HollAnd Advisors

Holland Views: JD Wetherspoon – Price: 718p Mcap: £920m

Show me the money + Scratched records

Our Wetherspoons past work is once again re-attached. The essence of our assessment of this company changes little because neither does the company's business model. The only reason for our numerous comments over the last twelve months is due to the mispricing of the shares which we feel has been ongoing. Post a call with management following yesterday's Q3 trading statement we add a few new comments below. These are far less about current trading and more an updated assessment on the company's business model & outlook. Those unfamiliar with our JDW work we would recommend reading our *Walton on Thames* and *Modelling Spoons* pieces.

Scratched record

Recently we observed the following about JDW:

Whilst we of course see and accept the uncertainties around the cost of living and how that can affect discretionary expenditure like eating/and drinking out we are comforted by the fact that those with genuine low-price offerings (such as Greggs or JDW) have:

- *A huge ability to protect their profits if they chose to do so with small price increases*
- *Are by far the lowest price providers for what they do, so are postponed well from any trading down that will occur*
- *Have weathered many different cost of living environments during their long periods as listed companies*

Source: Holland Views: JDW March 2022

Since we wrote those words the company has released its interim results and now also its Q3 trading statement. Pleasingly for those of us that enjoy playing our scratched records (i.e. re-iterating how attractive this company's shares look) the management team very much echoed points 2+3 above in their comments. On point one JDW Management are always very coy, often choosing to evade talking about prices whenever possible. Your author however realising that pricing is the key differentiator of this company from its peers often pushes for insights on this issue.

Pricing power and pricing gaps

Yesterday JDW confirmed that they put up bar prices in March by 2%. Also, food prices in April by 8-10%. The latter sounds a lot, but we must remember this includes the Government re-introduction the full VAT rate on food (i.e. back to 20% from 12.5%). Those that might not frequent 'Spoons' may not know that they passed the Covid VAT cut to customers in full during the pandemic when it took place. **Almost all other pub/eating out companies did not-instead pocketing the difference straight to profits.** The differing effect of these respective actions on profitability to the sector and JDW was huge and should not be underestimated. However, that prices have now risen just a little above the required VAT increases shows to some, that JDW is not just being run for its customers. Also, for shareholders too! I.e. that in the face of a pandemic recovery and *some* cost pressure the company is prepared to make small rises in prices.

Crucially for our assessment of the company however we note that the gap with restaurant and pub peers gave JDW ample room to do this. **We want readers to note that a 2% rise or cut in prices alone (i.e. assuming no other changes in volume and /or cost inflation) would swing JDW net profits by c.40 % in a year.** This assumes a starting 4% net margin on £1.8bn of sales (i.e. where the company was trading in 2019, the full year before CV-19). As an ardent Wal-Mart follower and excellent scale economy shared business sneaking extra price rises through in order to make a little more short-term profit is **not** in JDW's DNA. Indeed, we would recommend the video below to any that have not listened to it. It is Tim Martin talking about a trading period where they could have avoided a past profit warning just by putting a few pence on beer prices – he chose not to do so. We think it is enlightening as to the company's culture not just towards pricing, but also on important areas like long-term staff and customer loyalty also.

https://vimeo.com/305746906

When asking a little more about pricing yesterday the company was happy to tell us something we already knew, but were delighted to have confirmed. This being that the pricing gap with its pub peers is likely at the biggest gap it has ever been. With the VAT actions others took during CV-19 (i.e. they all kept it) and with other pub/restaurant price increases we also have seen, this fact was anecdotally clear to us (and our sons!). That said it was still good to hear the company call it out. In the past when looked at over a basket of food and drinks JDW was c.20-30% cheaper than its nearest peers. As to what that gap is today, we do not know apart from to say it is "bigger", maybe "much bigger". Another fact to consider as the company has pointed out to us before is the following. I.e. that the basket checks the company does occasionally to estimate this gap is done by each pub manager. They assess the pricing of different food and drinks in the pubs and bars nearby which they compete with. But most pubs trading near a Wetherspoon have to be price conscious to survive. This has always suggested to us that the gap with the wider industry (including a pub say 10 miles away is likely even greater still).

Inches and chasms

A few years back your author spent a little too much time looking at the UK food retail sector. Much as he learnt a lot, he also learnt about places he did not want to fish. This experience led to Holland having a new mental model to add to our list:

> *"Avoid the trenches – i.e. businesses where you have to fight 24/7 to win 6 inches of no-man's land, only to give it back the next day."* **Source: Holland Advisors**

This tries to encapsulate those industries where the pricing differences are very small and very hard to gain any sort of real lasting dominance in. What has always interested us about JDW vs say a supermarket company is that like a lot of successful scale-economy businesses it is the only player in its field operating with this model (i.e. in the UK/Irish pub sector). Also, that the pricing difference between it and is peers is not small and hard to see, but huge, and therefore most importantly **obvious to the consumer.**

> "*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**

In our *Walton on Thames* piece, we spent some time considering the true moat of JDW. We did this using an approach that Buffett himself once used to look at Geico.

We looked at what was given back to customers, employees and shareholders over time to make each of them happy/better off. We were then delighted when no less than Jeff Bezos used exactly the same methodology to assess his time at Amazon in his last annual letter a few months later…

Hypotheticals

The benefits that have accrued to each group are laid out in our *Walton on Thames* report. However, a short cut could be to consider what the profits of JDW might be today were the pricing gap with peers not c.30%+ as it likely is today, but only c.20%. Using the price sensitivity calculation, we made above we can adjust for prices being 10% higher, not 2% higher. This suggests that 2019 profits after-tax might have been £216m vs the £72m they were reported at! Today market cap just for a recap is £920m. We note the staff cost inflation that has been prevalent in this sector for the last 5+ years would have given this company ample reason to have such a pricing architecture if it had chosen to. Also, its customers would have still enjoyed much lower prices than anywhere else where they could have eaten/drunk out at. finally, such a large profit of £216m vs £72m would have been a Net Margin of c.12%, ie similar to Youngs!

Were those profits to have been reported, we suggest that Tim Martin might be looked at somewhat differently by our friends in other finance jobs! JDW would still be a powerful leading-on-price company, but in the customers' eyes maybe not quite as powerful as it is seen as today. Indeed, likely its volumes might have been a tad lower as a result, reducing a little the net profit figure we just guesstimated above. **JDW however chose not to do this.**

DNA

Reflecting on this hypothetical scenario we are reminded of some reading we did around Costco some years ago, particularly the language of Sol Price and Jim Sinegal. Costco customer centricity was just so ingrained in its DNA that it stopped any shorter-term opportunities to profit at the customer's expense. **By always using a mark-up of only 14% made on any item it sold, this stopped a buyer who had secured 100,000 pairs of jeans for $10 each marking them up to anything other than $14, even when they knew the customer would be delighted to pay $25 for them.**

Sadly, for us city scribblers, JDW has never given an easy rule of thumb around mark-up or another metric that makes the company easier to forecast. That said its long-term commitment to low prices, even in the face of lasting cost pressures is a true testament to its genuine long-term customer focus. It shows an ingrained deferred gratification gene. Investors should note just how rare this trait is. Tim Martin is often characterised in the press for one reason or other, but his desire to challenge consensus thinking and frankly his stubbornness is the exact trait needed from such-scale-economy shared founder managers. We read the motto below recently:

"You don't go into value investing for the group hugs" **Source: Anon**

The same we suggest is true for these types of super long-term deferred-gratification business models.

"Show me the money"

Those that want greater insights into the more detailed drivers of JDW current trading and outlook should look at two PDF's we attach. They have been helpfully distributed by the company's Finance Director and outline questions that arose during two periods of investor meetings. Also, giving the company's answers.

Most observers will have by now read that JDW's most recent weeks trading is now back to fiscal year 2019 level. Whilst the company has spoken to cost inflation being contained at JDW due to high freehold ownership, leases with limited uplifts + good staff retention, the company have accepted there are *some* cost pressures.

The company has also now spoken of expecting a "*normalisation*" of profits in the coming financial year (i.e. to July 23). This profit recovery was clarified by JDW's management as likely to need turnover of c. £1.97bn (i.e. 8.3% above that in fiscal 2019) due to cost/other inflation. Mr Market's lack of reaction to this prospect of a full profit recovery is notable. We suspect with all that has gone on in the last few years and the slow trading recovery JDW has made vs other pubs thus far, this c.+8% caveat is just too much of a leap of faith. When once Mr Market was able to look past the Covid trough, discounting an expected recovery for companies like JDW, now he is in a tired Gerry Macquire mood, i.e. I will only believe all this when you … *"show me the money."* For that reason, the investment return prospects are excellent for those prepared to take a long-term view on JDW's customer proposition and its likely continuing growth and dominance of it.

Super-models

The time we spend modelling companies is mostly just to understand likely earnings power. It is not be accurate in any short-term outlook. The piece we wrote in December (*Modelling Spoons*) and the spreadsheet that accompanied it are re-attached (with no changes). At that time assuming a return to 2019 sales levels might have seemed optimistic, now this seems once again realistic. Indeed, our June 2023 sales estimate was £1.93bn, vs company guide now of c.£1.97bn – not a bad guess maybe! That the company needs 8% higher sales in order to remake 2019 profits may cause concern for some observers, not for us. This is for a number of reasons:

- In January 2020, just before Covid struck JDW had just reported LFL sales growth of 5% above the 2019 year. This implies the group only needs to return to pre-Covid trading
- The sensitivity we have shown to pricing is illustrative of what the company can do to pass on cost inflation if it needs to. Whilst the company did not disclose the price/volume component of the c.8% rise in sales needed we suspect this is currently all volume.
- This company's value proposition pre-Covid was exceptional and drinkers and diners knew it hence the multiyear LFL sales growth they enjoyed up until that point. The price for product/service gap with peers has leapt to a chasm during the Covid years. Whilst there is as yet not the evidence to prove it, we stand by the view that JDW during Covid was a Mo Farah stock. By that we mean i.e. it will turn out to be a market-share winner at competitors expense.
- All of this points to consistent likely good LFL sales being reported in future normal years to come

Another quick look at our December model gives the following conclusion, notably from a then starting price of 911p:

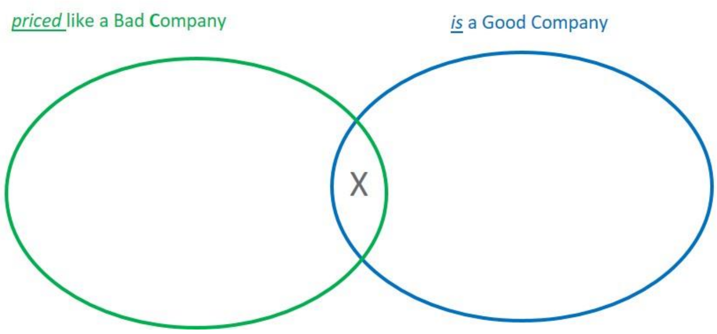
- We made the best guesses we could about future growth and its likely investment cost whilst also assuming a gradual rise to 10% margins in year seven. This margin rise is not price gouging but just the effect of greater scale throughput using existing well-invested pub assets. **The result of this was a 7year investor IRR of 25%.** With a £43 share price in June 2029.
- Even keeping margins constant over the whole forecast period gave a 15% IRR

Reducing our start price to £720p increases these returns to 26% and 17%pa respectively. These are extraordinary potential returns from a proven low-cost producer business that your 21-year-old children can tell you will be a winner.

Easy to say - Hard to do

For many years now we have used the following Venn diagram in marketing and research pieces. We think it shows investing as its simplest. We also think it shows exactly what Buffett has been doing for the last 80 odd years, I.e. buying great business when they were not priced as such. (e.g. Coke/Amex/Apple)

Fig.1 Buy, when great companies are price like bad ones:



Identifying great powerful, resilient businesses with good compounding prospects when all around you have written them-off we don't think is easy to do psychologically. However, that is what we think todays JD Wetherspoon opportunity is for those prepared to do the work. As Munger opines:

"if it was easy, everyone would be rich"

Buy JD Wetherspoon

*Any estimates on the future of the company returns are the view of the author only. These should not be used as forecasts or recommendations.

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