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Mining equipment maker Joy Global could bring investors happiness

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SPECIAL TO THE GLOBE AND MAIL

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Despite working at an investment bank in Toronto for nearly a decade, I have always avoided investments in the commodity sector.

As a value investor and student of Warren Buffett, I look for stable businesses with pricing power than can earn abnormally high returns. Commodity producers don't qualify because they compete primarily on price with little or nothing to differentiate their offerings.

But I recently made an exception to my commodity-sector aversion when I purchased shares in Joy Global Inc. Joy is a Milwaukee-based company that makes high-productivity mining equipment. Its customers are major global miners – high volume producers who demand equipment that helps them mine ore at the lowest cost per ton.

Joy's customers run mines that operate non-stop. Downtime costs these producers thousands of dollars per minute so reliability and support are extremely important to them. For this reason, the high-productivity specialty mining equipment industry is close to a duopoly. Joy and Bucyrus (recently purchased by Caterpillar) are the two dominant players.

Both companies enjoy exceptional margins and avoid competing on price. Joy has historically managed to earn an impressive 40-per-cent return on equity. It is an excellent, well-managed business and also a truly global one, with 54 per cent of its revenue generated outside the U.S.

When commodity prices are falling, Joy's customers will reduce capital expenditures as their profits are squeezed. However, if they are still mining, they will continue to consume Joy's equipment and replacement parts. Aftermarket sales of parts and service generate 60 per cent of the company's revenues and are highly profitable.

So why is the company still trading for only a bit more than eight times earnings? The answer is headwinds related to coal. Approximately two-thirds of Joy's machines are used in coal mining and the U.S. coal mining industry is going through a difficult transition.

Coal has two main uses. Metallurgical coal is used primarily in steel-making and represents about 15 per cent of global coal production. Thermal coal represents 85 per cent of global goal production and is used primarily by power plants to generate electricity.

In the United States, reduced electricity demand due to the anemic recovery and a warm winter has hurt thermal coal demand and prices. In addition, a natural gas glut has led U.S. power producers to switch from thermal coal to natural gas. New environmental regulations also mean that new coal-fired plants are unlikely to be constructed in the U.S.

The international situation is different. New coal-powered generation capacity already in construction will consume more coal than is currently produced in the U.S. China consumes about 50 per cent of the world's coal and is four times the size of the U.S. coal market.

Joy's management anticipated that international coal demand would make up for the tough conditions in the United States. Unfortunately, Asia is now also slowing. However, one of the lessons that I learned from the Oracle of Omaha is to think long term.

While U.S. coal production is likely in long-term decline, international production should more than offset it – just not right away. In five years' time I am confident that the world will be consuming significantly more coal than it is today. As a result, Joy's revenues and profits should also be materially higher. Other catalysts could also propel the stock higher. For instance, General Electric's push into mining equipment would make Joy a perfect acquisition candidate. But I don't need that to happen for Joy to work out as a long-term investment. When you buy great companies cheap, good things tend to happen.

Mr. McCloskey is the founder and president of GreensKeeper Asset Management. GreensKeeper, its affiliates, and certain accounts managed by them may hold long or short equity positions of a profiled company and may from time to time trade in these securities.