Time to take stock

By Rob Rose

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After an 18-month trial of nasty discoveries, it's no wonder Leon Kirkinis, CEO of African Bank Investments (Abil), pauses when asked if given the chance again, he'd still buy Ellerines.

“Yes,” he says finally, “but I would pay a lot less than we did.”

It was a landscape-altering deal in August 2007: microlender African Bank paid R9,2bn for Ellerines, marrying the two worlds of furniture retail and finance to create a combined company with 2 million clients and 2000 outlets.

Though the deal was lauded as “brilliant” by some pundits at the time, others asked what Kirkinis knew about running a furniture store. His response was simple: “There's just as much risk in not doing a deal as there is in doing a deal.”

Investors would now beg to differ, pointing out that after three shoddy sets of financials from Ellerines, there was far more risk in doing this particular deal.

The Ellerines albatross was evident in Abil's half-year results to March, where overall profit went up 16% to R958m.

But the contrast between the two business units was alarming. At Ellerines, the gloomy truth was that sales slumped 21%, return-on-equity fell to 4.1% and its sales/metre dropped 10%. Yet at African Bank, you wouldn't know we were in a slowdown — new loans grew by 11% and it produced a return on equity of 56%.

Investors weren't charmed: Abil's share price fell 3.6%, signalling that they'd had enough of Ellerines' disasters.

Kirkinis told the FM that he understood this view. “We believe Ellerines will still prove to be a great investment, but I fully understand the cynicism after three sets of poor numbers.”

If all goes well, the integration of Ellerines and African Bank will be complete by September next year, and the lacklustre furniture retailer will begin turning an “economic profit”.

This measure of profitability is a good yardstick, as it reduces the bottom line profit by the cost of the capital (the new shares issued to make the deal happen) to show whether the original deal was good or bad for shareholders.

So Abil made an overall R11m “economic loss” for this six months; the African Bank unit made a R537m “economic profit”; Ellerines made a R170m “economic loss”; and the group took a R377m charge for the massive R4bn goodwill paid for

Ellerines.

Clearly, Abil's due diligence wasn't up to scratch. “Well, we did our own due diligence,” says Kirkinis, “and we didn't uncover what we should have. We didn't fully understand the charges within Ellerines. We have to look in the mirror and confront that.”

Besides being a business in worse shape than Abil thought, Ellerines employed the same risk management tactics in the few months before the deal as that of a taxi driver in rush hour.

But if Kirkinis gets the model right, it'll be a compelling offering. The plan is to use the volume of customers to reduce prices for financial services clients and furniture clients. Already there has been progress — the “all-in yield” paid to Abil by customers has dropped from 53% to 49% and Abil has slashed the cost of “insurance” for customers.

But pundits will be surprised that African Bank's total loans keep soaring, growing in the past six months by 40% to R15,6bn. How long can this continue?

“I'm not a big believer in the view that markets get saturated,” says Kirkinis. “I think management brains get saturated, not markets. So if you want to, in this market, you can grow.”

What is even more surprising is that while big banks such as Absa fight to keep a lid on bad debts, Abil's bad debts actually dropped from 10.7% to 10.4%.

“If our core competency is about taking risk, then we should have stable bad debts or we should be shot,” he says. “It's about being focused, deciding where you want to take risk and where to avoid it.” On this thinking, he might have done well to avoid Ellerines.

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