GRANT'S
INTEREST RATE OBSERVER®

Vol. 34, No. 14c — Two Wall Street, New York, New York 10005 • www.grantspub.com — JULY 15, 2016

Borrow to rent

The cacophony of jackhammers, brick saws and excavators outside our window would suggest that American business, or at least particular segments of that business, is thriving. And, indeed, through May, according to the Bureau of the Census, the value of nonresidential construction put in place was up by 8.2% over the year-ago figure. Now unfolding is an analysis of a pair of equipment-rental companies that ought to be prospering in their turn. If they are, we judge, they won't be for long. They are United Rentals, Inc. (URI on the NYSE) and Ashtead Group plc (AHT on the London Stock Exchange).

There's nothing complex about the shared business model. The two buy equipment from "A" to "Z," or, at least from "A" to "W": e.g., from aerial work platforms to welders. They rent that hardware to construction companies and industrial concerns. When business is good, it is very good—and the opposite is true as well.

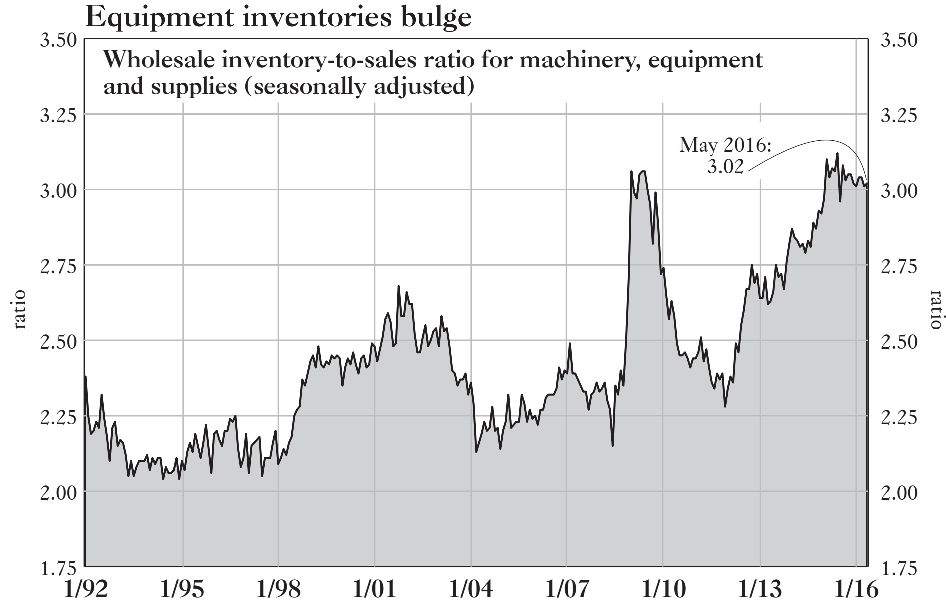
Invited to spell out the bullish story, Jefferies analyst Justin Jordan (he rates both companies a buy) kindly took a call from colleague Alex Hess. "[Bulls say] you've got this dual tailwind of continued modest nonresidential construction growth and increasing penetration as renting becomes a more accepted norm," says Jordan. URI cites a 2016 forecast from IHS Global Insight that projects U.S. construction will grow at a 6% cumulative average rate through 2019 from 2014. A recent Ashtead presentation suggests that rental penetration of the equipment market could grow to a mid-60s percentage in the 2020s from a low-50s percentage in 2015 (in the UK, rentals command an 80% market share).

United Rentals, our first subject, is the top player in U.S. equipment rental, with a 12% market share. At year-end 2015, it had 430,000 pieces of equipment in inventory. In the past 12 months, rental income contributed 85% of revenue; the sale of used equipment, 9%; and the sale of new equipment and the provision of miscellaneous supplies and services, 6%. Over the period, rental revenues weighed in at $4.9 billion, up 18% from $4.2 billion in fiscal 2013. At the bottom line, diluted earnings per share rose to $5.95 in the 12 months through March from $3.64 in 2013.

Once upon a time, United was almost synonymous with the building trades. Thus, in 2008, 60% of overall revenues stemmed from commercial construction. Add in residential building, and that figure rose to 70%. Such concentration explains much of URI's 92% stock slump during the Great Recession, to $3.03 per share in March 2009 from $37.57 in May 2006. In 2015, by contrast, URI generated 51% of its rental revenues from industrial and non-construction sources, and the remaining 49% from construction markets.

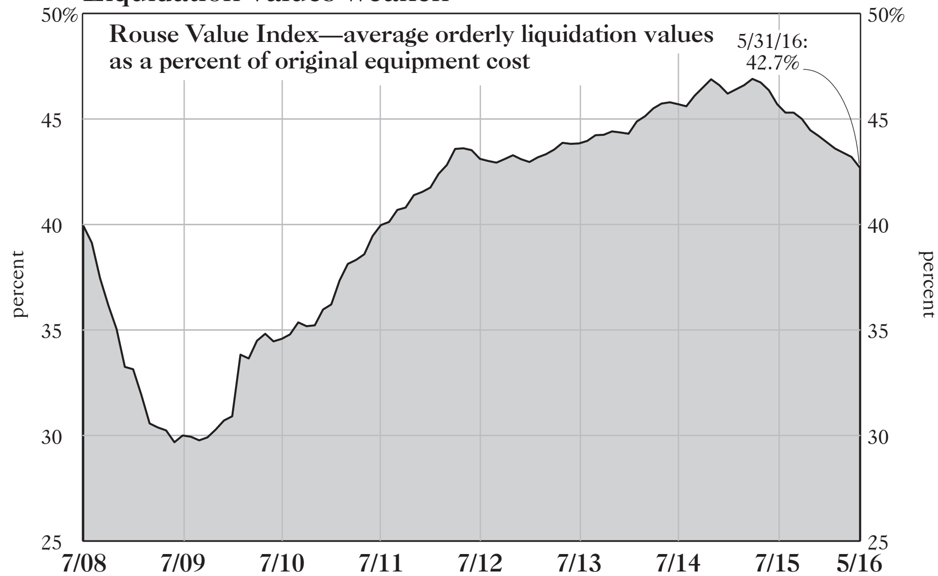
Reached by phone, Ted Grace, vice president for investor relations at United Rentals, told Hess the business has been reconfigured to be more resilient

Equipment inventories bulge



source: U.S. Census Bureau

Liquidation values weaken



sources: Rouse Services, the Bloomberg

in the down portion of the business cycle. "Compared to the last cycle," said Grace, "there are a lot of big structural differences in our business, not the least of which is our profitability." He pointed to the company's EBITDA margin—the product, he said, of structural cost improvements. It registered 34% in 2007, on the eve of the slump. It reached 47% in the past 12 months.

Debt is the rub, we think. A $70 stock, United has a market cap of $6.2 billion, trailing-12-month revenues of $5.8 billion, operating profit of $1.5 billion—and gross debt of $7.8 billion, which is rated in the upper reaches of junk. Trading at 11.8 times trailing diluted earnings and a ratio of enterprise value to trailing-12-month EBITDA of five times, URI might appear cheap as well. It is not so cheap on deeper inspection.

This publication was bullish on URI before it was bearish. We liked it at $18.26 a share in February 2008 (we might have postponed that declaration of support for about 12 months). At seven times earnings and 0.84 times book value, the stock seemed cheap. It was just as cheap in May, when we reiterated our bullishness and remarked on the quality of the balance sheet. URI, we said, "is moderately leveraged ($2.4 billion in [long-term] debt to $5.9 billion in assets), which is more than enough, we judge, for a company so heavily exposed to the vicissitudes of credit and the macroeconomy." Add in short-term and convertible borrowings, and the ratio of debt to assets was 46%, while net debt footed to 1.7 times trailing-12-month EBITDA. Eight years later, in the first quarter of 2016, the company's debt-to-asset ratio amounted to 66% and net debt amounted to 2.8 times 12-month EBITDA.

A significant degree of URI's industrial business, as well as a hefty chunk of that $7.8 billion debt, came with a 2012 merger with RSC Holdings, at the time URI's largest rival. In 2011, RSC derived 60% of its rental revenues from less-cyclical industrial markets and the remaining 40% from construction. URI absorbed more than $1 billion in debt to complete the deal, and borrowed to fund its own nearly $1.2 billion cash consideration. The value of goodwill for the deal, at $2.7 billion, accounted for all the value assigned to assets net of liabilities acquired. Excluding goodwill, the value of net assets acquired footed to negative $75 million.

"Strip out goodwill of $3.3 billion from URI's March 31 balance sheet," Hess observes, "and liabilities exceed assets by almost $1.8 billion. The afore-quoted Justin Jordan points out that, as a hypothetical, 'If you liquidated every piece of equipment in the United Rentals fleet, they could not pay off their debt. They do not have a net asset value.' (You might not guess this from the pricing of URI's public debt; for instance, the $7\frac{5}{8}$s due 2022, callable in April 2017, trade at 107.5 to yield 2.5%, according to Trace.)"

If the industry becomes oversupplied, and rental rates and residual values for equipment on the balance sheet decline, the $7.8 billion in debt and negative tangible book value would loom large. Remarks a short-seller who asks to go nameless, "When the market is oversupplied, [rental companies] will start getting hyper-competitive. And that is where the real danger lies, because when you start valuing this business on price to book, instead of EV to EBITDA, you realize what you own."

"There are already some signs of oversupply," Hess goes on. "The Rouse Value Index, which measures orderly liquidation values as a percent of the original cost of equipment, fell to 42.7% in May from a peak of 46.9% in mid-2015. (An orderly liquidation value assumes a company has to sell assets to meet obligations to creditors). According to a May 5 note from Goldman Sachs (whose analysts rate URI a sell), 'Historically, used values have led URI's pricing by one quarter, and accelerating [year-on-year] declines in the used-value index provide visibility on further rate pressure as we progress through 2016.' Census Bureau data likewise flash bearish signals for equipment demand. The ratio of wholesale inventories to sales for machinery, equipment and related supplies has been in excess of 3:1, and close to all-time highs, for most of the last year."

URI has announced it will spend $700 million this year buying rental equipment, net of assets sold, down from $1 billion last year. Restraining fleet size may be a prudent way to protect margins should the industry tip (or have already tipped) into oversupply. "Once I'm long the piece of equipment, I'm willing to rent it out for anything," says our short-seller. "When the equipment-rental market gets oversupplied, they compete like animals to the bottom." Some signs of margin deterioration are already emerging at URI. Gross margins slipped to 38.2% in the first quarter from 39.8% in the year-ago period. Rental rates charged dropped by 2.8% year-on-year in the first quarter, and the company projects a fall of 3% to 4% for the year. Gains on sale of used equipment amounted to 40.9% of depreciated book value in the first quarter, down from 44.8% the year before.

Grant's is not the lone less-than-optimistic voice on United Rentals:

Short interest amounts to some 8% of the stock's float, and only six sell-side analysts rate URI a buy, versus 10 holds and four sells. Insiders, too, have been net sellers, shedding 96,507 shares in the last 12 months for $6.89 million.

On, now, to Ashtead, which trades at a market cap of £5.6 billion (or $7.5 billion) and reported £2.5 billion in revenues and £700 million in operating profit in the year ended April 30. The company operates two subsidiaries: Sunbelt, a U.S.-based equipment-rental business, and A-plant, a U.K. rental business. With a 7% market share, Sunbelt is second only to United Rentals in the U.S. Sunbelt generated $3.3 billion in sales and $1 billion in operating profit during the company's 2016 fiscal year, up 19% and 22% year-on-year respectively. After currency conversions, Sunbelt accounted for almost £2.2 billion, or 86%, of Ashtead's sales and £651 million in operating profits, 91% of Ashtead's total before corporate overhead. Likely as a result of Ashtead's American presence, shares have risen 8% since June 23, the day before Brexit rocked the world, on a weakened pound.

Construction end markets accounted for 47% of rental revenues at Sunbelt in fiscal 2016, with the remaining 53% from other, "non-construction" sources. That compares with 55% from construction in 2007, the last of the pre-crisis boom years. According to Ashtead's 2015 fiscal-year annual report (its latest), aerial work platforms made up 36% of the Sunbelt fleet, forklifts 17% and earth movers 16%. Miscellany—pumps, scaffolding and all other—filled out the remaining 31%.

Ashtead shares trade at 1,126p (or £11.26) for a trailing price-to-earnings ratio of 13.9, a dividend yield of 2.0% and a price-to-book ratio of 3.8. Analysts are bullish on continued successful expansion. According to Bloomberg, consensus expectations are for revenues to reach £3.0 billion in the next two fiscal years, from £2.5 billion in the latest year. The seven analysts who produce statutory-earnings forecasts foresee EPS rising to 90p next year and to 98p by fiscal 2018, from 81p in fiscal 2016. Of the 17 total analysts who cover the stock, 11 rate it a buy, four a hold and two a sell.

Ashtead is, at this stage, largely a Sunbelt growth story (unlike URI, it is not a balance-sheet story; tangible equity is positive and net debt amounts to 1.7 times EBITDA, compared to 2.8 times for its American-headquartered rival). Last year, Sunbelt's rental revenue grew by 19%, with same-store sales accounting for 12 percentage points of this growth. Same-store growth was split evenly between ongoing expansion in end markets and "structural share gains" for equipment rentals over purchases. The remaining seven percentage points came from bolt-on acquisitions and store openings. In the past four years, Sunbelt has opened or acquired 212 locations across the U.S., increasing its store count to 559.

CEO Geoffrey Drabble told listeners on the latest earnings call, "you can't buy a 10-year, 14% compound annual growth business with 19% ROI and 47% EBITDA margins on the [order of] 10 times P/E. Well, you can. . . . That's why I'm buying back my own shares." We might take issue with Drabble's selection of pronoun. The company announced in June it would buy back £200 million in shares. Drabble, by contrast, has been a net seller in the last year, disposing of 303,236 shares for nearly £3.3 million. Insiders have followed suit, selling 644,193 shares for £6.9 million in the past 12 months. Ashtead declined a request for an interview.

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