DeMatteo Research

IDEA NOTE

Michael Zhuang ■ (212) 833-9920 ■ mzhuang@dmllc.com

CTB

S SHORT

Cooper Tire & Rubber Co

Industrial/Transportation, Consumer

01/31/2018

PRESENTED

DATE		01/29/2018
PRICE	MARKET CAP	ENT VALUE
$39.40	$2.07B	$2.10B
P/E RATIO	BOOK VALUE	DIV YIELD
10.15x	$22.78	1.07%
SHARES O/S	AVE DAILY VOL	SHORT INT
52.44M	728,035	19.88%

CURRENT

PRICE	$29.50	MARKET CAP	$1.48B

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Chart
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Cooper Tire & Rubber Co. engages in the manufacture and trade of tires. It operates through the following geographical segments: North America, Latin America, Europe, and Asia. It offers replacement tires for light trucks, sport utility vehicles, and passenger cars. The company was founded by John F. Schaefer and Claude E. Hart in 1914 and is headquartered in Findlay, OH.

Publicly traded companies mentioned herein: Cooper Tire & Rubber Co (CTB), Goodyear Tire & Rubber co (GT), Hankook Tire Co Ltd (161390 KS), Cie Generale des Etablissements Michelin SCA (ML FR)

Highlights

The presenter is short shares of Cooper Tire (CTB), identifying the company as particularly challenged by cyclical headwinds in the tire industry due to its heavy exposure to the US market. As tailwinds that have led to CTB over-earning fade while new competition enters the US, CTB could find itself dealing with both top line and margin pressures. The presenter believes CTB is set to revert back to a normalized EPS in the $2.00 - $2.50 range, compared to Street estimates of ~$3.75.

- The presenter states that CTB was in an extended period of over-earning, caused by a “collapse” in raw material pricing in 2015 – 2016, which coincided with a tariff on Chinese tires that restricted supply. Historically, declines in input costs have been passed through to pricing, but the reduction in supply allowed tire players to hold firm on pricing and enjoy outsized margins. The presenter also notes that the industry as a whole has refrained from adding meaningful new supply since the 2006 – 2009 range.
- However, CTB is now set to see these trends reverse:
    - Raw material costs are strongly linked to crude prices, which have been appreciating.
    - The industry is getting more promotional on price due to new supply coming online for the first time in a decade. The presenter estimates a 15% bump in supply over the next two years, which has been acknowledged by CTB on its earnings calls.
    - Asian players, particularly South Korean companies like Hankook, are expanding production in the US. Hankook is targeting 15% growth for 2018, compared to the industry’s 1% growth, which implies Hankook is looking to aggressively take share. The presenter explains that CTB is viewed as a “second tier” tire player behind the likes of Goodyear, and is in

  - much more direct competition with Asian companies. As such, CTB's market share is the most exposed to new competition. The presenter notes CTB has seen negative volumes for the past 7 quarters, and has seen market share decline from the 16% - 20% range a decade ago to only 12% today.
  - CTB has seen DSO increase ~30% from the mid-40s a few years ago to 64 days this past quarter, the highest on record. DSI has seen a similar upwards trend, climbing ~30% over the past two years.

- The presenter believes these headwinds, and CTB's challenged fundamentals, have been thus far obscured by a number of one-time events that neither the company nor the Street adjusts for. Though CTB reported a 10% EBIT margin for 2017, which the Street is carrying over to 2018, the presenter believes adjusted margins are closer to 6.5% in light of industry headwinds.
  - CTB benefited from the reversal of a tariff, as well as lowered production liability expense, which have not been acknowledged by Street analysts.
  - There were also some benefits from a one-time adjustment of pension expense as well as cuts in stock-based incentives.
  - The presenter notes tire businesses typically operate at sub-10% EBIT margins, and CTB has already seen its inflated EBIT margins decline from 14% last year to 10% today, and he expects further declines back to historical norms.
- Though all of the tire players will likely see some impact from the shifting competitive landscape, CTB is particularly impacted as the player with the largest US exposure. Players like Goodyear and Michelin have global reach, whereas CTB lost its China JV and is mainly limited to the US, outside of a very small international segment.
- Street models have CTB generating $3.70 - $3.75 of EPS over the next two years. The presenter thinks EPS, as fundamental headwinds mount and one-time benefits fade, will come in closer to the $2.00 - $2.25 range.
  - EPS could come in ~$0.20 higher due to tax reform assuming a mid-20% tax rate, versus ~30% today. However, the presenter notes that a $2.25 - $2.50 EPS is still a meaningful downgrade from consensus estimates.

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Hans Noering, Co-Director of Research, 212-833-9932, hnoering@dmllc.com

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