

Results Note
5 September 2016

ARB Holdings Ltd
FY 16 Results – Another Good Year

Share Code: ARH – Market Cap: R1.4bn – PE: 10.0x – DY: 3.8%

12m Target Price	762cps
Share Price	600cps
Implied Return	27%

Industrials | [South Africa](#)

FY 16 – Performance Exceeded Our Expectations

- ARB Holding’s revenue grew by 16% to R2.49bn (FY 15: R2.15bn) while Gross Profit (GP) Margin compression in the Electrical Division from 24.1% in FY 15 to 22.0% was offset by Group efficiencies and led the Group to beat our HEPS expectation of 53.6cps by 11% to reach 59.7cps (FY 15: 51.7cps).
- This reflected 15% y/y HEPS growth and was matched by an equal hike in the dividends to 23.1cps (FY 15: 20.1cps).
- Another 10cps special dividend (FY 15: 10cps) was declared with further special dividends likely in the coming year or two.

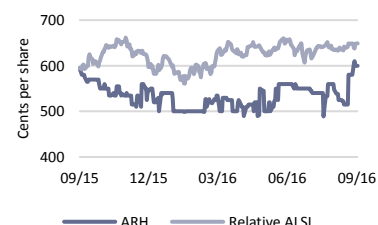
Our Thoughts: Tough Trading Environment Unlikely to Abate

- We have marginally raised our expected FY 17E revenues for ARB Holdings to R2.8bn (previous forecast: R2.7bn).
- Despite this, we have lowered previously noted margin assumptions and see this margin squeeze continuing into at least FY 18E.
- Therefore we forecast FY 17E HEPS growth of 10% to 65.4cpscps (previously forecast: 64.9cps), though we note the high degree of forecast risk in the present economic environment (both to the downside due to the economy and the upside due to management initiatives and the potential for acquisitive activity).

Forecast, Valuation & Implied Return: Attractive Upside Potential

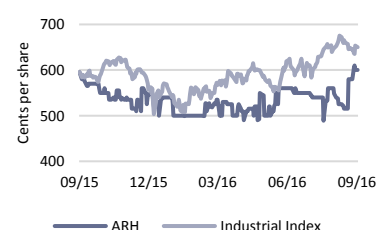
- We raise our fair value for ARH to 650ps (previously: 520cps) on an implied Price Earnings (PE) of 10.9x, which appears unreasonable against either ARH’s own history or the various comparatives in the market.
- Rolling our fair value forward at our CoE we arrive at a 12m TP of 762cps (previous 12m TP: 609cps), on a comfortable Exit PE of 11.6x, implying a 27% return.
- Key risks to the Group are unchanged from our original [Initiation of Coverage](#).

Share Price against the ALSI



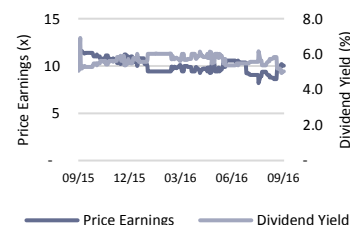
Sources: Bloomberg, Blue Gem Research

Share Price against the Industrial Index



Sources: Bloomberg, Blue Gem Research

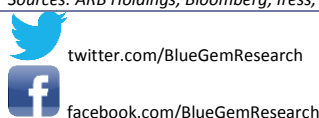
Price Earnings (x) and Dividend Yield (%)



Sources: Bloomberg, Blue Gem Research

Key Forecast (R m)	FY 14A	YoY %	FY 15A	YoY %	FY 16A	YoY %	FY 17E	YoY %	FY 18E	YoY %
Revenue	2217	14%	2151	-3%	2490	16%	2780	12%	3101	12%
EBITDA	215	28%	208	-3%	228	10%	271	19%	324	20%
HEPS (cps)	50.3	27%	51.7	3%	59.7	16%	65.4	10%	78.4	20%
Return on Equity (%)	17.3%	-	16.7%	-	17.2%	-	17.6%	-	18.9%	-
Price Earnings Ratio (x)	11.9x	-	11.6x	-	10.0x	-	9.2x	-	7.7x	-
DPS (cps)	30.0	15%	30.0	0%	33.9	13%	26.2	-23%	31.4	20%
Dividend Yield (%)	5.0%	-	5.0%	-	5.6%	-	4.4%	-	5.2%	-

Sources: ARB Holdings, Bloomberg, Iress, Blue Gem Research; * FY 13, 14 and 15’s total distributions include a special dividend of 10cps



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BLUE GEM RESEARCH

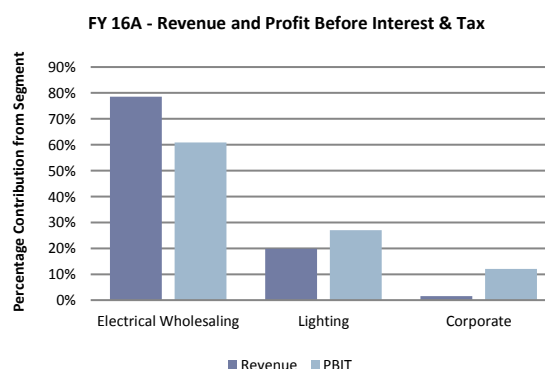
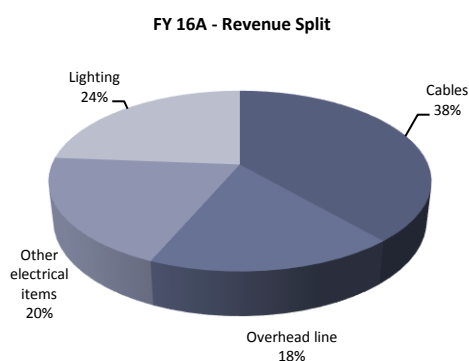
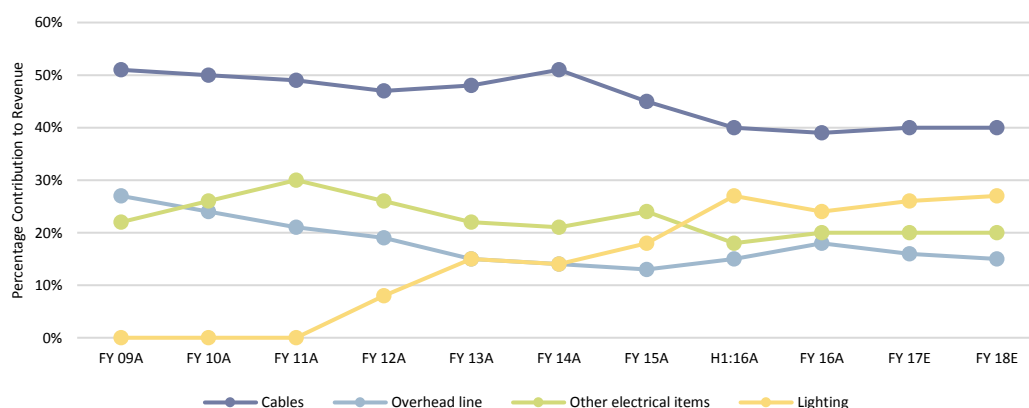
Key Forecast (R m)	FY 14A	YoY %	FY 15A	YoY %	FY 16A	YoY %	FY 17E	YoY %	FY 18E	YoY %
Revenue	2217	14%	2151	-3%	2490	16%	2780	12%	3101	12%
Electrical Wholesaling	1876	12%	1741	-7%	2006	15%	2207	10%	2427	10%
Lighting	351	25%	425	21%	507	19%	598	18%	700	17%
Gross Profit	527	24%	517	-2%	548	6%	620	13%	704	14%
<i>Gross Profit Margin (%)</i>	23.8%	-	24.1%	-	22.0%	-	22.3%	-	22.7%	-
Operating expenses	-329	22%	-325	-1%	-338	4%	-368	9%	-401	9%
EBITDA	215	28%	208	-3%	228	10%	271	19%	324	20%
<i>EBITDA Margin (%)</i>	9.7%	-	9.7%	-	9.2%	-	9.7%	-	10.4%	-
Operating Profit/(Loss) Before Interest	203	27%	197	-3%	217	10%	258	19%	310	20%
Interest Received	11	10%	15	32%	12	-21%	12	2%	14	15%
Finance Charges	-0	-80%	-	-100%	-	0%	-	0%	-	0%
Net Profit (Parents)	118	24%	122	3%	136	12%	154	13%	184	20%
Weighted Ave. Number of Shares (millions)	235.0	0%	235.0	0%	235.0	0%	235.0	0%	235.0	0%
EPS (cps)	50.3	24%	51.7	3%	57.7	12%	65.4	13%	78.4	20%
HEPS (cps)	50.3	27%	51.7	3%	59.7	16%	65.4	10%	78.4	20%
Gross Ordinary DPS (cps)	30	15%	30	0%	34	13%	26	-23%	31	20%
<i>Dividend Yield (%)</i>	5.0%	-	5.0%	-	5.6%	-	4.4%	-	5.2%	-
Dividend Cover (x)	1.7x	11%	1.7x	3%	1.8x	2%	2.5x	42%	2.5x	0%
Property, Plant & Equipment	206	6%	222	8%	226	2%	250	11%	279	12%
Intangible Assets	84	-1%	84	0%	78	-7%	78	0%	78	0%
Current Assets	931	9%	967	4%	1122	16%	1264	13%	1440	14%
Net Cash	198	-3%	227	15%	243	7%	279	15%	338	21%
Cash	198	-3%	227	15%	243	7%	279	15%	338	21%
Overdraft	-	-	-	-	-	-	-	-	-	-
Interest-bearing Liabilities	-	-	-	-	-	-	-	-	-	-
Shareholder's Equity (Parent)	712	9%	769	8%	825	7%	917	11%	1028	12%
Non-current Liabilities	107	181%	115	8%	126	10%	130	3%	139	7%
Current Liabilities	287	3%	255	-11%	320	26%	350	9%	387	11%
NAV per share (cps)	296.6	6%	322.5	9%	351.1	9%	390.4	11%	437.4	12%
TNAV per share (cps)	264.7	5%	292.8	11%	322.0	10%	357.2	11%	404.2	13%
Cash Generated by Operations	144	-27%	170	19%	168	-1%	206	23%	258	25%
<i>Cash Conversion Ratio (%)</i>	67%	-	82%	-	74%	-	76%	-	80%	-
Net Cash Flow from Financing Activities	-25	-69%	-14	-44%	-10	-26%	-36	252%	-43	18%
Net Increase / (Decrease) in Cash	-2	-86%	-0	-99%	-7	40394%	-9	17%	-6	-33%
<i>Return on Equity (%)</i>	17.3%	-	16.7%	-	17.2%	-	17.6%	-	18.9%	-
<i>Return on Capital Employed (%)</i>	14.9%	-	13.4%	-	14.7%	-	15.4%	-	16.2%	-
<i>Return on Assets (%)</i>	12.5%	-	12.0%	-	11.2%	-	12.2%	-	12.9%	-
Price Earnings Ratio (x)	11.9x	-	11.6x	-	10.0x	-	9.2x	-	7.7x	-
Price-to-Book (x)	2.0x	-	1.9x	-	1.7x	-	1.5x	-	1.4x	-
Price-to-Tangible-Book (x)	2.3x	-	2.0x	-	1.9x	-	1.7x	-	1.5x	-
Current Ratio	3.2	-	3.8	-	3.5	-	3.6	-	3.7	-
Quick Ratio	1.9	-	2.3	-	2.1	-	2.2	-	2.3	-

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

FY 16 Results Highlights

- ARB Holdings (ARH) reported strong FY 16 results with the following key aspects:
 - The Group’s revenue grew by 16% to R2.49bn (FY 15: R2.15bn), slightly beating our R2.43bn expectations.
 - Gross Profit (GP) Margin compression in the Electrical Division from 24.1% in FY 15 to 22.0% was offset by Group efficiencies and led the Group to beat our HEPS expectation of 53.6cps by 11% to reach 59.7cps (FY 15: 51.7cps).
 - This reflected 15% y/y HEPS growth and was matched by an equal hike in the dividends to 23.1cps (FY 15: 20.1cps). The Group’s strong cash generation has led to another 10cps special dividend (FY 15: 10cps special dividend). Collectively, these two dividends put the ARH share on a Dividend Yield (DY) of c.5.6%.
 - Interestingly, during the year the utility and municipal activity in electrification projects picked up, helping boost Overhead Line (OHL) contribution to the Group. Lighting performed excellently as well, gaining apparent market share. The only real negative came from cabling, which continues to trade through a tough market with minimal-to-no infrastructural project-led demand and Rand-price Copper volatility. See Figure 1 for more details hereon.
 - An evergreen Put Option on the minorities in Eurolux (the Group’s Lighting segment) saw some IFRS-dictated retrospective adjustment and a liability of R84m (FY 15: R75m) being raised on the Group’s balance sheet. We consider this largely immaterial, because the higher the Put Option value, the better Eurolux’s performance (actually, the other way around), hence this uplift in liability is offset by improved operating profitability of the enlarged Group and the economics of the Group remains intact.

Figure 1: Expansion and Split of ARB Holdings’ Product Range



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

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 15A	FY 16A	FY 17E	FY 18E
Revenue	1 209	1 088	1 258	1 449	1 679	1 876	1 741	2 006	2 207	2 427
Change in Revenue	-	-10%	16%	15%	16%	12%	-7%	15%	10%	10%

Sources: Bloomberg, Blue Gem Research and ARB Holdings

- ARB Holdings' Electrical Division grew revenue by 15% to R2bn (FY 15: R1.7bn). This is 5% better than our forecast and appears to be attributable their competitiveness in the market (albeit at the sacrifice of some margin) and the steady traction gained from their ARB Connect store roll-out.
- While the Rand-price of Copper (RCP) continues to be a challenge to the business, increased municipal electrification projects were beneficial. The former remains a challenge while the latter implies upside into the short- to medium-term for the business.
- While Copperweld and CHINT agencies continued to grow, the ACCC® product uptake remained slow. The latter was due to a competing product entering South Africa, though various patents potentially have been breached on this and the matter is in the process of being unresolved.
- The business opened two new ARB Connect stores in Silver Lakes and Diep Rivier respectively, and plans to open another one in Pine Town during FY 17E.
- While contingent liability regarding the ARBEW summons were noted, management do not believe this is a material risk. About R400,000 of legal fees were incurred on this matter during FY 16.
- In building our segmental forecasts, we have assumed continued modest volume growth from municipal and Eskom-related spending, but margins remaining tight well into FY 18E.
- **Note:** While copper is a key input cost in cables, given the fact that cables are steadily decreasing as a percentage of ARB's inventory/sales (Figure 1) and that copper is just a percentage of their value, we do not believe that the Segment/Group's prospects hinge on the copper price. Therefore, we ignore this variable for the purposes of our forecasts and have assumed a flat Rand Copper Price going forward.

Lighting segment

Table 2: Lighting – Key Revenue History and Forecasts

Key Forecasts (R m)	FY 11A*	FY 12A	H1:13A	FY 13A	H1:14A	FY 14A	FY 15A	FY 16A	FY 17E	FY 18E
Revenue	-*	120	140	281	174	351	425	507	598	700
Change in Revenue	-*	>100%	>100%	135%	24%	25%	21%	19%	18%	17%

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 grew its revenues by 19% to R507m (FY 15: R425m). This was more or less in line with our expectations, as management continue to gain market share by expanding both product range and customer base.
- For example, during the period the business launched the Eurolux Nouveaux range of high-end lighting products and its Crabtree JV added new products for distribution to retail clients.
- Similar to Electrical Division's forecasts, we see Lighting's volume growth continuing (if not, slightly slower) than previous years, but the tight margins remaining well into FY 18E.

Group services segment

- **Strategic acquisitions:** Management has reiterated their acquisitive intentions, particularly focussing on a "third pillar" in the Group bringing further scale and diversification to its operations. We have built this report and our view of ARB Holdings without attempting to factor in any future acquisition, so we note here that this implies upside optionality in the Group comes from this segment. I.e. The

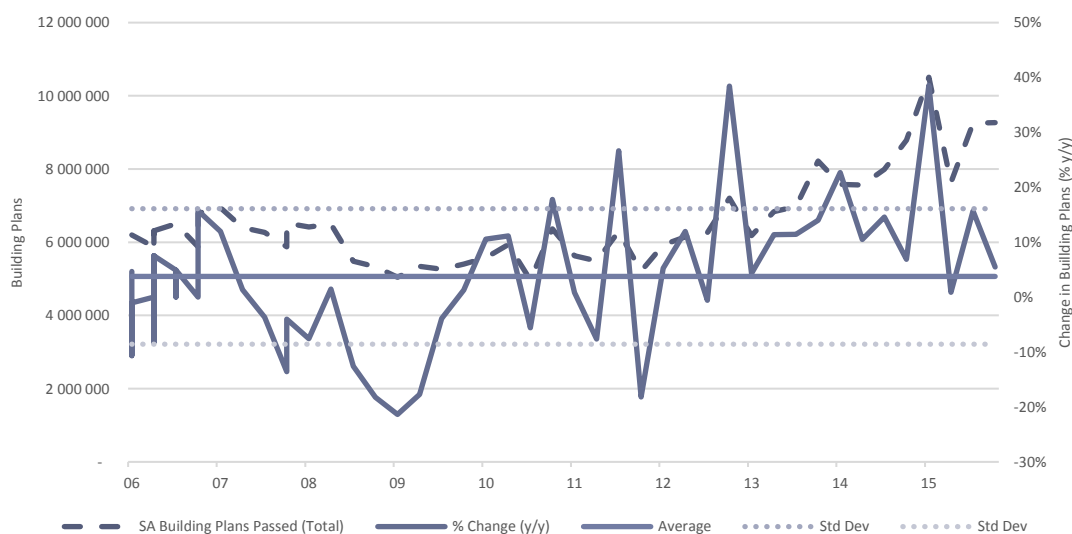
conclusion of a value-enhancing acquisition can potentially make our valuation(s) and forecasts for the Group too low.

- **Property:** The property segment operated in line with expectations and was valued at R178m (FY 15: R181m) with the decrease being due to a small disposal during the period.

Construction, Building Materials & Electrical Wholesaling Industries

- While South Africa’s building plans (Figure 2) indicate some level of buoyancy in the construction activity, the reality of traumatized investor sentiment following recent political events and a looming downgrade to the country’s credit rating have all had a negative impact on the local economic outlook (Figure 3). Likewise, while Eskom and municipal spend appear to be in the early stages of opening up, this activity has come from a relatively low base and we remain cautious about its full recovery.

Figure 2: Building Plans Passed, Growth in Building Plans Passed (actual, average and standard deviations)

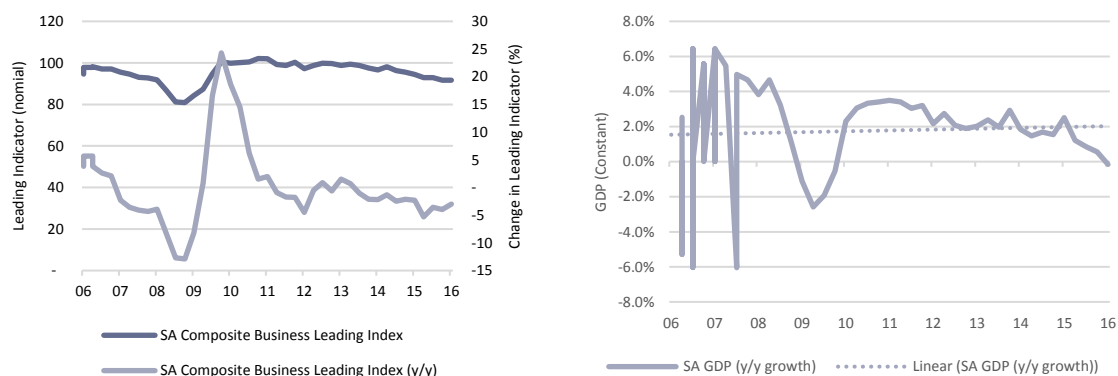


Sources:

Bloomberg, Blue Gem Research workings

- South African GDP continues to trend down, approach nil growth, and a number of systemic risks all create downside risk in the local environment (Figure 3).
- While the National Development Plan (NDP) is consistently communicated by the SA Government, little to no implementation and questions around funding and timing continue to erode confidence in any major infrastructural activity arising from this initiative.
- The upside to South Africa’s weak economy is that it has resulted in a dramatic weakening of the Rand, which has boosted domestic mining profitability and may see increased activity in this and its downstream supplier industries
- Likewise, the current drought afflicting the agricultural sector should eventually dissipate and agri-volumes may normalize in the short- to medium-term. Therefore, the wealth affect from this normalization may filter through to the real economy.

Figure 3: South African GDP and South African Leading Indicator



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

Forecasts

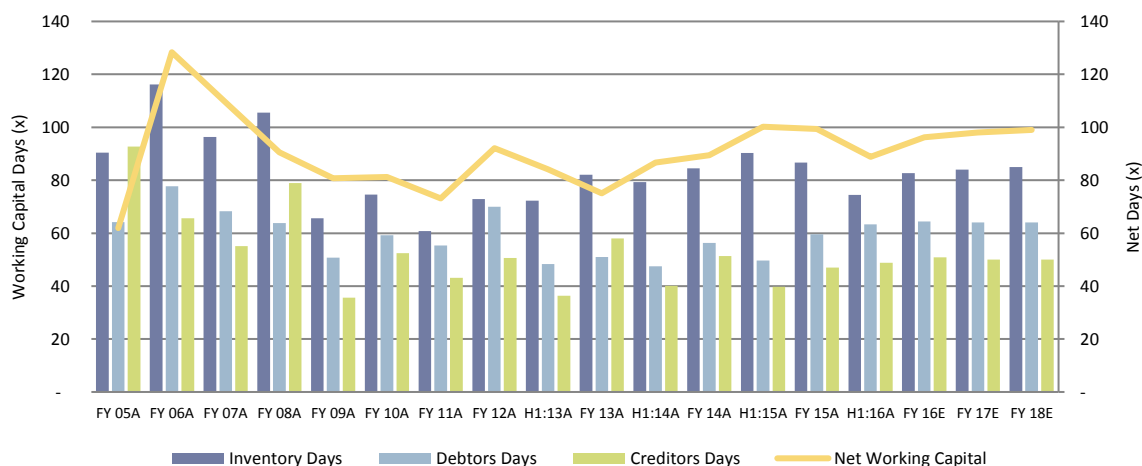
Revenues and profitability

- We have marginally raised our expected FY 17E revenues for ARB Holdings to R2.8bn (previous forecast: R2.7bn). Refer to the above segmental commentary to get more granular detail hereon.
- Despite this, we have lowered previously noted margin assumptions and see this margin squeeze continuing into at least FY 18E.
- Therefore we forecast FY 17E HEPS growth of 10% to 65.4cpscps (previously forecast: 64.9cps), though we note the high degree of forecast risk in the present economic environment (both to the downside due to the economy and the upside due to management initiatives and the potential for acquisitive activity).
- Our forecast indicates a Return on Equity (ROE) of 17.6% (FY 16: 17.2%), bolstered by a number of special dividends removing excess capital from the Group’s balance sheet.
- In conclusion, the Group’s profitability prospects remain robust, while its cash generative nature implies a health forward DY and its balance sheet remains very accommodative.

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 4).

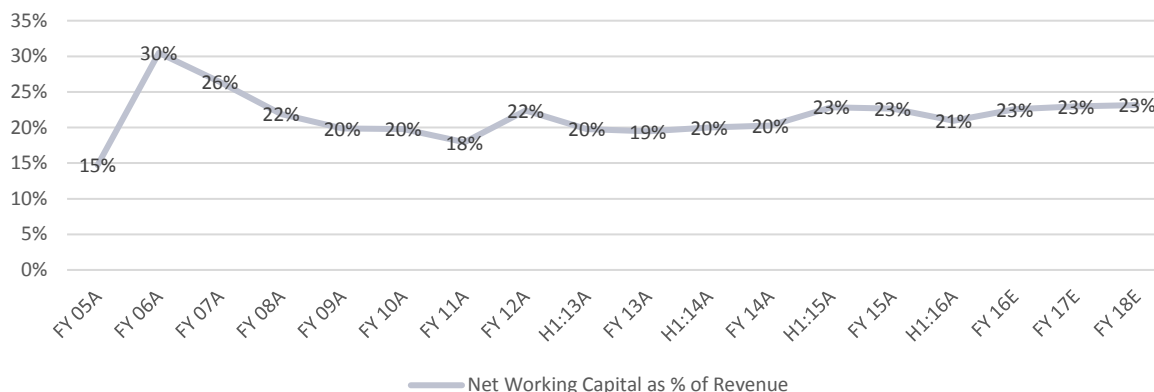
Figure 4: Working Capital History of ARB Holdings



Sources: ARB Holdings, Blue Gem Research workings

- Management track working capital as a percentage of revenue. On this basis, working capital has remained relatively stable (Figure 5).
- We do not expect any major change to this relationship and consider the Group’s long history of excellently managed working capital as likely indicative of what we can expect going forward.

Figure 5: Net Working Capital as Percentage of Revenue (Management Target: Between 20% and 25% of turnover)



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 methodology remains unchanged from our [Initiation of Coverage](#) where we discuss it in more detail.

Discounted Free Cash Flow (DCF) Model

- The basis of our DCF model (Table 3) remains unchanged, except for the following updates:
- Cost of Equity (CoE) of 17.2% (previously 17.6%) based off a “Rule of Thumb” beta of 1.5x (previously 1.5x) and an Equity Risk Premium of 5.5%.
- Growth rates of the following:
 - FY 17E and FY 18E: per our forecasts in this report,
 - FY 19E to FY 25E: 20% y/y (15% real and 5% inflation), and
 - FY 26E/Terminal Year: 10% y/y (5% real and 5% inflation).
- Finally, we take out an effective estimate of the minority interest of c.25% from the Group (attributable to Eurolux and the outside shareholders in ARB Electrical Wholesalers).

Table 3: DCF Model – ARB Holdings

	FY 17E	FY 18E	FY 19E	FY 20E	FY 21E	FY 22E	FY 23E	FY 24E	FY 25E	Terminal year
EBITDA	271	324	373	447	537	644	773	927	1113	1224
Less: Tax	-76	-91	-104	-125	-150	-180	-216	-259	-311	-342
Less: Working Capital	-77	-80	-92	-111	-133	-159	-191	-230	-276	-303
Less: Capex	-19	-21	-24	-29	-35	-42	-51	-61	-73	-40
Free Cash Flow (FCF)	99	132	152	182	219	262	315	378	453	539
Discounted FCF	85	96	94	97	99	101	104	106	109	903
NPV (Enterprise Value)										1793
Add: Net Cash										243
Fair Value, inc. Minorities (R m)										R2 036m
Fair Value, ex. Minorities (R m)										R1 527m
Fair Value of ARB shares (cps)										650cps
Implied Price Earnings (x)										10.9x
Discount to Fair Value (%)										8%
12m TP (cps)										762cps
Exit Price Earnings (x)										11.6x
Implied Return (%)										27%

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

- We arrive at a fair value of 650cps (previously: 520cps) on an implied Price Earnings (PE) of 10.9x. Rolling this forward at our CoE, this fair value implies a 12m TP of 762cps (previous 12m TP: 609cps) on an Exit PE of 11.6x.
- Note our previously stated acquisitive upside to this valuation.

Dividend Discount (DD) Model

- Other than those indicated in the DCF model above and an aggressive unwind in the Dividend Cover of the Group, our DD model remains unchanged (Table 4).
- Interestingly, given ARB Holdings’ high and sustainable dividend payout and its penchant for special dividends, ARB’s DD fair value is actually higher than its implied DCF fair value.

Table 4: DD Model – ARB Holdings

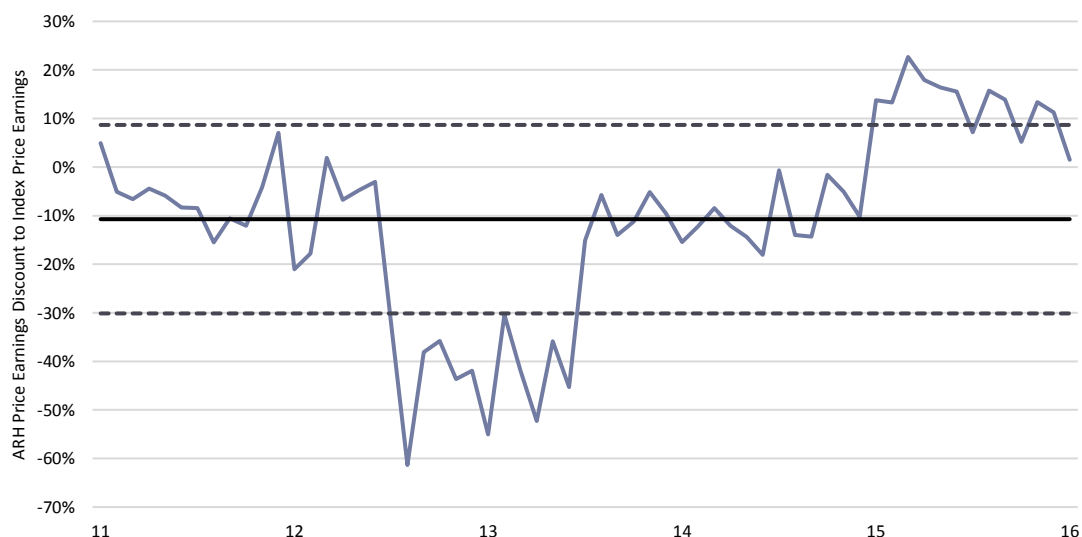
	FY 16A	FY 17E	FY 18E	FY 19E	FY 20E	FY 21E	FY 22E	FY 23E	FY 24E	FY 25E	Terminal year
HEPS (cps)	59.7	65.4	69.7	76.7	88.2	101.4	116.6	134.1	154.2	177.3	186.2
Dividend Cover (x)	1.8	1.8	1.8	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.0
DPS (cps)	33.1	36.2	38.6	51.1	58.8	67.6	77.7	89.4	102.8	118.2	186.2
DWT (15%)	-5.0	-5.4	-5.8	-7.7	-8.8	-10.1	-11.7	-13.4	-15.4	-17.7	-27.9
Net DPS (cps)	28	31	33	43	50	57	66	76	87	100	158
Discount Factor	1.00	0.85	0.73	0.62	0.53	0.45	0.39	0.33	0.28	0.24	0.20
Discounts DPS (cps)	28.1	26.3	23.9	27.0	26.5	26.0	25.5	25.0	24.5	24.1	449.6
Fair Value (cps)											706cps
Implied PE Ratio (x)											11.8x

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

Price Earnings (PE) Model

- The Group’s PE relative to the Electrical and Electrical Components Index has fallen from over a standard deviation premium to a position much closer to the mean (Figure 6).
- Given ARB’s low absolute (i.e. not relative) PE, we believe that this is more a symptom of the other index constituents PE’s distorting the base index than any real comment on ARB.

Figure 6: ARB Holdings Price Earnings (PE) Historical Discount versus the Electrical and Electrical Components Index

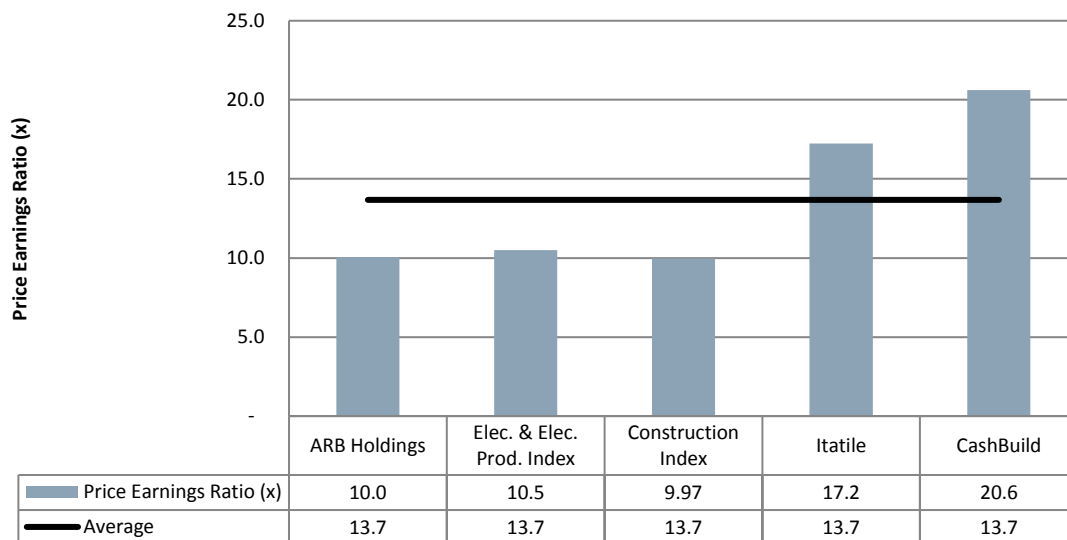


Sources: Bloomberg, Blue Gem Research workings

- Perhaps far more reflective of reality, ARB’s current 12m lagging PE of 10.0x compares favourably to the AllShare Index PE of 23.83x.
- Although ARB Holdings is listed in the electrical sector, we believe that the markets it supplies are linked to both hardware sales and/or construction-related.

- Once we consider ARH’s PE against comparatives in these markets (Figure 7), the share appears between fairly valued to somewhat cheap versus comparatives. The exception is perhaps against the Construction Index, but we believe that the Construction Index holds much higher implicit risk than the business of ARB (lumpy, once-off capex projects on a small margin versus a steady, comfortable margin product and distribution business), thus one could arguably demand a lower valuation rating for construction businesses than ARB.

Figure 7: ARB Holdings Price Earnings (PE) Versus Peers & Indices



Sources: Iress, Various Company Reports and 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 650ps (previously: 520cps) on an implied Price Earnings (PE) of 10.9x.
 - This PE does not appear unreasonable against either ARH’s own history or the various comparatives in the market (Figure 6 and 7).
- Rolling our fair value forward at our CoE we arrive at a 12m TP of 762cps (previous 12m TP: 609cps).
 - A 12m TP of 762cps places the share on a comfortable Exit PE of 11.6x
 - Our 12m TP also implies a return of c.27%.

Key risks to our valuation

- The major macro-economic variables in South Africa (specifically, GDP growth, construction and building sectors, labour environment, Eskom-related spend, potential sovereign downgrade, amongst other variables),
- The timing and successful implementation of ARB’s organic product, store and market expansion drive, and
- Finally, the timing, quantum and success of the Group’s acquisitive activity.

Disclaimer

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

** Market prices in this report predominantly set to intra-day price on 5 September 2016 (600cps).*

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