Alloy Steel International – For the Loser Now Will be Later to Win, For the Catalysts, They Are a-Catalyzin'

by Isaac Dimitrovsky, June 19, 2017

- AYSI appears to be a good business with a differentiated product.
- The stock has been very cheap for a long time, likely due to concerns about management and exposure to the mining sector.
- Taking an updated look, many of these concerns now appear less concerning.

This writeup covers Alloy Steel International (AYSI), a company that has been the subject of quite a few previous writeups on SeekingAlpha, dating from six years ago to one year ago. I may therefore be charged with lack of originality. However, when it comes to investing I believe there's no shame in waiting for other people's ideas to develop, and then jumping in when the time is right. In Warren Buffett's vivid metaphor for patience in investing: “All day you wait for the pitch you like; then, when the fielders are asleep, you step up and hit it.”

In more detail, a substantial series of writeups by David Pinsen, Nat Hunt, Paolo Santos, Butterfield Capital, and Thinley Wangchuk over the past six years made some good arguments for AYSI on valuation and quality of business grounds, noted some concerns with management and with exposure to the mining sector, and predicted some upcoming catalysts that could unlock shareholder value. In spite of these predictions, AYSI's stock price is currently little changed from where it started that six year period, though it has gone through a few gyrations in that time. However, I believe those writeups may have been early rather than wrong - considering some recent developments, I believe AYSI is well deserving of another look. For, some of the predicted catalysts finally appear to be catalyzing, while some of the concerns now appear less concerning. And, lulled by the long wait, the fielders are still asleep (the stock price remains little changed).

Business Description

For a good description of AYSI's business and competitive landscape, see this SeekingAlpha writeup by Thinley Wangchuk from a couple of years ago; also check out AYSI's website. Briefly, AYSI makes Arcoplate, a product line of plates that protect mining and other material transporting equipment from wear, reducing required downtime and maintenance. Arcoplate also greatly reduces “hangup” of transported material on equipment, which can be a big problem since some material is quite sticky (for example, this page mentions carry-back rates as high as 23% for copper mining). Reducing hangup saves fuel and equipment wear caused by wasteful transport of carried-back material. According to AYSI, the resulting savings can be astonishingly large. For example, installing Arcoplate on a copper miner's fleet of Caterpillar

740B dump trucks was estimated to save $980,000 per truck per year versus alternative protective plates.

Arcoplate is exceptional for its high wear resistance and reduction of hangup. AYSI produces Arcoplate using a proprietary computerized process that bonds a uniform smooth, chromium-carbide-rich layer to a steel substrate in one pass. This process produces plates superior to competitive products in several ways:

- better wear resistance (due to hardness and low rate of cracks and other flaws)
- less material hangup (due to a low-friction, smooth finished surface)
- better ability to bend and shape.

AYSI's customers include mining giants such as Newmont (NEM) and Rio Tinto (RIO) – see detailed case studies for Rio Tinto, Newmont, and Wesfarmers Premier Coal on the AYSI website.

Cheap Valuation, But Some Concerns

As noted in many of the above writeups, AYSI's valuation was and is extremely cheap by any standard. With a market cap of around $21M, AYSI earned $2.1M in the **six months** ended March 31, 2017 for an annualized P/E around 5. AYSI also carries a substantial amount of excess working capital; as of March 31, it has $10.2M in cash, 3.5M in receivables, and a building in the process of being sold for which it expects to receive $4M; total liabilities are only $2.1M. However, the skeptical will note that cheap valuation has persisted for quite some time now. Helpfully, the previous writeups covered some of the concerns that might have caused this discount. I'll summarize them here, along with some recent developments that I think make them less concerning.

Concerns With Management

Arcoplate was invented over 25 years ago by Gene Kostecki, with the first commercial sale of Arcoplate in 1991. Alloy Steel International was incorporated in Delaware in Sept. 2000, acquired 100% of Alloy Steel Australia in June 2001, and was listed on the OTCBB in July 2001. Corporate governance was clearly a concern in subsequent years. Until 2009, the Board apparently consisted solely of Gene Kostecki, the Chairman and CEO, who owned over 60% of the outstanding shares, and CFO Alan Winduss – not exactly a good setup for vigilant Board oversight. And, sure enough, a number of shareholder-unfriendly actions ensued, including:

- AYSI decided to go dark (stop filing with the SEC) in Sept. 2010, and apparently only released sporadic financial reports for the next few years.

- In April 2010, AYSI decided to make a large investment to build a manufacturing plant in Indonesia, with rather extravagant projections of future demand.
- There were some questionable related-party agreements involving payments from AYSI to entities controlled by the Kostecki family – more on this below.

As described in David Pinsen's writeup, AYSI made a short-lived attempt at reform in Feb. 2011, bringing in three new Board members including a new Chairman and a new CEO, but within about six months these moves were largely reversed and Gene returned as CEO. It wasn't until Gene's death in April 2014 that some serious signs of change appeared, after Gene's son Steve had taken over as CEO (another son, Andrew, is head of North American operations). The positive changes have taken longer to develop than anticipated in the writeups above, but an updated look gives some pretty convincing evidence of a more shareholder-friendly management:

- Starting in Sept. 2014, AYSI resumed filing regular financial reports on otcmarkets.com.
- AYSI made the decision to reverse the Indonesian expansion, and take the more conservative route of expanding their Australian plant to meet demand. The Indonesian land and building were put up for sale; the 2017 AGM Information Statement reports a preliminary offer has been received. AYSI also wound up their Mongolian subsidiary in 2016 due to lack of activity.
- Last but not least, management appears to be serious about cleaning up related-party transactions, as detailed below.

Related-party transaction cleanup

AYSI is required to pay intellectual property license fees to a Kostecki-controlled entity for manufacture of Arcoplate. As reported in the 2017 AGM Information Statement, on Sept. 1 2016, AYSI reached a revised agreement that clarified the IP licensed to AYSI, kept the royalty rate at 6% of revenue, and extended the license for 25 years with three options to renew for another ten years each.

AYSI had long-standing agreements to buy steel and alloy raw materials from Matrix Metals, another Kostecki-controlled entity. On Nov. 18, 2016, AYSI acquired Matrix for $7.85M AUD. It's hard to tell for sure if this was a decent deal, but it seems in a reasonable range considering that it eliminates payment obligations that totaled $2.296M AUD in FY2016 and $4.123M AUD in FY2015. Steven Kostecki recused himself as director for review of the transaction. AYSI also got an independent assessment of the acquired assets from Ernst & Young, and reports the price paid fell within the indicated valuation range.

According to the Sept. 30, 2016 financials, the only related-party transactions remaining with the Kostecki family are the aforementioned clarified and extended IP license agreement, and the rental of AYSI's manufacturing facilities in Australia.

Exposure to the mining sector and currency fluctuations

AYSI is exposed to fluctuations in the notoriously cyclical mining industry, since a large part of its sales go there. However, the past few years have provided an opportunity to see how AYSI copes with a down-cycle and the result has been that AYSI's business has held up considerably better than the mining sector in general. For example, AYSI remained operationally profitable in FY2015 and FY2016, a grim period for mining companies in general (note currency fluctuations caused a small loss in FY2016). A possible explanation: AYSI's equipment offers miners big savings in costs and downtime; during a down-cycle, this could actually be more important for miners as they look to cut costs and conserve cash.

AYSI is also exposed to fluctuations in the Australian dollar, since a large part of its cash and revenues are denominated in Australian dollars. However, this is probably less of a concern now with the Australian dollar in the mid-70-cent range than a couple of years ago when it was above parity.

Catalysts

It appears management may be preparing AYSI for a sale, since some of the measures they've taken appear to be ones that would be desired or demanded by an acquirer (particularly the cleanup of related-party agreements). A sale would, of course, be one possible catalyst. However, an independent AYSI also seems fairly attractive, considering the cheap valuation, very strong balance sheet (likely further strengthened in the near future with the sale of the Indonesian plant), the cleaned-up corporate structure, and the apparently more shareholder-friendly management. In this case, near-term catalysts could include closing the sale of the Indonesian plant, and a decision to start returning capital to shareholders.