EQUITY RESEARCH 12 July 2021

ADR – Adcorp Holdings Limited FY21 Results Equity Update

Valuation: Undervalued

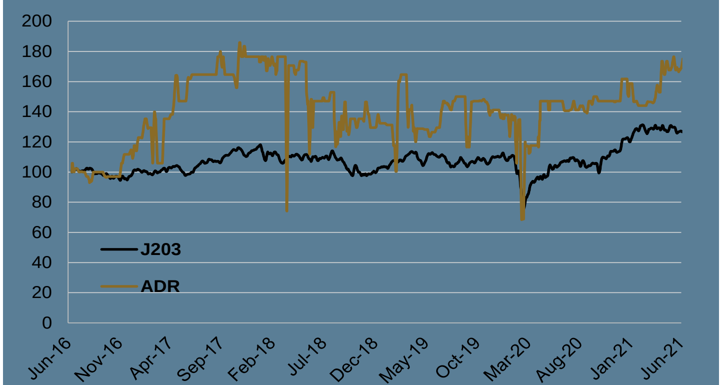
ADR released full year results on 31 May 2021 for the period ended 28 February 2021

Price (R)	**5.85**
PE Fair Value (R)	**6.24**
DCF Value (R)	**6.66**
Upside(Downside) to DCF (%)	13.8%
DY %	0.0%

Price Performance	Absolute	Relative to JALSH
1 month	-4.9%	4.5%
3 month	-6.3%	-5.9%
YTD	-21.2%	-4.1%
12 month	**High**	**Low**
(SA Rands)	8.87	1.29

No. of shares (m)	110	Price (R)	5.85
NAV per share	12.59	Mkt cap (Rm)	636
EV (Rm)	1067	Price/Book (x)	0.47

Financial results	**2020**	**2021**	**2022F**	**2023F**
Turnover (Rm)	12922	11717	12498	13405
EBITDA	-341	252	231	243
EBIT	-486	118	165	183
PAT	-605	41	96	115
HEPS (cents)	-17	34	89	107
P/E ratio	-20.8	17.1	6.6	5.5
EV/EBITDA	-5.8	1.5	2.7	2.6
EBITDA margin (%)	-2.6%	2.2%	1.8%	1.8%
EBIT margin (%)	-3.8%	1.0%	1.3%	1.4%
ROCE (%)	-16%	4%	7%	8%
ROE (%)	-38%	3%	7%	8%



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RESULTS COMMENTARY

While ADR's latest results highlight a significant improvement in earnings, its performance is still not on par with that of previous years.

- Group revenue from continuing operations contracted by 9.3% to R11.72bn, with all five segments recording decreases.
- Operating profit from continuing operations increased by 124.4% to R118.4m (FY20: R485.8m loss).
- Interest bearing debt decreased by 39.9% to R900.8m while cash on hand increased by 32.8% to R473.9m.
- HEPS increased by 298.8% to 34.2 cents (FY20: 17.2 cents loss). No dividend was declared or paid during the year in order to preserve cash resources.

OUTLOOK FOR NEXT REPORTING PERIOD

The 2021 financial year presented itself as a tough year for ADR to navigate. Being a workforce solutions provider, ADR's performance is highly correlated to the strength of the South African economy. The Covid-19 pandemic placed added pressures on South Africa's already strained economy, further exacerbating negative economic growth and rising unemployment.

During FY21, the South African economy contracted by ~7%. Every sector to which ADR caters was, to a lesser or greater extent, affected by Covid-19. The hard-lockdown period saw economic activity come to a near standstill, particularly in the hospitality, automotive, energy and education sectors. With their clients unable to trade, ensuring financial stability was at the forefront of management's focus. Significant cost reductions were implemented to establish a more sustainable cost base, non-critical services were stopped and discretionary spend was eliminated.

Significant components of ADR's Project Simplification exercise, intended to restructure and right size the business, were concluded during the period. The Group disposed of its 100% shareholding in Dare Holdings and Adcorp Holdings Singapore for a consideration of R41.4m, in line with the Group's strategy to focus on its core capabilities and utilise the proceeds from the sale of non-core assets to reduce its gearing. Similarly, the Group concluded the disposal of Adcorp Support Services, consisting of the FMS Marketing Solutions Division and the Employee Benefits Division, for a maximum consideration of R227.3m.

The Group has managed to stabilise its liquidity position by disposing of the non-core assets above and applying strict cash management measures. ADR's net debt to equity has significantly improved, from 91.7% to 31.6%.

ADR operates in a very saturated market, and thus ensuring competitive edge is vital when competing for market share. During the period, the Group achieved a level 1 BBBEE rating which places it at an advantage when competing for South African business. Moreover, notwithstanding the cost saving measures it undertook during FY21, the Group continued with its technology transformation which, upon completion, places it in a position to extract greater value from its existing portfolio and drive innovative growth.

While its performance in FY21 may not have been on par with previous years, the Group has laid the groundwork upon which future sustainable growth can be built. An improvement in ADR's operations can be expected in FY22 as the economy slowly journeys its way back to pre-covid activity levels. However, the slow vaccine rollout is likely to hinder the economy's recovery, with GDP growth forecast at ~3% in 2021. In anticipation of a hobbled economy, ADR is unlikely to realise the full extent of the benefits associated with its restructure in the short-term to medium term.

Overall, revenue is forecast to increase by 6.7% to R12.50bn and a further 7.3% to R13.41bn in FY23. A 25.0% improvement in net profit to R165.3m is expected in FY22, promoted by a recovery in the training segment and management's continued efforts to drive a more sustainable cost base. Thereafter a 10.4% increase to R182.5m is expected in FY23. HEPS is forecast at 89.1 cents in FY22 and 107.1 cents in FY23.

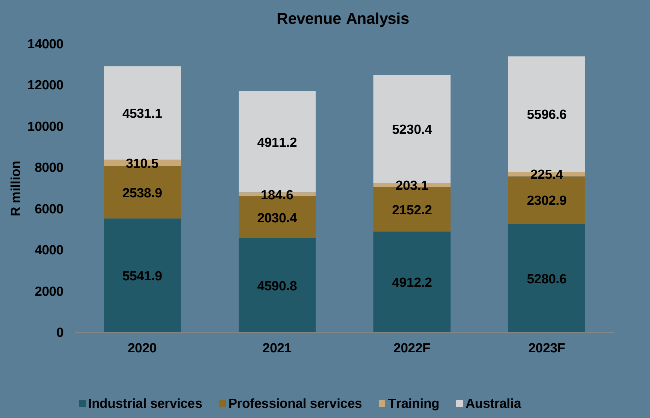
SEGMENTAL PERFORMANCE

Following the restructure, the Group has four main segments: Industrial Services, Professional Services, Training and Australia.

The **Industrial Services** segment, which houses the Group's largest revenue generators, being contingent industrial workforces and functional outsourcing, saw revenue contract by 17.2% to R4.59bn. Operating profit improved significantly to R123.5m (FY20: R78.9m loss) as result of significant cost interventions and no impairment expense (FY20: R207.0m).

The contraction in revenue is mostly owed to a decline in the contingency business which suffered reduction in demand in sectors deemed non-essential, particularly the hospitality and automotive sectors, and the loss of a large energy sector client in the Cynergy business. Conversely, the functional outsourcing business experienced a 9.0% increase in revenue due to its exposure to large grocery retailers and FMCG manufactures which remained operational throughout the lockdown period.

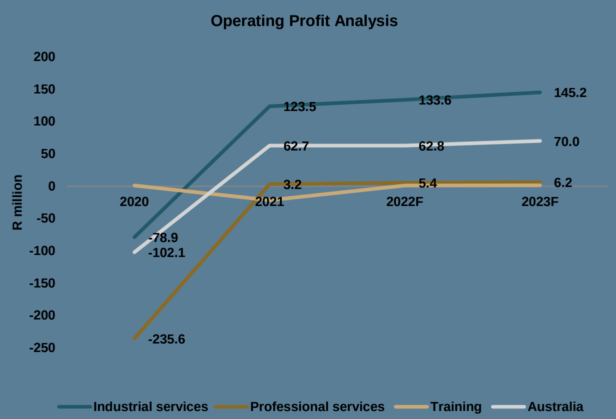
The outlook for the segment is improving with demand picking up in the contingent business as the headcount and number of hours increases. We expect this trend to continue as the economic activity increases. Furthermore, management has realigned its focus to resilient sectors, with the intention of driving client growth. Overall, revenue is forecast to increase by 7.0% to R4.91bn in FY22 and a further 7.5% to R5.28bn in FY23. Cost management initiatives will be continued by management and are expected to contribute to improved operating profit margins of 2.72% in FY22 and 2.75% in FY23. Operating profit is expected to grow by 8.2% to R133.6m in FY22 and 8.7% to R145.2m in FY23.



Revenue decreased by 20.0% to R2.03bn in the **Professional Services** segment, which now includes Support Services, as a consequence of limited permanent placements and the rebalancing of non-profitable clients. The segment recorded operating profit of R3.2m (FY20: R235.6m loss), made possible by the resetting of its cost base.

The IT resources and solutions brand, Paracon, suffered as clients revised budgets in response to macro-economic pressures which were amplified by the Covid-19 pandemic. The permanent placement brands of DAV and TPC were the most materially impacted during the period as a result of many clients freezing recruitment activities, which led to the rightsizing of the business. Reduced elective procedures, and thus lower demand for nurses, saw revenue decline in the Charisma nursing business.

While permanent placement demand is expected to remain under pressure, contingent headcounts are increasing, and elective procedures have been reinstated in private healthcare facilities. Revenue is expected to increase by 6.0% to R2.15bn in FY22 and by a further 7.0% to R2.30bn in FY23. Operating profit is forecast at R5.4m in FY22 and R6.2m in FY23.



The **Training** segment took the biggest hit from Covid-19, recording a 40.5% contraction in revenue to R184.6m and an operating loss of R21.7m (FY20: R1.1m operating profit). Minimal revenue was brought in during the lockdown period as clients cut back on learning and development to save costs. Moreover, the national lockdown prevented in-classroom training, upon which the segment relied heavily.

Management executed several changes during the latter part of the year, including the shift to digital content and virtual instructor led training, made possible by the Group's recent significant technology investment. The digital shift facilitated the delivery training services within the Covid-19 environment. Moreover, it provided a solid foundation upon which management drove the expansion of the training portfolio into new delivery models, products and market segments.

The segment's digital transformation is expected to drive revenue growth of 10.0% in FY22 and 11.0% in FY23 to R203.1m and R225.4m, respectively. The segment is expected to return to profitability, with operating profit of R1.0m in FY22 and R1.4m in FY23.

Post restructure, the **Australian** segment is now represented by brands within both the Industrial and Professional services client portfolios. The segment experienced a revenue contraction of 6.5% in AUD$, mainly due to limited permanent placements and the rebalancing of non-profitable clients, but this was negated by Rand devaluation over the period. Operating profit improved significantly to R62.7m (FY20: R102.1m loss), augmented by Government relief measures.

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While the outlook for the Australian labour industry is improving as market demand increases, the ability of the Australian segment to drive growth is dependent on how the labour shortage crisis plays out. Growth will be contingent on the execution of a value proposition and the expansion into industry verticals that can deliver quality margins.

Revenue growth of 6.5% in FY22 and 7.0% in FY23 to R5.23bn and R5.60bn, respectively, is expected. Operating profit is expected to remain flat at R62.8m in FY22 before increasing by 11.5% to R70.0m as the segment finds its footing in the industry.

VALUATION

ADR has shown resilience in the face of Covid-19, delivering an improved set of results. Despite performance not being on par with that of previous years, management's efforts during FY21 provide a solid foundation upon which to drive future growth. The Group is in a stronger position than it was a year ago, with an improved balance sheet, enhanced liquidity and a more sustainable cost base.

South Africa's slow economic recovery is likely to prevent ADR's from unlocking the full potential of its restructure in the short term to medium term. Stronger performance forecasted from the Australian economy provides a more supportive environment in which management can execute its value position and drive growth in the medium term.

Our DCF valuation indicates that the share is **Undervalued** with a 13.8% upside potential and our relative P/E valuation indicates that the share is **At Value** with a 6.7% upside potential.

With reference to the DCF table, we have considered a discounted cash flow analysis with cash flows forecast to FY24. Utilising a terminal growth rate of 6% and a discount rate of 22.6%[1], a value of R6.66 is returned.

With reference to the relative PE table on the right, we have compared ADR to other businesses of a similar size and service orientated nature and applied a 10% discount to the peer group owing to the Group's market uncertainty. The implied forward PE of 4.1x places the share at a valuation of R6.24.

Growth rate	DCF Discount rate 18.6%	20.6%	22.6%	24.6%	26.6%
0%	6.42	5.66	5.03	4.51	4.07
2%	7.12	6.20	5.47	4.87	4.37
4%	8.02	6.88	6.00	5.29	4.71
6%	9.20	7.75	**6.66**	5.80	5.12
8%	10.83	8.89	7.49	6.44	5.61
10%	13.22	10.47	8.60	7.25	6.23
12%	17.06	12.78	10.12	8.32	7.02

Staffing & BPO	**Price**	**Mkt cap (m)**	**1 year fwd PE**
Adapt IT	6.65	906	7.0
EOH	6.81	1189	4.9
Workforce	1.17	282	2.4
Adcorp	5.85	636	5.1
Average			**4.6**
			12%
Adcorp	**5.85**	636	5.1
Premium (Discount) applied to average:			-10%
Adcorp: Implied current gain/(loss):	6.24	7%	**4.1**
*Consensus forecasts used			

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[1] The discount rate is based on the average implied discount rate obtained from cash flow forecasts for companies with market capitalisations ranging from R301m to R10bn in our research universe