



Will Westport Innovations Inc. Pay a Heavy Price for This Move?

Description

In a surprising move earlier this month, **Westport Innovations Inc.** (TSX:WPT)([NASDAQ:WPRT](#)) announced plans to acquire **Fuel Systems Solutions Inc.** (NASDAQ:FSYS) in an all-stock deal to create “a premier alternative fuel vehicle and engine company.” The merger is expected to close by the end of the year.

Considering that Westport has yet to turn a profit, is still transitioning from product development to product commercialization phase, and is burning cash at an alarming rate, what’s the logic behind this move and what does it mean for investors going forward?

A big deal, but...

It’s undoubtedly a big deal.

Both companies have strong foothold in the global alternative fuel (primarily natural gas) engine market that spans on-highway and off-highway vehicles and equipment. While Westport is more into the heavy-duty side, Fuel Systems specializes in light and medium-duty applications. Naturally, a merger should give Westport access to a much wider audience globally, especially into the industrial side of the alternative fuel market, which Fuel Systems has strong presence in.

Investors in Westport, however, are currently worried about one thing: profitability. They want to see the company break even soon, even as it restructures operations to curtail costs while finding ways to market its technologies profitably. But now that Westport is buying another loss-making company, could its turnaround get delayed further?

What’s the incremental revenue potential?

Investors expect a merger to be immediately accretive to the company’s top and bottom lines. Westport expects the combined company to be known as Westport Fuel Systems and expects to generate between US\$380 and US\$405 million in revenue this year. In 2014 Westport generated US\$130.6 million while Fuel Systems generated US\$339.1 million in revenue. Put together, the combined company’s revenue in 2015 is projected to be nearly 14% lower, even at the higher end of

the range.

So for now, there are no indications of any incremental revenue that Westport could generate from the cross-selling of Fuel Systems's offerings.

What about profits?

There's no question of accretive profits as Fuel Systems is also a loss-making company. So, when two loss makers merge, cost synergies gain priority. Costs should go down as the combined entity eliminates overlapping operations and exploits economies of scale.

Westport expects the merger to generate pre-tax savings of US\$30 million to be fully realized by 2018. That target looks small given the size of the two combining businesses. Moreover, while US\$15 million of that is on account of merger synergies, the remaining is the potential savings expected from Fuel Systems's restructuring efforts. In fact, both companies are in the middle of aggressive restructuring, which also involves costs. So, there's every possibility that one-time costs could eat into the already small savings target.

Worse yet, Fuel Systems will likely incur bigger losses this year, considering that its net loss for the six months through June (excluding a big one-time charge incurred in 2014) more than quintupled year over year. Even if I assume a no profit or loss second half for Fuel Systems and half the 2014 losses for Westport, the combined entity will still lose more than US\$90 million this year.

It doesn't help either that both companies are burning cash at a rapid pace. Westport's cash and short-term investments through June slumped 64% year over year, and Fuel Systems ended the period with 30% lower cash balance.

Is the merger any good for Westport investors?

Things aren't going right for the two companies right now thanks to the recent slide in oil prices that have rendered alternative fuel options less attractive. Westport hopes to take advantage of this downturn by buying out a complementary company at a cheap price.

Fuel Systems's stock has been knocked down in half year-to-date. That's a smart strategy to gain traction in the industry, but investors need to see visibility in terms of incremental revenue and profits before giving the move a thumbs up.

There's not much to get excited about for now as it's more of a wait-and-see game.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NASDAQ:WPRT (Westport Fuel Systems Inc.)

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