

Valuing Hudson General

B8399 Valuation Case Study of Hudson General

This case study relates to Chapter 4 in the Book, Valuing the Assets from Book Value to Reproduction Costs.

Dayton Hudson-not a simple example.

Start with a principle, which you should keep in mind. Two things:

What do I know and what do I not know?

As I move through this process, what am I learning about the attractiveness of this investment and what are the things that I still don't know? Where are the major *uncertainties*?

1. When you become a professional analyst, you will spend your time trying to resolve those uncertainties. What I know, what I still need to know to see whether this is a good investment.
2. Am I using all the information available here? Are there things that I need to be looking at that I haven't already looked at? Is the information fitting together to tell a coherent story? Am I getting the most out of it?

When you start with *Hudson General*—what was your *first* thought? Thank God it wasn't *Microsoft*. I am not in the pits with all the other equity analysts trying to understand *MSFT*. The company is small and obscure—good.

From the statistical data, it probably is too small to have major institutions driving the price up above what it should be. Good: Small-Cap.

This is not a stupid stock to be on the buy side. You start off with a general impression from names and then you look at this in more detail. 2.1 million shares outstanding, price is \$48 a share or \$100 million to buy the whole company.

If you filed a 13-D, you could buy 5 million shares of 5%. What does that tell you right away about the big funds—they can't or won't invest. \$250 billion to invest-0.00005% to invest in *Dayton Hudson*.

What does this company do? Aircraft servicing, land developing. Boring!

Bad thing: The managers are clowns. They are sitting on cash, paying themselves big salaries, investing in land 1000's of miles away from their HQ while being an aircraft servicing company. If this is a bad enough mgt., then they are apt to have destroyed value.

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In our search strategy, where we are going to look? Does this company fit our criteria? This is not a glamorous, excellent, fast growth company. Not a high flier.

We look at boring, obscure, and disappointing. The performance of the stock since 1977, 1978. 13% and 17% stock returns, while the market was stronger. Disappointing relative performance. This is a small firm with a complex structure, multiple businesses, subsidiaries off on their own, and other features that confuse security analysts. Here undervalued assets can get lost, overlooked by the investment community and chief executive. This company fits our criteria for unknown and obscure.

Look at the pattern of stocks. The stock is up from \$30 per share to \$48 per share. Long-term disappointing stock performance. This stock is up 60% over the past 4 months. Why?

Why is the stock going up? Mario Gabelli is buying the stock. He filed a 13-D and owns over 5%.

182 stockholders—not widely owned. Is this only family and friends--which would be a bad sign? No, Gabelli owns shares—a noted value investor.

Look at the standard value metrics. **We are looking for cheap.** 1.6 mkt value over book value--not super cheap. Dividend yield is 2.1%--not great. Earnings are depressed due to crappy mgt.

Why is the mkt. value above the book value? When is it a good deal? Are there hidden assets? They may have intangibles like long-term service contracts. This is starting to integrate to put together a complete picture of this investment.

Red flags: mgt. How to get mgt. out? People who can put the company into play. Gabelli. He is mentioned in the Proxy Statement.

What if Donald Trump was a buyer—he wants greenmail. He is not the friend of the minority shareholder. Call the mgt and say I may have to do a proxy fight or you can buy me out. After the greenmail, you still have the bad management and the \$20 million is gone to pay-off Trump.

Showed up on a screen. Gabelli started buying at \$25.00. Value it and track it. Get all the filings.

Above are the preliminary search steps in our process.

So far, it looks like it is worth going forward.

Now we do more in-depth analysis.

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Start with assets. One piece at a time—start with the holding company. You know there are **three pieces to analyze and break-out**, so you will not do an amalgam of land, aircraft business and cash in the bank. Do a Break-Out Analysis for each division.

People look at the sum of General Electric rather than the sum of its parts.

Revenues have fallen from \$157 million to \$5 million while net income only dropped by half? Mgt. redefined the structure. They created a separate company and treated aircraft business as a subsidiary--*Hudson, LLC*.

In 1996, the company created a separate sub called *Hudson, LLC* to run its airline maintenance and service business. It sold 26% of itself to Lufthansa Airlines for almost \$24 million; it gave Lufthansa the option to buy up to 49% at a price linked to the profitability within the aviation business.

Hudson General reports its 74% ownership of *HLLC* under the equity method of accounting, in which only its share of the LLC's earnings shows up on its income statement.

Table 4.7: Reproduction Cost of Hudson General Assets

\$000's	Book Value 1998	Reproduction
Assets		
Cash	19,001	19,001
Marketable securities	19,002	19,002
Receivables	563	563
Advances to HLLC	2,057	2,057
Prepaid Expenses	56	56
Total CA	40,679	40,679
PPE (net)	2,389	2,389
Investment in HLLC	22,306	?
Investment in Kohala JV (net)	4,962	?
Note Rec. from HLLC	3,130	3,130
Total Assets	73,466	46,198
Liabilities		
A/P	200	200
Other CL	2,628	2,628
Total CL	2,828	2,828
Deferred Income Taxes	\$2,197	\$2,000 PV
Total Liabilities	5,025	5,000
Net Worth	41,000	41,000

Without adjustment, and ignoring the two partnership interests, the assets are worth \$46 and the liabilities are \$5 million, leaving the net worth at **\$41 million**.

General Characteristics of *Hudson General* (30/June 1998)

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Size (Market Value): 2.1 million shares * \$48 = \$100 M. No Debt.
Industry: Aircraft Service, Hawaiian Land Development

Performance: FY 1997 up 13% in stock price
FY 1998 + 17% } Well below S&P Index or Dow.

Shareholders: 182

Dividend Yield: \$1.00 Dividend/\$48 stock price = 2.1% (Moderate)

Price Earnings: \$48/\$3 = 16 (Moderate)

Market to Book: \$100 mkt. Cap. /\$68.4 = 1.46 (Lowish)

Candidate for Value Stock? Obscure, Disappointing - Y
Cheap - Not Really

Start at the parent company level. *Hudson General*

Cash and Securities	\$38.0 million
Receivables owed from sub. (no question on collection)	\$2.5
PPE (leased to Hudson General, LCC.	\$2.5

They take 3.5% of revenues for SG&A--not a economically viable business. So liquidation value, not reproduction value.

Take NPV of the lease payments.	\$2.5
Note to Hudson General	\$3.0
Current Liabilities	(\$3.0 million)
Deferred Tax	(\$2.0 million)

Value	\$41.0
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+74% *Hudson General, LLC* (Partnership Hudson General and Lufthansa
+50% *Kohala JV* (Hawaiian Land Development)

How much residual value do I have at risk here? I would get 70% to 80% of my money back if I bought at \$48 a share.

\$30 million (\$29.6) in cash coming from the LLC for the Option value paid for by *Lufthansa* on Oct. 1, 1998 (4 months from now). So added to the \$41 million in cash, you have another \$29.6 million in cash for a total of approximately \$70 million in cash or \$35/share. If you had bought this at \$25 or \$30 per share, would you have anything at risk? NO.

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Hudson General owns 51% of the LLC after the sale of 23% to Lufthansa which brought in \$29.6 million. This is looking more interesting.

If you got a call from Mario Gabelli to sell the shares? Would you take that trade? NO.

Hudson General LLC

\$31 million of Sh. Eqty. in the LLC. No goodwill.

What do you have in intangibles? You want to see a private market transaction (PMV) between sophisticated participants to give you a valuation reference. Transaction in LLC. Lufthansa is willing to buy 23% of LLC. for \$29.6 million, which puts a value of **\$128.7 million (\$129 million)** on the value of the entire business-(\$29.6 M/0.23).

Footnotes #2: Investment in Hudson General LLC:

Lufthansa was approved the exercise by LAGS USA of the LAGS option to increase its equity interest in Hudson LLC from 26% to 49% (difference: 23%). The exercise price is \$29.6 M to be exercised on or about Oct. 1, 1998. This is a PMV transaction.

Does this look like a lowball offer or a crazy (high) price? The assets won't help on the LLC--how do we see if this is a good offer? When you are in this situation, whose perspective do you want to adopt? **Adopt the Lufthansa perspective.**

The Buyer is setting the price. What is *Lufthansa* thinking about? *Lufthansa* is an operating company hoping to run this business. Buyers not investors. Can Lufthansa make money running this business? Ans.: Yes. They won't say, "Screw this, lets buy in the open market and get into a proxy battle in the US?" NO. Lufthansa will ask if they can make money owning 49% of this business and operating it.

If you are going to be value investors, you have to think about the reality as investors. Value is reality, the reality of PMV and the reality of people on the other side.

If you are buying the Sub., you are getting the Parent Company as well. The Parent is sucking 3.5% of revenues from the company. *Lufthansa* gets the creeps (lousy mgt.) as well. If you can get rid of the creeps, then the value goes up--remember that mgt is sucking 3.5% of revenues out of the LLC. Probably more value there. So this offer isn't going anywhere. It is a firm offer.

Lufthansa has an insider's view of the operations and they know what prices can be cut. Assets aren't helpful here due to the huge amount of intangibles.

Let's look at the EPV of the subsidiary to see the value of the service. Right now we know there is \$30 million there from the option and the balance of *Hudson LLC* is worth (51% of \$129 million) or \$66 million plus what we could get for the control premium (CP).

So far we have \$41 M in net worth + \$30 M cash from the *Lufthansa* Option + \$66 worth of *Hudson LLC* for a total of \$71 M + \$66 + CP = \$137 M + CP or \$65 per share in value + CP. (We exclude the Hawaiian Land Co. for now).

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Now do an EPV

Look at this *from every conceivable perspective*. We are going to do an Earnings Power (EP) for *Hudson LLC*. Start with Operating Income of \$14,608.00. Adjust for the charge for the parent company, *Hudson General*.

In Footnote #2: The Corporation and LAGS USA agreed to overhead fees for Fiscal 1998 of 3.5% for *Hudson General*. These fees are 3.5% of 169 M of revenue or \$5.91 M in fees. Add this back to Operating Income of \$14,608 + 5,913 = approx. \$21 million in operating income. Take a tax rate of 40% (high so to be reasonably conservative) to get \$12.5 M in after-tax income. There is a lot of depreciation (\$45.6 M) so you could add back the excess depreciation. To be conservative we won't.

Is this a risky or relatively safe business? It has long-term contracts, so it is safer. To be conservative, we will use a weighted average cost of capital (WACC) of 10%. $\$12.5 \text{ M} / 10\% = \125 M . This value cross-checks with the PMV of \$130. If we added another 2.5 M back in depreciation and used 8% as a WACC, then the value would be closer to \$190 M ($(\$12.5 \text{ M} + 2.5 \text{ M}) / 0.08$). The PMV looks solid, even a low-ball bid.

The control premium is probably at \$20 million. The difference is \$130 PMV vs. an adjusted EPV of \$190 or \$60 M. \$20 million seems like a conservative number, but it is an educated guess.

We are sure of \$130 M, but let's put aside the CP since we are unsure. We are valuing 51% of *Hudson LLC's* \$130 M. We believe that this valuation is conservative. **Separate the certainty from the uncertainty.**

Don't put numbers on these until you have to. You want to keep in your mind where the risks are and think about that, you have to keep in your mind where the reality is. We have \$137 M in *certainty* plus the (CP and Hawaiian Land), which is uncertain.

Where do we stand now? We have a safe \$41 M in the Parent + \$30 M for the Option + \$66 M for the LLC + CP (still excluding Hawaiian Land company)--for a total of \$137 + CP. Is this worth buying at \$100 M vs. our estimate of \$137 M +? Yes, we have a margin of safety of 37%.

The Hawaiian Land is not make or break for this investment.

3. Value Investment in Kohala JV

It started with 4,000 acres total. 2,175 lots sold. The residual acres are (4,000 - 2,100 Acres - (15 * 5) = 1,820 acres) Divide by 2 because of the 50%/50% split in the JV, so you have 910 acres. **I am starting with the reality of the assets.** I am starting with the 910 acres. Original value was \$30,000 per acre (Paid \$58 * 1/2 = \$29 M Starting in 1981

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or approx. \$30,000/acre. If you really need to know, call the RE assessor in Hawaii--not expensive.

Do I care about the book value of the land? Is it the history of the assets or what is there now that counts? What value is there now? One question to the RE agent--has there been a recent impairment to the assets?

Suppose we sold it for \$30,000 per acre? You have \$5.5 M in other assets--so you have about \$2M in other assets to the \$29 M for the land. This is shakier than for the \$137 M, but it gets you to approximately \$170 M--($137\text{ M} + \text{CP} + \$29 + \$2\text{-}\$3\text{M} = 168\text{ M} + \text{CP}$).

Kohala Cash	\$355
Mortgages	\$2,137
Foreclosed	\$2,186**
Other	\$1,549
Liabs.	(860)

Total \$5,367 - 1,500**

Approximately \$4,000/2= **This is selling = \$2M +Land.

From Footnote #3: 550 acres ready for sale, 1,490 units ready to develop in Phase IV. \$17 M charge to assets due to lawsuit

What about an EPV? It tells us what we will make if we don't get rid of management. $\$2\text{ M} / .08\text{ WACC} = \25 M in EPV. Current earnings are \$2 M. WACC is 8%. This is a tribute of the poor management.

Review:

What is the intrinsic value of *Hudson General's* interest in *Hudson LLC* and the Hawaiian Land investment? On the books, it carries its 74% stake in HLLC at \$22 M, which would put the Book Value of all of *Hudson LLC* at \$30 M. PMV transaction by *Lufthansa* indicates that that value is too low. *Lufthansa* is willing to pay \$30 million for 26% of *Hudson LLC*. At those prices, *Hudson LLC* must be worth \$130 w/o the CP. *Hudson General* has 51% interest in *Hudson LLC* for which there is a premium paid in the PM for control.

Second, *Hudson LLC* has earnings after-tax of \$12.7 M. The Company has no debt, and its earnings stream is secured by long-term contracts with airlines and airports. If the WACC is 10% or you placed a 10 x multiple on those current earnings, you would have an approximate value of \$127 M or proportionately what *Lufthansa* is paying out in the PM transaction for the Option (\$29.6 M for 23% of LLC).

Those contracts are hidden assets that don't show up on the balance sheet. They are, from another perspective, the specific competitive advantage that allows *Hudson LC* to earn more than it would on a level playing field.

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After the Option is exercised for \$30 M, *Hudson General* would have 51% of *Hudson LLC* or \$66.5 M

\$130 M x 51% = \$66.5 M
 Cash from Option = \$30.0 M
 Total = \$96.5 M

Hawaiian Land JV:

50% ownership of slightly more than 1800 acres at a value on their books of \$4.9 million or \$5,500 per acre. Original cost was \$30,000 per acre. 910 x \$30,000 = \$27.3 M. Losses of \$3 M in 1998.

Best check is to have an appraisal done in Hawaii. Or we can say ignore the value to be conservative.

Total Value so far is \$41 M + \$96.5 M + CP = \$137.5 M + CP + Land Co???

2nd Step: Earnings Power

Hudson General, LLC	9,426	9,426
Operating Loss	(2,724)	0
Kohala JV	(2,822)	0
Earnings	\$3,880	\$9,426
Tax @ 36%	\$2,780	\$2,780
Net Income	\$1,100	\$6,646

WACC = 50% x 12% for Equity Cost of Capital + 50% x 8% x (1-36 tax rate)
 = 8.5%

EPV = \$6,646/0.085 = \$78 M + \$41 M
 = \$119 M + Land + Control Premium (?)
 = \$132 M + Control Premium

Add back excess assets to the EPV.
 You also have the land value.

Asset Value (AV) is \$130 M to \$170 M. EPV cross checks AV.

What is the bottom line? **\$130 to \$150 M in sure value. It could be as much as \$170 + M.** The market value is \$100 M

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Table 4.8 Reproduction Cost of Hudson General Assets, Round 2

	Book Value 1998	Reproduction
Assets		
Total Current Assets	\$40,679	\$40,679
PPE (net)	2,389	2,389
Investment in LLC	22,306	\$130,000 x 51% = \$66,300
Plus Cash from sale to Lufthansa		\$30,000
Investment in Kohala JV (net)	4,962	
Note Receivable from LLC	\$3,130	\$3,130
Total Assets	73,466	142,498
Liabilities		
Accounts Payable	200	200
Other Current Liabilities	2,628	2,628
Total Current Liabilities	2,828	2,828
Deferred Income Taxes	2,197	2,197
Total Liabilities	5,025	5,842
Net Worth	68,441	
Adjusted net worth		137,670

The management sucks. The current earnings power is \$22 million. If you could eliminate mgt., then earnings power would improve. Here is a classic situation.

AV = \$170 M and EPV is \$22 M. Mgt. is the issue.

How likely is it to remove management? Call Gabelli. Is there a staggered board, is there a poison pill? Questions left to answer after our valuations and cross checking.

With Gabelli owning 48%, he will take it over. The question is how long will it take?

1 year discounted at 10% = $\$150/1.10 = \135 M

2 years discounted at 20% = \$120 M

What other things do we think about doing? Whose concern that this company will be competitive? Lufthansa has made a bid for the company-so that is one guarantee. This business is easily entered, however long term contracts offer some degree of certainty and stability.

Mgt. is your enemy while Gabelli is your friend. Get rid of mgt. and put the company, *Hudson LLC*, into the hands of good German Management.

How would you try shortening that period? Sue Mgt. for looting the company.

A staggered board: 1/3 of the board gets elected every year.

At the end of the 2nd year, Gabelli would have a majority control of the Board. Find out when the date of the Board Meeting is.

We will sue the mgt. for stealing from the company. Mgt. will want to negotiate. Eventually, the company went for \$90 per share in seven months. He got lucky. He started buying at \$25 to \$30.

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I want to stress the process we went through.

Breaking the value up into pieces. Looking at the value from every perspective and tying it down.

What other information have we not used? Not much else. We have used as much information as possible. We have assessed the risks along the way.

The crucial information is the corporate bylaws and the time of the annual meetings. We have figured out the problems to look at and what information is crucial.

That is the kind of analysis, you want to complete.

Compare this to the handle you had in your earlier **Valuation Class 6301**.

This is what value investors do.

End