OSHKOSH

TRADITION
INVESTMENT MANAGEMENT

Oshkosh's Stable Dividend Driven by Long-Term Contract Wins

Price $106.56 **Dividend Holding** **October 23, 2024**

- 1.8% dividend yield.
- Secular tailwind from municipal underspending and defense rearmament.
- Revenue forecasted to grow 10.8% in 2024, driven by increased demand in the vocational segment.
- Expanding access business into Europe, trying to get ahead of tariffs.

Investment Thesis

Oshkosh (OSK) is an American manufacturer of heavy equipment, primarily targeting municipal and military customers. Despite the loss of the JLTV contract (Joint Light Tactical Vehicle), OSK has a strong backlog originating from a major win from the USPS (US Postal Service), renewed municipal spending, and expansion into Europe.

Oshkosh has a 1.8% dividend yield and a growing free cash profile which we expect to accelerate as startup costs from major contracts roll off going into late 2025 and 2026. For this reason, we believe that OSK has a strong growth avenue in its existing business, coupled with some expansionary spending in Europe.

Estimated Fair Value

EFV (Estimated Fair Value) = EFY25 EPS (Earnings Per Share) times P/E (Price/Earnings)

EFV = E25 EPS X P/E = $11.80 x 14.0x = $165.2

A 14.0x P/E brings OSK more in line with peers and more accurately reflects its secular tailwinds. These tailwinds for the business are continued rearmament spending for the US and its allies and the consequences of decades of underspending by municipalities.

	E2024	E2025	E2026
Price-to-Sales	0.7	0.7	0.6
Price-to-Earnings	9.1	9.3	8.3

Access Equipment

The access equipment segment produces telehandlers, boom lifts, and construction equipment for vertical handling. Currently, Oshkosh has a licensing agreement through 2025 with Caterpillar to produce telehandlers. While orders are down year over year in June 2024, OSK reports that the access equipment book of business is full for the remainder of 2024. In September 2024, OSK purchased Spanish manufacturer of light specialty construction equipment AUSA for $124 million, which will add approximately $142.6 million in sales per year. Acquisitions have been focused on Europe to get ahead of proposed EU tariffs on Chinese equipment and US aluminum and steel products.

The backlog ending June 2024 decreased by 25.4% year over year, which OSK attributed to normalizing order volumes. We expect that most orders for 2025 delivery will be made starting the last quarter of this year. With continued inflationary pressures and high interest rates, US construction spending is likely nearing its cycle bottom at July's 16 month lows. Deloitte expects some recovery in construction going into 2025, but more substantially in 2026 with a boost in housing construction and factory construction.

OSK revised down its guidance for revenue to $5.3 billion, a 6.2% year over year increase, but increased its operating margin target to 16.3% due to better mix, which would be an expansion of around 150bps compared to 2023.

Defense

Defense produces a variety of heavy vehicles for mostly military end-customers, though it does include federal contracts like the NGDV.

The NGDV (next-gen delivery vehicle) is the contract to develop a new mail truck for the USPS at scale. Over the next 10 years, Oshkosh will deliver between 50,000 and 165,000 vehicles with a mix of internal combustion (ICE) and battery electric (BEV) versions. Initially, the contract stipulated 10% BEV, and 90% ICE, but the Inflation Reduction Act increased the number to 50% BEV. This number could increase in the future, with Executive Order 14057 stating that all future light vehicles procured by the government starting in 2027 must be BEV.

Initial engineering awards were $482 million in February 2021, followed immediately by a $2.98 billion order for 60,000 NGDVs. In August 2022, this amount was bolstered by a further $3 billion to support the 50% BEV number. The environmental impact statement for the NGDV contract has estimated that a full BEV fleet would cost $11.6 billion to procure.

According to OSK, production will start small and will begin to ramp starting in the final quarter of 2024 reaching full rate by the second half of 2025. In the short term, the startup costs of the full NGDV procurement will result in a drag on operating income.

In August 2024 Oshkosh announced that the US Army has renewed its $1.5 billion contract for the FHTV (family of heavy tactical vehicles), including a $231.9 million rider for upgrading current vehicles, which will last to 2031. Since winning the original FHTV contract in 1991, Oshkosh has delivered more than 70,000 vehicles to the US and allies.

We believe that the renewal of FHTV contract likely indicates that the US army will renew the FMTV (family of medium tactical vehicles) when the contract comes up for renewal in the first half of 2025, likely to be in the neighborhood of $1 billion to 2027.

OSK expects defense revenue to be flat at $2.1 billion for the full year 2024, with an operating margin of 2.3%.

Vocational

Finally, the Vocational segment includes a wide variety of commercial and civil equipment including airport vehicles, firetrucks, waste collection vehicles, and other special-duty vehicles. Over the past decade or so, municipalities' budgets have been tight, and capex postponed. According to S&P, capex as a portion of state budgets fell from 13% to 8% from 1991 to 2019, causing an underinvestment of $1.5 trillion. As the price of heavy-duty vehicles has continued to increase since the pandemic, state governments and the federal government are beginning to make up for the lack of spending. On the federal level, the American Rescue Plan and the Inflation Reduction Act injected hundreds of billions into local infrastructure and public safety spending, freeing up money for upgrading aging fleets.

Thus far, the backlog in the vocational segment is up 47.5% year over year as of the quarter ending June 2024, filling the backlog well into 2025 even if no more orders come in. For the full year 2024, OSK expects sales of $3.2 billion, a 24% year over year increase, and margin expansion to 11.3%, compared to 2023's 7.2%. The reason for the margin expansion is OSK continues to have pricing tailwinds in this area, reporting a gross margin expansion of 330 bps for the first 6 months of 2024. We expect some operating margin headwinds from moving some specialty businesses like garbage trucks to a dealer network rather than factory direct sales. However, this will likely be offset by volume increases associated with a larger market reach and continued municipal spending on higher margin items like fire trucks.

Risk

In 2015 Oshkosh won the initial $6.7 billion JLTV (Joint Light Tactical Vehicle) contract and has delivered more than 20,000 JLTVs and 10,000 trailers for the US Army and allied nations. However, in February 2023, Oshkosh lost the JLTV contract to AM General but will continue to supply vehicles to 2025. Oshkosh estimates the ramp down will be $700 million in revenue to the end of 2025, though it will retain commercial rights to sell the JLTV to allied nations.

Typically, procurement contracts for the military are fixed price and realized as delivered. Newer contracts typically have economic price adjustments which allow OSK to claw back some lost value due to inflation. Fixed price contracts go both ways, if OSK manages to deliver below estimated cost it retains the full contact amount which provides a level of revenue stability and high margins. However, if material costs increase above the initial estimate, the scope changes, or there is insufficient economic price adjustments, it can produce drag on operating income.

Financials

For 2024, OSK broadly expects revenue growth in the 10.8% area, with a 33.5% increase in operating income due to both more favorable mix and pricing tailwinds. Overall, companywide revenue and margins are expanding other than the defense segment, which is flat due to the previously discussed startup costs. We expect the vocational segment to continue to be a margin and growth leader until 2026, when funds from the American Rescue Plan dry up.

Over the longer term we expect defense margins to expand back to the long-term average of 5%. Associated startup costs for longer-term defense contracts provide an operating income drag, for the first 6 months of 2024 OSK reported 60bps drop in operating margin associated with startup costs. Given the previously discussed renewal of FHTV and the likely renewal of FMTV contracts, there could be further temporary drags on operating income. However, OSK expects to end 2024 with positive defense segment operating margins.

6 Months Ending June 2024			
Segment	% of Total Revenue	EBIT Margin	Expected Operating Margin (2024E)
Access Equipment	49.0%	17.2%	16.5%
Defense (also includes Federal contracts)	21.0%	-2.5%	2.3%
Vocational (Civil and Commercial)	30.0%	11.6%	12.8%
Company Wide	-	10.6%	10.7%

Timing issues for working capital lowered the guidance on free cash by around $50 million, which will alleviate going into 2024.

2024E Guidance		
Item	Change from 2023	Absolute ($ billions)
Revenue	10.8%	$10.70
Operating Income	33.5%	$1.14
CapEx	-7.8%	$0.30
FCF	38.5%	$0.38

OSK has a modestly leveraged balance sheet with EBIT interest coverage ratio of 11.8x, and a net debt to EBITDA of 1.2x on a trailing twelve-month basis. Currently, acquisitions are focused on expanding the access equipment segment in Europe to get ahead of tariffs. Acquisitions across all segments are usually under $1 billion in size, and all recent European acquisitions have been under $250 million.

Currently OSK pays out a 1.8% dividend, which is a payout ratio of 14.7%. The dividend is well covered, and OSK has consistently increased its dividend in line with its earnings. As of the quarter ending June 2024, OSK has authorized to repurchase 16.6% of outstanding shares. Typically, OSK targets returning 25-35% of cash flow to shareholders both through the dividend and repurchases. Thus, we feel that the dividend or pace of repurchases could increase going into 2026 once NGDV begins full production and startup costs roll off.

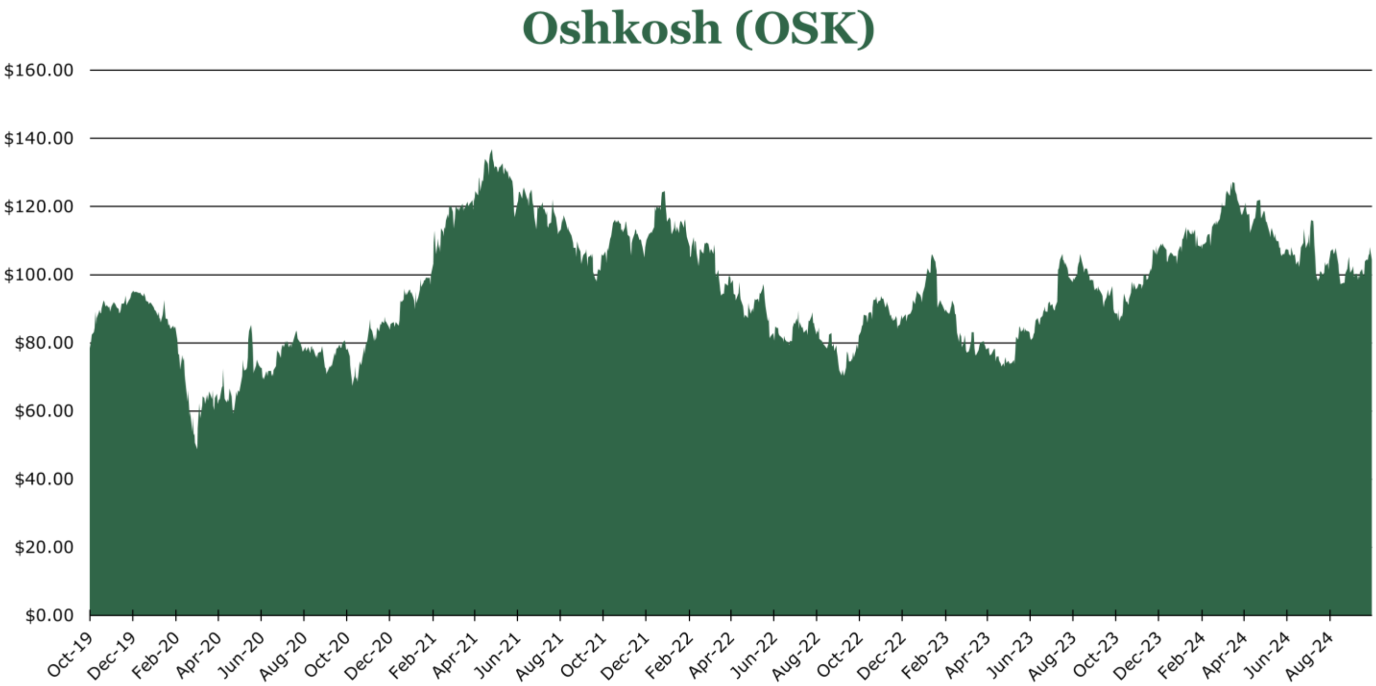
Conclusion

We expect defense margins to normalize as start-up costs for contracts roll off going into late 2025 or early 2026, with revenue and margin growth to continue to be elevated in the vocational segment until American Rescue Plan funds begin to leave municipal budgets in 2026. By that point, we feel construction spending will have recovered giving the access segment a boost.

With the backlog increasing by 2.7% to $15.4 billion for the quarter ending June 2024, a diverse customer base with no one customer making up more than 10% of revenue, and government spending tailwinds, we believe OSK provides a stable opportunity for dividend investors to take advantage of elevated federal and municipal spending.

Peer Comparisons

	Oshkosh (OSK)	Federal Signal (FSS)	REV Group (REVG)	Terex (TEX)	General Dynamics (GD)
Price-to-Earnings	9.14	26.84	18.26	8.98	21.72
Price-to-Sales (TTM)	0.66	2.95	0.65	0.70	1.87
Price-to-Book (TTM)	1.73	4.89	3.81	1.96	3.84
Net Income Margin	6.58%	11.17%	9.92%	9.55%	7.89%
Dividend Yield	1.76%	0.55%	0.69%	1.26%	1.84%


Oshkosh (OSK)
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