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Value Line: JB cranks up the volume

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PORTFOLIO POINT: The retailer's same-store and overall sales were strong, it is dominating its sector and its prospects are bright.

Value Line's objective is an instructive one. The aim is to track the returns of several approaches to stock selection and portfolio construction using a limited portfolio of eight excellent businesses. One – which we called the Buffett approach – only buys when a stock is below its intrinsic value.

When Value Line started investing, only JB Hi-Fi met that criterion. As a result, the entire allocation available to be invested in JB Hi-Fi was invested at $14.80 a share. As an aside, I have to admit I was fortunate enough to buy JB Hi-Fi personally for about $8.50 in November last year after emailing chief executive Richard Uechtritz to tell him what he probably already knew: that the shares were finally cheap. But Value Line did not exist then so it needs to be satisfied with $14.80.

We also tried the "blind Freddy" approach. The idea was to invest in a way that mirrors what sometimes happens when a client visits an adviser with a blank cheque to be invested in the stockmarket; it is usually fully invested near to that very day. With an eye to conservatism, Value Line invested a smaller proportion of its portfolio across the board in this way. Given the superior quality of the companies selected, even this approach should beat the average because the average contains inferior businesses, many of which are also trading at unattractive prices. And to represent this latter group, we are also watching two expensive stocks with inferior economics.

By tracking the performance of the invested portfolio, the total portfolio and the individual stock performances, we should gain some understanding of the merits and weaknesses of each approach.

This week's profit result by JB Hi-Fi, and the impact it has had on both the company's valuation and share price, is a win for the Buffett approach to stockmarket analysis and investing. We take a break this week from our plan to describe each company in detail and the reason for its inclusion in Value Line, to report on JB Hi-Fi's result.

The company's reported profit grew by 45% on $2.3

Value Line portfolio, as at August 11, 2009

Company	ASX	July 1 Price	Price Today	Est. Value	Margin of Safety at time of purchase	Margin of Safety	Shares Purchased	Invested Capital ($)	Capital Value ($)	Divs Rec	Total Return	Total Return
JB Hi Fi	JBH	14.8	17.3	18.1	18.23%	4.4%	845	$12,500	$14,611	0	$2,111	16.89%
The Reject Shop	TRS	11.62	12.76	11.45	-1.48%	-11.4%	513	$5,959	$6,543	0	$585	9.81%
Westpac	WBC	19.68	23.02	18.13	-8.55%	-27.0%	295	$5,811	$6,797	0	$986	16.97%
Woolworths	WOW	26.16	27.09	22.86	-14.44%	-18.5%	206	$5,377	$5,568	0	$191	3.56%
Cochlear	COH	56.36	58.66	48.7	-15.73%	-20.5%	102	$5,744	$5,978	0	$234	4.08%
CSL	CSL	31.81	31.49	25.18	-26.33%	-25.1%	163	$5,197	$5,145	0	-$52	-1.01%
Reece	REH	17.8	20.2	12.81	-38.95%	-57.7%	236	$4,209	$4,777	0	$568	13.48%
Platinum Asset Mgt	PTM	4.06	4.8	2.18	-86.24%	-120.2%	854	$3,467	$4,099	0	$632	18.23%
Since July 1, 2009												
Security Value												$53,519
Cash Value												$51,736
Total Value												$105,255
Total Return ($)												$5,255.01
Return Invested (%)												10.89%
Total Return (%)												5.26%
XAO Change												9.79%
Outperformance (I) - invested portion												1.10%
Outperformance (T) - total portfolio												-4.53%
Under observation												
ISOFT	ISF	0.635	0.75	0.038		-1873.7%						-18.11%
Amcor	AMC	4.79	5.3	2.66		-99.2%						-10.65%

billion of sales. Sales were up 27% on last year and same-store sales improved by about 11.5%. Net profit margins grew from 2.4% in 2003 and 3.6% last year to 4.1% in 2009. EBIT margins (earnings before interest and tax) have grown from 4.66% in 2002 to 6.1% this year, reflecting constant cost vigilance. Gross margins fell from 21.9% to 21.6%, reflecting pressure on prices from somewhat irrational competition, but JB Hi-Fi's cash flow and balance sheet allow it to dominate the EDLP (Every Day Low Prices) space, entrenching the company's franchise and allowing it to build an even wider and deeper moat around the business.

The quality of the profit was very high thanks in part to ongoing reductions in the working capital required (due to improvements in inventory turnover) as a percentage of sales. The company was able to cover its dividends and interest many times over and substantially reduce borrowings such that gearing fell from 76% to just 23%. This derisking should see some analysts adopt lower required returns in their valuation modelling which in turn, will produce higher values.

The company's prospects – one of our selection criteria – remain bright, with the company reporting its sales are expected to grow 20% to $2.8 billion next year. Sales in July and August have also met internal expectations. If margins remain the same as this year, profit would grow by 22% to about $115 million. Interestingly, this increase corresponds to the growth rate implied by the retained return on equity. If a return on equity of 48% was achieved again and 50% of the earnings were distributed to owners as dividends, the implied earnings growth rate is 23.5%.

It is possible of course that as more stores mature, a demonstrated driver of higher EBIT margins, the increase in sales will translate to even greater increases in EBIT. Lower debt will also improve the NPAT margin and a 22% earnings growth rate may be conservative. The company could earn more than $119 million next year.

At today's price of $17.30 the shares are trading at just under 20 times earnings per share of 88¢, 16 times forecast 2010 earnings per share and about 13 times 2011. Many value investors believe that a low price/earnings (P/E) multiple is a necessary attribute of a value stock but such a characteristic is not required for a share to be cheap. JB Hi-Fi's obviously high P/E is in no way inconsistent with our value investing philosophy. Using a return on equity of 40% ($119 million/$295 million), each $2.75 of equity per share is worth about $17. While JB Hi-Fi is not the bargain it was at $8 in November last year, it is not as expensive as the P/E watchers would have you believe.

JB Hi-Fi was the largest investment I made when Value Line commenced and it will remain so. ◆

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