An Industrial Goods Intermediary (XYZ)

XYZ is a company that supplies products to industrial and automobile companies. It is a subsidiary of a multinational company. XYZ is the most dominant player in its segment with a good brand name. Globally the parent company is also a dominant player in the segment.

Recommendation

We recommend that investors should buy this stock at current prices with a five year holding period. The growth potential is substantial while the stock is available cheaply. If the industry continues to grow at current rate the returns would be huge. Even if the growth moderates the returns would be substantial. We expect an annual return of 20 per cent during next five years from the current price. (17th December 2007)

Investment Thesis

- **Growth in industry and capital goods segment**: Growth in industry is fuelling demand for products of the company. This growth is expected to continue in near future. If the GDP continues to grow at rates of 6 per cent or more (very likely scenario) the industrial sector (including capital goods) would grow at a faster rate. Capital goods is another segment in which more investment is needed. Currently this segment is growing at a rate more than 10 per cent. The growth in this segment is again expected to sustain at may be slightly lower level. This growth would continue to fuel demand for company's products.
- **Strong brand equity, significant barriers of entry**: XYZ has a strong brand. The type of products it manufactures is not only critical but also made by only few others. The chances of too much competition in the segment are small. This is truer for higher end products it manufactures for heavy use. The margins for these products are higher.
- **Expansion plans and unfulfilled demand**: XYZ is going for huge expansion. In the first phase of expansion the production of existing products would increase by 50 per cent. In the second phase the production of high end products would start which would expand the margins. The current demand scenario is that the customers are asking for the products and the company does not have the required capacity for fulfilling the demand. This has lead to increase in pricing power of the company and higher margins.
- **Good corporate governance**: The corporate governance standards are good. The minority shareholders would stand to benefit in case profits increase. If the share prices remain low the investors can expect a buy back by the company.
- **Reasonable Valuation and high cash flow**: The valuation of the company is at moderate level. The stock trades at 15 times trailing twelve months earnings. In the current scenario that implies a profit growth expectation of around 5 per cent. The company is well placed to exceed that level. The expansion in capacity is being funded by internal cash flows. So there is no need of equity dilution.

Risks

- **Slowdown in economy**: The slowdown can reduce demand and pricing power of products. In case of sharp slow down of the economy capital goods demand would be most adversely affected. That situation can lead to slower growth (or even negative growth) for the company.
- **Overinvestment**: There is a risk of overinvestment. In case the production capacity becomes much higher than the demand the company will lose its pricing power.