LSB Industries (LXU)

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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

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 - business (cont'd)

LSB Industries – Misc thoughts

- What can go wrong?
  - No housing recovery – HVAC sale losses
  - Alternative HVAC sysems – 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:
  - 2009: 14 2010:16 2011:28
- 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)