CAPITOL SECURITIES MANAGEMENT, INC.

EQUITY RESEARCH

*February 12, 2019*

| | |
|---|---|
| CURRENT PRICE: | **$21.57** |
| RATING: | **HOLD** |
| PRICE TARGET: | **N/A** |
| CURRENT YIELD: | **0.5%** |

### EPS Estimates - Non-GAAP

| | SEP 18A | SEP 19E |
|---|---|---|
| 1Q | $0.42 | $0.21A |
| 2Q | $0.31 | $0.16 |
| 3Q | $0.67 | $0.43 |
| 4Q | $0.49 | $0.49 |
| | **$1.88** | **$1.29** |

### Trading Data

| | |
|---|---|
| 52-WEEK PRICE RANGE: | **$43.78 - $20.13** |
| SHARES OUTSTANDING: | **19.33(M)** |
| MARKET CAP: | **$417.0(M)** |
| AVG. DAILY TRADING VOLUME: | **0.17(M)** |
| S&P 500: | **2,745** |

### Valuation Data

| | |
|---|---|
| BOOK VALUE: | **$12.76** |
| PRICE TO BOOK: | **1.69x** |
| DIVIDEND: | **$0.12** |

# INSTEEL INDUSTRIES, INC (NSDQ: IIIN)

*1Q19 Earnings*

## Highlights

- 1Q19 earnings of $0.21/share vs. $0.42/share during 1Q18
- Earnings hurt by construction delays, shipments, & tariffs
- Gross margins decrease
- IIIN hoping for stable 2019 US economy
- Maintain HOLD rating

## Investment Thesis

IIIN could be an interesting speculative play for aggressive investors. Since most of IIIN's business is related to the US construction market, its stock has been volatile during the past four years as investor's have moved in and out of the shares based on expectations of a recovery in the construction industry. While an increase in meaningful customer orders may start to materialize, improvement in construction spending may lead to earnings growth for IIIN. Aggressive and speculative investors should look for attractive entry points into IIIN for potential price appreciation when the US construction market improves and increases demand for the company's products.

## Company Summary

Insteel Industries (IIIN-$21.57), headquartered in Mt. Airy NC, is the nations largest manufacturer of steel wire reinforcing products for concrete construction applications. IIIN manufactures/markets PC strand and welded wire reinforcement (WWR) products. Products are sold through its sales force, primarily to concrete product manufacturers for use in nonresidential construction. Virtually all of the company's sales are from within the US.. Started in 1958, the company had approximately 810 employees (as of 10/1/18), and generated total revenues of $453.2 million during FY18. An estimated 85% of IIIN's sales went towards nonresidential construction (approximately 50% infrastructure & 50% non-infrastructure) and 15% to residential construction. IIIN is debt free and has a $100 million revolving credit facility.

***For Important Disclosure information regarding the Firm's rating system, valuation methods and potential conflicts of interest, please refer to the last two pages of this report.***

## Recent Earnings

IIIN reported 1Q19 earnings of $0.21/share vs. $0.42/share during 1Q18. This decline was due to lower shipments and higher unit manufacturing costs on lower production volume, when compared to 1Q18. When, comparing the two quarters, net sales rose to $104.1 million from $97.7 million, as cost of sales increased to $93.1 million from $86.1 million, causing gross profit margins to fall to $11.0 million from $11.7 million.

1Q19's sales rose 6.5% to $104.1 million because of a 28.7% increase in average selling prices. This offset a 17.2% decrease in shipments resulting from bad weather in many parts of the US, customers' project construction delays, and competition from low-priced imports. The PC strand business was hurt by the low price imports generated by the Section 232 tariff program. Higher manufacturing costs for IIIN and reduced shipments resulted in the gross profit margin falling to 10.5% from 11.9%, when comparing 1Q19 to 1Q18.

SG&A expense increased to $6.5 million from $5.8 million mainly due to the relative year-over-year changes in cash surrender values of life insurance policies on key persons. The value of these policies fell $500,000 due to the decline of the financial markets during 2018. Higher SG&A costs were partly offset by lower incentive compensation expense under IIIN's return on capital plan driven by weaker results during the current year.

## Our Thoughts

IIIN's earnings decline ($0.21/share vs. $0.42/share) was due to several factors, such as lower shipments and higher manufacturing costs on lower production volumes. Additionally, the section 232 tariff program has negatively impacted earnings. During the conference call, management was hopeful the business cycle could improve going forward into 2019 assuming a resumption of customers' project construction programs, a steady economy, and a resolution of the tariff situation between the US & trade partners. Under these conditions, both shipments and gross margins could improve during the next few quarters. However, given potential domestic, and international headwinds, we believe investors should wait on the sidelines to determine the direction of the US economy during the next 3-6 months. We continue to rate this stock a HOLD.

## Risks

There are no guarantees IIIN will be able to grow future earnings. Declining customer orders, rising commodity prices, and rising operating costs could negatively affect the company's profits. An influx of foreign imports and increase in competition could cause a decrease in overall revenues. Negative equity markets, rising interest rates, terrorist attacks, and failure to comply with the Sarbanes Oxley Act could cause a decline in IIIN's share price. Given the relatively small amount of daily trading activity in IIIN's stock, any increase in trading volume could significantly accelerate the volatility of its share price movement.

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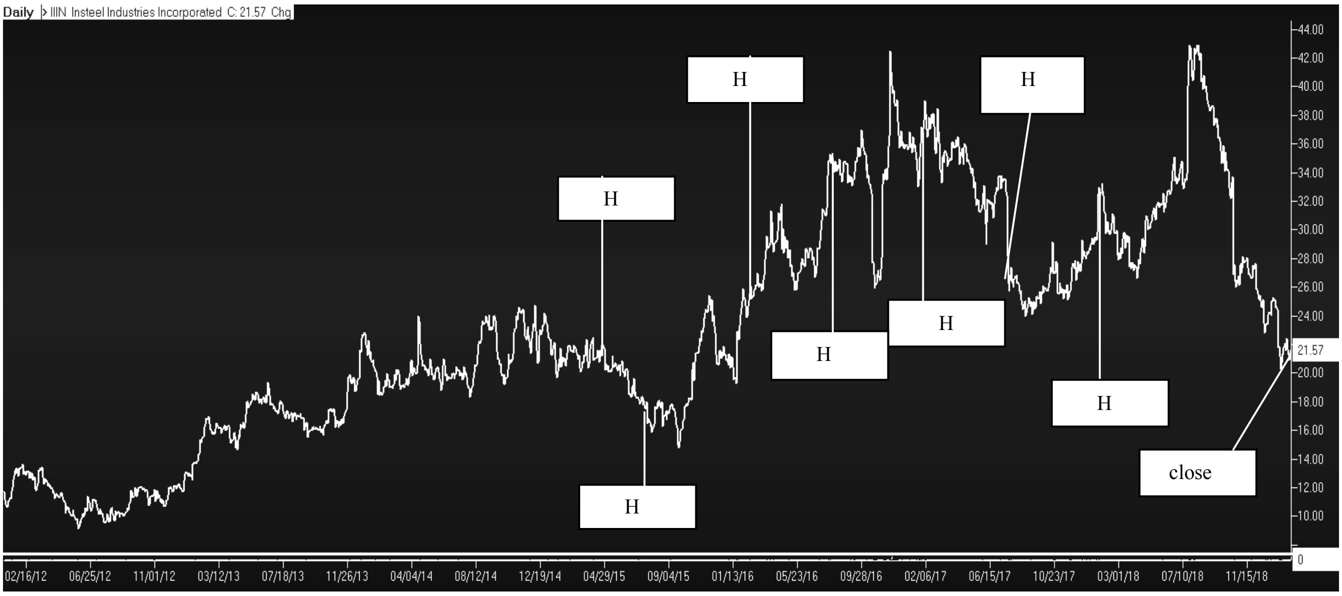
INSTEEL INDUSTRIES, INC.
FY ends 9/30
(in thousands except per share amounts)

| | 1Q18 | 2Q18 | 3Q18 | 4Q18 | 2018 | 1Q19 | 2Q19e | 3Q19e | 4Q19e | 2019e |
|---|---|---|---|---|---|---|---|---|---|---|
| Revenues | $97,741 | $107,417 | $126,688 | $121,371 | $453,217 | $104,110 | $111,486 | $138,689 | $135,844 | $490,129 |
| Cost of sales | 86,080 | 92,001 | 102,502 | 101,827 | 382,410 | 93,134 | 100,449 | 121,630 | 116,282 | 431,495 |
| Inventory write-downs | | 15,416 | | | | | | | | |
| Gross profit | 11,661 | 7,475 | 24,186 | 19,544 | 70,087 | 10,976 | 11,037 | 17,059 | 19,562 | 58,634 |
| SG&A | 5,763 | 6,815 | 7,541 | 7,525 | 28,304 | 6,534 | 6,756 | 6,927 | 7,113 | 27,330 |
| Acquisition costs | | | | | | | | | | |
| Bargain Purchase gain | | | | | | | | | | |
| Gain on debt exinguishment | | | | | | | | | | |
| Pension settlement loss | | | | | | | | | | |
| Restructuring charges | | | | | | | | | | |
| Other expenses/income | 19 | 166 | 32 | 121 | 274 | 829 | 259 | 58 | 42 | 470 |
| Income | 5,379 | 7,775 | 16,677 | 11,898 | 42,229 | 5,271 | 4,022 | 10,074 | 12,407 | 31,774 |
| | | | | | | | | | | |
| Interest expense | 28 | 23 | 23 | 40 | 114 | 30 | 32 | 41 | 38 | 141 |
| Interest income | 76 | 53 | 150 | 236 | 515 | 155 | 94 | 75 | 127 | 451 |
| | | | | | | | | | | |
| Income taxes | 2,184 | 1,026 | 3,936 | 2,686 | 6,364 | 1,270 | 960 | 2,426 | 2,937 | 7,593 |
| Earnings from continuing Ops. | 8,111 | 5,879 | 12,868 | 9,408 | 36,266 | 4,126 | 3,124 | 8,312 | 9,559 | 25,121 |
| Earnings from discont. Ops | | | | | | | | | | |
| Net Earnings | $8,111 | $5,879 | $12,868 | $9,408 | $26,775 | $4,126 | $3,124 | $8,312 | $9,559 | $25,121 |
| | | | | | | | | | | |
| Net earnings/share | $0.42 | $0.31 | $0.67 | $0.49 | $1.88 | $0.21 | $0.16 | $0.43 | $0.49 | $1.29 |
| | | | | | | | | | | |
| Cash dividends/share | $1.28 | $0.03 | $0.03 | $0.03 | $1.37 | $0.03 | $0.03 | $0.03 | $0.03 | $0.12 |
| | | | | | | | | | | |
| Fully diluted shares outstanding | 19,224 | 19,258 | 19,274 | 19,353 | 19,217 | 19,336 | 19,336 | 19,336 | 19,336 | 19,336 |

## Important Disclosures




3/07/11 $11.74 Initiate HOLD

Ratings:
Buy: B
Hold: H
Sell: S

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