HollAnd Advisors

**Holland Views – J D Wetherspoon: Price 1216p; MCap £1,280m**

# Low Risk Compounding + Red Herrings

We have written a lot on JDW over the years and we are proud of this work. In the summer we claimed something that no-one else seems to believe possible in this company; i.e. that one day its seemingly long-lost operational gearing will return. Over the last few weeks we have spent time with Tim and many of those in his team. As such we reflect on this and other ideas.

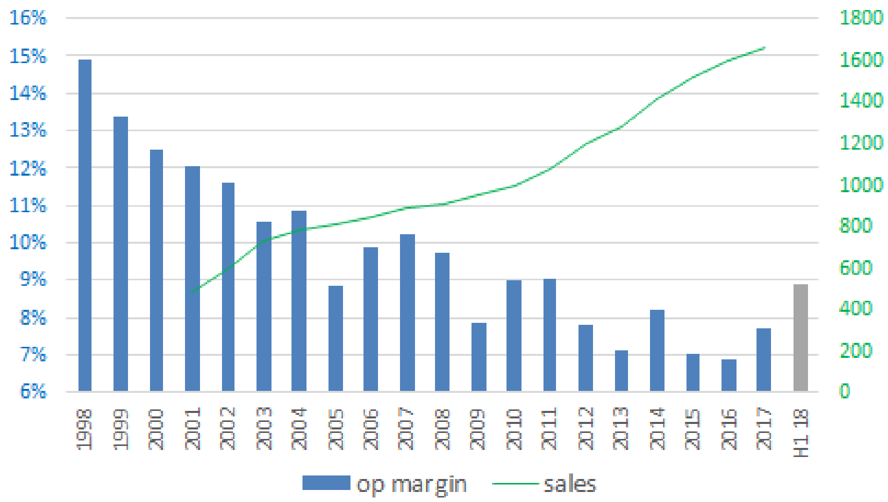
In a recent trading statement, the company commented that they thought full year 2019 profits would be flat as cost increases will not be passed on in higher prices to the customer – the shares reacted falling 10%. As statements go, we think this is the perfect red herring. Post recent meetings with JDW we add a few points to our thesis on the company.

## The Red Herring

Almost every other company who is putting wage rises through is passing these on in routine smaller price increases (NB: Next did exactly that post Sterling's Brexit fall).

- But JDW is not like any other company – Tim Martin has many strong beliefs (in case you have not noticed!) and keeping prices very low to win over customers year after year is one of them.
- During 2018 while the company has had a 5% increase in like for like sales its LFL profit per pub only grew 1.2%. The main reason being strong rises in staff costs (up 9%). However pretty much all of that 5% sales increase was volume <u>not</u> price.
- Had JDW increased prices a little in this period (say 2%) to pass on cost increases we doubt its LFL sales would have been impacted that much, but profits would have been higher (much).
- When we seek to find companies with "pricing power" surely this is what we are after; Companies that 'could' rise prices. Whether they chose to or not is a different issue.

<u>Fig.1: No-one, it seems, expects margins to *ever* buck the long downward trend (except us!)</u>




**Source: Bloomberg**

## A great employer

- JDW is now a great place to work:
    - Prior to the November 18 pay rise for all staff JDW were paying 20-30p a hour above the minimum wage across all bands. Post this month's rises it will be 45-50p above. In some areas the pay gap is much higher.
    - In addition, there is an annual bonus of c.5% of pay.
    - Managers are now on maximum 40 hour weeks with far better terms for accommodation and other allowances.

*"We have now got quite a big buffer in wages"* John Hutson, CEO Sept 2018

## An investment phase

- The company has been on a strong investment phase for the last few years – investing heavily in its pubs and its people. Arguably quite soon they might run of out of things to spend the money (that rising volumes generate) on.
- Notably the group is far more careful about new pub expansion these days. Interestingly this is not due to a lack of ambition or lack of demand (huge swathes of London are crying out for a 'Spoons) but due to the company's careful consideration of the return on capital they want to ensure each new pub will make.
- During this phase JDW have also largely completed the closure of less profitable sites that they have admitted were a function of past over expansion in some towns

## Pricing gap only increasing

Due to Tim's and his teams desire to keep prices low wherever they can:

- The groups like for like sales continue to grow at industry beating rates. It should be noted that there are some operators who have similarly good LFL sales data as JDW (Youngs, Fullers + Marston's are examples) but these companies have put up prices consistently in recent years. In volume LFL growth we think JDW is streets ahead.
- The JDW team keep a close eye on the pubs they are closest to make sure that they are always 20-25% cheaper across the range of drinks/food offered against their local peers. However, with the industry raising prices and JDW not following suit this gap is widening.
- Furthermore, we believe JDW has a deflationary effect on prices around its pubs as competitors have to respond to offer better value to compete. The result is JDW now admits they are likely now far more than 20-25% cheaper if compared to a broader basket of pub sites in the industry. (Our own experiences easily backs up this point).

## Investor reflection

We would ask readers at this moment to stop and reflect on how many companies they can find that:

a) Have a strong customer centric culture and one of continuing improvement
b) Where the price offering is so much lower than peers for the same product
c) Where as a result there is arguably significant untapped pricing power
d) Where EBIT margins are at a record low despite the companies growing scale

Answer – not many!!

## JDW's Future – Like the past, but with a twist

Tim Martin and his wider team at Weatherspoon are well worth studying. We feel they are a great example of how a company and its managers can incrementally get better each day and each year. There are no Stuart Roses or Paul Polmans on display here – No charismatic leaders with a dreamy vision of how things can be changed radically due to their brilliance. There is just a steady stream of managers doing a good job for the customer week in week out and then listening to that same customer and the staff that connect with them to see how things can be improved. Over time this has built a business of real substance and one which we now believe now has a strong moat around it. Tim talks about a pub business not have having a brand like 'Coke'. Instead it has a 'reputation'. Wetherspoons has been building its reputation for 30 years. All its drinkers and its competitors know that its stands for low prices and the gap with these competitors is now so large as to be in most cases unbreachable.

### Operate/Allocate

Over many years Tim has spent a great deal of time better understanding areas that can create shareholder value, the two key ones being Return on Capital and the use of share buy backs. The combination of the two we think will lead to industry beating equity investor IRRs whilst still charging customers very low prices.

- The company's evolution in its use of return on capital has seen it set higher and higher hurdles for itself to ensure all costs are being considered against any new expansion. In a sector with high property prices in the locations JDW desires (i.e. some city centres) this has resulted in a slowing of their pub rollout growth. Also, an exciting of some sites.
- On this point there is a notable difference between JDW actions and those of other pub companies. An owned freehold estate and beer/food price rises to a captive audience can mean returns on historic assets may be good resulting in high margins. A few other pub companies have these traits and as a result Mr Market rewards them with high PE's. We observe however that ever greater spending on new expensive sites means that investors in these companies will not get the benefit of such returns.
- In the wider language of our work on Franchises some of JDW's peers we describe above have barriers to entry due to their site locations (often London/South East hot spots) but we believe they are falling short on the "allocate" function.

In speaking with managers at Wetherspoons it is clear that there is demand from the customer and a desire by the company to one day have more sites in parts of London. What stops them is the runaway Freehold prices of pubs and the fact that other competitors will pay these prices (and make poor returns on the capital they spend as a result). Were a change to come to London property values one day this is one company we feel sure would pounce. In the meantime, we admire their return discipline.

### 50% sales uplift target

JDW in the past was the disrupter, opening pubs at a fast rate due to the wider demand for its low prices. Today it is a different beast. With the low price reputation now assured it has set about improving all aspects of the customer experience. This is extensive and ongoing. So much so that today you might enter a Wetherspoons without even realising it is one. This is the Weatherspoon of the future. With its volume advantage per pub assured the group is re-investing heavily in the estate, its people and in the quality of the product it sells (especially the food).

The result of which can be seen in recent years sales (read volume) growth. The builder and late morning drinker found Wetherspoons many many years ago. Now with a better-looking estate, improved food offering and friendly staff a wider cross section of the public are gradually discovering it to (Remember those Range Rovers' in the Aldi car park). As we observed some 6 years ago now: *'This is snowball on a long hill'*.

The return on capital discipline the group possesses combined with its customer focus is leading it to focus on the throughput of its existing pubs. The group is targeting to have 50% more sales though the existing estate in ten years' time. This might seem optimistic to some, but we note Average weekly sales per pub have grown at a cagr of 4% for the last 10 years.

## Operational gearing+ red herrings

To take the recent trading comments by Tim at face value (i.e. wage cost but no prices rises) would suggest that the idea of positive operational gearing at Wetherspoons is fanciful. But we remind readers that JDW's decisions on pricing are its choice and year after year it has chosen to keep re-investing in price to reward its customers, and further build its reputation. This is exactly the franchise behaviour we seek out in companies. As a result, it has built a moat that others cannot match.

> *Why can't they match JDW?* *The reason for this is that JDW has a very low mark up on the products it sells but as they sell these (per pub and across the whole estate) in such large volumes they still make an acceptable net margin. This is analogous to comparing Costco to say McColl's- high volume vs low but greater convenience. What is rare is to have a similar format of store (eg pub in a high street) that is able to offer such a differentiated priced product. The reason say Greene King cannot respond in Shepherds Bush is because their reputation has not been built on low prices so it would take a long while to build up the scale of traffic in their local pub to compensate for the new lower prices. Aka, they would lose a lot of money for a long time before the payback could be proven to have worked.*

The work we did in the summer outlined how EBIT margins could and we believe will rise in the future. We stand by it. But we ask; Did Walmart make more money one day by rising prices for a week-even though it could have? Does Amazon do that? No. The value is created in such businesses by the long-term loyalty and attraction that the combination of low prices and good service brings. If Wetherspoon's get even close to rising sales 50% in its existing pubs in the next 10 years, and were most of that volume related, is it really such a stretch to assume that its EBIT Margin will rise from 8% to 10% – we think not. (The chart on the front page puts these margins into context vs JDW history. Your Bloomberg Terminal will also help you see that they are ½ industry peer levels).

In a recent meeting with Tim we asked him this very question, i.e. "*surely having invested in the estate and people to such an extent now we must start to see some operational gearing?*" His answer we thought was telling. He observed that during the late 1990's there was an over expansion by the financial sector into pubs. When that reversed he observes that JDW benefited. Today he suggested there had been a similar over expansion into the restaurant sector and he suggested that were capital to leave this area (i.e. closures) they could benefit again. Specifically, on operationally gearing he said:

*"some probably does drop though at some point in time to us"* Tim Martin Oct 2018

We stand by our past work on the company and think it one of the lowest risk compounders we can find today, We think equity holders can look forward to IRRs of 11-16% pa for many years to come.* – Our money is on the higher figure.

(*NB: the models that shows these prospective returns are in the Appendix of our June 2018 note – attached. It should be noted that these models assume only 2% annual LFL sales growth. JDW's target of 50% higher existing estate sales in 10years suggests this is far too low.)

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