

Next in Stock

Share buybacks pay off for High Street hero



Next sells fashionable but reasonably priced clothes in its shops and through its home order directory.

Picture: Next Watford, Waterfield Retail Park, next.co.uk.

With over 370 stores, Next is Britain's third biggest fashion and home furnishing retailer. Over the last five years Next has performed strongly and has gained a reputation as one of the most successful High Street retailers. Investors had plenty to smile about: between

2000 and 2004, revenue grew from £1,425m to £2,516m

and Next's share price rose by 244 per cent.

But will Next's success story continue? Although rapid growth is not the company's main target, Chief Executive Officer Simon Wolfson aims at doubling Next's market share from six to twelve per cent over the coming five to ten years, which could make the retailer bigger than Marks & Spencer.¹ This is an ambitious target; but recent history suggests it may be achievable. Yet, a degree of modesty is appropriate because the upward trend of Next's share prices is partly caused by a share buyback program. Although buybacks are only possible because of the underlying success of a company, it camouflages the proportionate contribution to success of company performance.

Since the start of 2004, Next's stock has soared by 45 per cent to a new record high of 1,720p per share in early October. Results for the six months to July showed sales up by 16 per cent to £1.2bn compared with the same period in 2003 and half year pre-tax profits rose £38m to

¹ The Guardian, 15/09/2004; The Times, 15/09/2004.

£163m. Performance was above expectations and, subsequently, stock analysts upgraded the full-year profit forecast from £403m to £420m.²

As figure one shows, Next's success contrasts sharply with its main competitor M&S, whose share price rose 34 per cent since 1999 while Next's stock appreciated by more than 200 per cent. Despite a set back in 2002 when weak sales of an unpopular autumn range of women's clothing prompted shares to fall by a third, Next still surpassed the FTSE 100 and the FTSE for General Retailers.

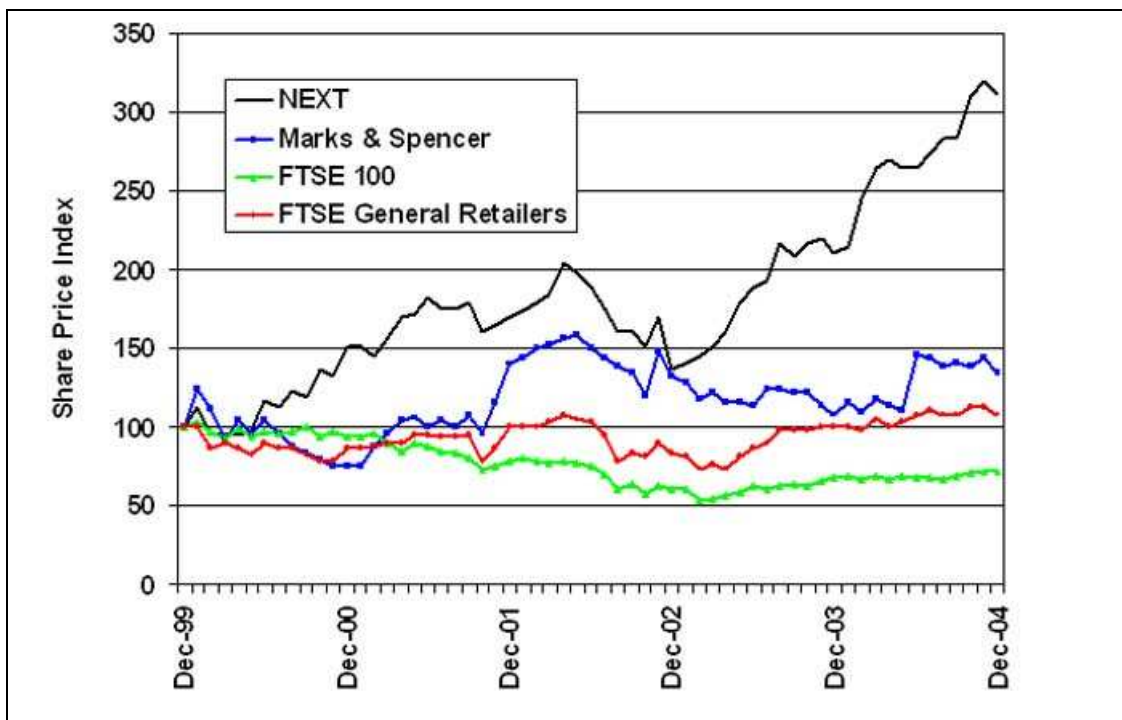


Figure 1: Share price comparative indices (12/1999 – 12/2004; 12/1999 = 100). Source: *bigcharts.com*

While healthy revenue growth and improving profitability played a role, another factor responsible for Next's growth is an extensive share buyback scheme introduced in 2000. Since then, Next has reduced the number of outstanding ordinary shares by buying back 27 per cent. Buybacks generally boost share prices. But this practice cannot be sustained in the long run because a disproportionate

² FT 15/09/2004.

difference between profit growth and share price rises generally illustrates unbalanced corporate performance.

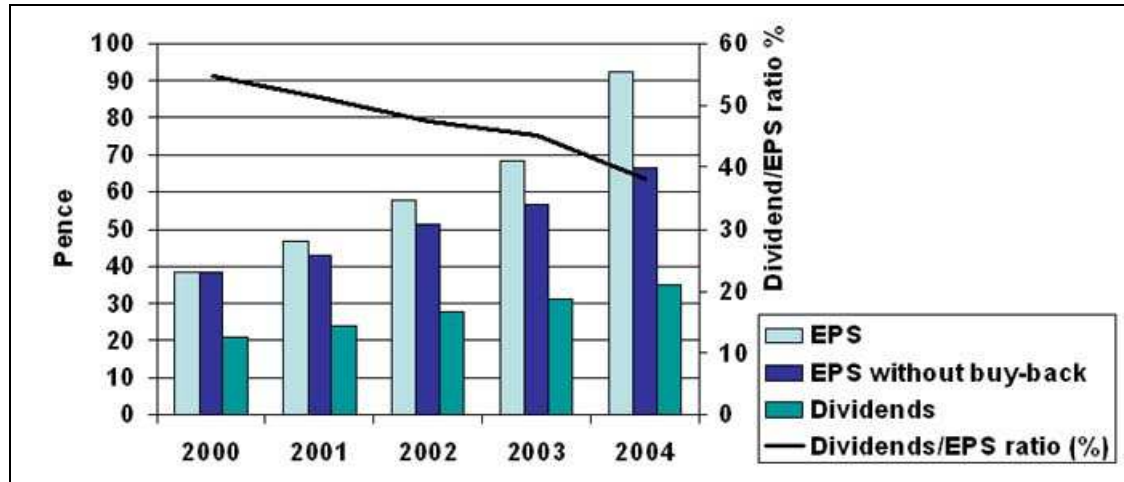


Figure 2: Earnings per share and dividends (FY 2000 – FY 2004). Source: Next Plc Annual Reports.

According to Mr Wolfson “shares will only be purchased when [it] will result in an increase in earnings per share [EPS]”.³ And, as figure two demonstrates; that is precisely what happened. Over the past five years EPS grew 140 per cent from 38.4p to 92.1p. Closer analysis suggests that without the scheme EPS would have increased by 73 per cent; from 38.4p in 2000 to 66.4p in 2004. Arguably, 67 per cent of the 140 per cent rise in EPS is caused by the retiring of shares. As follows from figure two, the gain in EPS and related share prices relies for 48 per cent on the buy-back scheme and for 52 per cent on actual performance.

Consequently, dividends were up 67 per cent from 21p in 2000 to 35p in 2004. Over the same period, dividends as percentage of EPS decreased 16.7 per cent; from 55 per cent to 38 per cent. As opposed to paying dividends to investors, Next’s net profits are thus increasingly spent on share buybacks and the creation of new store space.

³ Next Plc (2003).

In January 2004 Next had 358 stores with a total of 2.84m square feet of selling space. The company expects to increase store space by 35 per cent by the end of FY 2006. The expansion will peak in October 2005 when Next opens its first 80,000 sq ft store in Manchester, twice the size of Next's current biggest store in Cardiff.⁴

Although, according to Mr Wolfson, "the main focus of the business still remains on growing in the UK"⁵, with 70 franchise stores on the European mainland, the Middle East, Asia and a recently opened wholly owned store in Copenhagen, Next is increasingly focusing on overseas markets.

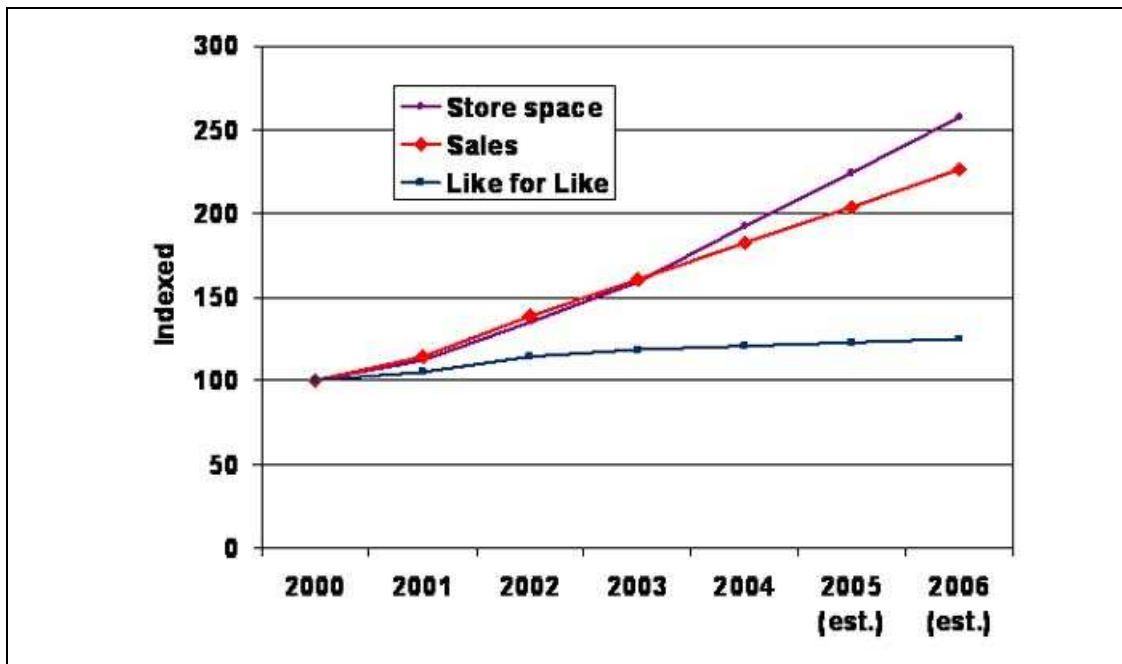


Figure 3: Indexed store space and sales (FY 2000 – FY 2006; 2000 = 100).

The prognoses for 2005 and 2006 are estimates based on a similar growth pattern as experienced in the previous years. *Source: Next Plc Annual Reports.*

As figure three shows, the increase of store space over the last couple of years is higher than the accompanied increase in sales. That demand lags behind supply can most likely be attributed to

⁴ The Independent 15/09/2004.

⁵ FT 8/11/2003.

consumer slowdown and rising interest rates affecting all UK companies. But the reason why growth in like-for-like sales (total sales in stores that have traded for at least one year and were not affected by new stores) decreased from nine per cent in FY 2002 to less than two per cent in FY 2004 can be attributed to “its [Next’s] aggressive policy of expanding, [...] depresses its underlying sales growth because the new sites cannibalise existing ones.”⁶

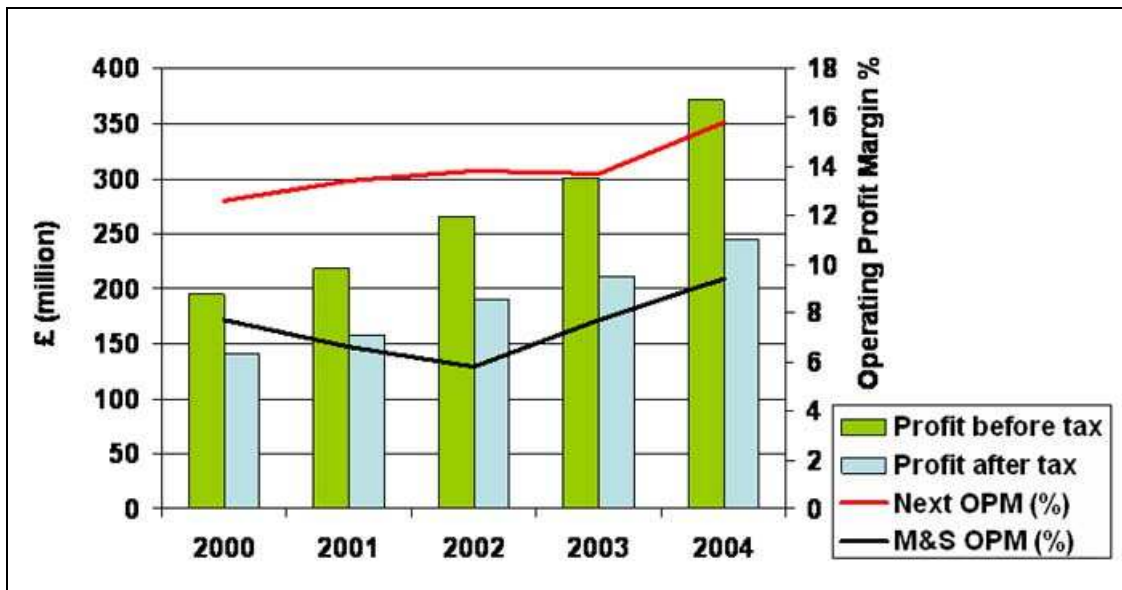


Figure 4: Profits Next and Operating Profit Margin (OPM, net profits as percentage of turnover). Because the FY of M&S does not synchronise with Next’s FY, the M&S figures are actually the figures for a FY earlier. *Source: Next Plc Annual Reports and Marks & Spencer Annual Reports.*

Even though underlying sales grew at a slower pace over the last years, the additional store space has apparently paid off. Between 2000 and 2004 Next’s turnover grew by an average annual rate of 15.2 per cent. As figure four demonstrates, after-tax profits rose from £140.2m to £245.2m. According to a study by Oxford University, Next ranks first out of 20 British and American retailers in terms of profit density per square foot of selling space.⁷ Next’s operating profit margin (OPM) increased by

⁶ The Independent 14/05/2004.

⁷ Oxford Institute of Retail Management (2004).

2.5 per cent over the last five years and is nearly twice the OPM of M&S: a sign of Next's increasing cost effectiveness.

Looking ahead, Next might be affected by fiercer competition. Not only will high interest rates, increasing taxes and consumer debt levels exert pressure on consumer spending, M&S could also make its return after it recently announced drastic restructuring. Additionally, Arcadia retail group has joined the fight for High Street supremacy. Although Arcadia's CEO Mr Phillip Green's main competitive target is M&S, "if he can fell Next along the way, so much the better".⁸

Yet, Next's directors appear confident of the company's future performances as they placed a £2.6 million bet on its share prices. If shares average £20 or less in the three months to July 2008 the money is lost but if they reach £24.50, £13 million will be gained. In order to achieve that, Next's stock has to appreciate between 7.7 and 13.6 per cent annually.

As argued earlier, almost fifty per cent of the stock appreciation since December 1999 can be attributed solely to share retirements. When applying this figure to share price growth over the coming four years – provided instant resumption of the buybacks while internal and external factors remain constant- Next's stock could appreciate by 27.5 per cent reaching £20.24 per share: just enough for the Next directors to break even.

If the growth of Next's stock remains based on buybacks, share prices might well reach up to £26 in 2008, which means Next's bosses win the £13m jackpot. An abolishment of the scheme seems thus unlikely in the foreseeable future because it serves its purpose well: increasing shareholder value.

Reflection

⁸ The Independent 15/09/2004.

The most important lesson I have learned in the module is that companies and financial institutions do not just latently exist 'out there'. Because companies influence every day life so strongly, there is a need to study and reveal the implications and real intentions of the business sector.

At first I thought that studying corporations meant you would have to be a 'proper' economist with an almost obsessive interest in figures. I was therefore surprised that even basic calculations on percentage changes and indexing of share prices could give valuable insights.

The fact that everybody in our class did a case study on a different company has added a lot of practical value to the module in terms of research and analysis. By going beyond dry business theory, I actually developed a feeling that Next was 'my company'. It definitely made me more eager to get to the bottom of its performance.

When analysing Next's annual reports, I became intrigued by the amount of hidden information in numbers and I wanted to understand more of the 'specialised' business terms used to describe company growth. Unfortunately this was not covered by the module.

My biggest challenge was to narrow down the overflow of information according to its relevance. The step by step approach of doing weekly assignments and getting feedback on them has made this process a lot easier.

Although I had always wanted to understand stock markets, I would never have guessed it was so easy to learn. And now I somehow understand it, I might invest some money myself one day. Of course with a similar objective as the business sectors: maximising my earnings per share.

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