Merchantec Research

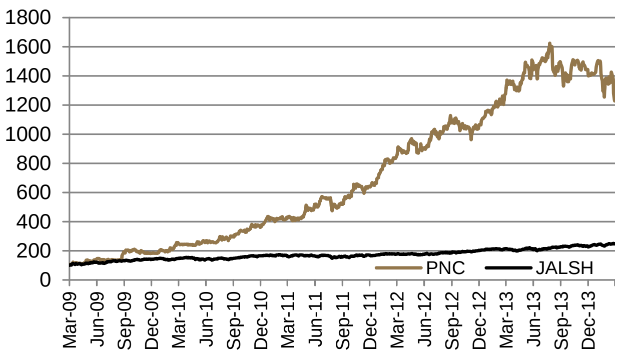
PNC – Pinnacle Holdings Limited Interim Results Equity Update

Valuation: Undervalued

PNC released interim results on 07 March 2014 for six months ending 31 December 2013

Price (R)				**19.30**
PE Fair Value (R)				**26.93**
DCF Value (R)				**21.91**
Upside(Downside) to DCF (%)				13.5%
DY %				2.1%
Price Performance				**Relative**
		Absolute		**to JALSH**
1 month		-13.3%		-12.4%
3 month		-15.9%		-21.4%
12 month		-12.4%		-22.4%
12 month		**High**		**Low**
(SA Rands)		27.24		18.85
No. of shares (m)	170		Price (R)	19.30
Ave. volume 3 month # ('000)	488		Mkt cap (Rm)	3283

Financial Year	2012	2013	2014F	2015F
Turnover (Rm)	5845	6596	6714	7271
EBITDA	419	493	499	562
EBIT	401	473	477	527
PAT	282	326	354	413
HEPS (cents)	175	206	223	259
Dividend (cents)	41	45	52	59
P/E ratio	9.0	11.6	8.9	7.7
EV/EBITDA	6.8	9.4	7.6	6.5
EBITDA margin (%)	7.2%	7.5%	7.4%	7.7%
EBIT margin (%)	6.9%	7.2%	7.1%	7.2%
Net debt/equity	0.39	0.82	0.49	0.29
ROCE (%)	50.2%	37.3%	26.5%	25.0%
ROE (%)	38.9%	35.0%	29.8%	27.5%



RESULTS COMMENTARY

PNC released a marginally improved set of results with minimal growth at both the top and bottom line.

- ICT Distribution sales were slow in the current economic environment, while IT Projects and Services and Financial Services saw good growth on comparatively small revenue streams.
- Gross profit margin improvements were largely absorbed by increased operating costs, due to the slow revenue growth and increased cost with new vendors Cisco and Trend.
- Cash generated from operations increased to R113m with days out standing on receivables and payables remaining in check. Inventories have built up before the upcoming high sales period with the depreciation of the Rand and lower than expected sales in H1:FY14 contributing as well.
- The 34.99% holding in Datacentrix results was equity accounted for two months after conditional approval by Competition authorities. The overall effect of the inclusion was a breakeven performance after the ~R4.6m relating interest charge.
- HEPS increased by 1.7% to 95.4cps and as in previous years no interim dividend was declared.

OUTLOOK FOR NEXT REPORTING PERIOD

The group's revenue growth stalled in H1:FY14, falling short of the ~R3.30bn suggested by historical trends. This was due to marginal growth from the dominant ICT Distribution segment with economic conditions making for tough trading. That said IT sector sales have shown some resilience with PNC volumes flat to slightly down amidst double digit price increases.

Growth from sales into Africa helped to prop up volumes and revenue with year on year (YoY) revenue growth of 46% increasing from 9% of ICT Distribution revenue in H1:FY13 (R275m) to 13% in H1:FY13 (R404m). The division also passed on lower margin business opportunities of ~R300m which has since been taken back according to management. Had this revenue been included we estimate HEPS would have increased by ~7%, which is still well behind the historical growth.

Overall we forecast revenue to increase by 1.8% to R6.71bn in FY14, with the EBITDA margin decreasing to 7.4%. HEPS is forecast to increase by 8.5% to 223cps in FY14 and 259cps in FY15 with a dividend of 44.6cps in FY14.

VALUATION

The inclusion of Datacentrix for 8 month contributes ~6% of FY14 HEPS growth and a further ~10% in FY15. We expect Pinnacle to raise capital after receiving shareholder permission at the next AGM to purchase a significant portion of Datacentrix, providing the increased access to IT services that the group has been seeking. However, due to Datacentrix being a listed systems integrator trading at full market value, PNC will pay a premium on the current price.

Considering this and the potential disruption PNC may inflict on its own channel, we are sceptical as to whether or not PNC can in fact gain enough synergistic value and earnings growth out of the deal to outweigh the potential loss in business from other large (also listed) systems integrators. Our DCF model indicates that the share is

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currently at value and our relative PE valuation indicates that the share is currently **undervalued**. In our opinion, it appears that the market is betting against the benefits of the Datacentrix deal.

SEGMENTAL PERFORMANCES

Revenue from the ICT Distribution division increased by 1.9% to R3.11bn in H1:FY14 from R3.05bn in H1:FY13, representing 44% of our full year forecast. When stripping out other African revenue the result is a ~2.6% decrease in SA revenues. If we Include the ~R300 contract and exclude African revenue, SA revenue growth would have been ~8%, of which we estimate ~1% came from the addition of Modrac and JAG. The profit before tax (PBT) margin decreased to 6.2% from 6.4% in H1:FY13 and 6.6% in H2:FY13, this was despite the higher gross profit margin achieved as operating costs increased ahead of anticipated revenue increases.

We forecast revenue growth from ICT Distribution of 2.3% in FY14 and 8.3% in FY15 with revenue increasing to R6.61bn and R7.16bn respectively. Volumes in FY14 are expected to remain flat while undergoing a change in product mix as tablet sales replace desktop and notebook sales. The lower average selling price of tablets and change in product mix results in below inflation price improvement for the division, despite double digit price increases on the individual products. The EBITDA margin is forecast to decrease to 6.8% in FY14 and 7.1% in FY15, on increased operating costs and slower FY14 revenue growth.

Revenue from the IT Projects and Services division increased 39.3% to R94.8m in H1:FY14 from R68.0m in H1:FY13 and was in line with H2:FY13, representing 43% of our full year forecast. The group continues to believe prospects for the division are good, while revenue has remained stagnant around ~R160m for the previous 3 years. The PBT margin was in line H1:FY13 at 12.5% and up from 9.9% in H2:FY13. The project nature of the business has resulted margins for the division which have historically shown little correlation to revenue levels.

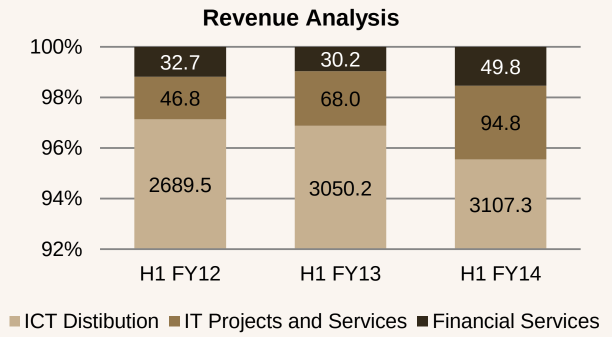
We forecast revenue growth from IT Projects and Services of 10.0% in FY14 and FY15 to R178m and R196m respectively, reflecting the slow growth historically. The EBITDA margin has been forecast to be maintained at 12.5% in FY14 and 12.0% in FY15, in line with FY13.

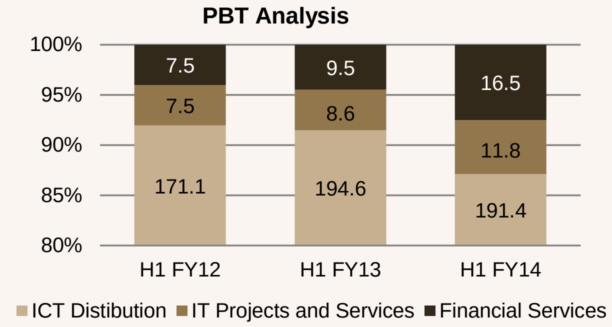
Revenue from the Financial Services division increased by 65.0% to R49.8m in H1:FY14 from R30.2m in H1:FY13, whilst growing 16.1% from H2:FY13, representing 56% of our full year forecast. Revenue increased as the debtor book increased by 49% YoY from R233m to R348m. The PBT margin increased to 33.2% from 31.5% in H1:FY13 and 29.7% in H2:FY13, as revenue increased and margins were maintained while market penetration was increased.

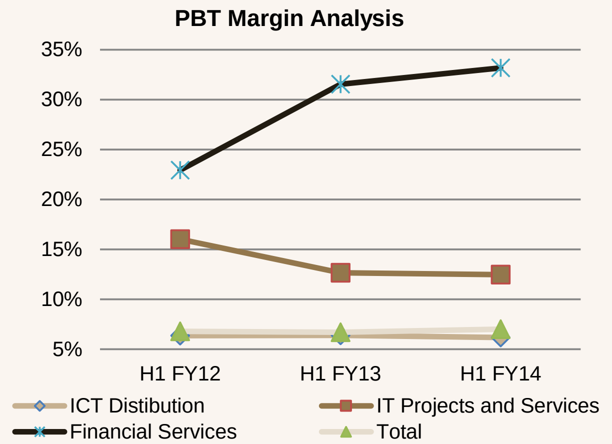
We forecast revenue growth from the Financial Services division of 44.8% in FY14 to R106m and 8.1% growth in FY15 to R114m, as the division continues to grow its book towards ~R450m. The EBITDA margin has been forecast to increase to 32.0% for FY14 and FY1, following on from H1:FY13 margin improvement and increased revenue.

VALUATION

With reference to the DCF table on the right, we have considered a discounted cash flow analysis and with cash flows forecast to FY16, utilising a terminal growth rate of 6% to yield our sensitivity table, for which we used a discount rate of 15.6%[1], yielding a value of R21.91.







DCF Discount rate

Growth rate	11.6%	13.6%	15.6%	17.6%	19.6%
0%	20.07	17.14	14.96	13.27	11.94
2%	23.42	19.42	16.59	14.49	12.87
4%	28.54	22.65	18.79	16.07	14.05
6%	37.36	27.59	**21.91**	18.20	15.58
8%	56.09	36.10	26.69	21.22	17.64
10%	123.01	54.17	34.90	25.83	20.55
12%	-410.86	118.76	52.36	33.76	25.01

[1] The discount rate is based on the average implied discount rate obtained from cash flow forecasts for companies with market capitalisation ranging from R701m to R10bn in our research universe

With reference to the relative PE table on the right, we have compared Pinnacle to other IT businesses and the forward PE was kept in line with the peer group. The implied forward PE valuation of 10.8 places Pinnacle at a price of R26.93.

Merchantec ICT	Price	Mkt cap (m)	1 year fwd PE
Adapt IT	7.58	845	16.9
BCX	5.57	2256	8.3
Datacentrix	4.45	913	9.0
EOH	87.50	9922	20.2
Jasco	0.85	124	6.2
Mustek	6.00	651	5.3
Pinnacle Tech	19.30	3283	7.8
Mix Telematics	4.95	3882	18.3
Digicore	2.11	523	8.5
FoneWorx	2.35	320	12.3
Secure Data	0.36	89	6.5
Average			**10.8**
*consensus forecasts used			-28%
Pinnacle Tech	**19.30**	**3283**	**7.8**
Premium (Discount) applied to average:			0%
Pinnacle Tech: Implied current gain/(loss):	**26.93**	40%	**10.8**

DISCLAIMER