HollAnd
Advisors

Holland Views: Boohoo plc – Price: 320p; MCap: £4bn, EV: £3.5m

We have seen this movie before

Are there similarities in being a movie critic and a business analyst? Assessing storylines, actors, blown budgets, dealing with suspense, rumours all seem to be at the heart of both fields. Today we discuss a movie that was released in 2014 but until recently we had yet to watch as it was targeted at a millennial audience (and frankly we were too snobby to review!). It is already deemed a box-office hit but we think it could in time be a classic.

We see many similarities within it and key elements of some of the old (out of favour) classics that we love. This particular movie got some very bad press earlier in the year with tabloid headlines along the lines of "*Billionaire impresario employs slave labour in Leicester sweat shop"*. This to us seemed like a re-run of a recent critic take-down of another cult classic "*Boss with wad of £50 notes pays less than minimum wage*" for which we had a ring side seat!

OK, enough of the awful analogies. The business at hand today is Boohoo.

Boohoo and the merits of cloning

Many years ago we saw there was often significant value in arriving second. We read constantly how master business people such as Michael O'Leary and Sam Walton set out to copy proven business practices. Pioneers in an unconventional sense, they cherry-picked a good idea that someone else was doing and just executed it much better. Memorably, we read of Sam Walton found lying down in a competitor's store to measure how wide the supermarket aisles were. Or how O'Leary sat drinking Bourbon all night with Herb Keller and almost forgot the wisdom gleaned the next morning. Interesting too, that Tim Martin gave a copy of Sam Walton's autobiography to all 400 of his pub managers.

The closer we get to understand these great founder CEOs and their methods, the more intelligent plagiarism we see all around us. We sense there is much of this at work at Boohoo. This observation is not designed to take anything away from the powerful business which the Boohoo entrepreneurial founders have built from scratch. Rather, we are trying to provide perspective on some of the intelligent building blocks employed and implications for Boohoo's future prospects.

The lucky generation of retailers

Many an established business when confronted with the ever-evolving dynamic of customer demand and the cost of fulfilling it is cursed with the "*you would start from here*" problem. In retail, that largely relates to legacy stores estates (and associated rates and labour burden) that were requisites of past growth. As a so-called "disruptive" business, Boohoo and others enjoy the advantage to solely sell via online retail channels. These disruptors also enjoy the benefits of large-scale data-driven insight into customer habits and ever improving supply chain and delivery infrastructure.

The barriers to entry are *theoretically* lower. But when exceptional operators take advantage of these new found business tools, and scale compounds, the result can be a tremendous flywheel as online operators outside fashion already demonstrate.

Buy or build (or indeed both)?

An obvious distinction in the world of fashion retail is whether a business choses to develop and distribute its own in-house brands or resell those of a third party (or indeed do both). Each strategy has its own attractions and drawbacks and its own eases and difficulties. A myriad of more mature businesses from Next to ASOS to Sports Direct and Superdry offer multiple approaches and thus learnings for investors thinking about Boohoo.

- The third party brand model means that the platform (business) can sell a broad range with the higher likelihood of traffic thanks to the attraction of known reputable brands. But resulting retail margins are likely lower on such products and come with the risk that in time, such brands might choose to exert excessive control over your supply and distribution of *their* products (ref. Nike's influence over SPD).
- Alternatively, retailers could develop and distribute their own brands. The challenges are obvious but doing so successfully builds brand loyalty if done right and results in higher margins. It also allows control and flexibility. Next plc, in its early days, was a good example of this. Interestingly Next's success in the area of own brand also reminds us of a resulting success orientated challenge. That of taking your customers with you as they get older and attracting a new demographic (daughters do not want to wear the brand their Mum's or Grandma's wear). Actually, Next's considerable achievements as a business should be seen against the formidable challenge that an aging brand comes with in the world of fashion.

Another ASOS? ASOS is an obvious comparison to make with Boohoo given their history as pure-play e-commerce disruptors. Actually, their brand strategies are very different. ASOS derives roughly 50/50 of revenues from own-brands and "curated" third party brands all sold via a single asos.com website. In fact, ASOS resells a long-tail of over 1,000 third-party brands. ASOS plausibly claims that its scale and real-time insight into customer demand trends is highly valuable to these third-party brands as vital customer feedback for the 'fast fashion' treadmill. Nevertheless, we think there is always a chance of tension between any retailer selling 50/50 own brand and third party brands. Notably, ASOS has never acquired any other brands. Would its third party suppliers be uncomfortable if it did?

By contrast, 100% of Boohoo products are sourced entirely in-house via the corporate's seven or so built or acquired brands. Each corporate brand has its own distinct website and identity (boohoo.com, prettylittlething.com, nastygal.com etc. – remember ASOS has only one website) but crucially each brand is aggregated and distributed over a common Boohoo logistics platform. We discuss later how the Boohoo corporate model lends itself to a continued accumulation of add on brands and how this potential for scaling the business excites us.

Cherry pickers

Having been close observers of both the Sports Direct and Next business models in recent years and adjacent business such as Superdry we thus find the Boohoo model of great interest. **Boohoo look to have cherry picked all the best bits from established player models.**

From day one, Boohoo has developed and promoted its own in-house brand, 'Boohoo' and later 'Pretty Little Thing' and currently those two brands account for c.90% of sales. But this is a dynamic business and it looks like it has learned how it might avoid Next's 'aging customer' dilemma by building/buying a collection of online brands that complement each other.

The acquisition of US brand 'Nasty Gal' was a replication of the early Boohoo UK strategy but last year's purchase of Karen Millen surely is much more revealing, a huge clue that even we oldies cannot fail to grasp. Such a brand as Karen Millen (acquired 2019) or Oasis (acquired this year) look perfectly positioned for the gradual aging of the loyal Boohoo customer. Notably, all these brands were bought cheaply ($18m for Karen Millen) and offer significantly improved economies when moved to an efficient online only model. **Additions of further brands in this way is likely a powerful driver of future growth that we are attracted to.**

> "*Boohoo has demonstrated that its platform is capable of integrating high-quality fashion brands. The recent acquisitions of the Karen Millen and Coast brands evidence its successful transition of brands to a pure online proposition on its scalable multi brand platform; plugging them into its test and repeat model, and leveraging the Group's infrastructure and insight into the fashion e-commerce market. Moreover, the Group's earlier acquisitions of the NastyGal and MissPap brands demonstrate its ability to develop and grow brands successfully.* ***The Group sees significant opportunity to replicate this success globally***" **– May 2020 £200m Placing Document (emphasis ours)**

Alchemy

We've seen this before of course. Such third party brand acquisitions and growth is reminiscent of what Mike Ashley successfully did with sportswear brands like Slazenger c.15years ago. Standalone, these brands had fading value, but inside a sports goods supermarket they provided real pricing power and drove higher margins.

- Notably recent failings at SPD were not due to a lack of demand for its own brands but due to its souring relationship with Nike and Adidas
- Again, Boohoo looks to be copying a format that works, but improving on it too

In this context, Boohoo has the potential to possibly become a unique retail distribution platform, at least in the UK, particularly so if it finds itself as the only real buyer of ailing brands that it has the platform to revitalise.

> "*Boohoo's market positioning also presents a strategic challenge. Its predominantly female customers in the 16-24 age range tend to outgrow its teen-focused designs as they enter the world of work. "We'll keep our focus on 16-24 year-olds. You never like to see a customer leaving but it's right thing to do if you want to keep your brand focused on young fashion. One response was the surprise acquisition earlier this year of the online business of Karen Millen out of administration. The label's tailored coats and eveningwear seem a long way from Boohoo's £5 hot pants, but the international resonance of the brand was similar. "To build a brand with that recognition takes a lot of money." Other initiatives could follow; Mr Lyttle cites menswear, athleisure and beauty as potential areas for future product launches or acquisitions*." **– John Lyttle, CEO, Nov 2019 FT interview[1] (emphasis ours)**

Distribution platforms and use of scale

The best businesses that we study use scale cleverly to drive efficiencies (Ryanair, Wetherspoons are well-worn examples). Next has been doing this for years in both logistics and delivery. Sports Direct did it via the purchasing power they had with the big brands. Sometimes these savings can be kept, but more often than not they are re-invested back for the customer benefit (Ref. Next shorter delivery times, lower prices etc.). Boohoo is now using its scale to make unviable businesses profitable and thus worthless businesses valuable. Alchemy indeed.

[1] https://www.ft.com/content/ff604a6e-fb28-11e9-a354-36acbbb0d9b6

Perhaps another subtle advantage of scale usage in the retail market is the ability to create a local supply chain of sufficient volume to allow cheap local production. This counter-intuitive approach to supply chains was pioneered by Zara but replicated by few others. For years Zara used its local expertise in Spain to produce garments quickly to meet fast fashion demand whilst competitors focused on cheaper traditional (slower) sourcing from Turkey, North Africa and Asia. Boohoo again looks to have picked the best of these strategies, with efficient self-run warehouses and local supply chain. According to a recent FT interview with John Lyttle, over half of Boohoo's clothes are made in the UK. The FT article goes on to say *"this allows it to react quickly to trends, with up to 3,000 new lines arriving on its website each week under a test-learn-repeat model."* Whilst our 'v' neck jumpers prohibit us from personally assessing the success of such innovations the organic growth of the group's young brands speaks to its success.

Scale begets scale – the flywheel

This note is not going to attempt to make forecasts for Boohoo, there are plenty of others with long spreadsheet guesses you can rely on for that. Instead will postulate on the future growth levers that and likely scale advantages – qualitative forecasts if you like. When we looked at Next's 'LABEL' (third party brands) businesses a few years ago we were excited by what it could bring to Next. The reason being that a likely winner in trusted third party brand aggregation and distribution would not end up growing at 20% pa as Next had then forecast for LABEL. Instead more likely it would reach a point where it (or a competitor business) could command a notable share of the market i.e. if successful it would be a step change bigger business.

Boohoo looks to us to be similar to consider against this sort of yardstick. Not as a distributor of others brands, but as the logical buyer and distributor of respected brands that cannot make money outside its platform. Up to now Sports Direct has almost been the only buyer of troubled retail brands in the UK but is Mike just a little too wedded to bricks and mortar? His purchasing of HoF maybe suggests so. That his business is an online laggard and not a leader is notable too. This sadly puts him at a big disadvantage to Boohoo when both might be looking at new brand purchases.

The fashion clothing/footwear market in the UK, remains enormous[2] and Boohoo has the optimum route to market (i.e. online only) and plenty of distribution capacity (the current distribution capacity can be scaled to £3bn i.e. roughly 3x current run-rate) to utilise. The other point we will observe is that Boohoo are focussed on the right customer i.e. the young women's market. We are well outside our circle of competence in assessing the subjective and fickle world of 16-24 year-old fashion trends, but we will say with some confidence that any pivot by Boohoo to in time add menswear brands (beyond its in-house BoohooMan), will surely be easier than the other way round. Ladies young fashion is surely the hardest market to crack.

When we do get to meet the Boohoo team this will be the key area we would like to explore. Ergo, "*When Jack Wills was sold 18 months ago were you in the market for such brands? If it came today would you buy it?"* Our suspicion, looking at the activity of the company in the last 12 months, is that they might now say yes. Indeed, similar brands that come up for sale, we think, now make far more sense sitting inside a Boohoo platform than a Frasers one – we will see. We also note the scale of turnover in numerous other brands such as say Superdry or Ted Baker and the low valuations that are attached to them due to their store based legacy business models. There is a potentially big arbitrage opportunity in front of Boohoo.

> "*And that point's relevant when you talk about further acquisitions. Are there likely to be similar deals to what we've done in recent times with Nasty Gal, Karen Millen and Coast*

[2] Citing a UK market size £71bn Boohoo suggests a 4.6% market share of the addressable online market in UK, 0.4% in EU and 0.4% in US

> *and Warehouse and Oasis, which have been in distress of some sort? And we do think there will be distressed brands that we can definitely add value to and reinvigorate, but there could be more of those types of deals, but also maybe some more established brands as well because -- but we -- I think the key factor is that we'd have to see very clearly the plan and where we can add value for those brands post acquisition to create real organic growth from there."* – **John Lyttle, CEO, June 2020 investor call (emphasis ours)**

Growth but with profitability

The other observation we will make about Boohoo is the middle ground they have driven directly between Next and ASOS when it comes to profitability.

We have sat through many a Next presentation marvelling at the margins they make online, but looking across in envy at the growth ASOS was achieving. Seemingly both were not achievable – or so we thought. **The Boohoo plc execution so far seemingly disproves this point through its 33% revenue cagr, 54% gross margins and 9% EBITDA margins (7% EBIT).**

We always welcomed Next plc's online margin discipline. But were always a little troubled by the 'growth at any cost' mentality of others like ASOS (4% EBIT margin), fearful that it might not be as profitable in the terminal year as many hoped. Boohoo's combination of growth and profitability while executing a model we can relate to and admire puts our past observations in a whole new light.

Management – more than just another Maverick retailer

We have not met with the Boohoo founders Mahmud Kamani and Carol Kane yet. Neither have we met with the new CEO John Lyttle, but judged on operational performance and the business model to date, this looks like an excellent team of retailers and managers.

We see much similarity with Kamani's retail and entrepreneurial instincts and that of early Mike Ashley – the latter all readers know we have studied closely. The press treatment of Boohoo's Leicester scandal[3] also has much in common with Sports Direct's Shirebrook take-down in 2016 and whilst there is no smoke without fire (in both cases) we think the tabloids will continue to revel in their castigation of "retail billionaires" like Ashley and Kamani.

The UK stock market in turn has strange love/hate relationships with such companies and like the press seemingly revels in any mis-step. We noted earlier in the year in a Next note that customer trust was really important for brands; we are old enough to have seen the 'Ratner' moment in real time (look it up if you are not). As investors we need to be attuned to whether a company has made terrible errors for which its customers' will punish it when revealed or whether something is being blown out of all proportion. More often than not the latter is occurring in these types of companies when headlines break. How companies and consumers then respond matters greatly and we note Boohoo's actions post this issue being raised and seemingly a muted customer reaction.

We should really mention in passing another similarity with Sport Direct – nepotism, or the concern of it. We mentioned the entrepreneurial prowess of co-founder Mahmud Kamani, but we have not yet mentioned the acquisition of the 34% PrettyLittleThing minority interest for £328m in May this year from its Founder, one Umar Kamani, **son** of Mahmud. Nor have we mentioned the recent new 3-year £150m management incentive plan[4] of which 17% (potentially £25m) is

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[3] https://www.theguardian.com/business/2020/jul/10/boohoo-co-founder-jalal-kamani-linked-to-leicester-garment-factory
[4] https://otp.tools.investis.com/clients/uk/boohoo/rns1/regulatory-story.aspx?cid=798&newsid=1398898

allocated to Samir Kamani (**another son** of Mahmud) who runs the BoohooMan brand. Quite the entrepreneurial family indeed!

> "*With all the companies we share a little but one of us takes the lead. I take the lead on property, my father on Boohoo, Umar on Pretty Little Thing and my younger brother Samir on BoohooMan*." **– Adam Kamani (one of the three Kamani sons)**[5]

That the all-powerful ESG and corporate governance committees at large asset managers will frown on many of the above issues does not concern us. If mismanagement of employees or favouritism of family is happening at the expense of the businesses and its growth prospects then we like to think we will pay close attention. But if it is not and the underlying businesses is seemingly more powerful than many others it competes with, we think investors should learn to be more pragmatic. We have now studied many, many, quoted company entrepreneurs of all shapes and sizes and learnt to take these foibles as part and parcel of investing alongside many of them. To us boring institutional investors, family business relationships like these might seem odd, but to many self-made people they are commonplace. By allowing relatives to grow related business units they are able to explore new avenues of growth but do so with people they know they can trust 200%. When you are worth c.£1bn, knowing who you can/cannot really trust is not as easy as it is for the rest of us. Sadly many speak very differently to money.

Bench depth

It also seems to us that Kamani is perhaps a little more refined than Ashley in terms of his relationship with the City and press. Maybe for that reason the '*Slave Labour'* issue has been better handled and not been escalated as a story. Boohoo also looks to have something important that Sports Direct has always lacked, bench depth in management roles and an ability to recruit external talent. If its new CEO can stay the course and develop the business and the team around him that will be an achievement that many other entrepreneur-led groups will have failed at. Interestingly last year, special mention was made of Lyttle's ability to source new brands to add to the portfolio. Nor should we ignore or diminish the contribution of Carol Kane herself who has been alongside Kamani for over 20 years and seems to be a key brain behind the fashion operations of the business. One of our criticisms of Sports Direct in recent years was the lack of depth to its management bench and its lack of a rigour in formal financials oversight. That seems not to be an issue at Boohoo plc. That said, it would be incredibly rare for a business experiencing such incredible growth not to hit a speed bump as it ramps new brands, new warehouses and new geographies – all while operating above the speed limit of normal corporate activity!

A word on the shares

That Boohoo is well positioned for a Covid affected economy is self-evident. That our reflections show it is also structurally set up well for future organic and acquired growth suggest we should be a buyer of the shares. For choice that will be our recommendation. However to buy just with those two drivers makes you a GAAP investor (Growth At Any Price). That this approach has worked well for the last 5 years does not guarantee its success. We look for mis-priced compounders or wonderful businesses that might not be priced as such (GARP if you like). For all of our admiration of Boohoo the margin of safety in paying today's price is far from clear. Buffett once described great businesses as '*Snowballs with long wet hills in front of them'*. We do see some of that in front of Boohoo today, but we are mindful of the alternative value opportunities elsewhere in the stock market in out of favoured businesses. We think it plausible,

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[5] https://www.insidermedia.com/publications/north-west-business-insider/north-west-business-insider-march-2018/empire-of-the-son

even likely that Boohoo achieve sales to fill their capacity of c.£3bn in say 5 years' time. We also think it possible that a little more operational gearing could one day become evident.

As such the following is plausible:

- Might £3bn of sales produce a 12% EBITDA margin (10% EBIT?). Might such a company then be respected and valued highly? All possible
- £3bn x 10% x 20x EV/EBIT =£6bn
- We note the £150m management incentive scheme is based on market capitalisation targets from £6.3bn to £7.5bn (vs. today's £3.7bn).
- This would give c.50% upside

Don't start from here

The other way to think about value is the market opportunity in front of Boohoo. A UK fashion market that in 5 years grew 25% from today's level and grew from 21% online penetration to 30% would be worth £27bn. If Boohoo had 10% of that market vs. c.4.5% today its sales would be 4x those of today. A crucial factor we think will be who turns up to the party. If for a while Boohoo is the only buyer of troubled fashion brands, its future growth could be secured, if others could find a way to fit them into their business models such speedy growth might moderate – Lord Wolfson your move.

Road bumps

Current trends and investing markets do not seem to suggest any other way of investing in such a business than paying up for the shares today, but we have learnt that the investing world is a funny place. Once loved brands such as Chipotle or Greggs can fall 50% and then treble. Next plc the stable, best in class incumbent in this sector still sees it shares fall c.30% every 5 years. Maybe an opportunity will arise. In maverick run businesses' in the UK they have a habit of doing so.

This note is really intended as a marker. Boohoo we think has cherry picked and executed upon some of the best retail business models out there and married these traits with some great technological, logistical and social trends/brands of today. **It has that unusual combination of owner-manager, very high organic growth, extremely high returns on capital and best of all: its model looks very scalable.**

Oh, and its all on our doorstep. Let's watch this one closely.

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