Results Note
11 September 2019

ARB Holdings Ltd
FY 19 Results – (Still) Awaiting Macro-Tailwinds

Share Code: ARH – Market Cap: R0.9bn – PE: 7.0x – DY: 6.2%

12m Target Price	**670cps**
Share Price	**405cps**
Implied Return	**65%**

Industrials | South Africa

FY 19 – Macro-headwinds Remain Strong

- ARB Holdings grew revenue +4.5% y/y, partially bolstered by Radiant, GMC and CraigCor acquisitions.
- An anaemic domestic economy and construction sector, supply chain disruptions, competitor activity & a volatile currency all combined to put downward pressure on Group results, while the Group also began accounting for Radiant with restructuring once-offs costs, relocated operations in Gauteng and suffered some non-cash impairments and Put Option revaluations due to subsidiary results.
- IFRS HEPS slipped -19% y/y to 58.2cps (FY 18: 71.7cps), but this materially beat our conservative expectations of 50.1cps. We see our calculated 'Normalized' earnings figure as c.-21% y/y.
- The Group maintained its dividend at 25cps (FY 18: 25cps + 10cps special dividend) as cash flows remained strong.

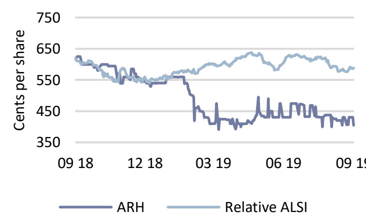
Our Thoughts: Domestic versus Global – Eskom versus Trump

- Globally, a red-flags are flashing as the US-China Trade War escalates and the global economy suffers.
- Domestically, Brexit (as the UK is a large South African trading partner) and Eskom continue directly hurting our economy.
- While these global and domestic risks are well-known, any positive resolutions to them would create macro-upside that should bolster prospects going forward.
- Given the depth of discount the valuation of the domestic small cap sector currently trades at, we would argue that no positives anywhere have been priced in and therein lies the opportunity.

Forecast, Valuation & Implied Return: Still Quality & Still Value

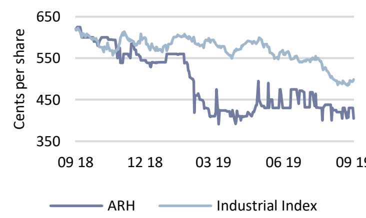
- Our fair value for ARH is 576cps (previously: 636cps) on an implied Price Earnings (PE) of 9.9x, indicating that the stock is c.42% undervalued at its current share price.
- Rolling our fair value forward at our CoE, we arrive at a 12m TP of 670cps (previous 12m TP: 744cps) on an Exit PE of 12.6x.
- Key risks to the Group are unchanged from our Initiation of Coverage.

Share Price against the ALSI



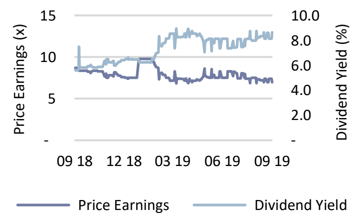
Sources: Bloomberg, Blue Gem Research

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 17A**	***YoY %***	**FY 18A**	***YoY %***	**FY 19A**	***YoY %***	**FY 20E**	***YoY %***	**FY 21E**	***YoY %***
Revenue	2479	*0%*	2590	*4%*	2706	*4%*	2913	*8%*	3008	*3%*
EBITDA	230	*1%*	218	*-5%*	173	*-21%*	208	*20%*	231	*11%*
HEPS (cps)	**61.9cps**	***4%***	**71.7cps**	***16%***	**58.2cps**	***-19%***	**53.2cps**	***-9%***	**60.2cps**	***13%***
Return on Equity (%)	*17.3%*	-	*18.2%*	-	*13.8%*	-	*11.8%*	-	*12.4%*	-
Price Earnings Ratio (x)	*6.5x*	-	*5.6x*	-	*7.0x*	-	*7.6x*	-	*6.7x*	-
DPS (cps)	35.0cps*	*3%*	35.0cps*	*0%*	25.0cps	*-29%*	21.3cps	*-15%*	24.1cps	*13%*
Dividend Yield (%)	*8.6%*	-	*8.6%*	-	*6.2%*	-	*5.3%*	-	*5.9%*	-

*Sources: ARB Holdings, Bloomberg, Iress, Blue Gem Research; * FY 17 & 18's distributions include a special dividend of 10cps*

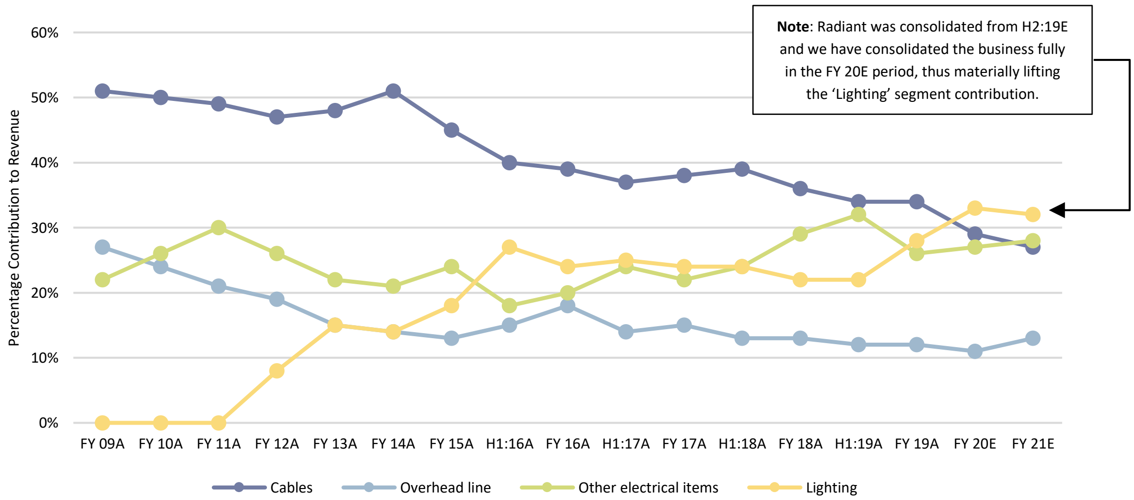
Key Forecast (Rm)	FY 17A	YoY %	FY 18A	YoY %	FY 19A	YoY %	FY 20E	YoY %	FY 21E	YoY %
Revenue	**2479**	***0%***	**2590**	***4%***	**2706**	***4%***	**2913**	***8%***	**3008**	***3%***
Electrical Wholesaling	1996	*0%*	2120	*6%*	2097	*-1%*	2097	*0%*	2149	*3%*
Lighting	511	*1%*	502	*-2%*	649	*29%*	858	*32%*	902	*5%*
Gross Profit	**594**	***8%***	**615**	***3%***	**651**	***6%***	**720**	***11%***	**745**	***3%***
Gross Profit Margin (%)	*24.0%*	-	*23.8%*	-	*24.0%*	-	*24.7%*	-	*24.8%*	-
Operating expenses	-388	*15%*	-417	*8%*	-497	*19%*	-539	*8%*	-541	*0%*
EBITDA	**230**	***1%***	**218**	***-5%***	**173**	***-21%***	**208**	***20%***	**231**	***11%***
EBITDA Margin (%)	*9.3%*	-	*8.4%*	-	*6.4%*	-	*7.1%*	-	*7.7%*	-
Operating Profit/(Loss) Before Interest	214	*-1%*	230	*7%*	177	*-23%*	184	*4%*	207	*12%*
Interest Received	22	*82%*	25	*13%*	17	*-29%*	8	*-55%*	11	*41%*
Finance Charges	-	*0%*	-	*0%*	-	*0%*	-7	*0%*	-11	*0%*
Net Profit (Parents)	**147**	***8%***	**168**	***15%***	**135**	***-20%***	**125**	***-7%***	**141**	***13%***
Weighted Ave. Number of Shares (millions)	*235.0*	*0%*	*235.0*	*0%*	*235.0*	*0%*	*235.0*	*0%*	*235.0*	*0%*
EPS (cps)	**62.4cps**	***8%***	**71.7cps**	***15%***	**57.4cps**	***-20%***	**53.2cps**	***-7%***	**60.2cps**	***13%***
HEPS (cps) (Normalized HEPS (cps))^	**61.9cps (63.3cps)**	***4% (5%)***	**71.7cps (56.5cps)**	***16% (-11%)***	**58.2cps (44.2cps)**	***-19% (-21%)***	**53.2cps (53.2cps)**	***-9% (+20%)***	**60.2cps (60.2cps)**	***13% (13%)***
Gross Ordinary DPS (cps)	35cps*	*3%*	35cps*	*0%*	25cps	*-29%*	21cps	*-15%*	24cps	*13%*
Dividend Yield (%)	*8.1%*	-	*8.1%*	-	*5.8%*	-	*5.0%*	-	*5.6%*	-
Dividend Cover (x)	*1.8x*	*0%*	*2.0x*	*16%*	*2.3x*	*14%*	*2.5x*	*7%*	*2.5x*	*0%*
Property, Plant & Equipment	237	*5%*	331	*40%*	413	*25%*	550	*33%*	556	*1%*
Intangible Assets	78	*0%*	96	*23%*	76	*-20%*	76	*0%*	76	*0%*
Current Assets	1198	*7%*	1162	*-3%*	1201	*3%*	1305	*9%*	1408	*8%*
Net Cash	307	*26%*	259	*-15%*	181	*-30%*	256	*41%*	337	*32%*
Cash	307	*26%*	259	*-15%*	181	*-30%*	256	*41%*	337	*32%*
Overdraft	-	-	-	-	-	-	-	-	-	-
Interest-bearing Liabilities	-	-	-	-	-	-	-	-	-	-
Shareholder's Equity (Parent)	899	*9%*	967	*8%*	1022	*6%*	1098	*7%*	1182	*8%*
Non-current Liabilities	41	*-67%*	76	*85%*	64	*-16%*	186	*193%*	191	*3%*
Current Liabilities	412	*28%*	403	*-2%*	478	*19%*	513	*7%*	526	*2%*
NAV per share (cps)	382cps	*9%*	412cps	*8%*	435cps	*6%*	467cps	*7%*	503cps	*8%*
TNAV per share (cps)	354cps	*10%*	374cps	*6%*	408cps	*9%*	434cps	*6%*	471cps	*8%*
Cash Generated by Operations	212	*26%*	225	*6%*	226	*0%*	253	*12%*	221	*-13%*
Cash Conversion Ratio (%)	92%	-	103%	-	130%	-	122%	-	96%	-
Net Cash Flow from Financing Activities	-14	*33%*	-115	*735%*	-204	*78%*	-160	*-21%*	-30	*-81%*
Net Increase / (Decrease) in Cash	-	*-100%*	0	*0%*	39	*>100%*	77	*97%*	-6	*-108%*
Return on Equity (%)	***17.3%***	-	***18.2%***	-	***13.8%***	-	***11.8%***	-	***12.4%***	-
Return on Capital Employed (%)	***13.4%***	-	***13.8%***	-	***9.9%***	-	***9.1%***	-	***9.5%***	-
Return on Assets (%)	*11.3%*	-	*12.0%*	-	*8.6%*	-	*6.9%*	-	*7.3%*	-
Price Earnings Ratio (x)	***6.5x***	-	***5.6x***	-	***7.0x***	-	***7.6x***	-	***6.7x***	-
Price-to-Book (x)	*1.1x*	-	*1.0x*	-	*0.9x*	-	*0.9x*	-	*0.8x*	-
Price-to-Tangible-Book (x)	*1.1x*	-	*1.1x*	-	*1.1x*	-	*0.9x*	-	*0.9x*	-
Current Ratio	*2.9x*	-	*2.9x*	-	*2.5x*	-	*2.5x*	-	*2.7x*	-
Quick Ratio	*1.8x*	-	*1.6x*	-	*1.2x*	-	*1.2x*	-	*1.5x*	-

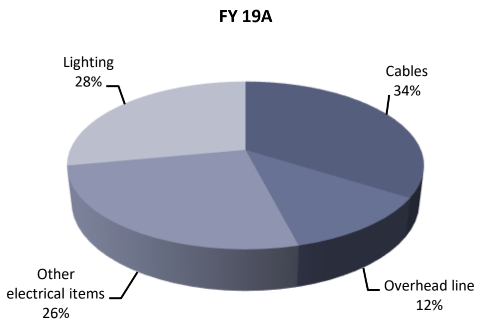
*Sources: ARB Holdings, Bloomberg, Iress, Blue Gem Research workings, assumptions, and forecasts; * Only final dividends declared. Periods include 10cps special dividend; ** Including Radiant acquisition that we have consolidated full in FY 20E onwards. Note high forecast risk due to consolidation, forecasts and turnaround risk of this business. Also, we have inserted properties and mortgage bond onto ARB Holding's balance sheet from FY 20E; ^ Based off Blue Gem Research workings and a range of assumptions to attempt to control for IFRS non-cash items, fair value adjustments and restructuring and legal costs incurred.*

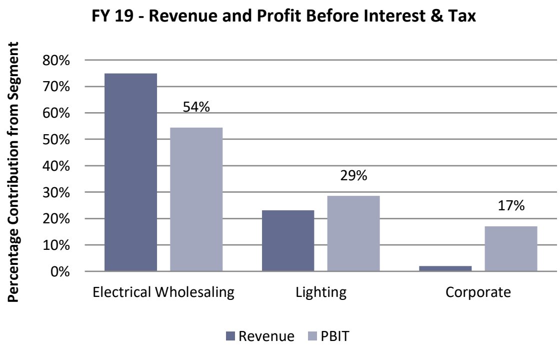
FY 19 Results Highlights

- ARB Holdings published a tough set of FY 19 results but still showed revenues growing +4.5% y/y to R2.70bn (FY 18: R2.59bn), partially bolstered by Radiant, GMC and CraigCor acquisitions.
- An anaemic domestic economy and construction sector, supply chain disruptions, competitor activity & a volatile currency all combined to put downward pressure on Group results, while the Group also began accounting for Radiant with restructuring once-offs costs, relocated operations in Gauteng and suffered some non-cash impairments and Put Option revaluations due to subsidiary results.
- These matters aggregated to show IFRS HEPS -19% y/y at 58.2cps (FY 18: 71.7cps), which materially beat our conservative expectations of 50.1cps. Once we control for the range of once-offs and non-operational items going through the Group's profits, we estimate that "Normalized HEPS" was closer to -21% y/y from an equivalently calculated "Normalized HEPS" in FY 18.
- The Group maintained its dividend at 25cps (FY 18: 25cps + 10cps special dividend). Operational cash flows remained strong, the Group's net cash balance at year-end was R181m, and its property portfolio was worth c.R354m.
- We have significantly lowered our FY 20E expectations due to a slower South African economic recovery and now expect FY 20E HEPS of 53.2cps (Previously: 68.4cps) and only see the recovery coming through towards the FY 21E year.
- Upside risk may lie in management's ability to turn Radiant around (it is worth noting, towards the end of FY 19, the business was approaching break-even on a monthly basis per management narrative) while material downside risk may still exist in the domestic macro-economic recovery.

Figure 1: Split of and Trends in ARB Holdings' Product Range & Segments







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

Electrical Division segment

Table 1: Electrical Division – Key Revenue History and Forecasts

Key Forecasts (Rm)	FY 14A	FY 15A	FY 16A	FY 17A	FY 18A	FY 19A	FY 20E	FY 21E
Revenue	1876	1741	2006	1996	2120	2097	2097	2149
Change in Revenue	*12%*	*-7%*	*15%*	*0%*	*6%*	*-1%*	*0%*	*3%*

Sources: Bloomberg, Blue Gem Research and ARB Holdings

- The Electrical Division's revenue hit our expectation at R2.1bn (FY 18: R2.1bn), but its margin contracted with Operating Profits coming in -34% y/y.
- There was a goodwill impairment at subsidiary-level here, though, this is a technicality due to performance and carrying value for minorities and had no notable effect on ultimate shareholders.
- A range of negative factors converged as headwinds buffeting this segment:
    - Broadly, the South African economy remained sluggish and, specifically, the construction sector and Eskom-related spend were particularly weak to non-existent.
    - In the first half of the year, the cable manufacturers struggled with a copper shortage (after a fire in Palabora in 2018) that saw them playing catch-up and creating a surplus supply that squeezed margins in the second half of the year.
    - Aberdare Cables continues to drive its margin-cutting direct-to-client sales strategy that keeps wholesaler margins under pressure. We remain of the view that this is not a sustainable practise and expect normal market dynamics to revert in the medium-term.
- During the year, the Group did make a range of positive strategic moves. Despite this, none has yet added materially to the segment's bottom-line (we do expect them to begin to annualize benefits from FY 20E onwards):
    - The CraigCor acquisition performed well during the period and grew nicely,
    - Lord's View DC in Gauteng opened (incurring costs) and it now ramping up to create (working capital) efficiencies for the underpenetrated, economic hub of South Africa, &
    - The Group acquired GMC with an approved Eskom product range imported from China at/near Net Asset Value, though it is not yet operating at its full potential.
- Given the slow start to FY 20E and our dimming view of a quick economic recovery in South Africa, we have trimmed our revenue for the Electrical Division by -9% to R2.1bn (previously: R2.3bn), cut some of our gross margin and released some of our overheads (from the Lord's View efficiencies, however small) to arrive at what will probably a relative flat FY 20E period's profit for this segment.
- We do see a recovery post-FY 20E, though, as structural issues (hopefully) debottleneck in the domestic economy and some of the "green shoots" in the large infrastructure sector that we are currently seeing (if only, anecdotally) move into execution phase with a post-stabilized Eskom.
- **Note**: See the "Lighting Division segment" note on the Put Option regarding CraigCor.

Lighting Division segment

Table 2: Lighting – Key Revenue History and Forecasts

Key Forecasts (R m)	FY 14A	FY 15A	FY 16A	H1:17A	FY 17A	H1:18A	FY 18A	H1:19A	FY 19A	FY 20E*	FY 21E
Revenue	351	425	507	271	511	254	502	288	649	858*	902
Change in Revenue	*25%*	*21%*	*19%*	*R7*	*1%*	*-6%*	*-2%*	*13%*	*29%**	*32%**	*5%*

*Sources: Bloomberg, Blue Gem Research, South Ocean and ARB Holdings; * Radiant's effective date is 1 January 2019, thus we have consolidated fully into our forecasts for FY 20E onwards. The consolidation during H2:19E boosted FY 19E, though the business's forward profitability remains a large variable in our forecasts and we note this as a key risk to this segment and the Group results.*

- The Light Division's revenue and profits came in light (no pun intended) as the retail market in South Africa came under major pressure and no significant project revenue materialized from a stagnant construction and projects industry.
- Management took control of Radiant at the start of H2:19 and drove a material restructuring of the loss-making business. While this created once-off costs in the results, it is worth noting that the business was at/near break-even on a monthly basis by the end of the reporting period.

- We highlight our original assumptions for Radiant below and—unless more applicable as data becomes available—we have kept them largely unchanged in these forecasts:
    - We have consolidated our (latest) Radiant forecasts for the full FY 20E, the turnaround targets remain intact and the fact that this segment has a 40%-minority interest.
    - Refer to our previous note (FY 18 Results Note) for some underlying assumptions in building our forecasts for Radiant, though we have lowered some revenue expectations given the currently weak domestic environment.
    - The properties are still to be transferred for R88m and will likely be acquired via a bond. We have assumed that this transfer occurs during the FY 20E reporting period.
    - These facts all contribute to a level of increased forecast risk in our forecasts.
- We have cut our segmental-FY 20E revenue expectation by -4%, though see some margins recovering and expect Radiant to begin to contribute positively to the Group during the year (though its full benefit is only likely to come through to the bottom-line during FY 21E).
- **Note**: The management of Eurolux owns 40% of Eurolux's equity (the acquiror of Radiant). They have a put option with these shares against ARB Holdings. The option is currently exercisable and, if it were exercised, we calculate that it would be accretive to the Group. This Put Option is fair valued through the Group's profits each period. While Craigcor (in the Electrical Division) also has a similar Put Option, it is non-current and not yet exercisable. Both create IFRS fair value adjustments that go through the profits of the Group and we reverse for the purposes of normalizing earnings.

Group services segment

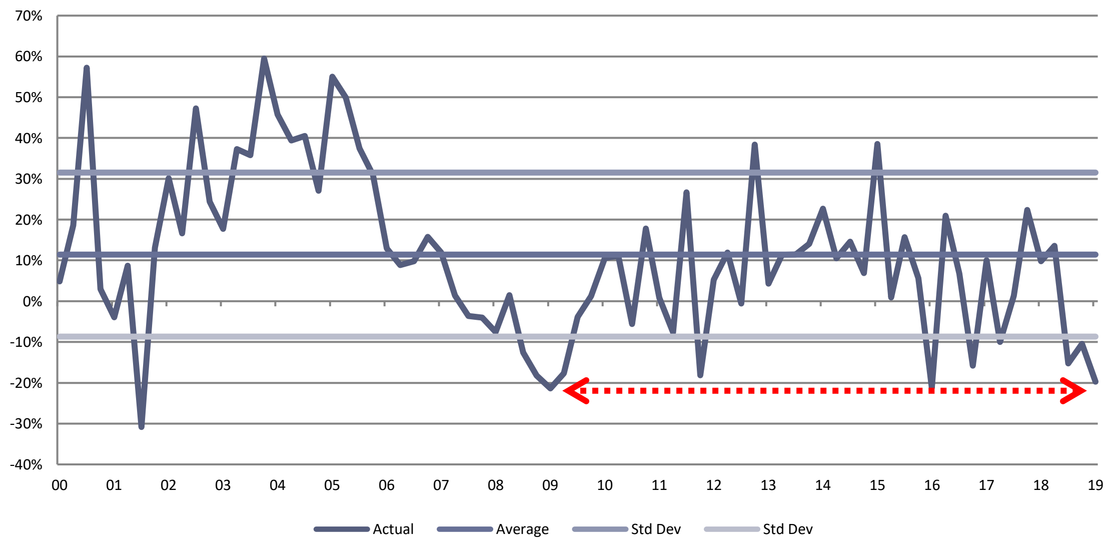
- **Strategic acquisitions**: Given that management has passed on declaring another special dividend and due to the large capital outflows from the Radiant acquisition and Lord's View development, we believe that the Group's conservative balance sheet has now been largely deployed (without gearing). Given the negative domestic environment, we believe that this conservative capital position is justified and do not expect any more material acquisitions in the near-term, although minor bolt-on acquisitions may still occur when and where they make tactical sense.
- **Property**: The property segment operated in line with expectations and was valued at R354m (FY 18: R333m) as normal capex combined with the Group continues at the Lord's View development. The Radiant Group's property portfolio is likely to be acquired for R88m.

Macro Analysis

- We refer you to our previous report's macro-economic analysis (ARB Holdings – H1:19 – Awaiting Macro-Tailwinds) where we noted South Africa's weak economy and its effect on the small cap equity market. Three key trends identified remain relevant:
    1. **Weak domestic economy**: First quarters sharp GDP contraction is not forgotten, though the second quarter's GDP'print was better than expected at +3.1% q/q (consensus was c.2.5% q/q). That said, annualized GDP still remains weak with a <1.0% y/y growth expected (Reserve Bank forecast is 0.9% y/y) as the public sector and Eskom bottlenecks remain large drags on the economy and consumers remain under pressure.
    2. **Weak US dollar**: Following the 10/2 bond yield inversion in the States, the Fed has cut the rate and US dollar weakness (as captured by a rallying gold price) has broadly remained the trend. A number of (other) warning signs and soft data point have started being reported, thus indicating (at best) a slowdown in the State and (at worst) a coming recession. Indirectly, this does appear to be a result of President Trump's US-China Trade War.
    3. **Local small cap sector out of favour**: Given the above, the local small cap sector has remained out of favour and is still one of the cheapest equity sectors in the world on a relative basis.

- Unfortunately, none of the above trends has reversed, although we do highlight the Q2:19 GDP print for South Africa being a surprise positive.
- Zooming into South Africa, a great leading indicator to both the economy and those businesses operating in the construction sector, the South African Building Plans Passed remains weak (Figure 2):
    - In fact, the indicator is *over* one standard deviation weak and it is currently equivalent in level to the Credit Crisis.
    - It is worth noting, though, that not only is this indicator seasonally weak at the beginning of each year (building plans tend not to be passed around and after Christmas and volumes start to pick up again well after the builders' holidays), but the indicator can rebound incredibly quickly too (see 2001/2002 on into 2004).
    - Finally, it is also worth noting that the over-trading in the shopping centre / retail space has led to growing vacancies and slowed (if not, halted) the shopping centre build across the country. This will have a knock-on effect on the Building Plans data but is not an indicator of GDP growth or economic health. Rather this is a structural over-extension that needed to cool down (i.e. there were too many shopping centres and not enough consumers).

Figure 2: Percentage Change in South African Building Plans Passed

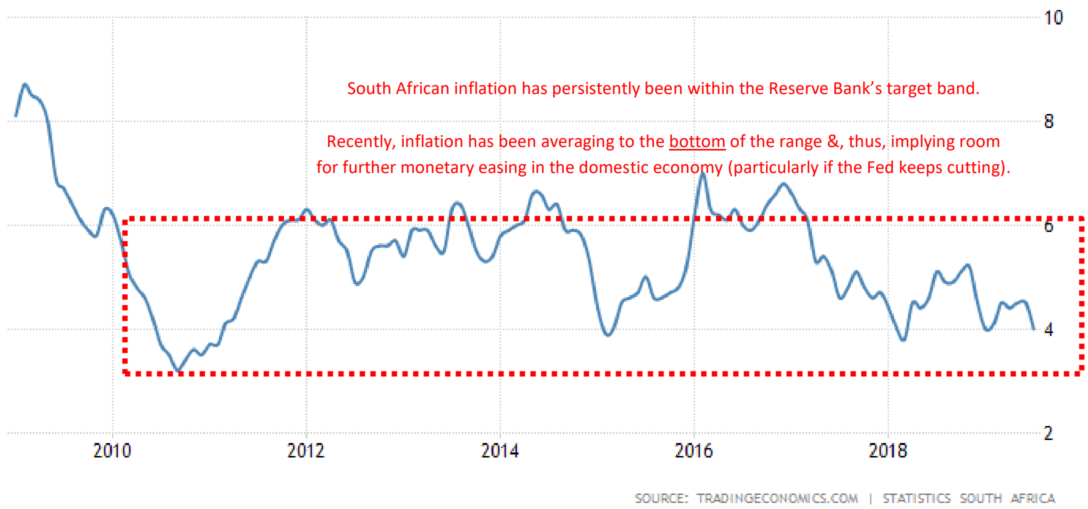


Sources: Bloomberg, Blue Gem Research workings and assumptions

- Domestically, there is a range of drivers that may improve the situation going forward:
    1. **A stabilized Eskom**: While excruciating slow, South Africa's Government does appear to be moving the key SOE towards a stabilized position. If this was affected and (best case scenario) Eskom were to be entirely self-sustaining and able to grow/reinvest in itself, the direct benefits (i.e. Eskom spend) and the indirect benefits (i.e. business confidence and a rise in fixed capital formation & GDP growth) would be *material*. The timing (and chances) of this, though, are hard to tell and deeply mired in politics.
    2. **Lower interest rates**: Inflation remains persistently lower in South Africa (Figure 3) and—adding to the recent Repo cut by the SARB—implying some room for monetary easing that may help stimulate the economy (albeit, we acknowledge many of the domestic problems are structural and not monetary in nature). It is worth noting that global interest rates are falling, thus, this would just keep us in line with the world.
    3. **Resolution to the US-China Trade War**: While unlikely, a positive resolution to the US-China Trade War would drive risk-on capital flows into Emerging Markets and buoy our domestic economy along with it and, likely, rallying hard commodity prices. That said, forecasting (irrational) politics is impossible and we will not attempt it.

4. **Resolution to Brexit**: As South Africa's major trading partner, the Brexit-driven weakness in the UK has had a knock-on effect on our economy. Any positive resolution of this political own-goal would likely invigorate the UK and South Africa along with it. That said, forecasting (irrational) politics is impossible and we will not attempt it.

Figure 3: South African Inflation Rate



Sources: tradingeconomics.com

- In conclusion, global and domestic macro-economies are currently extremely difficult to forecast. While there is a range of negatives and red-flags out there, there is also a range of positive outcomes, resolutions and high-roads that may play out too.
- Hence, we have been conservative in our macro-assumptions and you will note the trimming of expectations at a segmental-level we have done in this note. That said, also note the range of potential (global and domestic) positive outcomes that could materialize and surprise to the upside.

Forecasts

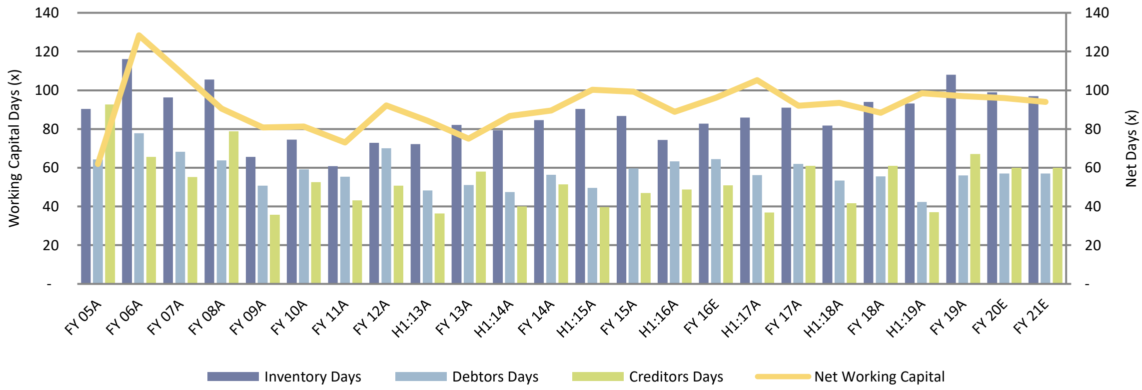
Revenues and profitability

- Refer to the individual segments for more detailed forecasts.
- We do note that forecast risk is elevated from both the Radiant consolidation and the generally weak domestic conditions.

Liquidity, solvency and assets

- The Group continues to manage its working capital superbly and key ratios and days remain relatively stable during the period (Figure 4).
- We do not expect this to change in the near-future.

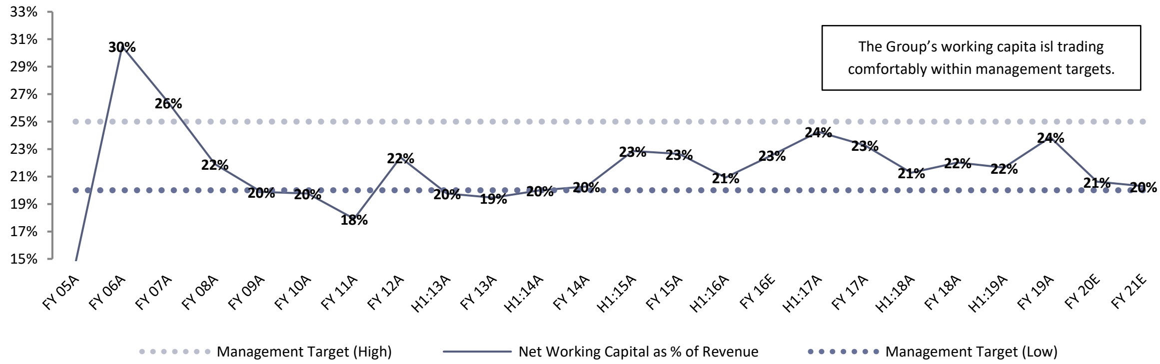
Figure 4: Working Capital History of ARB Holdings



Sources: ARB Holdings, Blue Gem Research workings

- Working capital has remained relatively stable.
- Perhaps more importantly, the Group's working capital remains within set management targets (Figure 5) of 20% to 25% of revenue, tending towards the lower-end of the band.
- As noted above, we do not expect any major change in this relationship.

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 (it is worth c.R354m at the time of writing this). This methodology remains unchanged from our Initiation of Coverage.

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 16.4% (previously: 17.1%) based off a "Rule of Thumb" beta of 1.5x (unchanged) and an Equity Risk Premium of 5.5% (unchanged).
- The 10-year South African Government bond yield is around 8.1% (previously: 8.8%).
- Growth rates of the following:
  - FY 19E and FY 20E: per our forecasts in this report,
  - FY 21E to FY 26E: 13% y/y (7.5% real and 5% inflation), and
  - FY 27E/Terminal Year: 10% y/y (5% real and 5% inflation) – see note below.

- Finally, we take out an effective estimate of the minority interest of c.12% (previously: 14%) from the Group.

Table 3: DCF Model – ARB Holdings

	FY 19A	FY 20E	FY 21E	FY 22E	FY 23E	FY 24E	FY 25E	FY 26E	Terminal Year
EBITDA	195	208	231	254	285	321	361	406	503
Less: Tax	-56	-60	-58	-63	-71	-80	-90	-102	-126
Less: Working Capital	-76	45	-10	-11	-12	-13	-15	-17	-21
Less: Capex	-93	-35	-47	-52	-58	-65	-74	-83	-51
Free Cash Flow (FCF)	-30	157	116	128	144	162	182	205	305
Discounted FCF	-	135	86	81	79	76	73	71	688
NPV (Enterprise Value)									1358
Add: Net Cash									181
Fair Value, inc. Minorities (Rm)									R1,539m
Fair Value, ex. Minorities (Rm)									**R1,354m**
Fair Value of ARB shares (cps)									**576cps**
Implied Price Earnings (x)									*9,9x*
Discount to Fair Value (%)									*42%*
12m TP (cps)									**670cps**
Exit Price Earnings (x)									*12,6x*
Implied Return (%)									*65%*

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

- We arrive at a fair value of 576cps (previously: 636cps) on an implied Price Earnings (PE) of 9.9x. This implied PE compares favourably against the various comparatives in the market (Figure 6) and is broadly in line with the Electrical & Electrical Products Index's PE of 9.5x.
- Rolling this fair value forward at our CoE implies a 12m TP of 670cps (previous 12m TP: 744cps) on an Exit PE of 12.6x.
- Note our upside and downside risks to our forecasts (i.e. Radiant & South Africa's economic recovery) that filter through into this valuation.
- **Note:** The Terminal Year growth rate of 10% is made up of the following:
  - 5% inflation assumption, &
  - 1.5~2.0% population growth + 1.5~2.0% urbanisation growth + 1.0~1.5% technological/efficiency growth = c.5% real growth rate.
  - That said, South Africa's recent decade has seen below-mean real GDP growth and it is prudent to consider that long-term average nominal GDP growth may not materialize.
  - Thus, if we adjust downwards our assumed 5% y/y real growth rate to 2% y/y, we arrive at the following:
    - **DCF Fair value**: 525cps (i.e. c.9% lower than the above), &
    - **DCF 12m TP**: 611cps (i.e. c.9% lower than the above).
  - Hence, we want to highlight the Terminal Year and the sustainable growth rate of the domestic economy as a key risk and a notable variable in the valuation of ARB Holdings.

Dividend Discount (DD) Model

- Other than those indicated in the DCF model above, our DD model's assumptions remain unchanged (Table 4).
- Our DD model indicates a fair value of 386cps (previously: 639cps) on a 6.6x PE, albeit, we have not considered special dividends and kept our growth and cover ratios quite conservative.
- The divergence from the DCF fair value is largely around the terminal value wherein a lower long-term growth rate has a material effect on the perceived value of future potential dividends that are not sufficiently offset by currently lower interest rates/Cost of Equity.
- As with the DCF, though, we note the risks (also to the upside) built into our assumptions, but specifically note the Group's propensity to pay special dividends as an upside to this model's valuation (we have *not* assumed any special dividends).

Table 4: DD Model – ARB Holdings

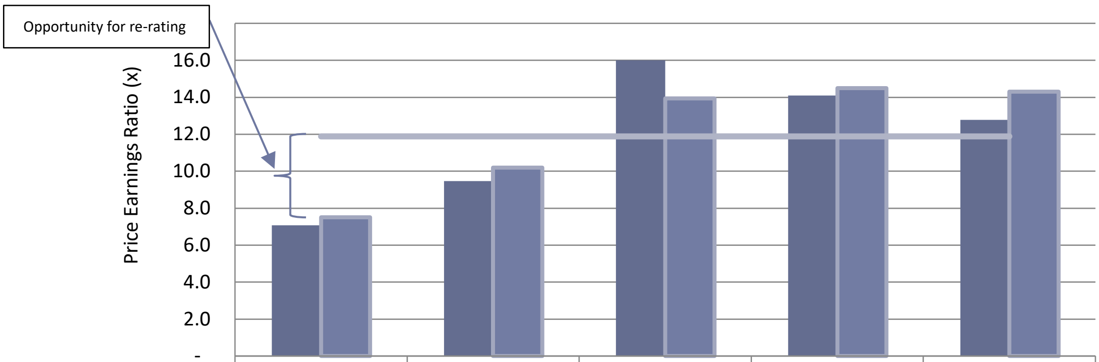
	FY 19A	FY 20E	FY 21E	FY 22E	FY 23E	FY 24E	FY 25E	FY 26E	Terminal Year
HEPS (cps)		53,2	52,3	54,9	59,0	63,5	68,2	73,3	77,0
Dividend Cover (x)		*2,2*	*2,1*	*2,0*	*1,5*	*1,3*	*1,2*	*1,1*	*1,0*
DPS (cps)	25,0	24,2	24,9	27,5	39,4	48,8	56,8	66,7	77,0
DWT (20%)	-5,0	-4,8	-5,0	-5,5	-7,9	-9,8	-11,4	-13,3	-15,4
Net DPS (cps)	20	19	20	22	31	39	45	53	62
Discount Factor	*1,00*	*0,86*	*0,74*	*0,63*	*0,55*	*0,47*	*0,40*	*0,35*	*0,26*
Discounts DPS (cps)	20,0cps	16,6cps	14,7cps	13,9cps	17,2cps	18,3cps	18,3cps	18,5cps	248,2cps
Fair Value (cps)									**386cps**
Implied PE Ratio (x)									***6,6x***

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

Price Earnings (PE) Model

- Despite ARB Holdings' superb track record, the share still appears to trade at a discount versus comparative domestic shares and various indices touching on the Group's space (Figure 6).
- That said, it is worth noting the general de-rating that has occurred across the market and the peer group from a mere six months ago (see 'PE at H1:19 (x)' in Figure 6). This has not just been earnings under pressure, but the market generally paying a lower multiple for a lower earnings figure across the board and, thus, resulting in material share price declines across the JSE. This de-rating *is* taken into account by our valuation of the Group and note how our models do indicate to a lower fair value than we pegged the share to at H1:19 period.
- While headwinds against ARB Holdings' share's relative rating include its illiquidity and domestic sector focus, the Group's solid track record is a point in its favour as is its ungeared balance sheet.
- We do believe that there is a significant opportunity for a positive re-rating in the stock's multiple if domestic small cap conditions improve (refer to macro-analysis earlier in this report).

Figure 6: ARB Holdings Price Earnings (PE) Versus Peers, Indices (& Compared to Prior H1:19 PE's six month's ago)



	ARB Holdings	Elec. & Elec. Prod. Index	Construction Index	Itatile	CashBuild
Current PE (x)	7.1	9.5	16.0	14.1	12.8
PE at H1:19 (x)	7.5	10.2	13.9	14.5	14.3
Average	11.9	11.9	11.9	11.9	11.9

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 576cps (previously: 636cps) on an implied Price Earnings (PE) of 9.9x.
  - This fair value implies that ARH shares are c.42% undervalued at current levels.
  - Our fair value implied PE does not appear unreasonable against the various comparatives in the market (Figure 6).
  - In fact, this implied PE appears cheap versus many comparatives and could imply upside risk to our valuation assumptions.

- Rolling our fair value forward at our CoE, we arrive at a 12m TP of 670cps (previous 12m TP: 744cps).
    - A 12m TP of 670cps places the share on a fair Exit PE of 12.6x.
    - While this exit multiple may be higher than normal, we see the Group as having an embedded option on South Africa and Eskom's turnaround and note that the multiple actually in line with our peer group average (Figure 6).
    - Our 12m TP also implies a return of c.65%.

Key Risks to Our Valuation

- The major macroeconomic variables in South Africa (specifically, GDP growth, construction and building sectors, labour environment, Eskom- and municipal-related spend, sovereign risk, amongst other variables + the above noted 'Terminal Year' growth rate),
- The exercise of the Eurolux (& Craigcor) put option(s) against ARB Holdings,
- The successful turnaround of the Radiant acquisition,
- The successful extraction of operational upside from the Lord's View DC,
- The timing and successful implementation of the Group's organic product, store and market expansion drive, and
- The timing, quantum and success of the Group's future, unquantified acquisitive activity.

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** Market prices in this report predominantly set to closing price on during 8 September 2019 (405cps).*

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