Castlebay
Investment Partners

Security through compounding: Knowledge, Returns & Trust

Evolution, Antifragility and the compounding of ideas...why optimism is so important

Dear fellow shareholders,
In 1778 William Clark opened a store selling expensive fabrics, bonnets, gloves and parasols at 44, Wigmore Street in London's West End. The business maintained a modest start to its life, with Mr Clark continuing to run his single store for several decades. That is until he met another William— a potential investor. This investor had bigger plans as well as the funds to deliver this greater vision. So in 1813, thirty-five years after its opening, William Debenham formed a partnership with Mr Clark and Clark & Debenham was formed. It took a series of acquisitions and a further number of decades before Debenhams ltd was formed in 1905. Further success and growth followed.

By the 1950s it was the largest department store in the UK. By the turn of the century following a merger and then demerger with Burton Group, Debenhams was listed on the London Stock Exchange. Then came its acquisition by Baroness Retail in 2003—a private equity backed organisation. It was this next period in its life that sowed the seeds of its ultimate demise. Baroness started to strip the company of its assets, selling many of the stores and then leasing the properties back. The company was beginning to be weighed down by expensive rental agreements. Yet it still continued to grow until profits declined in 2014. The 'great disruption' in the UK high street was already underway and by 2019 Debenhams paid the ultimate price. It entered into administration in April that year, as its high fixed cost base exacerbated the impact of declining sales—as consumers began to shop more online and through multi-channel retailers.

When Debenhams first opened who could ever have envisaged in those early days the extent to which its number of stores would expand; and then ultimately how the changing retail landscape would evolve leading to its collapse? Yet, therein lies the point. As we look to the future, who knows which ideas will fade and which will be the seeds of future innovation. So in many ways the Debenhams story, like so many others, is the story of compounding. The compounding of ideas. These ideas can compound in good ways and in bad ways. It was a good decision for William Debenham to invest in William Clark's initial idea as the country embraced the nascent idea of the department store. By the middle of the 19th century, the Great Exhibition of 1851 in Hyde Park set the look and feel of our department stores for the next century and a half—bringing all the fashion ideas of the day into one place.

Yet interestingly, at the very same time in Victorian Britain the brilliant British physicist, James Clerk Maxwell, was formulating a set of equations to describe the behaviour of electric and magnetic fields. These equations showed that a changing electric field creates a changing magnetic field, creating an electromagnetic wave that travels at the speed of light. This idea laid the foundation for the ultimate development of modern telecommunications upon which the internet has been built. That's quite a lot of good ideas building one upon the other to bring about something that would have been unimaginable in the 1850s.

So at the same time that the idea of experiencing your shopping, 'department by department' in one place, was becoming the norm, the seeds of future innovation were being sown. Seeds that would radically alter the retail landscape and contribute in part to Debenhams' downfall. Today, we have a virtual market place that extends far beyond the physical parameters of a shop. When private equity were selling Debenhams' assets and 'leveraging-up' the business it may have seemed a 'good idea' at the time. The problem with creating 'optimal returns', however, is that they often require conditions to be optimal as well. Throughout the 2010s it became increasingly clear that consumers were wanting to take advantage of both physical and online shopping experiences.

Debenhams' business structure did not allow it to **evolve** quickly enough, to its ultimate cost—and herein lies the crux of the issue. The compounding nature of these ideas, can change conditions gradually but ultimately radically. Entities must not just be robust, they must be flexible enough to evolve in the changing landscape.

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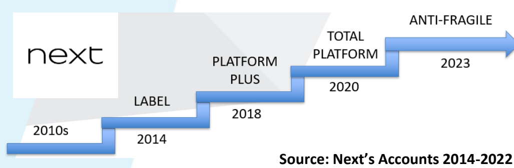
next

Castlebay recently had the opportunity of speaking at the London Value Investor Conference where we presented the 'Next Surprise'. Our presentation focused on two main ideas—the extent to which we use mental models to navigate the investment world; and secondly, how Next plc has used some of these mental constructs to evolve its business model over the last decade and create a business that has actually got stronger through the disruption in the UK high street.

One of the mental models mentioned was the principle of 'Inversion'. In the early 2010s, Lord Wolfson and his management team at Next, realised the landscape of British retail was changing. Next stores numbered in excess of 500 at the time and yet it became clear that consumer preferences, through the desire for greater convenience, were moving more online. 'Beginning with the end in mind' - a type of 'Inversion', they realised that the business needed to pivot. This was not an easy task to undertake. Often businesses resist change as the perceived costs of change are too high. Blockbuster video could have snapped up Netflix, in its infancy, but ignored them and resisted changing their business model because of the money they made from those annoying 'late fees'. Then it became too late to repel the Netflix juggernaut!

In order for Next to change their business model they had to accept a certain amount of cannibalisation of their store sales in order to develop their online business. Yet having a picture of a multi-channel retailer in their minds, allowed them to take this step back in the short-term for the longer term benefit of the business. They reinvested their thirty year knowledge from the catalogue business into developing their online presence.



Source: Next's Accounts 2014-2022

Incidentally, we're not saying that Next had all the answers as to what today's business would look like back in 2010. It's the principle that's important here. As they climbed the steps towards an 'anti-fragile 2023' they corrected their course, adapting to changing opportunities. In 2014 Label was created online. It was designed to be a distribution platform for third party retailers, accessed through Next's own website, Next.co.uk. Four years after its advent, Next innovated again with a system called Platform Plus. This allowed it to consolidate customer orders, combining the stock of its Label retailers from their respective warehouses to Next's. In 2018 there were around 500 retailers on Label. Platform Plus helped to double that number by 2020. The table shows the four main business models used for Label customers: **Commission; Wholesale, Licensing and Wholly-owned**. Next though, continue to encourage the first of these—the Commission model; and they do this for two main reasons, even though it makes the lowest net margin.

Firstly, the revenues of this Commission model have grown three times faster than for the Wholesale model. This is from where the growth will continue to come. The second, even more important reason, is shown in the table's column entitled 'Stock risk'. **Commission** is the only model where the third party retailer takes all the stock inventory risk—and here is where the magic lies! Imagine two retailers *'Catch the Trend'* and 'Oops we missed the Wave', both of which are on Label.

Business model	Design	Sourcing	Stock risk	Examples	2022/23 Net margin
*3rd party Brands sold on **Commission***	3rd Party	3rd Party	3rd Party	Fat Face, River Island Boss, Reiss	*10.9%*
*3rd party Brands purchased **Wholesale***	3rd Party	3rd Party	NEXT Group	Nike, Adidas, Superdry	*14.4%*
***Licensing** and collaborations*	3rd Party	NEXT Group	NEXT Group	Baker by Ted Baker, Myleene Klass	*14.9%*
***Wholly-owned** brands*	NEXT Group	NEXT Group	NEXT Group	Lipsy, Love & Roses, Friends Like These	*15.7%*
TOTAL					***12.9%***

Source: Next's Accounts 2022

Next charges them both 37% commission on their gross revenue transactions delivered through the Label platform. As the sales flood into 'Catching the Trend', Next benefits as the sterling value of their commission increases from rising revenues. As 'Oops we missed the Wave' sees its revenues go nowhere, Next doesn't bear any risk of inventory write-downs, as stock is priced lower to try and sell it. In other words, there is an asymmetry in the risk profile with this model—with the upside disproportionately benefitting Next in relation to the potential downside. Furthermore, having 997 retailers currently on Label should mean that a good proportion of them are catching varying fashion trends at any given time. Label is effectively helping retailers lower their direct to consumer operating costs—which can often be around half the value of revenues. The 37% commission rate which has already been reduced, will likely continue to become more attractive for retailers, as Next pass on their scale efficiency benefits to their Label customers.

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By 2020, Next was ready to evolve their business model further with the introduction of Total Platform. Given their experience in retail, logistics, IT and distribution. So they started taking equity stakes in businesses like Reiss, UK Gap and more recently Joules, Made.com and Jojo Maman Bébé. This allows these brands to have their stand alone websites and focus on designing great products. Next effectively takes care of everything else from distribution to website functionality. Yet the benefits don't stop there for Total Platform customers.

Total Platform retailers also get access to friction free capital expenditure growth. Effectively they are gaining advantage from the significant investment that Next has made in its warehouses—and it has been significant. Over the last three years Next has invested over £400m in technology and warehouses. Its automated, boxed warehouse at Elmsall near Leeds is nearly complete. It will reduce the marginal labour cost per unit by around 40%. Effectively, Next is taking its expenditure from developing new stores and reallocating it to the development of warehouse capacity. This new capacity gives Next far greater optionality in following future customer demand, whether it comes through its core retail brand, Label or Total Platform.

So what is the Next surprise? Simply put it is the realisation that Next is not just a clothing retailer. It's also a third party distribution platform and an equity investor as well. Furthermore, these three pillars of the business have evolved over the last decade to create a special type of business. To coin Nasem Taleb's book of the same name, it has created an 'anti-fragile' business. One that benefits from disruption. As any shopper will tell you, UK retailers have been at the centre of a great disruption over the last eight years.

Quality Table: The premium in Quality of our businesses remains intact in comparison to the market, as evidenced by our Return on Equity and Operating Profit Margin figures. It is true that the market's operating margin has increased from 14% to 17% over last quarter. However, we would still make the point that we believe a large part of this rise is being driven from the more cyclical sectors—seemingly at peak profits, which we would anticipate declining as the cycle rolls over. How sustainable will the market's profits be and by extension its margin and free cashflow yield? We should get a clearer idea over the new few quarters.

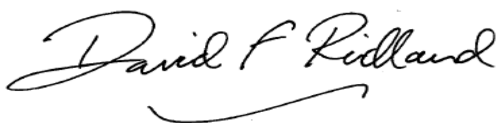
Quality Table	Castlebay Fund	Market
Return on Equity	41%	14%
Operating profit margin	22%	17%
Net debt to equity	61%	79%
Cash conversion	87%	85%
Free Cashflow yield	4.4%	4.4%

Source: Refinitiv as at 30/06/2023

What remains the case is that we continue to own a collection of really good businesses that have delivered robust financial results. As 2022 signalled the 'end of free money' with interest rates rising to counter rising inflation, our companies were offered to us at increasingly attractive prices and valuations. Our companies are not only resilient but can continue to benefit from the economic uncertainty and inflationary environment, as they do something different which people value. Remember, our Quality Table, is also called our 'table of constancy'. It shows us that our businesses continue to reinvest to create greater value over the long term, even if the market's myopic attention is focused elsewhere.

Thank you once again for your continued support and we hope that you find this letter of interest.

Best wishes



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