RANSOM RESEARCH, INC.

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Crane Corporation
(CR-$43.03)

"Highlighting Lean At An Inflection Point?"

<u>Company Description</u>*: *Crane is a broadly-diversified, multi-industry enterprise that provides highly-engineered, proprietary products, aftermarket parts, and services to end markets in Aerospace and Electronics (including both commercial and defense), Fluid Handling, Engineered Materials, and Merchandizing Systems. The company has not yet, in my estimation, been given adequate recognition for the fact that it has already transitioned from its historical role as a holding company for opportunistic acquisitions to being a culture-centric operating company built around the principles of "lean," in both the manufacturing arena and the administrative world I refer to as "transactional."

<u>Investment Thesis</u>

I just love companies willing to correct me when I overlook something important. I am not being snide: I really do love it, since I am always "polishing my sword," as instructed by the great 16th century *samurai*, Miyamoto Musashi.

Although I have long favored Crane as one of my "Other Favored Companies," in the taxonomy favored by Ransom Research, Inc., I was taken to task last year by several members of Crane's management for not "giving enough credit" to the company for its efforts. My response? "Prove it to me." I made it clear that I welcomed the opportunity to understand where the company stood with respect to the development of the Crane Business System, because one of the two principal research discriminators of Ransom Research, Inc., is a 20-year base of building knowledge about all things Toyota-like.

That dialogue led to a long and complicated travel schedule to visit numerous facilities, first across Crane's <u>industrial</u> portfolio. Half-way through the first three days of joint travel with senior members of Crane's management, I admitted, "You are right. I <u>have</u> under-estimated the progress which you have already made in applying lean thinking to your businesses." At the end of that first three-day itinerary of plant tours, I was asked, quite reasonably, "Well, what are you going to do about it?" My response? "I need to go see your <u>aerospace</u>

businesses, because that's a common area where even well-intentioned lean adopters break down in their application of lean thinking." Fortunately, a subsequent set of days on the West Coast to do *gemba* walks in Southern California and the Northwest gave me confidence that Crane was very much on the right track. In addition, I gained intriguing insights into how Crane is attempting to refine the manner in which it recruits, trains, retains, and dispenses with talent and how is applying lean tenets to the essential task of new product development, launch, ramp, and optimization.

Based on those detailed company visits, I was comfortable at the end of 2010 in elevating Crane from the category of "Other Favored Companies" to a much more select list which I call "Next-Generation Danahers." This change in classification within the research universe of the Ransom Research, Inc., is, in my world, a very big deal. In a subsequent section, I will elaborate on this topic.

Wall Street may never be completely comfortable with the composition of the served industries targeted by Crane. Smart investors embrace the highly-profitable and annuity-like aspects of aerospace/defense/electronics operations, and the fluid handling business (which cuts across potable and waste water, chemical and petrochemical, energy, building services, and utilities) has long been a favorite area of investment by knowledgeable money managers. For better or for worse, however, vending operations and truck-siding businesses may never get the credit that they deserve, although I am convinced that they represent very sound, accretive, cash-generating business lines with well-articulated and clearly-sustainable business models.

As I outline in the "Conclusion" of this report, I believe that investors may be at an important inflection point in how they view Crane's businesses, both in terms of cycles and in terms of the lean culture that drives the company. Plus, we as investors still have a lot to anticipate with respect to enhanced operational excellence, margins, earnings, and cash.

Thinking About Lean Beyond The Factory Floor

One of the most impressive aspects of Crane's lean journey is the discipline and speed with which it is applying "lean' principles of employee empowerment, waste reduction, and continuous improvement well beyond the factory floor. Many companies have learned that they can marshal a few crowbars and lifts and reposition production machinery to achieve one-piece flow, but very few of them are exercising the skill sets necessary to build a true culture, which goes well beyond having kiosks in cells for dashboards and standard production metrics posted hourly.

Lean culture, as I proselytize incessantly to institutional investors and management teams, can never be viewed as sustainable until all facets of the enterprise embraces lean principles. On this score, Crane is performing quite well.

My rough tally of effective lean adopters across my industrial research universe may somewhat higher than the historic benchmark of 5% that I have cited, in all unscientific glory, but it is clearly true that very few ever take lean

tenets beyond physical product production areas. Crane is going bang-busters on moving its codified process transformation techniques deep into the enterprise, which puts in in league with maybe 1% of companies. None of the following bullets constitute anything close to material inside information, but each area of activity outlined certainly represents areas of world-class lean work. I will decline to cite specifics, in order to preserve Crane's proprietary edge.

- **New Product Development**
- **Human Resources**
- **Accounting and Finance (and, yes, they are two different things)**
- **Warranty Administration**
- **Sustaining Intellectual Capital**
- ***Hoshin Kanri***
- **Sales and Marketing**
- **Supply Chain**
- **Value Stream Linkage**
- **Business Development**
- **Customer Alignment**
- **Acquisition Integration**
- **Product Support and Aftermarket Operations**
- **Development and Protection of Intellectual Capital**
- **Talent Psychological Profiling (don't let they folks at Crane talk you, as they did me, into taking the company's customized test; the accuracy of competencies and deficiencies can be sobering, even for those of us who have been using such tests since the mid-1060s.)**

It's the extension of these disciplines that will give shape and context to "The Crane Way."

<u>Let's Not Get Hung Up on Classification; It's the *Journey* That Counts</u>

There will undoubtedly be a few of my loyal readers who wonder why Crane has been elevated "just" to "Next-Generation Danaher" instead of becoming the sixth of my five "Super-Achiever" companies (Danaher, General Electric, Illinois tool Works, Roper industries, and United Technologies).

The reasons are two-fold: one, it takes a very long track record to warrant "Super-Achiever" status (the category consisted of only four names for the first seven years of its existence); and, two, there are still few companies on my "Next-Generation Danahers" which are not close to 10 years into the implementation of lean principles and the creation of a lean culture. Certainly, I would not want my loyal readers to believe that the qualifications for any category relate to time or even lean (since ITW, Roper, and Ametek are not classic lean emulators). I followed Roper for at least 15 years before it hit top-tier status, despite the fact that it may have been the second most successful investment I've ever recommended to clients.

For the record, the other companies previously on my "Next-Generation Danaher" list, in approximate order of elevation (which is decidedly NOT in order of implementation thoroughness), include Actuant, Ametek, Teleflex, Parker Hannifin, Circor, Snap-on, Wabtec, Regal-Beloit, and Gardner Denver. Gardner

Denver did achieve ‘Next-Generation” status in roughly three years, mostly due to my intimate experience that the past management track record of three of the senior managers of Gardner Denver, one of them for more than two decades.

All represent pretty august company. With the exception of Actuant and Teleflex, all have out-performed the market over the past five years. In fairness, back on the last day of December, 2008, I was thinking about adding Harsco to the list, but I fortunately ducked that bullet. It is also clear that I need to elevate Esterline, Raytheon, and Toro, but those events will have to wait for another report. In similar fashion, I am holding off on decisions about moving Caterpillar and Terex from my “Other Favored Companies” list, but I should have enough data in the next month or so to make that determination.

Some time ago, I wrote that Chairman Eric Fast had made "the most rapid and successful transition from being an investment banker to being the chief executive officer of diversified industrial operating company." (He was kind enough to e-mail me after that report and say, "From you, that's a compliment ... I think!) He and his board deserve enormous credit for essentially transforming the complexion of Crane Corporation in the 10 years that he has been President and Chief Executive Officer of Crane.

In 2005, the company began to move in earnest to acquire "lean" talent, beginning with Max Mitchell, who joined Crane in 2004 as Vice President of Operational Excellence, after stints at Pentair, Danaher, and Ford. He climbed rapidly through the management ranks at Crane and now heads the Fluid Handling segment. I consider him to be both a sparkplug and bellwether for lean thinking at Crane, but, today, the upper management masthead of Crane is populated by lean zealots with extensive experience at cultures as strong as Danaher and Parker Hannifin.

In simplest terms, the company has embarked well on its first concentrated half-decade of lean. The issue, as with all companies, will be sustainment, but the rigor with which the company stuck to its lean knitting during a very severe economic downturn makes it clear that it is deadly deliberate with its actions.

Getting “CRISP”

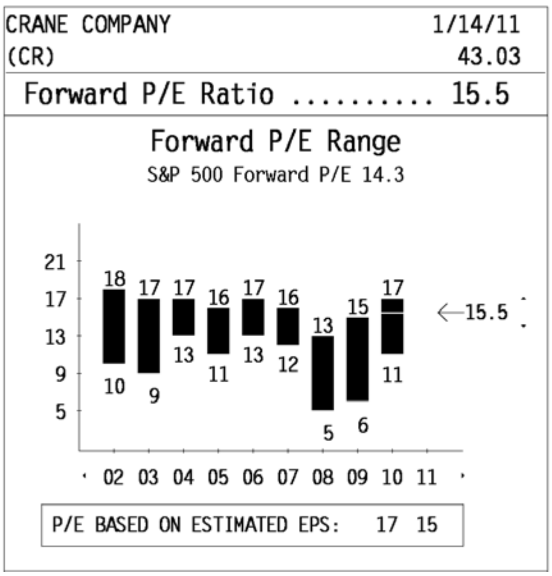
I have a simple construct about why I like lean operations. I use the acronym, CRISP, meaning, “Consistent, Repeatable, Integratable, Sustainable, and Predictable.” These conditions tend to arrive during sincere lean adoptions sometime between year five and year eight of implementation. I have often lamented that there are fewer than a dozen of us on Wall Street who truly understand lean principles, but all investors, however subliminally, give credit to those companies who produce superior results over a long period of time. It’s metrics like nearly twenty years of cash flow exceeding net income at Danaher and nearly twenty years of margin improvement at United Technologies that warrant investor approval, via valuations.

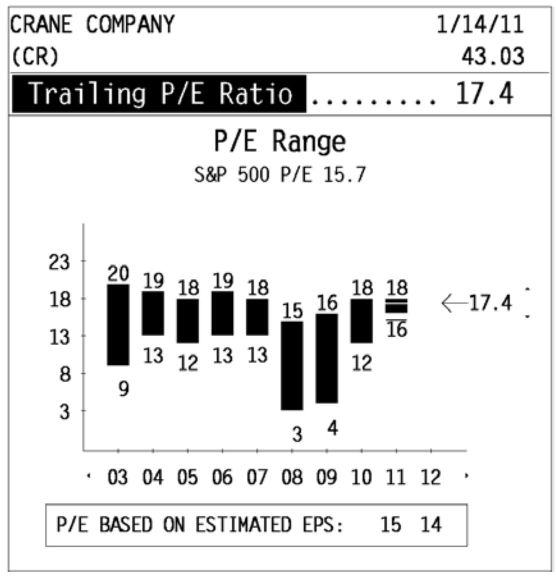
The final characteristic, “Predictable,” is the most difficult to attain. Yes, The Great Recession can throw everything into a cocked hat, but the lean companies did relatively well. Parker Hannifin stayed profitable and margins only

slid under 10% for one solitary quarter. It will probably take the next recession to have investors believe that Crane is CRISP, but the near-term still brings considerable promise.

<u>Valuation and Earnings</u>

The share price of Crane is still down roughly 11% from its late-2007 all-time high in 2007, but the stock has still out-performed the market over that time frame and over the past five years. The P/E ratio of the company, however, is near the high end of its recent range, at least since the last industrial and aerospace/defense recessions, as shown in the following Baseline charts showing forward and trailing valuations.





Crane has long been a prodigious generator of free cash flow, which it has used to manage its balance sheet, pay dividends, and fund both share repurchases and acquisitions. In additon, the company has been paring its portfolio, since 2000, greater than $200 million in sales (roughly 10% of the total) have been divested. On the other hand, the company has made at least one meaningful acquisition a year since Eric Fast became CEO, and Crane has not cut its dividend since at least 1971.

There have been several flat years in the dividend, as recognition of tough economic times, but this Board clearly understands the role of a consistent dividend policy. Management and the Board of Crane own 6.7% of the company, as of the filing of last year's proxy statement. The company also has a long history of re-purchasing its own shares opportunistically, particularly when acquisition alternatives are not clear.

Total debt to capital at 9/30/2010 was less than 30%, with net debt at less than $100 million.

Crane does has asbestos and pension issues, both of which it has managed well, in my opinion.

Conclusion

So, the question from my loyal readers may become, "Why write up Crane now?"

I have been talking to my institutional investment management clients for several months about my perceptions of the transformation taking place at Crane. Certainly, the shares have well-outperformed the market since the late-2008, early-2009 stock market collapse.

The answer to "why Crane now" all comes down to earnings and then to valuation. Take a look at the following chart of consensus estimates from Baseline.

CRANE COMPANY 1/14/11
(CR) 43.03

Earnings Per Share - % change
Latest Qtr (Sep 10) ....up 15 %

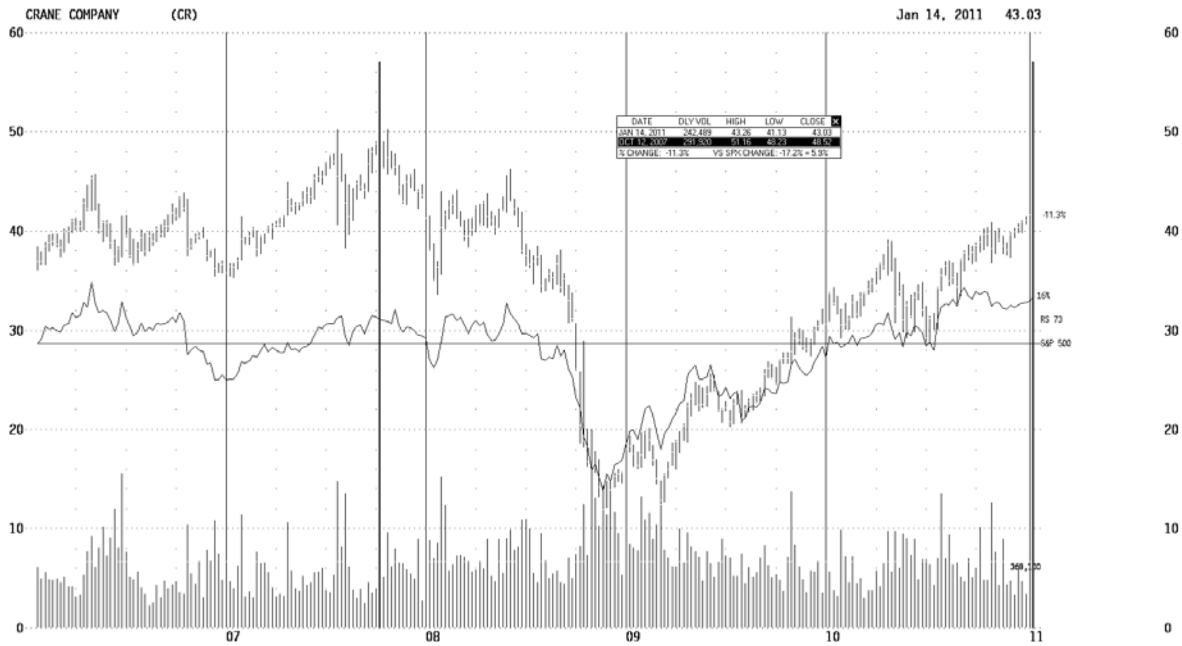
%Y Earnings Per Share
Next Expected EPS Date: Jan 24
68 · · 12

	2006	2007	2008	2009	2010	2011	2012
Mar	.61	.71	.79	.48	.56	.64	.70
Jun	.71	.84	.93	.50	.66	.75	.85
Sep	.74	.87	.60	.60	.69	.75	.82
Dec	.61	.77	.56	.57	.65	.73	–
Yr.	2.67	3.19	2.88	2.15	2.57	2.84	3.16
Yr. to Yr.		19 %	–10 %	–25 %	19 %	10 %	12 %

I have been a contrarian in being steadfast believer in the stability of aerospace/defense and water markets, street still think of them as "late-cycle" industries. That perception, which I would postulate has been inexact, may now accrue to Crane's benefit, particularly because the company exhibits very high incremental margins on incremental revenues, a theme I have stressed since early 2009 want which has not yet run its course.

To make money from current levels, we only have to get Crane to earn a valuation modestly above my "normalized" long-term market valuation of 15 times earnings. In the next up cycle, it seems reasonable that Crane will get the 17-plus multiple typically accorded, as a minimum level, to my highest-caliber companies. At the 17-times level, the share price of Crane would climb from current levels by almost 25% to close to $53 per share.

The prospects for continued double-digit earnings advances in 2011 in 2012 may well differentiate Crane from many other companies, whose "comps" will decelerate or even deteriorate as we march through 2011. The company will release fourth quarter, 2010, financials on January 24, 2011, and hold its normally-well-attended and quite-complete annual analyst meeting on February 17, 2011, in New York City. I believe that long-term investors should do a lot of homework before that time.



Source: Baseline

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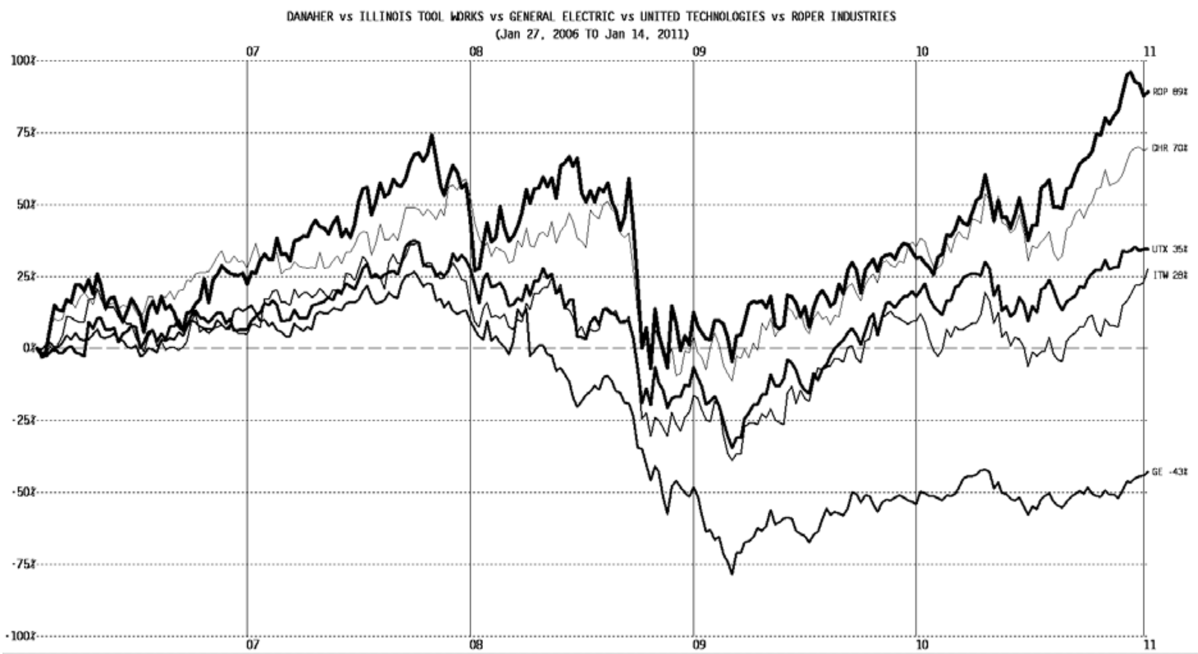
Super-Achiever Outperformance
(With Only GE An Underperformer)



Source: Baseline

And, to make the point one additional time, being characterized as a "Super-Achiever" is a call on *culture*, not stock market attractiveness at any given hour on any given trading day. Yes, I admit that I suffer from a bad case of the dreaded "Buy-Danaher-Every-Day-All-Day Syndrome," but I tend to wait for appropriate entry and exit points, based on stock market action, for all other stocks. For example, I had little interest in General Electric until the company got pole-axed by its financial operations. I will admit, as I did in a report dated February 1, 2009, I did buy early and repeatedly, but ultimately well.