



# Applied Investment Management (AIM) Program AIM Class of 2015 Equity Fund Reports Fall 2014

## You are invited to join us in person:

Date: December 5th | Time: 2:00 - 3:00 p.m. | Location: AIM Research Room (488)

<b>Student Presenter</b>	<b>Company Name</b>	Ticker	Price	Page No.
Vanessa Foltinger	Michael Kors	KORS	\$73.32	2
CJ Swift	Con-way Inc.	CNW	\$48.96	5
Menga Luo	INSYS Therapeutics, Inc.	INSY	\$38.73	8
Brandon Cloete	Meritor Inc.	MTOR	\$14.15	11

These student presentations are an important element of the applied learning experience in the AIM program. The students conduct fundamental equity research and present their recommendations in written and oral format — with the goal of adding their stock to the AIM Equity Fund. Your comments and advice add considerably to their educational experience and is greatly appreciated. Each student will spend about 5-7 minutes presenting their formal recommendation, which is then followed by about 8-10 minutes of Q & A.

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## Michael Kors Holding Ltd. (KORS)

December 5, 2014

Vanessa Foltinger

**International Consumer Discretionary** 

Michael Kors Holding Ltd. (NYSE: KORS) is a designer, marketer, distributor, and retailer of branded women's and men's apparel and accessories. The company operates its business through three reportable segments: Retail (48% of revenues), Wholesale (48%) and Licensing (4%). The Retail segment consists of collection and lifestyle stores, including concessions and outlet stores primarily in North America (82% of retail sales), Europe (15%) and Japan (3%). Wholesale revenues are principally derived from major department and specialty stores located in the United States (44% of wholesale sales), Canada (8%) and Europe (48%). The firm licenses its trademarks on products such as fragrances, watches, men's suits, furs, and ties. Michael Kors was incorporated in 2002 and is headquartered in Hong Kong, China.

Price (\$): (12/02/14)	73.32	Beta:	1.60	FY: March	2014 A	2015 E	2016 E
Price Target (\$):	87.85	WACC (%):	10.52%	Revenue (\$mil)	3,310.80	4,511.86	5,527.03
52 WK H-L (\$):	68.25 - 101.04	M-Term Rev Gr. Rate Est:	33.34%	% Growth	51.8%	36.3%	22.5%
Market Cap (mil):	15,800.2	M-Term EPS Fr. Rate Est:	43.27%	Gross Margin	60.9%	61.5%	62.0%
Float (mil):	187	Debt/Equity (%):	0.00%	Operating Margin	30.4%	30.5%	30.9%
Short Interest:	5.60%	ROA (ttm):	33.34%	EPS (Cal)	\$ 3.22	\$ 4.39	\$ 4.99
Ave Vol 10 day (mil):	5,027,850	ROE (ttm):	43.27%	FCF/Share	\$ 2.13	\$ 2.17	\$ 3.99
Dividends (\$):	N/A			P/E (Cal)	18.7	16.7	17.6
Yield:	0.00%			EV/EBITDA	12.3	11.5	9.2

#### Recommendation

Michael Kors is a rapidly growing global luxury brand. Over the last three years, the company has grown at a sales CAGR of 36% and it has become a leader in the handbag segment in North America. Currently, KORS operates in 649 retail stores and 3,728 department stores while also generating revenues from its licensing arrangements. KORS offers two primary collections: the Michael Kors luxury collection and the Michael Kors accessible collection. Taken together, the company's two primary collections target a broad customer base while retaining a premium luxury image. KORS remains well positioned to capitalize on its growth momentum with accelerating awareness in targeted international markets. The global luxury market is projected to reach \$223 billion in FY2014 and is expected to grow to more than \$322 billion by FY2015, according to a report released by Bain & Company. Luxury accessories captured 29% of the market and is currently the fastest growing product category in the global luxury goods industry. The stronger relative growth in high net income categories in the U.S. and Europe poses an opportunity for KORS future growth. Accelerating product newness is driving domestic market share gains for Michael Kors as the North American handbag category (55% of sales) continues to grow in the high-single digit range toward \$13B by year-end. KORS weighted average price was \$242, which is up 11% from last year on top of a 9% gain the year prior. Strong double-digit top line growth, 30% square footage growth and international expansion paints a favorable outlook for the firm. With a target price of \$87.85, representing a potential upside of about 20%, it is recommended that KORS be added to the AIM International portfolio. The company does not yet pay a dividend.

## **Investment Thesis**

• Revenue Runway. Given strong top line growth, management's guidance seems conservative. KORS top-line roadmap remains intact (\$7-8B by FY2018) with Europe and Asia driving growth. Doubling growth in the international market is expected from 16% currently to 30%. In Europe with a 60% expected growth rate, KORS has the ability to triple their European revenue base by FY2018 (\$1.5B goal by FY2017 vs. \$505M today) given expanded retail presence (200 stores from 80 current) and wholesale (2000 doors vs. 1344 today). Asia's low penetration rate of only 1.2% of KORS present sales, (including a 50% growth rate the past 2 quarters) poses ample room for growth.

- Attractive Long Term Business Model. Over the next year, KORS plans to improve their online channel by establishing a "best in class" e-commerce platform to provide an omni-channel customer experience. Also, the company will embark on a product segmentation strategy by developing select channel-specific items. This new segmentation strategy should drive ongoing desirability and exclusivity of the KORS brand. Management believes e-commerce could grow to become 15-20% of its total retail sales. Further, the company announced that it will take direct control of the Michael Kors stores in South Korea by FY2016, which could add \$100M. In addition, the ten year deal with its new licensee, Luxottica, is also expected to help KORS establish a stronger foothold in the eye wear industry.
- Shareholder Friendly Capital Allocation. Management recently announced a \$1B share repurchase program (over a 2 year time period). As the firm does not pay a dividend, this provides an opportunity to return capital to shareholders.

#### Valuation

In order to reach an intrinsic value for KORS, a five-year KORS model was utilized. Using a terminal growth rate of 3.0% and a WACC of 10.5% resulted in a valuation of \$84.92 per share. Sensitivity analysis on both the terminal growth rate and WACC provided for a range between \$60.73 and \$129.38. Additionally, relative valuation methods using P/E and EV/EBITDA multiples were conducted. Using a comparable average P/E multiple of 21.2x and a 2015 expected EPS of \$4.39, a value of \$97.25 was obtained. An EV/EBIDTA peer average of 12.5x yielded a valuation of \$84.31. By weighing the DCF model 50%, the P/E multiple 25%, and the EV/EBITDA 25%, a price target of \$87.85 was established, representing 20% upside. The company does not pay a dividend.

#### **Risks**

- Subject to Changes in Customer Tastes. Competition is based on a number of factors; one of them is maintaining favorable brand-name recognition. KORS is subject to fashion trends. Increased competition in the space can hurt sales at new stores if Michael Kors' products lose favor with consumers.
- **Growing Expenses.** FY2015 will be another heavy capex year to further increase capacity and to expand. E-commerce, retail build-out, global supply chain, and distribution top growth will lead to a sustainable \$400M capex.
- Uncertain Macroeconomic Cycle. Purchases of discretionary luxury items are subject to cyclical variations regarding future economic prospects that can affect consumer-spending habits. Economic instability in Europe and Japan results in risks, including the European debt crisis. However, KORS has proven its ability to deliver double-digit EPS growth even in poor economic conditions due to the firm's valuable brand name, rigorous margins, effective cost control and its experienced management team.

## Management

John D. Idol has been the Chairman of Michael Kors since September 2011 and the Chief Executive Officer and a director since December 2003. Previously, Mr. Idol served as CEO and Director of Anne Klein Brand and Donna Karan International Inc. Joseph B. Parsons is the Executive Vice President, Chief Financial Officer, Chief Operating Officer and Treasurer of Michael Kors and has been with the Company since January 2004.



Ownership			
% of Shares Held by All Insider and 5% Owners:	3.24%		
% of Shares Held by Institutional & Mutual Fund Owners	90.64%		
	Source: Bloomberg		
Top 5 Shareholders			
Holder	Shares	Out%	
Lone Pine Capital, LLC	11,525,497	5.60%	
Vanguard Group, Inc.	10,176,351	4.94%	
Jennison Associates LLC	8,755,327	4.25%	
State Street Corporation	7,871,398	3.82%	
Ameriprise Financial, Inc.	6,096,112	2.96%	
	Source: Bloomb	erg	

## Con-Way Inc. (CNW) December 5, 2014

CJ Swift Domestic Industrials

Con-way Inc., (NYSE: CNW) together with its subsidiaries, provides transportation, logistics, and supply chain management services to various manufacturing, industrial, and retail customers in North America and internationally. It operates through three segments: Freight (63% of revenue), Logistics (27%), and Truckload (10%). The Freight segment offers day-definite regional, inter-regional, and transcontinental less-than-truckload freight services with a fleet of line-haul, and pickup-and-delivery tractors and trailers. This segment owns and operates approximately 9,300 tractors and 24,600 trailers. The Logistics segment develops contract logistics solutions, such as manages complex distribution networks; and provides supply chain engineering and consulting services, as well as multimodal freight brokerage services. This segment's supply-chain management offerings are primarily related to transportation management and contract warehousing services. The Truckload segment offers dry van transportation services that include short and long-haul, and asset based transportation services using a fleet of tractors and trailers. This segment owns and operates approximately 2,700 tractors and 8,200 trailers. CNW was founded in 1929 and is headquartered in Ann Arbor, Michigan.

Price (\$) (12/1/14):	\$ 48.96	Beta:	1.24	F	Y: December	2013A	2014E	2015E
Price Target (\$):	\$ 56.86	WACC	9.34%	R	levenue (\$Mil)	5,473.10	5,836.85	6,254.11
52WK L-H (\$):	36.34-53.54	M-Term Rev. Gr Rate Est.	7.1%	%	6 Growth	-1.92%	6.65%	7.15%
Market Cap (mil):	2,896	M-Term EPS Gr Rate Est.	8.5%	0	perating Margin	3.81%	4.95%	5.10%
Short Interest:	3.28%	Debt/Equity:	59.9%	El	PS (\$Cal)	\$1.73	\$2.44	\$2.73
Avg. Vol (90 day)	1,040,020	ROA:	3.8%	F	CF/Share	\$2.00	\$3.10	\$3.00
Dividend:	\$ 0.60	ROE:	11.2%	P/	E (Cal)	28.32	23.31	20.79
Div. Yield:	1.20%			E	V/EBITDA	5.78	5.90	5.56

## Recommendation

Since the establishment of its less-than-truckload (LTL) services in 1983, Con-way has been able to consistently grow this segment to become one of the largest firms to operate in the \$36B LTL industry (current market share of 12%). As other global economies continue to struggle, the U.S. reported a stronger than expected GDP growth of 3.9% in Q3'14. Looking ahead to 2015, estimates of U.S. GDP growth of 3% are favorable for the trucking and shipping industry which is highly dependent on the health of the economy and consumers willingness to buy and ship goods. Bloomberg's Trucking Team reported strong truck tonnage growth, rising 3.2% in Q2'14 compared to a year earlier, after increasing 2.3% in Q1, 9.1% in Q4 and 6.3% in Q3'13 respectively. The rise in trucking tonnage has increased LTL pricing in the first half of 2014. The average rate increase was 4.7%, slightly down compared to 2013's rate increase of 5.4%. However, the trucking rates are expected to rise as much as 8% through 2016, aided by an increase in shipping volumes and truck driver shortages. CNW has been able to capture the rising demand throughout 2014 through management led initiatives of cost management to increase operational efficiency and focusing on quality revenues versus pricing aggressively to maintain capacity utilization. Both strategies have helped CNW reduce costs through investments in proprietary line haul networks and the ability to be more selective of what goods CNW chooses to ship. As a result of management's success in improving the overall probability and growing the revenues in combinations with strong domestic macroeconomic fundamentals supporting trucking industry, it is recommended that CNW be added to the AIM Equity Fund with a price target of \$56.86, representing a potential upside of 16.14%.

## **Investment Thesis**

• Continued Margin Expansion. As part of CNW's long-term plan, management has focused on optimizing the company's operating efficiency, particularly in the freight segment to drive overall

profitability. In recent quarters, CNW has realized better than expected yields (revenue per hundredweight-net of fuel), a sign that management is improving its efficiency. In Q2 and Q3 of 2014, CNW reported yields of \$18.60 and \$19.20, an increase of 4.1% and 5.3% y/y respectively. Also, CNW's Freight operating ratio has rebounded significantly to 95.7%, an improvement from 2010's OR of 99%. As the U.S. economy continues to grow and demand for LTL increases, CNW has an opportunity to expand its profitability through concentrating on its cost structure.

• Focus on Revenue Management. As demand for CNW's LTL services increased through 2014 with stronger expected growth into 2015, management has the ability to be more selective of its shipping customers. Management has stated going forward that CNW will focus on disciplined pricing in order to grow its contractual business as opposed to one time shipping. This allows CNW to lock in quality customers for multiple years by offering competitive prices through long-term contracts. In a recent trucking conference, CEO Doug Stotlar mentioned that CNW wants to and is expecting to increase volume through the end of Q4 and into 2015 at roughly 2%-4%. As LTLs have already raised rates in the first half of 2014 due to high demand, including CNW, management has an opportunity to price more competitively to gain more market share.

## Valuation

In order to reach an intrinsic value of CNW, a five-year DCF model was conducted. Using a terminal growth rate of 3% and a WACC of 9.34%, the DCF resulted in a valuation of \$57.82. Sensitivity analysis on both the terminal growth rate and WACC provided a price range between \$45.73 and \$68.23. In addition, an EV/EBITDA relative valuation model of peer multiples was used for CNW, which resulted in a price of \$55.91. By weighing the DCF model and EV/EBITDA model equally, a price target of \$56.86 was reached, offering a potential upside of 16.14%. CNW currently pays a \$0.60 annual dividend per share and the firm's dividend yield is 1.30%.

## Risks

- **Dependent on Economic Growth.** Because CNW operates in a highly cyclical business, they are heavily exposed to domestic economic conditions and customers' markets during a downturn. When individuals and companies purchase and produce fewer goods, CNW's businesses are hindered. Since CNW has a relatively high fixed-cost structure and is capital-intensive, it is difficult at times adjust to shifts in volume levels.
- Lack of Qualified Employees. During high growth periods in the trucking industry, there is significant competition and demand for experienced drivers. Therefore, CNW may be required to increase driver compensation and benefits to retain and hire new drivers or be unable to meet the demands of its customers. This could put strain on CNW's margins, as they would need to absorb the costs compared to passing the rate increases onto customers.
- Menlo's Customer Concentration. The logistics segment of CNW, Menlo Worldwide, has a moderate level of customer concentration with its top three clients accounting for roughly 34% of the segment's gross revenue (13% of overall revenue) in 2013. A loss in a key customer would have an adverse impact on operating results for this unit and the company.

## **Management**

Douglas Stotlar has served as the President and CEO of CNW since April 2005. Before his current position, Mr. Stotlar has held numerous positions within the firm, including president and CEO of Con-Way's Freight segment and COO of Con-Way Freight prior to that. Mr. Stotlar has been with the since joining back in 1985. Stephen Bruffet is the current CFO of CNW and has held this position since September 2008. Gregory Lehmkuhl has served as President of Con-Way's Freight segment since 2011 and has been with the firm since 2005.



Ownership		
% of Shares Held by All Insider and 5% Owners:	1%	
% of Shares Held by Institutional & Mutual Fund Owners	95%	

Source: Bloomberg

Top 5 Shareholders						
Holder	Shares	% Out				
BlackRock Fund Advisors	5,106,313	8.82%				
Hotchkis & Wiley Capital Management	5,026,791	8.68%				
The Vanguard Group, Inc.	3,314,802	5.72%				
BlueMountain Capital Management	2,674,570	4.62%				
FMR LLC	2,531,605	4.37%				

Source: Bloomberg

	Peer Group					
Company	Market Cap	EV/EBITDA				
Werner Enterprises	2.19B	6.89x				
Swift Transportation	4.00B	9.29x				
Knight Transporation	2.66B	11.73x				
Heartland Express	2.28B	10.06x				
Old Dominion Freight	6.78B	12.73x				

Source: Bloomberg

## **INSYS Therapeutics, Inc. (INSY)**

December 5, 2014

Mengna Luo Domestic Healthcare

INSYS Therapeutics, Inc. (NASDAQ: INSY) is a commercial-stage specialty pharmaceutical company that develops and commercializes supportive care products. The company markets Subsys, a proprietary sublingual fentanyl spray for breakthrough cancer pain in opioid-tolerant patients. The company also provides Dronabinol SG Capsule, a generic equivalent to Marinol (dronabinol), an approved second-line treatment for chemotherapy-induced nausea and vomiting, and anorexia associated with weight loss in patients with AIDS. INSY's leading product candidate, Dronabinol Oral Solution, is a proprietary orally administered liquid formulation of dronabinol, which is currently in the pre-NDA stage. Insys Therapeutics, Inc. was incorporated in 1990 and is headquartered in Chandler, Arizona.

Price (\$): (11/30/14)	38.73	Beta:	1.18	FY: Dec.31	2013A	2014E	2015E
Price Target (\$):	48.35	WACC	11.74%	Revenue (Mil)	99.30	218.00	279.50
52WK H-L (\$):	57.91-20.52	M-Term Rev. Gr Rate Est:	26.7%	% Growth	541.00%	120.00%	28.00%
Market Cap (B):	1.35B	M-Term EPS Gr Rate Est:	26.0%	Gross Margin	87.00%	88.00%	88.00%
Float (mil):	13.5	Debt/Equity:	0.0%	Operating Margin	33.00%	33.00%	32.50%
Short Interest (%):	50.55%	ROA:	40.16%	EPS (Cal)	1.15	1.60	2.07
Avg.Vol (3m):	470,825	ROE:	40.16%	FCF/Share(S)	\$1.36	\$1.52	\$1.60
Dividend (S):	N/A			P/E (Cal)	33.66	24.20	18.71
Yield (%):	N/A			EV/EBITDA	23.61	15.94	11.58

#### Recommendation

Cancer is a prevalent disease that is often accompanied by severe pain. 50% to 90% of all cancer patients suffer from breakthrough cancer pain (BTCP). INSY's Subsys is specifically designed to treat this kind of pain. The firm has managed to emerge as a market leader in just over two years of commercial availability. As of 2Q14, Subsys accounted for approximately 40% of the total transmucosal immediaterelease fentanyl (TIRF) market and TRx's have grown at a compound quarterly growth rate of 32% since the product was launched in 2Q12. The TIRF prescriber audience is highly concentrated; with 1,850 physicians writing nearly 90% of all TIRF prescriptions. As of December 2013, 81% of the top 118 TIRF product prescribers (which account for 30% of all TIRF prescriptions) had prescribed Subsys. The Subsys prescriber base has widened over the past 18 months and should continue to widen as INSY's sales force continues to target its sales effort on these 1850 physicians. Besides the two commercialized products, the company is also actively developing its dronabinol pipeline with the leading product, Dronabinol Oral Solution, currently in the pre-NDA stage and four others ready to move into Phase III clinical trials in 2015. Due to its successful commercialization of Subsys, the company has seen a 541% revenue growth from FY 2012 to FY 2013. It is well positioned to double its revenue in FY 2014 with projected sales of \$218 M. Based on strong product acceptance and a favorable pipeline, it is recommended that INSY be added to the AIM equity fund with a target price of \$48.35, representing a potential upside of 24.8%. INSY does not pay a dividend.

## **Investment Thesis**

• Subsys' Distinct Advantage Over Competing TIRF Products. Subsys has emerged to become the "best in class" product in the transmucosal immediate-release fentanyl market due to its rapid onset of action, improved bioavailability, most complete range of dosage strengths and ease of administration. Patients can administer Subsys in less than one minute while Actiq and Fentora, the leading branded TIRF products, require 14 to 30 minutes to administer. Subsys also has the fastest onset of action; it provides statistically significant pain relief in five minutes, versus 15 minutes for Actiq and between 15 and 30 minutes for Fentora. As of 2Q14, Subsys was the most frequently prescribed branded TIRF product with a 40% market share. With its superior feature,

- Subsys is well positioned to capture greater BTCP market share.
- **Dronabinol Oral Solution (OS).** INSY's leading pipeline product, dronabinol oral solution, is a liquid formulation of Marinol (dronabinol). In a 52 patients bioequivalence and pharmacokinetic (PK) study conducted in 2012, Dronabinol OS showed faster absorption and less dose-to-dose variability compared to current Marinol formulation. The company recently received a Refusal to File Letter (RTF) from the FDA due to an incomplete pediatric study plan. However, the RTF is unlikely to cause any material delay in the launching of Dronabinol OS as the company will refile the NDA in 4Q14 or 1Q15; this setback is likely to be only temporary.
- Vast Addressable Market. As of 2009, there were approximately 12.5 million people in the United States who had been diagnosed or were living with cancer. The number of patients with cancer will continue to increase as the population ages and among these cancer patients, 50% to 90% of them suffer from BTCP. With Subsys being the most advanced BTCP treatment, INSY is well positioned to increase its revenue from the growing market. It's estimated that the value of the U.S. cancer pain market was \$3.1 billion in 2008 and will increase to \$5.3 billion by 2018. Besides CINV, Dronabinol SG Capsule can also be used to treat decreased appetite and weight loss, which can be triggered by a variety of conditions including psychological disorders, gastrointestinal disorders and chronic infections (such as AIDS). INSY has the option to broaden Dronabinol SG Capsule's application to treat other anorexia (besides AIDS) patients.

### Valuation

In order to reach an intrinsic value for INSY, a seven-year discounted cash flow model was conducted. Using a terminal growth rate of 3% and a WACC of 11.74% resulted in a valuation of \$49.29. Sensitivity analysis on both the terminal growth rate and WACC provided for a range between \$40.58 and \$63.01. Additionally, a P/E multiple approach was analyzed. Using the peer group average P/E multiple of 22x, and the 2015 forecasted EPS of \$2.07; a value of \$45.54 was obtained. By weighing the DCF model 75%, P/E multiple 25%, a price target of \$48.35 was established. INSY does not pay a dividend.

#### Risks

- Reliance on Major Wholesale Pharmaceutical Distributors. The majority of INSY's sales of Subsys are to wholesale pharmaceutical distributors which in turn, sell the products to pharmacies, hospitals and other customers. In FY 2013, four wholesale pharmaceutical distributors, Rochester Drug Corporation, AmerisourceBergen Corporation, McKesson Corporation, and Cardinal Health, individually accounted for 30%, 21%, 20% and 19%, respectively, of the total revenue of Subsys. The loss of any of these wholesale pharmaceutical distributors will significantly impact INSY's revenue.
- Concentration of Ownership. As of December 31, 2013, INSY's founder, Executive Chairman John Kapoor, owned approximately 72% of the company's outstanding shares. By virtue of his holdings, John Kapoor effectively controls the company's election of board members, management, and other company affairs. The concentration of ownership can potentially have adverse impact on INSY.

## **Management**

John Kapoor is the chairman of the company and he is also the principle holder of the company's stock (72% ownership). Michael Babich has been with the company since 2007 and in 2011 he assumed the role of president and CEO of INSY. Before joining INSY, Darryl Baker has held the position of VP and CFO of Igo Inc. Darryl Baker currently hold the position of chief financial officer of INSY.



Source: Yahoo! Finance

# Ownership

% of Shares Held by All Insider and 5% Owners:	71%
% of Shares Held by Institutional & Mutual Fund Owners:	29%

Source: Yahoo! Finance

**Top 5 Institutional Holders** 

<u>Holder</u>	<u>Shares</u>	% Out
JANUS CAPITAL MANAGEMENT, LLC	1,545,633	4.42
Consonance Capital Management LP	1,119,917	3.20
FMR, LLC	1,036,170	2.96
Empyrean Capital Partners, LP	868,000	2.48
Millennium Management LLC	772,896	2.21

Source: Yahoo! Finance

# Meritor Inc. (MTOR)

December 5, 2014

Brandon Cloete Domestic Industrials

Meritor, Inc. (NYSE: MTOR) is a leading global supplier of drivetrain, mobility, and braking and aftermarket solutions for commercial vehicle and industrial markets. Based on 2013 sales, the company operates in two major segments including: Commercial Truck & Industrial (76% of sales) and Aftermarket & Trailer (24%). Its products are axles, undercarriages, drivelines, brakes and braking systems. Meritor serves a range of customers worldwide, including medium- and heavy-duty truck original equipment manufacturers (OEMs), specialty vehicle manufacturers, certain aftermarkets, and trailer producers. The company reaches markets in North America (57% of sales), Europe (21%), South America (12%) and Asia Pacific (10%). The company has more than 9,000 diverse employees in 18 countries on five continents. MTOR is headquarter in Troy, Michigan.

D.: (6) (12/02/14).	14.60	D. et al.	2.21	EV. E-1	2013A	20144	2015E
Price (\$) (12/03/14):	14.00	Beta:	2.31	FY: February	2013A	2014A	2015E
Price Target (\$):	\$ 19.63	WACC	11.69%	Revenue (\$Mil)	3,701.00	3,766.00	3,819.90
52WK L-H (\$):	\$7.47 - \$15.14	M-Term Rev. C	Gr Rate Est. 4.0%	% Growth	-16.2%	1.8%	1.4%
Market Cap (mil):	1,061.60	M-Term EPS G	or Rate Est. 4.4%	Gross Margin	10.62%	12.93%	13.00%
Short Interest:	6.10%	Debt/Equity:	6.9%	Operating Marg	in 0.03%	5.76%	6.00%
Avg. Vol (90 day)	1,750,830.0	ROA:	5.6%	EPS (\$Cal)	-\$0.19	\$2.85	\$1.23
Dividend:	N/A	ROE:	N/A	FCF/Share	(1.50)	1.34	2.43
Div. Yield:	N/A			P/E (Cal)	-78.78	6.89	15.95

#### Recommendation

Meritor management has shown a deep interest in improving its productivity and has set forth a detailed strategy as to how to achieve their goals. In fiscal 2013, management announced it's M2016 strategy aligned around four key growth areas with specific goals that will ultimately lead to three key financial measures of success. 1) EBITDA margins to increase to 10%, 2) Reduction of long-term liabilities, and 3) Incremenatally book revenues of \$500 million per year. This success will be achieved through four key areas: operational excellence, customer value, product cost, and improved management practices. Steps taken thus far are as follows: MTOR consolodated its Canada and Wuxi, China facilities by transferring the the manufacturing to facilities in Plainfield IN and Xuzhou, China respectively. These consolodations will help improve operating performance to achieve its EBITDA margin target. By re-focusing on customer value, MTOR dropped its light vehicles business in 2013 to focus on its value proposition being manufacturing, engineering and testing premier axle and brake products. This has allowed them to provide higher quality products with better delivery and improved service. MTOR also began focusing on reducing the product cost and creating a purchasing team to work with suppliers in reducing COGS and improving margins. Results from this caused EBITDA margins to improve from 7.2% in FY13 to 8.3% in FY14. Finally, in 2013 MTOR took debt reduction initiatives by repurchasing \$167 million of 2015 notes and issuing \$275 million of 2021 notes, helping to extend its credit facility to at least 2017. A settlement of \$209 million was awarded to MTOR from Eaton Corp, and MTOR also completed the sale of Suspensys JV in FY13, with proceeds of \$160 million. These events, coupled with the the generation of free cash flow and the excecution of pension de-risking strategies has allowed MTOR to reduced its net debt by \$476M to \$1,439 million at the end of FY14. Because of these reasons and a favorable valuation, it is recommended that MTOR be added to the AIM Equity Fund with a target price of \$19.63, which offers a potential upside of 34.43%.

## **Investment Thesis**

• M2016 Strategy Playing Out. Q4 and FY14 results beat street expectations on almost every metric, placing greater confidence in the M2016 strategy (EPS was \$0.35 versus the consensus \$0.15, with reported revenue of \$933M over estimates of \$912M). EBIT of \$80M beat estimates

- of \$67M and FCF was \$74M versus an expected \$8M. Management also adjusted the M2016 margin target, believing it can achieve 10% EBITDA margin on revenue of \$4.2B rather than \$4.5B, reflecting confidence that it can hold margins with lower sales. Also, management now expects to complete its share repurchase program of \$210M by the end of FY16 after it managed to achieve its M2016 net debt reduction goal of \$400M in FY14.
- Strong Heavy Truck Industry. The heavy-truck industry has performed strongly in recent times. According to ACT Research, recent orders for heavy-duty (Class 8) North American trucks gew 76% YoY to 45,795 units. This was the second-highest number ever experinced in the industry and was driven by several large fleets placing orders to be built throughout 2015. Truck fleets are as aged as they have ever been, and this coupled with the industry running at near full capacity, and frieght growth expected to remain strong throughout 2015 is spurring companies to replenish their fleets and replace aged parts in existing trucks. This will provide solid demand for the entire 2015 time period.
- Contract Renewals and New Business Wins. During the year, MTOR excecuted a 4-year contract with Daimler Trucks North America, to retain their position of providing parts to the company. MTOR also entered into long-term supply contracts with its largest customer, Volvo. A seven year agreement for axles in Europe and South America, along with a four year agreement for axles in Australia and another four year agreement for axles and drivelines in North America.

#### Valuation

In order to reach an intrinsic value for MTOR, a five year discounted cash flow model was conducted. Using a terminal growth rate of 2.5% and a WACC of 11.69% resulted in a valuation of \$19.63. Sensitivity analysis on both the terminal growth rate and WACC provided for a range between \$16.71 and \$22.08. A price target of \$19.63 presents a potential upside of 34.43%. MTOR does not pay any dividend.

## **Risks**

- Large OEM customers. MTOR is dependent upon large OEM customers with substantial bargaining power with respect to price and other commercial terms. In addition, the company has long-term contracts with certain of these customers that are subject to renegotiation and renewal from time to time. Loss of all or a substantial portion of sales to any large volume customers for whatever reason, continued reduction of prices to these customers, or a failure to obtain new customers, could have a significant adverse effect on MTOR's financial results.
- **Downturn in the global economy.** Although the global economy has improved since the global economic recession that began in late 2008 and continued through 2009, the recession had a significant adverse impact on the business, customers and suppliers. If the global economy were to take another significant downturn, depending upon the length, duration and severity of another recession, the results of operations, financial condition and cash flow would be materially adversely affected again.
- Cyclical Industry. MTOR operates in an industry that is cyclical and that has periodically experienced significant year-to-year fluctuations in demand for vehicles; as well as seasonal variations in demand for products.

## Management

Ivor J. Evans is the Chairman and Chief Executive Officer and has been a member of the Board of Dierctors since 2005. He was appointed CEO in August of 2013. Jeffery A. Craig is the President and Chief Operating Officer, overseeing both major business segements. Kevin Nowlan is the Chief Financial Officer as well as a Senior Vice President. Members of the Board of Directors include the following: Joseph B. Anderson, Jr., Rhonda L. Brooks, David W. Devonshire, Victoria Jackson Bridges, William J. Lyons, James E. Marley, William R. Newlin, and Thomas L. Pajonas.



Owne rs hip		
% of Shares Held by All Insider and 5% Owners:	7%	
% of Shares Held by Institutional & Mutual Fund Owners	85%	

Source: Yahoo! Finance

Top 5 Shareholders			
Holder	Shares	% Out	
Lasry, Marc	7,345,557	7.51%	
Vanguard Group, Inc. (The)	7,054,986	7.21%	
Glenview Capital Management, LLC	6,516,803	6.66%	
Hotchkis & Wiley Capital Management, LLO	5,409,942	5.53%	
Lsv Asset Management	4,139,760	4.23%	

Source: Yahoo! Finance