# ART – Argent Industrial Limited Interim Results

## Valuation: Undervalued

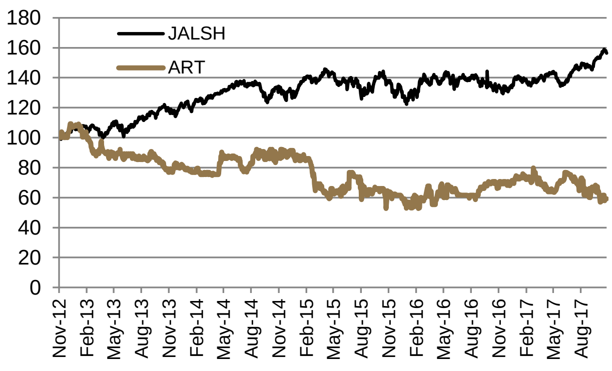
### ART released Interim results on 13 November 2017 for the period ended 30 September 2017

| | |
|---|---|
| Price (R) | **3.92** |
| PE Fair Value (R) | **4.84** |
| DCF Value (R) | **5.98** |
| Upside(Dow nside) to DCF (%) | 52.6% |
| DY % | 5.1% |

| Price Performance | | **Relative** |
|---|---|---|
| | **Absolute** | **to JALSH** |
| 1 month | 3.2% | -1.3% |
| 3 month | -17.5% | -23.1% |
| 12 month | -12.9% | -27.5% |
| 12 month | **High** | **Low** |
| (SA Rands) | 5.20 | 3.60 |

| | | | |
|---|---|---|---|
| No. of shares (m) | 95 | Price (R) | 3.92 |
| Ave. volume 3 month # ('000) | 176 | Mkt cap (Rm) | 388 |

| **Financial Year** | **2016** | **2017** | **2018F** | **2019F** |
|---|---|---|---|---|
| Turnover (Rm) | 1707 | 1849 | 1869 | 2016 |
| EBITDA | 123 | 138 | 85 | 148 |
| EBIT | 91 | 106 | -212 | 128 |
| PAT | 56 | 63 | -235 | 88 |
| HEPS (cents) | 62.8 | 63.2 | 67.4 | 102.9 |
| Dividend (cents) | 18.0 | 19.0 | 19.0 | 29.0 |
| P/E ratio | 7.5 | 7.9 | 5.9 | 3.9 |
| EV/EBITDA | 4.6 | 4.3 | 5.0 | 2.4 |
| EBITDA margin (%) | 7.2% | 7.5% | 4.5% | 7.4% |
| EBIT margin (%) | 5.3% | 5.7% | -11.3% | 6.3% |
| Net debt/equity | 0.11 | 0.11 | 0.09 | 0.02 |
| ROCE (%) | 6.9% | 8.0% | -16.8% | 11.1% |
| ROE (%) | 4.7% | 5.2% | -21.3% | 8.8% |

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## RESULTS COMMENTARY

Argent experienced a challenging 6 months with results constrained by significant and unpredictable South African economic headwinds.

- Revenue increased 0.1% in H1:18 to R941bn.
- The Group underwent a significant restructure during the period to better position and streamline the company for the South African economic climate. Total impairment and goodwill amortisation amounted to R292m.
- The Group EBIT margin declined to -13.0% as a result of the above impairments. This would have been ~4.2% if impairments were stripped out.
- Loss per share for the period was 292cps compared to a profit of 42.1cps in the comparative period. Striping out impairment and amortisation HEPS declined by 25.9% from 42.5cps to 31.5cps.
- An interim dividend of 10cps was declared.

## OUTLOOK FOR NEXT REPORTING PERIOD

During the current period the Group underwent a significant restructure in order to streamline operations, reduce costs, and create efficiencies across the business. As a result of this the Group impaired the value of some of its subsidiaries to better reflect the prevailing market conditions.

This continues to highlight the emphasis management has placed on focusing on core operations and the consolidation will have the benefit of reducing the capital base while allowing a much more hands on approach by management. This process, though disruptive for the current period's results, sets the Group up for significantly improved performance in the long term. A key benefit of the restructure is the stripping out of ~R8m in depreciation which combined with the closing down of the Automotive division in the prior year (another saving of ~R6m in losses), saves the Group ~R14m which will flow through directly to HEPS.

The restructure, along with the sale of properties in the Group has significantly improved the cash position of the company and it is management's intention to buy back ~5% of ART's shares. This would result in reducing shares in issue by ~4.5m, ~450 000 of these shares have already been repurchased.

During the period the Group also impaired goodwill by R130m. The remaining goodwill in the Group consists of R35m for Xpanda and R45m for OSA Door Parts and Cannock Gates combined (both UK based).

These impairments are a once-off cost for the Group and further impairments are not expected in H2.

Argent is sensitive to the commodity cycle, currency movements and governmental regulation (specifically import protection tariffs). In relation to the commodity cycle, industry consensus suggests that steel prices are expected to plateau as China continues to battle with oversupply. However in SA, the government has indirectly raised steel prices by up to 20%, through protective tariffs, and made the entire downstream market in SA more expensive. ART is forced to pass on higher prices to its customer base, which may come at the expense of volumes.

The recent acquisition of UK-based OSA Door Parts continues to expand the Group's global footprint, albeit at a smaller revenue contribution level than its domestic manufacturing operations, but at a higher operating margin. The Group recently expanded into a new vertical through acquiring a 75% stake in Pro Crane Services, a Johannesburg-based manufacturer and importer of overhead cranes and provider of high margin, heavy machinery services. Pro Crane is a distributor for the global crane manufacturer, SWF Krantechnik. Owing to being associated to Pro Crane Services, the deal came packaged with Lifting Online, an e-commerce company specialising in lifting and rigging equipment delivered throughout

Africa. Although both businesses will perform significantly better in a strong economic environment they are still contributing strongly to the Group's performance.

Cedar Paint, which is included in the Manufacturing division contributed strongly for the period. Management is in the process of closing, downsizing and consolidating branches, thereby reducing administrative costs and improving cash flows. During commodity down cycles, companies that sell paint benefit significantly from low material prices and we expect this to translate into a higher margin as strong volume growth continues.

The Group closed its Automotive division in the prior year owing to the sudden decision of General Motors, a key customer, to divest from South Africa. We believe the cessation of the division (stripping out ~R6m in loses) is significantly beneficial to the Group's future performance. Overall, the Automotive division was exposed to continuous once-offs and project start up delays, while situated in a tough and contracting industry. High lending rates and high import costs associated to the SA automotive industry continue to plague the local consumer and ART can now circumvent having to invest into a suffering division.

Overall, we expect energy costs to continue rising, but to be offset by distributive and operational efficiencies. At current commodity price levels, we expect the steel market to sustain volumes. The Group's foreign earnings base will be used to fund further internal and external offshore acquisitions, while domestic funds should be used to decrease the capital base. We expect the Group to maintain high acquisitive activity in its Manufacturing division to overcome sluggish organic growth while the SA economy remains constrained.

We forecast revenue to increase by 1.1% in FY18 to R1.87bn despite up to R115m in revenue being lost owing to the closure of the Automotive division. We forecast revenue to increase by 7.9%, off a lower base, to R2.01bn in FY19 as full year acquisitive earnings are included and the Steel Trading division experiences volume growth. The EBIT margin is expected to decline from 5.7% in FY17 to -11.3% in FY18 as a result of the impairments. We forecast the margin to be 6.3% in FY19 owing to once off costs not recurring, an increase in efficiency as a result of the restructure, and general improvements across the Group's divisions.

We forecast HEPS of 67.4cps in FY18 (stripping out the impact of the once off impairments as a result of the restructure). The planned buyback of ~5% of the Group's shares will help to further concentrate HEPS. We forecast a HEPS improvement to 103cps in FY19 as once off costs don't recur and as margins start to return to historic norms.

## SEGMENTAL PERFORMANCES

The Group has three main divisions: Manufacturing, Steel Trading, and Properties.

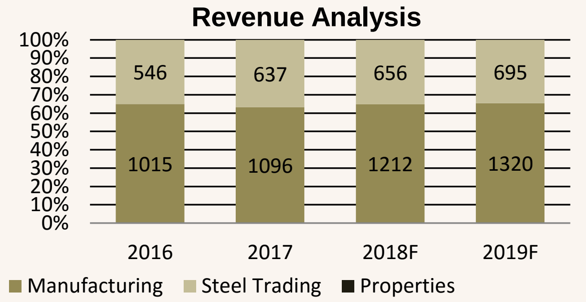
Revenue from the **Manufacturing** division was up 22.0% in H1:18 driven by a significant contribution from the Group's 3 overseas companies.

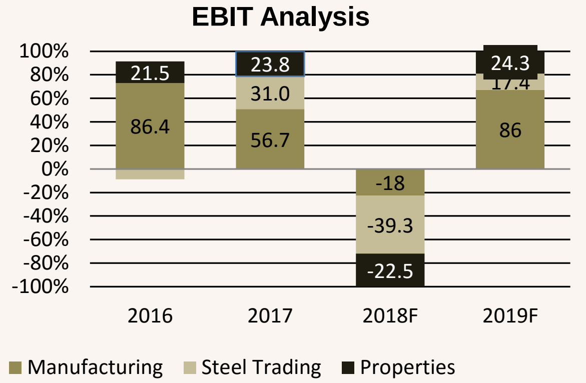
The Group is in the process of downsizing a number of its operations, namely Jetmaster, Gammid Cape, Gammid Johannesburg and Toolroom Services. Gammid Johannesburg along with Jetmaster will need to move premises while Xpanda Security is moving into the Toolroom premises which will consolidate costs while also allowing Xpanda to increase its footprint in the Johannesburg area. This also has the added benefit of consolidating management for Toolroom and Xpanda.

The downscaling has resulted in the retrenchment of 144 staff members at a cost of R3.08m and management expects a further 100 retrenchments at an estimated cost of R2.7m

Overall the division generated a profit before tax and impairments of R25.8m. The downsizing and restructuring of the division resulted in impairment losses of R68.1m resulting in a net loss before tax of R42.2m. Margins on core operations were 4.2% for the period but when factoring in impairments this drops to -6.8%.

Operations at Toolroom have been significantly hampered by ongoing strikes and a labour "go slow" with labour actions costing the business an estimated R2.6m. 126 out of 154 staff have been dismissed following the



disciplinary process. The business is already in the process of refilling the positions and is already back at ~50% production capacity. Management expects disruptions, from the ramping up of capacity and training of new staff, to continue in November and December before returning at full capacity in January 2018.

The performance of Cedar Paints bolstered the division's performance and should continue to see strong volume growth.

Xpanda should continue to deliver strong growth in a high crime environment as well as off continued entry into new markets. The Group's OSA Door Parts division in the UK should continue to see demand growing at ~7-10% per annum according to industry consensus.

The SA manufacturing industry remains generally weak as manufacturers have cut back on capital spending in recent years and investment prospects are unlikely to recover meaningfully in the short term, not only due to the challenging business climate, but also owing to many sectors of the economy having spare production capacity. Despite this ART's brands remain strong and should continue to see positive growth in the short term and the Group is well positioned to capitalise on any medium or long term economic recovery.

We forecast revenue to increase by 10.6% in FY18 owing to the full year inclusions of acquisitions, and by 8.9% in FY19 as volume growth starts to improve in line with a recovering SA economy. We forecast EBIT margins of -1.5% for FY18 as impairments and disruptions are not expected to impact H2 as significantly. FY19 margins of 6.5% are expected as once-off impairments are not expected to recur and as margins return to historic norms. The downscaling and streamlining of the Group will also lead to further margin improvement and the division has the potential to return to FY16 margins of ~8.5% in the medium to long term.

Revenue from the **Steel Trading** division decreased by 3.0% in H1:18 as difficult market conditions prevailed. Overall the division generated a profit before tax and impairments of R4.5m. The downsizing and restructuring of the division resulted in impairment losses of R48.6m resulting in a net loss before tax of R44.2m. Margins on core operations were 1.4% for the period but when factoring in impairment this drops to -13.9%.

The Group is currently in the process of downsizing Gammid Cape and Gammid Johannesburg and is also in the process of selling its 2 tube mills and related tooling for an amount of R10m. This should provide the Group cost efficiencies as purchase agreements are in place with the potential buyers. The stock level held in this sector has decreased from R249m as of 31 March to its current level of R216m.

The slight recovery in the iron ore price and subsequently steel prices filtered through to ART's customer base. Recent consensus estimates suggest, however, that the global iron ore supply is accumulating and is expected to lead to flatlining iron ore/steel prices.

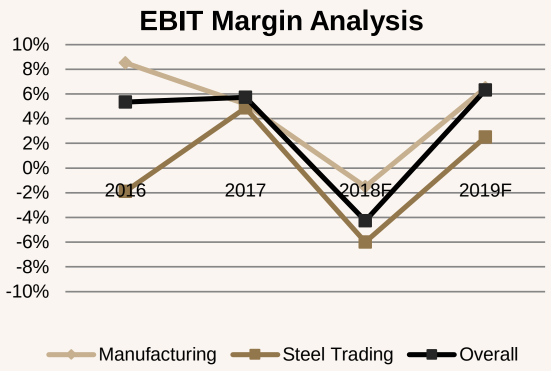
At this low-growth stage of the economic and commodity cycle, and considering the government is forcing higher input costs in the interim through protective tariffs, ART will be forced to strategically scale back on operations to generate stronger returns. Nonetheless, management expects steel demand and volumes in SA to remain relatively healthy, despite higher prices being forced onto customers, as steel remains a staple input.

We forecast revenue to increase by 3.0% in FY18 and by 6.0% in FY19.

Management's focus on strategically reducing stock levels and containing operating costs is expected to continue and was a major rational for the Group wide downscaling and restructure. This should result in some overall margin upliftment and some working capital release.

We forecast the EBIT margin to decline to -6.0% in FY18 as the impairments from H1 come through. H2 margins should trend towards the core H1 margin of ~1.4%. We forecast margins of 2.5% in FY19. However, as the division's profitability relies almost centrally on underlying commodity prices, one should reasonably expect volatility within the margin.

Revenue from the **Properties** division decreased by 15.0% in H1:18. The Group is in the process of selling its Jetmaster property in Johannesburg for ~R33.5m and is still trying to sell its Xpanda Johannesburg property. The Cedar Paints property in Klerksdorp is also under offer for ~R7.5m.



The division incurred impairment costs of R45m for the period relating to 3 properties that received lower offers/indicative offers, and Phoenix Steel Gauteng which revalued along with the balance of the steel sector assets.

Our EBIT forecasts are based on relative property trends and their effects on rental yields. Subsequently, we anticipate a 5.0% escalation per annum as Argent's property portfolio continues to benefit off a supply-suffocated property arena, allowing for yearly yield increases and thereby providing a hedge against other divisional headwinds.

We forecast the rental yield at 6.6% in FY18 and 7.1% in FY19, which translates to core EBIT of R25.3 in FY18 and R27.6 in FY19. Factoring in H1:18 impairments EBIT for FY18 is forecast at –R19.5m.

## VALUATION

H1:18 was a challenging period for the Group having undergone a significant restructure amid a difficult economic climate. The changes, while disruptive to the latest set of results, appear to have significantly streamlined operations and should unlock margin improvements in the future.

Challenges in the South African market aren't expected to abate in the short term and the market remains sceptical toward the expected profitability of the highly cyclical SA steel and manufacturing industries. While operations are capital intensive and cyclical, the Group continues to maintain a strong cash conversion ratio and the recent operational restructuring has the potential to unlock long term value to shareholders.

We believe that management is strategically steering the Group back toward core operational competencies and ART's balance sheet is in good stead to increase leverage and start gearing up returns. We have maintained a conservative approach when assessing ART's commodity-driven prospects, particularly against a backdrop of high political and economic uncertainty. However, at ART's current share price and assuming a liquidation rate of 50%, ART's liquidation value sits at ~R5.25 per share, despite the impairments. While economic conditions are expected to continue to hamper ART's operations, pending the success of the restructure, there is potential for value to be unlocked in the medium to long term.

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

With reference to the DCF table, we have considered a discounted cash flow analysis and with cash flows forecast to FY20, utilising a terminal growth rate of 6% to yield the sensitivity table to the right, for which we used a discount rate of 22.9%[1], yielding a value of R5.98.

With reference to the relative PE table, we have compared Argent to other companies in the industrials sector and have applied a 30% discount to the peer Group PE due to the relatively smaller size of Argent. The implied forward PE valuation of 5.4 places the share at a valuation of R4.84.

**DCF Discount rate**

| Growth rate | 18.9% | 20.9% | 22.9% | 24.9% | 26.9% |
|---|---|---|---|---|---|
| **0%** | 5.86 | 5.29 | 4.82 | 4.42 | 4.08 |
| **2%** | 6.36 | 5.68 | 5.13 | 4.68 | 4.30 |
| **4%** | 7.00 | 6.17 | 5.51 | 4.98 | 4.54 |
| **6%** | 7.84 | 6.79 | **5.98** | 5.35 | 4.84 |
| **8%** | 8.98 | 7.60 | 6.58 | 5.81 | 5.20 |
| **10%** | 10.64 | 8.70 | 7.36 | 6.39 | 5.64 |
| **12%** | - | 10.31 | 8.44 | 7.14 | 6.20 |

| General Industrials | Price | Mkt cap (m) | 1 year fwd PE |
|---|---|---|---|
| KAP* | 8.82 | 23401 | 13.5 |
| Insimbi | 1.11 | 455 | 3.9 |
| Invicta | 52.95 | 5642 | 8.9 |
| Argent | 3.92 | 388 | 4.3 |
| **Average** | | | **7.6** |
| *consensus forecasts used | | | -43% |
| Argent | **3.92** | 388 | 4.3 |
| Premium (Discount) applied to average: | | | -30% |
| **Argent: Implied current gain/(loss):** | 4.84 | 24% | **5.4** |

[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

## DISCLAIMER