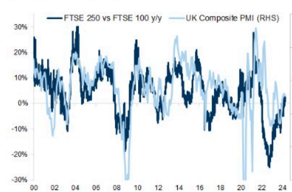
April 17, 2024

THE LONG PULL: Costain Group (COST.LSE) – Fishing in Hated Markets

A few days ago, [I tweeted about](#) how hated and cheap the UK market is and used the following Goldman Sachs graphic as evidence.

Exhibit 1 : FTSE 250 is poised to outperform as economic activity picks up

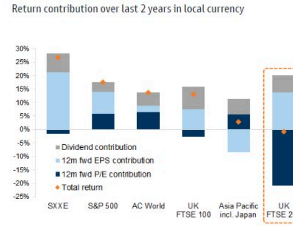
Relative price performance FTSE 250 vs. FTSE 100 (y/y% Chg) and UK Composite PMI (RHS)



Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 2 : Valuation offsets all gains from earnings and dividends for FTSE 250

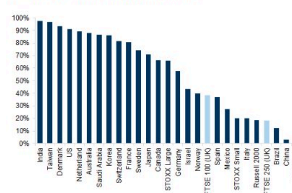
Return contribution over last 2 years in local currency



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 3 : FTSE 250 offers one of the best entry points, in our view

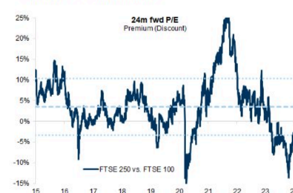
12m fwd P/E percentile rank in 18y history



Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

Exhibit 4 : Domestic headwinds have been a drag on FTSE 250

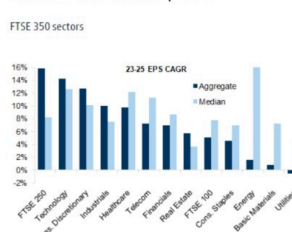
24m fwd P/E Premium (Discount)



Source: FactSet, Goldman Sachs Global Investment Research

Exhibit 5 : FTSE 250: The Catch-up Trade

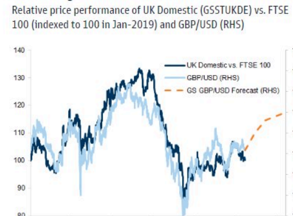
FTSE 350 sectors



Source: FactSet, Goldman Sachs Global Investment Research

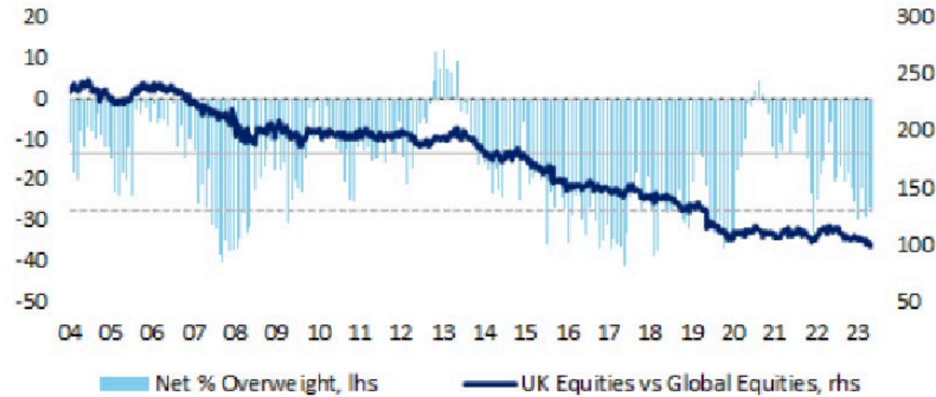
Exhibit 6 : UK Domestic and FTSE 250 could outperform if Cable strengthens further

Relative price performance of UK Domestic (GSSTUKDE) vs. FTSE 100 (indexed to 100 in Jan-2019) and GBP/USD (RHS)



Source: Bloomberg, Goldman Sachs Global Investment Research

This isn't a "new" phenomenon. Hedge funds have been underweight in UK equities for the last decade (since 2013).



FMS allocation to UK equities was flat at net 27% underweight.

FMS investors have been consistently underweight UK equities since Jul'21.

Current allocation is 0.9 stdev below its long-term average.

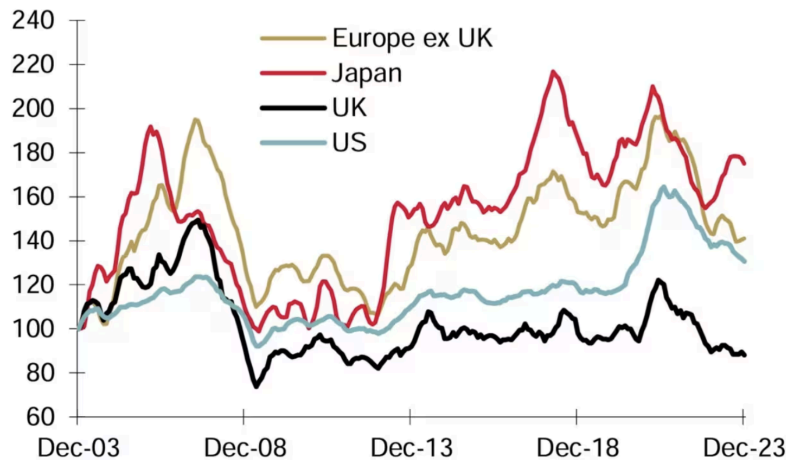
But it is *kind of* odd, considering that the FTSE 100 is at all-time highs (see below).

In some ways, there's a disconnect between how investors *feel* about a country versus how the country's stocks are performing.

For example, while the FTSE 100 index hits new highs, P/E ratios in the FTSE 250 remain in the 20th percentile over the past 18 years (the only difference between the two indices is that the FTSE 250 adds the next 150 largest companies).

But now we're seeing all the signs of complete investor apathy.

London-listed IPOs are declining. A January FT.com article states, *"The UK is the only major developed market where the number of reasonably liquid stocks has actually shrunk over the past two decades."*



I love seeing bombed-out sentiment and increased illiquidity as investors flee with their capital. It means there are opportunities to buy ridiculously cheap stocks for those willing to do the work.

In other words, the UK has become a stock pickers market.

But it's not enough to be a stock picker's market. We've seen what's happened in Japan (at least until now). Cheap stocks are usually cheap for a reason. And they typically *stay* cheap until, well, forever.

David Einhorn calls this the "old" value investing strategy (emphasis added):

> *1) Find stocks that are "sort of" cheap due to temporary issues that caused the stock to drop farther than what's likely rational.*
>
> *2) Realize that those issues are, in fact, temporary and not as bad as everyone thinks, and buy the stock at ~10x profits.*
>
> *3) Wait 3-6 months until some larger fund recognizes what you've known for months and buys a ton of stock over the next 9-12 months.*
>
> *4) Sell the stock for 13-15x profits and party.*

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But as we explained in that December *Long Pull Report*, that strategy doesn't work anymore (emphasis mine):

> *"Einhorn's entire point is that this strategy no longer works. Why? There aren't large, active funds finding undervalued stocks. Instead, passive indexes buy the same seven stocks on every rebalance.*
>
> *This results in cheap stocks staying cheap, and nobody cares. If a tree falls in the middle of a forest, and nobody's around to hear it, why should it trade at greater than 5x profits?*
>
> ***A lot of value investors still play the old game.** They're constantly complaining on Twitter/X about how their cheap stocks are still cheap five years after they bought them. They mumble that nobody cares about their stocks. And they're right.*
>
> *Here's the point. The solution isn't for other people to notice your boring value stocks. It's to adjust your strategy so that you don't need others to notice your stocks."*

Einhorn realized this, changed his game, and created the "new" value investing framework:

> *1) Find companies that nobody cares about that are trading at ridiculously low valuations.*
>
> *2) Ensure that those companies will keep earning profits at some sustainable level.*
>
> *3) Buy the ones explicitly saying, "we will return most of our earnings to shareholders through dividends, buybacks, or both."*

I'd add a fourth point to the "new" value investing framework:

> *4) Buy the ones that are so cheap that eventually their cash balances will overtake their market caps, forcing some catalyst or event to unlock value.*

Costain (COST.LSE) fits that fourth point.

Costain Group (COST.LSE): Too Cheap To Ignore

COST is a large infrastructure services provider based in the UK. The company operates through two segments: **Transportation** and **Natural Resources**.

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Transportation services include roads (A1, M1, M6, and A30. Mobilised for A303), rails (HS2 main), airports (Heathrow and Manchester Airports), and highway refurbishment projects. The segment generated £943M in revenue with 3% margins in 2023 from Transportation.

Natural Resources comprise **Water, Energy,** and **Defense/Nuclear Energy** projects. This segment generated £389M in revenue with 5.6% margins in 2023.

Here's why you should care.

COST sits at the forefront of **£700B+** in UK government infrastructure spending:

- ➢ £27B on Road
- ➢ £142B on Rail
- ➢ £29B on Intregrated Transport
- ➢ £96B on Water
- ➢ £67B on Energy
- ➢ £272B on Defense/Nuclear

The company has ~£4B in order/preferred bidder book or nearly 4x its 2023 annual revenue, which should expand as the UK government starts spending that £700B.

CEO Alex Vaughn mentioned the UK spending plan in the company's latest earnings report (emphasis added):

> *"Costain is operating in critical long-term investment markets and our markets represent the critical national needs that the UK has in order to drive economic growth, deliver positive social change, and meet the UK's decarbonization targets."*

There's reason to feel confident in the company's ability to capture some of that spending.

COST is a preferred vendor because it is large, has a fortress balance sheet, and pays its suppliers faster than almost anyone else in its industry. In other words, there is little counterparty risk when partnering with COST.

The stock is down 83% from its 2018 highs after a series of delayed projects, an unfavorable arbitration decision, the cancelation of low-margin projects, and poor sentiment for UK-listed small caps.

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COST has a £215M market cap with **77% (£164) of its market cap in cash** with no debt and **trades at ~1x EBITDA.**

The company released guidance for 2024-2025 and a path toward 5% operating margins (from 3% today) as they shift from low-margin transportation projects to higher-margin Natural Resources projects.

Over the next three years, COST could generate £136M in cumulative free cash flow or nearly 300% of its EV.

In 2026 alone, COST could generate £72M in operating profits at 5% margins or 156% of its current EV.

So, to recap, COST is a direct beneficiary of the UK's £700B (non-discretionary) infrastructure investment program, a preferred partner in the value chain, has 77% of its market cap in cash with no debt, and trades at ~1x today's EBITDA and 0.43x 2024E profits.

At this point, the only thing that matters is capital allocation. If COST executes its plan, the company will soon have more cash than its market cap. And they need to spend that cash.

The Opportunity: COST Capital Allocation Policy

The most important thing to understand about COST's capital allocation is its pension scheme liability.

Like most European companies, COST pays a certain amount of money each year into its pension fund. The company recently negotiated this annual payment from £12M to £3M/year (further increasing FCF).

However, COST's pension scheme has a "dividend parity" clause that artificially caps dividend payments.

The company must match any dividends paid to shareholders with pension fund contributions. That's why the company will pay £3.3M in dividends this year—anything higher than £3.3M would incur increased pension costs.

I know what you're thinking … *"Doesn't this ruin the entire thesis if the company caps shareholder returns?"*

No. And here's why.

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During its pension negotiations, COST inserted an "annual check" clause. Alex Vaughn explained the clause in the company's earnings call (emphasis added):

> *"Each March, there's a test and if at that point of the test the scheme has tipped into an actuarial surplus, payments to the pension scheme would pause, so we wouldn't have to pay the £3.3M. And more importantly,* ***the dividend parity for that future year would cease.****"*

In other words, COST is free to return as much capital to shareholders as it wants without needing to match contributions as long as the pension stays in a surplus.

That's why this opportunity exists. Most investors see a UK-listed company with tons of cash, then read that it has a pension liability with a cap on dividends and say, "Yep*, I won't get my money back."* And they move on.

But that's not true. The company needs *one year* of actuarial surplus and could return however much cash it wants.

COST management already telegraphed this strategy in their latest earnings call. Here's CFO Helen Willis on the pension scheme and dividends (emphasis added):

> *"We are making sure we're considering how we allocate our capital across all of these requirements [dividends, reinvestment in the business, buybacks]. If we took into surplus, obviously, that will allow us to think again in terms of dividend away from the natural ceiling that we currently have."*

If I were COST management, I would put the pension in surplus this year and return a lot of cash via special dividends or buybacks.

This begs the question, *how much cash can the company return without jeopardizing working capital?*

Let's start with COST's cash balances. The company segments its cash into two buckets: **unencumbered** and **joint venture** (or JV).

Think of JV cash as cash allocated for specific ongoing projects (e.g., £25M for Road Project A, £10M for Energy Project B, etc.). COST has **£59M** in JV cash.

The other £105M (or 50% of the market cap) is sitting in a savings account collecting interest.

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From the latest earnings call, the company could live with just the JV cash and use cash from operations to fund the rest of the business. Here's Helen Willis (emphasis added):

> *"So the cash is unencumbered apart from the JV cash. It's ours, on deposit, and we're earning interest on it. There aren't prepayments in there, either. And the £25M in working capital surplus is the difference between receipts and payments, and that's a fairly regular balance."'*

So £105M is the effective ceiling on how much they could return if they issue special dividends or buybacks *today*.

That's **£0.38/share in special dividends** against a £0.78 share price. Or a **135M reduction in share count (276M to 141M)** to raise the stock price to £1.50/share.

Another helpful exercise is to model the company's cash generation and expected EV over the next few years, assuming steady-state capital returns.

Here's my basic capital return model for the next three years (see below).

Unit Economic Model	**2024**	**2025**	**2026**
Total Revenue	$1,300.00	$1,350.00	$1,390.50
Total Costs	-$1,255.00	-$1,300.00	-$1,331.40
Net Profits	**$45.00**	**$50.00**	**$59.10**
Less Capex (inc: pension)	$5.00	$6.00	$7.00
Free Cash Flow	**$40.00**	**$44.00**	**$52.10**
Current EV	$52	$52	$52
EV Yield	**77.2%**	**84.9%**	**100.5%**
Capital Allocation	**2024**	**2025**	**2026**
Year-end Cash	$204	$243	$273
Dividends	$3	$20	$25
Buybacks	$2	$2	$2
Post Allocation Cash	$199	$221	$246
Market Cap to EV			
Market Cap	$216	$216	$216
Cash	$199	$221	$246
Debt	$0	$0	$0
Enterprise Value	$17	-$5	-$30
EV/FCF	**0.43**	**-0.11**	**-0.57**
Cumulative Shareholder Re	**2024**	**2025**	**2026**
Dividend	$3	$20	$25
Buyback	$2	$2	$2
Total Shareholder Return	**$5**	**$22**	**$27**
Annual Shareholder Yield	10.22%	42.44%	52.08%
Sum of 3YR Shareholder Re	$54		
Shareholder Yield	104.74%		

I assume ~£5M in capital returned in 2024 via £3M in dividends and £2M in buybacks. Then, £22M and £27M in shareholder returns for 2025 and 2026, respectively.

COST would end 2026 with a -£30M EV even after accounting for £54M in shareholder returns.

And that's the point. COST is so cheap that *something* will happen to unlock the value—something far beyond what I've modeled above.

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COST is the perfect takeover or activist target.

They have 77% of their market cap in cash with no debt, 50% of that sitting in a savings account earning interest. Margins should increase from 3.5% to 5% over the next two years, and they're at the forefront of a £700B non-discretionary government spending program.

The best part about the thesis is that it's math. COST will not trade at a negative EV forever. In a consolidation move, someone will eventually buy this company at a multiple of earnings (EBITDA, profits, etc.). In the meantime, shareholders will get paid for waiting.

So, how do we lose here? A few ways:

- ➢ Loss of major contracts
- ➢ Failure to win preferred/order book bids
- ➢ Take-under from management
- ➢ Severe recession reduces UK government investment
- ➢ Working capital blow-outs (i.e., inability to collect receivables and ballooning payables)

I view those risks as a) non-material and b) compensated for in the current stock price.

Finally, COST is a textbook Ted Warren stock. It looks ready to launch from its four-year rectangle base (see below).

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