



Holland Views – Next plc – Price: 5567p; MCap: £7.6bn

Model Retailer

Next's guided (and most probable) cash flows in the next few years have become very bond-like in their stability and lack of growth. Bond investors know that the return you make from such an investment will be driven largely by the price you pay upfront. Whilst our modelling shows how the group can turn +3% FCF growth into +8% value per share growth, we still think it right to be selective with the starting price we pay for the shares. (Indeed, such a contrarian approach has served us well in this company's past – we were interested sub 12x PE but less so at 17x).

In c.4 years' time, better growth may emerge but Mr Market is not known for his patience. While we wait for Mr Market to offer us a better value again there are two long-shot bets with more favourable outcomes we will watch for. One is that further out, LABEL becomes a much bigger business than all are expecting – indeed this would be consistent with a dominant aggregator model. The second is that a large global retailer notices the great job Wolfson and team are doing in such a tough (but huge global) sector. They then seek to secure Next's delivery, own label online EDLP clothing and aggregator skills for their global use.

A Great Manager + Poor industry = ...?

Last week we reminded clients of the quality of thought and analysis that Simon Wolfson brings to the Next business case with his latest shareholder letter. We also re-iterate the idea that his approach and communication of the business trends and their challenges means that most brokers' results commentary become redundant as Wolfson does their job for them!

As a result, our work on the company has always been designed to try and add some wider perspective. Our original piece on it cited Phil Fisher¹, noting the traits that Fisher looked for being present in Next, is research we remain proud of. But what can we add now? In terms of the outlook for each business line, we think very little, but we think we can put Wolfson's view in some perspective giving investors a framework to consider the company as an investment going forward. This we do below; mostly by looking at the impact to shareholders of the 15 year view the company outlined. We also add a few words on the company's role as an aggregator, a position we feel as having great potential.

Not a forecast, but

Two years ago at the FY17 results, Wolfson presented his first draft of a 'Retail Store Portfolio Stress Test', an attempt to take a brutally honest view on the outlook for Next's retail store negative LFLs. We wrote afterwards that investors couldn't handle Wolfson's truth². Wolfson's candid conclusion at that time was that it simply was not clear to him how the transition to online would pan out for Next. Two years on, he offers much more clarity and cautious optimism.

This research piece will assume that investors have read Next recent results and the 15 year stress test scenario outlined (we have created a PDF of this which is attached). The company was at pains to state that this scenario was neither a plan nor a guidance of future profitability. That said

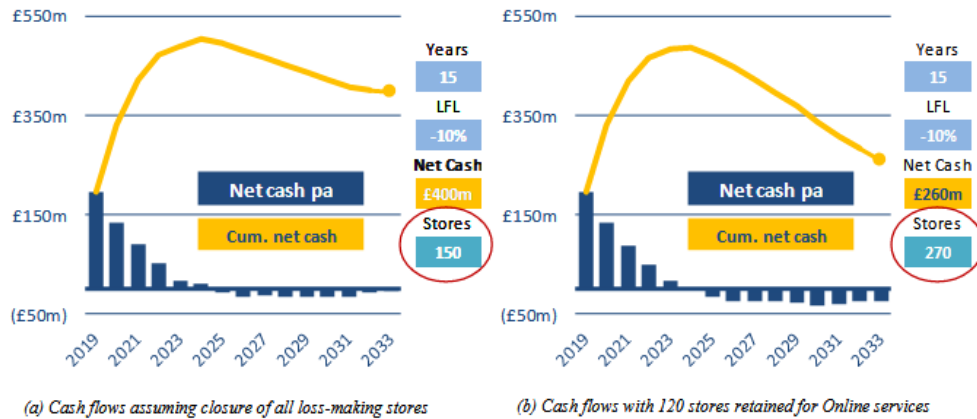
¹ Holland Views – Next – Phil fisher under our noses 0911 – 2567p

² Holland Views – Next – You can't handle the truth – 0317 – 4000p

it does provide a well analysed critique of the company’s present and future challenges and one that in truth we do not feel we can improve upon.

The following three slides extracted from company report and accounts outline the assumptions the group is making under this 15 year scenario. As we state above, we assume a good amount of study of this plan by the reader has already taken place. As such we will jump forward quickly in the next section to consider what this means for shareholders:

Fig.1: Retail Cashflow assumptions a) 150 remaining stores and b) 270 stores



Source: Next plc

Fig.1 summarises the cash implications from retail operations (i.e. physical stores) under two store count scenarios. As a reminder the Next hybrid retail model benefits from having and retaining a strategic store base for online customer returns. Please note the inflection point circa 2025 when retail cashflows are likely to go negative.

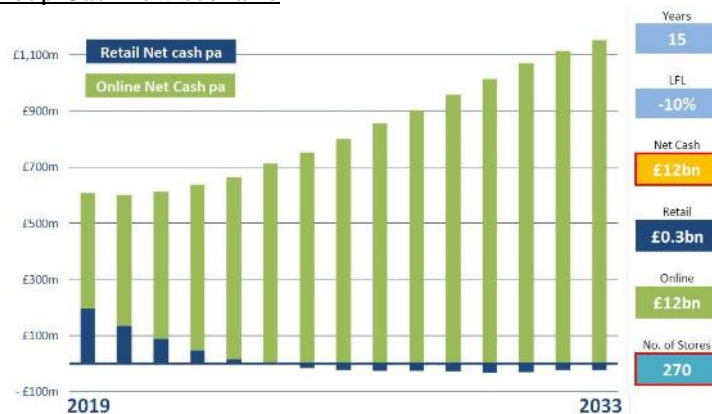
Fig.2: Next Online Cashflow assumptions

CAGR	Years 1-5	Years 6-10	Years 10-15	15-year CAGR
UK NEXT Online	+5.7%	+4.5%	+4.2%	+4.8%
UK LABEL	+14.6%	+6.9%	+4.1%	+8.4%
Total Online UK	+8.4%	+5.4%	+4.2%	+6.0%
UK Retail	- 10.1%	- 13.7%	- 13.5%	- 12.4%
Total UK	+0.0%	+0.7%	+2.2%	+1.0%
Overseas	+18.1%	+11.5%	+7.3%	+12.2%
Group Total	+2.4%	+3.1%	+3.6%	+3.0%

Source: Next plc

Fig.2 looks at the assumptions underlying Next’s ambitions in online retail. Again, as a reminder, Next is pragmatically morphing into an aggregator of 3rd party fashion brands in scale (LABEL). It expects LABEL will outgrow its own brand business (albeit from a lower starting point) which seems plausible to us. More on this innovative strategy later.

Fig.3: Next plc – Group Cashflow scenario



Source: Next plc

Fig.3 combines that two previous charts (along with the now regular separate investment in the Debtor book over the forecasted period) into an aggregate group pre-tax group cashflow.

Shareholder Return Modelling

On a number of occasions, we have shared with readers the simple IRR/compounding modelling we do for nearly all of the companies we follow in order to compare them with other opportunities³. Without such a framework we think it is not easy to compare companies with different levels of returns, growth, different starting multiples and different capital requirements/distribution policy. A detailed study of each company on the above metrics with some simple, but well thought through modelling however, can give far greater clarity to an investor of the sort of annual rate of return they might expect from owning the shares.

A last point before we get into the detail of Next. All the modelling of this nature we do is trying to be as realistic as possible (so we assume buybacks if excess cash is clearly available and is likely to be distributed). We also try to have a degree of prudence, so high starting multiples that may discount low prospective returns might be assumed to fall a little, but low ones for a high-quality business might rise.

What this all means for Next

The above chart (Fig.3) and the attached PDF (being an extract of the company's annual report that cover the detail of the 15 year scenario) clearly show the pre-tax free cash flow that Next plc might generate in each of the coming 15 years were this scenario to become a reality. These are shown simply in the table below (derived by eyeballing Next's summary chart). What can also be determined is how they compare to Next's current Market Cap (£7.7bn) and how much each grows or declines on the previous year. The CAGR of these cashflows is c.3% as the company observes in its statement, but as we observe later this is importantly back end loaded.

Fig.4: Next's (pre-tax) 15 year cashflow scenario

£m	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
pre-tax Group Cashflow	600	600	600	650	675	710	725	750	825	875	900	925	950	975	1,100
Mkt Cap	7,635														

Source: Holland Advisors

The power of Allocation

In all our work on Next and other cannibals (those companies that eat their own tails as per Charlie Munger's metaphor), it is important to model or think-through the power of continuous and savvy allocation to buy backs with genuine excess cash flows. As Next has been the poster child for this policy in the UK, it is right to consider the company in this way. In the following tables we do just that, making basic assumptions about a level of dividend and buy back consistent with Next's past policies.

On close inspection, readers will see that our starting point is the aforementioned pre-tax FCF which Next provides in the stress test and which we apply a 20% tax rate to. In our model which we present in two phases (Fig.5a and 5b), we also adjust for what we call the 'cost of growth' which we think is important to consider for all companies under this framework. In Next's specific case, where CAPEX and depreciation are likely to remain roughly equal, the cost of growth is largely confined to Working Capital and Investment in the Online Credit debtors book.

³ Indeed we hope this modelling and, to a greater extent, the thought process behind it is one of our key selling points as research providers. It has taken us many years but we have a way to compare cross industry ideas via this methodology – something we do not believe others even try to do.

Next has guided for -33m and -79m respectively in FY20 for these two items and its stress test assumes c.£900m in total investment in the Online credit over the 15 years which is helpful to know.

Fig. 5a: Holland Compounding Model [Phase 1: 2019-2024]

		2019	2020	2021	2022	2023	2024	5y cagr
pre-tax FCF (as per Next)		600	590	600	630	650	710	3.4%
implied Growth			-2%	2%	5%	3%	9%	
Less Tax(at 20%)		480	472	480	504	520	568	
Investment in Online Credit + Working Cap		110	110	100	90	80	70	
Implied PAT		590	582	580	594	600	638	
implied Growth			-1%	0%	2%	1%	6%	
Current Multiple	13x		13	13	13	13	13	
Ending Multiple	13x							
Company Value		7,670	7,566	7,540	7,722	7,800	8,294	
PAT		590	582	580	594	600	638	1.6%
	0%							
Cost of growth			110	100	90	80	70	
Excess Cash			472	480	504	520	568	
Dividend Paid	30%		142	144	151	156	170	
SBB Cash	70%		330	336	353	364	398	
Number of shares		137						
Number of shares bought			5.90	5.82	5.86	5.63	5.80	
Start of yr no. of shares			137	131	125	119	114	
End of year no. of shares			131	125	119	114	108	-21%
Subsequent End of Year value per share		55.99	57.71	60.19	64.67	68.55	76.81	20.8
DPS			1.08	1.15	1.27	1.37	1.58	6.4
Total return								27.3
% return								48.7%
Annualised return								8.3%

Source: Holland Advisors

What can be seen from Fig.5a above, is that, under Next's stress test scenario, an investment in Next shares today could compound for investors at 8.3% pa in the coming five years – without any assumed PE multiple expansion. This figure being very different from the c.2% CAGR growth of profits – the difference wholly explained by the use of excess cash.

A PE multiple of 13x is not unreasonable for a company that is effectively paying an earnings yield of 8% (i.e. 1/13) and growing free cash flow at a 0-3% rate.

Five years out

However, 5 years from now Next, with a more established online platform might be looking at the prospects of 5-8% pa growth in free cash flow. It would then have the ability to appeal to Mr Market's better side by stating that all this cashflow was coming from Online growth, with a store base there to just to support this growth, but no longer dragging it in terms of falling profitability. Might at that point Mr Market decide the share of Next are worth a little more than 13x.

Fig.5b shows the 2025-29 scenario. It starts a new five-year period when cashflow seems more likely to show more positive growth trends assuming Next realises its aggregator ambitions. Notably, as more sales will be realised outside the UK, the online credit investment will be reduced also as non-UK Online is predominantly a cash sales business. Again, without assuming any multiple expansion (i.e. staying at 13x PE) such a cashflow and distribution scenario would lead to c.11% per share returns for investors over that period. These returns are little more interesting and suggest a PE upward re-rating might be justified. The point here is not to be precise but to give ourselves a framework to think about Next and an investment that can be considered against others.

Fig.5b: Holland Compounding Model [Phase 2: 2025-2029]

		2025	2026	2027	2028	2029	5y cagr	
pre-tax FCF (as per Next)		740	790	860	900	940	5.8%	
implied Growth		4%	7%	9%	5%	4%		
Less Tax(at 20%)		592	632	688	720	752		
Investment in Online Credit + Working Cap		60	50	40	40	40		
Implied PAT		652	682	728	760	792		
implied Growth		2%	5%	7%	4%	4%		
Current Multiple	13x	13	13	13	13	13		
Ending Multiple	13x							
Company Value		8,476	8,866	9,464	9,880	10,296		
PAT		652	682	728	760	792	4.4%	
	0%							
Cost of growth		60	50	40	40	40		
Excess Cash		592	632	688	720	752		
Dividend Paid	30%	178	190	206	216	226		
SBB Cash	70%	414	442	482	504	526		
Number of shares								
Number of shares bought		5.40	5.35	5.28	4.90	4.64		
Start of yr no. of shares		108	103	97	92	87		
End of year no. of shares		103	97	92	87	82	-19%	
Subsequent End of Year value per share		82.62	91.18	102.92	113.49	124.92	48.1	
DPS		1.73	1.95	2.24	2.48	2.74	4.7	
							Total return	52.8
							% return	68.8%
							Annualised return	11.0%

Source: Holland Advisors

Reflections

Such framework leads us to the follow conclusions:

- By 2024 the worst headwinds created by falling store profitability will be passed. At which time the group might prospectively see profits and free cashflow growth revive to 5-7%. With good allocation of plentiful cashflow this could result in attractive investor IRR's of c.11% or greater. But 2024 is obviously a long way off in investor minds.
- Ahead of that time and importantly post the recent strong rally in the shares (£40 to £55) they now look at fair value (i.e. discounting an 8% IRR).
- The recent past of the company however has seen notable volatility in the multiple the shares have commanded as investors second guess its future. This is where the opportunity may present itself to investors.
- Due to the lack of near term free-cashflow growth the shares could be considered in a more bond-like manner. As such the starting prices we pay matter a great deal.
- **In the scenarios shown above we have laid out best guess investor IRRs of 8% pa for the first five-year period and 11% in the second. However, were these same cashflows to start with an 11x PE and have a 14x PE at the end period the returns would rise to 14.5% and 10.5% respectively. These returns are far more appealing hence our desire to be mean in the starting prices we are prepared to pay.**
- Indeed, the reason for our recent years renewed enthusiasm for Next was exactly this point i.e. that a once loved manager with proven compounding skills was offered to us for 10x when only a few years before we were asked to pay 17x. ROIC, growth and allocation of capital all matter but so do starting prices.

Today the shares seemingly do not present an obvious mispricing to near term cashflows (13x for 8% IRR) but they may well do again someday soon.

Two further observations + that crazy idea again

A way through the woods

Two years ago, we attended a number of meetings with Next shared with other shareholders. At the time we were struck about how obsessed these investors were about Next's decision to halt its buy back, instead opting for the odd special dividend. Rather than asking questions about the underlying business all were focused on this issue. One shareholder tellingly observed the following:

“Clearly you know more than us about the company's future (and intrinsic value) - so why are you not buying stock?” - Next Institutional shareholder – Spring 2017

At this point Simon Wolfson pushed back, stating that “98% of the information required to value Next was in its Report and accounts”. At the time we highlighted this disconnect between investors and the company with a note entitled “You can't handle the truth”. Next were then, as ever, being far more open than other businesses about the challenges that faced them. This was a shock to investors so used to the polished messages they received daily from so many other CEO's who were perhaps trying hard to hide from investors and themselves some of the unconfutable truths about their businesses.

Against this backdrop Wolfson comments last week when presenting the 15 year scenario we thought were telling:

“We think the business is positioned well, not just to survive, but also to develop a world-class aggregator business in the UK and develop as a brand overseas.

That is a very different position from the one we were in two years ago. Two years ago I said we were going to stop buying back shares because we can't see exactly how this is going to pan out. We still don't know, there is still a huge amount of uncertainty but we are much more confident today that we can see a route through the structural change towards a more successful online future for the group” – Simon Wolfson, March 2019

Prior to its recent results Next shares traded multiples to those in 2017 when it was looking into a far more uncertain environment. The risk reward on offer today is surely improved.

LABEL – an aggregator winner

We have raved before about the extent of business innovation at Next. We remain of the view that this has been crucial to the company's past success and think its future role will be just as important. For us there was for too long a debate amongst analysts that wanted to look at the 'underlying' numbers, often citing the problems at say Next Retail. This to us always missed the point, i.e. that Next always needed to be considered holistically. That its new developments were minnows in the profitability they created vs. the core led to them being sometimes dismissed, but these once minnows (Online, Overseas and LABEL) are now the drivers (saviours if you like) of the business today.

LABEL we think is worthy of special mention. The reason being that in quite a short space of time it has established a strong position as an aggregator of third-party clothing brands online in the UK. It is not the only one we accept, but we think its prospects are potentially very good indeed. Aggregators need to be great in terms of delivery and logistical efficiency and this is an area where we think Next have real and long lasting expertise.

That they can run a business like this for a c.15% margin is also interesting as they have to keep scaling up but doing so with an eye on efficiency the whole way. How much easier might it be to go for growth telling yourself that when you are bigger the efficiencies will come? Ignoring its brand, Next has for some time arguably been the best, most efficient distributor of online clothing

in the UK. It has constantly re-invested and stayed ahead of others trying to catch it. When spending time in front of the Next team one expression clearly come to mind, that...

“retail is detail”

...or more appropriately for the modern world: efficient and profitable distribution is all about detail.

An example of this can be gleaned by listening to the recent webcast⁴ of the Next Results. In it Wolfson talks at length about how they are now moving to get store workers after shop hours to handle and repackage online returns they have received so stock can more quickly go back into warehouse inventory for re-sale. Such return will soon be ready for sale in 2 days rather than the current 14. These are impressive improvements on what is already a very slick logistical machine. Despite how hard others have tried they have not been able to either replicate or catch up with Next in these important areas. Arguably as time and scale build so does the moat around its clothing distribution operation in the UK.

It is clearly premature to declare LABEL the defacto aggregator of UK clothing on line in UK. After all it only has sales of £414m in the last 12m. ASOS' UK sales are c.£900m and the total UK clothing market is estimated to be £48bn (of which £11.6bn is online according to ASOS). That said, we think due to its current position in the market and the distribution expertise Next has, LABEL has a chance of becoming a leader in UK clothing distribution. What does this mean? Well it might mean that the assumptions for LABEL's growth in Next 15years scenario could be too low. As Wolfson says *“we do not know what the future high street will look like but we do know that those walking will have clothes on”*. If the decimation of high street carries on as per widely held expectations brands will continue to distribute more and more online, but for most brands that entails a cost of fulfilment that is too high for them to burden alone. The aggregator who shares the economies of scale with them enabling them to focus on product design and innovation offers a compelling alternative.

In Next's 15 years scenario, LABEL is assumed to grow at 15% for the first 5 years and then 7% from the second phase (years 6-10). This would result in a business that had turnover of £820m 5y from now and £1.2bn 10 years from now. Were this business to achieve that level of scale and a position of respected dominance as the role of best UK clothing aggregator by customers and brands alike something else might happen. This being a tipping point that would create a much much bigger business.

[The crazy idea that we retain](#)

In our last piece on Next⁵, post reflecting on a number of these and other issues we made what we thought was a slightly 'out there' observations:

“What a potentially great add-on business Next plc would be for Amazon's fashion business!” – Andrew Hollingworth

Was it a slip of the hand or a pre-Christmas joke to see who might notice it? No. Just for the sake of clarity, we will repeat the assumption we made at the time.

“In short, the tremendous evolution of Fast Fashion pioneered (notably in Europe) by the likes of Inditex, H&M, ASOS (and to be fair, Next) requires a skillset that even the mighty Amazon lacks. We suggest Next could offer this expertise and an established presence and thus proof of concept in the UK market and a credible own label brand.

⁴ <https://www.investis-live.com/next/5c654901cad1ac0c00deca26/ghts>

⁵ Holland Views – Next – Observations on an innovator – 1018

The reason that Next specifically would make sense is that culturally, much of Next's approach is very similar to Amazon in its constant evolution/investment and being very focused on giving the customer what she wants and when. Let's not forget that Next have managed to do all this in the UK at scale" – Holland Views – Observations on an innovator

The logic of these opinions holds true today, we suggest.

Conclusion

All we are trying to do above is to create a structure in order for us to think in a disciplined way about a well-managed company in a tough sector. We are not blindly assuming the company's 15 year model will pan out as per plan, but do think it reasonable as the best lens to look at the company through today. Our compounding approach overlaid on it just makes this model easier for investors to interpret. We are inclined to be greedy. In the next 3-4years we just need Mr Market to worry once again (like he did in 2017 and Jan 2019). At that point, say on a multiple closer to 10x earnings, we think locking away a Next bond-like equity investment with some nice optionality will be compelling.

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