My MBA investment students found this deep value stock intriguing

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With the 2022-23 school year at its end, my value-investing students submitted their final stock picks and analysis, which are a very important element of my value-investing classes at the Ivey Business School.

As has always been the case for young investors, it is much easier to find "deep value" stocks (those Ben Graham would have liked, normally lower-quality small-cap stocks that have low price-to-earnings and price-to-book ratios), than finding "quality" stocks (those that would appeal to Warren Buffett, with a high degree of competitive advantage and sustainability, which can still be found to be undervalued, even with a higher P/E, or market cap).

And so, all groups in my recently completed MBA value investing class chose to value Ben Graham-like stocks. One group's stock pick, however, got my attention. Sanjog Mishra, Jeff Smith, John MacKinnon, Salena Nazarali and Vallabh Desai chose to study and value TerraVest Industries Inc. (TVK) TRRVF (/investing/markets/stocks/TRRVF/) +0.19% ▲ . TVK got my attention and prompted me to profile it in this article because, according to the students, the stock is valued by the markets as a Ben Graham stock when in fact the stock should be viewed more like a Buffett-like stock.

TVK passed all Ben Graham screening criteria. At time of valuation (early June), its market cap was $496-million, and its P/E was 10.5 times, both of which meet the Ben Graham benchmarks.

TVK operates in the industrial goods industry, which includes companies involved in manufacturing or distributing capital goods, such as construction, engineering, industrial machinery, commercial services, and electrical equipment. The performance of the industrial goods industry is tied to the overall economy, as fluctuations in demand are dependent upon general economic activity and so the overall economic cycle determines revenue fluctuations. This exposes the industry to high business risk.

TVK's products and operations, however, fall in a subset of the industrial goods industry which is known as "heavy industry." TVK is a diversified industrial company that sells goods and services to a variety of end markets, manufacturing home heating products, propane, anhydrous ammonia and natural gas liquids transport vehicles and storage vessels, energy processing equipment and fibreglass storage tanks.

Factors mitigating TVK's business risk vs. the industry are: First, while TVK has significant exposure to oil and gas and steel prices, as well as currency exchange, the firm has mitigated both through futures contracts. Second, in the heavy industry subsector, barriers to entry are high as capital requirements, scale, and the complexity of operations are high. Third, TVK must meet multiple compliance standards related to ESG in order to operate, which also acts as a barrier to entry and shields TVK from new entrants.

For a company to succeed in the industry, it needs scale to service large contracts, and economies of scale to cost-effectively offer goods and services. TVK seems to have a scale advantage vs. its competition as is exemplified by the following: First, it has 21 locations across Canada and the United States and 19 brands under its umbrella. Second, its operating margins (OM) have been higher than those of its key competitors, such as Shawcor Ltd., Enerflex Ltd. and Total Services Energy Inc., since 2017 and quite stable over time, averaging 12 per cent annually since 2011. Finally, TVK's return on assets (ROA) has significantly exceeded that of competitors since 2017 and is increasing while those of competitors are on the decline.

TVK's chief executive, Dustin Haw, has a PhD in physics and a CFA. His tenure at TVK indicates that he is a competent operational leader for the firm and his investment experience grants him proficiency as a capital allocator. Other members of the management team display impressive and relevant experience suitable for supporting TVK's success. Since ROAs and OMs have remained consistently high and stable throughout multiple acquisitions, students concluded that TVK's management has strong operating and capital allocation skills.

TVK has cost, demand, and economies of scale advantage.

TVK has a cost advantage, as it can produce the same goods at a lower cost than new entrants owing to its technology-based intangibles, trademarks, proprietary technology, processes, and know-how. It also has a demand advantage through the long-term nature of its contracts and high searching and switching costs.

Search costs: The fact that TVK also offers customized products is attractive to buyers, so once a customer is onboarded, there is a very low likelihood that they will seek out a competitor to supply new goods. Moreover, the products that TVK supplies often represent a small unit of the buyer's cost base (storage solutions, transportation, and processing equipment), therefore buyers are not motivated to invest time and effort to search for a new supplier.

Switching costs: Engineering requirements and standardization of operations indicate high switching costs. The products that TVK's customer base works with are of high value, so downtime associated with switching suppliers is very costly. TVK also offers the benefit of adjacent delivery services and servicing for some products, which makes it an even stickier supplier.

Finally, TVK also enjoys an economies-of-scale advantage due to the inherent high fixed costs of operating in this industry in relation to variable costs and its dominating position in the industry, as explained above.

Given the reasons mentioned, and particularly the stability of the company's gross and operating margins and considering its diversified operations and immense scale that shields TVK from its industry's high business risk, students concluded that TVK has a medium business risk. With the company targeting a roughly 55 per cent debt-to-capital ratio, students reckoned that TVK has high financial risk. This led to a cost of capital of 7.87 per cent, which students determined using an algorithm taught in the value investing course, which is based on business and financial risk.

The company's adjusted return on invested capital (ROIC) was estimated at 12.97 per cent.

The magnitude and stability over time of the difference between ROIC and cost of capital reinforced students' belief that TVK has a sustainable competitive advantage. This was important as it allowed the students to value the company as a growth company.

Intrinsic value was estimated to be $41.76 a share and, accounting for the margin of safety, the entry price was estimated to be $27.84. With the stock trading at the time of valuation at about $26.99, students felt TVK was a buy.

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