Chapter 7

The Various Incarnations of Research Cottrell

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Research Cottrell is known to readers of *The Contrarian Research Report*, since its last incarnation before its demise was as a division of Air and Water Technologies. Air and Water Technologies was the subject of a recent report dealing with its distressed convertible bonds and its recent recapitalization. The assets of Research Cottrell were written off and it no longer has a corporate existence. It came to be part of Air and Water Technologies via a leveraged buyout and a merger with another pollution control company.

Research Cottrell bears the unique distinction of being a disastrous investment as a publicly traded equity. It was notably unsuccessful as an LBO and it was a catastrophe as a division of Air and Water Technologies. Consequently, such an investment is a most appropriate topic for this column.

Research Cottrell was a pollution control company. One of its specialties was the construction of scrubbers used to remove pollutants from the exhaust fumes of coal fueled electricity plants. In 1973, this company sold for an average P/E ratio of 54x. It had a market capitalization of $284 million and revenues of $140 million. Since its earnings were growing, it paid out only 6-7% of profits in the form of dividends. The company was essentially debt free, as debt comprised 1-2% of corporate capital.

The growth of profitability began to falter somewhat during the energy crisis. Utilities were financially burdened by the high cost of fuel which, in many instances, they were not entirely permitted to pass on to the ratepayers. The various state regulatory agencies became increasingly disinclined to mandate the inclusion of scrubbers in existing plants.

In addition, with regard to new plants, coal was not considered to be a fuel of choice. In any event, due to a variety of measures including energy conservation and the construction of various alternative energy plants, the national demand for electric power did not grow very rapidly. Indeed, in most years it did not grow. There was consequently a dearth of new construction of coal fired plants and increasingly less demand for scrubbers.

By the period 1977-1978, this situation had become apparent to investors as the shares now traded at 9-10x earnings. The company was still conservatively capitalized with debt at only 7% of capital and a 6-7% dividend payout ratio. As the United States entered the second energy crisis, Research Cottrell was determined to alter its strategy to the new reality. It appeared that nuclear power was the most cost efficient source of energy as well as the most politically secure. Thus, the company shifted much of its effort to the production of water cooling towers to be used to reduce thermal pollution associated with nuclear reactors.

Unfortunately, from the time that these products were introduced to the current day, no utility has applied for permission to build a new nuclear plant. Virtually every nuclear plant that was under construction was plagued with regulatory and other problems and many were never completed.

Thus, Research Cottrell found itself to be a conservatively capitalized enterprise with a low equity valuation, with good and honest management and with excellent products that could not be sold. If there is any lesson in this history, it is that product obsolescence is such an incredibly powerful variable that, when it does occur, it will determine the fate of an enterprise. Once capital is deployed in an effort to manufacture a product with no demand, redeployment is the most difficult of exercises.