THE GLOBE AND MAIL

This stock pick of students learning investing offers value that would satisfy even Warren Buffett

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In the midst of turmoil in financial markets, the war in Ukraine, deglobalization, inflation and rising interest rates, value-investing students at the Ivey Business School could still find value in stocks that would satisfy even Warren Buffett. One such stock is **Malibu Boats Inc.** MBUU-Q (/investing/markets/stocks/MBUU-Q/) +1.37% ▲

Malibu Boats also met the basic criteria of Ben Graham, the father of value investing, for being obscure and undesirable. It has a market capitalization of US$1.2-billion, which falls below the value threshold of US$1.5-billion, while its price-to-earnings ratio of 10.1 falls below the value threshold of 15. Moreover, as of May 20, Malibu Boats was trading around its 52-week low.

That said, Malibu has 11 analysts covering the company and a price-to-book ratio of 2.9, which is higher than the desired threshold of between 1.3 and 1.4. Nevertheless, the students proceeded with the valuation as they believed the company, in addition to satisfying some of the Graham criteria for possible undervaluation, also has a potentially sustainable franchise.

Founded in 1982, Malibu Boats makes recreational powerboats. It operates in three segments. The Malibu segment (49 per cent of fiscal 2021 revenue) has held the No. 1 market share position in the U.S. for performance sport boats since 2010. Saltwater Fishing (30 per cent of revenue) holds the No. 2 share position in the outboard fibreglass fishing market. The Cobalt segment (21 per cent of revenue) is the market share leader in the 20-foot to 40-foot segment of sterndrive, or inboard/outboard, boats.

The U.S. recreational powerboat industry is highly cyclical – the market declined 61.5 per cent after the Great Recession. Recreational boats are often considered the ultimate discretionary purchase and are intimately linked to economic vicissitudes. The industry, whose key players, in addition to Malibu, include Brunswick Corp. (BC-N), MasterCraft Boat Holdings Inc. (MCFT-Q), Marine Products Corp. (MPX-N) and MarineMax Inc. (HZO-N), is highly capital intensive. Its proprietary technology and leveraging of multiyear customer agreements prevent new large-scale entrants. However, there is the possibility for smaller manufacturers to capture niches in the industry without significant upfront investment. Competition in the industry is largely based on brand name, price and product performance; therefore, only companies with strong product offerings, vertically integrated operations and strong customer relations will survive the erosion of their operating margins.

Malibu is less risky than its industry. The company produces 95 per cent of the materials that go into its boats by manufacturing its own engines, boat trailers, flooring and other accessories. The continued focus on vertical integration opportunities, including a 2019 decision to move the manufacturing of engines and flooring in-house, has helped Malibu reduce reliance on suppliers, improve costs and achieve greater control over construction quality.

For the past 40 to 50 years, Malibu Boats brands have generated a loyal following of recreational boaters and water sports enthusiasts. The company has continued to increase its market share in all three of its segments over the past decade, and in terms of aggregate market share, the company is the largest in its industry.

When comparing Malibu's operating margins with its peers over the past nine years, the company consistently has the highest margins, with a historical spread of between three and nine percentage points above the peer group average. Additionally, the company has maintained a stable and growing return on assets roughly in line with the industry average for the past seven years.

The threat of substitutes by way of used boat sales poses minimal risk to Malibu because of its focus on premium performance products. The affluent customer base that purchases these products is less inclined to purchase a used boat. In the same way, Malibu is better protected from the cyclical nature of the industry because of its target market.

Given the reasons mentioned above and particularly the stability of the company's operating margins, which have largely ranged between 12 per cent and 18 per cent over the past 10 years, and considering the industry in which it belongs, Ivey's value-investing students concluded that Malibu Boats had a medium business risk. With a four-year average debt-to-capital ratio of 36 per cent, students felt Malibu had medium financial risk, with the company deserving a credit rating of A. This led to a cost of capital (May 20 valuation) of 6.9 per cent. Adjusted return on invested capital was 16.6 per cent. Intrinsic value was estimated to be US$112.12 and the entry price US$74.74. With the stock trading at the time of valuation at US$54.51, Malibu Boats was a strong buy.

Buffett-type stocks are hardly ever found to be undervalued, but owing to the uncertainties that markets are facing these days, particularly concerning growth stocks, from the students' analysis, Malibu fits the bill.

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