Title:
An Analysis Of Lexmark

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Summary:
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Article Body:
In 2005, Berkshire Hathaway bought about a million shares of Lexmark. I haven’t followed this story closely, but I assume the stock was purchased by Lou Simpson rather than Warren Buffett. I have only two reasons for believing this: the total purchase was small relative to Berkshire’s investable assets and the Lexmark purchase is typical of Simpson’s investment philosophy (or at least, what little I can glean about his investment philosophy from his past purchases). Regardless of who actually makes the purchases, a new Berkshire holding always draws a lot of commentary.

The commentary on Lexmark has been almost uniformly negative. Even many value investors have a very dim view of Lexmark at these prices. Now, I am not a contrarian investor. Psychology and sentiment do not enter into my considerations at all. I’ve bought stocks trading near five year lows, and I’ve bought stocks trading near five year highs. I just try to be rational. I’m not afraid to agree with the consensus, if it’s an accurate representation of reality. Here, it isn’t. The model of Lexmark that has emerged in my mind over the past few weeks bears little resemblance to the Lexmark I’ve seen described elsewhere.

Most of the negative comments about Lexmark have focused on the consumer segment. Yet, more than 75% of Lexmark’s profits come from the business segment.

The business segment is Lexmark’s franchise. There, the company has managed to build a moat, not a very wide moat, but a moat nonetheless. Lexmark is the only focused, integrated printing company of any consequence. It understands its business customers’ needs, and provides specially tailored solutions that none of its competitors can offer. Worldwide, some very large companies use Lexmark’s products for some very specialized tasks. Among these are retailers, banks, and pharmacies. Lexmark has complete control of their product including the printing technology itself and the software used to manage its printers (i.e., to interface with the user’s computer). Businesses that care about getting these specialized tasks done right (and getting them done cheap) use Lexmark.

Even Lexmark’s competitors have to concede the fact that Lexmark knows printing better than anyone else. Lexmark is the only company that develops its own ink – jet, monochrome, and color laser technologies. It is a vertically integrated printer business like no other. The two competitors most often mentioned as threats to Lexmark are HP and Dell. While everyone will suffer from deep price cuts; I think it’s HP and Dell who should be scared.

Lexmark has the much stronger competitive position. For years to come, it will be launching the best printing products for high ink consumption tasks. Lexmark hasn’t been focused on competing directly with these companies in the consumer segment; that’s going to change because of the emerging photo printing market.

Lexmark isn’t interested in selling hardware. It’s interested in selling ink. Now that there is real demand emerging for high quality printing within the home, Lexmark is going to start going after the consumer market. Over the next few years, Lexmark will be selling more printers in this segment. A few years after that, the company will see strong recurring revenues from ink sales.

Generic ink cartridges are the biggest threat to the high margin printing business. However, I believe, of all the players in this industry, Lexmark will be the least affected. Its highest margin sales are its most insulated sales. Its lowest margin sales, in its least dominant businesses, are where generic ink will hurt the most.

There is also some concern that Dell could always move away from using Lexmark printers. Let them. From what I can see, sales to Dell will not be a particularly significant high free cash flow margin business. There’s no benefit to the Lexmark brand either. That brand is going to become stronger over the next decade, because the quality is already there. Lexmark simply hasn’t been that visible to consumers. The Dell deal doesn’t help build the Lexmark brand. Honestly, I wouldn’t be terribly troubled if Lexmark’s sales to Dell dropped to zero tomorrow. Such an occurrence would not materially affect my valuation of

Lexmark.

As far as I can tell, Lexmark's management is excellent. They understand the printer business better than anyone (they also happen to understand the science of printing better than anyone – CEO Paul Curlander has a PhD in electrical engineering from MIT). Lexmark's management also sees highly profitable opportunities in printing long – term, despite a very competitive situation short – term. I agree with that assessment.

Within the printer business, there is a real danger of ferocious price competition. However, I do not believe there is a real danger of prolonged ferocious price competition. Lexmark is the company best positioned to weather the storm. It will generate tons of free cash flow, none of which has to be siphoned off to other lines of businesses, as it does at all of Lexmark's competitors. Lexmark's high free cash flow margin recurring revenue stream will supply it with more than enough ammunition to outlast its competitors. They may be deep pocketed, but eventually, they will have to answer to Wall Street. Long – term, they can't compete with Lexmark. It will take them some time to realize that. But, Lexmark has the time.

That's my assessment of Lexmark on qualitative grounds. How does the stock look quantitatively?

The stock is selling for about 15 times earnings and 10 times cash flow. Right now, a dollar of Lexmark's stock buys you a dollar of sales. I think that's a bargain. Not many companies of this caliber sell at a price – to – sales ratio of one.

For the last ten years, Lexmark's return on equity has not fallen below 20%. During the same period, the company's return on assets never fell below 10%. The free cash flow margin has generally been in the 5 – 10% range.

I wouldn't be surprised to see Lexmark's ROE and free cash flow fall substantially in the next few years. However, long – term, I believe a return on equity of 15 – 20% and a free cash flow margin of 8 – 10% are sustainable. In fact, if I was forced to pick an exact ROE that Lexmark could sustain I would pick 20%. But, I would also caution you not to expect that for the next five years or so.

The important estimate is the 8 – 10% free cash flow margin. That's the best way to value Lexmark. At one times sales, you have an 8 – 10% yield, if you think sales can be sustained. If you think sales can grow, you have to factor that into your analysis. At present, a discount rate of 8% seems appropriate.

I never do a discounted free cash flow analysis on this blog, because I feel the variables that go into are something you have to decide on for yourself. I don’t want to slap an exact figure on the value of a company, because I don’t want to suggest that kind of precision. But here, you can clearly see how I’d value Lexmark. I gave you what I think Lexmark’s free cash flow margin will be (8-10%), you know what Lexmark’s sales are ($5.4 billion), and I gave you the discount rate I thought was most appropriate (8%). The only necessary variable I haven’t provided is a sales growth estimate, and I’m not going to provide that, because I don’t want you to think it has anything to do with the next five years.

It doesn’t. I’m looking at this company well beyond that point, and I like what I see. Lexmark will strengthen its brand (with consumers), and people will still be printing. So, yes, I am projecting revenue growth for Lexmark; and yes, it is enough to suggest Lexmark is worth substantially more than $5.5 billion.