

# Altron: A small cap delivering big value


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**KEY TAKE-AWAYS**

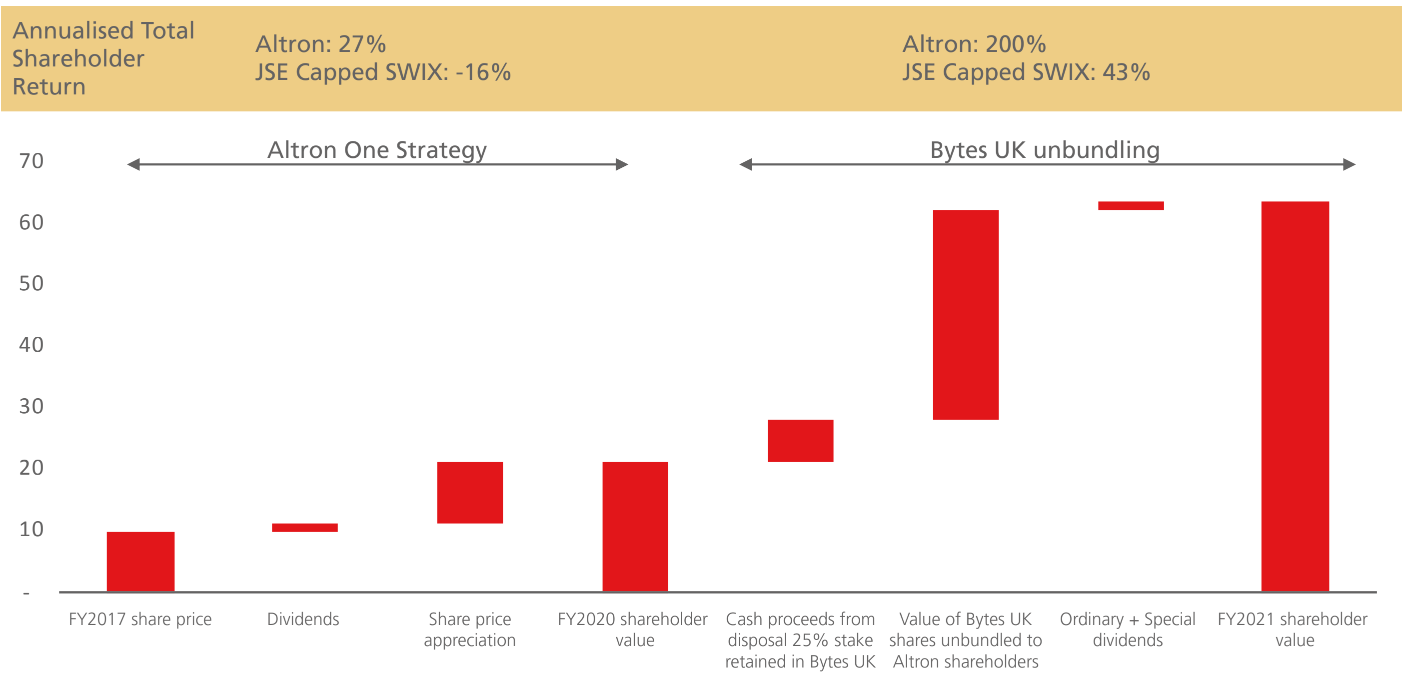
- *Altron's share price has outperformed the JSE in recent years due to the company's value added through restructuring, consolidation and debt reduction, plus a change in management.*
- *The dual-listing of its Bytes UK subsidiary on the LSE also unlocked tremendous value.*
- *Despite its strong outperformance, Prudential is holding onto the share due to its ongoing strong growth potential. Altron plans to sell more low-returning businesses and focus on high-growth areas like digital platforms, cloud computing, analytics, automation and cyber security.*

**Small cap stocks are often neglected** and underappreciated, but that is what makes the sector the perfect hunting ground for the value investor seeking investment opportunities. Altron was one such opportunity we identified that is an excellent example of how Prudential adds outperformance (or alpha) to our client portfolios. We have been holding active positions in Altron in the Prudential Equity Fund and across our Namibian unit trusts.

Altron is an information, communication and technology (ICT) business that has delivered a tremendous amount of value for shareholders over the last four years, as new leadership successfully executed on a transformational "value unlock" (added value) strategy. The company delivered a return of 60% p.a. over the last four years, massively outperforming the 7% recorded by the FTSE/JSE Capped SWIX.

Graph 1 shows the two component parts contributing to this value unlock – the Altron One Strategy, and the Bytes UK unbundling.

## Graph 1: Components of Altron's value added per share since 2017




**SOURCE:** Prudential Investment Managers, Company data

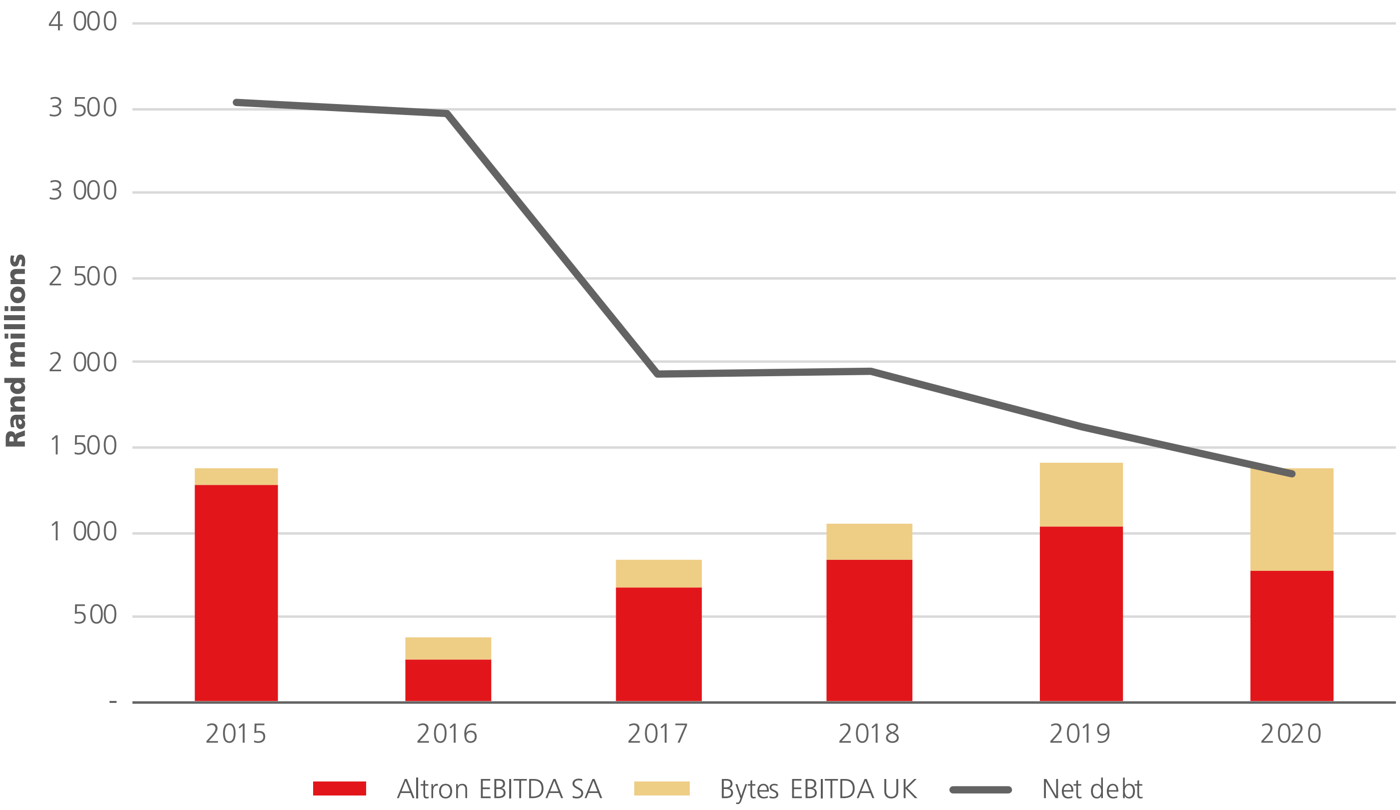
Altron was formed in 1965 and was a family-run business for 51 years, over which time the business grew into a holding company of many separately managed businesses within the electronics manufacturing and ICT services industries.

The manufacturing businesses produced electric cables, power transformers, automotive batteries and decoders used for Pay TV. Following some years of weak economic growth, declining state infrastructure spending and increased competition from cheap imports, the group's manufacturing capacity utilisation fell to a point where the businesses became loss-making. By 2016 Altron experienced a drastic decline in group profits, while debt levels remained unsustainably high. Consequently, its share price halved.

Fortunes began turning in 2017 when Altron formed a strategic partnership with Value Capital Partners (VCP), who provided a much-needed equity injection in return for a 15% stake in the business. VCP is an investment group that applies private equity principles to unlock value in listed companies. Their involvement sparked some much-needed change. For starters, the dual share structure giving the founding family absolute voting control was collapsed. The founding family father and son stepped down from their chairman and CEO positions, respectively. VCP appointed two of their founding members to the board, and a new CEO, Mteto Myati, was appointed. Having served as CEO of MTN and Microsoft and held various leadership roles at IBM, he brought a wealth of experience to Altron.

For the first time, Altron was now an independently run business, setting the stage for the Altron One strategy. This entailed disposing of loss-making manufacturing businesses and using the proceeds to pay down debt, while simultaneously cutting head office costs by centralising corporation functions and consolidating office space. By 2020 the company's net debt had halved, and its earnings (earnings before interest, tax, depreciation and amortisation, EBITDA) were back to historic levels, as Graph 2 highlights. The business was stabilised and the balance sheet de-risked, leading to a re-rating in the share price.

## Graph 2: Altron's earnings rebound and debt falls significantly




**SOURCE:** Prudential Investment Managers

### Next step: The UK Bytes unbundling

Altron acquired the Bytes UK business in 1998, a business providing software and hardware solutions to corporations and government organisations, and the biggest Microsoft product reseller in the UK. While its South African businesses struggled to deliver real growth, the UK business boomed and by 2020 contributed 45% of group EBITDA. At that time, Bytes UK had a peer group listed on the London Stock Exchange (LSE) which traded on a 27x EV*/EBITDA multiple, a material premium to Altron which traded at only 7x EV/EBITDA. This was a clear opportunity for management to unlock value.

In December 2020 Bytes UK was dual-listed on the LSE, with 75% of Altron's

*EV (Enterprise Value) = Market capitalisation plus net debt stake unbundled to shareholders (one Bytes share for every two Altron shares) and 25% sold in the open market. The net proceeds were then used to settle debt and the rest returned to shareholders via a special dividend. The unbundling was a huge success; Bytes UK re-rated in line with peer valuation multiples, and the share price gained another 70% from the date of unbundling.

## Altron 2.0: Reasons to keep holding on

Although so much value has already been unlocked, we still see more value on offer in Altron as management embarks on the next phase of their strategy. Their objective is to dramatically improve Altron's return on invested capital (ROIC)** which currently falls materially below their cost of capital. This shortfall in a key measure of investability indicates that the company is not deploying its capital in the most efficient way that maximises shareholder returns.

The plan is to dispose of those businesses that require considerable capital and generate low ROICs, and invest in businesses that require little capital and generate high ROICs (essentially, capital-light businesses driven by skilled employees and intellectual property).

Businesses it has earmarked for sale include operations in print and document solutions, call center management, and its last remaining electronics manufacturer. These businesses require significant investments in inventory and fixed assets and operate in struggling markets with limited growth prospects. Together they account for 50% of Altron's invested capital, while only contributing 5% to group profits, thereby significantly depressing the group ROIC. Some offers have already been received, and we expect sales to be concluded over the next year.

Once the low-returning businesses are sold, the businesses remaining within Altron are mostly high-quality, capital-light operations that we believe are underappreciated by the market. More on what we like:

The platform segment of Altron (generating 60% of group EBITDA)

**Return on invested capital = [net operating profit after tax/capital employed (net debt + shareholder equity)].

consists of well-established, scalable platforms that generate exceptional returns on capital, produce defensive annuity income underpinned by long-term service contracts, and achieve high operating profit margins (north of 30%). These businesses include:

- Netstar, one of South Africa's biggest vehicle tracking and fleet management businesses;
- Health-tech, which provides the healthcare sector with a cloud-based health administration system that facilitates online patient management with linkages to medical aid systems for claim submission; and
- Fin-tech, which provides unbanked consumers, informal traders and unregistered micro-lenders with solutions to digitise their operations. Offerings include point-of-sale devices, lending systems to facilitate credit checks, disbursements and collections.

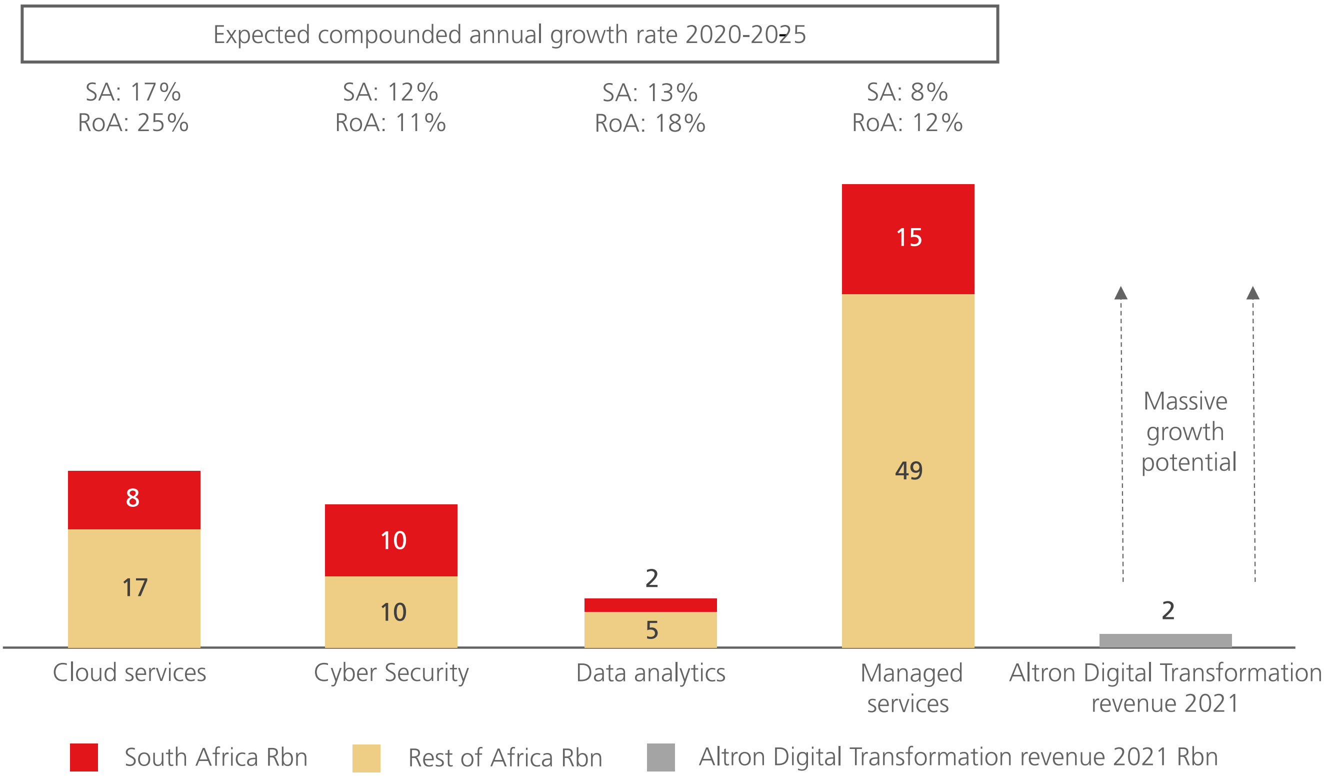
The Digital transformation segment (20% of group EBITDA) provides bespoke integrated ICT solutions that help businesses transition into the rapidly evolving digital age. Altron's clients include some of SA's blue-chip listed companies in the Banking, Insurance, Telecoms and Media sectors. Core services span cloud computing, data analytics, automation, and cyber security – sizeable markets offering a robust runway for growth over the next five years.

## What the digital transformation segment can do

Graph 3 shows that Altron Digital Transformation has a R115 billion-rand market opportunity in South Africa and the Rest of Africa through to 2025, driven by robust demand from companies for modern technology solutions, shown in four primary segments. Off a mere R2 billion rand revenue base, its runway for growth is massive, with ample opportunity for Altron to expand and take market share.

If we look at the first segment, Cloud services, cloud computing is the future of how business computer systems operate. In the past, applications were loaded onto physical computers located in offices. Cloud computing runs all applications from the Internet (the cloud), allowing multiple users to access data in real time and share project work effortlessly – from anywhere

## Graph 3: Digital transformation: A R115bn market opportunity




**SOURCE:** Prudential Investment Managers

and on any device. This capability is critical as work from home becomes the new norm in a post-Covid world.

Data science and machine learning, meanwhile, is about analysing vast amounts of data to drive insights into customer demand and business performance. This allows business strategy to be informed by real-time data that can be visualised and communicated using powerful dashboards and autogenerated reports.

Cyber security, the third segment, serves to protect the businesses' data and applications as they become increasingly vulnerable to external threats in a digital age. Services include a range of access controls, threat detection, firewalls and encryption solutions.

Finally, Managed services is the end-to-end package deal offered by Altron, which comprises consulting, solution implementation and ongoing servicing (to ensure client needs are met as technology rapidly evolves). Businesses can then focus on core operations, while being assured their technology needs are being handled by the experts. Altron benefits by getting a "sticky" client who pays a recurring service fee, thereby improving the quality of earnings – whereas in the past there was a once-off sale until the next time the client needed something.

## Altron is well worth holding onto

Based on the above, we believe Altron presents a unique opportunity to invest in a business with ambitions to grow aggressively in the modern ICT market, where demand is robust and underpinned by the undeniable need for businesses to adapt in a rapidly advancing digital landscape. Its strong balance sheet and adept leadership give us confidence that the next phase of Altron's value unlock journey will, once again, be very rewarding for shareholders.

Lastly and most importantly, despite its strong share price gains and re-rating in more recent years, Altron's current valuation remains very attractive. If we subtract the total proceeds expected from the disposal of its businesses earmarked for sale from its current market capitalisation, investors are effectively buying the remaining high-quality capital-light businesses at a very undemanding price-earnings ratio (P/E) of 8X compared to the Capped SWIX P/E of 11X.

With excellent growth prospects and a very attractive valuation, Altron should be able to deliver its shareholders an above-market performance over the medium term, making Altron a counter well worth holding onto. ■

*Rahgib joined Prudential as an equity analyst in July 2020, and is responsible for select coverage of the Listed Property sector. Prior to joining Prudential, Rahgib completed his) articles at PwC before taking up a position at Kagiso Asset Managers as an equity and property analyst. He currently has five years of industry experience. Rahgib holds an Honours Degree in Business Science and Accounting from UCT, a Post-Graduate Diploma in Accounting, and is also a qualified Chartered Accountant and CFA charterholder.*