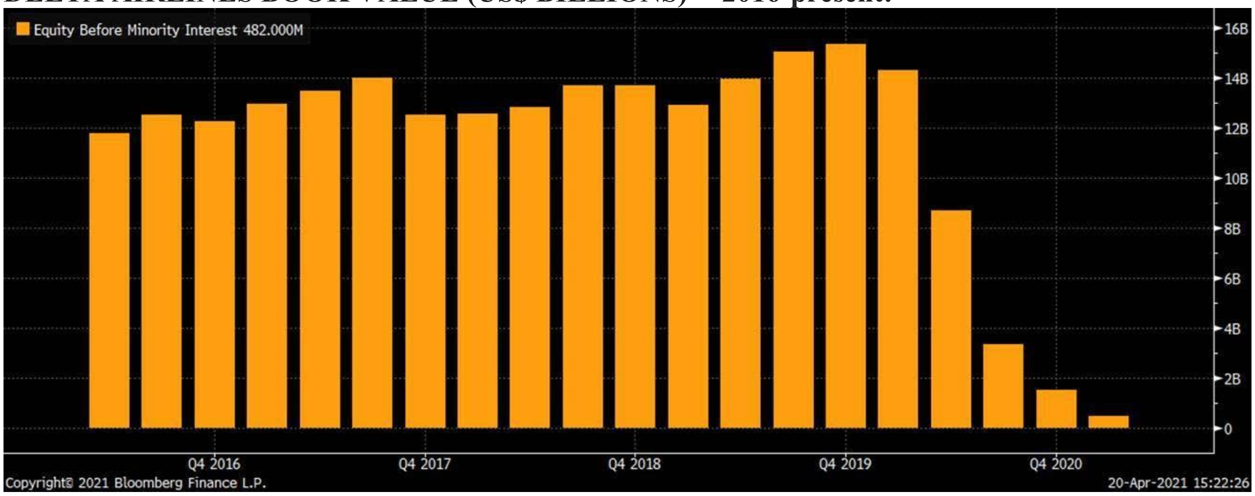
Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights bullet points - April 19, 2021

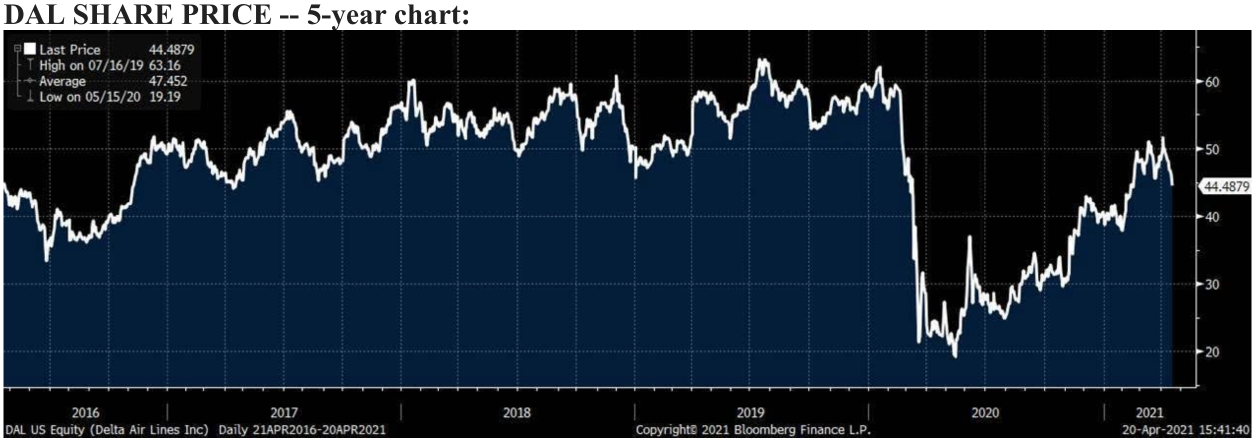
Book value of the US airlines has completely collapsed. Delta, which pre-COVID had the strongest balance sheet of the major legacy airlines (ex Southwest) has seen its book value fall from $15 billion down to just $0.5 billion in five quarters.

DELTA AIRLINES BOOK VALUE (US$ BILLIONS) -- 2016-present:



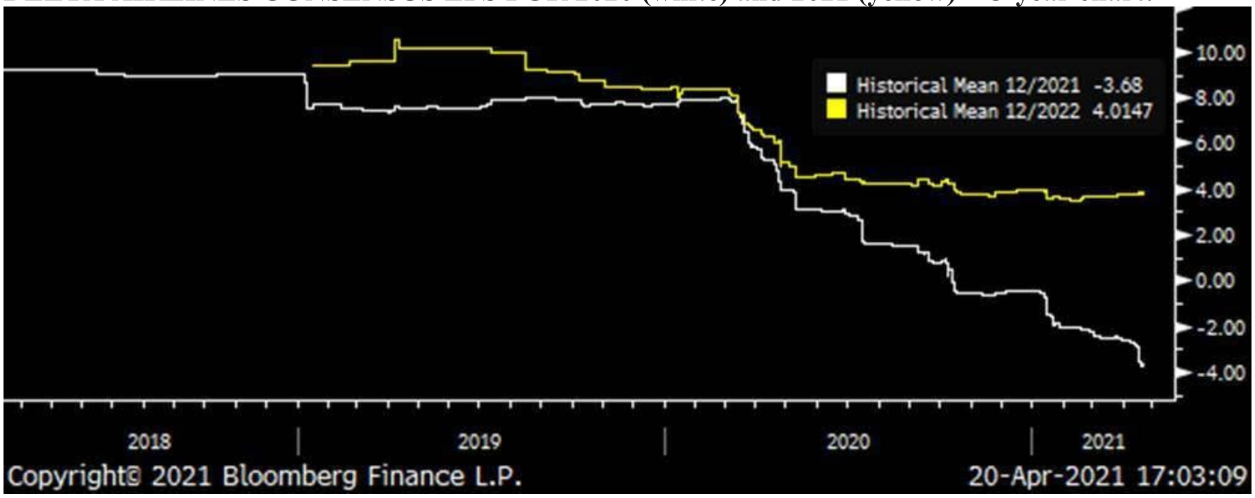
Yet the Delta stock price is $45/share and the market cap is $28 billion. That puts the stock at 56x book.

DAL SHARE PRICE -- 5-year chart:



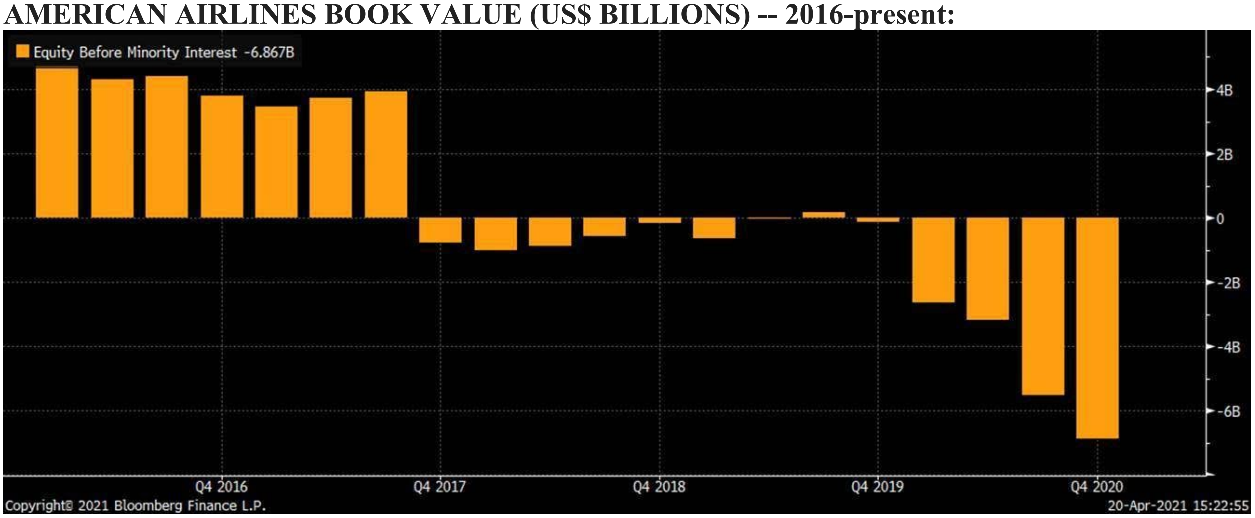
It's interesting to consider the evolution of consensus EPS estimates for Delta. Since COVID was introduced globally in early 2020, the 2021 EPS estimate has been steadily falling. Last September it was still fractionally positive, and now it's -$3.68/sh. So expectations have been getting worse and worse over time. Meanwhile the 2022 estimate has been flat at around $4/share for nine months. Will that hold? Or will it start to weaken too? I would have to think it will weaken, but we'll see.

DELTA AIRLINES CONSENSUS EPS FOR 2020 (white) and 2021 (yellow) -- 3-year chart:



The situation at American Airlines is more dire. Book value was around zero going into COVID and now is -$7 billion. That compares to a market cap of $13 billion. It's hard to envision a scenario in which American doesn't tap equity markets to stay alive.

AMERICAN AIRLINES BOOK VALUE (US$ BILLIONS) -- 2016-present:

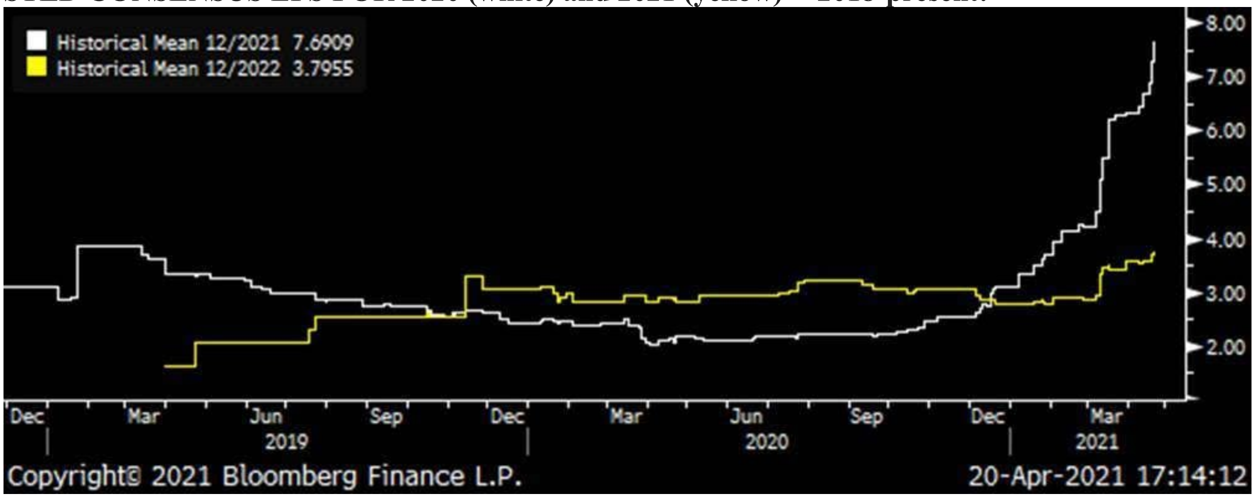


The problem with business models for airlines now is that they assume a "return to normal." But there can't be a return to normal as long as COVID panic is being pushed 24/7 around the world. Vaccines aren't an answer for airlines because 30%+ of the population will refuse to get vaccinated. Meanwhile, the idea that the planetary elite will let go of the vision of biological control via DNA vaccines doesn't *seem* like it's going to happen soon either. So it's a Mexican standoff. Europe looks like it remain basically closed to tourism all summer. None of this works for airlines because they need 80% load factors and fairly robust route structures in order to make a profit.

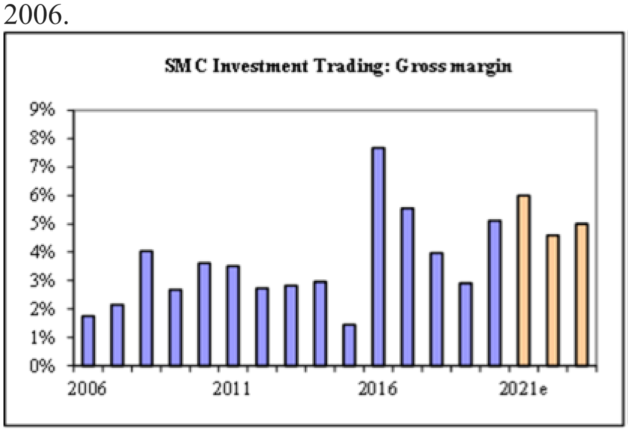
The only way the airline stocks work is if COVID is de-emphasized and life allowed to go back to normal. That's possible. But those enormous holes in airline balance sheets will still be there, begging to be filled by fresh equity issuance.

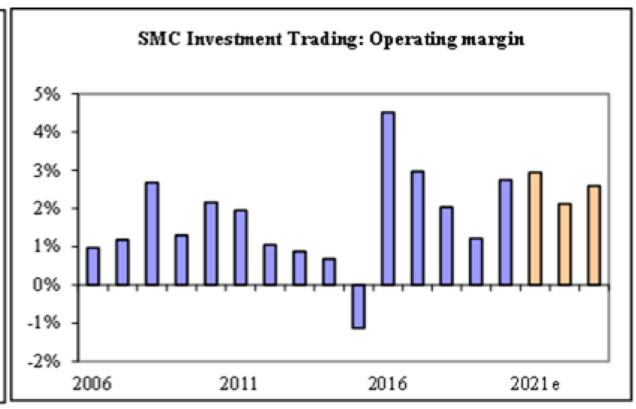
The story is much happier for steel. US structural steelmaker Steel Dynamics (STLD -- $50.12) just reported strong Q1 earnings ($1.91/sh), said Q2 would be even better (consensus is $2.39/sh), said US inventories are very low and predicted good times lasting the balance of the year. That said, consensus expects STLD's earnings to fall by HALF in 2022, to $3.80 (though granted the 2022 estimate is on the rise.

STLD CONSENSUS EPS FOR 2020 (white) and 2021 (yellow) -- 2018-present:



In Vietnam some of the steel stocks have tripled and quadrupled. So the question is whether there is more to go. For SMC Investment Trading, which does distribution and processing (cold-rolling, galvanizing, pipe, coils) the Q1 gross margin was 8.5%. That's better than the margin of every full year going back to 2006.





Realistically this is a 4-5% gross-margin business, according to management. So that's what I model for in 2023. And that generates an EPS estimate of 5,895 VND/share. Put a 6.5x on that and you have a price target 14% above the current level.

SMC Investment Trading (SMC VN) -- 33600

all data in VND

Sales and earnings

	2020	2021e	2022e	2023e
Sales (mlns.)	**15735581**	**21243034**	**20180883**	**21795353**
Sales growth	-7%	35%	-5%	8%
EPS	**4935**	**6628**	**4116**	**5895**
Cash flow	6446	8199	5750	7594
FCF	4476	6071	3451	5112
Cons. EPS				

cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.

Target price & valuation data

My 12-mo. target	38,318	(based on 6.5x 2023 EPS)	
Upside to target	14%	Div yield	3.0%
Mkt cap (mlns.)	2,032,800	*Adj EV*	*1,648,654*
Market cap ($mlns)	$88	EV (mlns)	2,950,084
P/sales (2021e)	0.10	EV/sales (2021e)	0.14
P/E (2021e)	5.1	EV/EBITDA (2021e)	4.1
P/E (2022e)	8.2	EV/EBITDA (2022e)	5.6
P/E (2023e)	5.7	EV/EBITDA (2023e)	4.4
		Daily vol ($000s)	$656
		Price/book	1.28

But this raises a couple of issues. First, SMC has a 20% share of the construction steel distribution market in South Vietnam, as well as a growing business in coil, pipe and galvanizing. Doesn't that seem like it should merit a valuation of more than $88 million?

Second, we have the problem of FIFO gains and losses. The reason steel distributors are making astronomical margins now relates in part to FIFO accounting (gains on inventory when prices rise). But when steel prices correct downward, FIFO gains turn to losses. Do I want to be around for that? Maybe not. In my model, I've raised 2021 estimates rise but cut 2022 because I now assume FIFO losses. 2023 rises because overall steel prices have risen, volumes are up and we may be moving into some sort of structurally stronger steel price environment buttressed by easy US monetary policy.

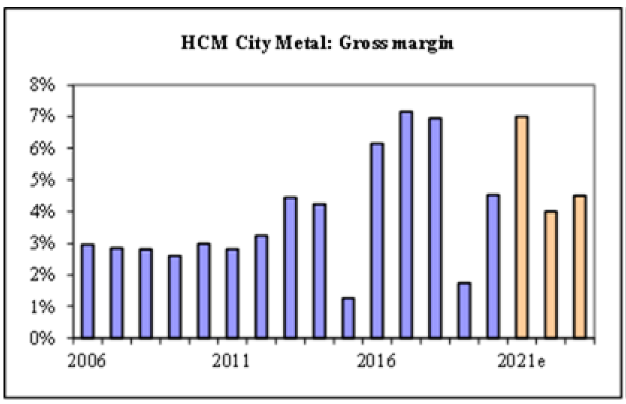
Changes to SMC EPS ests

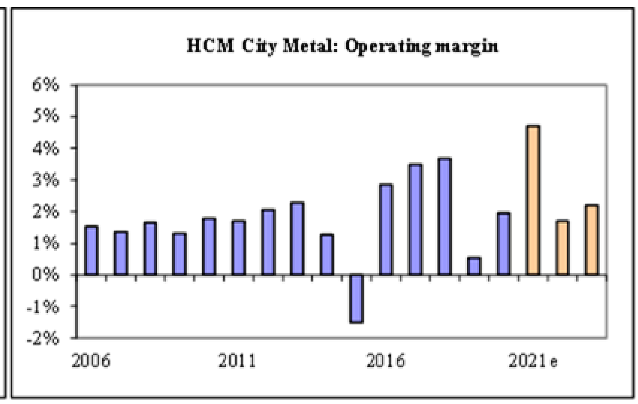
	was	is
2020 act	3,441	**4,935**
2021e	5,597	**6,628**
2022e	4,614	**4,116**
2023e	4,297	**5,895**

source: Churchill Research ests.

So, bottom line, I am on the fence about lightening up on this position. I will sell 20% of it.

HochiMinh City Metal is a similar situation to SMC. Here again we see that Q1 gross margin was huge at 9%. That's literally off the scale in the chart below (left). Here again I assume a FIFO hangover in 2022 and normalization in 2023.





This generates 4,817 VND/share in earnings in 2023. Put a 5.75x multiple on that and the resulting target is 19% above the prevailing price.

Hochiminh City Metal (HMC VN) -- 22350

all data in VND

Sales and earnings

	2020	2021e	2022e	2023e
Sales (mlns.)	**3630935**	**5000000**	**4800000**	**5136000**
Sales growth	-19%	38%	-4%	7%
EPS	**3205**	**9409**	**3592**	**4817**
Cash flow	3419	9632	3824	5058
FCF	3261	9461	3640	4858
Cons. EPS				

cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.

Target price & valuation data

My 12-mo. target	26,491	(based on 5.75x 2023 EPS)	
Upside to target	19%	Div yield	8.9%
		Adj EV	*188,692*
Mkt cap (mlns.)	469,350	EV (mlns)	616,613
P/sales (2020)	0.13	EV/sales (2020)	0.17
P/E (2020)	7.0	EV/EBITDA (2020)	8.2
P/E (2021e)	2.4	EV/EBITDA (2021e)	2.6
P/E (2022e)	6.2	EV/EBITDA (2022e)	7.1
		Daily vol ($000s)	$48
		Price/book	1.15

As with SMC, my 2021 estimate rises sharply, 2022 falls and in this case 2023 is flat.

Changes to HMC EPS ests

	was	is
2020 act	3,080	**3,205**
2021e	5,401	**9,409**
2022e	4,908	**3,592**
2023e	4,835	**4,817**

source: Churchill Research ests.

So here again the question becomes, "Does one want to hang around for the FIFO hangover in 2022?" Maybe not. So here again I will sell 20%.

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