IEH Corp. – A Good Business at a Cheap Price, Undergoing a Promising Generational Transition

by Isaac Dimitrovsky, June 5, 2017

- IEHC's business has good qualities including high switching costs and long-lasting revenue streams.
- The stock valuation is cheap at a single-digit P/E, especially considering recent growth and the opportunity to tighten working capital management.
- A recent generational transition appears promising as the new CEO seems sharp and shareholder friendly.
- There are several levers to increase shareholder value, and the new management has already started to pull them.

In a recent annual letter, Warren Buffett credits Charlie Munger with convincing him that in the long run it's better to buy a good business at a reasonable price than a mediocre business at a cheap price. With all respect to those investing immortals, wouldn't it be even better to buy a good business at a cheap price? I believe IEH Corp. (IEHC) currently provides that opportunity.

Let's consider the “cheap price” part first, since that's pretty straightforward. Starting with the income statement, IEHC has grown revenues and earnings at a very respectable (if somewhat uneven) clip in the recent past. Over the past four reported fiscal years it has gone from 13.3M in revenue and 0.40 EPS to 19.36M and 0.73 EPS, though the current fiscal year is running a few percent down. With a current share price in the mid-6's, this gives a P/E below 10, which looks quite cheap considering that growth. Furthermore, a survey of the balance sheet makes things look even cheaper, since IEHC is carrying a substantial amount of excess working capital. With a market cap around 15M, the company has about 2.9M in cash and prepaid taxes, accounts receivable of another 2.4M, inventory of 8.5M (mostly raw materials), and total liabilities of only 1.3M. It seems that with some tighter management of working capital, around 5M in cash could be fairly easily be extracted from the ongoing business. For a business making about 1.7M in net income, this would move the valuation solidly into the “damn cheap” category.

Turning to the “good business” part, we'll start with some numeric tests of business quality, which generally indicate at least a pretty good business. For example, in the last complete fiscal year gross margin was around 34%, operating margin 16%, and after-tax ROIC over 15%. The aforementioned very respectable growth in sales and income also indicates the business offers some good opportunity for reinvestment over time.

Let's turn to some qualitative reasons IEHC might be a good business. (Some of what follows is based on my impressions from their last annual meeting, which was held in December at the company's headquarters in the historic Brooklyn Army Terminal).

Business summary: IEHC makes connectors that join electronic circuit boards to each other. These perform the same function as the connectors inside your laptop or smartphone, but instead of the pennies that those connectors cost, IEHC's connectors can sell for more than a whole laptop. That's because it's really, really important that they work perfectly every time they are plugged in and that they stay connected even under extremes of vibration and temperature. Their major markets include connectors used within commercial and military jet planes, other aerospace applications like missiles and rockets, and electronics that go “down the hole” in oil and gas production.

This suggests one reason IEHC is a good business. To use value investing parlance, it has a moat around it - the “penny-wise, pound-foolish” moat. Suppose a product manager considers saving money by substituting Blatz brand cut-rate connectors for the expensive IEHC ones in his jetliner. He'll surely notice that while the percentage saved on the connectors is high, it's a miniscule percentage of the jetliner's price. And, it would take lots of time and effort to test the new connectors, let alone to establish a long-term record of reliability matching IEHC's connectors. And, the consequences of a connector failure could be astronomically more costly than any possible savings from switching. This implies that once IEHC's connectors get into some program, it's very hard to dislodge them.

This opinion was strengthened at the annual meeting, particularly for military programs; management reported that IEHC is still doing volume manufacturing of some military components first designed 50 years ago, for example connectors that went into the first generation Patriot missile.

This leads to another nice qualitative property of IEHC's business – many of the projects they go into such as jet planes and missiles tend to last a long time and be expanded to new versions and markets over that time. IEHC gets the benefit of that expansion while the marketing and development costs are borne by other entities. In other words, many of IEHC's products, once established, are effectively long-lived annuities with some builtin growth.

Finally, I'll argue that IEHC might now be a particularly timely buy since it's passing through a promising generational transition. I've included links below to a number of good writeups covering IEHC over the past several years. You can consult these for more details, but I'll summarize by saying that, in past years, while IEHC was apparently well run from the customer and employee viewpoints, it fell short as far as running a tight ship to maximize shareholder value. The issues varied from the merely irritating such as late filings, to the substantive including paying a bizarrely high corporate tax rate of 46%, slack working capital management, and failure to return cash to shareholders.

These complaints fell under the tenure of long-term CEO Michael Offerman. Michael's son David joined the company in 2004, becoming VP of Sales/Marketing in 2011. He was quite successful in that role as reflected in the growth in recent years. The generational transition picked up steam in 2016 as David was elected to the Board of Directors along with two contemporaries, expanding the Board to six members from the previous three septuagenarians. The transition culminated on March 26 when, after Michael died suddenly, David was quickly selected to replace him as CEO.

I liked both Michael and David at the meeting, but got the impression Michael was relatively relaxed and less concerned about shareholder complaints, while David was sharper and more responsive to shareholder concerns. More concretely, as David took a greater role recently, some shareholder-friendly actions ensued, including the upgrading of IEHC stock trading from the pink sheets on March 17, and, more significantly, the announcement of an 0.25 dividend on May 22.

Catalysts:

Further shareholder-friendly actions including tighter management of working capital and lowering their corporate income tax rate (46% in the most recent FY).

Continued growth as IEHC has been executing well and some of their markets including civilian and military aerospace and energy, appear to be expanding.

Risks:

I can't come up with much, other than the usual asteroid-impact risks that imperil almost every company, such as technical breakthroughs rendering their products obsolete, or some scandal involving defective products. These seem unlikely considering IEHC's record over the past 75 years.

Conclusion:

IEHC is a good-quality business selling at a cheap valuation (*very* cheap taking the balance sheet into account). It looks particularly timely now, with new management that seems sharp and shareholder-friendly. There are a number of levers available to that management to increase shareholder value, and they have already started to pull them.

References:

IEHC website

SEC filings

A few good old writeups on IEHC – somewhat outdated, but useful background:

Bull, Bear and Value

No Name Stocks

OTC Adventures