December 18, 2016

Howdens Joinery Group Plc.

Ticker:	**HWDN**, London Stock Exchange
Share Price:	**£ 3.70**
Market capitalization:	**£ 2.34 billion**
Enterprise Value:	**£ 2.87 billion**
EV/EBIT (TTM):	**10 x**
Price / earnings (TTM):	**13 x**

Thesis

Howden Joinery is UK's largest manufacturer and supplier of fitted kitchens, appliances and joinery products with a differentiated - and an efficient - business model under the helm of an outstanding management that constantly focuses on its niche customer- the small builders. Howdens is a trade –only business that means they sell only to other businesses and not to the general public and its operating model is based on low cost individual depots that offer nearly 60 kitchen ranges together with appliances, sinks and taps, worktops, flooring, lighting and hardware, and a range of joinery including internal and external doors, skirting and stair parts to small builders within a local community. A high quality cash generative business with above average profitability, lowest operating costs in the industry and good growth prospects, Howden has consistently generated excellent returns on invested capital of around 30% pre-tax over the last 5 years and its enterprise value is currently 10 x trailing adjusted operating income.

Howdens was founded in 1995. During its first year of operations it had just 14 depots and sales of £1million. Today, armed with 630 depots, 8000 plus employees and over 360,000 active customer accounts Howden clocks sales of about 1.2 billion pounds. In 2015 it supplied more than 400,000 kitchens, 2.4million doors and 750,000 appliances to UK homes.

Howden actually independently emerged in 2006 from a break- up of MFI Furniture Group plc that was orchestrated by Matthew Ingle who is the CEO and has been responsible for Howden's growth into a successful business today. Grappling unsuccessfully with operational problems and encumbered with debt, MFI group sold its loss making retail business and subsequently changed its name to GALIFORM which comprised of two businesses – Howden Joinery and Howden Kitchens.

The group under the able management of Ingle disposed off some peripheral divisions and activities and entirely focused on these two divisions. The former operated the network of depots to supply to builders and the latter focused on sourcing, design and manufacturing. In 2010, the Company changed its name from Galiform Plc to Howden Joinery Group Plc.

Howdens manufactures all its kitchen cabinets and most of their worktops in its two factories: one in Howden, Yorkshire and one in Runcorn, Cheshire and sources raw material from trees grown in managed forests in Scotland. Approximately 33% of the costs of goods sold by Howdens are accounted for by products they manufacture within these two UK factories. The remaining 67% products that include items such as internal and external joinery doors, hardware, cabinet doors, sinks and taps, flooring, lighting and, kitchen appliances are bought in from their national and international supply base. Howdens also operates a fleet of lorries to deliver products to their depots across the country.

The first thing to note is that Howdens does not operate in a fickle industry.

Kitchen is a basic necessity. No one makes a home without one! It serves basic human needs and aspirations .You can visualize what this industry will look like in a decade from now. Technological or obsolescence hazard is minimal. Nor is the industry facing fierce competition from other industries.

Right from the outset Howdens' management believed that growth in disposable incomes would drive the kitchen market from DIY (Do it yourself) towards DFY (Done for you) that is installation by a professional. And to exploit the tailwinds they would have to focus their resources on building a great relationships with skilled trade persons who would act as their sales force .Therefore, their business model was and is designed around the needs of these entrepreneurs –builders and kitchen fitters-who run small businesses. The builders' customers may be owner-occupiers, private landlords or local developers. They may be housing associations or local authorities. Sometimes the small builder will fit out a shop, or a studio, or an office, as well as a private home. Understanding the needs of its customers and understanding the needs of its customers' customers has been the key advantage of Howden in capturing the kitchen market.

Capital Structure and Valuation

The following table summarizes Howden's capital structure and valuation.

(in millions £ except share price)

Stock Price	3.70	
Common shares outstanding	632.70	
Basic Market capitalization	2340.99	
		% of common
Options outstanding	2.00	0.32%
Restricted shares granted		0.00%
Non-vested restricted stock units and awards		0.00%
Fully diluted share count	634.70	
Diluted market capitalization	2348.39	
plus,		
Short- term debt		
Long term Debt		
Capital/financial leases		
Operating leases	528.00	66x8
Pension deficit or unfunded pension liabilities	86.50	
other fixed or contingent liabilities		
minority interests		
Preferred stock		
less,		
Excess cash	91.35	50% of 182.7
Extra assets		
Enterprise value	2,871.54	

Market capitalization / earnings (TTM)	13.39x
EV / EBITDA (TTM)	9.35x
EV / EBIT (TTM)	10.05x

Since Howden leases its depots these operating leases are kept out of the balance sheet .On the table above these leases have been capitalized. (The 8x multiple has been derived from capitalizing infinite operating lease payments by required rate of return of 12.5 %.) Operating lease payments for these depots are indispensable, needed as long as the business exists. Apart from this hidden debt and underfunded pension plan the balance sheet is not encumbered with any sort of bank debt as the management is wary of it and favors prudent capital structure. Not being highly leveraged contributes to the staying power of the business.

The tables below summarize Howden's return on average capital employed and margins.

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Net Fixed assets	97.10	91.20	89.40	79.40	80.80	81.70	89.30	95.50	107.10	129.20
Capitalized leases	1128.00	448.00	372.80	385.60	384.80	402.40	444.80	440.00	445.60	528.00
operating cash	31.45	21.85	12.6	8	20.3	29.7	48.35	69.85	108.45	113.05
Inventories	126.10	101.00	121.30	86.30	105.50	118.50	115.90	123.40	143.10	177.10
Receivables	102.40	122.30	99.20	95.40	95.00	95.30	96.00	122.40	133.10	129.50
Other current assets	3.10	2.40	1.30	0.70	0.20	0.00	0.00	0.00	0.00	0.00
Total Current Assets	263.05	247.55	234.40	190.40	221.00	243.50	260.25	315.65	384.65	419.65
Accounts payables	244.4	201.1	120.4	119.4	136.8	139.1	137.1	158.4	186.1	197.7
short term debt	2.2	3.3	3.4	2.3	1.5	1.1	1.2	0.1	0	0
Other Current Liabilities	3	8.5	4.9	12.8	18.9	16.9	16.9	18.7	7.9	5.2
Total Current Liabilities	249.6	212.9	128.7	134.5	157.2	157.1	155.2	177.2	194	202.9
Net working Capital	13.45	34.65	105.7	55.9	63.8	86.4	105.05	138.45	190.65	216.75
Capital Employed	1238.55	573.85	567.90	520.90	529.40	570.50	639.15	673.95	743.35	873.95
Average capital employed		906.2	570.875	544.4	525.15	549.95	604.825	656.55	708.65	808.65
Net sales	n/a	976.5	805.7	769.5	808	853.8	887.1	956.5	1090.8	1220.2
Adj. EBIT	n/a	108.70	127.30	127.60	155.50	164.60	175.40	193.00	244.50	285.60
EBIT Margin		11.13%	15.80%	16.58%	19.25%	19.28%	19.77%	20.18%	22.41%	23.41%
X										
Capital turnover		1.08	1.41	1.41	1.54	1.55	1.47	1.46	1.54	1.51
Pretax ROCE		12.00%	22.30%	23.44%	29.61%	29.93%	29.00%	29.40%	34.50%	35.32%

Margins										
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Gross margin	48%	46%	53%	56%	60%	60%	61%	62%	64%	64%
Adj. EBITDA margin	29%	15%	18%	19%	21%	21%	22%	22%	24%	25%
Adj. EBIT margin	24%	11%	16%	17%	19%	19%	20%	20%	22%	23%

The data in the above tables show the quantitative evidence of moat .Howdens has high returns on capital because it enjoys consistent high gross and EBIT margins. Also

Howdens deploys its earnings in opening new depots every year so adjusted EBIT is a good proxy for its owner earnings.

The table below shows it earns excellent returns on incremental capital too.

Return on Incremental Invested capital-roiic										
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	year 7	year 8	year 9	year 10
Net Fixed Assets	97.10	91.20	89.40	79.40	80.80	81.70	89.30	95.50	107.10	129.20
leases	1128.00	448.00	372.80	385.60	384.80	402.40	444.80	440.00	445.60	528.00
Current Assets	263.05	247.55	234.4	190.4	221	243.5	260.25	315.65	384.65	419.65
Current Liabilities	249.60	212.90	128.70	134.50	157.20	157.10	155.20	177.20	194.00	202.90
Working Capital	13.45	34.65	105.7	55.9	63.8	86.4	105.05	138.45	190.65	216.75
Capital Employed	1238.55	573.85	567.90	520.90	529.40	570.50	639.15	673.95	743.35	873.95
EBIT	174.5	108.7	127.3	127.6	155.5	164.6	175.4	193	244.5	285.6
Change in capital employed		-664.70	-5.95	-47.00	8.50	41.10	68.65	34.80	69.40	130.60
Change in EBIT		-65.80	18.60	0.30	27.90	9.10	10.80	17.60	51.50	41.10
Return on inc.cap		10%	-313%	-1%	328%	22%	16%	51%	74%	31%

Howdens derives its high profitability from having a **low-cost operating model.** Howdens' kitchen ranges are built on the concept of product families the most popular styles in the most popular colors. The standardization of range content across the families helps them to achieve lowest cost production and manage their stock efficiently. This cost effective manufacturing of the rigid kitchen cabinets is so crucial to the Howdens business model. Also since Howdens sells in huge volumes, it places purchase orders in bulk and gets them at low prices. Management knows what to focus on and what to fold. For example , in 2006 they did a strategic review of their sourcing and manufacturing processes and that resulted in a decision to buy-in kitchen fascias and own label appliances instead of making them themselves . As a result they closed their factories at Stockton and Scunthorpe and now only manufacture carcasses and worktops – one of their core competencies. This approach enabled Howdens to introduce less expensive products. This also gives us insight into their corporate culture which will be described in detail later.

By being a trade only business Howdens avoids high costs that are associated inherently with retails showrooms.

This is how it works: Through their national network of depots they offer the builder a range of well-designed, well-made kitchens and associated joinery and hardware, all of which are available all the time in every depot. A howdens depot is a low-cost operation, located on a trading estate rather than a high street, with convenient access and parking for the builder. It employs about a dozen people. It occupies around 10,000 square feet, costs approximately £250,000 to fit out and breaks even once it has achieved sales of £650,000. Rent averages £5 per square foot which is far below than that of a retail showroom.

In nutshell, at depot level, Howdens has none of the costs usually associated with kitchen retailers such as expensive showrooms, installation services and advertising. Depots need low maintenance capital expenditure . Managers of these depots hire their own staff locally and develop relationships with local builders. They do their own marketing to existing and potential customers. They also adjust their pricing to suit local conditions. Managers are accountable too. Depot stock is the responsibility of the staff in each depot, and if it goes missing it is deducted from the manager's bonus. In this way they eliminate stock loss.

Another competitive advantage of Howdens' is a strong corporate culture. Culture cannot be quantitatively analyzed but does count. As Buffett wrote in his 2011 letter "*Our final advantage is the hard-to-duplicate culture that permeates Berkshire. And in businesses, culture counts".* And although having good or outstanding management is not exactly a moat but it is actually the one that carves the corporate culture which in addition to other advantages may build the moat around their businesses. Charlie Munger once remarked: *The three best operating companies I'm aware of are Costco, Kiewit, and Glenair. There is nothing remarkable about the product or field for any of these three. But there is something remarkable about the culture of all three."*

One cannot underplay the role of culture- that was sculpted by Sam Walton – in the success of Walmart.

The problem is that the moat bestowed on by the culture carries in itself a 'risk of forgetfulness' after the death of its key manager or founder who first built the culture in the first place. Will the great culture sustain? Munger gives an example of Walmart. A culture that has lasted for many many years even after the demise of Sam Walton. The trick seems to be how long the people of the company adhere to the principles forged by the key founder/manager.

And that's why Buffett remarks in his 2007 letter that:

"*So I've taken the easy route, just sitting back and working through great managers who run their own shows. My only tasks are to cheer them on, sculpt and harden our corporate culture, and make major capital-allocation decisions. Our managers have returned this trust by working hard and effectively*."

CEO and founder Matthew Ingle has built and promoted a distinctive culture at Howdens that has been responsible for the company's success. And one of the hallmarks of a great leader /company is empathy. And this is how the company puts itself into its customer's shoes:

Builders do not like to waste time travelling long distances or dealing with impersonal, centralized operations. And Howden eliminates both these hassles through these local depots.

Consider these two quotes from Howdens Annual reports

"The builder has no time to waste and his idea of travel time is less than ten minutes. We are confident there is scope for at least 650 Howdens depots in the UK."- **2010 Annual *report***

"Local means on the doorstep, not half an hour's drive away. The closer he is to the depot, the easier it is for the builder to collect what he needs, arrange a visit for his own customer, or drop in for some friendly advice. That's why Howdens have already opened 529 depots across the country and why we believe there is scope for at least 700." **2012 Annual report**

When a builder comes into a Howdens depot for the first time, they open a net monthly account for him, which gives him the ability to manage his cash flow. The builder can complete the job and get paid long before he has to pay Howdens. That actually becomes negative working capital business for the builder. Howdens extends a significant amount of working capital to their customers/builders on a continuous basis. This results in NOT tying up of builder's working capital (receivables and inventory) in his business and hence has a positive impact on his profitability. Who doesn't like this kind of funding? The result is that Builders love to pay to Howdens promptly. This is a powerful model: Howdens, by extending generous capital to its customers drives down their capital requirements and in the process drives up its own.

And to make sure that the builders do not experience delay in installations Howdens promptly keeps on replenishing its depots with the right stock at the lowest cost. Howdens' in-stock model allows the small builder to plan and sell a kitchen and fit it when he wants to do so. And they sell in high volumes. It also provides designers to select products and help out with kitchen layouts.

Empathy matters**.** If a company succeeds in eliminating or even mitigating the pain of its customers it offers something much deeper: a value proposition to customers that will make them want to come back again and again. Going back to its old annual reports one can really ascertain that the management remains committed what it laid out candidly in its 2006 annual report:

Howden Joinery builds relationships with the skilled tradesperson by offering what we call our 'four aces': ***1*** *A good range of well-designed products supported by excellent sales literature.2 No call back quality, with skilled tradesperson returning to us time and time again.3 Local commercial pricing.4 Products that are always in stock locally.*

They have also developed a 'virtual showroom' in their depots using high-definition projectors and large-format plasma screens to show 3D visualizations of their plans so that the builder, and the end-user, can see exactly what they will look like once installed.

Howden's management is well incentivized and ensures that its employee's interests are aligned too.

Depot managers have local accountability that is each depot is responsible for its own profit and loss account .They can tailor stock to what they know sells locally, and they can price and market it to suit local demand. And with this comes great responsibility. Their bonus is based on a percentage of their own depot's profit, less any stock loss. Their staff is incentivized on local margin, too. The following excerpt from the Sunday Times makes poignant observation:

Howdens has an entrepreneurial culture and they are committed to rewarding and incentivizing the hard work, discretionary effort and contribution of all their employees. There are formal reward mechanisms and local incentives at all levels across the entire business. One of the most distinctive and effective of these is the 'depot pot', in which the whole business participates. Each depot and site accumulates a 'pot' of money which they can then spend in whatever way they choose. The pot is filled by performance related rewards and incentives of different kinds throughout the year. Incentives may relate to specific targets or to outperformance against a range of indicators compared to the previous year's achievements. In the year to August 2013, the accumulated total of all pots was £2.2m an average of £350 per head. The largest individual depot pot was £13,000. Clearly, the pot system allows teams to aspire to and enjoy significant, memorable benefits – for example, Centre Court seats at Wimbledon, international rugby finals at Twickenham and imaginative, spectacular adventures such as 'The Italian Job'. The pot system is team focused and highly motivating to employees at all levels. It is aligned with both with Howdens' business objectives and with the entrepreneurial spirit and sense of community that are so characteristic of Howdens.

Ingle himself puts it in his 2013 letter that "*Local service delivered directly by individuals who take responsibility for their actions is a powerful source of competitive advantage, so we have no intention of reducing headcount or automating customer relationships as the business grows*"

Not only Ingle does a good job writing candidly about Howden's strategy in the annual reports but he himself walks his talk. A fan of face-to- face meetings, he may spend three days a week visiting depots throughout the country interacting with depot employees and managers to obtain direct information about what is really going on in the business. He eschews bureaucracy. And has skin in the game. His current shareholding in the company is 3500% of his salary which is far above the required 200 %.

Management has identified scope for up to 800 depots in the UK, and expects to open 30 new depots in 2016. Howdens also sees further growth from the 25% of depots that are not yet mature. This should bolster up earnings in future.

The company is also experimenting with expanding outside UK into continental Europe. It has 24 depots outside UK and plans to open more .As of now the revenue contributed by depots outside UK is just puny- less than 2%.So there is a lot scope for more in this area.

Ingle makes a point in 2016 Annual report "*We are still at the trial stage outside the UK. We continue to make interesting and sometimes surprising discoveries in these different markets – for example, about the levels of discount that motivate builders, which formats are the most attractive to most customers, and the complex relationships between the various parties involved in installing a kitchen. By the end of 2016, we will have a better view of the strategic options."*

This should be viewed as an attached 'option.'

The company announced a £70million share repurchase program in early 2015, and has already returned £45 million to shareholders. In 2016, they further announced £55 million of share repurchase program to be implemented over the course of the next two years. That's a smart deployment of free cash flow. In the past the company has intelligently used the free cash to reduce its pension liabilities and legacy lease liabilities which it inherited from its parent. In the future it is expected that the management continues to deploy cash flows that would create significant value for its shareholders.

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