JB Hi-Fi: Good But Not That Good

On a recent Saturday morning I wandered up to JB Hi-Fi looking for a new sound system. Two hours later I was climbing into a cab with a new sound system, new television and a nice new iMac on which I'm now writing this piece.

They get me every time. Every time they get me I see them getting everyone else – the place resembles a beehive of reckless consumer spending – and I think to myself 'what a wonderful business, I'd love to own this'.

The good news is you can own JB Hi-Fi. Buying some shares is as simple as a few clicks of your mouse. Before you fire up the Commsec account, however, there are a few points to consider.

This type of 'ground up' investing is simple but can be devastatingly effective. It's an area in which you can have a serious advantage over the fishbowl-dwelling professional investor. Typically, they're basing their investment decisions off the financial statements, which are only ever a look at the past. You didn't need an accounting degree to realise JB was going to be a sensational business five years ago, you just needed to walk around one of its original Melbourne stores and realise that this was a successful retail business that could be replicated all over the country.

Had you done so, you'd have made five times your money in the seven years since the company listed on the stock exchange in 2003. Not bad. Not bad at all. But how is today's buyer going to fare?

Well, today's $20 share price translates to a value for the entire business of approximately $2 billion. Now, two billion dollars is a lot of money. And, Australia is NOT a very big place. Armed with these two mind-boggling analytical insights, I'm prepared to posit that today's buyer of JB Hi-Fi stands little chance of doing as well as their predecessor seven years ago.

Think about it this way. If JB's share price even doubles over the next 7 years, it will have a market capitalisation of $4bn. Assuming the business is by then mature, you'd need it to be making something like $400m of pre-tax profit per year to justify this price tag. The company earns fairly consistent margins of 6%, so you'd need it to be generating more than $6bn in annual sales.

Australia's total spending on household goods during the past 12 months was about $42bn. That includes furniture, whitegoods and all the bored-husband stuff you find at Bunnings Warehouse, none of which JB Hi-Fi sells.

Let's say that in 7 years' time total household goods spending has increased to $50bn. You'd need JB Hi-Fi to be collecting 13% of that in order to justify a $4bn price tag. That's probably 30-40% of the market JB competes in.

Anything up to 100% is theoretically possible. But 30-40% market shares are rarely seen (unless you're Coles and Woolies) and it's certainly hard to imagine much upside from there.

Investing in retail businesses can be a highly profitable exercise. But you need to find them when they're 10 or 20 stores and have a model that can be replicated up to 200 stores (I might post something on Kathmandu soon, is it a potential?). Buying a business like JB Hi-Fi, when everyone already knows about it, is more likely to lead to rags than riches.

Note: There's an important aside here relating to retail businesses and return on capital. A good retailer doesn't need much capital. JB's $335m of inventory is almost offset by $290m of accounts payable – its suppliers are basically paying for everything in the store. So the economics can be absolutely mouth-watering. For the 2010 financial year, JB Hi-Fi's return on equity was north of 40%. But a high historical ROE doesn't necessarily justify a high price-to-earnings ratio. You can only justify a high multiple if you can get more capital into the business at the same high returns, and in a market the size of Australia, this is often a serious constraint.