THE EUROPEAN CONTRARIAN

October 3, 2022

Wärtsilä Oyj Abp

(BUY)

Price: €6.92
52-Week Range: €6.80 – €13.87
Shares Outstanding: 590.0 million
Market Capitalization: €4.1 billion ($4.6 billion)[1]

Ticker[2]: WRT1V FH
Dividend: €0.24
Yield: 3.5%

Data as of September 27, 2022

[1] One euro (€) is equivalent to $0.9594 as of September 27, 2022.
[2]The common shares of WRT1V FH trade on Nasdaq Helsinki.

PCS RESEARCH SERVICES

Exclusive Marketers of The European Contrarian Report

PCS Research Services
100 Wall Street, 20th Floor
New York, NY 10005
research@pcsresearchservices.com
(212) 233-0100
www.pcsresearchservices.com

HORIZON KINETICS

Research Team

Murray Stahl **Steven Bregman**

Rich Begun, Thérèse Byars, Ryan Casey, James Davolos, Peter Doyle

Matthew Houk, Utako Kojima, Eric Sites, Fredrik Tjernstrom, Steven Tuen

Investment Thesis

Wärtsilä (WRT1V FH) is one of the world's largest manufacturers of engines that are designed to integrate alternative fuel sources, such as ammonia, hydrogen, liquified natural gas, or battery power. The primary end markets for these engines are utility companies, which use them in lieu of turbines to generate electricity, and marine vessels. The company also offers a portfolio of supporting equipment (electricity storage, propulsion systems, etc.) and services to these industries, the latter typically being provided under long-term contracts. Services have grown to represent approximately 50% of revenues and have lent considerable stability to the consolidated business. Furthermore, order intake has rebounded from the lull experienced in recent years and points to record sales in the near term. Lastly, the company has outlined a set of financial goals that includes a near doubling of operating margins to levels slightly better than what were earned prior to the pandemic. In aggregate, these factors point to the potential for significant earnings growth over the near term.

Wärtsilä currently trades at 11.3x the consensus earnings forecast and 6.7x the EBITDA estimate for 2023. These estimates represent significant improvements from 2022 expectations and may ultimately prove to be aggressive, but the forecasts are still well below what the company earned prior to the pandemic. When one further considers that 2022 revenues are poised to be the highest on record and that the company's order book is within 5% of its previous peak in 2018, a return to previous levels of profitability seems to be only a matter of time.

The pace of earnings improvement will depend on the company's ability to improve operating margins, which have fallen from a range of 10.5%-11.5% from 2014 through 2018, to 6.5% in 2021. Wärtsilä has stated a goal to improve operating margins to 12% over time, which, when combined with its expectation of growing sales by at least 5% per year, has the potential to create significant earnings growth. For example, if one assumes these ambitions can be achieved over the next five years, earnings would increase by approximately 120%.

Under this scenario, shareholders would experience share price appreciation plus dividends of approximately 12%-15% a year over this period, as Wärtsilä has also committed to returning at least 50% of earnings to shareholders via dividends. This is an attractive rate of return considering that the company has negligible debt, is a leader in a growing industry, and has exhibited an impressive degree of stability and consistency throughout the cycle. The risk-adjusted return is compelling and the downside is mitigated by the fact that current valuation represents a low multiple of depressed earnings. As such, shares of Wärtsilä are recommended for purchase.

.

Company Description

Wärtsilä, based in Helsinki, Finland, is one of the world's leading manufacturers of engines designed to integrate alternative fuel sources. There are two broad end markets for its products: Energy, namely power plants, and Marine, which offers engines and propulsion systems for vessels ranging from tankers and bulk carriers to cruise ships, tugs and ferries. The company also has a large services business that offers maintenance and logistics solutions such as crew training, port and traffic management, and fleet optimization.

Wärtsilä traces its history back to a sawmill in the Karelia region of Finland that was founded in 1834. The company was officially named Wärtsilä in 1898, by which time it had integrated an iron works. In 1938, it merged with a company that gave it control of a shipyard in Helsinki and, in 1942, it manufactured its first diesel engine for ships using a design licensed from Friedrich Kupp Germania Werft AG in Germany. The company eventually designed its own 6-cylinder diesel engine, the first of which was manufactured in 1959.

Today, the company designs engines that can phase in the use of alternative fuels, such as liquified natural gas ("LNG"), carbon-neutral methane and methanol, and hydrogen/natural gas blends. They are also able to integrate battery power and can be fully electric or used as a hybrid with either fossil fuels or alternatives. The mix allows a power plant or shipping company to both hedge against the price volatility of fuel costs by allowing it to change inputs and to lower its carbon emissions while not sacrificing power or stability. Wärtsilä expects to have an engine that can run 100% on ammonia by 2023 and one that can run 100% on hydrogen by 2025.

The company is run by CEO Håkan Agnevall, who joined the company in 2021 after having served as President of Volvo Bus Corporation from 2013 through 2020. Tom Johnstone was appointed Chairman of the Board in 2020 and has been a member of the Board since 2015. The company is 17.7% owned by Investor AB (INVEB SS), a Swedish holding company, which has been a shareholder since 2012. The President and CEO of Investor, Johan Forssell, also serves on the Board of Wärtsilä.

The company reports the results of its business by both end market (Energy or Marine) and type (Equipment or Services). The Energy segment manufactures engines that are used by power plants in lieu of a turbine to generate electricity, while its storage and software solutions help manage and optimize the use of renewables across a client's entire energy grid. The Marine segment is further subdivided into Marine Power, or engines, and Marine Systems, which includes items such as propellers, gears and transmissions, thrusters and control systems. Services include equipment upgrades and retrofits, as well as a suite of offerings related to such tasks as operations management and data collection, such as Autonomy Solutions that can help automate certain crew tasks, thus enhancing safety and increasing energy efficiency; crew training; fleet optimization; dynamic positioning systems; and port and traffic management. These latter services are reported under the company's Voyage segment. Exhibit 1 shows the company's order intake for the first half of 2022 broken down by energy client and vessel type.

Exhibit 1 Wärtsilä: Revenue Contribution by Customer Segment; 1H 2022

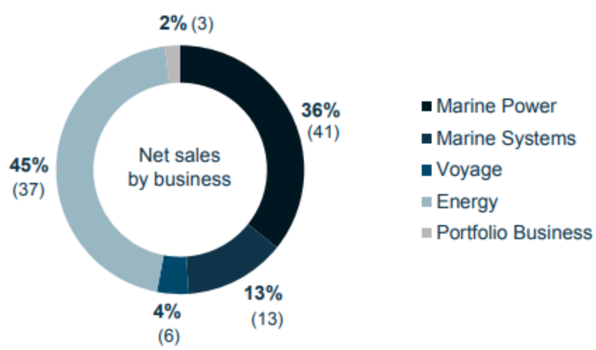
Marine Businesses	Gas carriers	Cruise & ferry	Offshore	Navy	Special vessels	Merchant	Other
Marine Power							
Equipment	19% (9)	24% (42)	3% (6)	1% (8)	16% (21)	37% (14)	0% (0)
Services	17% (19)	23% (17)	14% (14)	7% (10)	11% (14)	27% (24)	2% (1)
Marine Systems							
Equipment	33% (71)	2% (8)	1% (0)	37% (4)	0% (1)	11% (16)	15% (0)
Services	2% (3)	8% (9)	7% (6)	26% (29)	7% (7)	47% (43)	3% (4)
Voyage							
Equipment	0% (1)	36% (32)	1% (7)	11% (4)	2% (17)	45% (18)	5% (21)
Services	1% (4)	44% (22)	10% (6)	1% (2)	8% (7)	21% (45)	15% (3)

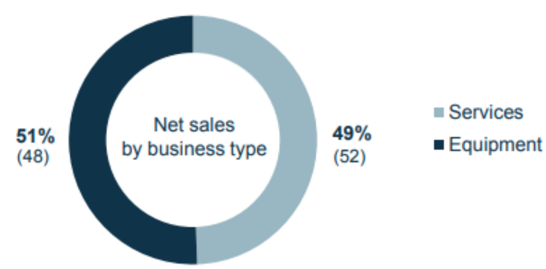
Energy	Utilities	Independent Power Producers	Industrials	Other
Equipment	41% (31)	40% (57)	18% (12)	0% (0)
Services	34% (33)	29% (26)	28% (30)	10% (11)

Source: Company reports.

Exhibit 2 better illustrates the fact that the company's revenues are roughly evenly split between Energy, which contributed 45% of second quarter revenues, and Marine (Power, Systems and Voyage), which totaled 53%. Wärtsilä's other revenues are reported under Portfolio Business, which amounted to 2% of sales. Revenues are also evenly split between Equipment (51% in 2Q 2022) and Services (49%).

Exhibit 2 Wärtsilä: Revenue Contribution by Business Segment; 2Q 2022

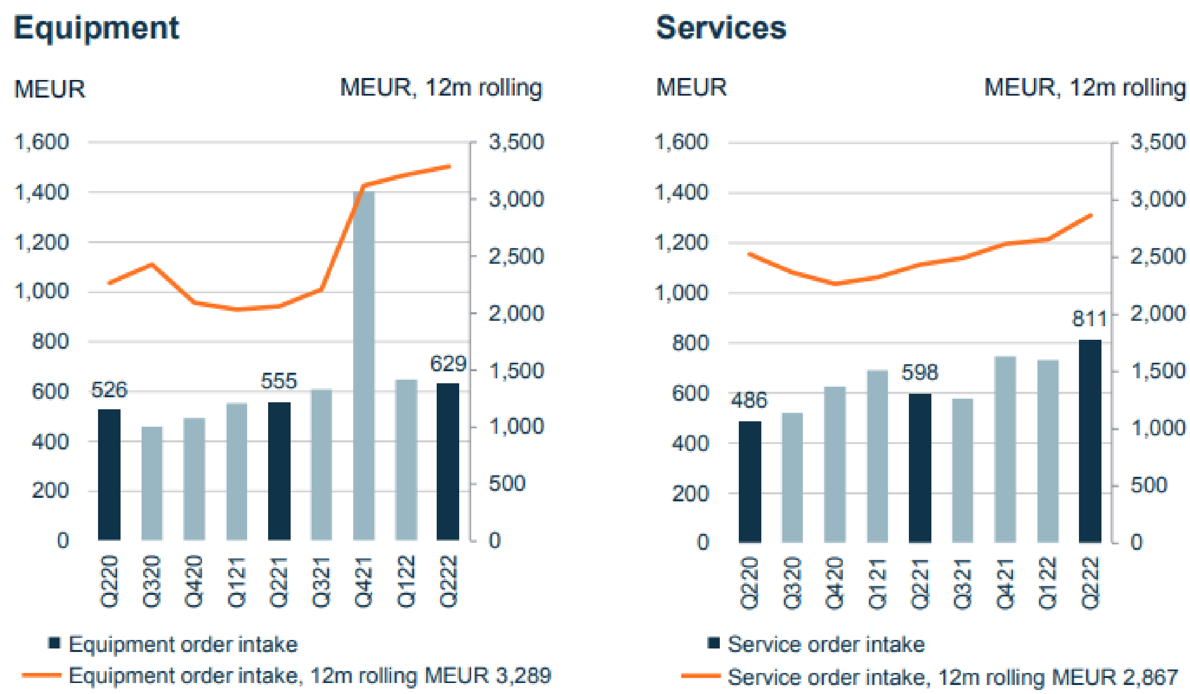




Source: Company reports.

While the Equipment has been steadily growing, it can be subject to a degree of volatility. The Services business, on the other hand, is more consistent and, apart from a large equipment order in the fourth quarter of 2021, has been growing more rapidly in recent years (see Exhibit 3).

Exhibit 3 Wärtsilä: Breakdown of Order Intake by Segment; 2020-2022
(€ in millions)



Source: Company reports.

Despite the inherent volatility of the equipment business, Wärtsilä's financial results have been impressively consistent. As one can see in Exhibit 4, sales and earnings suffered minor setbacks in 2020 and 2021 due to the Covid-19 shutdowns, and the first half of 2022 was negatively impacted by €200 million in expenses and write downs related to the company exiting Russia. Still, other than the extraordinary circumstances regarding the war in Ukraine, Wärtsilä has been consistently profitable and sales through the first half of 2022, combined with the delivery schedule for the remainder of the year (discussed below) put revenues on a path to be the highest on record.

Exhibit 4 Wärtsilä: Revenues by Category; 2017 - 2019
(€ in millions)

	2014	2015	2016	2017	2018	2019	2020	2021	1H21	1H22*
Net Sales	4,779	5,029	4,801	4,911	5,174	5,170	4,604	4,778	2,078	2,639
EBITDA	637	711	670	672	673	542	408	476	175	84
Depreciation & Amortization	115	124	138	134	130	180	174	162	81	156
Operating Profit	522	587	532	538	543	362	234	314	94	-72
Net Income	351	451	357	375	386	218	133	193	61	-92
Order Intake	5,084	4,932	4,927	5,644	6,307	5,327	4,359	5,735	2,398	2,820
Order Book	4,530	4,882	4,696	5,100	6,166	5,878	5,057	5,859	5,238	5,936
Book-to-Bill	1.06	0.98	1.03	1.15	1.22	1.03	0.95	1.20	1.15	1.07

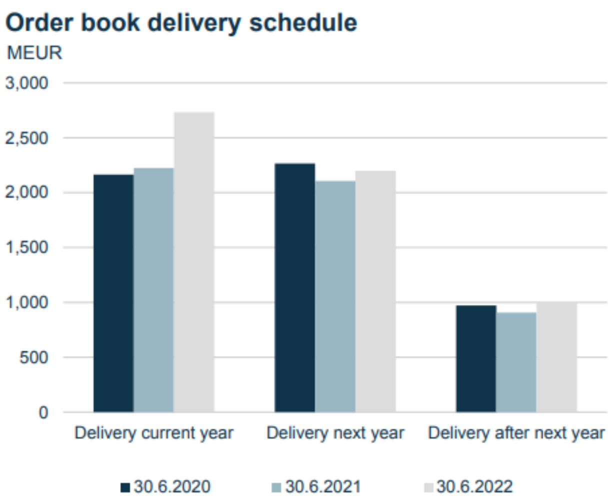
*1H22 includes approximtely €200 million in impairment charges and extraordinary expenses related to its business in Russia

Source: Company reports.

Exhibit 4 also shows order intake to be strong, with 2021 and the first half of 2022 to be near pre-pandemic levels. The company's stability is also on display here, as there are only two years when it didn't record more in order intakes than it billed (intakes that are higher than sales is indicated by a book-to-bill ratio over 1.0).

The delivery schedule for the order book is slightly higher than normal for the remainder of the year, which is further evidence that the business is on pace for record revenues this year (see Exhibit 5). Furthermore, with the charges from having exited Russia now in the past, profitability should recover accordingly. Going forward, the company's delivery schedule is comparable to what is has been in prior years, even after having removed €240 million in Russia-related business from the order book.

Exhibit 5 Wärtsilä: Order Book Delivery Schedule; 1H20 – 1H22
(€ in millions)



Source: Company reports.

Wärtsilä's consistency is further demonstrated by the progression of cumulative value created per share, which is equity attributable to shareholders plus accumulated dividends. As shown in Exhibit 6, this metric increased every year since 2014, growing at a rate of 10.2% per year over the last seven years. It is worth noting that this metric is up again in the first half of 2022 despite the charges related to Russia

Exhibit 6 Wärtsilä: Cumulative Value Created per Share; 2014 – 2021
(€ in millions, shares in millions)

	2014	2015	2016	2017	2018	2019	2020	2021	1H22
Equity Attributable for Shareholders	1,960	2,201	2,288	2,352	2,418	2,396	2,177	2,135	2,105
Shares Outstanding (millions)*	591.7	591.7	591.7	591.7	591.7	591.7	591.7	590.0	590.0
Book Value per Share	€ 3.31	€ 3.72	€ 3.87	€ 3.97	€ 4.09	€ 4.05	€ 3.68	€ 3.62	€ 3.57
Dividends Paid	211	242	250	264	274	284	286	121	73
Cumulative Value Created per Share		€ 4.13	€ 4.70	€ 5.25	€ 5.83	€ 6.27	€ 6.38	€ 6.54	€ 6.61
7-Yr. CAGR: '14-'21	**10.2%**								

*adjusted to reflect a 3-1 stock split in March 2018

Source: Company reports.

Valuation Analysis

Wärtsilä currently trades near its 52-week low; a price that is on par with the previous trough experienced approximately two years ago. Prior to this period, the company's share price had not been this low since 2011. While the current valuation may not be surprising given the recent pandemic, the impact that the war in Ukraine has had on Europe's economy and the seemingly increasing odds of a global recession in the near term, the company's recent sales figures and order intake stands in opposition to these negative indicators. Therefore, one could argue that the market is still valuing Wärtsilä's based on recent trough earnings and not on the likelihood that the business is not just recovering, but that earnings should reach new highs in the coming years.

As shown in Exhibit 7, the consensus earnings forecast for 2022 (adjusted for the extraordinary charges related to Russia) is still below what was earned prior to 2019, although it is an improvement from recent periods (see Exhibit 4). This forecast also shows that net income is expected to recover meaningfully next year. Although one could argue that the company's order book does not yet support the case for a rebound of this magnitude, order intake is undoubtedly improving, and the consensus forecast for 2023 is still well below the earnings potential of the company prior to the pandemic. In other words, while the timing of a recovery is uncertain, Wärtsilä's prospects are undoubtedly improving, and earnings will eventually follow. Despite this, the company trades at a low multiple (11x) of a 2023 earnings forecast that is still well below its full earnings potential.

Exhibit 7 Wärtsilä: Current Valuation Metrics
(€ in millions, shares in millions)

Share Price (9/27/2022)	€ 6.92		
Shares Outstanding (millions)	590.0		
Market Capitalization	**€ 4,083.0**		
Net Debt	192.0		
Enterprise Values	**€ 4,275.0**		
2022 Adj. Earnings	242.9	2023E Adj. Earnings	361.1
Price/2022 Adj. Earnings	**16.8x**	**Price/2023E Adj. Earnings**	**11.3x**
2022 EBITDA	478.1	2023E EBITDA	640.3
EV/2022 EBITDA	**8.9x**	**EV/2023E EBITDA**	**6.7x**

Source: Company reports, *Bloomberg*, *The European Contrarian* estimates.

These forecasts are also well below what the company could earn if it is able to make good on its recently announced financial goals, shown in Exhibit 8. The organic revenue growth target is modest at 5% per year, and the leverage goal is already met, as current gearing, which is net debt divided by equity, is only 0.21x. The notable goal, therefore, is the expected operating margin of 12%. This represents a slight improvement to pre-pandemic margins, which ranged from approximately 10.5% to 11.5% from 2014 through 2018, though it is a significant move from the ~6% margin it is currently realizing. No firm timetable was given to achieve these goals.

Exhibit 8 Wärtsilä: Financial Goals Outlined in 2021

Net sales	**5%** annual organic growth
Profitability	**12%** operating margin
Capital structure	Gearing **below 0.50**
Dividend	**At least 50%** of earnings

Source: Company reports.

If one assumes that these goals can be achieved over a five-year time period, then returns to shareholders would be attractive. Exhibit 9 shows estimated revenues in 2027 based on 5% annual growth from the 2022 revenue forecast of €5.67 billion. This analysis then assumes the 12% operating margin, interest expense of €50 million, which is substantially higher than both the interest expense recorded in 2021 of €18 million and the €3 million recorded through the first half of 2022, and a tax rate of 35%, which is on par with rate paid in 2021. Under these assumptions, Wärtsilä would earn an estimated €531 million, which is a 120% increase to the 2022 forecast.

Exhibit 9 Wärtsilä: Forecast 2027 Financial Results
(€ in millions)

2022 Revenue Forecast	€ 5,664
2027E Revenues @ 5% Growth	€ 7,229
Operating Income @ 12% Margin	**€ 867**
Estimated Interest Expense	-€ 50
Estimated Pretax Income	€ 817
Estimated Taxes @ 35%	-€ 286
2027E Earnings	**€ 531**

Source: Company reports, *Bloomberg*, *The European Contrarian* estimates.

If one then assumes a modest 12x earnings multiple on this estimate (compared to a normalized historical range of approximately 16x-21x), Wärtsilä's market capitalization would increase by 56%, representing an annualized return of 9.3% before dividends (see Exhibit 10). When one factors in that the dividend yield, assuming the minimum 50% payout ratio, would be 6.5% relative to the current price and that the current yield is 3.5%, total returns to shareholders could exceed 12%-15% a year over the near term.

Exhibit 10 Wärtsilä: 2027 Fair Value Estimate
(€ in millions)

2027E Earnings	€ 531
Assumed P/E Mulitple	12x
Implied Market Capitalization	**€ 6,376**
Current Market Capitalization	€ 4,083
Implied Upside	**56%**
Dividend @ 50% of 2027E Earnings	€ 266
Dividend Yield Relative to Current Mkt Cap	6.5%

Source: Company reports, *Bloomberg*, *The European Contrarian* estimates.

One could argue that there is little downside risk to Wärtsilä from the current levels, as the company has minimal debt and its recent financial results and order book indicate that the company is recovering strongly from the pandemic. Furthermore, while one cannot deny the risk of a global recession, the company's contracted services business represents a steady income stream that should support it through the cycle. In other words, while there may be some short-term economic volatility, there is little existential risk to Wärtsilä's business.

Over the long term, the company's practical and innovative solutions to supporting the energy transition make it a unique player in the industry. This bodes well for its growth prospects going forward. If it is also able to achieve its profitability goals, shareholders stand to generate significant share price appreciation and an attractive dividend yield relative to the risk of the company.

Conclusion

Wärtsilä is well positioned as a top company in a growing industry. While the nature of its business can be somewhat volatile, it has demonstrated an impressive degree of stability, having consistently generated positive cash earnings in recent years. Wärtsilä's revenues slowed modestly during the pandemic and the recent war in Ukraine has forced to abandon business in Russia, but its order book has fully recovered and sales going forward are poised to reach new highs.

Despite this improvement, the company still trades at low multiples of depressed earnings, thus offering investors the opportunity to purchase shares at a price that provides a significant margin of safety. The investment thesis is made even more compelling given Wärtsilä's goal to improve margins to their widest in recent history while simultaneously growing the business. Should the company be successful in achieving this, earnings would increase by an estimated 120% over the next five years with just 5% annual sales growth. Wärtsilä has also committed to a dividend of at least 50% of earnings.

This potential upside combined with the dividend policy equates to an attractive return profile for investors. Furthermore, the company's strong balance sheet, order book, market position and valuation all serve to significantly mitigate risk. Based on these factors, shares of Wärtsilä are recommended for purchase.

Exhibit 11 Wärtsilä: Consolidated Income Statement

(€ in millions)

MEUR	4–6/2022	4–6/2021	1–6/2022	1–6/2021	2021
Net sales	**1,407**	1,131	**2,639**	2,078	4,778
Other operating income	**14**	11	**26**	23	85
Expenses	**-1,313**	-1,043	**-2,581**	-1,925	-4,388
Result from net position hedges				-2	-2
Depreciation, amortisation and impairment	**-34**	-42	**-156**	-81	-162
Share of result of associates and joint ventures		1	**1**	2	3
Operating result	**75**	58	**-72**	94	314
Financial income and expenses	**-2**	-5	**-3**	-6	-18
Profit before taxes	**72**	53	**-74**	88	296
Income taxes	**-20**	-18	**-16**	-29	-103
Profit for the reporting period	**52**	35	**-90**	59	193
Attributable to:					
equity holders of the parent company	**51**	37	**-92**	61	194
non-controlling interests	**1**	-2	**2**	-2	
	52	35	**-90**	59	193
Earnings per share attributable to equity holders of the parent company:					
Earnings per share (EPS), basic, EUR	**0.09**	0.06	**-0.16**	0.10	0.33
Earnings per share (EPS), diluted, EUR	**0.09**	0.06	**-0.16**	0.10	0.33

Source: Company reports.

Exhibit 12 Wärtsilä: Consolidated Balance Sheet
(€ in millions)

MEUR	30.6.2022	30.6.2021	31.12.2021
Non-current assets			
Intangible assets	1,710	1,751	1,776
Property, plant and equipment	326	291	312
Right-of-use assets	240	175	192
Investments in associates and joint ventures	28	26	27
Other investments	18	18	18
Deferred tax assets	184	206	167
Other receivables	49	46	48
Total non-current assets	2,555	2,512	2,539
Current assets			
Inventories	1,215	1,257	1,185
Other receivables	2,086	1,471	1,833
Cash and cash equivalents	506	912	964
Total current assets	3,807	3,640	3,982
Assets held for sale	2	11	2
Total assets	6,365	6,163	6,523
Equity			
Share capital	336	336	336
Other equity	1,769	1,813	1,979
Total equity attributable to equity holders of the parent company	2,105	2,149	2,315
Non-controlling interests	9	8	8
Total equity	2,114	2,157	2,323
Non-current liabilities			
Lease liabilities	204	140	157
Other interest-bearing debt	528	806	694
Deferred tax liabilities	59	76	65
Other liabilities	200	221	236
Total non-current liabilities	991	1,242	1,153
Current liabilities			
Lease liabilities	42	40	39
Other interest-bearing debt	170	181	82
Other liabilities	3,048	2,538	2,925
Total current liabilities	3,259	2,759	3,047
Total liabilities	4,251	4,002	4,199
Liabilities directly attributable to assets held for sale		5	
Total equity and liabilities	6,365	6,163	6,523

Source: Company reports.

This report was produced by Horizon Kinetics ("HK"). The following persons employed by HK contributed to this report: Murray Stahl, Chairman, Steven Bregman, President, and Peter Doyle, Managing Director. HK is located at 470 Park Avenue South, New York, NY 10016. At the time of this report, there are no planned updates to the recommendations. To the extend HK has provided previous recommendations concerning the same issuer(s) during the preceding 12-month period, such recommendations do not differ from the recommendations contained here.

HK is the parent company to registered investment adviser Horizon Kinetics Asset Management LLC. It manages a variety of investment products including mutual funds, private funds and separate accounts. PCS Research Services ("PCS") is the exclusive marketer and distributor of this and other reports produced by HK. HK and PCS are not affiliated with one another. Neither entities perform or are expected to perform investment banking services for the issuer(s); are not market makers, and are not party to any agreements with the issuer(s). The issuer(s) has not been a client of HK or PCS. None of the research analysts involved in creating this report have received compensation from the issuer(s). HK analysts are compensated based on the success of the firm in general, along with the quality and accuracy of the analysts' research. Remuneration from HK to research analysts is not linked to investment firm activities of any affiliates. Conflicts of interest for employees of HK and PCS, and their affiliates, are managed by a formal code of ethics and information barrier procedures which include, but are not limited to, policies related to restricted lists, personal trading rules, and the prohibition of misuse of material non-public information.