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Value Line: The Reject Shop

By Roger Montgomery

PORTFOLIO POINT: At $2.40, few investors wanted The Reject Shop. Now at $12, it is much more popular. But where to from here?

How many of us have a mother, an aunt or grandmother who will buy things simply because; “it was on special”. I call it “going broke saving money” but somehow the primal hunter-gatherer urge has evolved into the need of grabbing a bargain and is as fundamental a driver of the consumer psyche today.

Today, if you want a bargain, a Chinese factory worker has made sure you can have one and The Reject Shop is only too happy to be the middle man between the Australian consumer and the land of cheap manufacturing. Bringing together Australian dollars and Chinese goods is something The Reject Shop does with aplomb.

I remember first buying shares in 2004 at $2.40, only a few years after I started my first funds management business. It was the first listed company I had come across in which I felt I could apply Warren Buffett’s advice to concentrate rather than diversify.

The company had about 100 stores, $17 million of equity and no debt. Its profit of $5.6 million generates a 36% return on equity and a 48% gross margin. Further, it produced very strong cash flows and was being run by a retailing icon of Australia, Barry Saunders, someone I have grown to respect and admire.

More than 90% of adult Australians recognised the brand despite its presence of only 100 stores (something that other retailers with vast sums of money find difficult to replicate); and, most importantly, the company’s shares were trading at about half my estimate of the intrinsic value at the time.

Why so cheap? Because the media and the analysts at the time were focused on how tough discount variety retailing was. Warehouse Group and Millers Retail were making a mess of things and the logic at the time was that The Reject Shop was one of the same. The difference, which was reflected in the numbers and free for all to see, was as stark as night and day. Better numbers, better balance sheet, better cash flow, better economics and better people. The market just saw it as being “same as Warehouse Group, same as Millers Retail”.

Since then, the company has gone from strength to strength and, perhaps most remarkably, it has survived a change at the helm. Jerry Masters now runs The Reject Shop

Value Line portfolio, as at July 21, 2009

Company	ASX	July 1 Price	Jul 21 close	Est. Value	Margin of Safety*	Shares Purchased	Invested Capital ($)	Capital Value ($)	Divs Rec	Total Return	Total Return
JB Hi Fi	JBH	14.8	15.79	17.68	12.0%	845	$12,500	$13,336	0	$836	6.69%
The Reject Shop	TRS	11.62	12.76	11.45	-10.3%	513	$5,959	$6,543	0	$585	9.81%
Westpac Banking Corp.	WBC	19.68	20.31	18.13	-10.7%	295	$5,811	$5,997	0	$186	3.20%
Cochlear	COH	56.36	54.8	48.7	-11.1%	102	$5,744	$5,585	0	-$159	-2.77%
Woolworths	WOW	26.16	27.7	22.86	-17.5%	206	$5,377	$5,694	0	$317	5.89%
CSL	CSL	31.81	30.01	25.18	-16.1%	163	$5,197	$4,903	0	-$294	-5.66%
Reece	REH	17.8	19.49	12.81	-34.3%	236	$4,209	$4,609	0	$400	9.49%
Platinum Asset Mgt	PTM	4.06	4.17	2.18	-47.7%	854	$3,467	$3,561	0	$94	2.71%
Since July 1											
Security Value											$50,228
Cash Value											$51,736
Total Value											$101,964
Total Return ($)											$1,963.80
Total Return (%)											1.96%
XAO Change											-3.46%
Outperformance											5.42%
Under observation											
ISOFT	ISF	0.635	0.74	0.038	-94.9%						-16.54%
Amcor	AMC	4.79	5.05	2.66	-47.3%						-5.43%

* The safety margin is the difference between the price of the security and its valuation.

and the numbers still look impressive.

Since listing, profit has grown by 21%, 39%, 36% and 36% and unlike many other companies, this growth has been without the help of capital raisings. It's easy to grow profits when your shareholders hand you millions or billions of dollars; just go out and make an "earnings accretive" acquisition. But The Reject Shop has abstained from joining the toad-kissing competition, where recent entrants include PaperlinX, Foster's and Wesfarmers. Rarely does a company grow its return on equity in any way even remotely resembling sustainably, but The Reject Shop has, by more than 40% to over 56% in 2008.

Benjamin Graham once said in the short run the market is a voting machine where the voters arguably have little clue about what they are doing. But in the long run he pointed out that the market is a weighing machine. In other words, over longer periods, the share price tends to follow the intrinsic value of the company.

After listing at $1.95 in June 2004 the shares today trade at close to $12 – a compounded gain of 44% per year even after the effects of the GFC, and dividends have grown from 17¢ in 2005 to 51¢ in 2009.

But as they say, if history was the key to financial success, librarians would be the richest people in the world, so it is the future that will determine our returns from this holding in the Value Line portfolio.

This year The Reject Shop is expected to earn about $18.6 million on its $36 million of equity, or 51%. In percentage terms profits have grown substantially, particularly since 2008 was a 53-week year for the company. With the benefit of a rising payout ratio and fully franked dividends, the return to shareholders is even higher.

There are now 156 stores and if reports from David Jones, JB Hi-Fi and Myer are anything to go by, the federal government's stimulus cheques have really given retailing a boost. Rising unemployment and the short-term nature of the government's stimulus package suggest to my ivory tower forecasters that retailing may soften. They are probably right but The Reject Shop has a special offering with a very low unit price that is likely to be more resilient (but not immune) in the face of a weaker retailing environment.

Achieving 56% store growth in five years has required a serious investment in a decentralised distribution network, including supply chain management and resource planning system changes and distribution centres. As a result, the company's debt has risen but it remains well under any level of concern.

But other concerns remain. Most worrying for me is that return on equity appears to have topped out. I reckon 2010 will show a return on equity of about 51% again and although there are many more stores to roll out, the company will eventually reach a point where new sites are simply not of the highest quality: they're already taken.

As saturation occurs, the ability to retain profits and generate similar returns on the incremental equity is more challenging, if not impossible. Sensible managers and sensible allocators of capital see this and increase the payout ratio in response. But when two companies each have the same high return on equity, the one that pays out more as a dividend is worth less. And if they are not sensible allocators of capital they will retain the money and make an overpriced acquisition. In either case the value of the company declines.

Finally, The Reject Shop is now popular. At $2.40 nobody wanted to touch it and I became one of the largest shareholders in the company. At $12 you can't find anyone that dislikes it. I will be taking an even closer look at The Reject Shop once the results are out next month. Stay tuned. ◆