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ValueLine: JB Hi-Fi without Uechtritz

By Roger Montgomery

PORTFOLIO POINT: Richard Uechtritz built revenue from $158 million to $2.8 billion in a decade. Will JB Hi-Fi be the same without him?

This week JB Hi-Fi released its half-year results and what a spectacle! Along with a strong result came a resignation, a promotion and a share price collapse!

The result was excellent, but the company has traditionally exceeded the market's expectations for earnings and sales growth. This week's interim 2009-10 profit was up 29% on sales growth of 19%, and although it was at the upper end of expectations it didn't exceed them. Believe it or not, the market wasn't happy and it is highly likely that downward revisions to analysts' future estimates will result.

But it wasn't just the profits that caused the share price decline, it was also the result of Ben Graham's "voting machine" saying: "The growth is not going to be as high as we envisaged" … not to mention the fact that chief executive Richard Uechtritz announced his impending retirement.

Uechtritz was part of the management team buy-in at JB Hi-Fi, which was funded by Macquarie bank's private equity arm. Since arriving from Rabbit Photo and Kodak before that, he has built revenues from $145 million to $2.8 billion in a decade. His resignation (due to take effect in August) is indeed a blow to the company.

His replacement, Terry Smart, will be no slouch. Smart moved to JB Hi-Fi with Uechtritz; they have worked together for about 16 years and they've all made millions. Importantly, plenty of Smart's money remains invested.

The changeover reminds me of the retirement from the Reject Shop of one of Australia's retailing legends, Barry Saunders.

Saunders handed the reins over to Jerry Masters who continued to grow and expand The Reject Shop. Masters was an outsider and arguably not the first choice. Smart is a JB Hi-Fi insider and I still hold the firm view that the business boat you get into is more important than who is rowing it.

Even more importantly, if a business is run well it gains a certain momentum, much as a cricket ball does when thrown. Once the ball has left the fielder's hands it keeps going up for a time. It's the same with JB Hi-Fi: the business trajectory is still up and even a completely incompetent retailer would have a hard time derailing the growth anytime soon. Perhaps most importantly, Uechtritz's resignation is similar to The Reject Shop in another way: neither he nor Saunders departed to compete. Like Saunders, Uechtritz will remain a consultant, and he will be on the board for three years.

With 122 stores and a target of 210, there is still plenty of room for growth. But as my famous chef friend pointed out with his statement that "revenue is vanity, profit is santity", it is not growth that determines intrinsic value.

It's the return on equity, the payout ratio and the equity itself that determines whether the value continues to rise.

The big news on this front is that the dividend payout ratio continues to increase. Now at 60%, the increased dividend is a classic response by the board to a business that is generating cash faster than it can use it. That's a shame because the company is generating 45% returns on equity. I would much prefer it kept the money than hand it to me as a dividend. The best I can do with it is perhaps 8% in a five-year term deposit. Not bad, but the 8% is pre tax and not the 45% JB Hi-Fi achieves.

If JB Hi-Fi could re-employ all of its profits at the returns of about 45% it is generating now, its value would be over $38. That's a pipe dream. The company is generating cash faster than it can ask its employees and contractors and landlords to employ the funds to open new stores. And because the profits also produce taxes and associated franking credits that have no value for the company, shareholders are being handed back the funds, which is a disappointment. However, as chairman Patrick Elliott implied when I spoke with him on radio this week, this is a function of growth and the limited size of the Australian population.

It happens eventually to all retailers and it will happen to JB Hi-Fi in the next five to seven years. The best you can hope for is that once the stores have saturated the market, directors stick to their knitting, and the company continues to generate high returns and pays out all of those earnings out as a dividend (becoming like a bond) rather than make some grand attempt to buy something offshore or diversify too far away from their core expertise (often at the behest of some institutional shareholder) and blow up the returns.

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The result of not employing as much retained earnings at 45% is that the intrinsic value declines. It is still going up but not as much. The conservative intrinsic value before this result was about $20.30 and where previously I was looking for it to rise to about $30 by 2012, it now seems the value will be around $26.50 (which would mean the current margin of safety is around 27%).

The sole reason for the change to intrinsic value is the increase in the payout ratio. More dividends means less profits being retained in the business, earning about 45%.

Now don't get me wrong: this is still an amazing business, one of the best, and intrinsic value is still forecast to rise from yesterday's closing price by a compounded 15.4% a year over the next two years or so. To get really excited, however, I want a bigger discount to the current intrinsic value before adding more shares to the portfolio.

I added it to the ValueLine portfolio at $14.80 when I opened the portfolio in July last year. There is no reason not to add more shares at the right price because: Its value continues to rise at a good rate; it has manageable debt (remembering, of course, the contingent lease liabilities); has very high rates of return on equity; and it is entrenching its competitive advantage, which is evident in the declining gross profit margin but rising EBIT margin. ◆

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