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BARRON'S ROUNDTABLE

Scott Black: Making Chips and Crushing Sand

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PHOTO: JEREMY LIEBMAN FOR BARRON'S

Barron's: Scott, what appeals to you today?

Scott Black: We like companies that generate a good return on equity and free cash, and we like to buy them at low absolute multiples. My first pick is Lam Research [LRCX]. It is a powerhouse in semiconductor capital equipment, and its products are used primarily in front-end wafer processing, which is becoming a $50 billion business. Lam has a 56%-57%

market share in wafer etch, and about a 40% share in vapor deposition. It wants to gain another four percentage points in both through 2019.

The fiscal year ends in June. We estimate that Lam will have $10.3 billion of revenue in fiscal 2018, up 28% year over year, and $3.065 billion in profit before taxes. With a 14% tax rate, after-tax income will total $2.6 billion. Divide by 182 million shares, fully diluted, and you get $14.48 a share in earnings. Doing a similar calculation for fiscal 2019 gets you earnings per share of $15.45. Splitting the difference, the company will earn about $15 a share for calendar 2018. There is no stock-based compensation to consider, so that's a clean number. Shares closed on Friday [Jan. 5] at $196.40. Lam has $22 a share in net cash. Exclude that and the stock sells for 11.6 times earnings. It is a giveaway. The average company sells for 19 times earnings, and LAM isn't an average company.

Where is the cash?

Black: Seventy-one percent is trapped overseas, and it isn't clear that it is going to come back here. Return on book value could top 30% in calendar 2018. Free cash is equal to net income. Breaking down the business, 66% of revenue comes from memory and the rest from logic and foundry. What is driving demand is smaller line widths and multipatterning, along with the Internet of Things and cloud. Lam has the wind at its back. It generates 86% of its revenue in Asia, and its chief customers include Micron Technology [MU], Samsung Electronics [005930.Korea], and Taiwan Semiconductor Manufacturing [TSM]. Semi equipment stocks sold off in the fall, when Samsung said demand for NAND memory chips had come down, but that was just a blip. Visibility is good for the next 18 months to two years.

> ***Paul Wick:*** We were the largest shareholder of Novellus Systems, which Lam bought in 2011. Lam, Applied Materials [AMAT], and some other semiconductor equipment makers

have had explosive growth in the past few years. Yet their valuations are still modest, especially in relation to U.S. industrial stocks, which aren't growing nearly as fast and don't have the huge barriers to entry that these companies do.

Why has the market overlooked the stocks?

Wick: People are still living in the past. They retain a notion from 1995 to 2000 that semiconductor-equipment manufacturing is wildly cyclical and a bad business. In fact, the chip industry has become much less volatile.

Black: Also, people are concerned that the business will decelerate in 2019.

Mario Gabelli: That is a good idea, Scott. What is your next one?

Scott Black

Founder and president

Delphi Management

Boston

Black: Hi-Crush Partners [HCLP] mines fracking sand [used in the process of hydraulic fracturing of shale energy formations]. The stock fetched $11.40 on Friday. There are 92 million fully diluted shares outstanding, and the market cap is $1.05 billion. The company pays a 60-cent dividend per share and yields 5.3%. It is a limited partnership. Earnings are rising, and you get paid while you wait.

Hi-Crush mines sand in Wisconsin and at its new Kermit facility in the Permian Basin. It is the industry leader. Last year. it mined 8.8 million tons, or 11% of the industry total. This year, it will have a 13% share. Revenue could total $878 million. We calculate operating income of $191 million, interest expense of $11 million, and

profit before taxes of $180 million. Our earnings estimate for the year is roughly two bucks. The Street is higher at $2.28.

Gabelli: Scott, are there significant capex charges associated with the mines?

Black: No, that's behind them. The stock trades for 5.7 times this year's expected earnings. The company could earn about 21% on book value, and maintenance capital spending is only about $17 million. Two of Hi-Crush's biggest customers are Schlumberger [SLB] and Halliburton [HAL]. Each has an annual contract with the company. Based on my analysis, free cash flow will total $140 million this year.

View Scott Black's Picks

Oil prices have gone up a lot in recent months. The rig count is up 25% from a year ago. There are 22,600 oil and gas wells operating in the U.S., up from 16,950 a year ago. Natural gas is trading at about $2.80 per thousand cubic feet. It is still economical to drill at that level. Primary demand [for energy] is driving demand for sand. Hi-Crush produces several types of sand. Fine sand, put through a mesh, is 75% of the mix. Coarser sand is 25%.

On the financials, debt is 1.5 times Ebitda. Net debt is 0.22 times equity. Tangible book value is $8.53 a share. The stock is trading for 1.34 times tangible book.

Why are you recommending Hi-Crush, and not another sand company?

Black: Hi-Crush has better economics than competitors. We looked at Smart Sand [SND], but it isn't as good a company. Hi-Crush has the dominant position in the market and excellent logistics. It has good relationships with the railroads, including Union Pacific [UNP] and Canadian Pacific Railway [CP], and has built its own infrastructure and terminals down in the Permian Basin. It offers a good yield and a good opportunity for growth.

Mario will know my next pick: Gray Television [GTN]. The company is based in Atlanta. The stock closed on Friday at $16.10. There are 89.9 million shares outstanding, and the market cap is $1.45 billion. The company doesn't pay a dividend. A little background: Gray has 103 stations in 57 markets. It is rated No. 1 or No. 2 in 55 of those markets. Each station operates as its own profit center. The company operates 39 CBS, 29 NBC, 21 ABC, and 14 Fox stations. Gray stations have the highest political-ad spending per household of any of independent-owned and -operated stations in the U.S.

Meryl Witmer: How much debt does Gray have?

Black: Total debt is five times annual Ebitda. Net debt is 2.8 times. Let me take you through our 2018 numbers. Gray ended 2017 with $880 million of revenue, which could climb to $1.1

billion this year. Winter Olympics advertising could add about $9 million and political advertising, about $130 million. Some 81% of Gray's markets have gubernatorial elections this year, and 65% have senatorial elections. Every market has a House election, of course. The company could have $416 million of broadcast cash flow. The stock is trading for 7.5 times enterprise value to broadcast cash flow, which is quite cheap. We look for net income of $155 million, or $1.72 a share. Gray's No. 1 priority for cash flow is to use it to reduce debt. The company is well-run and dirt cheap.

Gabelli: Gray's supervoting shares [GTN.A] trade at about a $2 discount to the ordinary shares. Which are you recommending? I own the voting stock.

Black: I am recommending the nonvoting stock.

Next, Ares Capital [ARCC] is a specialty-finance and business-development company. It invests in the debt and equity of privately held companies. I chose it in part because it is a yield play; it pays a dividend of $1.52 a share and yields 9.6%. You might have to reach down in quality to buy a junk bond with a 5% or 6% yield. Not here, and you're getting a higher yield. The company has an investment-grade credit rating [BBB]. Shares closed on Friday at $15.79. There are 426 million shares outstanding, for a $6.7 billion market cap. As a BDC, Ares likes to invest in noncyclical businesses with attractive growth prospects and high free cash flow. Core earnings, as the company calls it, are about 36 cents a share per quarter. If Libor [the London interbank offered rate] rises by half a percentage point this year, that could add eight cents to earnings. Ares has a Libor-sensitive balance sheet. The company's net debt-to-equity ratio of 0.61 allows it to increase its leverage and grow its portfolio. It has $600 million in excess borrowing capacity. I have an earnings estimate of $1.61 a share for this year, compared with the consensus estimate of $1.57. The stock trades for 9.8 times earnings. Tangible book value is $16.49 a share. The stock is selling for 96% of tangible book, with dividend coverage of 124%. Return on equity is about 10.2%. If interest rates move up a little, ROE could return to 12%, where it stood in 2012.

What do loan losses look like?

Black: Loan losses, or nonaccruing loans, are only 0.9% of the fair value of the total portfolio. Ares doesn't make many mistakes. It grades all its loans and is diligent about watching the portfolio. It avoids retailing and mining, and is cautious on oil and gas. About 21% of the portfolio is health care, 19% is business services, and 7% is consumer products. The management team is the same as at Ares Management [ARES]. The investments are an outgrowth of the deals done by Ares Management.

Ares does a lot of due diligence. Only 4.4% of the deals the company considers come into the portfolio. Management looks chiefly at investing in companies with $15 million to $75 million

of annual Ebitda. Some 91% of the portfolio is floating-rate, and the rest is fixed-rate. But their funding is 82% fixed and 18% floating. They have locked in the rates on the liability side but can benefit from an uptick in interest rates. Ares borrows from a consortium of 27 banks. It pays a commitment fee of 0.375% per year on any unused portion of the revolving credit facility. The average maturity of its loans is 4.2 years, and the loan-to-value ratio is about 54%. Of the loans, 41% are first-lien senior secured, and 35% are second-lien senior secured. It isn't trading down in credit quality to get more yield. The management team charges a fee of approximately 25% of interest income.

ROUNDTABLE PART 2

- Henry Ellenbogen: The Case for a Credit Bureau, a Ski Resort, and More
- Mario Gabelli: Bullish on Media and Entertainment
- Jeffrey Gundlach: Bullish on Commodities and Bank Loans
- Abby Joseph Cohen: Drilling for Oil and Making Gadgets
- William Priest: Bullish on Screen Technology and Chip Gear
- Scott Black: Making Chips and Crushing Sand
- Meryl Witmer: Used Cars and Carbon Black
- Oscar Schafer: Loading Up on Auto Parts, Off to the Movies
- Paul Wick: How to Play the Big Trends in Tech

Will more banks target this business if regulations loosen?

Black: I'm not worried about commercial banks getting into it. My last idea is Hooker Furniture [HOFT], a tiny company based in Virginia. Shares closed on Friday at $40.75. There are 11.7 million fully diluted shares, and the market cap is $477 million. Hooker pays a 56-cent dividend and yields 1.4%. The company's furniture is sold through retailers across market segments. About two years ago, Hooker acquired Home Meridian International.

The legacy business produced $233 million of revenue in the fiscal year ended in January 2017 and Home Meridian, $344 million, for a total of $577 million. In the year just ended, revenue was about $630 million. The company expects mid-single digit growth this year, which suggests revenue of $662 million. Add the recent acquisition of Shenandoah Furniture and you'll get $706 million, reflecting a gain of 12% year over year. The Street is at $709 million. We see 7.3% operating profit margins this year. The tax rate will fall from 35% to 21% since this is a domestic company. Net income could total $40.7 million, or $3.48 a share, versus $2.62 the prior year. The stock trades for 11.7 times expected earnings. Hooker isn't as

cheap on a price-to-book basis. The stock trades for 2.15 times book value of $18.96 a share. The company could be debt-free by the end of the year.

Is the housing market driving Hooker's growth?

Black: Consumer confidence is the key driver. The Conference Board's Consumer Confidence Index was 122.1 in December, up from 113.3 a year ago. The housing backdrop helps, too. Existing-home sales were 5.8 million for November, up 3.6% from a year ago. Sales of new homes rose 27%, to 733,000, in November. Costco Wholesale [COST] accounts for 10% of Hooker's revenue. Macy's [M], the only traditional department-store customer, is under 10%. The company has good supply-chain management. It has been able to grow the top line by 27% over the past five years. Operating income is up 31.9% annually in that span. About 85% of the furniture is imported from Asia. You're paying a low multiple for a decent return on equity, solid free-cash generation, and a clean balance sheet. Almost no one follows the company.

Except you! Thanks, Scott.

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