JB Hi-Fi Limited

JBH.AX

MST Marquee
A research platform of MST Financial

15 August 2022

The peak is now in sight

FY22 result insights

JB Hi-Fi reported FY22 EBIT growth of 7%, with 2H22 EBIT rising 33%. Sales momentum has strengthened slightly in July 2022 and the first-half of FY23e should see good earnings growth. Based on our analysis, it is calendar 2023 where sales could fall and profit margins decline. We lift our FY23e EPS forecasts by 7% and FY24e by 3%. The near-term upgrade mainly reflects higher sales growth. We lift our target price from $43.30 to $43.80. We lower our rating to Hold from Overweight. We are increasingly cautious on the stock given sales trends are likely to turn negative in calendar 2023.

No sales slowdown just yet

JB Hi-Fi's trading update showed good July sales momentum. The cleanest way to read the numbers is to look at three-year growth rates. July 2022 three-year CAGR was 11.2%, compared with the June half at 10.3%. Reported year on year growth will strengthen over coming months given lockdowns. However, by early next year, once income growth has been crimped, JB Hi-Fi Australia comp sales may fall -6% in 2H23e. The Good Guys may be a little more lagged given the renovation and housing cycle but we still forecast a slowdown to -3.5% in 2H23e.

Gross margins to normalise in calendar 2023

The company's gross margins expanded by 81bp in 2H22 and are well up on FY19 levels. There have been a number of distortions to gross margins. For JB Hi-Fi, lockdowns in 1H22 artificially depressed margins, while in 2H22, a lack of discounting led to higher than normal margins. In The Good Guys, we estimate stock profits were more than half the 163bp gross margin gain in 2H22. These gains will not persist, moreover floor discounting is also likely to resume by 2H23e as sales turn down. We forecast group gross margins at 22.1% in FY23e, dropping to 21.8% in FY24e, compared with 21.5% in FY19.

Operating costs rising

We expect the cost of doing business to rise by 8% in FY23e, driven by some normalisation in 1H23e, as well as wage rate growth of 5.1% and rental growth of 5%. In the first half, such cost growth shouldn't be a problem given we forecast sales up 9%, but in 2H23e, we forecast sales to fall 5%, creating a margin squeeze. Staff hours will be adjusted but we expect the CODB to sales ratio to rise by 70bp in FY23e and a further 90bp in FY24e.

Earnings revisions

We lift our EPS forecasts by 7% in FY23e given we raise our sales outlook, mostly in 1H23e, given the strong run-rate for July 2022. We lift our EPS by 3% in FY24e and beyond, reflecting higher price inflation supporting revenue growth.

Our view

We reduce our rating to Hold from Buy. JB Hi-Fi trades on a PE ratio of 10x FY23e. However, given our forecast for a trough in earnings in FY24e, that year is more appropriate at 12.5x PE. While we see fair value at $43.80, we caution that it will be a choppy 12 months. As comparable sales turn negative, there may be a cheaper entry point next calendar year.

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Retail sector

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Rating	**HOLD** *(Prev Overweight)*
Target price (12 months)	**A$43.80** *(Prev A$43.30)*
Current price	**A$45.10**

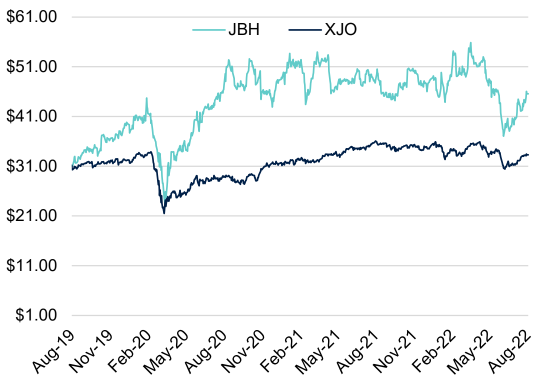
Figure 1: Financial forecasts

Year end 30 June	2020a	2021a	2022e	2023e	2024e
Revenue (A$m)	7,919	8,916	9,232	9,454	9,315
EBITDA (A$m)	732	962	1,014	938	817
EBIT (A$m)	503	743	795	712	592
EPS (cents)	281.3	437.8	477.1	438.6	360.6
PE ratio (x)	16.0x	10.3x	9.5x	10.3x	12.5x
EV/EBITDA	6.6x	5.1x	4.8x	5.2x	6.0x
Dividend yield (%)	3.3%	6.4%	7.0%	6.3%	5.9%
ROE (%)	30.4%	41.9%	42.1%	35.3%	26.4%

Share price	$45.10	Next year div (cents)	316.0
Target price	$43.80	Dividend yield	7.0%
Implied capital return	-2.9%	Expected TSR	4.1%

Source: Company reports, MST Marquee

Figure 2: Share price



Three year history. XJO re-based to stocks's share price

Source: FactSet, MST Marquee

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ABN 617 475 180 AFSL 500 557 Risk statement, certifications and disclosures in appendix, and on website

JB HI-FI LTD (JBH.AX)

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All figures stated in AUD

Company Overview			
Current price ($)	45.10	Target price ($)	43.80
Market capitalisation ($m)	4,929	12 month dividend ($)	3.16
Shares outstanding (m)	109	Expected return (%)	4.1
Enterprise value	4,863	**Recommendation**	**Hold**

Year to 30 June

Profit & Loss ($m)	2020a	2021a	2022e	2023e	2024e
Sales revenue	7,919	8,916	9,232	9,454	9,315
% change	11.6	12.6	3.5	2.4	-1.5
Gross profit	1,694	1,977	2,080	2,092	2,033
Gross margin (%)	21.4	22.2	22.5	22.1	21.8
EBITDA	732	962	1,014	938	817
Depreciation	-69	-59	-57	-50	-35
Amortisation	-160	-159	-163	-177	-190
EBIT	503	743	795	712	592
EBIT margin (%)	6.35	8.33	8.61	7.53	6.35
Net interest expense	-35	-23	-19	-24	-26
Pre-tax profit	468	720	775	688	566
Tax expense	-141	-214	-230	-206	-170
Minorities & associates	0	0	0	0	0
Net profit	326	506	545	482	396
% change	30.6	55.1	7.7	(11.6)	(17.8)
Significant items	-24	0	0	0	0

Balance sheet ($m)	2020a	2021a	2022e	2023e	2024e
Current assets					
Cash and near cash	252	263	126	445	506
Receivables	220	103	133	125	128
Inventory	739	939	1,135	1,131	1,156
Other	35	36	31	31	31
Total current	1,246	1,341	1,425	1,732	1,821
Non-current assets					
Property, plant and equipment	172	169	169	186	219
Investments	0	0	0	0	0
Right of use assets	642	536	462	565	584
Goodwill	747	747	747	747	747
Other intangibles	284	284	284	284	284
Other non current	61	69	75	75	75
Total non-current	1,907	1,806	1,737	1,857	1,909
Total Assets	**3,152**	**3,147**	**3,161**	**3,589**	**3,730**
Current liabilities					
Accounts payable	854	669	722	896	916
Short-term debt	0	0	0	0	0
Lease liabilities	164	167	167	167	167
Other	328	411	418	418	418
Total current	1,346	1,247	1,306	1,481	1,501
Non-current liabilities					
Long-term debt	0	0	59	59	59
Provisions	42	43	43	43	43
Lease liabilities	578	464	378	462	478
Other	82	85	95	95	95
Total non-current	701	592	575	659	675
Total liabilities	2,047	1,838	1,881	2,140	2,176
Net assets	**1,106**	**1,308**	**1,280**	**1,449**	**1,554**
Shareholders' equity	1,106	1,308	1,280	1,449	1,554
Outside equity interests	0	0	0	0	0
Total equity	**1,106**	**1,308**	**1,280**	**1,449**	**1,554**

Cashflow ($m)	2020a	2021a	2022e	2023e	2024e
EBITDA	732	962	1,014	938	817
Working capital	418	(186)	(162)	186	(7)
Net interest	(35)	(23)	(19)	(24)	(26)
Tax	(141)	(214)	(230)	(206)	(170)
Other	8	20	25	0	(0)
Operating Cashflow	981	559	627	895	613
Capital expenditure	(43)	(58)	(58)	(67)	(67)
Net acquisitions/disposals	0	0	0	0	0
Other	0	0	0	0	0
Investing Cashflow	(43)	(58)	(57)	(67)	(67)
Financing Cashflow	(806)	(489)	(707)	(508)	(485)
Net change in cash	132	12	(137)	319	62
Free cash flow	**938**	**501**	**570**	**827**	**546**

Key metrics	2020a	2021a	2022e	2023e	2024e
EPS - underlying (¢)	**281.3**	**437.8**	**477.1**	**438.6**	**360.6**
% change underlying EPS	29.4	55.6	9.0	-8.1	-17.8
EPS - basic (¢)	284.0	440.9	479.2	440.6	362.3
Wtd avg ordinary shares (m)	115	115	114	109	109
Wtd avg diluted shares (m)	116	116	114	110	110
DPS (¢)	**150.0**	**287.0**	**316.0**	**286.0**	**266.0**
Dividend yield (%)	3.3	6.4	7.0	6.3	5.9
Payout ratio (%)	53.3	65.6	66.2	65.2	73.8
Franking (%)	100	100	100	100	100
PE ratio	16.0	10.3	9.5	10.3	12.5
EV/EBIT (x)	9.7	6.5	6.1	6.8	8.2
EV/EBITDA (x)	6.6	5.1	4.8	5.2	6.0
EBIT margin (%)	6.4	8.3	8.6	7.5	6.4
Tax retention rate	69.8	70.3	70.3	70.0	70.0
Asset turnover	2.8	2.8	2.9	2.8	2.5
Interest expense rate (%)	1.2	0.7	0.6	0.7	0.7
Financial leverage multiplier	2.7	2.6	2.4	2.5	2.4
Minority interest adj factor (x)	1.0	1.0	1.0	1.0	1.0
ROE (%)	30.4	41.9	42.1	35.3	26.4
ROIC (%)	31.7	39.9	41.7	33.0	25.7
Net debt ($m)	-252	-263	-66	-385	-447
Debt to equity (%)	0.0	0.0	4.6	4.1	3.8
Net debt to EBITDA (x)	-0.3	-0.3	-0.1	-0.4	-0.5
EBIT interest cover (x)	14.2	32.2	41.2	30.2	22.8
Days inventory	47.7	44.1	52.9	56.2	57.3
Days receivable	10.5	6.6	4.7	5.0	5.0
Days payable	44.3	40.0	35.5	40.1	45.4

Half-year ($m)	1H21a	2H21a	1H22e	2H22e	1H23e
Sales	4,941	3,975	4,862	4,370	5,292
EBITDA	572	390	529	485	581
EBIT	463	280	421	374	462
EPS - underlying (¢)	**274.6**	**163.1**	**249.5**	**227.4**	**287.2**
DPS (¢)	180.0	107.0	163.0	153.0	163.0

DCF valuation			
PV of free cash flows	2,354	Terminal value year	FY31
PV of terminal value	2,652	Beta	1.04
Enterprise value	5,005	Cost of equity (%)	9.2
Net debt	-66	Cost of debt-AT (%)	4.2
Equity value	5,071	Debt to EV (%)	0.0
Shares on issue	110	Equity to EV (%)	100.0
DCF valuation per share	**$46.19**	**WACC (%)**	**9.24**

Segments ($m)	2020a	2021a	2022e	2023e	2024e
JB Hi-Fi Australia					
Store Count	197	197	199	201	202
Sales ($m)	5,319	5,957	6,197	6,341	6,197
Same store sales growth (%)	12%	13%	3%	2%	-3%
EBIT ($m)	392	523	545	495	432
EBIT margin (%)	7%	9%	9%	8%	7%
The Good Guys					
Store Count	105	105	106	107	108
Sales ($m)	2,389	2,716	2,789	2,861	2,826
Same store sales growth (%)	11%	14%	2%	2%	-2%
EBIT ($m)	113	215	241	208	151
EBIT margin (%)	5%	8%	9%	7%	5%
JB Hi-Fi New Zealand					
Store Count	14	14	14	15	17
Sales ($m)	211	244	246	252	291
Same store sales growth (%)	-6%	17%	0%	5%	1%
EBIT ($m)	(1)	5	8	9	9
EBIT margin (%)	-1%	2%	3%	3%	3%
Total group sales	**7,919**	**8,916**	**9,232**	**9,454**	**9,315**
Total group EBIT	**503**	**743**	**795**	**712**	**592**

Source: Company reports and MST Marquee

AASB-16 from 2020a onwards

JB Hi-Fi FY22 result analysis

JB Hi-Fi reported FY22 EBIT growth of 7%, with 2H22 EBIT rising 33%. Sales momentum has strengthened slightly in July 2022 and the first-half of FY23e should see good earnings growth. Based on our analysis, it is calendar 2023 where sales could fall and profit margins decline. We lift our FY23e EPS forecasts by 7% and FY24e by 3%. The near-term upgrade mainly reflects higher sales forecasts. We lift our target price from $43.30 to $43.80. We lower our rating to Hold from Overweight.

Figure 3: JB Hi-Fi FY22 profit result

Year	FY21(a)	FY22(a)	% change
Sales ($m)	8,916	9,232	4%
EBIT ($m)	743	795	7%
EBIT margin (%)	8.3%	8.6%	+27bp
NPAT ($m)	506	545	8%
EPS (cents)	441	479	9%
DPS (cents)	287	316	10%

Source: Company reports, MST Marquee

Key issues we explore

1. When will sales turn negative?
2. What is the risk to gross profit margins?
3. What is the operating cost outlook for FY23e?

Revisions to forecasts and investment case

We increase our EPS forecasts by 7.0% on JB Hi-Fi in FY23e, with a smaller 3% lift in FY24e and FY25e. The increase in our earnings is a function of higher sales growth forecasts. While we still expect a meaningful downturn in calendar 2023, the component related to price is less likely to drop. Trading for July 2022 was strong and momentum for the remainder of 1H23e is likely to support earnings in this fiscal year. While we have lifted our sales forecast by 4% across the horizon, we have also lifted our operating costs given higher wages and rents, resulting in very little movement in our medium-term EBIT margin outlook.

Figure 4: JB Hi-Fi earnings revisions

Period	FY22(a)	FY23(e)	FY23(e)	FY23(e)	FY24(e)	FY24(e)	FY24(e)	FY25(e)	FY25(e)	FY25(e)
Revision ($m)	**Actual**	**New**	**Old**	**Rev**	**New**	**Old**	**Rev**	**New**	**Old**	**Rev**
Sales	9,232	9,454	9,088	4.0%	9,315	8,976	3.8%	9,522	9,183	3.7%
EBIT	795	712	666	6.8%	592	575	2.9%	603	587	2.8%
Net profit	545	482	450	7.0%	396	385	2.8%	403	393	2.7%
Underlying EPS (¢)	477	439	410	7.0%	361	351	2.8%	367	358	2.7%
DPS (¢)	316	286	279	2.5%	266	279	-4.7%	274	287	-4.5%

Source: Company reports, MST Marquee

We lift our target price by 1% to $43.80 per share. Given the recent share price strength and likelihood of negative comparable sales in calendar 2023, we lower our rating on JB Hi-Fi from Overweight to Hold. We still see a 20% chance of a major drop in sales and earnings (a recession scenario) that cannot be ruled out. Our base case valuation is $47.52 (80% probability) and in our view represents the upper bound of a likely trading range over the next year. The share price could show increasing volatility when sales turn negative next calendar year. While we are cautious on the outlook for sales, we expect our near-term earnings forecasts are higher than Visible Alpha consensus estimates given better near-term sales and higher gross margins.

Key Issues discussed

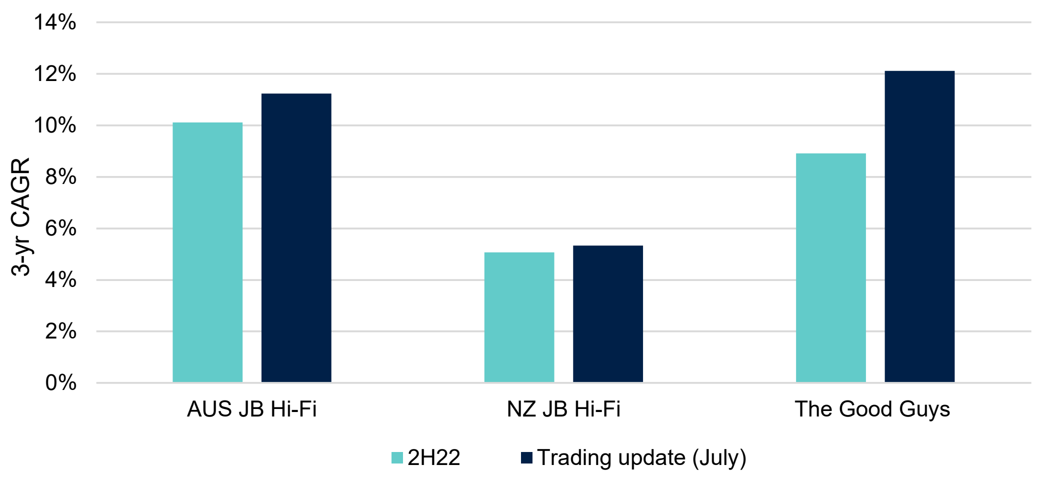
1. When will sales turn negative?

JB Hi-Fi reported a strong trading update for July 2022. Comparable sales rose 9.2% in JB Hi-Fi Australia and 7.8% in The Good Guys. However, it is important to note this period is lapping lockdown last year. New Zealand reported negative comparable sales growth of -0.9%, lapping an elevated pcp of 8.1%. We expect comparable sales growth to turn negative for JB Hi-Fi in 2H23e. We expect The Good Guys comparable sales growth will turn negative later than JB Hi-Fi. There is upside risk to our sales outlook for The Good Guys given its home appliances category is well positioned for sustained renovation activity and higher price inflation.

Trading update (July)

JB Hi-Fi reported a positive trading update for July. On a three-year CAGR of comparable sales, all three businesses are performing strongly, showing an acceleration from 2H22. JB Hi-Fi Australia's result was strong at 11.2% in the July period, and JB Hi-Fi New Zealand was 5.3%. The Good Guys accelerated the most at 12.1%, increasing from 8.9% in 2H22 on three years ago. This is likely driven by high renovation activity driving sales in home appliances that represent 60% of sales, and price rises.

Figure 5: Three-year CAGR on 2H22 and July 2022 trading update

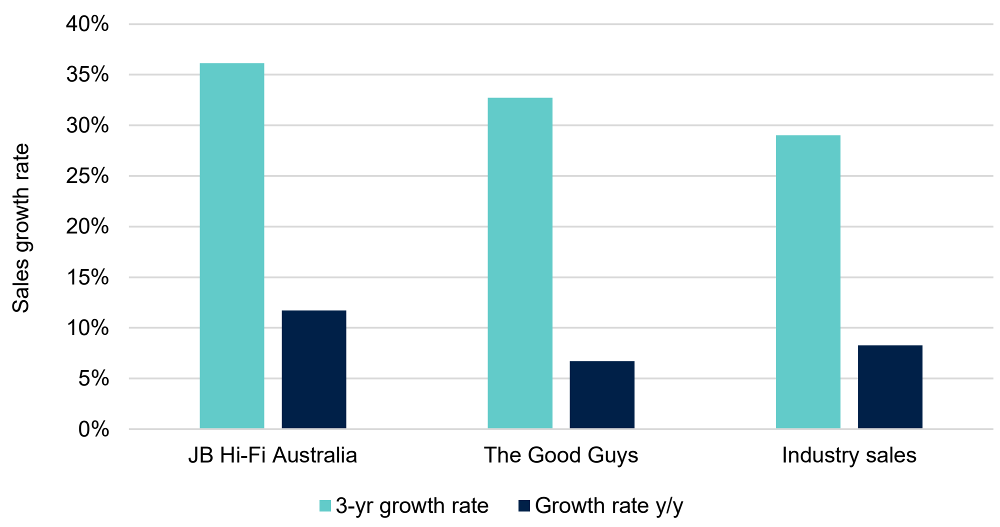


Source: Company reports, MST Marquee

Winning market share

JB Hi-Fi Australia grew faster than the market on one year ago. The chart below compares six months to June 2022 on three years and on one year ago. On one year ago, JB Hi-Fi Australia's sales growth rate of 12.7% outpaced the market growth rate of 8.3%. While The Good Guys lost market share in the last year, with sales growth 160bps below market at 6.7%. However, on a three-year basis both JB Hi-Fi Australia and The Good Guys won market share.

Figure 6: Comparable sales growth of six months to June 2022 on three years and YoY



Source: Company reports, MST Marquee

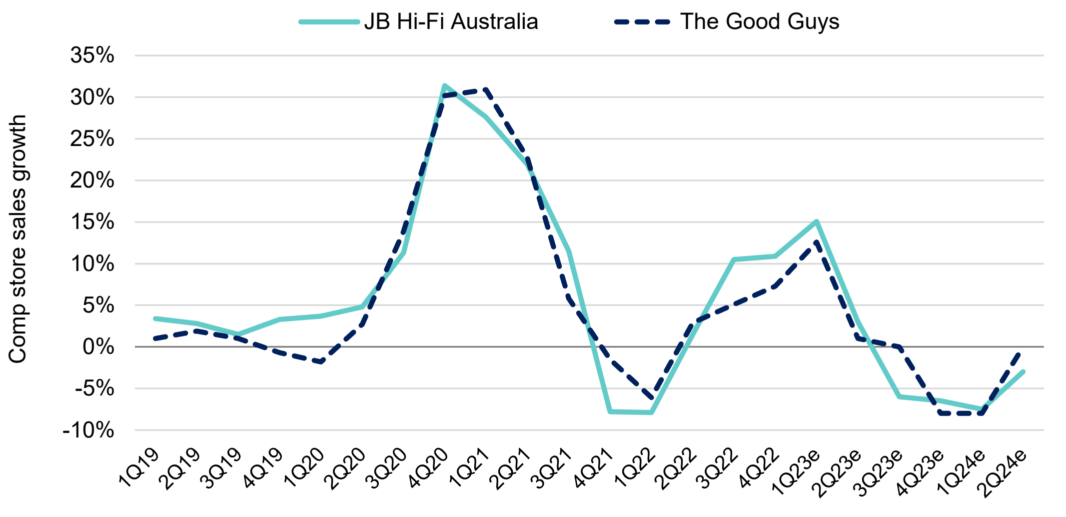
When will comparable sales turn negative?

We don't believe comparable sales will turn negative in this calendar year. We view it highly likely in 2023.

We forecast JB Hi-Fi Australia comparable sales growth will decline 6% in 3Q23e and The Good Guys to decline 8% in 4Q23e on one year ago.

We do expect The Good Guys to turn negative later than JB Hi-Fi due to its defensive product mix positioning the retailer to benefit from the backlog of renovations, with home appliances representing 60% of sales. Further, this category has some additional price rises over the next six months which will contribute to incremental sales growth.

Figure 7: JB Hi-Fi and The Good Guys comparable sales growth



Source: Company reports, MST Marquee

2. Will higher inventory lead to gross margin downside?

JB Hi-Fi reported a 36bp improvement in gross profit margins for FY22. The improvement was more significant in 2H22 at +81bp, with some stock profit and a smaller drag from online delivery costs. Gross margins are likely to rise again in 1H23e in our view, but then fall as discounting across the industry reverts to normal and the mix effect partly unwinds. We forecast group gross margins to fall back to 21.8% by FY24e, slightly above FY19 levels of 21.5%. The more permanent difference is better buying in The Good Guys.

Gross margins by division

We show segment and group gross margins in Figure 8 below. The largest gross margin movement has come from The Good Guys, which had gross margins of 20.6% in FY19 and was at 23.3% in FY22. The division has seen reduced in-store discounts, a favourable sales mix, some stock profit associated with price rises from suppliers and better buying. The company has signalled half of The Good Guys' gross margin gains could be retained. We are more conservative and assume that one-third are retained by FY24e.

Figure 8: JB Hi-Fi Group gross margins by division

Gross margin	FY18(a)	FY19(a)	FY20(a)	FY21(a)	FY22(a)	FY23(e)	FY24(e)
JB Hi-Fi Australia	22.2%	22.1%	22.0%	22.2%	22.4%	22.1%	22.1%
….gross margin change (bp)	-7bp	-3bp	-16bp	+27bp	+19bp	-33bp	+2bp
The Good Guys	20.3%	20.6%	20.5%	22.4%	23.3%	22.4%	21.5%
….gross margin change (bp)	+0bp	+33bp	-9bp	+189bp	+89bp	-85bp	-99bp
JB Hi-Fi NZ	17.7%	17.3%	16.5%	17.8%	17.4%	17.3%	17.3%
….gross margin change (bp)	-50bp	-39bp	-76bp	+130bp	-40bp	-15bp	-0bp
Group	21.4%	21.5%	21.4%	22.2%	22.5%	22.1%	21.8%
….gross margin change (bp)	-41bp	+7bp	-13bp	+78bp	+36bp	-40bp	-30bp

Source: Company reports, MST Marquee

Transitory factors in gross margins

It is important to recognise a number transitory factors have impacted gross margins over the past 12 months. In JB Hi-Fi Australia, gross margins fell 21bp in 1H22, but rose 58bp in 2H22. In The Good Guys, 1H22 gross margins were up 19bp, while 2H22 gross margins rose 163 basis points. There are a few factors that will unwind going forward (in both directions). These include:

- Online delivery costs in 1H22 were elevated because stores were closed with COVID-19 lockdowns. JB Hi-Fi offered free delivery. We estimate this dragged 25bp from reported margins in 1H22 and will boost 1H23e.
- High margin items like mobile phone plans, warranties, services were well down in 1H22 given lockdowns also dragging down gross margins. As shown in Figure 9 below, the mix effect was -30bp on our estimates.
- Stock profit is where a retailer buys inventory before a price rise and is able to sell at higher retail prices. This is evident in home appliances, which are close to 60% of sales in The Good Guys. Prices had risen by 5%-10% across much of the category over FY22. The stock profit may have been 88bp or more than half of the reported gross margin gain in 2H22.

As shown in Figure 9 below, the underlying gross margin movement for both JB Hi-Fi Australia and The Good Guys was much more modest than the reported change during FY22.

Figure 9: Potential source of gross margin change for JB Hi-Fi (year on year)

JB Hi-Fi Australia	1H22	2H22	The Good Guys	1H22	2H22
Underlying	+34bp	+48bp	Underlying	-8bp	+25bp
Free delivery	-25bp	+0bp	Reduced floor discounts	+0bp	+20bp
Mobile phone plans, warranties etc	-30bp	+0bp	Mix	+15bp	+30bp
Stock profits	+0bp	+10bp	Stock profits	+13bp	+88bp
Total GP margin move	**-21bp**	**+58bp**	**Total GP margin move**	**+19bp**	**+163bp**

Source: MST Marquee estimates

Inventory levels are higher, but not the driver of gross margin risk

JB Hi-Fi reported inventory up 28% from FY19 to FY22 in line with COGS growth over the same time horizon. As a result, inventory levels are largely normalised. However, this does pose a risk as sales slow. While a risk, relative to most other discretionary retailers, we see the risk as low for two reasons. Firstly, the stock turn is high. JB Hi-Fi operates with 50-60 days of inventory typically. Many other discretionary retailers are at 90-180 days. Secondly, suppliers fund the majority of discounts in the electronics industry and if there is a shift in demand, it is likely large retailers like JB Hi-Fi will seek support from suppliers.

Figure 10: JB Hi-Fi inventory turnover and inventory days

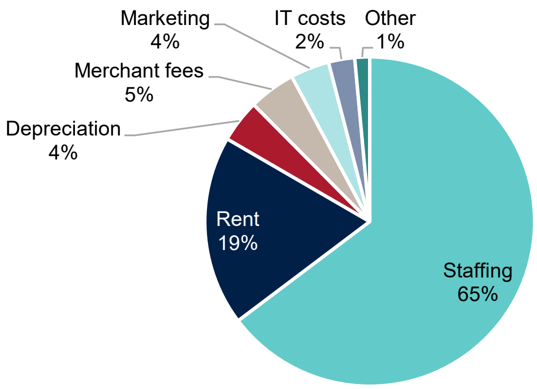
Year	FY17(a)	FY18(a)	FY19(a)	FY20(a)	FY21(a)	FY22(a)	FY23(e)
Inventory turnover (x)	6.3	6.1	6.3	7.7	8.3	6.9	6.5
Inventory days (#)	58	59	58	48	44	53	56

Source: Company reports, MST Marquee

3. What is likely operating cost growth in FY23e?

JB Hi-Fi's two largest costs are staff and rent. As shown below, we estimate these two cost items account for 80% of operating costs. The challenge for FY23e is that these costs are likely to rise by 6%-8%, which may create a margin squeeze in 2H23e.

Figure 11: JB Hi-Fi estimated cost structure



Source: MST Marquee

Wages

JB Hi-Fi tends to manage staffing costs in line with sales. However, given the outsized sales growth over the past three years, staffing costs has fallen from 10.3% of sales in FY19 to 9.0% in FY22. What's more relevant is that we estimate hours worked has risen by between 1% and 2% per annum over three years. If sales do slow, the company will cut hours at the margin. However, wage rate growth in FY23e will be 5.1% for store staff (4.6% Fair Work wage determination plus 0.5% superannuation increase). Note we could see an additional 0.4% associated with the timing of the wage increase, which was 1 September 2021 compared with a usual effective date of 1 July.

Rent

JB Hi-Fi leases virtually all its stores. We estimate the rental cost is $210-240 million a year. Most of its leases are a fixed rate increase of 4.0% or 4.5%. However, around 15% of JB Hi-Fi's stores are in Scentre Group shopping centres. Many of these leases have a clause that stipulates rents rise by "CPI+2.5%". This could lead to rental growth of 8%-10% on these leases in FY23e

Margin forecasts

We show our group margin forecasts in Figure 12 below. Operating costs are likely to rise by 70bp relative to sales on our estimates in FY23e. This pressure on profit margins could be more significant in FY24e, particularly given we forecast weaker sales growth in that year.

Figure 12: JB Hi-Fi profit margin drivers

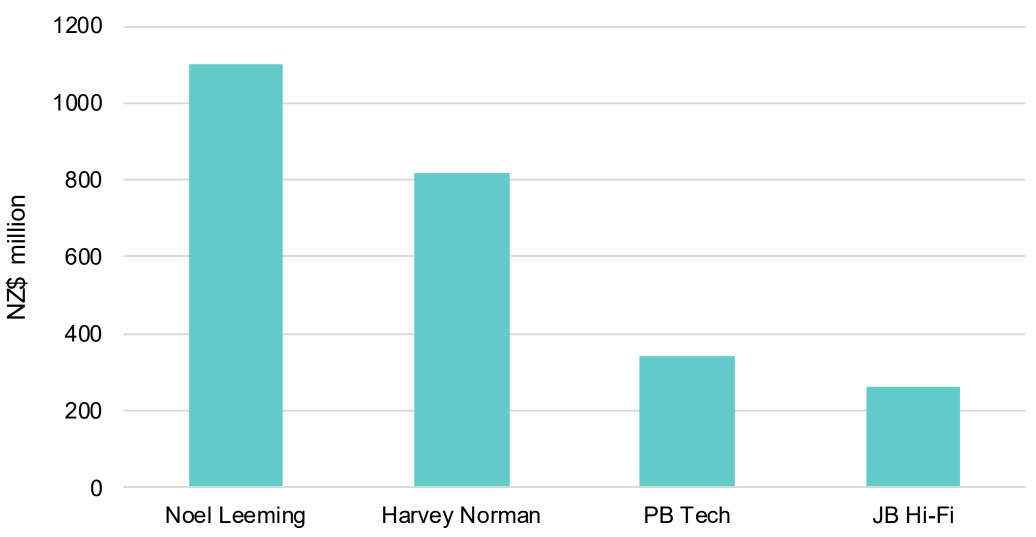
Post AASB-16	FY18(a)	FY19(a)	FY20(a)	FY21(a)	FY22(a)	FY23(e)	FY24(e)
Gross margin	21.4%	21.5%	21.4%	22.2%	22.5%	22.1%	21.8%
CODB margin	16.3%	16.3%	15.0%	13.8%	13.9%	14.6%	15.5%
EBIT margin	5.1%	5.3%	6.4%	8.3%	8.6%	7.5%	6.4%
Pre AASB-16	**FY18(a)**	**FY19(a)**	**FY20(a)**	**FY21(a)**	**FY22(a)**	**FY23(e)**	**FY24(e)**
Gross margin	21.4%	21.5%	21.4%	22.2%	22.5%	22.1%	21.8%
CODB margin	16.3%	16.3%	15.5%	14.2%	14.3%	15.0%	15.9%
EBIT margin	5.1%	5.3%	5.9%	7.9%	8.2%	7.1%	5.9%

Source: Company reports, MST Marquee

A note on New Zealand

JB Hi-Fi provided some detail about its plans in New Zealand. The company recently appointed a new MD of the division Tim Edwards, who had previously led Noel Leeming. JB Hi-Fi has been sub-scale in New Zealand for a number of years. The division is a slight negative NPV business on our estimates given low margins and capital intensity. However, the company signalled plans to spend $5-10 million in capex a year. It will migrate its online offer to Shopify and open up to three stores a year.

Figure 13: Electronics retailers estimated sales in New Zealand



Note for Harvey Norman we assume two-thirds of sales are electronics and appliances.
Source: MST Marquee

We maintain a cautious stance on JB Hi-Fi in New Zealand. As the table above shows, JB Hi-Fi is less than one-quarter the size of the #1 operator Noel Leeming. JB Hi-Fi may be successful on a 5-10 year horizon, but the fight for market share is likely to keep a lid on gross margins and EBIT margins. In Figure 14 below, we show the outlook for JB Hi-Fi NZ. We assume EBIT margins remain between 3%-4%. Note this is a post AASB-16 figure and many of the lease amortisation costs have been written off. Put another way, the EBITDA margin is 4.6% in FY22, far below JB Hi-Fi Australia at 11.0%.

Figure 14: JB Hi-Fi New Zealand forecasts (in NZD)

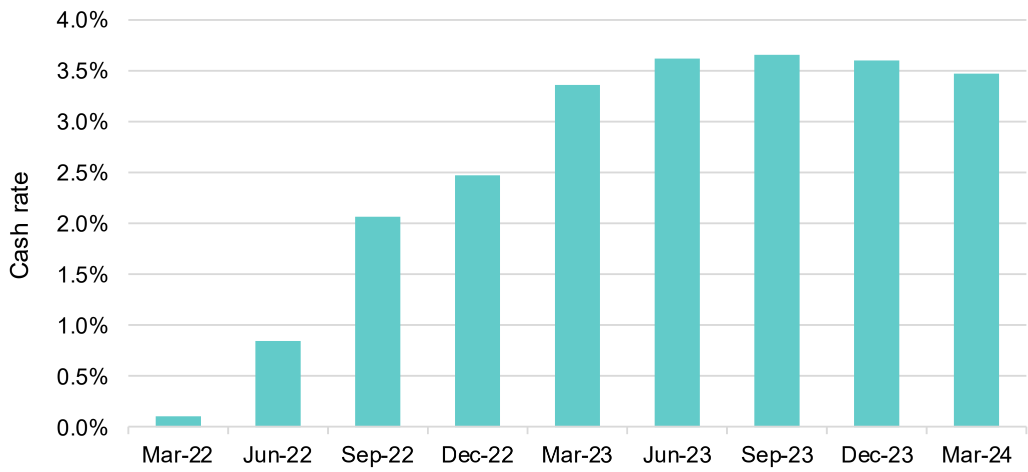
JB Hi-Fi New Zealand	FY18(a)	FY19(a)	FY20(a)	FY21(a)	FY22(a)	FY23(e)	FY24(e)
Stores (#)	15	14	14	14	14	15	17
Sales ($m)	213	221	211	244	246	252	291
Sales growth (%)	-1.1%	2.0%	-5.7%	17.4%	0.3%	6.5%	16.7%
Comp sales growth (%)	2.4%	8.2%	-5.7%	17.4%	0.3%	4.8%	1.0%
EBIT ($m)	-3	-2	-1	5	8	9	9
EBIT margin (%)	-1.3%	-0.8%	-0.7%	2.2%	3.4%	3.5%	3.1%

Source: Company reports, MST Marquee

Appendix

In deriving our valuation on JB Hi-Fi, we have taken a probability-based approach. We have reduced the probability of a recession from 33% back in June to 20% today. From a macro-economic perspective this is because expectations about the magnitude of interest rate increases have been pared back. Back in June this year, financial markets expected the cash rate to peak at 4.5% in June 2023. Now that peak is 3.5% by June 2023. This is still a very steep rise given household debt levels, but less likely to cause a recession in our view.

Figure 15: Financial market expectations of the Australian cash rate



Source: IRESS, MST Marquee

Investment case

JB Hi-Fi (JBH.AX)

Investment case

We have a Hold rating on JB Hi-Fi. While the company has a strong market position, we expect both sales and earnings to decline in calendar 2023. Given this is within a 12-month horizon, we are more cautious about the stock and expect more share price volatility. The company has some flexibility in its cost base to manage lower sales. However, profit margins will fall from peak levels seen in FY22. We do note that our near-term earnings forecasts are higher than consensus estimates given better near-term sales and higher gross margins. JB Hi-Fi also has a good dividend yield, modest PE and a net cash position. We see the fair value PE at 13x FY24e.

Valuation drivers

Our fundamental valuation is $47.52 per share. We use the blended average of a PE relative to the ASX Industrials, sum of the parts and DCF valuation to arrive at our valuation. Our downside case is $25.07 per share, which is FY24e EPS of 251 cents, at 10x PE. Our blended valuation is the weighted average of our base case (80%) and our downside case (20%).

Our target price is $43.80 per share, which is the 12-month roll forward of our blended valuation at a cost of equity of 9.2%, less the next 12 months of dividends.

The components of our valuation are:

- PE relative to the ASX Industrials, ex banks and REITs: JB Hi-Fi has historically traded at a PE discount of 30% to the Industrials. We apply a 50% discount to FY23e earnings which acknowledges less store growth potential, but higher margins than historically the case.
- Sum of the parts: We use a sum of the parts valuing its JB Hi-Fi Australia segment at a premium to global peers given its superior sales productivity and margins. We value The Good Guys and NZ with respect to local peers. Our fair value EV/EBIT is 8.6x FY23e.
- DCF valuation: We use an equity beta of 1.04, a WACC of 9.2% and terminal growth rate of 3.75%.

Risks to consider

- **Competition in its key markets** – JB Hi-Fi sells branded goods and often price competition is intense. This competition is likely to rise as more sales are made online where price comparisons are easy to make. Amazon is the key risk in the online segment, while Harvey Norman is the key risk in the bricks and mortar industry.
- **Price deflation** —JB Hi-Fi may be caught with higher levels of price discounting and deflation as inventory positions across the industry are mis-aligned. Excessive deflation can lead to lower overall revenue growth because the volume uplift is insufficient to offset the price decline.
- **Housing cycle** – JB Hi-Fi will experience some sales volatility associated with housing activity. Stronger house prices and housing churn could lead to stronger retail sales growth, particularly in The Good Guys.

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	NWS	HVN	MTS	OSH		EBO	MND		CSR		ORG
	OML	JBH	TWE	STO		FPH	RWC		FBU		
	REA	JIN	WOW	SXY		HLS			JHX		
	SEK	PBH	COL	VEA		RHC			ORA		
	SWM	SGR	EDV	WOR		RMD					
	TLS	SKC	ING	WPL		SHL					
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	UWL	TAH	TWE								
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		TPW			CGF	VRT		BVS			
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					HUM	REG		PPS			
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				RLT	LAW	BCAL	VRS	LVH	DGO		
				TBN	MAF	CDX		OLL	KSN		
				VEN	PNC	CYP		SEN	MGL		
					PYR	EMV			MIN		
					TWR.NZE	MDR			MKR		
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						OSP			VML		
						PAR			ABR		
						PXS					
						RAC					
						RCE					
						RHY					
						RSH					

Methodology & Disclosures

Target Price Methodology

Target Price	**$43.80**	**Methodology applied:** Base case valn (80% wtg). PE relative with -30% to ASX200 Industrials FY24e; EV/EBIT of 8.6x FY24e; DCF with beta 0.94, WACC 8.6% and terminal growth 3.75%. Downside case (20% wtg) $25.10 per share at 10x PE with 251c EPS. **Timeframe to achieve Target Price:** 12mths.
Rating	Hold	**Clarifying Terms & Comment:** see below.
Return (Target Price + Div Yield vs Benchmark)	4.1%	Benchmark is: 6.5% (Comprising 3.25% plus 12mth forward average dividend yield).
Key risks	Risk from reduced sales as economies reopen and consumers spend more on travel and leisure. May be caught with higher levels of price discounting and deflation as inventory positions across the industry are mis-aligned. Also faces risk of higher competition from online pure-play retailers like Amazon.	

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