What Happened To My Margin of Safety?

I have a civil engineer friend who has worked most of his career in the Irish construction industry. During the Celtic Tiger boom years he told me that aggregates were in short supply. I must admit that at the time I was surprised to hear that basic sand and stone had become such a scarce commodity but he said that issues like planning permission and environmental protection were making it difficult to open new quarries and some of the existing quarries had been exhausted. At the time the only quoted companies that owned aggregates in Ireland were CRH and Readymix. The Irish operations of CRH were too insignificant to make a difference to its share price and therefore only Readymix looked like a potential play on the idea. For readers not familiar with the company, the following description is taken from their website:

Readymix was founded in Dublin in 1965. Initially called Readymix (Eire) Limited, by the early 1970s the group had expanded into aggregates in Dublin and opened concrete operations in Limerick and Waterford.

In 1972, the company changed its name to Readymix Limited and its shares were admitted to trading on the Irish Stock Exchange. In December 1983, the company re-registered as a public limited company under the name Readymix plc.

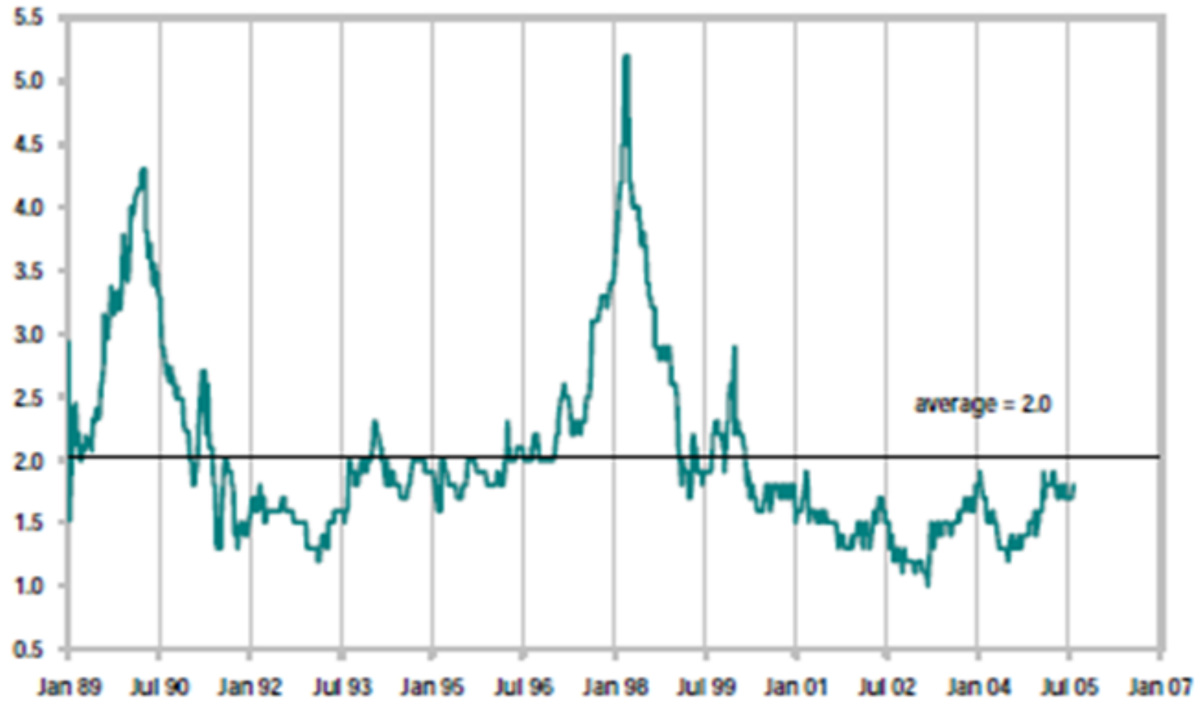
Readymix is now a major supplier to the construction industry throughout the island of Ireland.

In April 1996, Readymix acquired the Catherwood group of companies in Northern Ireland which enhanced Readymix's range of products and provided strategically placed supply locations for Readymix customers across the island of Ireland. In 1999, Readymix acquired the Finlay concrete products group which expanded and complemented the services and products available to Readymix's customers.

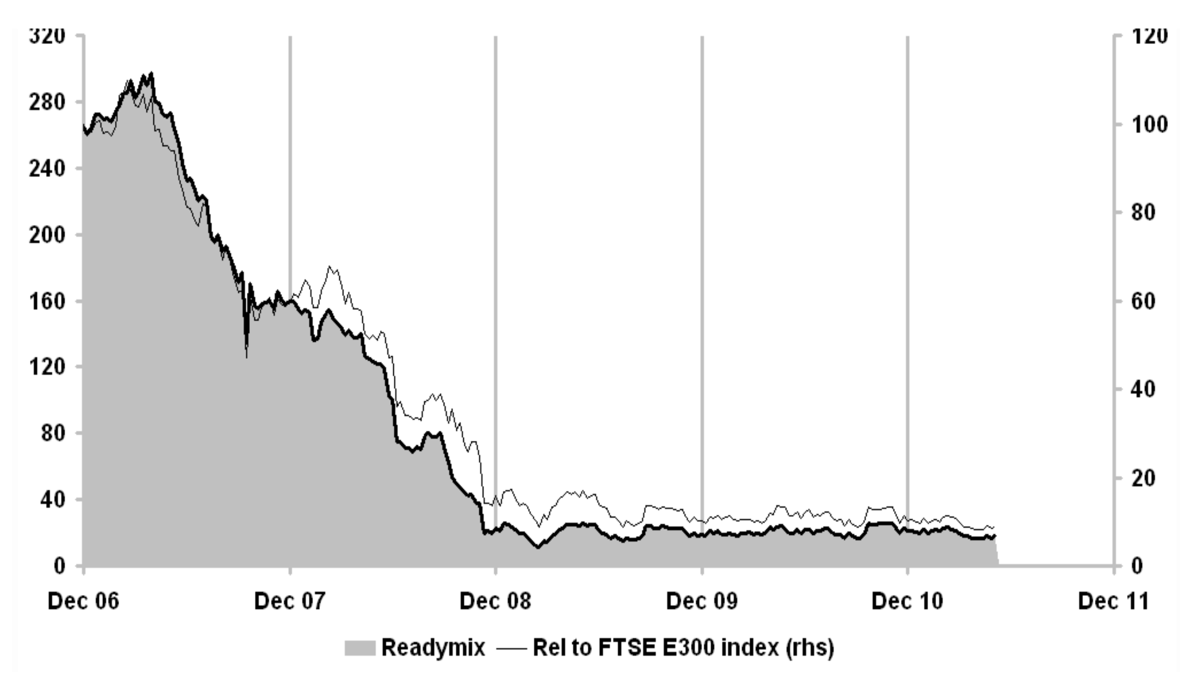
On 1 March 2005, the CEMEX Group indirectly acquired 61.2 per cent. of Readymix following the acquisition of Readymix's then indirect majority shareholder, RMC plc.

Readymix may have been the only pure play on the shortage of aggregates but as the following chart shows, throughout the boom years it never looked particularly cheap.

Readymix Price/Book Multiple



After the Celtic Tiger era ended the Readymix share price collapsed and by late-2008 it was selling on a Price/Book of 0.2x. However it was not until late-2009, when a fellow member of the Value Investment Institute asked me had I looked at it, that I researched the company in detail. By that stage the Market Cap was around €20m and with CEMEX owning over 60% of the company, the free float was less than €7m. Such a small free float normally scares away many investors but I hoped that this might have resulted in it becoming neglected and cheap.



By late-2009, construction demand in Ireland had fallen and there was no hope of an immediate recovery. It was clear that this would be a tough industry for a number of years and only the strongest would survive. I was therefore in a situation where I had to find out whether this was a potential liquidation situation or whether Readymix was strong enough to be one of the survivors.

The first thing I did was look at the balance sheet and here is a copy of the one I would have used from the 2009 Interim results:

	Notes	As at 30th June 2009 €000's	As at 31st December 2008 €000's
Assets			
Non-current assets			
Property, plant and equipment		125,276	125,520
Investments		1,721	1,482
Deferred income tax assets	7	2,245	2,565
		129,242	129,567
Current assets			
Inventories		7,508	8,130
Trade and other receivables		23,955	27,677
Cash and cash equivalents		2,134	6,737
Assets classified as held for sale	10	5,551	5,551
		39,148	48,095
Total assets		168,390	177,662
Equity and liabilities			
Equity			
Called up share capital		13,157	13,157
Capital conversion reserve fund		749	749
Share premium account		15,749	15,749
Foreign currency translation reserve		(12,491)	(15,218)
Retained earnings		99,034	99,396
Total equity attributable to equity holders of the Company		116,198	113,833
Non-current liabilities			
Retirement benefit obligations	9	14,316	20,840
Deferred tax liabilities	7	4,728	4,352
Provisions	11	2,051	2,570
Loans and borrowings	11	250	326
		21,345	28,088
Current liabilities			
Loans and borrowings	11	2,130	1,124
Current tax liabilities	7	2,204	1,670
Trade and other payables		23,802	28,806
Provisions	11	2,711	4,141
		30,847	35,741
Total liabilities		52,192	63,829
Total equity and liabilities		168,390	177,662

This was obviously not a Ben Graham 'net-net' but I thought it still might be interesting if I could estimate the value of the fixed assets.

I remember thinking that this was a company with a balance sheet that should allow it to survive the downturn and eventually come out the other side as a going concern because this was a company with insignificant net debt and significant tangible assets. At worst management could probably mothball a large amount of capacity and bring it back on stream when the market normalised. My civil engineer friend indicated that most of the competitors (apart from CRH) were private companies that were far more likely to have bank debt and therefore be under pressure to restructure.

Even though my core assumption was that Readymix was strong enough to survive the downturn, I thought that the conservative thing to do was to value it as if it was a liquidation situation.

From the Balance Sheet above I could see that Property Plant and Equipment (PP&E) at €125m was critical to estimating a liquidation intrinsic value. I therefore went back to the 2008 annual report to get a more detailed analysis of PP&E:

15. Property, plant and equipment

Group – 2008	Land and Buildings €000's	Mineral Reserves €000's	Plant, Machinery and Equipment €000's	Truck Mixers and Motor Vehicles €000's	Total €000's
Cost					
At 1st January 2008	36,287	53,767	96,539	27,685	214,278
Additions	16,757	2,984	7,382	1,359	28,482
Disposals	(458)	(1,079)	(9,315)	(2,656)	(13,508)
Reclassifications*	(4,368)	4,383	(15)	–	–
Reclassification to assets held for resale	(4,756)	–	(7,606)	(489)	(12,851)
Currency translation	(2,059)	(3,634)	(5,962)	(2,247)	(13,902)
At 31st December 2008	**41,403**	**56,421**	**81,023**	**23,652**	**202,499**

Group – 2008 *continued*	Land and Buildings €000's	Mineral Reserves €000's	Plant, Machinery and Equipment €000's	Truck Mixers and Motor Vehicles €000's	Total €000's
Depreciation and impairments					
At 1st January 2008	4,364	12,356	44,064	18,817	79,601
Charge for year	564	894	4,911	2,266	8,635
Disposals	(151)	(36)	(6,068)	(2,025)	(8,280)
Impairments (Note 7)	941	2,193	6,196	14	9,344
Reclassifications*	(29)	34	(5)	–	–
Reclassification to assets held for resale	(1,024)	–	(5,198)	(457)	(6,679)
Currency translation	(480)	(684)	(2,920)	(1,558)	(5,642)
At 31st December 2008	**4,185**	**14,757**	**40,980**	**17,057**	**76,979**
Net book amounts					
At 31st December 2008	**37,218**	**41,664**	**40,043**	**6,595**	**125,520**

The crucial thing for me was the value of the mineral reserves because here was an asset lying in the ground that would retain value during the downturn and at €41m it was a significant percentage of the asset value. I asked my civil engineer friend if any quarries had

been sold since the crisis began but as far as he could find out nothing had transacted. This meant estimating intrinsic value was going to be difficult.

Land and buildings at €37m was also important but equally as difficult to value because it was spread over the whole island from rural to urban locations, but at least these were assets that would last long enough to see the business cycle turn (even if mothballed).

Given the difficulty involved in coming up with an accurate estimate of PP&E I decided to try and come up with a simple conservative estimate. At the time I thought cutting the value of all non-current assets by 50% would surely be enough to reflect a long and severe recession. With regard to current assets I thought cutting them by 10% should be enough because trade receivables were the major constituent. This left me with the following simplified balance sheet:

	€m		€m
Non-Current Assets	65	Liabilities	52
Current Assets	35	Equity	48
TOTAL	100	TOTAL	100

In other words I thought that I was in a situation where the estimated intrinsic value was €48m and at the then share price the company was valued at €20m. This seemed like an interesting margin of safety.

I was aware that the losses being incurred by the company would reduce the intrinsic value but I made the assumption that the industry would consolidate rapidly over the next couple of years and therefore I thought it was unlikely that much of my margin of safety would be used up.

Analyst estimates indicated that the construction industry in 2009 had already halved from the peak and Readymix had reacted to this by slashing capital expenditure, cutting employee numbers in half and cutting back on all variable costs. I remember thinking that they would have to burn through another €29m in the next couple of years before the intrinsic would be the same as the market value and by that stage the weaker competitors will have closed down and the industry would be back to the rational competition that existed during the recession of the 1980s when Readymix was profitable. I assumed that the worse things became the faster the competitors would go out of business and, as Readymix was in a stronger position starting off, it was bound to be one of the survivors. In January 2010 I therefore personally bought a position in Readymix shares.

I was prepared to be patient and I was not assuming that CEMEX would buy out the minority shareholders. I was relying on market forces to reduce the number of competitors and bring the industry back to rational competition.

In August 2010 Readymix published its interim results and it made a loss of over €6m. As can be seen from the following comment by the Chairman the market remained difficult:

As a result of the weakness in the housing and commercial sectors and the uncertain timing of new infrastructure projects, Readymix plc expects the very demanding trading conditions to continue for the remainder of 2010 and into 2011.

Even though I had not heard of any competitors closing I was expecting news any day, but before there was any news in that regard in October 2010 the Readymix Board announced that it had received an approach from a third party that might or might not lead to an offer for the Group. This was obviously good news because it meant someone else regarded Readymix as cheap. I now began to think about how much I was going to make and what I would do with the money!

In December 2010 before there was any further news on an offer for Readymix there was the first indication that market forces were beginning to work. Whelan Group went into liquidation. Here is how Irish newspaper *The Examiner* reported the event:

The High Court has made an order winding up five companies in the Whelan group, one of the largest concrete suppliers in the country, after the directors of the companies yesterday withdrew their petition for examinership. The directors said they "profoundly regretted" that some 120 jobs will be lost. The companies have 2,000 creditors with the largest secured creditor being the National Assets Management Agency which has taken over some €50 million debts owed to Anglo Irish Bank and opposed examinership due to the proposed large write down of secured debts. Irish Cement Ltd, owed €4m of a total €10m due to unsecured creditors and Lagan Cement, owed €383,000, also opposed examinership. Lagan had also brought a petition to wind up one of the Whelan companies and its proposed liquidator, Carl Dillon, was appointed by Mr Justice Brian McGovern as liquidator of all five companies. The judge made orders for the companies' directors to file statements of affairs by January 28. Other creditors of the companies included Bank of Scotland Ireland, owed €12m, and the Revenue, owed €641,000, both of which adopted a neutral position.

The directors had argued the companies had a reasonable prospect of survival on the basis of a proposed survival scheme involving sale of non-core assets, mostly property; procuring investment and the support of NAMA and the banks. The petition for examinership was due for hearing yesterday but at the outset, John O'Donnell SC, for the companies, told Mr Justice McGovern an independent accountant had expressed the view the companies did not have a reasonable prospect of survival given the decision by NAMA to oppose the petition. He said the directors had presented the petition in good faith on the basis Anglo would be neutral on examinership as it had indicated. He said the papers in the matter were served on NAMA and there was no indication there was any change in relation to Anglo's position until very recently when NAMA made clear it was emphatically opposed to examinership.

This was a family business in existence for almost 40 years, and while there were disputes about figures and about issues of corporate governance, which were addressed, it had not been contested most of the 120 jobs would have been saved if examinership was successful, counsel said. His clients were very concerned that NAMA should have "drawn the axe" on these jobs. He added, NAMA was within its legal rights to oppose examinership and, given that opposition, the companies had no reasonable prospect of survival.

When Mr Justice McGovern said "serious and grave issues" had also been raised by other creditors of the companies, counsel said his side would have been happy to deal with those. The judge said he would not allow the court be used as a forum to put "a spin" on the matter.

Rossa Fanning, for NAMA, said he took exception to the criticism of his client which was entitled to oppose the examinership. Other creditors had taken a similar view the companies had no reasonable prospect of survival, he added. The judge made orders that NAMA, Irish Cement and Lagan should get their costs of the petition against the five companies in the winding up. Mr O'Donnell had argued it would be unduly harsh to make costs orders against them.

The Whelan companies had said they have a consolidated deficit of €10m as a going concern rising to about €50m if placed in liquidation. The five companies in liquidation are Whelan Group (Ennis) Ltd; Whelans Limestone Quarries (Contracts) Ltd; Whelans Limestone Quarries Ltd; Whelans Quarries (Carrigtwohill) Ltd and Shannon Explosives Ltd. The directors said the Whelan Group was affected in recent years by the severe contraction in the construction industry, the funding crisis in the country and an unsuccessful investment and trading involvement with Uniform Construction, the main contractor on the Limerick drainage scheme.

They also said audit completion work and due diligence work on behalf of Bank of Scotland Ireland had identified financial inaccuracies, including the recording of duplicated sales invoices, in the internal accounts of the group and its subsidiaries for the years ending December 2008, December 2009 and September 2010. This led to BOSI withdrawing invoice discounting facilities about November 2010 and there was now an excess drawdown on the BOSI facility of €2.9m, they said. In light of those issues, they had accepted the resignation of the group finance director.

What surprised me was how long it took for the Whelan Group to be closed. It should have been clear that a company owing €50m to Anglo Irish Bank, €12m to Bank of Scotland and €4m to Irish Cement was not in a position to compete with CRH and Readymix. It was my first indication that rationalisation may not happen as fast as I had hoped but I was still optimistic that this was the start of the process. In any regard there was no need to think too much about it because there was likely to be an offer for Readymix in the near future.

In March 2011 Readymix announced that all third-party discussions had been terminated and that no offer was likely in the near term. Any thoughts of quick and easy profits quickly disappeared and, as the following extract from the Concrete Industry Federation shows, the industry background continued to deteriorate.

Construction Industry Output

	2007	2008	2009	2010
Construction Output (€bn)	38.6	32.6	18.0	11.7

Source: DKM

In April 2011 Readymix published its annual results. Net Debt had increased to €3.8m as

the company continued to make losses. Still, compared to the situation as described above in Whelan Group, I felt that Readymix remained in a strong position to survive. Here is the Dec. 2010 Balance Sheet:

	Notes	2010 €000's	2009 €000's
Assets			
Non-current assets			
Property, plant and equipment	14	**108,926**	119,393
Investments	15	**1,629**	1,713
Deferred tax assets	12	**-**	649
		110,555	121,755
Current assets			
Inventories	16	**3,860**	5,612
Trade and other receivables	17	**9,938**	18,913
Cash and cash equivalents		**1,589**	3,137
Assets classified as held for sale	18	**4,189**	4,189
		19,576	31,851
Total assets		**130,131**	153,606
Equity and liabilities			
Equity			
Called up share capital	19a	**13,157**	13,157
Capital conversion reserve fund	19a	**749**	749
Share premium account	19a	**15,749**	15,749
Foreign currency translation reserve	19b	**(12,748)**	(13,536)
Retained earnings		**67,410**	90,869
Total equity		**84,317**	106,988
Non-current liabilities			
Retirement benefit obligations	20	**18,836**	15,629
Deferred tax liabilities	12	**4,409**	4,099
Provisions	21	**1,889**	1,801
Loans and borrowings	22	**5,418**	1,530
		30,552	23,059
Current liabilities			
Loans and borrowings	22	**61**	366
Current tax liabilities		**2,837**	3,075
Trade and other payables	23	**10,803**	18,199
Provisions	21	**1,561**	1,919
		15,262	23,559
Total liabilities		**45,814**	46,618
Total equity and liabilities		**130,131**	153,606

Undertaking the same liquidation valuation exercise on the end-2010 Balance sheet as before (non-current assets reduced in value by 50% and current assets reduced in value by 10%) gave me the following simplified balance sheet:

	€m		€m
Non-Current Assets	52	Liabilities	46
Current Assets	18	Equity	24
TOTAL	70	TOTAL	70

In other words, using the same liquidation valuation approach, my intrinsic value had fallen to €24m and my margin of safety had dropped dramatically from my acquisition price. The losses and impairment charges had not come as a surprise, but the increase in the pension deficit was something that was not anticipated. The Chairman focused on the pension situation in his commentary:

On 2 February 2011, the Board took the very difficult decision to advise Trustees of its Defined Benefit Pension Schemes in the Republic of Ireland of its intention to cease contributions. In light of the extremely difficult trading conditions facing the Group, the future funding required to maintain these pension schemes is simply not sustainable. If these schemes are subsequently wound up, then under IAS 19, any settlements or curtailments which may arise will be reflected in the 2011 financial statements.

The Board is currently engaging with the Trustees of these pension schemes in order to reduce the impact of any winding up of the schemes on the accrued benefits of members. Ultimately, it is anticipated that this may involve the contribution of Group assets, but the precise structure of any such arrangement will need to be discussed and agreed with the Trustees.

I began to wonder if I had found myself in a value trap. I began to worry that my original analysis had not been conservative enough. Should I have discounted the non-current assets by more than 50%? Was I wrong to think that the competitors would go out of business before Readymix? I had gone from the greed in October 2010 when the news of third party interest had emerged, to the fear in April 2011 when the results were announced. Meanwhile the share price had fallen from my 20c acquisition price to 17c.

Once again I looked at the PP&E because I had originally been interested in the value of the mineral reserves:

	Land & Buildings €000's	Mineral Reserves €000's	Plant, Machinery and Equipment €000's	Truck Mixers and Motor Vehicles €000's	Total €000's
Net book amounts					
At 31 December 2010	**35,336**	**38,822**	**31,515**	**3,253**	**108,926**

I was inclined to think that on the balance of probability these mineral reserves would eventually be a valuable asset and that valuing them at 50% of Net Book Amount was being too conservative and therefore a realistic intrinsic value was higher than my €24m calculation. I convinced myself that being patient was the right thing to do in the belief that eventually the more leveraged competitors would be forced to close, even though there had been no further closures since the Whelan Group.

By the time the 2011 interim results were released in late August, the share price had fallen to 13c. More losses, higher net debt, further impairments and still no sign of market forces working.

At the end of October the share price hit 10c after the interim management statement

indicated no improvement. By end-November the share price fell to 6c and in December it reached 4c valuing the total business at €4m. Did I buy more shares? No, because I was paralysed by the fear that my analysis was wrong. There was no further significant rationalisation in the industry. The IMF was in charge of the country. Construction was still contracting and there was obviously still too much spare capacity.

On January 19th 2012 the following announcement was made by Readymix:

The directors of the Company announce that they have received an approach from Readymix Investments, a wholly owned indirect subsidiary of Cemex España, S.A outlining the terms of a possible offer which it may be prepared to make for all the shares of the Company other than shares currently owned by it or another member of the CEMEX group.

Readymix Investments has indicated to the directors of the Company that it would be prepared to offer Euro 0.22 per share in cash. Shareholders should note that the approach is preliminary in nature and there can be no certainty that an offer will be made

From a situation where I completely doubted my own analysis I was back on the roller coaster of wondering whether my original analysis was correct and wondering whether CEMEX was trying to use the weak share price and weak construction market as an opportunity to buy out the minority shareholders on the cheap. This made me realise that unfortunately I did not know with any degree of certainty. I had to accept my own limitations and acknowledge that I had too little confidence in my calculation of intrinsic value.

On February 2nd 2012 the following announcement was made:

Readymix announced today that, for the year ended 31 December 2011, revenues fell 15% compared to the same period last year, with the fall impacting all of the Group's products.

Readymix expects an operating loss (before exceptional items) of approximately €13 million for the full year to 31 December 2011. This compares to an operating loss (before exceptional items) of €15 million for 2010, the reduction being largely due to lower operating costs.

In light of the continued decline in aggregate volumes and the uncertainty that surrounds the housing and construction sectors, and the economy as a whole, the Board has again conducted a detailed year end review of asset holding values. Independent professional valuers were engaged to assist in this process, with a particular focus placed on mineral reserves. All land, construction and reserves assets, along with plant and machinery across the Group, were reviewed, with professional valuations carried out on 85% of the land, construction and mineral assets in the Republic of Ireland.

As a result of this review, using assumptions which reflect the further deterioration in market conditions, particularly in the Republic of Ireland, the Board expects that there will be an impairment charge of €27 million for the second half of 2011, giving a total impairment charge of €39 million for the full year to 31 December 2011. Of the total impairment, €35 million relates

to assets in the Republic of Ireland.

Total losses before tax for 2011 are expected to be in the region of €54 million.

Although this will not be reflected in the financial statements, the external valuation process also identified certain assets as having potentially higher values than their carrying values, amounting in total to approximately €10 million.

As at 31 December 2011, the Group had net debt of approximately €16 million.

Here I was being told that independent third party valuers had been brought in and had looked particularly closely at mineral assets and had reached the conclusion that a €39m impairment charge was appropriate. I was also being told that net debt was up to €16m and clearly would continue to rise.

On February 6th another announcement was made:

In line with the requirements of the Irish Takeover Rules, and to ensure the independence of the assessment of the merits for Readymix of any possible offer, on 23 January 2012 the Board established an Independent Committee comprising the Chairman, Adrian Auer, and Donal O'Connor (the "Independent Committee") to consider the approach and determine the Company's response.

Following further discussions with the Independent Committee, CEMEX has agreed to increase the possible offer from €0.22 per share to €0.25 per share in cash, an increase of 13.6%.

In consultation with its advisers, the Independent Committee has considered the merits of this increased possible offer, and has determined that the terms are fair and reasonable. The Independent Committee has accordingly informed CEMEX that, if announced, it would recommend Readymix shareholders to accept the offer.

I was experiencing mixed emotions because 25c was a reasonable return on my 20c acquisition price and was a massive increase from the low of 3c seen only a few weeks earlier, but I was still left with a niggling feeling that I was being forced to sell at the bottom of the cycle.

On February 22nd the offer was formally recommended. Following the required legal steps the takeover went ahead and I received my 25c a share at the end of May 2012.

CONCLUSIONS AND LESSONS LEARNED:

I thought Readymix met one of the important criteria for many value investors of being a company that I could easily understand. On the face of it there is nothing complex about concrete and I thought by having a friend working in the broader construction industry I was getting a deep understanding. I now realise however that there were complex aspects

that neither I nor my friend understood.

Here are a couple of examples of the things that make me realise just how little I did understand:

- I did not know that the cost involved in mothballing some of their quarries was higher than the cost of keeping them open due to contracts they signed that included minimum royalty payments to farmers from whom they bought the land.
- I did not know how to put a truly conservative value on long term assets like property, plant and equipment.
- I did not know enough about the financial position of private companies that were competitors and therefore did not know how long it would take for market forces to work.

This highlighted to me how the concept of intrinsic value and margin of safety is easy to understand but is not always so simple to implement.

Some other lessons I learned include:

- I need to pay more attention to pension deficits.
- I ignored operating leases and in future I will build these into my calculations.
- No matter how much I study Behavioral Finance it is still a horrible feeling when you begin to think you have got your analysis wrong and you wonder whether you are in a value trap. Mr. Market sure did send me on a roller coaster of emotion.
- Don't get carried away when things work out in the end!

The Value Investment Institute, October 2012