First Cut Stock Study Report

Company Name:	KMG Chemicals, Inc.	**Ticker:**	KMGB
Date of Study:	5/29/2010	**Price:**	$ 15.82
Your Name:	Ross A. Meredith Jr.		
Email address:	rossmeredithjr@msn.com		
City:	Salt Lake City	**State:**	UT
Chapter Name (if applicable):	Utah		

Discuss why you consider this to be a high quality, growth company that should be investigated further. Please include comments on historical sales and EPS growth, pre-tax profit margin, return on equity, and debt.

KMG changed its business model to one of growth by acquisition in 2002 and has grown EPS at a 20% compounded annual rate since then. The company has made seven successful acquisitions since 2002 and has expanded its margins and cash flow with each purchase. This is a small company with only 12 million shares outstanding. The company maintains a strong balance sheet with manageable debt given its strong free cash flow growth, and good liquidity. A $35 million credit line is currently unused. The company recently sold 1 million shares at $17.50 per share.

KMG produces specialty chemicals in the wood treatment, animal health and electronic chemicals industries. The company holds leadeship positions in narrowly defined niche markets in each industry. The company seeks to buy mature, specialty chemicals businesses occupying narrowly defined markets. These product lines often become available from much larger businesses who chose to devote capital to faster growing lines. The company seeks targets having significant market positions in stable markets with few competing manufacturers.

KMG seeks to improve operating efficiencies, product quality, distribution and customer responsiveness thereby enabling KMG to expand margins and extent the life of mature products. These stpes typically require minimal capital expenditures and KMG can increase free cash flow. Since 2002, free cash flow has grown faster than earnings.

The company has been a participant in past BINCs, a Corporate member of NAIC and belonged to the former low cost plan. It appears to be well interested in individual investors.

Briefly describe how the company makes money:

See first paragraph above.

Projected growth rate for sales: 12.0**%**
Why did you select this rate? Discuss from where future growth will come.

I assume that current economic conditions reduce the historic rate of sales growth in order to be conservative. Future growth will come largely from acqusitions to be made and from internal growth of past acquisitons. Since KMG buys mainly mature product lines, internal growth is not expected to be strong for more than a short initial period after acquisition. The company has closed a deal for the purchase of the electronic chemicals business unit of General Chemical in April 2010. This purchase will add approximately $42 mil to sales in FYE 2011 (FYE is July 31st). That is an approximate 20% increase. If we assume that acquisitions are only made every other year from this point, sales may grow about 12%. Faster acquisitons may produce greater sales growth. I can't predict that although purchases have been made annually for the last five years. Acquisitons to date are as follows:

Milestones

- 1985 – Original penta distribution business acquired.
- 1986 – Built penta manufacturing plant in Matamoros, Mexico.
- 1991 – Acquired creosote distribution business from Bernuth-Lembke
- 1993 – Acquired sodium penta business from Rhone-Poulenc.
- 1996 – IPO; KMG begins trading on Nasdaq.
- 1998 – Acquired significant creosote assets from Allied Signal.
- 2000 – Acquired MSMA herbicide products from Zeneca Ag Products.
- 2002 – Entered animal health business with acquisition of Rabon from Boehringer Ingelheim.
- 2003 – Acquired the assets of Wood Protection Products, a key penta distributor.
- 2004 – Acquired the creosote distribution business and assets of Trenton Sales.
- 2004 – Expanded animal health business by acquiring Ravap from Boehringer Ingelheim.
- 2005 – 1.2 million-share private equity placement.
- 2005 – Acquired penta manufacturing assets from Occidental Chemical.
- 2006 – Acquired U.S.-based animal insecticide business of Boehringer Ingelheim.
- 2006 – 3.2 million-share public offering, including 1.7 million newly issued shares.
- 2008 – Acquired High-Purity Process Chemicals business from Air Products and Chemicals, Inc.
- 2010 – Signs definitive agreement to acquire General Chemical's Electronic Chemicals business.

Projected growth rate for earnings per share: 15.0**%**
Why did you select this rate?

I used the preferred procedure to compute this rate. I assume the growth of cash flow and margins will be faster than sales. The company has been able to increase margins significantly over the last few years.

Projected High P/E: 14.1
Why did you select this value?

Elimination of the three highest PEs in the company's ten year recorded history results in this number. This is a very conservative estimate. It includes extremely low PEs from 2009 when the market price of the stock dropped enormously and earnings held up. I believe it is, however, validated by the implied PEG ratio of a bit more than 1.175 times expected earnings growth. I again tried to be conservative, especially in light of the nature of the company's growth program. I think growth by acquisition entails a bit more risk that management will miss something in its due diligence than the risk evident from internal growth.

Projected Low P/E: 7.5
Why did you select this value?

Again, elimination of the three historic highest low PEs results in this number. It is less than expected overall growth and 10% below expected internal growth rate of revenues. The current PE is only moderately above this PE.

Projected Low Price: $10.80
Why did you select this value?

This price is based on the trailing twelve months earnings of $1.44. It appears to incorporate all reasonable possibilities of downside events.

At the current price, the stock is a (check one):

☐ **Buy** or ☒ **Hold** or ☐ **Sell**

At the current price, the upside-downside ratio is: 2.0 **to 1**

Projected compounded rate of return: 11.2**%**

Your final recommendation (check one):

☒ **Buy** or ☐ **Hold** or ☐ **Sell**

Explain:

Both the company and its industry's prospects appear solid. The company is well managed, financially strong, generates strong cash flow and has funded its growth without excessive debt to date. While this is a young company and subject to significant competition, its business model appears to minimize the effects of direct competition. As an acquirer, its financial strength and high selectivity in targets enable it to find good candidates for purchase in a very fragmented industry. The company has grown faster than its industry and its results have sidestepped the recession so far. My estimates of future growth and profitability may be significantly understated because future acquisitions may have a much stronger effect on results than I project. Its rather unique business model largely insulates it from immediate competition. Its growth rate has accellerated in recent years. Internal growth was largely discounted in my analysis and it may have a more pronounced effect on results than I included. The company lists a high Return on Equity of 23%, a five year growth rate of 30%, a price to operating cash flow of 6.68% and current ratio over 2 to 1. My estimate of intrinsic value using discounted cash flow analysis is twice the current price. The stock offers a nice DRIP and may be a good subject for periodic accummulation.

Company	KMG Chemicals, Incorp..	Price Date	05/21/10
Study by	RAM	Data Date	05/21/10
Sector	Basic Materials	Data Source	StkCntrl
Industry	Specialty Chemicals	Reference	Morningstr
Preferred($M)	0.0		
Common(M Shares)	11.4	% Insiders	46.0
Debt($M)	43.3	% Institutions	30.7
% to Tot.Cap.	37.3	Quality	1.6 (Take Stock)

Stock Study

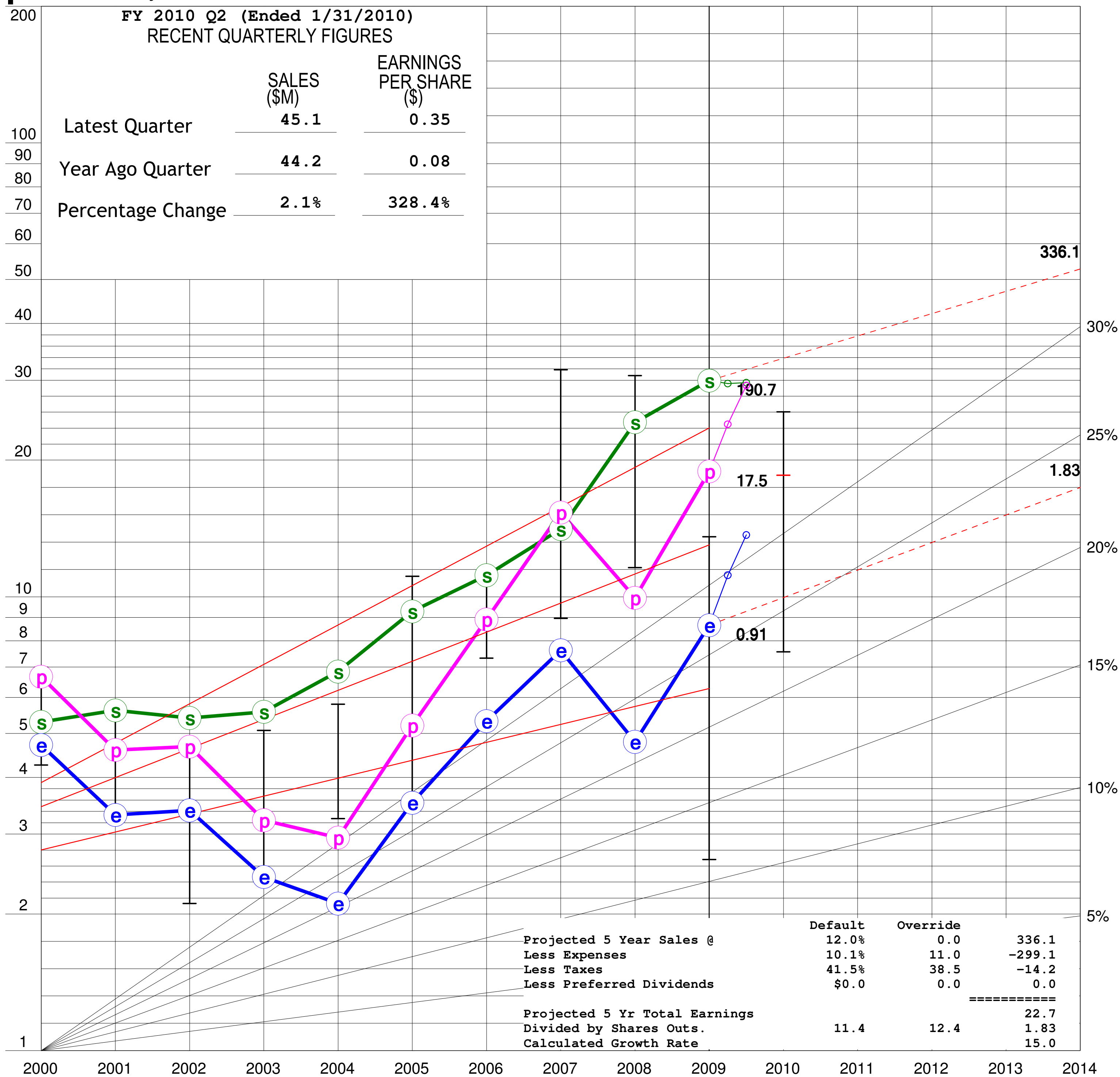
1 Growth Analysis

NASDAQ KMGB

FY 2010 Q2 (Ended 1/31/2010)

RECENT QUARTERLY FIGURES

	SALES ($M)	EARNINGS PER SHARE ($)
Latest Quarter	45.1	0.35
Year Ago Quarter	44.2	0.08
Percentage Change	2.1%	328.4%



	Default	Override	
Projected 5 Year Sales @	12.0%	0.0	336.1
Less Expenses	10.1%	11.0	-299.1
Less Taxes	41.5%	38.5	-14.2
Less Preferred Dividends	$0.0	0.0	0.0
			===========
Projected 5 Yr Total Earnings			22.7
Divided by Shares Outs.	11.4	12.4	1.83
Calculated Growth Rate			15.0

(1) Historical Sales Growth 22.1 %

(2) Estimated Future Sales Growth 12.0 %

(5) Sales Growth R^2 0.89

(3) Historical Earnings Per Share Growth 9.5 %

(4) Estimated Future Earnings Per Share Growth 15.0 %

(6) Earnings Per Share Growth R^2 0.36

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2 QUALITY ANALYSIS

Company KMG Chemicals, Incorporated (KMGB) 05/21/10

		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	5 YEAR AVG.	TREND UP / DOWN
A	% Pre-tax Profit on Sales	18.3	11.9	12.6	8.4	6.3	8.1	11.6	15.8	6.0	9.2	10.1	DOWN
B	% ROE (Beginning Yr)		15.3	13.9	8.9	7.2	11.3	15.0	18.0	9.5	15.8	13.9	UP
C	% Debt to Equity	14.4	8.3	7.9	18.3	45.2	57.2	33.3	18.0	82.6	54.8	49.2	UP

3 PRICE, PRICE/EARNINGS RATIO and DIVIDEND ANALYSIS

CURRENT PRICE 15.820 52-WEEK HIGH 21.800 52-WEEK LOW 6.450

	Fiscal Year	High Price	Low Price	EPS	High P/E	Low P/E	Dividend	% Payout	% High Yield
1	2005	9.5	3.1	0.37	25.7	8.4	0.070	18.9	2.3
2	2006	9.9	6.3	0.56	17.7	11.3	0.080	14.3	1.3
3	2007	27.0	7.7	0.80	33.7	9.6	0.080	10.0	1.0
4	2008	26.2	9.9	0.50	52.0	19.6	0.080	15.9	0.8
5	2009	11.6	2.3	0.91	12.7	2.5	0.080	8.8	3.5
6	AVERAGE		5.9		28.4	10.3		13.6	

AVERAGE P/E RATIO	19.3	PROJECTED P/E RATIO	9.6	TTM EPS	1.44
CURRENT P/E RATIO	11.0	PEG RATIO	0.6	FTM EPS	1.66
RELATIVE VALUE	57.0%	PROJ. RELATIVE VALUE	49.5%		

4 EVALUATING REWARD and RISK over the next 5 years

A FUTURE HIGH PRICE ANALYSIS -- NEXT 5 YEARS

Selected High P/E ~~28.4~~ 14.1 X Estimated High Earnings/Share 1.83 = Forecast High Price $ 25.8

B FUTURE LOW PRICE ANALYSIS -- NEXT 5 YEARS

(a) Avg. Low P/E ~~10.3~~ 7.5 (as adj.) X Estimated Low Earnings/Share ~~0.91~~ 1.44 = $ 10.8

(b) Average 5-Year Low Price = 5.9

(c) Recent Severe Low Price = 2.3

(d) Price Dividend Will Support = Present Divd. ÷ High Yield = 0.080 ÷ 0.035 = 2.3

Selected Estimated Low Price = $ 10.8

C PRICE RANGES

Forecast High Price 25.8 - Estimated Low Price 10.8 = Range 15.0 25% of Range = 3.7

BUY (Lower 25% of Range) = 10.8 to 14.5

MAYBE (Middle 50% of Range) = 14.5 to 22.1

SELL (Upper 25% of Range) = 22.1 to 25.8

Current Price 15.820 is in the Hold Range

D REWARD/RISK ANALYSIS (Potential Gain vs. Risk of Loss)

(Forecast High Price 25.8 - Current Price 15.820) ÷ (Current Price 15.820 - Estimated Low Price 10.8) = 2.0 To 1

5 TOTAL RETURN ANALYSIS

A CURRENT YIELD

Present Full Year's Dividend $ 0.080 ÷ Current Price of Stock $ 15.820 = 0.5 % Present Yield or % Returned on Purchase Price

B AVERAGE YIELD OVER NEXT 5 YEARS

(Avg. EPS Next 5 Years 1.39 X Avg. % Payout 13.6) ÷ Current Price $ 15.820 = 1.2 %

C % COMPOUND ANNUAL TOTAL RETURN

Average Yield 1.0 % + Annual Appreciation 10.3 % = Compound Annual Total Return 11.2 %

D % PROJECTED AVERAGE RETURN

Average Yield 1.3 % + Annual Appreciation 4.6 % = Projected Average Total Return 5.8 %