Questions in the air

The depression that hit JD Group's share price (down 60% in two years) reflects “scepticism that our strategy o splitting financial services from retail will work,” says chairman David Sussman.

By Rob Rose 13 Feb 2009

Sussman was speaking after JD Group's AGM, where he received a working over from activist Theo Botha about the fallin margins in the traditional retail business, which sells furniture and appliances to people through stores including Joshua Doore, Hi-Fi Corporation, Barnetts and Electric Express.

Last year, JD Group went through a process of splitting its two core divisions: financial services, which provides credit an insurance for people to buy furniture, and selling furniture.

After the divorce it became clear the hefty margins on financial services were subsidising the lazy retail business.

While the “traditional retail” business's operating profit margin dropped to 2.1% from 10.8% in 2007, the financial services arm continues to keep its margins above 20% — a reflection of just how much money clients are paying in insurance and repayments. “All these issues are a reflection of the environment,” says Sussman. “We could not continue in the form we were in, as traditional retail had become a healthy dinosaur, cross-subsidised by financial services.”

Sussman's plan — and something similar was implemented at Ellerines once African Bank Investment (Abil) climbed into t driving seat — was to separate the two businesses, increase the margin in the “traditional retail business” and reduce cos in that business. It has done that largely by shutting stores.

But this plan, along with claims it ripped off low-income customers by hiding the true cost of credit, had investors fleeing fo less grim pastures.

One analyst from a major brokerage, who asked to remain anonymous, doesn't agree that the share has been hit by scepticism over the strategy. “I think many investors believe JD Group's going the right way. If anything, the discount in th share price is due to a lack of faith in management, after the merger they proposed with Steinhoff failed, and also the mec claims they overcharged customers,” he says.

Even at a share price 60% lower than two years ago, investors aren't convinced. Of nine analysts covering the stock, including Deutsche Bank, four rate it a “sell” despite the recent rate cuts.

One of the problems cited by Deutsche was the falling rand, which made it more expensive for JD Group to import produc it could then sell.

But the view that credit retailers are the most vulnerable to the “credit crunch” may be wrong. A research note from Cadiz Securities said “credit retailers, while vulnerable to declining profitability, may benefit from annuity cash flows from their debtor books”. Cadiz says investors should focus on “retailer liquidity” while there is a shortage of capital across the globe

Credit retailers benefit from repeat cash flows from people repaying accounts, while cash retailers rely on cash based payments that could dry up at any moment. On this score, JD Group and Lewis are better placed than Pick n Pay, Shopri or Massmart — yet their share prices have been hit worse.

But Sussman — a man who doesn't mince his words — says that if he worried about the share price the whole time, he wouldn't have taken the steps to fix the business.

“Sometimes you've got to take a step back to improve,” he says. “This group is much healthier than it was two years ago.”

This seems counter-intuitive, considering JD Group wrote off R862m in bad debts — 35% more than the R641m of the previous year.

However, Sussman says JD Group is “over the worst” when it comes to bad debts — a sentiment which seems out of step with his competitors, who are still bracing for the worst.

“In 2006, we were criticised badly for saying the cycle had turned [for the worse]. Everyone was in denial. But we're confident we're over the worst now,” he says.

After last year's beating — when headline earnings plummeted from 626c/share to 302,8c — there is some light at the end the tunnel. On average, analysts expect earnings to grow by 38% for the year to August 2009 to 416c/share.

And though JD has underperformed its peers — its stock has underperformed the general retail index by 22% — it may b better placed than the others.

Lewis has done nothing to separate retail from financial services, while Abil is likely to come under pressure to dump the loss-making Ellerines.

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