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Value restoration project

Evan Lorenz writes:

A barrel of West Texas Intermediate crude, which traded at $37.63 below zero in the pandemic spring of 2020, today fetches $73.08 above. The cure for low prices is still low prices, it would seem—even, perhaps, for a certain low stock price that has made no net progress in 18 years.

Fluor Corp. (FLR on the New York Stock Exchange) is the price in focus. Weak commodity markets, compounded by high costs and managerial missteps, have been the bane of this builder of mines, wells, liquefied natural gas terminals, etc. In preview, we're bullish on it.

Key to understanding the rise, fall and—so we project—recovery of Fluor is the arc of prices for raw materials. The Bloomberg Commodity Index, which tracks futures contracts weighted by trading volume and global production, dropped by 51.9% between 2010 and 2020. While the index has rebounded by 17.3% this year, it remains 43.6% below its Dec. 31, 2010 level.

Constant readers can anticipate the silver lining: As that decade-long sinking spell prompted drillers and miners to spend less on exploration and development, so a rebound would lead them to spend more.

"Global oil markets are firmly in deficit, as evidenced by rising prices, falling inventories, and growing backwardation," write Goehring & Rozencwajg Associates, LLC, commodity analysts and investors, in a June 15 post on the company website. "After having peaked in June 2020 at nearly 400 million barrels above average, OECD inventories have drawn by 250 million barrels relative to seasonal averages, suggesting the market has been 1.2 million barrels per day in deficit—the highest reading on record."

If the G&R brains trust is correct, it will be a long time before new supply quells the bull market. Rising U.S. shale production served that rally-killing function over the past decade, but, as our friends argue, the choicest shale acreage is already exploited and America may no longer be the world's swing hydrocarbon producer.

Shifts from abundance to scarcity could be playing out across the commodity complex. Rising Chinese grain imports and a rage for biofuels are creating the potential for a "mini supercycle" in agricultural commodities, Alex Sanfeliu, head of Cargill's world trading group, told the *Financial Times* last month. Then, too, green energy and electric vehicles don't come from nowhere. Production requires ample supplies of iron ore, copper, lithium and rare earth metals, among other items dug up from the ground.

John Simon Fluor, a general contractor, founded his eponym in 1912 in Santa Ana, Calif., and promptly perfected a technique to render buildings earthquake-proof (his secret: precast concrete). In 1915, Fluor received its first energy-related contract from the Southern California Gas Co. to build a compressor station and meter shops. The client list of the mature Fluor Corp. includes such boldface names as the Manhattan Project, the Trans-Alaska Pipeline and the Governor Mario M. Cuomo Bridge in New York. The company has built more than a third of all installed copper-mining capacity in Chile and over half in Peru. It co-manages Los Alamos National Laboratory, among other federal facilities.

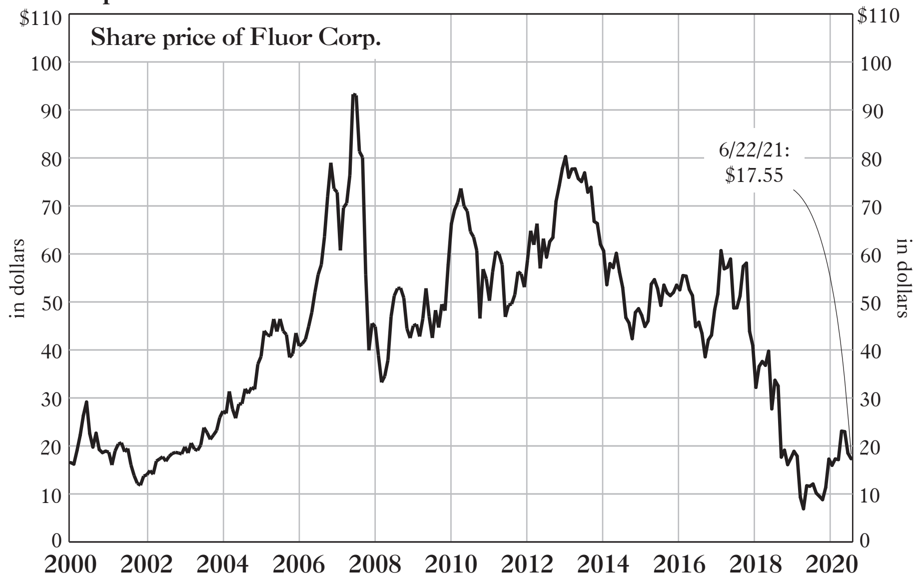
One of the largest engineering, procurement and construction (EPC) companies in the world, Fluor employs 43,717 people and boasts a $14 billion-plus top line. It divides its operations into three units: energy, standard oil and gas work, green-energy projects and chemical-related work (34% of first-quarter sales); miscellany, curiously designated "urban," ranging from mining and metals projects to life-science facilities and professional staffing services (41%); and government contracting, both domestic and foreign.

The commodity-price decline that followed the housing bust led contractors such as Fluor into temptation. To compensate for a dwindling backlog of new work, they pursued large-scale, fixed-price contracts. The immediate optical effect of this strategy was pleasant enough—Fluor added $27.7 billion to its backlog in 2018—but the proportion of that backlog, made up of fixed-price contracts, bulged to 62% in the third quarter of 2019, from 20% at year-end 2014.

Fixed-price work can be more remunerative than the cost-plus variety. Just deliver a project for less than the cost to build it, and the savings are yours. Then, again, the cost overruns are yours, too, should you incur them, which Fluor disastrously did in 2019, ringing up $839 million's worth of nonreimbursable charges, including $714 million in the second quarter (compared with just over $200 million per annum in the prior four years).

The charge-off in the June 2019 quarter prompted the dismissal of Fluor CEO David Seaton and a debt downgrade to high-rated junk, Ba1, from low-rated investment-grade, Baa3. To

Upside comes next



source: The Bloomberg

draw a line under the problem contracts, the board conducted a financial review that delayed publication of the 2019 10-K report until Sept. 25, 2020. The Securities and Exchange Commission and the Department of Justice began investigations.

Uncapped losses from megaprojects can be company killers, as McDermott International, Inc., discovered with its $2.9 billion purchase of Chicago Bridge & Iron Co. N.V. in 2018. Exposure to a handful of legacy fixed-price LNG construction contracts seems not to have registered fully on the acquirer's due diligence team. Disclosure of that information, in July 2019, sent the McDermott 10⅝ unsecured notes due 2024 tumbling to 75 from 95.5. Six months later, McDermott found itself in Chapter 11.

Not surprisingly, EPC companies have been moving away from construction, especially in the energy sector, to focus on safer engineering and management work. Jacobs Engineering Group, Inc. sold its energy, chemicals and resources unit to Worley Ltd. in 2019, following which peers Aecom, KBR, Inc. and SNC-Lavalin Group, Inc. sold, wound down or moved away from construction. Once bitten, Fluor says that it's avoiding certain fixed-price contracts but intends to remain in the building business. Which decision leaves it and Bechtel Corp. as the only big, full-service EPC companies in the West.

Assuming that Fluor minds its risk, the quality of its business should improve in 2022 and 2023, but job No. 1 is to polish off the Seaton-era backlog. The biggest, and most worrisome, fixed-price contract remaining is the LNG Canada project in Kitamat, British Columbia, a joint venture led by Royal Dutch Shell plc and slated for completion in 2025. Accounting for more than $5 billion of Fluor's $23.8 billion backlog, it's the type of large-scale, fixed-price contract that pushed McDermott into bankruptcy.

Issuance last month of $600 million in Fluor preferred shares that convert to common equity at a price of $22.24 sent imaginations racing. This is an expensive form of capital and has the potential to dilute shareholders by 19%. Why would management do what it did except to signal trouble ahead? Quick as a whistle, the common sold off and is quoted today at $17.55 (versus $24.43, before the preferred hit the market).

"From my seat just at this juncture, it's really hard to recommend a company with this much exposure to a fixed-price EPC," Sean Eastman, who rates Fluor a hold for KeyBank Capital Markets, Inc., tells me. "And it's really hard to do any analysis that can kind of ringfence the uncertainty and the risk around [the LNG Canada project, specifically]."

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You can have low prices and bad news or high prices and good news, but you can't have low prices and good news, as Darren Maupin, founder and director of Pilgrim Global, has reminded the readers of *Grant's* (see the issue dated Feb. 22, 2019). It's not for no reason that Fluor is quoted today as it was in 2003. But if management can get its hands around the remaining troubled contracts, the stock will be seen as commandingly cheap.

And the front office appears to be doing the right things. On May 2, 2019, Alan Boeckmann, currently 72, who led the company from 2002 through 2011, was appointed chairman of the board. Under his tenure as CEO, Fluor's common shares generated a compound annual return of 19.4%, including reinvested dividends (versus 3.9% for the S&P 500), the Great Recession notwithstanding. Boeckmann recruited D. Michael Steuert, also currently 72, Fluor's CFO from 2001 through 2012, to retake the company's top finance job. The pair conducted a forensic scrub of the company's fixed-price book of business at the cost of a delayed filing of the 2019 10-K report and the restatement of results from 2016 through 2018. The changes mainly related to the timing of charges and revenues; pretax earnings were downwardly revised by $3.8 million.

Late in 2020, Fluor got itself a new CEO: David Constable, 59, a 30-year veteran of the company who left in 2011 to work at Sasol Ltd., which, helpfully, happens to be a Fluor customer.

In January, the new broom laid out a three-year recovery plan. By 2024, Constable said, 75% of the order backlog should consist of reimbursable, or cost-plus, contracts, compared with 43% in the first quarter; return on invested capital should reach 20%, from negative 5.4% last year; and the ratio of debt to total capital should be in the range of 20% to 40%, from 57% in the March quarter. While Fluor will consider lump-sum contracts, it will do so only via direct negotiations with its clients and not through competitive bidding. Costs will continue to be cut (to the tune of $100 million over the next four years) and noncore assets sold.

Looking at the March 31 balance sheet, you might wonder why Fluor chose to issue the dilutive preferred: $2 billion in reported cash appears to be greater than the $1.7 billion in debt. However, only 25% of Fluor's cash balance is readily accessible, the balance being invested in ongoing projects or in

Fluor Corp. at a glance

all figures in USD millions except per share data

	TTM*	2020	2019	2018	2017
sales	$14,388.0	$15,668.5	$17,317.3	$18,851.0	$14,806.5
profit before taxes	-203.1	-207.1	-1,071.5	385.8	53.8
net income	-256.1	-435.1	-1,522.2	173.5	153.7
shares	140.9	140.5	140.1	141.3	139.8
earnings per share	-1.82	-3.10	-10.87	1.23	1.10
cash	1,956.5	2,222.1	2,004.5	1,979.6	1,965.2
debt	1,683.2	1,735.6	1,690.5	1,688.5	1,619.0
total assets	7,020.9	7,309.8	7,966.7	8,882.6	9,327.7

* Twelve months ended March 31, 2021.

source: company reports

unhandy overseas accounts. Adjusting for those effects, Fluor's net debt foots to $1.2 billion (that is, $1.7 billion in borrowings, less $489 million in available cash), a figure that sums to 6 times the 2021 estimate for Ebitda and 3.2 times the 2022 guess. Last year's financial restatements mean that the company is barred from filing a shelf registration statement to raise capital on an opportunistic basis through the end of 2021.

Proceeds from the preferred sale are earmarked for debt reduction. As the rating agencies and creditors are well aware of bankruptcies in the EPC sector, the company tells me that they, too, are eager to see balance-sheet improvement. In any case, after giving effect to the preferred, Fluor's leverage ratio falls to three times 2021 estimated Ebitda and 1.6 times the 2022 figure.

The low level of mining and energy investment over the past decade primes the longer-term bull argument. "Fluor is a company that benefits from reflation, inflation and improved commodity prices, which leads to improved investment in capacity," Michael Dudas, who rates the shares a buy for Vertical Research Partners, LLC, tells me. "This is a multiyear story. We're probably going to start to see the real benefits on bookings and improved orders later this year and into 2022."

While the Street is rightly focused on large, fixed-price contracts and is naturally wary of any business signed in the Seaton era, Fluor believes that LNG Canada will finally prove profitable. "Unfortunately, prior management put us in a bad place, but LNG Canada was handled differently from day one because everyone knew the seriousness and gravity of what it means for Fluor from an upside and a downside," says Jason Landkamer, head of investor relations.

Incorporation of language relating to force majeure is one example, Landkamer says. Change-of-law provisions is another. In both cases, the protective clauses cover not only the job site, "but also the shipping lanes and the fabrications facilities in China."

The company has already locked in much of the cost for the natural-gas project, Constable told analysts last month, including 93% of the required equipment and materials and agreements with 80% of the subcontractors. "So, there's not really a lot left on that front from an escalation perspective in some of the higher prices you're seeing in commodities and materials," the CEO said.

Tucked away on the Fluor balance sheet is a potentially promising option on nuclear technology in the shape of majority control of NuScale Power, a manufacturer of small modular nuclear reactors (SMRs). Last August, the U.S. Nuclear Regulatory Commission certified NuScale's SMR design, making it the first and only small nuclear reactor to gain such approval. The hope and promise is that these reactors can be installed more quickly and cheaply than large ones. NuScale signed its first customer, the Utah Associated Municipal Power Systems, on Jan. 11, and 2030 is the target date for the start of electricity generation. To date, NuScale has been a drag on the P&L, lowering operating income by $84 million in 2020 and $66 million in 2019.

Of the nine analysts who follow the stock, eight say hold compared to the one who says buy. Short interest has percolated to 8.6% of the float today, from 2.6% before the preferred was issued, evidently because arbitrageurs are hedging the convertible portion of the preferred shares rather than making outright bets against the company. Management is keeping its hands in its pockets, however, with exactly no buys or sales over the past 12 months.

At the Jan. 28 strategy day, Fluor guided for earnings per share of between $3.00 and $3.50 by 2024—or, after adjusting for the subsequent dilutive preferred offering, $2.43 and $2.84. To put this in context, annual EPS ranged from $3.09 to $4.45 between 2010 and 2016. Using the midpoint of the adjusted guidance and giving Fluor a 15 times multiple would put the value of the stock at $39.49 versus its current price of $17.55.

"Value investing" is a term that gets stretched and abused 12 years into a bull market, even one that was interrupted by a pandemic. "Something is inexpensive and attractive in a value sense if it is cheap relative to the performance it has already proven it can achieve," Steven Grey, CEO and eponym of Grey Value Management, LLC, which holds a position in Fluor, tells me. "That's it. That's what we are talking about with Fluor."

While finding a potential value play is exciting, living through value restoration is another matter entirely. "For the past three years, it has been a pretty difficult situation for Fluor to be in," Landkamer confides. "But the fact that we have turned the corner is something that you can feel in the hallways. The optimism and energy level have gone up dramatically. As our CFO says, 'The train has left the station.'"

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