously have a major negative impact on marginal profit. But the added problem is this being a structural rather than a cyclical decline. Some managers seem in denial on this issue.

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