Buying: N Brown Group PLC (BWNG)

Improve the portfolio : *As companies grow (or shrink) and as their share prices go up (or down) the attractiveness of the investment changes. If a company's share price shoots up too fast, or if a company falls into a long-term decline, it may be time to sell and replace it with something that appears to offer better value for money.*

Price on 1st Nov 2014	Index	Sector
355p	FTSE 250	General Retailers
FTSE Market Cap	**Revenue**	**Adjusted Pre-tax Profit**
£950 million	£835 million	£100 million

"N Brown Group, and its principal subsidiary, JD Williams and Company Ltd, is a leading internet and catalogue home shopping company, with over 140 years of experience in the distance shopping market." (www.nbrown.co.uk)

Overview

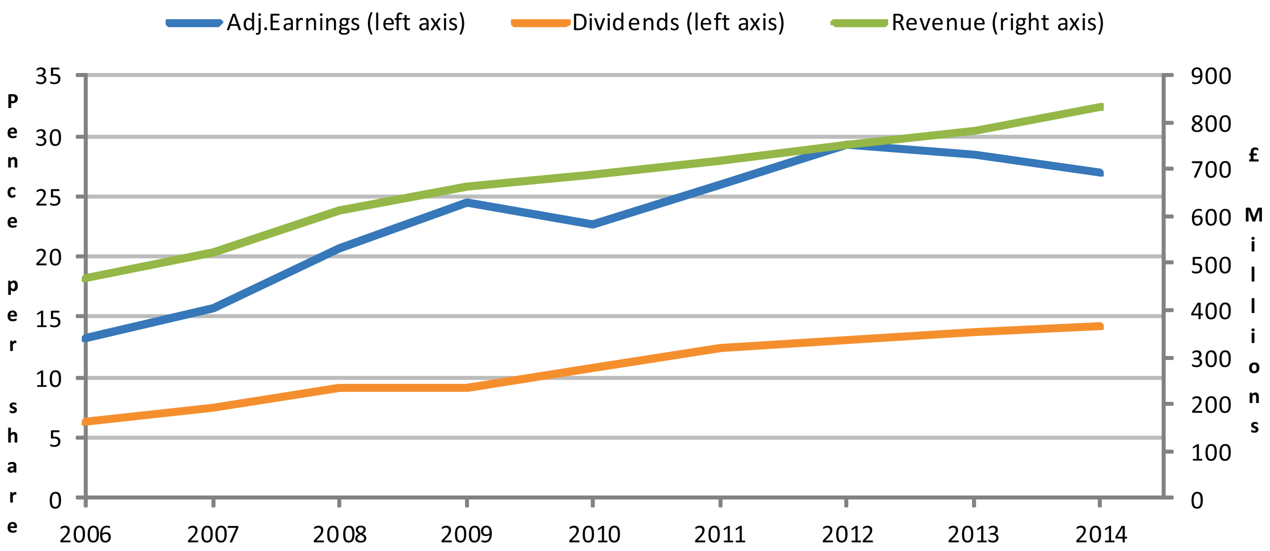
JD Williams, the primary subsidiary of N Brown, is the UK's largest independent multi-channel home shopping retailer. It mostly sells niche fashion items for larger and older customers through 25 brands including Simply Be, Jacamo and figleaves.com. It's also a company which has been in the model portfolio before, having joined in May 2012, only to leave just 8 months later after the shares quickly gained 50%.

It started out as a mail order business over 100 years ago and still sells via catalogue today (along with websites which generate the majority of sales, and even a few high street stores too). The business model is somewhat different to traditional high street-based retailers, as clothes are sold on credit rather than cash. This makes it easy to order several items in different styles, colours or sizes. Once delivered you can try on what you've ordered, pick the one you like and send the others back, all without having to pay up front. Of course the credit comes at a price, but it's a price that many are willing to pay for the added convenience.

Now though things are different and the World Wide Web is effectively one giant shopping catalogue. Home shopping companies have had to adapt to survive, and so far N Brown has adapted exceptionally well.

Growth Rate	Dividend Yield	Return on Capital	Valuation (PE10)
8.7%	4.2%	11.2%	14.5
Growth Quality	**Debt Ratio (max 5)**	**Pension Ratio (max 10)**	**Rank**
88%	2.3	0.9	17 (out of 233)

Green = Better than FTSE 100, Red = Equal to or worse than FTSE 100



Investment checklist

Successful investing requires the methodical application of a systematic approach in order to achieve specific objectives, and a checklist is a great aid towards that end. This checklist helps to ensure that the company under investigation is high quality, and that its shares are likely to improve the portfolio in the long-run.

Industrial diversity: Will this investment mean that 1) There are no more than 3 companies from this sector in the portfolio and 2) The portfolio is invested at least 50% in defensive sectors (including cash)?

YES 1) N Brown will join JD Sport as the second General Retailer in the portfolio.

YES 2) General Retailers is a defensive sector, according to the Capita Dividend Monitor. If 4% of the portfolio is invested in N Brown it will be approximately 52% invested in defensives (including 6% cash).

Geographic diversity: Will the addition of this company leave the portfolio's international focus above 50%?

YES N Brown is more or less 100% focused on the UK, although it does have a growing "toe in the water" business in the US. After buying N Brown the portfolio would still be approximately 52% international.

Operational diversity: Does the company have low dependency risk by not relying on a small number of key customers, suppliers or employees?

YES There are no dependency risks highlighted in the annual report and there are none in particular that I can see, other than the fairly common risk among retailers of a small number (2, in this case) of huge central warehouses. The recent ASOS warehouse fire, for example, cost it around £30 million in lost sales.

Market leadership: Is the company in the leading group within its markets?

YES JD Williams, the group's principle subsidiary, is the UK's leading multi-channel home shopping retailer. It also owns the UK's largest online lingerie retailer, figleaves.com.

Organic growth: Has growth been primarily organic and within the same industry?

YES N Brown has been involved in its fair share of acquisitions and disposals. In recent years the board have seen the sense of focusing on what the company does best, which is distance selling niche fashion items. This has resulted in the sale of non-core and out of date business such as its TV shopping channel, its door to door sales business and its transaction fulfilment business.

In terms of acquisitions, the company has mostly been involved in buying up brand names such as High and Mighty or Gray & Osbourn, or the fashion website figleaves.com. Just as important as the acquired brands is the list of customer contact details that often come with them. This allows the company to leverage its direct marketing expertise to cross sell other group brands to newly acquired customers.

As for risks from these acquisitions, I don't think they're excessive as the acquired businesses are very closely related to N Brown's core business of home shopping and niche market fashion.

Competitive advantage: Does the company have any low cost and durable competitive advantages?

NO To my mind N Brown has several factors working in its favour, and some are even relatively low cost and durable, but I don't think any of them provide a powerful "moat" to protect it from competition.

The first positive factor is scale, although this is probably not that important and becoming less important as time goes by. N Brown is the UK's leading direct home shopping company and size does help in retail. It allows more data to be gathered from more customer interactions, which hopefully leads to more lessons learned. It also helps on the costs front of course, with marketing, distribution and other overheads centralised and optimised as much as possible.

The second positive factor is its experience in direct marketing. As a long-time home shopping business it has a lot of experience with direct marketing over many decades. Direct marketing and its emphasis on split tests and quantitative analysis of results is more or less exactly how email and online display marketing works.

In contrast, while high street retailers may have used direct advertising before the internet, it wasn't necessarily a core part of their business. Nowadays though it must be because of the increasing proportion of sales occurring online. How much of an advantage this is for N Brown is impossible to quantify, but I imagine it must be very helpful to have had direct market at the core of your business for over a century.

Another factor is its default use of customer credit as opposed to cash payments. The default option of "no money down" and monthly payments for clothing is a differentiator when compared to other fashion retailers. The appearance of easy credit and credit cards in recent years must have had an impact on this, but the idea of not having to pay up front, and therefore being able to try on multiple items at home at no cost, obvious has merit for many people and it's something the company has deep expertise in.

The final positive factor I'll mention is its focus on niche fashion, primarily for older and larger shoppers (both of which are growing markets) who may not be well catered for in mainstream stores. Having found a brand which can supply them with clothing which looks good and fits, customers are then often more loyal than an equivalent mainstream shopper who can get their clothing from just about any high street.

However, all of these capabilities could be replicated by another competent retailers if it really wanted to, so while they add up to a highly successful business they do not guarantee an easy ride in the future.

Past problems: Has the company been free of major crises during the last decade? If there were any, were they resolved successfully?
YES There have been no crises in the last decade.

Current problems: Is the company free of any obvious problems or risks (including excessive debt) which could materially impact its future prosperity?
YES As always, a company's shares will not be attractively valued if everything is going swimmingly. There will inevitably be problems, large or small, which have depressed the market and the share price. This is no different for N Brown and in this case I can see two obvious problems.

One problem appeared at the company's most recent interim results. It issued a "profit warning" and lowered its "guidance" on full year profits. I've put both of those terms in brackets as I'm not a fan of either of them.

Company earnings are inherently volatile and, in my opinion, to run a company with one eye on quarterly earnings numbers just because you have provided the market with guidance on them is likely to be a poor way to maximise the long-term value of a company.

Long-term investors should not be thinking about quarterly or even annual profits. Instead they should be looking at how a company has performed over the previous 5 or 10 years and thinking about how it might perform over the next 5 or 10 years.

Having said that, the negative reaction from the market following a "profits warning" can be useful for long-term investors as appears to be the case with N Brown, as the shares fell 13% (13%!) on the announcement. This sort of reaction can create a compelling investment opportunity.

And the reason for this profit warning? In large part it was down to the unseasonably warm weather we had during the autumn. Warm weather means that people are happy to stick with their summer clothing for longer rather than buying the latest winter fashions. Of course as a long-term investor I would never dream of basing an investment decision on how a short-term weather anomaly impacts a company's results, but I would base one on the share price that results from the panic selling of other investors.

The other problem is the long slide in share price that N Brown has suffered since February this year. Back then the shares high a high of almost 600p, which was a 150% gain from 2012 prices. However, that was clearly "too high" and so the shares have slumped as the company failed to match investors' short-term expectations.

Share prices do have momentum and so a share which has seen a pronounced decline may well keep going down as investors jump off the bus in fear of it going off a cliff. Eventually all the nervy investors have gone and value-based investors start to pile in, reversing the trend. At least in theory.

Beyond those two main factors I can't see any other obvious problems, which of course doesn't mean to say there aren't any, it just means that if there are problems then they're not obvious.

Future problems: Is it likely that the company's economic engine can continue to grow and avoid becoming obsolete in the next decade?

YES N Brown has a long history as a successful and leading home shopping company, supplying fashion items to niche markets for more than a century. By enabling people to shop from home, especially people who would rather shop from home than visit a high street store, they have profited handsomely.

However, the World Wide Web is in many ways a giant home shopping catalogue and so it was obvious long ago that businesses like N Brown would be massively impacted by the widespread acceptance of internet shopping. To their credit, N Brown has adapted fantastically well, but the journey is still ongoing.

Angela Spindler, the company's relatively new CEO, has spent the year pushing through a more ambition program of change to make the business a true "multi-channel" retailer.

The company now has an ambition of opening 25 stores nationwide, with almost 10 up and running already. These stores aim to be profitable in their own right of course, but they are also there to raise awareness of the company's niche brands.

As well as stores on the high street, the online stores now accept cash payments by credit or debit card alongside the credit payment method which is traditional among home shopping businesses.

And then there's the international expansion effort, with a fledgling Simply Be business in the US.

So while I am always the first to say that I do not have a crystal ball, I see no obvious reason why N Brown can't continue to produce decent rates of growth for quite a few years yet. Whether it will or not is, of course, another matter.

Making the trade

I will be adding N Brown Group PLC to the model portfolio a few days after this issue is published. It will have a position size of approximately 4%, slightly above the default 3.3% (1/30th of the portfolio) in order to utilise some of the portfolio's excess cash. My expectation will be, as usual, that the shares will be held for around 5 years, although it could be considerably more or less than this depending on future events.

Higher ranked companies that were not selected	Reason for not investing
Sainsbury (J) PLC	Portfolio already holds 3 Food & Drugs Retailers
ITE Group PLC	Stock screen data is almost 1 year out of date as annual results are due out in December
Chesnara PLC	Portfolio already holds 4 finance companies

"Acknowledge the complexity of the world and resist the impression that you easily understand it."
Robert Shiller, Professor of Economics, Yale University