Thomas Livesey, CFA – MiF FT 2017

	3rd March 2016 (close)	
Share price	£ 39.47	
Shares out. (m)	**147.7**	
Mkt cap (£m)	5,828	
Net debt (£m)	850	
EV (£m)	6,678	
	FY17E	**FY18E**
EBIT (£m)	830	773
EV/EBIT	8.0	8.6
EPS	£ 4.32	£ 4.04
P/E	9.1	9.8

Next plc (LSE: NXT) **BUY** Share price: £39.47 (3rd March 2016)

NXT has a track record of exceptionally high ROIC and ROE. Retail is out of fashion right now as consumer spending is expected to fall and the cost of clothing imports is pushed up by a weak pound. NXT has superior margins to its peers, a strong physical-and-online presence and a 16 year-tenure CEO with outstanding capital allocation prowess. At <10x forward P/E it is one of the cheapest retailers on the high street, yet has the highest EBIT and net profit margins and an 8.3% dividend yield.

NXT's one-year forward P/E increased from 8.8x in early 2011 to 16.3x in late 2015. Today it is back down to less than 10x. My **target price of £60** is derived from a DCF valuation (£59), sense checked by applying NXT's 5-yr avg ROIC to peer group avg EV/EBIT (£61) and applying NXT's 5-yr avg ROE to peer group avg P/E (£58).

	5 yr avg		today	5 yr average		today
	EBIT margin	ROIC	EV/fwd EBIT	net profit margin	ROE	P/fwd EPS
Next	19%	64%	8.0	15%	204%	8.8
Debenhams	6%	12%	8.4	4%	14%	8.6
Marks & Spencer	7%	13%	11.2	5%	17%	11.7
ASOS	5%	32%	42.0	4%	23%	54.5
H&M	16%	47%	13.0	12%	38%	17.2
Sports Direct	9%	23%	10.8	7%	25%	16.8
JD Sports	6%	29%	12.5	4%	21%	17.4
American Eagle	7%	21%	6.7	5%	12%	11.9
Urban Outfitters	12%	27%	8.0	8%	17%	13.6
GAP	12%	42%	7.0	7%	37%	12.2
Median ex-Next	**7%**	**27%**	**10.8**	**5%**	**21%**	**13.6**

Another approach is to look at free cash flow yield. My estimate of normalised FCF (assuming no growth and only maintenance capex) is £580m – which is similar to consensus estimates for FY19. This gives NXT a prospective FCF yield of 10%.

Why is sentiment negative? (Investment risks)

Brexit-related macro

- Weaker consumer confidence is expected to affect discretionary spending. This has not yet materialised in survey data, but NXT's Christmas sales figures were worse than expected. What is not clear is whether that was down to competitive pressure from rivals discounting earlier than usual, or something more serious. Whatever it is, I believe the business is still solid and well-run.
- Several guidance cuts have caused alarm for investors who had grown used to the stock's 6 year upward momentum. We saw pressure from many long-term holders bailing out at the same time.
- The weakening of the pound since June 26th 2016 (Brexit vote) has meant NXT faces an increased cost of inventory. The magnitude is of the order of 5% according to the CEO, and he intends to pass it on to his customers.

How much of the FX-driven cost increases can NXT pass on to its customers? Citing low observed price elasticity of demand in the 2007/8 financial crisis, NXT intends to raise prices by 5% in the belief that volumes will be relatively unaffected. One can question the underlying assumption, noting online and deep-discounters give NXT's consumers more choice now than a decade ago. But taking the hit directly to margins would be more costly to shareholders (NXT estimates £80m, vs £16m from raising prices and losing some sales). And just as some of NXT's customers will defect when faced with price rises and/or squeezed incomes, so will customers from pricier shops defect to NXT. The firm is far from unique in the retail sector for selling almost exclusively imported produce. What is unusual is the company's candour in flagging these issues and discussing its response. This may have hurt it in the short-run but will help in the long-run.

The market dislikes the fact that NXT is expanding its store portfolio amid a downturn for its industry. I am comfortable with this strategy, since new stores can still be attractive opportunities when rent per sq ft for new stores is about 1/3 cheaper than their existing store estate. Measured by turnover, 76% of existing stores have an operating margin >20%, and the avg lease expiry is 7 yrs. NXT has a more modern store estate than M&S's older store designs, allowing it to better integrate its online offering (e.g. facilitating in-store collection).

Business overview

NXT is a high street clothing and homeware retailer operating out of physical stores and online. Whilst it has a franchised presence around the world, it is effectively a UK & Ireland-only business. Its financial year runs to January, so we are currently in early FY18 and await the FY17 results due on 24th March.

NXT operates 540 leased stores in UK/Ireland selling fashion (80% of sales) and home products (20%). The stores generate 60% of group sales but only 50% of EBIT, since online is more profitable. Same-store sales have been negative for 8 of the last 10 years, but this masks a proactive and successful programme of store closing and reopening. Since 2007 NXT has opened 190 stores and closed 130. Over that period EBIT per sq ft has risen 3% whilst total EBIT is up 70%, driven by the growth of the online unit.

NXT's median customer is a woman aged 35-54 who shops with them for herself, her husband and her children. Womenswear is particularly competitive - surprisingly, NXT's market share is stronger in menswear (8%) and kidswear (13%) than in womenswear (5.5%).

Next Directory is the name of the online business. It differs from other online retailers in two ways:
1) it spends £120m (6% of online revenues) p.a. sending hardback catalogues to 3m customers (though this is declining as the internet renders catalogues less useful)
2) it extends credit to customers in order to increase average spend & frequency of purchase (credit customers spend c.£440 p.a. vs £380 for cash customers)

Take-up of credit is declining, but the impact is limited because it is mostly infrequent users who are closing their credit accounts. The company relaxed lending terms in the last year, which has grown the debtor book to £1bn. This shows up as an increase in working capital, but it represents a sizeable asset for the firm.

Directory's performance has been the bright spot in recent years, growing at an 8% CAGR over the past decade. This compares to less than 1% in Retail (stores), and an overall sales growth CAGR of 2.4%. Market share in online apparel is a healthy 11%. Though that share is expected to fade in coming years, it is still the engine of growth.

Revenues	FY06A	FY07A	FY08A	FY09A	FY10A	FY11A	FY12A	FY13A	FY14A	FY15A	FY16A
Retail	**2,217**	**2,255**	**2,255**	**2,202**	**2,279**	**2,229**	**2,198**	**2,197**	**2,246**	**2,349**	**2,406**
YoY change	*8%*	*1.7%*	*0.0%*	*-2.4%*	*3.5%*	*-2.2%*	*-1.4%*	*-0.1%*	*2.2%*	*4.6%*	*2.4%*
Directory	**685**	**775**	**800**	**816**	**873**	**936**	**1,089**	**1,196**	**1,357**	**1,520**	**1,658**
YoY change	*14%*	*13.1%*	*3.3%*	*2.1%*	*7.0%*	*7.1%*	*16.4%*	*9.9%*	*13.4%*	*12.0%*	*9.1%*
Total (inc. other)	**3,106**	**3,284**	**3,329**	**3,272**	**3,407**	**3,298**	**3,441**	**3,563**	**3,740**	**4,000**	**4,177**
YoY change	*9%*	*5.7%*	*1.4%*	*-1.7%*	*4.1%*	*-3.2%*	*4.3%*	*3.5%*	*5.0%*	*6.9%*	*4.4%*

NXT's lacks truly enduring competitive advantages, but its medium-term moat is made up of its:
- industry-leading logistical set-up; well-run customer loyalty card scheme; captive sourcing unit that competes with external suppliers for NXT's business; well-known brand …
- … but most significant to me is the quality of its management - particularly CEO Lord Wolfson, who has spent his whole career at NXT. He took the top job aged 34 and outperformed the FTSE100 (including reinvestment of dividends) by 850% from 2001-2015. He has run the firm with a relentless focus on return on capital. Unlike other retailers, he focuses primarily on profitability, not sales growth. Given that he owns 1% of the company's shares (worth c.£60m) and is aged 49 there is good reason to believe he is well-incentivised to act like an owner and that he will continue to run the company for many years to come.

Margins

Operating margin is expected to decline by several ppts (from 21%) over the next few years as part of a cyclical downturn in the fashion industry exacerbated by a possible inflation-driven squeeze on consumer spending and a rise in the cost of goods - both caused by a weak pound. Sales are expected to fall by a low single digit % in FY18 (y/e 1/18). On the consensus EPS numbers that fall out of those assumptions NXT is on 9.8x P/E.

	FY16A	FY17E	FY18E	FY19E
Revenue (£m)	4,177	4,226	4,139	4,190
EBIT (£m)	872	830	773	763
EBIT margin	*21%*	*20%*	*19%*	*18%*
Net income (£m)	667	635	596	591
EPS	£ 4.35	£ 4.32	£ 4.04	£ 4.04
Free cash flow (£m)	431	587	565	575

Consensus estimates (Capital IQ)

But the interesting thing is free cash flow, which is forecast to remain broadly constant over the next 3 years. This is where the nature of the CEO comes into play, for I expect him to act shrewdly in deploying this capital. On top of annual dividends of £485m I would expect to see opportunistic buybacks if the stock remains at these levels or declines, particularly when the economic outlook begins to stabilise. The most recent buybacks took place in October 2016 when the stock was at £46.50, or 20% higher than its current level. The company bought back no stock for 11 months during 2015 when the share price was at its highest, suggesting buybacks are deployed selectively when Wolfson sees value. It is true that he isn't buying back right now, but I believe this is a product of caution. When the outlook begins to stabilise I expect buybacks to recommence.

Shareholder returns

The chart shows a total of £5bn has been returned to shareholders over the last 10 years (note the current market cap is £5.7bn). Whilst payouts are apt to change as the company goes through a tougher period, NXT has confirmed 4 special dividends of £64m paid quarterly from May this year. The ordinary dividend is expected to be maintained, meaning total dividend payouts of £485m in the coming year, FY18 (analysts expect the same the following year, FY19). **The forward dividend yield stands at 8.3%.** Given my estimate that the company can generate over £0.5bn per year in free cash, it seems reasonable to expect this to continue.

We have seen this before (broker views, similarity in 2011 and 2017)

6th January 2011	**5th January 2017**
"Estimates downgraded post Jan update"	"This morning's update from Next was weaker than expected … We reduce our forecasts … continue to see negative earnings pressure in the UK sector"
"Inflation remains the main risk … uncertainty regarding consumers' reactions to price increases"	"consumer confidence will step down from here as inflation starts to come through."
"As an already well run business, Next has little self help to drive either top line or earnings"	
Price at the time: £20.74 **Price 5 years later: £69.40**	**Price at the time: £40.89**

Environmental, social & governance

NXT scores highly on the Sustainalytics ESG quality framework (80 vs FTSE100 median of 73). It is better than its peers (from the table on p1) on environmental metrics but has a lower proportion of women in management. On the ISS corporate governance metric it scores highly, at 2 out of 10 (lower is better).

APPENDIX

1. HISTORICAL BALANCE SHEET

	FY10	FY11	FY12	FY13	FY14	FY15	FY16
ASSETS							
Cash And Equivalents	107	49	56	136	273	276	66
Short Term Investments	-	-	-	-	-	-	-
Trading Asset Securities	-	-	-	11	-	-	2
Total Cash & ST Investments	**107**	**49**	**56**	**147**	**273**	**276**	**68**
Accounts Receivable	520	533	597	622	704	738	954
Other Receivables	10	11	12	9	10	17	10
Total Receivables	**531**	**544**	**609**	**631**	**714**	**754**	**964**
Inventory	309	368	372	332	386	417	487
Prepaid Exp.	86	101	91	87	94	90	86
Other Current Assets	9	4	13	11	1	79	37
Total Current Assets	**1,041**	**1,067**	**1,140**	**1,208**	**1,468**	**1,616**	**1,642**
Gross Property, Plant & Equipment	1,319	1,435	1,484	1,536	1,578	1,626	1,684
Accumulated Depreciation	(742)	(843)	(902)	(999)	(1,069)	(1,122)	(1,147)
Net Property, Plant & Equipment	**577**	**592**	**582**	**537**	**509**	**503**	**536**
Long-term Investments	28	30	52	38	26	68	59
Goodwill	43	43	43	43	43	43	43
Other Intangibles	5	4	3	2	2	1	1
Deferred Tax Assets, LT	-	-	-	-	27	13	3
Other Long-Term Assets	-	56	35	66	70	38	46
Total Assets	**1,694**	**1,792**	**1,854**	**1,894**	**2,145**	**2,282**	**2,330**
LIABILITIES							
Accounts Payable	175	196	193	189	195	225	219
Accrued Exp.	66	73	77	82	95	99	87
Short-term Borrowings	5	125	8	5	3	3	129
Curr. Port. of LT Debt	-	1	-	91	-	-	214
Curr. Port. of Cap. Leases	0	0	0	0	0	0	-
Curr. Income Taxes Payable	110	108	103	98	80	64	65
Unearned Revenue, Current	-	-	61	66	69	74	74
Other Current Liabilities	403	330	301	285	394	422	383
Total Current Liabilities	**758**	**833**	**742**	**816**	**835**	**887**	**1,171**
Long-Term Debt	525	474	657	567	802	850	629
Capital Leases	1	1	0	0	0	-	-
Pension & Other Post-Retire. Benefits	50	-	-	-	-	-	-
Def. Tax Liability, Non-Curr.	4	23	15	4	-	-	-
Other Non-Current Liabilities	223	229	217	221	222	224	219
Total Liabilities	**1,560**	**1,560**	**1,632**	**1,608**	**1,858**	**1,960**	**2,018**
Common Stock	19	18	17	16	16	15	15
Additional Paid In Capital	1	1	1	1	1	1	1
Retained Earnings	1,615	1,783	1,763	1,904	1,907	1,886	1,909
Comprehensive Inc. and Other	(1,501)	(1,569)	(1,558)	(1,635)	(1,637)	(1,580)	(1,613)
Total Common Equity	**134**	**232**	**223**	**286**	**286**	**322**	**312**
Minority Interest	(0)	0	-	(0)	(0)	(0)	-
Total Equity	**133**	**232**	**223**	**286**	**286**	**322**	**312**
Total Liabilities And Equity	**1,694**	**1,792**	**1,854**	**1,894**	**2,145**	**2,282**	**2,330**

2. HISTORICAL INCOME STATEMENT & SELECTED FINANCIAL RATIOS

	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16
Total Revenue	**3,329.1**	**3,271.5**	**3,406.5**	**3,297.7**	**3,441.1**	**3,562.8**	**3,740.0**	**3,999.8**	**4,176.9**
Cost Of Goods Sold	2,380.0	2,363.0	2,409.6	2,332.6	2,395.8	2,431.1	2,499.9	2,656.4	2,724.2
Gross Profit	**949.1**	**908.5**	**996.9**	**965.1**	**1,045.3**	**1,131.7**	**1,240.1**	**1,343.4**	**1,452.7**
Selling General & Admin Exp.	413.8	427.3	468.7	402.3	447.0	470.5	513.9	541.1	580.9
Other Operating Expense/(Income)	1.7	0.5	-	(2.2)	-	-	-	-	-
Operating Income	**533.6**	**480.7**	**528.2**	**565.0**	**598.3**	**661.2**	**726.2**	**802.3**	**871.8**
Interest Expense	(41.7)	(49.1)	(27.5)	(22.5)	(25.2)	(24.4)	(25.3)	(30.6)	(31.9)
Interest and Invest. Income	4.3	1.3	0.8	0.9	0.5	0.4	0.7	0.8	0.5
Net Interest Exp.	**(37.4)**	**(47.8)**	**(26.7)**	**(21.6)**	**(24.7)**	**(24.0)**	**(24.6)**	**(29.8)**	**(31.4)**
Income/(Loss) from Affiliates	1.2	0.9	0.9	1.8	1.5	0.6	2.5	0.9	1.0
Currency Exchange Gains (Loss)	2.3	(3.3)	0.7	-	(1.1)	3.4	(5.9)	8.9	(5.6)
Other Non-Operating Inc. (Exp.)	(1.6)	(1.7)	0.4	(1.3)	(2.8)	(4.6)	(3.0)	(0.1)	0.3
Other Unusual Items	-	-	1.8	(0.5)	8.3	29.9	-	12.6	-
EBT	**498.1**	**428.8**	**505.3**	**543.4**	**579.5**	**666.5**	**695.2**	**794.8**	**836.1**
Income Tax Expense	144.2	126.5	141.3	150.3	145.3	157.9	142.0	159.9	169.3
Earnings of Discontinued Ops.	-	-	-	7.8	40.6	-	-	-	-
Net Income to Company	**353.9**	**302.3**	**364.0**	**400.9**	**474.8**	**508.6**	**553.2**	**634.9**	**666.8**
Minority Int. in Earnings	0.2	0.1	0.1	0.2	0.1	0.1	-	-	-
Net Income	**354.1**	**302.4**	**364.1**	**401.1**	**474.9**	**508.7**	**553.2**	**634.9**	**666.8**
Cash from operations	518.0	448.8	571.5	452	525.9	659	614.8	743.2	608.3
Capex	177.2	139.9	179.3	120.6	98.6	144.3	135.1	92.4	102.9
ROIC	74%	56%	62%	65%	61%	66%	64%	66%	64%
RoE	N/A	N/A	266%	219%	209%	200%	193%	209%	210%

3. ANALYSIS OF MARGINS

Margin analysis	FY06A	FY07A	FY08A	FY09A	FY10A	FY11A	FY12A	FY13A	FY14A	FY15A	FY16A
Gross margin	*27.9%*	*27.8%*	*28.5%*	*27.8%*	*29.3%*	*29.3%*	*30.4%*	*31.8%*	*33.2%*	*33.6%*	*34.8%*
EBIT margin	*15.1%*	*15.4%*	*16.0%*	*14.7%*	*15.5%*	*17.1%*	*17.4%*	*18.6%*	*19.4%*	*20.1%*	*20.9%*
Net profit margin	*10.1%*	*10.1%*	*10.6%*	*9.2%*	*10.7%*	*12.2%*	*13.8%*	*14.3%*	*14.8%*	*15.9%*	*16.0%*
Asset turn		2.2	2.1	1.9	2.0	1.9	1.9	1.9	1.9	1.8	1.8
Net debt/EBIT		84%	136%	134%	80%	98%	102%	78%	73%	72%	104%