**Initiation of Coverage**
**14 April 2014**

# ARB Holdings Ltd
## A Good Story in a Tough Market

**Share Code: ARH – Market Cap: R1.4bn – PE: 12.7x – DY: 2.2%**

| | |
|---|---|
| **12m Target Price** | **727cps** |
| **Share Price** | **600cps** |
| **Implied Return** | **21%** |

**Industrials | South Africa**

### Business Overview: Market, Store and Product Expansion

- ARB has built a scalable electrical products distribution and wholesaling business off the back of a core cable product supply with key growth drivers being the expansion in product lines, movement into new territories, markets and industries and selected strategic bolt-on acquisitions.
- The Electrical Division is predominantly a wholesaler of cables, overhead lines and related electrical components in Southern Africa.
- In mid-FY 12 ARB Holdings acquired a 60%-stake in Eurolux (Pty) Ltd, a fast growing importer and distributor of light fittings, lamps and ancillary electrical products.
- The Group Services segment includes the strategic and operational activities as well as holding the underlying property portfolio of the Group with a book value of R163m.

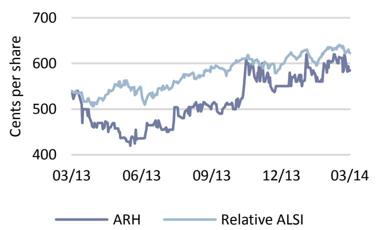
### Key Issues: Macro-economic Variables Worrying

- With many frothy indicators, the construction, building and related market in South Africa has many short-term downside risks including the current labour environment, the rising interest rate cycle and the upcoming elections.
- Despite this, South Africa's infrastructure needs are significant as encapsulated in the National Development Plan (budgeted c.R827bn spend) and the building materials market stands to benefit handsomely from this (eventual) roll-out.

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

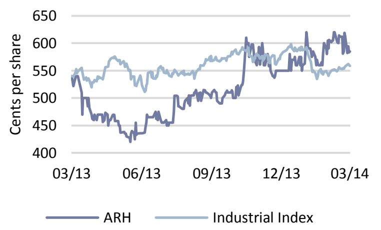
- Our fair value for ARH is 622cps on a PE of 13.5x. Rolling this forward at our Cost of Equity (CoE), we arrive at a 12 month Target Price (TP) of 727cps on an Exit PE of 12.7x implying a return of 21% from the current levels.
- The two key risks to our above valuation methodologies are (1) the major macro-economic variables in South Africa (noted above), and (2) the timing and successful implementation of ARB's product, store and market expansion drive (including any potential future acquisitions).

**Share Price against the ALSI**



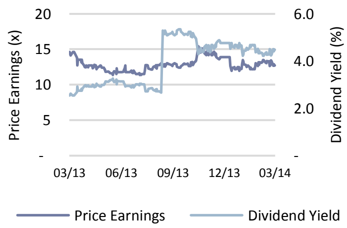

*Sources: Bloomberg, Blue Gem Research*

**Share Price against the Relevant Index**




*Sources: Bloomberg, Blue Gem Research*

**Price Earnings (x) and Dividend Yield (%)**




*Sources: Bloomberg, Blue Gem Research*

| Key Forecast (R m) | FY 12A | FY 13A | YoY % | H1:14A | FY 14E | YoY % | FY 15E | YoY % |
|---|---|---|---|---|---|---|---|---|
| **Revenue** | **1565** | **1945** | **24%** | **1154** | **2329** | **20%** | **2565** | **10%** |
| EBITDA | 133 | 167 | 26% | 104 | 211 | 26% | 244 | 16% |
| **HEPS (cps)** | **34.2** | **39.5** | **15%** | **24.9** | **52.1** | **32%** | **59.9** | **15%** |
| *Return on Equity (%)* | *14.5%* | *15.4%* | - | *17.3%* | *18.1%* | - | *19.0%* | - |
| Price Earnings Ratio (x) | 17.5x | 15.2x | - | 13.0x | 11.5x | - | 10.0x | - |
| DPS (cps) | 13.7 | 26.2 | >100% | - | 20.8 | -20% | 24.0 | 20% |
| *Dividend Yield (%)* | *2.3%* | *4.4%* | - | *4.3%* | *3.5%* | - | *4.0%* | - |

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


**Keith McLachlan***

BLUE GEM RESEARCH

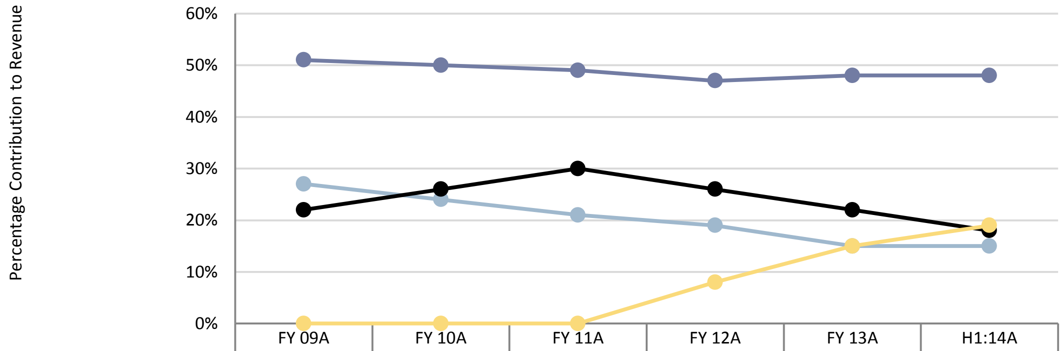
| Key Forecast (R m) | FY 12A | FY 13A | YoY % | H1:14A | FY 14E | YoY % | FY 15E | YoY % |
|---|---|---|---|---|---|---|---|---|
| **Revenue** | **1565** | **1945** | **24%** | **1154** | **2329** | **20%** | **2565** | **10%** |
| Electrical Wholesaling | 1449 | 1679 | 16% | 985 | 2014 | 20% | 2216 | 10% |
| Lighting | 120 | 281 | 135% | 174 | 323 | 15% | 356 | 10% |
| **Gross Profit** | **307** | **425** | **38%** | **250** | **500** | **18%** | **550** | **10%** |
| *Gross Profit Margin (%)* | *19.6%* | *21.9%* | - | *21.6%* | *21.5%* | - | *21.4%* | - |
| Operating expenses | -186 | -270 | 45% | -151 | -303 | 12% | -321 | 6% |
| **EBITDA** | **133** | **167** | **26%** | **104** | **211** | **26%** | **244** | **16%** |
| *EBITDA Margin (%)* | *8.5%* | *8.6%* | - | *9.0%* | *9.1%* | - | *9.5%* | - |
| Operating Profit/(Loss) Before Interest | 128 | 160 | 26% | 100 | 203 | 27% | 235 | 16% |
| Interest Received | 18 | 10 | -42% | 6 | 9 | -12% | 9 | -1% |
| Finance Charges | -1 | -1 | 37% | -0 | -0 | -100% | - | -100% |
| **Net Profit (Parents)** | **81** | **95** | **18%** | **59** | **122** | **29%** | **141** | **15%** |
| Weighted Ave. Number of Shares (millions) | 235.0 | 235.0 | 0% | 235.0 | 235.0 | 0% | 235.0 | 0% |
| **EPS (cps)** | **34.3** | **40.5** | 18% | **24.9** | **52.1** | 29% | **59.9** | 15% |
| **HEPS (cps)** | **34.2** | **39.5** | 15% | **24.9** | **52.1** | 32% | **59.9** | 15% |
| Gross DPS (cps) | 14 | 26 | >100% | - | 21 | -21% | 24 | 15% |
| *Dividend Yield (%)* | *2.3%* | *4.4%* | - | *4.3%* | *3.5%* | - | *4.0%* | - |
| Dividend Cover (x) | 2.5 | 1.5 | -40% | - | 2.5 | 66% | 2.5 | 0% |
| Property, Plant & Equipment | 163 | 194 | 19% | 205 | 233 | 20% | 256 | 10% |
| Intangible Assets | 78 | 84 | 8% | 84 | 84 | 0% | 84 | 0% |
| Current Assets | 737 | 857 | 16% | 814 | 864 | 1% | 995 | 15% |
| Net Cash | 179 | 203 | 13% | 120 | 201 | -1% | 265 | 32% |
| Cash | 185 | 203 | 9% | 120 | 201 | -1% | 265 | 32% |
| Overdraft | -6 | - | - | - | - | - | - | - |
| Interest-bearing Liabilities | - | - | - | - | - | - | - | - |
| Shareholder’s Equity (Parent) | 582 | 656 | 13% | 653 | 698 | 6% | 782 | 12% |
| Non-current Liabilities | 41 | 38 | -8% | 36 | 49 | 29% | 56 | 15% |
| Current Liabilities | 210 | 279 | 33% | 245 | 247 | -12% | 277 | 12% |
| NAV per share (cps) | 247.8 | 279.2 | 13% | 277.9 | 296.8 | 6% | 332.8 | 12% |
| TNAV per share (cps) | 214.4 | 252.4 | 18% | 250.9 | 260.9 | 3% | 296.9 | 14% |
| Cash Generated by Operations | 95 | 197 | 107% | 23 | 181 | -8% | 216 | 19% |
| *Cash Conversion Ratio (%)* | *72%* | *118%* | - | *22%* | *86%* | - | *88%* | - |
| Net Cash Flow from Financing Activities | -112 | -79 | -29% | -17 | -47 | -41% | -32 | -32% |
| Net Increase / (Decrease) in Cash | -7 | -16 | 120% | -1 | -27 | 70% | 5 | -120% |
| ***Return on Equity (%)*** | ***14.5%*** | ***15.4%*** | **-** | ***17.3%*** | ***18.1%*** | **-** | ***19.0%*** | **-** |
| *Return on Capital Employed (%)* | *11.6%* | *12.9%* | - | *16.0%* | *15.1%* | - | *15.4%* | - |
| *Return on Assets (%)* | *10.3%* | *10.8%* | - | *13.8%* | *12.8%* | - | *13.0%* | - |
| Price Earnings Ratio (x) | 17.5 | 15.2 | - | 13.0 | 11.5 | - | 10.0 | - |
| Price-to-Book (x) | 2.4 | 2.1 | - | 2.2 | 2.0 | - | 1.8 | - |
| Price-to-Tangible-Book (x) | 2.8 | 2.4 | - | 2.4 | 2.3 | - | 2.0 | - |
| Current Ratio | 3.5 | 3.1 | - | 3.3 | 3.5 | - | 3.6 | - |
| Quick Ratio | 2.3 | 1.8 | - | 1.7 | 2.0 | - | 2.1 | - |

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

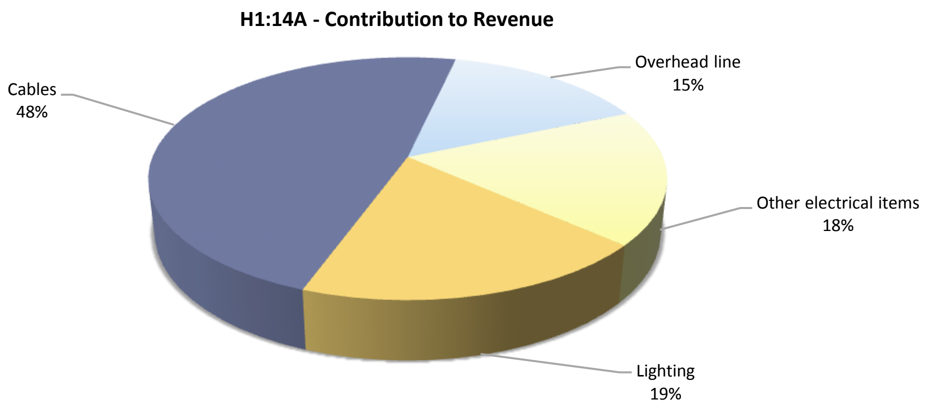
## Investment Case

ARB Holdings (“ARB”) has built a scalable electrical products distribution and wholesaling business off the back of a core cable product supply with key growth drivers being the expansion in product lines (Figure 1), movement into new territories, markets and industries and selected strategic bolt-on acquisitions.

**Figure 1: Expansion of ARB Holdings’ Product Range**




| | FY 09A | FY 10A | FY 11A | FY 12A | FY 13A | H1:14A |
|---|---|---|---|---|---|---|
| Cables | 51% | 50% | 49% | 47% | 48% | 48% |
| Overhead line | 27% | 24% | 21% | 19% | 15% | 15% |
| Other electrical items | 22% | 26% | 30% | 26% | 22% | 18% |
| Lighting | 0% | 0% | 0% | 8% | 15% | 19% |




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

Despite current muted growth in the core construction, infrastructure and related markets serviced by ARB, the Group has managed an impressive growth rate (revenue CAGR of over 18% per annum since FY 05) as well as positioning the business for any potential recovery in these markets across South Africa.

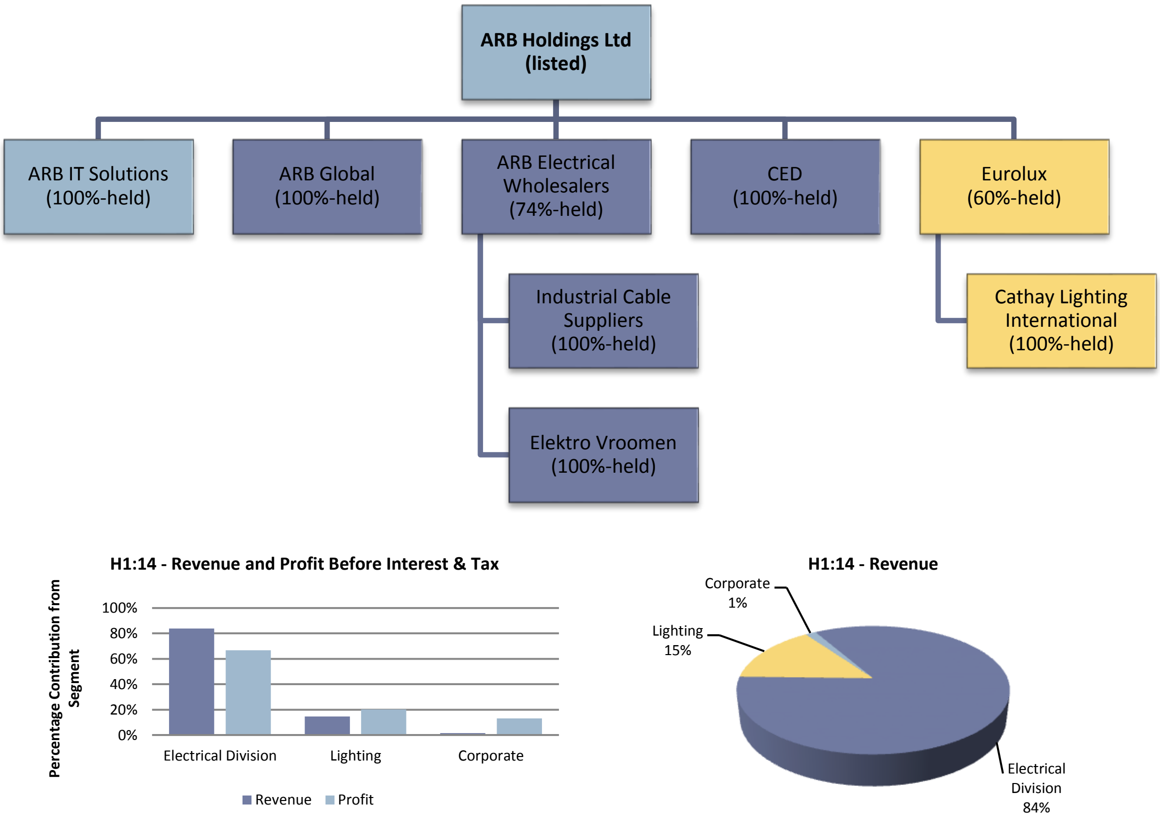
With regards to ARB as an investment proposition, this weak macro-environment appears as the key downside risk, and unfortunately a variable that is largely out of management’s control. That said, the activity in South Africa’s construction and infrastructure market does appear to be (very) slowly recovering (Figure 6 & 7), although the current year’s elections do pose a risk to the public sector’s contribution to this.

Overall, ARB is a well-run, defendable wholesaler growing into a number of markets and territories with an expanding product range. The Group has cleverly employed its balance sheet in acquisitive growth over the last couple years of stagnant local economic growth, positioning the Group to capture the pent-up infrastructural demand in South Africa while lowering the Group’s overall risk profile.

Our fair value for ARH is 622cps on a PE of 13.5x. Rolling this forward at our CoE, we arrive at a 12m TP of 727cps on an Exit PE of 12.7x implying a return of 21% from the current levels.

## Group Overview

**Figure 2: Summarised Group Structure & Segmental Contribution**




*Sources: ARB Holdings and Blue Gem Research workings*

ARB Holdings was built out of the ARB Electrical Wholesalers (Pty) Ltd, which still forms the vast majority of the Group's Electrical Division (formerly called "Electrical Wholesaling") and its broader business (Figure 2), with a BEE investor (Batsomi Power) at the subsidiary level holding 26% in the company.

ARB IT Solutions was acquired by ARB a number of years ago and is essentially an in-house ERP system custom-built for and maintained by the Group. More recently, the lighting business, Eurolux, was acquired. Note that Eurolux is 60%-held by the Group, with Eurolux's existing management (being the vendors of the sale to ARB) holding the minority shares in the company. Over the years, various other bolt-on acquisitions have buffered up the Group, while a policy of investing in the Group's underlying properties it operates from has built up a property portfolio with a book value of c.R163m.

**Table 1: Summarised Corporate Governance Checklist**

| Corporate Governance Aspect | In Place? | Comment |
|---|---|---|
| External auditors? | Yes | PKF (Durban) Inc. |
| Internal audit function? | Yes | Reports directly to the Independent Chairman of the Audit Committee. |
| Appropriate management incentives? | Yes | Determined by the Remuneration Committee. |
| Independent non-executive Chairman? | No | Founder and controlling-shareholder (51%) of ARB Holdings Ltd, Alan R Burke, sits as the Non-executive Chairman of the Board. A Lead Independent Director, Ralph Patmore, has been appointed to compensate for this governance risk. |
| Balance of non-executives on the Group Board? | Yes | Five non-executives (of which three are independent) versus only two executives. |

*Sources: Company AFS, Blue Gem Research*

ARB's founder, Alan R Burke, remains on as the Non-executive Chairman (and majority shareholder with c.51% of the Group). While this may theoretically lead to a slightly weaker corporate governance environment, it does arguably also help to align the Board's interest with those of the shareholders. Overall, we are comfortable with this arrangement and believe that the pros outweigh the cons.

## Electrical Division segment

**Table 2: 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 14E | FY 15E |
|---|---|---|---|---|---|---|---|---|---|
| Revenue | 1209 | 1088 | 1258 | 1449 | 829 | 1679 | 985 | 2014 | 2216 |
| *Change in Revenue* | - | *-10%* | *16%* | *15%* | *19%* | *16%* | *19%* | *20%* | *10%* |

*Sources: Bloomberg, Blue Gem Research and ARB Holdings*

The Electrical Division segment is predominantly a wholesaler of cables, overhead lines and related electrical components (Figure 4) into the local market, sourcing product from a combination of local and international suppliers. The business buys in bulk, offering customers the advantage of buying suitable volumes for their own needs at conveniently located stores scattered across South Africa as well offering a “one-stop shop” with numerous other related electrical products. The business has over 6,500 customers across seven sectors with less than 5% exposure to any single one customer (Figure 3).

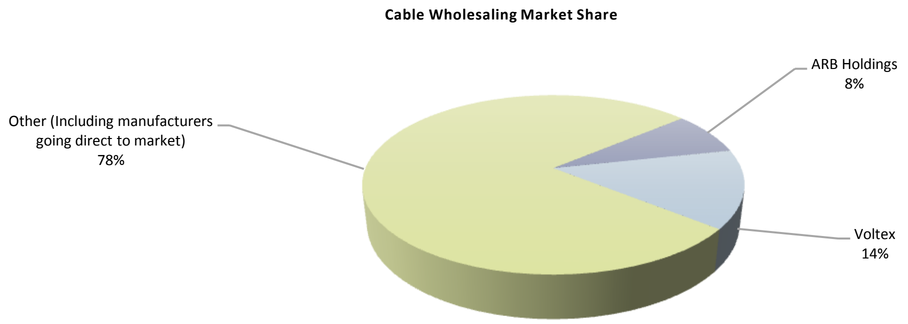
**Figure 3: Cable Sector Supply Chain**


*Source: Blue Gem Research*

The Electrical Division’s product revenue remains dominated by cable supplies (c.48% - Figure 1) and it is key to understand this market (Table 3 and Figure 4) for a macro understanding of the business.

**Table 3 and Figure 4: South African Electrical Cabling Market (Manufacturing versus Wholesaling)**

| | Estimated Market Share* | Full Year Revenue* |
|---|---|---|
| **Local Cable Manufacturers** | | |
| South Ocean Electric Wire (South Ocean) | 11% | 1 336 285 000 |
| MTEC (Jasco) | 15% | Unknown |
| Abedare (Altron) | 27% | 3 192 666 667 |
| CBI Electric - African Cables (Reunert) | 29% | 3 400 000 000* |
| Other | 18% | 2 180 461 708 |
| **Estimated Cable Manufacturing Market** | **100%** | **R11 893 427 500** |
| **Local Cable Wholesalers (ex. Other products)** | | |
| ARB Electrical (excl. Eurolux & Corporate segments) | 8% | 917 195 500 |
| Voltex | 14% | c.1 680 000 000* |
| Other (Including manufacturers going direct to market) | 78% | 9 296 232 000 |
| **Estimated Cable Wholesaling Market** | **100%** | **>R12 000 000 000** |




*Sources: Statistics South Africa (various publications), ARB Holdings, Blue Gem Research estimates and workings*
** Best estimated numbers available and that can be extrapolated from various company reports. Do not rely on data as factual, but rather illustrative.*

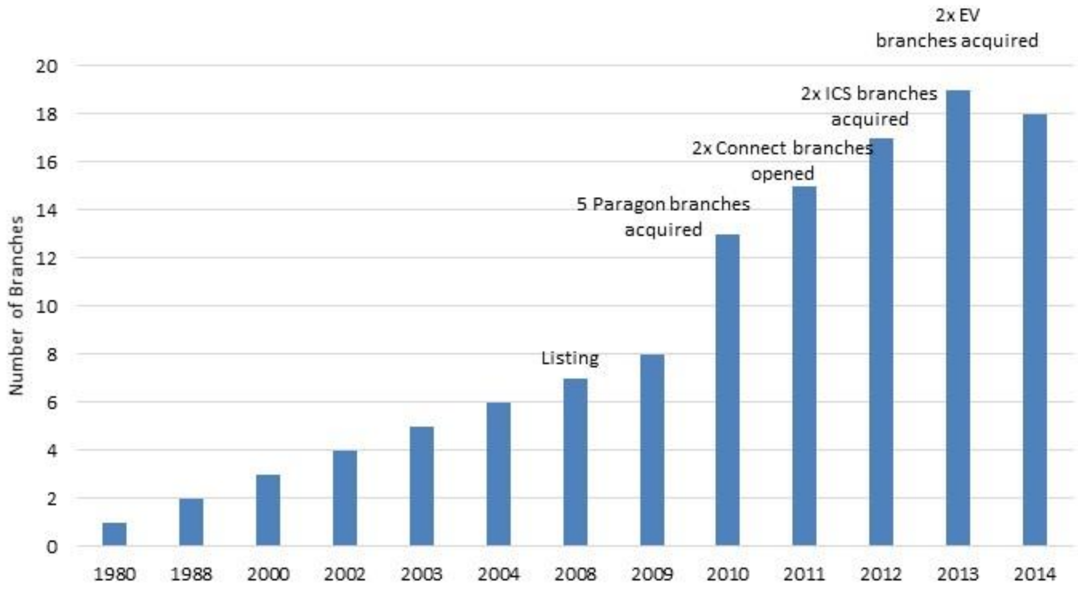
While the temptation may exist for ARB to pursue backward integration by buying a local cable manufacturer, the wholesaling business model would not likely work as well if it was backwardly integrated:

- Cable manufacturers have significant volume risk (due to the manufacturing business model's naturally large fixed cost base), which wholesalers do not normally have as much exposure to. The introduction of this type of volume risk into ARB would likely raise the volatility of the Group's profits (and therefore its risk profile).
- The wholesaling business model works best when it has the flexibility of choosing suppliers, as this keeps the procurement costs down and drives stocking efficiencies. If forced to source (majority of its) supply only within the ARB group, this would not necessarily lead to the best price (or quality) being obtained, which would limit the competitiveness of the wholesale offering to its customers, eventually decay volumes across the Group and likely lead to inventory management problems.

Rather than backward integration, management have focussed on growing this business by store, market and product expansion:

- **Product expansion**: Figure 1 illustrates how ARB's product range has steadily expanded from cable dominating over half its turnover to currently a much more even split between its products. This product range expansion is also likely far from over with management's key strategic intention at a Group and segmental level to further diversify into other strategically aligned industrial products. Examples of this include the recently signed exclusive distribution agreements for CHINT® low voltage products within a newly established subsidiary, CED, as well as the Copperweld and ACCC™ products.
- **Store (Figure 5) and market expansion**: Select acquisitions have moved the business more into, for example, the mining sector (the Elektro Vroomen acquisition). The Group has also established a renewed focus on exports into Africa. Store expansion into new South African geographies has been continuous and also includes the expansion of existing stores. Another aspect of this strategy has been the establishment of the "ARB Connect" store format, which is largely a walk-in, cash sales model with a smaller store design, a lower debtors book, higher margins and a focus on convenience. The Group has a general policy of owning its stores' underlying properties to remove relocation risk and bolster business continuity (see commentary in "Investment Case" above and "Group Services" below).

**Figure 5: ARB Holdings Branch Roll-out**




*Source: ARB Holdings*

While we expect cable volumes to remain flat in South Africa for the foreseeable future, we have assumed that product and market expansion will lift overall Group volumes that, along with certain price increases (partly due to a weaker Rand lifting the Rand Copper Price) sees FY 14E revenue rise 20% y/y and FY 15E revenue rise 10% y/y.

Gross Profit (GP) margins should also marginally rise due to the increasing weight of higher margin non-cable products to the segment's product mix, albeit due to the Group's segmental disclosure excluding GP margins (for competitive reasons) this will only be noticeable at a Group consolidated level.

While copper is a key input cost in cables, given the fact that cables are steadily decreasing as a percentage of ARB's inventory and that copper is just a percentage of their value, we do not believe that this segment (and Group as a whole) has its prospects materially hinged on the copper price. Therefore, as a simplifying assumption, we ignore this variable for the purposes of this research report (beyond FY 14E, we have assumed a flat Rand Copper Price).

## Lighting segment

**Table 4: Lighting – Key Revenue History and Forecasts**

| Key Forecasts (R m) | FY 09A* | FY 10A* | FY 11A* | FY 12A* | H1:13A | FY 13A | H1:14A | FY 14E | FY 15E |
|---|---|---|---|---|---|---|---|---|---|
| Revenue | - | - | - | 120 | 140 | 281 | 174 | 323 | 356 |
| *Change in Revenue* | - | - | - | *>100%* | *>100%* | *135%* | *24%* | *15%* | *10%* |

*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.*

In mid-FY 12 ARB Holdings acquired a 60%-stake in Eurolux (Pty) Ltd, an importer and distributor of light fittings, lamps and ancillary electrical products. The stake was acquired from Eurolux's management, who still retain the remaining 40%-stake in the company (although both parties remain with effective call and put options over this minority stake).

Management's key strategic focus in this segment is to:

- **Grow the customer base**: Eurolux has added Cashbuild as a major new customer and intends to aggressively pursue further new major customers in the retail space, both in South Africa and the SADC region.
- **Expand the product range**: Similar to both the Electrical Division and the overall Group strategy, Eurolux's intention is to steadily expand its product range to related products as a means to entering new markets and growing the overall business's volumes.

The lighting market in South Africa has been recently distorted by Eskom's Residential Mass Rollout (RMR) that saw Phase I and II lift overall volumes, but then Phase III was basically retracted. Whether Eskom continues with RMR is a short-term variable in this market, but effectively only adds to the market's upside potential.

Lighting is both a fairly inelastic consumable (therefore driving more stable product volumes) and is benefiting from increasingly energy efficient technology and consumer awareness of this trend. The market has seen reasonable growth over the last couple of years and we believe this trend is likely to continue.

This growth has attracted a number of new competitors from local businesses entering the lighting market for the first time (for example, Ellies) and may yet do so from international competitors.

The lighting market in South Africa is based purely on imported products with no local manufacturers. Therefore, while the Rand does impact Eurolux, this is an industry-wide characteristic affecting all lighting businesses and in reality a weakening Rand is collectively passed onto local consumers.

Overall, though, we are impressed with the quality of the Eurolux business, furthered by signing a distribution agreement with one of the leading international manufacturers of LED light sources and the addition of Cashbuild as a customer. We feel that the business can achieve relatively steady revenue growth of between 10% to 15% y/y for the medium-term (with upside risk if the addition of new products and the drive into the commercial and project lighting markets gain serious traction). We have assumed a steady margin over our forecast period.

### Group services segment

ARB Holdings offers group services to its subsidiaries that include the following activities:

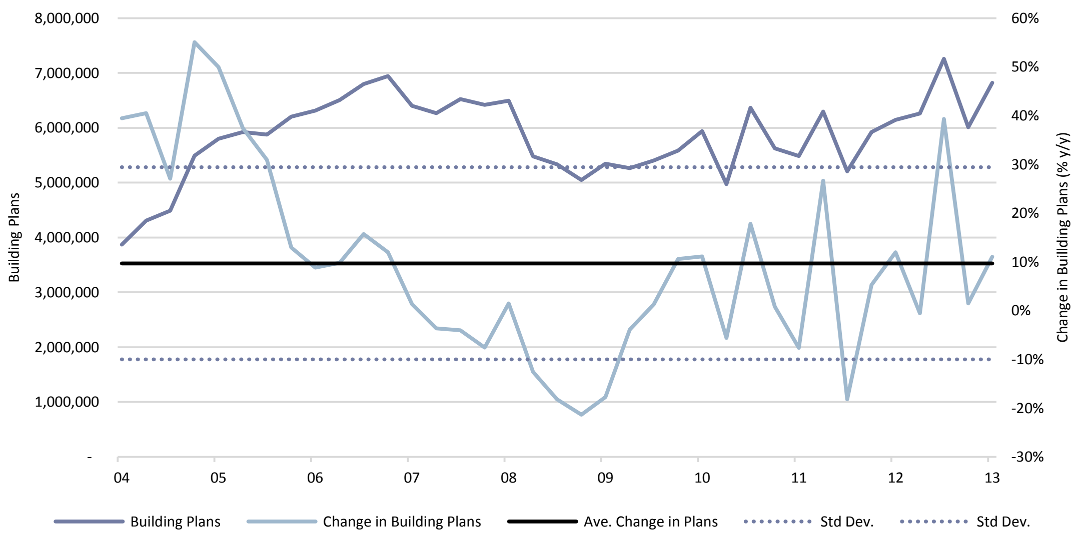
- **Strategic acquisitions**: Management aim to grow and diversify the Group by acquisitions of trading and distribution businesses in related industrial products.
- **IT software (Xact ERP Solution)**: The Group's proprietary Enterprise Resource Plannning (ERP) system was originally built and is currently maintained by the Group. The entire Electrical and Corporate segments run on this platform and pay implementation and maintenance fees to the Group for this.
- **Property**: The Group has a policy of owning its various stores and businesses underlying properties. This both lowers the business's risk and allows the Holding company to charge the underlying operating subsidiary companies rental income. The current property portfolio is worth c.R163m.

## Construction, Building Materials & Electrical Wholesaling Industries

Activity in the local construction and infrastructure sector appears to be in (slow) recovery mode following both the Credit Crisis and the post-2010 World Cup overcapacity, though both down- and upside risks currently exist.

Building Plans passed have steadily risen in nominal terms (Figure 6), but the percentage growth in this activity has been frothy and is indicative of the challenging operational environment that many of the players in this market are experiencing.

**Figure 6: Building Plans Passed, Growth in Building Plans and Various Statistics**




*Sources: Bloomberg, Blue Gem Research workings*

Similar to Building Plan statistics in South Africa, GDP growth has been weak (Figure 7) and not expected to rise significantly in the near term.

Even the country's Leading Indicator is flat and its year-on-year change is approximately 0%, though labour and mining market challenges might have created significant short-term distortions in historical and forecast numbers.

**Figure 7: South African GDP (Historical and Forecast) and South African Leading Indicator**

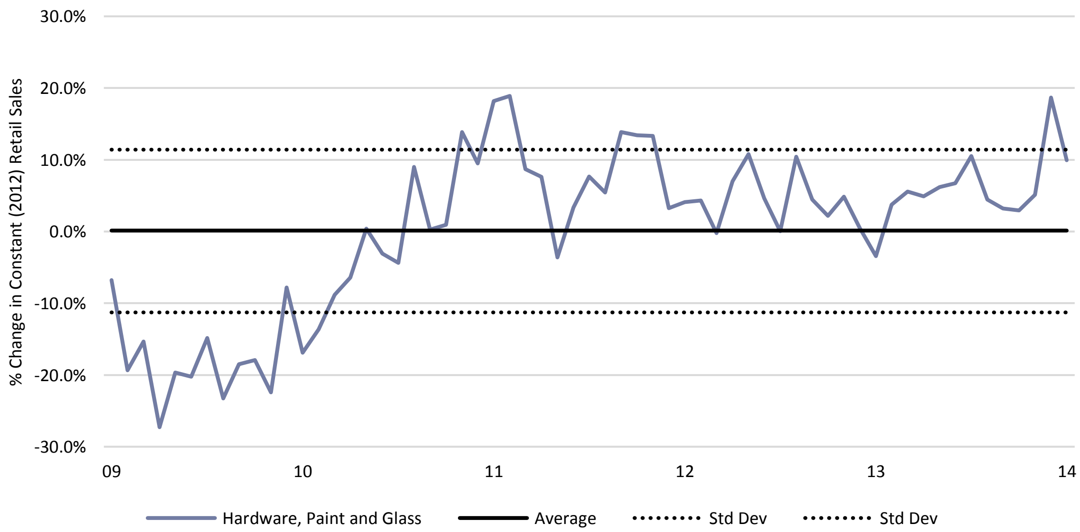

*Sources: Economist Consensus (Bloomberg), Bloomberg, Blue Gem Research workings*

Despite these indicators pointing towards softer conditions in South Africa (particularly in the cyclical construction and infrastructure markets) there remains material underlying demand in these markets. South Africa's infrastructure needs are significant as encapsulated in the National Development Plan (and its budgeted c.R827bn infrastructure spend) and implies large pent-up demand still existing in this market.

While the construction and infrastructure market draws on the building materials market as part of its supply chain, the building materials market also sells into numerous other markets. Looking specifically at the building materials market (Figure 8), we see a growing market with less apparent cyclicality.

The current (average) growth rate of c.6% y/y across the 2013 and the start of 2014 is quite positive, but it also lies above the market's mean. We believe that this recent above-mean-growth is at least partially due to the unsecured lending market's growth in South Africa. This has driven sales growth in various lines of home improvement and building materials products. If mean reversion is assumed, though, then some downside in the building materials market's forward volumes can be assumed, which is well timed against the backdrop of a recently muted unsecured lending market.

**Figure 8: South African Retail Sales – Hardware, Paint and Glass (Constant 2012 Prices)**




*Sources: Bloomberg, Blue Gem Research workings*

We believe that the recent stagnation in the local construction sector has at least partially shaken out the excess capacity. The remaining players are leaner and more focused, while the mounting pressure on the Government to implement its National Development Plan (and its budgeted c.R827bn infrastructure spend) may soon drive major infrastructural tender opportunities. While the timing of the (public) spend is opaque and the ever-present threat of labour unrest disconcerting, we believe that the medium-term outlook for construction (and those businesses that supply into the construction sector) is reasonably optimistic. Albeit, the South African 2014 elections remain a short-term downside risk given public sector spend's likely stagnation over this period.

While this should be positive for building material supplier's long-term volumes, the short-term downside risk (particularly for those supplying into major retailers) is the weakness in the local consumer market and the broader economy as a whole.

## Forecasts

### Revenues and profitability

Refer to above segment sections for more specific assumptions on forecast revenues and profitability.

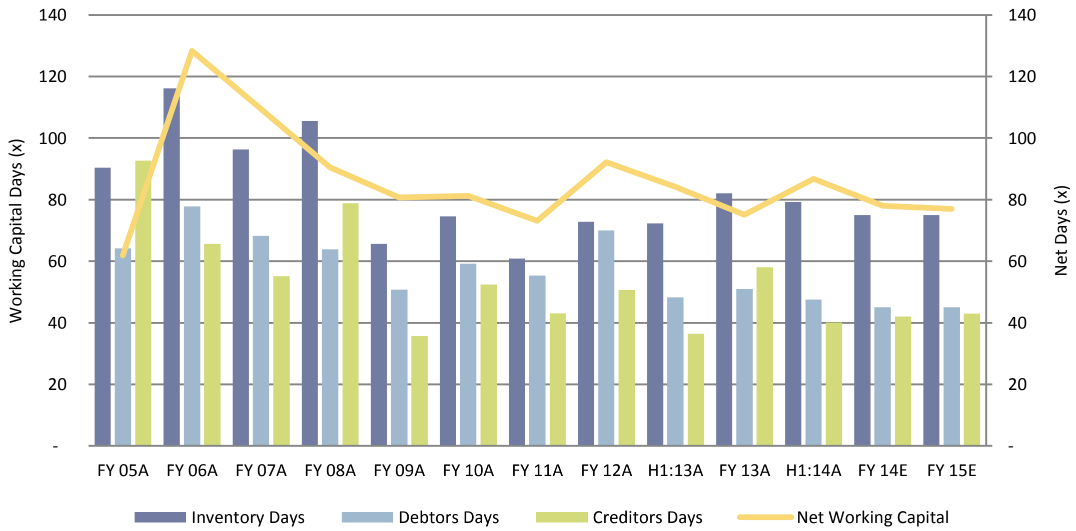
We see ARB's revenues rising by c.20% in FY 14E and c.10% in FY 15E, with a slight rise in GP margins creating a nice leveraged effect that sees Profit After Tax (Attributable to Parents) rising by c.29% and c.15% respectively. This leads to HEPS growth across these years of c.32% and c.15% respectively and a comfortable Return on Equity (ROE) of between 18% and 19% being achieved.

Given that the Group's strategy includes acquisitive growth and management have built a good track record of successfully executing on this, further acquisitions present an upside risk to our forecasts. As noted above, the macro-economic environment in South Africa remains the major downside risk to our forecasts.

### Liquidity, solvency and assets

ARB has controlled its working capital extremely well (Figure 9) and remains both ungeared (net cash of R116m) and with a balance sheet underpinned by its property investments (R163m).

**Figure 9: Working Capital History of ARB Holdings**




*Sources: ARB Holdings, Blue Gem Research workings*

Therefore, we do not expect any liquidity or solvency problems for ARB in our forecast period, though a large acquisition could always potentially change this.

## 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.

While it may be tempting to do a Sum-of-the-Parts (SOTP) valuation adding the property to the operational value of the businesses, the property portfolio leads to rental savings to the Group and, therefore, its yields are already captured in the enhanced operating margins of the Group.

Hence, by valuing the operations one is inherently valuing the effective property yield and, therefore, separately valuing the property would lead to double counting and risk downside to the final valuation.

#### Discounted Free Cash Flow (DCF) Model

Our preferred valuation model is the DCF (Table 5), given its key focus on cash flows and the ability to capture the long-tail growth potential of the Group.

Our key assumptions for the DCF are:

- Cost of Equity (CoE) of 16.8% based off a "Rule of Thumb" beta of 1.4x and an Equity Risk Premium of 5.5%.
- An inflation rate of 5% per annum.
- Real growth rates of the following:
    - FY 14E to FY 15E: per our forecasts in this report.
    - FY 16E to FY 22E: 15% y/y
    - FY 23E/Terminal Year: 3.5% y/y
- We also forecast the following key working capital requirement of the Group:
    - Inventory Days: 75x
    - Debtor Days: 45x
    - Creditor Days: 43x
- Finally, we take out an effective minority interest of c.30% from the Group (attributable to Eurolux and the outside shareholders in ARB Electrical Wholesalers).

**Table 5: DCF Model – ARB Holdings**

| R m | H2:14E | FY 15E | FY 16E | FY 17E | FY 18E | FY 19E | FY 20E | FY 21E | FY 22E | Terminal year |
|---|---|---|---|---|---|---|---|---|---|---|
| EBITDA | 107 | 244 | 293 | 351 | 422 | 506 | 607 | 729 | 874 | 949 |
| Less: Tax | -30 | -68 | -82 | -99 | -118 | -142 | -170 | -204 | -245 | -266 |
| Less: Working Capital | -20 | -37 | -35 | -42 | -50 | -60 | -73 | -87 | -105 | -113 |
| Less: Capex | -16 | -20 | -25 | -30 | -36 | -43 | -52 | -62 | -75 | -40 |
| Free Cash Flow (FCF) | 41 | 118 | 151 | 181 | 217 | 260 | 312 | 375 | 450 | 529 |
| Discounted FCF | 38 | 94 | 102 | 105 | 108 | 111 | 114 | 117 | 120 | 1063 |
| NPV (Enterprise Value) | | | | | | | | | | 1 972 |
| Add: Net Cash | | | | | | | | | | 116 |
| Fair Value, inc. Minorities (R m) | | | | | | | | | | R2 089m |
| **Fair Value, ex. Minorities (R m)** | | | | | | | | | | **R1 462m** |
| **Fair Value of ARB shares (cps)** | | | | | | | | | | **622cps** |
| *Implied Price Earnings (x)* | | | | | | | | | | *13.5x* |
| *Discount to Fair Value (%)* | | | | | | | | | | *4%* |
| **12m TP (cps)** | | | | | | | | | | **727cps** |
| *Exit Price Earnings (x)* | | | | | | | | | | *12.7x* |
| *Implied Return (%)* | | | | | | | | | | *21%* |

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

We arrive at a fair value of 622cps on an implied Price Earnings (PE) of 13.5x. Rolling this forward at our CoE, this fair value implies a 12m TP of 727cps on an Exit PE of 12.7x.

**Dividend Discount (DD) Model**

Using the same assumptions as in the DCF Model, but stripping out Dividend Withholding Tax (15%) from the annual dividends, our DD model (Table 6) arrives at a fair value of 591cps on an implied PE of 12.8x.

In the absence of the DWT, the fair value would c.695cps. This is a premium to the DCF fair value of 622cps, thus giving us some confidence in our underlying assumptions. It also gives us an indicative fair value range of 600cps to 700cps for the share, depending on an investors preferred valuation methodology.

**Table 6: DCF Model – ARB Holdings**

| | FY 14E | FY 15E | FY 16E | FY 17E | FY 18E | FY 19E | FY 20E | FY 21E | FY 22E | Terminal year |
|---|---|---|---|---|---|---|---|---|---|---|
| HEPS (cps) | 52.1 | 59.9 | 68.9 | 79.2 | 91.1 | 104.8 | 120.5 | 138.6 | 159.4 | 164.9 |
| Dividend Cover (x) | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 2.5 | 1 |
| DPS (cps) | 20.8 | 24.0 | 27.6 | 31.7 | 36.4 | 41.9 | 48.2 | 55.4 | 63.7 | 164.9 |
| DWT (15%) | -3.1 | -3.6 | -4.1 | -4.8 | -5.5 | -6.3 | -7.2 | -8.3 | -9.6 | -24.7 |
| Net DPS (cps) | 18 | 20 | 23 | 27 | 31 | 36 | 41 | 47 | 54 | 140 |
| Discount Factor | 0.93 | 0.79 | 0.68 | 0.58 | 0.50 | 0.43 | 0.36 | 0.31 | 0.27 | 0.27 |
| Discounts DPS (cps) | 16.4 | 16.1 | 15.9 | 15.6 | 15.4 | 15.2 | 14.9 | 14.7 | 14.5 | 452.1 |
| **Fair Value (cps)** | | | | | | | | | | **591cps** |
| ***Implied PE Ratio (x)*** | | | | | | | | | | ***12.8x*** |

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

**Price Earnings (PE) Model**

ARB Holdings' shares went through a strong re-rating period from 2008 to 2011/2012, but it has settled on a PE relatively in line with the Electrical and Electrical Components Index, less an average 9% discount.

While far from conclusive, this does imply that the share is fairly valued at its current levels.

**Figure 10: ARB Holdings Price Earnings Historical Discount versus the Electrical and Electrical Components Index**


*Sources: Bloomberg, Blue Gem Research workings*

## Valuation, 12m TP and Implied Return

We reiterate our preferred valuation methodology as the DCF, therefore implying that our fair value for ARH is 622cps on a PE of 13.5x. Rolling this forward at our CoE, we arrive at a 12m TP of 727cps on an Exit PE of 12.7x implying a return of 21% from the current levels.

## Key risks to our valuation

The two key risks to our above valuation methodologies are:

- The major macro-economic variables in South Africa (specifically, GDP growth, construction and building sectors, labour environment, amongst other variables), and
- The timing and successful implementation of ARB's product, store and market expansion drive (including any potential future acquisitions).

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