Wealth Management

Smart Company Analysis

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The Company: Hudaco Ltd

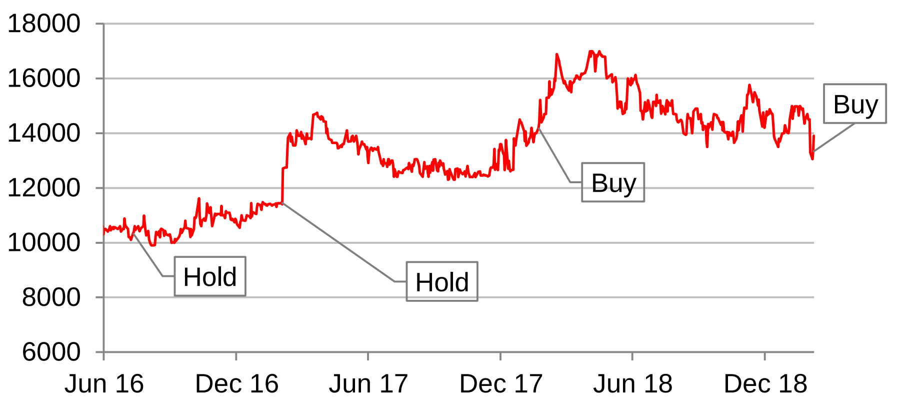
Economic conditions to remain tough but shares worth a "buy"

Our call

Buy

Intellidex estimate of fair value:	***R161.78c***
Spot price:	***R133.20c***
Potential move:	***R21.5%***

Hudaco share price graph and Intellidex's previous calls



Background

Hudaco imports and distributes branded automotive, industrial and electrical consumable products, mostly in southern Africa. 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%	2%	3.5%
Wacc	10.6%	20 377	22 326	25 374
	12.6%	16 675	17 827	19 486
	13.6%	15 262	16 178	17 458
	15.6%	12 803	13 386	14 161
	16.6%	11 806	12 280	12 899

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

While Hudaco's share price did not gain as we projected in our note early last year, we are still confident that it will do so in due course. The group ticks all the boxes when it comes to criteria for a solid, investable company for the long term.

It boasts a consistently high return on shareholders' funds, a double-digit operating margin and strong cash generation. Its recent results of 8% growth in the top line and 3% growth in headline earnings were achieved in a very tough environment. That demonstrates resilience in the group's business model.

Its shares, trading on a forward price:earnings ratio (PE) of 9 and at 1.8 times its net asset value, look affordable for the quality it offers. Hudaco's forward free cashflow yield (cash available to distribute to shareholders or expand the business, divided by total market capitalisation) is also very attractive relative to both history and peers. Underpinning those metrics is a juicy dividend yield of 4.8%, not far off what money market investments are offering after tax. Notably, Hudaco has never skipped paying a dividend since 1995.

Over the past decade Hudaco aggressively diversified its portfolio, reducing its reliance on the declining manufacturing and mining sectors. Using a combination of debt and own funds, the group made several significant acquisitions of consumer-oriented businesses: Filter and Hose Solutions, Global Communications, Miro, Dosco and Partquip.

Partquip, which serves the automotive after-market, is now the group's largest single business. Miro and Global Communications expose the company to the high-growth communication equipment market.

Following these acquisitions, the consumer-related businesses now contribute 55% of Hudaco's sales and 65% of operating profit. While the division is dependent on consumer spending, which is not buoyant at the moment, the business is relatively resilient and well positioned to grow should the economy recover.

The engineering division was reconfigured to suit the currently depressed mining and manufacturing industries. While the division serves mature economic sectors where prospects of growth are not that good, returns from the division are acceptable. The division also generates cash which management can use to diversify and expand the portfolio of businesses into other growth industries.

Overall, we think this is a quality counter which is worth having in a portfolio with a long-term focus. While we acknowledge that the group is unlikely to shoot the lights out in the currently depressed economy, we think it can fly should its key markets recover.

Our models arrive at a fair value of R161.78/share which is 21.5% higher than its current market price. The valuation utilises a continuous growth estimate of 2.5% and a discount rate of 13.56%. We conservatively assumed that revenue growth will remain in the single-digit region.

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Analysis of results

Revenue for the year to end-November rose 8% but operating profit decreased 3%. Sales from ongoing operations grew 2.6% to R6bn, while operating profit declined 11%. Management reported that both the consumer and engineering divisions battled with pricing in a difficult economy and extremely volatile exchange rates.

Sales from ongoing operations in the consumer-related products segment were up 6%, whereas engineering consumables' sales from ongoing operations increased 1%. Headline earnings per share were up 3%. A final dividend of 380c/share was declared, giving a total dividend of 570c/share for FY18.

Prospects

2019 has begun with elevated uncertainty. Economic data released so far show the economy remains under pressure though there are a few positives. Mining production fell by 6% for the first 11 months of 2018. Contrarily, November retail sales increased by 3.1%. However, recent trading updates by apparel retailers – Woolworths and Mr Price – have so far disappointed, suggesting consumer spending is still under pressure.

We expect economic growth to remain muted and the recovery slow, at 1.5% this year and 1.9% in 2019. The local scene will be dominated by politics as the state capture inquiry drags on while elections are expected sometime in May. More worrying is the high debt burden carried by state owned enterprises (SOEs), specifically Eskom, whose debt now stands at R419bn. As the international rating agencies averred, it is potentially the biggest risk to the economy. This, coupled with a possible credit ratings downgrade, will likely weaken the currency later in the year, though we think inflation will remain stable.

Overall, we believe our local macro environment will be shaped by weak economic growth and a weak currency; stable inflation; an interest rate hike; no significant policy reforms bar land reform; unsustainable SOE debt; a credit ratings downgrade; and a simple majority ANC election victory.
The outlook paints a mixed outlook for Hudaco. The positive economic growth outlook, albeit pedestrian, is a boon for Hudaco which is a pure SA Inc play whose performance hinges on the country's broader economic performance.

A weak rand outlook also bodes well for Hudaco. The group imports about 65% of its costs of sales and sell the products at prices linked to the dollar-rand exchange rate. But at the same time its operating costs are largely in rands. So, while the sales line is affected by exchange rate movements, its expense line is affected by local cost dynamics.

The group benefits when the rand is weakening against major currencies and suffers when the rand is strengthening. However, the extent to which the group will benefit from a weak rand is path dependent. A sharp depreciation in the rand weakens the group's ability to push through the corresponding increases in selling prices. An interest rate hike is negative for consumer spending and for Hudaco.

Bull Factors

- 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: **R4.7bn**
Net debt:equity ratio**: 54.3%**
Price:earnings ratio: **10.59**
Forward PE ratio (FY19): **9**
Dividend yield: **4.18%**
Forward dividend yield: **3.27%**
Risk: **High**

12-month high: **R178.50**
12-month low: **R125.00**
Ave monthly volume: **1.22-million**
Financial year-end: **30 November**
Latest event**: Final results**
Date announced: **31 January 2019**

RESULTS IN BRIEF	FY18	Change	FY17
Turnover (R'm)	6 381	8%	5 902
Operating profit (R'm)	655	-3%	676
Operating margin (%)	10.26%	-10%	11.45%
Attributable earnings (R'm)	381	-4%	397
Heps (cents)	1 289	3%	1 256.00