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Research

ART – Argent Industrial Limited Interim Results and Initiation Report

Valuation: Undervalued

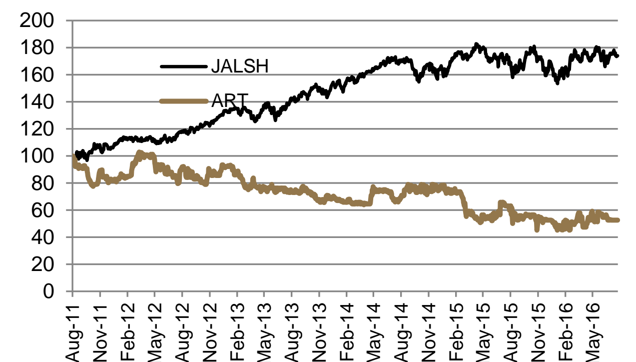
ART released interim results on 17 November 2016 for the year ended 30 September 2016

Price (R)	**4.32**
PE Fair Value (R)	**5.37**
DCF Value (R)	**5.83**
Upside(Downside) to DCF (%)	34.9%
DY %	4.2%

Price Performance	Absolute	Relative to JALSH
1 month	-2.8%	-1.3%
3 month	11.3%	16.1%
12 month	9.9%	13.3%
12 month	**High**	**Low**
(SA Rands)	4.90	3.35

No. of shares (m)	95	Price (R)	4.32
Ave. volume 3 month # ('000)	178	Mkt cap (Rm)	429

Financial Year	2015	2016	2017F	2018F
Turnover (Rm)	1791	1707	1975	2174
EBITDA	93	123	164	190
EBIT	58	91	133	158
PAT	38	56	91	111
HEPS (cents)	40.8	62.8	100.3	124.3
Dividend (cents)	15.0	18.0	20.0	20.0
P/E ratio	10.1	7.2	4.5	3.7
EV/EBITDA	6.4	4.4	3.2	2.6
EBITDA margin (%)	5.2%	7.2%	8.3%	8.7%
EBIT margin (%)	3.2%	5.3%	6.7%	7.3%
Net debt/equity	0.18	0.11	0.09	0.06
ROCE (%)	4.5%	6.9%	10.0%	11.1%
ROE (%)	3.2%	4.7%	7.4%	8.5%



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RESULTS COMMENTARY

Argent released a defensive set of results that were in line with our expectations, despite a volatile commodity cycle experienced throughout the period.

- Revenue is up 10.9% y-o-y in H1: FY17 as a result of turnaround in the Steel market and resilience in its Manufacturing division
- The y-o-y operating margin was up as a result of operating profits flowing through from the Steel division again, as well as the Manufacturing division defending its margin against a tough environment.
- The group recently acquired OSA Door Parts, a UK manufacturer and supplier of industrial warehouse doors.
- H1: FY17 HEPS is up 26.8% to 42.5 cps and would have been up 29.7% if not for forex losses. An interim dividend of 10 cps was declared.

OUTLOOK FOR NEXT REPORTING PERIOD

Last period's slump in the steel market benefited the group in the current period as inventory was absorbed at low prices and the group has been selling it off at high prices, riding off a ~45% steel price recovery during 2016.

The group's recent acquisition of OSA Door Parts Limited has been efficiently expanding the group's manufacturing division as well as its footprint in the UK, albeit at a smaller revenue contribution level than its domestic manufacturing operations. OSA's high operating margin of 35% has been filtering through comfortably thus far, alongside synergies gained off superior technology and leveraging of existing local businesses, like Xpanda, off the technology used at OSA which will continue to unlock potential synergies.

The group carries a defensive balance sheet despite difficult conditions in the steel industry, having decreased gearing by ~20% and increased asset turnover by 4.1% y-o-y since 2011, alongside net profit margins being restored by 59.3% y-o-y since its 2014 slump. A further defensive signal conveyed by the company has been its 28.5% annualised growth rate of its dividend pay-out. Such resiliency is a fundamental strength throughout unpredictable commodity cycles.

While the cost of energy inputs are set to rise, the absence of anticipated striking, distributive efficiencies and steel's survival value should offset increasing cost pressures experienced by ART's core operations.

We forecast revenue to increase by 15.7% and 10.1% to R1.97bn and R2.17bn in FY17 and FY18, respectively. The revenue increase will come off the back of a larger inclusion of OSA's results, along with continued growth from the rest of the manufacturing division, albeit off a high base. The operating margin is expected to increase to 6.7% and 7.8% in FY17 and FY18, owing to recoveries in the Steel Trading division 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. and further losses being recouped by struggling divisions.

We expect HEPS to increase by 59.7% to 100.3 cps in FY17, with the group's share repurchase program continuing to bolster HEPS somewhat. We forecast a further 23.9% bump in FY18 HEPS to 124.3 cps as improved margins filter through to the bottom line.

SEGMENTAL PERFORMANCES

The group has five main divisions: Manufacturing, Steel Trading, Automotive, Watch List and Properties. The segments service both domestic and non-domestic markets. The table below contains our revenue and operating margin forecasts for FY17 and FY18.

	FY16	H1: FY17	Growth	FY17F	Growth	FY18F	Comments
Revenue	**1706.9**	**940.1**	**15.7%**	**1975.2**	**10.1%**	**2173.7**	
Manufacturing	1015	512.5	8.0%	1097	6.2%	1164	Excellent performance from Xpanda, diversified entry into the school furniture market and the group's OSA Door Parts Limited acquisition, which sees demand growing at ~7-9% y-o-y. This being combined with the fact that the 2014 strikes are not expected to recur again bode for further booms in the division, particularly as H2 is the dominant revenue driver off customer restocking-demand. However, the manufacturing industry in general is weak and spend will continue to be pressured.
Steel Trading	546.0	325.1	25.0%	682.5	15.0%	784.8	Recoveries in iron ore and subsequently steel prices caused a short-term boost for steel demand. However, recent consensus estimates suggest that iron ore supply is accumulating and steel demand is slowing, particularly in China, which is expected to lead to lower iron ore/steel prices going forward, which is in line with management's estimates. New low-cost capacity is expected over the next 2-3 years. Management expects steel demand and volumes in SA to remain healthy as steel remains a staple input.
Automotive	94.2	56.2	13.0%	106.5	10.0%	117.1	The division's losses were attributable to inconsistent take-offs and project start up delays, against a tough automotive climate. High lending rates and high import costs built into automotive pricing constrained consumers. Estimates by NAAMSA suggest that the automotive market only grows 4% per 1% GDP growth. Regardless, APDP should spur on some growth despite the overall sector still struggling, allowing modest growth in FY17 and FY18 as the best possible outcomes off strategic price increases. Management is hoping to have exited the segment by FY18, should it have not reached healthy profitability.
Watch list	50.6	45.8	75.0%	88.6	20.0%	106.3	While ART is looking to remove Cedar paints from the group, the segment is now operating close to break-even off recoveries made in volumes in FY17 and should reach profitability by the end of FY17. Assuming no offers are made, revenue should see a steadily declining y-o-y uptick off a higher base owing to construction/infrastructure spend picking up, despite slow moving inventory.
Properties	0.9	0.6	8.0%	1.0	8.0%	1.1	No real increase in property revenue as income comes through directly on an operating profit level.
EBIT Margin	**5.35%**	**5.68%**		**6.8%**		**7.28%**	
Manufacturing	8.5%	7.8%		8.3%		8.6%	Restructuring benefits are not causing major material effects as of yet, however, the non-occurrence of strikes will allow the group to return to and/or maintain a higher margin along with higher offshore margins (OSA enjoys a ~35% operating margin) offsetting lower local margins. Expecting incremental improvements.
Steel Trading	-1.9%	3.5%		3.8%		4.0%	Global commodity prices have been booming due to recoveries made in Chinese production and its economy stabilising, with higher steel prices driving the FY17 margin rally. Moreover, the group has stock which was purchased at lower costs during the slump in the steel market and is focused on containing operating costs and absorbing its steel supply in its manufacturing division in order to drive returns in FY17. Forecasted margins will remain somewhat flat owing to the inherent difficulties associated to forecasting metal prices which ultimately drive margins.
Automotive	-1.5%	-9.7%		-5.0%		0.0%	Sentech Industries will see cost saving and streamlining measures while being instrumental toward increasing asset turnover from its manufacturing plant and processes, alongside price increases. Margins should see incremental improvements, particularly as striking action is not expected to continue, but the division will continue facing direct headwinds and the division may already have reached cessation by FY18.
Watch list	-9.8%	-0.4%		0.0%		1.5%	Cedar paints' operating frailties continue to contribute to overall losses in the division, however, cost-cutting exercises should see some alleviation on margins, with breakeven being reached in FY17.
Properties	N/A	N/A		N/A		N/A	The sale of a number of properties near the end of FY15 has diminished the overall rental stream in the division. FY17 and FY18 operating profit is based on recent property sales and management's expectation of 8% y-o-y increase in rental rate. Decreasing margins are only a result of the revenue figure expected to grow at 10% vs 8% growth in rental rates.

VALUATION

The group has shown good earnings recovery since restructuring and downward pressure on steel prices in FY14, with ROE having increased ~3.4 times. However, this has not yet reflected in the group's share price, probably owing to the scepticism being portrayed toward a volatile steel industry.

However, we believe that management remains well-versed in the steel arena and comprehends where ART's faults lie on a divisional basis, which is shown in its efforts to return to its core operational competencies, which particularly lie in the trading realm.

The group has been maintaining a healthy working capital equilibrium and continues to muster a strong balance sheet.

Argent's property portfolio is one of the largest contributors at an operating profit level, seeing its 14 properties charging market-related rental rates which seem to be incessantly booming in a supply-suffocated property arena, allowing for y-o-y operating profit resiliency and a hedge against its other divisions' market headwinds.

When examining our HEPS forecasts, which have incorporated a highly conservative outlook toward ART's commodity-driven backyard, at ART's current share price it holds excellent entry potential and at a forward P/E of 4.6 it looks highly attractive as a recovery stock.

Both our DCF model 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 FY19, utilising a terminal growth rate of 6% to yield the sensitivity table to the right, for which we used a discount rate of 22.9%[1], yielding a value of R5.83.

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 4.6 places the share at a valuation of R5.37.

	DCF Discount rate				
Growth rate	**18.9%**	**20.9%**	**22.9%**	**24.9%**	**26.9%**
0%	5.69	5.12	4.65	4.25	3.92
2%	6.20	5.52	4.96	4.51	4.13
4%	6.85	6.01	5.35	4.82	4.38
6%	7.69	6.63	**5.83**	5.19	4.68
8%	8.85	7.45	6.43	5.65	5.04
10%	10.54	8.58	7.23	6.24	5.49
12%	-	10.20	8.31	7.01	6.06

General Industrials	Price	Mkt cap (m)	1 year fwd PE
Dawn	2.25	545	2.9
KAP*	7.79	19043	17.3
Insimbi	1.09	286	4.6
Invicta	62.85	6781	10.0
Argent	4.45	426	3.8
Average			**7.7**
*consensus forecasts used			-50%
Argent	**4.45**	426	3.8
Premium (Discount) applied to average:			-40%
Argent: Implied current gain/(loss):	5.37	21%	**4.6**

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[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