

**Results Note**  
17 March 2017

**ARB Holdings Ltd**  
**H1:17 Results – Quietly Growing**

Share Code: ARH – Market Cap: R1.5bn – PE: 10.6x – DY: 3.0%

12m Target Price	779cps
Share Price	635cps
Implied Return	23%

Industrials | [South Africa](#)

**H1:17 – Steady Does It...**

- ARB Holding's revenue rose by 3% to R1.27bn (H1:16 – R1.23bn) with Lighting leading the growth while soft municipal spend dampening Electrical's contribution during the period.
- HEPS rose 1% to 28.07cps (H1:16 – 27.79cps) while cash flow generation remained good and the balance sheet ungeared with R175m of net cash on hand.
- Although in the ARB's results are a bit below our expectations, the Group continues to steadfastly execute their strategy of geographic, product and customer expansion with cabling dropping from >50% of the Group's turnover seven years ago to c.37% of it in these results.

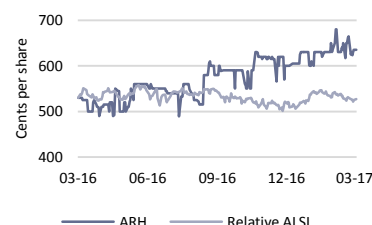
**Our Thoughts: Stagnation in the Base, Upside in the Future**

- While we may be premature in this call, we believe that we are currently in the trough in both South Africa (2016/17) and in ARB's market (FY 17E and, perhaps, FY 18E).
- SA's Leading Indicator and as well as many global indicators everywhere are, at worst, not falling anymore and, at best, starting to rise.
- That said, we do not expect a sudden recovery and would not be surprised if this trough stretched out (i.e. flat growth) into 2018.

**Forecast, Valuation & Implied Return: Attractive Valuation**

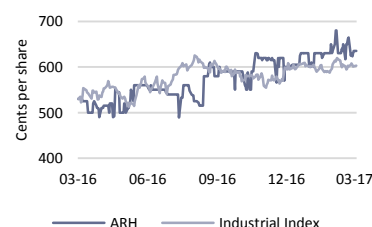
- We lift our fair value for ARH to 664ps (previously: 650cps) on an implied Price Earnings (PE) of 11.1x. This PE does not appear unreasonable against either ARH's own history or the various comparatives in the market.
- Rolling this fair value forward at our CoE we arrive at a 12m TP of 779cps (previous 12m TP: 762cps), which places the share on a comfortable Exit PE of 11.4x.
- This 12m TP also implies a reasonably attractive return of c.23%.
- Key risks to the Group are unchanged from our original [Initiation of Coverage](#).

**Share Price against the ALSI**



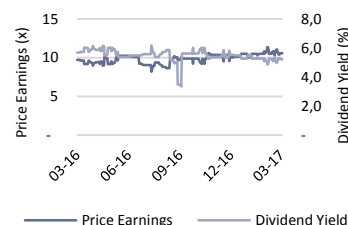
Sources: Bloomberg, Blue Gem Research

**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 %	H1:17A	FY 17E	YoY %	FY 18E	YoY %
Revenue	2 217	14%	2 151	-3%	2 490	16%	1 274	2 607	5%	2 856	10%
EBITDA	215	28%	208	-3%	228	10%	112	239	5%	270	13%
HEPS (cps)	50.3cps	27%	51.7cps	3%	59.7cps	16%	28.1cps	61.4cps	3%	69.9cps	14%
Return on Equity (%)	17.3%	-	16.7%	-	17.2%	-	16.3%	17.0%	-	17.1%	-
Price Earnings Ratio (x)	12.6x	-	12.3x	-	10.6x	-	11.3x	10.3x	-	9.1x	-
DPS (cps)	30.0cps	15%	30.0cps	0%	33.9cps	13%	-	24.6cps	-28%	28.0cps	14%
Dividend Yield (%)	4.7%	-	4.7%	-	5.3%	-	0.0%	3.9%	-	4.4%	-

Sources: ARB Holdings, Bloomberg, Iress, Blue Gem Research; \* FY 13, 14, 15 and 16's total distributions include a special dividend of 10cps



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Keith McLachlan\*



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BLUE GEM RESEARCH

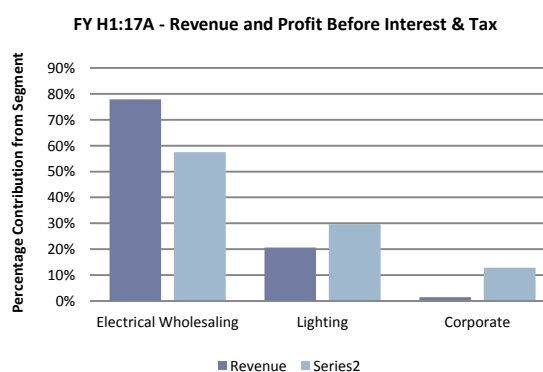
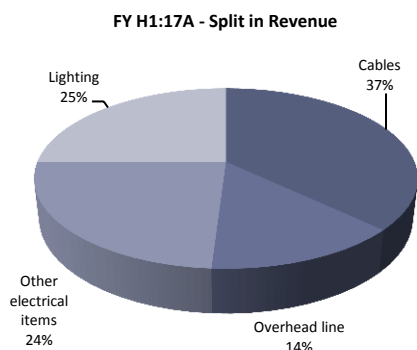
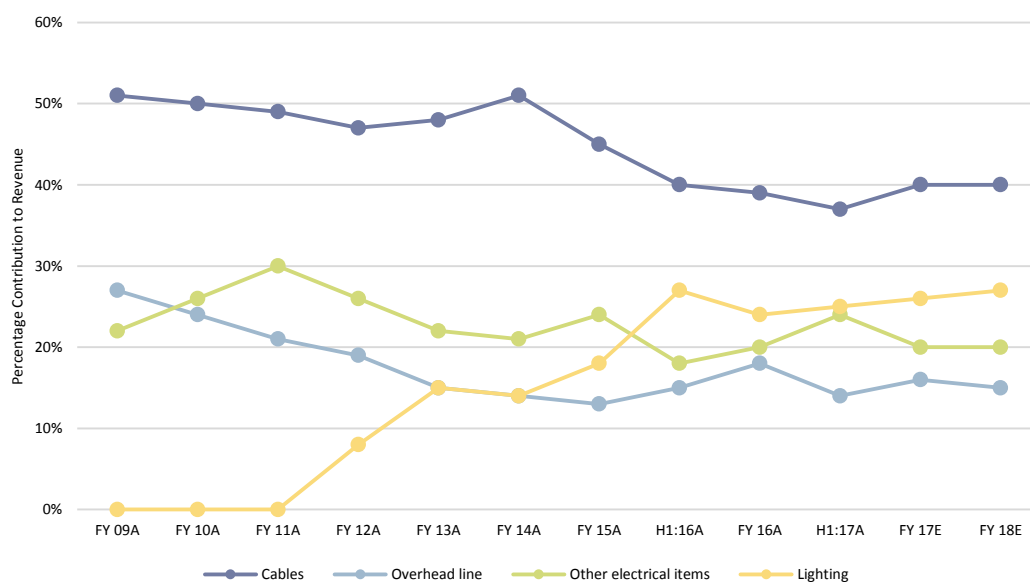
Key Forecast (R m)	FY 14A	YoY %	FY 15A	YoY %	FY 16A	YoY %	H1:17A	FY 17E	YoY %	FY 18E	YoY %
<b>Revenue</b>	<b>2217</b>	<b>14%</b>	<b>2151</b>	<b>-3%</b>	<b>2490</b>	<b>16%</b>	<b>1274</b>	<b>2607</b>	<b>5%</b>	<b>2856</b>	<b>10%</b>
Electrical Wholesaling	1876	12%	1741	-7%	2006	15%	1018	2066	3%	2221	8%
Lighting	351	25%	425	21%	507	19%	271	558	10%	652	17%
<b>Gross Profit</b>	<b>527</b>	<b>24%</b>	<b>517</b>	<b>-2%</b>	<b>548</b>	<b>6%</b>	<b>290</b>	<b>592</b>	<b>8%</b>	<b>655</b>	<b>11%</b>
<i>Gross Profit Margin (%)</i>	23.8%	-	24.1%	-	22.0%	-	22.8%	22.7%	-	22.9%	-
Operating expenses	-329	22%	-325	-1%	-338	4%	-188	-372	10%	-405	9%
<b>EBITDA</b>	<b>215</b>	<b>28%</b>	<b>208</b>	<b>-3%</b>	<b>228</b>	<b>10%</b>	<b>112</b>	<b>239</b>	<b>5%</b>	<b>270</b>	<b>13%</b>
<i>EBITDA Margin (%)</i>	9.7%	-	9.7%	-	9.2%	-	8.8%	9.2%	-	9.4%	-
Operating Profit/(Loss) Before Interest	203	27%	197	-3%	217	10%	105	227	5%	257	13%
Interest Received	11	10%	15	32%	12	-21%	7	12	2%	15	26%
Finance Charges	-0	-80%	-	-100%	-	0%	-	-	0%	-	0%
<b>Net Profit (Parents)</b>	<b>118</b>	<b>24%</b>	<b>122</b>	<b>3%</b>	<b>136</b>	<b>12%</b>	<b>65</b>	<b>144</b>	<b>6%</b>	<b>164</b>	<b>14%</b>
Weighted Ave. Number of Shares (millions)	235.0	0%	235.0	0%	235.0	0%	235.0	235.0	0%	235.0	0%
<b>EPS (cps)</b>	<b>50.3cps</b>	<b>24%</b>	<b>51.7cps</b>	<b>3%</b>	<b>57.7cps</b>	<b>12%</b>	<b>27.8cps</b>	<b>61.4cps</b>	<b>6%</b>	<b>69.9cps</b>	<b>14%</b>
<b>HEPS (cps)</b>	<b>50.3cps</b>	<b>27%</b>	<b>51.7cps</b>	<b>3%</b>	<b>59.7cps</b>	<b>16%</b>	<b>28.1cps</b>	<b>61.4cps</b>	<b>3%</b>	<b>69.9cps</b>	<b>14%</b>
Gross Ordinary DPS (cps)	30	15%	30	0%	34	13%	-	25	-28%	28	14%
<i>Dividend Yield (%)</i>	4.7%	-	4.7%	-	5.3%	-	0.0%	3.9%	-	4.4%	-
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%	231	235	4%	257	10%
Intangible Assets	84	-1%	84	0%	78	-7%	78	78	0%	78	0%
Current Assets	931	9%	967	4%	1122	16%	1030	1204	7%	1379	15%
Net Cash	198	-3%	227	15%	243	7%	175	306	26%	366	20%
Cash	198	-3%	227	15%	243	7%	175	306	26%	366	20%
Overdraft	-	-	-	-	-	-	-	-	-	-	-
Interest-bearing Liabilities	-	-	-	-	-	-	-	-	-	-	-
Shareholder's Equity (Parent)	712	9%	769	8%	825	7%	813	912	10%	1010	11%
Non-current Liabilities	107	181%	115	8%	126	10%	42	125	-1%	131	4%
Current Liabilities	287	3%	255	-11%	320	26%	328	297	-7%	360	21%
NAV per share (cps)	296.6	6%	322.5	9%	351.1	9%	345.9	388.0	10%	430.0	11%
TNAV per share (cps)	264.7	5%	292.8	11%	322.0	10%	318.4	354.8	10%	396.8	12%
Cash Generated by Operations	144	-27%	170	19%	168	-1%	62	208	24%	232	11%
<i>Cash Conversion Ratio (%)</i>	67%	-	82%	-	74%	-	55%	87%	-	86%	-
Net Cash Flow from Financing Activities	-25	-69%	-14	-44%	-10	-26%	-13	-20	94%	-35	76%
Net Increase / (Decrease) in Cash	-2	-86%	-0	-99%	-7	40394%	-	-13	83%	-10	-24%
<i>Return on Equity (%)</i>	17.3%	-	16.7%	-	17.2%	-	16.3%	17.0%	-	17.1%	-
<i>Return on Capital Employed (%)</i>	14.9%	-	13.4%	-	14.7%	-	14.4%	13.8%	-	14.0%	-
<i>Return on Assets (%)</i>	12.5%	-	12.0%	-	11.2%	-	11.6%	11.3%	-	11.4%	-
<i>Price Earnings Ratio (x)</i>	12.6x	-	12.3x	-	10.6x	-	11.3x	10.3x	-	9.1x	-
<i>Price-to-Book (x)</i>	2.1x	-	2.0x	-	1.8x	-	1.8x	1.6x	-	1.5x	-
<i>Price-to-Tangible-Book (x)</i>	2.4x	-	2.2x	-	2.0x	-	2.0x	1.8x	-	1.6x	-
Current Ratio	3.2	-	3.8	-	3.5	-	3.1	4.1	-	3.8	-
Quick Ratio	1.9	-	2.3	-	2.1	-	1.7	2.5	-	2.4	-

Sources: ARB Holdings, Bloomberg, Iress, Blue Gem Research workings, assumptions and forecasts; \* Only final dividends declared.

## H1:17 Results Highlights

- ARB Holdings (ARH) reported fair H1:17 results with the following key aspects:
  - Revenue rose by 3% to R1.27bn (H1:16 – R1.23bn) with Lighting leading the growth while soft municipal spend dampening Electrical’s contribution during the period.
  - HEPS rose 1% to 28.07cps (H1:16 – 27.79cps) while the cash flow generation remained good and balance sheet ungeared with R175m of net cash on hand.
  - The Group continues its Connect store roll-out while hunting for the next major acquisition.
  - Although in the short-term ARB’s results are a bit below our expectations, the Group continues to steadfastly execute their strategy of geographic, product and customer expansion with cabling dropping from >50% of the Group’s turnover seven years ago to c.37% of it in these results.
  - The Group’s dividend policy dictates a single distribution at the end of the financial year, thus the Group did not declare an interim dividend. In the absence of any acquisitions and with normal trading, management expects to once again declare a special dividend at that time as well.

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	H1:13A	FY 13A	H1:14A	FY 14A	FY 15A	FY 16A	H1:17A	FY 17E	FY 18E	FY 19E
Revenue	1209	1088	1258	1449	829	1679	985	1876	1741	2006	1018	2066	2221	2443
Change in Revenue	-	-10%	16%	15%	19%	16%	19%	12%	-7%	15%	-49%	3%	8%	10%

Sources: Bloomberg, Blue Gem Research and ARB Holdings

- Competitive pressures on margins and continued delays in municipal projects combined for a tough trading period in the Electrical segment. The volatile Rand Copper Price during this period did not make things easier (although see our note at the end of this section).
- Three new ARB Connect stores were opened as management are constantly learning from and tweaking this higher-margin, cash-generative retail-orientated store model as they steadily roll it out across South Africa.
- Electrical's various unique product ranges had mixed results during the period with ACCC® performing poorly and CHINT performing well.
- We have lowered our FY 17E forecast revenue from R2.2bn to R2.1bn and shaved off some margin for the continued margin pressure during this year. We have lowered FY 19E growth rate from 10% y/y to 8% y/y, but see the slow recovery reaching more normal levels in FY 20E where growth reached 10% y/y. These forecast changes are largely due to our view that in the short-term there is unlikely to be any major recovery in the market, but we also think that we may have seen the worst of the downside for the time being.
- **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	H1:17A	FY 17E	FY 18E	FY 19E
Revenue	-	120	140	281	174	351	425	507	271	558	652	750
Change in Revenue	-	>100%	>100%	135%	24%	25%	21%	19%	-47%	10%	17%	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 was the star performer during the period with revenue growing 6% y/y and operating profit rising 9% y/y. That said, this was below our expected growth rate of 18% y/y, and we have adjusted this downwards going forward.
- The Lighting segment continues to expand both its product range and customer base. While the former was successful during the period, the latter was slow and the business focused more on expanding their sales into existing customers during the period.
- The new Euro Nouveau lighting showroom opened with positive results while the Crabtree JV growth continues (albeit at a slower rate than initially expected).
- We have lowered our FY 17E revenue target from R598m to R558m, though we continue to be extremely positive about this segment and expect growth rates to normalize higher in the long-term.

## Group services segment

- **Strategic acquisitions:** Management continues to reiterate 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

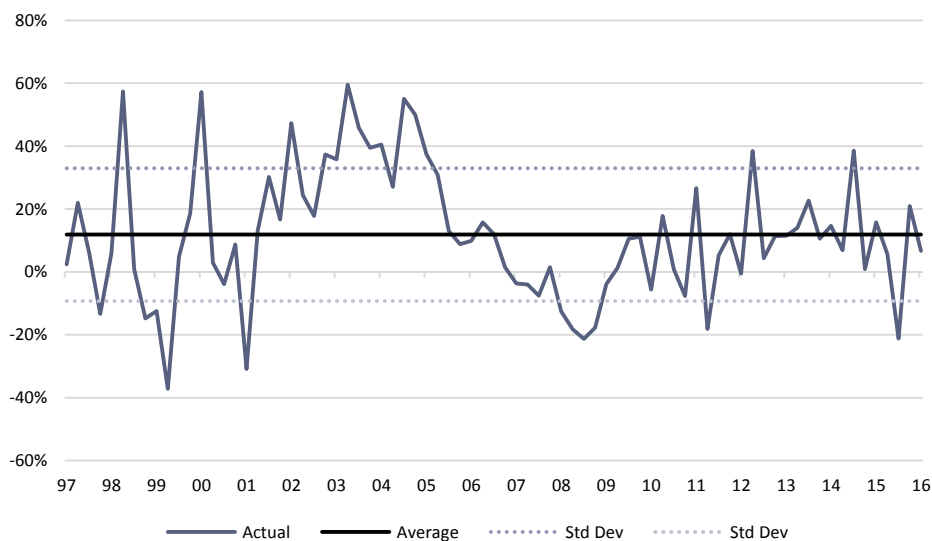
acquisition. Thus, we note here that this implies upside optionality in our valuation and forecasts regarding the Group. I.e. A conclusion of a value-enhancing acquisition can potentially make our valuation(s) and forecasts for the Group inaccurate.

- **Property:** The property segment operated in line with expectations and was valued at R177m (FY 16: R178m) with the decrease being due to a small disposal during the period.

### Construction, Building Materials & Electrical Wholesaling Industries

- While there are no fireworks indicated in the Building Plans (Figure 2), the downside appears to have happened during 2016 and we feel quietly optimistic regarding the next few years.

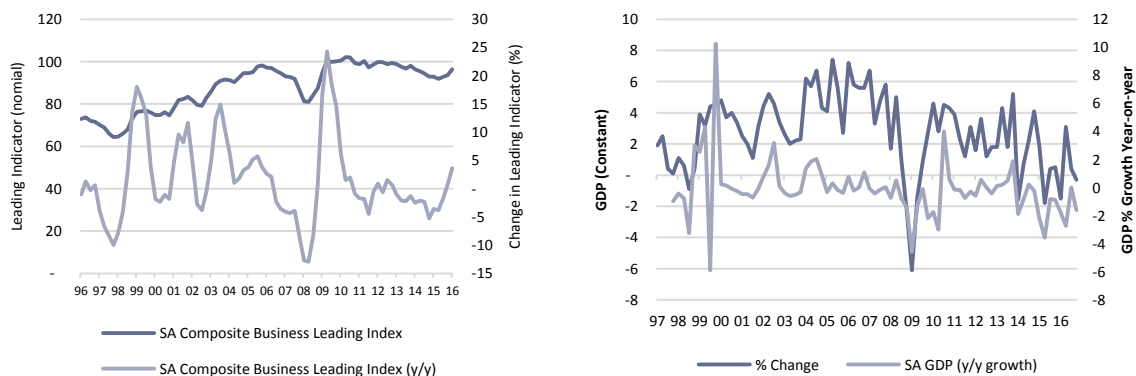
Figure 2: Building Plans Passed, Growth in Building Plans Passed



Sources: Bloomberg, Blue Gem Research workings

- This quiet optimism is perhaps visually captured by the rising SA Composite Business Leading Indicator (Figure 3) and its jump in y/y growth (i.e. rate of change of movement).
- The combination the flat GDP with rising optimism and leading indicators does point towards *this* period having been the trough and, thus, the next couple years may see a slow recovery in growth rates and activity levels to more normal levels, assuming global and domestic political stability.

Figure 3: South African GDP and South African Leading Indicator



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

## Forecasts

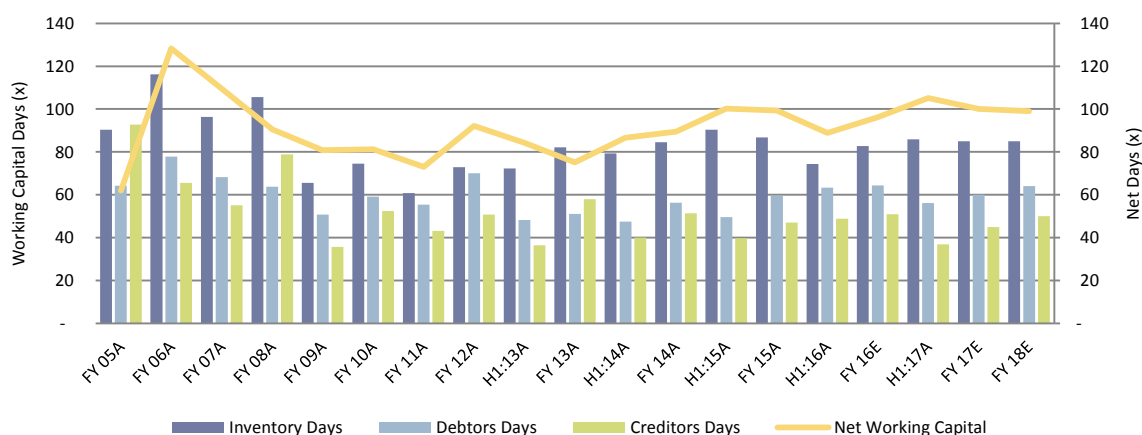
### Revenues and profitability

- Resulting from the more specific segmental forecast adjustments (see details in the earlier sections), we have lowered our target FY 17E revenue from R2.78bn to R2.60bn. Broadly, margins are slightly lower and our forecast FY 17E HEPS, thus, has been cut from 65.4cps to 61.4cps (which still reflects a fair +3% y/y growth on FY 16A HEPS).
- Despite us lowering our forecasts, the Group’s profitability and its prospects remain robust. It remains cash generative and its balance sheet remains well capitalised and quite accommodative for any potential corporate activity that may arise.

### 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).

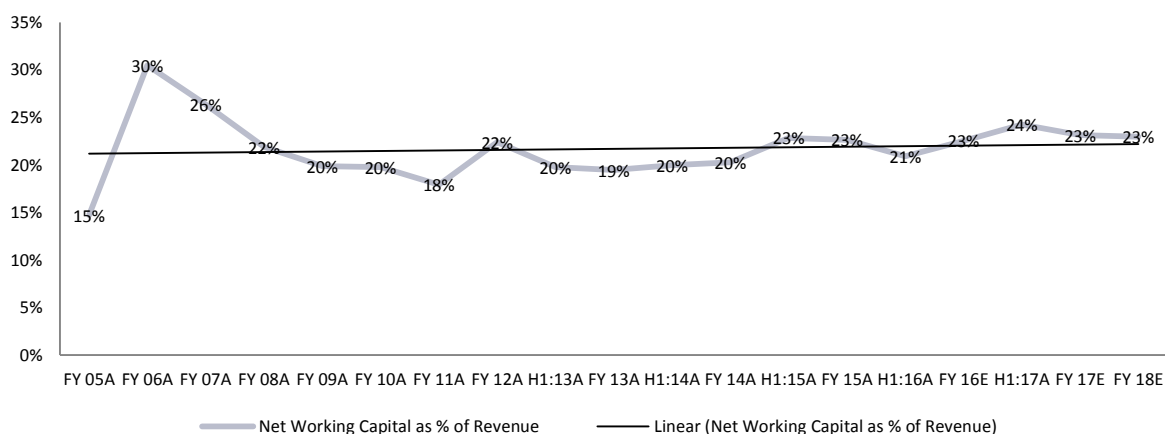
Figure 4: Working Capital History of ARB Holdings



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 (it is worth c.R177m 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 17.2% (unchanged) based off a "Rule of Thumb" beta of 1.5x (unchanged) and an Equity Risk Premium of 5.5% (unchanged).
- Growth rates of the following:
  - FY 17E and FY 18E: per our forecasts in this report,
  - FY 19E: 15% y/y (10% real and 5% inflation),
  - FY 20E 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.19% from the Group.

**Table 3: DCF Model – ARB Holdings**

	H2:17E	FY 18E	FY 19E	FY 20E	FY 21E	FY 22E	FY 23E	FY 24E	FY 25E	Terminal year
EBITDA	127	270	310	372	447	536	643	772	926	1019
Less: Tax	-34	-76	-87	-104	-125	-150	-180	-216	-260	-286
Less: Working Capital	15	-53	-61	-73	-87	-105	-126	-151	-181	-199
Less: Capex	-8	-24	-27	-33	-39	-47	-57	-68	-82	-45
Free Cash Flow (FCF)	99	118	135	162	195	234	280	337	404	489
Discounted FCF	92	93	91	93	95	98	100	102	105	888
NPV (Enterprise Value)										1756
Add: Net Cash										175
Fair Value, inc. Minorities (R m)										1931
<b>Fair Value, ex. Minorities (R m)</b>										<b>R1 561m</b>
<b>Fair Value of ARB shares (cps)</b>										<b>664cps</b>
Implied Price Earnings (x)										11.1x
Discount to Fair Value (%)										5%
<b>12m TP (cps)</b>										<b>779cps</b>
Exit Price Earnings (x)										11.4x
Implied Return (%)										23%

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

- We arrive at a fair value of 664cps (previously: 650cps) on an implied Price Earnings (PE) of 11.1x. Rolling this forward at our CoE, this fair value implies a 12m TP of 779cps (previous 12m TP: 762cps) on an Exit PE of 11.4x.
- Note our previously stated acquisitive upside to this valuation.

### Dividend Discount (DD) Model

- Other than those indicated in the DCF model above, hiking the Dividend Withholding Tax (DWT) from 15% to 20%, our DD model remains unchanged (Table 4).

**Table 4: DD Model – ARB Holdings**

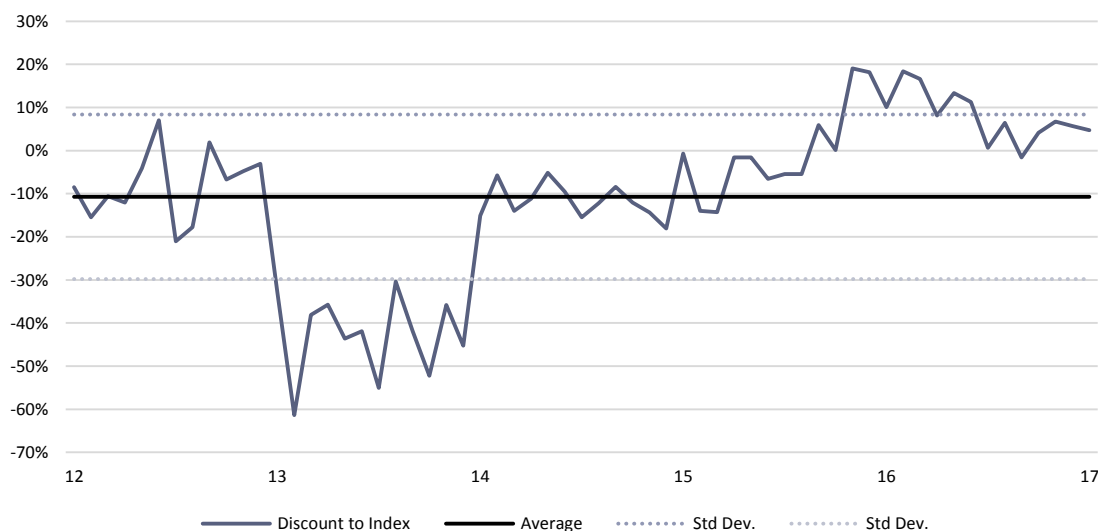
	FY 16A	FY 17E	FY 18E	FY 19E	FY 20E	FY 21E	FY 22E	FY 23E	FY 24E	FY 25E	Terminal year
HEPS (cps)	59.7	61.4	64.2	70.6	81.2	93.4	107.4	123.5	142.1	163.4	171.5
Dividend Cover (x)	1.8	1.8	1.8	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.0
DPS (cps)	33.1	34.0	35.6	47.1	54.2	62.3	71.6	82.4	94.7	108.9	171.5
DWT (20%)	-5.0	-5.1	-5.3	-7.1	-8.1	-9.3	-10.7	-12.4	-14.2	-16.3	-25.7
Net DPS (cps)	28	29	30	40	46	53	61	70	81	93	146
Discount Factor			0.79	0.67	0.57	0.49	0.42	0.36	0.30	0.26	0.22
Discounts DPS (cps)			23.8	26.9	26.4	25.9	25.4	25.0	24.5	24.0	448.4
<b>Fair Value (cps)</b>											<b>650cps</b>
<b>Implied PE Ratio (x)</b>											<b>10.8x</b>

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

### Price Earnings (PE) Model

- From a low in 2013, ARB Holding’s share has been slowly re-rating upwards relative to the Electrical Component Index.
- Given this steady re-rating, we are starting to think that the average (naturally a lagging statistic when re-rating is occurring) is not very indicative of the Group’s underlying valuation, albeit ARB’s current multiple is within a standard deviation of this average.

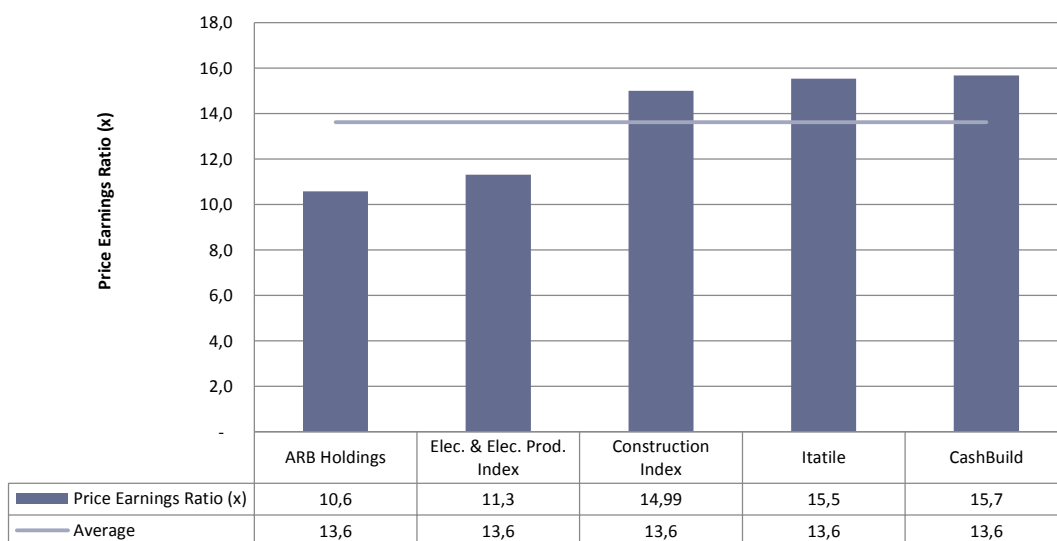
Figure 6: ARB Holdings Price Earnings (PE) Historical Discount versus the Electrical and Electrical Components Index



Sources: Bloomberg, Blue Gem Research workings

- Perhaps far more reflective of reality, ARB’s current 12m lagging PE of 10.3x compares favourably to the FTSE/JSE AllShare Index PE of 19.70x.
- 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 relatively cheap versus comparatives.

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 664ps (previously: 650cps) on an implied Price Earnings (PE) of 11.1x.
  - 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 779cps (previous 12m TP: 762cps).
  - A 12m TP of 779cps places the share on a comfortable Exit PE of 11.4x.
  - Our 12m TP also implies a return of c.23%.

### **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, 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 during 13 March 2017 (635cps).*

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