HollAnd Advisors

Holland Views – JD Wetherspoon (Price £4.26p; MCap £537m)

A snowball on a really long hill..?

Many investors have a layman's view of JD Wetherspoon. Some will tell you that the pubs are dirty or that the beer is old and that is why it is cheap. Others will claim the business model is poor due to return on capital being low and falling. We have looked at this group very closely now and strongly contest all of these pre-conceived views. We believe we may have found another high quality UK consumer franchise with a wide and growing moat. This one charges industry smashing prices that others cannot match, but only has a 1.5% market share. As such we wonder if this is what a snowball at the top of long hill looks like?

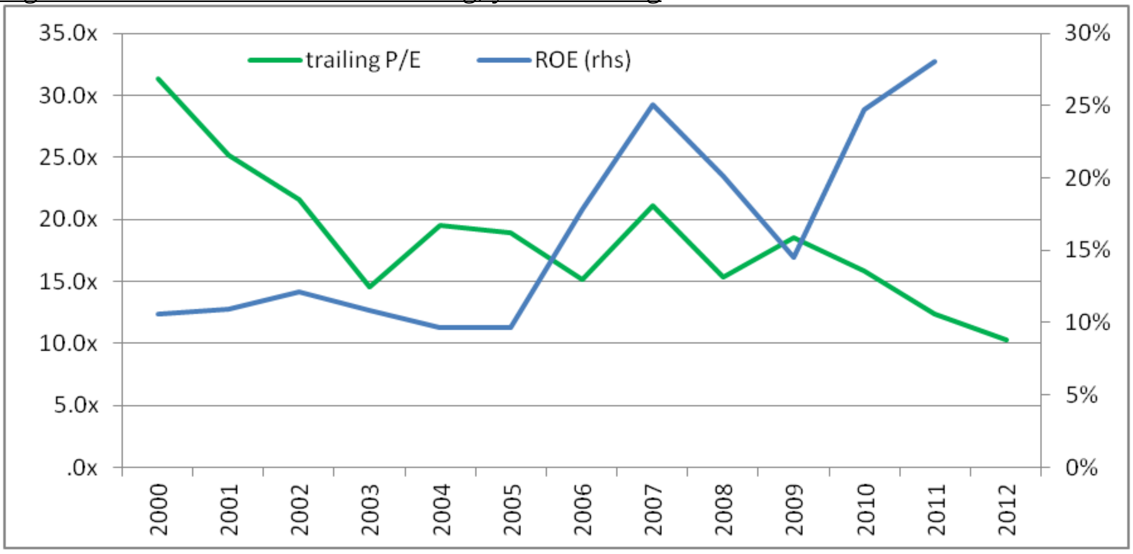
Now it's even undercutting the British Legion

It is ironic that many of the UK retail businesses which we find most attractive as investments are often those which seem least likely to be frequented by City fund managers. To our list of often overlooked (and undervalued) retail franchises - which includes Next, Greggs, Tesco and Morrison - we now add pub chain JD Wetherspoon.

In Wetherspoon, we believe we have found a business that has successfully applied the tried-and-tested formula of some of the world's greatest low-cost retailers to the UK pub market:

- An unmatched depth and breadth of merchandise
- The lowest operating costs among its peers
- Shrewd buying power via huge volumes (which, given the negative working capital characteristics of the business, throws-off huge cashflows for equity owners)
- Gross margins (and prices) far below the competition
- Friendly and efficient service, consistently

Fig.1: Mr. Market in denial - ROE rising, yet P/E falling



Source: Capital IQ, Holland Advisors

We also find in Wetherspoon a prudent business ethic that translates the above into impressive and improving returns, latterly through strong asset-efficiency gains. Later, we dispel the commonly held perception that returns are falling, arguing that the oft-cited cash returns used in this sector – the so called CROCCE – maybe are just not appropriate for this business. In fact the opposite is true: ROEs have averaged 15% over the last 10 years and 22% since the UK recession began in 2008 and return on tangible assets has risen.

Combining this with a business that has a strong track record in capital allocation (payouts have averaged 81% of Net income over the last 10 years) is we suggest, highly attractive. That the shares have been de-rated to just 9.8x EV/EBIT (11.2x historical P/E) as shown in Fig.1 indicates that Mr. Market sees it differently – hence the opportunity.

Fig.2: Long-term track record (note similarity with Berskhire's format – not a coincidence)

Summary accounts for the years ended July 1984 to 2011

Financial year	Total sales £000	Profit before tax and exceptional items £000	Earnings per share before exceptional items pence	Free cash flow £000	Free cash flow per share pence
1984	818	(7)	0.0		
1985	1,890	185	0.2		
1986	2,197	219	0.2		
1987	3,357	382	0.3		
1988	3,709	248	0.3		
1989	5,584	789	0.6	915	0.4
1990	7,047	603	0.4	732	0.4
1991	13,192	1,098	0.8	1,236	0.6
1992	21,380	2,020	1.9	3,563	2.1
1993	30,800	4,171	3.3	5,079	3.9
1994	46,600	6,477	3.6	8,284	5.1
1995	68,536	9,713	4.9	13,506	7.4
1996	100,480	15,200	7.8	20,972	11.2
1997	139,444	17,566	8.7	28,027	14.4
1998	188,515	20,165	9.9	28,448	14.5
1999	269,699	26,214	12.9	40,088	20.3
2000	369,628	36,052	11.8	49,296	24.2
2001	483,968	44,317	14.2	61,197	29.1
2002	601,295	53,568	16.6	71,370	33.5
2003	730,913	56,139	17.0	83,097	38.8
2004	787,126	54,074	17.7	73,477	36.7
2005	809,861	47,177	16.9	68,774	37.1
2006	847,516	58,388	24.1	69,712	42.1
2007	888,473	62,024	28.1	52,379	35.6
2008	907,500	58,228	27.6	71,411	50.6
2009	955,119	66,155	32.6	99,494	71.7
2010	996,327	71,015	36.0	71,344	52.9
2011	1,072,014	66,781	35.3	78,818	59.7

2011 FCF at 2004 levels
but
2011 FCF / share +60% since

Source: JD Wetherspoon 2011 Annual Report

In Fig.2 above we include a summary financials chart from Wetherspoon's annual report for two reasons:

1. It mimics – intentionally – the style and substance of Berkshire Hathaway's annual report summary table thereby giving investors a not-so-subtle hint as to Wetherspoon's modus operandi
2. The dataset shows a very impressive financial track-record for this business. We highlight one subtle but important point: while Wetherspoon's FCF does not look to have grown in absolute terms since 2004, by stark contrast FCF per share is now +60% higher due to the share buybacks in the intervening years

The Customer Proposition – 'Cheap & Cheerful' (in the best sense)

In 2008, in an op-ed written to deflect rising criticism that Wetherspoon's aggressive pricing was fostering a binge drinking culture in the UK, Tim Martin pointed out that if low prices were the "real issue" that leads to binge drinking, then the British Legion would be the epicentre of drink excess! Nice deflection. However, to our mind, the undeniable fact is that Wetherspoon's USP can in fact be summed up in two words: low prices.

It is hard to over-emphasise just how low Wetherspoon's prices are versus the competition - and not just in the area of mainstream lagers. Across the board, from popular lagers to niche ales to coffees to steak lunches, it can be clearly shown that Wetherspoon undercuts its high street and pub competition in some cases by up to 75% on a brand like-for-like basis.

Oh, and by the way – four years on from Martin's comment above – a pint of Carlsberg at our local Wetherspoon is now itself 25% cheaper than the aforementioned British Legion!

Lower prices than you might expect

- For customers, this market positioning is represented by some frankly astonishing price differentials that are typical across the chain:
  - A pint of Ruddles for £1.79 (vs. £3.40 at our 'local'): a 50% undercut
  - A pint of Carlsberg for £1.99 (vs. £2.65 at the British Legion in Guildford and c.£3.25 in local independent or Punch/Enterprise pubs): at least a 25% undercut
  - Steak lunch with glass of wine for £6.99 (vs. more than £10 in most reputable establishments): a 30% undercut
  - Lavazza cappuccino for 99p (vs. £2.15 typically at say Costa Coffee): a 55% undercut
  - Occasional offers such as cappuccinos for 50p between 7am and 9am (vs. £1.38 at McDonalds): a 65% undercut
- For context, this pricing strategy manifests itself as a gross margin of just 13.6% which gives a clear indication of how difficult it is to compete against this business

For investors who might not be regular customers of Wetherspoon, it is perhaps easy to overlook just how cheap the offering is – and not just in alcohol products. We had lunch in our local Wetherspoon recently – Rump steak (perfectly cooked medium rare) with chips, salad and a glass of excellent house red wine – all for just £6.99 (Fig.3 below). The staff were efficient and the surroundings were pleasant.

Fig.3: Our menu from last week: (£6.99 for a steak lunch with wine!)

Source: JD Wetherspoon

Think about it: that is incredible value. The customer proposition was made very clear to us on that occasion – good quality food and drink in a nice environment at the lowest price-point on the high street. Importantly, it proved that quality and service were not being sacrificed to achieve the low prices. Furthermore, the offering is simple to understand (no gimmicks) and consistent across the chain so customers know what to expect and therefore are understandably loyal. The wide cross-section of society from labourers to students to office-types to pensioners at different times of the day show that its popularity is not confined to a specific demographic either.

What is particularly encouraging to us is the consistency of the process behind this service. It is not rocket science but such a pricing strategy can be lucrative when scaled-up consistently over 823 pubs across the UK. For example, since 2010 breakfasts are served from 7am with paper breakfast menus on all tables from that time. These menus are then replaced with lunch menus (as shown above) at midday, with specific lunch themes and special offers most days (e.g. 'Steak Club', 'Curry Club' and 'Sunday Club'). All combined, the low-pricing and the resulting volume gains across the chain forms the basis of a tremendous virtuous circle which is extremely difficult to compete against or replicate and is similar to other low cost industries.

Another consequence of combining the scale of the chain with this consistent low-pricing strategy has become very clear to us: Wetherspoon now has strong brand recognition across the UK. Not in the sense of say a Burberry, but there is recognition among the public of what the name stands for: quality at a low price.

> *"My local tipple is HBB (Hogs Back Bitter) and my local pub (Enterprise owned) is 53 yards from my house (on average – return journeys are typically 10 yards longer). The 'local' charges charge £3.60 a pint for HBB (vs. £2.29 at Wetherspoon 10 miles away). I pay it due to the convenience and the people that I meet there. Pub and Enterprise knew/know this and that is why they brought in such pricing policies. The brewery that HBB comes from is 5 miles away and if buying in bulk it only charges £2.17 a pint."* – **Andrew Hollingworth (beer drinker)**

Dispelling the common myths

"Aren't the pubs dirty and horrible?" Actually, no. Whilst obviously given there are over 800 pubs, we are generalising but if you go into a variety of Wetherspoons and then a cross section of other pubs - not just the posh ones you like - what you will find is that the standards in Wetherspoons are better than you expect and better than the average pub. Hygiene standards are closely monitored. This is backed-up by industry standards (such as www.scoresondoors.org.uk) where the chain averages a score of 4.27 out of 5 for quality and cleanliness - an impressive average for such a sizeable business spread across such a diverse area.

"Isn't the beer old or near to being out of date, and that is why it is so cheap?" - Whilst this may sound plausible, we suggest that given:

- Wetherspoon sells 10% of all cask beer in the UK
- The chain has over 800 'Cask-Marque accredited' pubs, and has "more pubs in CAMRA's good beer guide than any other pub company"

It seems unlikely that you can build such a large UK wide franchise for selling beer if it is actually low quality.

A look at the pricing earlier vs. our local brewery confirms that Wetherspoon's margins are indeed thin, but they will be buying in bulk from the breweries and may even have relationships that say, "let us know when you are worried you have a little too much/ i.e. you have mis-read local demand and we will take beer off of you". All of these points are exactly the same with any high-volume, low-price business model and is backed-up by the very low (c.15%) gross margins of the group. As an aside, seasoned beer-drinkers know that the quality of beer is much better in pubs that serve it in greater quantities as it sits around less.

"If the prices are so cheap, the service must be awful?" More often than not, it seems true that the trade-off these days for low-cost retailing is the quality of service (have you ever queued for a checkout at Lidl?). It does seem that Wetherspoon is cognisant of this: Tim Martin allocates a great deal of time to visiting pubs across the country assessing service quality levels and collecting feedback for weekly review meetings. Investment in staff training seems a priority and there are incentives to maintain consistent standards across the group. Wetherspoon paid-out £22.6m in staff bonuses in FY11 (flat YoY) equating to about 7% of total staff benefit expenses and 48% of reported net income.

The 'Sam Walton' of the UK pub industry

Wetherspoon has a unique business model, culture and, most importantly, a unique figurehead in Founder and Executive Chairman (and 28% equity owner) Tim Martin. To understand the Wetherspoon business franchise is greatly helped by an understanding of Martin and his attitude to the business. Though no longer CEO since 2004, Martin remains the driving force behind the company and it is Martin's business acumen that really separates Wetherspoon from the rest of the pack. Upon closer inspection it will becomes obvious which famous businessmen he is trying to emulate (Sam Walton and Buffett). Martin is most famously inspired by Sam Walton's autobiography 'Made in America' (he bought 500 copies to give to all his managers!). We believe he is cut from the same cloth as some of the world's top low cost retailers.

What is the 'secret sauce'?

A question that Buffett often poses in evaluating a business' franchise is *'how difficult would it be for a new entrant with unlimited capital to enter this market and compete head-to-head?*" One indication of just how difficult it is to make money in this sector is that Wetherspoon operates on a gross margin of just 15% Another is that it has over 400 freehold properties; c.45% of its entire portfolio. Given the malaise across the UK pub sector (driven in large part by the decision of the tenanted Pubcos to substantially gear-up their balance sheets to expand thereby creating large estates of tied landlords) – did Wetherspoon simply get lucky or is its success in the industry a function of a long-standing strategy? We argue that it is the latter. Much of what you need to know about the Wetherspoon's culture and business strategy can be gleaned from the following insights from Tim Martin over the last decade or so.

Emulating the passion of Sam Walton

As we continue to work our way through a plethora of business books and biographies it seems uncanny to us how the great business leaders across the world in diverse industries employ very similar tactics. For example, our sense is that Tim Martin is regimental in keeping close to the coal-face (he religiously visits pubs three days each week – similar to Starbucks' Howard Shultz who apparently used to visit up to 25 stores every week).

He is very big on detail (such as critiquing the foam on the Wetherspoon's coffee – reminiscent of Conrad Hilton bathtub inspections) and is very vocal on placing his employees and service at the centre of all his endeavours (ala Southwest's Herb Kelleher maxim, "treat your employees as your primary customers"). Most of all, though, Tim Martin is a self-confessed Sam Walton devotee.

> *"I read Sam Walton's 'Made in America' three or four years ago. It was such an interesting book in terms of what it said about management and expansion: fine-tuning one particular type of outlet and rolling it out across the country, but not in a cloned fashion. It was adapted from town to town, and built a management culture which meant a programme of improvement could be enshrined in the company, to avoid atrophy. Once I'd read it, I bought 500 copies and gave one to each of my pub managers. At Wetherspoon we've also copied WalMart's practices of meeting once a week, keeping bureaucracy to a minimum and spreading information across the country quickly by phone. We critique the business - not a very British phrase."* – **Tim Martin (in a 1999 interview)**

In the same way that Walton was a retailer to his core, Martin loves pubs.

> *"I noticed in the early days that not everyone in this business likes going to pubs. I do, and that's a big help".* – **Tim Martin**

Managing for the long-term – "ultra patient"

In answer to our question at the top of this section, we think it was not luck that caused Wetherspoon to retain a prudent balance sheet post the 2008 crisis – Martin understands the need for a long-term 'strategy'. The long-term target for Wetherspoon pub density (one for every 40,000 of population equating to about 1600 pubs) clearly shows this type of thinking and while unquestionably ambitious, is typical of the long-term thinking of a founder. Equally, he is seems very aware of the business cycle, and as a result the business was far better prepared to weather the current recession than its competitors were (as evidenced by this quote from 1999!):

> *Good companies can turn recession to their advantage sometimes because it has a worse effect on a badly run company than on a well-run one, so we are just trying to make sure ours is well run,"* – **Tim Martin (June 1999)**

> *"We're ultra-patient, ultra-dogged. I've got a quote on my office wall that says: 'We never get tired, we never get depressed' - that's how Wetherspoon works. One of my best-performing pubs didn't make a profit for five years, but I knew the people, and knew it would work in the end."* - **Tim Martin**

> *'I don't save time for strategy per se, because our strategy has never really changed. Improve the pubs we've got, boost their sales and profits, and then build more of them. It's the implementation that takes the effort.'* - **Tim Martin**

The importance of freeholds

This is a crucial point (and central to understanding Wetherspoon's true return on capital as we discuss later). It is interesting too that Martin seems to be cognisant of other retailers core competitive advantages – a freehold asset base (the Wetherspoon chain is about 45% freehold).

> *'Freeholds are important, although you can't always get 'em. The businesses which are sustainable in the long-term in pubs and in retail are the ones with freeholds. Shepherd Neame (Britain's oldest brewer, dating back to 1698) wasn't built on leaseholds. Nor was Tesco.'* – **Tim Martin**

Shrewd Media Operator – outwardly pessimistic

Martin is a savvy media operator and uses the media channels to publicise and lobby for the greater cause, the latest of which is the dichotomy between UK VAT regime for pubs and supermarkets. Martin is invariably pessimistic (on the outside at least) in all his discussions of the outlook for the sector. His constant pessimism toward the sector's prospect, while understandable, is very reminiscent of Michael O Leary's tactics and perhaps one should pay more heed to the fact that Martin bought an additional £2.5m worth of stock for his personal account last month.

In the past, the Wetherspoon chain has been accused in the press of facilitating a binge-drinking culture across the UK through its low pricing strategy. Martin seems to be acutely aware of this criticism and it may be partly for this reason that Martin seeks to downplay the acknowledgement of pricing as the company's key competitive advantage. Most of us ought to be able to see beyond this rhetoric – pricing is undeniably a cornerstone of the success of this business.

How the culture & 'customer offer' translates into shareholder returns

The Wetherspoon business is either good or very good when looked at in the context of our three franchise hurdles: 'Operate', 'Generate' and 'Allocate'.

1. Operate: Driving a virtuous circle through value for money and service

Buffett reminds us that a key performance indicator for a retail business is volume per store, not value per store. JD Wetherspoon is clearly a business that is first and foremost volume-driven and the scale benefits can be seen not just in the beer prices referred to earlier.

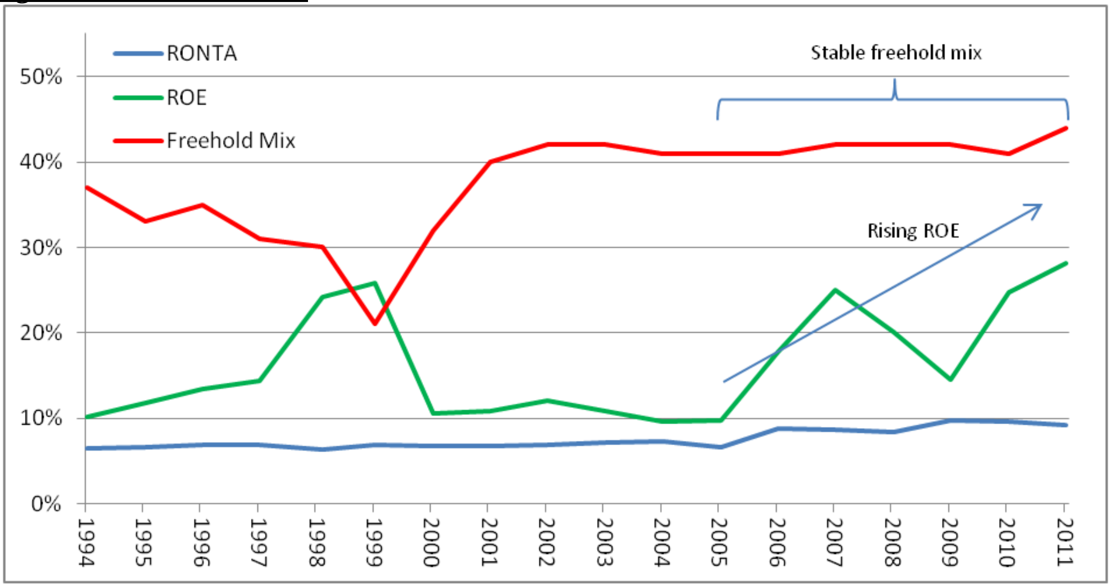
- In the space of four years since its introduction across the chain, Wetherspoon is now the largest seller of Lavazza coffee in the UK and in fact is one of Britain's largest coffee retailers
- The chain is the largest seller of Pimms – worldwide...
- …and sells 350,000 breakfasts every week

The resulting value for money that such scale brings is hugely compelling for customers as evidenced by the strong customer loyalty that we see. Arguably the (price) gap versus its pub competitors (some of whom are lumbered with hefty debt repayment schedules) has never been as wide. Operationally, Wetherspoon has done an excellent job of improving asset-turns through the recession as a compensation for the inevitable margin pressure. Similar to McDonalds, the move into breakfasts, coffee, all-day meals and late openings has been a material boost to asset-turnover and therefore RONTA. How many establishments have grannies and workers eating breakfasts in the mornings and revellers downing cheap WKD's at 11pm in the same building?

2. Generate: Returns improving with asset efficiency and some gearing-up

On our usual Holland measure of RONTA (Return on Net Tangible Assets) and ROE – shown below in Fig.4, the business look solid/good. A common question from investors is whether this is due to a change in the freehold mix but as the chart shows, the mix has been relatively constant over the last 10 years. As we show later, the big driver of improving ROEs has been increased leverage (especially via share buybacks) and also through improved asset-efficiency (i.e. rising asset turn ratios).

Fig.4: RONTA and ROE



Source: Capital IQ, Holland Advisors

- RONTA has not been below 7% since 2000 and importantly has improved from 7% (2000-05) to 9-10% (2007-11) - despite EBIT margins falling over the same period from 12% to 10% due to price reinvestment and cost inflation. Current returns are now at a similar level to Morrison or Tesco in the UK

- ROE has improved significantly, partly as the Group has taken a little more debt, but actually the level of indebtedness (EBIT/Int) and (Net Debt to EBITDA) has not changed that much. More importantly ROE has improved significantly because the group has bought back so many of its own shares. Thus we now have a solid and likely very, very hard to displace (or compete-with) business that offers shareholder an interesting/ compelling return on their equity investment

3. Allocate: Savvy and efficient allocation of capital

What can be seen below in Fig.5 is that in recent years the group's sales generated from existing pubs has slowed materially as the overall business scale grew and the market conditions in the sector deteriorated. As a result the group likely concluded that there are more limited opportunities to open stores in a tough economic climate and challenging sector. This slower opening program can also be seen in the total capital expenditure ratio which - whilst still a multiple of depreciation - has also slowed.

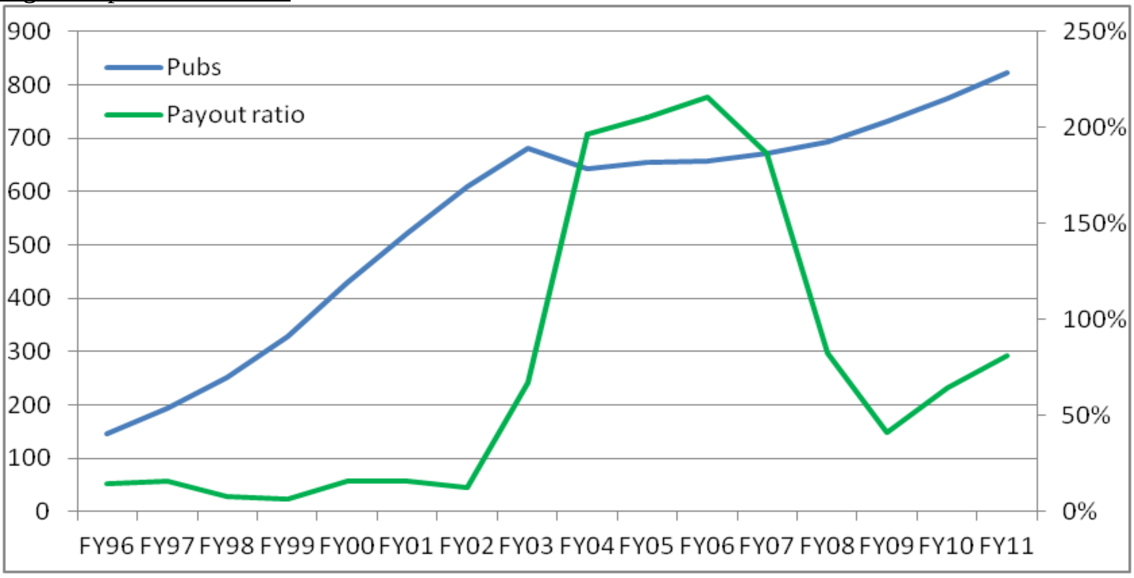
Fig.5: Growth and Capex trends

	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11
Group Sales YoY	43.1%	37.1%	0.0%	24.2%	21.6%	7.7%	2.9%	4.6%	4.8%	2.1%	5.2%	4.3%	7.6%
LFL sales YOY	8.6%	12.4%	7.5%	5.0%	4.0%	3.4%	-0.6%	2.0%	5.6%	-1.1%	1.2%	0.1%	2.1%
Capex/Depreciation			483%	415%	216%	170%	87%	89%	177%	139%	111%	192%	294%

Source: Capital IQ, Holland Advisors

This changing use of capital from store opening to buybacks when opportunities are less obvious and the share price is low suggests the group scores highly on our third metric of 'capital allocation' as shown overleaf in Fig.6.

Fig.6: Capital Allocation



Source: Capital IQ, Holland Advisors

The Magic of Negative Working Capital Businesses

A somewhat unorthodox characteristic we look for in companies is whether their business and its future expansion is partly funded by others (usually customers or suppliers but sometimes - in the case of Burlington Northern - the Taxman via tax rebates). More often than not, such funding comes from suppliers and this is the case with Greggs, Tesco, Sky and Wetherspoon. It is in essence, a float – a quasi-permanent source of capital which lowers the effective cost of capital for companies who enjoy it. Rarely are its benefits given much fanfare by the investment community.

Some of our early work on Tesco *(see "Holland Views – Tesco – Owner earnings and man with a hammer" May 2010)* highlighted the subtle but sizeable benefit that companies with negative working capital enjoy. In essence, 'owner earnings' (as Buffett labels it) distinguishes operating real cash flow from reported earnings (the main difference being working capital and tax). As we put it at the time:

> *"[negative working capital is] the float that the tax man and suppliers give to shareholders which can then be invested at no cost"* – **Holland Views, Tesco, May 2010**

Fig.7: Wetherspoons working capital

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	cagr
Net Income	30	35	34	29	26	40	47	36	25	41	47	**4.6%**
YoY		19%	-4%	-14%	-11%	54%	17%	-24%	-29%	61%	15%	
Working Capital (inflow)	-60	-74	-83	-91	-96	-105	-97	-96	-120	-134	-156	**9.9%**
change YoY		- 13.10	- 9.92	- 7.03	- 5.22	- 9.48	8.00	0.87	- 23.35	- 14.71	- 21.64	
% sales	-10%	-10%	-9%	-10%	-10%	-10%	-9%	-9%	-11%	-12%	-13%	
as % net income	**-203%**	**-208%**	**-245%**	**-309%**	**-369%**	**-264%**	**-208%**	**-271%**	**-473%**	**-330%**	**-334%**	
YoY		21.7%	13.5%	8.4%	5.8%	9.9%	-7.6%	-0.9%	24.2%	12.3%	16.1%	
Cashflow from Ops	91	107	120	115	87	91	76	84	110	110	117	
YoY		17%	12%	-4%	-25%	5%	-16%	10%	32%	0%	6%	
Capex	-143	-151	-93	-75	-39	-38	-76	-61	-49	-82	-126	
Dividend	- 5	- 4	- 5	- 7	- 8	- 7	- 10	- 17	- 10	- 17	- 5	
Buybacks	0	0	-18	-50	-46	-79	-77	-12	0	0	-33	

Source: Capital IQ, Holland Advisors

What Fig.7 shows is that in the case of Wetherspoon (and similarly Tesco, Morrisons and Greggs), working capital inflows have consistently boosted earnings vs. those reported.

For context, the change in this working capital (i.e. the cash impact) in 2011 was a £22m inflow, almost 60% of the amount paid-out to investors via dividends and buybacks that year. In other words, the working capital efficiency is a subtle but major driver of shareholder returns that receives little attention.

Cash Returns (CROCCE) – when theory gets out of hand

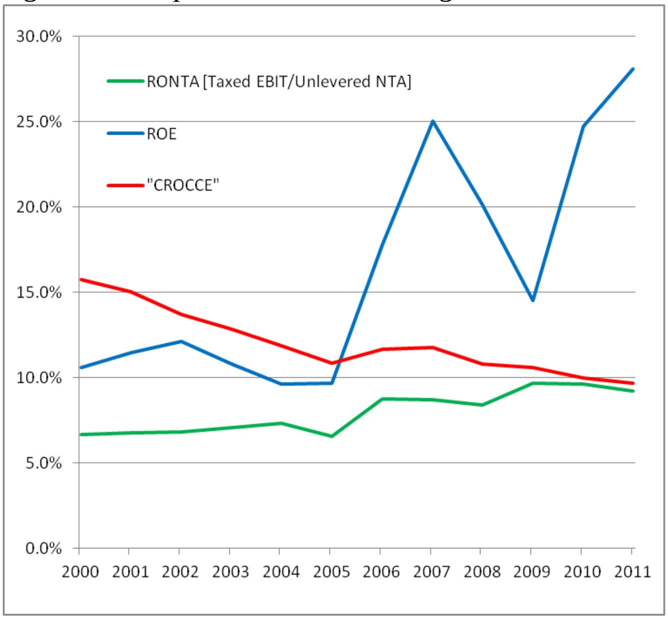
A common concern made to us by investors is that Wetherspoon's return on capital is in decline. On closer inspection what is typically being referred to here is the 'cash returns' of the business (or so-called CROCCE – Cash Return on Cash Capital Employed) – a metric which was advocated by certain sell-side analysts in the pub sector some years ago and seems to have become accepted as one of the de-facto KPIs used by the industry itself in its reporting to the City.

Financial metrics can of course be emphasised or manipulated in various ways to support a given argument and few other financial metric definitions generate as much debate as return on capital. However, at the end of the day common sense ought to prevail in the appropriateness of financial metrics for the businesses or industry under analysis.

Wetherspoon reports CROCCE annually and the chart below in Fig.8 (and Appendix 1) we reconstruct the historical CROCCE trends to provide context for the current performance shown on the right. It is the decline in CROCCE shown above that has investors worried.

Yet overlaid on the chart are the more regular metrics that we consistently use – ROE and RONTA – which in fact show the opposite, rising returns. So which is correct?

Fig.8: Wetherspoon's 'CROCCE': long-term trends and definition



		2011
Profit after tax		**46.792**
+ exceptionals	-	5
Underlying PAT		**52.181**
+ Interest		36
Profit pre-interest		**87.745**
+Deferred tax (credit)/charge	-	5
+Depreciation		42.866
=Cash return		**126**
Shareholders equity		171
+ exceptionals		53.286
+ hedging provision		42
+ net debt		495.573
Capital Employed		**762**
+ deferred tax assets		71.448
+cumulative depreciation		514
- revaluation reserve		
=Cash Capital Employed		**1,347**
CROCCE		**10%**

Source: JD Wetherspoon, Capital IQ, Holland Advisors

We make the following observations:

1. To our mind, 'Cash Return' calculations – which notably add back cumulative depreciation to the asset base calculation - are a very useful way to determine the capital allocation prowess of *specific* types of companies'. It is deliberately backward looking

and is most relevant for businesses which are capital intensive and are obliged to replace their capital base.

But we ask does Wetherspoon (or say, Tesco) today have to replace its freehold asset base originally acquired in the 1990s? Of course not. Now if this was an airline business or a semiconductor business with finite asset lifecycles then perhaps there would be justification to adjust the asset base to reflect future replenishment costs. To us, this does not seem appropriate in the case of Wetherspoon and to our mind distracts from the actual return on capital available to the equity holder.

2. Because depreciation policies (and freehold mixes) vary across the pub sector, there may be some merit in using CROCCE for *comparison* purposes. This might be the strongest justification for the metric. However because of Wetherspoons' far better franchise, higher freehold mix, strong balance sheet and careful capital allocation, intra-sector comparisons are of much less interest to us.

3. The CROCCE calculation is ultimately based on *current* cost accounting, i.e. in a sense it assumes that today you would have to repurchase the group's assets in order to generate the cashflow produced today. The key attraction of compounding franchises is that you already control a long-term asset that was purchased many years ago and the cash flow produced on that asset gradually rises with inflation (i.e. you the shareholder get the benefit from of inflation – not the accountants with their current cost accounting!).

4. Were the group still investing at the aggressive rate it was at the start of the decade such CROCCE returns might suggest future returns might not equal those reported in the past. However, this is not the case as the group clearly sees relatively less potential in its opening plan, using excess cash flow to repurchase shares instead.

5. As share repurchases progress the group's equity base contracts quite fast meaning that a greater and greater proportion of the CROCCE return is made up of added back historic deprecation making the calculation more and more academic.

It's how you interpret the numbers that matters

At the end of the day it is the way these ratios are interpreted that matters. As Charlie Munger said at the Berkshire meeting this spring:

> *'Business School teaches investors how to calculate all the numbers it just does not teach you how to interpret them'*

Another pertinent point to make is that return calculations in isolation do not give the full context for investors. In the same way that ROE is most useful in the context of the multiple being paid for it, then if investors insist on using a CROCCE on this business, then they ought to look at 'Price/CCE' i.e. the price paid for that return. In Wetherspoon's case P/CCE would be a multiple of 0.36x. In other words, the market cap of the group is significantly less than calculated 'Cash Capital Employed' asset value, so future returns are in effect amplified from 10% to 26.9% - quite close to our ROE calculation.

In our view, the price of the shares the group can repurchase and the efficiency (stock turns) it can drive from the assets it already owns are far more important drivers to the value of this business than the somewhat hypothetical question of how much capital would be needed to today to replace the existing assets.

ROE and RONTA trends

As shown below in Fig.9, the bulk of the improvement in RONTA and ROE was via improved asset-turns and leverage. In particular, the latter has been materially improved via the share buyback. To show the improvement in asset efficiency between 2001 and 2011 (notably – a time when the freehold mix did not change), it is very clear that sales outgrew assets considerably.

- 2001-11 Sales cagr: +8%
- 2001-11 Total Assets cagr: +4%
- 2001-11 Net Tangible Assets cagr: +2.6%

Fig.9: ROE: Du Pont Analysis

ROE (du Pont decomposition)	2004	2005	2006	2007	2008	2009	2010	2011
Tax Burden (Net Inc/Pre-tax)	0.63	0.65	0.68	0.76	0.66	0.56	0.67	0.76
Interest Burden [Pre-tax/EBIT]	0.6	0.6	0.7	0.7	0.6	0.5	0.6	0.6
EBIT Margin [EBIT/sales]	9.9%	8.2%	9.9%	10.2%	9.8%	10.2%	10.0%	9.5%
Asset Turns [Sales/unlevered NTA]	1.1	1.2	1.3	1.3	1.3	1.4	1.4	1.4
Leverage [unlevered NTA/Equity]	2.4	2.7	3.2	4.0	3.9	4.0	4.3	4.3
ROE	**9.6%**	**9.7%**	**17.8%**	**25.0%**	**20.1%**	**14.5%**	**24.7%**	**28.1%**
RONTA	**7.4%**	**6.6%**	**8.8%**	**8.7%**	**8.4%**	**9.7%**	**9.7%**	**9.3%**

Source: Capital IQ, Holland Advisors

Risks

In our discussions with investors on this business, several concerns are consistently expressed:

1. *"The business has achieved all the easy asset-efficiency gains in recent years. Margins are highly unlikely to rise, therefore returns have peaked and are likely to fall."*
    a. There may be truth in this argument but we are not suggesting that margins or returns *need* to expand from here for the stock to be under-valued. Rather it is the low valuation coupled with the resilience and compounding features of the business model that provide the margin of safety.
    b. We think it is worth pointing-out that given the blatant low pricing policies that the company employs, there is room for a moderation or indeed selective price increases
2. *The quality of earnings is sometimes cited as a worry – in particular the nature of exceptional charges in recent years.*
    a. Given that Cashflow from Operations last year was 2.7 times reported earnings, the quality of earnings in this business is clearly high although we do concede that exceptionals write-downs have been a little too frequent especially since 2009.
3. *The question of appropriate levels of leverage is often asked*
    a. Our sense is that with EBIT/Net interest still close to 3x and Net debt/EBITDA of 3.4x, the company remains sensibly structured.
    b. Whilst these ratios are low when compared to other UK pub companies they are higher than those of the franchises we normally recommend
4. *Perhaps the greatest risk to Wetherspoon is regulatory pricing.*
    a. The issues of supermarket alcohol pricing (often perceived to be below cost) and the phenomenon of binge drinking are hot topics in the UK and it is possible that Wetherspoon could get caught in the crossfire.

Conclusion

We see many attractions in the JD Wetherspoon business that Mr. Market seems to ignore and as ever, therein lies the opportunity. We see a business that has an excellent culture and long-term track record, a constantly widening competitive position, is innovative (and has the returns profile to show for it) and is a dab-hand at allocating capital opportunistically via share buybacks.

Investors are not short of reasons to dismiss Wetherspoons as an investment – UK retail and in particular UK pubs is a sector that is understandably derided by many and has undoubtedly been subject to many headwinds such as rising cost inflation, government taxes, supermarket discounting and cuts in consumer spending.

Yet, Wetherspoon stands out by a mile in the sector. It has shown that it can innovate in one of the toughest UK retail environments, improve its asset efficiency, use its scale to drive down prices for customers and enjoy an extremely healthy working capital benefits from suppliers. In short this is a high-return business run in a long-term quasi-private fashion whose interests and actions are extremely-well aligned with shareholders'. We have not felt the need to closely consider the group valuation as we see it as priced very cheaply in the context of the business traits that we have outlined but it trades on 9.8x EV/Historical EBIT and 11.2x past year P/E.

With pricing levels in all products sold that are so far below all others in this industry this group may well have a long road of expansion ahead of it. Today new openings are limited, likely by the combination of high asset prices and cost/tax pressures, hence the current use of capital for share buy backs instead. This combination of high asset prices and high costs might not always be present though and where the group to consider it attractive we think expanding significantly their 1.5% market share would be something they could now easily achieve. As such and we wonder whether JDW could be the "*snowball with wet snow and a really long hill*" that someone famously said we should look for.

Buy JD Wetherspoon

Andrew, Mark and Ramsey **firstname@hollandadvisors.co.uk**

Contact: Holland Advisors London Limited
1 Berkeley Street
London
W1J 8DJ

Tel: (0)871 222 5521
Mob: (0)7775 826863
www.hollandadvisors.co.uk

Appendix 1 – Historical CROCCE

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Profit after tax	**24.056**	**29.86**	**35.416**	**34.044**	**29.274**	**25.93**	**39.901**	**46.834**	**35.535**	**25.299**	**40.778**	**46.792**
+ exceptionals	-	-	-	-4	-8	-2	-	0	-3	-21	-11	-5
Underlying PAT	**24.056**	**29.86**	**35.416**	**38.061**	**37.032**	**27.857**	**39.901**	**46.429**	**38.36**	**46.517**	**51.335**	**52.181**
+ Interest	13	15	17	19	23	25	25	29	33	31	29	36
Profit pre-interest	**37.503**	**45.17**	**52.682**	**57.386**	**59.576**	**52.418**	**65.253**	**75.724**	**70.926**	**77.699**	**80.349**	**87.745**
+Deferred tax (credit)/charge	10	12	10	5	-	2	0	-3	-0	-2	-2	-5
+Depreciation	20.946	29.674	36.343	43.209	43.948	44.405	42.314	42.902	43.901	43.983	42.62	42.866
=Cash return	**69**	**87**	**99**	**106**	**104**	**98**	**108**	**115**	**115**	**120**	**121**	**126**
Shareholders equity	247	274	310	318	289	247	202	173	181	168	162	171
+ exceptionals	15.693	15.693	15.693	15.693	15.693	15.693	15.693	15.693	30.661	53.286	53.286	53.286
+ hedging provision	-24	-24	-23	-23	-24	-1	-1	-2	-1	25	43	42
+ net debt	169.383	241.577	302.637	308.86	337.559	326.445	347.625	438.074	443.18	426.021	449.782	495.573
Capital Employed	**407**	**507**	**605**	**620**	**619**	**588**	**564**	**625**	**653**	**672**	**708**	**762**
+ deferred tax assets	35.688	47.803	57.399	62.419	66.244	83.211	82.958	79.4	79.231	77.633	75.579	71.448
+cumulative depreciation	63	93	129	169	206	246	282	321	362	421	470	514
- revaluation reserve												
=Cash Capital Employed	**506**	**648**	**792**	**852**	**891**	**917**	**929**	**1,026**	**1,095**	**1,171**	**1,254**	**1,347**
CROCCE	**16%**	**15%**	**14%**	**13%**	**12%**	**11%**	**12%**	**12%**	**11%**	**11%**	**10%**	**10%**

Source: Capital IQ / Holland Advisors

Appendix 2 – JD Wetherspoon Financials

GBP (in millions)	Year-end: July 2001	2002	JD WETHERSPOON PLC (LSE:JDW) 2003	2004	2005	2006	2007	2008	updated: 11-Jun-2012 2009	2010	2011	10-yr calcs
Operating Track Record												
Sales	484	601	731	787	810	848	888	908	955	996	1,072	8% cagr
YoY	0%	24%	22%	8%	3%	5%	5%	2%	5%	4%	8%	
10 year cagr	37%	35%	32%	28%	23%	20%	17%	13%	10%	0%	8%	
Sales/share	2.3	2.8	3.4	3.9	4.4	5.1	6.0	6.4	6.9	7.4	8.1	13% cagr
Gross Margin	17.0%	16.2%	14.9%	14.1%	11.9%	14.9%	15.1%	14.8%	14.8%	14.4%	13.6%	
R&D as % sales (if reported)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
EBIT	58.4	70.1	75.0	77.6	66.1	83.6	90.7	89.2	97.1	100.0	102.3	6% cagr
Reported EBIT margin	12.1%	11.7%	10.3%	9.9%	8.2%	9.9%	10.2%	9.8%	10.2%	10.0%	9.5%	
'Clean' EBIT Margin	*12.1%*	*11.7%*	*10.8%*	*10.8%*	*8.4%*	*9.9%*	*10.2%*	*10.1%*	*12.4%*	*11.1%*	*10.0%*	
P&L Tax Rate	33%	34%	35%	37%	35%	32%	24%	34%	44%	33%	24%	
Net Income	30	35	34	29	26	40	47	36	25	41	47	390 sum
Diluted shares outstanding	213	215	215	201	186	166	148	141	139	135	132	-4.7% cagr
Reported Diluted EPS	0.1	0.2	0.2	0.1	0.1	0.2	0.3	0.3	0.2	0.3	0.4	10% cagr
Book Value											17%	
Shareholder Equity	274	310	318	289	247	202	173	181	168	162	171	
Book Value per share	1.3	1.4	1.5	1.5	1.4	1.3	1.2	1.3	1.2	1.2	1.4	.4% cagr
Tangible Book value per share	1.3	1.4	1.5	1.5	1.4	1.3	1.2	1.3	1.2	1.2	1.3	
'Unusual items'/exceptionals in P&L	0.0	0.0	-4.0	-7.8	-1.9	0.0	0.4	-2.8	-21.2	-10.6	-5.4	-53 sum
Capital Employed												
Total Assets	657	783	821	830	810	804	844	851	857	911	990	4.2% cagr
LT Assets	626	745	774	784	753	727	782	793	774	811	881	3.5% cagr
Unlevered NTA [PP&E - WC]	576	685	707	707	671	639	699	711	671	694	740	2.6% cagr
Goodwill	-	-	-	-	-	-	-	-	-	-	-	
Other intangibles	-	-	-	-	3	3	4	4	5	7	12	
[Goodwill+Intangibles]/Total Assets	0%	0%	0%	0%	0%	0%	0%	1%	1%	1%	1%	
Working Capital												
'Net Working Cap' (CIQ definition)	(60)	(74)	(83)	(91)	(96)	(105)	(97)	(96)	(120)	(134)	(156)	10% cagr
Check: working capital (basic calc)	*(50)*	*(60)*	*(67)*	*(77)*	*(83)*	*(88)*	*(84)*	*(82)*	*(103)*	*(117)*	*(141)*	
Inventory Days	7	6	6	6	7	7	9	8	8	9	8	
DSOs	0	1	2	2	1	1	2	2	1	2	2	
Payable Days	46	39	34	28	28	29	28	24	33	38	37	
Working Cap % sales	-10%	-10%	-9%	-10%	-10%	-10%	-9%	-9%	-11%	-12%	-13%	-10% av
Working Cap % of Net Income	-203%	-208%	-245%	-309%	-369%	-264%	-208%	-271%	-473%	-330%	-334%	
'Owner Earnings' [Net Income + WC]	90	109	118	120	122	145	144	132	145	175	203	8% cagr
Return on Capital												
ROCE [Taxed EBIT/unlevered NTA]	7%	7%	7%	7%	7%	9%	9%	8%	10%	10%	9%	8% median
ROE	11%	12%	11%	10%	10%	18%	25%	20%	15%	25%	28%	15% median
Capital Allocation												
Dividends - common	(4.5)	(4.4)	(5.4)	(7.3)	(7.5)	(7.4)	(10.3)	(17.4)	(10.4)	(16.5)	(5.2)	96 sum
Dividends - special	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	(9.6)	0.0	10 sum
Buybacks	(0.2)	0.0	(17.5)	(50.1)	(45.7)	(78.7)	(77.0)	(12.0)	0.0	0.0	(32.8)	314 sum
Payout Ratio [(divs+buyback)/net inc]	16%	13%	67%	196%	205%	216%	186%	83%	41%	64%	81%	81% median
Capex (PP&E)	(143.4)	(150.8)	(15.9)	(20.6)	(14.2)	(20.8)	(24.0)	(10.9)	(9.5)	(21.8)	(31.8)	
Capex (intangibles)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	(2.2)	(2.4)	(6.2)	(7.4)	
Capex as % of sales			2%	3%	2%	2%	3%	1%	1%	3%	4%	2% av
Cash Acquisitions (aka 'Leakage')	0.0	0.0	(77.3)	(54.1)	(24.5)	(16.8)	(52.0)	(47.8)	(36.9)	(53.8)	(86.8)	-450 sum
as % of net income	0%	0%	227%	185%	94%	42%	111%	134%	146%	132%	185%	132% median
Cashflow from investing	(160.8)	(170.0)	(103.6)	(87.4)	(30.1)	(32.9)	(71.2)	(60.1)	(48.3)	(81.6)	(124.9)	
Check - other 'investing' items?	*(17.5)*	*(19.1)*	*(10.4)*	*(12.7)*	*8.5*	*4.6*	*4.8*	*0.8*	*0.5*	*0.2*	*1.1*	
Capex/depreciation	483%	415%	37%	47%	32%	49%	56%	25%	22%	51%	74%	
Equity Issuance	2.1	5.8	0.2	1.2	0.3	7.0	5.9	0.5	0.6	0.5	0.2	24 sum
ROE (du Pont decomposition)												
Tax Burden (Net Inc/Pre-tax)	0.7	0.7	0.6	0.6	0.7	0.68	0.8	0.7	0.6	0.7	0.8	
Interest Burden [Pre-tax/EBIT]	0.8	0.8	0.7	0.6	0.6	0.70	0.7	0.6	0.5	0.6	0.6	
EBIT Margin [EBIT/sales]	12.1%	11.7%	10.3%	9.9%	8.2%	9.9%	10.2%	9.8%	10.2%	10.0%	9.5%	
Asset Turns [Sales/unlevered NTA]	.8x	.9x	1.0x	1.1x	1.2x	1.3x	1.3x	1.3x	1.4x	1.4x	1.4x	
Leverage [unlevered NTA/Equity]	2.1x	2.2x	2.2x	2.4x	2.7x	3.2x	4.0x	3.9x	4.0x	4.3x	4.3x	
CHECK: ROE (via Du Pont)	*10.9%*	*11.4%*	*10.7%*	*10.1%*	*10.5%*	*19.8%*	*27.1%*	*19.7%*	*15.1%*	*25.1%*	*27.4%*	
Debt/Leverage												
Net Debt	242	303	309	338	326	348	438	443	426	450	496	
Total Debt Issued	40	65	33	48	30	305	76	3	0	97	50	
Total Debt on balance sheet	251	316	324	347	345	369	457	460	450	476	523	
Debt / Equity	0.9	1.0	1.0	1.2	1.4	1.8	2.6	2.5	2.7	2.9	3.1	
Pension liability on balance sheet	-	-	-	-	-	-	-	-	-	-	-	
as % of current market cap											0%	
EBIT / Interest	3.8	4.1	3.9	3.4	2.7	3.3	3.1	2.7	3.1	3.4	2.9	
Net Debt / EBITDA	2.7x	2.8x	2.6x	2.8x	2.9x	2.7x	3.3x	3.3x	3.0x	3.2x	3.4x	
Check: CFO/Net Income	*306%*	*303%*	*353%*	*393%*	*334%*	*227%*	*163%*	*236%*	*437%*	*271%*	*251%*	298% av
Historical Valuation in GBP												
Av market cap	751	765	496	570	490	603	987	545	469	646	577	-2.6% cagr
EV	992	1,067	805	908	817	951	1,425	988	895	1,096	1,072	
EV/EBIT	17.0x	15.2x	10.7x	11.7x	12.4x	11.4x	15.7x	11.1x	9.2x	11.0x	10.5x	
EV/CE [EV/Unlevered NTA)	1.7x	1.6x	1.1x	1.3x	1.2x	1.5x	2.0x	1.4x	1.3x	1.6x	1.4x	
P/E	25.1x	21.6x	14.6x	19.5x	18.9x	15.1x	21.1x	15.3x	18.5x	15.9x	12.3x	
P/Book	2.7x	2.5x	1.6x	2.0x	2.0x	3.0x	5.7x	3.0x	2.8x	4.0x	3.4x	
P/Tangible Book	2.7x	2.5x	1.6x	2.0x	2.0x	3.0x	5.7x	3.0x	2.8x	4.0x	3.4x	
Dividend yield	0.6%	0.6%	1.1%	1.3%	1.5%	1.2%	1.0%	3.2%	2.2%	2.6%	0.9%	
FCF yield	-10%	-9%	15%	11%	14%	11%	5%	13%	22%	12%	13%	

Latest Val [Share Price GBP3.968]	Reports in GBP	Priced in GBP	GBPGBP= 1.00	HQ: United Kingdom
Current market cap in GBP	475			
EV	971			
EV/EBIT (LTM)	**9.1x**			
P/E	**10.2x**			
P/Tangible Book	**2.9x**			
Dividend yield	1.1%			

Largest Region	Sales	Mix
United Kingdom	1116	104%

10 Year Share price Trend

JD Wetherspoon plc owns and operates pubs.

1. Martin, Tim	4. Schroder Investment Manag
2. Sanderson Asset Managemen	5. OppenheimerFunds, Inc.
3. Columbia Management Inves	6. BlackRock, Inc.

1. Analyst Coverage	14	
of which buyers	6	
of which sellers	0	
2. Fulltime employees	-	
3. Insider Holders?	Martin, Tim	
Value of holding in GBPm	131	28%
Top 10 insiders in GBPm	133	28%

Source: Capital IQ / Holland Advisors

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