Mossberg's Investor Digest

## From the Editor…

June 2018 Issue #120

Thank you for your subscription to Mossberg's Investor Digest.

Headquartered in Chicago, Tenneco, Inc. (NYSE:TEN) is a global leader in automotive ride performance (suspension, braking, etc.) and emission control products. TEN announced a two-stage strategic transformation in which it will acquire automotive powertrain and aftermarket parts supplier, Federal-Mogul from Carl Icahn. After the acquisition, which is expected to be completed this year, the combined entity will be separated into two sperate companies. One company will be focused on aftermarket parts and ride performance, and the other will be focused on providing powertrain technologies including emission controls and various combustion engine components. The split is expected to happen by the end of 2019, after the transaction clears various regulatory hurdles. Post-acquisition, Icahn will own approximately 36% of the combined company, but will only have voting shares that represent 9.9%. The remaining shares given to Icahn are non-voting.

The increase in debt will significantly expand coverage ratio to 3x (pre-synergies), up from 1.3x previously. Increased leverage, along with the transaction's complicated nature, as well as the 2-year time frame to complete the transaction are all likely causes for recent weakness in the stock. Since the transaction was announced, the stock has decreased in value by 21%, which we believe is an opportunity.

For 2018, the combined company is expected to produce $1.8 billion of Adjusted EBITDA (proforma and post-synergies). This yields a valuation for the combined entity of approximately 4.6x. We believe there is opportunity to expand the multiple by at least 1.5 turns in the coming 18-24 months as more details are revealed about the acquisition and the split. Value expansion should also increase as investors realize that the two separate companies are well-positioned for above industry growth.

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Every month we hear ideas suggested from our large network of professional investors. Here are a few of the ideas we heard this month, but have not reviewed in detail…

**Apollo Endosurgery, Inc. (APEN) -** Is a medical device company focused on less invasive therapies for the treatment of obesity, a condition facing over 600 million people globally, as well as other gastrointestinal conditions. Apollo's device based therapies are an alternative to invasive surgical procedures, thus lowering complication rates and reducing total healthcare costs. Apollo's products are offered in over 70 countries today and include the OverStitch™ Endoscopic Suturing System, the ORBERA® Intragastric Balloon, and the LAP-BAND® Adjustable Gastric Banding System.

**Universal Stainless, Inc. (Nasdaq: USAP)-** produces semi-finished and finished specialty steel long products and plate, including nickel alloy, stainless steel, tool steel and aircraft quality low alloy steels, in a wide variety of grades and product forms. Their products are sold to service centers, forgers, rerollers and original equipment manufacturers, and are further processed by their customers for use in a variety of industries, including aerospace, power generation, oil & gas and heavy equipment manufacturing.

**Perspecta Inc. (NYSE: PRSP)–** Armed with a portfolio of more than 260 patents, and unparalleled knowledge in the areas of cyber, cloud, analytics, mobility, advanced networking, systems engineering, machine learning, and agile software development, no one has an innovation engine as powerful as Perspecta. With a track record of exceptional performance, a legacy rich in accomplishment and a base of passionate and highly skilled employees, they have a deep understanding of their customers and their missions, and lasting relationships because of it.

**Methode Electronics, Inc. (NYSE: MEI)**- Offers over 500 cabinet styles for the remodeling and new home construction markets under four major brands: American Woodmark®, Shenandoah Cabinetry®, Timberlake® Cabinetry, and Waypoint® Living Spaces. AMWD sets the industry standard for fully integrated, just-in-time manufacturing. Renowned as an industry leader, they are admired for our award-winning cabinetry, state-of-the-art distribution network and steady corporate growth.

## Mossberg's Investor Digest Idea Performance

The table below shows the relative change in the value of the ideas published since September 2015 and the Russell 2000. **Performance data quoted represents past performance and does not guarantee future results.** Current performance of ideas may be lower or higher than the performance quoted.

| Company | Pub. Date | Original Price | Recent Price | Change | Russell 2000 Change Since Pub. Date | Relative Perf. vs. Russell 2000 |
|---|---|---|---|---|---|---|
| Calloway Golf Company (NYSE: ELY). | 30-Sep-15 | $8.39 | $18.99 | 126.3% | 49.5% | 76.9% |
| New Gold (NYSE: NGD). | 31-Oct-15 | $2.47 | $2.08 | -16.0% | 41.6% | -57.6% |
| Townsquare Media (NYSE: TSQ) | 30-Nov-15 | $11.43 | $6.46 | -43.5% | 37.3% | -80.8% |
| Build-A-Bear Workshop (NYSE: BBW) | 31-Dec-15 | $11.72 | $7.60 | -35.2% | 44.8% | -80.0% |
| Dycom Industries, Inc (NYSE: DY) | 31-Jan-16 | $62.18 | $94.66 | 52.2% | 58.9% | -6.6% |
| Rackspace Hosting, Inc. (NYSE: RAX) | 29-Feb-16 | $21.54 | $32.00 | 48.6% | 59.1% | -10.5% |
| Kopin Corporation (Nasdaq:KOPN) | 31-Mar-16 | $1.66 | $2.87 | 72.6% | 47.7% | 24.9% |
| PAR Technology Group (NYSE: PAR) | 30-Apr-16 | $6.39 | $17.69 | 176.8% | 45.5% | 131.4% |
| Full House Resorts Inc. (Nasdaq: FLL) | 30-May-16 | $1.60 | $3.24 | 102.5% | 43.0% | 59.5% |
| Control4 Corporation (Nasdaq: CTRL) | 30-Jun-16 | $7.99 | $24.33 | 204.5% | 42.8% | 161.7% |
| KapStone Paper and Packaging Corporation (NYSE: KS) | 31-Jul-16 | $14.28 | $34.50 | 141.6% | 34.8% | 106.8% |
| Ampco-Pittsburgh Corp. (NYSE: AP) | 31-Aug-16 | $11.12 | $10.35 | -6.9% | 32.7% | -39.6% |
| Select Comfort Corporation (Nasdaq: SCSS) | 30-Sep-16 | $22.51 | $32.50 | 44.4% | 31.4% | 13.0% |
| Northwest Pipe Co. (NWPX) | 31-Oct-16 | $13.16 | $19.45 | 47.8% | 38.1% | 9.7% |
| Mitel Networks Corporation (Nasdaq: MITL) | 30-Nov-16 | $7.25 | $10.97 | 51.2% | 24.4% | 26.8% |
| Black Box Corporation (Nasdaq: BBOX) | 31-Dec-16 | $15.25 | $2.05 | -86.6% | 21.2% | -107.8% |
| RadNet, Inc. (Nasdaq: RDNT) | 31-Jan-17 | $5.80 | $15.00 | 158.6% | 20.8% | 137.8% |
| Guidance Software, Inc. (Nasdaq: GUID) | 28-Feb-17 | $6.60 | $7.10 | 7.6% | 18.6% | -11.1% |
| Calgon Carbon Corporation (NYSE: CCC) | 31-Mar-17 | $14.25 | $21.50 | 50.9% | 18.7% | 32.2% |
| LRAD Corporation (Nasdaq: LRAD) | 30-Apr-17 | $1.51 | $2.60 | 72.2% | 17.5% | 54.7% |
| Trecora Resources (NYSE: TREC) | 31-May-17 | $10.65 | $14.90 | 39.9% | 20.1% | 19.9% |
| EVINE Live Inc. (Nasdaq: EVLV) | 30-Jun-17 | $1.00 | $1.23 | 23.0% | 16.2% | 6.8% |
| LSI Industries Inc. (Nasdaq: LYTS) | 31-Jul-17 | $8.38 | $5.35 | -36.2% | 15.4% | -51.6% |
| Cooper Tire & Rubber Company (NYSE: CTB) | 31-Aug-17 | $33.80 | $26.30 | -22.2% | 17.1% | -39.2% |
| RealNetworks, Inc. (Nasdaq: RNWK) | 30-Sep-17 | $4.78 | $3.68 | -23.0% | 10.3% | -33.4% |
| NCI Building Systems, Inc. (NYSE: NCS) | 30-Oct-17 | $15.65 | $21.05 | 34.5% | 10.3% | 24.2% |
| TransAct Technologies, Inc. (Nasdaq: TACT) | 30-Nov-17 | $13.60 | $12.35 | -9.2% | 6.5% | -15.7% |
| Regis Corporation (NYSE: RGS) | 30-Dec-17 | $15.36 | $16.55 | 7.7% | 7.1% | 0.6% |
| Team, Inc. (NYSE: TISI) | 30-Jan-18 | $16.95 | $23.10 | 36.3% | 3.9% | 32.4% |
| Andina Acquisition Corp II (Nasdaq:ANDA) | 28-Feb-18 | $9.85 | $8.60 | -12.7% | 8.8% | -21.5% |
| GSE Systems, Inc. (NYSE:GVP) | 31-Mar-18 | $3.25 | $3.20 | -1.5% | 7.6% | -9.1% |
| Telaria, Inc. (NYSE:TLRA) | 30-Apr-18 | $4.13 | $4.05 | -2.1% | 6.7% | -8.7% |
| Avaya Holdings Corp. (NYSE:AVYA) | 31-May-18 | $21.57 | $20.05 | -7.0% | 0.7% | -7.5% |
| | | | **Average** | **36.3%** | **26.0%** | **10.2%** |

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**Best Idea Profile:** **Tenneco, Inc. (NYSE:TEN)**

## DESCRIPTION:

Headquartered in Chicago, **Tenneco, Inc. (NYSE:TEN)** is a global leader in automotive ride performance (suspension, braking, etc.) and emission control products. The Company announced a two-stage strategic transformation in which it will acquire automotive powertrain and aftermarket parts supplier, Federal-Mogul from Carl Icahn. After the acquisition, which is expected to be completed this year, the combined entity will be separated into two sperate companies. One company will be focused on aftermarket parts and ride performance, and the other will be focused on providing powertrain technologies including emission controls and various combustion engine components. The split is expected to happen by the end of 2019, after the transaction clears various regulatory hurdles.

Post-acquisition, Icahn Enterprises will own approximately 36% of the combined company, but will only have voting shares that represent 9.9% of the total. The remaining "Class B" shares given to Icahn in consideration of the transaction are non-voting. The acquisition also comprises about $4 billion of assumed debt, which combined with a cash consideration of $800 million and the equity value at today's stock price yields an EV/EBITDA multiple of about 8.1x and 6.4x, pre- and post-synergies, respectively.

The $4 billion increase in debt will significantly expand coverage ratio to 3x (pre-synergies), up from 1.3x previously. Increased leverage, along with the transaction's complicated nature, as well as the 2-year time frame to complete the transaction are all likely causes for recent weakness in the stock. Since the transaction was announced on April 10, the stock has decreased in value by 21%, which we believe is an opportunity.

**Tenneco, Inc. (NYSE:TEN)**
Investment Data (as of 6/30/18)

| | |
|---|---|
| **Recent Price** | **$43.96** |
| 52-Week Range | $43.43 - $65.59 |
| Fiscal Year End | December |
| Dividend | $1.00 |
| Yield | 2.0% |
| | |
| Shares Outstanding* | 80.9 M |
| Average Trading Volume (3 mos) | 644,000 |
| | |
| Market Capitalization* | $3.6 B |
| Cash & Equivalents* | $778 M |
| LT Debt* | $4.8 B |
| Enterprise Value (EV)* | $8.3 B |
| | |
| 2017 Proforma Value-Add Rev* | $14.9 B |
| EV/ Revenue | 0.6x |
| | |
| 2017 EBITDA* | $1.8 B |
| EV/ EBITDA | 4.6x |

*proforma - post acquisition

For 2018, the combined company is expected to produce $1.8 billion of Adjusted EBITDA (proforma and post-synergies) and carry leverage of approximately 2.6x. This yields a EV/EBITDA valuation for the combined entity of approximately 4.6x. We believe there is opportunity to expand the multiple by at least 1.5 turns in the coming 18-24 months as more details are revealed about the acquisition and the split. Value expansion should also increase as investors realize that the two separate companies are well-positioned for above industry growth.

## KEY INVESTMENT CONSIDERATIONS:

### Growth Driven by secular trends

The newly created companies will be well positioned to benefit from transformation in the automotive industry. Several secular trends are likely to help shield the company from downturns in the economic cycle. Key trends include:

**Aftermarket Growth –** According to McKinsey, the global aftermarket industry is expected to grow at a rate of 3% annually through 2030.

- **Vehicles are built to last longer** - According to an IHS Markit, the average age of the U.S. vehicle fleet has increased 17% in the last ten years and the average length of vehicle ownership for new and used vehicles has increased 60% in the last ten years.
- **Growth will be driven by Asia –** The average age of vehicles in China is 4.5 to 5 years, which compares to 11 to 12 years for the average in the U.S. and Europe. As cars in Asia age, the market for automotive aftermarket parts in will increase at an annual rate of 8.1% in China and 6.5% in the rest of Asia, according to McKinsey,
- **Significant scale and scope –** After the Split, the Aftermarket and Ride Performance Company will be one of the largest multi-line, multi-brand aftermarket company in the world with approximately $3.6 billion in aftermarket part sales. The new company will already have established brands and distribution globally with 12% of sales from APAC, 37% form EMEA an 51% from North America.
- **Leading brands in aftermarket** – The Aftermarket and Ride Performance company will have the #1 position globally in suspension systems under the MONROE brand. In addition, the company will have leading positions in steering components, gaskets, brakes, ignition, emission controls with brands such as MOOG, WAGNER, CHAMPION, and WAGNER, among others.

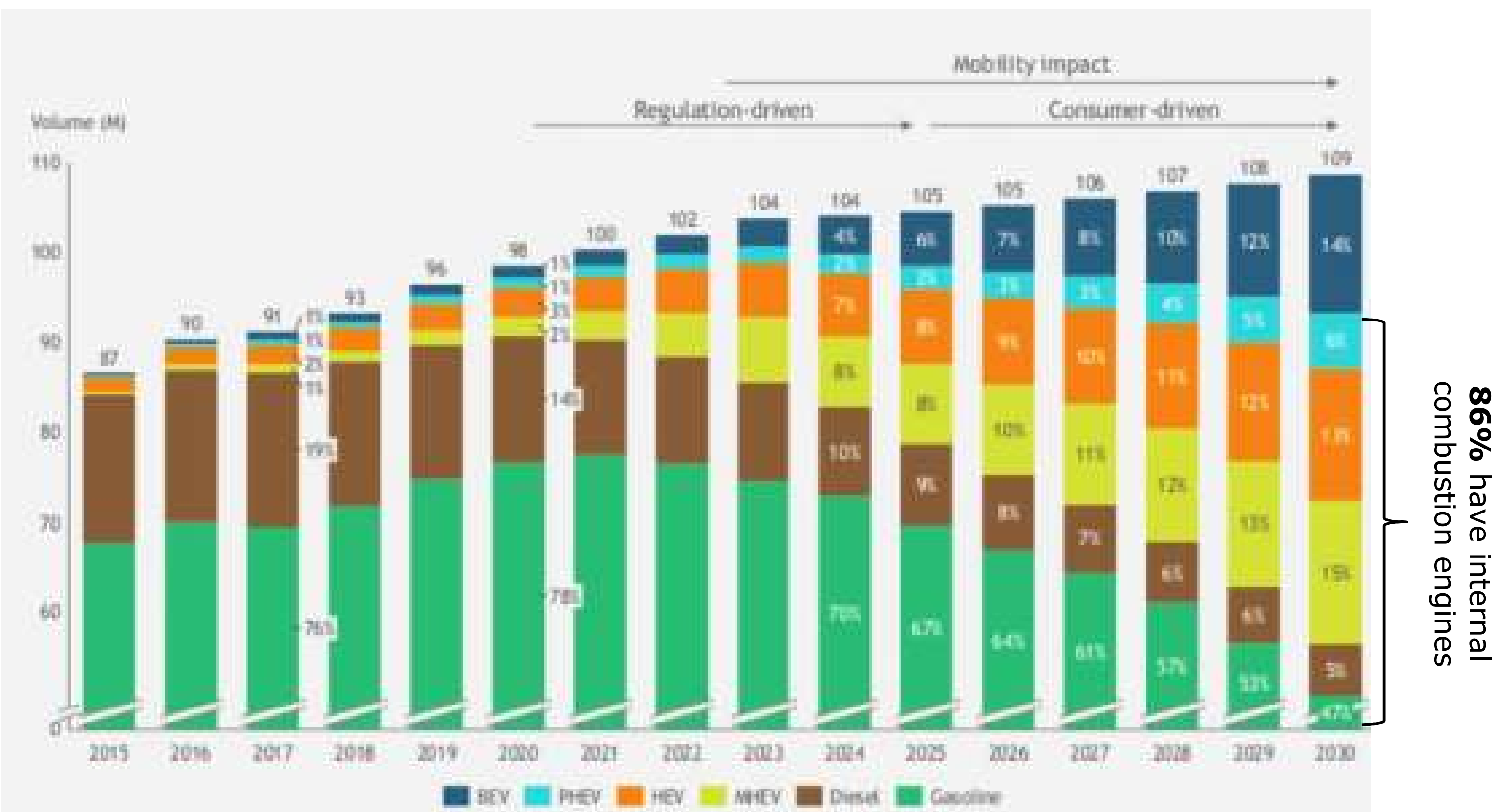
**Strengthening/Tightening of emissions regulations around the world –** In the U.S. and Europe an increasing number of commercial truck and off-highway powertrains have come under emission and fuel economy regulation in recent years. In the APAC region regulations are 8 to 10 years behind, but are likely to rapidly catch up, as that part of the world deals with increasingly polluted air.

- **Combining combustion and emission control technology to offer systems solution and take share -** There is a tradeoff between tuning an engine for efficiency and reducing emissions. The better an engine is tuned for efficiency, the dirtier the output of the exhaust gas and the more cost for emissions components. And, visa versa, the more an engine is designed for clean air, the less efficient it is. The advantage of combining combustion and emissions technologies is that offering a systems solution can help the manufacture optimize for efficiency and clean air requirements. This advantage will be particularly important in helping the company gain market share in Asia and the commercial truck markets, as manufactures in these markets have not necessarily built up the systems capability on their own.

## KEY INVESTMENT CONSIDERATIONS:

**The reports of the death of the internal combustion engine are greatly exaggerated** – While electricity will continue to grow as a source of power in vehicles over the next 12 years, the internal combustion engine will continue to play the major role in power generation for automobiles for decades to come. In fact, there will be more internal combustion engines produced in 2030 than in 2018, according to the Boston Consulting Group. The chart below shows that the growth of Battery Electric Vehicles (BEV) will only represent 14% of the global vehicle market by 2030. Hybrids in multiple flavors, standard, Plug-in, and Mild; will grow to 34% of the market during that time period. Importantly for Tenneco and the new Powertrain Technology Company, each hybrid will still require an internal combustion engine and will still need to comply with increasing clean air regulations.

- **Light vehicle hybridization increases content per vehicle –** With hybrids, about 1/3 of the total body length is taken up by a battery pack, so all the post activity from emissions (noise reduction, thermal management, exhaust scrubbing, etc.) has a shorter distance to take place. This directly translates into high content per vehicle of approximately 10 to 15%.




Source: Boston Consulting Group

## KEY INVESTMENT CONSIDERATIONS:

**The Growth of intelligent suspensions is accelerating -** Today intelligent suspension technology is present on about 3% to 4% of vehicles…. By 2025, it is estimated to be in about 15% of vehicles. Importantly this rate does not assume any increase in adoption of autonomous vehicles. Active suspension requires about 4x the content of a normal suspension, or about $200 to $250 per vehicle. The Company has wins with 10 new intelligent suspension programs this year, with 7 that are incremental. There are 11 new programs next year, 6 that are incremental.

- **Systems approach will enable market share gains in intelligent suspensions –** Following the acquisition, the Aftermarket Parts and Ride Suspension Company will be better positioned from a system capability in the intelligence suspension space. The combination of Tenneco's leading position in shocks, struts, and NVH/ elastomers combined with Federal Mogul's leading position in suspension and braking, will give the combined company a full suspension corner capability that will be important to capture market share in the intelligent suspension space.

**Strong Historical Financial performance –** The Company has consistently outpaced the industry, growing revenue, mostly organically, at nearly twice the rate of light vehicle production. Over the last several years, the company has also expanded margin by 300 basis points and delivered top decile performance in ROIC. The five-year average ROIC is 22.8%.

## Valuation

| | 2017 | 2018 | 2019 |
|---|---|---|---|
| **Aftermarket & Ride Performance Company** | | | |
| Revenue | 6,400 | 6,592 | 6,790 |
| Revenue Growth | | 3% | 3% |
| EBITDA | 710 | 659 | 679 |
| EBITDA Margin | 11.1% | 10.0% | 10.0% |
| **Powertrain Technology Company** | | | |
| Revenue | 10,700 | 10,914 | 11,132 |
| Revenue Growth | | 2% | 2% |
| EBITDA | 1,110 | 1,091 | 1,113 |
| EBITDA Margin | 10.4% | 10.0% | 10.0% |
| Combined EBITDA | 1,820 | 1,751 | 1,792 |
| FCF | | 525 | 538 |
| Debt | 4,800 | 4,275 | 3,737 |
| Cash | 780 | 780 | 780 |
| EV/ EBITDA Multiple | | | 6 |
| EV | | | 10,753 |
| Market Cap | | | 7,796 |
| Shares Outstanding | | | 81 |
| **Share Price** | | | **$ 96.25** |

Our back of the envelop model above makes the following assumptions:
**Revenue:** We assume a 3% revenue growth in the Aftermarket & Ride Performance Company and 2% growth for the Powertrain Technology Company. Given the growth characteristics of these businesses, we believe these are conservative assumptions.
**EBITDA Margin:** We assume a 10% adjusted EBITDA margin for both businesses for the next two years. This is below the proforma numbers given by the company, but within recent historical performance.
**Free Cash Flow:** We assume approximately 30% of EBITDA is converted into Free Cash Flow.
**Valuation:** We assume FCF is used to pay down outstanding debt balances and use a 6x multiple of 2019 enterprise value to derive a $10.8 billion combined value. Working backwards from enterprise value, we calculate a share price of $96.25 per share, which represents more than 100% upside from current levels.

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The value proposition of the digest is essentially an "Idea Generator". During the course of my 18-year career in capital markets, I've had the chance to meet and work closely with some very smart professional investors who have consistent track records of outperforming the market indexes. Some of these investors, which include mutual fund managers, hedge fund managers, and other professional investors, are kind enough to share their best ideas with me. I conduct my own analysis of their ideas and publish summaries of those ideas I think represent timely investment opportunities. Over time, I trust the majority of these ideas will pan out and help subscribers generate index-beating returns.

The goal of the Best Idea Profiles in this newsletter is to briefly describe the most relevant investment merits and risks of a company.  It is not intended to be an exhaustive report including every detail.  With limited space available, I am forced to include only those data points that I feel are most important for subscribers to know before they begin their own due diligence.  Thank you for your interest in Mossberg's Investor Digest.

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