Snapshots – May 2019

Snapshots are meant to provide a brief overview of investment opportunities we find interesting. We highlight various aspects of each company such as a business overview, business model, competitive dynamics, management track record, valuation and technical analysis. Please let us know if one or more of these companies peak your interest so that we can furnish more information and discuss the opportunity further.

Allergen (NYSE: AGN) - Allergen is the 20th largest pharmaceutical company in the world by revenue. The company has grown revenue from $12.6 billion in 2015 to $15.8 billion in 2018. However, 2018 revenue is down 1% from 2017 and 2019 revenue is expected to be down 4%. The stock price is down over 50% to $135 per share from an all-time high in 2015 of $340 per share. The equity currently trades at below 10x EV/EBITDA and 9x trailing 12 month adjusted EPS. The company has had a negative effective tax rate for the last several years has $38 billion in net deferred tax assets on its balance sheet.

Allergen focuses on four therapeutic areas including medical aesthetics, eye care, the central nervous system, and gastroenterology. Medical aesthetics, the company's largest segment, generated $4.3 billion in revenue in 2018, growing 13% year over year and representing 27% of the company's revenue for the year. This segment was led by Botox, Allergen's largest product which represented 23% of the company's overall revenue in 2018. Botox is a premium brand name product and is frequently requested by name similar to Kleenex or Qtips. Botox is typically paid for in cash and is therefore less effected by the widely publicized pricing pressure in the pharmaceutical industry. Allergen expects the medical aesthetics business to double in revenue over the next 5 years driven by consumer trends, geographic expansion and innovation. An industry study sponsored by the company estimates that only 7% of people who have indicated interest in facial injections have acted not that interest. This is partially driven by digital social media and the "selfie generation". At their investor day last year, the company said they plan to more than double their marketing budget to drive customer acquisition.

The company is well diversified outside of Botox with 3 products (including Botox) generating over $1 billion in revenue and 34 products (total) generating over $200 million in revenue. Unfortunately, some of these products have not performed well and in aggregate have offset the growth in medical aesthetics to date resulting in roughly flat revenue for the last two years. Restatis, the company's second highest revenue product ($1.2 billion in 2018) is expected to decline 50% with generics entering the market (this is factored into overall 2019 revenue expectations). Rapastinel, an acute depression resistant drug that's delivered as an IV injection had passed phase 2 with some very encouraging signs and then failed to meet clinical end points in the most recent trial. This was a potential multibillion dollar drug. Also, several Botox competitors have recently emerged but none have the premium brand and history of Botox or the wide range of approved indications. That being said, some of these products could put a dent in Botox's 65% market share. These are some of the reasons that Allergen trades at such a low EPS multiple.

Allergen has several promising drugs that are late in its pipeline. The company plans to release 1-2 new drugs per year. However, there is always the risk that a drug fails to achieve clinical end points. One way to measure the company's new drug potential is to look at R&D spending. Allergan has 2,150 employees working in R&D and expects to invest between $1.6 billion - $1.7 billion in their pipeline in 2019. This represents 24% of revenue, well over the industry average of 17% of revenue spent on R&D.

Appaloosa Management (one of the top performing hedge funds in the world run by David Tepper) has built a position in Allergen representing roughly 8% of the funds' assets. Appaloosa has issued several public letters to the company suggesting ways to unlock value in the company including management changes, dividing the company into separate business units or a sale of the entire business. Breaking Allergen into two separate entities would likely unlock shareholder value. The overall aesthetics business represents 60% of revenue with 55 percent operating margins and $9 per share of the company's net income. If the aesthetics business is able to maintain an 18x earnings multiple as a standalone company it would be worth more than the current stock price by itself.

Allergen PLC – (NYSE: AGN) 25 Year Chart

Technical Opinion - Allergen broke out of a long term period of consolidation from 2000 – 2012 and rallied from $70 to $340 per share. The stock has been declining in a consistent uniform channel. Volume has declined significantly since the beginning of the selloff that suggests selling has started to abate. A rally to the top of that channel would be a 20% return on investment from the current level.

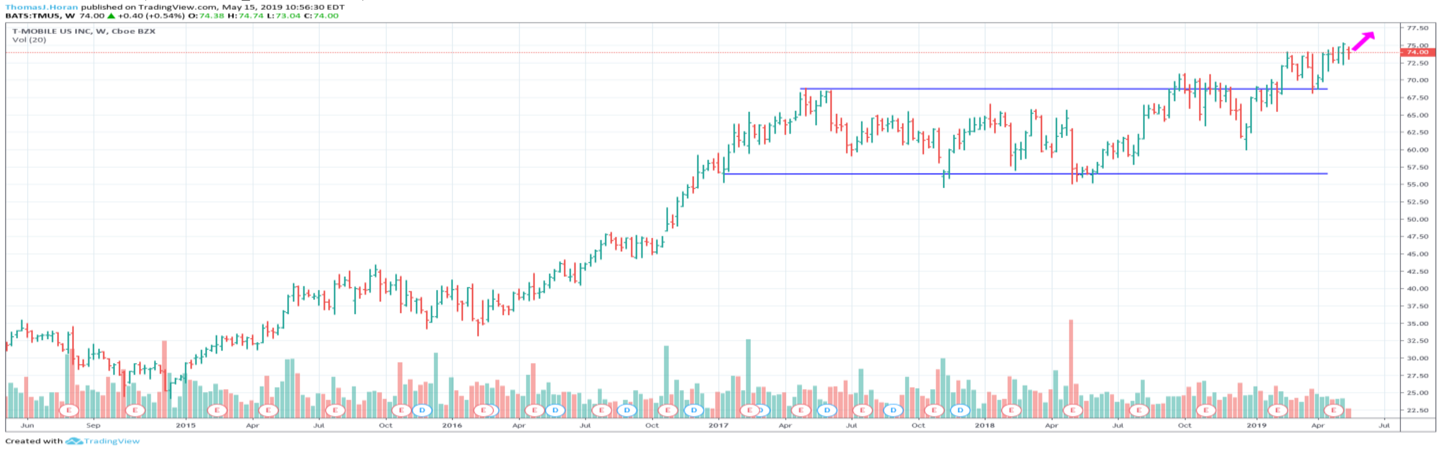
Principal Risks – Allergen relies on FDA approval of new products to increase sales. Current products are always subject to competition from newly FDA approved products. The company's flagship product, Botox, faces competition from new FDA approved products to combat wrinkles. The pharmaceutical sector as a whole may face lower prices for prescription drugs through increased regulations such as "Medicare for all". Although this is unlikely to effect Botox it may effect other products marketed by Allergen.

<u>T Mobile (Nasdaq: TMUS)</u> - T Mobile is the third largest wireless communications service provider in the United States, behind AT&T and Sprint. The company is in the process of attempting to acquire Sprint, the fourth largest wireless provider. T-Mobile trades for a $62 billion market cap and a $100 billion Enterprise Value. From 2015 to 2018 the company has grown from $32.5 billion to $43.2 billion in revenue. The company's adjusted EBITDA estimate for 2019 is $12.7 billion to $13.2 billion. The stock trades in parity with competitors AT&T and Verizon at EV/EBITDA multiples of 8x although T Mobile has grown revenue at over 10% per year for the last 3 years versus less than 5% for AT&T and Verizon.

In addition, T Mobile is expected to be first to market with real 5G. The company acquired 45% of all low band capacity in the 2017 FCC auction. T Mobile spent $8 billion on the spectrum and quadrupled their low band coverage. AT&T, Verizon and Sprint largely sat out of the auction because they are investing in high band spectrum. 5G is the new mobile standard that will significantly increase the speed and battery life of mobile devices. Low band capacity is optimal for wide distance and deep indoor coverage but lacks the speed of mid band and high band coverage. Sprint has the most high band coverage in the industry (used for IoT and industrial communication) but lacks low band coverage which is why they are trying to merge. T Mobiles bet is that low band coverage will be good enough for quite some time.

T-Mobile may be correct because at present mobile data usage in the US is not growing all that rapidly. T-Mobile will have significantly more low-band spectrum per customer than any other major provider, potentially allowing the company to compete head-on with AT&T and Verizon, who have typically used coverage as a key factor to justify their premium pricing. If the merger does not go through T Mobile intends to buy back $7.5 billion in stock and will most likely need to spend upwards of $20 billion on mid to high band coverage. If the deal does go through T Mobile will quickly be very well positioned against Verizon and AT&T even in high band coverage.

T-Mobile (Nasdaq: TMUS) – 5 Year Chart



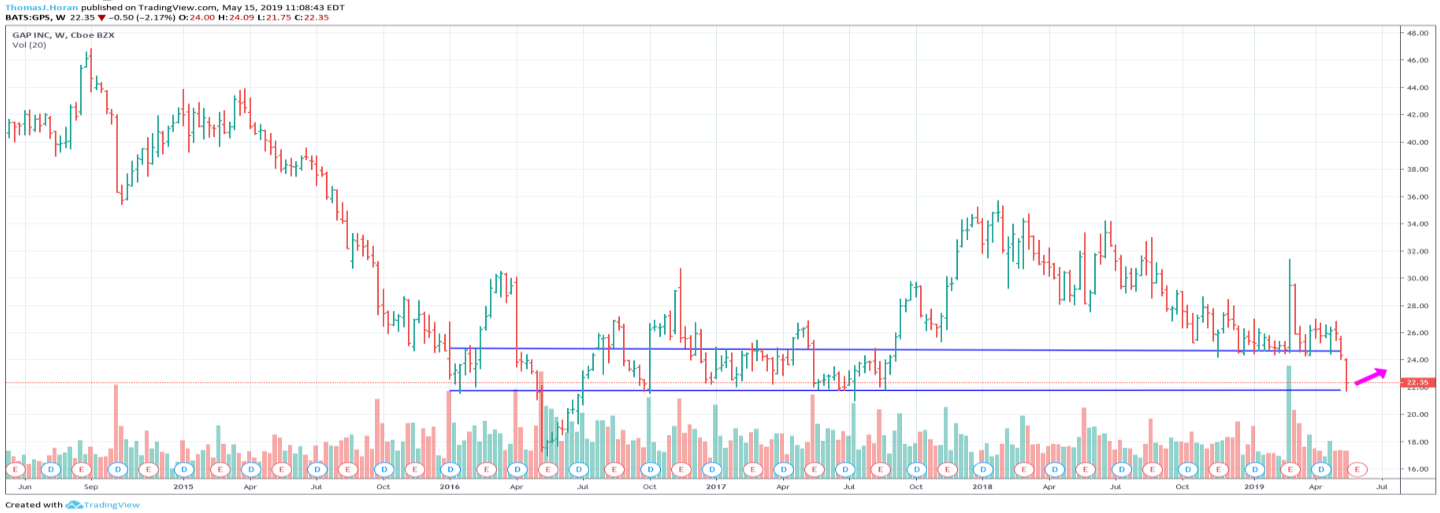
Technical Opinion - T- Mobile appears to be in the process of breaking out of a long term period of consolidation from 2017 – 2019. The breakout has not been confirmed with increased volume so there may be some backing and filling before the stock moves significantly higher, especially if the overall market sells off.

Principal Risks - The equity is relatively cheap but not dirt cheap. Some of the price appreciation may be in anticipation of the merger with Sprint being approved. If it isn't approved, the equity could decline in the near term.

The Gap (NYSE: GPS) - The Gap announced in early March that they will spin off Old Navy into a separate company. The stock price rallied over 20% to almost $30 per share but has now declined back to $25, the price is was trading at before the announcement was made. The Gap is one of the largest operators of mall stores in the United States. Old Navy, by itself, is the second largest apparel brand in the United States behind Nike. The company has stated that Old Navy has industry leading operating profit margins which would imply margins of around 13%. The segment accounts for $8 billion of the Gap's revenue which would mean $1.2 billion in EBITDA (after adding back D&A). This means that Old Navy by itself would be worth $25 per share with an 8x EV/EBITDA multiple.

The Gap has 383 million shares outstanding, $1.4 billion in cash and $1.25 billion in debt. The Gap also owns Banana Republic, The Gap, and Athleta and Intermix. Athleta and Intermix are a women's athletic wear brand and a women's apparel brand generating a combined $1 billion in revenue and growing 20% per year. Altogether, the non Old Navy brands are generating $9 billion in revenue and $613 million in EBITDA. There are some issues with the Gap such as operating leases at malls where consumer traffic has significantly declined but most retailers (like Macy's) in a similar situation trade at about 5x EBITDA implying another $12 per share in valuation for these brands as a standalone company. This analysis adds up to $37 per share versus todays stock price of $25.

The Gap Inc (NYSE: GPS) – 5 Year Chart



Technical Opinion - The Gap has declined to a level of significant support, a 2 year base trading range formulated from 2016 to 2017. The equity only broke down through this trading range briefly in May of 2016, then recovered within 60 days. Certain headwinds such as a broad market sell off or implementation of further tariffs on apparel could cause the equity to retest these lows at which point we would be even more aggressive buyers.

Principal Risks - Being in the retail space, the Gap is particularly vulnerable to a recession. Also, the company has stated that just over 20% of their manufacturing comes from China and if the new tariffs are implemented the company will likely have no choice but to pass some of those costs off to the consumer.

<u>North American Construction Group (NYSE: NOA)</u> - North American Construction Group is the premier provider of heavy construction and mining contract services to the resource, development and construction industries in as Canada. Canada has the third largest volume of proven oil reserves in the world (behind Venezuela and Saudi Arabia) with 97% located in Alberta. It is the largest reserve in the world open to private sector investment, estimated at 1.7 - 2.5 trillion barrels. North American Construction Group's core market is the Canadian oil sands industry, accounting for 90% of the company's revenue in 2018.

The Canadian oil sands industry has two major issues. The first issue is that oil sands have a significantly higher carbon intensity than that of conventional oil. Oil sands (or tar sands) are a combination of sand, water and bitumen (oil that is too heavy to flow on its own). Bitumen has a different composition than conventional oil and must be treated and upgraded before it can be used to make fuels such as gasoline. This process is energy intensive and causes emissions that are carbon intensive. These emissions are a global problem as they are harmful to the environment and have been pointed to as the reason Canada is the worst polluter per capita in the world and is failing to meet its emissions caps under the Paris Agreement.

The second issue is a derivative of the first. Due to environmental concerns and regulatory issues, the Canadian oil industry has been unable to get pipelines approved which would help the country sell the oil it is producing at competitive prices to international markets. This predicament has significantly decreased investment in the Canadian oil sector. Total capital spending has decreased almost 50% from $81 billion in 2014 to an estimated $42 billion in 2018.

This all may seem like it should be an issue for a business like North American Construction Group that derives more than 80% of their revenue from the Canadian oil sands market, however, their revenue stream should be relatively unaffected by these circumstances in the near to medium term. The company operates in two segments, operations support services, which includes a variety of services that the company provides to help customers maintain their mines up and construction services, which includes new mine development and expansion projects. The former is relatively unaffected by the decline in capital spending and accounts for the vast majority of the company's revenue. The latter has been effected by the decline in capital spending but accounts for a small portion of the company's revenue.

Operations support services are funded from their customers' operating budgets and are therefore a recurring revenue stream for the company. These services include overburden (topsoil) removal, mine infrastructure development, reclamation (restoring damaged land), tailing ponds remediation and equipment and labor supply. Oil Sands producers outsource these services to service providers like North American Construction Group because they can be dialed up or dialed back more easily than stopping production on an oil sands mine. However, these are necessary components of operating an oil sands mine so the work is ultimately consistent as long as the mine is operational.

Due to the decline in capital spending, since 2014, Canadian oil companies have been increasing production at existing mines and selling oil in bulk to lower their operating expenses. As a result, operating support services grew to account for 90% of the company's revenue in 2018.

North American Construction Group trades at a discounted valuation, 4x EV/EBITDA with 20% annual maintenance capex while the business is growing at 20% per year organically, due to its association with the Oil Sands industry. The decline in capital spending is causing companies to increase, not decrease, production to make up for low prices on volume. This is resulting in more business for the company and this trend should continue. If pipelines are approved production should increase which should also result in more business for the company. The company has long term contracts for operating support services with their customers mines that have a 50 year life so this recurring revenue stream is unlikely to decrease any time soon.

In addition, management has executed exceptionally well and has exceptional integrity. The CEO is the second largest shareholder with 5% of the company. The company has repurchased 30% of their outstanding equity since 2012 at 4x EBITDA or better and has stated that they will continue to do so as long as their equity remains this cheap.

North American Construction Group – (NYSE: NOA) – 5 Year Chart

Technical Opinion - North American Construction Group broke through a prior level of resistance at $8 per shar in October of 2018. The stock traded as high as $13 on heavy volume before retesting the $8 level in late 2018 with the broad market sell off. It has now rallied back to the prior high of $13 and is starting to form a new consolidation level between $11 and $13. We would be buyers here and buy more aggressively if the stock pulled back to the top of the prior trading range around $10.50 per share.

Primary Risks – North American Construction Group provides contract services so there is always the risk that the company's customers will scale back service contracts before scaling before laying off employees internally if there is a downturn in the industry. This doesn't seem to be likely in the near term though. The company's oil sands customers export a lot of oil into the United States so there is always political risk as well if a more liberal administration is elected.

<u>Express Inc. (Nasdaq: EXPR)</u> – Express is a men’s and women’s apparel brand with 631 stores across the United States located primarily in shopping malls and outlet centers. The company focuses on professional attire and casual wear for young adults. Sales at express have been roughly flat at $2.1 billion per year for the last 4 years, however, the mix of those sales has been shifting significantly. In 2014, the company generated $1.77 billion in sales from stores and $354 million in sales from e-commerce. In 2018, the company generated $1.44 billion in sales from stores and $600 million in sales from e-commerce. The company’s strategy has been to focus on growing online sales for the e-commerce division while shifting in store sales from retail to outlet stores. Both strategies focus on millennial consumers whose purchasing trends have shifted to e-commerce and outlet stores.

The equity is extremely cheap. The stock trades for $3.45 per share. There are 66.5 million shares outstanding. The market capitalization is $230 million, and the enterprise value is $59 million. The company has $171 million in cash ($2.57 per share) and no debt. In 2018 the company reported $28.2 million in operating income and $9.6 million in net income ($0.13 per share). The company has a book value of $8.80 per share and a tangible book value of $5.83 per share.

In the Q4 conference call the company stated that their goal is to return to mid-single digit operating margins. Operating income of 5% on $2 billion in sales would be $100 million. With a 30% tax rate the company would earn over $1.00 per share on $2 billion in sales.

Express Inc (Nasdaq: EXPR) – 5 Year Chart

Technical Opinion – Express has been in a downtrend since early 2016 which seems extreme at this point given the valuation. From early 2016 to the summer of 2017 the stock declined over 70% to $6 per share while sales were relatively flat. The stock then rebounded to $11 per share before again declining 70% to the current level below $3.50 per share. In our view, a slight increase in operating margins could propel the stock back to the $5-$6 range representing a gain of 50% or more from the current level.

Primary Risks – Express is facing headwinds from consumers shifting purchases to online and making it more difficult for the in store business to be profitable. That being said, over 60% of the company’s leases are up for renewal in the next 3 years. In addition, the company may face pressure from tariffs on China that effect apparel. The company has well diversified manufacturing partnerships with 89 vendors utilizing 315 manufacturing facilities in 24 countries.

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