



August 21, 2024

THE LONG PULL: Hemisphere Energy (HME) Earnings Update & Freightcar America (RAIL)

Happy Wednesday, Operators! Here's what we got today.

First, we review HME's latest earnings report (spoiler: they crushed it) and its price action relative to crude oil.

Then, we pitch why staying on the sidelines might be the best way to play oil.

Finally, we dive deep into our latest "invest then investigate" company, FreightCar America (RAIL). Like Druck and Soros, we bought RAIL because it met our initial Trifecta Lens criteria:

- **Technicals:** Breakout from compressed volatility on the monthly time frame
- **Fundamentals:** Inflecting fundamentals across every part of the business
- **Sentiment:** Completely left-for-dead having returned -69% since inception

Now it's time to answer the question ... *"Does RAIL deserve more of our capital?"*

Let's get after it.

Hemisphere Energy (HME): Another Great Quarter

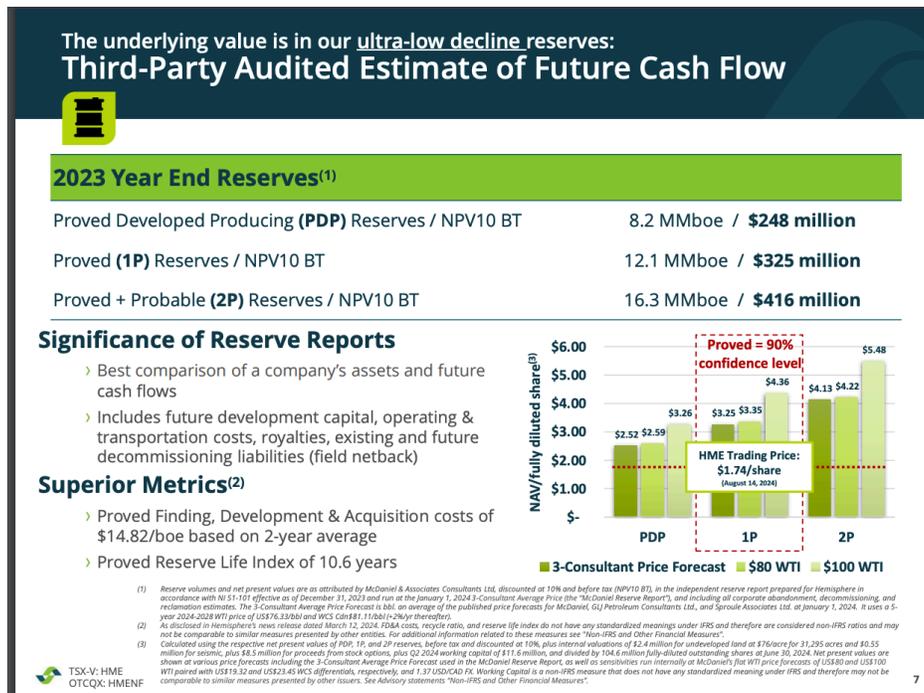
HME is our Canadian small-cap heavy oil producer. It owns a 100% interest in the Atlee Buffalo property in southeastern Alberta and its new Marsden, Saskatchewan property.

We bought HME because it met our criteria for a "perfect" oil producer:

- Ultra-low decline rates
- Low operating costs
- High insider ownership (16%+)
- Long reserve lives
- Low capital intensity
- Minimal decommissioning/reclamation liabilities

Plus, the company had a history of returning excess cash to shareholders via regular/special dividends and an NCIB buyback program.

We bought our position at a ~\$170M market cap for a 30% discount to PDP (proved, developed, and producing) and a 60%+ discount to 2P reserves (see below).



HME is unique because it has the highest per-barrel value of reserves *and* one of the lowest EV/Reserves.

We believe the market will recognize this divergence and re-rate the company accordingly ... somewhere around 1-1.25x EV/Resources.

Also, I interviewed HME's CEO, Don Simmons, on *The Value Hive Podcast*. Listen to [learn more about the company](#).

Alright, onto its quarterly earnings.

Here are the highlights:

- Record Q2 production of 3,628boe/d (+26% YoY)
- Increased revenue by 52% to \$28.9M
- Delivered \$17.7M in Operating Netbacks (\$53.58/boe)
- Generated Adjusted Funds Flows of \$13.6M (\$41.13/boe)

And then there's the capital returns:

- Distributed \$2.5M in regular dividends
- Paid \$0.03/share special dividend
- Repurchased 1.054M shares under its NCIB

As Don mentioned on my podcast, HME spent ~\$3M drilling their Marsden property. Most of the company's capex will go towards exploring the Marsden property.

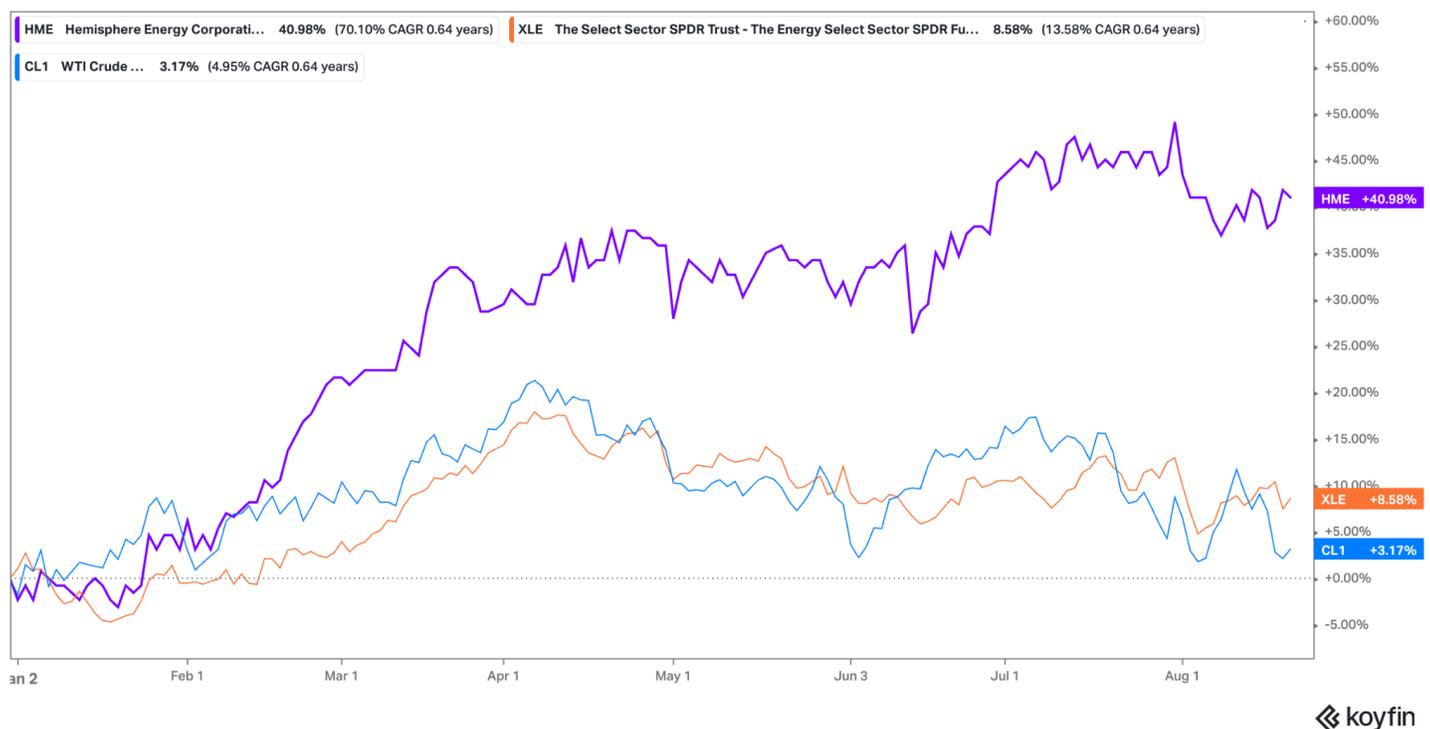
Then there's valuation.

The company trades at <3x NTM EBITDA, which seems too cheap for a producer with industry-leading decline rates, minimal capital intensity, a potentially transformational property (Marsden), and a history of shareholder returns.

I don't know what's "fair." But something around 5-6x EBITDA if we get an upcycle in crude oil pricing seems right (\$270M-\$330M).

Let's talk price action.

HME marches to the beat of its own drum. The stock is up 41% YTD, while XLE and crude oil return 9% and 3%, respectively.



This is what relative strength looks like. This is why you buy the leaders.

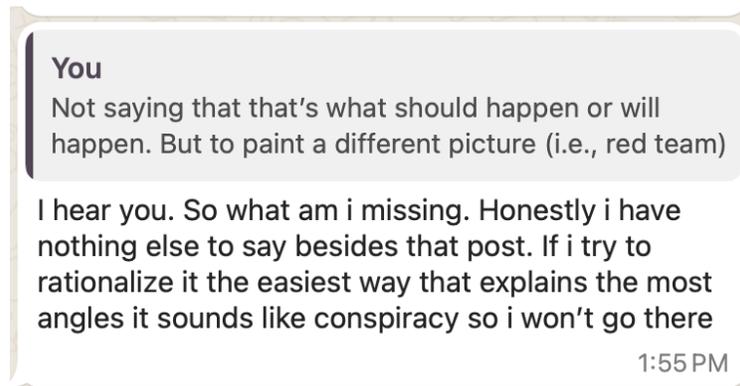
I want to end this section with my thoughts on the oil market. Disclosure: I am the patsy at the crude oil table. Plenty of investors have forgotten more about the oil market than I'll ever remember.

I'm 25 pages into *The Prize*, so that counts for something, right?

I don't know about you, but I've seen so many oil bulls complain on Twitter about how oil prices *should* be higher because of x, y, and z ... the Houthis, Russia/Ukraine, Iran, inventories, and "paper barrels" are some of their buzzwords.

Yesterday, I texted one of my much brighter friends (who will remain nameless) about oil and why it's going down despite all the above reasons for it to trade higher.

Here's what they said.



"If I try to rationalize it ... it sounds like a conspiracy so I won't go there."

In other words, "the only way I could be wrong is if there's a giant conspiracy against me, the oil market, and specifically my portfolio of oil bets."

Don't get me wrong. This investor is one of the smartest commodity traders I know. They've made millions trading oil.

So what's the point?

The point is that crude oil is a HUGE market ... and the crowd is *usually right* in big markets (greater liquidity and more market participants, etc.).

If you have all these reasons why a commodity should trade higher ... **but it's not** ... maybe you're wrong?

There's nothing wrong with being wrong in markets. It's the *staying* wrong that kills you.

Crude oil is an excellent example of investors getting whipsawed while trying to fit narratives into range-bound price action.

Here's the latest crude oil chart.

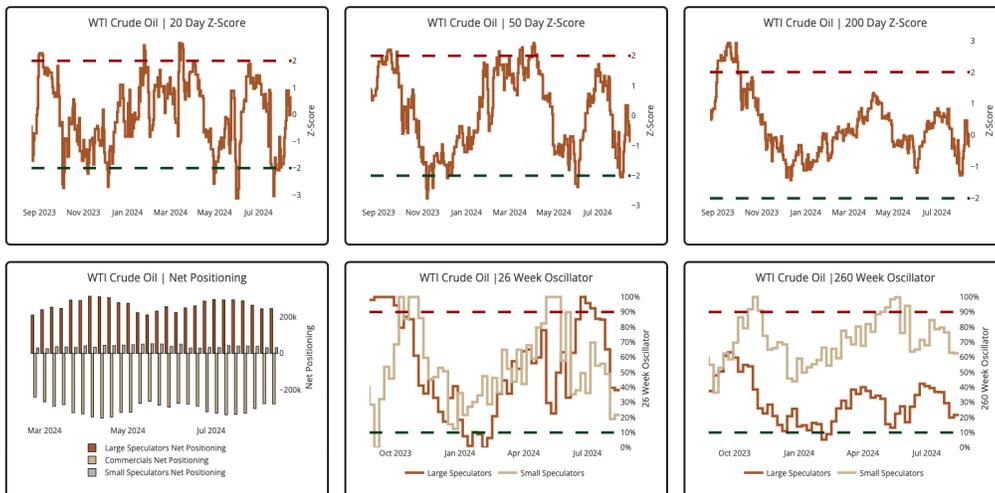


Crude has traded between \$65/bbl and \$95/bbl for two years.

I know this sounds ridiculous, but it's okay *not* to have conviction in crude oil.

While we wait for crude to tip its hand, there are easier markets to play, like precious metals.

The CoT data isn't flashing any BUY NOW signals, either.



I'm happy to hide out in HME while crude whipsaws every ego-driven trader into oblivion ... and when that happens, it'll be time to back up the truck.

Alright, onto Freightcar America (RAIL).

FreightCar America (RAIL): Lots To Like About This Left-for-Dead Play

RAIL designs, manufactures, and sells railcars and railcar components for transporting bulk commodities and containerized freight products in the United States and Mexico.

According to its website, the company offers a range of railcars, including open-top hoppers, mill gondola cars, intermodal and non-intermodal flat cars, coal cars, bulk commodity cars, covered hopper cars, coil steel cars, boxcars, woodchip hoppers, aluminum vehicle carriers, and articulated bulk container railcars.

RAIL is on pace to sell 4,300-4,700 railcars this year.

As mentioned, we bought an initial "invest then investigate" position because RAIL met our Trifecta Lens criteria. Let's break each component down.

Technical: Left-For-Dead Chart w/ Monthly Breakout

Check out the RAIL monthly chart below.



The stock has been down 69% since its inception. In other words, anyone who bought this stock and held it for any period has lost money.

However, the chart is inflecting this month, with August posting a massive bull breakout bar above its upper Bollinger band. A monthly close around this price would confirm the trend change.

Sentiment: Nobody Wants To Touch This Stock

Nobody is looking at this stock.

The latest *ValueInvestorsClub* write-up is from 2014. Seeking Alpha hasn't written about the company since 2023.

One analyst covers the company, and two people talk about it on Twitter.

On the surface, RAIL is a low-margin manufacturer in a highly cyclical industry with a history of operating losses and financing troubles.

The company lost money on an EBITDA basis *every year* from 2017 to 2022. Quantitative value-based screens won't catch this name.

Still interested?

Fundamentals: Inflecting More Than The Share Price

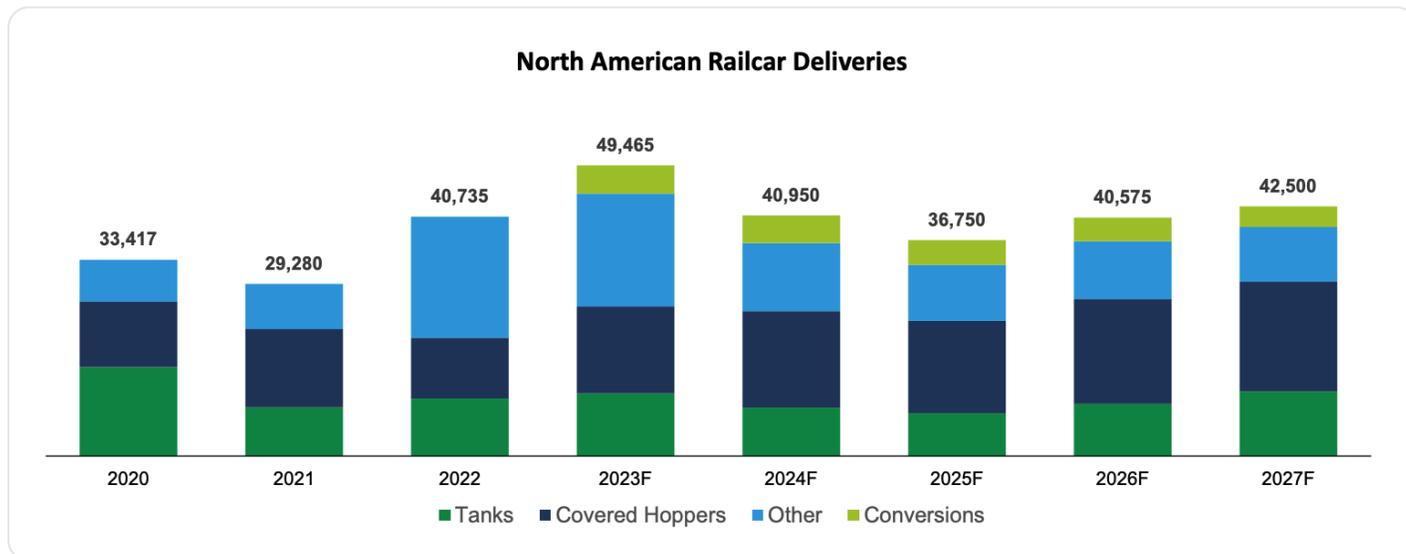
The company is inflecting on all aspects of its business – revenues, margins, orders, backlog, and cash flow (see below).

| Metric | Target | YoY Growth at Midpoint |
|--|--|--|
|  Railcar Deliveries | 4,300 - 4,700 Cars <small>(Previous: 4,000 – 4,400 cars)</small> | 48.9% <small>(Previous: 39.0%)</small> |
|  Revenue | \$560 - \$600M <small>(Previous: \$520 - \$572M)</small> | 62.0% <small>(Previous: 52.5%)</small> |
|  Adj. EBITDA ¹ | \$35 - \$39M <small>(Previous: \$32 – \$38M)</small> | 84.1% <small>(Previous: 74.1%)</small> |

RAIL spent the past four years investing in its new Castanos Mexican manufacturing facility. This led to **annual operating losses** and **-\$20K in gross profit per railcar sold**.

Today, RAIL generates \$6.6K in EBITDA per railcar sold at 60% production capacity with minimal capex requirements (management guides 0.5% - 0.7% of revenues).

Since 2021, the company has gained market share in North America by growing orders by 9.4% annually versus the industry average of 0.2%, representing ~10% of the NA market (see below).



Here's CEO Nick Randal on the industry outlook.

As we have discussed before, rail equipment demand remains healthy, with stable industry dynamics providing confidence in our ability to capture consistent inquiries and orders within our target market. This spans across our diversified portfolio and flexible production lines that provide us with the ability to execute in any market environment.

In terms of order activity for the quarter, we received net orders of 2,916 units valued at \$285 million, the highest we have seen since the fourth quarter of 2014. With replacement rates projected to be close to 40,000 cars for the full year, a stable industry demand outlook gives us continued confidence in our business model and our ability to further grow our pipeline.

What's interesting about RAIL – and the broader railcar industry – is how RAIL competes and differentiates itself from its competitors.

RAIL doesn't compete with railcar lessors (think of equipment rental companies). Instead, it partners with them to build the railcars they need.

More companies are shifting towards the lease business. One Tegus transcript highlighted that the railcar manufacturing industry had consolidated from ~24 suppliers a decade ago to 4-6 today.

Leasing railcars is a better business model—higher margins, higher cash flows, and less capital-intensive.

But someone still needs to make the railcars.

Manufacturing Footprint / Cost

- Minimized fixed costs to provide agility during cyclical downturns
- Breakeven Adj. EBITDA at extremely low volumes¹
- Fast changeovers / reduced downtime
- Vertically integrated
- Ample ability to source lower cost skilled labor

Differentiated Market Position

- Pure play manufacturer, serving leasing, shipping, and railroad customers
- Well-positioned to respond to customer delivery requirements by achieving fast and efficient order-to-fulfillment times
- State of the art manufacturing and industry-respected technical team able to efficiently deliver customized product requirements

RAIL says, “You guys do the leasing thing. We’ll keep making these railcars and selling them to you.”

The company generates 10-12% gross margins and 5% EBITDA margins as a manufacturer. But if you're one of the only games in town ...

So, to recap, you have a business with inflecting revenues, margins, backlog, and profits ... and it's yours for **~0.2x NTM sales and 5x EBITDA**.

Earnings Power Inflection: New Tank Orders & Capacity Expansion

There are two ways RAIL can increase earnings power over the next 2-3 years:

- 1) Penetrate higher-margin product segments like tank cars/tank conversion
- 2) Increase capacity at the Castanos manufacturing facility

This quarter, the company announced a major tank car conversion order. This will allow it to capture some of the 8,000 tank car market, which currently has a 0% market share.

Tank car orders are higher-margin products. One Tegus interview mentioned gross margins of 20-30%.

TEGUS CLIENT ▶ 00:07:58

So the premium part of the market is really the tank cars, hazardous tank cars, or even higher autoracks, chemicals and intermodal cars, right?

PRINCIPAL AT RAIL SUPPLY CHAIN ASSOCIATES (CONSULTING) ▶ 00:08:06

Yes. That's a rule of thumb, just follow the money. The higher the value, the rating, the more premium the **railcar** is.

More tank car/conversion orders RAIL means a higher consolidated gross margin.

RAIL can also increase earnings by expanding production capacity at its Castanos facility. At 60% capacity, the company generated \$6.6K in EBITDA per railcar.

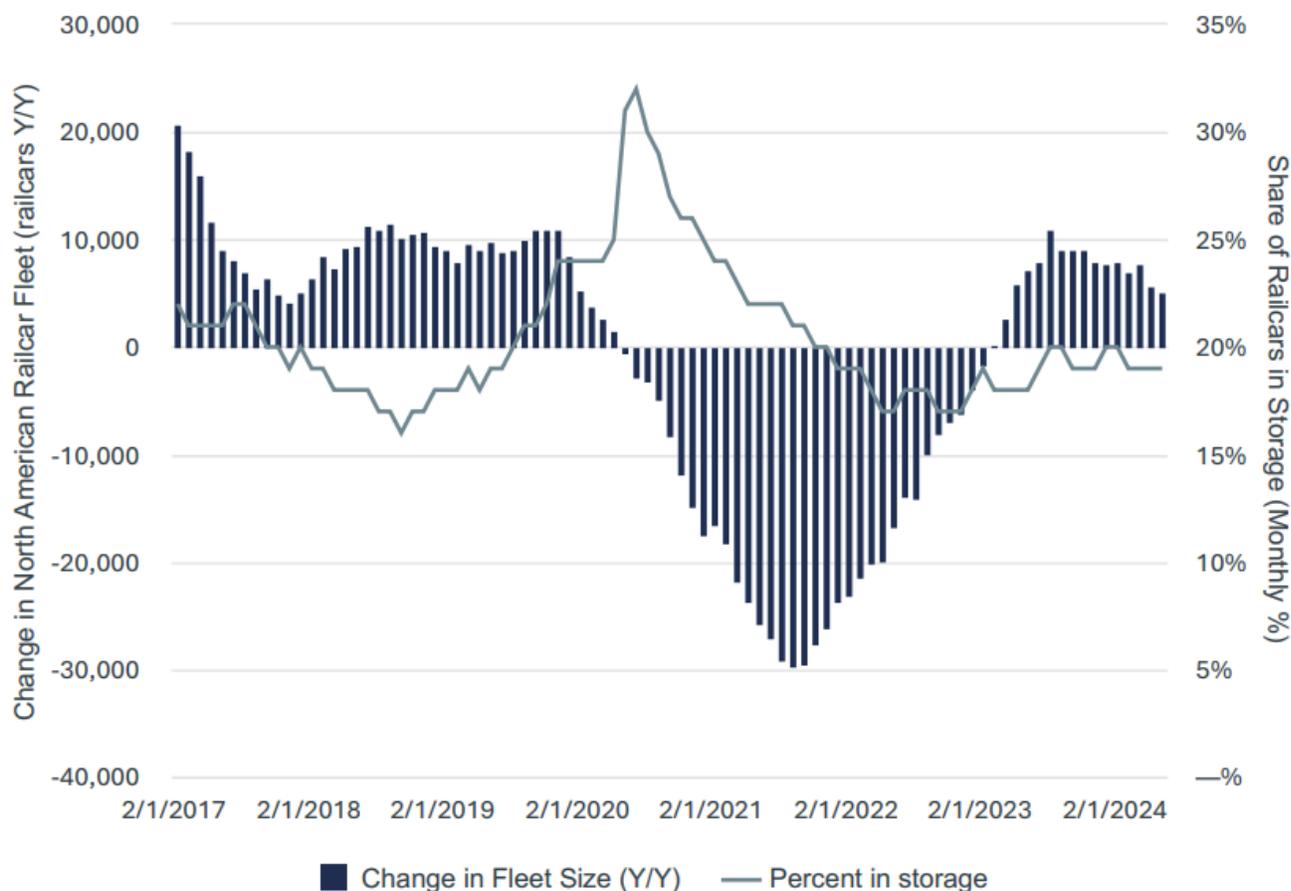
A higher capacity allows RAIL to spread more fixed costs across more railcars, improving per-railcar EBITDA margins and profits.

For example, increasing capacity from 60% to 70% would translate into \$7,700 in EBITDA per railcar. 80% capacity gets us \$8,800 in EBITDA per railcar.

How do you generate higher capacity? More orders.

Railcar deliveries should average ~40,000 units/year over the next few years, supported by a healthy railcar fleet and storage percentage (see below).

North American Railcar Fleet and Railcars in Storage



Source: AAR

Now that we understand the company's earnings drivers let's construct a back-of-the-envelope model for the next three years.

Let's assume RAIL expands production capacity from 4,500 railcars delivered in 2024 to 5,500 by 2026. During that time, the company produced more high-margin tank railcars, which increased the gross profit margin from 11% to 13%.

Finally, we assume capacity improvements add ~200bps to the EBITDA margin from 6.5% to 8.5%.

By 2026, RAIL could generate \$700M+ in annual revenue, \$93M in gross profit, and \$60M+ in EBITDA.

The current market cap is ~\$110M.

| Unit Economic Model | 2024 | 2025 | 2026 |
|------------------------------|------------------------|------------------------|------------------------|
| Railcars Delivered | 4500.00 | 5000.00 | 5500.00 |
| Avg. Railcar Price | \$129,000.00 | \$129,000.00 | \$129,500.00 |
| Total Revenue | \$580,500,000.00 | \$645,000,000.00 | \$712,250,000.00 |
| Gross Profit Margin | 11.00% | 12.00% | 13.00% |
| Total Gross Profit \$ | \$63,855,000.00 | \$77,400,000.00 | \$92,592,500.00 |
| OPEX | \$26,122,500.00 | \$29,025,000.00 | \$32,051,250.00 |
| EBITDA | \$37,732,500.00 | \$48,375,000.00 | \$60,541,250.00 |
| <i>% Margin</i> | 6.50% | 7.50% | 8.50% |
| <i>Less Capex</i> | \$2,902,500.00 | \$3,225,000.00 | \$3,561,250.00 |
| Pre-Tax Free Cash | \$34,830,000.00 | \$45,150,000.00 | \$56,980,000.00 |
| FCF Yield | 29.89% | 38.75% | 48.90% |
| Current EV | \$116,530,000 | \$116,530,000 | \$116,530,000 |
| FCF Per Share | \$1.83 | \$2.38 | \$3.00 |
| | | | |
| Valuation Metrics | 2024 | 2025 | 2026 |
| EV/Sales | 0.20 | 0.18 | 0.16 |
| EV/Gross Profit | 1.82 | 1.51 | 1.26 |
| EV/FCF | 3.35 | 2.58 | 2.05 |

Before we extrapolate investment returns under the model, I want to discuss the company's outstanding warrants and potential dilution.

RAIL has ~19M common shares outstanding, ~2M shares worth of employee options and warrants at the current stock price (\$5.50), and another 13.81M shares worth of convertible warrants.

In other words, the company could increase its share count from 19M to 36M depending on strike prices, etc. (see image below).

Diluted Share Count at Various Prices

REPRESENTS SHARES AND DILUTED SECURITIES OUTSTANDING AT VARIOUS PRICE PER SHARE LEVELS
(SHARES IN MILLIONS)

| Common Stock | \$ 3.49 | \$ 4.00 | \$ 4.50 | \$ 5.50 | \$ 6.50 | \$ 7.50 | \$ 8.50 | \$ 10.00 | \$ 15.00 | \$ 20.00 |
|-----------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Shares held by Affiliates | 6.47 | 6.47 | 6.47 | 6.47 | 6.47 | 6.47 | 6.47 | 6.47 | 6.47 | 6.47 |
| Shares held by Other Shareholders | 12.40 | 12.40 | 12.40 | 12.40 | 12.40 | 12.40 | 12.40 | 12.40 | 12.40 | 12.40 |
| Subtotal | 18.87 |
| Potentially Dilutive (1) | | | | | | | | | | |
| Employee Options | 0.68 | 0.85 | 1.01 | 1.26 | 1.44 | 1.57 | 1.67 | 1.79 | 2.02 | 2.14 |
| Public Warrants | - | 0.18 | 0.34 | 0.57 | 0.74 | 0.86 | 0.95 | 1.05 | 1.25 | 1.34 |
| Subtotal | 0.68 | 1.03 | 1.35 | 1.84 | 2.17 | 2.42 | 2.62 | 2.85 | 3.27 | 3.49 |
| Convertible Instruments | | | | | | | | | | |
| Public Warrants | 13.81 | 13.81 | 13.81 | 13.81 | 13.81 | 13.81 | 13.81 | 13.81 | 13.81 | 13.81 |
| Subtotal | 13.81 |
| Total as of 6/30/2024 | 33.36 | 33.71 | 34.03 | 34.52 | 34.85 | 35.10 | 35.30 | 35.53 | 35.95 | 36.17 |

This is where the red flags appear. According to the company's latest 10-K, these public convertible warrants have an exercise price of \$0.01/share (see below).

Warrant

In connection with the Credit Agreement, the Company issued to an affiliate of the Lender (the "Warrantholder") a warrant (the "2020 Warrant"), pursuant to that certain warrant acquisition agreement, dated as of October 13, 2020, by and between the Company and the Lender, to purchase a number of shares of Common Stock equal to 23% of the outstanding Common Stock on a fully-diluted basis at the time the 2020 Warrant is exercised (after giving effect to such issuance). The 2020 Warrant was issued on November 24, 2020 and is exercisable for a term of ten (10) years from the date of the issuance of the 2020 Warrant. As of December 31, 2023 and 2022, the 2020 Warrant was exercisable for an aggregate of 8,712,618 and 6,799,139 shares, respectively, of Common Stock with a per share exercise price of \$0.01. The Company determined that the 2020 Warrant should be accounted for as a derivative instrument and classified as a liability on its Consolidated Balance Sheets primarily due to the instrument obligating the Company to settle the 2020 Warrant in a variable number of shares of Common Stock. The 2020 Warrant was recorded at fair value and is treated as a discount on the term loan. The discount on the associated debt is amortized over the life of the Credit Agreement and included in interest expense.

Pursuant to the Fourth Amendment and a warrant acquisition agreement, dated as of December 30, 2021, the Company issued to the Lender a warrant (the "2021 Warrant") to purchase a number of shares of Common Stock equal to 5% of the outstanding Common Stock on a fully-diluted basis at the time the 2021 Warrant is exercised. The 2021 Warrant has an exercise price of \$0.01 and a term of ten years. As of December 31, 2023 and 2022, the 2021 Warrant was exercisable for an aggregate of 1,894,047 and 1,473,726 shares of Common Stock, respectively with a per share exercise price of \$0.01.

The 2022 Warrant was issued on April 4, 2022 with an exercise price of \$0.01 and a term of ten (10) years. As of December 31, 2023 and 2022, the 2022 Warrant was exercisable for an aggregate of 1,894,047 and 1,473,726 shares of Common Stock, respectively with a per share exercise price of \$0.01.

In other words, it means RAIL receives almost no cash for the additional dilution.

Let's construct a fully diluted enterprise value with 36M shares outstanding.

Current assets include:

- \$37M in cash
- \$16M in receivables
- \$65M in inventory (sale-ready railcars)

Debt includes:

- \$84M in preferred stock (sits senior to ordinary shares)

So, the updated cap table would look like this.

| Cap Table | |
|--------------------------------|---------------|
| Price as of Last Update | \$5.90 |
| Diluted Shares | 36.00 |
| Market Cap | \$212 |
| Total Debt | \$84 |
| Cash + AR | \$53 |
| Net Debt | \$31 |
| Enterprise Value | \$243 |

This dramatically changes our expected returns and, thus, the attractiveness of the investment (see below).

| Unit Economic Model | 2024 | 2025 | 2026 |
|------------------------------|------------------------|------------------------|------------------------|
| Railcars Delivered | 4500.00 | 5000.00 | 5500.00 |
| Avg. Railcar Price | \$129,000.00 | \$129,000.00 | \$129,500.00 |
| Total Revenue | \$580,500,000.00 | \$645,000,000.00 | \$712,250,000.00 |
| Gross Profit Margin | 11.00% | 12.00% | 13.00% |
| Total Gross Profit \$ | \$63,855,000.00 | \$77,400,000.00 | \$92,592,500.00 |
| OPEX | \$26,122,500.00 | \$29,025,000.00 | \$32,051,250.00 |
| EBITDA | \$37,732,500.00 | \$48,375,000.00 | \$60,541,250.00 |
| <i>% Margin</i> | 6.50% | 7.50% | 8.50% |
| <i>Less Capex</i> | \$2,902,500.00 | \$3,225,000.00 | \$3,561,250.00 |
| Pre-Tax Free Cash | \$34,830,000.00 | \$45,150,000.00 | \$56,980,000.00 |
| FCF Yield | 14.31% | 18.55% | 23.41% |
| Current EV | \$243,400,000 | \$243,400,000 | \$243,400,000 |
| FCF Per Share | \$0.97 | \$1.25 | \$1.58 |

FCF yields declined from ~14% in 2024 to 23% in 2026, which isn't bad, but it's not the face value of 48% under the non-dilutive assumption.

Conclusion: Wait and See + A Lesson Learned

The good news is that the company could take its free cash flow, pay off the preferred stock, and refinance to stunt some warrant dilution.

Management can improve the capital structure and in turn, the investment opportunity.

I'm fine holding our current "invest-then-investigate" position and waiting to see what they do.

We risked 75bps of actual capital at a \$3/share stop. If things turn south, we'll jam stops and exit this position with a <25bps loss.

This is the power of buying starter positions. I learned about a new industry and did the necessary research to add to our position *should* we see improvements in the capital structure.

Until next week,

Brandon