This article by Matthew Haynes is excerpted from a letter of 1949 Value Advisors, an absolute return-oriented global value investment firm based in Mahwah, New Jersey. Matt is a valued contributor to The Zurich Project.

Matt will share his thesis on Smart Sand at Best Ideas Omaha 2018.

Smart Sand, Inc. (SND) is a leading supplier of industrial sand primarily serving customers in the oil & gas industry. Headquartered in The Woodlands, TX, Smart Sand is a pure play, low-cost producer of high-quality Northern White raw frac sand (NWS). Raw frac sand is a proppant, "designed to keep an induced hydraulic fracture open, during or following a fracturing treatment". (Wikipedia) It is added to water to create a fracturing fluid which is then blasted down the well bore at very high pressure to "prop open" the fracture once the pumps are shut down, allowing release and capture of hydrocarbons.

Smart Sand is one of only five publicly traded pure play frac sand producers (in aggregate, representing ~50% of industry capacity). The company has one producing mine in Oakdale, WI adjacent to the Canadian Pacific railroad, well situated to supply its Northern White sand to any of the shale plays in North America. Logistics is one of the most important considerations in this industry, as transportation costs are a significant component of production costs (~40%) and contracts are typically priced on a delivered basis.

Recent plans to initiate frac sand production within the Permian basin, thus dramatically reducing the transportation cost element, has worried frac sand investors that NWS producers will be priced out of the market. Permian brown sand is considered to be of lower quality than NWS and uncompetitive without a logistical advantage.

In addition, Permian frac sand is a captive market, with no alternative homes outside the Permian basin. These imply that supply growth will likely undershoot announced nameplate capacity plans, limiting the negative impact to NWS pricing.

With a market cap of $225 million and net cash of $34 million, shares traded near $5.50 at the time of our purchase, down from $20 a year ago. Representing ~5.5x current year EPS and 4x EBIT (4.7x and 3.7x 2019 estimates, respectively), we believe that we have a margin of safety against permanent loss.

The sector has seen consolidation activity, with EV/ton of productive capacity being the most relevant metric in frac sand transactions. Deals have been in the range of $100-120/ton, versus the current valuation of Smart Sand closer to $40/ton.

We believe that SND could be an attractive target for larger frac sand companies, oil field services companies looking to vertically integrate, or a larger shale oil & gas producer looking to secure reliable supply of its higher quality NWS.

The reversion to a more appropriate trading multiple over time is likely to be our surest path, with takeover interest potentially catalyzing its higher private market value.