This example is an investment thesis Posted by a member on 28 August 2012 - 04:31 PM on MicroCapClub. This is a good example because it is a clear and concise thesis on a company with significant upside potential (100%+) over the following 12 months.

Willdan Group (WLDN)
Ticker: WLDN
Price: $1.21
FD shares outstanding: 7.3 million
Market cap: $8.8 million
Cash: $5.5 million
Debt: $3.4 million
Enterprise value: $6.7 million

Willdan Group (WLDN) is an ignored micro-cap cigar-butt being left for dead by the market, but I think there could be another puff left. Recent contract renewals and new contract wins combined with right sizing the labor cost structure should lead to at least modest profitability. With $108 mm in trailing revenues and a $7 mm EV, it shouldn't take much in the way of profitability for a nice uptick in the stock from the current rock bottom valuation levels.

Willdan Group is "a provider of professional technical and consulting services to public agencies at all levels of government, public and private utilities and commercial and industrial firms in California and New York." The company was founded in 1964 and went public in 2006 at $10 a share. The traditional focus of Willdan had been on engineering consulting for California municipalities. In 2008 WLDN acquired an energy efficiency-consulting group, which has grown to now generate most of the company's revenues. WLDN now operates in 4 segments (with % of 2011 revs): engineering services (32%), energy efficiency services (54%), public finance (9%), and homeland security (5%).

The last few years have been difficult for the engineering segment, which was heavily exposed to the downturn in the California residential markets. The energy efficiency segment has picked up the slack and it generated most of WLDN's profits in 2010 and 2011. The business lines outside of energy have been stable in terms of revenues, but still in the aggregate slightly unprofitable. WLDN sees these lines being stable going forward, but do not see much in the way of growth. The WLDN story at least for the foreseeable future will revolve around the energy segment.

Electric utilities have begun to sponsor energy efficiency programs, which provide incentives for their customers to reduce their energy consumption. In 2009 WLDN won a contract to manage the small business direct install program (SBDI) for Con Edison of New York City. In WLDN's description:

The SBDI Program helps small businesses achieve energy and financial savings, offering both free measures and cost-shared incentives to encourage installation of high-efficiency lighting; heating, ventilation, and air conditioning; and refrigeration energy conservation measures. As the program implementer, Willdan performed (1) contractor recruitment, training, and management; (2) outreach and sales; (3) data tracking, analysis, and reporting; (4) engineering oversight; and (5) billing, invoicing, and financial oversight. Critical to this effort is our customer-facing role; Willdan staff was responsible for driving program participation and generating project applications and incentives.

This was a major contract for WLDN, which provided 21% of WLDN's revenues in 2010 and 28% in 2011. WLDN expected the contract to be renewed in January, while it only ended up being renewed in July. The delay in renewals for this contract and a similar utility contract in CA caused WLDN to retain excess personnel that was not being fully utilized. There was a short term mismatch between head count and revenues. This caused WLDN to generate negative $6 mm in EBITDA in the first two quarters of 2012 (revenue has been about flat YoY) after achieving positive EBITDA around $4 mm in both 2010 and 2011. Both of these large contracts have been renewed albeit at lower revenue run rates. Con Ed decided they wanted another contractor involved in the program, and gave WLDN only 4 out of the 6 regions they had been handling. The Con Edison contract was renewed for 2 years with an option for another 1.5 years at about a $14 mm a year run rate (it generated $30 mm in revs in 11).

WLDN has recently won a batch of new energy efficiency contracts in Texas, Illinois, Ohio, Tennessee, and California that management thinks when fully ramped up should fill in the revenue lost from the contract resets. Some of those new contracts have already started, while they should all be at least started by the end of Q3. In June, WLDN made cuts to their labor overhead to bring it in line with expected revenues, and expects to generate pre-tax profitability for both Q3 and Q4 of this year between 5-10% of revenues.

Aside from the labor mismatch, there was also an issue with the nature of the work being performed for the Con Ed contract. The program process involves doing an audit of a Con Ed small business customer's energy usage and exploring ways in which they can reduce their consumption. Con Ed in certain cases will install certain energy savings measures such as new lighting. WLDN as program implementer for Con Ed hires electrical subcontractors to perform that work. This is not very profitable business for WLDN as they don't get paid any mark up for the subcontractor work - the revenue is basically a pass through to the subcontractor. As the initial 3 year program was coming to an end there was a rush to get these measures installed, and thus the mix of business on the contract was skewed towards install business that is low margin for WLDN. Now that the contract has been reset, the mix should be normalized and the contract should be more profitable for WLDN than it has been in the last 2 quarters.

WLDN is exploring the possibility of bringing the electrical install work for these utility energy efficiency programs in-house. One motivation is to be able to earn margin on the labor and materials. A second is that they think the trend is that utilities will start looking for program managers who can handle the installations themselves. But WLDN management has said they will not start building this out until they are sure they have the revenues to support the fixed labor expense.

I think it is likely that WLDN can return to modest profitability in the range of what they did in FY 2010 and 2011. The revenues are there, and the question is just one of aligning the expense structure. The energy efficiency area is a growth market, and WLDN is one of the early movers in the space. Their experience with Con Ed has earned them a reputation in the space as evidenced by their host of recent energy efficiency contract wins. This is not a high margin business, but WLDN can be profitable. In a base case I model that WLDN makes up only half of the approx. $15 mm in lost Con Ed revenue to hit a $100 mm annual revenue run rate. I model 4.5% EBITDA margins, below the low end of guidance of 5% EBIT margins (EBITDA margins were 4% and 5.2% in 2011 and 2010). $4.5 mm EBITDA at 4X multiple would come to an $18 million enterprise value, or a $20.1 million equity value ($2.75 per share). On a free cash flow basis- The company has $13.5 mm of federal and $16.3 million of state NOLs so no cash taxes for a few years. Capex runs a few hundred thousand a year. Assuming $100 thousand of interest expense and $400 thousand in capex, FCF would come to $4 million or 45% of the current market cap. On an asset basis the current valuation at $1.21 a share is 95% of net working capital and 55% of book value (which no longer includes any goodwill after the Q2 write off of the energy segment goodwill). A $2.50 a share price target seems reasonable (between $2.21 a share book value and the $2.75 a share earnings based value above).

WLDN has $3 mm out on a $5 mm line of credit with Wells Fargo. They have been in violation of net income and debt to EBITDA covenants for the last two quarters as earnings have turned negative and they cannot currently draw down any more on the line. They received a covenant waiver last quarter. But notably, WLDN has been cash flow from operations positive in the last 2 quarters (900 k) despite the negative EBITDA and has a $5.5 mm cash balance. As is typical with consulting companies with government exposure they have long cash conversion cycles, but they have managed working capital well the last few quarters and management has said they are pushing for better payment terms on contract renewals to aid cash flow.

Three directors have bought stock on the open market in August in the $1.35-$1.46 range. For some perspective on how the stock trades, with EBITDA around $4 million in 2011 the stock traded around $4.00. It was in the $3.50 range as recently as May of this year before the disappointing results the last two quarters. Despite the lack of liquidity, I would think that if WLDN can return to similar levels of profitably then the stock will be much higher than the current quote.

Long WLDN