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Altron Ltd

Changes in strategic focus and disposal of non-core assets set to improve growth

Background

Allied Electronics Corporation (Altron)'s core operating entity is Altron TMT – a combination of Altech and Bytes with interests in telecommunications, multimedia & electronics and information technology. Its other two small divisions are Altech Netstar and Altech Arrow.

Its non-core power electronics unit, Altron Power (Powertech), is being disposed of. The company is now focusing on building new core capabilities in: cyber security; cloud services; advanced analytics; managed services; and mobile application development. Its major operations are in SA and the UK.

Our Thoughts

Altron seems to have delivered on its strategy of switching sectors – to computer software from being predominantly an electronics business. It is now bedding things down and we like the way it is diversifying both geographically and by product. Companies in the computer software sector have superior margins, and as such we expect Altron to derive a lot of value from expanded margins. Its transition is well advanced and management is confident that it will start paying a dividend in 1H19.

However, it is still disposing of its legacy businesses and remains highly geared. Asset disposal proceeds are earmarked for debt reduction. In the meantime, this is suppressing earnings as some of the assets held for sale keep incurring losses. However, once all disposals are completed it will free up resources, including management, to focus on growing the business in its new direction. The good news is that its continuing operations are managing consistently to expand their margins.

Management changes & equity injection. The shift from a family-run business to an independent management structure necessitated by new equity partners is encouraging. The investment by its new equity partners has triggered a number of actions. First was the collapsing of the company's historical dual share capital structure and the removal of the founding Venter family's absolute voting control. Second was the introduction of strategic partners and their appointments to the board. These moves are expected to be a catalyst in driving shareholder value creation and halting poor capital allocation decisions of the past.

Our call. Altron seems to be heading in the right direction. We believe the new management and strategic partners add significant value. Furthermore, the focus on innovation, research & development and streamlining the cost base bodes well for margins. And the disposal of the rest of the non-core assets should free resources and reduce debt levels (although they will remain a drag on performance until they are actually sold). We maintain our speculative buy call. Altron's future is tied to the success of its new business model and, specifically, on significant margin improvement.

Performance review

RESULTS IN BRIEF	FY18	Change	FY17
Revenue (R'm)	14 743.0	6.1%	13 892.0
Operating profit (R'm)	745.0	1.2%	736.0
Operating margin (%)	5.1%	-4.6%	5.3%
Attributable earnings (R'm)	187.0	-201.1%	(185.0)
HEPS (cents)	121.0	70.4%	71.0

Growth metrics for the year to end-August were marred by the strengthening of the rand – on translation of international income – and once-off costs associated with its various restructuring processes. SA and the UK generate the bulk of group revenue at 47.1% and 41.3% respectively.

Equity Research

BUY

12-month target price	R16.37
Spot share price	R14.01
12-month implied total return	16.8%

Altron price graph

Source: I-Net BFA

Key statistics:

Market cap: R5.65bn

Net debt:equity ratio: 78%

Price:earnings ratio: 11.8

Forward PE ratio (FY17): 10.6

Dividend yield: nil

Forward dividend yield: nil

Risk: high

12-month high: R14.27

12-month low: R10.05

Ave monthly volume: 9.7-million

Financial year-end: 28 February

Latest event:

Annual results

Date announced: 10 May

Share details:

Company: Allied Electronics Corporation Ltd

JSE Code: AEL

Sector: Electronic equipment

Sensitivity analysis				
Terminal growth		2.0%	4.0%	6.0%
Wacc	10.0%	2 444	3 245	4 846
	12.0%	1 620	2 029	2 709
	13.0%	1 332	**1 637**	2 115
	15.0%	906	1 086	1 346
	16.0%	745	887	1 086

This reflects the sensitivity of our forecasts to assumptions of the terminal growth rate and the weighted average cost of capital (Wacc). The highlighted cell shows our target price in cents.

The ICT segment grew revenue 11% to R13.28bn, driven by a strong UK performance. UK revenue climbed 35% to R6.09bn, buoyed by acquisitions. In local currency terms, UK revenue spiked by 49% while its earnings before interest, tax, depreciation and amortisation (Ebitda) rose 29%.

SA and other international operations were disappointing. SA revenue fell, 3% to R6.94bn, and revenue from other international operations dropped 14% to R244m. Management attributes the decline to a lack of spending in the financial sector. However, SA Ebitda increased 8%, with the margin improving to 9% from 8%.

Other segments

Altech Netstar revenue rose 13% to 1.38bn, while its Ebitda improved by 9%. Growth is coming from various innovations plus insurance telematics.

Altech Arrow's performance was poor, with revenue falling 7% to R560m and Ebitda by 18%, due to a stronger rand and weak demand from the defence industry.

Valuation

We expect average revenue growth of 10% a year in the short to medium term, which should gradually fall to a sustainable growth rate of 3% in the long run. We estimate that Altron's adjusted pre-tax operating margin should stabilise at around 9% in the medium to long term. Most of Altron's peers have margins north of 10%. Using a discount rate of 13%, we obtain a target price of R16.37/share. That translates to upside potential of 16.8%.

Geographic and product diversification bode well for earnings

Bull Factors

- Changes in management and introduction of strategic partners
- Restructuring exercise to streamline cost base and release working capital
- Asset disposals to help pay down debt, which should improve risk profile
- Addition of new products
- A number of broadband network contracts were won during the year under review, setting a positive tone for FY19
- Diversifying into other sectors such as retail and hospitality to add to its financial services clients
- Recent acquisition of Blenheim Group in the UK, which focuses on IT infrastructure. Management says Phoenix (a subsidiary of Blenheim) operates in a double-digit growth market.

Bear factors

- Earnings drag due to lengthy disposal process of discontinued operations
- High debt levels
- High investment requirements in research & development

Extract of the DCF model	2018A	2019E	2020E	2021E
Operating profit (R'm)	745.0	908.9	1 090.7	1 308.8
Net operating profit after tax (R'm)	421.0	511.4	625.1	766.1
Working capital changes (R'm)	(298.0)	(330.8)	(370.5)	(407.5)
Capital expenditures (R'm)	(277.0)	(362.9)	(406.4)	(447.1)
Unlevered free cashflows (R'm)	81.0	76.8	136.2	225.2
Headline earnings per share (cents)	121.0	131.9	161.2	197.6
PER (times)	11.6	10.6	8.7	7.1

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