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Value Investor INSIGHT

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Pipe Dream?

There is a secular demand story to tell for Northwest Pipe, the leading U.S. manufacturer of steel pipes for water infrastructure. While Scott Hood isn't buying that particular story, he still sees plenty of upside in the company's stock.

First Wilshire Securities' Scott Hood can rattle off a number of statistics describing the sorry state of water-system infrastructure in the U.S. Nearly half of the country's infrastructure in place is past its stated useful life, but at the current rate that obsolete pipes are being replaced it would take 200 years to replace the system. There are some 240,000 water-main breaks each year, resulting in two trillion gallons of already-treated drinking water – 14-18% of the annual total – being wasted. "It's all pretty scary, to say the least," Hood says.

He could use all that to support the investment case for Northwest Pipe Co., the country's largest manufacturer of engineered large-diameter steel pipe used for the conveyance of water to and from major treatment plants. The company's six factories in the U.S. are well located to serve growing-demand markets and provide it with scale and reach to incrementally benefit were necessary system upgrades actually made in earnest. But Hood isn't counting on that being the case: "I've given up on expecting the broader problem to be truly addressed," he says.

Nevertheless, he believes the stars are aligning for a strong rebound in Northwest Pipe's business. The company has been plagued in recent years by two key challenges, a sharp downturn in its tubular-pipe division focused on energy end markets, and an irrational competitive pricing environment for water pipes. The first it has addressed by selling off its energy-related business lines, leaving it with a pure-play focus on water. In addressing the second it has been helped by the exit from the business of two loose-cannon competitors that were focused less on profitability than top-line wins. At the same time those challenges have been addressed, the company has also been cutting costs and bolstering an already strong balance sheet, which now sports no debt and roughly $45 million in cash.

That sets Northwest up well for what appears to be an improving sales cycle, says Hood, as project requests for proposal multiply due to increased state funding for water-system projects, most prominently in Texas and California. North-

INVESTMENT SNAPSHOT

Northwest Pipe
(Nasdaq: NWPX)

Business: Leading manufacturer of engineered steel pipe that is used in water and wastewater systems in North America.

Share Information (@4/27/18):

Price	**19.95**
52-Week Range	13.33 – 21.36
Dividend Yield	0.0%
Market Cap	$194.0 million

Financials (TTM):

Revenue	$132.8 million
Operating Profit Margin	(-6.2%)
Net Profit Margin	(-7.6%)

Valuation Metrics
(@4/27/18):

	NWPX	S&P 500
P/E (TTM)	n/a	24.1
Forward P/E (Est.)	14.6	17.0

Largest Institutional Owners
(@12/31/17):

Company	% Owned
Royce & Assoc	12.5%
Dimensional Fund Adv	8.3%
William Blair Inv Mgmt	7.3%

Short Interest (as of 4/13/18):

Shares Short/Float	8.3%

NWPX PRICE HISTORY

THE BOTTOM LINE

U.S. water infrastructure is in clear need of upgrading, but Scott Hood believes even an overdue cycle upturn could yield far better performance for what is now a more-focused company. He believes within three years the share price could increase at least 50%.

Sources: Company reports, other publicly available information west's backlog of confirmed orders rose 33% last year, to $88 million. He believes by next year revenues could reach $200 million, up from roughly $130 million pro-forma last year, and within three years could reach $250 million – all without the company having to increase capacity.

Assuming 9% operating margins on his out-year revenue estimate would translate, he says, into roughly $1.85 per share in annual earnings. At that point he says a 16x P/E would be more than reasonable, resulting in a $30 share price. Is this a long-time keeper? "You never know, but if we're right about the fundamentals, there should come a time when more analysts follow the company, market sentiment gets better and the valuation goes beyond what we consider reasonable," Hood says. "And then we'll happily move on." VII