Equity Analysis for

Tenneco (TEN)

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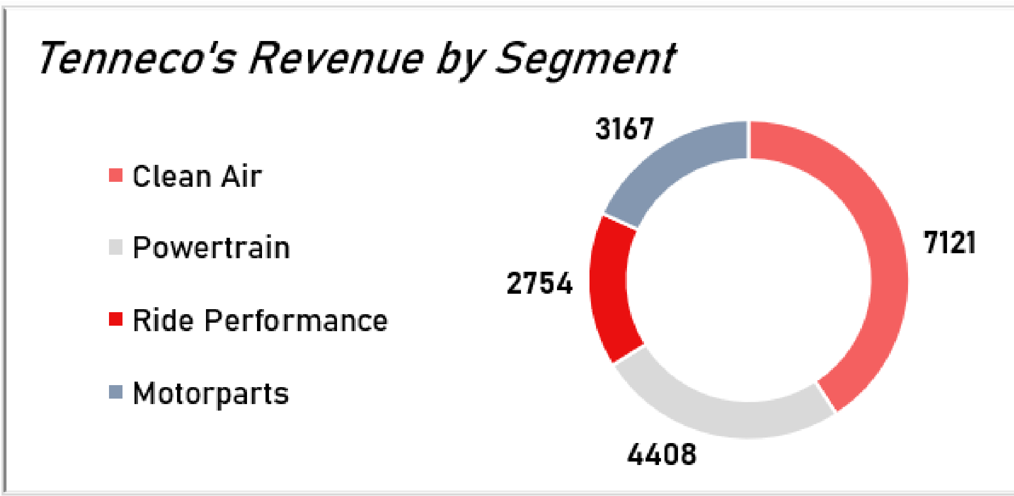
Company Overview

Tenneco is one of the large parts manufacturers in the world. Their company designs, manufactures, and sells products or services for light-vehicles, commercial trucks, off-highway and industrial vehicles. A large segment of their revenues are also aftermarket parts, as you can see below:

Operations

Aforementioned, Tenneco manufacturers both Original Equipment (OE), and Aftermarket parts. Original Equipment parts are essentially the parts that a car rolls off the assembly line with. For Tenneco, Original Equipment parts comprise their Clean Air, Powertrain, Ride Performance, and the Motorparts segments. In contrast, the only segment to not be Original Equipment was their "Aftermarket" segment, which has since been combined with Motorparts.



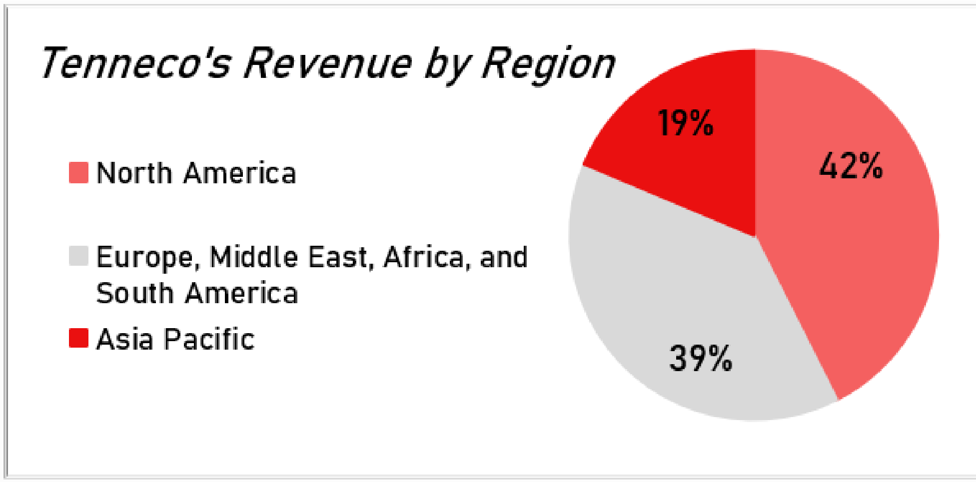
In total, OE segments used to make up around 89.5% of their revenues. However, since the Federal-Mogul merger, OE parts actually make up a higher percentage of their revenues now. Nevertheless, their largest segment is Clean Air, where they seek to help many auto giants meet their various emissions regulations. Before we talk about the merger, let's breakdown Tenneco's sales around the world.

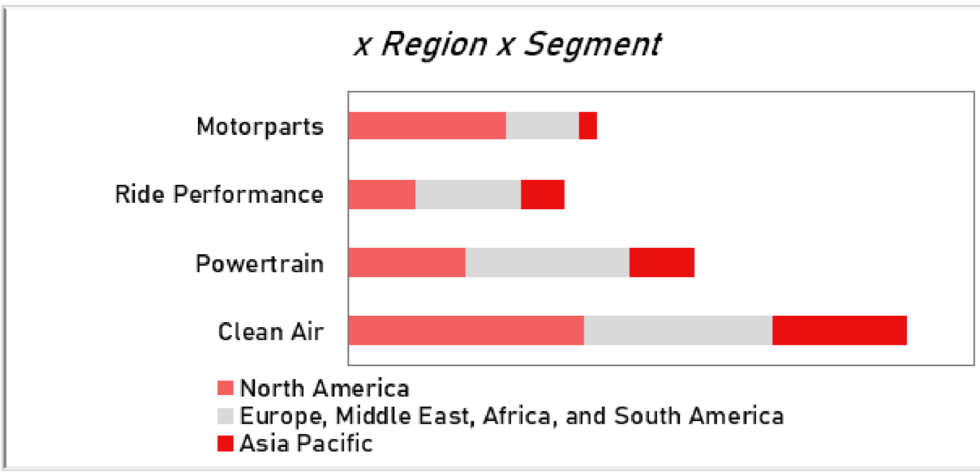
As of recent, Tenneco has been highly publicized for their purchase/merger of another parts manufacturer, Federal-Mogul.

Federal-Mogul was previously a public company but was taken private by Carl Icahn in 2017. However, just over a year later Icahn agreed to sell the company to Tenneco for a deal worth around $5.4 billion. In this deal, Icahn would be the beneficiary of 9.9% of Tenneco voting shares.

Ultimately, Tenneco's plan with this merger was to create synergies that would lead to cost savings throughout the company.

Geography





Industry

The three areas of the auto industry that influence Tenneco, are light vehicle sales, commercial sales, and aftermarket replacement parts.

In the company's OEM segments, demand for new vehicles are what drives revenues. Total new-car sales are typically reliant on macro-economic factors such as credit availability, interest rates, fuel prices, consumer confidence, etc. Overall, this OEM market is very cyclical.

For the commercial vehicle market, sales are still somewhat cyclical. However, sales here are insulated from consumer credit and spending. Rather, purchases are made based off of business spending, and how those businesses perceive the economic outlook.

In contrast to OEM, Tenneco's Aftermarket segment provides very consistent revenues. As the economy slows, consumers tend to fix their current vehicles instead of fueling sales in the OEM market.

It’s also important to note, that growth in the automotive manufacturing industry has been in the low single digits. Although there is no sign of rapid growth anytime soon, companies like Tenneco hope to expand within their industry. Larger companies also benefit from their scale, which allows them to be more operationally efficient.

Furthermore, growth in the automotive sector varies by region. For example, China and India have been two of the fastest growing markets in the world. Whereas, developed markets have significantly lagged behind.

Lastly, the parts manufacturing industry is highly competitive. As a result, margins stay relatively thin. Additionally, companies like Tenneco find themselves competing with cheaper, non-labeled, alternatives more and more often.

It’s also important to realize the future that electrification will play in the automotive sector. The number of total vehicles that will be powered by electricity is estimated to be 35% by 2025. Today, electrification only represents about 5%.

This shift is being pushed by OEMs continuing to focus on improving fuel efficiency, whilst also reducing emissions to meet regulatory requirements.

Short Term Outlook

In early 2017, Tenneco’s stock was approaching $70/share. However,in early April of 2020, these same shares hit yet another 52 week low below $3.00.

The last two years have wiped out over 90% of Tenneco’s market cap. There are several main reasons for this drop.

First, the acquisition of Federal-Mogul was a surprise to investors. It was a surprise because Tenneco is a much larger company than the one they acquired. Any company that makes an acquisition of close or equal size puts incredible strain on a company.

Yet, arguably the biggest concern to investors was Federal-Mogul’s pile of debt that Tenneco would inherit. On top of having to dilute their own shares, Tenneco would be taking on approximately $3.3 billion in long-term debt. This was on top of the $2 billion that Tenneco already had on their balance sheet.

Needless to say, Tenneco made one of their near-term goals to start slowly paying off this debt. However, with the automotive industry lagging behind the economy, and Coronavirus shutting down factories across the world, this has not happened. In fact, the company now has approximately $6.9 billion outstanding debt (including the recent tap of their revolving line).

In contrast, in an effort to negate the effects of the merger, Tenneco also announced their new spinoff company, DRiV.

Their “start up” as they refer to it, will be comprised of what was formerly Tenneco’s Ride Performance and Aftermarket segments. This has been the only light at the end of the tunnel for a company whose stock has been battered.

That being said, the Coronavirus has put a halt on these plans indefinitely. Until their is a wide-spread economic recovery, the company plans on maintaining their current corporate structure.

Another problem, was that Tenneco was also at the forefront of the US-China Trade War. Tariffs of just 10% put a large strain on the company. Therefore, moving forward it’s important that trade relations between the world’s two largest economies stay positive.

In summation, Tenneco has struggled to gain their footing in the last few years.

Long Term Outlook

Tenneco’s goal with Federal-Mogul was to not only increase revenues by around $6 billion per year, but it was also to create efficiency. Once all of their synergies have been aligned, Tenneco expects to see increased margins from all around. This is especially important to a manufacturing company, where margins are crucial.

Secondly, Tenneco expects their new spin-off, DRiV, to be a huge success. Essentially, their plan is to re-brand two of their own segments by modernizing them into a 2020 feel. That being said, the spin-off will most likely be used to debt load the new company.

Aforementioned, Tenneco is the owner of quite a bit of debt. Substantial debt like they’ve acquired becomes limiting in the long term, as the company finds it hard to take out more debt to finance new projects. Therefore, it’s unlikely that Tenneco is going to be ushering new projects any time soon.

Another potential drawback facing Tenneco, is the automotive industry as a whole.

Economists have generally agreed that light vehicle production is going to grow at a slow, but steady, rate of 2% per year until 2025. A 2% growth rate per year keeps Tenneco’s growth aspirations relatively low. Yet, this growth rate is an aggregate of the global industry. If you section the numbers out by region, you start to see some outliers. India and China, for example, have much higher growth rates; with China leading globally.

Tenneco has also been negatively influenced by a second industry shift. In their Aftermarket/Motorparts segment, they’ve seen revenue lost to their private label competition. These private label companies have become more popular mainly because of cheap prices and availability. The consumer has been willing to trade-off certain quality and technological aspects, for the cheaper prices.

Lastly, Tenneco has just over $180 million in differed tax assets that they can utilize in the future. They can choose to use these assets at their will, and when they do it’ll really help the bottom line.

Risk Factors

Goodwill

A not-so-obvious risk factor, is the company's *goodwill*, under assets on the balance sheet. Although it's not officially a risk factor, Tenneco can choose to write down the value of this goodwill at any time if they feel that there has been an impairment. This risk factor became especially important after the company bought Federal-Mogul, and added an amount to goodwill that totaled up to around $800 million.

Variable-Rate Debt

When Tenneco purchased Federal-Mogul, it wasn't just a large pile of debt that they inherited; they inherited a pile of variable interest rate debt. In 2019, of their total $5.34 billion borrowings, about $3.32 billion has a variable rate. What's more, Tenneco has 349 million of additional floating rate notes that are denominated in Euros.

Due to these rates being derived from the LIBOR rate, Tenneco has gotten lucky in the sense that rates have been dropping amid uncertainty and quantitative easing from federal banks. However, if rates were to rise at all in the next several years investors should be worried about Tenneco's ability to service these debts.

Debt

Aforementioned, the company has a crippling amount of debt. Though we believe they will be able to squeeze by, a prolonged recession could surely send the company into default.

With the addition of another $1.5 billion from their oldest revolving line, the company now has $6.9 billion outstanding debt. However, they also have around $1.8 billion cash, and no major repayment of debt obligations until late 2021.

10% Exposure

The last major risk factor for Tenneco is their exposure to several major clients. Both Ford and General Motors make up around 12-14% of Tenneco's annual sales, each. Volkswagen also makes up a large portion of revenues, but since the portion is less than 10%, the exact amount doesn't have to be disclosed.

This became especially relevant during early 2020, when a strike a General Motors influenced a great deal of their revenues.

Valuation

CIR Valuation			
	$44.88		
Error (%)			
15.0	**$38.15**	to	**$51.61**

Despite enthusiasm for Tenneco's long-term assets, their current debt burden may very well force the company to declare bankruptcy. In contrast, our valuation assumed that they would continue operations indefinitely. The real equity valuation of a publicly traded company declaring bankruptcy is, theoretically, 0. Though we believe operations at the firm will continue, we cannot accurately predict the outcome. There are too many macro factors at play to do so.

Tenneco is currently in a transitional phase. They've just acquired a massive company for which they've incurred debt, transactional costs, and numerous unusual expenses recorded on their income statement. Furthermore, they have done so at a horrible time. Not only has the automotive sector slowed down, but essentially all manufacturing jobs have come to a halt, because of Coronavirus.

Other important factors we had to consider were Tenneco's increased revenues, lower margins in the near term, their synergies with Federal-Mogul, and what their long-term capital structure would look like.

For the near-term at least, the company will be struggling with their debt load. Therefore, we don't expect the company to be making any significant capital expenditures any time soon. That being said, we began to adjust their reinvestment rate to mirror the sector average by the terminal valuation.

Lastly, Tenneco's debt situation is abnormal for the sector. However, they have always maintained higher debt ratios than most other automotive companies. Because of this, we adjusted their long-term Debt/Equity ratio to be 150%, versus the sector average of around 51%.

	Short Term		Long Term
Unlevered Beta:		1.24	
Levered Beta:	6.17	→	4.20
Growth Rate:	3.8%	→	1.8%
Discount Rate:	10.4%	→	9.3%

Cash Flows

	ADJ 0	1	2	3	4	5	6	7	8	9	10
EBIT (1-Tax)	17	-480	-105	242	707	807	915	1035	1169	1316	1479
FCFF		-120	-13	208	593	659	729	802	882	966	1054

Terminal Value

$$\frac{1{,}479 \quad (1.03) \quad (0.69)}{(\ 0.0927 \quad - \quad 0\ )} = 11{,}216$$

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