ISB – Insimbi Refractory and Alloy Supplies Limited – Full Year Results

Valuation: At Value

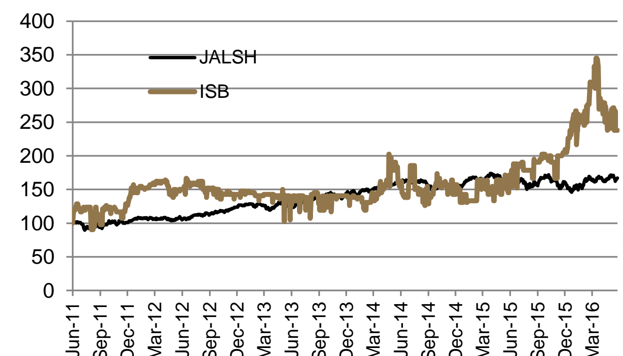
ISB released results on 19 May 2016 for the year ended 29 February 2016

Price (R)			**0.95**
PE Fair Value (R)			**0.98**
DCF Value (R)			**1.08**
Upside(Downside) to DCF (%)			13.5%
DY %			4.7%

Price Performance		Absolute	Relative to JALSH
1 month		-12.8%	-12.6%
3 month		-25.8%	-28.3%
12 month		31.9%	29.7%
12 month		**High**	**Low**
(SA Rands)		1.50	0.40

No. of shares (m)	260	Price (R)	0.95
Ave. volume 3 month # ('000)	17	Mkt cap (Rm)	247

Financial Year	2015	2016	2017F	2018F
Turnover (Rm)	958	955	1023	1090
EBITDA	47	53	62	66
EBIT	40	44	48	53
PAT	27	29	32	38
HEPS (cents)	11.0	12.4	13.5	15.9
P/E ratio	5.5	8.0	7.4	6.3
EV/EBITDA	4.0	6.3	5.1	4.4
EBITDA margin (%)	4.9%	5.6%	6.1%	6.1%
EBIT margin (%)	4.2%	4.7%	4.7%	4.9%
Net debt/equity	0.34	0.67	0.45	0.29
ROCE (%)	18.6%	17.6%	17.3%	17.7%
ROE (%)	21.5%	20.9%	20.0%	20.7%



RESULTS COMMENTARY

ISB released a good set of results given the difficult conditions in the steel industry in South Africa.

- Group revenue for the year was down 0.3% from R958m to R955m due to the decline of the steel industry affecting the performance of the foundry and steel divisions. Despite this operating profit increased by 10.4% from R40.2m to R44.4m.
- The weak growth by the steel division was somewhat offset by strong growth in the refractory division and the maiden contribution of the group's plastics division.
- On an operating profit level only the steel division contributed negatively falling 34% with the foundry division growing operating profit 19.9% despite negative revenue growth. The refractory division grew operating profit by 75% for the year.
- The operating margin increased from 4.2% to 4.6% largely as a result of strong profit increases in the foundry and refractory divisions despite a decreasing revenue base. The group also executed tight control of overheads.
- ISB incorporated a new plastics division with the acquisition of Polydrum Ltd on 1 August 2015. The division contributed R19.6m to revenue in its 7 month inclusion. The drought impacted demand for containers from the agricultural sector and erratic electricity supply caused some production losses. As a result the division did not achieve the expected profitability and operated close to break even.
- On 22 June 2016, ISB announced the proposed acquisition of the AMR group, a company specializing in the aggregation, processing, recycling and sale of scrap metal. The transaction, which is priced at R284m, is subject to the conclusion of the purchase agreement and regulatory approvals, and ISB is subsequently trading under cautionary.
- HEPS increased 10.2% from 11.3cps to 12.4cps. The total dividend declared for the year was 4.5cps.

OUTLOOK FOR NEXT REPORTING PERIOD

A low economic growth forecast along with difficult market conditions in the steel industry is expected to continue to place revenue and margins under strain.

Despite this the foundry segment which contributes 72.5% of the group's revenue is expected to continue its slow steady volume growth trajectory as a high level of product diversification should result in an increase in demand and slight margin improvement.

In the refractory division the introduction of a number of new players in the cement market has put cost cutting pressure on customers, resulting in margin pressure. This should be offset by the introduction of tariffs on cement imports resulting in an increase in demand for local cement which should filter through to ISB.

The steel division is expected to continue to experience difficult conditions as the steel industry still shows little sign of recovery as high input costs, competition from imports and low local demand erode

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volumes and put margins under pressure.

The plastic division is expected to be profitable in the coming period provided the impact of the drought on agricultural container demand does not recur. The group is working on a solar solution to prevent production losses from erratic electricity supply.

The acquisition of AMR, if successful, should add value to ISB through diversifying its metals product offering as it looks to become a major player in the metals industry. While further details are expected to come as the transaction is finalised, particularly in terms of the share placement that will be used to finance the deal, initial indications show that the AMR group will add ~R2bn of revenue and ~R46m in profit after tax. Given a purchase price of R284.1m, this equates to a P/E of 6.2, which when compared to ISB's current P/E of 8.0, indicates that the deal will result in some share price appreciation. Given the earnings enhancement of the deal and the flow through of the P/E uplift, we see a potential upside of ~25% should the transaction go through.

Overall we forecast turnover to increase by 7.1% from R955m in FY16 to R1.02bn in FY17 and by 6.5% to R1.09bn in FY18. The operating margin is forecast to rise to 4.7% in FY17 and 4.9% in FY18. The improvement is a result of increased local and international demand in the foundry division and refractory division. There is a focus on overhead control and as volumes increase, average cost will decrease leading to better margins. HEPS is forecast to grow by 8.9% from 12.4cps in FY16 to 13.5cps in FY17 and 17.6% to 15.9cps in FY18.

VALUATION

ISB is well positioned to capitalise on an upturn in demand for its products and services, however with sluggish economic growth forecasts and low expectations of demand in the steel sector in the short and medium term, revenue and margin growth are expected to continue to be low.

While our DCF valuation indicates the share is currently undervalued, our relative PE valuation indicates the share is **at value.**

A successful conclusion of the recently announced acquisition further underpins a value unlock for the group.

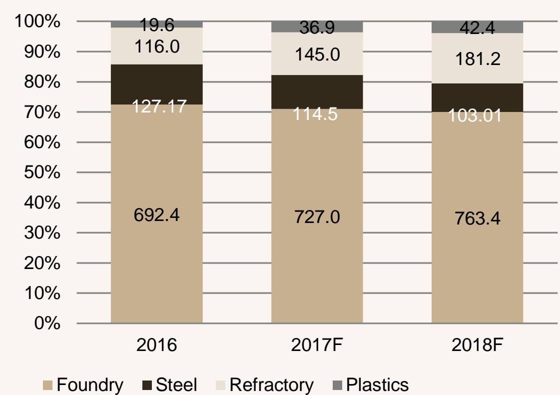
SEGMENTAL PERFORMANCES

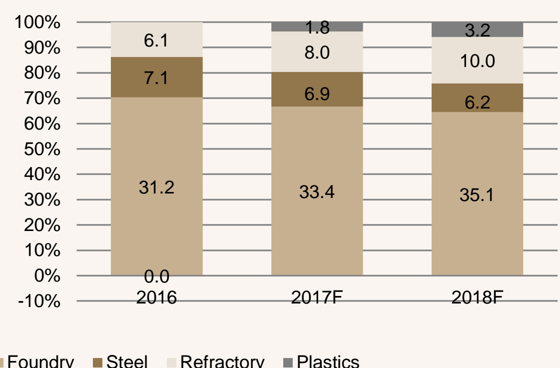
Foundry revenue decreased by 5.0% from R729m in FY15 to R692m in FY16. The division experienced mixed trading conditions and a degree of volatility, albeit at a more stable level than in previous years. Revenue was impacted by the general slowdown of the steel industry resulting in decreased demand from ferrous and non-ferrous metal smelters.

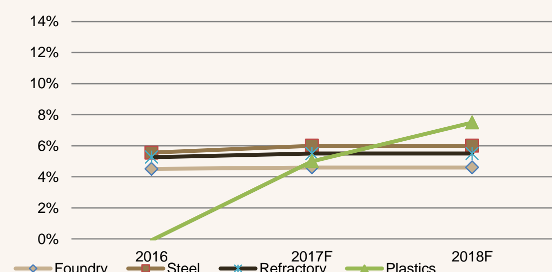
Despite this decrease in revenue, operating profit for the segment increased by 19.9% from R26.1m to R31.2m with margins increasing from 3.6% to 4.5%. This improved margin was a result of a focus on cost efficiency as well as a strong contribution from the powder division. The sourcing of scrap aluminium for the smelters has traditionally been expensive which eroded margins in the division. New purchase agreements are in place that significantly unlock margins.

An increase in efficiency from the 2 secondary smelters contributed to increased profitability and a weaker rand made the division's products more competitive in global markets. ISB is focusing heavily on the sale of products in African and international markets, however the division still faces challenges in terms of raw materials, energy and logistics when compared to foreign competitors. Results started to show from the division's African export focus.

We forecast revenue from the foundry division to increase by 5% in FY17 and FY18 to R727m and R763m respectively. Revenue







increases are anticipated from growing customer demand with a moderate improvement in market conditions. Exports of products to African and international markets, bolstered by a weaker rand are also expected to contribute. Despite many client foundries closing down, the ones that remain are operating efficiently and generating demand. Operating margins are forecast to increase slightly from 4.5% in FY16 to 4.6% in FY17 and FY18. This improvement in margin is a result of increased sales in the company's existing cost structure as well as a focus on cost reduction and efficiency. The Johannesburg smelter has been upgraded to operate more efficiently and the powders segment should continue to contribute strongly.

Steel revenue decreased by 5.8% from R135m in FY15 to R127m in FY16. Trading conditions were significantly affected by the subdued steel sector in South Africa as well as a general lack of infrastructure spend locally and in emerging markets. Despite a weak rand, the South African steel industry struggled against high input costs, low market demand, and high levels of competition from China and other eastern countries. Failed business rescue lead to Evraz Highveld Steel closing its doors which also had an impact on local demand. Operating profit for the segment decreased by 34% from R10.7m to R7.1m during the year with margins decreasing from 7.9% to 5.6%.

We forecast revenue from the Steel division to decrease by 10% in FY16 and FY17 to R115m and R103m respectively. Revenue decreases are driven by continued difficult conditions in the steel industry and general low demand for steel products. It is not likely that the high input costs and competition with China and other Eastern countries will abate in the short to medium term despite the introduction of new tariffs to curb foreign imports. Operating margins are forecast to increase to 6.0% in FY16 and FY17 as the division adjusts its products basket away from the traditional high volume low margin offering to a higher value product.

Refractory revenue increased significantly by 23.6% from R93.9m in FY15 to R116m in FY16. The strong performance was a result of the division's increased product offering and strong market demand from a number of sectors. A weaker rand relative to the euro also assisted in boosting revenue and improving margins. Operating profit for the segment increased by 75% from R3.5m to R6.1m during the period with margins increasing from 3.7% to 5.7%.

We forecast revenue from the Refractory division to increase by 25% in FY17 and FY18 to R145m and R181m respectively. Revenue increases are expected as a result of increased demand for the segment's diversified product range by a wide range of industries which should offset the loss of demand from the steel industry. Operating margins are forecast to increase to 5.5% in FY17 and FY18.

The newly incorporated **Plastics** division was included for 7 months in the group's results after the acquisition of Polydrum Ltd on 1 August 2015. Revenue of R19.6m was recorded for FY16 however due to the severe drought affecting some parts of the country demand from the agriculture industry for the group's plastic containers was severely constrained which impacted profitability. Intermittent electricity supply resulted in wastage at the production phase which also eroded profit. As a result the division operated at around breakeven for the 7 months. This acquisition was in line with the group's policy to continue diversifying away from the metals industry. It unlocks a number of logistic synergies such as the ability to piggy back plastic products on trucks already making trips to Durban and Cape Town for other divisions.

We forecast full year revenue of R36.9m in FY17 as revenue is included for a full 12 months. FY18 revenue is forecast to increase by 15% to R42.4m as the division experiences high growth off a low base. The impacts of drought and electricity disruptions are not anticipated to continue in FY17 resulting in a return to profitability. Operating margins are expected to be 5% in FY17 increasing to 7.5% in FY18 as volumes increase on a fixed cost base.

DCF Discount rate

Growth rate	16.3%	18.3%	20.3%	22.3%	25.0%
0%	1.03	0.91	0.82	0.74	0.64
2%	1.15	1.00	0.89	0.79	0.68
4%	1.31	1.11	0.97	0.86	0.72
6%	1.53	1.26	**1.08**	0.94	0.78
8%	1.86	1.48	1.22	1.05	0.84
10%	2.44	1.80	1.43	1.19	0.92
12%	3.66	2.36	1.75	1.39	1.03

Industrial	Price	Mkt cap (m)	1 year fwd PE
SEPHAKU	4.10	828	6.7
Vesuvius	72.14	19635	12.8
Afrimat	19.90	2851	11.8
Insimbi	0.95	247	7.0
Average			**9.6**
*consensus forecasts used			-50%
Insimbi	**0.95**	**247**	**6.99**
Premium (Discount) applied to average:			-25%
Insimbi: Implied current gain/(loss):	**0.98**	3%	**7.2**

VALUATION

With reference to the DCF table on the right, we have considered a discounted cash flow analysis and with cash flows forecast to FY19, utilising a terminal growth rate of 6% to yield our sensitivity table, for which we used a discount rate of 20.3%[1], yielding a value of R1.08.

With reference to the relative PE table on the right, we have compared ISB to other Industrial companies in the industry, however due to its relatively small size and sector risk we have applied a 25% discount. The implied forward PE valuation of 7.2, in combination with the earnings forecast places ISB at a price of R0.98.

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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 capitalisation ranging from R0-R700m in our research universe