

ARB Holdings Ltd  
FY 14 Results – Growth Despite the Odds

Share Code: ARH – Market Cap: R1.8bn – PE: 15.5x – DY: 3.8%

12m Target Price	836cps
Share Price	780cps
Implied Return	7%

Industrials | South Africa

**FY 14: In Line With Our Expectations**

- ARB Holdings reported their FY 14 results with revenue growing by 14% to R2,2bn (FY 13: R1,9bn) versus our forecasts of R2,3bn.
- The Group achieved better margins than we had expected due to both a rising contribution from the higher margin Lighting segment and from the Group driving purchasing savings across its business in H2:14, which saw HEPS rising nicely by 27% to 50.3cps (FY 13: 39.6cps) versus our expectation of 52.1cps.
- The Group remains highly cash generative and declared both a dividend of 20.1cps (FY 13: 16.2cps) and a special dividend of 10cps (FY 13: 10cps), yet remained ungeared (R197m net cash).
- While cognisant of the tough trading environment, management remain focussed on both organic growth and, potentially, adding the elusive “third pillar” (acquisition) to the Group.

**Our Thoughts: High Quality Group, High Quality Share**

- ARB has proven itself a remarkably high quality group in some very tough trading conditions as it successfully executes on its communicated strategies of expanding product lines, geographies and markets (both organically and acquisitively).
- While our valuation metrics indicate the share is fully valued, the “quality” quotient is a hard one to quantify and likely to prove very valuable for the long-term investor.

**Forecast, Valuation and Implied Return: Attractively Priced**

- Our fair value for ARH is 715cps on a PE of 14.2x (previously 622cps). Rolling this forward at our Cost of Equity (CoE), we arrive at a 12m TP of 836cps (previous 12m TP: 727cps) on an Exit PE of 14.7x implying a total return of c.7%.
- The key risks stated in this report remain the same from our [Initiation of Coverage](#) on the Group. Also note the newly added risk relating to the phasing out of incandescent lamps in South Africa and the uncertainty it creates in the Lighting segment.

Share Price against the ALSI



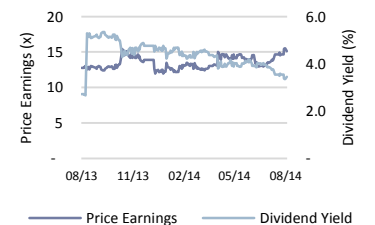
Sources: Bloomberg, Blue Gem Research

Share Price against the Relevant Index



Sources: Bloomberg, Blue Gem Research

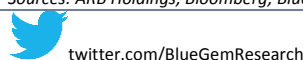
Price Earnings (x) and Dividend Yield (%)



Sources: Bloomberg, Blue Gem Research

Key Forecast (R m)	FY 12A	FY 13A	YoY %	FY 14A	YoY %	FY 15E	YoY %	FY 16E	YoY %
Revenue	1565	1945	24%	2217	14%	2552	15%	2787	9%
EBITDA	133	167	26%	210	26%	241	13%	262	8%
HEPS (cps)	34.2cps	39.5cps	15%	50.3cps	27%	56.8cps	13%	61.9cps	9%
Return on Equity (%)	14.5%	15.4%	-	17.3%	-	17.7%	-	17.4%	-
Price Earnings Ratio (x)	22.8x	19.7x	-	15.5x	-	13.7x	-	12.6x	-
DPS (cps)	13.7cps	26.2cps*	>100%	30.0cps*	15%	22.7cps	-24%	24.7cps	9%
Dividend Yield (%)	1.8%	3.4%	-	3.8%	-	2.9%	-	3.2%	-

Sources: ARB Holdings, Bloomberg, Blue Gem Research; \* FY 13 and FY 14's total distributions include a special dividend of 10cps



Keith McLachlan\*



BLUE GEM RESEARCH

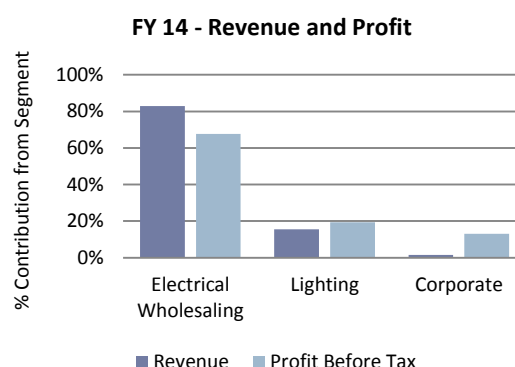
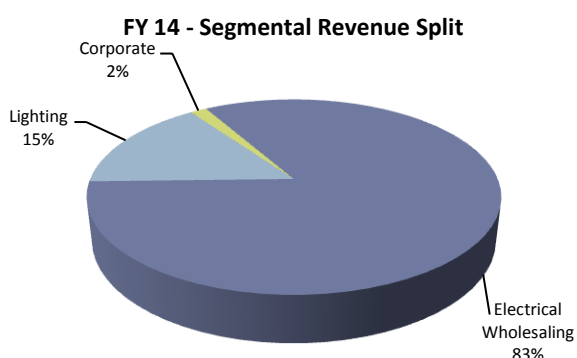
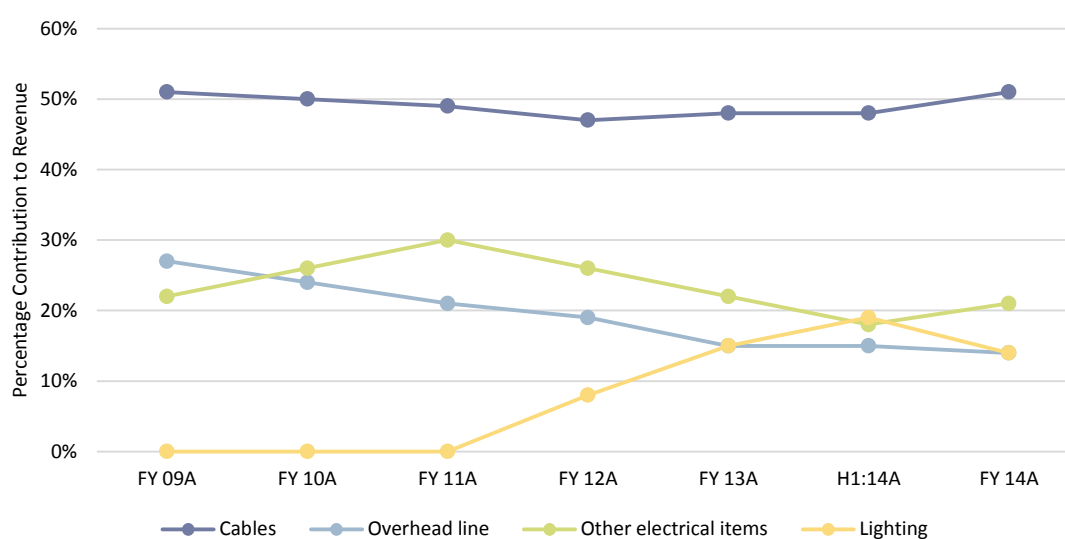
Key Forecast (R m)	FY 12A	FY 13A	YoY %	H1:14A	FY 14A	YoY %	FY 15E	YoY %	FY 16E	YoY %
<b>Revenue</b>	<b>1565</b>	<b>1945</b>	<b>24%</b>	<b>1154</b>	<b>2217</b>	<b>14%</b>	<b>2552</b>	<b>15%</b>	<b>2787</b>	<b>9%</b>
Electrical Wholesaling	1449	1679	16%	985	1876	12%	2157	15%	2330	8%
Lighting	120	281	135%	174	351	25%	403	15%	464	15%
<b>Gross Profit</b>	<b>307</b>	<b>425</b>	<b>38%</b>	<b>250</b>	<b>527</b>	<b>24%</b>	<b>575</b>	<b>9%</b>	<b>619</b>	<b>8%</b>
<i>Gross Profit Margin (%)</i>	19.6%	21.9%	-	21.6%	23.8%	-	22.5%	-	22.2%	-
Operating expenses	-186	-270	45%	-151	-329	22%	-352	7%	-376	7%
<b>EBITDA</b>	<b>133</b>	<b>167</b>	<b>26%</b>	<b>104</b>	<b>214</b>	<b>28%</b>	<b>241</b>	<b>13%</b>	<b>262</b>	<b>8%</b>
<i>EBITDA Margin (%)</i>	8.5%	8.6%	-	9.0%	9.7%	-	9.5%	-	9.4%	-
Operating Profit/(Loss) Before Interest	128	160	26%	100	203	27%	229	13%	248	8%
Interest Received	18	10	-42%	6	11	10%	12	5%	14	19%
Finance Charges	-1	-1	37%	-0	-0	-80%	-	-100%	-	-
<b>Net Profit (Parents)</b>	<b>81</b>	<b>95</b>	<b>18%</b>	<b>59</b>	<b>118</b>	<b>24%</b>	<b>133</b>	<b>13%</b>	<b>145</b>	<b>9%</b>
Weighted Ave. Number of Shares (millions)	235.0	235.0	0%	235.0	235.0	0%	235.0	0%	235.0	0%
<b>EPS (cps)</b>	<b>34.3</b>	<b>40.5</b>	<b>18%</b>	<b>24.9</b>	<b>50.3</b>	<b>24%</b>	<b>56.8</b>	<b>13%</b>	<b>61.9</b>	<b>9%</b>
<b>HEPS (cps)</b>	<b>34.2</b>	<b>39.5</b>	<b>15%</b>	<b>24.9</b>	<b>50.3</b>	<b>27%</b>	<b>56.8</b>	<b>13%</b>	<b>61.9</b>	<b>9%</b>
Gross Ordinary DPS (cps)	14	26	>100%	-	30	15%	23	-24%	25	9%
<i>Dividend Yield (%)</i>	1.8%	3.4%	-	3.4%	3.8%	-	2.9%	-	3.2%	-
Dividend Cover (x)	2.5	1.5	-40%	-	1.7	11%	2.5	49%	2.5	0%
Property, Plant & Equipment	163	194	19%	205	206	6%	230	12%	251	9%
Intangible Assets	78	84	8%	84	84	-1%	84	0%	84	0%
Current Assets	737	857	16%	814	931	9%	1071	15%	1206	13%
Net Cash	179	203	13%	120	198	-3%	267	35%	349	31%
Cash	185	203	9%	120	198	-3%	267	35%	349	31%
Overdraft	-6	-	-	-	-	-	-	-	-	-
Interest-bearing Liabilities	-	-	-	-	-	-	-	-	-	-
Shareholder's Equity (Parent)	582	656	13%	653	712	9%	792	11%	880	11%
Non-current Liabilities	41	38	-8%	36	35	-9%	39	11%	42	9%
Current Liabilities	210	279	33%	245	287	3%	328	15%	352	7%
NAV per share (cps)	247.8	279.2	13%	277.9	303.1	9%	337.2	11%	374.3	11%
TNAV per share (cps)	214.4	252.4	18%	250.9	275.9	9%	301.5	9%	338.6	12%
Cash Generated by Operations	95	197	107%	23	144	-27%	224	56%	246	10%
Cash Conversion Ratio (%)	72%	118%	-	22%	67%	-	93%	-	94%	-
Net Cash Flow from Financing Activities	-112	-79	-29%	-17	-25	-69%	-37	50%	-35	-5%
Net Increase / (Decrease) in Cash	-7	-16	120%	-1	-2	-86%	3	-221%	2	-12%
<i>Return on Equity (%)</i>	14.5%	15.4%	-	17.3%	17.3%	-	17.7%	-	17.4%	-
<i>Return on Capital Employed (%)</i>	11.6%	12.9%	-	16.0%	14.9%	-	14.8%	-	14.3%	-
<i>Return on Assets (%)</i>	10.3%	10.8%	-	13.8%	12.5%	-	12.4%	-	12.1%	-
Price Earnings Ratio (%)	22.8	19.7	-	17.0	15.5	-	13.7	-	12.6	-
Price-to-Book (x)	3.1	2.8	-	2.8	2.6	-	2.3	-	2.1	-
Price-to-Tangible-Book (x)	3.6	3.1	-	3.1	2.8	-	2.6	-	2.3	-
Current Ratio	3.5	3.1	-	3.3	3.2	-	3.3	-	3.4	-
Quick Ratio	2.3	1.8	-	1.7	1.9	-	1.9	-	2.1	-

Sources: ARB Holdings, Bloomberg, Blue Gem Research workings, assumptions and forecasts

## FY 14 Results Highlights

- ARB Holdings reported their FY 14 results with the following key attributes:
  - Revenue grew by 14% to R2,2bn (FY 13: R1,9bn).
  - While the revenue growth was just shy of our forecasts of R2,3bn, the Group achieved better margins than we had expected due to both a rising contribution from the higher margin Lighting segment (Figure 1) and from the Group driving purchasing savings across its business in H2:14 (the latter are benefits of an enlarge group creating purchasing power).
  - This resulted in HEPS rising nicely by 27% to 50.3cps (FY 13: 39.6cps) versus our expectation of 52.1cps.
  - The Group remains highly cash generative and declared both a dividend of 20.1cps (FY 13: 16.2cps) and a special dividend of 10cps (FY 13: 10cps).

Figure 1: Expansion of ARB Holdings’ Product Range



Sources: Various ARB Holdings’ presentations, Blue Gem Research workings

- The Group’s retail, cash and export sales performed well, while the mining, industrial and government markets disappointed as labour unrest/strikes and post-election slumps negatively impacted volumes.
- Overall, management remain cognisant of the tough trading environment the business is operating in, but they emphasise their continued focus on organic growth (via product, geography and market expansion) while actively pursuing acquisitions to build the elusive “third pillar” of the Group.

## Electrical Division segment

**Table 1: Electrical Division – Key Revenue History and Forecasts**

Key Forecasts (R m)	FY 09A	FY 10A	FY 11A	FY 12A	FY 13A	FY 14A	FY 15E	FY 16E
Revenue	1 209	1 088	1 258	1 449	1 679	1 876	2 157	2 330
Change in Revenue	-	-10%	16%	15%	16%	12%	15%	8%

Sources: Bloomberg, Blue Gem Research and ARB Holdings

- The Electrical Division segment experienced a poor Q4:14 due to the combination of a post-election public sector slow-down and the continuing knock-on effects of labour unrest and strikes in the mining, industrial and related sectors of South Africa.
- Despite this context, the segment grew revenues 12% and delivered an impressive 37% rise in operating profit largely driven by procurement and trading efficiencies being leveraged across the enlarged business (predominantly coming through in H2:14 and likely quite sustainable).
- ICS was rebranded and absorbed into the Group, Elektro Vroomen continues to improve and turned profitable during H2:14, and the Group's exclusive agencies (ACCC, CHINT and Copperweld) continue to gain traction in the local (and some cases, African) market(s).
- The softness experienced in Q4:14 has somewhat continued into early FY 15E, but we expect the backlog within the industrial and mining markets to create a small volume spike during FY 15E as it plays catch up off FY 14's low base. Hence, we have raised our FY 15E revenue expectation from 10% to 15%. This creates a high-base for FY 16E and therefore we see this year only growing by c.8%.

## Lighting segment

**Table 2: Lighting – Key Revenue History and Forecasts**

Key Forecasts (R m)	FY 09A*	FY 10A*	FY 11A*	FY 12A*	FY 13A	FY 14A	FY 15E	FY 16E
Revenue	-	-	-	120	281	351	403	464
Change in Revenue	-	-	-	>100%	135%	25%	15%	15%

Sources: Bloomberg, Blue Gem Research and ARB Holdings

\* Eurolux was acquired in January 2012, therefore there was no contribution before then, 6 months contribution in FY 12 and a full 12 months contribution in FY 13.

- The Lighting segment beat our expectation as it continued to roll-out across Cashbuild stores and expanded its product range driving revenue growth of 25% and operating profit growth of 30%.
- Adding to this base, the segment has signed another large customer, added hazardous and warning lighting and magnetic ballasts to its product range and continues to aggressively pursue more of both new customers and new products.
- Note that the phasing out of incandescent lamps is likely to impact the segment's performance during the next year or two, but the quantum of the effect is hard to judge (a "known unknown"). On the one hand, the incandescent lamps are high volume due to faster replacement cycles than their replacement products, but they are also lower margin on an individual product level. We have assumed a net nil effect in our model going forward, though this could well be proven wrong.

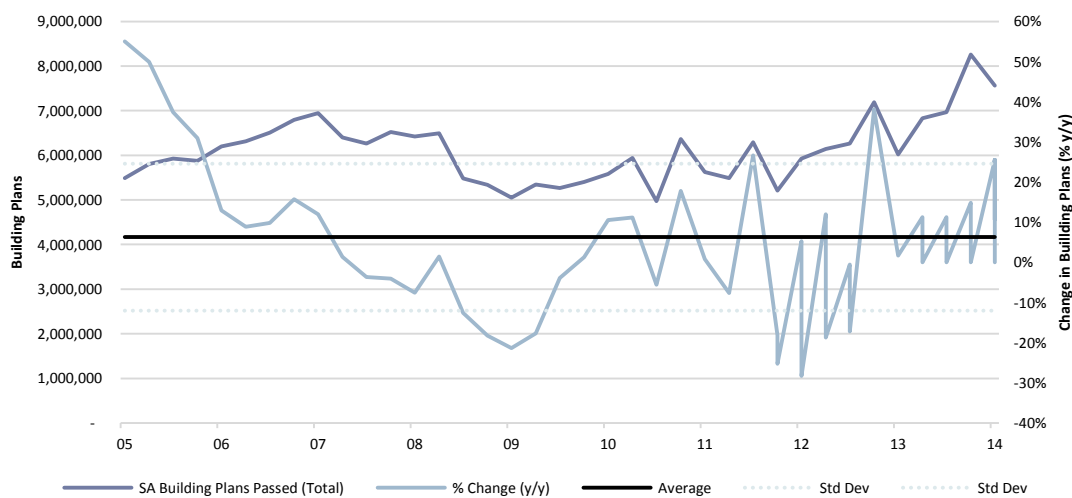
## Group services segment

- **Strategic acquisitions:** The Group made no acquisition during FY 14, focussing rather on bedding down the acquisitions made in previous years. Management continue to actively seek out acquisitions and, in our opinion, there will likely be some activity on this front during the FY 15/16E period.
- **IT software (Xact ERP Solution):** XACT II saw no roll-out during this period, thus seeing implementation revenue fall away. Other than that, the ICT revenue at Group-level was in line with expectations.
- **Property:** The property segment operated in line with expectations and was valued at R163m.

## Construction, Building Materials & Electrical Wholesaling Industries

- In essence, the building materials and related cabling industries remain in limbo where the slow roll-out of public sector infrastructure projects and Eskom spending softness (likely due to funding difficulties and, perhaps, a management change) have seen growth as flat to non-existent. The domestic mining sector slowdown during the abnormally long and violent strike season has further negatively impacted on this picture.
- Despite this, we do note some activity picking up in the residential sector (anecdotal evidence from other businesses we interact with in this market) and expect both Transet and Eskom spend to gain momentum in CY 15 given the spending cycles these respective institutions find themselves in. Furthermore, the mining sector’s labour disruptions have largely passed and spending in this sector should normalize going forward.
- Building plans remain volatile, though arguable with a positive trend (Figure 2).

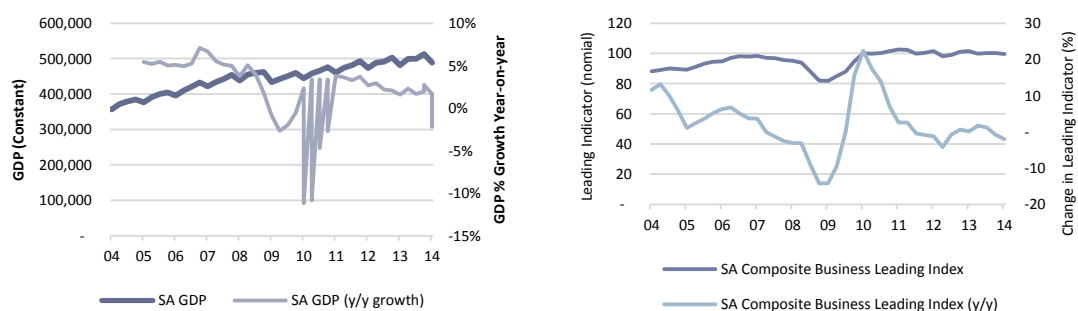
Figure 2: Building Plans Passed, Growth in Building Plans and Various Statistics



Sources: Bloomberg, Blue Gem Research workings

- South Africa’s GDP remains soft and, indeed, slipped in negative territory in Q1:14 (Figure 3). It is no surprise therefore that the country’s Leading Indicator has softened and its trend moved into negative territory.
- This is probably a direct impact of the labour unrest and strikes experienced in the mining, upstream mining supply industries and broader heavy and light industries impacting on volumes across the broader economy. This is compounded by the weak local consumer.

Figure 3: South African GDP (Historical and Forecast) and South African Leading Indicator



Sources: Economist Consensus (Bloomberg), Bloomberg, Blue Gem Research workings

- Overall, we see continued pressure across these industries and markets in the short-term, the result of continued labour unrest knock-on effects, soft consumer demand and stagnant economic growth.
- Despite this, we do believe that the broader construction and infrastructure market is likely to correct to more normalized levels in the medium-term as the pent-up infrastructural demand comes to market, mining and industrial activity resume at normalized levels and the general South African economy stabilises and begins to grow again at more historically normal rates.
- Refer to our [Initiation of Coverage](#) for further information regarding our view of this market.

## Forecasts

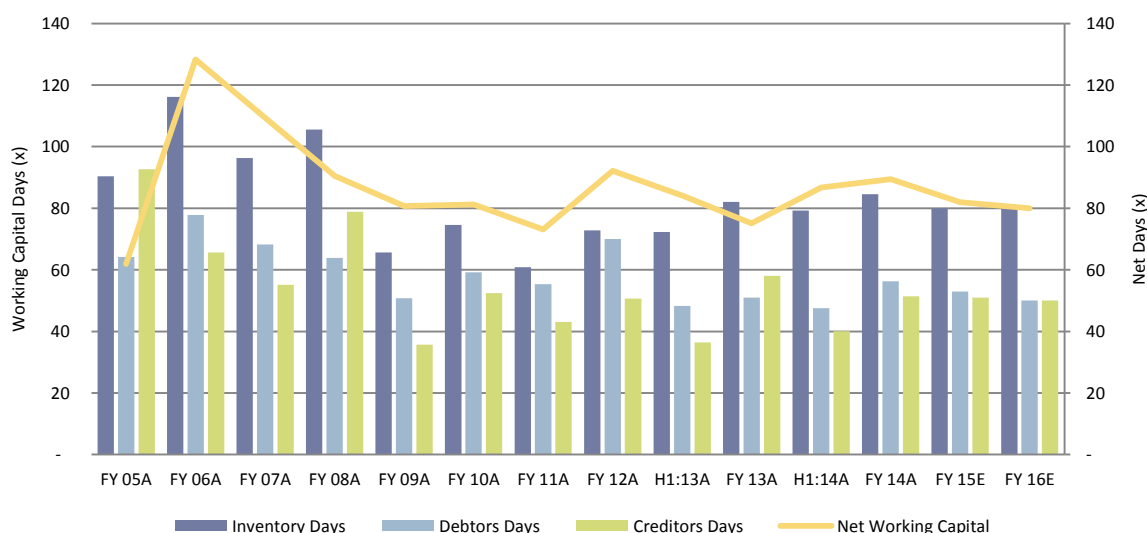
### Revenues and profitability

- We have raised ARB’s Lighting segment’s forecast revenue from 10% to 15% on growing volumes through existing and new customers coupled with product range expansion see this business performing well.
- We have also adjusted the Electrical Wholesaling segment’s FY 15E growth rate from 10% to 15%, while softening it in FY 16E (due to the Base Effect).
- Overall, these major changes and a number of other minor ones see our FY 15E HEPS coming in at 56.8cps (previous forecast: 59.9cps) and FY 16E HEPS growing to 61.9cps.
- Note that these forecasts assume no acquisitions being made during the period.

### Liquidity, solvency and assets

- The Group continues to manage its working capital excellently with key ratios and days remains relatively stable during the period (Figure 5).

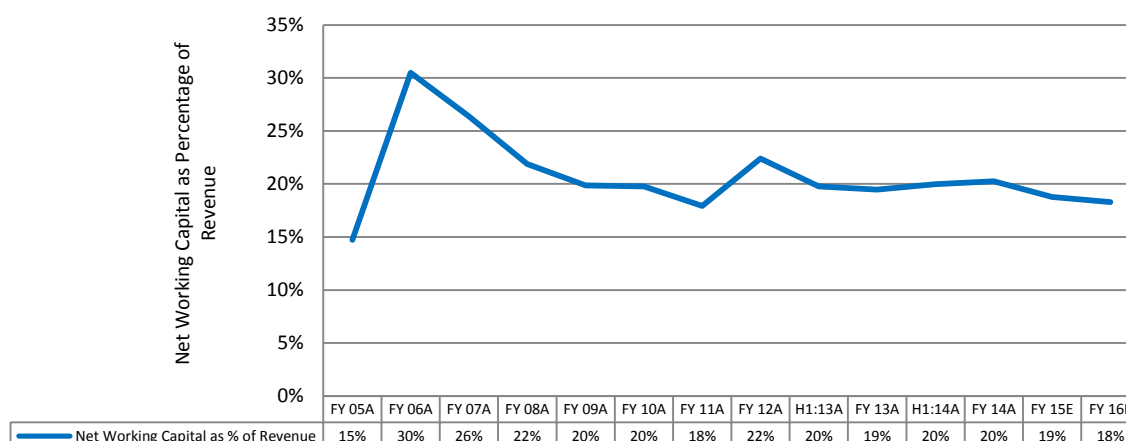
Figure 5: Working Capital History of ARB Holdings



Sources: ARB Holdings, Blue Gem Research workings

- Viewed slightly different, the Group’s investment into its net working capital has remained relatively stable versus its revenue (Figure 6). Further, we do not expect any major change to this relationship.

**Figure 6: Net Working Capital as Percentage of Revenue**



Sources: ARB Holdings, Blue Gem Research workings

## Valuation and 12m TP

### Valuation Models

- A key consideration in all of our valuation models of ARB Holdings is that we do not value the property portfolio on the Group’s balance sheet separately. This remains unchanged from our [Initiation of Coverage](#).

### Discounted Free Cash Flow (DCF) Model

- Our DCF core assumptions remain unchanged, except for the following minor changes:
- Cost of Equity (CoE) of 16.8% based off a “Rule of Thumb” beta of 1.4x and an Equity Risk Premium of 5.5%.
- Real growth rates of the following:
  - FY 15E to FY 16E: per our forecasts in this report.
  - FY 17E to FY 23E: 15% y/y
  - FY 23E/Terminal Year: 3.5% y/y
- Finally, we take out an effective minority interest of c.30% from the Group (attributable to Eurolux and the outside shareholders in ARB Electrical Wholesalers).

**Table 5: DCF Model – ARB Holdings**

	FY 15E	FY 16E	FY 17E	FY 18E	FY 19E	FY 20E	FY 21E	FY 22E	FY 23E	Terminal year
EBITDA	241	262	314	377	453	543	652	782	939	1018
Less: Tax	-67	-73	-88	-106	-127	-152	-183	-219	-263	-285
Less: Working Capital	-29	-30	-36	-43	-52	-62	-74	-89	-107	-116
Less: Capex	-20	-25	-30	-36	-43	-52	-62	-75	-90	-49
Free Cash Flow (FCF)	125	134	160	192	231	277	332	399	479	568
Discounted FCF	107	98	101	103	106	109	112	115	118	1234
NPV (Enterprise Value)										2204
Add: Net Cash										198
Fair Value, inc. Minorities (R m)										2402
<b>Fair Value, ex. Minorities (R m)</b>										<b>1681</b>
<b>Fair Value of ARB shares (cps)</b>										<b>715cps</b>
Implied Price Earnings (x)										14.2x
Discount to Fair Value (%)										-8%
<b>12m TP (cps)</b>										<b>836cps</b>
Exit Price Earnings (x)										14.7x
Implied Return (%)										7%

Sources: ARB Holdings, Bloomberg, Blue Gem Research workings and assumptions

- We arrive at a fair value of 715cps (previously: 622cps) on an implied Price Earnings (PE) of 14.2x. Rolling this forward at our CoE, this fair value implies a 12m TP of 836cps (previous 12m TP: 727cps) on an Exit PE of 14.7x.

### Dividend Discount (DD) Model

- Other than those indicated in the DCF model above, our DD model remains unchanged (Table 6):

Table 6: DCF Model – ARB Holdings

	FY 14A	FY 15E	FY 16E	FY 17E	FY 18E	FY 19E	FY 20E	FY 21E	FY 22E	FY 23E	Terminal year
HEPS (cps)	50.3	57.0	61.8	71.1	81.8	94.0	108.1	124.4	143.0	164.5	148.0
Dividend Cover (x)	2.5x	2.5x	2.5x	2.5x	2.5x	2.5x	2.5x	2.5x	2.5x	2.5x	1.0x
DPS (cps)	30.1	22.8	24.7	28.4	32.7	37.6	43.3	49.7	57.2	65.8	148.0
DWT (15%)	-4.5	-3.4	-3.7	-4.3	-4.9	-5.6	-6.5	-7.5	-8.6	-9.9	-22.2
Net DPS (cps)	26	19	21	24	28	32	37	42	49	56	126
Discount Factor	1.00	0.86	0.73	0.63	0.54	0.46	0.39	0.34	0.29	0.25	0.29
Discounts DPS (cps)	25.6	16.6	15.4	15.2	14.9	14.7	14.5	14.3	14.0	13.8	438.5
<b>Fair Value (cps)</b>											<b>598cps</b>
<b>Implied PE Ratio (x)</b>											<b>11.9x</b>

Sources: ARB Holdings, Bloomberg, Blue Gem Research workings and assumptions

### Price Earnings (PE) Model

- The Group’s PE re-rating appears to be stabilising (Figure 7).
- Given this re-rating, we would *not* consider the mean and standard deviations of the stock to be all that insightful (i.e. they are likely too low). Rather we would consider the fact that the stock trades on an historical PE of 15.5x with a forecast growth rate of c.13% (i.e. a PEG ratio of c.1.1x) as a better indication of the appropriateness of this market multiple.

Figure 7: ARB Holdings Price Earnings Historical Discount versus the Electrical and Electrical Components Index



Sources: Bloomberg, Blue Gem Research workings

### Valuation, 12m TP and Implied Return

- We reiterate our preferred valuation methodology as the DCF, therefore implying that our fair value for ARH is 715cps (previously: 622cps) on a PE of 14.2x. Rolling this forward at our CoE, we arrive at a 12m TP of 836cps (previous 12m TP: 727cps) on an Exit PE of 14.7x implying a return of 7% from the current levels.



### **Key risks to our valuation**

- The major macro-economic variables in South Africa (specifically, GDP growth, construction and building sectors, labour environment, amongst other variables),
- The timing and successful implementation of ARB's product, store and market expansion drive (including any potential future acquisitions, which we have *not* forecast), and
- Finally, the phasing out of incandescent lamps in South Africa and the effect of this on the Group's Lighting segment could be an upside, downside or neutral event (we have chosen "neutral", therefore anything other than this implies a risk to our valuation of the Group).

**Disclaimer**

**Confused by this report? View our [methodology](#), [FAQ](#) and [this disclaimer](#).**

*\* Market prices in this report predominantly set to closing prices reported on 25 and 26 August 2014.*

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ARB Holdings Ltd	B, C
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