

Search Criteria

Miller Industries Inc. (MII) meets most of the traditional value investing criteria. MII fulfills the P/E criteria with a P/E of 12.21. Additionally, MMI has a market capitalization of only \$281 million. MII has very minimal analyst coverage. As well as, MII has stable cash flows, a simple business model and has consistent dividends. MII do have a competitive advantage as they have several patents, and strong customer relationships (Exhibit 1). It is believed that MII meets enough of the criteria to demonstrate potential undervaluation. We will continue the valuation process to determine if MII is undervalued.

Industry and Company Analysis

MII operates in the towing and equipment recovery manufacturing industry. The industry is moderately exposed to cyclicalities, with sensitivity to economic conditions and fluctuating commodity prices. The industry has high barriers to entry due to patent protection, allowing industry incumbents to be shielded from new entrants. As a result, it is believed that the industry risk is medium. MII is the largest player in the industry, with greater than 50% market share. MII have stable, but relatively thin operating margins, due to the high fixed cost nature of the business. Considering this, as well as the medium industry risk, we have determined that MII has **medium business risk**. MMI's optimal capital structure should fall within 30-49%. MMI's two-year average capital structure of 4.61% is well below the optimal capital structure, meaning that MMI has **low financial risk** (Exhibit 2). A company with medium business risk and low financial risk implies a credit rating of A-AA. After analyzing MMI's financial ratios, we have decided that MMI should have a AA bond rating. A AA bond rating implies a credit spread of 0.69% over the risk-free rate of 2.82%, providing a cost of debt of 3.51%. Using the appropriate equity risk premium of 4% and MII's 22% tax rate a WACC of 7.29% is calculated (Exhibit 3). MII's average first-pass ROIC is equal to 11.44%, which is above WACC, indicating that EPV is expected to be above NAV.

Valuation

After performing an NAV valuation, it has been determined that the replacement cost of MMI's assets less its liabilities is \$341 million. With 11 million shares outstanding, MII's NAV/share is equal to \$20.49 (Exhibit 4). After normalizing zero-growth free cash flows, further adjustments were made to finalize an EPV of 313 million, equating to \$28.36/share (Exhibit 5). MII's NAV exceeds its EPV by 6%, indicating that they are not efficiently using their asset base to generate cash flows. MMI's final-pass ROIC of 6.79% is less than their WACC, concluding that MMI is destroying value through growth (Exhibit 6).

Strategic Analysis

The main reason that EPV is below NAV is due to a temporary competitive disadvantage stemming from MII operating at less than full capacity during 2017 due to plant renovations. MII's assets continued to grow, while sales lagged. Management believes that 2018 growth will revert to historic averages as they will be operating at full capacity and have a large backlog of sales. Additionally, MII is operating outside of the optimal capital structure. If management increased their capital structure to 40%, EPV/share would change from \$28.36 to \$36.66. There does not seem to be excess capacity in the industry. Thus, we have assigned a **probability of catalyst of 70%**. It is very likely that the temporary competitive advantage will no longer exist throughout 2018. Additionally, even though management has begun to increase their target capital structure, it is unlikely they will adjust all the way to optimal.

Recommendation

Applying the 70% probability of catalyst to MII, provides an intrinsic value of \$29.50. Once a one-third margin of safety is applied to the intrinsic value MII has an entry price of \$19.66. MII's entry price is well below their current stock price of \$24.75, meaning that one should wait and not invest until the stock price falls below \$19.66 (Exhibit 7).