Patrick Industries, Inc. (PATK)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

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<tbody>
<tr>
<td>52WK H-L ($) :</td>
<td>53.62</td>
<td>Suitability:</td>
<td>Higher Risk</td>
<td>Q1</td>
<td>0.91A</td>
<td>0.88A</td>
<td>0.85A</td>
</tr>
<tr>
<td>Market Cap (mil):</td>
<td>1,248</td>
<td>Price Target ($) :</td>
<td>58</td>
<td>Q2</td>
<td>(0.09)E</td>
<td>0.60E</td>
<td>0.63E</td>
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<tr>
<td>Shares Out (mil):</td>
<td>23.3</td>
<td>L-Term Rev. Gr Rate Est:</td>
<td>8%</td>
<td>Q3</td>
<td>57.8%</td>
<td>57.8%</td>
<td>57.8%</td>
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<tr>
<td>Float (mil):</td>
<td>21.7</td>
<td>L-Term EPS Gr Rate Est:</td>
<td>12%</td>
<td>Q4</td>
<td>18.6%</td>
<td>18.6%</td>
<td>18.6%</td>
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<tr>
<td>Avg. Daily Vol (mil):</td>
<td>0.30</td>
<td>Debt/Cap:</td>
<td></td>
<td>Total</td>
<td>2.05E</td>
<td>3.05E</td>
<td>3.05E</td>
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<tr>
<td>Dividend ($) :</td>
<td>1.00</td>
<td>ROE:</td>
<td></td>
<td>FY P/E</td>
<td>26.2x</td>
<td>17.6x</td>
<td>17.6x</td>
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<tr>
<td>Yield (%):</td>
<td>1.9</td>
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<td></td>
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<tr>
<th>Headquartered</th>
<th>IPO/Founded</th>
<th>Dec</th>
<th>2020E</th>
<th>2021E</th>
<th>2022E</th>
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<tbody>
<tr>
<td>Elkhart, IN</td>
<td>1968 / 1959</td>
<td>Revenue (Mil)</td>
<td>1,991.0</td>
<td>2,145.5</td>
<td></td>
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<tr>
<td>Management</td>
<td></td>
<td>% Growth</td>
<td>(14.8)%</td>
<td>7.8%</td>
<td></td>
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<tr>
<td>CEO &amp; Director</td>
<td>Andy Nemeth</td>
<td>Operating Margin</td>
<td>6.6%</td>
<td>5.1%</td>
<td>5.9%</td>
</tr>
<tr>
<td>Interim CFO</td>
<td>John Forbes</td>
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Company Description

Patrick is a key partner to OEMs involved in making recreation vehicles and manufactured homes. The company manufactures decorative interior products and other components and distributes building products and other materials. OEMs value Patrick as a source of ideas to differentiate products in competitive markets – creativity that comes to life in The Studio, a design and innovation center opened in the heart of Elkhart, which is known as the RV capital of the world. Patrick is a leading consolidation platform in the recreation vehicle and manufactured housing industries, and has also acquired businesses in other industrial markets, such as marine. Since 2010, the company has acquired over 40 companies representing over $1.5 billion in annualized revenue.

Revenue Profile

Patrick Revenue Mix - 2019

Revenue mix by end-market

- RV 55%
- MH 19%
- Industrial 12%
- Marine 14%

Source: Company data, Baird research

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**Competition**

Patrick generally commands a strong market share position in its existing product lines, with share typically ranging anywhere from 20-70%, achieved through a combination of organic market share growth and acquired product lines. Broadly, content per unit growth is driven by new products, product extensions, acquisitions, market share gains, and changes in industry mix. The company estimates the addressable market for Patrick in RVs is approximately $4 billion ($6,300 per unit), while the addressable market in MH is roughly $900 million ($6,900 per unit). Existing content per unit and management’s estimate of the total addressable market imply that Patrick currently has 51% share of its addressable market in RVs (content of ~$3,200 per RV unit) and 67% of its addressable market in MH (content of ~$4,600 per MH unit).

**Quick Summary**

Patrick beat our previously lowered estimates and set a course to manage through the pandemic. With good liquidity, a highly variable cost structure, and fixed cost reductions, Patrick is well positioned to emerge from the crisis as a strong consolidator serving several attractive end markets. We maintain a cautious RV and marine outlook as demand falls and dealers limit orders but raised our estimates on better results and incremental cost cuts.
Investment Thesis

Price target. Our $58 price target for Patrick Industries is based on 17-18x our forward EPS estimate one year from now, above the five-year average (12-13x) as interest in outdoor recreation grows in the wake of the pandemic. It also takes into account solid FCF (~8% yield).

- **Key RV and MH supplier.** Patrick is a key partner to OEMs involved in producing RVs and MHs, emphasizing design and décor. The company manufactures decorative interior products and other components and distributes building products and other materials. OEMs value Patrick as a source of ideas to differentiate their products in competitive markets. Patrick’s newly introduced design and innovation center, termed “The Studio,” serves as a key differentiator. The Studio offers one space in which buyers and product managers can view Patrick’s suite of products, making the purchasing and design process easier for its customers.

- **Leading consolidator.** Patrick is a leading consolidator in the RV, MH, and industrial markets – and more recently has entered adjacent markets such as marine. Since 2010, Patrick has over 30 companies with acquired revenue of approximately $900 million. Management generally pays 5.0-6.5x EBITDA for well-run businesses with established product niches – seeking to expand market share and reduce costs. In 2016, Patrick acquired seven businesses – Parkland Plastics; The Progressive Group; Cana Cabinetry; Mishawaka Sheet Metal; L.S. Manufacturing, Inc.; BH Electronics, Inc.; and Sigma Wire & KRA Intl. – adding $167 million to annualized sales.

- **Healthy end markets.** Patrick manufactures and distributes products with demand tied to three primary end markets – RVs, MH, and residential housing. While we believe the RV market is later-cycle, given the consolidated industry has surpassed prior peak volume, we think there is good retail momentum early in the season. Additionally, we believe secular factors such as lower-priced units, attracting younger buyers to the RV lifestyle, and increased towing capacity support demand beyond prior peak. Meanwhile, our analysis of dealer inventory suggests inventory levels are balanced, supportive of the shipment growth forecasted by RVIA in 2017. In MH, the industry finished near 81K units in 2016 – just 22% of the 1998 peak (373K units) and 50% of the average from 2000-2006 (163K units). Given the low base and potential for an improvement in financing conditions, we believe this market can grow modestly. Finally, roughly half the demand for Patrick’s Industrial products is tied to residential housing. U.S. single-family housing starts reached 1.17 million in 2016, 43% below the 2005 peak. Pent-up demand and favorable fundamentals (e.g., income, credit) support continued growth in residential housing starts over the next several years.

- **Increasing content per unit.** Patrick generally commands a strong market share position in its existing product lines, with share typically ranging anywhere from 20-70%, achieved through a combination of organic market share growth and acquired product lines. Broadly, content per unit growth is driven by new products, product extensions, acquisitions, market share gains, and changes in industry mix. The company estimates the addressable market for Patrick in RVs is approximately $4 billion ($6,300 per unit), while the addressable market in MH is roughly $900 million ($6,900 per unit). Existing content per unit and management’s estimate of the total addressable market imply that Patrick currently has 50% share of its addressable market in RVs and 50% of its addressable market in MH. Net, management sees ample opportunity to increase content per unit in both the RV and MH industries.

- **Entering adjacent markets.** As a continuation of Patrick’s strategy to grow through acquisition, the company is also targeting growth in adjacent industries. The acquisition of BH Electronics, Inc. is one example of recent growth through adjacencies and was Patrick’s first solely marine-focused acquisition (the company had done two deals previously that provided marine exposure in addition to RV and Industrial end-market exposure). Management has articulated a longer-term strategy of becoming a supplier to broader leisure industries – and sees particular opportunity in the marine industry, given fragmented supplier and distribution models, as well as significant pent-up demand. Still, revenue from acquisitions in adjacent markets does not contribute materially to consolidated revenue today.

Risks & Caveats

- **Economic cycles.** Demand for RVs, MH, and residential housing is sensitive to economic conditions, especially wealth, credit, employment, consumer confidence, demographic trends, and tax policy. The current RV cycle has exceeded prior peak volume. An industry slowdown could cause channel partners to destock inventory.

- **Competitive market.** The RV and MH housing industries are highly competitive with low barriers to entry. Part of Patrick’s growth strategy relies on increasing its content per unit, whether organically by gaining market share in existing product lines or through acquisition. However, given the competitive nature of the industry, there is no guarantee Patrick will continue to increase its market share position.

- **Acquisitions.** Patrick has articulated a strategy to supplement organic growth in the business with growth through acquisition. As a result, success against its growth plans hinges, in part, on the company’s ability to continue acquiring businesses at reasonable multiples and integrating them effectively. We note that Patrick is not the only supplier working to roll up the RV and MH supplier industries – and the company faces competition sourcing deals from other large consolidators such as LCI Industries. Additionally, there is execution risk associated with acquiring and integrating larger and more complex businesses, completing more deals in a given year, and entering adjacent markets in which the company has less experience.

- **Access to credit.** Consumer demand for RVs, MH, and residential housing is sensitive to availability of consumer credit.

- **Customer concentration.** Patrick’s two largest customers (Thor and Forest River) represented a combined 49% of consolidated net sales in 2018.

- **Labor costs.** Patrick is experiencing labor shortages in its manufacturing facilities in Elkhart County as the RV industry continues to grow. The Elkhart County unemployment rate was just 2.7% in December 2019. Low unemployment in the Elkhart area may result in higher labor costs.
Cyber incidents or data breaches. Like all companies, Patrick is at risk from cyber security threats or data breaches, coming from items such as phishing scams. Recently, the company was a victim of a targeted email phishing message that resulted in the inadvertent disclosure of the W-2s for current and former employees. While Patrick maintains insurance to cover the company in the event of a data breach like this, data breaches like this could happen again in the future and the company's costs to insure against these incidents may also increase. And in a competitive labor market, the breach could be used against Patrick.

Lack of long-term supply contracts. Patrick does not have long-term supply contracts with customers. In addition to the risk of unanticipated customer attrition, Patrick bears the risk of accurately forecasting customer demand and maintaining appropriate inventory on hand to fulfill customer orders. The ability to accurately forecast inventory can be particularly troublesome if there is a sharp downturn in demand.

Raw materials. Patrick sources large quantities of raw materials, such as gypsum, lauan, particleboard, MDF, and aluminum as key inputs for its products. Prices for these inputs can be volatile and the company may not be able to pass along higher raw material costs to its customers. Additionally, Patrick sources a significant portion of its raw materials and other inputs from suppliers located in Indonesia, China, and Malaysia, which would be subject to a proposed (though increasingly less likely) border adjustment tax.

Financial leverage. As of December 2019, Patrick had net leverage of 3x debt/LTM adjusted EBITDA. Investors may consider this level of leverage high for a business in a cyclical industry.
Appendix – Important Disclosures and Analyst Certification

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Rating and Price Target History for: Patrick Industries, Inc. (PATK) as of 05-28-2020

3 Robert W. Baird & Co. Incorporated and/or its affiliates have received investment banking compensation from Patrick Industries, Inc. in the past 12 months.

1 Robert W. Baird & Co. Incorporated makes a market in the securities of PATK.

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