ISB – Insimbi Refractory and Alloy Supplies Limited – Interim Results

Valuation: Undervalued

RESULTS COMMENTARY

ISB released a satisfying set of interim results showing strong growth in both revenue and headline earnings.

- Revenue increased by 13.1% to R2.4bn, owing to the acquisition of Group Wreck and a strong contribution by the Group's Ferrous division which grew revenue by 33.4%.
- Operating profit grew by 8.3% to R67.3m despite operating expenses increasing 25.3%. The increase in operating expenses, excluding the acquisition of Group Wreck, was only 2.3% which shows the resilience of the Group in the current economic conditions.
- ISB has announced the acquisition of the Treppo Group for R109m, which will provide further geographic synergies in the metal recycling and processing vertical.
- HEPS increased by 11.3% from 8.5cps to 9.4cps. An interim dividend of 2.0cps was declared.

OUTLOOK FOR NEXT REPORTING PERIOD

The main industries ISB is exposed to are the foundry, steel, plastics and refractory industries, which are mainly exposed to the same economic conditions. The Group's commoditised goods are highly customisable and scalable, allowing ISB to charge a premium for providing more personalised services than its competitors.

However, commodities and in particular metals prices have been subdued in the first 6 months of the year, and ISB's weighted average basket price of products are estimated to be between 12% and 15% down on international pricing which pressures the Group's operating margins.

The Group's future earnings trajectory is very much dependent on the fast resolutions of the trade war between USA and China which continues to plague the market and in particular ISB's volumes, selling prices and margins.

The Plastic division, which has undergone some fairly drastic restructuring, decreased revenue by 26.7% and made an operating loss of R2.9m. The Plastic division remains a challenge for management given the related labour issues which resulted in the nationwide strike action in FY18. ISB decided to downsize the segment further to achieve profitability on a significantly reduced cost base. The plastics industry is currently suffering from rising cost of polymers and cheaper imports.

The acquisition of the Treppo Group has been approved and will be consolidated within the Ferrous division. The initial consideration of R109m will be settled with R74m cash, ~11.5m ISB shares and a vendor loan valued at R20m. The acquisition will provide ISB with an even closer proximity to the Durban harbour for export purposes and is anticipated to deliver significant synergies with ISB existing recycling operations.

ISB's profitability over the next few years will depend on the economic stimulus and the implementation of infrastructure upgrades promised by President Ramaphosa. ISB's performance is also centred around and dependent on an upward trending commodity cycle and any general improvement in economic activity or rise in commodity prices bodes well for the Group's profitability.

Overall, we forecast revenue to increase by 30.0% in FY20 to R5.9bn and by 25.2% in FY21 to R7.4bn. The operating profit margin is

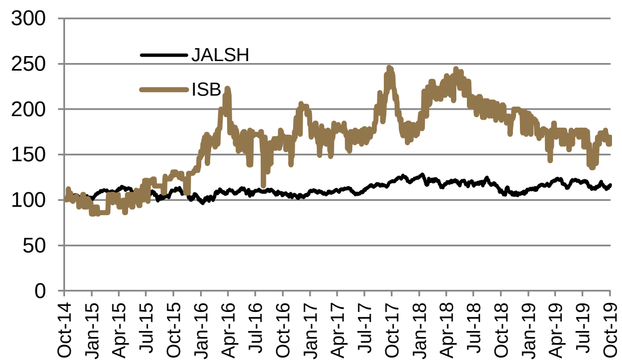
ISB released interim results on 8 October 2019 for the period ended 31 August 2019

Price (R)	**1.10**
PE Fair Value (R)	**1.33**
DCF Value (R)	**1.38**
Upside(Downside) to DCF (%)	25.5%
DY %	3.6%

Price Performance	Absolute	Relative to JALSH
1 month	-2.7%	-2.4%
3 month	-3.5%	-0.7%
12 month	-15.4%	-21.4%
12 month	**High**	**Low**
(SA Rands)	1.35	0.85

No. of shares (m)	428	Price (R)	1.10
Ave. volume 3 month # ('000)	17	Mkt cap (Rm)	471

Financial Year	2018	2019	2020F	2021F
Turnover (Rm)	3492	4545	5910	7399
EBITDA	151	125	171	228
EBIT	130	103	138	192
PAT	71	46	66	103
HEPS (cents)	18.5	13.5	15.1	23.5
P/E ratio	8.1	8.4	7.5	4.9
EV/EBITDA	5.3	6.8	5.4	4.1
EBITDA margin (%)	4.3%	2.7%	2.9%	3.1%
EBIT margin (%)	3.7%	2.3%	2.3%	2.6%
Net debt/equity	0.56	0.91	0.84	0.73
ROCE (%)	20.5%	14.2%	16.7%	21.0%
ROE (%)	20.1%	11.1%	13.8%	19.0%



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forecast to increase from 2.2% to 2.3% in FY20, before increasing to 2.6% in FY21. We expect margins to be under pressure in FY20 owing to acquisitive costs, before benefitting in FY21 from additional operating profit from the Treppo Group filtering through off a well-controlled fixed cost base. HEPS is forecast to grow by 11.7% from 13.5cps in FY19 to 15.1cps in FY20 owing to acquisitive synergies continuing to positively impact earnings. HEPS is forecast to grow by 55.4% in FY21 to 23.5cps with the full effects of the Treppo acquisition coming through for the year.

SEGMENTAL PERFORMANCES

The Group has four main divisions: Non-Ferrous, Ferrous, Refractory and Plastics. ISB has included Group Wreck within the Non-Ferrous division while Treppo Group will form part of the Ferrous division.

Other than acquisitive effects and once-off impacts, we assumed a similar performance in H2 across the divisions.

Revenue (Rm)	FY19	H1:20	Growth	2020F	Growth	2021F	Comments
Non-Ferrous	3830.0	1918.5	27.5%	4884.5	12.0%	5470.7	Together with the newly acquired Group Wreck, we believe ISB's dominant market share in metal recycling positions the Group for long term growth. Group Wreck will also boost revenue growth in its first full year inclusion in FY20. AMR provides a strong Rand hedge for the Group as over 45% of AMR's produce is exported. However, the impact of foreign exchange volatility does influence the ultimate profitability of Insimbi. We believe management will continue to expand operations throughout SA and further realise synergies between the exisiting foundry business and new acquisitions.
Ferrous	540.1	403.0	54.7%	835.8	106.3%	1723.9	The Ferrous division experienced strong revenue growth of 33.4% to R403m despite subdued metals pricing. SA is in the process of expanding and bettering its infrastructure and will continue to require steel inputs. The Treppo Group is consolidated for 4 months in FY20 and is forecast to contribute ~R270m revenue in FY20 and ~R840m in FY21.
Refractory	123.8	73.7	18.0%	146.1	13.0%	165.1	Revenue from the Refractory division grew by 31.6% in H1 and is expected to see a further uplift in revenue in FY20 as the majority of the division's output is related to the cement industry. We believe there may be some early signs of a recovery in the cement industry, which could send pricing upward. Subsequently, increased profitability in the cement industry should cause higher demand for capacity upgrades provided by ISB.
Plastics	51.3	21.8	-15.0%	43.6	-9.0%	39.7	The Plastics division, which is now less than 1% of Group income, decreased revenue by 26.7% as a result of labour unrest and management's decision to donwscale operations. Due to the ongoing restructuring, we forecast revenue to decrease by 15.0% and 9.0% in FY20 and FY21, respectively.
TOTAL REVENUE	**4545.2**	**2417.0**	**30.0%**	**5910.0**	**25.2%**	**7399.3**	

Operating Profit Margin	FY19	H1:20	Growth	2020F	Growth	2021F	Comments
Non-Ferrous	1.9%	2.3%		1.9%		2.0%	The Non-Ferrous division's margins were under pressure and remained unchanged during the period. We expect margins to remain low until economic stimulus and infrastructure upgrades have been implemented and the US China trade stand-off have been resolved. We expect the subdued margins in the metal recycling and aluminium smelter businesses to recover once these factors are resolved.
Ferrous	6.5%	4.5%		5.4%		4.3%	The operating margin decreased from 6.1% to 4.5% in H1 owing to subdued commodity prices which reduced volumes of some of the Group's products. We expect margins to remain subdued over the medium term owing to lower acquisitive margins and low metal prices.
Refractory	11.2%	10.6%		10.6%		11.0%	The operating margin decreased from 11.7% to 10.5% after a very strong FY19. A lower fixed cost base should keep margins around ~11%.
Plastics	-37%	-13%		-35.0%		-24.0%	The division made an operating loss of ~R3m in H1 compared to a loss of R3.2m in the comparable period. We expect margins to slowly recover over the short term but to remain in a loss-making position.
TOTAL OPERATING MARGIN	**2.22%**	**2.78%**		**2.34%**		**2.60%**	

VALUATION

ISB's traditional clients will undoubtedly continue to face headwinds in a sluggish SA economy in the short to medium term, however expansion into new verticals will continue to boost earnings. ISB has been diversifying revenue streams and will continue to offer high value services to its clients, including efficient delivery, specialised technical support services and highly scalable production capabilities.

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

With reference to the DCF table on the right, we have considered a discounted cash flow analysis and with cash flows forecast to FY22, utilising a terminal growth rate of 6% to yield our sensitivity table, for which we used a discount rate of 23.1%[1], yielding a value of R1.38.

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 35% discount. The implied forward PE valuation of 5.4x, places ISB at a price of R1.33.

	DCF Discount rate				
Growth rate	**19.1%**	**21.1%**	**23.1%**	**25.1%**	**27.1%**
0%	1.32	1.17	1.05	0.95	0.87
2%	1.47	1.28	1.14	1.02	0.93
4%	1.66	1.42	1.24	1.10	1.00
6%	1.91	1.60	**1.38**	1.21	1.09
8%	2.28	1.85	1.55	1.34	1.19
10%	2.84	2.20	1.79	1.51	1.32
12%	3.82	2.75	2.13	1.74	1.50

Industrial	**Price**	**Mkt cap (m)**	**1 year fwd PE**
SEPHAKU	1.54	321	8.1
PPC*	3.87	6165	11.0
Afrimat	31.50	4513	9.6
Insimbi	1.10	471	4.5
Average			**8.3**
*consensus forecasts used			-46%
Insimbi	**1.10**	**471**	**4.46**
Premium (Discount) applied to average:			-35%
Insimbi: Implied current gain/(loss):	**1.33**	21%	**5.4**

DISCLAIMER

[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