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## TIH – Toromont Industries

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### **Intended Audience**

Personal investors looking at opportunities that pose both a mix of investment income through dividends and capital gains through share appreciation. As well, investors following the construction industry.

### **Summary Points to Take Away**

- **Strong Points:** (1) Steady Dividend Income (2) Stable Operating Performance (3) No Financing Issues (4) Growth Opportunities (5) Stock buyback program (6) Positive Free Cash Flow Production.
- **Risks:** (1) Stock Heavily Followed by Analysts (2) Revenue Increasing at Decreasing Rate (3) Customer Issues (4) Forward P/E is Not Significantly Undervalued.

### **Analysis**

Toromont Industries Limited is a Canadian-based company listed on the TSX under ticker symbol TIH. The Company serves its customers through two business groups: (1) The Equipment Group (EG) (2) The Compression Group (CG). The EG sells, rents and services a range of construction equipment and industrial engines. The EG is comprised of Toromont CAT and Battlefield – The CAT Rental Store. The activities of the EG include sales and product support activities for Caterpillar engines used in a range of applications, including on highway trucks, industrial, commercial, marine and power generation applications. The CG is engaged in the design, engineering, fabrication and installation of compression systems for natural gas, fuel gas and carbon dioxide, as well as process systems, and industrial and recreational refrigeration systems. During the year ended December 31, 2007, the EG represented 58% and the CG represented 42% of the total revenues. As of Q3 2008, this business composition has shifted resulting in both groups being relatively more equal as the CG has seen strong gains from the natural gas compression customers.

### **Positive Factors**

#### Steady Dividend Income

Current dividend yield based on last quoted market price of \$24 is 2.3% assuming an annual dividend of \$0.56 per share (which is 2008 payout). Provides a cushion for investors in addition to the expectation of capital appreciation. TIH has raised the annual dividend for 19 consecutive years; thus, demonstrating management's ability and desire to reward shareholders in good times and in bad as both were experienced during that time frame. A significant number of corporations pay dividends during boom periods but scale back during recessionary periods. TIH continues to not only pay dividends, but increases them year after year, which provides a strong assurance of constant dividend income now and into the future.

#### Stable Operating Performance

Both gross profit and operating income as a % of revenue have remained stable during the past 4 quarters as well as during fiscal years 2004 to 2007 with gross profit at around 20 to 23% and operating income at 9 to 10%. This coincides with TIH's ability to continue dividend payments to shareholders with annual increases. The stability of these fundamental performance metrics will enable TIH the ability to continue paying dividends to investors. TIH is a

major player within their market; thus, have power over customers to retain margins even in tough economic times; thus, margin and operation income are expected to continue.

#### No Financing Issues

TIH has \$203M left in available credit facilities that has been not drawn down on with the majority of the facility expiring in 2011; thus, providing adequate time frame for renewal. To put the available credit in perspective, TIH has enough cash available to continue dividend payouts for 22 quarters (little over 5 years), even with no cash flow contributions from operations.

Total debt only makes up 11% of total assets as of Q3 2008, which has fallen quarter after quarter since fiscal year 2005 (high point of 21% of total assets). Excess cash is being used wisely by TIH as evidenced by the two biggest uses of free cash flow: (1) rewarding shareholders through dividend income (2) reduction of outstanding debt. Total cash on hand as of Q3 2008 was \$239M, as compared to long term debt of \$175M; thus, cash exceeds debt by 1.4:1.

Current ratio and quick ratio as of Q3 are 1.91 and 0.98, which are close to the 2:1 and 1:1 industry rules of thumb. Working capital accounts can reveal valuation issues if they continue to build up, but for TIH accounts receivable and inventory, as a % of assets have remained relatively flat year over year since 2005.

#### Growth Opportunities

Two significant growth opportunities have been outlined during TIH's August 2008 investor presentation (specifically within the equipment rental side of the business – which represents roughly 52% of total operations):

- (1) **Mining Sector:** Majority of mining sector business comes from Canada and it currently makes up a minor % of total equipment rental revenue. Given that mining is a very significant industry in Canada where many projects are underway that require equipment rental services, TIH expects to see higher demand from this area. Currently there are 70 mines in operation within TIH's territory as well as over 60 projects in some stage of development, which upon completion will almost double mines in operation; thus, leading to higher expectations of demand for TIH equipment rental products.
- (2) **Infrastructure Industry:** Government bodies in both the US and Canada have outlined aggressive infrastructure budgets to be carried out over the next few years, which will mean significant levels of infrastructure construction that will require equipment rentals and technical support. Canada's current infrastructure budget commits \$33 billion to projects through to 2014. While in the US, the current estimates are \$700 billion (but will be known with more certainty as Obama takes his presidency).

#### Stock Buy Backs

TIH's board has approved buybacks up to 4.6 million shares as of August 31, 2008 expiring in 12 months. The potential buyback is a significant part of the current outstanding float and total potential diluted shares, 10% and 8% respectively. If this is acted upon, it'll benefit shareholders through capital appreciation and is further evidence that management is focused on rewarding the shareholders, not wasting excess cash on poor acquisitions, etc. Investors should follow this situation closely as though this is good for shareholders in theory, management has yet to make any stock buy backs based on the current approved buyback limit, nor did they buy back any shares during the last 4 quarters. This isn't a benefit to investors till management exercises their right to purchase up to 4.6 million shares. During the past 4 quarters, the trend has been the opposite, where ownership has become more diluted due to exercising of employee options no buy back to decrease the total outstanding shares. Total diluted shares have gone from 64.7 million shares to 65.13 during the last 4 quarters, and have been further diluted in comparison to 2005's level of 63.08 million.

#### Positive FCF

Free cash flow is the most relevant cash flow performance metric to monitor for TIH because capital expenditures are a required to maintain and grow revenue levels. Due to that factor, FCF provides the more realistic measure of how much cash is available for use (i.e. to pay down debt, buy back shares or provide dividend income to shareholders). During the last 4 quarters, the accumulated FCF produced has been approximately 10% of the current share price of \$24; thus, based on this understanding, TIH produced enough cash to pay out a theoretical dividend yield of 10% based on a market price of \$24.

During the last 4 quarters, TIH produced \$157M of free cash flow, which is approximately equal to 90% of present long term debt as of Q3 2008 (\$175M); thus, if TIH continues their pace, long term debt can be paid off within two years even under the assumption that current dividend level continues.

## Risks

### Heavily Followed Stock

Approximately nine analysts follow TIH; thus, the stock is heavily followed implying that the stock price has a higher probability of being closer to its intrinsic value, given the theory that the more investors following a stock the less likely the stock price shall divert from its real value. Peter Lynch, famed author of "One up on Wall street" and "Beating the street" claimed that identifying stocks with little analyst coverage was key to obtaining abnormal stock returns. TIH has a market capitalization of \$1.6 billion; therefore difficult for the value of the company to grow significantly (i.e. double or triple) as compared to smaller companies, for example growing from \$100M market cap to \$1 billion, as compared to going from \$1 billion to \$100 billion for larger corporations.

### Revenue Increasing at Decreasing Rate

Revenue has risen over the past few years, but at a decreasing rate showing signs the business is entering the maturing phase where growth is in line with movements in GDP; thus, significant capital appreciation from growth is not as likely. Revenue growth has gone from 12% in 2005, to 10% in 2006 and then dropping in 2007 as well as the last 4 quarters to 8%. TIH has grown to the point that sustaining a rising sales growth rate is likely not realistic as the market capitalization of the company has already reached \$1.6 billion.

### Customer Issues

As discussed in TIH's Q3 MD&A, many of TIH's customers are reliant upon access to credit and equity capital markets to finance the projects for which TIH's products are used for. An inability to finance some of these projects would adversely impact TIH's business prospects. Given the current state of the credit market, cost of raising money has increased significantly in the latter half of 2008 and is expected to continue in 2009, which would lead to lower demand and drops in backlogs as changes in present financing options could lead to the cancellation of previously approved capital projects. Continue to monitor the credit situation as it'll impact revenue estimations for TIH.

### Forward P/E

Based on the last 4 quarters of earnings, P/E is roughly 12 times earnings (based on market price of \$24), which is cheaper than the stocks historical high, but is not relative to other companies within the market that are selling for half the P/E ratio. Trailing P/E is likely a reflection of the future P/E as growth as value gained from growth opportunities will be offset by fewer projects from current customer base. Keep an eye on the stock price to see if the stock goes on sale, which could make it a good buy at that point as the fundamentals of the company are strong.

## Where to go from here?

Overall at the current price level of \$24, suggested action is to be neutral on the stock (take no action regardless of own or not), while following it closely to take advantage of purchases at the lower end of its 52 week low. In this case, TIH has strong fundamentals, but the stock price seems to reflect that. TIH is a publicly traded company on the TSX.

Would love to hear your feedback – contact [thatstockguy.NET@gmail.com](mailto:thatstockguy.NET@gmail.com) .

Thanks,

Simon

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