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Landstar System Inc (LSTR: NASDAQ)

Financial Analysis By: Kevin Akbaraly – Industrials

Company Profile as of 2/18/2015

Market Price: $68.51
Industry: Road and Rail
Market Cap: $3,065M
52-Week: $56.44 - $80.61
Beta: 0.90

Source	Target Price	Recommendation
Siena	$83.70	BUY
Capital IQ	$74.14	OUTPERFORM
Yahoo Finance	$74.00	HOLD
Bloomberg	$74.46	BUY

Thesis

- Favorable macro outlook for the trucking industry
- Well positioned to benefit from expected market conditions
- Increase in operating margins expected through 2017
- Potential share repurchase during the year
- Current stock price offers an entry opportunity

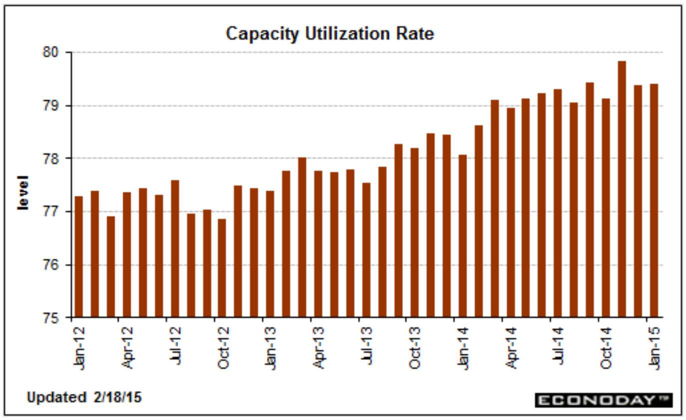
A BUY is recommended on Landstar System Inc. with a 1-year target price of $83.70 representing an upside potential of 24% compared to the current market price. Current market conditions are expected to remain strong through 2015. The company's particular business model could highly benefit from the expected macroeconomic trend, leading to growing revenues and improving operating margins. Also, the company could potentially distribute additional returns to shareholders through a share repurchase around the second quarter of 2015.

Company Overview

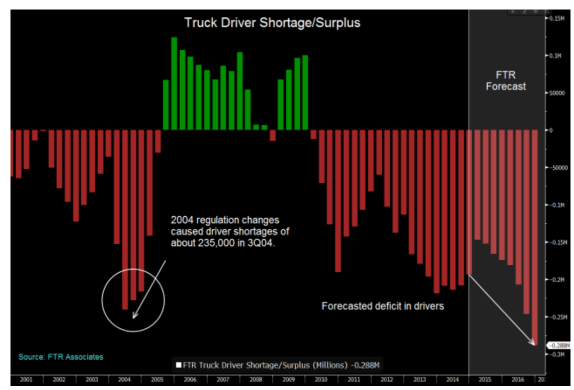
Landstar System Inc provides transportation management solutions within the U.S., Canada, and Mexico. The company offers a wide range of solutions that serves a broad number of customers by using its network of independent agents, third-party capacity owners and employees. Landstar has been founded in 1991 and is headquartered in Jacksonville, Florida.

Macro Outlook

The trucking industry is an essential component of the American economy as it services different sectors that require transportation of raw materials, finished goods, machinery, and other goods across the country and internationally. Since the Credit Crisis of 2008, the U.S. government has continuously aimed at reducing the unemployment rate to help the economy recover and gain in productivity. The BEA reported 2.4% GDP growth in 2014 from 2013, the highest full-year growth since 2010, and is expected to grow around 3% during 2015. The Industrial Production index showed a 4% year-over-year growth in 2014, and the Capacity Utilization rate reflecting the use of the nation's factories, mines and utilities recently reached its highest range with 79%-80% since 2008. The industry is dependent on a wide range of different markets such as the housing, automotive, machinery, retail, materials and oil & gas production. Although the latter is actually experiencing a slowdown due to lower energy prices, other industries are actively participating in the economy's expansion, which should lead to higher demand for goods transportation. Additionally, the expansion of both Canadian and Mexican economies could also lead to higher cross-border opportunities in the future.



One concern that is shared among the trucking industry is the driver shortage that is experienced since early 2010. Indeed, the aging driver workforce coupled with "intrusive" government's regulations has led to a decrease in both the number of available drivers and productivity in recent years. The Federal Motor Carrier Safety Administration has eased the hours-of-service regulation on December 2014, which aimed at limiting the number of hours spent driving and working since 1938. This new measure represents only a small change compared to prior rules, but it is expected to help slightly increase productivity among the industry. However, the deficit in drivers is still expected to exceed 2004 levels by the end of 2016 with 288,200. As a result, an increase in wage expense helps companies to retain their drivers, and related costs are directly transferred to shippers. Also, due to a limited supply, companies have more incentive to raise their prices accordingly in order to meet the demand side. FTR Transportation Intelligence estimates at least 4.4% increase in rates through 2016.



All Sectors	
Sectors vs. S&P 500	1 Year Performance
S&P 500 Index	+16.38%
Transportation	+24.39%
Medical	+19.50%
Retail / Wholesale	+16.59%
Computer and Technology	+16.54%
Business Services	+12.96%
Consumer Staples	+12.46%
Aerospace	+11.52%
Finance	+8.93%
Consumer Discretionary	+6.57%
Utilities	+5.90%
Auto / Tires / Trucks	+4.84%
Construction	+4.53%
Multi-Sector Conglomerates	+4.47%
Industrial Products	+2.72%
Basic Materials	-2.47%
Oils / Energy	-6.12%

Another factor impacting the trucking industry is related to oil prices. The commodity has seen an important downtrend since mid-2014, which led to more than 50% drop in prices. This can impact the trucking industry in two different ways. First, companies operating within the industry could benefit from lower gas prices, which in turn would lead to an increase in operating margins, or lower prices for shippers. Secondly, oil is also a major commodity that needs to be transported all around the world. Lower oil prices could lead oil companies to lower their production, which would therefore lower the needs of oil transportation. Recently, U.S. energy companies have increased their production level; however, a decline in production can be expected due to the number of companies struggling to survive.

Currently, the Transportation sector is the best performer year-to-date with 24.4% increase compared to 16.4% for the S&P500 index. This performance is almost 5% higher than for the Medical sector. Following the recent market environment and 2015 macroeconomic outlook, the

Transportation sector, and especially the Trucking industry could offer investors an attractive opportunity. As stated above, demand is expected to increase; supply is expected to remain limited, which in turn could lead to higher shipping rates and revenues. On the other hand, some attention should be given to the energy industry, which could also impact the demand for oil & gas transportation over the next year.

Landstar System Inc's Business Model

Landstar System Inc (LSTR) offers transportation management services to its customers through different transportation modes both domestically and globally. The company's goal is to offer its clients a solution for all their transportation and logistics needs from enterprise-wide to small shipping solutions including logistics and warehousing solutions. LSTR's main solutions include trucking, air and ocean freight, but also include documentation preparation, coordination and insurance (accounting only for 1% to 2% of revenues)

LSTR operations are based through the use of independent agents, business capacity owners and third-party capacity providers. Independent agents represent the company's sales workforce that are not directly employed by LSTR, but who have entered into contractual arrangements with the company. Their role is to market and provide their clients LSTR's transportation and logistics solutions. Once they receive an order from a client, they have to inform LSTR through the use of the company's internet-based application. Independent agents are paid based on a fixed rate of revenue for each deal they provide to LSTR. As of December 2013, the company reported 478 independent agents within their network generating $1 million or more of revenue (referred to as Million Dollar Agents). The average revenue per MDA was $5,081,000, and their contribution represented 91% of LSTR's total revenues. On January 29th, 2015, the company announced that its MDA network increased to 525, and increased their revenues by 18% during the year. Agents are spread all over the U.S. offering LSTR a competitive advantage in terms of geographic location, and do not need the company to increase its capital expenditures to gain market recognition. The company reported in its 2013 10-K that it "believes the company has more independent commission sales agents than any other asset-light integrated transportation management solutions company". Additionally, LSTR is protected by a non-competition agreement that has been agreed upon a contractual agreement with its independent contractors, which limits them to represent exclusively LSTR. The annual termination rate is about 3% or less.

Third-party capacity providers represent the external individuals or entities that provide LSTR with the vehicles needed by the company to perform its services. The company relies on different types of third-parties that are Business Capacity Owner (BCO) independent contractors, Truck Brokerage Carriers (TBC), air and ocean cargo carriers and railroads. Trucks provided by BCO contractors are using exclusive lease arrangements, while TBC and railroads capacity is provided through non-exclusive contractual arrangements. LSTR accounted 8,432 exclusive trucks provided by BCO contractors and 32,000 approved non-exclusive trucks that can be provided by TBCs. On January 29th, 2015, the company estimated its total truck capacity network at over 46,000. The management team stated that it believes LSTR has the highest number of trucks provided by BCO independent contractors within the United States. BCO, TBC and railroads contributes to about 50%, 43% and 3% of company's revenues respectively. Deals involving BCOs generally leads to higher gross profit margins compared to TBCs, but also incurs higher SG&A expenses. These third-parties are also spread all over the country, which increase substantially the company's presence and limits LSTR's capital expenditure requirements. Therefore, the company is able to meet the demand side coming from its independent agent network. All third-party capacity providers are generally compensated based on a fixed percentage of revenue related to the freight they haul.

Landstar's success has been built around its network's entrepreneurial spirit as it does not own tractors or employs drivers itself. This innovative business model provides the company many advantages that allow it to be efficient, and lower fixed costs at the same time. Indeed, an important portion of the company's operating costs are directly linked to the revenues it generates because it uses a compensation rate based on each shipment made. Also, because both agents and capacity providers are independent from LSTR, the quality of services provided to customers remain high in order for them to build a good relationship and continue to work along in the future.

Porter's Fiver Forces

Barrier to New Entrants

The threat of new entrants is considered to be moderate. Indeed, companies entering the trucking industry generally need to invest considerably in capital expenditure including vehicles and warehouses, in marketing and in the development of a network. The high competition could discourage potential entrants. However, due to the industry's fragmentation, one could also take advantage of an underserved sub-market. Another threat would also be related to small companies operating within small geographic areas, but current market conditions would favor global transportation and logistics solutions rather than local ones, emphasizing even more the need of initial capital expenditures.

LSTR's business model helps in the development of its competitive advantage. The use of independent sale agents and capacity providers has enabled the company to expand its presence all over the U.S. by limiting its needs of capital expenditures. Additionally, each member of the company's network often specialize within a specific market area, limiting LSTR's risks related to the industry's operational and geographic fragmentation.

Clients' Bargaining Power

Clients' bargaining power is considered to be low. As stated above, current market conditions show a rebound in productivity and economic expansion. Demand for goods transportation is expected to remain high during 2015, and supply is currently impacted by a driver shortage that is expected to worsen through 2016. Goods transportation is an essential component of economic expansion, and demand should come from various different sectors. Based on the demand and supply theory, shipment rates within the industry are expected to rise by at least 4.4% during 2015, and could see an upward pressure if economic conditions turn to be better than expected.

LSTR has stated during its Q4 earning call that their revenues were generated through a well-diversified client portfolio, and that they would raise prices according to market conditions. The company also expects an increase in operating margins through 2017.

Supplier's Bargaining Power

Supplier's bargaining power is considered to be moderate to high. "Supplier" has to be divided into two components here. First, truck manufacturers do not, and are not expected to put any pressure in terms of supply or increase in prices. Secondly, as stated above, driver shortage is a rising concern for the industry and is expected to worsen through 2016. The reasons that are causing this trend are an increase in the number of driver retiring, but also general complaints about wages and work conditions. Wage expenses are expected to rise over 2015 in order for companies to attract and retain drivers, but costs should be transferred to shippers following current market conditions.

LSTR is limiting its risks related to capacity shortage by its use of exclusive and non-exclusive contractual agreements with third-parties. The company reported that it has more BCO independent contractors than any other companies within the U.S. and that wage rates offered by third-parties were competitive among the industry, which help LSTR maintain a descent level of transport capacity.

Threat of Substitutes

Transportation can hardly be substituted. Indeed, goods transportation is an essential part of any economy, and without it, a country could suffer a brutal downturn in terms of sustainability. Different transportation modes are offered to clients depending on their needs. These solutions include road, rail, air, and ocean transportation.

LSTR is currently offering its services through all possible transportation modes within the U.S. and to a lesser extent to Canada and Mexico. However, trucking represents more than 90% of company's revenues and is the main driver for growth.

Industry Rivalry

The trucking industry is highly competitive and fragmented. Generally, companies operating within this industry specialize in a specific area from small packages or mailing services to massive machinery transportation, but also on a certain geographic area. Currently, there is a tendency to see a consolidation within the industry, helping companies gain in recognition and market share over the long term.

LSTR has been able to develop a business model that offers many advantages regarding current market conditions. Indeed, the company has found a way to limit its need in capital expenditure by expanding its visibility and capacity at the same time. Additionally, the company is able to take advantage of the current industry's fragmentation by offering its clients a portfolio of different solutions that respond to almost all transportation and logistics needs. The company is currently well positioned to benefit from market conditions that are expected during 2015 by increasing its revenues and margins over the year.

Management

Jim B. Gattoni has recently been promoted President and **CEO** of Landstar System Inc in December 2014. Mr Gattoni is a Certified Public Accountant and has joined the company in 1995 as Corporate Controller. He has been promoted as CFO and Vice President in 2007, a position that he held until he has been promoted CEO. Prior to LSTR, MR Gattoni was employed by KPMG within the audit division where he worked from 1987 to 1995. Mr Gattoni is well respected for his experience and knowledge within both the company and the industry.

Kevin Stout has been promoted as **CFO** in December 2014 following Mr. Gattoni's promotion. Mr. Stout joined Landstar in 1997 as Director of Financial Reporting. He has then been promoted as Director of Budget and Planning in 2003, and as President of Finance for the Landstar Carrier Group in 2004. He worked as Vice President and Corporate Controller as well from 2007 to 2014. Mr. Gattoni and Mr. Stout have been working together during 17 years, and he is highly trusted for his integrity, work ethic, and experience within the transportation industry.

Other executive members have been working for the company for more than 10 years in average. The executive team is considered solid and well experienced, which can bring the company forward in the future.

Key Statistics

In Millions of USD	FY 2011	FY 2012	FY 2013	FY 2014	Current/LTM	FY 2015 Est	FY 2016 Est
12 Months Ending	2011-12-31	2012-12-29	2013-12-28	2014-12-27	2014-12-27	2015-12-31	2016-12-31
Revenue	2,650.8	2,772.4	2,666.3	3,186.2	3,186.2	3,456.0	3,710.4
Growth %, YoY	10.4	4.6	-3.8	19.5	19.5	8.5	7.4
Gross Profit	407.8	398.7	380.3	446.7	446.7	793.2	646.8
Margin %	15.4	14.4	14.3	14.0	14.0	23.0	17.4
EBITDA	209.1	226.0	204.3	251.9	251.9	278.7	303.5
Margin %	7.9	8.2	7.7	7.9	7.9	8.1	8.2
Net Income Before XO	112.9	126.6	108.9	138.8	138.8	152.8	167.5
Margin %	4.3	4.6	4.1	4.4	4.4	4.4	4.5
Adjusted EPS	2.38	2.77	2.42	3.07	3.09	3.46	3.88
Growth %, YoY	30.8	16.4	-12.6	26.9	24.6	12.8	12.1

Landstar System Inc. reported $3,1863M of revenue for FY2014 representing an 19.50% growth compared to FY2013. On January 29th, 2015, the company announced $863M of revenue for Q4 2014 representing 25% growth compared to Q4 2013, which also represents the highest revenue reported quarterly, as well as annually for the company so far. Expectations were ranging $820M to $840M for the period. The management team stated that this performance was the result of significant opportunities "based across many industry segments, customers, and geographic regions".

Gross margins represented 14.02% of revenues for FY2014, a slight decrease from 14.26% during 2013, while operating margins increased to 7.04% from 6.62%. Net Income was $38.5M for FY2014 compared to $36.8M for FY2013, representing a 4.4% net margin for both yearly periods. The company stated during its most recent earning call that the company is aiming at improving operating margins through 2017.

The number of Million Dollar Agents has increased to 525 from 478 in FY2013. Also, the number of trucks provided by third parties has increased to more than 46,000, and are both expected to help the company capitalize over expected market conditions in the future. The termination rate of MDAs is still under 3% as of January 2015.

LSTR has discontinued its operations in December 2013 within the "Supply Chain" division that it acquired in 2009. The reason of that strategy was to focus further on its Transportation and Logistics division, which accounts for 98.6% of company's total revenues. The reminder 1.4% goes to the Insurance segment, which generated $36.6M, up from $35.9M in 2013.
The company reported $37M gain from the transaction, and announced a $1 special dividend during the year to shareholders.

Finally, the company also stated that the management was continuously looking for acquisition opportunities to consolidate its operations within the industry. However, LSTR does not foresee any potential target through 2015. It has been stated that the company might distribute some cash to shareholders during the year, which currently accounts for 15% of total assets on the balance sheet. The company bought back 940,000 shares around the second quarter of 2014, and still has 1.8M shares authorized under its repurchase program. Investors can therefore anticipate a potential share repurchase that may be announced around Q2 2015.

Valuation

The valuation of Landstar System Inc. has been made using a proforma that is presented on the last page of this report.
Revenue growth for FY2015 and FY2016 reflects market's expectations with 8.5% and 7.4% respectively. The growth rate has then been reduced to 3% by 1% decrement year over year to reflect an expected long-term growth of 3%. Operating costs over revenues for FY2015 has been estimated at 92% reflecting FY2014 level, and reduced to 90% by 1% decrements year-over-year to reflect management's focus on reducing operating costs. However, this reduction has been made in a conservative manner, and is still well above the industry average representing a 10-year median of 88% to reflect LSTR's particular business model. Unlevered beta has been set at 1.00 even though the 10-year median is about 0.77 only and the company's debt has been reduced to its all-time low. This approach is considered to be conservative in order to do not underestimate WACC levels over the future. Finally, 60% of SG&A expenses have been capitalized over 10 years in order to reflect the company's investments made in its technological applications that are provided to its sale agents network and third-party capacity provider. Indeed, the company launched its new smartphone-enabled GPS tracking tool called Landstar Connect, which provided timely in-transit visibility.

The 1-year target price expected is therefore $83.70, representing 24% upside potential based on current market price.

Conclusion

To conclude, a BUY is recommended on Landstar System Inc. (LSTR) with a target price of $83.70 representing a 24% upside potential compared to current market price. The company shows an innovative business model offering transportation and logistics solutions to its clients within the U.S., Canada, and Mexico. Current market conditions are expected to remain strong through 2015, and LSTR seems to be well-positioned to take benefit of this macroeconomic trend. Growing revenues and improving operating margins are expected over the next years. The company may also distribute some additional return to shareholders through a share repurchase around the second quarter of 2015. Finally, current share price level could offer investors an interesting entry opportunity.

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Landstar System Inc.	LSTR	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	Target Return	BUY
		Kevin Akbaraly	$68.51	$72.47	$83.70	2%	24.04%	

General Info

Sector	Industrials
Industry	Road and Rail
Last Guidance	Jan-29-2015
Next earnings date	4/23/2015

Market Data

Enterprise value	$3,013.87
Market Capitalization	$3,068.87
Daily volume	0.33
Shares outstanding	44.79
Diluted shares outstanding	45.17
% shares held by institutions	105.89%
% shares held by insiders	0.77%
Short interest	4.34%
Days to cover short interest	4.03
52 week high	$81.80
52-week low	$57.28
5y Beta	0.90
6-month volatility	18.21%

Peers	Market Cap.
Werner Enterprises Inc	$2,251.91
Swift Transportation Company	$3,867.47
Con-way Inc	$2,546.74
Knight Transportation Inc	$2,655.16

Current Capital Structure

Total debt/market cap	4.84%
Cost of Borrowing	2.31%
Interest Coverage	7062.39%
Altman Z	9.00
Debt Rating	AAA
Levered Beta	1.03
WACC (based on market value weights)	8.24%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Gerkens, Henry	Executive Chairman, Member of	$ 2,159,263.00	$ 6,655,121.00	$ -
Gattoni, James	Chief Executive Officer and Presi	$ 2,013,507.00	$ 1,413,014.00	$ -
Beacom, Joseph	Chief Safety & Operations Office	$ 1,496,682.00	$ 1,065,308.00	$ -
Kneller, Michael	Vice President, General Counsel	$ 1,487,992.00	$ 1,074,335.00	$ -
O'Malley, Patrick	Chief Commercial & Marketing (	$ 1,505,442.00	$ 1,085,487.00	$ -
Stout, L.	Chief Financial Officer, Secretary,	$ -	$ -	$ -

Historical Performance

	LSTR	Peers	Industry	All U.S. firms
Growth	1.5%	3.2%	4.6%	6.0%
Retention Ratio	24.4%	50.2%	31.6%	61.6%
ROIC	22.0%	11.6%	20.3%	11.8%
EBITA Margin	7.0%	6.6%	10.0%	13.7%
Revenues/Invested capital	198.2%	172.8%	240.1%	202.3%
Excess Cash/Revenue	4.5%	4.7%	4.8%	18.5%
Unlevered Beta	0.77	1.09	0.87	0.95
TEV/REV	0.9x	0.9x	1.1x	2.4x
TEV/EBITDA	11.7x	7.3x	9.0x	11.3x
TEV/EBITA	12.9x	13.3x	15.5x	15.4x
TEV/UFCF	34.1x	42.2x	32.2x	26.8x

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS
Last Quarter	3.4%	2.6%	6.2%
Last Quarter-1	-0.1%	1.4%	1.2%
Last Quarter -2	3.9%	1.8%	2.6%
Last Quarter -3	3.2%	2.0%	3.4%
Last Quarter -4	3.4%	-14.1%	-16.7%

Non GAAP Adjustments

Operating Leases Capitalization	100%	Straightline	10 years
R&D Exp. Capitalization	100%	Straightline	10 years
Expl./Drilling Exp. Capitalization	0%	N/A	N/A
SG&A Capitalization	60%	Straightline	10 years

Proforma Assumptions / **Forecasted Profitability**

		Period	Rev. Growth	Adj. Op. Cost/Rev	Revenue	NOPLAT	Invested capital	UFCF
Operating. Cash/Cash	0.0%	LTM	19%	85%	$3,186.17	$170.91	$1,124.67	$631.84
Unlevered Beta	1.00	LTM+1Y	9%	86%	$3,457.71	$201.09	$1,659.33	$127.57
Rev/Invested Capital	200.0%	LTM+2Y	7%	85%	$3,713.43	$260.68	$1,740.20	$179.81
Continuing Period Revenue Growth	3.0%	LTM+3Y	6%	84%	$3,936.13	$312.06	$1,825.09	$227.18
Long Term ROIC	13.6%	LTM+4Y	5%	84%	$4,132.82	$335.06	$1,913.38	$246.76
Invested Capital Growth	Equals to Maintenance	LTM+5Y	4%	84%	$4,298.01	$351.27	$2,002.23	$262.42
Justified TEV/REV	1.1x	LTM+6Y	3%	84%	$4,426.95	$362.07	$2,084.79	$279.52
Justified TEV/EBITDA	9.0x	LTM+7Y	3%	84%	$4,559.76	$372.52	$2,164.57	$292.74
Justified TEV/EBITA	13.3x	LTM+8Y	3%	84%	$4,696.56	$383.05	$2,241.85	$305.78
Justified TEV/UFCF	32.2x	LTM+9Y	3%	84%	$4,837.45	$393.94	$2,316.49	$319.30

Valuation

	ROIC	WACC	EVA	Enterprise Value	Total Debt	Other claims	Equity	Adjusted Price
LTM	10.8%	8.2%	$28.95	$3,139.23	$145.95	-$200.95	$3,194.23	$73.10
LTM+1Y	17.9%	8.4%	$157.78	$3,543.43	$145.95	-$338.78	$3,736.26	$84.42
LTM+2Y	15.7%	8.5%	$126.21	$3,604.69	$145.95	-$514.35	$3,973.10	$89.73
LTM+3Y	17.9%	8.6%	$171.04	$3,705.50	$145.95	-$733.11	$4,292.66	$96.78
LTM+4Y	18.4%	8.7%	$185.48	$3,761.79	$145.95	-$970.82	$4,586.66	$103.33
LTM+5Y	18.4%	8.8%	$192.05	$3,800.68	$145.95	-$1,221.28	$4,876.02	$110.07
LTM+6Y	18.1%	8.9%	$192.10	$3,822.23	$145.95	-$1,484.40	$5,160.68	$116.13
LTM+7Y	17.9%	9.0%	$192.61	$3,836.42	$145.95	-$1,758.65	$5,449.12	$122.57
LTM+8Y	17.7%	9.1%	$193.35	$3,842.44	$145.95	-$2,043.87	$5,740.35	$129.08
LTM+9Y	17.6%	9.2%	$194.58	$3,837.46	$145.95	-$2,341.24	$6,032.74	$134.68

Monte Carlo Simulation Assumptions

	Base	Stdev	Min	Max	Distribution
Revenue Variation	0	10%	N/A	N/A	Normal
Op. Costs Variation	0	10%	N/A	N/A	Normal
Market Risk Premium	6%	N/A	5%	7%	Triangular
Long term Growth	3%	N/A	2%	6%	Triangular
Terminal Value	0	0.1	N/A	N/A	Normal

Monte Carlo Simulation Results

	Intrinsic Value	1y-Target
Mean est.	$73.10	$84.42
σ(ε)	$0.21	$0.24
3 σ(ε) adjusted price	$72.47	$83.70
Current Price	$68.51	
Analysts' median est.		$73.46