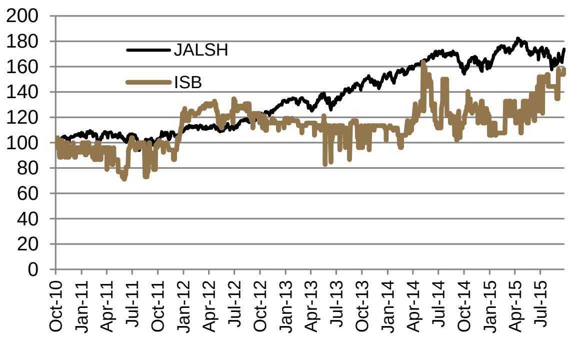
ISB – Insimbi Refractory and Alloy Supplies Limited – Initiation Report

Valuation: Undervalued

ISB released results on 29 September 2015 for the period ended 31 August 2015

Price (R)			**0.82**
PE Fair Value (R)			**0.95**
DCF Value (R)			**1.31**
Upside(Downside) to DCF (%)			59.9%
DY %			5.5%
Price Performance			**Relative**
		Absolute	**to JALSH**
1 month		9.3%	3.1%
3 month		13.9%	11.5%
12 month		36.7%	25.1%
12 month		**High**	**Low**
(SA Rands)		0.87	0.40
No. of shares (m)	260	Price (R)	0.82
Ave. volume 3 month # ('000)	164	Mkt cap (Rm)	213

Financial Year	**2014**	**2015**	**2016F**	**2017F**
Turnover (Rm)	939	958	1019	1078
EBITDA	43	47	60	64
EBIT	36	40	50	53
PAT	20	26	34	38
HEPS (cents)	8.4	10.9	14.2	16.2
P/E ratio	81.6	62.9	48.1	42.1
EV/EBITDA	39.6	35.6	27.9	25.7
EBITDA margin (%)	4.5%	4.9%	5.9%	5.9%
EBIT margin (%)	3.8%	4.2%	4.9%	4.9%
Net debt/equity	0.22	0.34	0.29	0.14
ROCE (%)	0.0%	18.6%	23.1%	22.8%
ROE (%)	0.0%	20.5%	23.8%	23.6%



RESULTS COMMENTARY

ISB released a solid set of results, which were better than expected given the difficult trading conditions that have affected the steel industry in South Africa.

- Group revenue for the period was up 7.5% from R459m in H1:15 to R493m in H1:16, with operating profit up 30.8% from R16.4m to R21.5m.
- Positive revenue increases in the Foundry and Refractory divisions were offset by difficult conditions in the Steel division.
- The operating margin increased from 3.6% in H1:15 to 4.4% in H1:16 largely as a result of strong revenue and profits in the Foundry and Refractory divisions as well as a tight control of overheads.
- A weaker rand contributed to stronger exports for ISB and made competitor imports relatively more expensive.
- ISB incorporated a new Plastics division with the acquisition of Polydrum Ltd on 1 August 2015. The division contributed R2.9m to revenue and gross profit of R1.1m despite only being included for one month.
- HEPS increased 73.3% from 3.41cps in H1:15 to 5.91cps in H1:16. An interim dividend of 2cps was declared for the period.

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.

The Foundry segment which contributes 76% of the group's revenue is expected to continue steady volume growth with slight margin improvement anticipated. Management feels the industry has reached a comfortable level of sustainability locally and there are opportunities for ISB in international markets.

The Steel division is expected to continue experiencing difficult conditions as high input costs, competition from imports and low local demand erode volumes and put margins under pressure.

Overall we forecast turnover to increase by 6.3% from R958m in FY15 to R1.02bn in FY16 and by 5.8% to R1.08bn in FY17. The operating margin is forecast to rise to and remain constant at 4.9% in FY16 and FY17. 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 the average cost will decrease leading to better margins. Full year HEPS is forecast to grow by 30.1% from 10.9cps in FY15 to 14.2cps in FY16 and 14.1% to 16.2cps in FY17.

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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.

Both our DCF and relative PE valuation indicate the share is **undervalued**

SEGMENTAL PERFORMANCES

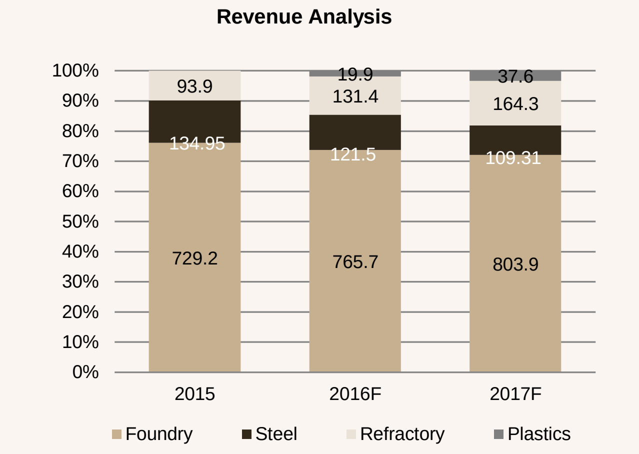
Foundry revenue increased by 4.5% from R351m in H1:15 to R367m in H1:16. The division experienced mixed trading conditions and an increase in competition both locally and from foreign companies. An increase in revenue was driven by improved efficiency from the 2 secondary smelters and a weaker rand made the division's products more competitive in global markets which bolstered revenue via exports. 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 and the powders segment continued to grow strongly.

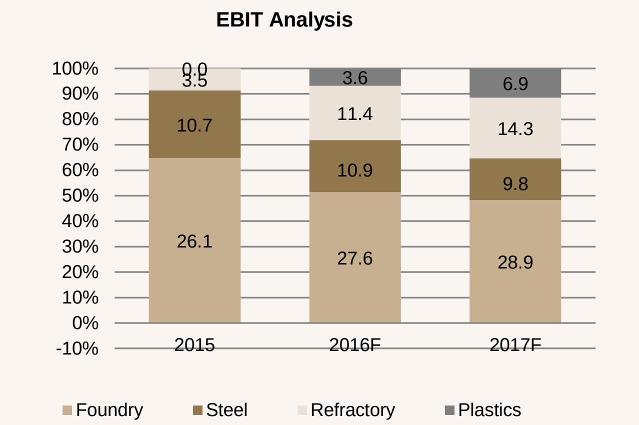
Operating profit for the segment increased by 45.4% from R6.9m to R10.1m with margins increasing from 2.0% in H1:15 to 2.8% in H1:16. This improved margin was a result of a focus on cost efficiency as well as lower average costs due to higher revenue on a fixed cost base. The sourcing of scrap aluminium for the smelters has traditionally been expensive which eroded margins in the division, new purchase agreements are in place that significantly unlock margins. A change in the product mix as well as the weaker rand helped lift margins as the sector uses London Metal Exchange (LME) pricing based in foreign currency. A more stable labour environment along with improved commodity prices further benefited the division.

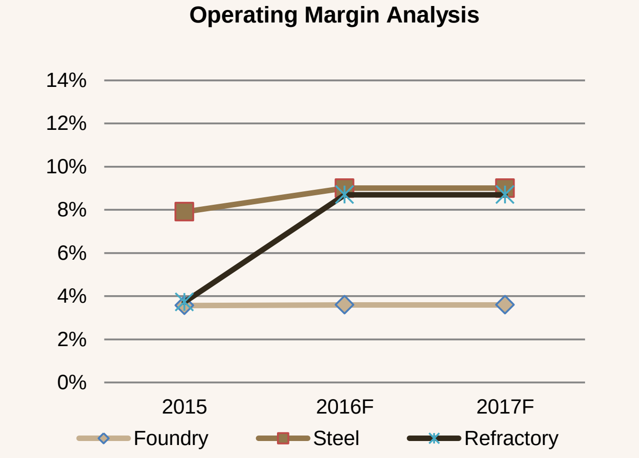
We forecast revenue from the Foundry division to increase by 5% in FY16 and FY17 to R766m and R804m respectively. Revenue increases are driven by growing customer demand as well as the export of products to African and International markets, bolstered by a weaker rand. Despite many foundries closing down the ones that remain are operating efficiently and generating demand for the division's products. Operating margins are forecast to increase slightly from 3.57% in FY15 to 3.60% in FY16 and FY17. 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 is being upgraded to operate more efficiently and will be operational in November 2015.

Steel revenue decreased by 11.1% from R66.3m in H1:15 to R59m in H1:16. 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. Operating profit for the segment decreased by 26.4% from R7.1m to R5.2m during the period with margins decreasing from 10.7% to 8.9%.

We forecast revenue from the Steel division to decrease by 10% in FY16 and FY17 to R122m and R109m 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. It is expected that power interruptions and labour unrest will continue to be a factor in the South African economy. Operating margins are forecast to increase to







9.0% 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 55.6% from R41.5m in H1:15 to R64.6m in H1:16. Trading conditions were boosted by an increased demand from the cement industry, a key customer of the division. A weaker rand relative to the euro also assisted in boosting revenue and improving margins. Operating profit for the segment increased by 139% from R2.3m to R5.6m during the period with margins increasing from 5.7% to 8.7%.

We forecast revenue from the Refractory division to increase by 40% in FY16 to **R131m** and by 25% to **R164m** in FY17. Revenue increases are as a result of increased demand from cement producers and an expected uptick in general infrastructure spend. Operating margins are forecast to remain constant at 8.7% in FY16 and FY17.

The newly incorporated **Plastics** division was included for 1 month in the group's results after the acquisition of Polydrum Ltd on 1 August 2015. Revenue of R2.9m was recorded for H1:16 contributing gross profit of R0.52m at an operating margin of 18.3%. 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 R19.9m in FY16 as revenue is included for 7 months. FY17 revenue is forecast to increase 89% to R37.6m as the division grows organically at 10% and as a full 12 months revenue is included for the first time. The decision has already been taken to step up production capacity with the introduction of 2 new production lines. Operating margins are expected to remain high at 18.3% in FY15 and FY16.

VALUATION

With reference to the DCF table on the right, we have considered a discounted cash flow analysis and with cash flows forecast to FY18, utilising a terminal growth rate of 6% to yield our sensitivity table, for which we used a discount rate of 28.5%[1], yielding a value of R1.31.

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 40% discount. The implied forward PE valuation of 6.1, in combination with the earnings forecast places ISB at a price of R0.95.

DCF Discount rate

Growth rate	24.5%	26.5%	28.5%	30.5%	25.0%
0%	1.21	1.04	0.91	0.80	0.64
2%	1.40	1.17	1.00	0.88	0.67
4%	1.68	1.35	1.13	0.97	0.72
6%	2.13	1.62	**1.31**	1.10	0.77
8%	2.96	2.06	1.57	1.27	0.83
10%	5.06	2.86	1.99	1.52	0.92
12%	20.30	4.89	2.77	1.93	1.02

Industrial	Price	Mkt cap (m)	1 year fwd PE
PPC*	17.25	10425	11.3
SEPHAKU	6.57	1368	12.6
Vesuvius	74.76	19635	9.9
Afrimat	21.14	3029	12.0
Insimbi	0.82	213	5.3
Average			**10.2**
*consensus forecasts used			-50%
Insimbi	**0.82**	**213**	**5.31**
Premium (Discount) applied to average:			-40%
Insimbi: Implied current gain/(loss):	**0.95**	16%	**6.1**

[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

COMPANY PROFILE

Insimbi Refractory and Alloy Supplies Limited provides the steel, aluminium, cement and foundry industries with resource-based commodities like ferrous and non-ferrous alloys, as well as refractory materials, by integrating the supply, logistics and technical support function.

ISB sources its product lines through longstanding agency agreements with a wide variety of International and local suppliers. ISB packages, warehouses, finances and in some cases adds value to the products (cutting to size etc.). The products are then sold on to a large and diverse customer base in the construction, automotive, manufacturing and mining industries. ISB has an extensive logistics network across South Africa, including its own fleet of vehicles with which to provide efficient delivery to customers. The company also offers technical support services to its customers such as kiln alignment and maintenance.

The business is highly exposed to the construction, infrastructure and manufacturing industries as its main customers are steel and cement producers as well as foundries.

Insimbi's Business model over the years has evolved into 3 distinct segments, namely Foundry, Refractory and Steel, which each complement each other while at the same time provide the group with much needed diversification in order to survive through the various difficult commodity and trading cycles experienced since it started.

The 3 operating segments are divided into a number of specialty divisions:

Refractory – supplies the steel industry's refractory requirements
Speciality – services the welding and optical industries
Steel – supplies the steel industry's raw material requirements
Foundry – services the automotive and heavy foundry industry
Non-Ferrous – services the aluminium industry
Rotary – services the cement industry's refractory requirements
KwaZulu-Natal – supplies all of the above products to KZN
Western Cape - supplies all of the above products to Western Cape

DIVISIONS

The **Foundry** division is ISB's main operating division. As of FY15 the division contributed 76% of group revenue.

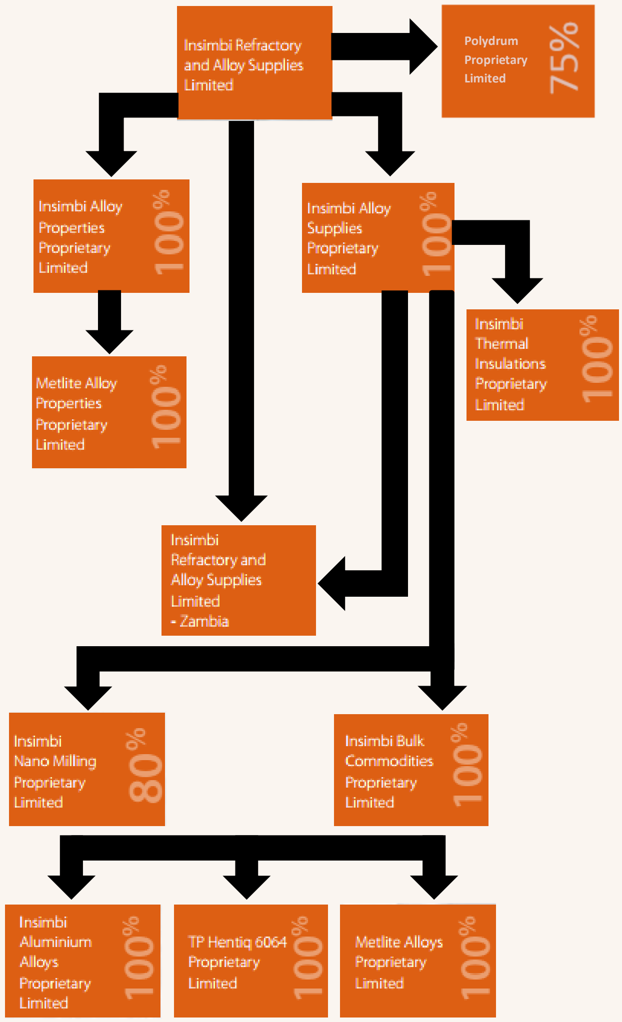
The division specialises in the provision of a comprehensive range of consumables, hardware, and software to the foundry industry. This includes a diverse range of alloys and ancillary raw materials, e.g. foundry sand and ceramic ducting to ferrous and non-ferrous foundries across the board, including heavy-duty foundries, automotive foundries, electroplating specialists etc., it is closely aligned with the steel segment in terms of the products supplied.

Examples of the division's major customers include Scraw Metals Group, Halburg Guss, Steloy Castings, Sasol, Exxaro and Amplats.

The **Steel** division is ISB's second largest division. As of FY15 the division contributed 14% of group revenue.

This segment focuses on the supply of a wide range of alloys, including non-ferrous alloys to the steel and stainless steel industry locally, regionally and globally; with a specific focus on the needs of South African producers but with a growing customer base in other emerging market countries.

Examples of the division's major customers include ArcelorMittal, Columbus Steel, Cape Gate Steel and Highveld steel.



The division has been subdued by difficult economic conditions as the steel industry in South Africa has experienced a number of challenges including high input costs, low market demand and high levels of competition from China and other eastern countries. Traditionally this division has relied on high volume low margin sales to generate profit. In order to mitigate exposure to the difficult conditions which the Steel industry has experienced ISB has actively diversified away from the steel sector and at the same time changed their product mix in the division to focus on lower volume, higher margin speciality products.

In 2011 the Steel division contributed, 30.0% of revenue and 32.5% of profits. In 2015 this revenue contribution was reduced to 14.1% yet still contributed 26.5% to group profit.

The **Refractory** division as of FY15 contributes 10% of group revenue.

This segment specialises in the supply of high quality and highly specialised ceramic refractory linings to the cement, paper and pulp, steel and platinum industries.

Examples of the division’s major customers include Scraw Metals, PPC Cement, Afrisam Cement and Sephaku Cement.

The **Plastics** division was added to the group with the acquisition of Polydrum Ltd in August 2015. It only contributed 1 month’s revenue in the current period but we forecast it to account for ~3.5% of revenue when its results are fully incorporated in FY17.

The acquisition is in line with the group’s intention to continue its diversification from the metals industry and unlocks a number of synergies in terms of logistics.

Polydrum produces durable plastic products with its main operation being the production of a large variety of blow-moulded products such as storage drums or pool filters.

The opportunity exists to package existing products from other divisions in Polydrum packaging thus supplying Polydrum products to existing customers while also benefiting from Polydrum’s existing client base.

DISCLAIMER