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Value Investor INSIGHT

The Leading Authority on Value Investing

Attention Deficit

Spinoffs after gaining their independence can take quite some time to capture broad investor attention and interest. Springview Capital's Guy Baron explains why he expects that to eventually happen in the case of Worthington Steel.

He regularly looks at spinoffs for potential ideas, but Springview Capital Management's Guy Baron wasn't expecting much in looking into Worthington Steel following its separation last December from industrial conglomerate Worthington Enterprises. "You see steel in the name," he says, "and immediately think cyclical and not high quality."

Digging deeper he concluded his first impression was deceiving. The company is a steel processor, buying hot-rolled steel and then cutting it, coating it, shaping it or otherwise treating it to meet industrial end-customer specifications in a range of industries – the largest of which is automotive, accounting for close to 50% of total sales. The capital intensity of the business is relatively low – annual capital spending is typically around 15% of earnings before interest, taxes, depreciation and amortization [EBITDA] – and inventories turn relatively quickly without much obsolescence risk. The value-added nature of the business has resulted in average 17-18% returns on invested capital over the past decade.

Trading recently in the mid-$30s, the stock is above its initial trading price but Baron sees little investor enthusiasm for its prospects. Part of that he attributes to lack of interest – only two analysts at small firms follow the stock – but the steel-industry backdrop is also cyclically weak, and the company's earnings have been further dampened by an ongoing $300 million investment program to expand capacity for processed steel to be used in electric vehicles and in upgrading the electricity power grid. "Management is doing what it should be doing as an independent company, reinvesting in the core business while also streamlining the cost structure," he says. "But for various reasons there just aren't a lot of eyes on it right now."

Assuming a 15% increase in annual EBITDA from the capacity expansion program and 3-4% annual organic EBITDA growth, Baron believes Worthington in its fiscal year ending in May 2027 can earn close to $370 million in EBITDA. In assigning a multiple, there have been precedent deals – usually involving a big steel producer like Nucor or Steel Dynamics adding a steel processor to their portfolio – priced at 8x EV/EBITDA or better. At

INVESTMENT SNAPSHOT

Worthington Steel
(NYSE: WS)

Business: Processes hot-rolled steel to meet industrial-customer specifications; now independent after late 2023 spinoff.

Share Information (@8/30/24):

Price	**35.40**
52-Week Range	21.00 – 41.01
Dividend Yield	1.8%
Market Cap	$1.78 billion

Financials (TTM)

Revenue	$3.43 billion
Operating Profit Margin	6.3%
Net Profit Margin	4.5%

Valuation Metrics
(@8/30/24):

	WS	S&P 500
P/E (TTM)	11.4	24.0
Forward P/E (Est.)	11.1	23.0

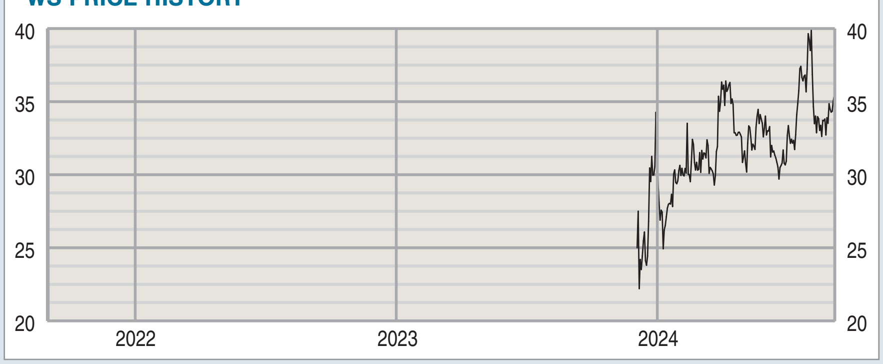
Largest Institutional Owners
(@6/30/24 or latest filing):

Company	% Owned
BlackRock	9.8%
Vanguard Group	8.1%
Dimensional Fund Adv	4.7%

Short Interest (as of 8/15/24):

Shares Short/Float	1.4%

WS PRICE HISTORY



THE BOTTOM LINE

This is a higher-quality and more-profitable business than he originally expected it to be, says Guy Baron, who argues the market has yet to fully recognize that. At 7x EV/EBITDA on his 2027 estimates the shares would trade at more than 40% above the current price.

Sources: S&P Capital IQ, company reports, other publicly available information

7x, the shares on his fiscal 2027 estimates would trade at around $50. At 8x, they'd go for around $60.

The private-value approach to valuation is relevant, he says. As part of a bigger conglomerate, the company was more focused on delivering cash to its parent rather than reinvesting capital back into its business. Now independent, management doesn't have that constraint, he says, and has the expertise and balance sheet to pursue accretive M&A. Eventually he also considers Worthington an attractive target itself for steel manufacturers looking to expand their range of value-added products and deepen their customer relationships. "This is a management team capable of running a much bigger business," he says. "I think they ultimately will." VII