ART – Argent Industrial Limited Full Year Results and Initiation Report

Valuation: Undervalued

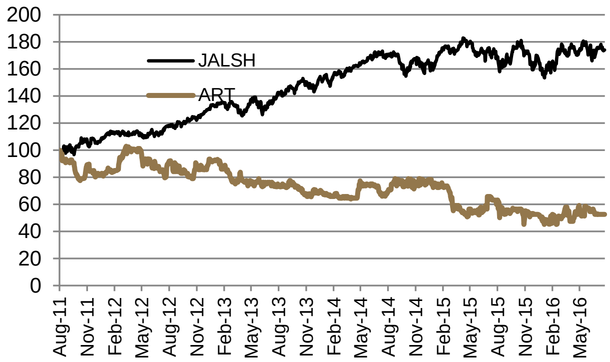
ART released full year results on 24 June 2016 for the year ended 31 March 2016

Price (R)	**3.99**
PE Fair Value (R)	**5.47**
DCF Value (R)	**5.15**
Upside(Downside) to DCF (%)	29.0%
DY %	4.5%

Price Performance		Relative
	Absolute	**to JALSH**
1 month	-0.2%	0.4%
3 month	-6.1%	-7.5%
12 month	-15.1%	-16.5%
12 month	**High**	**Low**
(SA Rands)	4.90	3.02

No. of shares (m)	96	Price (R)	3.99
Ave. volume 3 month # ('000)	63	Mkt cap (Rm)	382

Financial Year	2015	2016	2017F	2018F
Turnover (Rm)	1791	1707	1768	1846
EBITDA	93	123	172	176
EBIT	58	91	142	144
PAT	38	56	97	99
HEPS (cents)	40.8	62.8	107.2	110.6
Dividend (cents)	15.0	18.0	30.7	31.7
P/E ratio	10.1	6.4	3.7	3.6
EV/EBITDA	6.4	4.0	2.8	2.7
EBITDA margin (%)	5.2%	7.2%	9.7%	9.6%
EBIT margin (%)	3.2%	5.3%	8.0%	7.8%
Net debt/equity	0.18	0.11	0.10	0.09
ROCE (%)	4.5%	6.9%	10.7%	10.1%
ROE (%)	3.2%	4.7%	7.9%	7.6%



RESULTS COMMENTARY

Argent released a respectable set of results despite tough trading conditions and volatile steel prices.

- Revenue decreased by 4.7% as a result of tough conditions in the steel market and the group streamlining the business.
- The operating margin improved as a result of a strong manufacturing division margin along with reduced losses in the automotive division.
- The group recently acquired OSA Door Parts, a UK manufacturer and supplier of industrial warehouse doors.
- HEPS increased by 54.0% from 40.8cps to 62.8cps and a total dividend of 18cps was declared.

OUTLOOK FOR NEXT REPORTING PERIOD

The slump in the steel market along with a sudden drop in steel prices cost the group R18m in trading margin. However, the steel price recovered by 24.1% between January and April 2016 and the benefit will be reflected in the group's next set of results.

The group has expanded its business offshore over the past few years and currently 6% of revenue and 23% of PBT is generated from offshore.

The group recently acquired OSA Door Parts Limited for R54.2m. OSA is a manufacturer and supplier of specialised industrial warehouse doors and operates in the UK. The acquisition will be funded by offshore cash and debt.

OSA will expand the group's manufacturing division as well as its footprint in the UK. The group can leverage existing local businesses like Xpanda off the technology used at OSA which will unlock potential synergies. The group paid £2.5m for OSA, which has a NAV of £0.85m, indicating a significant premium. The premium paid is as a result of OSA's high operating margin of 35%, potential synergies and superior technology. On a PE basis, we believe that the acquisition is at a fair price as OSA's PE of 6.25 is in line with Argent's PE of 6.4.

The group maintained a strong balance sheet despite difficult conditions in the steel industry, this is reflected in its low debt:equity ratio which has reduced from 24% to 4% over the last 5 years.

We forecast revenue to increase by 3.6% and 4.4% to R1.77bn and R1.85bn in FY17 and FY18. The revenue increase will come off the back of the inclusion of OSA's results along with growth from the rest of the manufacturing division. The operating margin is expected to increase to 8.0% before returning to a normalised level of 7.8%. We expect HEPS to increase to 107cps and 111cps as the expected revenue increase and improved margins will filter through to the bottom line.

The increased FY17 HEPS is as a result of an expected increase in the Steel Trading margin as a result of stock which was purchased at lower costs during the slump in the steel market. This lower input cost will result in a short term increase in the margin. The group is also expected to continue its share repurchase program which will bolster HEPS somewhat. As a result we have included a 1m share repurchase per annum in our forecasts.

VALUATION

The group has shown good earnings recovery since restructuring in FY14 and HEPS has increased ~4 times from FY14 levels. However,

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this is not reflected in the group's share price as it has not experienced the same level of growth as earnings. We believe that given the group's strong balance sheet and recent acquisition that a re-rating is possible, but that the industry within which it operates will make it difficult as investors remain sceptical about the steel industry.

Both our DCF model and our relative PE valuation indicate that the share is currently **undervalued**.

SEGMENTAL PERFORMANCES

Revenue from the **Manufacturing** segment increased by 6.4% from R954m in FY15 to R1.02bn in FY16 as a result of strong performance from Xpanda as well as the group's diversification into school furniture. The operating margin increased from 8.2% to 8.5% as international operations performed well.

We forecast revenue to increase by 8.6% in FY17 to R1.10bn as the inclusion of OSA is expected to contribute ~R27m. The international operations are well positioned to continue their current trend and as a result revenue is forecast to increase by 6.8% to R1.18bn in FY18. The operating margin is forecast to improve to 8.8% and 9.0% respectively as higher offshore margins contribute. OSA is expected to add ~R9.3m to operating profit as the business operates at a 35% operating margin.

The **Steel Trading** segment's revenue decreased by 3.8% from R568m to R546m and contributed 32% to group revenue. Revenue decreased as difficult trading conditions resulted in a drop in the steel price from R7 654 per ton in April 2015 to R 6 442 per ton in June 2015. This sudden drop cost the group R18m and as a result the operating margin reduced from 2.7% to -1.9%.

We forecast revenue to remain flat at R546m before increasing by 5.0% to R573m. Management has indicated that the demand for steel is expected to remain flat in the short term and we have subsequently included this in our forecasts. The operating margin is expected to improve to 4.0% in FY17 as the group has stock which was purchased at lower costs during the slump in the steel market. This lower input cost will result in a short term increase in the margin. The operating margin is expected to return to a normalised level of 2.0% in FY18.

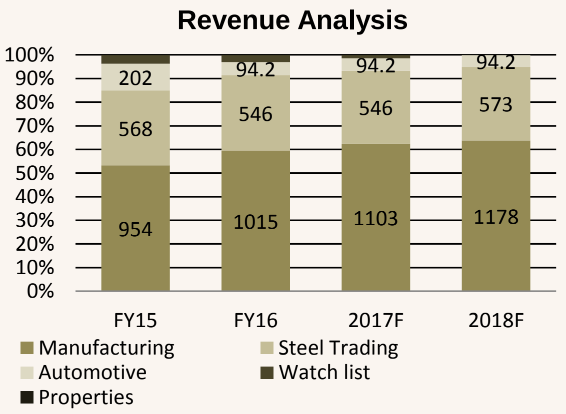
The **Automotive** segment's revenue decreased by 53.4% from R202m to R94m due to the closure of some plants as a result of the group streamlining the division. The operating margin improved from -31.1% to -1.5% but remains under pressure as a result of a reduced order book.

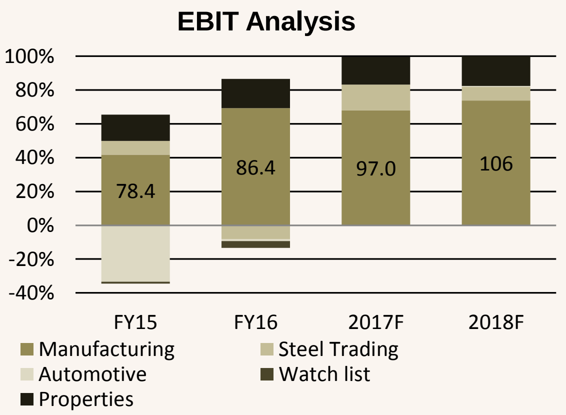
We forecast revenue to remain flat at R94.2m in both FY17 and FY18 as a result of the depressed automobile industry outlook. The operating margin is also expected to remain low at 0% and 1.0% respectively. Management will look to exit the business and focus on core operations.

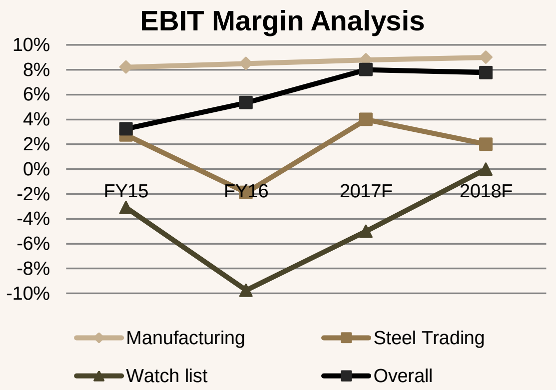
Argent has placed Cedar Paint into its **Watch List** segment due to its poor performance over the last 3 years. Revenue decreased by 23.0% from R65.7m to R50.6m and the operating margin reduced from -3.1% to -9.8%.

The group is currently in negotiations with an interested party to dispose of the business but will still focus on operational efficiencies to improve margins. We expect the transaction to be concluded by September and as result have included 6 months revenue and operating profit in our FY17 forecasts. The division is expected to contribute R24m to revenue and realise a R0.6m operating loss.

Operating profit from the **Properties** segment decreased by 26.0% from R29.1m to R21.5m as the group sold 4 properties. The group currently owns 14 properties valued at R363m. Income is generated by charging market related rental fees for the properties.







We forecast operating profit to increase by 8.0% in FY17 and FY18 to R23.3m and R25.1m in line with the average property escalation rate.

VALUATION

With reference to the DCF table, we have considered a discounted cash flow analysis and with cash flows forecast to FY19, utilising a terminal growth rate of 6% to yield the sensitivity table to the right, for which we used a discount rate of 22.2%[1], yielding a value of R5.15.

With reference to the relative PE table, we have compared Argent to other companies in the industrials sector and have applied a 40% discount to the peer group PE due to the relatively smaller size of Argent. The implied forward PE valuation of 5.0 places the share at a valuation of R5.47.

	DCF Discount rate				
Growth rate	**18.2%**	**20.2%**	**22.2%**	**24.2%**	**26.2%**
0%	5.03	4.53	4.12	3.78	3.49
2%	5.47	4.87	4.40	4.00	3.68
4%	6.04	5.31	4.73	4.27	3.89
6%	6.80	5.86	**5.15**	4.59	4.15
8%	7.86	6.59	5.68	5.00	4.46
10%	9.43	7.61	6.39	5.51	4.85
12%	-	9.13	7.38	6.20	5.35

General Industrials	**Price**	**Mkt cap (m)**	**1 year fwd PE**
Dawn	2.60	630	3.5
KAP*	6.75	16476	15.0
Insimbi	1.00	260	7.2
Invicta	54.60	5924	12.6
Argent	3.99	382	3.7
Average			**8.4**
*consensus forecasts used			-56%
Argent	**3.99**	382	3.7
Premium (Discount) applied to average:			-40%
Argent: Implied current gain/(loss):	5.47	37%	**5.0**

[1] The discount rate is based on the average implied discount rate obtained from cash flow forecasts for companies with market capitalisations ranging from R301m to R700m in our research universe

COMPANY PROFILE

Argent Industrial Limited Group is listed on the JSE main board and trades under the ticker ART. The group acts as a holding company for a collection of companies in a number of different sectors, including property investment, engineering, fabrication, concrete and stone, materials and steel trading.

The group is predominantly an industrial manufacturing business that manufactures branded consumer goods that are sold both locally and internationally. The group has 25 subsidiaries which operate throughout South Africa and within North America and the United Kingdom.

Some of the major companies controlled by Argent include:

- Phoenix Steel: Adds value to steel products and is a large steel trader for a range of products including sections, sheet, coil and plate.
- Jetmaster: Manufacturer of fireplaces for worldwide distribution.
- Xpanda Security: Producer of a wide range of security products including security gates, roller shutters, trellis doors and garage doors.
- Megamix: Suppliers of Readymix concrete and mortars as well as crushed stone products.
- Tricks: Manufacturer and supplier of steel products to the domestic, commercial and industrial sectors.

DIVISIONS

The **Manufacturing** division is the largest revenue contributor, and forms the core focus of selling locally and internationally. The branded goods are sold directly to the consumer via its broad footprint of companies based in all the major centres around South Africa, as well as its businesses based in the United Kingdom and North America.

The **Steel Trading** division is the second largest revenue contributor and includes a complete range of ferrous steel, aluminium and stainless steel products. The division's goal is to supply as many value-added products and services as possible, which includes cut-to-length, blanking, tube manufacture and flame cutting. The group has distribution centres that offer a combination of steel trading and the distribution of manufactured products.

The **Automotive** division provides value added services in the motor industry and operates through Allan Maskew and Sentech Industries. The group's reduced automotive sector is still under pressure in terms of order book and margin.

The **Watch List** segment holds Cedar Paint, a manufacturer of decorative and industrial paint and coatings sold through national retailers and branches. Specialised products include steel coatings, varnishes, road marking paint, mine mark spray and urethane coatings.

Argent's **Property Portfolio** is the 2nd largest contributor at an operating profit level. The portfolio has 14 properties valued at R363m and income is generated by charging market-related rentals for the properties.

Argent Industrial Limited Group

Manufacturing | Steel Trading | Automotive | Watch List | Properties

Subsidiaries

Allan Maskew, Argent Investments, Atomic Office Equipment, Burbage Iron Craft, Cannock Gates

Castor and Ladder, Cedar Paint, Excalibur, Fencing & Gates, Gammid

Hendor Mining, Jetmaster, Kochs Steel Centre, Life 'n Leisure, Megamix

NewJoules Engineering, Phoenix Steel, Sentech Industries, Specialist Steel Profiles, Toolroom Services

Tricks Wrought Iron, Tricks Joint Venture, Villersdorp Quarries, Xpanda Security

Financial Year	2015	2016	2017F	2018F
ROE	3.2%	4.7%	7.9%	7.6%
Net Profit Margin	2.1%	3.2%	5.5%	5.3%
Asset Turnover	1.17	1.14	1.09	1.09
Leverage Ratio	1.34	1.26	1.30	1.29
Debt to Equity	0.07	0.04	0.06	0.05
Current Ratio	2.25	3.23	2.85	2.93
Interest Cover	2.55	5.53	11.25	12.00
Dividend Cover	2.72	3.49	3.49	3.49
Cash Generated from Operations/EBITDA	1.39	0.83	0.99	0.81
ROA	3.7%	6.0%	9.1%	8.6%
NAV per share (Rand)	12.55	12.96	13.84	14.69
Price / Book value	0.33	0.31	0.29	0.27
Weighted avg Shares	91.5	91.6	90.2	89.2

DISCLAIMER