

Lindsay Corporation (LNN) ***Irrigating the Emerging Markets with a Modest Valuation***

We are long shares of Lindsay Corporation (NYSE:LNN), a global irrigation business headquartered in Omaha, Nebraska. Lindsay owns a world-renowned brand name (*Zimmatic*), sells into an under-penetrated market and benefits from the secular trends of increasing global food scarcity and rising protein consumption. Given this long-term growth opportunity, a robust capital efficiency profile (ROIC of 25%+), and the stock trading at 13.7x net-cash P/E on trough FY 2014E earnings, we believe LNN shares trade at a 50% discount to our conservative estimate of intrinsic value.

The mechanized irrigation business is a global duopoly, with Lindsay and Valmont Industries (VMI) combining for about 75% of the global market share. During the 1970's there were over thirty domestic manufacturers of center pivot irrigation systems. But the market's cycles eliminated most of the competition and the past two decades saw Lindsay and Valmont emerge as the clear leaders. Mechanized irrigation systems improve crop yields, enhance water efficiency, and provide a higher return on investment for farmers than competing irrigation methods. Thanks to these benefits, market penetration of mechanized systems has increased from 35% to 46% in the U.S. over the past decade. This has driven 15% annualized revenue growth in Lindsay's irrigation business over the same period.

Over the next decade, we believe attention will shift to the international market, where just ~2% of irrigated fields employ mechanized systems. If market penetration reaches the level seen in the U.S., we believe Lindsay's international opportunity exceeds \$2.5bn in annual revenue, or about ten times where its international business stands today.

The bear case contends that lower corn prices in 2014 will depress farmer sentiment and cause year-over-year declines in pivot sales. But even if U.S. farmers temporarily defer purchases, in past cycles Lindsay's growth has historically returned after just a few quarters. Furthermore, continued growth in Lindsay's international segment, which contributed 58% of irrigation revenue in FQ4 2013, can work to offset any short-term declines in U.S. farmer spending.

Looking beyond the next few quarters, Lindsay's continued cash flow generation and projected return to growth next year will compress the stock's already cheap EV / EBITDA valuation to 6.0x in FY 2015 and 4.7x in FY 2016. Lindsay's completely unlevered balance sheet, minimal capex requirements, and secular growth might also attract private equity interest. With the stock currently depressed because of the market's myopic focus on quarterly results, we have taken a long position in the shares.

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I. Situation Overview

A snapshot of Lindsay's financial and valuation metrics is below.

<i>Capitalization & Multiples</i>			<i>Financial Statistics</i>				
<i>Fiscal Year End Aug 31st</i>				2010	2011	2012	2013
Share Price (US\$)	\$73.83		U.S. Irrigation	\$152.9	\$227.6	\$305.4	\$385.7
Diluted Shares	13.1		Int't Irrigation	105.8	142.3	169.9	240.3
Market Cap	\$966.2		% Growth	6.4%	34.5%	19.4%	41.4%
Debt + Pension	6.3		Infrastructure ⁽¹⁾	99.8	109.0	76.0	64.8
Cash	(151.9)		% Growth	23.6%	9.2%	(30.3%)	(14.7%)
Enterprise Value	\$820.6		Total Revenue	\$358.4	\$478.9	\$551.3	\$690.8
			% Growth	(17.7%)	33.6%	15.1%	25.3%
Trading Multiples							
EV / LTM EBITDA	\$119.7	6.9x	EBITDA	\$48.6	\$68.3	\$78.0	\$119.7
EV / NTM EBITDA	102.0	8.0x	Capex	(5.8)	(8.4)	(9.9)	(11.1)
LTM P/E	\$5.47	13.5x	EBITDA - Capex	\$42.8	\$59.9	\$68.1	\$108.5
NTM P/E	4.58	16.1x	EPS	\$1.98	\$2.90	\$3.38	\$5.47
Ex-Cash LTM P/E ⁽²⁾	\$6.44	11.5x	ROE	11.4%	14.6%	14.8%	20.4%
Ex-Cash NTM P/E ⁽²⁾	5.40	13.7x	ROIC	15.4%	20.8%	24.8%	30.4%

Source: Lindsay Filings.

(1) Before corporate G&A, 2012 Infrastructure EBIT was -\$0.01m

(2) Assumes net cash balance is deployed to repurchase ~2m shares at LNN's current share price

Lindsay Corp is known for its *Zimmatic* line of center pivot and lateral irrigation systems. The value proposition to farmers is clear: i) yield enhancements of up to 50-70%, ii) 3 - 7 year payback periods with a 20+ year machine life, and iii) improved water conservation versus traditional "flood" or drip irrigation methods. Last year's drought conditions, not to mention continued unpredictable weather patterns, have put irrigation at the forefront of many farmers' minds. In the past, irrigation systems were viewed as a safety net, only used during the occasional weather disruption. But after three major droughts in the past five years, farmers now view advanced irrigation systems as a necessity. In the words of an Indiana corn and soybean [farmer](#), "we don't want Mother Nature to control our destiny anymore."

Lindsay holds the #2 market share position as part of a duopoly with Valmont (VMI), an engineered products company with an irrigation business on the side. Between the two, we believe Lindsay is the technological leader. It pioneered an application to remotely monitor pivots using GPS as early as 2001, it offers soil moisture and weather sensing tools, and most recently, Lindsay announced a partnership with Syngenta, a \$40bn global crop input business. This [partnership](#) will combine Lindsay's technologically advanced pivots with Syngenta's soil

additives and modified seeds to help farmers grow more corn with less water. Valmont has no comparable partnership, speaking to the level of innovation at Lindsay Corporation.

Lindsay currently controls 30% of the global market while Valmont owns 43%. Over the past three, five, and ten-year periods, Lindsay's irrigation business has grown more quickly, implying relative market share gains for Lindsay. As part of our diligence, we spoke with industry participants in emerging markets such as Brazil, Ukraine, and the Middle East. In each of these geographies, we've found that Lindsay and Valmont split the #1 and #2 positions while local competitors are relegated to the background. When asked about quality, farmers almost unilaterally recommend Lindsay and Valmont with equal vigor. Lindsay's brand reputation is supported by a robust dealer network that would be very difficult to replicate. Irrigation dealers typically trade in a single brand, much like a car dealership does, and these dealers are less willing to hold inventory for a manufacturer that lacks an existing customer base. Proximity to a local dealer is critical for the farmer. If a sprinkler breaks or a tire deflates, the farmer needs immediate access to replacement parts. A combination of market-leading technology, global mindshare built up over many decades, and an international dealer [network](#) gives Lindsay the sustainable competitive advantage that it has enjoyed thus far.

Lindsay's share price is depressed due to the market's focus on short-term, cyclical trends in U.S. agricultural spending. A fall in corn futures from \$7 to \$4.50/bushel on expectations of a larger 2013 harvest means that farmers will have less disposable income next year, potentially leading to a slowdown in capital equipment buying. The sellside has already adjusted their guidance for this impact, predicting that Lindsay's EPS will fall from \$5.47 in FY 2013 to \$4.58 in FY 2014. Lindsay's international segment should help mitigate a temporary U.S. slowdown. The strength of the international segment was proven in FQ4, when international irrigation revenues were 58% of the irrigation revenue mix, representing the first quarter ever in which international sales exceeded 50% of the total revenue mix.

Lindsay's historical financials, shown below, demonstrate that its business quickly recovers after temporary disruptions in the corn cycle. There were meaningful disruptions in farmer income once in 2005 and again in 2009 after the global recession. In both instances, Lindsay quickly recovered to double-digit growth after two or three sluggish quarters. Viewed over the long-term, Lindsay has compounded earnings at a 17% annualized growth rate going back to 2003.

For a business with a proven track record, sustainable competitive advantages, and a visible path to further expansion, we believe a capitalized earnings valuation is appropriate. By building this valuation on the consensus FY 2014 EBIT estimate of \$90m, which would likely be trough earnings, we have been quite conservative. For comparative purposes, we also calculate a price target using the FY 2015 EBIT estimate of \$100m. We assume Lindsay's U.S. business grows at just 2.5%, in-line with GDP forecasts. For Lindsay's international business, we believe earnings can compound at a double-digit rate well into the next two decades. Blending these two assumptions together yields a long-term growth rate of 6%. When combined with a 10.5% WACC, this works out to a 22x P/E multiple.

Note that we have excluded the infrastructure business from the target valuation, as we assume it remains break-even on a cash flow basis. A potential turnaround of the business adds upside. Our assumptions do not include margin expansion since a mix shift towards the international business could offset some of the operating leverage from domestic growth.

Historical Financials and Valuation Targets

\$mm; FYE Aug 31st	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Revenue											
Irrigation	\$151	\$183	\$156	\$194	\$217	\$375	\$256	\$259	\$370	\$475	\$626
Infrastructure	12	13	21	32	65	100	81	100	109	76	65
Total Revenue	\$163	\$196	\$177	\$226	\$282	\$475	\$336	\$358	\$479	\$551	\$691
Order Backlog	22	17	14	27	49	92	44	38	46	57	67
COGS	(124)	(157)	(144)	(178)	(212)	(351)	(256)	(260)	(349)	(403)	(496)
Gross Margin	\$40	\$39	\$34	\$48	\$70	\$124	\$81	\$99	\$130	\$149	\$195
EBIT											
Irrigation	28	27	20	26	33	67	36	41	60	80	125
Infrastructure	1	1	3	7	14	10	(0)	11	12	(0)	(1)
Unallocated G&A	(13)	(16)	(17)	(17)	(24)	(14)	(13)	(14)	(15)	(15)	(18)
Total EBIT	16	12	6	16	24	62	22	38	57	66	107
EBITDA											
Capex	(2)	(5)	(4)	(4)	(15)	(14)	(11)	(6)	(8)	(10)	(11)
NWC	(1)	(13)	4	0	(12)	(21)	30	(13)	(7)	(5)	(26)
EPS	\$1.10	\$0.78	\$0.42	\$1.01	\$1.34	\$3.25	\$1.12	\$1.99	\$2.93	\$3.40	\$5.47
Long-term EPS CAGR											17.4%

Illustrative Equity Valuation

Estimated FY 2014 EBIT		\$90	\$100
Tax Rate		35%	35%
Unlevered Income		\$59	\$65
WACC - Growth		4.5%	4.5%
Implied EV		\$1,300	\$1,444
Less: Debt + Pension		(6)	(6)
Add: Cash		152	152
Implied Equity Value		\$1,446	\$1,590
Shares		13.1	13.1
Implied Share Price		\$110.00	\$122.00
Current Share Price		\$73.83	\$73.83
% Premium		49.0%	65.2%

P/E Multiple (ex-Cash)

Levered Cost of Equity	10.5%
Long-term Growth Rate	6.0%
WACC - Growth	4.5%
Implied P/E (ex-Cash)	22.2x

Growth Opportunity

U.S. Irrigation	Assume GDP	2.5%
Int'l Irrigation	International TAM	\$2,500
	Current Int'l Size	240
	25-Year Growth CAGR	9.8%

P/E Multiple Sensitivity (ex-Cash)

		Unlevered Beta				
		1.7x	1.6x	1.5x	1.4x	1.3x
Long-term Growth	5.0%	15.4x	16.7x	18.2x	20.0x	22.2x
	5.5%	16.7x	18.2x	20.0x	22.2x	25.0x
	6.0%	18.2x	20.0x	22.2x	25.0x	28.6x
	6.5%	20.0x	22.2x	25.0x	28.6x	33.3x
	7.0%	22.2x	25.0x	28.6x	33.3x	40.0x

WACC

Risk-free Rate	3.0%
Market Risk Premium	5.0%
Unlevered Beta	1.5x
Debt / EV	0%
Tax Rate	35%
Implied Lev. Beta	1.5x
Levered Cost of Equity	10.5%

Sources: Kerrisdale Analysis, Company filings, Bloomberg

Lindsay possesses a unique combination of a low valuation, an unlevered balance sheet, a high-growth end-market, and solid capital efficiency, making it an ideal private equity target. Lindsay Corporation satisfies many of private equity's requirements for an attractive target: i) it's

easy to understand; ii) Lindsay carries a world-renowned brand name that allows the company to exercise pricing power; iii) secular trends of population growth, protein consumption, and water scarcity will drive long-term growth; and iv) the stock is cheap, satisfying a 10%+ pre-tax return hurdle. Lindsay would also be a nice fit for Berkshire Hathaway, which we mention because Warren Buffett's son, Howard Buffet, has [been](#) a Lindsay board member since 1995. Other than Lindsay, the only other board that Howard serves on is the Coca-Cola Corporation. Howard is the future chairman of Berkshire Hathaway and was recently re-elected to the Lindsay board for a three-year term through 2016.

We estimate that private equity could add approximately \$425m of leverage, helping to shield Lindsay's earnings from a burdensome 34% effective tax rate. The debt could be easily serviced given \$90-100m+ of pre-tax operating income and Lindsay's modest capex requirements, which typically amount to only \$15m/year. Our LBO projection model employs consensus numbers for FY 2014 (15% EBITDA decline) and FY 2015 and then grows revenue by 15% a year until FY 2018, in-line with Lindsay's historical rate. Using these inputs, we believe a sponsor could pay approximately \$107/share for Lindsay today and still achieve a 20% IRR over a five-year period.

Illustrative Offer Price Per Share

		EBITDA Exit Multiple				
		11.0x	12.0x	13.0x	14.0x	15.0x
	15.0%	\$109.42	\$116.52	\$123.62	\$130.72	\$137.82
Sponsor	17.5%	102.22	108.60	114.97	121.35	127.72
Required	20.0%	95.89	101.63	107.36	113.10	118.84
IRR%	22.5%	90.30	95.47	100.65	105.82	111.00
	25.0%	85.35	90.03	94.71	99.39	104.06

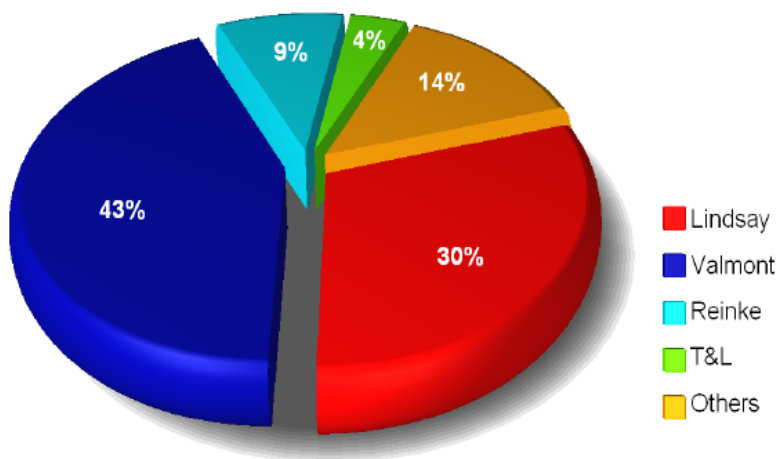
Source: Kerrisdale Analysis; see Appendix for details.

II. Business Description

Lindsay is headquartered in Omaha, Nebraska, in the heart of the U.S. Corn Belt. Lindsay's *Zimmatic* brand has a 55-year history in the irrigation business and is known globally for its dependability, efficiency, and market-leading technological innovations. Lindsay's product line includes the traditional center pivots system, lateral move systems for rectangular fields, and bent-arm configurations for customized terrain. The workhorse of Lindsay's irrigation fleet is the 75/85/9500P [line](#) of center pivots. The typical center pivot is 1,300 feet long and designed to irrigate a plot of 130 to 135 acres. Pivots can operate for 20-30+ years, making farmers reluctant to save a few thousand dollars on second-tier brands. These are extremely high-return tools, with average payback periods of typically 5 – 7 years, although this shrinks to just 3 years when farmer incomes are high. In addition to the cost of the pivot itself, farmers incur secondary upfront costs from well installation, pumps, underground pipes, and electrical needs. We recommend watching [this](#) helpful instructional video for a visual representation of the product.

The mechanized irrigation market is a global duopoly consisting of Lindsay Corporation, the most pure-play irrigation business in the market, and Valmont Industries, a conglomerate that also makes traffic signs, light poles, and other basic metal tubing. The irrigation system is critical to health of a farmer's crop, and both Lindsay and Valmont have a reputation for strength and reliability. A broken pivot in the middle of a drought could ruin a farmer's year. The prevalence of Lindsay's and Valmont's individualized dealer-networks, both of which are global, further entrenches their competitive advantage over second-tier U.S. manufacturers and local copycats.

**Estimated Global Market Share
(Pivots and Laterals Only)**



Source: August 2013 Lindsay Corporate [Presentation](#)

The Benefits of Mechanized Irrigation over Competing Techniques

Other than mechanized irrigation (pivots and laterals), there are two alternative methods: gravity and drip. The simplest method is gravity, requiring just a sloped field and a water source. Water floods down the sloped field and irrigates the field along the slope. This method has several major drawbacks, the most significant of which are uneven water distribution, poor water efficiency, and an inability to irrigate uneven fields. But because gravity irrigation requires little upfront costs, it is still employed by 90%+ of the international market. In the United States, where farmland is some of the most productive in the world, just 39% of irrigated fields utilize the gravity method.

One irrigation salesman [explains](#) the disadvantages of gravity: “Producers are just finding it harder and harder to find good qualified help if they are doing flood irrigating. A center pivot system will replace two to three persons. Flood irrigation is hard work. And there's the efficiency of the system. A seven-tower center pivot will use a third to a half less water than what's used in flood irrigation. In five to seven years, it'll pay for itself.”

Gravity Irrigation



A second alternative method is drip, or trickle, irrigation. This technique involves a perforated pipe that is strung along the field near the root level. Drip systems run across the entire field, requiring a complex system of tubes and spouts to ensure proper irrigation at each planting. Given the intricacy of the system, drip irrigation is better suited for smaller areas, like vineyards, orchards, and small vegetable fields. In areas like Brazil, with two growing seasons, crop rotation is challenging given the fixed spacing of water spouts. Drip systems are cumbersome to maintain since rodent damage, dirt clogs, or residue buildup can disrupt an entire system. Furthermore, drip systems typically have a 10-year lifespan versus 20+ years for center pivots. After accounting for these extra expenses, drip systems can cost [twice](#) as much as a mechanized system over a 50 hectare field.

Drip Irrigation



Drip irrigation has just 7% market share in the United States. John Deere, the blue-chip agricultural equipment maker, recently [announced](#) the exploration of strategic options for its drip irrigation [division](#). Deere's potential sale of its drip unit indicates that mechanized irrigation continues to be the preferred choice of farmers.

The most prevalent irrigation method in the U.S. is mechanized irrigation. Pivots and laterals represent approximately 46% of the domestic market, up from 35% ten years ago.

Mechanized (Center Pivot or Lateral) Irrigation



In addition to its reputation for making durable, high-quality equipment, Lindsay is also arguably the most technologically advanced. This [video](#) provides an overview of Lindsay's leading-edge tools, known collectively as *The Lindsay Advantage*. These supplementary products include [FieldNET](#), a remote monitoring application that tracks and controls entire irrigation systems from a laptop or iPad, and [Growsmart](#), a weather station and soil monitoring probe. By pioneering the [use](#) of GPS positioning and field monitoring tools as early as 2001, Lindsay has positioned itself as the industry's technological leader. These tools will grow in importance as techniques like variable-rate irrigation transform the industry. VRI, a method to adjust water delivery for field geography and moisture levels, is discussed further in this March 2012 *Economist* [article](#).

Another recent innovation is Lindsay's [partnership](#) with Syngenta, a \$40bn goliath in crop protection and genetically modified seeds. The collaboration will integrate Lindsay's pivots, monitoring, and sensing tools with Syngenta's purpose-designed crop inputs to reduce a field's water needs. Valmont, typically behind Lindsay on the technological curve, has no comparable arrangement.



FieldNET®



Growsmart®

The secular trends of growing protein consumption and mounting global water scarcity have allowed Lindsay to compound revenue at an impressive 15% per year over the last decade. This expansion was achieved despite two down-cycles in corn prices, once in 2005 and again in 2009.

In each of the timeframes shown below, Lindsay's growth has surpassed Valmont's irrigation segment. Based on these figures, Lindsay has gained approximately 6 percentage points of market share relative to Valmont over the past decade.

	Long-Term Revenue CAGR				
	3-year	5-year	7-year	10-year	
Lindsay Irrigation	34.7%	10.8%	18.2%	15.3%	
Valmont Irrigation	31.6%	10.4%	16.2%	12.3%	
<i>LTM Revenue (\$m)</i>	8/31/2003	8/31/2006	8/31/2008	8/31/2010	8/31/2013
Lindsay Irrigation	\$151.3	\$193.7	\$374.9	\$256.3	\$626.0
Valmont Irrigation	280.5	312.0	544.6	391.9	893.4
<i>LNN Share of Big 2</i>	35.0%	38.3%	40.8%	39.5%	41.2%
<i>VMI Share of Big 2</i>	65.0%	61.7%	59.2%	60.5%	58.8%
Relative LNN Share Gain		3.3%	2.5%	(1.2%)	1.7%

Source: Company Filings

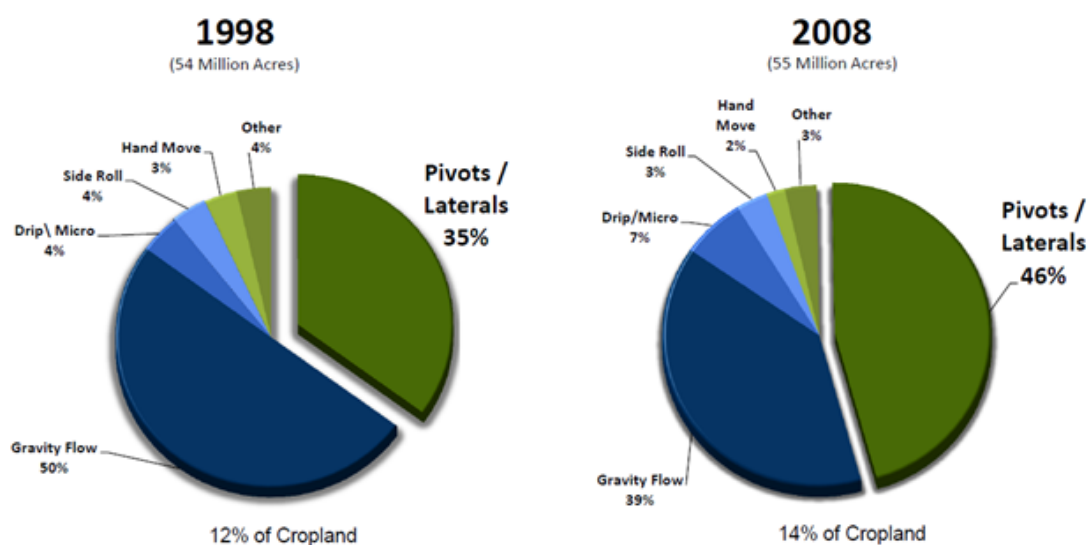
Note: Valmont LTM data is period-ending 9/30 while Lindsay is through 8/31

Growth over the past decade was largely driven by technology upgrades in the U.S. farming industry. Looking out to the next ten 10 years, we believe much of Lindsay’s growth will be abroad.

III. The International Opportunity

The prevalence of mechanized irrigation systems is increasing rapidly. Given the many advantages of mechanized irrigation, such as yield enhancement, water conservation, and automation, pivots and laterals are now employed on nearly half of irrigated farmland in the U.S.

Domestic Market

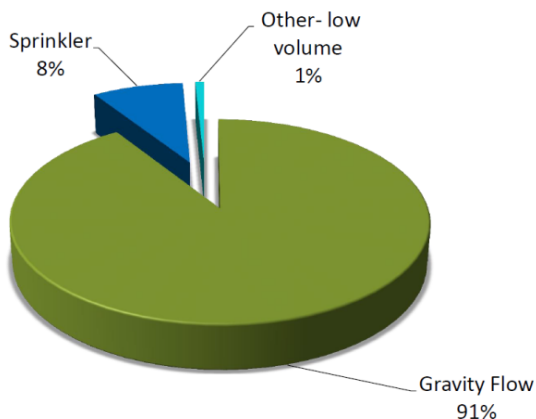


Source: Lindsay August 2013 Corporate Presentation (1998 & 2008 Farm and Ranch Survey)

In the United States, there are roughly 55 million [acres](#) of irrigated farmland. Abroad, there is over ten times that amount. These 563 million irrigated acres abroad sit much lower on the technology curve. Over 90% of international acreage still utilizes simple gravity irrigation systems. However, a combination of well-capitalized corporate farmers and government funding support in certain countries is causing a dramatic increase in the use of mechanized irrigation. Over the next decade, if international enthusiasm for mechanized irrigation matches that seen in the U.S., we believe Lindsay’s annual revenue opportunity could expand by tenfold.

International Market

563 million Acres Irrigated



Source: Lindsay's August 2013 Corporate Presentation

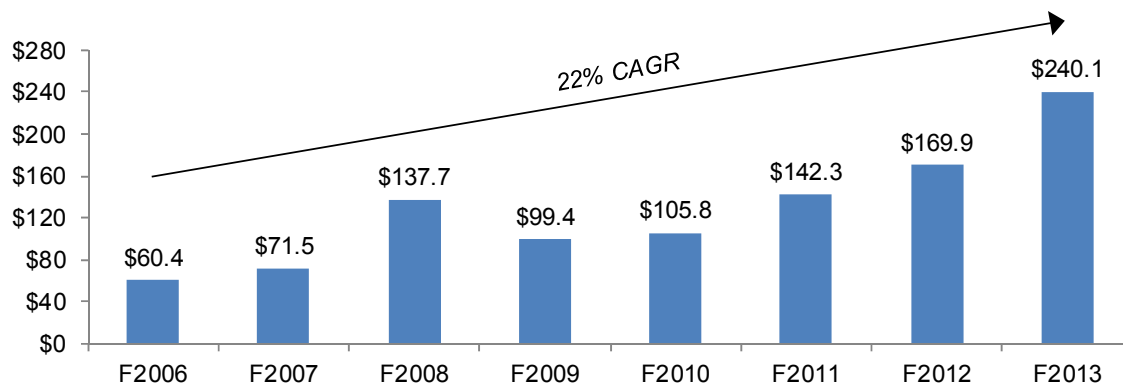
Currently, Lindsay's top three international markets are Brazil, Ukraine/Russia, and Europe. These markets are closely trailed by Mexico, a natural customer given its proximity to the U.S, and China, an area always challenging for international suppliers.

International growth has begun to surpass growth of Lindsay's domestic segment over the past two quarters, posting year-over-year growth of 87.7% and 43.7%. While Lindsay does not disclose revenue by country, we know from the FQ3 call that irrigation revenue from Brazil doubled year-over-year while Ukrainian revenue grew by more than 40%.

Lindsay's Irrigation Business

Revenue (\$m)	Year-Ended August 31st			Quarter-Ended				
	2011	2012	2013	8/31/12	11/30/12	2/28/13	5/31/13	8/31/13
United States	\$227.6	\$305.4	\$385.7	\$56.2	\$96.5	\$117.2	\$118.3	\$53.9
% YoY Growth	48.9%	34.2%	26.3%	18.0%	59.1%	41.4%	12.0%	(4.1%)
International	\$142.3	\$169.9	\$240.3	\$51.7	\$37.7	\$45.5	\$82.6	\$74.3
% YoY Growth	34.5%	19.4%	41.4%	18.3%	(6.0%)	33.4%	87.7%	43.7%

International Irrigation Revenue



Source: SEC Filings

While the sellside remains transfixed on the daily, weather-driven machinations in U.S. corn prices, and its effect on next year's earnings, we're more interested in the long-term potential of Lindsay's international business. As of 2008, the most recent year with available data, only 2% of international farmland employed mechanized irrigation. Lindsay's CEO, Rick Parrod, explained on their Q4 2008 [call](#) that "contrary to the U.S. market where we estimate that between 40 and 50% of irrigated land is irrigated with mechanized systems, market penetration of mechanized irrigation in the rest of the world is relatively low, estimated to be below 2% of irrigated crop land."

We believe that Lindsay's international business can grow to a \$2.5bn+ annual revenue standalone business should mechanized irrigation reach 45% of international irrigated farmland, a similar level to that currently seen in the U.S. This estimate does not account for an expansion of irrigated acreage, an assumption that will likely prove to be conservative.

Quantifying the International Opportunity

<i>mm</i>	<i>mm Acres</i>	<i>Penetration of Mech Irrig</i>	<i>Mech Irrig Acres (m)</i>	<i>LNN's '08 Revenue</i>	<i>LNN Rev/ Mech Acre</i>
U.S. Irrigated Farmland ⁽¹⁾	55	46.0%	25	\$237.2	\$9.4
International Irrigated Farmland ⁽¹⁾	563	2.0%	11	\$137.7	\$12.2
Hypothetical International Penetration		5.0%	15.0%	25.0%	35.0%
International Irrigated Acreage	563	563	563	563	563
Implied Mechanized Irrigation Acreage	28	84	141	197	253
LNN Revenue per Mechanized Acre	\$10.0	\$10.0	\$10.0	\$10.0	\$10.0
Implied Revenue Opportunity	\$281.5	\$844.5	\$1,407.5	\$1,970.5	\$2,533.5
LNN's FY 2013 International Revenue	240.3				

Sources: Lindsay transcripts, corporate presentations, Kerrisdale estimates

(1) Market penetration data as of 2008 (as per Aug 2013 LNN presentation)

In the chart above, we've calculated Lindsay's hypothetical international revenue using data from 2008. In that year, Lindsay earned \$137.7m of revenue abroad while mechanized irrigation penetration was just 2%. If market penetration increases to 45%, we believe LNN's international opportunity would expand to at least \$2.5bn annual revenue, or roughly 10x where it stood in FY 2013.

Many discount the international opportunity because Lindsay's international gross margins are currently lower than in the United States. As of late 2011, Lindsay stated that "...the international business unit versus the U.S. shipments is generally a 5 to 7 point margin difference...because of the level of integration of the factories...[In] the U.S. factory, we're very vertically integrated, where[as] in the international factories, we're not" (FY4 2011 [Call](#)).

While this may sound troublesome at first, it actually reveals that the earnings power of Lindsay's international business could be much greater. Lindsay can expand non-U.S. gross margins by aggressively investing its cash hoard into upgrading its international plants. In FY

2013, Lindsay budgeted \$14 - \$17m of capex for this task: “[capex is] largely focused on manufacturing capacity expansion and productivity improvements” (FQ3 2013 [Call](#)). Such investments can offer very attractive returns on capital, as partly evidenced by the increase in Lindsay irrigation’s EBITDA margin from 17.6% in FY 2010 to over 20% today.

Lindsay has a Globally Respected Brand Name with a Sticky Dealer Network

Competition in the mechanized irrigation business has consolidated meaningfully over the past 40 years. During the 1970’s, there were over thirty domestic irrigation manufacturers (LNN 1999 10K). Today, that figure has been whittled down to just four: Lindsay, Valmont, Reinke, and T-L Irrigation. Reinke has 9% global market share while T-L has 4%. Both businesses were founded in the 1950s and neither has emerged as a preferred choice amongst farmers. Over the years, there have [been](#) more than 80 individuals or companies that have tried to make and sell center pivots, but only the four mentioned have had meaningful success.

One reason that so few have succeeded is the first-mover advantage afforded to incumbents. Local dealer networks are critical to the success of a manufacturer, and dealers will only partner with leading suppliers. Since these dealers typically trade in just one brand, it’s critical for a manufacturer to attract the widest geographic spread of dealers. Generally, farmers won’t consider a brand that doesn’t have a dealer location within driving distance. This is because sprinklers, nozzles, and hoses must be periodically replaced. Farmers cannot afford to damage a season’s crop while awaiting a spare part. This reliance on local dealers creates a network effect for the largest manufacturers, namely Lindsay and Valmont, which partially insulates them from new competition.

But a dealer network alone will not suffice if the product has a poor reputation. Much of our diligence centered on reading online reviews and speaking to customers, dealers, and consultants in the industry. Peer-to-peer online reviews by farmers indicate that Zimmatic (Lindsay) and Valley (Valmont) are the only two brands one should consider:

- “I just traded a 37 year [old] Zimmatic for a new one.... I've got no complaints.” – 5-11-13, ["datyerdog"](#)
- “...anything here that is Reinke or is replaced either with Zimmatic or Valley.” – 2-12-13, ["Ron.Koster"](#)
- “Valley and Zimmatic are the leading pivot company's much in the same way that John Deere and Case IH lead the market in ag equipment. And much in the same way with green and red much depends on your dealer.....if you've got a good dealer then you will most likely be happy with either one.” – 1-17-13, ["crabby"](#)
- “My preference would be a zimmatic with valley second. Valley's have a shorter wheel base and seems to me like they blow over worse. T&L would not get on my list.” – 12-17-12, “Nebraska [Sandhillier](#)”

- "My choices for new, in order of preference, Zimmatic, basically cause I like the way Lindsay has put everything under one umbrella, to stop the pass the buck game. Next would be Valley" – 12-17-12, "[ChrisTN](#)"
- "All the laterals around here have gone or been converted to center pivots. The best system I've seen was a Zimmatic diesel powered unit that traveled along a canal." – 5-3-12, "[offroadnt](#)"

We would also note that discussion of lower-cost Chinese substitutes is non-existent on these message boards. This is partially due to their reputation for being lower quality and partly because they lack a domestic dealer network.

We also made dozens of calls to international market participants. The paraphrased quotes from a few of these are below:

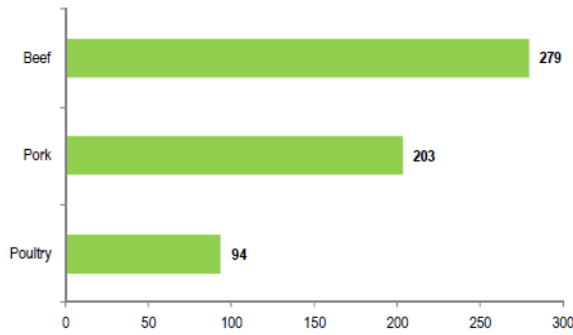
- 'Valmont and Lindsay have pretty comparable products...we don't deal with [Reinke and T-L] because they don't have critical market size.' – *Executive at a Global Agricultural Business*
- 'All of [Brazil's] corporate farms are well capitalized...some regions have more Lindsay equipment and others have more Valmont...there is no local competition' – *Former Farmer and Consultant in Brazil*
- '[In my region] Valley is the market leader, followed by Lindsay, and then Irrigabras [local competitor] with around 5% market share' – *Distributor in Brazil*
- 'Lindsay is the most successful brand in Ukraine...Valley isn't getting the right dealers.' – *Distributor in Ukraine*
- 'Russia is giving huge subsidies to agriculture...Valmont and Lindsay are both very active in Russia' – *Distributor in Ukraine*

This primary research helps confirm that Lindsay's Zimmatic is a premium brand with a loyal customer base.

Expanding Protein Consumption in Emerging Markets Drives Demand for Feedstock Crops

The Organization for Economic Co-operation and Development ("OECD") of the United Nations has published many reports on global food scarcity issues. The OECD [believes](#) that worldwide agricultural production needs to grow by 60% over the next forty years to meet increased demand. This trend is linked to population growth, urban migration, and a rapidly expanding middle class across the emerging markets. As living standards rise, people tend to consume more meat in their diets. Meat-based diets increase demand for grain; it takes roughly 6kg of corn to produce 1kg of beef. Therefore, growth in meat-based diets can have a logarithmic impact on the demand for corn.

Kilograms of Corn Required to Produce 45kg (100lbs) of Meat



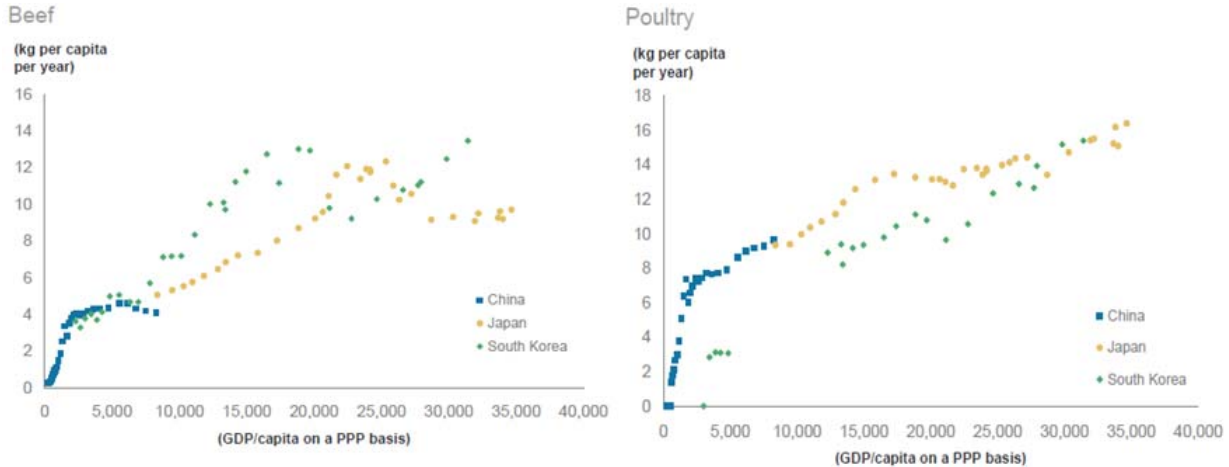
- **For an independent beef feedlot**, ~279 kg of corn is needed to produce 45 kg of boneless fed beef (11 bushels to produce 100 lbs).
- **For an independent producer of pork**, ~203 kg of corn is needed to produce 45 kg of boneless skinless meat (8 bushels to produce 100 lbs).
- **For a contract grower of poultry**, ~94 kg of corn is needed to produce 45 kg of boneless skinless meat (3.7 bushels to produce 100 lbs).

Source: Tyson Investor Presentation, J.P. Morgan Global Protein Conference, March 2011.

Source: October 26th, 2012 JP Morgan equity research report on SLC Agricola

As of 2007, the latest date for which comparable data is [available](#), the U.S. consumed 125kg of protein per person [compared](#) to 80kg in Brazil, 54kg in China, 25kg in Turkey, and a 39kg world average. Countries like China still maintain a grain-intensive diet with a lower daily caloric intake than the developed world. An October 2011 Morgan Stanley [report](#) explains that China is still in the early innings of its diet transformation. Morgan Stanley points to the precedent cases of Japan and South Korea, both of which increased pork and beef consumption by 50-100% as GDP per capita rose to their current levels.

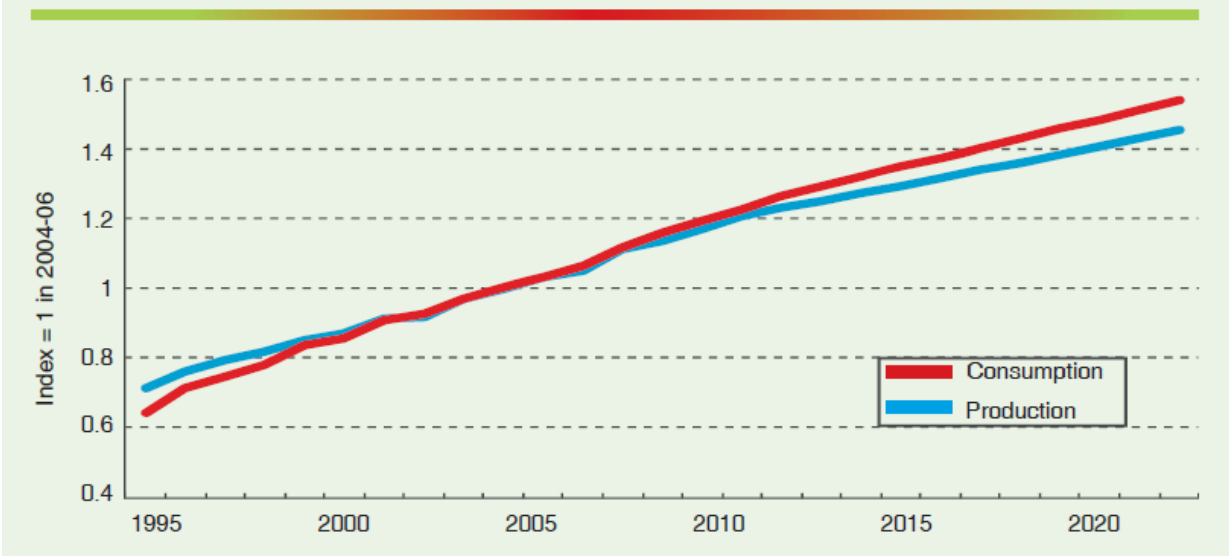
Beef and Pork Consumption in China, Japan and South Korea



Source: October 25th, 2011 Morgan Stanley report

China consumes a fifth of the world’s global food supply yet only possesses 9% of the world’s farmland. Chinese officials are acutely aware of this, and the country has made food security a key strategic priority. Over the next decade, the OECD-FAO predicts that China will become an even larger net importer of agricultural products.

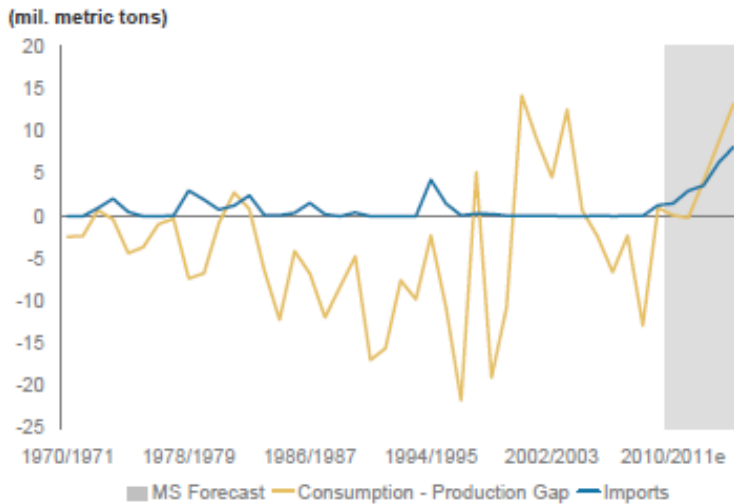
Figure 5. Indices of agriculture and fish consumption and production in China



Source: [Summary of OECD-FAO Agricultural Outlook 2013-2022](#)

At a conference in September 2013, a Chinese agricultural minister [said](#) China may import 20-30m tonnes of corn per year to cover growing supply shortages. Xu Xiaoqing went on to say, “Our corn needs are up, which means in the future we will see some imports.” In 2013, both Argentina and Ukraine have shipped corn to China. China is even considering [investing](#) in Venezuelan farmland to bolster food supplies.

China Likely To Become a Structural Importer of Corn as Consumption-Production Gap Widens



Source: USDA, Morgan Stanley Commodity Research estimates.

Source: October 25th, 2011 Morgan Stanley report

Lindsay is a major supplier of irrigation equipment in both Ukraine and Latin America. As these countries seek to enhance crop yields and expand irrigated acreage, global penetration of mechanized irrigation equipment should continue to increase.

Brazil – Abundant Water Supply and World’s Largest Area of Arable Land

According to the National Irrigation Secretary of Brazil, the country has the [potential](#) to irrigate 30m hectares (1 hectare = 2.47 acres) of land. Only about 5m hectares are irrigated today. Therefore, not only can mechanized irrigation capture a larger share of Brazil’s irrigated farmland, the Secretary’s guidance implies that Lindsay’s market opportunity can increase by an additional six-fold.

Brazil is blessed with the largest stock of arable land in the world, with about 85m arable hectares (*Brazilian Statistics and Geography Institute*). Roughly 73m hectares are currently planted, meaning that new land supplies will soon dwindle. Well-organized corporate farmers are beginning to colonize much of Brazil’s farmland. One example is SLC Agricola, a publicly-listed company that plans to expand its acreage from 280,000 hectares in 2012 to 700,000 hectares by 2012. These capital-rich companies are more likely to upgrade seed, equipment, and crop input technology than the previous small-scale operations run by individual farmers.



Source: SLC Agricola, September 2013 Corporate [Presentation](#)

Not only does Brazil benefit from vast untapped land reserves, but the country also holds an abundant supply of fresh water reserves. Water availability should expedite the transition to mechanized irrigation as farmers move up the technological curve.

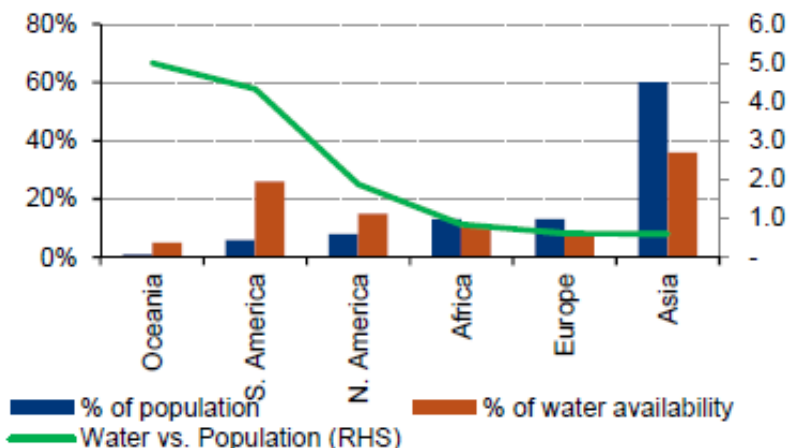
Exhibit 5: Brazil has abundant sources of water



Source: BrasilAgro, BofA Merrill Lynch Global Research

When comparing water availability to population size, the whole of South America is privileged. Asian countries, especially China and India, could remain strained in the coming years.

Chart 8: Water availability vs. population concentration



Source: FAO, BrasilAgro, BofA Merrill Lynch Global Research

The Brazilian irrigation market is dominated by Lindsay and Valmont. As an example, Reinke’s dealer search [page](#) shows it lacking a single dealer location in the country. Compare that to the twenty-three [dealers](#) listed on Lindsay’s Brazilian page. Our efforts to find local copycats revealed two small companies, [Irrigabras](#), also a maker of sprinkler systems, and Grupo [Fockink](#), a diversified heavy machinery business. Calls to distributors indicate that neither has more than 5% market share in most markets. Farmers further acknowledge that Lindsay and Valley are the undisputed quality and technological leaders. As an example, in 2010 Lindsay [installed](#) the largest pivot in all of Brazil, measuring in at over 4,000 feet with 26 separate towers. Lindsay does not itemize its international revenue, but on its FQ3 2013 [call](#) it mentioned that, “Irrigation equipment revenue in Brazil more than doubled over the same quarter of last year.”

As is common in Brazil, logistical and regulatory issues are [seen](#) as the most significant bottleneck to widespread adoption.

Ukraine – The Bread Basket of Europe

During Tsarist times, Ukraine was referred to as the Empire’s breadbasket. The country remained an agricultural dynamo when it was part of the former Soviet Union, helping to feed much of northern Asia. But upon the Soviet Union’s dissolution in 1991, Ukraine [declared](#) its independence and took some of the world’s most fertile land along with it. Ukraine contains 30% of the world’s black soil, a particularly fertile type of land that can grow cereals in [abundance](#). In the years after its independence, much of Ukraine’s mechanized farming [equipment](#) slowly depreciated due to underinvestment and neglect. But over the past few years, Ukraine has begun to make up for lost time, making large-scale investments to modernize its agricultural industry. The country is now home to one of the fastest growing farming industries in the world.

In October 2013, Ukraine announced the [receipt](#) of a \$3bn loan from the Export-Import Bank of China to support irrigation projects for the country’s farmland. The President of Ukraine, Viktor Yanukovich, further [elaborated](#) at the International Investment Forum:

“Ukraine is in active negotiations on the implementation of investment projects for the rehabilitation of irrigation systems in the south of the country...Now we see practical interest from the leading countries in irrigative agriculture. Ukraine is in active talks with foreign partners on the terms of the realization of investment projects to restore irrigation systems in the south of the country.”

Ukraine’s Agricultural Minister believes that China will become a key export market for Ukrainian cereal production.

The sparse press reports on the announcement indicate this will be a drip irrigation project, and it’s possible that Chinese drip manufacturers will be a key beneficiary. However, for a project on this type of scale, we suspect the installation is likely to contain a mix of drip and mechanized systems, particularly because drip irrigation is challenging to install on a very large scale. Lindsay’s CEO, Rick Parrod, recently deflected questions on the news report, but did mention “we’re definitely seeing more in opportunities in [Ukraine] than we did even one year ago. So I’m more optimistic about it today than I have been in the past” (FQ4 2013 [Call](#)).

Be it this project or others, Ukraine should remain a robust end-market for Lindsay’s irrigation systems.

Lindsay's Efforts to Combat Global Fresh Water Shortages

Simply put, the world's fresh water supplies are strained. Factors like a growing global population, changing diets, climate change, and hydraulic fracturing have contributed to the trend, and industry observers are [growing](#) increasingly alarmed. As an example, China feeds one-fifth of the world's population with only 6% of the world's fresh water. Here in the U.S., the 2012 drought throughout the Corn Belt put pressure on underground [aquifer](#) supplies. Growing more with less water is a challenge that irrigation manufacturers can help to solve.

Mechanized irrigation [uses](#) 45% less water than gravity, the method still practiced in 90% of the world. Internationally, farmers can immediately achieve water savings by switching to Zimmatic pivots. And because pivots apply water more evenly, customers also benefit from yield enhancements. This helps solve both sides of the food demand/water scarcity problem.

In the U.S., where mechanized irrigation is more prevalent, farmers may seek out other innovations. Lindsay has positioned itself as the technological leader in this emerging field by forging a strategic partnership with Syngenta, a world leader in seed and agricultural chemicals.

Officially announced on July 11th, 2013, the Lindsay/Syngenta partnership is the first of its kind. By combining Syngenta expertise in seed and crop input technology with Lindsay's Zimmatic pivots, *FieldNET* wireless irrigation management products, and *Growsmart* monitoring tools, the Lindsay/Syngenta platform can improve corn yields in water stressed environments. Syngenta told us that "we believe that the partnership can completely change the industry's mindset." The joint press [release](#) explains,

"During the next 15 years, nearly 40 percent of the global population will be experiencing severe water limitations, and a typical U.S. corn grower will face water issues in two to three out of every five years. One of the major issues on irrigated acres is making the best use of available water, and the Syngenta and Lindsay initiative brings together a comprehensive approach that allows water to be most efficiently used in irrigated programs".

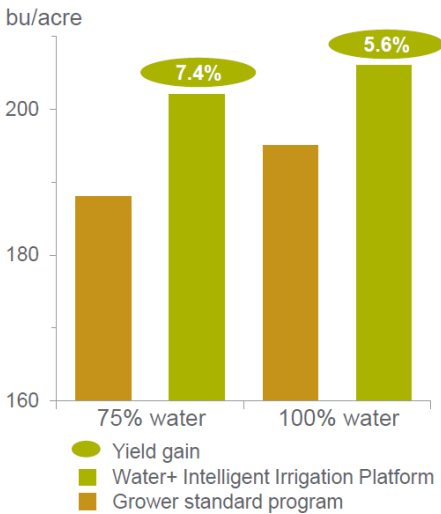
The Water Intelligent+ Irrigation Platform, as tested, [includes](#) locally adapted Syngenta corn genetics, Syngenta's water-resistant input chemicals (Agrisure), and Lindsay's industry-leading technologies, such as the FieldNET wireless irrigation management system and Growsmart soil and weather sensors. The Syngenta seeds and inputs make the plant more water resistant while Lindsay's soil sensors ensure that water is delivered where and when it is needed. David Elser, the head of water optimization at Syngenta, argues that:

"Our new irrigated corn solution is designed to take the worry out of water efficiency and allow farmers to take control of their farming operations. It's as simple as receiving a text message or email alert. The alert shows up on your smartphone, tablet or computer and tells you exactly what action you should take

on a specific pivot and when you should do it. So you can be at the soccer field watching your child and turning on Pivot #60. It's a lot more than a new technology – it's a life changer for farmers."

The platform was tested on 27 sites in Nebraska, Kansas, and Colorado using 26m unique data points. With just 75% of the water volume typically used, the Irrigation+ platform managed to increase crop yields by 7.4% over traditional methods.

US water optimization: growing more corn with less water



- Irrigation combined with genetics, crop protection and enhancement
- Convenient management of multiple pivots
- Remote crop monitoring
- ROI: average \$95 per acre*
- Targeting 250,000 acres by 2015
- Potential market: 9m irrigated acres

* Based on corn at \$7/bu
Data collected from 27 sites with over 26m data points through combined yield monitors: Colorado, Nebraska, Kansas

Source: June 18th, 2013 Syngenta corporate [presentation](#)

The partnership targets usage in 250,000 acres by 2015, a conservative estimate in light of the potential market opportunity of 9 million acres. Notably absent from the collaboration is Valmont, Lindsay’s main global competitor. Syngenta’s choice of the slightly smaller Lindsay over Valmont speaks to the technological advantages of the Zimmatic systems.

IV. The Infrastructure Business

Throughout most of Lindsay's history, their Infrastructure business was relegated to outsourced manufacturing. Lindsay would divert its excess manufacturing capacity to sell steel tubing to large industrial accounts. This sensible strategy lasted from 1987 to 2006 and was reported under "Diversified Products" in Lindsay's filings.

Lindsay pivoted from this approach on June 1st, 2006 with its acquisition of Barrier Systems. Barrier Systems was a maker of moveable road barriers (*Road Zipper*), crash cushions, and steel road gating for the U.S. highway system. Lindsay paid \$35m for this non-core business.

Lindsay's Road Zipper, a Moveable Barrier



System

From a financial standpoint, the Barrier Systems acquisition, and Lindsay's Infrastructure segment more generally, has been a disappointment. Decreased federal spending on roads and highways has not helped, and the unit has struggled since 2007. Given the political tension surrounding U.S. discretionary spending, we are cautious on the prospect of an immediate recovery. From a valuation perspective, we can effectively exclude this segment since it has operated at a break-even earnings level.

Lindsay's Infrastructure Business

\$ millions	Year-Ended August 31st						
	2007	2008	2009	2010	2011	2012	2013
Revenue	\$65.4	\$100.2	\$80.7	\$99.8	\$109.0	\$76.0	\$64.8
% YoY Growth	102.5%	53.2%	(19.4%)	23.6%	9.2%	(30.3%)	(14.7%)
EBIT	\$14.2⁽¹⁾	\$9.6	(\$0.0)	\$11.1	\$11.9	(\$0.0)	(\$0.8)
% YoY Growth	100.0%	(32.2%)	(100.4%)	n.a.	7.4%	(100.1%)	n.a.
% Margin	21.7%	9.6%	(0.0%)	11.1%	10.9%	(0.0%)	(1.2%)
RoA	14.4% ⁽¹⁾	7.7%	(0.0%)	9.3%	10.5%	(0.0%)	n.a.

Source: SEC Filings

(1) F2007 segment profitability is inflated due to a more generous G&A expense allocation policy

We believe that Lindsay strayed from its core strengths with the 2006 acquisition. Barrier Systems does not capitalize on Lindsay's globally recognized brand name in irrigation, nor does it overlap with their robust dealer network. It probably serves as a distraction for the management team and confuses analysts and investors who are studying the business.

Lindsay appears to have learned from these missteps. Days before the FQ4 2013 call, Lindsay announced that the President of the infrastructure unit will step down in November. To the division's credit, Lindsay kept the unit at break-even profitability even as revenue has declined. One of the division's major projects, a moveable barrier on the Golden Gate Bridge, has been delayed several times. The Golden Gate project is now [expected](#) to commence in late 2014 and should contribute to FY 2015 profitability. Most importantly, we shouldn't expect similar acquisitions in the future. When asked about M&A plans, Rick Parrod answered, "...we really don't want [added exposure] in terms of government spending related... our primary emphasis has been more, let's say, industrial applications or on the water side" (*FQ4 2013 Call*).

We believe Lindsay would be best served by divesting the infrastructure business and refocusing management's attention on the world-class, high-growth irrigation business. If Lindsay divested the segment near its asset value of ~\$110m, that would add roughly \$8/share to our valuation estimates.

V. Addressing the Bear Argument

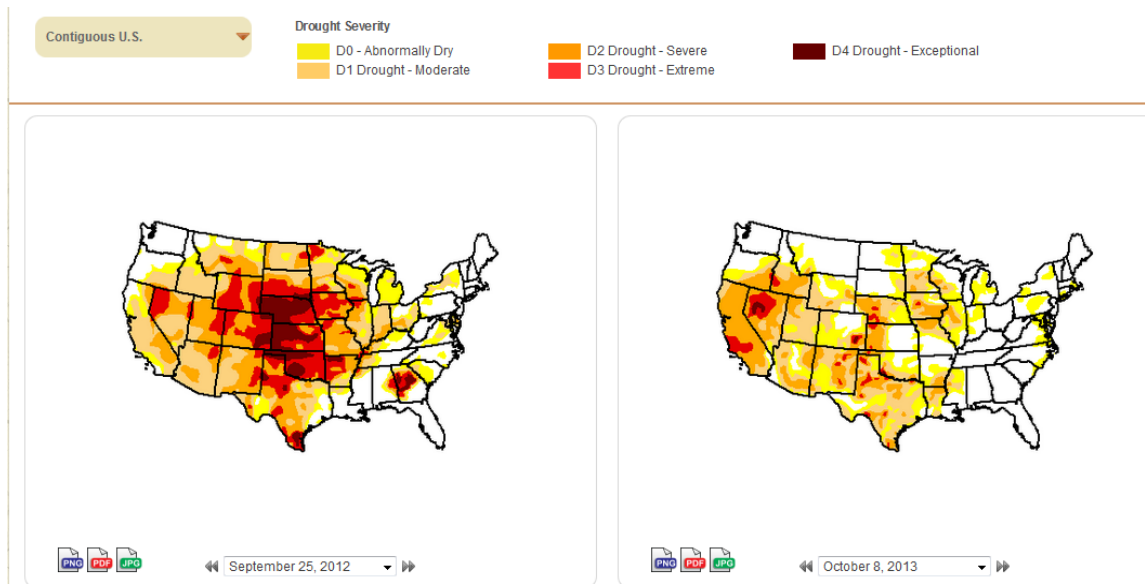
Lower Corn Prices will Lead to a Short-term Decline in Lindsay's Profits

Like many companies in the agricultural sector, Lindsay's business can be cyclical. Farmers typically upgrade and expand their equipment when crop prices are high and farmer sentiment is strong. High prices cause farmers to plant more crop, leading to larger harvests the next season and more supply. A larger supply leads to lower prices, which induces farmers to rotate into other crops, and the cycle repeats.

In the United States, irrigation systems predominantly support corn fields. Corn requires more water than soybeans and other staple crops, making corn sensitive to dry spells. According to [the](#) National Agricultural Statistics Service, the largest corn producing states are Kansas (14% of 2013 plantings), Illinois (12%), Nebraska (11%), Minnesota (9%), Iowa (6%), and South Dakota (6%).

The U.S. experienced a severe drought across the Midwest in 2012. The weather devastated that year's corn crops, leading to lower yields and much higher prices in 2013. This year, the weather has been more agreeable. The chart below compares drought conditions in 2012 to today.

Drought Coverage Areas in 2012 (left) and 2013 (right)



Source: USDA Drought [Monitor](#)

Farmers took advantage of higher prices by selling inventory while those most affected by the drought collected crop insurance premiums from the federal government. This led to another

year of record farmer incomes. The USDA predicts [that](#) 2013 farmer net incomes will reach \$120.6bn in 2013. Even adjusted for inflation, this is the highest level since 1973.



Source: [USDA 2013 Farm Income Forecast](#)

Better weather conditions this year, mixed with record corn plantings, should lead to improved corn yields. This new supply would pressure last year's record corn prices. The corn futures market, which reflects day-to-day machinations in weather patterns, is predicting lower prices in 2013. May 2014 corn futures have fallen from \$5.60/bushel in late June to approximately \$4.60/bushel today. This is a significant decline from the \$6 - \$7/bushel prices seen last year.

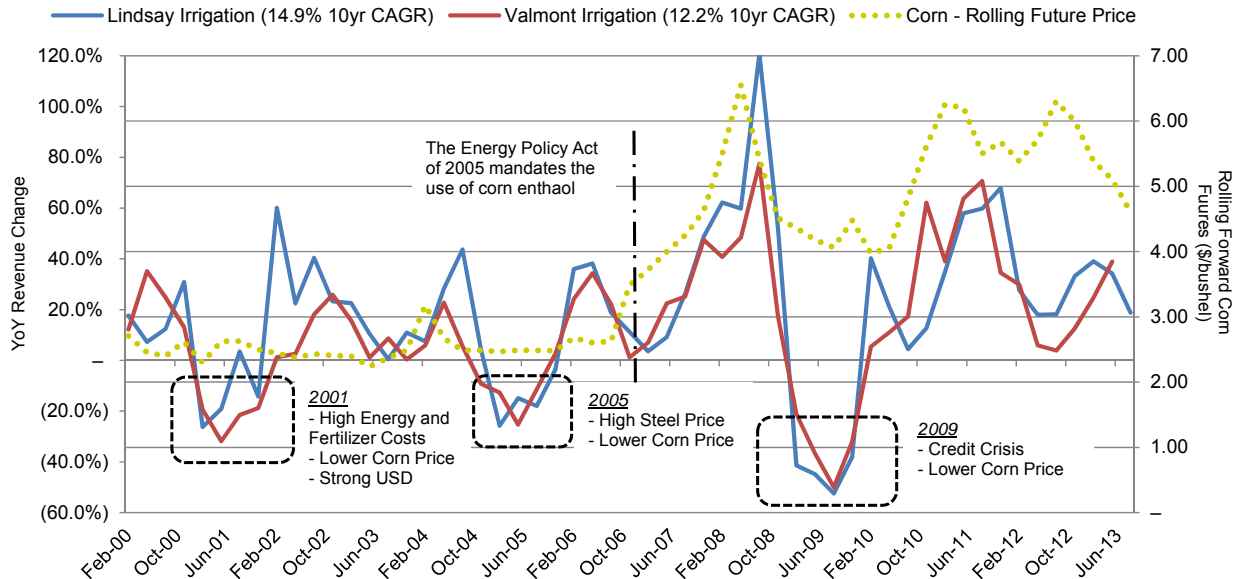
May 2014 Corn Futures



Source: [CME corn futures](#)

Historically, both Lindsay’s and Valmont’s irrigation businesses have demonstrated year-over-year slowdowns when crop prices fall. These declines have always been temporary, never lasting more than two or three quarters.

Lindsay and Valmont Irrigation Revenue Growth vs. Corn Futures



Source: Bloomberg, Company Filings, Kerrisdale Estimates

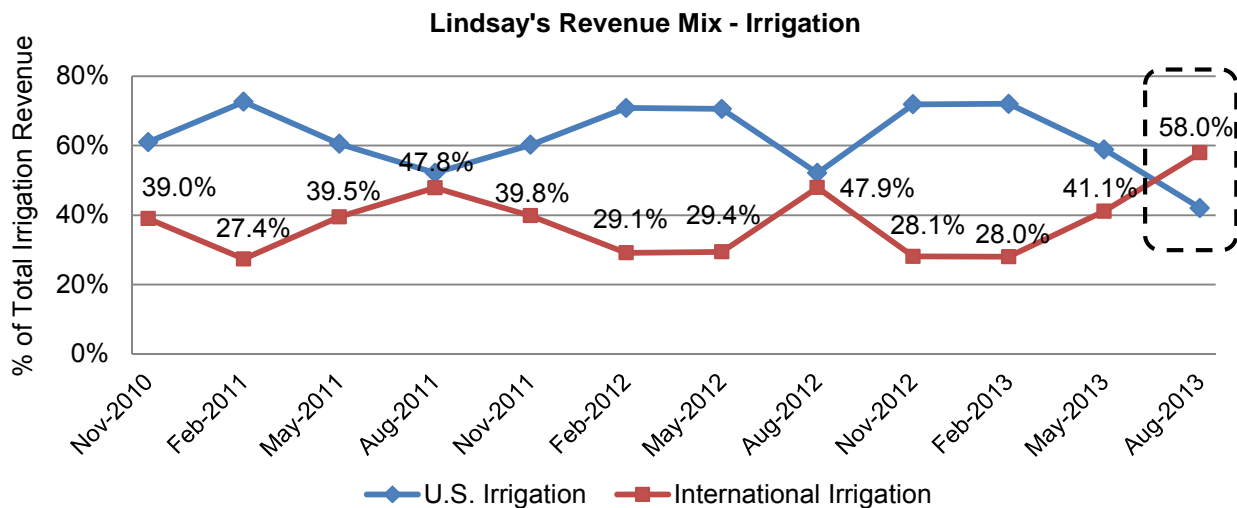
We can look to 2001 as a precedent for what may lie ahead. During the first two quarters of calendar 2001, Lindsay’s revenue fell by 26% and 19%, respectively. The prospect of lower farm incomes and high crop input costs weighed down farmer sentiment. But by the end of 2001, as commodity prices stabilized, Lindsay’s irrigation revenue was able to grow by 35% YoY in the 2002 calendar year. The agricultural market adjusts for lower corn prices and farmers plant more of other crops, stabilizing prices. While it’s still too early to predict where corn prices will end up in FY 2014, we are confident that the market will steady itself.

Irrigation equipment is increasingly becoming an indispensable tool, both in the U.S. and abroad. Should domestic farmers delay their orders in FY 2014, this would only shift demand into the next year. Furthermore, we believe a potential slowdown in Lindsay’s U.S. business could be partially offset by demand abroad. In FQ4 2013, Lindsay’s international segment represented 58% of total sales, the first quarter on record that international sales surpassed the U.S.

Lindsay’s Shift to the International Markets Could Offset U.S. Slowdown

Looking back at the 2005 to 2013 period, Lindsay’s international irrigation segment contributed an average of just 36% of total irrigation revenue. This figure has climbed to 41% and 58% in

the last two quarters. Now a global business, Lindsay is becoming less dependent on the U.S. corn cycle and more exposed to growth from emerging markets.



Source: Company filings

Lindsay’s Rick Parrod recently remarked, “We continue to see strong order activity in our international irrigation markets and believe these markets will continue to generate long-term growth” (FQ4 Call).

Analysts pressed Parrod on the sustainability of its strength abroad, and he responded that “...I think there are still very significant growth opportunities in the international market, where it may not be the Middle East, the next one may be Russia and Ukraine or it could be in Africa or anywhere in the world. So we still see those significant projects out there to quote, and we're working on many.”

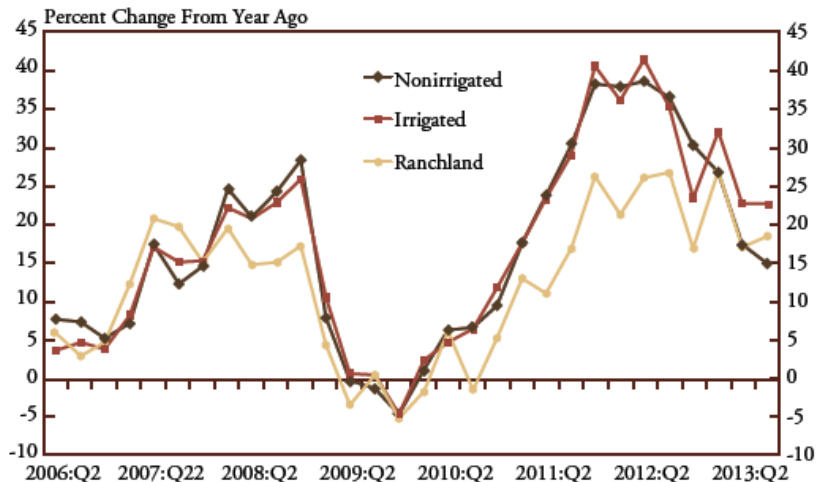
Even if the U.S. irrigation market temporarily slows in FY 2014, we believe it can be partially offset by year-over-year growth abroad. Management may also repurchase stock on market weakness, saying that “we...[will] opportunistically repurchase stock, and we will continue to [re]view that.” Lindsay has an 881,000 share repurchase plan in place, representing a \$60m plan at the current share price. Share repurchases in the coming quarters could provide a further EPS boost that isn’t accounted for in analyst models.

The Value of Irrigated Farmland Continues to Appreciate

The Federal Reserve Bank of Kansas City publishes quarterly economic reports on Nebraska, a bellwether state for irrigation demand. The September 2013 [report](#) revealed that scattered drought conditions remain a key driver for increased irrigated land values, writing that “irrigated farmland posted the strongest annual gains at 23 percent as water availability remained a key concern for buyers, particularly in areas enduring a second year of drought.” By comparison, non-irrigated farmland value increased just 15%. These figures demonstrate the strength of

farm acreage values while also revealing a growing disconnect between the values of irrigated and non-irrigated farmland.

Chart 8: Nebraska Farmland Value Gains



Source: Federal Reserve Bank of Kansas City.

The report also confirms the strength of farmer balance sheets, explaining that “agricultural banks reported ample funds were available to satisfy increased demand for farm operating loans.” With adequate capital at hand and the demonstrated 3 to 7 year payback periods on irrigation installations, we expect the U.S. farmer to remain a growing customer for Lindsay.

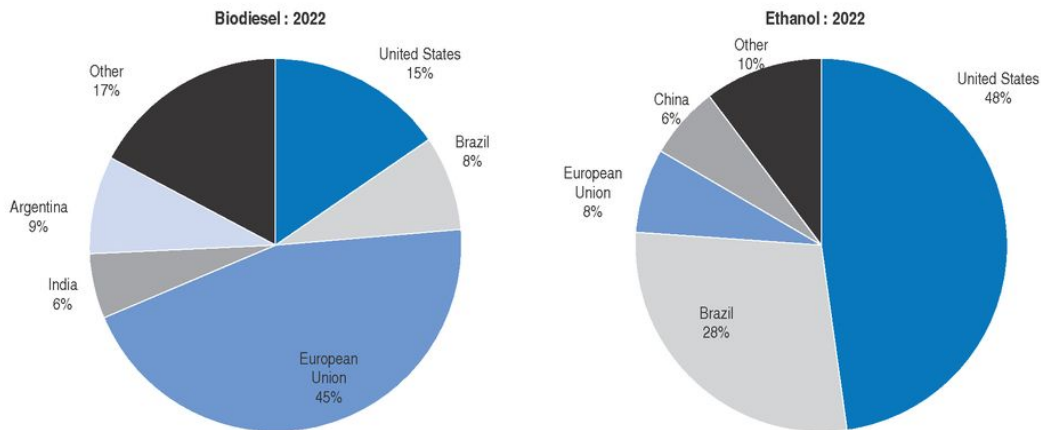
Regulatory Risks and Considerations

This being the U.S. agricultural industry, investors must be cognizant of the risks imposed by government involvement. Below, we’ve listed two regulatory issues relevant to Lindsay Corp.


Substantial Changes to Biofuel Requirements Would Affect Corn Demand

In the early 1990s, the U.S. began instituting laws to encourage biofuel and ethanol production. Biofuels, made from corn and other organic inputs, are a renewable resource that reduces the country’s dependence on foreign energy imports. Other governments, including the European Union, Brazil, and Argentina, have implemented similar laws. Brazil, an early adopter of ethanol-blend mandates, now [operates](#) the world’s largest fleet of flex-fuel vehicles, fed by the country’s ample sugar crop. The OECD [predicts](#) global ethanol production will increase by 4% per year and reach 168 billion liters by 2022. In addition to corn, biofuel production is expected to consume an increasingly large share of global sugar cane and vegetable oils.

Figure 1.17. **Country shares of bio-ethanol and bio-diesel production by 2022**
Per cent shares by country in 2022



Source: OECD and FAO Secretariats.

StatLink  <http://dx.doi.org/10.1787/888932858337>

Source: *Overview of the OECD-FAO Outlook 2013-2022*

Going forward, changes to country-specific biofuel mandates could negatively impact corn prices, thereby temporarily reducing demand for farming equipment. In the U.S., just over 1/3 of the corn crop is used for the creation of biofuels.

An October 10th [article](#) from Bloomberg reported that the Environmental Protection Agency was considering a slight amendment of next year's biofuel requirement. The proposal would reduce the 2014 mandate from 14.4bn gallons of corn-based ethanol to 13.0bn gallons. This revised proposal would be a modest reduction from the 13.8bn gallons required in 2013. Coming off a record high year for corn prices, refiners such as Exxon Mobile complain that input costs are onerous. Conversely, supporters of the Renewable Fuel Standard are vehemently against a change and are contemplating legal action to block a change.

While we believe that the current administration has an affinity for 'green' technologies, not to mention little sympathy for Big Oil's profit margins, this is a piece of legislation to monitor.

Changes to U.S. Tax Code May Impact Spending Patterns

The U.S. Tax Code contains two depreciation-based provisions that currently benefit farmers: bonus depreciation and Section 179 [expensing](#). Bonus depreciation allows farmers to depreciate 50% of the value of new machinery in the year it enters operations. Section 179 currently allows tax deductions (not credits) on new or used machinery. The exemptions were originally created as a capital spending incentive for small- and medium-sized businesses. As part of the financial stimulus bill in 2012, Congress [increased](#) the Section 179 deduction limit from \$125,000 to \$500,000 on capital purchases over \$2,000,000. As it stands under current law, the Section 179 deduction will fall to \$25,000 in 2014. Farmers have been particularly keen on taking advantage of the high depreciation limit before changes are made in 2014. Some

believe that this has front-loaded capital spending into 2013, especially for more discretionary equipment like high-end tractors.

Importantly, these incentives only affect the timing, and not the magnitude, of overall tax paid. A recent Morgan Stanley report lays out an example:

“Suppose a farmer bought a new tractor for \$300k in year 1 and depreciated the full \$300k value of the tractor in its year of purchase. Then, in year 2, suppose that the farmer decided to pay \$50k to trade in the old tractor for a new model with a market value of \$300k. When tax time comes in year 2, the farmer would only be able to depreciate the \$50k paid as a “boot” with the trade-in, and not the full \$300k purchase price of the new tractor, as the depreciation basis of the new tractor would only be the \$50k. Therefore, special depreciation allowances do not substantively change how much the farmer can depreciate in year 2, nor do they allow the farmer to realize a net gain by trading in used equipment.”

Many have misunderstood this point, instead believing that Section 179 offers a tax credit that would not otherwise be available.

While some farmers may take advantage of the tax deferral opportunities in 2013, we don't believe a change in the code will have a substantial impact on longer-term buying behavior. Additionally, many [expect](#) renewed calls for Congress to extend the break beyond 2013.

VI. Valuation

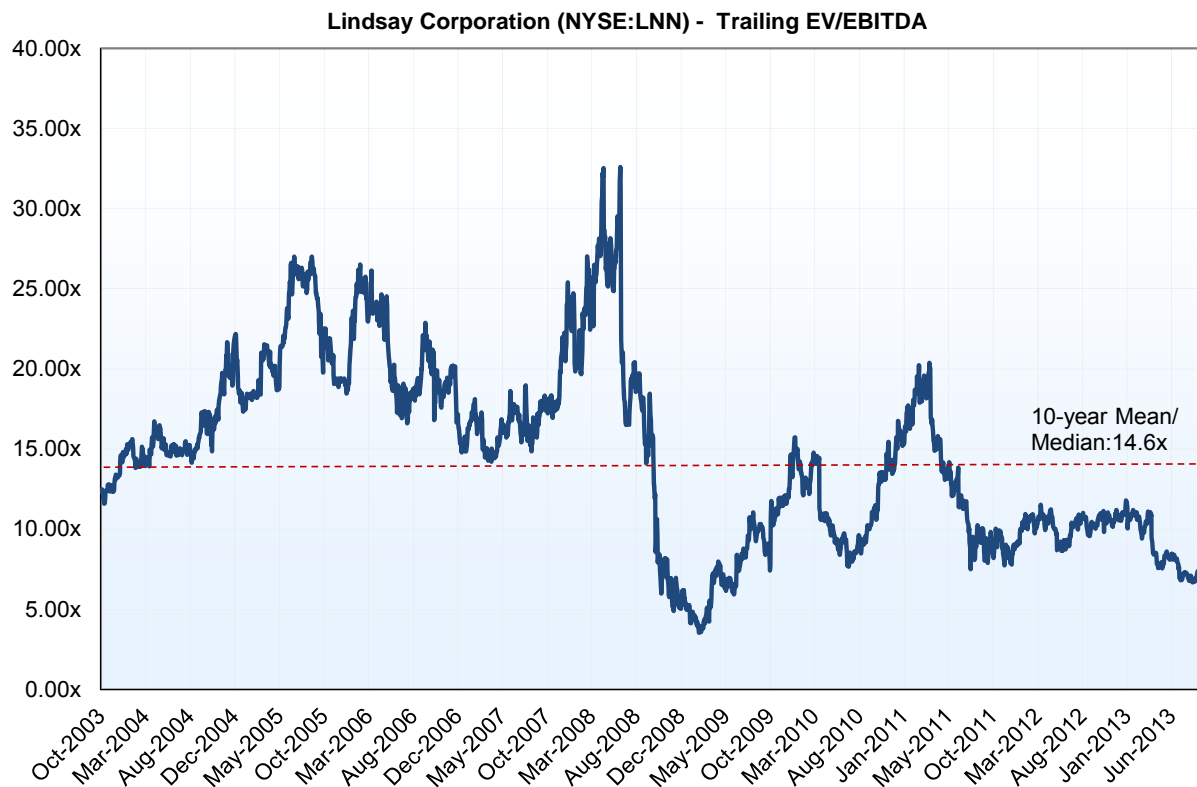
By almost any valuation metric, Lindsay's shares trade near all-time lows. We attribute this to the market's myopic focus on quarterly results, an underestimation of the international opportunity, and an artificially high P/E multiple due to Lindsay's unlevered balance sheet. Free of unorthodox accounting techniques or expense deferrals, almost all of Lindsay's net income is converted into cash flow. This allows the business to grow its cash balance through the cycle and compress its forward multiple over time.

Lindsay's Historical Valuation Multiples

<i>\$m</i>	8/31/2007	8/31/2008	8/31/2009	8/31/2010	8/31/2011	8/31/2012	Today
LNN Share Price	\$40.53	\$81.91	\$41.51	\$36.87	\$62.20	\$65.36	\$73.83
Diluted Shares Out	12.0	12.5	12.6	12.8	12.8	12.9	13.1
Market Capitalization	\$486.3	\$1,024.9	\$523.1	\$470.3	\$797.8	\$845.7	\$966.2
Add: Debt + Pension	43.7	40.7	33.4	13.8	15.8	11.7	6.3
Less: Cash ⁽¹⁾	(48.6)	(50.8)	(85.9)	(83.4)	(108.2)	(143.4)	(151.9)
Enterprise Valuation	\$481.4	\$1,014.8	\$470.5	\$400.7	\$705.4	\$713.9	\$820.6
LTM EBITDA	\$30.9	\$71.5	\$32.9	\$48.6	\$68.3	\$78.0	\$119.7
EV/EBITDA	15.6x	14.2x	14.3x	8.3x	10.3x	9.2x	6.9x
LTM EPS	\$1.34	\$3.25	\$1.12	\$1.99	\$2.93	\$3.40	\$5.47
Price / Earnings	30.3x	25.2x	37.0x	18.5x	21.2x	19.2x	13.5x
Net Cash P/E	30.0x	25.0x	33.3x	15.8x	18.8x	16.2x	11.5x

Sources: Company Filings

Looking back even further, the chart below shows that Lindsay hasn't traded at EV/EBITDA levels this low since the credit crisis. At its current share price of \$73.83, Lindsay's trailing EV / EBITDA is just 6.9x and its cash-adjusted forward EV/EBITDA is 7.5x, both nearly half of the 10-year average multiple of 14.6x.



Source: CapitalIQ

Lindsay has a track record of generating positive free cash flow during short-term growth corrections. After a record fiscal year in 2008, Lindsay's EBITDA fell by 50% in 2009 as commodity prices plummeted, farmer sentiment bottomed, and farmer credit became unavailable. That same year Lindsay still managed to generate profitability. Not only was Lindsay profitable in 2009, the business generated \$57.5m of cash flow from operations. In the years since, Lindsay's earnings power has only grown.

Lindsay's Cash Flow Generation

Fiscal year Ended (\$m)	8/31/2007	8/31/2008	8/31/2009	8/31/2010	8/31/2011	8/31/2012	8/31/2013
EBITDA	\$30.9	\$71.5	\$32.9	\$48.6	\$68.3	\$78.0	\$119.7
Net Income	\$15.6	\$39.4	\$13.8	\$24.9	\$36.8	\$43.3	\$70.6
Cash Flow from Operations	10.1	30.5	57.5⁽¹⁾	23.8	43.1	52.4	57.5
% Conversion (CFO / NI)	64.8%	77.4%	415.9%	95.9%	117.0%	121.2%	81.5%
Median							95.9%

Sources: Company Filings

(1) Includes a \$30.4m working capital benefit

Much of the bear case centers on Lindsay's unadjusted forward P/E of 16x, which seems high relative to other names in the agricultural equipment segment. We disagree with this conclusion. Not only does this P/E ratio fail to account for cash on Lindsay's superior balance sheet, it's also

based on a trough earnings projection. Instead, we believe Lindsay should be viewed in light of its long-term international growth opportunity.

In the chart below, we illustrate that once past the trough of FY 2014, Lindsay's multiple is expected to quickly compress after the business returns to growth in FY 2015 and FY 2016. Moreover, ongoing free cash flow will continue to accrete on the balance sheet. As long as Lindsay returns this cash to shareholders through opportunistic buybacks and dividends, or redeploys it into prudent, high RoE acquisitions or capital expenditures, the stock price should re-rate to a higher valuation.

Lindsay's Forward Valuation Multiples

\$m	Today	F2014E	F2015E	F2016E
LNN Share Price	\$73.83	\$73.83	\$73.83	\$73.83
Diluted Shares Out	13.1	13.1	13.1	13.1
Market Capitalization	\$966.2	\$966.2	\$966.2	\$966.2
Add: Debt + Pension	6.3	6.3	6.3	6.3
Less: Existing Cash	(151.9)	(151.9)	(211.9)	(280.2)
Less: CF Generation ⁽¹⁾	–	(60.0)	(68.3)	(76.4)
Enterprise Valuation	\$820.6	\$760.6	\$692.3	\$615.9
LTM EBITDA	\$119.7	\$102.0	\$116.1	\$131.8
EV/EBITDA	6.9x	7.5x	6.0x	4.7x
LTM EPS	\$5.47	\$4.58	\$5.22	\$5.84
Price / Earnings	13.5x	16.1x	14.1x	12.6x
Net Cash P/E	11.5x	12.7x	10.1x	8.1x

Sources: Company Filings, Consensus Projections

(1) Assumes the Sellside's net income projections are equal to cash flow generation

Private Market Valuation

Given its unlevered balance sheet, robust cash flow generation, and defensible market position in a secular growth industry, Lindsay makes for an ideal private equity target. And by going private, Lindsay would free itself from volatile share price swings due to the public market's obsession with quarterly earnings announcements. Moreover, an added layer of leverage would help shield Lindsay's earnings from its onerous 34% effective tax rate.

Our financial assumptions for a going private transaction are displayed below. We estimate Lindsay can comfortably service 3.5x of leverage, or about \$425m, at advantageous rates given the current interest rate environment. Using this capital structure, consensus estimates for FY 2014 and FY 2015, and normalized growth rates and margins for FY 2016-2018, we estimate that a private equity sponsor could acquire Lindsay for \$105 - \$115/share, depending on the exit multiple. In the output below, we have used a 13x EV/EBITDA exit multiple, a figure in-line with the purchase multiple and well below the historical average.

Leverage Buyout Model Assuming a \$107.36/share Purchase Price

Sources		Mult	% Total	Uses	
Senior Debt	299	2.5x	22.7%	Purchase Equity	\$1,405
Sub Debt	120	1.0x	9.1%	Net Debt (Retain \$50m)	(119)
Sponsor Equity	897	7.5x	68.2%	Transaction Fees	30
Total	\$1,316	11.0x	100.0%	Total	\$1,316

FY Ending August 31st,

Financials	2012A	2013A	2014E	2015E	2016E	2017E	2018E
Sales	\$551	\$691	\$646	\$702	\$807	\$928	\$1,068
% Growth	15.1%	25.3%	(6.6%)	8.8%	15.0%	15.0%	15.0%
EBITDA	\$78	\$120	\$102	\$116	\$137	\$162	\$187
% Margin	14.1%	17.3%	15.8%	16.5%	17.0%	17.5%	17.5%
% Growth	14.1%	53.5%	(14.7%)	13.8%	18.2%	18.4%	15.0%
EBIT	\$66	\$107	\$88	\$102	\$121	\$144	\$165
% Margin	11.9%	15.5%	13.7%	14.5%	15.0%	15.5%	15.5%
% Growth	15.8%	63.4%	(17.6%)	15.6%	18.7%	18.8%	15.0%
D&A	\$12	\$13	\$14	\$14	\$16	\$19	\$21
% Sales	2.3%	1.8%	2.1%	2.0%	2.0%	2.0%	2.0%
Maintenance CapEx	\$10	\$15	\$14	\$15	\$18	\$20	\$23
% Sales	1.8%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%
% D&A	79.3%	119.0%	101.7%	108.2%	108.6%	108.6%	108.6%
Δ in Net Working Cap	\$5	\$26	(\$3)	\$4	\$8	\$9	\$10
% Chg in Sales	6.5%	18.5%	7.5%	7.5%	7.5%	7.5%	7.5%

Free Cash Flow	2014E	2015E	2016E	2017E	2018E
EBITDA	\$102	\$116	\$137	\$162	\$187
Less: Maintenance CapEx	(14)	(15)	(18)	(20)	(23)
Less: Increase in NWC	3	(4)	(8)	(9)	(10)
Less: Cash Interest	(23)	(21)	(20)	(17)	(14)
Less: Cash Taxes	(22)	(27)	(33)	(42)	(50)
FCF for Debt Repayment	24	27	39	57	75

Returns Analysis

Terminal EBITDA	\$187	Terminal EBITDA	\$187
Exit Multiple	13.0x	Exit Multiple	13.0x
Enterprise Value	\$2,429	Enterprise Value	\$2,429
Less: Net Debt	197	Less: Net Debt	197
Equity Value at Exit	\$2,232	Equity Value	\$2,232
Sponsor Equity Value at Closing	897	Sponsor Required IRR	20.0%
IRR %	20.0%	Sponsor Equity at Closing	897
		Net Debt at Closing	419
		Implied TEV at Closing	1,316
		Less: Old Net Debt	119
		Less: Transaction Fees	(30)
		Equity Purchase Price	1,405
		FD Shares	13.1
		Implied Offer PPS	\$107.36
		Implied Offer Premium	45.4%

Sources: Kerrisdale Analysis, Company filings

Note: Model Assumes 2.5x of Senior Debt with a 5% annual coupon rate and 1x of Subordinated with a 7% rate

VII. Conclusion

Lindsay Corporation is an industry-leading agricultural equipment provider with direct exposure to high-growth international markets. The benefits of mechanized irrigation, along with the strength of Lindsay's market position, have been demonstrated over several decades. Secular trends such as global population growth, rising protein consumption, and conversion from gravity to mechanized irrigation in the emerging markets should power Lindsay's growth for many years.

The public market's focus on quarterly results and year-over-year growth comparisons currently affords investors the chance to invest in Lindsay at an attractive share price. At just 13.7x net cash P/E, we believe that Lindsay's shares are undervalued. Current projections indicate that an opportunistic private equity buyer could acquire Lindsay for a 45% premium and still achieve a 20%+ IRR over a five-year period. On a standalone basis, a valuation based on Lindsay's trough earnings of FY 2014 supports a price target of over \$110/share.

VIII. Full Legal Disclaimer

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