CPMT Calgary Portfolio Management Trust

Linde

Materials
NYSE: LIN
Market Outperform | Buy

September 30, 2020

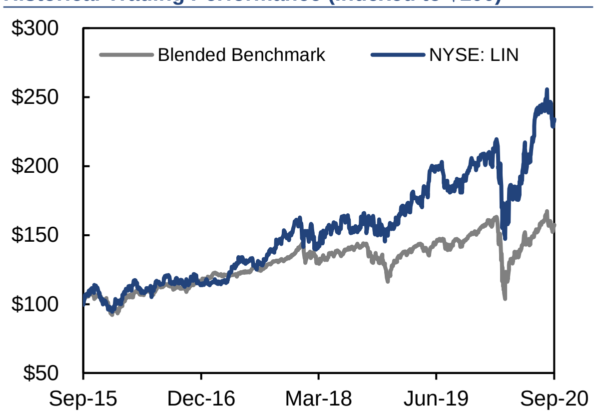
Akash Sekar, Portfolio Manager
Abhishek Sewak, Investment Analyst

Return on Investment	
Current Share Price	$238.13
Target Price	$270.00
Dividend Yield	1.62%
Holding Period Return	15%
Conviction Rating	2

Market Profile	
52-Week Range	$150.00 - $260.23
Market Capitalization (US$B)	$126
Net Debt (US$B)	$13
Enterprise Value (US$B)	$139
Beta (5-Year Monthly)	0.73

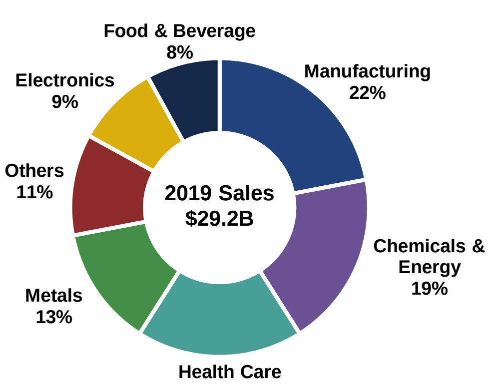
Metrics	2020E	2021E	2022E
Revenue (US$mm)	$26,764	$28,369	$29,539
EBITDA (US$mm)	$8,382	$9,213	$9,750
EPS	$7.78	$8.86	$9.76
EV/EBITDA	16.5x	15.0x	14.2x

Historical Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: End Markets Revenue



Source: Company Filings

Business Description

Linde Plc (NYSE: LIN), is world's largest industrial gas company, and is headquartered in Dublin, Ireland. LIN was formed in October 2018 through a business combination between Linde AG and Praxair and is known for being a major technological innovator in the industrial gas industry. The Company produces and distributes industrial gases through operating facilities which are designed and engineered in-house. The primary products for the industrial gas segment are atmospheric gases (oxygen, nitrogen, and argon) and process gases (carbon dioxide, helium, hydrogen, etc.). The Company also designs and builds equipment that produces industrial gases primarily for internal use, resulting in a wide range of gas production and processing services for the Company's customers.

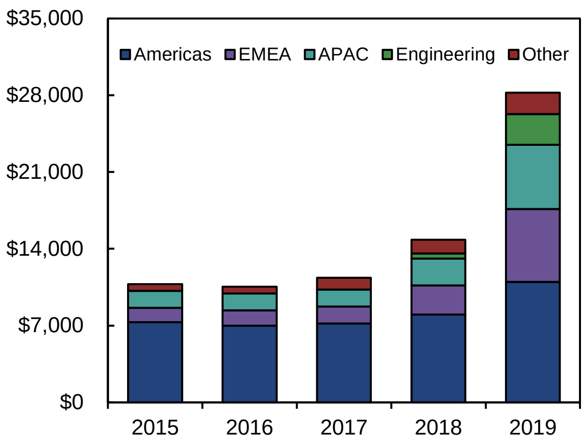
Merger of Praxair and Linde AG

On June 1, 2017, Linde AG and Praxair, Inc. announced their intentions to enter into a business combination agreement, creating a leading industrial gas company. The deal was financed through an all-stock merger of equal transaction, with the combined entity operating under the name "Linde Plc". The merger united Linde's extensive leadership in engineering and technology with Praxair's efficient operating model, creating the largest player in the global industrial gas business. This allowed for the combined entity to create a more diverse and balanced end-market portfolio while establishing strong positions in key geographies. The combined entity is expected to realize US$1.1B of synergies through cost reductions, most of which will manifest in 2020 and 2021. The combined entity diversifies its geographical reach and improves its financial stability emerging as a more sustainable enterprise. LIN reported annual sales of ~US$28B in 2019, compared to ~US$15B in 2018, an increase of approximately 90% YoY. The Company also reported an after-tax return on capital of 11.6%, representing a slight increase of 1.3% YoY. However, LIN has yet to realize the full potential after the merger and will continue to undergo cost reductions which are expected to result in margin expansion.

Industry Overview

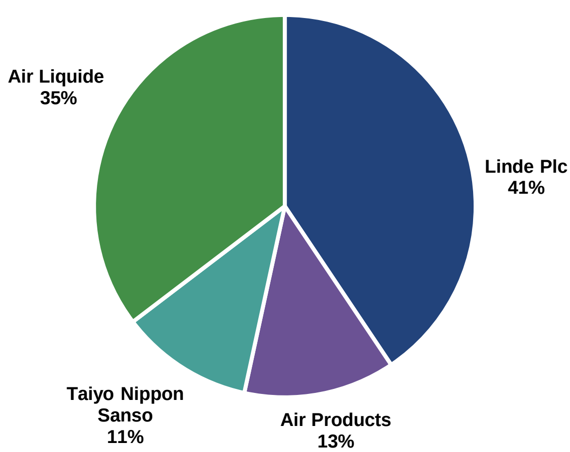
LIN operates in the highly concentrated global industrial gas industry. The industry has four major players (EPA: AI, NYSE: APD, NYSE: LIN, Taiyo Nippon Sanso), with LIN holding a significant 41% market share (Figure 3). Over the last few years, industry consolidation (Praxair/Linde, Air Liquide/Airgas) has allowed for an increase in pricing power, leading to increased profitability for companies in the space and giving rise to a competitive oligopoly. The industry tends to be less cyclical as compared to the overall chemical industry, which is highly fragmented and has growth heavily dictated by the direction of the economic environment. The industry is tied to global industrial production dynamics, which has seen declining demand across the world due to the COVID-19 pandemic but has began to pick up in recent months as stay-at-home restrictions are lifted. Players within the industry have focused over the last few decades on improving returns on capital by creating innovative solutions that can enhance product quality, energy efficiency and manufacturing productivity across a wide range of end-markets.

Figure 2: Segmented Revenue (US$mm)



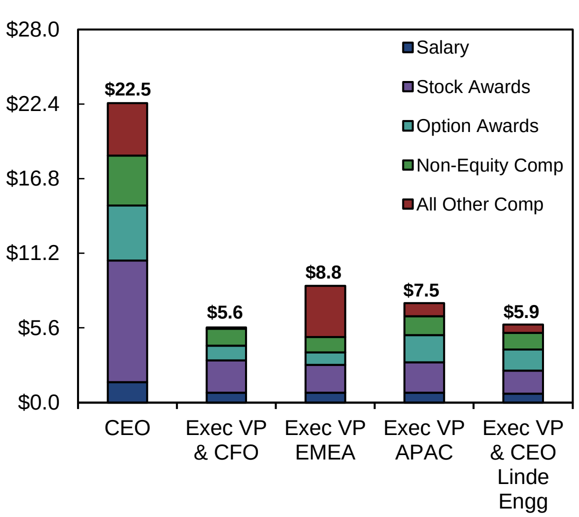
Source: Company Filings

Figure 3: Global Industrial Gas Market Share (2019)



Source: Company Filings

Figure 4: Total NEO Compensation (US$mm)



Source: Company Filings

Overall, in comparison to the broad chemical industry, the industrial gas market tends to be more defensive due to long-term supply contracts and large project backlogs. In addition to limited commodity price risk, this enables stable revenue streams as companies pass on the cost of raw materials through pricing formulas and tolling arrangements in their contracts with customers.

Operational Overview

LIN operates through three main modes: production, distribution and engineering. LIN uses air as a raw material and produces a large amount of atmospheric gases such as oxygen, nitrogen and argon through cryogenic air separation. The Company can also produce rare gases like krypton, neon and xenon through other air separation techniques. LIN's process gasses are usually produced through the separation of carbon dioxide (purchased from a chemical plant or refinery), which is then used to produce commercial and food grade carbon dioxide. The Company mainly produces hydrogen and carbon monoxide through steam methane reforming of natural gas, or by purifying by-products of chemical and petrochemical plants through the use of electrolysis.

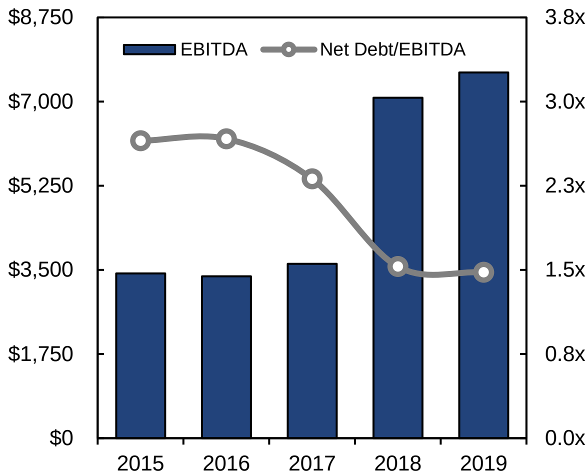
With respect to the distribution, LIN delivers its product to customers through three methods: 1) on-site; 2) merchant/liquid bulk; and 3) packaged gas. On-site delivery is primarily used for customers that require a large volume of product (usually oxygen, nitrogen and hydrogen), and are supplied to customers via pipeline, backed by requirement contracts ranging between 10-20 years. Merchant distribution is associated with liquid gases where deliveries are made by tanker trucks to customers' storage facilities; these are typically sourced through requirement contracts ranging between 3-7 years. Lastly, packaged gases are meant for customers requiring small volumes of gas that are distributed in cylinders. These are usually sold under short-term supply contracts that span 1-3 years. The Company delivered its products through all three main distribution modes prevalent in this industry, out of which the packaged mode accounted for 40% of all sales whereas merchant and on-site made up 28% and 24% of the total sales, respectively. LIN also has a global engineering business that focuses on a variety of gas plant and air separation markets and operates plants on behalf of customers under long-term gas supply contracts.

Mandate Fit

Strong Balance Sheet: Post-merger, LIN has been able to decrease its Net Debt/EBITDA significantly from ~2.3x to ~1.5x, which is ~1x lower than the industry median. LIN also boasts a strong 14.1x interest coverage ratio, which is well above the industry average of 5.1x. As LIN continues the integration process from the merger and further synergies are realized, it is expected that the Company will be able to achieve a ROE and ROA in the high single digits, bringing it closer to the levels Praxair had displayed as a standalone entity.

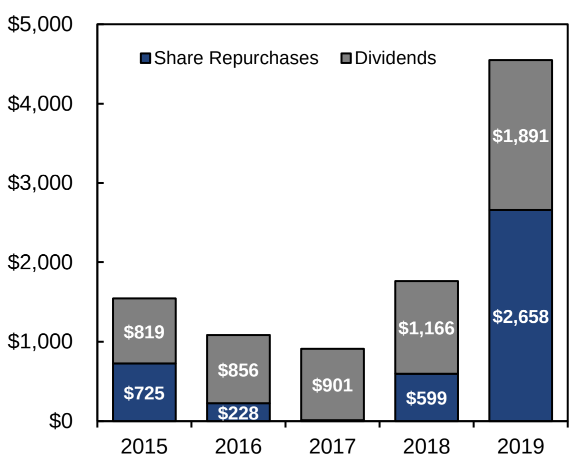
Competitive Advantage: The merger has provided LIN with economies of scale and expanded its global reach. LIN has been investing heavily in R&D to provide more sustainable products to its customers with increased profit margins. Due to the enhanced financial stability resulting from the merger, LIN has been able to venture into clean energy projects. The Company signed a memorandum of understanding with CNOOC to jointly develop China's hydrogen for the mobility industry. LIN is also be responsible for constructing the world's first hydrogen refueling station for passenger trains in Germany.

Figure 5: EBITDA (US$mm) & Net Debt/EBITDA



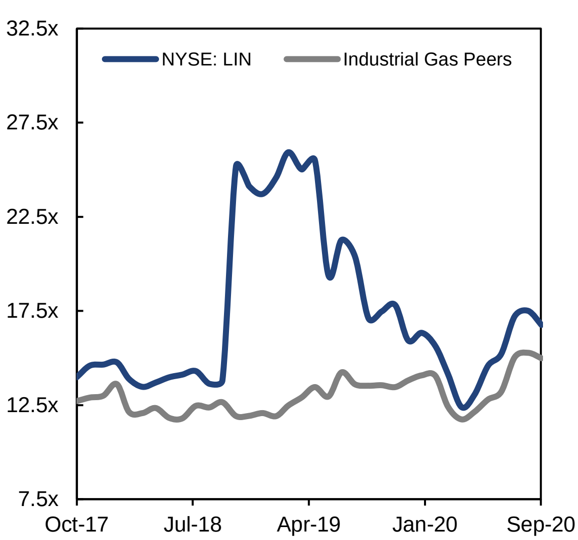
Source: Company Filings

Figure 6: Capital Returned to Shareholders (US$mm)



Source: Company Filings

Figure 7: EV/LTM EBITDA



Source: S&P Capital IQ

Growing Free Cash Flow: LIN has consistently been able to create value for shareholders, showcased through its ability to grow FCF over the last 5 years at an outstanding CAGR of ~17%. While this metric is inflated due to the merger of Praxair and Linde AG, the Company was able to grow FCFs by a CAGR of ~25% between 2012 and 2017, illustrating its history of strong FCF generation. LIN has also been able to maintain a solid EBITDA margin of ~29%, which is expected to exceed the low-30% margin that Praxair employed through cost synergies expected to be realized through 2021.

Strong Management Team: Stephen F. Angel, formerly led Praxair as its President and CEO, and now serves as the President and CEO of Linde. His extensive experience in the industry adds tremendous value to the combined entity. The Company has experienced robust sales growth and cost synergies through the merger and is expecting to realize additional synergies through 2021. LIN was able to return US$7.7B to shareholders in 2019. LIN also increased its annual dividend by 6% for 2019, with US$1.9B paid in total dividends in the year.

Attractive Valuation: LIN currently trades at an EV/LTM EBITDA multiple of 16.9x, which is slightly above the average multiple of its industrial gas peers (14.9x). Due to LIN's position as the largest industrial gas company in the world, coupled with its ability to leverage its engineering business, the CPMT believes LIN deserves to trade at a slight premium to its industrial gas peer group.

Key Risks

The pandemic has resulted in decreased industrial activity and increased demand uncertainty for industrial gases. Additionally, some of LIN's customers operating in the chemicals, energy, and metals industries are exposed to cyclical revenue generation which may adversely affect the demand for LIN's products. A second wave of the ongoing pandemic could result in another slowdown in industrial activity, which may lead to lower global demand for industrial gases. However, LIN's resilient business model, coupled with its large investments in clean energy projects, presents growth opportunities for the Company. LIN is well-positioned to continue its growth platform through its large, high-quality project backlog, supported by its defensive end-markets. Additionally, gradual improvement in China's industrial activity, increased orders from the healthcare sector and food & beverage storage facilities, and continued demand from space projects are expected to offset any headwinds in the event of a second wave.

Investment Thesis

LIN has continued work on integrating Praxair and Linde AG, which is expected to result in significant upside from cost reductions and cross-selling opportunities. Given increased industrial activity across the world, LIN can leverage its position as the world's largest industrial gas company to continue penetrating existing geographies and end-markets. This, coupled with its engineering segment should see the combined entity continue to lead the industrial gas industry in terms of returns to capital and profitability. Given that a large portion of LIN's management team is composed of Praxair executives, the CPMT believes that LIN will be able to successfully integrate the businesses by its stated goal of 2021 and realize most of its estimated ~US$1.1B of synergies. Due to the highly concentrated, oligopolistic nature of the industrial gas industry, we believe that LIN is well-positioned to take advantage of favorable pricing power and increasing industrial production around the world, leading to higher demand for industrial gases and Linde's expertise.