

Next plc: Simple, Well-Managed, Well-Positioned, Growing Business

Mark Walker of Tollymore Investment Partners presented his investment thesis on Next plc (UK: NXT) at Wide-Moat Investing Summit 2021.

Thesis summary:

Next plc is a soundly financed, simple business with modest cash flow volatility. The company has a strong track record and is strongly positioned to capture profitable growth avenues. Next plc benefits from solid stewardship, and the shares offer a 7-8% FCF yield.

Next plc is a multi-brand, multi-geography, omnichannel retail business with a forty-year heritage of innovation and expansion. The most exciting developments at the company have come in the last two years in the form of a marketplace model and an “operating system” for brands. Next Finance serves as a sales enabler and is highly profitable in its own right.

The following transcript has been edited for space and clarity.

Mark Walker: It’s a pleasure to chat with you again, John. Thanks so much for the kind words in your introduction. I would love to reciprocate this deep appreciation for what you do and the light you shine on this community.

The business I’d like to chat about is Next plc. I’ll run through a summary of the salient points as they relate to the vectors of business quality as we define them, and then I’ll flesh this out a little.

The first business quality is that Next plc is a simple business. It’s a an omnichannel retail business, but simple at its core. It has a history of successful investments in what have turned out to be profitable adjacencies where central expertise has been leveraged. Product and geographic expansion do bring some complexity to the business, particularly around distribution marketing. The company is a soundly financed one. It has a reasonably sized lending business, which is quite an important component of Next’s customer proposition. Bad debts have been manageable due to strong customer retention and reasonable provisioning. Dividends and share repurchases have been a feature of capital allocation and are symptomatic of a business that has generated a lot of excess cash flow. That cash flow volatility has been quite modest. Next remained profitable through 2020, which was one of the most challenging periods for retailers in history. An established online presence allowed Next to weather the 2020 storm better than many. The business is strongly positioned. SKU variety is probably the most valuable advantage online shopping has over traditional retailing. For the last six or seven years, Next capitalized on this advantage by selling third-party brands alongside its own with a vertically integrated wholesale model. More recently and in the last couple of years, it’s made inventory held in third-party warehouses available to consumers via a marketplace model. In the last year, it launched an operating system called Total Platform for third-party brands. This system enables Next to make its assets, its warehouses, its call centers, its distribution network, and its marketing engine available for third-party brands.

The track record of the business has been phenomenal. It has a 40-year business history demonstrating innovation and strategic pivots that have been both successful and important. It pioneered out-of-town stores, expanded apparel categories, and launched this multi-brand marketplace. Through that period, it’s earned consistently high operating margins relative to peers.

The growth opportunity at reasonable rates of return appears strong. It's leveraging existing assets to expand into adjacent opportunities. Label, which is the multi-brand marketplace offering, is still just 1% of the U.K. apparel market. It still sells mostly apparel. Home and beauty are a small portion of revenue, and that's growing. Next's online assets enable the company to profitably enter new regions because the online business model means it's not encumbered by the customer density required to justify physical store investments. We've seen overseas sales accelerate with high incremental investment returns on marketing investments. This stretch of the business has been demonstrated successful. Simon Wolfson is a capable and candid business leader who is properly incentivized by equity ownership. It's clearly above his compensation. It's interesting to consider the capital allocation priorities of the past and whether they might be appropriate for the future of the business.

We like good and cheap businesses. It's no more complex than that. This is a cheap business given the strength of competitive positioning, the appropriately aligned stewardship, and the reinvestment runway.

What is Next? It's a multi-geography, multi-brand, omnichannel retail business. Most consumers in the U.K. wouldn't describe it that way. They'd describe it as a brick-and-mortar high street retailer with an online presence selling Next-owned brand goods and services. The company sells Next products, but it also sells a thousand third-party brands via this aggregation business called Label, which is a £500 million business in the U.K. Next has around 8 million customers, 6 million of whom are in the U.K.

The business has a long heritage. It dates back to the 1800s when a business called J. Hepworth & Son was established as a men's retailer. Hepworth bought a chain of women's wear stores that was relabeled to Next in the early 1980s. Over time, Next launched a home interiors range also in the 1980s and established a directory catalog business. Then the online business was established in 1999. In about 2014 or 2015, it launched a multi-brand website called Label, which was vertically integrated in the beginning. But then, the perception of Next is this unsexy single brand that's been a staple of the high street for many years. It was quite surprising to me that over the last couple of years, it's had this transition away from third-party wholesale and toward a marketplace model. That has changed what Next is to both customers and suppliers. That facilitates value chain symbiosis, which is something we like to look for in our holding companies.

Since 2019, Next has provided customers access to their brands, products via a business called Platform Plus. That platform has materially broadened the range of third-party brands offered and it helped partner brands increase their sales. But the online sales are routed through Next's phone website, app, and brands.com websites. Next's store network, the importance of this being an omnichannel business, is interesting. The store network is an important part of the online value chain because half of online orders are collected from Next stores, and 80% of returns are processed through the stores. Next logistics assets, which is a legacy of their old catalog business, allow the company to offer next-day delivery, a standard in the U.K. Under Total Platform, Next makes all these assets, this distribution network, and the lending business available to third-party brands. More laterally, it's also been building an operating brand.com for the brands in return for a 39% commission on brand partner sales. Next Finance is a credit facility for U.K. online customers. It also has a facility that allows customers to spread the cost of orders over a period of months interest-free. It has about a £1 billion lending book. That serves two purposes. It's a sales enabler or a friction reduction tool, but it's also highly profitable. It's a business that generates 60% to 70% ROEs in its own right.

Next has about £600 million of net debt. It has a lease debt of about £1 billion. But offsetting that is a customer receivable balance of about £1 billion, which is not typically what you see in the net debt balance if you look at Bloomberg, for example. This level of debt is less than 1x the trailing operating cash flow of the business and comfortably below the bank and bond facilities of the company. Its current bad debt provision set against the £1 billion of receivables – it's 2x to 3x higher than the

average default rate of the last decade and also higher than the high single-digit default rates the company experienced following the global financial crisis.

Next has demonstrated resilient business characteristics through COVID-induced lockdowns. For the year of 2020, sales fell 17% and after-tax profits were cut in half as Next stores were closed for much of the year. But the business enjoyed cash inflows of around £500 million, which is what lowered the net debt level to around £600 million. A lot of that improvement in cash flows came from active management decisions, not necessarily the natural cost and cash structure of the business. That came from the suspension of stock repurchases and dividends, but probably half came from the collection of customer receivables. Some resilience in the natural SKU set of the company was afforded by a product range which included things that did quite well like home products, children's wear, and loungewear – these offset the more formal occasion or holiday clothing.

Next is perhaps uniquely positioned to invest in delighting customers because the strength of the supplier proposition strengthens the consumer proposition and vice versa. It's that observation that potentially positions Next to create more value for its consumers. Online shopping has two main characteristics that distinguish it from traditional brick-and-mortar retailing. One is product choice. Customers now have access to products from all over the world versus a few physical shopping locations. The other is convenience. Goods are shipped directly to the customer's front door.

Which of these is more valuable? We can observe increases in online penetration of retail sales across the world. The retail industry is typically divided by pure play online players and large physical retailers. But Next is both. Next might be the only scaled multichannel retailer in the U.K. Therefore, the behavior of its customers is quite instructive: We see half of online orders delivered to Next stores, suggesting its SKU variety is the most valuable advantage online shopping has. Northern Ireland is particularly instructive because delivery is free there, yet around a third of orders are still delivered to stores.

Then there are returns. Rather than attempt to suppress return rates, Simon Wolfson has embraced the customer's right to return unwanted items. Again, the stores play an important role in providing an efficient return process; return rates in online apparel can be high.

The store network is important. The store operates as an online reserve enabling deliveries from the store to home when there's no warehouse inventory. Or the inventory can be moved from store A to store B. That omnichannel aspect might be more defensible than simply subsidized shipping strategies. There just aren't that many places where people can shop across many different stores and pick up once in one convenient location.

You might draw two conclusions from this. One is the online penetration has some way to go before it stabilizes because product choice is a sustainable advantage versus home delivery. The second is that retailers with a physical store footprint might be best positioned to offer the most valuable proposition because they avoid the material cost of last-mile delivery. Therefore, they're positioned to offer the most profitable route to market for third-party brands. This profitable route to market is the essence of the supplier proposition. The internet has lowered the barriers to entry for brands seeking a route to market by just removing the upfront cash commitment associated with retail stores. E-commerce platforms like Shopify have reduced those barriers further by turning yet more fixed costs into variable costs for online brands. But 80% of retail shopping has historically and currently takes place in multi-brand environments. Brands can access more customers by being part of an aggregation marketplace like the one Next provides.

If we accept this consumer preference – one of the risks we'll discuss later is that this won't hold in the future. But if we accept this preference for multi-brand shopping and we accept the sustainable

product choice advantage of online, then two types of sellers will find it hard to generate value. The first is established physical retailers, and the second is brand.com. I've said "brand.com," where the brand equity required to stand alone and compete for the 20% of consumers - their shopping on those destinations is potentially missing.

Self-disruption is a form of time arbitrage. Next's business, its traditional business, falls into this first category, this first high-risk category, the high street retailer with burdensome fixed cash obligations like operating leases and wages. But we've seen that Next's investments in its website over the last two decades is clear evidence of willingness to self-disrupt and be customer centric. More recent efforts to help competing brands increase their own addressable markets is particularly forward-looking and has been necessary. That's why over the last five or six years, Next has been building this online platform label. The first order implication of that is to increase competition and potentially cannibalize the sales of Next's own brands which, historically, have traded well. But coming back to this idea of candid business leadership, the management team has fully acknowledged there's just nowhere to hide on the internet. By hook or by crook, customers will find the brands they want, and if they can't find what they want on Next's website, they'll go somewhere else. Since the introduction of Platform Plus, the number of available third-party brands has doubled, and active online customer growth has accelerated despite what is a much larger base. As of May this year, the visits to next.co.uk, after a period of trebling, have come off slightly but are still 150% above pre-COVID levels. That's comfortably the highest growth rate amongst established multi-brand, omnichannel peers. The most obvious of those peers are Marks & Spencer's and John Lewis. John Lewis has struggled. It has closed stores and given up all its pandemic-induced online traffic growth. It's back to pre-COVID levels.

Label was originally a wholesale model. But today more than half of its business is done on a commission basis. That portion is growing 3 times as quickly as the vertically integrated wholesale business. But Label is still only 12% or 13% of total Next sales. That will continue to increase because the proposition is compelling, so return for this flat, all-inclusive 39% take rate. Suppliers have access to an 8-million active customer pool, and it is growing 25% per year. They get to control price. Next is a full price retailer. It's only around 15% of sales that are on markdown versus the industry average of 35% to 40%. It gets access to this next-day delivery network, including returns and collections from the stores, and it has access to this large-scale consumer lending proposition.

"Vertically integrated omnichannel retail" is a complex idea, but it's also a hard thing to do. Over the last 20 years, Next's warehouse square footage has increased 5x and the number of units picked from its online warehouses has increased 10x. At the same time, the order cut-off for next-day delivery has been extended by seven hours. There's been an 80% reduction in the picking time to just two hours. That takes time and expertise along with all the mistakes and iterations along the way. I like businesses that have demonstrated the right model at the right time, and usually this is just another way of saying the company has been lucky. The timing of Label's quiet but notable progress has absolutely been fortuitous. It positions Next to gain from COVID and the restructuring of the UK apparel industry. The cross-shop between Next and retailers in disarray, in administration or in CBA arrangements, like Debenhams and Arcadia Group, is high. That cross-shop is high. Those retailers are around one-tenth of the U.K. market capacity, which is more than Next which is just around 7%. Online strengthens the offline offering. In addition to the omnichannel distribution advantage, you have this virtuous circle because there's an opportunity to use online information about consumer shopping habits and preferences to optimize the in-store inventory and customer service. This is nascent and not necessarily something Next talks about much. In-store collection returns drives footfall and therefore incremental selling opportunities.

Next has a long history that made various pivots. It was, at times, making unconventional and unpopular decisions in pioneering out-of-town stores and expanding into adjacent apparel categories.

Then more recently, it expanded into this multi-brand offering. It earned operating margins in the high teens, which is 3x to 4x higher than perceived market leaders like Marks & Spencer's or even online pure play businesses like ASOS and Zalando. You can see how continued progress in widening the SKU variety might drive increasingly attractive basket economics and better customer loyalty. The attrition rate for Next Credit customers is, therefore, half of what we would typically see at ASOS, for example. The value created by Next over the last 50 years against a tough backdrop of proliferation of e-commerce pure plays – of supermarket success in penetrating U.K. despite the parallel market – and with declining high street footfall – the value created is quite remarkable. Free cash flow per share has compounded in the mid to high teens. You could have bought the business for around £4 billion 15 years ago, and Next would have paid you back that amount in dividends. Today, the business can be sold in the market for more than double that amount. The industry backdrop against which Next will compete is more favorable than in the past.

Just thinking about the profitability of growth opportunity from a cash perspective – not just considering the gross or operating incremental margins of future capital reinvestment but the asset turns on those investments – the increasingly directed capital investments to online warehousing versus retail stores, for example, is positive for the asset turns in the business. The reported value of Next's online warehouse and distribution plant and machinery has shown depreciation, which is around 1% of online sales. Next is currently embarking on a six-year logistics investment program that will increase online sales capacity on the order of 5x to 6x the cost of the investment program. If you think about the working capital intensity of these investments and the future mix of their sales, the principal growth driver of online, which is the label aggregation business, doesn't carry any inventory and enjoys negative working capital.

I like to buy the future of Next's use of its existing assets to invest in new optionality and new revenue opportunities because I can leverage these existing assets to expand into these adjacencies. Also, you're providing immense value to third-party brand partners because they get immediate access to all these assets we've discussed. As the scale of the business increases, so does the utility of these offerings. The obvious one is having more customers and having a greater SKU set. But the value of things like nextunlimited, which is unlimited free home delivery for £20 per year – the value of that, the utility of that increases, and it's clearly something with high incremental margins. The Label opportunity is still quite nascent; it's only 1% of the U.K. apparel market. But the Next brand alone is around 6% of the U.K. apparel market. The sales per Label brand is still small but growing quickly. The proposition is strong in a world where consumers overwhelmingly prefer to shop in multi-brand environments. Label still sells mostly apparel. Home and beauty are only a small portion of revenues. The online penetration of beauty is less than 10% in the U.K. But this is a high value, small size, low returns rate, so it's well suited for online sales. Likewise, homeware online penetration is still around only half of the proportion of apparel and footwear sold online.

An increase in the online business model enables geographic expansion because you're replacing rent with digital marketing dollars. Therefore, you're able to profitably enter new regions because there's no longer a barrier of customer density required to justify a physical store investment. This overseas growth is quite valuable. Next has been ramping up digital marketing spend. In rough numbers, for every £1 spent on digital marketing, Next generates more than £1.50 in incremental orders. If you assume the company has 40% gross margins on those orders, that's a 20-month profit payback. Those customers typically spend 20% more each year than they are Next's customer; a customer spending £100 in year one is spending more than £350 in year seven. I'll leave you to put this into your own IRR calculations, but it's clear the incremental returns on those marketing dollars are high and the unit economics are attractive on digital marketing. But most new customers are still acquired organically.

New business adjacencies are more nascent, but the company uses existing assets, and that's existing experience and relationships that develop through extensions of the online platform. These haven't

recently contributed meaningfully to Next's financial results. One is licensing partnerships. Manufacturing is a nascent opportunity, but it's a natural extension of an operating system. Retail operating systems can further integrate into those value chains of their partners by reorganizing the value chains by connecting the merchants with the suppliers and the manufacturers. Next certainly sees an opportunity to leverage its existing sourcing expertise and distribute partner brands' products. It started to sign agreements in the U.K. with Ted Baker, Oasis, and Joules.

There's been a significant increase in the breadth of the beauty offer. Next sells around 300 beauty brands. It's partnering with some landlords in some locations for a new beauty and home concept. There's a potential opportunity for Next to have its brand connected with this category. If you look at apparel, ASOS dominates the share of voice in the U.K., but the brand resonance is lower and more fragmented in the beauty and homeware categories.

Potentially the most exciting opportunity is Total Platform. This effort leverages warehouses, call centers, distribution networks, marketing dollars, and the lending business. It makes them available to third-party brands. Next has promised those partner brands that any operational efficiencies gained through growth and scale will be passed through to them by way of commission reductions. This can enable value chain symbiosis. If you go to the Childsplay Clothing website, it just looks like an independent brand. But it's part of the Total Platform proposition. Next account owners can sign in using their Next logon credentials, and Next Credit customers can pay using NextPay.

What's made this possible is the success Next has had in the label aggregation business. I don't think a single online brand can just start offering this. That business has been built up for six or seven years, and Next has already been delivering label stock from hundreds of third-party brands in their warehouse for six years. It's not that easy to integrate that stock into Next's system. It's not that easy to know who bought returned items, how they bought them, and to ensure customers are refunded accurately regardless of whether they returned online, in a Next store, or through a brand partner store.

The cornerstone of this whole platform proposition is lower business risk. It works by allowing the brand to swap fixed costs for a single commission structure. That commission structure aligns the interests of Next and the partner brands. Perhaps in 2020 more than in any other year, it may have highlighted the benefits of such a cost structure for retailers that are suddenly mandated to shut their doors. But even in good times, the proposition of this is clear: Total Platform eliminates the growing pains of step-ups, fixed costs, and major capital investment projects needed in capacity and customer support. It allows Next brand partners to be capital light. The utility of that business resilience is much greater in this category than in a typically volatile fashion industry. As Next scales, the proposition becomes even more compelling because of the size difference that widens between Next and the partner brands. If you think of a 50% step change in warehouse capacity for a partner brand, it might be achieved by only a 1% increase in Next volumes.

Next invests more and more capital to service online demand, and those capital investments have attractive internal rates of return. Typical operating margin of the online business is running in the high teens. It's fair to say that incremental returns of 100% have been earned here. As for the lending book, that's also valuable. Next uses its group borrowing, which costs around 3% or 4% to lend to customers at 24%. Seventy percent ROEs are available in the lending business.

As for capital allocation, I hope the priorities for the use of cash will change. For a long time - maybe 10 or 20 years - Next has repurchased shares and issued special dividends because of limits on the amount of capital it could deploy internally in value-creative projects. Today, Next has this relatively new opportunity, this potential to use its capital to help smaller, more capital-constrained brands with a higher funding cost. In doing that, Next becomes the operating system of multi-brand omnichannel

retail. I have a broader concern in the U.K. public equity markets because sometimes the investor base sets capital allocation agendas. This requires sustained annual dividends to satisfy their own remits. Before 2019, Next's preference for returning excess cash was a result of this inability to deploy capital profitably in aggregation or overseas markets. But then it changed. The company has become much better at working out what customers want. It's found distribution partners able to deliver good service, good economics. The incremental returns Next has earned on these investments are very high. They're multiples rather than percentages. You have these extraordinary circumstances providing a good opportunity for management to reset the capital allocation agenda. Scale is much more important for Next today than it was in the past. Scale is a much bigger driver of success. In online versus offline business models – especially in capital-light marketplace models – scale drives advertising efficiencies. You'll win Google and Facebook options with lower bids if you have better quality scores, higher customer satisfaction, strong brands, lower shipping costs, and last-mile delivery. This idea of scale begetting scale is probably responsible for this winner-take-most structure in most online categories.

Simon Wolfson, the CEO, is a candid business leader, and that's potentially somewhat of an underappreciated characteristic. His ownership of the company is 100x his compensation. But his communication is refreshing. He is brutally honest about challenges faced by high street retailers, and he's also measured about the opportunities afforded by high street retail dislocation. I appreciate management's ability to confront the brutal facts. But there has been a clear change in tone reflecting greater positivity about the role Next has to play as these structural changes in how people shop for clothes and homeware online evolve.

Next's capital allocation priorities present the big risk for me. It's the possibility management won't take advantage of the opportunities. The IRR on efforts to exploit this huge optionality embedded in this idea of becoming an operating system for multi-brand retail seems high and could lead to extraordinary dominance of this industry. This is particularly true at this juncture in a period of competitor distress. Another company we own, Farfetch, has demonstrated strong progress acceleration in moments of maximum stress, particularly in 2009 and 2020. That company's capital allocation agenda was designed to widen a set of unfair advantages, so its assets became increasingly hard to replicate. I see similarities in this type of antifragility with Next. Next is a company whose competitive strength has increased by COVID-induced retail business failures and accelerated online shopping habits. Now, I might have misappraised this opportunity, and there is a risk that the capital allocation choices in Next will be governed by factors other than long-term business value compounding, like preferences for the shareholder register. But presupposing directionally reasonable analysis of Next opportunities, the capital returns to shareholders could potentially diminish the value of the optionality embedded in the current equity price. Dividends are often a symptom of businesses that lack these opportunities or are caught on the wrong side of time. I don't think that's the case for Next. There's also the possibility the future is online-only and it's not omnichannel. We're working with this assumption that multi-brand omnichannel shopping is valuable. That assumption is supported by existing customer preferences. In addition, you do see some of the world's most successful pure play e-commerce businesses – Amazon, JD, Alibaba, Wayfair, and Farfetch – they've all invested in this integration, this idea of integrating offline and online shopping experiences.

Finally, based on all of the factors I've presented, the businesses is cheap. The EV/EBITDA on FY '20, EBITDA is around 10x, and the pre-COVID free cash flow generation of the business represents an 8% yield to the quoted market cap. The owner earnings of the business is probably more like a 10% yield to the current price. That valuation anticipates no growth or a value neutral reinvestment. But you have a business here with an outstanding track record of economic progression. You have a lot of shareholder value creation despite an historically challenged industry backdrop. Those things mitigate against substantial loss of capital for equity owners. Meanwhile, Next might be uniquely placed to

leverage its assets, exploit this optionality, and become an operating system that's difficult to replicate across multiple categories: it could do that on terms valuable to owners, customers, and sellers.

The following are excerpts of the Q&A session with Mark Walker:

John Mihaljevic: Thank you so much for the presentation, Mark. Interesting, as always. Could you talk a little about how the Next team has evolved to take advantage of this opportunity? Has management hired a lot of programmers?

Walker: They have been very careful. Simon Wolfson's nature is not to get too excited. It would be interesting to see this business managed by, say, a U.S. entrepreneurial owner-operated business. The decisions in terms of resourcing the opportunities would be more aggressive in that case. Next has been careful to retain the existing team, looking after Next's core brand, and to not divest that team, not to diminish that team to resource the digital opportunities that have been externally supported. It's the Label team, the aggregation business team, that is responsible for the success of the Total Platform operating system. It leveraged those Label assets and those relationships with the brands that are important, and they are the advantage Next has in developing those assets.

Mihaljevic: What thought process would a third-party brand go through to decide whether to get on this platform? What are some of the alternatives available to those brands?

Walker: They'll look at the cost to partner with Next, which is spending 39% of their sales. Then they would compare that cost with doing it themselves. Typically, it costs more than half of sales to put in place these measures - warehousing, the customer support center, the cost of multi-brand marketing, and organizing distribution. Total Platform offers an immediate financial saving on the face of it, and then there's the consideration of the higher complexity of doing it yourself; the challenge can be particularly complex for small brands. There's a consideration of whether your brand equity is sufficient to compete in the 20% that are shopping on brand.com. If you are Prada, you won't have a problem. But if you are a smaller brand, which are the brands Next typically partners with - but also, larger brands. Ted Baker has a strong standalone brand in the U.K., but they're a part of this platform. You'd weigh these pros and cons and ask if you can compete in that. Do you need to be part of a multi-brand environment? Does that need to be a digital environment? Can you develop the shortcomings of something like Amazon as a pure play marketplace when you don't have the customer proximity or relationship or data? The shortcoming of a vertically integrated wholesale business is that you lose control of pricing, and you suffer 40% to 50% markdowns. The shortcoming of a Shopify window is that you are competing for the 20% of consumers shopping in single brand, and you rely on your brand equity, so it solves your cost structure problem. Then you ask to what extent are you willing to accept the volatility and uncertainty around cash flows associated with hard times and associated with good times. In hard times, you suffer a decline in retail footfall or not having the brand equity to standalone as brand.com. In good times you might need to build a new distribution center, build a new warehouse, or double the size of the customer contact center. You incur upfront costs for all of those. The unit economics associated those with costs might be attractive, the incremental return might be high, but there's an affordability issue. It's affordability or cash flow versus value that they will be weighing.

Mihaljevic: Who would you say are the closest comparables or competitors here?

Walker: The closest comps - the companies with the assets to go after this opportunity - are Marks & Spencer's and John Lewis. Marks & Spencer's has done reasonably well. But if you go to its website, you'll find a single-brand website with only nascent efforts at adding third-party brands.

John Lewis has been closing department stores. It's lost all its transitory website traffic boost through 2020, so it's back to pre-pandemic levels.

Then there are pure play online businesses, and two have done extremely well. One is Shein, which has been a phenomenal growth success in the U.K. and all over the world. Then H&M has done well. It has proven it can do a lot of things right. Its brand resonates. It has a strong brand.com presence. Pure plays like boohoo, ASOS, Zalando, and Zara are in the crosshairs of Shein's success. What we're relying on here, and assuming Next can continue to valuably deploy capital, is this multi-brand shopping environment.

Mihaljevic: You talk about the high returns on incremental investments in the business. But still, given the high free cash flow of £800 million, how much do you expect to see in terms of return of capital going forward?

Walker: On one hand, I never took a view that I can operationally manage a business better than any of the management teams in the companies we own. But given the superior opportunities of the future versus the past, I would certainly like to see reimbursement rates higher than in the past. When I have discussed this with Simon Wolfson, I've been reassured by his attitude toward the whole thing: He doesn't feel hamstrung by any historical commentary about the sustainability of dividends or share repurchases. He doesn't feel hamstrung by the preferences of institutional owners of the equity. His view on whether something makes sense to invest in in the context of incremental returns is a long-term one. He doesn't need an immediate return. He understands how investments can widen a set of advantages and maximize the total shareholder value added over a long period. But I do expect that capital returns to shareholders will remain a part of the capital allocation agenda. He explains that the constraint to value creation, the barrier to reimbursement rates being 100%, is not availability of capital. Nor is it the inability to take a long-term view or the willingness to make bold investments. It is that they are more technological and operational in nature. Therefore, the onboarding of these operating systems, these total platform partners, takes time. It's not simple. They want to make sure they get it right and that the partners are delighted with the outcome before they take on more people.

Mihaljevic: What are the key data points to track here to gauge how the thesis plays out?

Walker: In terms of the IRR I expect on an equity, it's a function of owner earnings yields, reinvestment rate, and incremental returns. The owner earnings yield will move around by function of the share price, so let's leave that aside in terms of just business-wise. If capital allocation is something to be mindful of - if, in the investors view and in the company's view, incremental returns are high and there are lots of avenues for profitable deployment - but then management returns two-thirds of excess cash flow to owners - that's an inconsistency that will be disconcerting. Reinvestment rates are important. As for incremental returns - management discloses a lot about what these projects cost and the likely asset turns and profit margins. They're explicit about what they see as the right blend between preserving the profitability of the business and depressing profitability through incremental investments. What are they spending on their warehouses? What are they spending on digital marketing dollars overseas? What must you assume to get to a point where those are not valuable investments?

About the instructor:

Mark Walker serves as managing partner of Tollymore Investment Partners, a private investment partnership for long term investors. Previously, he was a global equity investor at Seven Pillars Capital

Management, a long term value-oriented investment firm based in London. Mark has fifteen years of investment research and financial analysis experience. He joined Seven Pillars from RWC Partners, where he was part of a two-person team managing a long term global equity fund. Prior to that Mark worked as an investment research analyst on the sell-side for Goldman Sachs and Redburn Partners.

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