LSB Industries (LXU)

Raimondas Lencevicius
Disclaimers

• I am not a registered investment advisor and I do not offer any investment advise

• No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments
LSB Industries - business

- Climate Control Business: heating, ventilation, and air conditioning (HVAC) products
  - Geothermal and water source heat pumps (65% of Climate Control, 23% of total)
  - Hydronic fan coils (19% of Climate Control, 7% of total)
  - Custom air handlers, Modular geothermal chillers (16% of Climate Control, 5% of total)
  - To OEMs: 21%, 7%

- Chemical products
  - Anhydrous ammonia, fertilizer grade ammonium nitrate, urea ammonium nitrate, and ammonium nitrate ammonia solution for agricultural applications; To farmers, ranchers, fertilizer dealers, distributors (45% of Chemical products, 29% total)
  - Commercial grade anhydrous ammonia, ammonium nitrate, sulfuric acids, nitric acids in various concentrations, mixed nitrating acids, and diesel exhaust fluid for industrial applications; To the polyurethane, paper, fibers, fuel additives, emission control, and electronics industries (32%, 20% of total)
  - Industrial grade ammonium nitrate and solutions for the mining industry (23%, 15%) To Orica: 17%, 11%
LSB Industries - Misc thoughts

• What can go wrong?
  • No housing recovery - HVAC sale losses
  • Alternative HVAC systems - HVAC sale losses
  • Nat gas price goes up - chemical business margins shrink or disappear
  • Fertilizer price goes down - chemical business margins shrink or disappear
  • Greenhouse emissions taxed - not likely?
  • Russian/Ukrainian cheap gas subsidized AN dumping - dumping tax right now

• 18% control by CEO & family (Golsen Group)
  • Nepotism?
LSB Industries - Misc thoughts

• Opportunities:
  • Nat gas price in long time decline?
  • Fertilizer prices are at secular high?
  • Housing recovery? (Buffett)
**Strategic considerations**

- **Moat** (*switching costs, habit, low cost*):
  - What are the moats? HVAC brand? Fertilizer minimal.
  - What does it take to sustain the moats? HVAC brand.
  - Bargaining power of suppliers/customers? Not a big one
- **Is it a low risk business?** Somewhat.
- **Is there high uncertainty?** Medium
- **How capital intensive is the business?** Yes
- **Future growth - saturation?** Unknown, see Russian fertilizer issues
- **Are the revenues and cash flows of the business sustainable or overstated / understated due to boom or bust conditions?** Possibly overstated in fertilizer due to boom, understated in HVAC due to housing crisis
Management

- I don’t usually do management analysis. Included for template completeness
- No dilution
- Can I trust management?
- Management shareholding (> 10%)
- Management incentives?
- Are the salaries too high?
- Is there heavy insider buying?
- Is there heavy insider selling?
- Do I like the management? (Operators, capital allocators, integrity)
- Profitable reinvestment
- What has management done with the cash?
- Where is Free Cash Flow invested? Share buybacks, dividends, reinvested, ROE & ROCE, incremental BV
Piotroski Score

Only applicable to Graham Cos - N/A to LXU
1. Net Income: Bottom line. Score 1 if last year net income is positive.
2. Operating Cash Flow: Better earnings gauge. Score 1 if last year cash flow is positive.
3. Return On Assets: Measures Profitability. Score 1 if last year ROA exceeds prior-year ROA.
4. Quality of Earnings: Warns of Accounting Tricks. Score 1 if last year operating cash flow exceeds net income.
5. Long-Term Debt vs. Assets: Is Debt decreasing? Score 1 if the ratio of long-term debt to assets is down from the year-ago value. (If LTD is zero but assets are increasing, score 1 anyway.)
6. Current Ratio: Measures increasing working capital. Score 1 if CR has increased from the prior year.
7. Shares Outstanding: A Measure of potential dilution. Score 1 if the number of shares outstanding is no greater than the year-ago figure.
8. Gross Margin: A measure of improving competitive position. Score 1 if full-year GM exceeds the prior-year GM.
9. Asset Turnover: Measures productivity. Score 1 if the percentage increase in sales exceeds the percentage increase in total assets.

• Total: / 9
Is it a good business?

- 10 year history of profits
- ROE:
- Margins
  - 2009: 4  2010:5  2011: 10
- No growth: 3 year sales growth 2%, earnings growth 32%
- No dilution
- Strong balance sheet
  - Debt << cash/short term investments
- ROIC = Earnings / (Equity + Debt - Cash) = Earnings / (Assets - non-debt liabilities - Cash)
  - ~ ROE
Is it a good business? Cash flow

- Good operating cash flow, FCF:
  - 2011 83M earnings, 90M operating cash flow, 45M FCF (FCF = OCF - capital expenditures)
  - Free Cash Flow/Share higher than dividends paid
Is business cheap? - Buffettology calculations

• ROE 28% - use 15% as conservative cyclical
• Earnings in 10 years = ROE*Equity*(1+ROE)^9 = $155M
• Equity in 10 years = Equity*(1+ROE)^9 = $1B
• Market cap = 155M x P/E (15) = $2.3B
• Rate of return = 8% after tax (calculations omitted)

• 9 year earnings growth: 8%. Assuming 8% earnings growth: 1% share price growth.
Is business cheap? DCF

• Discounted cash flow
  • Current earnings of 83M (FCF 45M)
  • 10% growth for 5 years, leveling after that
    • 15% discount -> $807M current valuation
  • 5% growth for 10 years, leveling after that
    • 15% discount -> $743M current valuation
  • 10% growth for 10 years, leveling after that
    • 15% discount -> $1B current valuation
  • Owner’s yield = earnings / (market cap + debt - cash) = earnings/EV
    • $83M / (888M+90M-130M) = 9.8%

• What makes up the margin of safety? Valuation?
• Is there a sufficient margin of safety? Maybe.
Is business cheap? - Graham investment considerations

• N/A for LXU - included for completeness
• 3 P/Book - not a net net
• Altman Z score ( http://en.wikipedia.org/wiki/Altman_Z-score )