

**ARB Holdings Ltd**  
**FY 15 Results – Results Indicative of Quality**

Share Code: ARH – Market Cap: R1.4bn – PE: 12.0x – DY: 5.0%

12m Target Price	712cps
Share Price	599cps
Implied Return	20%

Industrials | South Africa

**FY 15: Tougher Trading Environment Than We Anticipated**

- Amidst a tough domestic economy and a management transition, ARB Holdings reported flat FY 15 results with a small decline in the Electrical Division being offset by growth in the Lighting and Corporates Divisions.
- The Group reported revenue of R2.1bn (FY 14: R2.2bn), strong cash generation and flat HEPS of 50.0cps (FY 14: 50.3cps).
- These results were driven by an unexpected drop in activity and spending by Eskom (particularly in their rural electrification programme) and infrastructure-related work in a slowing, troubled domestic economy.
- The Group's finances remain robust and management has declared a normal and a special dividend of 20.1cps (FY 14: 20.1cps) and 10cps (FY 14: 10cps) respectively, implying that the Group's share is trading on a Dividend Yield (DY) of c.5.0%.

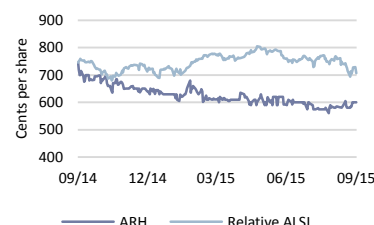
**Our Thoughts: Quality Business, Tough Market, Acquisitive Intentions**

- Given the tough environment, we see ARB Holdings' good FY 15 results as indicative of the Group's underlying quality.
- The macro-environment will be the biggest challenge for the Group's short-term organic growth ambitions, but the long-term strategy of expanding the Group's product lines, geographies and markets (both organically and acquisitively) should yield upside.
- In the short- to medium-term, though, it is likely that any major growth will be driven by acquisitive actions taken by the Group. While this is hard to forecast (and we do not even try), management have reasserted their intentions to conclude strategic and meaningful acquisitions in due course.

**Forecast, Valuation & Implied Return: Comfortably Priced**

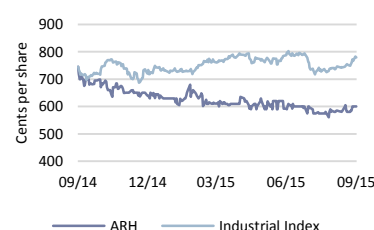
- We revise our fair value to 613cps (previously 715cps) putting the share on a Price Earnings (PE) of 12.3x. This arrives at a 12m TP of 712cps (previously 836cps) on an Exit PE of 12.9x implying a 12m return of c.20% with acquisitive upside risk to these numbers
- Key risks to the Group are unchanged from our original [Initiation of Coverage](#). In fact, the macro risks remain even more pertinent in the current environment.

Share Price against the ALSI



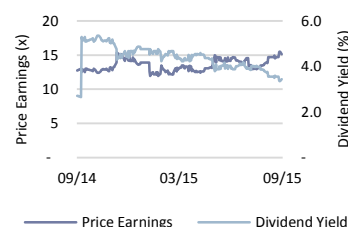
Sources: Bloomberg, Blue Gem Research

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 12A	FY 13A	YoY %	FY 14A	YoY %	FY 15A	YoY %	FY 16E	YoY %	FY 17E	YoY %
Revenue	1565	1945	24%	2217	14%	2151	-3%	2245	4%	2461	10%
EBITDA	133	167	26%	214	28%	209	-3%	234	12%	271	16%
HEPS (cps)	34.2cps	39.5cps	15%	50.3cps	27%	50.0cps	-1%	55.2cps	10%	65.0cps	18%
Return on Equity (%)	14.5%	15.4%	-	17.3%	-	16.2%	-	16.0%	-	17.1%	-
Price Earnings Ratio (x)	17.5x	15.1x	-	11.9x	-	12.0x	-	10.9x	-	9.2x	-
DPS (cps)	13.7cps	26cps*	>100%	30cps*	15%	30cps*	0%	22.1cps	-26%	26.0cps	18%
Dividend Yield (%)	2.3%	4.4%	-	5.0%	-	5.0%	-	3.7%	-	4.3%	-

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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Keith McLachlan\*



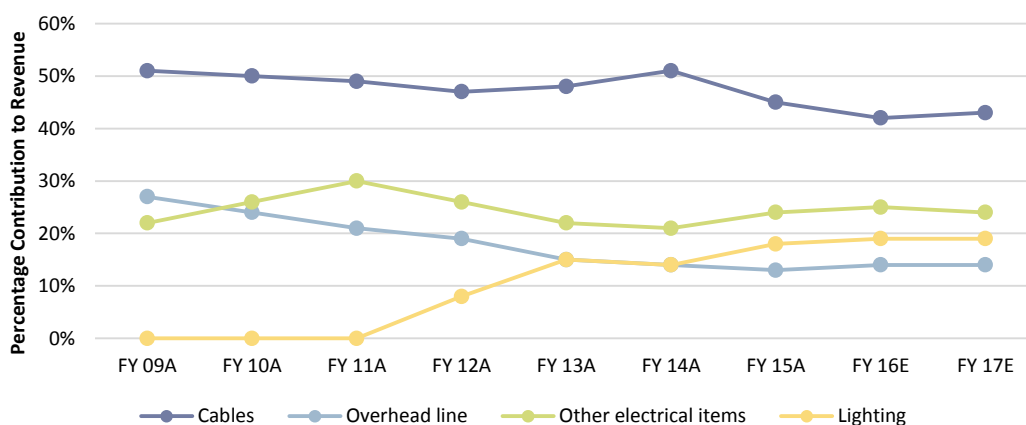
Key Forecast (R m)	FY 12A	FY 13A	YoY %	FY 14A	YoY %	FY 15A	YoY %	FY 16E	YoY %	FY 17E	YoY %
<b>Revenue</b>	<b>1565</b>	<b>1945</b>	<b>24%</b>	<b>2217</b>	<b>14%</b>	<b>2151</b>	<b>-3%</b>	<b>2245</b>	<b>4%</b>	<b>2461</b>	<b>10%</b>
Electrical Wholesaling	1449	1679	16%	1876	12%	1741	-7%	1741	0%	1880	8%
Lighting	120	281	135%	351	25%	425	21%	511	20%	587	15%
<b>Gross Profit</b>	<b>307</b>	<b>425</b>	<b>38%</b>	<b>527</b>	<b>24%</b>	<b>517</b>	<b>-2%</b>	<b>553</b>	<b>7%</b>	<b>619</b>	<b>12%</b>
<i>Gross Profit Margin (%)</i>	19.6%	21.9%	-	23.8%	-	24.1%	-	24.6%	-	25.2%	-
Operating expenses	-186	-270	45%	-329	22%	-325	-1%	-335	3%	-365	9%
<b>EBITDA</b>	<b>133</b>	<b>167</b>	<b>26%</b>	<b>214</b>	<b>28%</b>	<b>209</b>	<b>-3%</b>	<b>234</b>	<b>12%</b>	<b>271</b>	<b>16%</b>
<i>EBITDA Margin (%)</i>	8.5%	8.6%	-	9.7%	-	9.7%	-	10.4%	-	11.0%	-
Operating Profit/(Loss) Before Interest	128	160	26%	203	27%	197	-3%	223	13%	259	16%
Interest Received	18	10	-42%	11	10%	15	32%	11	-26%	17	48%
Finance Charges	-1	-1	37%	-0	-80%	-	-100%	-	0%	-	0%
<b>Net Profit (Parents)</b>	<b>81</b>	<b>95</b>	<b>18%</b>	<b>118</b>	<b>24%</b>	<b>117</b>	<b>-1%</b>	<b>130</b>	<b>10%</b>	<b>153</b>	<b>18%</b>
<i>Weighted Ave. Number of Shares (millions)</i>	235m	235m	0%	235m	0%	235m	0%	235m	0%	235m	0%
<b>EPS (cps)</b>	<b>34.3cps</b>	<b>40.5cps</b>	<b>18%</b>	<b>50.3cps</b>	<b>24%</b>	<b>50.0cps</b>	<b>-1%</b>	<b>55.2cps</b>	<b>10%</b>	<b>65.0cps</b>	<b>18%</b>
<b>HEPS (cps)</b>	<b>34.2cps</b>	<b>39.5cps</b>	<b>15%</b>	<b>50.3cps</b>	<b>27%</b>	<b>50.0cps</b>	<b>-1%</b>	<b>55.2cps</b>	<b>10%</b>	<b>65.0cps</b>	<b>18%</b>
Gross Ordinary DPS (cps)	14cps	26cps*	>100%	30cps*	15%	30cps*	0%	22cps	-26%	26cps	18%
<i>Dividend Yield, including Special Dividends* (%)</i>	2.3%	4.4%	-	5.0%	-	5.0%	-	3.7%	-	4.3%	-
<i>Dividend Cover, inc. Special Dividends* (x)</i>	2.5x	1.5x	-40%	1.7x	11%	1.7x	-1%	2.5x	50%	2.5x	0%
Property, Plant & Equipment	163	194	19%	206	6%	222	8%	213	-4%	221	4%
Intangible Assets	78	84	8%	84	-1%	84	0%	84	0%	84	0%
Current Assets	737	857	16%	931	9%	967	4%	1092	13%	1226	12%
Net Cash	179	203	13%	198	-3%	227	15%	337	48%	418	24%
Cash	185	203	9%	198	-3%	227	15%	337	48%	418	24%
Overdraft	-6	-	-	-	-	-	-	-	-	-	-
Shareholder's Equity (Parent)	582	656	13%	712	9%	769	8%	847	10%	939	11%
Non-current Liabilities	41	38	-8%	35	-9%	40	15%	43	9%	51	18%
Current Liabilities	210	279	33%	287	3%	255	-11%	253	-1%	251	-1%
NAV per share (cps)	248cps	279cps	13%	303cps	9%	327cps	8%	361cps	10%	399cps	11%
TNAV per share (cps)	214cps	252cps	18%	276cps	9%	302cps	10%	325cps	7%	364cps	12%
Cash Generated by Operations	95	197	107%	144	-27%	170	19%	227	33%	233	3%
<i>Cash Conversion Ratio (%)</i>	72%	118%	-	67%	-	82%	-	97%	-	86%	-
Net Cash Flow from Financing Activities	-112	-79	-29%	-25	-69%	-14	-44%	-3	-75%	-20	495%
Net Increase / (Decrease) in Cash	-7	-16	120%	-2	-86%	-0	-99%	3	>100%	7	89%
<i>Return on Equity (%)</i>	14.5%	15.4%	-	17.3%	-	16.2%	-	16.0%	-	17.1%	-
<i>Return on Capital Employed (%)</i>	11.6%	12.9%	-	14.9%	-	13.4%	-	13.5%	-	14.0%	-
<i>Return on Assets (%)</i>	10.3%	10.8%	-	12.5%	-	12.0%	-	12.0%	-	12.9%	-
Price Earnings Ratio (%)	17.5x	15.1x	-	11.9x	-	12.0x	-	10.9x	-	9.2x	-
Price-to-Book (x)	2.4x	2.1x	-	2.0x	-	1.8x	-	1.7x	-	1.5x	-
Price-to-Tangible-Book (x)	2.8x	2.4x	-	2.2x	-	2.0x	-	1.8x	-	1.6x	-
Current Ratio	3.5x	3.1x	-	3.2x	-	3.8x	-	4.3x	-	4.9x	-
Quick Ratio	2.3x	1.8x	-	1.9x	-	2.3x	-	2.7x	-	3.1x	-

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

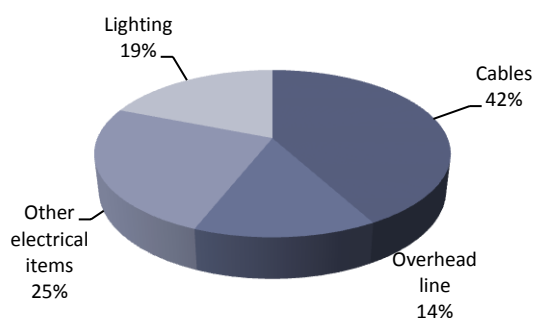
## FY 15 Results Highlights

- ARB Holdings reported flat FY 15 results with the following key aspects:
  - Revenue missed our [previously published R2.5bn forecast](#) to come in at R2.1bn (FY 14: R2.2bn). This predominantly driven by softer volumes at the Electrical Division due to a lack of activity in the domestic infrastructural and Eskom-related markets.
  - A key positive in the Group’s results was the continuing growth in the Lighting Division as both product and market share expansion continues (see Figure 1).
  - Margins continued rising due to the growing relative contribution from the Lighting Division and excellently controlled overheads in the Group (operating costs only rose 1% y/y on a nominal basis, thus they effectively dropped on a real basis).
  - The Group remained exceptionally cash generative with a comfortable balance sheet allowing management to declare a normal dividend of 20.1cps (FY14: 20.1cps) and a special dividend of 10.0cps (FY 14: 10.0cps) putting the share on a 5.0% Dividend Yield (DY).

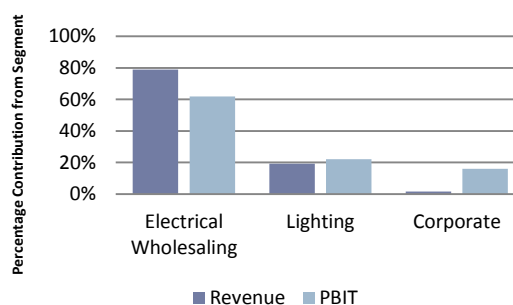
Figure 1: Expansion and Split of ARB Holdings’ Product Range



FY 15 - Product Sales Split



FY 15 - Segmental Revenue & Profit Split



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

- During FY 15 Byron Nichles resigned as Group CEO and William Neasham, the former FD, stepped into the role as Group CEO. A new, experienced FD has been appointed subsequent to year end.
- Management note the tough trading environment and weak near-term economic prospects in South Africa, but are remain focussed on the Group’s key strategy: growing the products, geographies and markets of the Group, both organically and acquisitively.
- While we see near-term organic growth prospects as limited by macro-factors, the Group’s ungeared, cash-flush, property underpinned (R181m portfolio or c.12% of market cap) balance sheet definitely positions it well for any potential acquisitions management may conclude going forward.

## 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 16E	FY 17E
Revenue	1 209	1 088	1 258	1 449	1 679	1 876	1 741	1 741	1 880
Change in Revenue	-	-10%	16%	15%	16%	12%	-7%	0%	8%

Sources: Bloomberg, Blue Gem Research and ARB Holdings

- The Electrical Division’s disappointing results can be traced to the soft economic conditions and lack on infrastructure and Eskom-related activity that negatively impacted its revenues. This resulted in the Segment reporting revenue declining 7% to R1.7bn (FY 14: 1.8bn), quite a bit below our previous forecast FY 15E revenue of R2.1bn.
- Despite this, the Segment’s gross margins improved due to procurement efficiencies. A challenging credit market was successfully navigated and management specifically focussed on stock levels to manage the Segment’s exposure to the volatile copper price (a large percentage of cable’s that are a large percentage of stock levels).
- The Segment has continued with its strategy of introducing further products and looking at new geographies for future store opens. The latter should see two new stores being opened in the greater Johannesburg region during FY 16E with a steady roll-out of future stores at key nodes thereafter.
- We have softened our revenue expectations for FY 16E, but also shaved costs off due to the efficiencies that this business is managing to realize. The net results is that we see FY 16E revenues flat (previously forecast at +8%) and profits marginally up on FY1 5E, yet below our previous forecasts.
- **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 (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 09A*	FY 10A*	FY 11A*	FY 12A*	FY 13A	FY 14A	FY 15A	FY 16E	FY 17E
Revenue	-	-	-	120	281	351	425	511	587
Change in Revenue	-	-	-	>100%	135%	25%	21%	20%	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 actually beat our revenue forecast, as it continued to gain momentum in its business by growing its product range, customer base, market share and, ultimately, its profits.
- FY 15 revenue grew 21% to R425m (FY 14: R351m), beating our previous forecast of R403m. The Segment’s Operating Profits also jumped 11% to R44m (FY 14: R39m).
- Significant challenges during FY 15 included a volatile exchange rate and the delayed offtake by a new customer resulting in some working capital build up. Especially the latter we expect should reverse post-year end, while the former is an industry-wide challenge (there are no local producers, so all of Eurolux’s competitors are also importers and also exposed to the volatile exchange rates).
- We have lifted our FY 16E forecast revenue by 10% to R511m (previous forecast: R464m). This is predominantly due to management-driven growth in product lines and customer-base, but it may also be helped indirectly by the challenges facing some of its competitors in the market.

## 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,

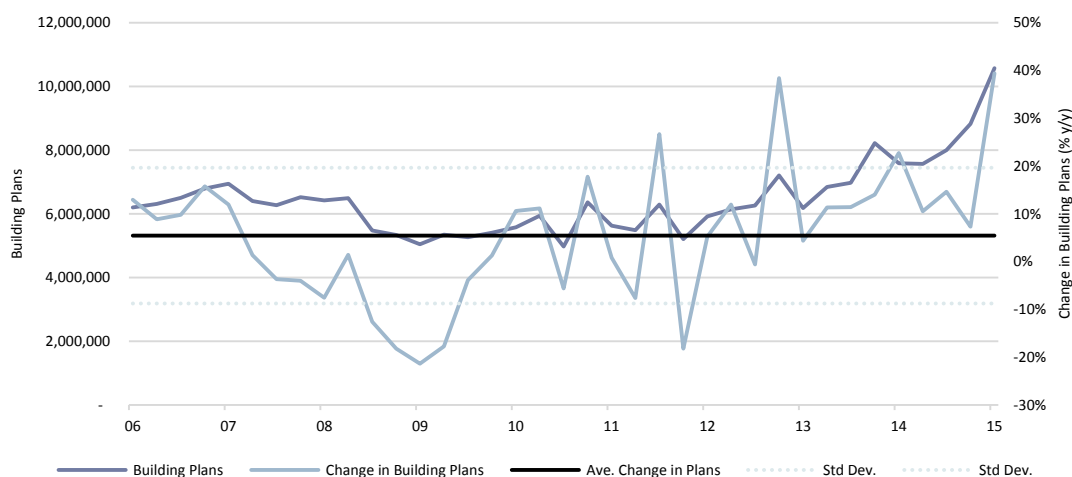
so we note here that this implies upside optionality in the Group comes from this segment. I.e. The conclusion of a value-enhancing acquisition can potentially make our valuation(s) and forecasts for the Group too low.

- **Property:** The property segment operated in line with expectations and was valued at R181m (FY 14: R163m).

## Construction, Building Materials & Electrical Wholesaling Industries

- South Africa’s economy, infrastructural activity and Eskom-related spend all continue to be soft.
- We consider the continuation or worsening of this trend to be the biggest risk to our view of ARB Holdings, though there are a number of positives to consider:
  - South Africa’s economic stagnation is a symptom of struggling mining, industrial and labour environments. While labour remains a complex variable to forecast, both the mining and industrial bases of the economy have slumped to such low bases that any improvement in these sectors will have a relatively large impact on them.
  - While the infrastructural market remains soft, the order books of the major construction companies and their tenders are broadly improving. This appears to be predominantly driven by smaller projects, rather than the previous cycle’s large, Government-driven mega-tenders. Perhaps a symptom of this structure change in this market can be seen in the relatively large spike in Building Plans Passed in South Africa (Figure 2), which is naturally a leading indicator of building activity, albeit not necessarily public sector infrastructural spend.
  - While Eskom-related spend, particularly in the rural electrification programme, is slow, its need to continue (if not, ramp up) remains and, logically, we should hope that this spend *will* eventually happen.

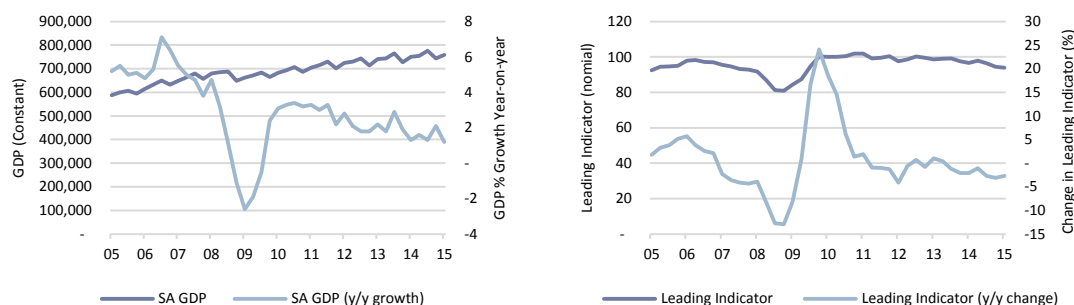
**Figure 2: Building Plans Passed, Growth in Building Plans Passed (actual, average and standard deviations)**



Sources: Bloomberg, Blue Gem Research workings

- Despite the above noted positives, the historical GDP and the South African Leading Indicator paint a bleak picture of the domestic economy (Figure 3).

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



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

## Forecasts

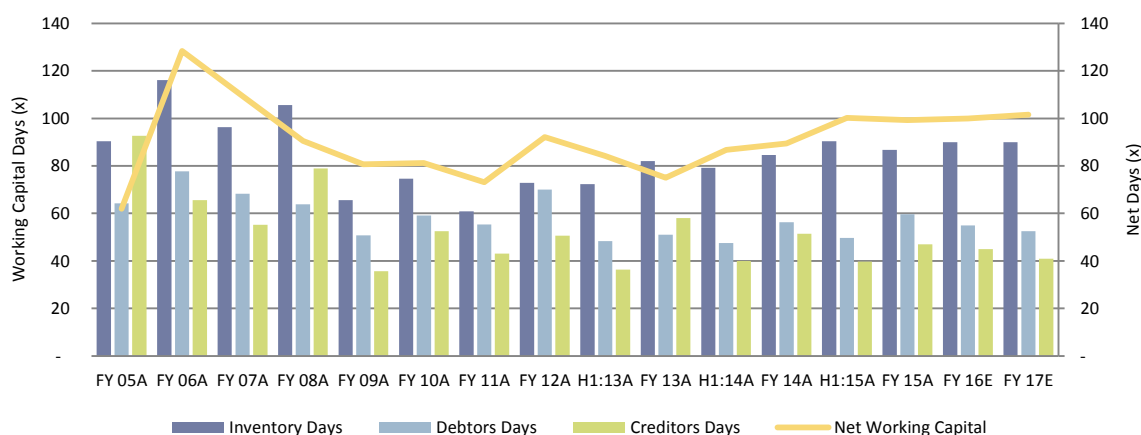
### Revenues and profitability

- We have lowered our expected FY 16E revenues for ARB Holdings to R2.2bn (previous forecast: R2.7bn). Refer to the above segmental commentary to get more granular detail hereon.
- Despite this, we still see margins steadily improving from the growing contribution from Lighting, ARB Connect and product expansion combined with operational efficiencies with a well-controlled overhead structure underpinned by significant property investment.
- Therefore we forecast FY 16E HEPS growth of 10% to 55.2cps (previously forecast: 61.9cps).
- Our forecast indicates a Return on Equity (ROE) of 16.0% (FY 15: 16.2%), so the Group’s profitability prospects remain robust, while its cash generative nature implies a health forward DY.

### 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).

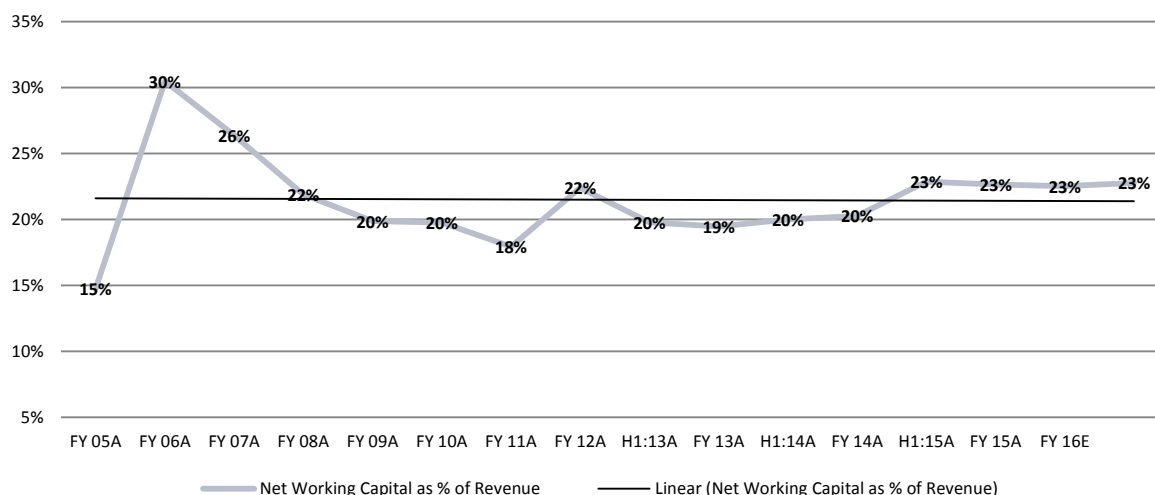
**Figure 5: Working Capital History of ARB Holdings**



Sources: ARB Holdings, Blue Gem Research workings

- Management track working capital as a percentage of revenue. On this basis, working capital has remained relatively stable (Figure 6).
- We do not expect any major change to this relationship and consider the Group’s long history of excellently managed working capital as indicative of what we can expect going forward.

**Figure 6: 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 5) remains unchanged, except for the following updates:
- Cost of Equity (CoE) of 16.6% based off a “Rule of Thumb” beta of 1.4x and an Equity Risk Premium of 5.5%.
- Growth rates of the following:
  - FY 16E and FY 17E: per our forecasts in this report,
  - FY 18E to FY 24E: 15% y/y (10% real and 5% inflation), and
  - FY 25E/Terminal Year: 9% y/y (4% real and 5% inflation).
- Finally, we take out an effective estimate of the 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 16E	FY 17E	FY 18E	FY 19E	FY 20E	FY 21E	FY 22E	FY 23E	FY 24E	Terminal year
EBITDA	234	271	312	374	449	539	647	776	931	1015
Less: Tax	-65	-77	-89	-106	-128	-153	-184	-221	-265	-289
Less: Working Capital	-19	-55	-63	-75	-90	-109	-130	-156	-188	-204
Less: Capex	-15	-16	-18	-22	-26	-32	-38	-46	-55	-30
Free Cash Flow (FCF)	136	123	142	170	205	245	294	353	424	492
Discounted FCF	117	92	91	94	97	100	104	107	111	918
NPV (Enterprise Value)										R1 831m
Add: Net Cash										R227m
Fair Value, inc. Minorities (R m)										R2 058m
Fair Value, ex. Minorities (R m)										R1 441m
Fair Value of ARB shares (cps)										613cps
Implied Price Earnings (x)										12.3x
Discount to Fair Value (%)										3%
12m TP (cps)										712cps
Exit Price Earnings (x)										12.9x
Implied Return (%)										20%

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

- We arrive at a fair value of 613cps (previously: 715cps) on an implied Price Earnings (PE) of 12.3x. Rolling this forward at our CoE, this fair value implies a 12m TP of 712cps (previous 12m TP: 836cps) on an Exit PE of 12.9x.
- Note our previously stated acquisitive upside to this valuation.

### Dividend Discount (DD) Model

- Other than those indicated in the DCF model above and a slightly more aggressive unwind in the Dividend Cover of the Group, our DD model remains unchanged (Table 6):

**Table 6: DCF Model – ARB Holdings**

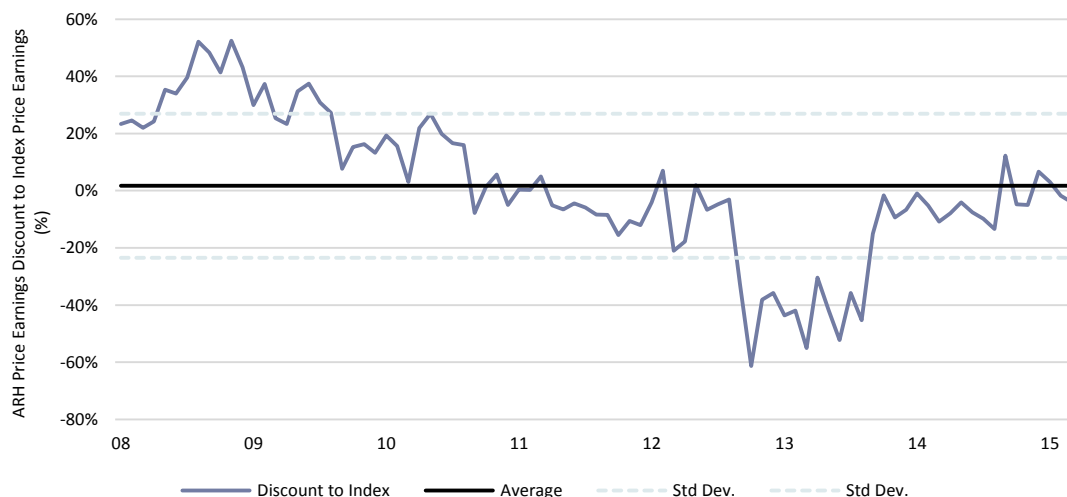
	FY 15A	FY 16E	FY 17E	FY 18E	FY 19E	FY 20E	FY 21E	FY 22E	FY 23E	FY 24E	Terminal year
HEPS (cps)	50.0	55.2	65.0	71.5	82.2	94.5	108.7	125.0	143.8	165.3	130.0
Dividend Cover (x)	2.5	2.0	2.0	2.0	1.5	1.5	1.5	1.5	1.5	1.5	1.0
DPS (cps)	30.0	27.6	32.5	35.7	54.8	63.0	72.5	83.3	95.8	110.2	130.0
DWT (15%)	-4.5	-4.1	-4.9	-5.4	-8.2	-9.5	-10.9	-12.5	-14.4	-16.5	-19.5
<b>Net DPS (cps)</b>	<b>25</b>	<b>23</b>	<b>28</b>	<b>30</b>	<b>47</b>	<b>54</b>	<b>62</b>	<b>71</b>	<b>81</b>	<b>94</b>	<b>111</b>
Discount Factor	1.00	0.86	0.74	0.64	0.55	0.47	0.41	0.35	0.30	0.26	0.23
<b>Discounts DPS (cps)</b>	<b>25.5</b>	<b>20.2</b>	<b>20.5</b>	<b>19.4</b>	<b>25.7</b>	<b>25.4</b>	<b>25.2</b>	<b>25.0</b>	<b>24.7</b>	<b>24.5</b>	<b>326.8</b>
<b>Fair Value (cps)</b>											<b>563cps</b>
<b>Implied PE Ratio (x)</b>											<b>11.3x</b>

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

### Price Earnings (PE) Model

- The Group’s relative PE has reverted back to just below its historical mean (Figure 7).
- We believe that a large part of this historical mean PE was formed by price discovery in the market that did not fully appreciate the quality of the Group’s underlying businesses. Thus, we do not consider this PE methodology to be overly illustrative of the share’s intrinsic value.

**Figure 7: ARB Holdings Price Earnings (PE) Historical Discount versus the Electrical and Electrical Components Index**

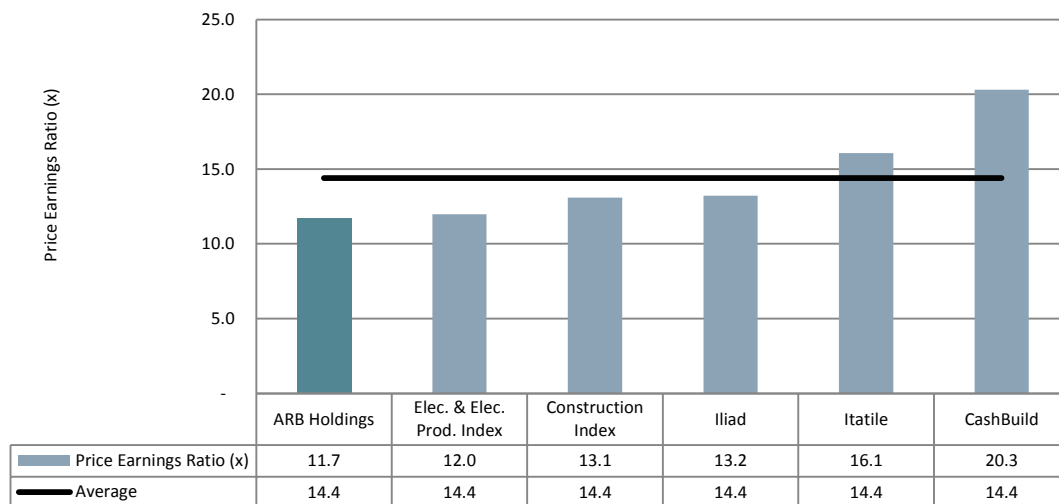


Sources: Bloomberg, Blue Gem Research workings

- 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 8), the share does look to hold some value at these levels.



**Figure 8: 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 613cps (previously: 715cps) on an implied Price Earnings (PE) of 12.3x.
  - This PE does not appear unreasonable against either ARH’s own history or the various comparatives in the market (Figure 8).
- Rolling our fair value forward at our CoE we arrive at a 12m TP of 712cps (previous 12m TP: 836cps).
  - A 12m TO of 712cps places the share on a comfortable Exit PE of 12.9x
  - Our 12m TP also implies a return of c.20%.

### 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, 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 2 September 2015 (599cps).*

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