Ivey Value Fund

Analyst Report

Recommendation	BUY
Company Name	Vista Outdoor Inc.
Ticker	NYSE: VSTO
Date	March 26th, 2018
Market Capitalization	$955M
Current Price	$16.54
Intrinsic Value	$25.55
Entry Price	$17.03
NAV/Share	$33.37
EPV/Share	$17.73
Catalyst Value	$7.82
Analyst Names	Harsh Naik, Hashu Rahim, Ajith Sukumar, Jonathan Wong

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Screening Process

Vista Outdoor Inc. (VSTO) meets many value investing criteria when running the initial screens and does **appear to be undervalued**. In terms of **undesirability,** as of March. 23rd 2018, VSTO has a M/B multiple of 0.8x, which is below the 1.2x threshold, and a negative price-to-earnings multiple due to an impairment of goodwill. Regarding **obscurity**, VSTO's market capitalization of $955mm is well below the threshold of $1.3bn. In terms of **management strategy & ownership**, VSTO's management commonly announces share buyback programs and operates a simple business model in a mature and highly regulated industry.

Industry & Company Analysis

Business Risk: Vista operates two primary segments, Outdoor Goods and Shooting Sports which represent 46% and 54% of revenue, respectively. The outdoor sporting goods industry is highly fragmented which presents an opportunity for Vista as they offer many complementary products. Concentration in the shooting sports manufacturing industry is low with the largest four players constituting only ~30.5% of the overall market. Management has been growing the outdoor sporting goods segment as in 2014, this segment represented ~24% of revenue and in 2017 it comprised ~46% of revenue. The growth of the outdoor sporting goods business mitigates the volatility in the shooting sports segment; which is highly susceptible to political events. Vista has experienced minimal fluctuations to operating profit and gross profit from 2012-2018 **(Exhibit 1)**. Additionally, as of October 2017, Vista hired Chris Metz as CEO. He has a history of building consumer brands and has already sold three non-core business units. Thus, with shooting sports cyclicality countered by positive outdoor recreation trends we believe the business risk is **medium**, indicating an optimal capital structure of 30%-49%.

Financial Risk: Vista's debt/capital has fluctuated greatly, increasing from 8.0% in 2013 to 55.5% in 2014, and then deleveraging back down to 20.3% in 2015. However, in the past three years, the company's debt/capital has stabilized within the 30%-50% range. We believe that this level is reflective of management's strategy going forward, and thus, we used an average of the past three years to represent the target capital structure. With a target debt/capital of 42.1% **(Exhibit 2)** we determined the financial risk to be **medium**, implying a debt rating of A-BBB.

WACC (8.48%): Given Vista has no publicly traded debt, we compared various financial ratios (interest coverage, FFO metrics, and debt/capital) to assess Vista's credit rating. The implied rating ranged from CCC to A, to be conservative we assigned a rating of B. Although this is lower than the implied rating of A to BBB, we believe it is appropriate as it reflects the high levels of goodwill impairment. Using the risk-free asset yield of 2.83% and a 3.68% credit spread for B-rated companies results in a 6.51% pre-tax cost of debt. The equity risk premium given their risks was 6.0% (due to the B credit rating) and with a marginal tax rate of 33.8%, a weighting of debt of 42.12%, results in a WACC of 9.06% **(Exhibit 3)**.

1st Pass ROIC (7.7%): The 1st pass ROIC resulted in a 6-year average ROIC of 7.7%, which is less than the WACC of 9.06%. Since the company records Goodwill Impairment in their operating expenses, we added them back to normalize ROIC across the six years. Since 1st Pass ROIC is less than WACC, we can expect that NAV > EPV **(Exhibit 4)**.

NAV & EPV Valuations

NAV ($33.37): Vista's NAV/share is $33.37, with the key drivers being PP&E, intangibles, goodwill, and receivables/inventories. PP&E is large given that it has been recorded at cost on the balance sheet, but the value of assets such as land and buildings have appreciated over time. Intangibles and goodwill are large because Vista has over 600 patents and the Company has been extremely acquisitive historically, acquiring 4 companies between 2015-2016 alone. Finally, given the inventory stockpiling which occurred in the industry due to the election results in November 2016, both inventory and receivables are high. The risk of obsolescence in terms of inventory is low simply because the industry is not highly innovative. Finally, a customer relations multiplier of 1.75x was used given that Vista holds the No. 1 or 2 market shares across all its brands and has over 20,000 customers, where the top 10 customers only account for 38% of sales **(Exhibit 5-10)**.

EPV ($20.09): Vista's EPV was determined to be $17.73/share. This was calculated using a zero-growth capex of $31mm which is equivalent to the Company's D&A. Zero-growth capex was initially calculated using both methods 1 and 2, however the value was almost twice as high as D&A. The value of $17.03/share represents a catalyst value of $7.82 **(Exhibit 11-16)**.

2nd Pass ROIC (5.7%): The second pass ROIC holds true the relationship noticed in the first pass calculation. Under the second pass calculation, ROIC was determined to be 5.7%, which is lower than a WACC of 9.06%, resulting in NAV > EPV.

Strategic Valuation Analysis

Management: Mark DeYoung, the former CEO, was empire building given the +$2.0bn spent on acquisitions during his tenure. DeYoung was also growing the wrong segments of the business (low margin/low ROIC) and was severely overpaying for acquisitions, given the ~$449mm impairment loss. This is evidenced through the ROIC and capital turnover at Vista declining from 12.9% and 1.5x in 2013, to 7.0% and 0.8x in the most recent fiscal year. We feel much more confident with the new CEO, Chris Metz's abilities. Metz has already downsized Vista by divesting non-core assets and has repeatedly indicated in earnings calls that he will continue to do so until the company is rightsized. As such, given the fact that Vista has already replaced the old CEO and the new CEO is already taking the right direction, **we believe the probability of management as a catalyst is high.**

Excess Capacity: In November 2016, the presidential election significantly exposed Vista's missteps, as it precipitated a cyclical decline in demand and highlighted the significant inventory build-up. Since then, a substantial inventory de-stocking has occurred, leading to meaningful declines in Vista's volumes, pricing and gross margins. However, it has been over 12 months since the election and at the time management indicated that it would take 18-24 months to recover from the cycle. Once inventories normalize, purchases will begin to reflect the underlying demand, which will restore revenue growth. With timing being uncertain **we believe the probability of catalyst is medium.**

Competitive Disadvantage: We do not believe Vista is operating at a competitive advantage. While Vista's ROIC is lower than its competitors, due to having a much lower capital turnover which can be attributed to poor capital allocation. Vista has over 50 different brands, all of which enjoy the No. 1 or 2 market shares in their respective product categories. In addition to this, Vista's market share has risen from just under 30% in ammunition to 40% in roughly 15 years. With that said, **we believe the probability of a competitive disadvantage existing is low.**

Valuation Summary & Decision

We arrived at an intrinsic value of $25.55 per share with potential catalyst value of $7.82 per share and entry price of $17.03 per share. Based off the current price of $16.54, it is **recommended to buy a position in Vista Outdoor Inc (Exhibit 17)**.