Reko International Group Valuation | Submitted by: Group 7 (Campbell, Tim; MacLeod, Pete; Mulherin, Pat; Savage, Coby)

Justification for Company: Reko International Groups' low price to adjusted earnings (P/E) multiple (6.9x – less than the 13x value benchmark), low price-to-book (0.5x – lower than the 1.2x value benchmark), low market capitalization ($22.5M CAD – lower than the $500M CAD value benchmark), low analyst coverage (very little) and stock performance (weak – stock price is currently at $3.50, close to the 52-week low of $3.29 and 42% lower than the 52-week high of $5.12) indicate that the stock is potentially undervalued. Based on the low P/E ratio, P/B ratio, market cap, analyst coverage and stock performance, the stock is potentially undervalued and therefore an intrinsic valuation of Reko is warranted.

Industry Overview: The machine services industry is highly fragmented and is typically serviced by standalone operations that are diverse both geographically and in terms of the services they provide. Suppliers who can best support their customers' needs in terms of quality, pricing, service and innovation are those with long-term competitive advantages. Innovation is required to meet customers constantly changing demands; therefore, manufacturers must accurately predict future trends and invest in technology that allows them to service their client's needs. Specifically, there have been shifts to autonomous technologies, green technologies and an application of the Internet of Things. Large customers typically exist in the automotive industry, in addition to oil and gas and aerospace. Industries in need of large machinery (specifically automotive, oil and gas and aerospace) are typically cyclical and largely tied to general economic conditions. Machine services are experiencing a constant threat of overseas competition, as suppliers operating in lower-cost countries can offer more competitive pricing. Additionally, there is the threat that domestic Original Equipment Manufacturers (OEM's) may shift parts of their manufacturing processes overseas, therefore eliminating their need for local suppliers.

Company Analysis: Reko is a technology-driven manufacturing organization. The company is diversified across multiple business units including robotic factory automation solutions, plastic injection, low compression acoustic tooling, and precision machining of large, critical parts. The company's diversification is seen as a strength, as it is not reliant on a single business line for the overall company success, and it is diversified across current and forward-looking products (robotic factory automations solutions); this implies that Reko is positioned to service its customers' needs now and into the future. Reko has also hinted that they may explore expanding into renewable energy as a source of additional income, suggesting that the company is trying to further diversify its product offerings[1]. Reko designs and manufactures customized products and services for OEM's and its tier 1 and tier 2 suppliers. Its customers are primarily in the automotive industry (representing 65% of sales), as well as oil and gas, aerospace and other industries (35% of sales). Within the automotive industry, its major clients are the big three Detroit OEM's, which combined represent 52% of total sales. Although this exposes Reko significantly to the overall performance of the automotive sector, it has enjoyed long-term relationships with these large players, which implies that over half of the company's revenue is from a stable and predictable source. 85% of Reko's sales are in the US and the company is therefore dependent on the strength of the economy in the U.S. NAFTA negotiations may impact Reko's ability to export into the U.S and, depending on the result of these negotiations, it may need to alter its strategy. Reko has acknowledged this risk and has been preparing for the possibility of geographical expansion. Although Reko's proximity to Detroit makes the automotive 'Big Three' natural partners, there are other major automotive manufacturing facilities across Ontario that could potentially replace any lost revenue if an unfavourable NAFTA agreement is reached. Overall, considering the nature of the machine factoring industry and the strength of Reko, we have rated the <u>business risk as medium.</u>

Financial Risk: With respect to financial risk, Reko has a target capital structure (B/V ratio) of 15% (discussed further in Valuation of Reko below). This was calculated with annually adjusted estimated capitalized operating leases (based on the FY 2017 capitalized operating leases as a % of sales). Reko is targeting a capital structure that is below the optimal capital structure range for a medium-risk business (30-49%). Therefore, based on this capital structure, this suggests that Reko has <u>low financial risk</u>. This suggests an expected credit rating of either "AA" or "A" for a company of low financial risk within the medium business risk category, implying an Equity Risk Premium (ERP) of 4%. Using financial metrics as a comparative measure, Reko was more closely aligned to the "A" bond rating based on Moody's rating chart for Distribution and Supply Chain Services. An S&P "A" bond rate in March 2018 was 194 bps over the 10-year US treasury yield. The 10-year Canadian yield was 2.158%.

Summary of Strategic Valuation:

WACC	1st Pass ROIC	NAV	EPV	2nd Pass ROIC	Prob. Of Catalyst.	Catalyst Value	Intrinsic Value	Entry Price
7.34%	6.3%	$12.70	$5.23	3.4%	20%	$1.50	$6.72	$4.48

Drivers of Catalyst:

Sources of Potential Catalyst	Indicators of Opportunity to Achieve Catalyst
Management	• Has seen revenue on average decrease over past 10 years (✓) • Has kept costs controlled which has facilitated bottom line growth and 26 consecutive profitable quarters (✖) • Has invested in innovation and accurately predicted customer trends (✖) • Recognized opportunity to restructure plant in 2011 to get rid of any excess capacity (✖) • Diane Reko and Reko family dominating decision making (?)
Excess Capacity	• Plant restructured in 2011 to get rid of excess capacity (✖)
Competitive Disadvantage	• 62.3% ownership by Reko family (?) • Inability to diversify beyond the automotive sector (✖) • Inability to diversify outside of the US (✖) • Small company size limits size of projects it's able to bid on (?)

Probability of Achieving Potential Catalyst (20%): The low probability of achieving potential catalysts is based on a good management team controlled by the Reko family, limited excess capacity due to the 2011 restructuring, and a competitive disadvantage that the company has acknowledged difficulty overcoming. From a managerial perspective, we think there is a low likelihood of a significant management change, as the company is 62.3% owned by the Reko family and Diane Reko has been CEO for over a decade. In terms of excess capacity, in 2011 the company underwent a corporate restructuring aimed at reducing operating costs and reducing capacity. Recently, Reko has started to expand again, as evidenced by its $5.6M investment in a new innovation and manufacturing facility. Given the previous restructuring and the recent growth, we believe there is no excess capacity for the company to remove at present, especially as the increased capacity of its new facility has not been factored into any of their financial results to date. Lastly, the company is at a competitive disadvantage due to its reliance on the automotive sector, its reliance on the U.S, and its relatively small size, limiting its ability to compete on large projects. Management has recognized these issues in the MD&A, and has specifically noted that it have been unsuccessful in its attempts to diversify significantly. Understanding management's recognition of the issues but historic inability to fix them, we have rated the probability of these changing as low. Overall, across the three criteria for achieving potential catalysts, we believe that there is a low chance that there will be a significant change, and therefore we have assigned a low probability rating (20%) in achieving potential catalysts.

Recommendation: <u>Buy</u>. We believe that REKO is currently undervalued at a share price of $3.50 as at March 15, 2018. The firm's Earnings Power Value alone exceeds the current trading price and its Net Asset Value far exceeds the current market price by a factor of almost 4x. Despite the low probability of achieving potential catalysts, our entry price, $4.48, is still substantially higher than the current market price after factoring in a MOS of 33.33%. Therefore, despite significant risks and the small-cap nature of the firm, we believe the company is currently a buy. We believe that the firm is a strong candidate for a take-over by a larger player (such as a Linamar) or that management may take purchase the remaining publicly held shares outstanding and take the firm private again. Either scenario would result in what we believe to be a significantly higher purchase price that the firms current market capitalization would suggest.

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[1] Schmidt, Doug. "Updated: Reko Announces $5.5M Plant Expansion in Lakeshore." *Windsor Star*, 3 Aug. 2017, windsorstar.com/news/local-news/reko-announces-5-5m-expansion-in-lakeshore.