Siena Market Line
1st week of November 2015

Cabot Corporation

CBT: NYSE

Analyst: Mark Papuzza
Sector: Materials

BUY

Price Target: $44.36

Key Statistics as of 10/27/15

Market Price:	$35.82
Industry:	Chemicals
Market Cap:	$2.32 B
52-Week Range:	$30.70-49.69
Beta:	1.15

Thesis Points:

- Leading Producers
- Margin Restoration
- Financials – EBITDA margins, Free Cash Flow

Company Description:

Cabot Corporation operates as a specialty chemicals and performance materials company. The company manufactures and sells carbon black, fumed silica, plastics, ink jet colorants, tantalum, niobium, and germanium. Cabot Corporation's specialty fluids business produces and markets cesium formate as a drilling and completion fluid for use in oil and gas well operations. Cabot was founded in 1882 and is headquartered in Boston, Massachusetts.

Thesis

Cabot Corporation is a leading global specialty chemicals and performance materials company. The company produces a wide range of products for customers all over the world, and serves several industries including transportation, infrastructure and environment. Being the leading producer for several of their key products, combined with their current margin restoration process, Cabot Corporation will continue to improve their EBITDA margins and continue to create value for the company and increase the price of their stock.

Leading Producers

The specialty chemicals field is a highly competitive market. In order to succeed in this industry, it is essential to have a competitive advantage over the competition, and Cabot has just that. Cabot's competitive advantages includes their global manufacturing presence, product differentiation and technological leadership. With 46 facilities in 21 countries, Cabot's global presence is known. As for their product differentiation, the company has four major product segments: Reinforcement Materials, Purification Solutions, Performance Chemicals, and Specialty Fluids. Reinforcement materials is the largest segment, accounting for 58.6% of their revenue. Performance chemicals comes in next at 26.7% of their revenue, followed by purification solutions at 8.9% and lastly specialty fluids at 2.8%.

The reinforcement materials segment is the largest due to their production of carbon black, and Cabot is one of the leading manufacturers of carbon black in the world. Carbon black is a form of elemental carbon that is manufactured to produce particles of varied structure and surface chemistry, and ultimately serves a wide range of end results. It is made from the residual heavy oils derived from petroleum refining operations, from the distillation of coal tars, and natural gas. Cabot mainly focuses on rubber black products, which are used heavily in the tire industry. Rubber blacks act as a rubber reinforcement and improve the quality and performance in industrial products. Being that the majority of the company's production of rubber blacks goes into automotive products, the success of this product and the reinforcement materials sector depends on the demand of the automotive industry. Currently, the outlook on the automotive and tire industry looks strong. Overall mobility trends have been growing, and so the tire industry has followed suit. Demand has been growing fastest in North America and Europe, which can be credited to several factors including the decrease in oil and gas prices. Being one of the leading producers of a product essential to an industry that is growing can only lead to success for Cabot.

On top of carbon black, Cabot is also a leading producer of two other products needed worldwide. The company is a top producer of specialty compounds in Europe, the Middle East and Asia, and also of the product fumed silica. Fumed silica serves as a thickening agent in powders, and is essential for well-known products such as paint, printing ink and toothpaste.

Margin Restoration

Being that reinforcement materials is Cabot's key product segment, having a poor year profitability wise has taken a toll on the company. The reasons for the decline in profitability this year include the negative feedstock effects, the decrease in oil prices, and the negotiation of last year's contracts. This is the company's number one priority to take care of, and they have a margin restoration plan set to get back on the right path immediately. The price of carbon black will be increased to keep up with the rising costs of sustainability for the product. Cabot focuses on a "value over volume" approach, and so the price adjustment for carbon black is necessary. The benefit from the rise in price will be evident in the first quarter of 2016. This increase in price will not hurt Cabot's sales, as this product continues to grow in demand. With this demand, Cabot is in a stronger contract position and so contracts are expected to be more favorable this year. The full effect from the new contract negotiations will show in 2016.

This past week, Cabot made an announcement of their new restructure plan. This plan is expected to terminate approximately 300 positions globally, saving approximately $50 million. These savings will make an impact in the second quarter of 2016. This change in cost structure is intended to improve the company's competitiveness and will further help the margin restoration process.

Financials – EBITDA margins, Free Cash Flow

One of the most notable aspects on Cabot Corporation's balance sheet is the EBITDA margins. Cabot's EBITDA margins have consistently outgrown their revenue growth in each of the past four years, and is estimated to continue this trend in the upcoming years. This validates that the company is creating value, and eliminating operating expenses that are eating into their bottom line.

Another notable feature on Cabot's balance sheet is the company's free cash flow. Cabot has been tightly managing their CAPEX to maximize their free cash flow for the margin restoration process. They have had positive cash flow each of the past four years, and currently have a free cash flow of $249 million; the highest amount they have had in twenty-six years. At the rate they are going, Cabot is expected to finish the year with free cash flow of approximately $352 million, which would be the most the company has ever had.

Cabot's ratios are also worth noting when viewing their financials. The P/E ratio of the company is 16.45, compared to its peer's average P/E ratio of 21.97. This lower ratio can be used to view the company as undervalued. The P/E ratio does not take into account debt, however, and so the next ratio to look at will be the EV/EBITDA ratio. Cabot's EV/EBITDA ratio is 7.58, compared to its peer's average ratio of 11.24. While taking debt into account, this ratio determines the value of a company, and being that Cabot has a lower ratio than its peers the company can be viewed as undervalued. Another key ratio to view is the company's ROIC/WACC. This ratio comes out to 1.63, proving that the company is creating value.

This past quarter, Cabot repurchased 575,000 shares from the market for $24 million. The company has now repurchased 1,800,000 shares this year for a total of $80 million. At this time, Cabot believes the best investment they can make is in themselves. With the amount of shares Cabot has reduced from the market this year, it indicates that they believe the shares are undervalued. Also noteworthy, Cabot has consistently paid dividends each quarter they have operated. This goes hand in hand with the company's key objective of creating value for their shareholders.

Conclusion

I am recommending a buy on Cabot Corporation because they will continue to grow financially as a result of being the leading producers of the product carbon black, and as a result of their margin restoration process. The company will continue to grow their EBITDA margins, and will continue to make the necessary adjustments in their cost pricing and cost structure in order to create value for the company and increase the price of their share.

CENTER FOR GLOBAL FINANCIAL STUDIES

Cabot Corporation	cbt	Analyst Mark Papuzza	Current Price $35.82	Intrinsic Value $39.02	Target Value $44.36	Divident 2%	1-y Return: 26.2%	NEUTRAL

General Info		Peers	Market Cap.
Sector	Materials	Albemarle Corporation	$5,910.79
Industry	Chemicals		
Last Guidance	August 4, 2015	Axiall Corporation	$1,382.51
Next earnings date	November 2, 2015	Celanese Corporation	$10,253.66
Market Data		RPM International Inc.	$5,992.39
Enterprise value	$3,513.70	Koppers Holdings Inc.	$390.10
Market Capitalization	$43.77	Eastman Chemical Co.	$10,656.26
Daily volume	0.02	Air Products & Chemicals Inc.	$30,048.10
Shares outstanding	62.91	Trinseo SA	$1,518.46
Diluted shares outstanding	63.95	E. I. du Pont de Nemours and Com	$54,625.07
% shares held by institution:	7.43%	**Current Capital Structure**	
% shares held by insiders	1.10%	Total debt/Common Equity (LTM)	1.10
Short interest	1.16%	Cost of Borrowing (LTM)	4.61%
Days to cover short interes	2.03	Estimated Cost of new Borrowing	6.36%
52 week high	$48.40	Altman's Z	3.09
52-week low	$30.70	Estimated Debt Rating	CCC
5y Beta	1.69	Current levered Beta	1.37
6-month volatility	29.49%	LTM WACC	6.95%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Prevost, Patrick	Chief Executive Officer, President, Dire	$6,327,852	$5,781,798	$6,309,405
Cordeiro, Eduardo	Chief Financial Officer, Executive Vice	$1,931,357	$1,784,558	$2,028,843
Berube, Brian	Senior Vice President and General Cou	$1,440,305	$1,285,120	$1,428,715
Keohane, Sean	Executive Vice President and Presiden	$1,565,274	$1,359,352	$1,542,243
Kelly, James	Principal Accounting Officer, Vice Pres	$0	$0	$0
Kutsovsky, Yakov	Chief Technology Officer and Senior V	$0	$0	$0

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS	Standard Error of "Surprise"
Last Quarter	-10.44%	0.00%	-12.33%	3.83%
Last Quarter-1	-15.77%	-58.29%	-15.87%	14.16%
Last Quarter -2	-7.31%	3.91%	25.00%	9.47%
Last Quarter -3	-2.15%	7.04%	3.66%	2.68%
Last Quarter -4	-0.27%	0.00%	-2.22%	0.70%
Standard error	2.8%	12.3%	7.2%	4.60%
Standard Error of Revenues prediction	2.8%			
Imputed Standard Error of Op. Cost predicti	12.0%			
Imputed Standard Error of Non Op. Cost prc	NM			

Industry Outlook (Porter's Five Forces)

Bargaining Power of Suppliers (25th Percentile), Bargaining Power of Customers (43th Percentile), Intensity of Existing Rivalry (33th Percentile), Threat of Substitutes (100th Percentile), Threat of New Competition (100th

Proforma Assumptions

Convergence Assumptio

All base year ratios linearly converge towards the Sub-industry ratios over an explicit period of 5 years

General Assumptions

Money market rate (as of today)	0.35%
Risk-Free rate (long term estimate)	2.87%
Annual increase (decrease) in interest rates	0.1%
Marginal Tax Rate	37.5%
Country Risk Premium	5.5%

Forecast Year	Revenue Growth Forecast	Revenue ($) Forecast
LTM		$3,111.00
FY2015	-6.4%	$2,911.90
FY2016	1.9%	$2,967.22
FY2017	2.9%	$3,053.27
FY2018	7.7%	$3,288.37
FY2019	4.7%	$3,442.93
FY2020	3.9%	$3,575.48
FY2021	3.4%	$3,697.94
FY2022	3.2%	$3,816.74
FY2023	3.1%	$3,935.29
FY2024	3.1%	$4,055.44
Continuing Period	3.0%	$4,177.11

Items' Forecast Assumptions

	Base year (LTM)	Convergence period (Sub-industr	Adjustment per yea
Operating Cash/Rev.	0.00%	0.00%	0.0%
NWV/Rev.	21.83%	17.26%	-0.9%
NPPE/Rev.	45.87%	28.33%	-1.2%
Dpr/NPPE	12.26%	14.62%	0.2%
NOPAT MARGIN	7.33%	6.10%	-0.1%
Op. Exp./Rev.	83.93%	86.00%	0.1%
SBC/Rev.	0.48%	0.45%	0.0%
Rent Exp./Rev.	0.84%	0.00%	-0.1%
R&D/Rev.	1.83%	1.36%	0.0%
E&D/Rev.	0.00%	0.00%	0.0%
SG&A/Rev.	8.78%	8.56%	0.0%
ROIC	8%	12.49%	0.26%
EV/Rev.	1.14x	0.85x	-0.02x
EV/EBITA	10.40x	8.74x	-0.11x
Debt/Equity	110%	128%	1.2%
Unlevered beta	0.81	0.94	0.01
Dividends/REV	2%	1%	0.0%

Other Assumptions

Tobin's Q	80%
Excess cash reinvestment	Money market rate
Other claims on the firm's asse!	$0.00

Capitalization

100% of all rent expenses are capitalized and amortized 'straightline' over 10 years
100% of all R&D expenses are capitalized and amortized 'straightline' over 10 years
E&P expenses are not capitalized
SG&A expenses are not capitalized

Valuation Focus

DCF Valuation	100%
Relative valuation	0%
Distress Valuation	0%

Monte Carlo Simulation Assumptions

Revenue Growth deviation	Normal (0%, 1%)
Operating expense deviation	Normal (0%, 1%)
Continuing Period growth	Triangular (5.335%, 5.5%, 5.665%)
Country risk premium	Triangular (2.91%, 3%, 3.09%)
Intrinsic value σ(ε)	$0.09
1-year target price σ(ε)	$0.10

Valuation

Forecast Year	ROIC	WACC	Invested Capital	Implied Enterprise Value	Claims on Assets and Dilution	Shares Outstandin	Price per Share
LTM	8.3%	6.9%	$2,663.37	$3,838.87	$1,475.02	62.91	$36.66
FY2015	8.0%	6.8%	$2,381.98	$3,605.45	$891.83	62.91	$43.91
FY2016	9.4%	7.0%	$2,338.30	$3,591.58	$803.69	62.91	$45.29
FY2017	9.8%	7.2%	$2,329.72	$3,612.07	$668.10	62.91	$48.58
FY2018	10.5%	7.3%	$2,436.65	$3,739.61	$579.24	62.91	$51.48
FY2019	10.4%	7.5%	$2,478.24	$3,807.47	$400.07	62.91	$49.76
FY2020	10.6%	7.9%	$2,573.63	$3,941.01	$353.28	62.91	$52.28
FY2021	10.6%	8.0%	$2,662.47	$4,073.86	$285.07	62.91	$55.06
FY2022	10.5%	8.1%	$2,749.06	$4,210.80	$222.95	62.91	$57.92
FY2023	10.5%	8.2%	$2,835.69	$4,354.79	$154.35	62.91	$60.99
FY2024	10.5%	8.3%	$2,923.59	$4,507.86	$80.60	62.91	$64.26
Continuing Period	12.5%	8.4%	$2,040.30				

Monte Carlo Simulation Results

The 3σ(ε)-adjusted intrinsic value is $39.02; the 3σ(ε)-adjusted target price is $44.36; and the analysts' median target price is $46.4

Sensitivity Analysis

Revenue growth variations account for 95.9% of total varianc
Risk premium's variations account for 2.5% of total variance
Operating expenses' variations account for 1.4% of total varia
Continuing period growth variations account for 0.2% of tota