

Fundamentals: Introduction to valuing industrials

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Experts share their ideas on how to evaluate shares of industrial firms.

Investor enthusiasm has grown about the industrials sector. One reason: Industrial companies stand to benefit disproportionately from growth in the developing world. They make the heavy equipment needed for urbanization and infrastructure projects, and build the factories that will supply burgeoning consumer classes.

“If we get a significant new middle class buying consumer products like radios and televisions in nations like China, look out,” says Mac Plumart, principal with Atlanta-based independent advisory firm Narwhal Capital. “That’s great news for industrials.”

Industrials’ top-down appeal may have you interested in selecting stocks within the sector. We asked several experts to describe some of their favorite ways to determine appropriate valuations for shares of industrial firms. They offered several methods, all relatively old-fashioned, that they say work well in this old-fashioned sector.

Start with the classic ratios

Investors in today’s sophisticated markets use ever-more-complex tools to value stocks. Industrials are the exception to that trend. These remain traditional, nuts-and-bolts companies: They hire workers, melt metal, bend steel, and make machines. Moreover, the basic tools of accounting—from balance sheets to income statements—were created to manage the finances of industrial firms, and they remain essential for gauging the health of their businesses.

Investors generally start valuing industrials stocks using the old standby, Price-to-Earnings (P/E). P/E is the price of a share of stock divided by earnings per share, and its advantages lie in its simplicity: P/E is easy to derive, and it provides a generally reliable way to quickly compare similar companies.

P/E has certain shortcomings as a tool to value shares of industrial firms, however. In particular, it’s sensitive to debt. Debt payments can erode company earnings for a given period, boosting their P/Es—but debt is less of an issue for industrials than for other sectors. “Industrials tend to be mature companies that throw off a lot of cash,” says Daniel Holland, an equity analyst at Morningstar. “The market understands that they have flexibility to take on debt.” That’s not to say that debt is irrelevant, of course: A good rule of thumb, says Holland, is to make sure the company could earn its way out of debt within two years.

Another traditional metric, EV/EBITDA, provides a good alternative to P/E when comparing companies with different levels of debt. Technically, EV/EBITDA is a company’s enterprise value—its market capitalization plus debt—divided by its earnings before interest, taxes, depreciation, and amortization. In other words, it strips out a company’s capital structure to give a more pure reading of its operational health.

Both P/E and EV/EBITDA are primarily useful for providing snapshots of how the market is valuing a company at a given moment. But Zahid Siddique, an associate portfolio manager of Gabelli Equity Trust, argues that the frequency with which those numbers change makes them imperfect gauges for measuring

the value of a company's stock. He prefers to determine what a buyer would pay for the firm in a private transaction. That number—commonly called intrinsic value—tends to hold relatively steady over time, providing a good benchmark for comparison to its stock price.

Calculate the intrinsic value

Siddique uses a relatively straightforward formula to arrive at intrinsic value. He starts with a company's annual cash flow, available on its cash flow statement. He applies a multiplier, then subtracts debt and adds cash. The art of this system lies in devising the multiplier—which helps you translate current results into intrinsic value.

The first place to look to determine your multiplier is mergers and acquisitions. You can derive the multiplier from a recent acquisition, start with the acquisition cost, then look at the company's financial statements and subtract cash, add debt, and divide by the cash flow. The result will be the multiplier.

Over the last two years the average multiplier across the sector has hovered between eight and ten, according to Siddique's research. You then want to look for specific acquisitions of companies similar to the one you are considering. "If you have three or four M&A benchmarks," says Siddique, "then the numbers from those transactions are going to get you 90 percent of the way to your multiplier."

So you can start with the industry average or select similar companies and use their multiplier. But, if you can't find strong, recent comps, then you want to adjust the average multiplier based on the company's competitive advantages (or lack thereof). The most important variables to consider are fairly obvious:

- Strong balance sheets
- Good cash flows
- Sound leadership
- Dominant market share

However, several more sector-specific issues come into play as well:

Stickiness of customer relationships. Replicable business models command higher multipliers. The classic example is the razors-and-blades model: Customers who buy razors keep coming back for the blades. Similarly, companies that make ATMs and also service them will generate recurring profits, stable cash flows, and lasting value.

Special access to resources. Industrials typically are in the business of converting raw materials into products. Reliable, low-cost access to those materials—a rare metal for a computer chip, say—can provide a significant advantage over competitors. Conversely, producers of generic, commoditized products like plastics command lower multiples.

Capital intensity versus return on capital. The sector is populated by capital-intensive industries like automobiles, chemicals, and construction. Companies that can obtain that capital inexpensively and invest it especially productively deserve higher multiples.

International tax advantages. Large urbanization projects in emerging markets have driven the sector's growth during the past decade: Today some 40% of U.S. industrial firms' revenues come from foreign countries. That trend is likely to continue in the years ahead, so companies that pay lower tax rates abroad merit higher multiples.

Once you have determined your multiplier, simply apply it to the firm's cash flow, then subtract debt and add cash to arrive at the company's intrinsic value. You can divide the intrinsic value by the total number of the company's shares to estimate its value per share, which you can compare to its stock price.

This model tends to work best for mature firms that have healthy cash flow and are comparable to other companies that have been acquired. But what about promising young companies with little or no history, or extremely large companies with no good M&A benchmarks?

Double back to free cash flow

The difficulty in evaluating young industrial firms, says Mac Plumart of Narwhal Capital, is that high debt levels and asset depreciation can distort earnings. Enter free cash flow: cash flow from operations minus capital expenditures.

In layman's terms, free cash flow is the amount of money the company's management has at its disposal to develop new products, make acquisitions, pay dividends, or otherwise create value for shareholders. This makes it a useful measure of an industrial company's flexibility to grow its business and weather the economic downturns that frequently hit this highly cyclical sector. "I think that if you're not generating free cash flow," says Plumart, "then you're one recession away from going out of business."

He argues that free cash flow is particularly useful for valuing young industrial companies. The reason: Young firms start generating free cash flow before they produce earnings. If you see steady gains in free cash flow, you can project with some confidence that earnings growth is on its way.

Free cash flow is also useful at the other end of the spectrum: to value the titans of the sector, which have few acquisition benchmarks. Plumart says the market can overestimate the value of these companies, which often have multiple ways to goose earnings that don't reflect improvements in operations. "If you're getting earnings but free cash flow is eroding, you have a big red flag that something is wrong," says Plumart.

Take the long view

The ultimate reason to estimate private market value is, of course, to identify companies that the market has undervalued. The number gives you the information you need to snatch up the stock when you believe its price is unjustifiably low—or sell it when the price is unjustifiably high. Bear in mind, however, that if your analysis compels you to invest in a company you believe is undervalued, you may have to wait awhile for the market's view to catch up.

Next steps

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