Merchantec
Research

ISB – Insimbi Refractory and Alloy Supplies Limited – Interim Results

Valuation: Undervalued

ISB released results on 10 November 2016 for the period ended 31 August 2016

RESULTS COMMENTARY

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

- Group revenue for H1: FY17 was down 2.6% owing to a 9.0% reduction in segmental revenue from its Foundry division as the anticipated rail infrastructure upgrades have yet to cause a material impact.

- ISB's Foundry and Steel divisions saw y-o-y operating profit boosts of 9.0% and 16.0%, respectively, owing to tight fixed cost controls in H1: FY17.

- ISB's new plastics division is continuing to perform strongly in line with our expectations and a recovery of agricultural demand should cause further revenue gains.

- H1: FY17 HEPS decreased by 19.2% due to rises in operating expenses associated with the new Plastics division and finance costs filtering through to the bottom-line. The group has declared an interim dividend of 1.5 cps.

OUTLOOK FOR NEXT REPORTING PERIOD

The group's Foundry segment was impacted by stagnation in the heavy foundry industry which translated into weakened demand for ferrous and non-ferrous alloys. However, the group controlled input costs well and renegotiated purchase agreements, which resulted in a margin hike. Management is focused on increasing the order book and efficiency of its two secondary smelters, with a focus on utilising the extra capacity for export.

Moving goods outside of the SA market is imperative, as SA is where most of the downside risk rests. Although African exports are starting to see promising uptake, more foreign exposure is required to offset local market sales volumes.

The introduction of new tariffs toward steel imports have not had enough material impact to drive out foreign entrants in the local Steel sector. China in particular sees its steel production being subsidised, allowing Chinese imports to enjoy predatory pricing models. Nonetheless, steelmakers' earnings have heightened off an increase in steel prices as China's economy stabilised and policy makers around the world pledged to back growth. This allowed ISB to boost revenue and operating profit in its Steel division.

ISB has been diversifying its revenue streams, with its acquisition of Polydrum and its pending acquisition of Amalgamated Metals Recycling (AMR). The acquisition of Polydrum has helped to reduce exposure to the metals industry and will realise higher margins off logistical synergies, lower input costs and high product uptake. The Plastics division saw operating outflows in H1: FY17, but this is to be expected during its acquisitive-integration phase.

The AMR acquisition is being finalised for a purchase consideration of R284.1m, which translates to an attractive P/E of ~5.1 (versus ISB's 2016 P/E of 9.0) and will bring in an additional ~R2.20bn in FY17 at an operating margin of ~4.6% and a net profit margin of ~2.5%. The acquisition's funding should see a D/E split of ~0.67, however, the increase in gearing and shares in issue will be offset by a surge in earnings, rendering the acquisition as highly accretive.

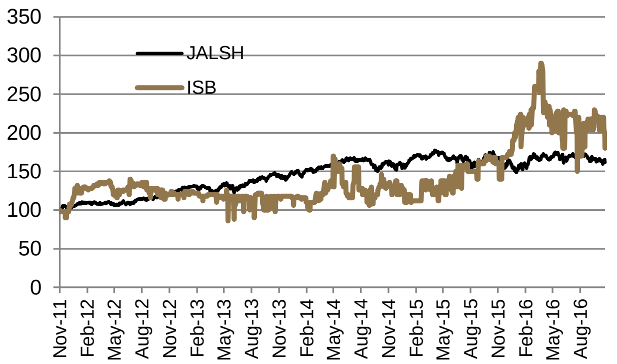
The AMR group is involved in the processing, recycling and resale of scrap metal, which has historically been viewed as more efficient than

Price (R)	**1.09**
PE Fair Value (R)	**1.68**
DCF Value (R)	**2.30**
Upside(Downside) to DCF (%)	110.9%
DY %	3.6%

Price Performance	Absolute	Relative to JALSH
1 month	-0.9%	0.6%
3 month	26.7%	32.3%
12 month	36.3%	40.5%
12 month	**High**	**Low**
(SA Rands)	1.50	0.55

No. of shares (m)	260	Price (R)	1.09
Ave. volume 3 month # ('000)	50	Mkt cap (Rm)	286

Financial Year	2015	2016	2017F	2018F
Turnover (Rm)	958	955	1431	3148
EBITDA	47	53	87	209
EBIT	40	44	70	164
PAT	27	29	41	109
HEPS (cents)	11.0	12.4	15.6	26.6
P/E ratio	62.1	7.7	6.2	3.6
EV/EBITDA	35.6	6.2	5.1	2.4
EBITDA margin (%)	4.9%	5.6%	6.1%	6.6%
EBIT margin (%)	4.2%	4.7%	4.9%	5.2%
Net debt/equity	0.34	0.67	0.52	0.26
ROCE (%)	18.6%	17.6%	16.8%	25.5%
ROE (%)	21.5%	20.9%	15.8%	26.6%



Contact us
2nd Floor, North Block
Hyde Park Office Tower
Corner 6th Road and Jan Smuts Ave
Hyde Park
research@merchantec.co.za
www.merchantec.co.za

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mining new ore. AMR should provide a Rand hedge, improved liquidity, increased clientele and revenue diversification, as well as logistical synergies for ISB. The scrap metal market is poised to increase off the back of rising metals prices, demand recoveries in China and increased automobiles entering the scrap stage of their lifecycle.

At an overall operating level, adjusting ISB's product basket toward higher value, lower volume products was a strategic expansionary move by management in a volume depressed environment. Insimbi remains superior in sweating its assets in comparison to its peer group (AFT and SEP), with an average 2.4x asset turnover largely driving existing ROE. Ultimately, ISB remains operationally healthy.

Overall, we forecast turnover to increase by 49.8% from R955m in FY16 to R1.43bn in FY17 as AMR is consolidated into ISB for 3 months, followed by an increase of 120.0% to R3.15bn in FY18 as market recoveries become fully apparent and AMR is fully consolidated. The operating margin is forecast to rise to 4.9% in FY17 and 5.2% in FY18, off the back of a higher value product mix and AMR's heavily weighted operating profit filtering through, alongside fixed cost controls and improved market conditions.

HEPS is forecast to grow by 25.4% from 12.4 cps in FY16 to 15.6cps in FY17 off the back of maiden AMR contributions and only a small portion of share dilution being realised. This will be followed by a 70.6% bump to 26.6 cps in FY18 due to fully consolidated earnings of AMR and synergies impacted cost and supply dynamics.

VALUATION

ISB is operationally poised to capitalise on an upturn in demand for its products and services, however, its clients will continue to face headwinds in the steel sector in the short and medium term. Nonetheless, the acquisition of AMR will diversify and boost the group's revenues and profits while Polydrom continues to earn its keep. The company is maintaining dividends and such positive signalling seems to be justified by resilient performance. Ultimately, the share price has the potential to double on a cash basis.

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

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 31.7%[1], yielding a value of R2.30.

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 20% discount. The implied forward PE valuation of 7.1, in combination with the earnings forecast places ISB at a price of R1.68. The large spread between the DCF and P/E valuations are owed to the current negativity demonstrated toward ISB's exposure to the commodity cycle and a depressed steel sector causing clientele losses, all of which have driven down its price.

	DCF Discount rate				
Growth rate	**27.7%**	**29.7%**	**31.7%**	**33.7%**	**25.0%**
0%	2.16	1.87	1.64	1.46	1.30
2%	2.45	2.09	1.81	1.59	1.39
4%	2.85	2.37	2.02	1.76	1.50
6%	3.42	2.76	**2.30**	1.96	1.63
8%	4.29	3.30	2.67	2.23	1.79
10%	5.80	4.14	3.20	2.59	2.00
12%	9.07	5.60	4.01	3.10	2.26

Industrial	Price	Mkt cap (m)	1 year fwd PE
SEPHAKU	2.98	580	7.4
Vesuvius	72.14	19635	12.8
Afrimat	28.05	4019	10.7
Insimbi	1.09	286	4.6
Average			**8.9**
*consensus forecasts used			-48%
Insimbi	**1.09**	**286**	**4.61**
Premium (Discount) applied to average:			-20%
Insimbi: Implied current gain/(loss):	1.68	54%	**7.1**

SEGMENTAL PERFORMANCES

The group has four main divisions: Foundry, Steel, Refractory and Plastics. However, we have added in "AMR" as a potential new division for the firm. The table below contains our revenue and operating margin forecasts for FY17 and FY18.

[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

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Revenue	FY16	H1: FY17	Growth	FY17F	Growth	FY18F	Comments
Foundry	692.4	333.6	-2.0%	678.5	5.0%	712.5	Upgrades to its foundries should start coming to fruition soon and the group is focusing on increasing its order book through exportation to China and Germany. The group is also in its final stages of acquiring Amalgamated Metals Group, which should better the group's chances of bettering its order book. Ultimately, revenue should see a slow uptick.
Steel	127.2	68.9	15.0%	146.2	15.0%	168.2	Forecasts by Trading Economics and SAICI suggest steel demand is alleviating in SA. Management is also confident that the sector will enjoy sustainable recoveries. SA is in the process of expanding and bettering its rail infrastructure and will continue to require steel inputs.
Refractory	116.0	55.5	18.2%	137.1	25.0%	171.3	The refactory division is held down by intermittent repairs & maintenance, which should be absent in H2. An introduction of tariffs on cement imports resulting in an increase in demand for local cement should filter through to ISB product demand. H2: FY17 should see a return to healthy operations and cause a profitability momentum effect.
Plastics	19.6	22.3	131.4%	45.3	30.0%	58.9	Polydrum is showing strong growth and three new production lines will be added to boost supply. The division relies on agri-chemical business and agricultural boosts which are dependent on good rainfall- the South African Weather Service' forecasting system shows enhanced chances for above-normal rainfall conditions for the coming seasons. Expecting continued growth.
AMR	-	-		294.1	592.9%	2037.6	AMR generated ~R2.04bn in FY16, of which FY17 will only reflect 3 months of revenue. Full-year inclusions will filter through in FY18 and expecting 12% growth as steel demand recovers and increases the need for scrap metals.

EBIT Margins	FY16	H1: FY17	Growth	FY17F	Growth	FY18F	Comments
Foundry	4.5%	3.3%	-1.3%	4.5%	3%	4.6%	The inclusion and expansion of higher margin profit lines as well as efficiently holding down costs should cause margins to continue climbing upward.
Steel	5.6%	8.8%	11.6%	6.2%	5%	6.5%	Rises in coal prices could offset an anticipated iron-ore price boost after a rebound this year on China demand, according to the World Steel Association, although 2019 could see global iron ore rebounding as more higher-cost Chinese production is shuttered. ISB's supply/margins will remain inelastic so long as its customers remain operational and its remaining customers seem resilient.
Refractory	5.3%	7.9%	13.9%	6.0%	3%	6.2%	Historically the division performs weakly in H2. Expecting it to normalise at higher levels from FY17 off bettered steel demand.
Plastics	-	-7%		2%	150%	5.0%	The group is working on a solar solution to prevent production losses from erratic electricity supply and will reel in cost benefits. The Polydrum product range provides high-margin offerings, which should increasingly filter in as acquisition costs are recouped and volumes grow off a fixed base.
AMR	-	-		5.1%	2%	5.2%	Using a peer operating margin as a guideline until exact margin is reported.

DISCLAIMER