Retailing maturity

Roger Montgomery now has reservations about JB Hi-Fi

FANS OF VALUE.ABLE KNOW I LIKE JB Hi-Fi. It was my value pick of the month last month, but the annual results have caused a rethink. JBH has produced outstanding returns but all this might be coming to an end and I would like to explain why. I also suggest some other businesses worth researching I will dissect for you next month.

JB Hi-Fi's retail model has produced some of the world's best retailers. From Walmart to Woolworths, the "everyday low prices" model can be a wonderful source of competitive advantage. Proof is in the numbers.

The company's gross margin, the difference between its revenue and its cost of goods sold, has been declining almost every year. This is the result of a strategy of continuing to reinvest profits into lower and lower prices. And while it complains that declining margins are the result of tough competition, it has really been entrenching its promise and its competitive advantage.

Competitive advantages are the source of high returns on equity and as an investor you want high returns on equity. You also want them to be sustained and the only way that can happen is if the competitive advantage can be sustained. If you are going to offer the lowest prices in the industry – and JB Hi-Fi does – you'd better be sure you have the lowest costs or are on your way there.

JB Hi-Fi's EBIT (earning before interest and tax) margin has increased every year – meaning its indirect expenses are falling. Its EBIT margin, which compares the profits after all operating expenses but before interest and tax to revenue, rose in 2010 from 6.1% to 6.4%. As in most years, it is running its business on a cheaper and cheaper "oily rag". Additionally, the $118.7 million profit was up over 25% on 2009's result and sales topped $2.7 billion – up 17%. And with the EDLP machine producing $94 million of cash, the dividend was up 50% to $67 million. On the surface, the numbers look great. But these aren't the only ones to look at.

Return on equity is the key. Let me be clear here. I am not looking at the return on total capital the company reports. Their number includes debt and because debt is falling (remember, lots of cash), the company can produce rising returns on total capital. I instead prefer return on equity. On that measure, the numbers are plateauing and have possibly seen their peak.

I estimate returns of 45%, 44.7% and 43.9% for the next three years. And, over the past eight years, profits have grown by $116.9 million and owners have committed $276 million more of equity, suggesting a return on additional equity of 42%. You cannot get that in a bank account – but returns in 2007 and 2008 were closer to 48%.

The decline is despite profits growing. It reflects the fact that the equity is growing faster. This is partly due to retention of profits as well as the capital being raised by the exercise of executive options. Now, I don't like to watch prices too much, especially short-term, which tend to reflect the bipolar nature of short-term trading.

I like to focus on long-term valuations – something I calculate for every company and for many years. Declining rates of return on equity, combined with increasing equity and large amounts of cash (suggesting the dividend payout ratio will increase again), all conspire to tell me intrinsic values will grow by slower and slower rates.

Over the past eight years JB Hi-Fi's intrinsic value has increased by 85% a year. Over the next three years the company's intrinsic value may grow by 15%pa, provided it doesn't increase the payout ratio again. Harvey Norman's intrinsic value has been doing that for a decade now and, because it's been in a bumpy fashion and the price was way above the value back in the year 2000, the share price today is about the same as at the start of the century.

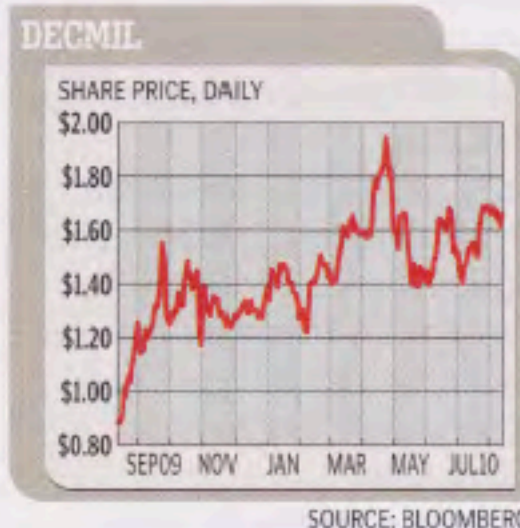
I have said I would rather be in JB Hi-Fi than many other retailers, but 85%pa rises in intrinsic value are over and there is always a risk that management will respond to the massive cash flow and "reward" shareholders with greater dividends.

Clearly if the company has matured it doesn't need the cash and it should indeed return it to the owners, but unfortunately that does mean the company is not worth as much as another that retains all its profits and achieves 45% returns on growing amounts of equity.

JB Hi-Fi is an outstanding business and while its intrinsic value continues to rise, there is no reason to make changes to any holdings. If the share price were to fall to $13 or $14 it would be sensible to consider the purchase of further shares.

With the market rarely that accommodating I have turned up several other companies worthy of careful research – including Decmil – that I will discuss next month. In the meantime, check out the returns on equity of the companies in your portfolio.

VALUE STOCK TO WATCH
Decmil (DCG)



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