HollAnd Advisors

Holland Views – Next plc – Price: 5567p; MCap: £7.6bn

Model Retailer

Next's guided (and most probable) cash flows in the next few years have become very bond-like in their stability and lack of growth. Bond investors know that the return you make from such an investment will be driven largely by the price you pay upfront. Whilst our modelling shows how the group can turn +3% FCF growth into +8% value per share growth, we still think it right to be selective with the starting price we pay for the shares. (Indeed, such a contrarian approach has served us well in this company's past – we were interested sub 12x PE but less so at 17x).

In c.4 years' time, better growth may emerge but Mr Market is not known for his patience. While we wait for Mr Market to offer us a better value again there are two long-shot bets with more favourable outcomes we will watch for. One is that further out, LABEL becomes a much bigger business than all are expecting – indeed this would be consistent with a dominant aggregator model. The second is that a large global retailer notices the great job Wolfson and team are doing in such a tough (but huge global) sector. They then seek to secure Next's delivery, own label online EDLP clothing and aggregator skills for their global use.

A Great Manager + Poor industry = …?

Last week we reminded clients of the quality of thought and analysis that Simon Wolfson brings to the Next business case with his latest shareholder letter. We also re-iterate the idea that his approach and communication of the business trends and their challenges means that most brokers' results commentary become redundant as Wolfson does their job for them!

As a result, our work on the company has always been designed to try and add some wider perspective. Our original piece on it cited Phil Fisher[1], noting the traits that Fisher looked for being present in Next, is research we remain proud of. But what can we add now? In terms of the outlook for each business line, we think very little, but we think we can put Wolfson's view in some perspective giving investors a framework to consider the company as an investment going forward. This we do below; mostly by looking at the impact to shareholders of the 15 year view the company outlined. We also add a few words on the company's role as an aggregator, a position we feel as having great potential.

Not a forecast, but

Two years ago at the FY17 results, Wolfson presented his first draft of a 'Retail Store Portfolio Stress Test', an attempt to take a brutally honest view on the outlook for Next's retail store negative LFLs. We wrote afterwards that investors couldn't handle Wolfson's truth[2]. Wolfson's candid conclusion at that time was that it simply was not clear to him how the transition to online would pan out for Next. Two years on, he offers much more clarity and cautious optimism.

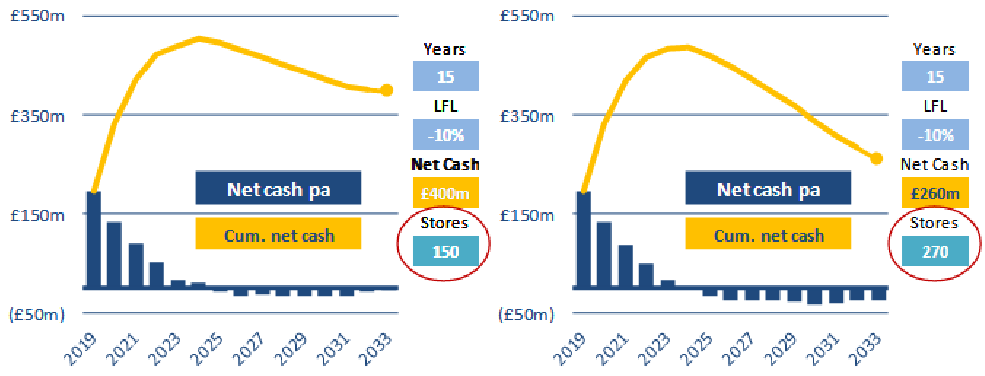
This research piece will assume that investors have read Next recent results and the 15 year stress test scenario outlined (we have created a PDF of this which is attached). The company was at pains to state that this scenario was neither a plan nor a guidance of future profitability. That said

[1] Holland Views – Next – Phil fisher under our noses 0911 – 2567p
[2] Holland Views – Next – You can't handle the truth – 0317 – 4000p

it does provide a well analysed critique of the company's present and future challenges and one that in truth we do not feel we can improve upon.

The following three slides extracted from company report and accounts outline the assumptions the group is making under this 15 year scenario. As we state above, we assume a good amount of study of this plan by the reader has already taken place. As such we will jump forward quickly in the next section to consider what this means for shareholders:

Fig.1: **Retail** Cashflow assumptions a) 150 remaining stores and b) 270 stores



(a) Cash flows assuming closure of all loss-making stores *(b) Cash flows with 120 stores retained for Online services*

Source: Next plc

Fig.1 summarises the cash implications from retail operations (i.e. physical stores) under two store count scenarios. As a reminder the Next hybrid retail model benefits from having and retaining a strategic store base for online customer returns. Please note the inflection point circa 2025 when retail cashflows are likely to go negative.

Fig.2: Next **Online** Cashflow assumptions

CAGR	Years 1-5	Years 6-10	Years 10-15	15-year CAGR
UK NEXT Online	+5.7%	+4.5%	+4.2%	+4.8%
UK LABEL	+14.6%	+6.9%	+4.1%	+8.4%
Total Online UK	**+8.4%**	**+5.4%**	**+4.2%**	**+6.0%**
UK Retail	- 10.1%	- 13.7%	- 13.5%	- 12.4%
Total UK	**+0.0%**	**+0.7%**	**+2.2%**	**+1.0%**
Overseas	+18.1%	+11.5%	+7.3%	+12.2%
Group Total	**+2.4%**	**+3.1%**	**+3.6%**	**+3.0%**

Source: Next plc

Fig.2 looks at the assumptions underlying Next's ambitions in online retail. Again, as a reminder, Next is pragmatically morphing into an aggregator of 3rd party fashion brands in scale (LABEL). It expects LABEL will outgrow its own brand business (albeit from a lower starting point) which seems plausible to us. More on this innovative strategy later.

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

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