Investors' Chronicle | Alpha

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Alpha shares analysis

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Quality business models always win out

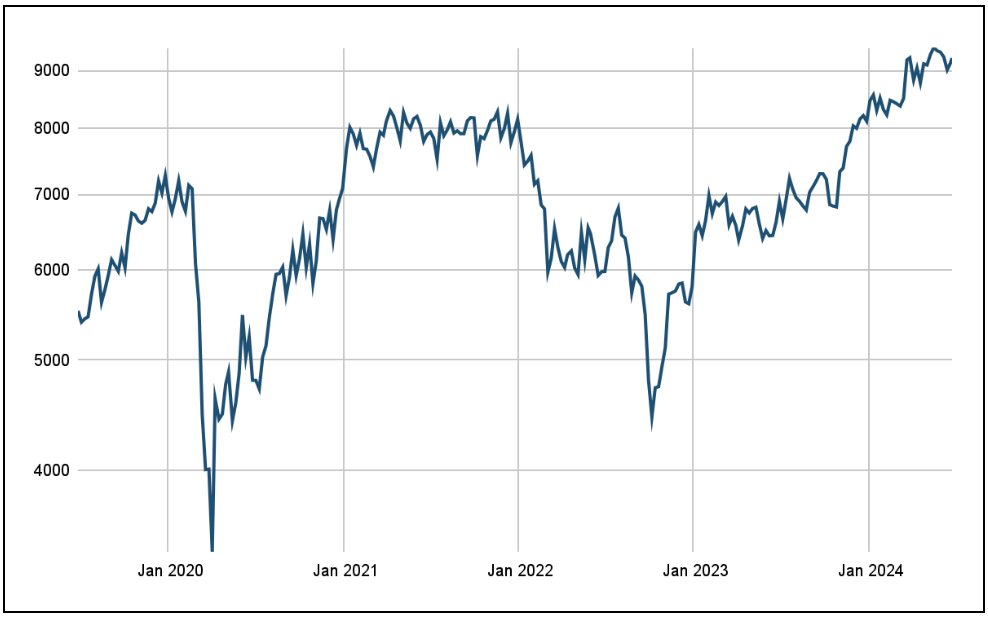
A well-established and well-executed business model in structural growth markets offers the best investment opportunities. Introducing innovative new models, especially those that are capital-light, further enhances this potential. We see potential for investors to achieve a double-digit Total Shareholder Return (TSR) from both the food services outsourcer Compass and, perhaps more unexpectedly, the fashion retailer Next.

- **Compass Group (CPG)** – This food services outsourcing company has an excellent track record. With ongoing structural industry growth, strategic acquisitions, and continuous internal improvements, Compass is well-positioned to continue delivering a double-digit Total Shareholder Return (TSR). A stable, long-term Price-to-Earnings (PE) ratio, market expansion, Earnings Per Share (EPS) increases through consistent share buy-backs, and a growing (though modest) yield all support the positive investment case for Compass. Despite the share price more than doubling since the end of Covid-19, spurred by high food price inflation that benefited food outsourcing, Compass remains a strong investment. As a 'growth compounder,' it is an excellent stock to buy, hold, and forget.

- **Next (NXT)** – Next has been a strong player in retail for many years, innovating in retail channel development, supply chain, logistics, and finance, while maintaining a leading position both on the high street and online. The innovation continues with the Total Platform concept. Next has been acquiring or partnering with quality brands, not just selling third-party brands online, and running these brands as independent businesses, but providing Next's comprehensive backend services, including supply chain, warehousing, website expertise, marketing, customer intelligence, and distribution. This capital-light operation has significant growth potential and has been a key factor in increasing the long-term Price-to-Earnings (PE) ratio from 12x to 15x. Although the re-rating is largely complete, there is still potential for investors to achieve a steady and reliable double-digit TSR.

Analyst: **Robin Hardy**

Next – what's Next?



Source: FactSet

Next (NXT) is an £11bn FTSE 100 retail company selling both own-brand and third-party fashion and homeware products in-store and online. It has sales close to £6bn and generates earnings before interest and tax (EBIT) of about £1bn. The online business, which includes a mix of own products and those from around 1,000 other brands, is now about two-thirds larger than from the physical stores. Total shareholder return (TSR) over the past five years has been a respectable 8.5 per cent. However, in the last four years, starting from the Covid-19 low point, TSR has averaged just over 20 per cent, and since the end of the global financial crisis (GFC), it has averaged 16 per cent. Most of this return has come from capital growth.

Operations

Next's business has four main components:

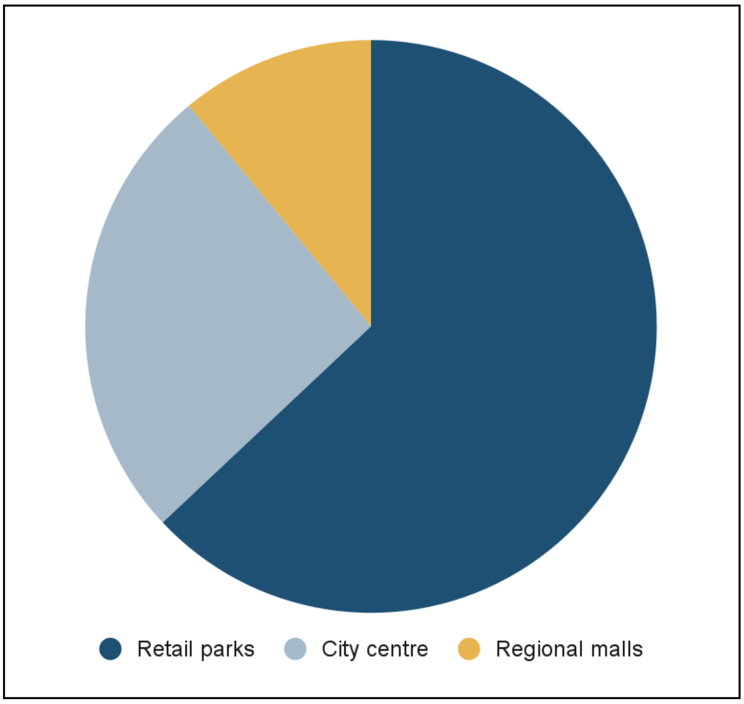
Retail: This includes the long-standing high-street and retail park operations, with around 700 stores, approximately 460 of which are in the UK (covering 8.3 million square feet) and about 200 across Europe, Asia, and the Middle East, primarily operating as franchises. Most of these are 'full price' stores, with a small number of 'outlet' locations. Over the past 10 years, the store count has declined by around 80, as high-street locations have closed in favour of larger formats with broader ranges in retail parks and regional shopping centres. In-store, Next sells almost exclusively own-brand fashion and homewares, primarily targeting younger families. There are also small concession stands in-store for brands such as Paperchase (owned by Tesco), Mamas & Papas (private equity-owned), SockShop, Costa Café, and GAP (owned by Next). Unlike the online segment, there are relatively few third-party brands available in-store.

Sales in the retail segment are around £1.8bn. As expected for a mature market segment, long-term growth is likely to be below the gross domestic product (GDP) rate. Although like-for-like (LFL) sales were up 1.8 per cent, overall store sales were flat in the last financial year as the high street continues to lose market share to online shopping.

Overseas sales have grown rapidly (up 70 per cent since 2019) and now stand at around £725mn (within the £1.8bn total). This suggests that UK sales are declining, consistent with market statistics showing high-street fashion sales down by more than 8 per cent over the last year.

To address the decline in sales, Next is investing in technology, warehousing, logistics, and the supply chain, and increasing the use of click-and-collect and in-store returns for online sales. Consequently, retail margins increased by 30 basis points last year, reaching 11.3 per cent. Falling rents on lease renewals are also expected to help improve profits.

Next's retail footprint full price sales revenues

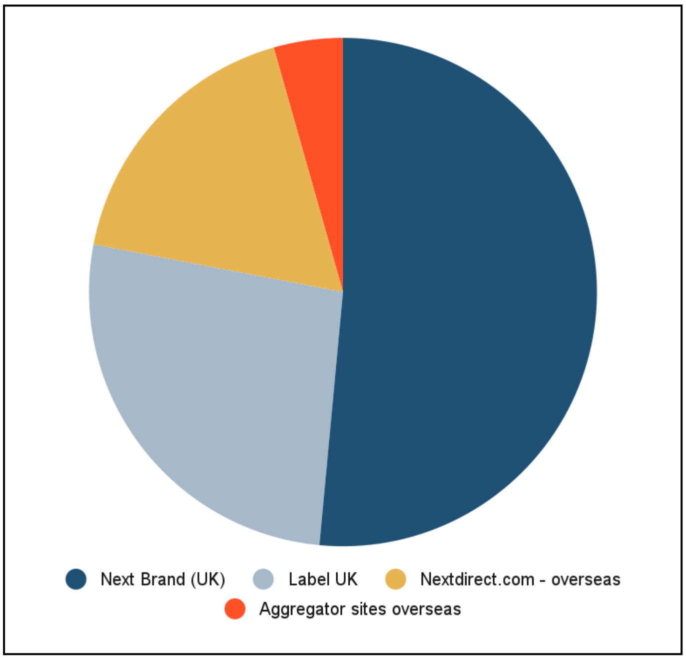


Source: Next

Online: This is the largest segment of the group, with revenues exceeding £3bn and growing at around 6 per cent. Sales are roughly split 78 per cent in the UK and 22 per cent overseas. UK sales are growing at 3 per cent, while overseas sales are growing much faster at 17 per cent.

Within the UK, sales are divided between 66 per cent for Next's own brand and 33 per cent for 'Label UK', which includes a wide range of everyday clothing, high fashion, sportswear, footwear, jewellery, perfumes, homewares, and accessories from 996 other brands.

Next online sales breakdown



Source: Next, Investors' Chronicle estimates

Label allows brands to sell through the Next website while controlling their own stock, fulfilment, warehousing, payments, and all associated risks. The brands pay a lead generator commission to Next, which, while lower than Next's own margins (13 per cent compared to 19 per cent), involves no risk and very limited capital, resulting in higher-quality earnings with a better growth outlook. The overall EBIT margin for the online segment is 16 per cent, with overseas operations at 13 per cent.

Finance: Next provides its own credit services for both store and online shoppers through its Next account card. Of its nine million registered customers, one-third use the credit service and typically spend more than double (£565 annually) compared to cash or card customers (£210 annually). Last year, credit sales totalled £2bn, on which £293mn interest was earned. Low overheads enabled a net profit of £211mn, an increase of 6 per cent. Bad debt is low at 3 per cent, and the average customer pays off 14 per cent of their balance each month.

Total Platform

This is the newest and most intriguing part of the group, formed of two arms: service and investment.

Service: For a commission (20 per cent of online Gross Transaction Value, GTV), Next will run the website of another brand, typically completely overhauling and re-engineering it. They manage payments, hold stock, handle returns, allow click-and-collect (C&C) to their own stores, fulfil orders, and service stock to any physical stores of that brand. Next also charges an additional 15 per cent fee for its services. This service can be used by any retailer in fashion, apparel, and accessories. Last year, £10.5mn EBIT was made from £52mn of fees.

Investment: Next either buys outright or invests in a brand and accounts for its sales and profits as a subsidiary or associate (owning less than 50 per cent). In this case, Next controls and manages the full operations, including stores, the Labels UK programme, and new websites as detailed in the **service** division above. The main brands in which Next has invested include Joules, JoJo Maman Bébé, FatFace, Made.com, GAP UK, Laura Ashley, Victoria's Secret, Swoon, Cath Kidston, Aubin, Sealskinz, and the largest, Reiss. Many of these brands were struggling or had failed and are being revitalised by integrating them into Next's full infrastructure: warehousing, fulfilment, credit, stock management, website, customer intelligence, and marketing. Last year, the 'equity' profit from these investments totalled £32mn.

Analysis and conclusions

Next has a strong business model that defies the apparent decline of fashion on the high street. It is clearly outperforming the high street (flat performance versus the market down 8 per cent). Online sales are growing slightly faster than the overall fashion eCommerce market (6 per cent versus 3 per cent growth according to Mintel), largely driven by overseas expansion.

The third-party labels proposition is strong and the financials look solid, though there is a potential threat from buy-now-pay-later (BNPL) providers. However, the Total Platform initiative appears very promising and is likely a key driver in the stock's re-rating over the past two years. The shares had traded for many years at a consistent price-to-earnings (PE) ratio of 12x, but since the end of Covid-19, the share price has doubled and the PE ratio has expanded to 15x. The question remains whether this is sustainable and expandable or if the shares are overbought.

Risk and capital-free online sales

The 'Labels UK' operation is an excellent risk- and capital-free revenue stream and is growing rapidly. Started around 2010, it reached £150mn in sales by 2015, and sales are now over £800mn, likely to hit £1bn within 18 months. This is a highly beneficial business, and although Next does rely on the brands' decisions to stay with them, the relationship is symbiotic. A quick online search indicated that many items are sold at full list price and are available elsewhere for less. However, the high level of service (next-day delivery for orders placed until 11 pm, click-and-collect, and in-store free returns) and credit facilities still appear to be a strong attraction.

Fast fashion brands seem to be losing ground (evidenced by the share prices of companies like ASOS and Sosander, and the growing backlash against Shein), and Next is well-positioned to capture market share.

Outpacing the market on the high street

Next is a dynamic fashion retailer that keeps up with trends well for its price point, maintaining fresh and relevant ranges for its target market, which is primarily family shoppers. The products are affordable and well-made, and Next has taken significant market share from Marks & Spencer for more functional, everyday, and work wear. However, there is a potential threat from M&S's resurgence, particularly with its 'Brands @ M&S' offering, which currently carries only 240 brands with moderate overlap. Both Next and M&S appear capable of capitalising where fast fashion has fallen out of favour.

Total platform (TP)

This initiative has significant potential and can provide a massive boost to any brand that joins the platform. It allows smaller brands to scale up with much lower risk and cost, whether or not Next is an equity investor. Many mid-tier businesses, especially those focused on the high street, would likely be happy to give up a large portion of their incremental revenue in exchange for a significant increase in sales. Even more attractive is the equity investment, as Next has full control and performs the same functions as it does for third-party brands but retains much more of the profits. In both cases, Next can leverage its substantial investment in warehousing and systems so its additional costs from the venture are likely to be modest.

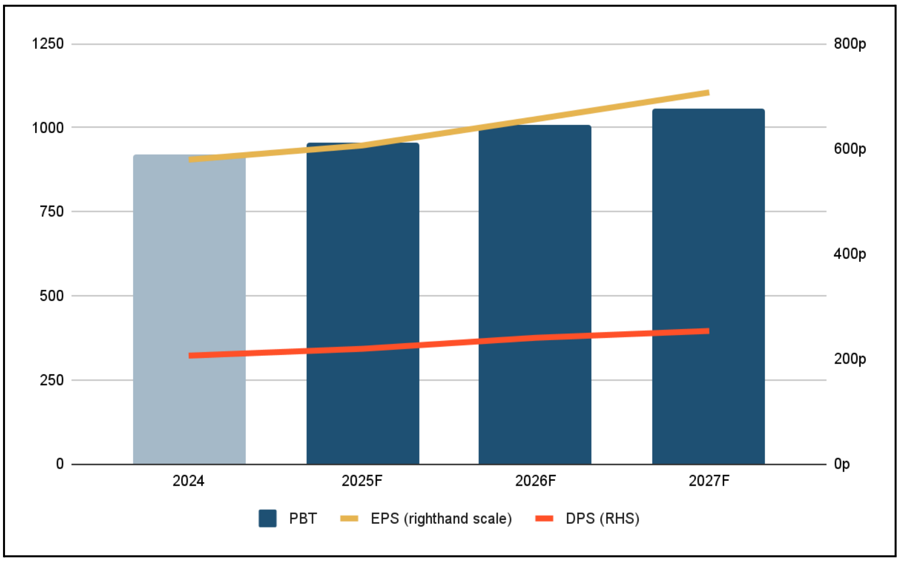
By achieving year run rates and unlocking the potential from a revitalised online presence, TP should contribute £77mn in 2025 (up from £43mn last year) and easily more than £100mn by 2026, which would represent 10 per cent of new profit from a cold start in just three years. Having invested heavily in data analysis, smart warehousing, and logistics, it is easy to see why brands would flock to join.

Forecasts

The consensus indicates continued progress in Next's profitability, with earnings per share (EPS) growing faster than profit before tax (PBT) due to ongoing share buybacks. Compound growth rates are expected to be 5 per cent for PBT, 7 per cent for EPS, and 7 per cent for dividends per share (DPS) from January 2024 (actual) to 2027 (forecast).

Continued below

Consensus estimates for Next



Source: FactSet

Strong balance sheet

Next appears to be under-geared, with net debt at just over 0.5 times earnings before interest, tax, depreciation, and amortisation (Ebitda). Most businesses of this size would typically have debt at 1-1.5 times Ebitda. The capital-light elements of sales are particularly beneficial here. This follows a period of significant investment in IT and warehousing, which should wind down over the next three years. By 2026, capital expenditure (capex) is expected to be less than half of that in 2023.

This provides the business with substantial capacity to continue investing directly in businesses on the Total Platform (TP), execute share buybacks (although at £92 per share, repurchases are much more expensive than in 2022 or 2023 when they averaged £65 per share), grow the ordinary dividend, and consider special dividends.

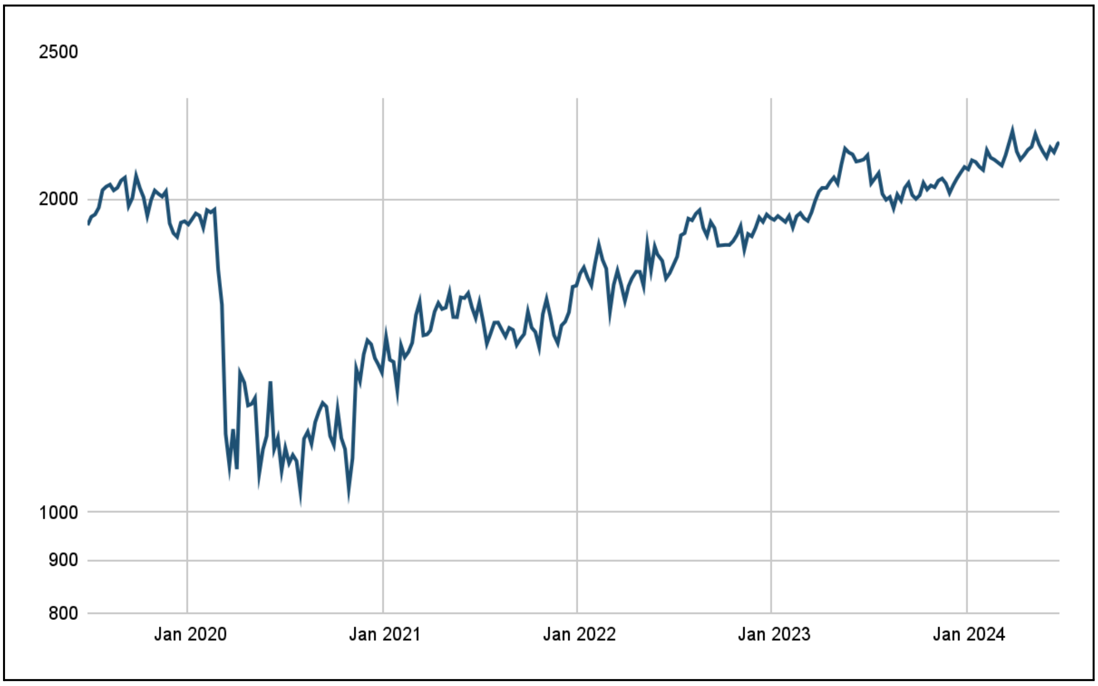
Valuation

The increase in valuation from a long-term range of approximately 12 times to around 15 times earnings is fully supportable. The faster growth in the capital-light Labels segment and the creation of a new revenue platform on already sunk capex, much of which is also capital-light, significantly enhances the quality of earnings (QoE). Utilising other brands (which handle the bulk of operations) to grow the sales base is another powerful tool. Next appears to be executing well in both the Labels segment and on TP.

While growth is not extraordinary, the 7 per cent EPS forecast feels very dependable, and with a yield approaching 3 per cent, a near double-digit total shareholder return (TSR) is achievable. The re-rating is likely complete (unless TP performs exceptionally well, which is possible), so future performance may not be as vibrant as it has been (the share price doubled in 18 months), but it should still be solid, though we might see a short-term pause.

In retailing, the revitalised Marks & Spencer (M&S) might be a better option for now, as its re-rating appears to have further to run—potentially another 25 per cent, as its price-to-earnings (PE) ratio has only just risen above 10 times, having bottomed out at six times two years ago. This suggests M&S offers potentially double TSR compared to Next. Nevertheless, large fashion retail still looks like a good investment, though it is advisable to avoid fast fashion and even former structural growth darlings like JD Sports, which seems to have stagnated.

Compass Group – still serving up a tasty growth story



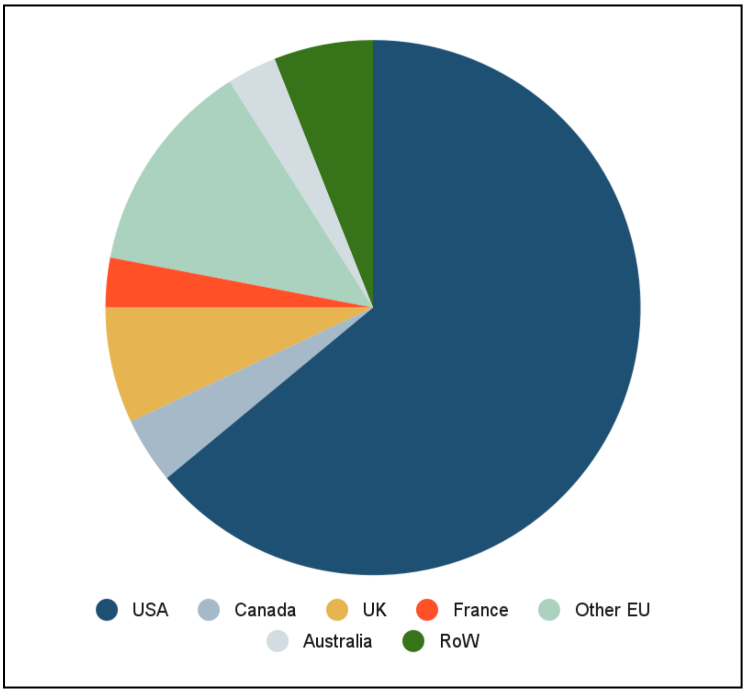
Source: FactSet

Compass Group (CPG) is valued at £38bn, primarily offers catering services across various industries and public sector organisations globally, especially in education and health/elder care. With revenues around £33bn, the company's Earnings Before Interest, Taxes, Depreciation, and Amortisation (Ebitda) is approximately £3.2bn, and its Earnings Before Interest and Taxes (EBIT) is £2.25bn. Compass reports its financials in US dollars since over two-thirds of its business is based in the United States. As the chart above indicates, Total Shareholder Return (TSR) has been consistently strong over the past four years since the Covid-19 pandemic, averaging over 21 per cent, though the five-year TSR is around 5 per cent annually due to a prolonged slump during the pandemic. Compass has a history of expanding through value-creating acquisitions, a trend expected to continue.

Operations

Compass offers similar services throughout its operations, mainly providing outsourced food, snack, and beverage services to a diverse range of organisations varying in size, market, and location. The company segments its business primarily by geography and gives general indications of its clients' end markets. While over 85 per cent of the business involves food services, the remainder includes other support services such as guest services (like venue receptions), cleaning, vending machines, third-party procurement and supply chain management, and general facilities management (buildings, groundskeeping, compliance, etc). Compass reports profits based on geographic regions rather than service types.

Compass' operating geography

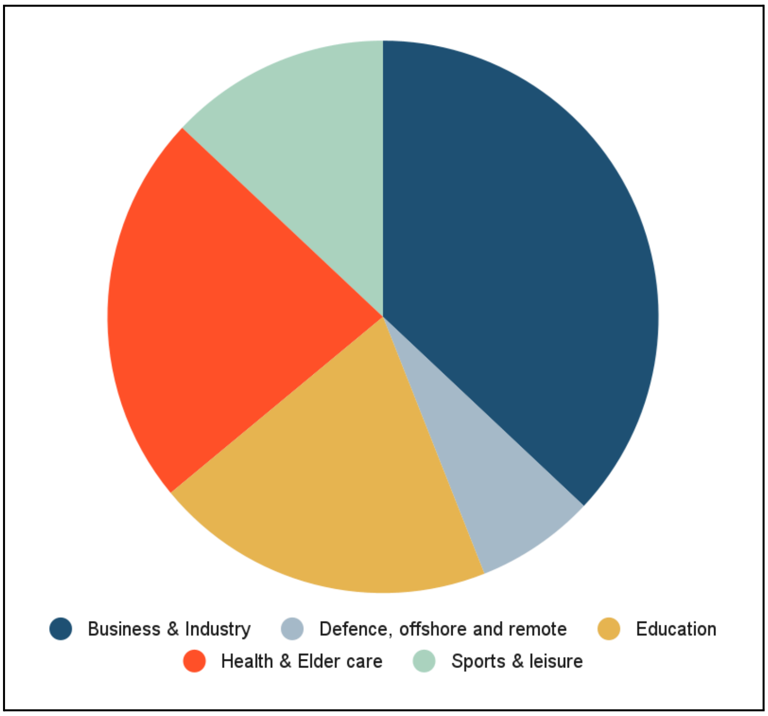


Source: Compass

Business and Industry (B&I) is the largest segment across Compass's three main regions. Defence, for example, accounts for only 1 per cent of the US business but almost 40 per cent in the rest of the world. Profit margins are significantly higher in the US at 8 per cent compared to 5 per cent elsewhere, indicating a structural difference.

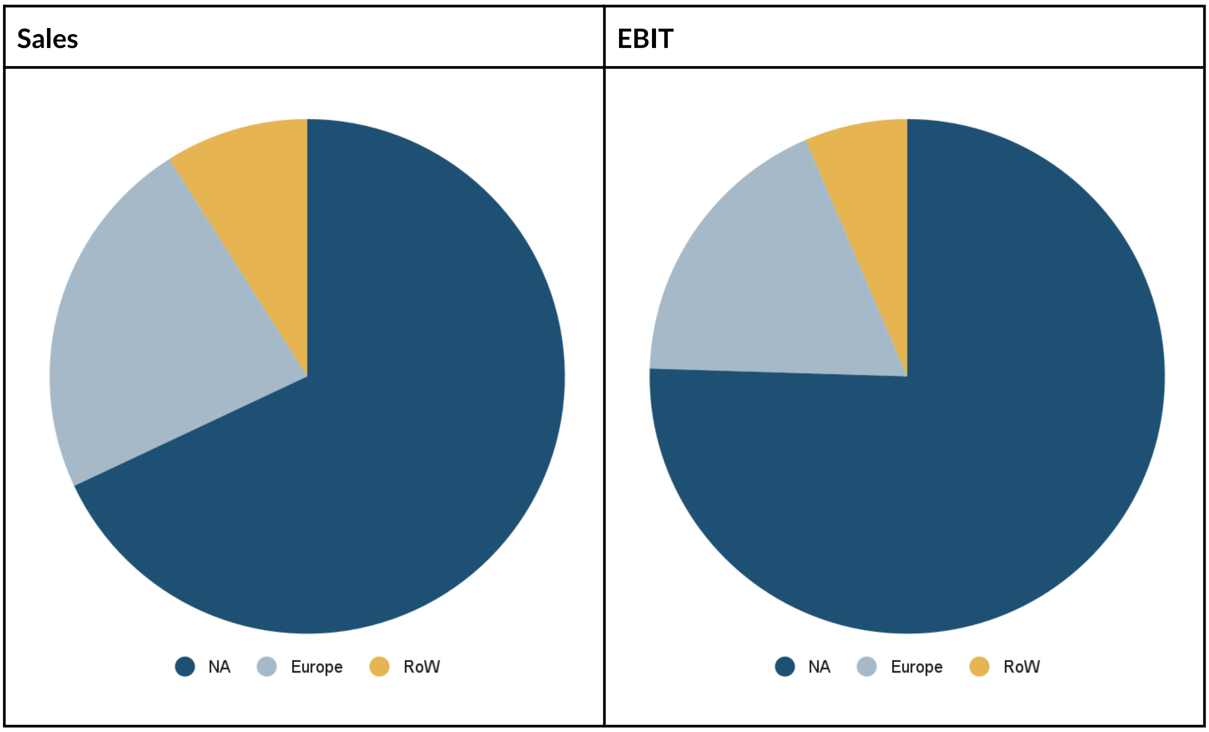
Recent revenue growth has exceeded 10 per cent, which is above the usual trend. This growth is likely due to the accelerated rate of outsourcing and food inflation. Margins are improving due to a significant gross-to-net gap with substantial fixed or slowly growing costs. Additionally, Compass has ongoing rationalisation and efficiency initiatives, particularly from integrating newly acquired operations.

Compass' client end market



Source: Compass

High level sales and EBIT split



Source: Compass

Compass exemplifies the benefits of outsourcing to a specialist, enabling organisations to focus on their core competencies while specialists handle other tasks efficiently. The Covid-19 pandemic and the recent surge in food price inflation have prompted many businesses to outsource food services, though significant untapped potential remains. With revenues of approximately $40bn, Compass holds around a 13 per cent share of the estimated global market potential, which it values at $300bn, with $100bn in the US. The trend in outsourcing within Business and Industry (B&I) often sets a precedent followed by other sectors.

Analysis and conclusions

Industry trends for food outsourcing look very promising, with recent market instability encouraging many organisations to adopt outsourcing. As shown in the chart below, two major areas of opportunity are health and education. Business and Industry (B&I) is viewed as the leading sector for others to follow. Despite a public sector mindset in many other markets (which includes an aversion to commercial interests) and additional layers of bureaucracy, these segments are expected to close the gap with B&I significantly.

Growth is normalising rather than slowing

Apart from the rebound from Covid-19, Compass's recent growth rates are largely due to the spike in inflation, particularly in food, which has sped up outsourcing decisions. The board is now guiding expectations towards higher single-digit growth rates rather than the recent low double digits, indicating a normalisation rather than a weakening macro trend. Relative to the underlying GDP growth rate, sustaining the growth rates management is putting forward would still be a strong outcome.

Margin scope

The board is confident (and analysts seem to agree) that there is room for margin expansion. One driver is scale, with Compass leveraging its growing base to improve procurement and supply chain. Another is the integration of new acquisitions, benefiting from combined scale and the removal of unnecessary overheads.

Compass has a long history of successful operational efficiency efforts, such as reducing food wastage and energy use. A key strategy is attracting client staff or event attendees to use the provided dining facilities rather than local shops or restaurants, focusing on the 'value gap to high street.' Client subsidies can further support this. Compass also seeks to optimise flexibility through real-time user feedback via apps to assess customer satisfaction and suggestions. Skill transfers from a diverse customer base enable continuous improvement.

There is not massive scope to utilise advanced technologies like AI or machine learning, nor for significant centralisation or large-scale automation in food service. The basics of food service are straightforward, which is reflected in the relatively low margins (6-8 per cent EBIT, only 200-300 basis points higher than food retailing without added service value). Therefore, effective execution and ongoing efficiency drives are crucial.

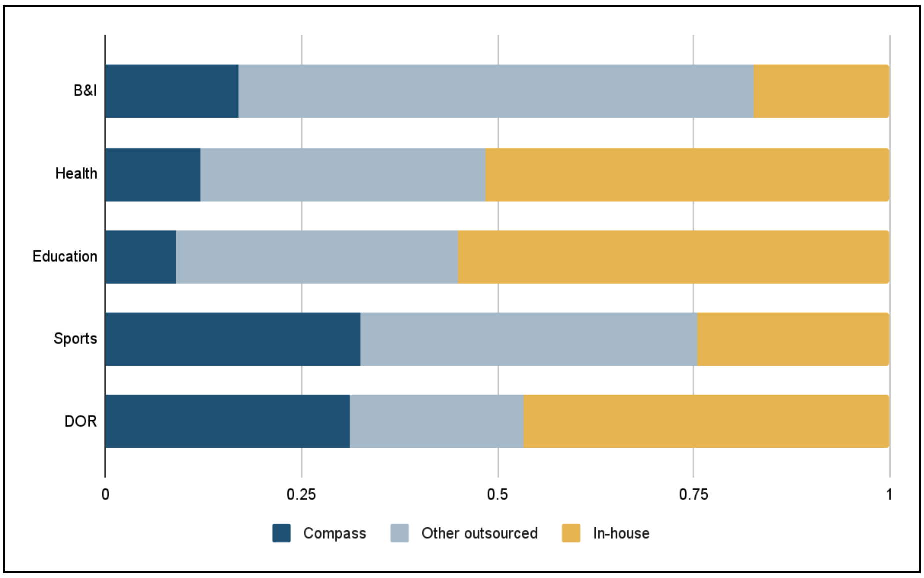
WFH trends have more to unwind

Working from home (WFH) remains significant, with 14 per cent of total working hours in the UK and 11-12 per cent in the US still spent out of the office. This is down from over 40 per cent in 2020-21 but still much higher than the 4.7 per cent seen in 2019 before Covid-19. WFH is stabilising, and while new norms are expected, more hours are anticipated to be worked in the office than today, especially in the US. A food offering is seen as a strong draw, which has the potential to increase Compass' revenue from the existing footprint and further narrow the gross-to-net margin gap.

More than adequate resources

Compass has a moderate amount of debt, rising at 1.3 times Ebitda, but this level is considered safe and within management limits. The company has decent cash flow, enough capital to fund growth and returns to shareholders, and a reasonably long debt maturity profile, with most debt maturing after 2028. Debt replacement may be more expensive, but Compass's refinancing timing has avoided the worst of the rate spikes. With a Moody's debt rating of A2, only the 2024 bond at 0.625 per cent (€750mn) is likely to see a significant increase in coupon. There is ample service headroom, with the interest change covered 16 times by Ebitda, making the financial position very robust.

Market structure and opportunities



Source: Compass

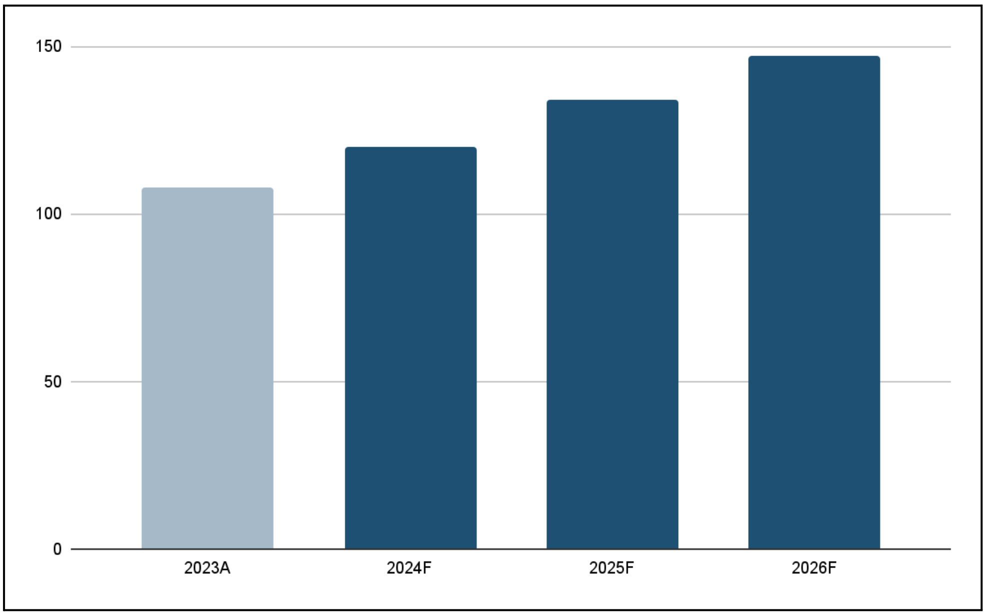
FM opportunities

Compass offers a range of services beyond food through its Facilities Management (FM) arm, and there is potential for growth. This could involve adding incremental services for existing clients or securing broader contracts as its reputation outside food improves. Many organisations prefer to outsource services to a single provider, and by sharing existing core overheads, Compass can achieve better net margins.

Forecasts and momentum

Structural market shifts, favourable pricing, growing internal efficiency, accretive acquisitions, and earnings per share (EPS) increases from share buybacks combine to create a positive environment for Compass's earnings growth. Between 2023 and 2026, the consensus is for EPS to show just under 11 per cent compound annual growth rate (CAGR). Although recent forecasts have been trimmed due to a less aggressive view on continuing food price inflation, they remain stable and higher than 12 months ago.

Current forecast consensus for EPS



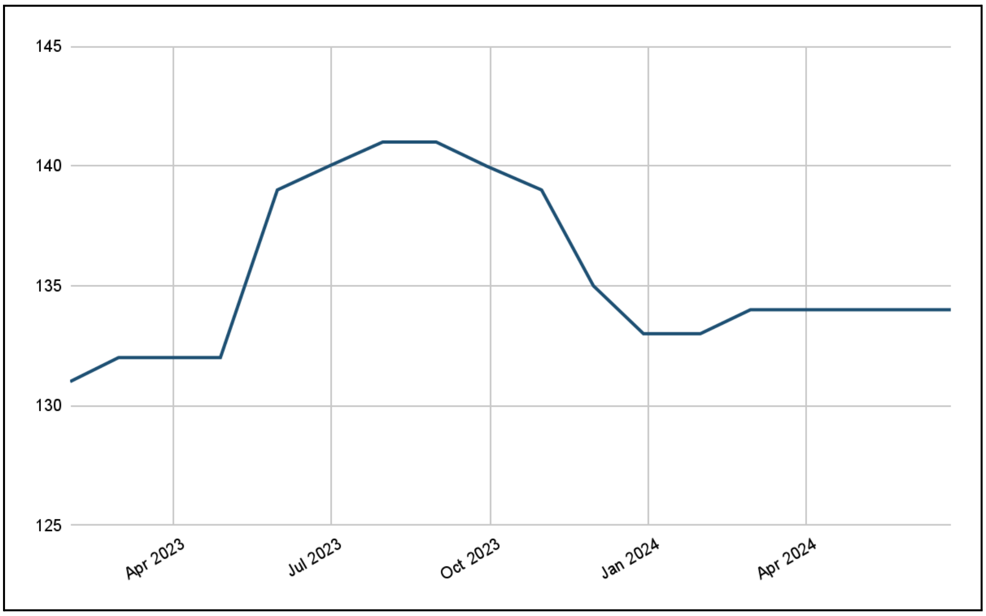
Source: FactSet

Valuation

When we last wrote about this stock in September 2022, we anticipated double-digit Total Shareholder Return (TSR) and a share price above 2,100p, both of which have been achieved. Does this mean there is little value left for investors? Not necessarily. There is still ample potential for a decent positive return:

- Structural growth markets
- Favourable pricing environment
- Potential for further value-accretive acquisitions
- Ongoing sizeable buybacks expected
- Sufficient balance sheet capacity for capital expenditures, acquisitions, and buybacks
- Moderate but growing dividends boosted by buy-backs

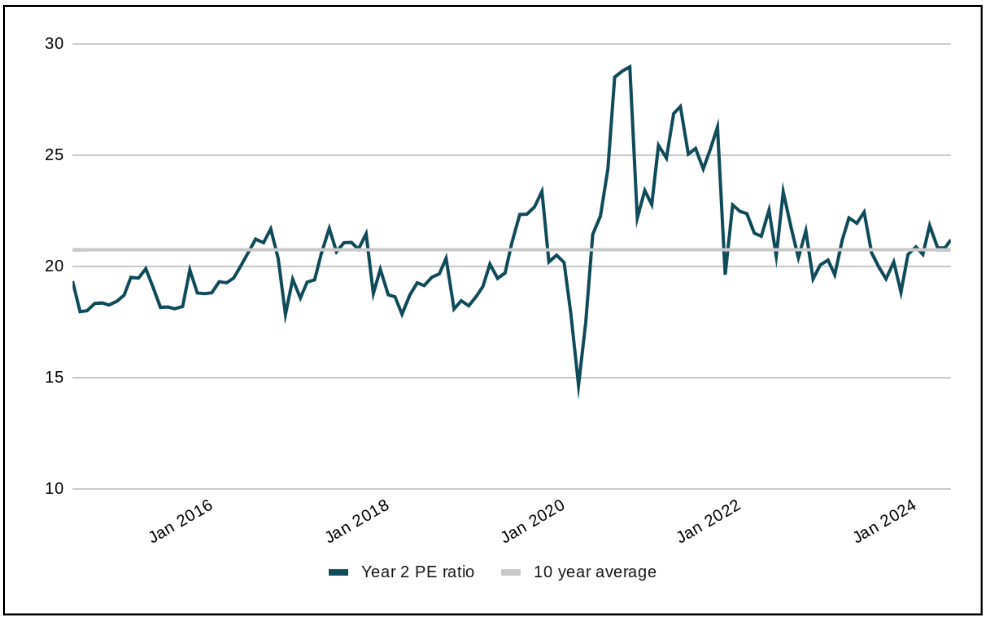
FY2025 forecast trend over last 18 months



Source: FactSet

Many observers and investors see Compass as a 'growth compounder'—a dominant player in a growing field with solid cash flow to support chosen capital allocation, capable of gradually expanding margins over time due to its increasing scale. Growth compounders are typically excellent buy-and-hold stocks.

Compass' own PE ratio history



Source: FactSet, Investors' Chronicle

Compass has a long history of stable Price-to-Earnings (PE) valuation, typically around 21 times the next full year EPS, which determines its share price. This is unlikely to change. If margin growth or FM expansion were to accelerate, there could be a small positive re-rating, but this is not necessary for a positive investment case. Maintaining the PE at approximately 21 times, the share price should grow with EPS, sustaining around 9-11 per cent, forming the capital element of a good TSR. While Compass is not a high-yield stock, good dividend growth is still expected, with a yield of about 2.5 per cent by 2026.

In summary, Compass can still be expected to deliver a double-digit TSR (11-13 per cent). The impressive share price momentum shown in the opening chart is likely to be sustained for at least the next two years, and probably the next five.

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