Holland Views – Sports Direct – Price: 374p; Mcap: £2,030m

Engine overhaul

Imagine a friend of yours had a car for sale over Christmas. Normally it might be worth £20,000, but it has had to go in to a garage for a major engine overhaul. Your friend however is desperate for the cash and offers it to you for £10,000. You are interested so ask to have a look. You go to the garage. You find bits of the car all over the place and the body work covered in winter salt. The engineers have not touched it for two weeks during their Christmas break it turns out – you decline your friends offer and wish him luck.

You find out later that his father lent him enough money to get by and pay the garage bills. In April you see your friend again. It is a nice sunny day and his picks you up to drive to a pub, 20 miles away. The car is looking spotless and driving beautifully on both the tight country roads and at speed on the motorway. You mention that the car is looking good and ask if he is still wants to sell it. 'Yes' he replies, in fact this is my last trip in it as a dealer is coming to pick it up in the morning – they paid me £19,000 for it.

Investment Phases

We use the car analogy as when it is in pieces maybe only the owner and the mechanic have some confidence of what it will perform like once it is put back together. The same we think can be said for some companies during periods of great change especially when they are run by owner managers – (i.e. those who are long standing and have a sizable stake in the company).

We have noticed now for many years the share buying opportunity that can arise from an investment phase a quoted business may sometimes need to go through. This can be to develop new products, new routes to market or just the need to update systems such as an SAP installation. The reason an investment opportunity often arises is that two unexpected factors often push down the share price.

1. Firstly, most such phases have uncertainty attached to them as to the time it may take to complete or the exact outcome that will be achieved
2. The second is that invariably things take a little longer than expected and cost a little more than originally planned, i.e. there are stumbles along the way

During these periods some investors will dismiss the outlook as too uncertain and others will try so hard to guess the ranges of possible future outcomes that they may miss the simple mispriced opportunity in front of them.

Simply put when the car is the garage we do not have to know exactly how much it might be worth when fixed to say its value will be £17k, £18k or £19k. We just need to know that its future operating performance ('earnings power' if you like) will result in it being worth a good amount above the price offered (i.e. £10k).

Owner-Manager Investment Phases

There are further observations we would make about the specific investment phases that can be experienced by companies with owner managers:

- These phases can last longer than an average company – lasting in some cases many years
- They can be deeper. In that we mean they may cost more in terms of lasting elevated OPEX (and the resulting often ongoing profit reduction) and CAPEX. The consequence being that with less operating cashflow being produced and significant capital being spent debt levels can rise in ways unusual for such a company
- Often little clear guidance is given by management to shareholders as to either the duration or depth of this investment phase. In addition any recovery targets given may indeed by missed as the new opportunity is explored by the manager further/was uncertain in the first place

At the outset the owner manager may be unusually open about how uncertain the outlook is and this unsettles many investors (Lord Wolfson last summer). Some years later when they maybe share their confidence in the coming recovery many investors are too weary to listen or believe them.

Assuming these observations are correct, i.e. that the investment phase of an owner managed company can be more severe than that for an average company – why might is this be the case?

- We suggest 'career risk' and the timescale involved are the main reasons – Owner managers do not have to worry in most cases about being fired, or even being agreed with
- As long-term owners of the business they are trying to make the necessary sacrifices today, if they believe them to be justified, to ensure a better and stronger lasting company is the end result
- This is maybe different from the actions of an ordinary five-year tenure CEO, for whom career risk is very real if he cannot keep the support of the shareholders he is answerable to. These shareholders rely on their appointed CEO to provide the future profit recovery forecast on which their investment bet is predicated. A leader who misses such targets might not be around to see the final recovery. Thus they can be inclined to deliver a quick fix if the alternative is a P45. (We accept that some may feel this point is actually just better accountability that shareholder appointed leaders have and there is some truth in this, but we still believe their timescales can be forced to fit career risk rather than the business cycle).
- We suggest that managers who are significant shareholders in the businesses they are running will be braver making the hard decisions to keep deferring shorter term profits if they think the resulting market position and ultimate earnings power are worth the sacrifice

What do you want your builder to say

Let's move the analogy on from a car to a house: There are cracks running down the back of your house inside and out. They have been there for a while but lately seem to have widened a little. You get two builders round. You tell both of them the same thing. "I am sure it is nothing but the walls are beginning to look ugly so I want them patched up. I hope it isn't anything serious as I really have not got the money to cope with a big expense right now".

- Builder A quotes £2,000 and says it is really nothing to worry about. He can fill and repaint all the affected rooms. He is friendly and mentions that other builders often exaggerate jobs when most things can be fixed quite cheaply. He can sort it for you next week.
- Builder B says – "I am sorry to tell you this but this house needs underpinning and it will likely cost at least £20,000". He said he was busy with other work and his tone was a little abrupt and you did not take to him.

You appoint Builder A and in two weeks your house looks like new. Six months later you are reading a local newspaper article about a couple whose back wall collapsed and they had just finished suing their builder who as a result had lost his licence and had gone bankrupt. You realised you recognised the deceptively friendly face shown in the paper. Your heart and stomach sink as you check your wall to see cracks reappearing.

Doing it right, for the long term, whatever the cost

Having watched many companies and managers now over the course of our long careers we, and you, our clients have witnessed almost all forms of manager. These range from visionary founders driving growth and constant innovation to outright frauds, and almost everything in between. Many good owner manager companies have the high returns on capital and the cash generative traits we seek. When something goes wrong (or right) and they feel the need to invest heavily, both of these traits can disappear and this comes as a shock to other investors who until now then had enjoyed their growing profits. Without a manager 'hand holding' investors throughout such investment periods it soon feels to them like a permanent change/deterioration has taken place. As more and more past supporters of the company give up waiting, the shares fall further.

Follow the money

During such periods we have also noticed a couple of other traits. Sometimes founders fall out of favour with previously supportive shareholders and sometimes with the market entirely. Often if they believe Mr Market's depressed share price fails to discount the long-term value of the business they will increase their stake either with their own or company money (i.e. buy-backs). As they are insiders who often already have c.90% of their wealth in this one enterprise, these are powerful messages. But this very action (i.e. taking advantage of the opportunity presented to them by the shareholders who they feel do not understand what they are trying to do) causes a conflict. Why try to spell out the future once again to an audience that does not want to listen, when the same audience will sell you their shares at a discounted price?

Earlier on we observed that investment phases for owner managed companies seemed to go on for longer, become deeper and seemingly offer less guidance to other shareholders. The conflicted position these opportunistic business owners find themselves in perhaps has an influence on these factors particularly after they have become exasperated with the investment market.

Not new

Whilst we hope readers will have relevant examples of their own we believe we have seen many of the traits outlined above in our experiences with companies such as **JD Wetherspoon**, **Sky**, **RyanAir**, **Microsoft**, **Liberty Global**, **Apple** and **WWE** to mention just a few.

Enter Sports Direct

The reason for outlining this thinking is our ongoing and lonely enthusiasm for **Sports Direct.** What we have outlined above we think is all evident at Sports Direct currently and we believe we are now at the later stage of the investment where the owner manager believes the recovery is now visible, but Mr Market is not inclined to listen or agree. We attach our piece from last summer in which we articulated our enthusiasm in the light of some early signs that the move to upscale the store offering was working. Just before Christmas we spent a little more time in front of Mike Ashley and his team as they presented their interim results. Our notes from this meeting are available to any who would wish to see them. All we include for a wider audience is reflections on the Sports Direct investment idea that follow on from those made in our July 2017 piece.

Sports Direct Update – In short:

- In July, Ashley expressed confidence that the upscaling of products in the new stores was working well, thus – in his eyes – proving the concept. Just before Christmas he was far far more insistent and passionate about this fact
- Football was the first product category to get the upscale treatment with Nike supplying SPD with a decent upscale product range. The sell though of this was reported to be ‘huge’. As a result Nike will now supply SPD with Good, Better & Best products across all sportswear categories. SPD believe they now have a better Nike offering than JD
- In 2014 the most expensive Adidas and Nike Football boot SPD stocked was c.£60. now it is £250 and they have all the price points in between
- As a result of this ‘success’ they will refurb more older stores faster as all refurbished stores will be allowed to stock such ranges
- The upscale evolution is working so well they are planning to be brutal with the rest of the estate. They have even closed a few stores that are profitable just so as not to sign a new lease, therefore leaving a geography for a while rather than recommit to anything other than a short-term extension
- Ashley acknowledged that Gross and EBIT margins *“will recover. They may not do so the whole way to previous levels while Sterling remains depressed but they will recover most of the way*”. This was an important part of the observation we made on the company in our July piece and in discussions since. Please see the section below on Margin recovery and earnings power
- Ashley is clear that they are investing and care little about current profitability – worrying and thinking only about the long-term profits of the group. Examples were given in the elevated Flannels stock levels and the rationale behind them.
- Each new SPD store will replace 2 old ones (across different fasciae), but Sq Footage will double. The reason is that they will still selling everything they sold before across brands and own label, but now they are selling more too, i.e. the high-end stock and flannels. That is why they can trade from more space

It was clear to us that Ashley cannot fathom why investors are not more excited about the potential for this upscaling in the share price *“if you won’t buy the share I will”* he retorted. This is a very very different level of confidence from that he had 12-18 months ago – at that time he expressed only uncertainty about the future. The share price we note is the same however.

Margin recovery and earnings power

The spike in the share price in the summer showed that investors (some of them at least) are noticing the improved customer and supplier sentiment towards the new stores. The disconnect we observed in July and which we think Ashley is pointing to now is more about the likely future earnings power of the *recovered* business.

The investment made in store freeholds, Shirebrook and by not raising prices when Sterling moved against them resulted in much lower recent profits vs. the groups past. Without any guidance from the company on what a recovered profit profile might look like, investors are left guessing/assuming the worst.

Ashley's admission on the recoverability of margins is not a surprise to us – not least due to the fact that part of the future branded sales will be at full mark-up, something that was never a feature in the past period of margins shown below. We remind reader that past SPD's margins were made whilst heavily discounting all stock sold and trying to kill competitors.

We remain of the view that margins will recover to near past levels (one day maybe even surpass them). Currently, while the group has been under pressure from suppliers and customers – it has chosen not to raise prices. That will not always be the case. For now the consumer is still getting amazing value in Sports Direct. In time just a little more of that will be kept in better margins, but the customer offer will still have great value and wide premium ranges.

As we have said many times before, little Jimmy's hockey stick will cost a little more in 3 years' time than 3 years ago, but:

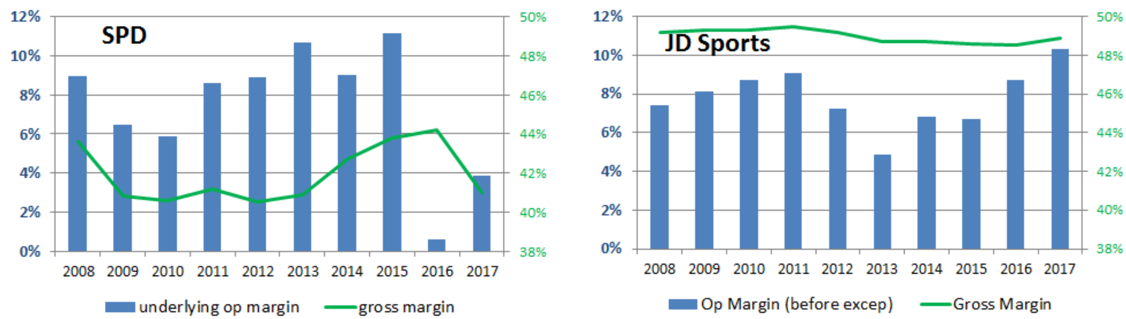
1. You will hardly notice
2. Every extra £1 you pay is profit to SPD, and
3. Where else are you going to go to buy it cheaper?

What about JD?

An obvious question you might ask is: *"what about JD Sports and new 'upstarts' like Foot Asylum – or indeed the online players such as Amazon, Zalando et al? Are they not eating SPD's lunch?"* We have considered at length these players – who, undoubtedly in the case of JD, have indeed benefitted from SPD's temporary impasse with Nike and Adidas. We remind readers that the UK sports apparel market remains essentially a duopoly and whilst we do not dismiss JD – clearly it has been very well run of late – our work has clearly shown that SPD remains the low-cost (and low-price) operator in the market. Said simply, JD and SPD operate under very different business models and SPD's model is, in our view, far more robust. (Mostly due to its low price offerings and that in the past it could make c.10% EBIT margins from 42% gross margins). That remains a significant structural advantage for SPD and, combined with Ashley's willingness to adapt, is the key factor in understanding SPD's attractiveness as an investment. A cursory look at Ryanair's 'Damascene conversion' is helpful here too.

The gross margin data below in Fig.1 supports this. JD Sports has a very consistent gross margin structure of 48-49% (recently listed FootAsylum – setup by JD's founders – similarly reports a high c.46% gross margin). We suggest this margin premium is due to mix and pricing strategy on JD's part. Interestingly, when SPD recorded a comparable level of sales to JD's current run-rate (say £2.2bn in FY13), SPD reported just a 41% gross margin, but a 11% EBIT margin despite its selling prices being far far lower.

Fig.1: JD vs. SPD Gross and EBITA margins



Source: Holland Advisors

The recent operating leverage experienced by JD (its op margins in four years went from c.6% to c.10% without any increase in gross margins) is, we think, as much due to opportunism arising from Sports Direct's lack of high-end stock as it is to any new found operational efficiency. Whilst JD has gotten some scale benefits in that time, we think this benefit it likely temporary due to its inferior business model which relies on price and mix more than cost efficiencies. The consistency of JD's gross margin also reflects its FX hedging which SPD lacked. With the roll-off of those hedges ongoing, our sense is that – encouraged by the brands – the UK sportswear market will see some price inflation, a tide which will lift SPD's boat when they pass it on to customers.

As Ashley's full capitulation to the brands has been accepted they are once again happy to supply a full-range it seems. One day soon, the UK sportswear market and the mix of what SPD sells will be just a little more expensive than it is today. The result, will be that in time Sports Direct's recovery in margins will be significant. Fig.1 (LHS) suggests that SPD's operating margins are depressed by the very investment phase we look for – a likely margin of safety for buyers of SPD shares today.

Given its market leading position in what essentially remains a duopoly, it is our view that SPD shares are compelling without requiring too much attention to be paid to JD Sports. Sports Direct is ultimately a self-help story: a story about a business with a hugely successful past which has had to reinvent itself but it is doing so fast, and it now claims successfully.

So how cheap might it be

Our ready reckoner for the value on offer in Sports Direct shares works off a recovered margin estimate of c.9%. The thinking behind which we outlined last summer:

> *The 43-44% gross margins and 9.5-11% EBIT margins of 2014-2016 were made by dominating the low-cost space. It is not unreasonable we think to conclude that similar margins could be made when the same organisation improves service, discounts less, improves its reputation but keeps the low-cost leadership. We concede that prices need to be raised to realise this – but this is a reality for the whole UK market due to currency pass-through and a function of SPD discounting a little less aggressively than its past.* **Source: Holland Views: Sports Direct, The Chameleon Jigsaw Puzzle, July 2017**

A 9% margin a few years out would suggest EBIT of c.£320m. The chart below offers some context as to others views on the likely recovery on EBIT. It also shows that whilst our £320m seems a huge leap vs. current forecasts it looks modest against the groups past earnings power.

Fig.2: Consensus analysts' forecasts for Sports Direct EBIT – 2017/2018/2019

Source: Holland Advisors/Bloomberg

If all cash generation were ignored/assumed spent on freeholds this EBIT level might still result in Net Income of c.£240m. With today's Market Cap of £2bn – this suggests a PE of 8.3x. A recovery to 15x giving 80% upside just from a re-rating. In truth we have no idea whether margins will recover to 8% or 12% nor what cash generation that will result post the ongoing requirement for freehold purchases. We also admit that Mr Market could ascribe a PE of 12x to the recovered business or 17x. Searching for accuracy on such points however we feel is tantamount to trying to work out whether the car in the garage when roadworthy will be worth £18k or £20k.

Due to its entrenched market position and cost (and price) leadership what we are very confident of is that one day soon the Sports Direct car will be operating and earnings well again having recovered from a huge investment/re-invention phase. Thus, we are also confident that at £10k (share price 370p) that car we are being offered is a bargain.

Buy Sports Direct… and let us know any other Owner Manger companies you think are in a similar position.

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