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JB Hi-Fi – can growth be maintained?

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One of the key conundrums in the practice of investment is estimating future growth rates. Not only is growth difficult to estimate, poor assumptions can lead to low investment returns. We have identified several businesses that have growth prospects we can reliably estimate and will likely trump our expectations.

Despite this, we are conscious that no business can continue to grow at jaw-dropping rates forever and even our most prized investments must be monitored on a continuous basis.

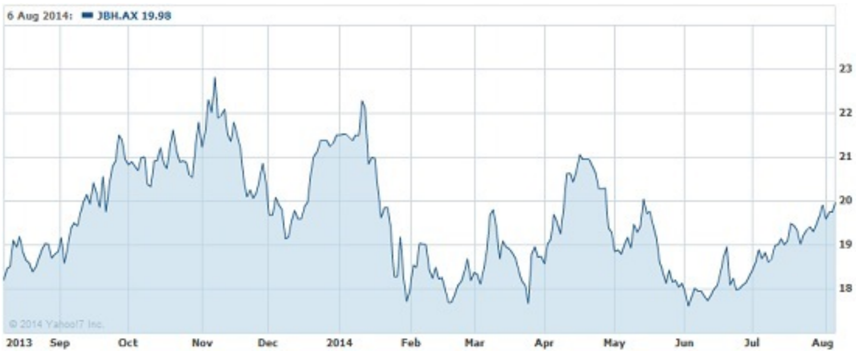
The outlook

JB Hi-Fi (ASX: JBH) is a company that has rewarded its shareholders with double-digit returns since its $1.55 listing in 2003. However, we believe that the past may not necessarily reflect the future.

Upon a review, a key question that any investor should ask is: what returns would the company need to generate now and in the future for the current share price to be justified? Montgomery Investment Management asked this question of JB Hi-Fi and came to some interesting conclusions.

The share price of JB Hi-Fi at the time was approximately $19 (as I write this the shares are trading at almost $20), and for the $19 price to be justified, JB Hi-Fi would most likely need to complete its 75 JB Home store roll out over the next two years, as well as open roughly 10 JB Hi-Fi stores per annum over the next three years.

JB Hi Fi (JBH)



Source: *Yahoo!7 Finance*

This may all well be possible, but the next question to ask is whether these future stores will deliver similar levels of profitability as established stores have done in the past. On this point, we are not certain. We believe that JB Hi-Fi is facing significant challenges in several of its key inventory segments including CDs and DVDs, personal computers (due to tablets), gaming software sales and perpetual licence software.

Competition increases

Most notably, we believe that future trading will be more difficult for JB Hi-Fi as online competition gains market share by offering prices for wares below that of what we expect JB Hi-Fi can offer profitably. I would add that deficiencies in some of these competing online offerings, such as long delivery times or poor quality products, are likely market share opportunities that other more sophisticated online retailers can take advantage of.

Amazon, for example, in the United States offers its customers one-day delivery, meaning you can view your favourite goods in department stores, then purchase them on your iPhone or online, for a significant discount, to be delivered to your doorstep the next day. This level of service has not yet reached Australia, however time is the friend of the wonderful business and we believe it is precisely that, a matter of time.

It would not surprise us if management were well aware of these issues. Evidence of this can be found in the firm's financial statements, which noted that recently, management's hurdle for long-term performance was reduced from 10 to 15% earnings per share growth per annum over a three-year period to 5 to 10%.

Are we saying that JB Hi-Fi will be unprofitable tomorrow? Most certainly not, but our focus is to invest in companies that will reliably achieve well above average profit growth in the future. This may not be the case for JB Hi-Fi.

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