The Hangover

Stock investing would be so easy if only I knew what the cash flows would be in the future. Ultimately the efforts of even the smartest investors are centred on trying to estimate future cash flows and while most practitioners use recent business performance as the baseline for these estimates, one must tread very carefully here. The conditions facing businesses are prone to change, sometimes violent, unpredictable change. It is only the truly great investors who are best able to price the likelihood of deviations in business performance versus expectations. Anyone hoping to become a successful investor must be better than average in this respect.

With this in mind, the struggles of the UK pawn broking industry, recently covered by the *Financial Times*, is educational.

History of Returns	%	FY 2012	FY 2011	FY 2010	FY 2009	FY 2008	FY 2007	FY 2006	FY 2005	FY 2004	FY 2003	FY 2002
Return on Common Equity		20.7	23.3	25.9	22.3	20.5	21.2	22.4	22.7	22.0	21.8	20.7

A glance at the above history of returns would certainly not give any indication of impending doom. **Albermarle & Bond Holdings PLC** (ABM), one of the leaders in this field, has quite suddenly found itself in great difficulty, and *may* be heading for bankruptcy.

The current share price of 28p and market cap of just £15.5 million, is a long way down from the 400p and £220 million reached in 2011. In recent weeks the company has warned investors about weak business conditions and has had to obtain approval from its bankers to defer covenant tests after its largest shareholder failed to agree the terms of a new share issue designed to plug a hole in its finances. Surely the still fragile economic conditions, featuring persistently high unemployment and tight-fisted banks, should suit credit providers such as pawnbrokers? What has gone wrong?

It seems as though ABM's difficulties have been created by a classic confluence of challenges, the likes of which typically visit mediocre companies just when business starts to boom.

Firstly, ABM's debt levels doubled since 2010, as the company funded an expansion program. When demand is robust and profits strong, it is hard for any management team to resist the lure of expansion, particularly when many struggle to recognise that perhaps business success is due to fortuitous circumstance rather than managerial prowess. This debt is now proving debilitating for ABM as business conditions weaken.

Secondly, the recent weakness in the gold price has proved troublesome for the business model. Gold has fallen by almost 30% in value over the past year. This has two effects. Firstly transaction values decline, which pressures profits, particularly as rental expense and some labour cost is fixed. Secondly, the value of collateral held against loans has declined, potentially exposing the company to losses if the collateral is not redeemed.

Thirdly, and least surprising of all, is the role of competition. According to the National Pawnbrokers Association, there are currently over 2,100 pawnbrokers in the UK versus less than 600 in 2007. With ABM's returns on equity in excess of 20% in recent years, and no apparent barriers to entry, it should not come as a great surprise that the number of new competitors has spiralled. What's more, the rise of payday loan offerings, from companies such as Wonga.com, also treads on ABM's turf.

ABM's difficulties might be described as a perfect storm. I have never owned or even closely researched the stock so I can't say for sure if I might have anticipated some of these difficulties had the case been presented to me some years ago. However, let this vicarious experience be a lesson to all of us – mediocre businesses should be expected to enjoy favourable business conditions only temporarily. To value these businesses assuming anything else is folly.

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