VSE Corporation (VSEC)

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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

VSE Corporation - business

- Logistics, engineering, legacy equipment sustainment, information technology (IT), construction management, and consulting services for US Government agencies

VSE Corporation – business (cont’d)

VSE Corporation – Misc thoughts

- What can go wrong?
  - Less government and military contracts, lower reimbursement and margin rates on contracts
  - Quote from 10K: "While our largest contract, the Rapid Response (“R2”) Program, is scheduled to expire in January 2011, we expect to continue our work on existing task orders under such contract through that time, however, specific task orders under the R2 contract will expire intermittently prior to the expiration date of the contract. We have submitted a bid for a follow-on to this contract that is currently under evaluation by our U. S. Army customer. However, we cannot determine revenue levels precisely even if we are awarded a follow-on contract." Have they obtained a follow-up contract? If not, how much this will affect them in 2011?
- Opportunities:

Strategic considerations

- Moat (*switching costs, habit, low cost*):
  - What are the moats? Washington connections, not much
  - What does it take to sustain the moats? N/A
  - Bargaining power of suppliers/customers? Government agencies have huge bargaining power
- Is it a low risk business? No.
- Is there high uncertainty? Yes
- How capital intensive is the business? Not really
- Future growth – unknown
- Are the revenues and cash flows of the business sustainable or overstated / understated due to boom or bust conditions? Not clear

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

Is it a good business?

- >10 year history of profits
- ROE:
  - 2008:25 2009: 23.7 2010 9mo: 20.97
- Margins
  - 2008: 1.8 2009:2.3 2010:2.8
- Growing earnings: 3 year sales growth 10%, earnings growth 21%
- No dilution
- Strong balance sheet
  - Practically no debt
- ROIC = Earnings / (Equity + Debt – Cash) = Earnings / (Assets – non-debt liabilities - Cash)
  - ~= ROE

Is it a good business? Cash flow

- Somewhat weak cash flow
  - 2010 9 mo 18M earnings, 10M operating cash flow, 5M FCF (FCF = OCF – capital expenditures)
  - Free Cash Flow/Share higher than dividends paid

Is business cheap? - Buffettology calculations

- ROE 20%
- Earnings in 10 years = ROE*Equity*$(1+ROE)^9$ = $123M
- Equity in 10 years = Equity*$(1+ROE)^9$ = 614M
- Market cap = 123M x P/E (15) = $1.8B
- Rate of return = ~25% after tax (calculations omitted) (17% assuming 15% ROE)

- 9 year earnings growth: 40%. Assuming 15% earnings growth: 25% share price growth.
- Not clear if the recent performance can be repeated for 10 years either in equity or earnings

Is business cheap? DCF

- Discounted cash flow
  - Current earnings of ~25M
  - 10% growth for 5 years, leveling after that
    - 15% discount -> $243M current valuation (if you buy company at <$243M, you will get 15% return or higher)
  - 5% growth for 10 years, leveling after that
    - 15% discount -> $224M current valuation
  - 15% growth for 10 years, leveling after that
    - 15% discount -> $416 current valuation
- Owner's yield = earnings / (market cap + debt - cash) = earnings/EV
  - 25M / (164M+20M-2M) = 13.7%

- What makes up the margin of safety? Low valuation
- Is there a sufficient margin of safety? Not clear

Is business cheap? – Graham investment considerations

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