Retailers and the JSE: explaining a success story

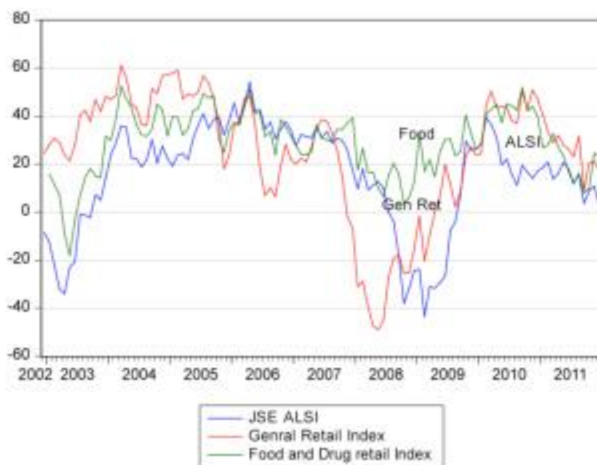
(from the Investec January 2012 Monthly View)

It seems clear that the retailers listed on the JSE are not expected to realise long term growth in earnings at anything like the rate at which earnings have been delivered over recent years. However they are no more demandingly valued today than they have been over the past 10 years. JSE retailers have provided excellent returns over the past year and they may well continue to do so.

Retailers listed on the JSE have provided exceptionally good rewards for their shareholders in recent years and 2011 proved no exception. The General Retail index of the JSE provided total returns (capital gains plus dividends) of the order of 18.6% in 2011 while the Food and Drug retailers returned as much as 26.8% last year. This is a highly satisfactory outcome especially when compared to the JSE All Share Index that returned 2.2% in 2011, dragged down by poor returns from resource companies, which account for about half the market.

In 2002 the JSE split listed retailers into a General Retail category and a separate index for Food and Drug Retailers. R100 invested in the JSE ALSI in January 2003 with dividends reinvested in the index would have grown to R445 by 31 December 2011. This is equivalent to an average annual return of 15.6% p. a. (calculated monthly since January 2003). R100 invested in the General Retail Index over the same period would have grown to a very impressive R893, providing an average annual return of 25.% p.a while investors in the Food and Drug retailers would have performed spectacularly well and seen their R100 investment grow to R1537 (with annual returns that averaged as much as 28.7%).

Retailers and the JSE: Total Annual Returns – calculated monthly

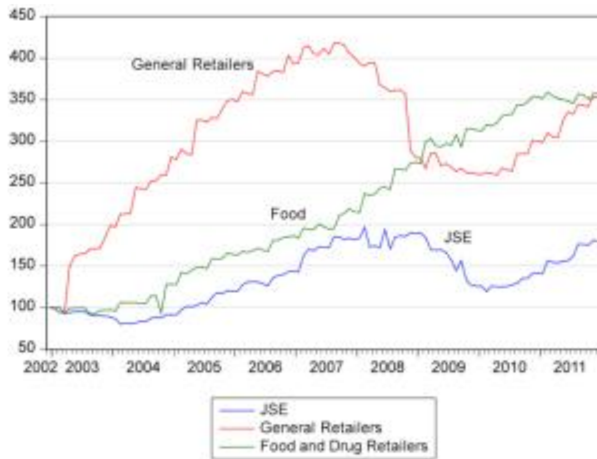


Source: I-Net Bridge and Investec Wealth & Investment

Consistently exceptional, market beating returns of the order of magnitude realised by JSE listed retailers can only occur when performance exceeds expectations. Very good economic performance in the form of earnings, dividends or cash flow growth and very high internal returns on shareholders' capital invested would, if these are expected, mean much higher initial values attached to the companies and so much lower realised returns even when performance is as good as expected. The market, when it expects good things to happen, sets the bar that much higher for the companies to clear, thus making it much harder for companies to surprise the market. Exceptional returns are realised when the share market plays catch up with surprisingly good reported economic results and when these are expected to be sustained. When this happens the bar in the form of share prices is then set ever higher, so providing shareholders with capital gains and high returns on their initial investments and more demanding expectations for management to meet.

The economic performance of the JSE listed retailers, measured by real (that is, adjusted for inflation) earnings per share has been truly exceptional over recent years, with the Food and Drug retailers outperforming their General counterparts by a very wide margin since 2008, as we show below. Since January 2003 the Food Retailers have consistently grown their real earnings per share at an annual average rate of over 15% p.a, while General Retailers have increased their real earnings at a close to 11% average annual rate, despite earnings set backs in the recession of 2009. The Food and Drug retailers rode through the recession of 2008-09 without losing earnings momentum. The JSE as a whole grew real earnings at a 6.6% annual rate since January 2003.

Real Index Earnings per share (January 2003=100)

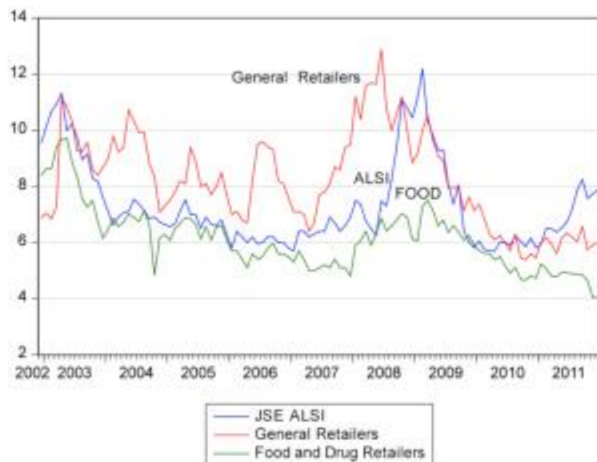


Source: I-Net Bridge and Investec Wealth & Investment

That the continued strength of the retail earnings momentum has came as a surprise to the market can be inferred from the ratings attached to the retailers. These ratings are implicit in the earnings yields of the retailers. The lower the earnings yield, the higher the price/earnings (PE) multiple or, implicitly, the faster earnings are expected to grow.

As may be seen in the chart below, the Food Retailers have consistently enjoyed a premium rating in the form of lower than the average earnings yield of the whole market. The premium rating for Food and Drug Retailers widened significantly when the recession took a large chunk out of average and general retail earnings, but left the food and drug retailers apparently unscathed. It may also be seen in the chart that the food retailers have benefitted from a lower earnings yield and higher price earnings multiple recently. This is due to the fact that Pick n Pay, a large contributor to the index, reported a decline in earnings in early October. The market is expecting a strong earnings recovery from Pick n Pay. The general retailers now also enjoy a more modest premium rating than they have had before.

Retailers and the JSE; Earnings Yield (earnings/prices)



Source: I-Net Bridge and Investec Wealth & Investment

It is possible to infer the earnings expected from the retail or any other sector of the JSE by making assumptions about the required returns of investors. These required returns are presumed to be reflected in the market prices of shares. If investors expect higher returns they bid up share prices and if returns are expected to disappoint they force share prices lower. At any moment in time share prices may therefore be regarded as in temporary equilibrium – high or low enough to reflect the returns required by investors. These required returns may be presumed to provide a return in excess of the returns currently provided by safe government bonds, the so-called equity risk premium. In the case of defensive food retailers this might be judged as 4% more than long dated government bond yields, while general retailers (which are more exposed to the risks of providing credit to their customers), suggest a higher risk premium and higher returns of about 5%.

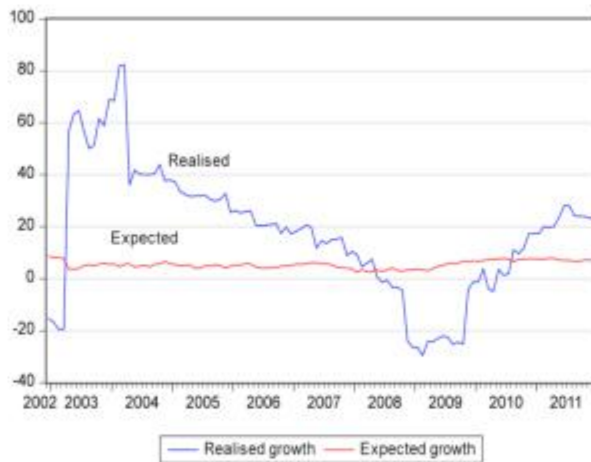
Given the logic that shares at any time are priced to provide a required risk adjusted return we can infer the long term growth in earnings expected by the market over the long run. This is equivalent to an internal rate of return calculation on an investment in real estate where the rate of return is approximately the sum of the initial rental yield plus the escalation in rentals. For example, if a building offered a first year yield of 10% with an agreed escalation of rentals for 5% p.a for 20 years, the expected internal rate of return on the property would be 15%. In the case of a share, the initial yield is the current earnings yield (trailing earnings /share price) and the growth in earnings expected is equivalent to the escalation clause in a typical rental contract with the realised sum of initial yield plus earnings growth making up an internal rate of return.

The permanent growth in earnings implied by current share prices and earnings yield and a presumed equity risk premium of 4% or 5% can be regarded as the difference between the 10 year RSA Bond Yield (currently 8.03 % *plus* the equity risk premium, 4% or 5% *less* the current earnings yield of 4.04% for Food Retailers or 5.99% for General Retailers). Thus the long term rate of growth in earnings per share implicitly expected of Food Retailers on 31 December was approximately 8% ((6.75%+4%-4.04%) = 8.04%).

For general retailers the implied growth in earnings expected was a less demanding 7.06%. In other words, were earnings to grow at this rate the the market would be correctly priced. If earnings grew faster than this, share prices could be expected to appreciate and if slower, to decline. It should be appreciated that the rate of inflation in SA implicit in long bond yields is about 6.5%. This analysis suggests that retail shares in SA are being valued with only 2% p.a real growth in earnings expected over the long run. As we show in the chart below, the actual growth in earnings realised has averaged much more than this. This is presumably why the retail shares have provided such outstanding returns. Investors have been surprised by unexpectedly strong realised growth in earnings.

As we show below the actual growth in retail earnings since 2003 has far exceeded the expected growth in earnings as per our calculation. Furthermore, these earnings expectations have not become markedly more demanding over the years. According to this metric the average growth rate in earnings expected of food retailers since 2003 has been 6.5% p.a, while general retailers have been expected to grow earnings at an average 5.4% a year. As we have indicated, actual growth rates have been on average much more rapid than expected growth rates - hence the extraordinarily good returns realised. The average growth rate in earnings per share since 2003 has been 18% p.a for the general retailers and 20% p.a. for the food retailers.

General Retailers: Expected and Realised Growth in Earnings



Source: I-Net Bridge and Investec Wealth & Investment

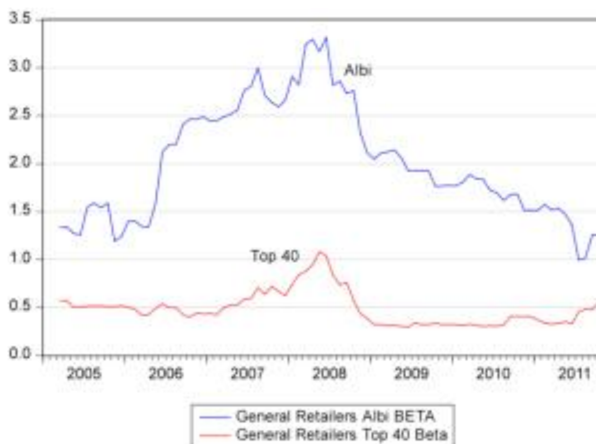
Food and Drug Retailers: Expected and Realised Growth in Earnings

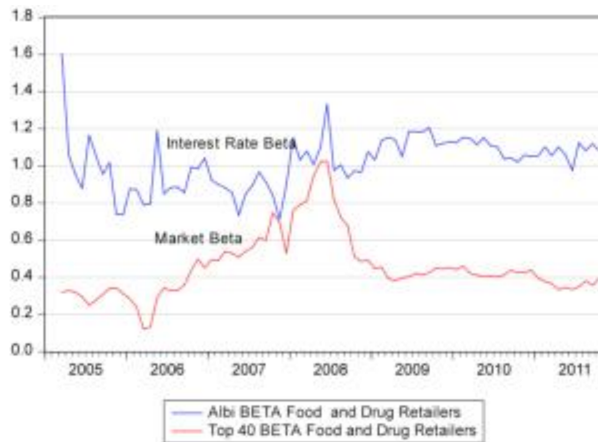
Source: I-Net Bridge and Investec Wealth & Investment

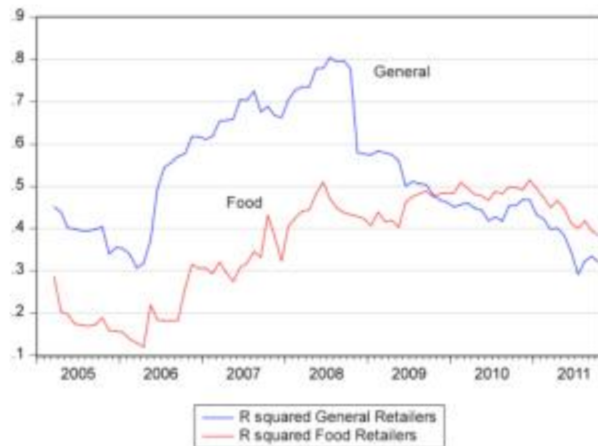
The equity and bond markets will, as always, have an impact on the valuations attached to retail shares in addition to earnings outcomes, relative to expectations. In fact it may be surprising to note that in the past, interest rates, as represented by the All Bond Index, have had a more powerful influence on returns realised by the General Retail Index than has the overall market, as represented by the Top 40 Index of the JSE.

We show the respective betas below. Beta is defined as the percentage influence up or down, on the returns realised by the General Retail or Food and Drug Index, of every one per cent move in the JSE Top 40 or All Bond Index. We present 36 month rolling betas to indicate the stability of these relationships. It should be noted that the impact of interest rate moves on General Retail Returns was at its most influential in 2008 as interest rates rose in SA before the global financial crisis to threaten growth in retail sales volumes and profitability. When measuring the impact of the share market and interest rates on retail shares we have removed the interest rate impact on the share market itself. This is so as not to double count the influence of interest rates on retail shares as well as the market itself.

General Retailers: Bond and Share Market Betas (Rolling 36 month estimates)







Source: I-Net Bridge and Investec Wealth & Investment

It seems clear that the retailers listed on the JSE are not expected to realise long term growth in earnings at anything like the rate at which earnings have been delivered over recent years. They are being valued with very modest growth rates in the market mind; in fact the indicated growth in earnings expected is less than the likely growth in nominal GDP. These undemanding earnings growth expectations, if exceeded, may well provide the basis for further excellent returns in the future, as they have in the past. Given the proven ability of JSE listed shares to increase their earnings and generate very high returns on capital invested in their enterprises, the biggest long term threat should be regarded as competition from new entrants into their markets rather than demanding share market valuations. In fundamental terms, as we have described them, JSE retailers are no more demandingly valued today than they have been over the past 10 years. JSE retailers have provided excellent returns over the past year and they may well continue to do so.