Justification for Choosing Company Consistent with Value Investing Principles

Owens & Minor (OMI) meets the value investing criteria and appears to be potentially undervalued. OMI's P/E ratio of 12.8x is below the 13.0x limit, along with their M/B ratio of 0.9x, below the 1.2x mark. They have also consistently returned value to shareholders through share buybacks and dividends. They have medium sell-side analyst coverage, and a market capitalization of $928 million, below the $1.3 billion threshold on US equities. However, the company may not be obscure, given that its market capitalization was $2.2 billion a year before. The healthcare distributor and wholesaler industry has stable growth, and is mature. Overall, OMI provides an interesting investment opportunity worth investigating.

Analysis of the Industry and Company

Business Risk (Medium): OMI is largely a medical distributor and wholesaler, sourcing medical and surgical products from manufacturers, suppliers and wholesaling to healthcare providers when needed. They also assemble the surgical procedure kits in their proprietary segment, ultimately vertically integrating to gain more control and differentiation in an increasingly competitive market. The broader healthcare industry is recession-proof, given that people will become sick or injured regardless of the broader economic cycle. OMI's end customers are healthcare providers. These customers include hospital networks offering a broad spectrum of healthcare services and as smaller, independent hospitals in the U.S. There are moderate barriers to entry because the vast distribution network is hard to replicate. Majority of the healthcare providers are represented by GPOs and building new relations is challenging for the new entrants with only a few major competitors.

Over the last decade, the company has mostly grown through acquisitions, a function of the mature-stage healthcare industry, to diversify their product and service offerings and reach new geographies. OMI has competition in their peer group, however the Company has access to a valuable and globally recognized distribution network that allows them to leverage their network strategy. Through this strategy, they are able to provide points of care and do activities that benefit themselves and manufacturers. The business risk for Owens appears to be medium. This is confirmed by their stable revenue growth with shrinking margins due to distribution over the last 12 years **(Exhibit 1)**. With a medium business risk, the optimal capital structure for OMI is between 30-49%.

Financial Risk (Medium): The Company has increased leverage with economic cycles, with ~40% debt-to-capital pre-financial crisis, ~30% for five years following the crisis, and 40-50% for the last five years (**Exhibit 2**). While 2017 debt to capital was 52.8%, above the medium financial risk bound, management indicated that this is a result of their recent acquisition and will de-lever soon. We believe their target debt-to-capital will tread closer to their 4-year and 12-year averages, in the 40.3 - 47.2% range, indicating medium financial risk. This aligns with our BBB implied credit (**Exhibit 3**) and Moody's BBB- rating.

WACC: Using the US 10-year note yield of 2.81% and a BBB US-corporate spread of 142bps, we arrived at a 4.23% Kd. Applying a 5% equity risk premium for being a medium business and financial risk company gives us 9.23% Ks. Using the Company's 4-year average target C.S. of 47.4% debt and 52.6% equity and a 25.3% marginal tax rate, we arrived at a **WACC of 6.4%** (**Exhibit 4**).

1st Pass ROIC: First pass ROIC (**Exhibit 5**) for OMI is calculated from 2006 to 2017, to normalize for a full business cycle, at 9.1%. This is greater than the WACC of 6.4%. As a result, we expect that OMI's EPV will be greater than their NAV.

Valuation

NAV ($23.02/share): Major valuation drivers for NAV (**Exhibit 6**) include working capital, goodwill, PP&E, customer relations, and debt. Implied marketing expense is 2% of sales, so we used a 1.0x multiplier for customer relations to account for keeping up relationships with GPOs and managing customer churn. OMI is not driven by R&D, so there is no value in the product portfolio thus we assumed a 0.0x multiplier for product portfolio.

EPV ($19.58/share): Major valuation drivers for EPV (**Exhibit 7**) are the present value of no-growth free cash flows, debt, and adjusted operating leases. An average operating margin of 1.7% was used to normalize operating profit for cyclicality, industry trends, and a one-off poor performance year in 2017. Other adjustments include underfunded pension obligations.

2nd Pass ROIC: The Company's second pass ROIC is 5.7% (**Exhibit 8**) lower than their WACC and 1st pass ROIC. This ROIC is lower than their 1st pass ROIC largely due to the inclusion of their S&IP acquisition and Customer Relations. The second pass ROIC is in line with their NAV per share being greater than their EPV per share.

Catalyst Discussion

Management: Although a lack of experience at the company and in healthcare is a cause for concern, the larger concerns are management's prior track record of poor capital allocation at Essendant Inc. (ESND) and credibility given their earnings misguidance. Management does not have stake in company performance, and there is no dual-class stock structure. Therefore, activist investors and additional pressure from shareholders could help realize a change, making management a potential catalyst.

Excess Capacity: Relative to their peers, the Company is in line with their asset turnover; largely a function of their U.S. operations. In 2017, OMI had a 3.8x asset turnover in their domestic segment. However, their international segment has historically had an ~0.9x asset turnover; well below their competition. Although the Company is making efforts to expand their international footprint, selling assets associated with Movianto, which, on average, over the last three years accounted for 14.2% of total assets, 3.7% of total sales, and 0.5% of EBIT, could be a potential catalyst.

Competitive Disadvantage: There is nothing that indicates a competitive disadvantage in the domestic segment aside from less benefits from economies of scale and the company being susceptible to the margin pressures in the industry.

Value Trap Analysis

Pursuant to the common signs of a value trap, OMI does not seem like a value trap. While there are concerns regarding management, they do justify establishing OMI as a value trap. Management does not seem to be exceptionally close to the firm, is open to changes in strategy, and does not see themselves as dominating their field. Additionally, OMI's operations and organization structure are understandable, and the company has transparent accounting policies. Unfortunately, management has been focused on acquisitions lately, in line with the CEO's strategy at ESND. This indicates a bad strategy and justifies the negative market reaction.

Intrinsic Value & Recommendation

OMI's intrinsic value is $21.30 (**Exhibit 9**). With entry price of $14.20 and current price of $15.09, we recommend waiting.