ON BEYOND INVESTING

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IDEA: Macro Enterprises

Macro Enterprises Inc. | MCR			
Share price:	2.13	P/E:	n/a
Market cap:	64.75mil	P/B:	0.78

In investing, there are two basic ways to value a business. First, you can put a price on all the assets the company has and then subtract the debt or liabilities. Second, you can place a value on its current and future cashflows. Some situations require a hybrid approach with different company divisions valued with different approaches. But really, those are the two valuation methods.

When valuing the assets, you are essentially trying to figure out what value would be left if you were to shut down the business, sell off the assets and pay down the debts. Usually the prudent approach is to haircut the assets by some amount. The reason for the haircut is to reflect the costs of liquidating, such as legal costs, taxes etc. Further, if it is known you are liquidating you may not get full price for your assets.

Let's apply these two valuation approaches to Marco Enterprises. But first a bit of background about this company.

Macro is a BC based pipeline building, maintenance and servicing company. Large pipeline companies like TransCanada Pipelines outsource both the building and maintenance/servicing of their pipelines to companies like Macro Enterprises. The pipeline servicers' work consists of large building projects and regular repair/maintenance work. This is a very volatile business to be in. Revenue will boom with huge projects but then have long periods where there is only maintenance work to be found. These cycles are further exacerbated by the notorious boom and busts cycles faced by the oil and gas customers that they service.

The proper way to run a business like Macro is to be extremely financially conservative to survive the inevitable down cycles. While this seems like simple logic, in practice it is very difficult to do. Humans have a tendency to get more aggressive during market booms. We continually expand, projecting that the good times will continue indefinitely. Usually servicing companies like Macro take on too much debt to buy equipment in the good times. This equipment then sits idle when the inevitable downturn occurs, and the debt incurred becomes very difficult to pay off. Most oil and gas servicing companies did exactly this, and there has been severe financial stress in the sector as a result.

Macro's recent revenue decline shows how drastic these boom and busts can be. The company's revenue peaked at $212mil in 2013. Revenues first collapsed to $115mil in 2015, then cratered to only $33mil for the first 9 months of 2016! For most businesses, a revenue decline that severe over 2 years would cause major financial stress or bankruptcy.

To their credit, Macro is not one of those companies. Despite the steep revenue decline, the company projects that they will break even this year. How many companies do you think would be able to break even with such a large revenue drop? Very few. This is a credit to the leadership of CEO Frank Miles. He has effectively run this business in an extremely conservative manner. The company sits on $36.4mil in cash, and their $14.1mil in receivables covers all their liabilities. The strength of their balance sheet gets even better, as they also have $47.5mil of equipment assets. These assets are likely worth more than the reported $47.5mil because the company has been aggressively amortizing their equipment values to reduce their taxes. The company wanted to highlight how conservative their balance sheet was and had their equipment valued by a third party in 2014. This assessment found their equipment to be worth $82mil. Since Macro lists all their equipment on their website, I went through their list and, using auction information, I estimate that the equipment is worth at least $55mil.

Let's look at the first valuation method; the liquidation scenario. Conservatively if we use the balance sheet equipment value of $47.5mil and add net cash, we arrive at a value of $83.7mil. That looks mighty attractive compared to the current market cap of $64mil. Shareholders would see a gain of roughly 31% if the company took this route!

Buying cheap compared to liquidation value is great but that is not what makes this company so interesting. I believe this company is better off alive - let's explore why.

In 2015, the company secured a line of credit for $115mil; $65mil from TD bank and $50mil from Business Development Canada. It is very unusual for a company to have a revolving credit facility almost 2x their market cap. Why would the banks provide such a large amount of credit to such a small company? The banks must feel the equipment value is higher than $47.5mil and therefore their loan is safely secured by that equipment. Also, the banks likely believe Macro will have large, profitable, construction projects in the future. To give some background on these large potential projects, let's take a step back and look at the natural gas (natgas) market in North America.

The largest natgas supply in North America is the Marcellus basin, which is in the Northeast of the US and conveniently close to the major economic centers in North America. The province of Alberta has the largest surplus of natgas in Canada but it is far from the large economic centers and therefore demand for it is lower. This lack of demand for Alberta natgas is reflected in the difference in pricing; Alberta gas trades at $2.09USD/mmbtu whereas the US benchmark price is $3.43/mmbtu.

A new market for this Alberta natgas could be found if a Liquefied Natural Gas (LNG) terminal was built in BC. A LNG terminal cools natgas until it is liquified so that it can be safely exported on ships. Asian countries, specifically Japan, are the largest LNG importers in the world. Japan's demand for LNG has increased substantially, as they shut down most of the nuclear power plants after Fukushima. The toll rate for getting natgas converted into LNG in the US is in the range of $2.50USD/mmbtu to $3USD/mmbtu. Alberta natgas could be converted to LNG at terminals for a total cost of $5USD/mmbtu, assuming a similar toll rate as the US, and then sold to Asia where LNG prices are now $9.50USD/mmbtu, that is an attractive margin for natgas producers and terminal operators to pursue. This attractive opportunity sparked a race to build LNG terminals in BC. In 2013, 20 different BC LNG projects were proposed. The oil price crash however, reduced this construction enthusiasm. LNG prices are tied to oil prices, so when oil crashed, LNG dropped to a low of $4.50USD/mmbtu making all proposed projects seemingly uneconomical. LNG projects however are very long-term ventures with 20 to 30 year time horizons and some of the 20 projects are still being considered.

Macro is very well positioned to profit if LNG plants are built. Looking at the stock history, it was as high as $7 in 2013 as investors anticipated Macro participating in some of the 20 projects announced that year. The building of very large infrastructure projects, such as LNG, can be a very political process. So if a project in BC is approved, there is considerable pressure for BC companies to get the construction contracts.

Since 2013, there have been major project delays with none of the 20 projects getting Government of Canada approval until very recently. In October, the Canadian government approved the first BC project - the Pacific NorthWest LNG project. This is a $36bil project by Malaysian government-owned Petronas. Petronas is currently evaluating whether to proceed and an announcement could come as early as April 2017.

Let's look at valuing this company on a cashflow basis assuming some LNG construction does occur. To quantify what the upside to this business could be, management has told me that the company needs about $30mil working capital per $100mil of revenue. With their $30mil in cash and $115mil line of credit, the company has the capacity to do up to $400mil in revenue. Because of their conservative financial structure, the company holds bargaining power. More desperate companies may have to take lower margin contracts but Macro does not - so it isn't unreasonable to predict historical margins of 22%. In this scenario, we could see revenues of $400mil, 18% margins (to be conservative) and fixed costs of $20mil (2x historical operating costs) resulting in earnings of $52mil pre-tax, or $38.2mil income after tax. If we applied a PE multiple of 10 to Macro's profits of $38mil you could assign a value of $380mil! It's worth pointing out that most companies are valued using a much higher PE multiple (usually north of 15) but given the cyclical nature of this business it is prudent to use a lower multiple.

If none of these LNG projects happen, there are plenty of other large projects that could bring Macro work. For example, Kinder Morgan's TransMountain oil pipeline has recently been approved, and there seems to be more pipeline work in Alberta with the rebound in oil prices.

Without any large LNG or oil projects, there is still plenty of work for Macro. Management tells me that most companies held back needed maintenance in 2016, and there is some pent-up demand for their services. They have Master Service Agreements (MSA) with big pipeline companies like Pembina, Spectra and TransCanada. These MSAs aren't contracts but they are open agreements, which means they don't have to negotiate a contract every time they do work. In the past, MSA work has been around $100mil a year. Macro's ability to survive this recent oil-price related downturn should make them a preferred servicer for customers as they know this company will be around for the long haul. So in this MSA-only scenario, a base level of $100mil in revenues, 18% margin, and $12mil in operating costs means $6mil in pre-tax earnings, or $4.4mil income after tax. Using a 13x PE multiple (we are at the bottom of a cycle so you typically use a higher multiple) we could assign a value of $57mil to these earnings. If we then add the $36mil of cash we arrive at a valuation of $93mil.

So let's recap the three Macro scenarios compared to its current market cap of $64mil:

- Liquidation: $83.7mil
- LNG project: $380mil
- Just MSA work: $93mil

This looks almost too good to be true, so how could this go wrong? Normally a concern in companies trading below liquidation value is that management will do something stupid or waste away the cash on the balance sheet. In this case though, the CEO Frank Miles owns 33% of the company and has proven to be a steward of shareholder capital. The company is also looking to buy back up to 5% of the outstanding shares, which should further boost value for shareholders.

Another concern is dilution. In the past, the company issued stock options at favourable levels to insiders. This arrangement can convert some of the massive upside from shareholders to management. Recently, the company changed the option price of some of their issued options from $3.35 to $1.63. This resulted in dilution to shareholders of ~5%. Not ideal. I immediately had a call with the CFO who explained that the options were mostly held by managers and not executives. After a couple of lean years, the board of directors decided to reward the workers who are actually doing the work to ensure they would stay with the company as the employment market improves. I think this was the right approach. Many investors likely misread the option restrike as management enriching themselves at the expense of shareholders. However, it was not the case in this instance.

I have had many discussions with the CFO, and I find him to be very intelligent and open to shareholders questions.

So why is this stock trading so cheap? As I mentioned above, a lot of money can be made buying a stock based on assets when it can later be sold for the cashflows it produces. Similarly, there is a lot of money to be made when shares change hands between different types of investors. My guess is that people that bought shares in 2013 - in the hype of a LNG construction boom in BC - bought for near-term growth and really didn't have the patience to wait. When the growth they paid for never came and then the oil crash happened, shares were sold indiscriminately. For example, 6.1% of shares traded in one trade at a price of $1.36 in October 2016. Apparently, it was a fund selling for "tax-loss purposes", which is completely irrational. The CFO has told me that the shareholder base has changed quite dramatically and most investors are like me, asking about the value of assets and capital allocation rather than growth. I take this as a good sign.

I think this is an unusually attractive scenario, and I own shares. Not often can you own something with such a large upside at such a discount to current assets.

ABOUT

I have 12 years of experience as a trader on a Proprietary Credit trading desk in New York and Toronto and at hedge funds in Toronto. In that time, I traded and invested in all asset categories - bonds, derivatives and equities - globally. Wanting more freedom, I decided to focus on managing my own portfolio and investments. I enjoy reading, learning and thinking deeply about markets and investments. When not investing, I spend time with my wife and son in Toronto.

INVESTING STYLE

My investing style focuses on value; buying good companies well below fair value or finding mispriced securities with a lot more upside than downside. This approach is a disciplined one with a long-term focus. I am opportunistic and focus on areas of the market where recent volatility or apathy may create interesting investments.

CONTACT

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