Investors' Chronicle | Alpha

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Alpha shares analysis

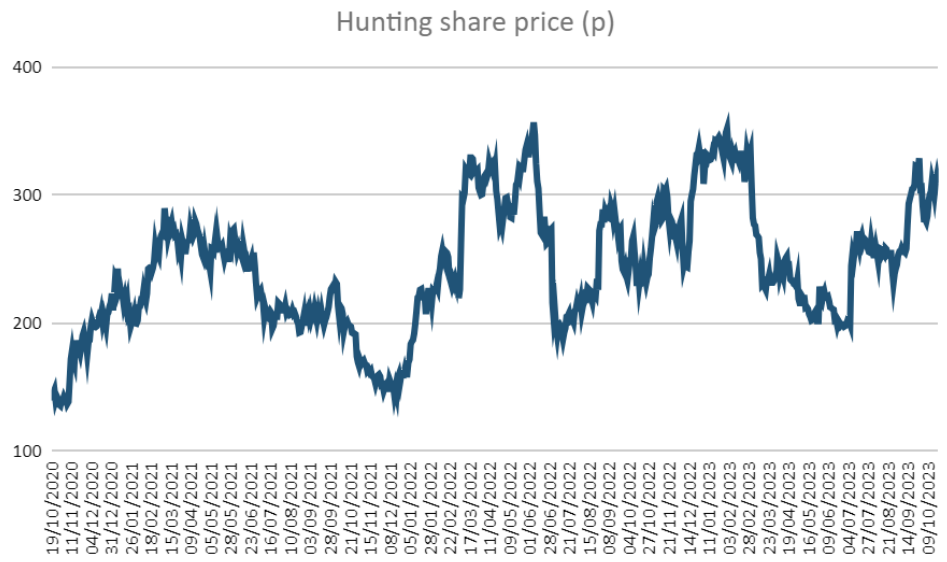
20 October 2023

Two companies to consider buying on dips

Our two companies this week operate in very different industries. One is an oil & gas support services specialist with a developing pipeline of business. Its prospects look decent but there could be dips in the share price on the way. Our other company is a quality data business with a stellar record of profit growth. This is one to keep a watch on as any dips here are a fleeting opportunity to own shares in a quality business

Analyst: Phil Oakley

Hunting (HTG)



Source: FactSet

With governments across the world pledging to slash their countries' carbon dioxide emissions, you'd be forgiven for thinking that the long-term outlook would be fairly bleak for companies which sell their products into the oil and gas industry.

In fact, things are looking decidedly bright.

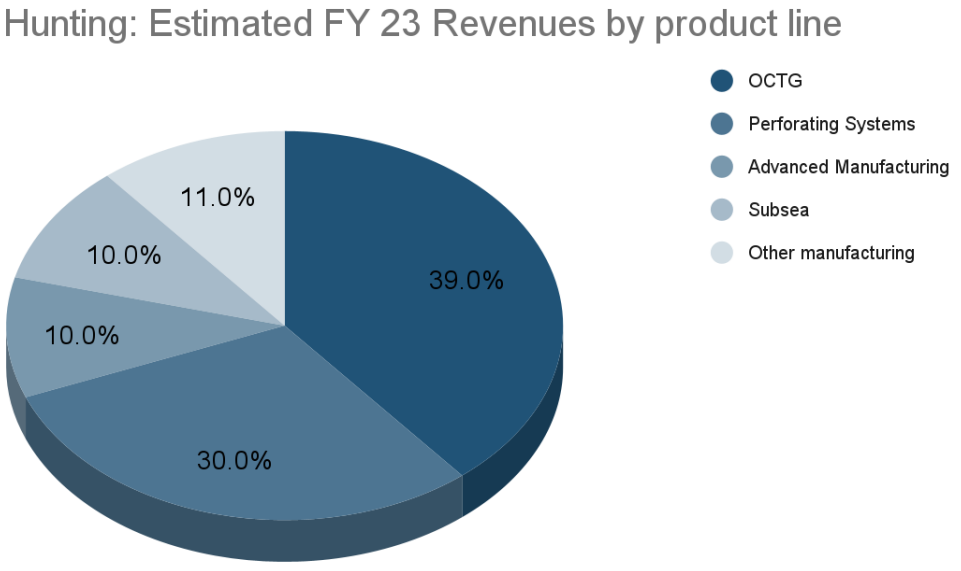
US domestic oil production has just hit an all time high. Countries such as the UK, Norway, France, Australia and Canada have all recently said that they will increase their drilling activities for oil and gas.

Russia's invasion of Ukraine has made energy security trump environmental concerns for the time being. Economic issues are also at play as oil producing countries seem to be reluctant to cut production only for another country to take up the slack and sell it to one of their customers.

The transition from fossil fuels to renewable energy is going to take decades to achieve. In the meantime, those countries and companies that are sitting on oil and gas reserves look set to milk them for all they are worth as long as prices stay high.

Whatever your view on this state of affairs, it looks like good news for **Hunting (HTG)**, which supplies advanced technological and engineered products to the oil and gas industry.

OCTG and Perforating to benefit from strong oil and gas markets



Source: Hunting

Hunting's business model aims to provide the following benefits for its customers:

- Lower the cost of operating
- Resolve technical problems
- Improve efficiency
- Improve safety

The company's revenues are dominated by its oil country tubular goods (OCTG) business. This business manufactures and sells premium connection and sealing products that are used in all areas of oil and gas wells over their entire lifecycle.

Its products are highly engineered and are capable of withstanding the harsh corrosive and high temperature environments experienced in oil and gas wells. The technology behind its products are protected by patents.

The revenues of the OCTG business are highly dependent on drilling activity, which in turn is dependent on the oil price.

When oil prices are low, Hunting's oil and gas customers spend less and its revenues can fall significantly and push the company into a loss.

Drilling activity has been subdued in recent years, but has been picking up rapidly as oil and gas prices have increased. This is resulting in higher revenues and profits for Hunting.

Hunting's perforating systems work by making holes in the sides of wells which make it easier to extract oil and gas. Revenues from this business are also expected to benefit from increased exploration and production activity with Hunting predicting 10 per cent annual revenue growth out to 2025.

Perforating revenues could also receive a boost from oil and gas companies looking to maximise recoveries from their existing wells. Instead of developing new wells, it is possible that some may decide to reperforate existing ones to improve recovery rates and optimise returns.

In both OCTG and Perforating, Hunting has built up a market leading position in the key North American market through its high performance technology.

Its products are used by blue chip oil and gas majors and oil service companies and have developed a reputation for being better quality and more reliable than many of its

competitors' products. This is then backed up with high levels of customer service and being located close to its customers' fields.

Strong growth expected from subsea, energy transition and new markets

As exploration and drilling remains buoyant, a larger chunk of it is expected to take place in deep waters in areas such as South America over the next five to 10 years. Offshore investment spending by energy companies is expected to double between 2023 and 2028.

This is expected to benefit Hunting's portfolio of products that have been tailored for subsea markets. It expects to see increased sales of control valves and seals, as well as titanium and steel stress joints used on rigs.

Whilst oil and gas remains the backbone of its business, Hunting is targeting markets that will play a big part in the transition to a low carbon economy. Its particular focus is on carbon capture and storage (CCS) and geothermal energy.

There are big project pipelines for CCS projects in North America, Asia-Pacific and Europe.

Geothermal heating is expected to double over the next decade.

As a result, Hunting is targeting $250mn of annual sales from these markets by 2030. There also exists the potential to cross sell OCTG and perforating products as well. OCTG products can withstand the high temperatures found in geothermal environments whilst perforating products can be used to inject carbon dioxide into CCS facilities.

Hunting is also very bullish on its ability to grow revenues outside its core energy markets and has set up an advanced manufacturing division to do this. It is aiming to have 15 per cent of its revenues coming from non oil and gas markets by 2025, increasing to 25 per cent by 2030.

The company is a world leader in making alloy printed circuit boards and high temperature circuit boards. These will be sold into areas such as medical electronics and defence markets..

Hunting also sees high growth opportunities in areas such as aviation, defence and commercial space travel. Defence spending by governments is expected to remain high in

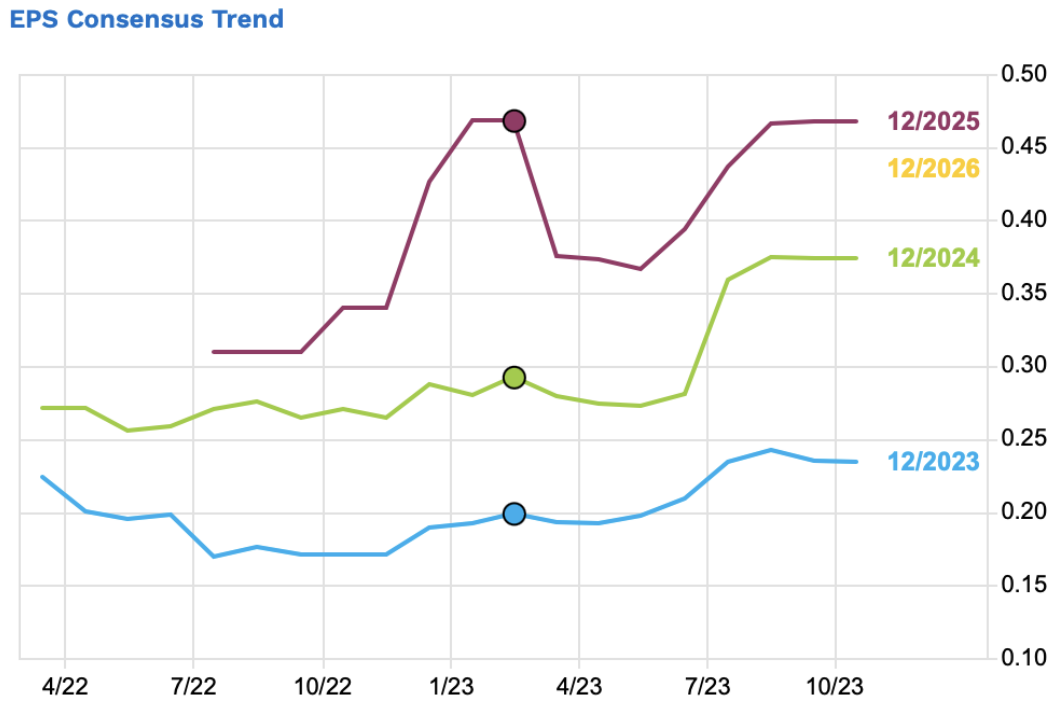
the US, but will also grow in Europe as many governments need to step up spending in order to meet NATO targets of two per cent of national income.

From loss-making to increasingly profitable

The buoyant backdrop to Hunting's markets is expected to see the company move from last year's loss-making position to an increasingly profitable one.

City analysts' forecasts have seen big upgrades since the middle of this year as more confidence has been placed in Hunting's profit recovery. Its earnings per share (EPS) is expected to double between 2023 and 2025.

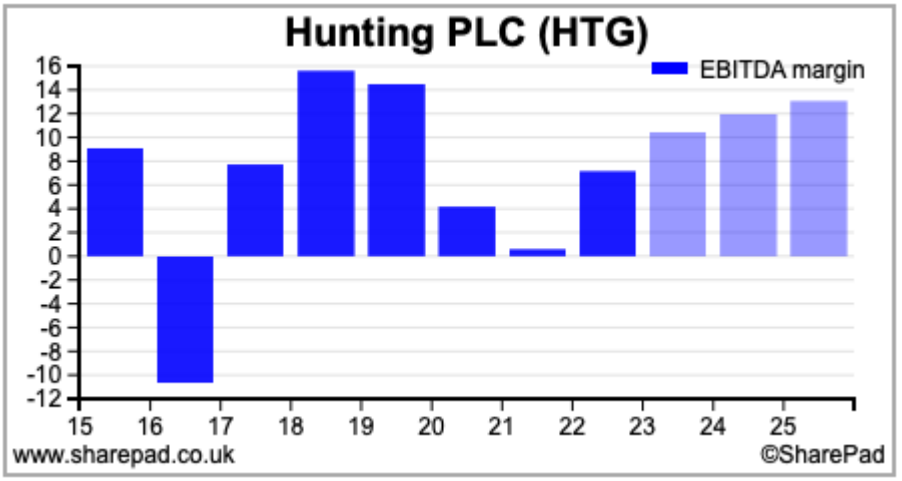
The company is providing a bullish medium-term outlook for its revenues, profits and financial position.



Source:FactSet

Revenues, which were $725mn last year, are expected to be $1.3bn by 2025 and as high as $2bn by 2030 if it makes some bolt-on acquisitions.

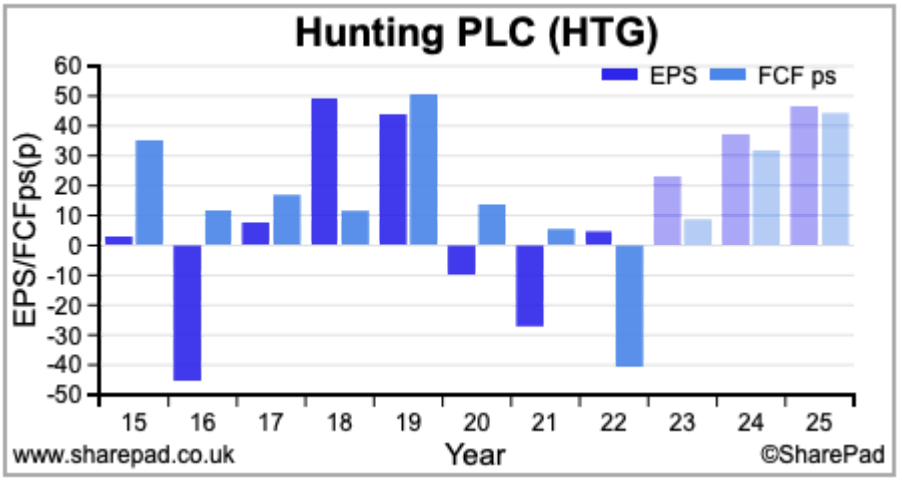
Ebitda (earnings before interest, tax, depreciation and amortisation) margins are expected to get to 15 per cent by 2025, with return on capital employed at the same level.



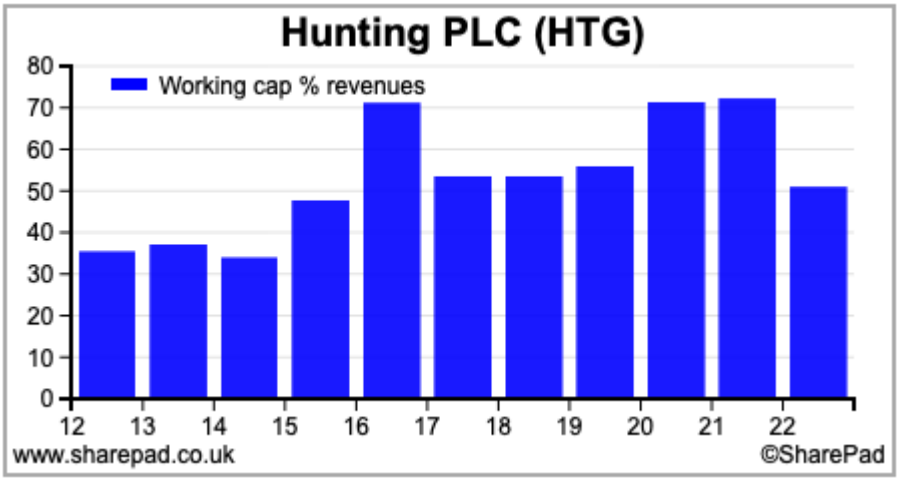
Free cash generation needs to improve

Hunting reckons that its free cash flow will improve so that annual dividends per share can increase at 10 per cent, with the possibility of spare cash being used to buy back shares.

This would represent a turnaround for a company whose free cash flow has been all over the place in recent years.



Apart from having very volatile profits, Hunting's free cash flow is dominated by a very big working capital position, which sees cash flows from the build-up and running down of stocks and trade debtors as a regular feature.



The company's working capital as a percentage of revenues is very high. In many ways, it reflects the power that its customers have over it. Hunting has to buy stocks of raw materials in advance of orders and then has to wait on average around three months to get paid when it has made a sale.

Are Hunting shares cheap or expensive?

Given how good Hunting's outlook seems to be – order books are at record levels with a big tender pipeline as well – it begs the question as to why the shares have been so lacklustre this year with total returns down 4.3 per cent.

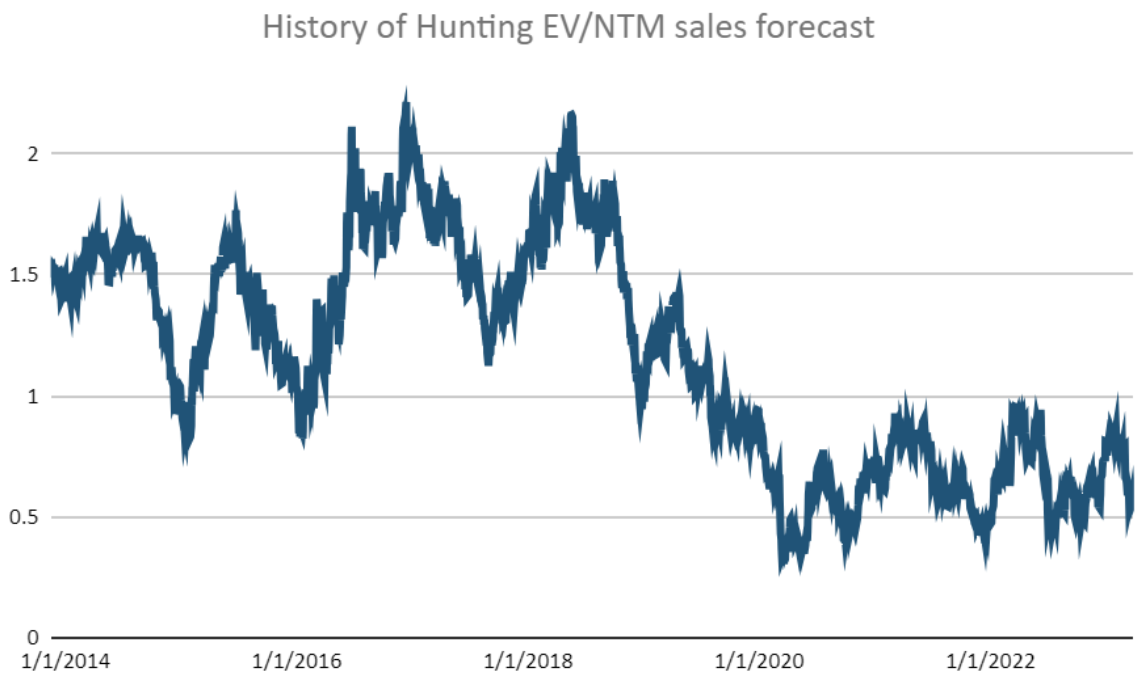
Granted, the shares are up 37 per cent over the last year and 138 per cent over the last three, but it seems that investors do not quite share management's bullishness. For example, current revenue forecasts for 2025 are still some way below the $1.3bn guidance.

Perhaps it is because investors do not believe the good times will last. You only have to look at the valuations placed on big oil companies such as **BP (BP)** and **Shell (SHEL)** to see that investors are not currently willing to pay even modest multiples of earnings for the shares.

On current forecasts, Hunting shares trade on a 2023 forecast PE of just over 16 times falling to just over eight times in 2025.

This may be fair enough, especially if the oil price falls back and companies pull back on drilling.

However, if you look at the valuation of the company on measures such as its next 12 months' EV/Sales multiple, Hunting has rarely been cheaper than it is now than at any time in the last decade.

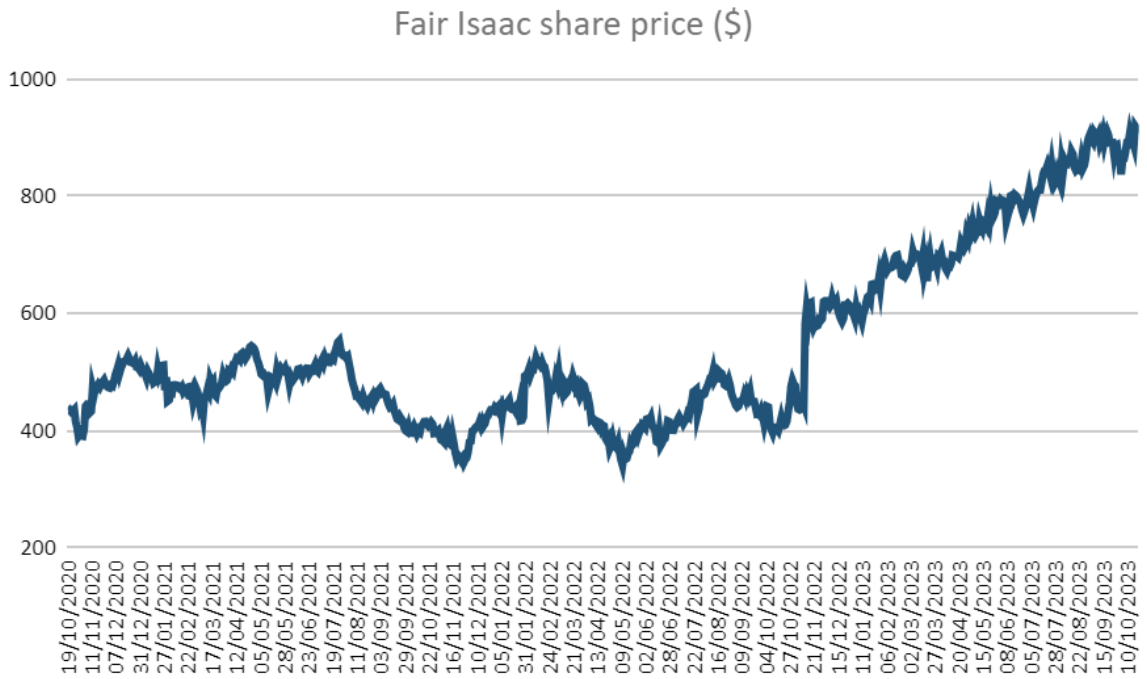


Source: FactSet

Given the nature of the industry it operates in, it's hard to argue that Hunting is a share to buy and hold for the long term. But if management can deliver on its medium-term targets – or analysts have more confidence that it can – then the shares can move higher from their current price of 310p, but don't expect the ride to be smooth.

Continued below

Fair Isaac (US:FICO)



Source: FactSet

Many of you might have heard the phrase 'data is the new gold'. It might be, depending on what is done with it.

The world is awash with data, but those companies that own it and more importantly turn it into valuable information they can sell, can create immense value for their customers and in so doing, their shareholders.

Valuations of data-related companies

TIDM	Name	PE roll 1	fc EV / EBIT	fc EV / EBITDA	fc EV / turnover
FICO	Fair Isaac Corp	38.6	32.2	31.5	16.1
MCO	Moody's Corp	28.4	28	23.6	10.6
FDS	Factset Research Systems Inc	27.2	22.3	21.2	8.1
MSCI	MSCI Inc	35.1	32	29.3	17.5
SPGI	S&P Global Inc	25.7	22.4	21.9	10.3
EXPN	Experian PLC	21.5	17.3	13.7	4.8
EFX	Equifax Inc	20.8	25	15.3	5

Source:SharePad

You only have to look at the stock market valuations placed on data business to realise this is true. Companies such as **YouGov (YOU)** in the UK, or financial data powerhouses such as **Moody's (US:MCO)**, **MSCI (US:MSCI)**, **S&P Global (US:SPGI)** and **FactSet (US:FDS)** see that they are richly-valued.

There are good reasons for this. Their datasets are highly prized by their customers as is the information they are turned into. The limited competition in their industries also means that these businesses have immense pricing power and can pass on chunky price increases without their customers leaving.

If you were to combine a data business with a successful software as a service (SaaS) business where the profit margins and returns can be very rich for the best in class then you would be looking at a company that many investors would like to own a slice of.

Fair Isaac (US:FICO) is a good example of such a company. It uses data and algorithms to predict consumer behaviour across many industries.

It is the company behind the FICO credit scores which has been the go-to measure of consumer credit risk in the US for decades.

It sells its scores to the major credit referencing agencies across the world, as well as most of the leading US banks, insurance companies, credit card providers, car loans companies, healthcare companies, retailers, utilities and debt collection companies. The scores allow these customers to make better informed loan decisions and minimise the risk of not getting paid back.

It also sells credit data directly to consumers and helps them monitor and manage their credit files through the myFico.com website.

Along with its Scores business, it has a software business which provides services to its customers to manage risk, fight fraud, build customer relationships and meet regulations.

First Isaac is essentially selling a business intelligence service. It increasingly sells its software on multi-year subscription packages where customers pay on the basis of the number of accounts used, transactions made or decision use cases subject to an agreed minimum payment.

The company has been developing the FICO Platform so that its customers can use all its software packages in one place. This may be a combination of packages such as predictive modelling, decision analysis, transaction profiling or consumer data integration.

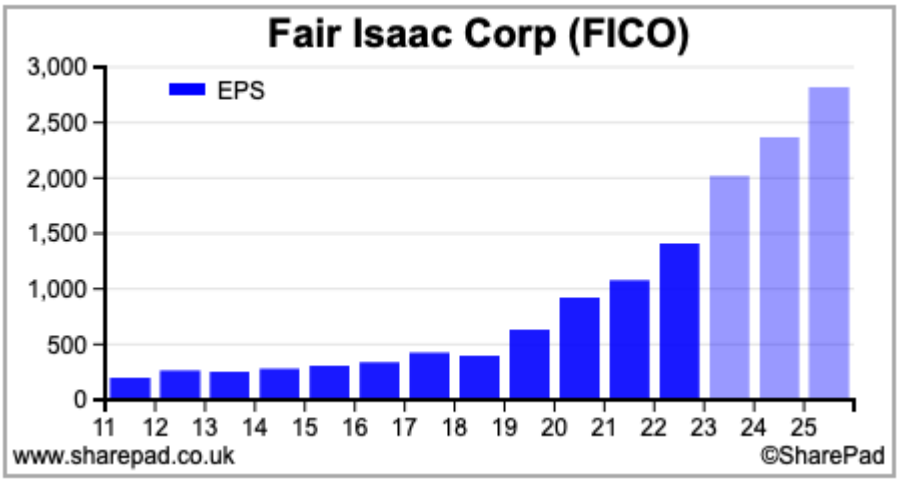
One of First Isaac's main growth strategies is to sell more software packages or bundles and get customers to migrate to the FICO platform.

As well as providing software, the company backs this up with a professional services business which helps customers install and use the software.

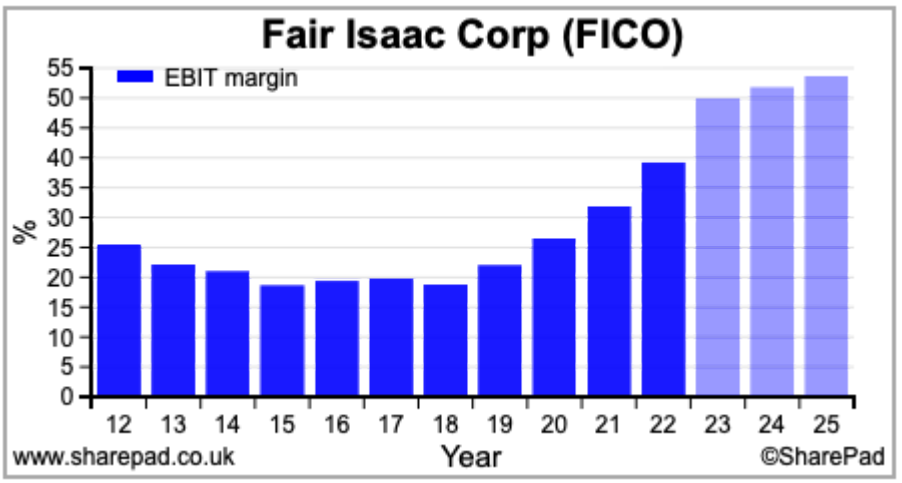
Stellar growth with very high profit margins

The company has been consistently successful with both its businesses for a long period of time.

Its growth rate of its earnings per share(EPS) over the last five years has been nothing short of stellar and is expected to keep on being so.



This growth has been driven by a significant expansion in the company's profit margins. Wall Street analysts also expect these margins to keep on getting bigger as the company's revenue growth leverages its fixed costs.



The company's return on operating capital employed (ROOCE) last year was an impressive 121 per cent.

These levels of profitability are the hallmarks of an outstanding business.

But can it stay this way?

Strong growth is expected to continue

If the company's financial performance so far in 2023 is anything to go by then the answer to this question seems to be yes.

Despite weak mortgage activity in the US, First Isaac put through a very big price increase to its customers at the start of the year. Whilst many weren't happy about this, the company has kept on innovating and offering better products in return.

As a result, most customers stay loyal as there are few alternatives. Whilst competition in scoring has come from Vantage – with its VantageScore 4.0 product – for mortgage loans from Fannie Mae and Freddie Mac, FICO's dominance and pricing power looks to be unthreatened right now.

The software business continues to grow strongly as more companies want to be able to make better business decisions with large amounts of data. More customers are moving to the FICO platform and this led to an increase in annual recurring revenue (ARR) of 20 per cent in the third quarter ending in June.

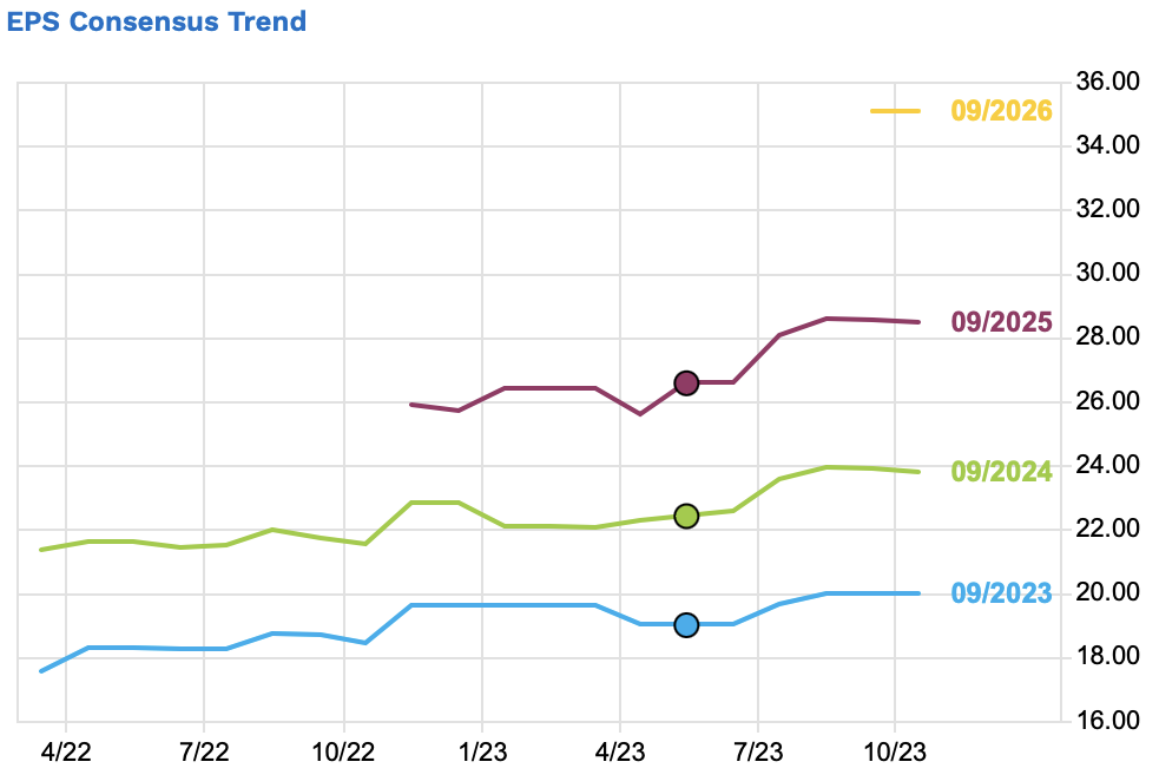
The ARR of the platform business increased by an impressive 53 per cent, which was the 15th consecutive quarter where growth exceeded 40 per cent. This is being driven by customers adding additional software packages and processing more volumes. Demand for the platform is expected to be very robust for some time to come.

ARR in the software business in general is also being driven by big deals from existing and new customers.

Whilst the software customers are increasingly migrating to cloud services, the legacy desktop software is still popular with customers. This product also tends to be very sticky and have a long revenue life. Contracts are typically renewed every three years whilst it is not uncommon for them to be renewed up to five times by customers.

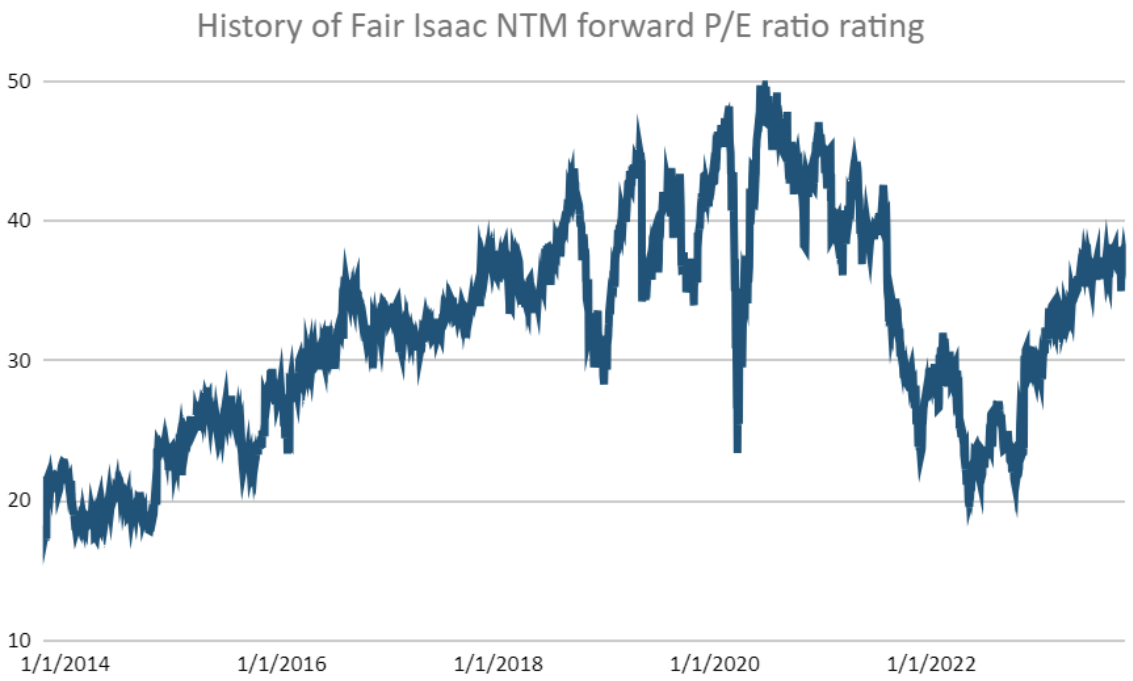
More earnings upgrades to come?

The company's third quarter results back in August saw an increase in analysts' full-year EPS forecasts. Management was very upfront that its guidance tends to be conservative, which has raised expectations that the company will deliver better results than current estimates.



Source:FactSet

With EPS growth expected to be around 40 per cent in 2023 and almost 20 per cent for the following two years, it is not really surprising that First Isaac's shares are richly-valued.



Source: FactSet

At $920, they trade on over 38 times the next 12 months' forecast EPS. The shares have been substantially rerated over the last year, which has delivered total returns of 126 per cent to investors.

There is no doubt that Fair Isaac is a very impressive business that can continue to grow. The problem for investors who currently do not own the shares is that the stock market knows this.

To maintain its current lofty price tag, the company arguably needs to be growing its earnings at an annual rate of 20 per cent for many years to come. Big forecast upgrades are probably needed to drive the share price higher.

Whether the stock market will put a higher multiple on those earnings remains to be seen. In a world of higher interest rates which has brought valuation multiples down, First Isaac's upwards rerating has been impressive but betting on the valuation continuing to expand may border on wishful thinking.

That said, for investors looking for a high quality business to put their money into, First Isaac looks worthy of a place on their watchlist at least.

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