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IEC Electronics
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Summary:

- IEC has grown organically at a 25% CAGR over the past six years
- IEC has grown at a 38% CAGR over the past six years including acquisitions
- IEC is steadily profitable and earns 15-30% returns on equity
- IEC insiders have recently made significant open market purchases
- IEC has an NOL worth almost one fifth of the current market cap
- IEC's closest peer, LaBarge, was recently acquired for 17x trailing EPS (by Ducommun)
- IEC trades for about 7.5x my fully-taxed 2012 EPS estimate

	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Revenue	37.8	45.1	27.4	16.4	28.3	42.8	55.8	70.0	107.3	138.5
Gross Profit	2.9	4.5	2.2	2.4	2.4	4.8	7.3	11.4	18.3	25.2
EBITDA	0.9	3.1	0.8	1.1	0.7	2.2	3.4	5.6	9.9	13.9
EBIT	(0.8)	1.8	(0.4)	0.4	0.2	1.8	2.9	5.2	8.3	9.4
Net Income	(2.3)	2.1	(0.9)	0.2	(0.3)	1.9	10.6	5.2	5.0	6.7
EPS	($0.12)	$0.10	($0.06)	$0.00	($0.02)	$0.10	$0.14	$0.33	$0.47	$0.53
Revenue Growth		20%	-39%	-40%	72%	52%	30%	25%	53%	29%
Gross Margin	7.7%	10.0%	7.9%	14.6%	8.6%	11.2%	13.1%	16.3%	17.0%	18.2%
EBIT Margin	-2.0%	3.9%	-1.4%	2.3%	0.6%	4.2%	5.3%	7.4%	7.8%	6.8%

IEC Electronics is a small U.S.-based contract manufacturer focused on a specific niche: low-volume, high-mix products. This includes electronic components, cable assemblies, sheet metal components, and a few other things. These products go into defense, aerospace, medical, and infrastructure applications such as spaceships, jets, and medical and capital equipment.

The contract manufacturing industry is enormous. The largest player, Hon Hai (FoxConn) does $110B in revenue. The companies that round out the top five, Flextronics, Jabil, Celestica, and Sanmina, do $30b, $17b, $7b, and $6b of revenue, respectively. These companies mostly manufacture high-volume, low-mix goods (TVs, phones, digital cameras, mp3 players, flash drives, coffee makers, hard drives, etc.), primarily in Asia. Competition is brutal and everybody earns operating margins in the 2-4% range. And because the migration of consumer electronics manufacturing to low-cost regions is already complete, organic growth in this part of the industry is in the low-single digits.

IEC's end markets are different. They are shielded from foreign competition for two reasons. First, parts that go into next-generation U.S. military applications will never be manufactured offshore, for obvious intellectual property reasons. Second, in a space shuttle, fighter jet, or piece of medical equipment, every single part is "mission critical", so quality assurance is far more important here than is the case with consumer goods. As a result, small domestic contract manufacturers like IEC are far more profitable on a margin basis than the Asian behemoths. IEC earns 8% operating margins, and LaBarge flirted with 9%. The mid-sized CMs (Benchmark, Plexus, CTS) have a mix of high- and low-volume work, so they all earn lower margins and grow more slowly.

Because quality control and trust are so important, IEC's customer relationships are fairly sticky. Once a customer has found a reliable and reasonably-priced supplier for a part, there is little incentive to look for an alternative, especially given the finite life of each program. New customer/supplier relationships also take a long time to develop because any new supplier must earn a customer's trust through the execution of multiple small, simple contracts before it can graduate to larger and more complex ones.

Of IEC's primary end markets, Military is approximately 45% of revenue, Medical is approximately 25%, and Aerospace and Industrial are each approximately 15%, with the percentages varying as contracts ramp or end. The first three are growing rapidly. Industrial revenues are the only laggard, and have been weak because they are driven primarily by domestic capital equipment spending.

End Market	% of Sales	2011 Growth Rate
Military	45%	30%
Medical/Other	25%	140%
Aerospace	15%	58%
Industrial	15%	-8%

The Military/Aerospace/Medical contract manufacturing niche is growing quickly. IEC has grown 25% organically for quite a few years now, and thinks it can grow revenue at a 17% organic rate for the foreseeable future. This jibes with expectations from other industry players. If you look at the Flextronics investor presentation you will see Flextronics forecasts zero growth from its core "high velocity solutions" segment (TVs, etc.) but 15-20% growth in its "high reliability" and "industrial and emerging" segments, the two business lines that most resemble what IEC does. Jabil's projections are similar. LaBarge, before being acquired, had grown revenue at a 13% annual rate over the past five years. GlobalData, an industry research firm, expects the medical outsourcing market to grow 17% annually for the next five years. I don't put too much stock in any one of these sources, but I think together they provide corroborative evidence for what IEC is seeing.

In the military and aerospace markets, the growth is being driven by a few factors. As more and more military spending is directed towards electronic equipment and weapons, the need for suitable manufacturing capacity (within U.S. borders) grows. At the same time, the prime contractors are saddled with significant pension and legacy liabilities and are facing budget cuts, particularly in their older programs, so they aren't in love with the idea of adding new manufacturing capacity.

In the medical and industrial/infrastructure markets, growth seems to be coming primarily from increasing acceptance of outsourcing as a sensible practice. This is especially true in the case of ultra-high margin medical equipment manufacturers, whose core expertise is in product development and sales, rather than manufacturing. Why tie up capital in a business that earns 8% operating margins when your core business earns 25%?

For IEC, the medical market is a relatively new area of focus, and strong growth should continue due to new customer wins, contract wins with existing customers, and overall growth in outsourcing within the industry. IEC was just awarded a $17M medical contract, its single largest contract ever. The contract will ramp up in late 2012 and run until late 2013.

On the margin, growth in IEC's niches is also driving consolidation. The primes realize that as they increase their outsourcing needs, the mom & pop one-location manufacturers are going to be less and less capable of meeting those needs. The predictable result has been a slow but steady stream of acquisitions by IEC, LaBarge, and Benchmark. I also believe that IEC has been winning business from competitors that are either large enough to take their eye off of the mil/aero ball (Benchmark, Plexus, the big guys) or are consumed with internal matters (LaBarge/acquisition integration).

So why is IEC so cheap, apart from the fact that it is small and illiquid?

First, the company's recent acquisition of Southern California Braiding (SCB) has not gone well so far. In the most recent quarter, IEC's EPS was down both sequentially and y/y, and the company doesn't expect material improvement until late this year. This poor earnings news snapped a long trend of breakneck EPS growth.

SCB manufactures cable assemblies and other parts for a number of next-generation military platforms, including unmanned and mine-resistant vehicles. Because of funding delays (not cuts) on some of these defense programs, SCB's revenue has been well below projections. Funding for these projects is beginning to be released, but delays remain in securing some of the parts involved. Meanwhile, IEC has borne the additional SG&A from the acquisition, hurting profitability.

With that said, the company actually remains very enthusiastic about the SCB acquisition, in part because of its placement on programs that are seeing high growth.

Second, the defense budget is under pressure. This is a headline risk but not much of a business risk, as the currently proposed cuts have no material impact on the programs IEC is being subcontracted for, largely because most of IEC's work is on next-generation programs that remain national defense priorities.

Third, the company might appear highly indebted to some. Debt is $34M while the current market cap is below $50M. The current debt level equates to about 2.5x EBITDA—seemingly high until you consider the details. The blended interest rate on the debt is 4%, so interest payments are about $1.7mm vs. $14M of EBITDA and essentially no cash taxes. The largest portion of the debt isn't due until 2017, and I expect FCF to be $10-15M annually for the next few years—more than enough to service any/all interest and maturity payments. The company is already paying down the debt at a rate of approximately $1M per month, and with a revenue backlog in excess of $120M, there is no near-term business risk. In my opinion the debt is a non-issue.

Finally, the company is small and has come out of nowhere. IEC has been doing quarterly conference calls for only a year. The market cap is currently about $50M, but it was $12M just five years ago. The stock trades on the AMEX, and institutional ownership is just 10%.

A few other things of note:

Management
Barry Gilbert became CEO in 2002, and has turned the company around. IEC's performance under his leadership has been fantastic. I should point out that this is his first public executive role and IEC has historically been owned mostly by insiders and retail investors, so his experience interfacing with institutional investors is limited.

Insider Purchases
Since August, insiders have spent $362k to purchase 73k shares in the open market. Given relatively low executive salaries I view these purchases as material. Further, they have come from five different insiders, including the CEO. Insiders as a whole own 19% of the company.

NOL
IEC has NOLs that it estimates will produce approximately $9M of cash tax benefits, or approximately $0.90 per share. The NOL should be largely exhausted within three years, so I don't think much discount is necessary for valuation purposes.

Competition
LaBarge was IEC's closest public peer. Other public semi-peers include Plexus, Benchmark, and CTS. All three trade for between 8x and 10x trailing EBITDA despite having worse end markets than IEC and thus lower margins and less growth.

Valuation
In 2012, IEC should do about $150M of revenue. Assuming an 8% EBIT margin, consistent with the past few years, EBIT would be $12M, and fully-taxed income would be about $7M, or roughly $0.60-0.65 per share. I can't foresee the timing of improvement at SCB so I don't view this as a hard target, but rather as a normalized earnings power figure.

LaBarge was acquired for 17x EPS. A more conservative 14x for IEC would suggest an $8.40 share price, almost 2x what you can buy shares for today. Add in the NOL, which has a cash value of $9M ($0.90 per share), and the price target rises to $9.30.

Valuation gets much more interesting looking out a few years. What if the company's 17% organic growth forecast proves accurate? A 17% revenue CAGR for five years would mean ~$290M of revenue in 2016. What if fixed cost leverage can generate a bit more margin? I assume, somewhat arbitrarily, that EBIT margin could improve to 9.5% from the current 8%-ish level. That would be 30bps of improvement per year. At that point, EPS would be roughly $1.50 (assuming 15% cumulative expansion in sharecount) and the company would have net cash, perhaps $1.00 or $2.00 per share of it. What would the stock trade for then? The same 14x multiple would call for a $21 stock, ignoring any net cash. A LaBarge-like 17x multiple would result in a $25 stock.

IEC is also a buyout candidate. I don't think the board will sell any time soon given how optimistic they are about the future, and I certainly hope they don't. But mid-sized CMs (Plexus, Benchmark, etc.) probably would not mind owning IEC given how starved they are for growth.