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The Sharpest Tool in the Shed

By Christopher C. Williams

INVESTORS ARE BUILDING POSITIONS in the shares of heavy-equipment makers, betting that the worldwide boom in infrastructure will mean even bigger business for companies such as **McDermott International** (ticker: MDR) and **Parker Hannifin** (PH).

Illinois Tool Works (ITW), a diversified manufacturer, is winning its share of fans, as well, with a stock that has risen 20% this year, to 55. They believe the company's growth-by-acquisition strategy will produce another year of stellar earnings, helping the conglomerate outrun the Standard & Poor's 500 stock index in 2007, as it has for the past 20 years. If the global economy stays strong, encouraging more development in Asia and elsewhere, Illinois Tool easily could rally into the low 60s in the next year, on solid quarterly results.

Dubbed "one of the sharpest tools in the shed" by Morningstar, the Glenview, Ill.-based company has produced double-digit earnings gains in the past 10 years, and is on track to do so again. Citing more than $1 billion of potential acquisitions and a growing international operation, analysts expect Illinois Tool to earn $3.33 a share this year, up from $3.01 in '06, on a 14% increase in revenue to almost $16 billion. Though acquisitions will account for much of that growth, better-than-expected organic growth also could boost results.

Notwithstanding its bright prospects, Illinois Tool trades for only 15 times consensus 2008 earnings projections of $3.72 a share, about 10% below the price-earnings multiples afforded diversified industrial multinationals such as **Danaher** (DHR), notes Goldman Sachs analyst Deane Dray. "It's exceptionally attractive," he says. "It has had a nice pop, but has a lot more room to run."

Dray calls his one-year price target of 61 "conservative." Given Illinois Tool's consistent earnings performance and sturdy balance sheet, he argues that the stock justifiably could be valued at a 10% premium to peers sector. That would translate into a P/E of 18 and a price of 67.

Founded in 1912 as a maker of metal-cutting tools, Illinois Tool now offers a dizzying array of products for the automotive, construction and food and beverage industries. It sells, among other things, fasteners, welding machines and plastic ring carriers for beverage cans. It has bought about 32 companies a year over the past 10 years, each averaging about $32 million in yearly sales. Last year, it scooped up a record 53 companies representing $1.7 billion in annualized revenue, a pace some analysts think it could match this year. Since 1982, return on invested capital has averaged 15%.

Illinois Tool is ultra-lean; only about 50 executives in the corporate center oversee 750 units in the U.S. and 48 foreign countries. Led by David Speer, 56, a 28-year company veteran who became CEO in 2005, its managers are expert in "80/20," meaning they concentrate the company's resources on the 20% of customers and products that deliver 80% of a unit's sales.

Daniel Dowd of Bernstein Research suspects that Illinois Tool would enjoy a higher multiple if its business model were better understood. "ITW's competitive advantage lies in its ability to create value through world-class capital allocation, and in identifying and systematically improving very small acquisitions," he observes.

Dowd also thinks that Illinois Tool is less exposed to the North American new-home and auto markets than some investors believe. In the first quarter, a 20% drop in its North American housing sales and a 7% slip in its auto business understandably focused investors' attention. But other operations, such as international welding, grew a healthy 21%, helping Illinois Tool produce on-target results. Those trends probably continued in the second quarter, ended last month, in which analysts figure the company earned 88 cents a share, up from 81 cents a year earlier. Illinois Tool reports results next Thursday.

Tooling Along

Barring a recession, Illinois Tool's profits are likely to rise more than 10% next year, a nice showing for an industrial-products producer.

Recent Price	$55.54	**EPS 2006**	$3.01
52-Wk Hi-Lo	$56.70 – $42.23	**EPS 2007**E	$3.33
Stk-Mkt Value (bil)	$30.9	**P/E 2006**	18.5
Revenue 2006 (bil)	$14.0	**P/E 2007**E	16.7
Net Income 2006 (bil)	$1.7	E=Estimate	Source: Thomson Financial

Dowd notes that the U.S. housing and auto markets represent just 13% of Illinois Tool's revenue, and that the company sells to many other customers, including renovation-construction specialists and foreign original-equipment manufacturers, that are counter-cyclical to those troublesome areas. He believes stronger-than-expected second-half results will convince skeptics that Illinois Tool will weather the downturns in housing and auto in fine shape, and help push the stock toward his 68 price target. "ITW has and will continue to grow with the global economy," he says.

Growth could be pinched if the pool of attractive acquisition candidates dries up, but that is unlikely to happen, at least in the near term. Besides, Illinois Tool has other, yes, tools, at its disposal to keep shareholders happy; among them, the company could use its copious cash flow– $1.8 billion last year–to repurchase shares.

As its customers might say, don't underestimate the value of a well-stocked tool kit. Or, a well-run company. ■