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)

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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)