HollAnd Advisors

Holland Views: JD Wetherspoon – Price: £13.20; MCap: £1.7bn

Walton on Thames

> "*There is only one boss. The customer. And he can fire everybody in the company from the Chairman on down, simply by spending his money somewhere else.*"
>
> – **Sam Walton, Wal Mart founder**

True EDLP businesses, i.e. businesses that *share* the benefits of scale are a rarity for UK investors. Yet in JD Wetherspoon we have one whose owner manager treks to Omaha, writes an annual report cloned from Berkshire Hathaway and distributes Sam Walton's biography to its top 100 executives. Oh, and its customers save an aggregate c.£500m in a typical year!

Like Sam Walton, Tim Martin is an obsessive owner manager who 'gets' that retail success is a result of a thousand cumulative details. Martin and his team are playing a long game, deferring today's profitability in order to build market share, cement customer satisfaction and loyalty. Martin regularly admits he could double profits at the drop of a hat simply by raising prices. Few investors, we think, realise the inherent future growth that today's 20-30% lower prices vs. peers almost guarantees. It seems customers love 'Spoons' far more than investors.

In January, at the time of the (second!) placing, we outlined a roadmap for assessing the earnings power of this business. Our work today suggests a plausible earnings power of £140m in Net Income looking out three years or so. Today's market capitalisation of the business post new capital raised is a 12x multiple of those earnings.

Scale Economics shared

In today's investing world there is a strong following of 'Scale Economics shared' business (or EDLP in old money). JDW is one such scale economics shared business we have studied now for a decade and it is one we feel is underappreciated. Few franchise or compounder investors own the shares and of the sector analysts that cover it, no less than 40% have been 'sellers' for the last 5 years.

This note is not about JDW's COVID-19 recovery or its balance sheet; both of which we/others have discussed ad-nauseam. We will comment briefly on each at the end just to remind readers of our conclusions.

Back to the beginning – A 2012 snowball

We have written reams on JD Wetherspoon since we laid out our original thesis on the company in 2012 (*Holland Views – Snowball On a really long hill – July 2012 – 426p*). Since then, we opted to focus less on the underlying business model and more on the hidden sources of operating leverage within the business. Today, we get back to basics and refresh readers on why this is such an excellent business. As much as the threats and opportunities that arise from COVID-19 need to be considered by all, it is the core EDLP model at the heart of this business that first and foremost needs to be understood and recognised.

1. We review our thoughts on JDW as a rare beast: a flywheel EDLP business. Most importantly, we think JDW's *current* estate can support significant volume growth (50-100%) and thus we expect important sales density increases.
2. We also address a long time retort from clients – that JDW's low ROIC (9%) and declining margins calls into question the existence of a moat. But ask yourself how many competitors would survive at -25% lower prices vs. peers (and then pass on the recent VAT cut?). We counter that the last 5-10 years have been a period of extensive investment in JDW freeholds, staff and food preparation facilities. In short, a period of under-earning and what Jeff Bezos might call 'deferred gratification for shareholders'.
3. The crux of our view on JDW centres on the operating leverage pent-up or hidden within this excellent business. In the context of a business that has seen headline margins decline steadily for years, clearly this is an unconventional view. But it is not an uncomfortable one for us. 10% operating margins are not at all far-fetched. In fact we see them as an easy target.

In short, Wetherspoon is following a well-worn track led by Wal-Mart, Costco, Geico et al to try and delight its customers. What we are about to describe is a UK business that, as its owner-manager states, "*tries to continually make customers feel a little bit better off*".

Shareholders of those aforementioned pioneering EDLP businesses needed to defer gratification and JDW shareholders need to do the same. **Maybe, its not that so few understand that Wetherspoon is an EDLP business, perhaps its more that few have the patience to own it?**

In this note

In this note, we focus on:

1. **Scale economics:** one of our big ideas
2. **Returns**, Moats and dividing the spoils
3. **A Mo Farah Stock**

For those that seek a refresher on the business 'from the horse's mouth', we highly recommend the following interview that Tim Martin gave in 2018. It offers excellent insight into the man and the business[1]

Scale economics/EDLP: what's the big idea?

We have spoken in the past about the importance in investing of knowing what you are looking for.

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] Interview link here https://vimeo.com/305746906

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