Holland Views – Next plc – Price: £40; MCap: £5,960m

'You can't handle the truth'

We have written on Next many times over the years highlighting what we think are tangible and intangible strengths the group possesses - trying to do so especially at times Mr Market feels more downbeat on the company. Last year's piece (*Holland Views – the Wizard of Oz – Sept 2016*) was written after meeting with the company and our reflections on the many levers the company management can chose to pull day to day to influence the business. Last week we, and some other investors, sat down with Simon Wolfson once again - our new reflections are below.

Allocate 'score': 9/10

For a business to be deemed a Franchise in our eyes, we make much of the need to tick the three boxes of Operate, Generate and Allocate. In particular, we find many European companies notably lacking on the last point. For many years now, Next plc has in our mind been the FTSE100 stand-out 'poster boy' of what to do with excess capital. Even going so far in the past as to articulate the framework for why and when it would buy back stock.

This being the case we find it odd that c.40% of the time at the Next investor meeting we attended was spent with investors debating the rights and wrongs of a Buyback vs a Special Dividend. We think the difference between the two is so nuanced as to make the debate somewhat futile. We might observe that if a manager really wished to be prudent why not just keep the cash for a year or two and then give it to shareholders, ie for now, do neither a Buy Back nor a 'Special'. One interesting insight which did come from this debate however was from an assumption by a few investors suggesting that '*clearly you know more than us about the company's future (and intrinsic value) - so why are you not buying stock?*' We re-visit this observation below, but for now will just summarise with the following rhetorical questions on this issue.

- Do we trust Wolfson and Team to allocate future excess capital wisely and to do so better than 98% of UK-quoted companies? Yes.
- Does Wolfson still have significant 'skin in the game'? Yes.
- Is he selling stock himself? No.
- Additionally, might things go right or wrong in the future suggesting a buy back today was either a good (or bad) idea in hindsight? Yes.

We observe that Next is one of the best allocators of capital in the UK stock market – therefore investor time is, we suggest, ill-spent over-analysing this area when other challenges confronting the company on the operational front are far more pressing.

How great companies *really* operate

In addressing the above point on the management team's ability to see/know better into the company's future than shareholders, Wolfson was incredibly candid. He observed that the vast majority of information needed to assess the group's prospects was actually in the Report and Accounts with management in possession of very little extra pertinent information on future prospects. A cynic may dismiss this point but we found it thought-provoking.

Maybe too many of us sit in front of a company manager wishing to glean absolute clarity and certainty in the way a gullible tourist might do from a fortune teller. Lord Wolfson could easily choose to lay out a road map, present it with confidence, and then try to deliver it. Next shares would likely rise and investors would feel more secure in their ownership. But Wolfson is an open and candid realist. He is also an entrepreneur. Last week we listened to an interesting TED talk on entrepreneurs and African Aid. Its ending strap line was we thought relevant:

> "*Planning is the death knell of entrepreneurs*" – Ernesto Sirolli's Ted Talk

Those words rang in ours head when the Wolfson explained why he has little more idea of what the business will look like in three years' time than we do. Ergo:

> *"we try things….if they work we preserve with them, if they don't, we do not".* – Simon Wolfson March 2017

In this context, he gave the example of 'Home' store formats and in-store Costas. He expanded *'we tried these ideas out, they worked so we expanded them more fully'* This is also likely why he feels he cannot have any great certainty on the company's outlook more than 2-4 years out, as some of the products/services they provide to customers he might not even know about yet. Next plc fans might think this next comparison is in bad taste (!), but Mike Ashley said something very similar in December. "*we throw a lot of mud at the walls and some of it sticks"*. This seemingly chaotic approach unsettles some investors, but we suggest it is part of the reason why such companies have done well for long periods. It shows a lack of fear of failure and openness to experimentation – a trait many great businesses share.

In an investment book we are currently reading - Jim Collins' *'Built To Last*' the author suggests that visionary companies have a core ideology that they preserve, but they are always trying new products, new approaches and the quest for self-improvement is perpetual.

Four Key Traits of visionary companies according to 'Built to Last':

1. Preserve a core ideology
2. BHAG (Big Hairy Audacious Goals)
3. Trying new things
4. Constant innovation in new products and services

Openness is unusual in our industry

In last Septembers piece, we observed Wolfson as being the Oz behind the curtain with many levers he can pull to determine the future of the company. The key is *when* to pull which one. Post this recent meeting we will take the analogy one step further.

When sales, profits and earnings were rising strongly the sun shone so brightly in the land of Oz that no-one cared what lay behind the curtain. That the company CEO now frankly outlines the challenges the business faces and the lack of certainty he or his management colleagues have in resolving them is unsettling to many investors, but he is just being honest and candid.

We perhaps should not reflect on how awful the outlook for Next must be as a result, but instead on how so many other companies pretend to have more certainty than actually exists. Their futures maybe equally uncertain, but they would really rather not think about it and certainly not discuss it with their shareholders. In openly admitting such challenges Next is half way to finding a solution.

An example of this is the answer Lord Wolfson gave to a good question on whether the group's currently-elevated Returns and Margin might not be sustainable. He quickly responded immediately and bluntly "*they might not*".

He, like us, can see the greater challenges the group faces with more companies catching-up online and today he either cannot see, or has not found a way yet to differentiate Next from these challengers as he has done in the past - hence the admission. However, alongside such realism, lies a deep-seated determination to keep trying to find new ways to innovate, grow and sustain such returns.

Next's history of innovation is on our side

With the headwind the group openly admits to facing, it is foolish to just assume that the company wins-out just because that is what they did 10 and 20 years ago when the last major profit challenges came. That said, the building blocks for likely success we suggest are surely in place; these being the openness and determination to find new customer offerings/formats that are relevant. We observe a relentless drive to constantly innovate for the customer's advantage and a focus on detail that is impressive from a CEO that could quite easily at this stage of his tenure chose to delegate more and take a more 'big picture' view of company strategy. This point was in evident when he and the FD were asked about possible acquisitions. Wolfson was crystal clear on both how little value acquisitions create, but also on the disruption that they cause as senior managers eyes are constantly distracted from the core task of running of the business. A distraction that he openly admits you cannot get away with in retail.

Fig.1: Next - Cycles come and go

Source: Next plc, FY17 presentation

High Risk- or just High Uncertainty

To be too certain on the outlook for such a retailer-even such a cheap (PE = 10x) well managed one as Next is bordering on delusional. From this point, like all investment, it is a game of odds; what does the share price today discount vs what will Wolfson and his team likely achieve? Our first ever piece on Next referenced Phil Fisher's book ('Common Stocks and Uncommon Profits'). The key Fisher highlighted in identifying growth companies was their ability to adapt and find new products and services that today we/they have not yet thought of. With that view in mind, with a manager of this pedigree still having skin in the game and working hard daily to innovate we are inclined to back him to succeed from this starting valuation.

We would also note a few further points:

1. The time to be perhaps most fearful of a company is maybe not now when an aligned manager is so candid about the future and as a result his collective shareholders are fearful. Instead it is when a heretofore great performing company sees its star CEO quietly drift off, selling his/her stock as they go.

The stock market has plenty of examples of these (Tesco/Aggreko). It has far too few mangers who are so open and honest about the difficulty and uncertainty their business faces and then get on with trying to address said challenges.

2. A key point remaining in our minds is the maintainability of the company's premium margins over its peers. When such a sales headwind is confronted, premium margins feel a stretch to maintain. Whilst this is any area we need to think about and investigate further a few points give us comfort:

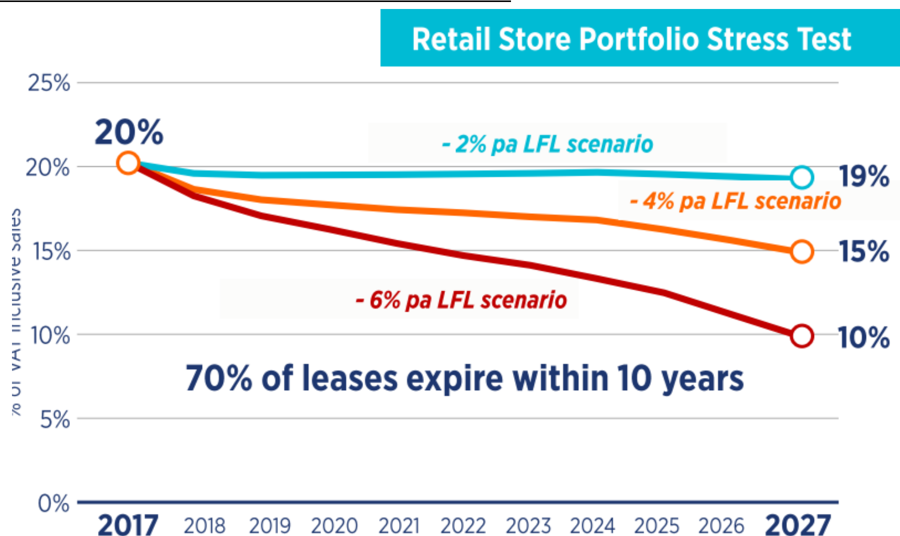
    a. In the bearish scenario laid out below. Next retail is suggested to have a 10% Margin after 10 years of 6% negative lfl sales. However current year forecasts already have it at 12%.

    b. The premium margin at Directory is a double-edged sword - impressive or at risk depending on your view. We note however the lack of scale in both Overseas Directory and Label and yet impressive margins of c.16-20% that are not so far behind total Directory at 25%. Understanding the future drivers of these on-line margins we think is crucial to the Next investment case. On this we will think harder.

3. The Share buy-back debate misses a crucial point we highlighted last year. Next have laid out for all to see all the headwinds they face – furthermore they have even done something we think unprecedented in illustrating what their retail business will look like if poor LFL trends persist for 10 years – see below. This shows how the retail business will make lower margins, but still some money, but under such a scenario will others fare much better? Probably not. More importantly is what will others do with shareholder capital were such a scenario to arise? That we think is easy to answer - they will bet all on Red or Black, ie make the scale of acquisitions that will help to mask such an underlying sales deterioration - and they will do so with your money. An owner manger like Wolfson will make no such gamble and has told his fellow investors such.

    When assessing total actual shareholder returns delivered over time, this careful stewardship of capital we think matter greatly.

Fig.2: Stress Test – not a common exercise in Retail



Source: Next plc, FY17 presentation

In summary

Our view on Next shares is obviously subjective and clearly, it is centred on the quality and lengthy track record of its 'jockey' Simon Wolfson. Two investors attending the same meeting as us last week might indeed have derived two contrasting views on the outlook for Next's shares; one perhaps only seeing his talent for innovation and the other only the headwinds the company is facing.

Our point is simply this: we, like Simon Wolfson, have no crystal ball into Next's future, but we retain enormous respect for the companies' innovation and dedication to the tasks of evolving a company while retaining its ethos. Current uncertainty provides a cheap valuation to buy into a business that has weathered enough storms to *suggest* it can prevail.

It is often said, "*you pay a high price for a cheery consensus*", but let us invert that and recognise that a consensus in disarray can provide a cheap entry price into a great business

Buy Next.

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