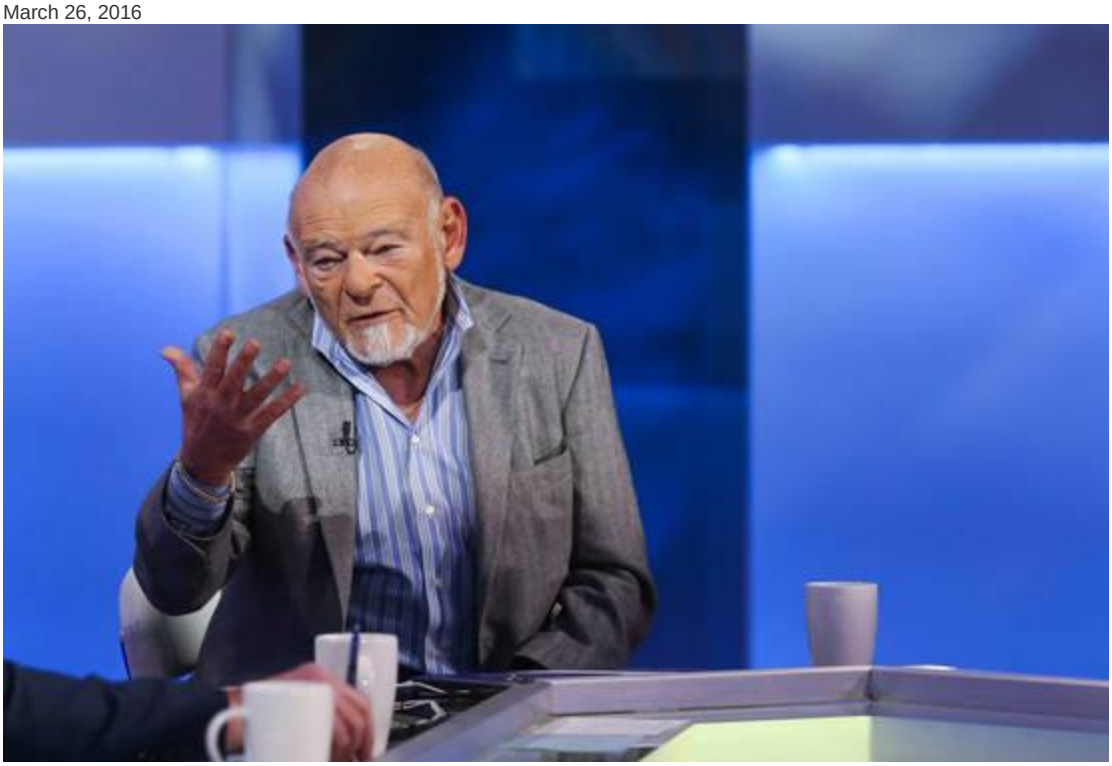
Sizing Up Small Caps

Two Stocks Worth a Wager

Real Industry, backed by Sam Zell, and International Game Technology look like buys at current prices.

By
David Englander
March 26, 2016



Veteran investor Sam Zell has a 7% stake in Real Industry. *Photo: Chris Goodney/Bloomberg*

Shares of Real Industry have had a real dismal couple of months. Commodity-price weakness and investor aversion to leveraged roll-up plays has hurt the stock, which has traded down 25% since the end of November.

Still, the opportunity in this acquisition-oriented company, backed by investor Sam Zell, looks as compelling today as it did last May, when this column recommended the shares (ticker: RELY). At a recent $7.65, they fetch about the same price they did at the time our story was published. They are still a buy.

Zell controls 7% of Real, formerly known as Signature Group Holdings, which has $900 million in federal net operating losses. The NOLs, which provide a tax shield for future earnings, are a legacy of subprime mortgage originator Fremont General, which filed for bankruptcy protection in 2008. Zell gained control in 2013.

In February 2015, under the leadership of CEO Craig Bouchard, Real made its first acquisition, buying the aluminum-recycling business of Aleris for $525 million.

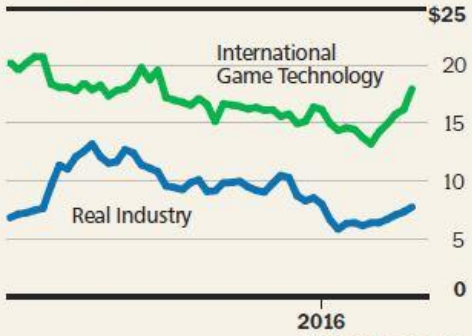
Another deal could follow this year, which would be a likely catalyst for the stock. In his annual letter, published two weeks ago, Bouchard sounded upbeat about acquisition prospects. As Real steps up its activity, it will realize the value of its NOLs, sending earnings and free cash flow soaring. In a few years, a much higher stock price could result. B. Riley & Co. analyst Josh Nichols puts fair value at more than double the current quote, or $16 a share, assuming Real can monetize all its NOLs.

In 2015, Real generated $58 million in Ebitda (earnings before interest, taxes, depreciation, and amortization) on $1.1 billion in revenue. The results include only 10 months of operations for the recycling business, known as Real Alloy. This year analysts look for $76 million in Ebitda on $1.2 billion in revenue, reflecting the full year of operations. Those estimates don't include potential acquisitions.

Double Play

Both Real Industry and International Game Technology still look like bargains.

Int'l Game Technology (IGT - NYSE)
Real Industry (RELY - Nasdaq)
Weekly close on March 24



Source: Bloomberg

Company	Real Industry	Int'l Game Technology
Recent Price	$7.65	$17.59
52-Week Range	$13.50 - 5.30	$21.23 - 12.48
Market Value (bil)	$0.22	$3.5
2016E Rev (bil)	$1.2	$5.0
2016E Ebitda (bil)	$0.076	$1.7
2017E Ebitda (bil)	$0.086	$1.8
Enterprise Value/ 2017E Ebitda	7.0	6.2

E=Estimate. Source: Bloomberg

Real Alloy buys scrap aluminum and converts it into reusable metal. It's one of the largest such businesses in the world, with 24 plants. Most of its finished goods are sold to the auto industry. The business should benefit from increased aluminum usage in cars and trucks.

While Real Alloy has been pressured by weaker aluminum prices, it isn't overly dependent on the commodity. Last year 55% of its tonnage came from tolling agreements with aluminum mills and auto companies. Under tolling, Real converts customers' scrap aluminum into finished aluminum for a fee and takes no commodity risk.

In 2015 Real submitted three acquisition offers. Twice, it was outbid, and it walked away from the third deal. In his letter, Bouchard said his priority "is to make accretive acquisitions versus fast acquisitions." Real is focused on companies with proven managers and high profit margins in sectors such as food, energy, and transportation.

The market turmoil has cut prices for acquisition targets, and that's an opportunity for buyers. Real relies on the high-yield debt market to get a deal done, and Bouchard believes it will support his next purchase.

In a March 16 report, B. Riley's Nichols wrote that he expects the company "to make another significant acquisition this year." If that's the case, the shares could finish 2016 much higher.

SHARES OF International Game Technology also merit attention. The stock (IGT), at a recent $17.59, is flat since this column featured it last June, following the April merger of lottery operator Gtech and slot machine giant IGT. It still looks attractive.

Two weeks ago IGT reported good earnings for the first time since the merger. The lottery operations have been growing, and the gaming business is stabilizing after a period of losing market share. The company, led by former Gtech CEO Marco Sala, is also ahead on its cost-synergy goals.

IGT is a free-cash-flow-generating monster, with an 80% recurring-revenue base. Management has guided for a normalized annual free cash flow rate of $500 million, or $2.50 a share, in the next few years. This year, revenue could reach $5 billion.

At only seven times free cash flow, the stock is cheap. One holder, Chris Mittleman of Mittleman Brothers, argues that 12 times free cash flow, or $30 a share, represents a "bare minimum fair value."

IGT draws more than 50% of its revenue from selling slot-machine gaming equipment and content to casinos, and from interactive games, including its popular Double Down. For years, the old IGT had been losing market share in its core slot-machine business to nimbler rivals. Turning around that business is key to a higher stock price. In the recent earnings report, progress was encouraging. Newly developed products have gained traction, and in North America, IGT reported that its installed base is stabilizing.

IGT is also the global leader in managing lotteries. In 2015, lottery revenue grew 7% in North America and 4% internationally. It's a stable business, secured by long-term contracts with government agencies, and switching costs are high. IGT has a lot of debt from the merger, so its free cash flow is important. Management plans to reduce leverage from 4.5 times Ebitda to four times by 2018.

IGT is 52% controlled by De Agostini, an Italian family-owned private-equity firm. Its chairman, Marco Drago, has racked up an impressive investing record since he took over in 1997, and IGT CEO Sala has been a longtime associate. That's another thing to like about the stock.