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The Company: Hudaco Industries Ltd

Sluggish economy hurts prospects but shares still worth a buy

Our Call

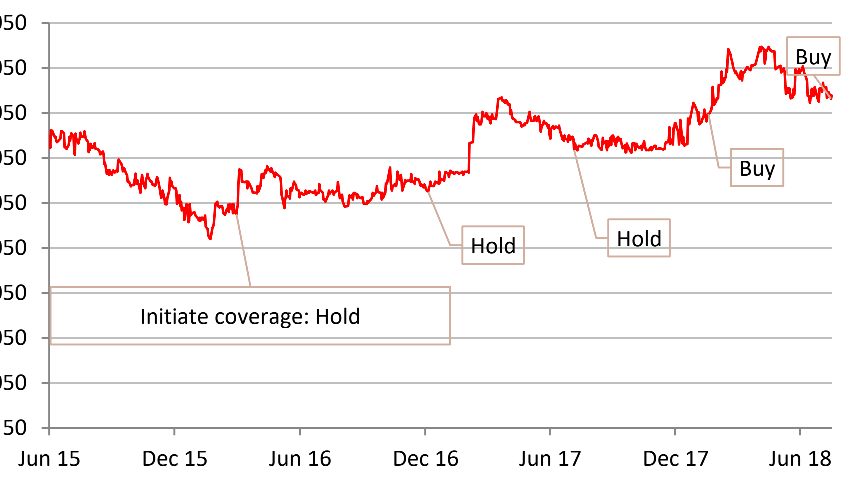
Undervalued

Intellidex estimate of fair value: ***R170.35***

Spot price: ***R146.93***

Upside potential: **15.9%**

Hudaco Share Price Graph



Background

Hudaco imports and distributes branded automotive, industrial and electrical consumable products mainly in the southern African region. The group sources branded products, mainly on an exclusive basis, directly from international manufacturers and to a lesser extent from local manufacturers.

Sensitivity Analysis

	Terminal growth	1%	3%	4.8%
Wacc	9.0%	22,446	26,532	34,465
	11.0%	17,361	19,477	22,946
	12.0%	15,459	17,035	19,479
	14.0%	12,608	13,552	14,904
	15.0%	11,468	12,213	13,249

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.

Investment thesis

In our review of Hudaco earlier this year, we rated its shares as a buy, a first since we started covering it. While the counter responded positively in the two months following our call, rising from R159/share to a high of R178/, it has regressed over recent months.

Our buy thesis on Hudaco was anchored on our expectations of an uptick in economic activity and investment in SA. We were encouraged by the positive investors sentiment at the time, stemming from the political changes post the 2017 ANC conference. Unfortunately, the positive sentiment has dissipated without translating into growth in the economy and into investments.

Economic data released since that note been disappointing. GDP contracted by a worse-than-expected 2.2% in the first quarter. And it was Hudaco's key markets – mining, manufacturing and agriculture – that were the worst performers. Household and government consumption also slowed and total fixed investment contracted.

The second quarter also started on a weak footing. Mining production fell 4.3% year on year in April. Annualised retail sales also disappointed, increasing a pedestrian 0.5% in April, its slowest pace in 15 months. Business confidence, which surged significantly in the first quarter, has since waned: the latest RMB/BER Business Confidence Index shows six out 10 respondents regarded prevailing conditions as unsatisfactory.

The poor economic performance in the first four months places downside risk on the 2018 real GDP growth outlook and we are forced to cut our short term earnings projections for Hudaco. However, even after making those downward revisions, Hudaco shares remains in the buy region. Our models arrive at a fair value of R170.35 which is 15.9% higher that its current market price.

The valuation utilises a continuous growth estimate of 2.75% and a discount rate of 12.02%. We conservatively assumed that revenue growth will remain in the single-digit region. However, we think that if the economy surprises on the upside there is room for improvement in margins. Industrial distribution businesses such as Hudaco's typically generate an operating profit margin of between 8% and 15%. Hudaco's operating margin is around 11.5%, which is commendable considering the low economic growth numbers over the past few years.

We also expect Hudaco to continue supplementing its earnings with acquisitions. Its financial position, with a net debt:equity ratio of 42%, can comfortably carry more acquisitions.

Analysis of recent results

Hudaco's results for the first half were decent considering the subdued economic performance during a large part of the its interim period and a strong rand in the first four months of its financial year. Revenue inched close to R3bn following 10.6% growth, driven by both acquisitions (5 percentage points) and existing operations (5.6 percentage points).

The operating margin contracted slightly to 9.8% (1H17: 10.1%), mainly due to a decline in profitability at the engineering consumables division. The group's effective tax rate fell to 26.9% (1H17: 28.6%), which helped the bottom line. Headline earnings climbed 9.3% to 528c/share, supporting a 5.6% hike in the interim dividend.

Prospects

Hudaco serves its clients via two divisions: the consumer-related products division and the engineering consumables division. The consumer-related products businesses supply products into the automotive aftermarket, power tool and security markets, which have a bias towards consumer spending.

Management reported that trading conditions in those markets were tough during the first half. We don't expect to see any departure from that trajectory for the remainder of the year given the pressures being faced by consumers and a sluggish economic growth outlook. However, we do expect the division to at least defend its profit margins, leveraging off its leading position in the market and its product diversification and client base consisting of both industry and consumers.

The engineering consumables businesses supply bearings, power transmission and diesel engines mainly to mining and manufacturing customers. Again, prospects for this division are not encouraging in the short term. Recent economic data show the mining and manufacturing sectors contracted in the first four months of the year. The Department of Mineral Resources published the eagerly anticipated draft of the Mining Charter in June which was expected to bring some sense of stability to the mining industry. However most experts think the charter is unlikely to spur investment into the sector.

Hudaco is also heavily dependent on the value of the rand. It imports about 65% of its costs of sales and sells the products at prices linked to the dollar-rand exchange rate. So, while the sales line is affected by exchange rate movements, its expense line is affected by local costs dynamics. Hudaco benefits when the rand is weakening against major currencies and suffers when the rand is strengthening or is volatile.

The land expropriation debate, SA's slow economic growth and Trump-induced trade wars are negative for the rand but positive for Hudaco.

Bull Factors

- The balance sheet still has enough wiggle room for further acquisitions
- Growth in consumer-related products diversifies the group's exposures

Bear Factors

- Still significantly exposed to the mining and manufacturing sectors
- Mining, Manufacturing and construction activity under tremendous pressure

Key statistics

Share details – JSE Code: HDC
Sector: **Industrial goods and services**

Market cap: **R5.09bn**
Price:earnings ratio: **11.45**
Forward PE ratio (FY19): **11.46**
Dividend yield: **3.83%**
Forward dividend yield: **4%**
Risk: **High**

12-month high: **R178.500**
12-month low: **R117.09**
Ave monthly volume: **520,000**
Financial year-end: **31 May**
Latest event: **Interim results**
Date announced: **28 June 2018**

RESULTS IN BRIEF	1H18	Change (%)	1H17	FY17
Turnover (R'm)	2,955	11%	2,671	5,902
Operating profit (R'm)	290	8%	269	676
Operating margin (%)	9.8%	-3%	10.1%	
Attributable earnings (R'm)	167	9%	153	397
Heps (cents)	528.0	9%	483.0	1254.0