

Down and Dirty on CRR on November 14, 2014

From **Value-Line, November 7, 2014** (See blog post)

Search Process

Flip through the tear sheets of value line one-by-one or 300 pages. Time 90 minutes.

What catch my eye?

Sales growth has been steady in the 15% range. Probably tapers off. **But not a franchise so no value to growth.** No growth asset value. Earnings power value and reproduction value since the business/industry is viable. Private Market Value?

KEY STAT: **Return on capital** has averaged **15%** over the past ten years, now about 10%. Probably averages about 11% to 13% normalized-A fair return. Returns are steady considering the cyclicity of this oil & service business. **Why steady**-some customer lock-in or strong service component? This is an OK business with a strong balance sheet.

No debt. Some excess cash of \$1 per share (3Q 2014). Returns cash to shareholders 2.4% dividend yield. Share count small 23 mil. No dilution.

Insiders own 14.6%. *Good.* So value this as an asset-based business with a normal return on no growth. What has the market thought in the past?

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Avg.
Low price	\$33.40	\$41.10	\$32.20	\$34.10	\$30.40	\$26.30	\$58.70	\$90.40	\$60.30	\$62.10	\$48.20	\$45.00	\$82
High Price	\$51.90	\$68.20	\$67.70	\$53.60	\$62.60	\$71.30	\$105.00	\$183.30	\$135.00	\$132.50	\$156.00		\$170
Book Value	\$10.19	12.08	14.06	15.88	18.72	19.82	22.59	27.27	30.88	33.3	\$34.08	34.08	
Low P/BV	3.28	3.40	2.29	2.15	1.62	1.33	2.60	3.31	1.95	1.86	1.39 xs	1.32 xs	2.41 xs
High P/BV	5.09	5.65	4.82	3.38	3.34	3.60	4.65	6.72	4.37	3.98	4.48 xs		5.01

For the past ten years and even going back fifteen years we see a range of price to book value between **2.4 to 5** times or **\$82 to \$170** based on today's (3/q 2014) \$34.08 book value. The low of price-to-book is **1.33** times during the depth of the 2009 Great Recession. 1.33 times book value of \$34.08 is **\$45.34** or close to today's \$47 to \$50 price.

Three minute review: Set this VL aside to dig a little deeper. **If I can buy a business with a steady and fair return at below asset value then worth the trouble to look further.**

Let's jump to the acquisition or private market value since it is easy to check:

Go here: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/vebitda.html

<http://www.stern.nyu.edu/~adamodar/pc/datasets/vebitda.xls> for "industry multiples

<i>Industry Name as of Jan. 2014</i>	<i>Number of firms</i>	EV/EBITDA	EV/EBIT	EV/EBIT (1-t)
Oilfield Svcs/Equip.	163	8.63	11.21	15.57

EV = 23 million outstanding shares x \$48 (1 PM EST Nov. 14th 2014) = \$1.104 million market cap. + \$0 debt minus 23 million in excess cash (\$30 million 3Q cash (see blog for Q) = **1,081 EV**

EBITDA = Operating profit for 9 months 3Q 2014 of \$80.53 million plus depreciation of 37.1 million or \$117.63 million of 9 months of EBITDA. Divide by .75 to annualize = **\$156.84 2014 Ebitda (est)**. Round up to 157.

EV/EBITDA = \$1,081/157 or **6.88 times**.

8.5 to 9 times industry multiple from above = **\$60 to \$63**. 10 xs. = \$70 per share. Maybe multiples have changed from 11 months ago but it is a *ball-park* that potential undervaluation may exist.

3Q 2014 Sh. Equity is \$784.4 million or \$34 per share. Deduct 1.37 for goodwill and intangibles for \$32.63 tangible book value. Not much "water" on the balance sheet.

Assets for a going concern: How much to get into the business?

(Prof. Greenwald from *Value Investing*) Our purpose in valuing a firm based on its assets is to discover if the economic value of the assets is accurately reflected in the price at which the firm’s securities are being bought and sold. Opportunities lie in the gap between value and price.

A firm in a **viable industry**, the economic value of the assets is their **reproduction costs**—that is, what it would take a would-be competitor to get into this business? I have no clue on fracking or what *proppants* (ceramic balls to inject into wells) are but the purpose of the business is to allow their oil and gas customers to efficiently and effectively extract the most resources at the lowest overall costs.

Reproduction value

Inventories: add last in, first our reserve, if any; adjust for turnover. \$0

Deferred taxes: Discount to present value. All current so no change

PP&E (net) Original cost plus adjustment. No expertise so \$0 adjustment.

Goodwill: relate to product portfolio and research and development. \$0

The depreciation rules by which the company reduces the value of its plant may bear only the slightest resemblance to what is actually happening to the economic value of the asset. Pass.

How many years of R&D spending? Pass.

How long to duplicate this business from scratch?

Developing customer relationships also costs money—money that never appears as an asset. We need to add some multiple of the selling, general and administrative line, in most cases between one and three-year’s worth, to the reproduction cost of the assets.

SG&A is 54 million for the 9 months ended Sept. 2014 or \$72 million per year. Take three years because they have 1024 employees in multiple locations and multiple plants or 3 times \$72 or \$216 million. Add this to the \$34 per share book value or \$34 plus (216/23 OS) = \$34 + \$9.4 or **\$43.40** per share. Close to the lowest price-to-book of the past 15 years or **\$45.34**

Multiple of Cash Flow

From Value Line:

Free Cash Flow Paul E. Debbas, CFA | December 07, 2010

It is understandable that most investors examine a company’s earnings when evaluating its common stock. Earnings often influence stock prices. But there are other things that investors can consider when evaluating a company’s prospects. One of them is free cash flow.

The bottom line tells investors how much money a company made (or lost) over a specified time period. However, reported earnings can be affected by accounting methods, and don’t indicate how much cash a company is generating. Some expenses, such as depreciation and amortization, reduce corporate profits, but do not lower cash flow.

Value Line defines cash flow per share as earnings per share plus depreciation and amortization per share. For many companies, this is a good approximation of actual cash flow. But some items, most notably deferred taxes and investment tax credits, are included in a company’s true cash flow but not in the Value Line definition. That’s why Value Line uses quotation marks in its presentation of “cash flow” per share.

Even with this limitation, the statistics on the Value Line page can be used to provide a gauge of a company’s free cash flow. We define free cash flow as “cash flow” per share after capital spending and common dividends are subtracted. This is not the only way to define free cash flow. For instance, some investors segregate “growth” capital spending from “maintenance” capital expenditures (the capital spending needed to keep ongoing operations running) and subtract just the maintenance capital spending. An investor can do this only if the company has provided a breakdown of maintenance and growth capital spending, however.

OK, so VL has \$5.85 for 2014 “cash flow” with depreciation of \$55 million or \$2.4 per share. But Maintenance Capex (MCX) I am estimating is less than that because of how long their factories last. Take of \$1.00 for MCX to get \$4.50 to \$5.00 in “Free cash flow”

What multiple? A cost of capital of .07 to .08 (I think this is what their debt would cost) or 12 to 13 times. The average multiple has averaged over 21 times. So 12 times \$4.50/\$5.00 and 13 times \$4.50 to \$5 gives you **\$54/\$60 with the 12 multiple and \$59 to \$65 with the 13 multiple.**

Summary

I have rock bottom **tangible book value of \$32**—a probable ugly case scenario if oil keeps falling to ?? Who knows.

Then I have **reproduction value** of about **\$43** per share which coincides with the lowest 1.3 times book value the stock has traded over the past 15 years. **\$45**.

Industry multiples of EV/EBITDA place the value at **\$60 to \$65**

Median to high price-to-book value is \$80 to \$170. Throw out the past high price.

Hard rock is **\$32** TBV

Replacement or reproduction value **\$43-45**

Industry multiples **\$60 to \$65**

Cash flow multiple 12 to 13 times = **\$55 to \$65**.

Median price to book value past 15 years is \$82, round down to **\$80**

\$32 on the extreme low side to \$80.

So before looking at annual report or competitors to refine my numbers, I have an idea that this business might be worth buying at or under replacement value of **\$45**. A plan for me based on *my psychology* and obtaining a price under replacement value might be to allocate a percentage of capital to buy this company starting at \$45 down to \$30. Perhaps three scaled buy orders on descending price.

Worth going through the proxy and 10-K for any problems.

Time: 15 minutes.

Next.....