

Ti Fluid: Brake and Fuel Lines Leader Undervalued due to Share Overhang

José Antonio Larraz of Equam Capital presented his in-depth investment thesis on Ti Fluid Systems (UK: TIFS) at European Investing Summit 2018.

Thesis summary:

Ti Fluid Systems is a leading supplier of fluid systems to automotive OEMs. It is the number-one global supplier of brake and fuel lines and number-three supplier of plastic fuel tank systems. The company operates in a global, niche business with strong market share and high barriers to entry, which are reflected in the company's high profitability (14% EBITDA margin) and return on capital employed (above 20%). Management has extensive industry experience, with the CEO having worked in the automotive industry for more than forty years. TIFS shares recently traded at a large discount to comparable auto suppliers (4.5x EV/EBITDA and 10+% FCF yield) due to a potential share overhang from the majority shareholder and the risk of transition to electric vehicles. However, electric vehicles are likely an opportunity rather than a threat as the company's addressable market could be significant higher in the coming years.

The following transcript has been edited for space and clarity.

Allow me to start with a brief introduction to Equam Capital. It is a management firm focused on investing in European companies, mainly with a very long-term approach. We leverage our past experience of investing in unquoted companies, where we collaborated closely with the management teams through being members of the board and helping the companies execute their strategic plans.

We invested in those companies for five to seven years, so we are used to being long-term investors. We really understand that in order to create value, you need to be patient. We took all of the experience from our private equity period and put it into this fund. Right now, we are trying to take advantage of what we believe is, on many occasions, the short-term view of the market. We are patient and look for companies we believe to be trading at low valuations for various reasons.

The companies we like have four main characteristics. First of all, they have good businesses, suggesting there is a barrier to entry. At the same time, we like businesses which are not growing too much because they would otherwise attract new competitors into the market. We don't like businesses which are not doing well or have structural problems. Mainly, we look for what we call boring businesses, but ones with a competitive advantage. The second main characteristic is that we don't like to invest in companies that have too much leverage. Second, we avoid companies with too much leverage. Since we are patient investors and need time, too much leverage can, in some situations, play against us. The third characteristic we look for is a management aligned with the rest of the shareholders. We traditionally like family-owned companies run by managers who own stakes in the business. Finally, we look for companies trading at attractive valuations. To get companies at attractive valuations, you need to buy when people are selling, to be contrarian, or to buy companies that are well-known to the market but, for whatever reason, people are not thinking about that investment.

The focus of my presentation is a company we believe to have these characteristics. Of course, it's difficult to find a company that matches all criteria, but we need to find situations where there is a good equilibrium among these four traits. TI Automotive (TI Fluid Systems) is a UK company based in Oxford, with a market cap of around €1.1 billion. It is a leading supplier of fluid systems to automotive manufacturers. TI has 118 manufacturing plants in 28 countries and 28,000 employees, with a presence in all the major automotive markets. The company had revenues of €3.5 billion and EBITDA of around €491 million EBITDA in 2017.

TI has two main divisions. One focuses on manufacturing and supplying brake and fuel lines. The company is a clear leader in this segment with a market share of 35%. The second division deals in fuel tank and delivery systems, where the company is among the top three players globally, with a 15% market share. With almost 100 years of history, present-day TI is the result of the merger of Tube Group and Smith Industries in 2000.

In recent years, the company has been in the hands of several private equity players. One of them acquired it in the early 2000s, but it put too much leverage in the company, so when the crisis came, TI found itself in a really difficult financial situation. Bain Capital bought the company in 2007 and decided to IPO it at the end of 2017, opting for a capital increase that raised around €360 million. The money was mostly used to reduce the company's debt. Bain Capital is still the major shareholder. It had over 60% after the IPO, but it sold another stake in the summer of 2018 and currently owns 54% of the company.

At present, the fluid carrying systems division represents 59% of TI's business, and 41% of the revenues come from fuel tank and delivery systems. In terms of market segments, the company is mainly focused on light vehicles, with 88% of revenues coming from there. It also has a small share in heavy trucks and aftermarket.

One important characteristic of TI Automotive is its strong diversification in terms of geographies. The company is more or less evenly split between Europe, North America, and Asia, with Europe having a slight lead with 37%. North America accounts for 27%, and Asia contributes 28% of the revenues, with China being an especially important market and one where the company has been present for many years. There is also strong diversification in terms of customers.

The fluid carrying systems is a market worth around €6 billion. TI is the clear leader, the other two big players being US-based Cooper Standard and Japan's Sanoh. The rest of the market is split among many smaller regional players. In this division, TI makes three main products: brake and fuel lines (the connectors and tubes related to brakes), thermal products (those used in vehicle air conditioning and heating systems), and powertrain products (gasoline and diesel lines, and cooling and lubricant fluid systems). Historically this division has delivered organic growth consistently well above market levels, as well as strong and consistent profitability over the 2014-2017 period.

The fuel tank and delivery systems unit has two main products: fuel tank systems (TI does the plastic variety) and pump and module systems. The company has a strong market position in this segment as well, but not as strong as in the other division because there are two bigger players here, Inergy and Kautex. This division has benefited greatly in recent years by a shift from steel to plastic fuel tanks. Since TI produces plastic fuel tanks, the change has allowed the company to grow significantly. Also, because of operational leverage, it has been able to improve the profitability as it gained more business. However, we need to be aware that around 28% of the market is still using steel fuel tanks, so there is ample room for further growth, even above-market growth.

One of the worries in relation with this company is what will happen to it amid the ongoing transition to hybrid and electric vehicles. After our due diligence, we strongly believe it will benefit from this trend. Today, the estimated content per internal combustion engine vehicle is €200 on average, of which around €100 corresponds to fluid systems and €100 to fuel tank products.

With hybrid cars, the content per vehicle for TI Fluids will increase significantly because these cars have the same combustion system as traditional vehicles plus battery-related components which will bring additional products for the company. On the combustion part of the hybrid vehicle, the additional content will come from the need to have higher value-added, specialized fuel tanks to protect all the electric parts of the car. In the electrical car, you also need additional cooling and heating systems for the batteries.

As regards electric vehicles, the company will obviously lose business related to the fuel tank products. But at the same time, we believe there will be additional thermal products to compensate for this loss. TI estimates it would have around 2x the content it has now per a combustion vehicle. With hybrids, we are talking up to 3.5x more content compared to traditional vehicles.

What does this mean for the future development and the potential market of TI Fluids? According to IHS, the well-known consulting firm for the automotive sector, the addressable market for TI Fluids will go from around €18 billion at present (€8 billion corresponding to fluid systems and €10 billion to fuel tanks) to around €31 billion. The reason is that the content of the hybrid vehicle, which is the faster-growing market, is much higher than the current content, and this increases the addressable market. Even if we go with 25% less hybrid or electric vehicle penetration or scenarios where electric vehicles develop much quicker than expected, the addressable market will be far larger than the current market. Therefore, the electric and hybrid vehicle transition should be a big opportunity for a company like TI Automotive.

The global automotive market is a cyclical one. If we look at historical trends, it has constantly been growing, but the fact remains that it is cyclical. We believe there are several trends with a positive effect for TI. The first one is the increase in regulatory requirements to reduce emissions and increase fuel economy. The second big trend is the constant increase of global platform standardization and the move of OEMs away from regional platforms. This is a trend that favors companies with a global footprint, such as TI Automotive. Because of it, they can gain market share at the expense of more regional suppliers. Finally, while it's true the market is cyclical, when you have a global presence, you can compensate for the maturity of certain markets through growth in other parts of the world. Besides, we need to consider that there is huge growth potential in emerging markets, where the number of vehicles per 1,000 inhabitants is much lower than in the mature occidental markets. TI has a solid presence in those segments and should benefit from the strong growth potential of Asia.

What do we like about this company and why do we believe this is a good investment opportunity? First, we are talking about a company with market-leading positions in niche markets. These small niche markets have significant barriers to entry. There are products critical for good vehicle performance and compliance with the recent regulatory requirements. There are not many players able to supply these kinds of products.

Second, TI's current management team has been in place for 10 years. These managers came in when the company was hit with financial problems in 2007. It's the management that did the initial restructuring and has achieved the strong performance of recent years.

Moreover, we see the electric and hybrid vehicle transition as an opportunity rather than a threat, and the addressable market will grow over time because of this.

We also have a company with a long-established presence in China and one truly unique characteristic – 100% ownership of the subsidiary in China. Traditionally, China doesn't allow it and always requires of foreign companies to have a local partner. However, TI Automotive has been in the country for many years, long before this department was in place, and it now has a 100% subsidiary in China and 18 manufacturing plants. Since it also works for Chinese manufacturers, it gets access to the local market.

Besides its global footprint and good relations with most OEMs, TI has high profitability, with margins well above those of other auto component suppliers. We believe it also has a quite flexible cost structure because first, 67% of its employees are located in low-cost countries, and second, it has high cost flexibility in terms of labor, with many temporary workers. Moreover, we see quite a strong pricing power because the products it makes have high value added and are critical components for automobiles.

Another notable thing is the strong cash flow generation capacity of the company. Its capex needs are relatively small – we are talking about 4% of revenues and quite consistent over time. The networking capital needs of the business are also quite modest because the company has 118 manufacturing plants, which puts it very close to its customers and keeps inventory levels low. Working capital is around 8% of revenue versus 15% or so for other auto component manufacturers. All of this means that 1) the free cash flow generation of the company is really strong, and 2) the return on capital employed is significant, consistently above 20% through the years. Another important thing related to the free cash flow generation is that the company deleveraged sharply after the IPO in December 2017, so it has greatly reduced its interest expenses, which should improve the free cash flow generation capacity in the years ahead.

This is a company with a strong financial performance, consistently delivering organic growth due to three factors: the rise in content per vehicle, the increased use of global platforms by automotive manufacturers, and a strong presence in emerging markets. In addition to growing revenues organically, the company has been significantly improving its operating profitability. This is the result of operational leverage and a strong production efficiency program the current management put in place after the restructuring process in 2008 and 2009.

Let's turn to the valuation because this is one of the reasons we decided to invest in this company. We consider TI Automotive a quality player and much better than many automotive components manufacturers. However, it is trading at a significantly lower valuation than other players. We have compared it to two similar companies. Norma also has returns on capital employed significantly higher than the rest of its peers because, like TI Fluids, it manufactures critical components, which gives it pricing power and generates higher margins. In the case of Norma, we are talking about margins of 19%, even higher than what we see with TI Fluids. Nevertheless, the return on capital employed is lower for Norma because TI Fluids has low working capital needs. Norma is trading at almost 10x EBITDA versus less than 5x EBITDA for TI Fluids. Cooper Standard is one of the competitors in the fluid systems segment. This company has lower profitability and much lower return on capital employed, the main reason being that it has other divisions with products less profitable than fluid systems products. Cooper's EBITDA margin is around 11% versus 14% for TI Fluids, and the return on capital employed is half what TI Fluids achieves. Despite this, it is also trading at significantly higher multiples than TI Fluids.

TI Fluids is greatly undervalued, in our opinion. We did a simple evaluation exercise, taking the average free cash flow generated by the company in the last four years (around €150 million) and excluding the working capital because TI had some additional working capital needs as it was growing. We also went with a 7% free cash flow yield, which is reasonable for a company like this given the cyclicity of the business. Thus, we reached a valuation of around €4.25 per share, whereas the company is currently trading at €2.2 to €2.3. This means we have an upside of around 92%. The implied valuation, also taking the average EBITDA in the last four years, would be 7.5x EV/EBITDA. If we take the numbers for 2018, the valuation we get is much higher, but we believe it's more conservative to use the average for four years since this is quite a cyclical business.

The big question is why this company is trading at a discount to peers even though it is of good quality. There are some good reasons justifying this. First, this is a recently IPO-ed company, so there isn't much public quoting history. Also, it was IPO-ed mainly by US brokers but is traded in the UK (therefore, in pounds) while reporting in euros. The headquarters are in Oxford, but all the management and the corporate office are in the US, in Michigan. It's the kind of complex situation that could justify the current low multiples.

Another reason the company is cheap is concern in the investment community over the electric and hybrid vehicle transition. To us, this is not a good reason, and our due diligence points to the transition being more of an opportunity for the company than a threat.

Finally, investors might be uncomfortable with Bain Capital still owning more than half of the company. It will probably continue to sell in the future, so some investors seem to be worried about an overhang in the stock. We are never worried about this; our concern is the value of the company. If somebody sells and the stock goes down, we will buy more.

As for the investment risks, we could start by noting the cyclicity of the business. Regardless, we think certain trends in the industry are playing in favor of TI Fluids – global platforms, presence in emerging markets, and the critical products it supplies are very important in the context of stricter regulations on emissions. The risk of lower-than-expected content in electrical vehicles is not on our list because we see this as an opportunity, but it still needs to be proved in the future. The company has started getting certain programs and contracts in the hybrid and electric vehicles space, and as it gets more, the investor community will become more comfortable. Regulatory risk is always present in the automotive sector. As for raw material prices, the company is using mostly steel, aluminum, and some resins. It has been consistently able to pass that to its customers, but there is always some time delay, so in the short term, it could suffer a huge and rapid increase in raw material costs. Finally, there is the foreign exchange risk, but we should take into account the good match between revenues and costs because the company has 118 manufacturing plants.

In summary, this company fits into our investment criteria for several reasons. First, it flies under the radar and has low coverage and a complex situation. We believe this is a sound business operating in a niche market with a high market share, making products which are critical for automotive manufacturers. Regarding leverage, the company is at 1.8 x net debt to EBITDA, which is not too high but is still higher compared to other peers. There are two important things to note here. First, the company has no financial covenants on its existing debt facilities, which helps. Second, it has impressive free cash flow generation capacity. This is a company which traditionally has not done any M&A, so it doesn't do inorganic development. In the last 10 years, it has made only one acquisition, buying a US business for €125 million, which is not significant. M&A is not on the management's agenda – the

leadership is dedicating the entire free cash flow to reducing the leverage. It should come down closer to 1x between this year and next year.

With regard to this being an owner-occupied business, it's true that the largest stockholder, Bain, is selling. But it's also true that management has been with the company for 10 years and has a 2.5% stake in the company, which is not insignificant for a €1 billion enterprise. This provides certain comfort about the alignment of the management team with the rest of the shareholders.

In terms of valuation, the company is trading at about 10% free cash flow yield, much lower than the rest of its peers despite its better quality.

The following are excerpts of the Q&A session with Jose Antonio Larraz:

Q: Capital allocation is always a topic of importance to value investors. Would you like to see the company bring down leverage or would you rather it prioritized other things to do with the cash flow?

A: My management and I agree that the current priority should be to reduce leverage. We are not particularly worried with 1.8x, but given the cyclical nature of the business, the company should be utilizing most of the free cash flow to reduce leverage. M&A is not part of its strategy, and it can continue to grow organically above the market without acquisitions. In terms of capex, it has a lot of regional capacity, so it doesn't need to make extraordinary capital investments to cope with future growth. We believe the company will and should be using the cash flow generated to reduce debt.

Q: Can you elaborate a bit more on the competitive landscape for automotive fluid systems and the specific competitive advantages of TI Automotive?

A: There are three top players in each of the segments where the company operates. In fluid carrying systems, TI is the clear market leader with a 35% share of the market, and there are two other big players. The rest are regional operators which have and will consistently lose market share because automotive manufacturers are looking for companies that can supply them on their global platforms. For that, you need to be on all continents, which is hard to achieve for a regional player. In the case of fuel tank and delivery systems, the situation is similar although it's true there is a little more competition and some other players apart from the top three. That, of course, affects the margins.

Q: For someone who would like to track this idea over time, what would be the key data points to keep an eye on?

A: The big question is how the company is developing and what contracts it is getting for hybrid and electric vehicle products. In 2018, it announced its participation in two important programs for hybrid and electric vehicles, but we need to see more of that to determine with certainty that the transition is an opportunity for the company. We strongly believe this is the case, but it still needs to be proved. The more contracts the company wins, the better the visibility will be.

Q: Could you shed a little more light on the management's incentives and how comfortable you are with them?

A: Since the management owns a 2.5% stake, this gives us some comfort because it's not small money. Second, the company has a long-term incentive plan aligned to the

performance of the stock and certain key performance indicators such as the cash flow and EBITDA. Although we know companies with a stronger alignment, this is sufficient for us in this case.

Q: Could we do a bit of a postmortem? Let's say we meet again in two or three years, and the idea has not worked as expected. What would you think might be the culprit?

A: The main risk for the next two or three years is a big downturn in the automotive sector dynamics. If there is a sharp drop in automobile production in the coming years, the company is going to suffer. But even then, we believe it will continue to generate good cash flow, and the current low valuation will give us a certain margin of safety, allowing us to go through that period. Our experience shows that in a down automotive cycle, companies with a clear market position come out reinforced from these situations, while the smaller players with lower-quality products are the ones that suffer. In such a scenario, we need to be more patient – instead of being three or four years in the company, we might need to hold it for five or six years.

About the instructor:

José Antonio Larraz is a founding partner of Equam Capital. Jose has 12 years of experience as a partner in Capital Alianza Private Equity, investing in Spanish private companies in the middle market. He has investment experience in chemical, food, retail, outsourcing and telecommunications sectors, having participated in the board of directors of six different companies. Jose has 4 years of experience in financial advisory, corporate finance and M&A at Lehman Brothers in London and New York and He is a Professor at Instituto de Empresa since 2008. Jose holds a degree in Law and Business Administration from ICADE University and MBA from Insead.