



BY JOHN KINGHAM

DIVIDEND HUNTER

IS TED BAKER THE PERFECT DIVIDEND GROWTH STOCK?

Ted Baker (LON:TED) is an interesting company. It started life in 1988 as a single store in Glasgow, selling its own brand of men's shirts. 30 years later it's listed in the FTSE 250, has several hundred stores and concessions and generates revenues of more than £500 million and net profits of more than £50 million. That happy little success story is somewhat interesting, but as an investor what's more interesting is the company's near-perfect growth record.

Ted Baker listed on the stock exchange in 1997, and from then onwards its revenues and dividends (which it started paying in 1999) have increased every single year. And if it wasn't for a minor one-year decline after the financial crisis, its profit growth would be just as impressive. As a cautious investor I find that very interesting, along with its double-digit growth rate over the last decade and near-3% dividend yield.

Both defensive and diverse

Ted Baker's super-consistent growth and near-obliviousness to the Global Financial Crisis suggest it's a defensive company, as does its listing in

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the defensive Personal Goods sector. However, there's a small question mark over its defensiveness, as it has significant retail operations, and retail is mostly a cyclical business. For example, **Next (LON:NXT)** (the high street fashion retailer and one of my current holdings) looks very similar to Ted Baker as far as I can see, and yet Next is listed in the cyclical General Retailer sector.

Despite this ambiguity, I'm willing to accept that Ted Baker may be more defensive than the average retailer, especially given its atomic clock-like consistency.

As well as being relatively defensive, Ted Baker is relatively diverse

TED BAKER LONDON



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“ONLY SIX COMPANIES ON MY STOCK SCREEN HAVE A 100% TRACK RECORD OF REVENUE, EARNINGS AND DIVIDEND GROWTH, AND TED BAKER IS ONE OF THEM.”

within its niche of affordable luxury fashion. For example, it is primarily a UK business, but almost half its revenues come from overseas. Its biggest business is selling clothing through retail stores and concessions, but retail generates less profit than its wholesale and license businesses combined (where wholesale allows other companies to sell Ted Baker products and licences allow other companies to use the Ted Baker brand on stores or products of their own). Ted Baker is known for men's shirts, but shirts are now just a small part of its product range and it sells more womenswear than menswear.

There are pros and cons to diversity in business, and in my experience companies that diversify into unrelated areas usually hit the rocks at some point. For Ted Baker, its diversity seems to be in the Goldilocks Zone; not too much and not too little.

Sustained, rapid growth

Over the last ten years, Ted Baker's revenues, earnings and dividends all grew by an average of about 19% per year. That's impressive, but a couple of years of exceptional growth have skewed that figure upwards. Looking at median rather than mean growth, the growth rate falls closer to 13%, but that's still very impressive.

Where did all that growth come from? Everywhere, mostly. By that I mean the company's overall retail, wholesale and licence revenues have each gone up by around 400% to 500% over the last decade. However, growth in the overseas and online businesses was higher, with US & Canada revenues going from £9 million to £120 million and online going from almost nothing (or at least not worthy of separate mention in the annual results) to £100 million today.

Why has the company been able to grow so quickly? Sadly, I have no idea. I am





no fashion guru and my wife will attest to that. All I can say is that the combination of Ted Baker's quality, price and style in both its products and stores, along with the intangible qualities of its brand, are something that its target audience (which doesn't include me) seem very happy to open their wallets for.

Of course, there are no guarantees that this sort of growth will continue, but even far more modest growth could justify the current share price (and I'll have more to say on that later).

Insanely consistent growth

There are just over 200 companies on my stock screen and all of them have a ten-year unbroken record of dividend payments. However, only six companies on my stock screen have a 100% track record of revenue, earnings and dividend growth, and Ted Baker is one of them.

I know from experience that this sort of super-reliable growth can in fact be merely the boom phase of a larger cycle, with an inevitable bust phase just around the corner. That doesn't seem to be the case with Ted Baker, partly because of the length of its "boom" and partly because it doesn't operate in a highly cyclical sector (at least relative to mining or oil & gas companies).

You only have to look back at Ted Baker's results prior to the last ten years to see that its consistent growth record extends pretty much all the way back to 1997 when it joined the stock market. Such a long and virtually unbroken record of growth really is exceptional.

Extremely high profitability

As with its Growth Quality (my term for consistency), Ted Baker's profitability is also high. I measure profitability as the median ten-year return on capital employed (where capital employed is fixed capital plus working capital) and once again Ted Baker is in an elite group.

This time the elite group is retailers with average returns on capital of more than 20%. Again, there are six of them including Ted Baker's rivals Next and **Burberry (LON:BRBY)** (both of which I already own). At the bottom end sits **Marks & Spencer (LON:MKS)** with its 9% average profitability. I know which end of the scale I'd rather invest in.

Why is high profitability important? There are two main reasons: It makes growth easier during booms and it protects profits during busts.

On the growth side, it's much easier to build a new £100 million factory when

you're confident that factory will generate profits of £20 million. Even if you had to borrow every penny of the £100 million, you could pay it off in about five years with the factory's profits and then you'd own it outright, along with its £20 million profits. But if you build a £100 million factory that will only produce £5 million in profit, then it's likely to take at least 20 years to pay off the debt (and that's not including debt interest, which would make building this low-return factory an even worse idea).

On the profit protection side, it depends on the mix of fixed and variable costs, but higher profitability usually means a company can absorb input price rises (e.g. rising raw material costs) and output price falls (e.g. lower shirt prices during a recession) more easily. You can think of fat profitability literally as fat, where a calorie deficit (i.e. lower revenues and higher expenses) reduces your fat percentage but doesn't negatively affect your health (assuming the calorie deficit doesn't go on for too long).

It's possible to stretch the fat analogy further by saying that skinny people (companies with skinny profitability) are likely to die first when there's a famine (recession). And once the skinny people are dead, the fat people (companies with fat profitability) can eat the food that would have gone to the



skinny people (i.e. gain market share), or perhaps even eat the skinny people (acquire assets – human or otherwise – from skinny dead competitors at knock-down prices).

That's a slightly odd and mildly unpleasant analogy, but hopefully it shows that fat profit margins and fat returns on capital employed are something to look out for as an investor, and something to aim at for most companies.

Absolutely acquisition-free

One way to drive growth is to borrow money from the bank and use it to buy other companies. This is a very easy way to boost revenues, and if the acquired company generates more profit than the loan costs in interest then profits and perhaps even dividends will go up too.

This sort of strategy can drive double-digit growth for years, *if* management are willing to consistently spend

more on acquisitions than they make in profits. However, this is often a bad strategy. The acquired companies add complexity and take management's focus away from the company's (often struggling) core business. And when the next downturn arrives (which it always does, eventually) the whole thing can collapse like a house of cards in a hurricane.

This highlights another attractive feature of Ted Baker, which is that it hasn't loaded up on acquisitions. In fact, as far as I can see, every ounce of its double-digit growth over the last decade has been generated by the company's core retail, wholesale and license businesses, which is exactly what I like to see. This means no expensive integration projects; no disgruntled employees to strip out; no imaginary synergies to find and no piles of acquisition rocket fuel (debt) to pay back. Instead, Ted Baker prefers to focus on improving its core business and then expanding that business across the globe.

No defined benefit pension and comfortable debt position

And speaking of the extremely powerful and potentially dangerous rocket fuel known as debt, Ted Baker seems to have that under control as well. Yes, it does have debt on its balance sheet; enough so that I wouldn't describe it as a low-debt company. But with five-year average net profits of £44 million and total borrowings of £130 million, its borrowings-to-average-earnings ratio of around three is comfortably below the UK average of four.

Just as importantly, the company is relatively young and like most younger companies it has no defined benefit pension scheme. This is good because it removes the risk of the pension tail wagging the corporate dog, which is something you'll often see with older companies that have enormous pension liabilities.

An excellent company, but what could go wrong?

Excellent is a subjective term, but if it means above average growth, above average consistency, above average profitability, below average acquisitions and below average levels of debt and pension obligations (and capex too, although I didn't mention that above), then Ted Baker is an excellent company.

“EVERY OUNCE OF ITS DOUBLE-DIGIT GROWTH OVER THE LAST DECADE HAS BEEN GENERATED BY THE COMPANY’S CORE RETAIL, WHOLESALE AND LICENSE BUSINESSES.”



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But there's a yawning chasm between excellent and perfect, and there is no guarantee that Ted Baker's future will be as impressive as its past. So, what could possibly go wrong?

A million things, of course. But the single biggest risk in my opinion is that Ted Baker somehow repeats the disaster that was the Burberry "chav cap"; the plaid baseball cap so beloved of a segment of society that the majority of Burberry's customers would rather not be associated with.

This is the double-edged sword of brand-based companies. Yes, Ted Baker can charge lofty prices for their shirts because for some people wearing the Ted Baker brand is worth it (and I'm sure the shirts are nice, too). But all it takes is one badly thought-through licence deal, and the Ted Baker name could be used to sell toilet paper. And even though that toilet paper deal may be profitable in and of itself, the remaining 99% of the company's profits could be flushed down the pan because of the negative association.

Of course, I have no idea whether anything like that will happen, but at least the Burberry disaster is recent enough so that it still provides an excellent example to all fashion retailers of what not to do.

Is Ted Baker a bargain or a value trap?

Despite this glorious track record, Ted Baker's shares are down by more than 30% over the last three years. That isn't exactly what I'd call a dream investment. To be honest, I don't see any specific reason why the shares have fallen so far. Yes, the current retail environment is tough, but if you look at

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the company's results they're still going in the right direction (i.e. upwards).

To me this decline looks more like a change of market sentiment from over-optimistic to less-optimistic. For example, back in 2015 when the shares reached 3,500p, the dividend was just 40p, giving Ted Baker a dividend yield of 1.2%. With that sort of yield you need the dividend to grow by almost 9% per year if you're going to get double-digit returns. That's a big ask, especially if you want double-digit gains for a decade or more.

With perhaps less optimism in the price, the dividend yield today is a far more reasonable 2.6%, thanks to a higher 60p dividend and a lower 2,300p share price. That yield requires dividend growth of "only" 7.4% per year to produce double digit gains (assuming the share price increases in line with the dividend), which is still optimistic but perhaps more realistic given Ted Baker's historic growth rate.

So, today's share price doesn't look completely insane, based on the dividend yield, but there's a small fly in the ointment. The small fly is that Ted Baker's longer-term valuation ratios (PE10 and PD10, the price to ten-year average earnings and dividend ratios) are a bit too high. This is largely down

to the company's rapid growth, where earnings and dividends a decade ago were tiny relative to today's. Even so, the ratios are high enough to make me uncomfortable.

As a rule of thumb, I don't like to invest in companies where PE10 and PD10 are above 30 and 60 respectively, as prices beyond that level can only be justified by impressive (and difficult to obtain) growth long into the future. In this case, Ted Baker's PE10 and PD10 ratios are 31 and 65 respectively. Admittedly these are only just over the limit, but they're over the limit nonetheless. Having said that, and to muddy the waters somewhat, those rules are only rules of thumb and I'm happy to override them if I think the company is worth it. And in this case, I think it might be, given (among other things) Ted Baker's super-consistent double-digit growth and entirely reasonable 2.6% dividend yield.

Taking all of that into account, my conclusion is this: I like Ted Baker, it appears to be an excellent company and at its current share price I think it's likely to produce above average returns over the next five or ten years (although of course there are no guarantees). And when I make my next purchase in August, I think there's better than even chance it'll be Ted Baker.

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.

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