

GRANT'S

INTEREST RATE OBSERVER®

Vol. 39, No. 23c

233 Broadway, New York, New York 10279 • www.grantspub.com

DECEMBER 10, 2021

Floor to ceiling

Evan Lorenz writes:

Businesses, like reputations, take decades to build but hours to tear down. Consider the only slightly stylized career of the average Wall Street trader. “You make a little bit every day,” as a friend described a not-atypical career path, “a little every day.” And then—sweeping his hand from his ear to his shoe—“you have a really bad day.” *Poof*.

Flooring giant Mohawk Industries, Inc. (MHK on the New York Stock Exchange), the subject of this unfolding analysis, is itself in the midst of a business and reputational rebuild. You’ll recall the name from the profile of Scopia Capital Management, L.P., which began on the front page of the prior issue. Anticipating questions, we lay to rest any imputation that *Grant’s* has merged with the hedge fund. Cheap stocks remaining a rarity, we seize good ideas where we can find them. In preview, we’re bullish.

A father and his four sons—by name, the Shuttleworths of New York’s scenic Hudson Valley—started a carpet mill with some used English looms in the mid-1870s. Fast forward to 1908, and the future Mohawk Industries struck it rich with the Karnak, a type of broadloom tufted carpet that became so popular that the Mohawk weavers “worked four and five years without changing either the color or the pattern on their looms,” according to a company history.

Following a Michael Milken-era leveraged buyout and a 1992 public listing, Mohawk rolled up, as it were, not only the rug, but also much of the rest of the flooring industry. From that

IPO to the fourth quarter of this year, when a pair of small deals are expected to close, there have been 48 acquisitions, encompassing ceramic tile, laminate, wood, stone, luxury vinyl tile and sheet vinyl flooring. Major brands include American Olean, Daltile, Durkan, Eliane, Feltex, Godfrey Hirst, IVC, Karastan, Marazzi, Mohawk, Pergo, Quick-Step and Unilin. While Mohawk grew up in America, Europe, over the past year, accounted for 28% of trailing sales, Russia 4% and parts unknown 13%.

Since most Americans shop for their flooring at small specialty shops rather than big-box retailers, the key to flooring success is distribution. Trucks, therefore, are a manufacturer’s sine qua non, and Mohawk, with its fleet of more than 750, would rank as the fifth largest independent trucking company in the United States. Truck power constitutes a formidable barrier to any who would challenge this behemoth’s scale and reach.

According to *Floor Focus* magazine, Mohawk was the biggest American flooring company in 2020, with a 25.1% share of the market, followed by Shaw Industries Group, Inc., a Berkshire Hathaway, Inc. holding, with 24.9%. The next eight largest American flooring companies controlled just 20.4% of industry-wide sales.

Worldwide, too, Mohawk leads in manufacturing and distribution, with revenues of \$11.1 billion. The company divides into three parts: global ceramic (35% of sales), North American flooring (37%) and rest-of-the-world flooring (28%). Sales outside the United States are especially profitable—trail-

ing operating margins in the ROW division are almost double those of the North American unit, at 18.8% versus 9.8%—a fact that Mohawk attributes to its heavy ownership of retail flooring outlets beyond the 50 states.

At first, the roll-up strategy paid off handsomely. In the five years ended in 2017, Mohawk commanded a price-earnings multiple 2.1 points higher, on average, than that of the S&P 500. Growth-stock investors couldn’t get enough of it.

The narrative began to fray in 2018 and 2019. Most flooring sales are driven by replacement demand, which is tied to the pace of residential real estate transactions. As the Fed slowly lifted its intervention rate to 2.25%–2.5% from near zero between Dec. 16, 2015 and Dec. 19, 2018, 30-year mortgage rates rose to 4.5% from 3.9%. Sales of “existing” (i.e., previously owned) houses fell by 3% in 2018 and then flatlined in 2019.

But a missed opportunity in luxury vinyl tile was a crisis of Mohawk’s own making. LVT started to take the flooring world by storm about five years ago. The interlocking vinyl tiles mimic the appearance of stone, ceramic or wood and form a waterproof barrier over a subfloor. They are cheap and quick to install (and laminate flooring, in comparison, can leak). According to Market Insights, Inc., American sales of LVT surged by 190% between 2016 and the 2021 estimate, taking share from all other categories.

Mohawk was hardly unaware of LVT. In 2015, it paid \$1.2 billion for IVC Group, a pioneer and patent holder in that product category. However, Mo-

Big Carpet regroups



source: The Bloomberg

hawk chose to produce LVT domestically, at a pair of newly constructed lines in Georgia, rather than follow its competitors to foreign parts, primarily China. Average capital expenditures weighed in at \$850.1 million in 2017 and 2018, from \$587.9 million in the two prior years.

Unfortunately, Big Carpet anticipated neither the booming demand for LVT nor the problems that slashed production at its brand-new Georgia plants. Short of the must-have flooring product of the cycle, Mohawk queued up to buy tiles in China.

A major expansion of ceramic-tile production capacity was one of the consequences of Mohawk's 2017–18 capex blowout. "It took utilization of their ceramic from 90% to 70% across the company, which killed the margins," Greg Slavin, the head of industrials research at Scopia, tells me. As a result, operating margins declined to 8.3% of sales in 2019 from 14.3% in 2017, sending operating income plummeting by 38%, to \$827.2 million from \$1.35 billion.

Nor did signs of incompetence, or worse, on the part of the former president of the North American flooring division, Brian Carson, help matters. A shareholder lawsuit alleges that Carson overstated sales by shipping unordered goods on the last day of the quarter, only for the annoyed recipients of those unwanted carpets, tiles and laminates to bounce them right back on the first day of the next quarter. Curious, the

Securities and Exchange Commission subpoenaed the front office for more information, though what's become of the inquiry, now almost 18 months old, is unknown.

Environmental liability risk, too, figures in the litany of corporate troubles, with municipalities in Alabama and Georgia suing Mohawk over deposits of per- and polyfluoroalkyl substances (PFAS), a class of chemicals that for many years was used to make carpets resistant to stains and spills. Extraordinarily slow to break down, PFAS are prone to leaking into aquifers and thence into drinking water.

Mohawk's third-quarter results, delivered on Oct. 29, went down badly. Adjusted EPS of \$3.95 handily beat the consensus estimate of \$3.81, but guidance for the fourth quarter, of \$2.80–\$2.90 per share, was below expectations of \$3.23. Management fingered resurgent European energy costs, and the shares fell a quick 11%.

The Mohawk stock price peaked at \$284.82 on Dec. 1, 2017 and traded as low as \$58.66 on March 20, 2020. Today, it's quoted at \$179.33. At Tuesday's close, the market values Mohawk at an 11.6 times trailing P/E ratio (for comparison, the S&P 500 commands a 25.7 times multiple) and at a 6.6 times trailing enterprise-value-to-Ebitda multiple. In view of these reasonable valuation data, Mohawk's bad news might just be old news.

Management has resolved the

manufacturing difficulties at its two LVT factories and is building a third. For the sharp recovery in demand for residential flooring (and the perhaps reciprocal weakness in the commercial kind), Covid-19 deserves some of the credit, if that's the word. "[W]hile spending more time at home, consumers rediscovered the comfort and noise-dampening values of carpet," Mohawk Chairman and CEO Jeffrey Lorberbaum pointed out in his 2020 shareholder letter. Trailing sales through the third quarter were 16.2% above the 2019 level on the back of both volume growth and price increases.

In the same quarter, management completed a year-old \$100 million cost-cutting program. It rationalized its manufacturing footprint to align capacity with demand, and has earned high marks for keeping the lights on during the pandemic. "Over the course of the past 18 months, Mohawk has not had the supply chain issues that Shaw has had on the carpet side," Kemp Harr, owner and publisher of *Floor Focus*, tells me.

Mohawk's creation of a waterproof laminates product in 2017 under the brand names RevWood and UltraWood was rather overshadowed by LVT's debut, but some consumers will never consider LVT, since it is derived from petroleum-based plastics. Laminate is made from real wood. "They have really pulled ahead in the laminate category," Harr says. "In the builder sector, often times you can't tell one from the other once it is installed."

While management is guiding for cost inflation to overtake price hikes in the fourth quarter, it did protect margins through the first nine months. Through September, prices ran ahead of cost inputs by \$351 million, driving a 5.5 percentage-point increase in gross margins. Over the past 12 months, operating margins have recovered to 12.3% from a low of 8.3% in 2019.

"They are going to fall a little behind price cost in the fourth quarter because they were delayed in offsetting the European natural gas costs that went through the business," Slavin says. "Our research suggests that they are going to get it all back and more starting Jan. 1, when they are taking price increases across their business between 10%–15% in every business, in every product and in every geography."

Home prices are rising even faster,

which may or may not imbue confidence in survivors of the uncontained real-estate-cum-mortgage bust of little more than a decade ago. The decision of the Federal Housing Finance Agency to lift conforming loan limits on Jan. 1—to \$970,800 from \$822,375 for high-price regions—may similarly recall the bad choices of yesteryear.

However, household net debt summed to 96% of disposable income in the second quarter, down from a peak of 134% in the mid-aughts, and millennials, the largest age cohort, are entering their 30s, the key age for first-time home-buying. The trouble is that once-burned builders didn't keep pace with the formation of new houses in the wake of the financial crisis. Freddie Mac estimates that, as of the end of 2020, the United States was short 3.8 million residential units.

The virus has weighed on housing supply in other ways. In October, reports the National Association of Realtors, there were 2.3 months' worth of supply (calculated at the current sales pace and excluding new homes), well below the conventional four to six months' worth. "You should start to see more listings come on the market next year," Rick Palacios, Jr., the director of research at John Burns Real Estate Consulting, tells me. "In 2020 and 2021 there was a lot of fear in listing your home. 'Do I want people to come walking through my house?' And, 'Where am I going to move?' We do a survey of about 5,000 resale agents every month. A lot of people don't want to sell because they don't know where they are going to move to."

Nor is it very likely for the lawsuits or the SEC investigation to break the company. Alerted to Carson's alleged scheme in 2018, Mohawk—the victim in this business, not the perpetrator—fired the suspect. And Mohawk's audit committee and external legal counsel have found so far no error or malfeasance that rises to the level of materi-

Mohawk Industries, Inc. at a glance

all figures in USD millions except per share data

	<u>TTM*</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>
sales	\$11,081.6	\$9,552.2	\$9,970.7	\$9,983.6	\$9,491.3
operating profit	1,364.6	636.0	827.2	1,095.3	1,354.2
net income	1,092.3	515.6	744.6	861.7	971.6
earnings per share	15.58	7.22	10.30	11.47	12.98
shares outstanding	68.5	71.4	72.3	74.8	74.8
cash	1,128.0	1,340.4	177.3	119.1	84.9
debt	2,298.9	2,734.1	2,569.9	3,258.0	2,763.6
total assets	14,450.3	14,317.8	13,386.7	13,099.1	12,094.9

* The 12 months ended Oct. 2, 2021.

source: company reports

ality at which a financial restatement is obligatory.

PFAS litigation is fast-evolving, but precedents suggest that Mohawk would not shoulder the costs of a future judgment alone. DuPont de Nemours, Inc. and 3M Co. manufactured most of the PFAS used in the United States and appear to retain at least some liability for the products they sold.

In 2018, the Michigan Department of Environment, Great Lakes, and Energy (EGLE) filed a suit against boot-maker Wolverine World Wide, Inc. for its PFAS pollution. Under a consent decree, EGLE agreed to cap Wolverine's liability at \$69.5 million. As the user—not manufacturer—of the substances in question, Wolverine sued 3M. On Feb. 20, 2020, the Post-it maker settled for \$55 million (*Grant's*, April 16).

Mohawk has begun to address its low valuation through self-help. In the first nine months of 2021, it repurchased \$473.3 million's worth of shares, and in the third quarter it boosted the quarterly pace of buybacks to \$208.8 million from \$122.9 million in the first. On Sept. 16, the board of directors authorized an ad-

ditional \$500 million's worth of repurchases. For a sense of scale, Mohawk's market capitalization runs to \$12.1 billion.

Mohawk's balance sheet is in better shape than its lower investment-grade rating, of Baa1/triple-B-plus, would imply. As of Oct. 2, net debt, including operating leases, footed to \$1.6 billion, or 0.7 times trailing Ebitda. In the third quarter, operating income covered interest expense by 24.1 times. The rating agencies cite the cyclical nature of the buildings-products sector for the diminished rating.

Of the 15 analysts who cover the carpet maker, seven say buy and only two say sell. With a short interest of 1.7% of the free float, bears seem uninterested. The Mohawk C-suite is broadly aligned with investors. Through direct stakes and family trusts, Lorberbaum controls 14.6% of MHK shares outstanding.

However, over the past 12 months, executives have sold 35,293 shares for proceeds of \$6.4 million while buying not one. *Grant's* can think of another way for Mohawk to restore its reputation.

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