**Holland Views: Frasers – Price: 350p; MCap: £1.8bn**

# *"He got you, didn't he?"*

We are still believers in Frasers as an attractive owner managed investment and think the shares could easily double. We have written at length on the company in the past. Today we will be briefer for three reasons:

1. Because much of what we believe to be important for Fraser's recovery we have articulated before
2. Because we think very few non-shareholders will have much interest in our work, having labelled the shares un-investable
3. Because it is hard for any potential investor to co-corroborate our opinions unless they have access to management and the experience of watching recent year events unfold

First an admission

At times Frasers is a hard share to own. This is partly due to share price volatility and the past overactivity of the "haters" (press/politicians). But it is also because the company is unconventional, esoteric and sometimes accident-prone. Indeed, our sense of frustration on such matters lead us to write an open letter to them last year to encourage more professionalism in certain non-operational areas.

We have been attending investor group meetings with Mike Ashley and his team for some years now. They are never easy and sometimes annoying due to the scale of interference that can come from those with a non-investor axe to grind such as journalists or union representatives. However, the collective learnings we have from listening to Ashley and his team at these meetings is critical to the view we maintain today. With the company/Ashley rarely keen to lay out a smooth future road map for investors it has been akin to a jigsaw puzzle with different pieces being visible at different times (see *Holland Advisors Engine Overhaul - Jan 2018*).

## We believe

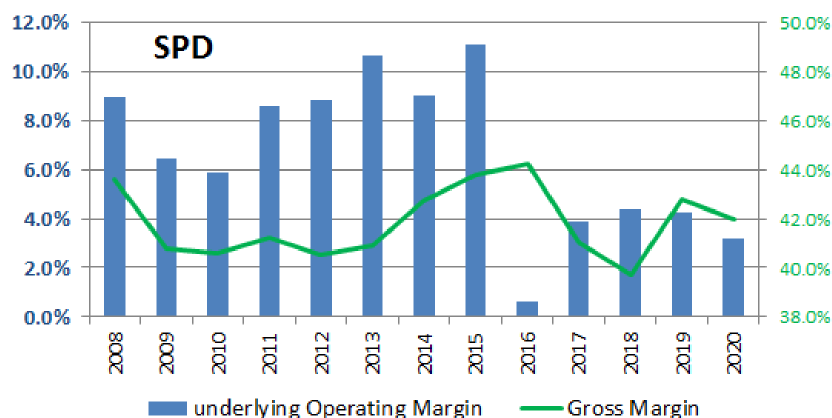
A summary of our previously written and still currently-held beliefs as to what is the most likely future of Frasers is as follows:

Margin Recovery

Whilst last week's share price rise was most likely due to the guidance for a 10-30% FY21 increase in EBITDA, we paid this guidance not a great deal of attention. Nor have we paid much attention to the last few years' guidance of +10% EBITDA. For us the longer-term prize has always been greater, i.e. that of a fuller recovery in profitability to past (or better) levels of margins. Figure 1 below we hope illustrates this potential.

When this company moved away from discounting in c.2016 we saw a likelihood that one day its margins would recover to their past levels. That it had previously made 8-10% EBIT margin in years 2011-2015 when making only 41-43% gross margins was appealing to us.

Fig.1: Margin trends




**Source: Holland Advisors**

At that time, it was a scale retailer who had low operating costs (see Opex comparison with JD in our model) and low selling prices. In time, we opined, reduced discounting and better product mix would inevitably lead to higher/recovered gross margins. Then if operating expense efficiency was maintained, past EBIT margins should be able to be recovered too. **(This has been our core thesis for c. 3years - It remains so)**

## Elevation

Time spent in the company stores both new and old have informed our view that product elevation was always real and clearly in evidence. This could first be seen in the group's lower level of discounting of third party brands and more recently in less discounting of their own brands too. That this strategy was only really delivered best in a smaller number of stores confused investor perception of the company's recovery. Whilst we too would like to see a further acceleration in store conversions that 'less discounting' is now in the company's DNA is already clear to see.

## Provisions and Prudence

Careful reading of the company's last 3-4years of accounts lead us to see the very prudent (perhaps exceptionally so) provisioning the company was doing. Inventory was growing fast during the Flannels build-out and post HOF/ other acquisitions. As a result, a much more prudent level of inventory provisioning (taken in COGS) was reasonable. However, our work suggests that the company actions in the area of inventory and other provisions are super prudent resulting in a likely under reporting of what might be considered core group profitability (*See Holland Views - SPD Underearning, Undervalued and Unloved- September 2019).*

## What you win if you win

Whilst we like to think we have not blindly followed Mike Ashley, raising many hard questions along the way, we do share his enthusiasm for the elevation strategy. Even though it was only working in a relatively small number of sites to start with. The reason for this was that it proved our core belief in the recovery of the company, i.e. that a good (record high) gross margins achieved from less discounting could produce great group economics. For us that is what this share is all about; a repositioning of the company using its dominant market position to improve mix and pricing. The financial results of which we believe should see EBITDA/EBIT/PAT margins recover at least to their past levels eventually.

Were this to occur at the EBIT level this would result in a future c.10% EBIT margin. On a 2020 sales level of £4bn this indicates a possible £400m EBIT. Compared to a company valued today at c.£1.8bn (+ debt at £350m) we hope it is easy to see why we feel a recovery is far from priced in. A 10x EV/EBIT would see the shares double.

# New for 2020 – More of the Same!

Against this backdrop the April 2020 results reported last week were just a continuation of our three-legged recovery thesis, i.e.:

- There was more progress on elevation/less discounting (though this was more obvious in H1 than H2)
- Inventory (and other) provisions were again high with more new provisions added. The progress made in rising group gross margin in H1 (43.8% up 230bp on the previous year) was not replicated at the full year. Full year group gross margin was 42% vs. 42.8% in 2019 and EBITDA margins saw little improvement also. This is partly explained by another step up in provisions for inventory and onerous leases but also due to the effect of acquisitions (mainly Game).
    - Of interest was the disclosure that *"excluding acquisitions, gross margins in the UK sports retail business increased to 43.5%".*
    - That all of this occurred in a period when the shops were closed for 6 weeks is both interesting and speaks to the underlying profitability of the core business.
- All of this being supportive of our longer-term margin recovery expectation that will one day take place at the EBITDA/EBIT/PAT level

## Elevated provisions still hide true profitability

Our updated work on the level of ongoing provisions and the effect they are having in reducing the recently reported level of profit/EBITDA can be seen in the attached spreadsheet. We stand by the view expressed last summer that this companies' provision charges will normalise at some stage either reducing as a percentage of sales or seeing just less new provisions. When that occurs a truer picture of the groups underlying profitability will be more evident to all. Our work makes adjustments to show this.

## Ashley talks to inventory provisioning

Of particular note last week was Mike Ashley's comment that in time (he suggested c.3years but we think less) "*better automation and all our stock in one cloud should mean less need for inventory reserve*" As this charge/provision along with higher depreciation are the main reasons why recently higher gross margins have not converted into higher EBIT margins we found this interesting to hear and telling that Mike called it out.

For the avoidance of doubt, we re-iterate the view expressed in our previous pieces. It is not that we are critical of the company's level of provisions taken up to now, nor do we claim that they are in any way incorrect. What we highlight is that a business in future being in more of a steady state would be highly likely to see lower (possibly far lower) additional provisions charged to the P+L each year thus at that time would report higher profits.

## What goes wrong?

In terms of what could go wrong enough for us to lose the potential upside in these shares we think the list is changing. A year or two ago maybe we would have focused on the dangers of overreach with Ashley and team trying to do too much by way of expansion in areas like Flannels and HOF/Debenhams. While we must accept these business lines carry a greater "fashion-miss" risk than the core Sport Direct business ever did, the progress Frasers have made in successfully rolling out Flannels and recovering/stabilising HoF must be acknowledged and applauded. Additionally, that Ashley is (rightly) being hard nosed on the future of the many of the less prestigious HoF sites in the face of a return to the 2015 rates' charge level next Spring we think shareholders should welcome.

Being cut off by third party suppliers has always been a risk in the last c.4years and it remains so. That said the group's recent move to buy (Jack Wills) or embrace (Hugo Boss) shows how new brand relationships can replace old ones.

That the Nike relationship is still not great is clear, but we suspect Nike would never want to completely break ties with Ashley. This is partly due to the scale of sports/elevated stores he controls, but also because they have seen the other side of him. I.e. the powerful deep discounter of the past. As such Nike might conclude that it is far better having him inside the tent than outside. We conclude that third party relationships in aggregate continue to gradually improve, albeit some more slowly than others.

The bigger risk for the business today is maybe that its laggard position in technology (and frankly e-commerce and logistics) meaning it just cannot complete as effectively online as it would like. I.e. offering the customer the service/returns etc. that they are now accustomed to. That its efforts are now being directed to this area we think is welcome. That they are behind some online peers is clear not just from the company's communication but from our own experience as an online customer of the company. Also, that even the industry leaders in this area keep moving forward fast we think is notable and therefore an increasing risk to Frasers. **We would like to see the group really focus on excellence in the technology/e-commerce arena above all other challenges and distractions in the coming years.**

Mike Ashley – "Maverick"

We have now spent 10-15 years studying companies controlled by a wide variety of owner managers. That this subset of global companies outperforms the average quoted share is well known. That owner managers come in all shapes and sizes is perhaps less appreciated by some investors looking for the more 'vanilla' aligned CEO/Owners. That we have looked at far more maverick types of managers shows we are perhaps more tolerant and embracing of the different approach they bring.

Those that have sat in front of Mike Ashley will attest to the fact that he is a long long way from being Simon Wolfson who provides an erudite and well laid out analytical view of his industry and how it may evolve. What Mike possess we think is a raw and perhaps rarer talent. His greatest skill we believe is his remarkable ability to understand his relative power vs. his competition and how to use both it and its associated levers of price, volume and brand appeal to draw customers in. When the relationship with Nike changed effectively stopping his ability to loss-lead third party brands to attract customers, he knew he had to then pivot the business away from discounting. However, he did so knowing he had already won the low-cost war; thus, he was unlikely to lose much market share in doing so. A few years back he famously answered the question of what customers might think of his brand repositioning (less discounting) with words that have stuck with us:

"*Where else are they going to go*"

Ashley's post 2016 re-invention of Frasers has been fascinating to watch. On the one hand he has constantly and consistently eaten humble pie to appease and please the third party brands. On the other he has repeated his past use of scale to buy up other brands and distribution outlets at ever-increasing speed (HoF, Jack Wills, Evan Cycles and most recently a stake in Hugo Boss/DW Sports etc.). That this juggling act has been accompanied by the backdrop of Brexit and then Covid has made the business unforecastable and impossible for most investors to comprehend. And yet against all this and a retail sector on the verge of bankruptcy backdrop, Frasers looks strong, recovering and we think (pre-provisions) very profitable.

Whilst the recovery in the business is far from complete its progress to date speaks both to Ashley's abilities and to the resilience of its core business.

We have before expressed the view that entrepreneurs such as this are loved by investors when they are delivering easy profits and growth. Indeed, the share price, and valuation attached to Sports Direct (as it was) in 2009-15 is evidence of this. However, their maverick, sometimes confrontational and never conventional style means that too few investors will stay the course when things get tough. That is fine by us.

The recovery at Frasers is far from guaranteed but we think on track. We believe in it.

**Buy Frasers**

With apologies to 'Top Gun'

**Jester: "His fitness report says it all. Flies by the seat of his pants, totally unpredictable."**

**Viper: "He got you, didn't he?"**

**Jester: "Yeah"**

With kind regards

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