



BY JOHN KINGHAM

DIVIDEND HUNTER

WHY WH SMITH COULD BE A SOLID CHOICE FOR DIVIDEND GROWTH

When I think of WH Smith (LON:SMWH), I think of a company which sells products that are either in decline (physical newspapers, magazines and books), can be purchased more easily online (note paper, pencils, exercise books) or are basically extinct (CDs, DVDs and vinyl records). In other words, my default mental image is of a company destined to become the next Woolworths.

However, if you look at WH Smith's financial results over the last decade, you'll see a company which has grown its earnings and dividends per share by about 10% per year, every year. That's pretty amazing, especially for a company that is over 200 years old.

With a current dividend yield of around 3%, this is no high-yield bargain, but combined with its double-digit dividend growth record, some would say it looks like a solid choice for dividend growth investors.

A tale of two businesses (part 1): High street

The Woolworths-like business I described above is WH Smith's high street business. It's the familiar high street newsagent we all know and (possibly) love, and it's in long-term decline. It's in decline because many

of its core products are now mostly consumed online (e.g. books, music) and many others have appeared in supermarkets (e.g. pens, pencils, paper, school exercise books, etc.).

This decline is already well-established. In 2010, the high street business had 573 stores which gener-

“THIS IMPRESSIVE INCREASE IN PROFITABILITY HAS BEEN DRIVEN BY A RELENTLESS FOCUS ON COSTS, PRODUCT MIX AND PRODUCTIVITY.”

ated revenues of £860 million and £51 million of operating profit. Fast forward to 2018 and while the number of stores has increased to 607, revenues from those stores have fallen by £250 million to just £610 million. However, despite losing such a large amount of revenue, the high street business still managed to squeeze out £60 million of operating profit in 2018, almost 20% more than in 2010.

This impressive increase in profitability has been driven by a relentless focus on costs, product mix and productivity. In fact, WH Smith's focus on costs has seen it languish near the bottom of the Britain's Best High Street Retailer list (via Which? Magazine) for eight years. There is even a dedicated Twitter profile showing pictures of the company's worn and torn carpets and damaged product stands.



“SOME PEOPLE WILL THINK THAT TATTY STORES ARE A SIGN OF A POORLY RUN BUSINESS. I THINK IT SHOWS THAT MANAGEMENT ARE SERIOUS ABOUT MAXIMISING SHAREHOLDER RETURNS.”



Some people will think that tatty stores are a sign of a poorly run business. I think it shows that management are serious about maximising shareholder returns. How so? Because running a publicly-traded business is about maximising long-term returns to shareholders and not maximising customer happiness, staff happiness or anything else. Yes, these things often overlap, but often they don't.

In the case of WH Smith, management could easily have chosen a route that was more popular with customers. They could have spent vast amounts of money refurbishing the company's high street stores. There would have been gleaming WH Smith stores up and down the land; a proud reminder of the company's 200-year history and position as a much-loved British company. But in my opinion (and management's), that would have been a huge mistake.

The stores would have become more expensive to run and maintain, which

would have eaten into the company's cash flows. I don't think nicer, cleaner WH Smith stores would have increased revenues very much, because WH Smith is a convenience store, not a destination store. People shop in WH Smith because it's there when they're out and about. While you're in the high street you might remember that you want a pencil, so you pop in and buy one along with a magazine that caught your eye and a can of something fizzy. Do you care about dirty carpets? Probably not. But if your visit is pre-planned, like a weekly shop at the supermarket or a day out visiting some snazzy fashion shops, you're much more likely to take things like the state of the carpet into account. So yes, tatty and tired stores are bad for some companies, but not for all. And probably not for WH Smith's high street business.

The cash that could have been spent on those carpets has been put to better use (probably), as dividends, share buybacks and investments into the

company's rapidly growing travel business.

A tale of two businesses (part 2): Travel

More people around the world are travelling by air, rail and car more often, and they want to be able to buy something to read and something to eat while they're doing it (although hopefully they won't be reading while driving). Lucky for them, they can now find WH Smith stores or concessions in airports, railways, motorway service stations, hospitals and anywhere else where a sandwich and a magazine will come in handy.

So, unlike its declining high street business, WH Smith's travel business is still growing, and in the last few years it's grown to be the largest part of the business in terms of both revenue and profit. The international part of the travel business is growing fastest of all and has expanded from 16 units in 2010 to 286 units in 2018. In terms of



kay roxby / Shutterstock.com



“THE INTERNATIONAL BUSINESS HAS GONE FROM BASICALLY NOTHING A DECADE AGO TO GENERATING 20% OF THE COMPANY’S PROFITS TODAY.”



profit, the international business has gone from basically nothing a decade ago to generating 20% of the company's profits today.

Much of this travel growth has been fuelled by cash extracted from the high street business. In some ways this is similar to the early days of Buffett at Berkshire Hathaway. Back in the 1970s, Berkshire's declining textile business was starved of investment as

the cash it generated was taken away and reinvested into higher return businesses such as insurance. It may have been sad to see the Berkshire Hathaway textile business fall into terminal decline, but Buffett was 100% correct to redirect cash away from that low return business and into higher return businesses.

The same logic applies to WH Smith's declining high street business and

its expanding travel business. Cash should flow to wherever returns are highest, and in this case that means away from the high street and into the travel business.

So that's a brief overview of the two sides of WH Smith. Let take a look at the company's accounts and then think about a target buy price.

Consistent double-digit growth

At first glance, it may seem as if WH Smith is on a fast road to nowhere because its revenues haven't grown at all in more than a decade. If anything, they've declined slightly. This is obviously not good and doesn't tie up with the company's 10% annual earnings and dividend per share growth rate. There are two main reasons for this.

The first reason is profit margins. WH Smith's net profit margin has increased from around 5% in 2009 to around 9% today, so for every item sold it makes about twice as much profit today as it did a decade ago. That's good and it's largely a result of the company's infamous high street-related cost cutting tactics and Scrooge-like behaviour.

The second reason is share buybacks. Over the last ten years, the company has bought back around 30% of its shares. This means each remaining share now represents a far bigger slice of the company pie, and that in turn means that per share revenues, earnings and dividends have increased handsomely. This is true even though the overall pie (i.e. the company) hasn't grown much at all.

For many, this sort of aggressive use of share buybacks is somehow morally wrong, but in reality it's just another way to return cash to shareholders. Buybacks make financial sense as long as management think the purchased shares will produce better returns than a reasonable hurdle rate, such as the market's average return (about 7% per year).

Share buybacks are also a very flexible way to return excess cash to shareholders. If a company has a lot of extra cash it can buy back more shares, but if cash flows get a little tight it can temporarily cancel any planned buy-





Martin Good / Shutterstock.com

backs. This is much less distressing to investors than a dividend cut, which is almost universally hated by income investors.

Dividends well-covered by free cash flows

As I just mentioned, WH Smith buys back a lot of shares to boost per-share returns and return cash to shareholders. In order to do that it must (or should) be generating excess cash (free cash) beyond that required to pay the dividend. And that is indeed the case.

Over the last ten years, the company has consistently generated enough maintenance free cash (i.e. cash from operations, minus debt interest, minus the depreciation of its existing fixed assets) to pay the dividend twice over. This cash is paid out as a mix of dividends and buybacks. Hopefully the fact that dividends are consistently well-covered by free cash means the dividend should (should!) be relatively safe, although of course there are never any guarantees.

Small debts and a big pension

WH Smith has almost no debt, which as far as I'm concerned is a good thing.



Nick Beer / Shutterstock.com

It's possible to boost profitability and returns by taking on more debt, but for cyclical companies like retailers it's often more trouble than it's worth. However, the company does have a large financial obligation in the form of a billion-pound defined benefit pension scheme.

Although the scheme has a negligible £11 million deficit, which is being reduced by a £3 million annual cash payment from WH Smith, the real risk is the size of the overall scheme. At just

over £1 billion, the total pension liability is about ten-times the company's recent net profits, which have averaged around £100 million.

A pension-to-profit ratio of ten is enough to make me avoid a company, so for me this is a potential red flag. However, in this case the pension size is only just 'too big', the deficit is tiny, and the company has strong cash flows, so WH Smith's pension scheme probably isn't large enough to stop me from investing.



Target purchase price

Overall then, WH Smith is exactly the sort of company I like to invest in. It has a long track-record of per-share revenues, earnings and dividend growth, it doesn't have a lot of debt, it's highly profitable and has good cash generation. It does have a big pension, but I would still be more than willing to invest at the right price.

At the time of writing, the company has a share price of 1,782p. That gives it a 3% dividend yield, which is slightly below a FTSE All-Share tracker's yield of around 3.4%. However, given that WH Smith's dividend growth record is far above average, that slightly below average yield still looks attractive.

For example, to get the average rate of return for equities of 7%, the dividend would only have to grow by 4% per year (i.e. 3% dividend yield plus 4% divi-

dend growth equals 7% total return, all else being equal). So, on the face of it, the current price seems attractive.

Another way to think about valuations is by using a stock screen which ranks stocks according to whatever criteria are relevant to you. In my case, my stock screen ranks companies based on their ten-year growth rates, growth quality and profitability, and then by share price relative to earnings and dividends. On that screen, WH Smith ranks 15th out of about 200 companies. That's very close to the top, and well within the top 50 zone that I prefer to buy from. So according to my stock screen, WH Smith is attractive at its current price.

In fact, the company is still attractive, according to my stock screen, at 2,200p. However, at that point it starts to reach valuation levels that I'm not entirely comfortable with. For exam-

“WH SMITH IS EXACTLY THE SORT OF COMPANY I LIKE TO INVEST IN.”

ple, at 2,200p the dividend yield would be 2.5%, which is about as low as I'm willing to go with new investments. And the company's PE10 and PD10 ratios (price to ten-year average earnings and revenues) would also reach the limits of my comfort zone, at 31 and 65, respectively (my limits are 30 and 60 for those ratios).

On that basis, **my current purchase price for WH Smith is anything below 2,200p.**

Obviously, the current price is already below this, so in theory I would be happy to buy WH Smith today. But in practice I don't expect to own WH Smith anytime soon. The reason is that my portfolio is currently slightly overweight the UK (53% of its revenues come from the UK compared to my preferred limit of 50%) and 71% is invested in cyclical sector stocks (compared to my preferred limit of 66%). It also already holds three companies from the general retailer sector, and I don't like to have more than three holdings (out of 30) from one sector.

So, while I like WH Smith and I also like its price, it just isn't a good fit for my portfolio at the moment. That's a shame, but if I want my portfolio to remain highly diversified then I'll have to avoid WH Smith, at least for now.

About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

John is also the author of *The Defensive Value Investor: A Complete Step-By-Step Guide to Building a High Yield, Low Risk Share Portfolio*.

His website can be found at: www.ukvalueinvestor.com.

