

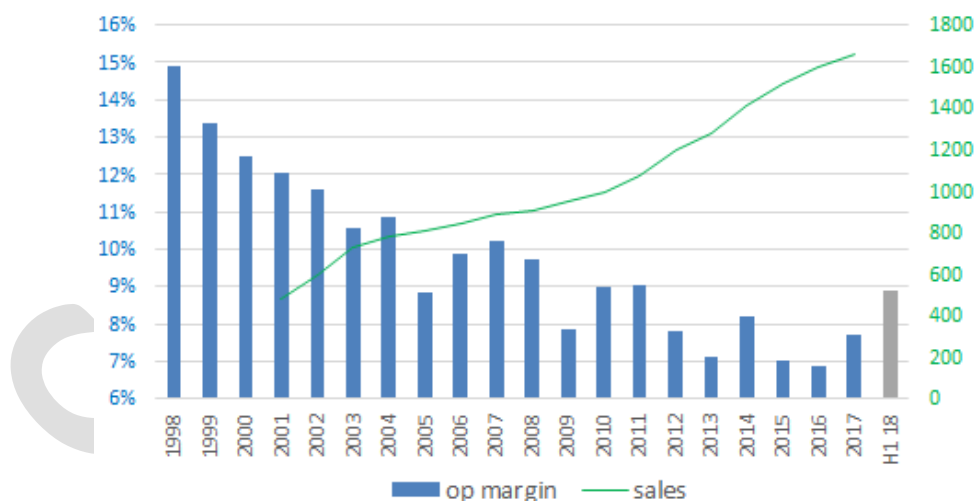
Holland Views – JD Wetherspoon: Price: 1245p; MCap: £1.3bn

## Operational gearing looms large

We have long held JD Wetherspoons (JDW) up as one of the pre-eminent compounding Franchises in the UK (see October 2017 note<sup>1</sup>). To us, JDW is a classic ‘Mispriced Compounder’. We have recently taken another close look at the business and as a result, have increased our conviction that JDW is ‘under-earning’. Higher operating margins will, we think, surprise most observers and possibly surprise them quite soon.

There has been no change to the low-cost, high volume business model that Wetherspoons has employed to great effect in recent decades. Over the same period, the company has not rested on its laurels (Fig.1) with sales boosted greatly by diversification into food provision. What was once seen (by some) as a grubby ‘no-go’ pub chain has transformed itself into an increasingly mainstream High Street eatery brand offering value *and* quality. If Wetherspoons had car parks, we might be hearing about the BMWs and Range Rovers starting to park outside (just like Aldi’s carparks circa 2008!).

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



Source: Bloomberg

The above chart shows a very strong long term sales growth.

Where then, you might ask, is the operational gearing that perhaps should have resulted from this growth and increased scale? Other volume-led, lowest price market leaders (the aforementioned Ryanair, Costco, Colruyt etc.) all saw operational leverage once they reached critical mass – so why not JDW? It is a great question. In short, it is primarily because the company chose to engage in a lengthy phase of judicious reinvestment of profits into selling food. But chefs and serving staff do not come cheap (unlike the food they sell) so it takes a long while for these all day fixed costs to be covered. Crucially, that investment cost is now well covered by the food sales it generates (NB: strong LFL JDW’s food sales for many years).

<sup>1</sup> Holland Views – JDW – Money for nothing and your growth for free – 1251p, Oct 2017

Yet, whilst Mr Market has his eye myopically on that ever-decreasing slope of operating margins (Fig.1) – assumed at 7.8% in FY 2018, it is our contention that – **without having to raise prices** – JDW’s volume growth from here will lead to margin expansion. We think JDW shares can potentially compound at a 16% IRR for 8 years without changing its model. We are buyers.

## Lollapalooza in action

We are unapologetic about the amount we have written on JD Wetherspoons since 2012<sup>2</sup>. In those six years we have learned an awful lot about the how the best businesses in the world compound capital for shareholders. Such learning has solidified our view that JDW remains one of these companies with some of the best compounding prospects in the UK today. That this is not a commonly held view is an understatement.

### Fig.2: A reminder of what we are looking for

We try hard to find compounding businesses – i.e. those businesses which can compound shareholder returns as a result of competitive positioning, advantageous business model and savvy capital allocation<sup>3</sup>. Whilst many of these businesses share common attributes (e.g. an ‘Outsider’ CEO, a disregard for investor short-termism, strong culture, exceptional capital allocation etc.) – very few, if any, advertise themselves explicitly as such. In other words, unearthing a Compounder requires a lot of digging – not to mention knowing what you are looking for. We modestly suggest we know what we are looking for and the mental (and spreadsheet) models that we use to assess businesses are helpful in this process.

In short, JDW is almost a textbook compounder business run by an Outsider Chairman that we highly admire. By understanding its model well, we can determine that even the apparently high

Source: Holland Views

Charlie Munger’s fantastic expression ‘Lollapalooza effect’ is very appropriate when thinking about these types of businesses. Lollapalooza might be described as ‘doing lots of things really well’ which results in an aggregate non-linear<sup>3</sup> result greater than the sum of the parts. It’s the *non-linear* part that causes the surprise for most of us when it transpires!

*“I’ve been searching for lollapalooza results all my life, so I’m very interested in models that explain their occurrence. Often results are not linear. You get a little bit more mass, and you get a lollapalooza result. Adding success factors so that a bigger combination drives success, often in non-linear fashion, as one is reminded by the concept of breakpoint and the concept of critical mass in physics. Really big lollapalooza effects, will often come only from large combinations of factors” – Charlie Munger (emphasis ours)*

To view the remainder of this in-depth report, please contact Andrew Hollingworth, [Andrew@hollandadvisors.co.uk](mailto:Andrew@hollandadvisors.co.uk) for a complete PDF copy.

<sup>2</sup> Holland Views – JDW – A snowball on a really long hill – 426p, July 2012

<sup>3</sup> All compounding is ‘non-linear’ and non-linear phenomenon are not intuitive to most of us mere mortals!

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