Western Digital Corporation (WDC)

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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
Western Digital Corporation - business

- Hard drives
- Competition: HGST, Samsung, Seagate, Toshiba and WD
  - HGST owned by WD, some (?) Toshiba assets too
  - Seagate bought Samsung’s assets (all of them?)
  - So really just WDC and STX
- Geo: 23% Americas, 19% EMEA, 58% Asia
- Channel: 63% OEM, 25% distributors, 12% retailers
- 73% units to PCs
- Units: 150 compute, 36 non-compute, 16 enterprise
Western Digital Corporation - business (cont’d)
Western Digital Corporation - Misc thoughts

• What can go wrong?
  • SSDs supplant HDs
  • Mobiles/tablets don’t need/use HDs
  • Price war with Seagate, Samsung, etc.
  • New Chinese competitors??
Western Digital Corporation - Misc thoughts

• Opportunities:
  • HDDs still needed for enterprise, data centers, etc. (but Seagate is more dominant there)
  • Competitive landscape shrunk to 2 major players and couple minor
Strategic considerations

- Moat (*switching costs, habit, low cost*):
  - What are the moats? Oligopoly
  - What does it take to sustain the moats? Sustain the above
  - Bargaining power of suppliers/customers? None

- Is it a low risk business? Somewhat.
- Is there high uncertainty? Somewhat.
- How capital intensive is the business? Somewhat.
- Future growth - Unknown
- Are the revenues and cash flows of the business sustainable or overstated / understated due to boom or bust conditions? Unknown
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 WDC

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:
  - 2010: 29  2011: 13  2012: 21  2013q1: 26
- Margins
  - 2010: 14  2011: 8  2012: 13  2013q1: 13
- 3 year sales growth 18%, earnings growth 15%
- No dilution (share buybacks)
- Strong balance sheet
  - Cash >> debt
- ROIC = Earnings / (Equity + Debt - Cash) = Earnings / (Assets - non-debt liabilities - Cash)
  - << ROE
Is it a good business? Cash flow

- Good 2012/2013 cash flow:
  - 2013 q1 519M earnings, 936M operating cash flow, >500M FCF (FCF = OCF - capital expenditures)
  - Free Cash Flow/Share higher than dividends paid
Is business cheap? - Buffettology calculations

- ROE 15%
- Earnings in 10 years = ROE*Equity*(1+ROE)^9 = $4.2B
- Equity in 10 years = Equity*(1+ROE)^9 = $28B
- Market cap = 4.2B x P/E (15) = $64B
- Rate of return = 20% after tax (calculations omitted)

- 9 year earnings growth: 24%. Assuming 15% earnings growth: 28% share price growth.
Is business cheap? DCF

- Discounted cash flow
  - Current earnings of 2B (FCF ~2B)
  - 10% growth for 5 years, leveling after that
    - 15% discount -> $20B current valuation
  - 5% growth for 5 years, leveling after that
    - 15% discount -> $16.7B current valuation
  - 10% growth for 10 years, leveling after that
    - 15% discount -> $25B current valuation
- Owner’s yield = earnings / (market cap + debt - cash) = earnings/EV
  - 2B / (8.4B + 2.5B - 3.5B) = 28%
- 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 WDC - included for completeness
- 10 P/Book - not a net net
- Altman Z score (http://en.wikipedia.org/wiki/Altman_Z-score)