HollAnd Advisors

Holland Views – Price £25.67, MCap £4,425m

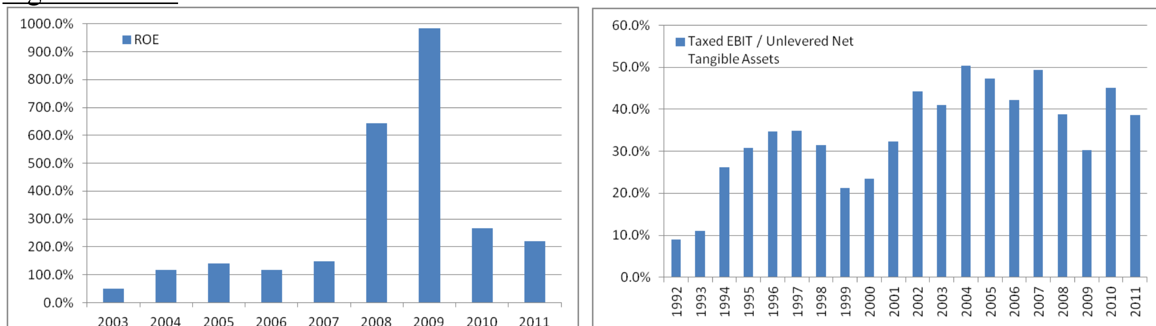
Phil Fisher right under our noses

We often tell our clients that we look at US markets a little more these days because there are so many more great investment franchises quoted there. Then we find one we have dismissed a little too quickly right under our noses. Whilst we have been aware of the attractive parts of the Next business model for a little while we have tended to dismiss it due to our continued caution on UK housing and consumption. In this note we try to give credit where it is due to Next and its managers who look to be 'innovating' and 'allocating' very well indeed.

Moved up, but still cheap vs. Returns

An impressive 25% appreciation of the groups share price so far in 2011 shows firstly how Next is bucking the all purveying gloom in the UK retail sector and also the error of us sitting on our hands in not looking at it more fully before now. That said the shares are still inexpensive for a business that we now observe is arguably doing all the right things. We are still being offered them at a PE of 10.8x company expected EPS to Jan 2012 or an 8.5x EV/EBIT to the same date.

Fig. 1: Returns



Source: Capital IQ / Holland Advisors

Financial excellence

- For a long while now we have insisted that great companies are defined by the level and quality of the returns they make on both assets and equity. As such when looked at on these two return metrics, Next looks in excellent shape.
- Next also demonstrates a number of traits we look for in many businesses, but specifically retail ones:
    - Goodwill is almost non-existent. It is currently less than 3% of total assets, demonstrating that the returns and growth the group reports have been organically achieved not bought.
    - Working capital, whilst not negative, is low. As a percentage of sales it averages 7%. This combined also with a large leasehold estate means the cost of growth for the group is very low. As a result marginal returns on capital are therefore very high. The cost of future growth could be lower still assuming it is likely to be directory / online orientated.

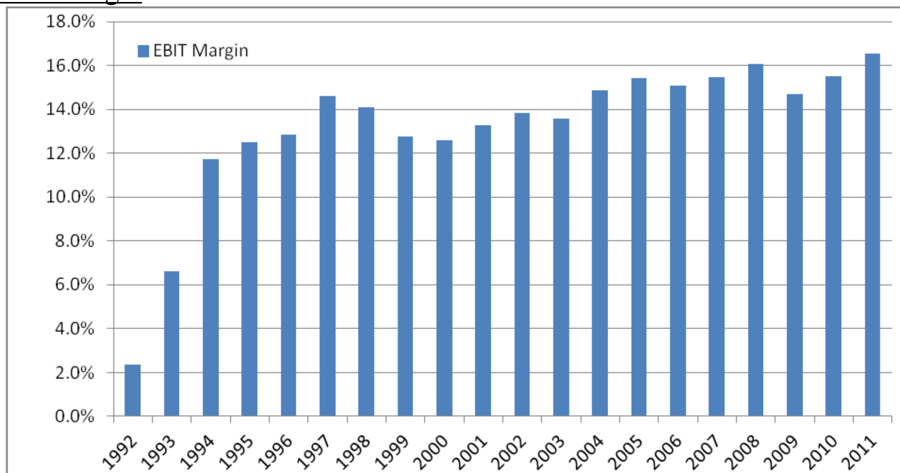
- The presence of mangers who act and think like owners.
- A low level of indebtedness.
- Constant innovation - An interesting point for Next which we will return to.
- A constant re-investment of scale that takes place for the customers benefit thereby securing future loyalty and likely growth - This is often visible in margins.

Margins

As with all our favourite retailers, stability of margin is something we look for as evidence of reinvestment in the customer offer/franchise. Whilst Next's margins are not the relentless and forecastable 6% we see every year from someone like Wal-Mart or Tesco, they do appear, over longer periods, to demonstrate similar stability. Watching the group's margin increase dramatically in the 1992-2002 decade, this author perhaps then assessed the group to be too keen to always keep the benefit of operational gearing for itself. Potentially therefore leaving itself one day more vulnerable.

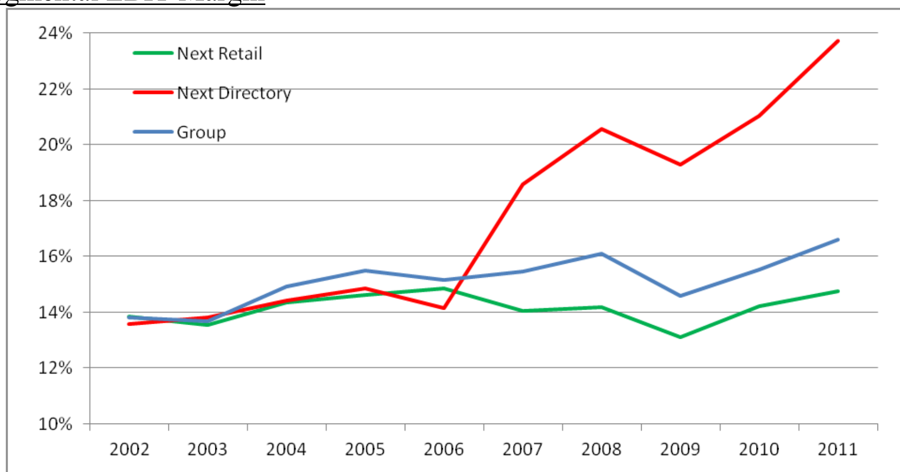
A re-look at both gross and EBIT margins over the years since and a re-reading of the company's philosophy suggests this assessment was wrong. As such the group looks to have exactly the margin stability trait we seek in franchise retailers. Current margins could be assessed as a little high in comparison to recent years, but clearly the directory business largely explains this as we illustrate below.

Fig. 2: EBIT Margin



Source: Capital IQ / Holland Advisors

Fig. 3: Segmental EBIT Margin



Source: Capital IQ / Holland Advisors

Current Trading

- As Next's Chief executive, Lord Wolfson, pointed out in the recent H1 statement, retail has been facing an almost '*perfect storm'* of rising input costs and depressed consumer sentiment. However, in the face of this adversity Next has experienced good sales trends reporting overall sales up 3.6% YoY for H12011. The key to which was, of course, the 15% rise in sales reported at Next Directory.
- What has maybe held Next's share price back before now has been the CEO's previous honesty about the retail situation. In the past he has talked of how '*retail is going to be different over the next few years'* and pointed out how bad the effects of inflation and a depressed consumer would be. Thus he has been right and consistent in this view. When therefore, Lord Wolfson suggested, as he did last week, that finally input cost inflation pressures are receding it was of note. The rise in the share price since these figures suggests we are not alone in being impressed by both the group's recent resilience and Lord Wolfson's improved assessment of current trading.

Next Directory - Growth and innovation

With all the admiration we show to Mr. Buffett another, equally influential investor is sometimes too easily over looked. Phil Fisher. Fisher was the great exponent of how to identify a growth company. One of his 15 tenets for such a company was whether a it was able to internally develop alternative businesses lines or product streams as additions to its core operations. Next directory looks just such a development. Equally a question Charlie Munger often asks is "*will technology kill your business or make it*?" Arguably technology and retail market changes are in the process of killing many retailers as we write but Next's development of its Directory division has significantly changed that debate for this group. We further observe:

- The background and speed of development of the Directory business is interesting especially when considered against the actions of other retailers over a similar period that arguably could have developed such a business and integrated it into the rest of their group but were slow to do so (Home Retail Group being a good example).
- Unlike such peers Next, whilst insisting that new store developments stand on their own feet when it comes to the justification of capital, realises the significant benefit of differing channels to market overlapping each other. This was shown in the groups 2011 full year results where they were able to exactly identify what amount of profit was derived from goods ordered on line but collected in store and what savings were made by Directory goods being returned via stores. In our view this is exactly the way a on and off line retail offering should be - Combined to build a competitive moat that single route to market operators will find progressively harder to breach.
- The scale of the profit that this division now makes is also interesting as it has now reached the tipping point where it has a far greater effect on the overall group profits reported as the recent figures clearly showed.
- Like the core retail operation, at some stage the Next directory business must reach a stable margin where more of the scale benefits are re-invested. At that point operating profit growth will clearly slow to the rate of sales growth but arguably this is not something we need to fear at the current valuation. The margin level at which this takes place however will be interesting to see.

- At this point we have not looked clearly enough at the inventory and therefore working capital levels that are required to run Directory as opposed to the core retail business, but note from our work on N Brown that they can be significantly reduced whilst offering a wider range of product and sizes. In Next's case this may likely reduce further the cost of future growth. We do however note the prudent Balance Sheet provisioning by Next of potential losses in Directory receivables.

Growth - 'New sources'

Whilst Directory will be the main source of growth for the group for the foreseeable future, what is also important is the process which lead to its development was one of innovation. Earlier this year Lord Wolfson said *"despite the gloomy prognosis for the economy Next can continue to grow new sources of revenue and that total sales can be maintained or possibly advanced on last year".* The key words for us here are "*new sources*". Clearly the group sees opportunities both in the Home segment of the market and internationally online, interestingly now focusing international expansion away from the idea of rolling out direct store ownership.

What is interesting about each of these areas is that the group discusses the economics of them very clearly and understands both where each division can help benefit another but also the need for each to quickly earn a return on the capital invested. We are not ones to swoon over management actions or future plans as we are skeptics at heart but we must confess to being highly impressed with both the exceptional development of the directory business and the current innovation which suggests to us that other '*sources'* of revenue could likely follow on behind Directory. This is what Phil Fisher tells us to look for.

A note of caution on Next

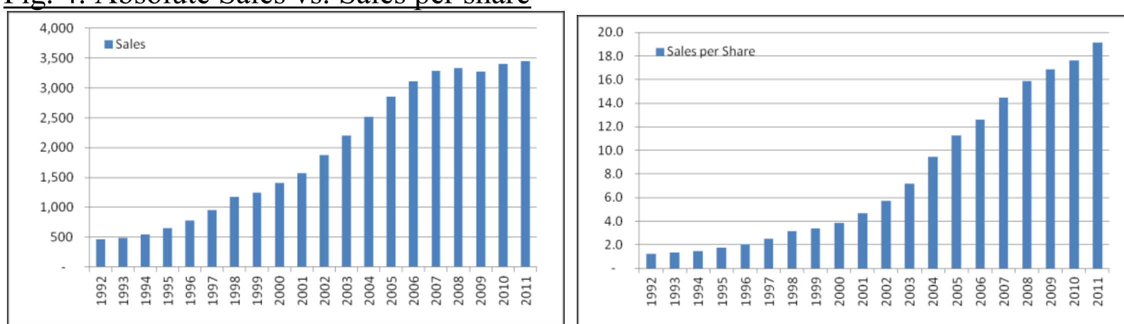
To you average Next bull we have maybe not unveiled anything in this note they were not already aware of, but we were keen to put a marker down. Firstly to correct the omission of not doing so previously and also ahead of any more detailed work we might do to improve, or not, our conviction in the Next business model. That all said we would highlight a couple of notes of caution:

- Firstly, identifying bullet proof investment franchises in the world of retail fashion is something that we think is much harder to do than in ultra low cost retailers such as Primark, Costco, Wal-Mart or Tesco as there is inherent discretionary spending attached to fahion orientated business models. As such despite its impressive past and recent trading resilience there will always be a greater uncertainly in our minds as to Next's earning power vs some other franchises. That said we realise this would have meant for many years ignoring such companies as ASOS, H+M, Inditex and even N.Brown. All of which have been excellent investments over the long term.
- The second is the leasehold nature of the business. This does mean the group (and admittedly its peers we highlight above) has a greater Equity downside if ever the earnings power were impaired for a period of time. Arguably by contrast there is far greater asset backing in groups like Tesco, Morrison or Wal-Mart. That said, like Greggs the lack of debt Next holds at the group level is a sign of its understanding of this fact.

Growth + Capital allocation - Top Marks

- The below charts show a key point concerning Next. I.e. Its management thinks like business owners and as a result has mitigated a tough economic period with prudent and logical capital allocation.
- The first chart on the left below shows absolute sales. Here is why investors worry about the group. Where does the growth come from in this environment?
    - Retailers will have slowing sales in recessions...That Next has managed to keep a relatively steady revenue line over the past three years is clearly an achievement – helped by the Directory businesses growth.
    - But, if we look at the right hand side chart we can see that the relentless buyback of shares means that sales per share have continued to rise at a very respectable rate.

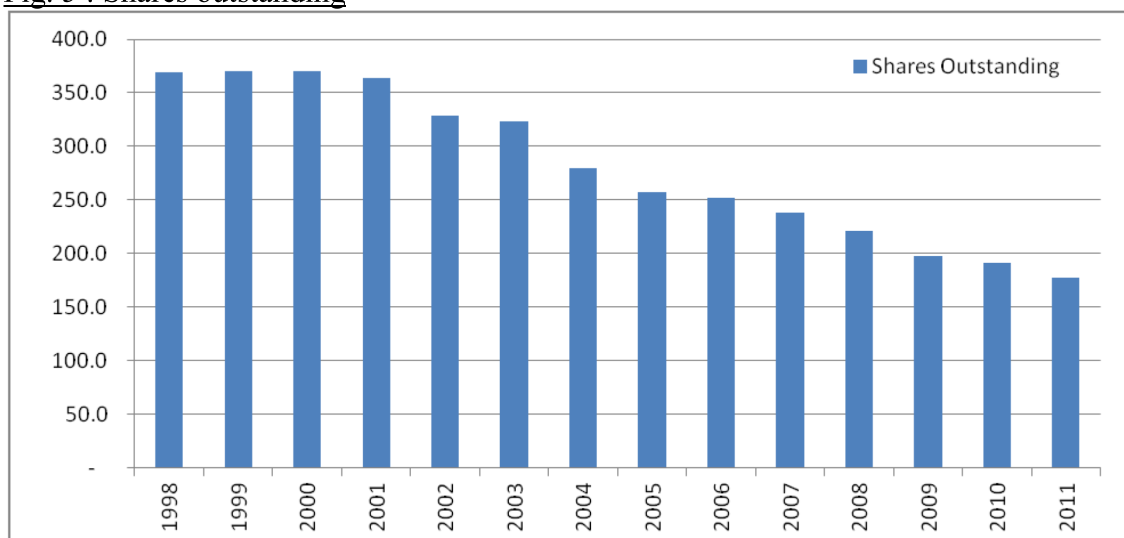
Fig. 4: Absolute Sales vs. Sales per share



Source: Capital IQ / Holland Advisors

- Shares outstanding are shown below. Most investors are familiar with this chart for Next. In the year 2000 Next's shares in issue were 370m. At the end of this year they are estimated to be 171m. That is 54% of shares bought back in 11 years. Fig.6 shows then shows just what an effect this has had on EPS and other per share growth rates.

Fig. 5 : Shares outstanding



Source: Capital IQ / Holland Advisors

Fig. 6: Absolute vs. Per Share Growth rates

	10 yr annualised growth to FY2011	
	Absolute	Per- Share
Sales	8.20%	15.10%
EBIT	10.60%	18.80%
Net Income	9.80%	16.30%
Dividends	6.10%	12.50%

Source: Capital IQ / Holland Advisors

One of the reasons we are so often distracted from our home market to analyse companies overseas is due in part to the excellent capital allocation decisions many great companies make. We have found many such businesses in the US which as a result means they are often more attractive investments than their UK alternatives. Examples include our favoring of: Lorillard over Imperial, Nothrop over BAE and Autozone over Halfords. The point here for Next is that we consider it world class in the allocation of its capital, investing in its stores and Directory formats when right to do so but otherwise returning excess funds to the business owners – shareholders. We quote Lord Wolfson again "*We will not pursue buy backs to the detriment of developing the business*" Many UK Boards could learn a great deal from this disciplined and simple process. On a wider note we conclude, post studying a number of such good capital allocators and other companies around the world, the following:

Stock markets nearly always over pay for growth (or perceived growth) but in turn nearly always under reward great allocators of capital.

The past (and arguably current) earnings multiples that Next shares trade on suggest that is true of this company too.

What 'Next' for the shares? – Our conclusion

Below is a table in which we compare Next's per share growth rate to those of H+M and Inditex. Headline growth rates in Sales and earnings at these two companies have exceed those at Next, but clearly the use of capital by the UK group to buy in its own shares has meant the gap is not so marked when looked at on a per share basis.

Fig. 7 : Absolute vs. Per Share Growth rates vs Peers

	Annualised growth rates - 1999-2011			
	Absolute Sales	Sales per Share	Absolute Earnings	Earnings per Share
Next	8.90%	15.50%	10.3%	16.3%
H&M	12.00%	11.99%	15.0%	15.0%
Inditex	18.80%	18.70%	21.6%	21.5%

Source: Capital IQ / Holland Advisors

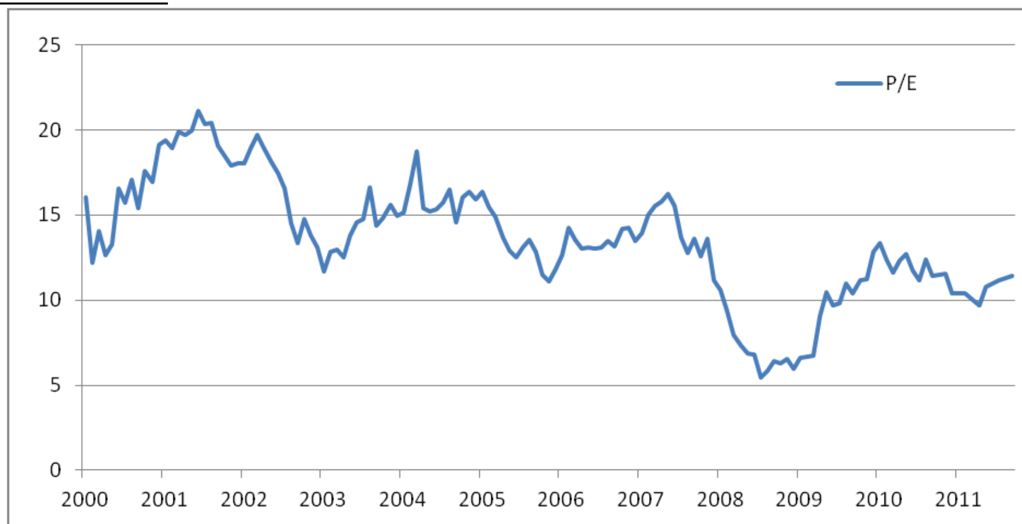
Why the difference in valuation?

Is the Directory business seen by UK investors as a one off innovation and therefore they are ultimately discounting a limit to Next's growth once it and the store base matures in the UK? Alternatively, is the valuation low just because of its dependence on the UK consumer means it must be rated more conservatively at this point in time?

Interestingly H+M and Inditex have proved for a long period, and in many retail environments, that they can grow their top line but remain highly profitable. Consequently their shares have been consistently highly rated to reflect this fact.

We therefore wonder, were Next to show continued resilience to a slowing UK consumer environment and innovation in wider areas such as overseas online, whether its low rating against such peers might not be reconsidered? Clearly one of the contributing factors that have made the buy backs of Next's own shares so powerful is the low rating Next shares sit on vs. their Return on Capital and growth. By repeatedly using excess cash to buy shares management is consistently but politely making that point year in year out to the stock market. Maybe one day it will take the hint.

Fig. 8 : Next P/E



Source: Capital IQ / Holland Advisors

In short we like Next's returns and we like its owner thinking managers. We are impressed by its past and current innovation and we love its capital allocation. The continued squeeze on all UK retail customers troubles us for we do not expect it to abate any time soon. That all said, on a P/E of 10.8x low end 2011 company guided EPS and EV/ LTM EBIT of 8.5x we think Next shares are maybe long overdue a more significant re-rating. Recent share price performance suggests it may have already started. Buy Next.

A wider comment on the changing face of UK retail

This section could easily justify a full research note in its own right. Having spent some time now looking at a number of retail companies and their models in the US and then re-assessing a number of UK businesses that have changed the way they are run, we feel there is a clear distinction between those that are embracing models we think are self re-enforcing and those that are dangerously carrying on as they always have.

Long suffering readers may remember the 'Northern Pike' analogy we made to describe the 1970's relationship between Wal-Mart and Sears. I.e. that once a Northern Pike got into a fresh water Canadian lake it was just a matter of time before it had killed off all the indigenous Trout.

As such we list our Pike and Trout contenders below in the UK retail sector. We have done more work on some companies than others, and the list is far from exhaustive but hopefully still of interest. Interestingly we think there are far more Pike's than there were 5 or 10 years ago (Primark's development, Bookers turnaround and Kingfishers?) and there may be wider consequences of this fact.

Fig. 8: UK retailers as Fish

Canadian Brown Trouts	Northern Pikes
Marks & Spencer	Primark
Home Group	Tesco
Halfords (?)	Wm Morrison
Marstons	Kingfisher (a trout pre recent changes)
	Booker
	Next
	Greggs
	J. D. Wetherspoons

Source: Holland Advisors

A few observations come to mind.

- Firstly, as more and more listed retailers follow the well proven price and quality re-investment model we admire it suggests a likely accelerated gain of market share from the unquoted independents in each field. A point that is hard to measure but one that could help to square the circle between quoted sector expansions and overall consumer retrenchment.
- Secondly, that there may come a point when if enough operators are now collectively pursuing equally good customer centric business models they start to cannibalise each other. Arguably this has happened in the US a little of late with Dollar and online stores stealing some market share from the likes of Wal-Mart and Target.

In turn this suggests as investors we need to be even more discerning in our choice as to what makes a "great" retail investment and even more careful in our assessment of those that make even the smallest slip up.

With apologies for being slow off the mark in our Next analysis.

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Appendix 1

NEXT GROUP PLC (LSE:NXT)

29/01/2011	Average	FY2011	FY2010	FY2009	FY2008	FY2007	FY2006	FY2005	FY2004	FY2003	FY2002	FY2001	FY2000	FY1999	FY1998	FY1997	FY1996	FY1995	FY1994	FY1993	FY1992	FY1991
Working capital		311.7	181.2	434.0	309.6	135.3	218.5	173.1	139.9	118.6	57.5	106.3	166.2	185.3	151.9	105.9	57.2	42.8	67.1	97.9	(41.1)	94.0
EBIT		570.8	528.2	480.7	535.3	507.3	468.9	440.3	373.5	298.8	258.6	208.6	177.8	157.9	165.9	138.2	99.5	81.6	63.8	32.0	10.9	7.0
Net Income		401.1	364.1	302.4	354.1	331.5	313.5	305.4	250.1	210.5	189.8	157.6	140.2	123.9	136.6	118.2	105.5	81.3	64.2	26.7	11.4	(220.2)
S.Equity		232.4	133.4	140.5	(79.1)	189.3	256.2	276.5	155.1	275.1	546.9	499.7	606.7	542.8	489.8	420.8	359.2	292.2	244.0	198.6	168.5	160.0
Sales		3,453.7	3,406.5	3,271.5	3,329.1	3,283.8	3,106.2	2,858.5	2,516.0	2,202.6	1,871.7	1,571.0	1,411.0	1,239.1	1,176.8	946.3	773.8	652.9	544.2	484.7	462.0	877.9
Sales Growth		1.4%	4.1%	-1.7%	1.4%	5.7%	8.7%	13.6%	14.2%	17.7%	19.1%	11.3%	13.9%	5.3%	24.4%	22.3%	18.5%	20.0%	12.3%	4.9%	-47%	-8%
WC % Sales		9%	5%	13%	9%	4%	7%	6%	6%	5%	3%	7%	12%	15%	13%	11%	7%	7%	12%	20%	-9%	11%
WC % Net Income		78%	50%	144%	87%	41%	70%	57%	56%	56%	30%	67%	119%	150%	111%	90%	54%	53%	105%	367%	-361%	-43%
EBIT Margin	14.9%	16.5%	15.5%	14.7%	16.1%	15.4%	15.1%	15.4%	14.8%	13.6%	13.8%	13.3%	12.6%	12.7%	14.1%	14.6%	12.9%	12.5%	11.7%	6.6%	2.4%	0.8%
Unlevered Net Tangible assets		990.2	786.1	1065.4	924.6	687.7	744.6	622.6	496.6	489.2	392.1	433.3	506.0	499.7	353.3	265.0	191.7	177.3	162.9	194.2	81.4	323.1
Total LT Assets		725.0	652.3	686.8	651.2	588.6	562.3	485.7	392.9	401.6	334.6	327.0	339.8	314.4	201.4	159.1	134.5	134.5	95.8	96.3	122.5	229.1
Gwth rate in Lterm assets		11%	-5%	5%	11%	5%	16%	24%	-2%	20%	2%	-4%	8%	56%	27%	18%	0%	40%	-1%	-21%	-47%	-25%
Returns	**10 Yr Avg**																					
Taxed EBIT/Unlevered Net tangible Assets	43%	39%	45%	30%	39%	49%	42%	47%	50%	41%	44%	32%	24%	21%	31%	35%	35%	31%	26%	11%	9%	1%
Taxed EBIT/Total LT assets	55%	53%	54%	47%	55%	58%	56%	61%	64%	50%	52%	43%	35%	34%	55%	58%	50%	41%	45%	22%	6%	2%
ROE (NI/AvgSE) Calculated	272%	219%	266%	985%	643%	149%	118%	142%	116%	51%	36%	28%	24%	24%	30%	30%	32%	30%	29%	15%	406%	411%
Payout ratio (incl Specials and Share repurchases)	38%	38%	38%	35%	33%	34%	35%	35%	38%	46%	48%	53%	56%	57%	50%	48%	0%	0%	0%	0%	0%	0%
BVPS	-1.3%	1.33	0.71	0.73	(0.40)	0.86	1.08	1.10	0.60	0.99	1.69	1.52	1.67	1.49	1.32	1.14	0.96	0.78	0.65	0.54	0.45	0.43
Total Dividends including Specials per share		0.78	0.66	0.55	0.55	0.49	0.44	0.41	0.35	0.31	0.28	0.24	0.21	0.19	0.18	0.15	-	-	-	-	-	-
Return Components																						
Gross margin		29%	29%	28%	29%	28%	28%	28%	30%	30%	30%	30%	32%	32%	31%	31%	32%	33%	31%	28%	16%	19%
EBIT Margin		17%	16%	15%	16%	15%	15%	15%	15%	14%	14%	13%	13%	13%	14%	15%	13%	12%	12%	7%	2%	1%
Asset turn		3.5	4.3	3.1	3.6	4.8	4.2	4.6	5.1	4.5	4.8	3.6	2.8	2.5	3.3	3.6	4.0	3.7	3.3	2.5	5.7	2.7
R&D as % Sales		0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Sales Increase	8%	1%	4%	-2%	1%	6%	9%	14%	14%	18%	19%	11%	14%	5%	24%	22%	19%	20%	12%	5%	-47%	-8%
Asset Increase	7%	11%	-5%	5%	11%	5%	16%	24%	-2%	20%	2%	-4%	8%	56%	27%	18%	0%	40%	-1%	-21%	-47%	-25%
What is the price?																						
EV/EBIT	8.6	7.6	6.9	6.1	9.6	9.1	8.9	9.4	8.8	10.5	11.0	10.6	13.4	12.2	15.4	(1.2)	(1.7)	(1.5)	(1.4)	(0.4)	8.2	70.1
EV/Unlevered Assets		4.4	4.6	2.7	5.6	6.7	5.6	6.7	6.6	6.4	7.3	5.1	4.7	3.8	7.2	(0.6)	(0.9)	(0.7)	(0.5)	(0.1)	1.1	1.5
Justified EV/Unlevered assets (using a 10% Hurdle)		5.8	6.7	4.5	5.8	7.4	6.3	7.1	7.5	6.1	6.6	4.8	3.5	3.2	4.7	5.2	5.2	4.6	3.9	1.6	1.3	0.2
P/E	10.8	9.5	8.8	7.5	12.5	12.7	12.1	12.8	11.9	14.0	16.0	14.6	17.9	16.0	19.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
P/B		16.4	24.1	16.2	(56.0)	22.2	14.8	14.1	19.1	10.7	5.6	4.6	4.1	3.7	5.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Justified P/B(using a 10% Hurdle)		32.7	39.7	147.0	95.9	22.2	17.6	21.1	17.4	7.6	5.4	4.3	3.6	3.6	4.5	4.5	4.8	4.5	4.3	2.2	60.5	61.3
Capex / Depreciation																						
Capex		120.6	98.6	120.6	179.3	139.9	177.2	144.0	99.8	86.3	72.8	61.6	67.3	118.9	75.6	37.7	40.2	33.4	19.8	8.9	5.0	0.0
As a % of Sales		0.0	3%	4%	5%	4%	6%	5%	4%	4%	4%	4%	5%	10%	6%	4%	5%	5%	4%	2%	1%	0%
Depr(From Report + Acc)		118.4	122.3	116.5	108.4	102.3	81.2	69.0	62.3	59.1	54.4	41.3	36.1	25.9	26.3	17.0	14.1	17.4	17.7	28.4	21.6	0.0
Capex as a percentage of Depreciation		1.0	81%	104%	165%	137%	218%	209%	160%	146%	134%	149%	186%	459%	287%	222%	285%	192%	112%	31%	23%	#DIV/0!
As a % of Total Lt Term assets		0.0	0%	0%	0%	0%	0%	1%	0%	0%	0%	0%	1%	2%	2%	2%	2%	2%	1%	0%	0%	NA

Debt analysis

	Today	FY2011	FY2010	FY2009	FY2008	FY2007	FY2006	FY2005	FY2004	FY2003	FY2002	FY2001	FY2000	FY1999	FY1998	FY1997	FY1996	FY1995	FY1994	FY1993	FY1992	FY1991
Total Debt	707.8	600.9	531.0	692.9	784.2	546.1	432.4	323.1	369.2	221.4	7.4	9.9	2.1	4.2	4.2	1.6	4.9	5	4	6	204	545
Total Debt / Equity	3.0	2.6	4.0	4.9	(9.9)	2.9	1.7	1.2	2.4	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0	0	0	1	3
Net Debt		551.6	424.0	645.1	728.2	424.4	362.6	250.8	306.9	188.8	(194.0)	(94.3)	(122.6)	(59.6)	(143.3)	(163.6)	(170.4)	(120)	(88)	(12)	89	491
Net Debt to Equity		2.4	3.2	4.6	(9.2)	2.2	1.4	0.9	2.0	0.7	(0.4)	(0.2)	(0.2)	(0.1)	(0.3)	(0.4)	(0.5)	(0)	(0)	(0)	1	3
EBIT/Interest	26.2	26.4	19.8	10.1	14.3	17.5	22.8	24.2	21.6	996.0	(35.9)	(45.3)	(22.5)	(17.5)	(15.4)	(10.5)	(7.8)	(10)	(10)	7	(9)	0
PBO		451	451	482	395	428	427	429	328	-	-	-	-	-	-	-	-	-	-	-	-	-

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