RESEARCH REPORT

January 8, 2018

Stock Rating	HOLD
Price Target	CAD $56.00

Bear Case	Price Target	Bull Case
$45.00	$56.00	$62.00

Ticker	SJ
Market Cap (MM)	$3,470
P/E NTM	22.1x
EV/EBITDA NTM	14.6x

52 Week Performance

Industrials

Josh Morris
jmorris@quiconline.com

Walid Herzallah
wherzallah@quiconline.com

Mathew Andreou
mandreou@quiconline.com

Nick Gakena
ngakena@quiconline.com

Stella-Jones Inc.

A Consistent Force

Introduction

Since pitching Stella-Jones in early 2017, the Company's share price has risen over 30%. The theses outlined in the initial report have played out largely as expected, causing the share price to recover from its 2016 losses. Stella-Jones remains one of Canada's best growth stories over the past decade, maintaining a wide economic moat and growing market share through acquisitions. The Company benefits from stable end markets, a suite of competitive advantages, and a stellar management team. Ultimately, these factors have allowed Stella-Jones to generate high returns for shareholders over the past decade.

Valuation

Without a proper set of comparable companies, relative valuation techniques were applied to the Company's historical multiples. Paralleling the valuation approach taken in January of 2017, forward EV/EBITDA and P/E multiples were blended with a discounted cash flow analysis at a 50/50 weighting to arrive at a target price of $56.00. Moving forward, the Industrials team would like to continue holding Stella-Jones' stock, believing that management's ability to identify and integrate accretive acquisitions will drive further growth in revenues, earnings, and returns on capital.

Proposed Action

Industrials is planning on maintaining our 14% position in Stella-Jones due to the Company's stable and diversified growth profile, defensibility against short-term risks, and acquisition-driven upside potential.

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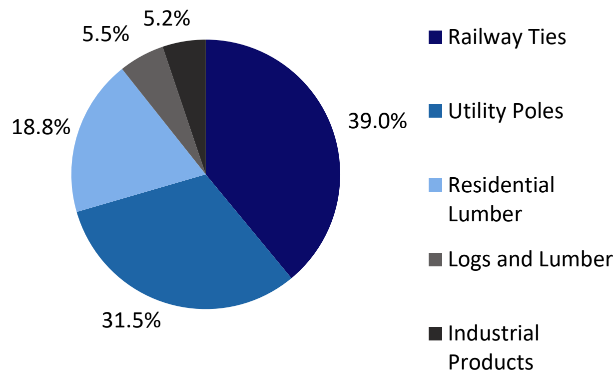
Company Overview I

Stella-Jones Inc. ("Stella-Jones", "SJ", "the Company") is a Canadian-based producer and marketer of wood treated products. The Company supplies North American railroad operators with railroad ties and timbers, electrical utility and telecommunication companies with utility poles, retailers and wholesalers with lumber for outdoor applications, and offers industrial products used in foundations and structural construction. Stella-Jones buys raw materials (wood) and via its manufacturing and treating process creates products that are used as railway ties, utility poles, and building materials. In 2016, Stella-Jones recorded 31.1% of its sales from railroad ties, 33.3% from utility poles, 24.3% from residential lumber, and the remainder from logs, lumber, and industrial products. Stella-Jones operates 37 wood treating plants, 16 pole peeling facilities, and a coal tar distillery. These facilities span five Canadian provinces and 19 American states. In 2016, 71% of revenue was from the U.S. and 29% from Canada. The Company maintains an extensive distribution network across facilities.

Exhibit I

Segmented Revenue Breakdown (2016)



Source(s): Company Reports

Exhibit II

Core Product Overview

Product	Description	Image
Railway Ties	Railway ties are rectangular support planks of wood that are placed perpendicular to railroad tracks. The purpose is to hold rails upright. Demand for railway ties are driven by maintenance purposes (~90%) which creates a steady line of demand for the product.	
Utility Poles	Utility poles are made of long poles that support telecommunication and electrical networks. Wooden poles are a better value over alternative materials, such as steel, composites, and cement.	
Residential Lumber	Residential lumber are planks of wood used for various outdoor applications, such as decks. In 2016, sales of this category doubled for Stella-Jones driven by the North American residential and commercial markets heightened demand for new construction and outdoor renovation projects.	

Source(s): Company Reports

Company Overview II

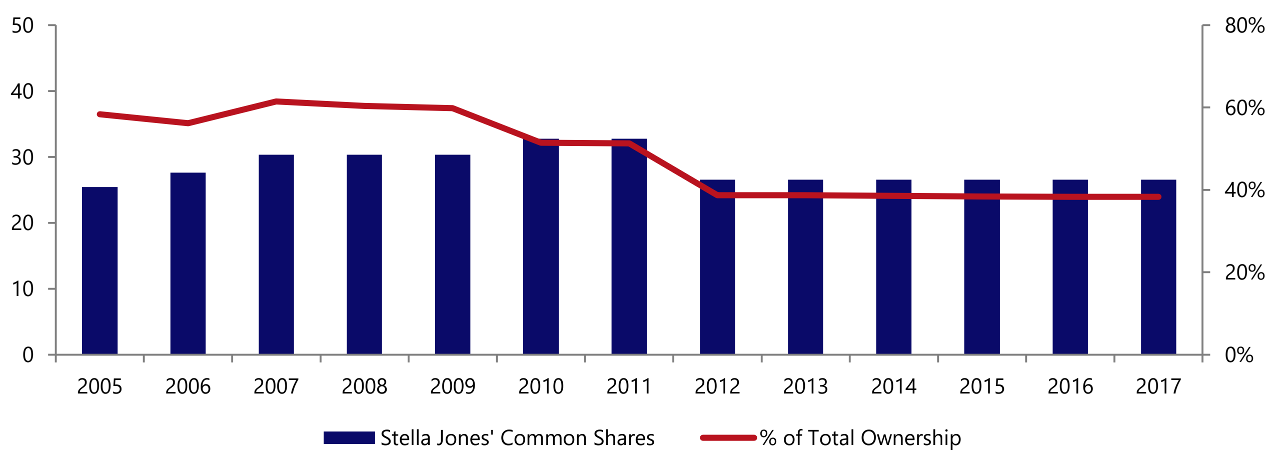
The Company's size has allowed it to develop key competitive advantages in the lumber industry, these include large resource stockpiles, effective distribution channels, and a solid financial position necessary in fulfilling larger orders. SJ's significant experience with railway and telecommunication companies has allowed the Company to establish relationships with key players and government municipalities in the form of long-term contracts. Stella-Jones has rapidly broadened its geographic reach through a series of small acquisitions. In 2015, the Company completed a variety of acquisitions which included purchasing an Ontario-based lumber plant, a pole-peeling company based out of Oregon, and two pole treatment companies found in Arkansas and South Carolina. The total cost of these acquisitions was a combined $67 million. Throughout 2016, Stella-Jones successfully completed several additional acquisitions of wood treatment product companies. Stella-Jones reported organic growth of 2.5% during Q3 2017, however faced negative F/X headwinds of 1.9%.

These acquisitions enabled the Company to continue its goal of extending its North American network and product line. Management uses acquisitions to grow both the top and bottom-line of the business as they believe cost synergies can be achieved through sharing of best practices, consolidation of SG&A, optimization of capacity and logistics and stronger purchasing power.

The Company's management team has significant internal experience and personal investment in the performance of the Company. President, CEO, and Director, Brian McManus, has worked as a Director since 2001 and was previously the COO. SJ's current CFO, Eric Vachon, has been in the role since 2012 and holds a CPA, CA designation. Stella-Jones' Chairman of the Board has been a Director since 1993. As of September 30, 2017, the Directors and executive officers owned or exercised control of 38.3% of the Company's outstanding shares. The high level of insider ownership aligns management with shareholders, which we view as an attractive element of SJ.

Exhibit III

Insider Ownership of Stella-Jones



Source(s): S&P Capital IQ

Investment Thesis I: Defensible Moat Through Competitive Advantages

In Industrials' original report, SJ's continental network was identified as a key competitive advantage. At the time (Q3 2016), SJ operated 34 wood treating facilities across North America. They have since added four facilities, now operating 37 wood treating facilities and across the continent. Of these 37 facilities, 13 are located in Canada, with the remaining 24 located in the United States. SJ also operates 16 pole peeling facilities and one coal tar distillery across North America. This compares to the eight locations Koppers Holdings, its largest competitor, has in its Railroad and Utility Products and Services segment. Having a wide operating network enables Stella-Jones to operate with a competitive advantage as it ensures their ability to satisfy customer orders quickly, and at the lowest possible cost is key to long term success. By maintaining locations across the continent and through its massive scale, SJ is able to purchase resources and transform them into sellable products at lower costs than competitors. This impressive network has grown through SJ's "smart" acquisition strategy, where it acquires regional players at reasonable prices.

The scale of SJ's operations and size of its network also helps with sourcing wood supply. Because of its size, SJ commands a substantial amount of bargaining power with suppliers. In addition to sourcing its wood through independent sawmills, state timber sales, private woodland owners, and purchases on the open market, SJ hold its own timber harvesting licenses in the U.S. and Canada. In 2016, SJ opted to relinquish its harvesting licenses in Quebec, favouring the province's auction system to acquire raw materials. SJ still holds a 15 year harvesting license in BC. These licenses can be a major entry barrier in the timber industry, as it is an expensive and time consuming process to acquire such harvesting rights.

SJ's network and variety of sourcing methods ensures that it rarely encounters supply challenges. The Company has also entered into trade agreements with numerous sawmilling and forest products companies in BC and Quebec which Industrials view as an attractive element to Stella-Jones' business model and helps drive a premium multiple.

Exhibit IV

Stella-Jones' Wide Operating Network

Source(s): Company Reports

Investment Thesis I: Defensible Moat Through Competitive Advantages

The following excerpt is taken from an interview Brian McManus, SJ's CEO, with Canadian Business magazine and talks about SJ's "smart" acquisition strategy:

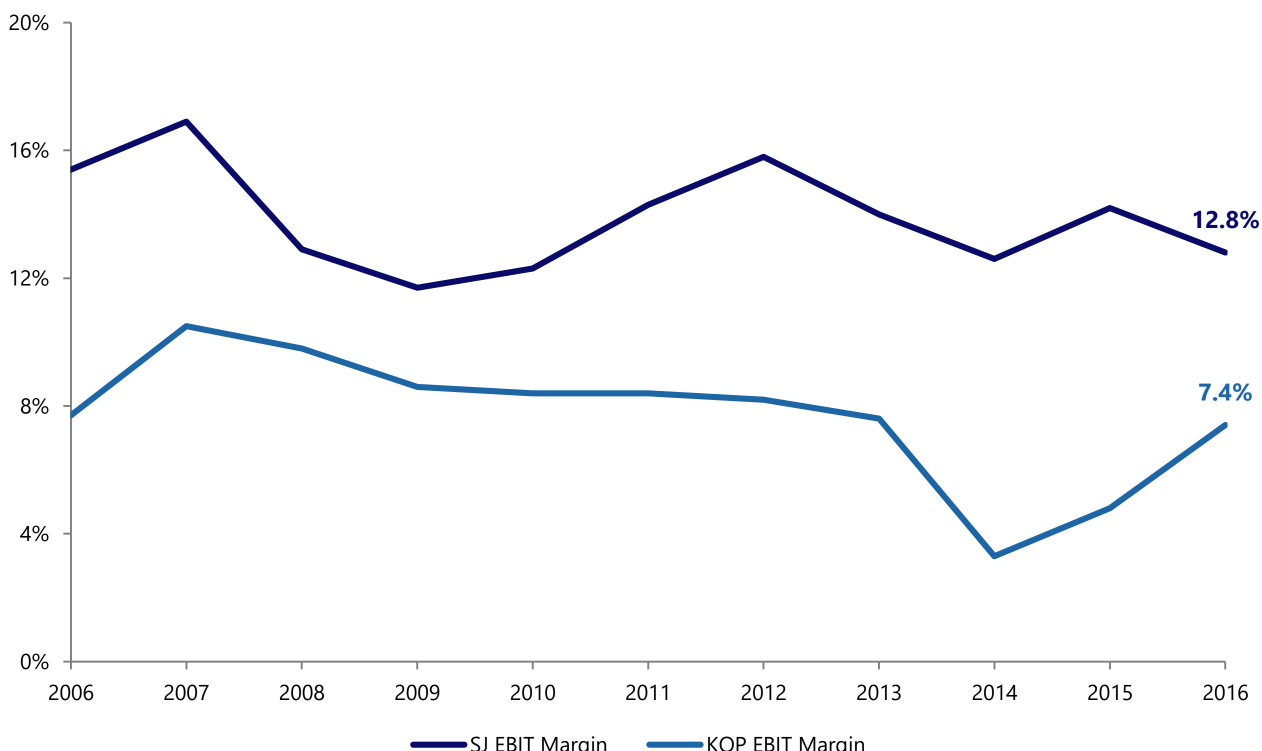
"*McManus's formula is simple: Identify target niches, stick to them like glue and steadily consolidate a fragmented market to become the undisputed number one player. Each acquisition the Company undertakes, roughly one per year, brings greater scale and cost-efficiency to Stella-Jones's supply network and enables it to provide more turnkey offerings to clients.*"

This strategy has allowed SJ to grow rapidly and sustain its large market share and profitability. Exhibit 5 shows SJ's EBIT margin versus Koppers Holdings, their largest competitor. SJ's cost advantages allow it to earn significantly higher operating margins than Koppers.

Moving forward, we expect that SJ's economic moat will remain defensible, allowing SJ to earn higher than average margins, which can be improved if management completes fundamentally sound acquisitions.

Exhibit V

Stella-Jones and Koppers Holdings EBIT Margin Comparison



Source(s): Company Reports

Investment Thesis II: Stable Core Markets and Growth Opportunities

Rail Ties and Utility Poles

Demand for railway ties comes from replacement and maintenance requirements, and new track construction. Replacement is by far the largest source of demand. Railway maintenance capex is relatively stable throughout economic cycles.

SJ's management estimates that between 1.5% and 3.0% of all ties on active railways require replacement every year. Railway tie purchases are relatively non-cyclical, showing little correlation with GDP growth (see Exhibit 6). The stability of SJ's revenue streams is highlighted by the fact that they have only had one year in which revenue declined (and by only -0.1%) since McManus joined the Company in 2001.

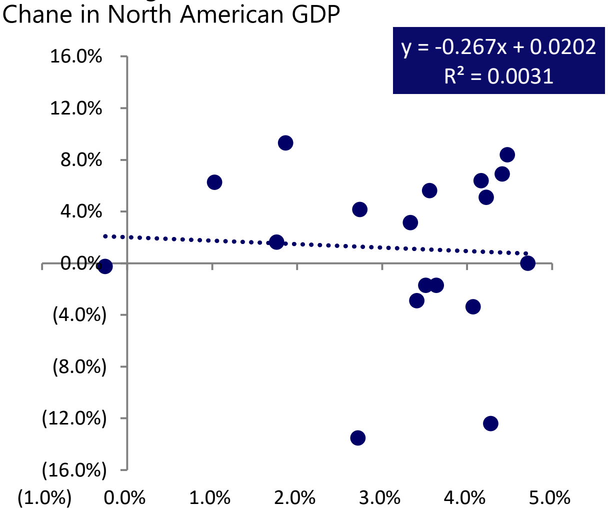
Wood utility poles are favoured over other materials because of their relatively lower purchase and maintenance costs, in addition to their durability. Wood poles typically last for between 40 and 50 years. Most of SJ's pole revenue is derived from multi-year contracts with regional telecommunication and electrical companies, giving a high degree of visibility to this segment's performance. This type of non-cyclical growth is beneficial to the Industrials portfolio throughout economic cycles, as it is less likely to suffer from recessions or other negative economic pressures.

Residential Lumber

Residential Lumber is SJ's fastest growing segment, with a five-year CAGR of 58%, compared to the next fastest growing segment, Logs & Lumber, at 47%. SJ's recent acquisition of Ram Forest Group and Ramfor Lumber Inc. gave the Company increased access to this market through a distribution contract it holds with Home Depot Canada. The residential lumber segment serves existing home renovations and new housing construction. Strong North American demand for residential lumber has been driven by rising housing starts and home renovation spending. SJ is continuing to position itself to capitalize on this industry's growth and capture market share.

Exhibit VI

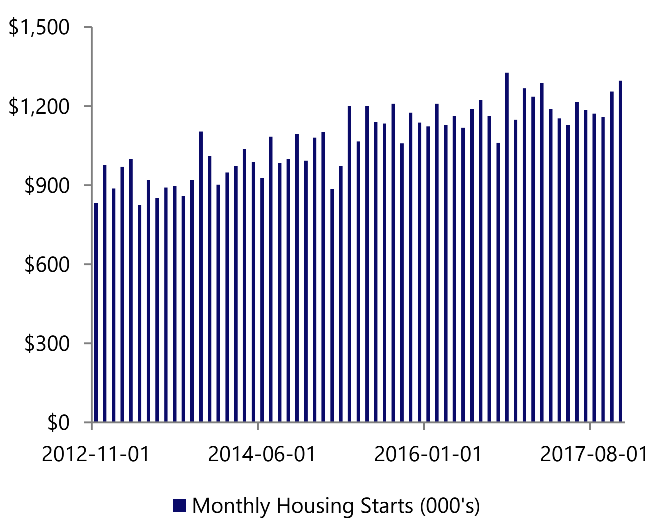
Annual Change in Rail Tie Purchases Versus Annual Chane in North American GDP



Source(s): World Bank, Railway Tie Association

Exhibit VII

New Privately Owned Housing Units Started



Source(s): Federal Reserve Bank of St. Louis

Investment Thesis II: Stable Core Markets and Growth Opportunities

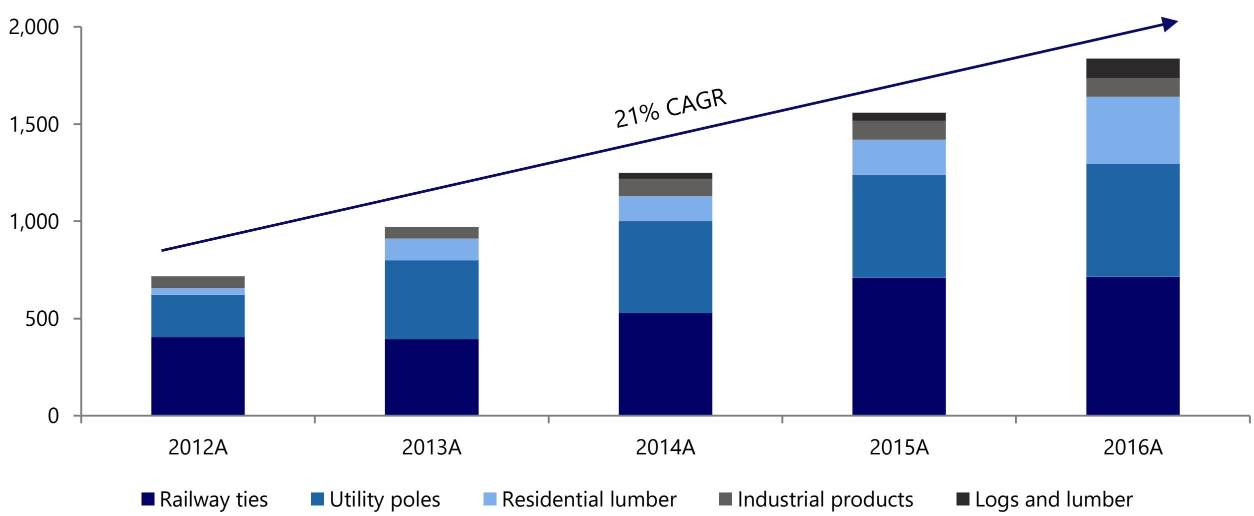
Growth Through "Smart" Acquisitions

Upon joining the Company in 2001 as CEO, McManus set out to begin consolidating what was then a heavily fragmented industry. McManus' three criteria for acquisitions are that they must: reinforce the company's core markets, meet specific price benchmarks, and supply identifiable synergies. He aims to complete approximately one acquisition per year. Since 2003, SJ has completed 15 acquisitions. The largest deal in SJ's history was its acquisition of McFarland Cascade Holdings, SJ's largest competitor in the U.S. utility pole market. SJ's acquisition strategy has helped it capture huge market share in its core markets. Market share in railway ties and utility poles is approximately 50% and 40%, respectively. Because of the slow pace of growth in its key markets (rail and utility infrastructure), SJ's growth comes primarily through growing its market share. The other source of growth is its push into Logs & Lumber and Residential Lumber. As its traditional markets reach maturity, growth will depend solely on management's ability to successfully acquire and integrate new businesses. The Residential Lumber segment, in particular, offers an attractive opportunity to tap into a higher growth industry. The Home Depot contract, acquired through Ram Forest Group, positions SJ well to continue growing this segment. Whether or not this growth is sustainable amid the economic climate of rising interest rates and a projected fall in housing starts will be a key determinant of future performance for Stella-Jones.

A key strength of this strategy is that it grows SJ's sourcing, production, and distribution network in addition to growing revenue. A major drawback with this strategy is that it relies heavily on management's ability to identify strong targets and integrate them effectively. SJ's returns over the past decade have been generated primarily through these acquisitions. Management's skill in business combinations is the key growth driver for this Company, as opposed to the underlying economics of the business or industry. McManus has proven to be extremely talented at acquiring family businesses. He cultivates relationships that ensure SJ is top of mind when owners want to sell. The concentration of managerial acumen and relationships this also poses a potential risk.

Exhibit VIII

Stella-Jones Historical Revenue Segmentation



Source(s): Company Reports

Investment Thesis III: Strong Record of Good Capital Allocation

In our original report on SJ, we noted that due to short term softness in operating results over several quarters, investors were underappreciating SJ's record of superior capital allocation. The stock had sold off over 2016, providing an attractive entry point with a sufficient margin of safety. Investors' concerns were proven to be temporary, short-term issues. Over 2017, the stock recovered as investors' outlooks improved.

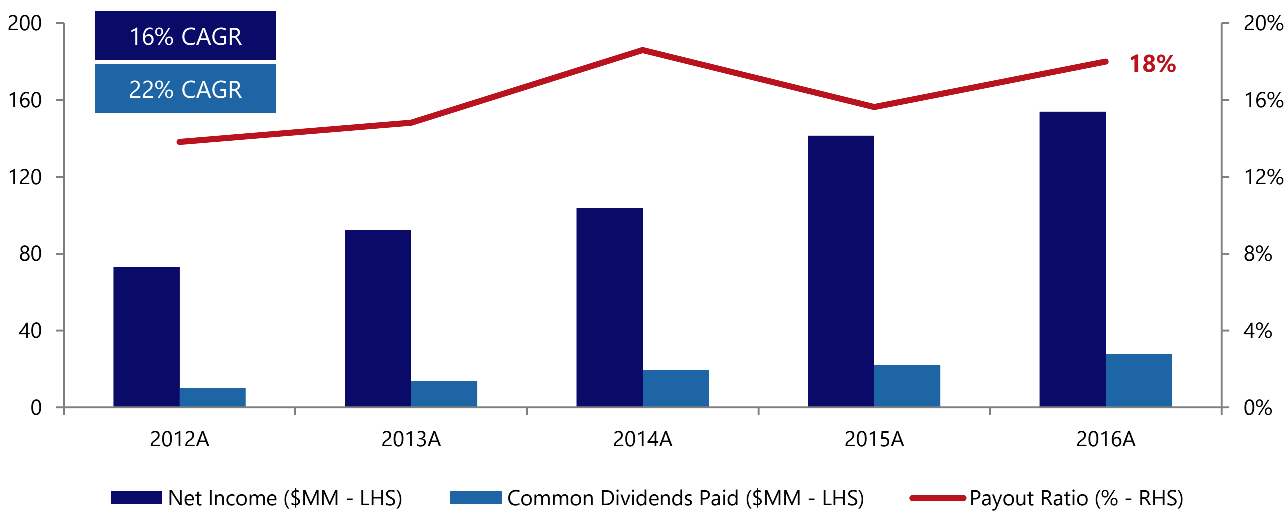
SJ's management, through responsible acquisitions and its dividend policy, has demonstrated a superior ability to reinvest in the business at high rates of return and return cash to shareholders. Since its first dividend payment in 2003, SJ has grown the per share distribution at a 24% CAGR. The current yield is approximately 0.9%. Total shares outstanding have increased by 73% since 2003, reflecting SJ's decision to finance growth initiatives.

SJ has earned a solid ROE, averaging 16.53% over the past five years. However, ROE has been declining in recent years, falling from 18.3% to 13.2% since 2012. This decline is likely the result of declining EBIT margins. Another potential explanation for the declining margins is that as SJ expands into new segments, such as Residential Lumber, it will not immediately have the same pricing power or cost advantages as its main segments. Its ROIC (10.6%) is higher than the Company's WACC (5.81%), meaning that SJ compounds value as it grows (See Exhibit 9).

As SJ gains pricing power and/or cost advantages through scale, ROE will likely revert to higher historical levels. Given management's track record growing market share in their primary segments, we believe that this increased profitability is likely. Given the consistently high economic value add spread (ROIC less WACC), we are confident that continued growth with generate high returns on invested capital.

Exhibit IX

Stella-Jones' 5-Year Dividend Per Share and Payout Ratio History



Source(s): S&P Capital IQ

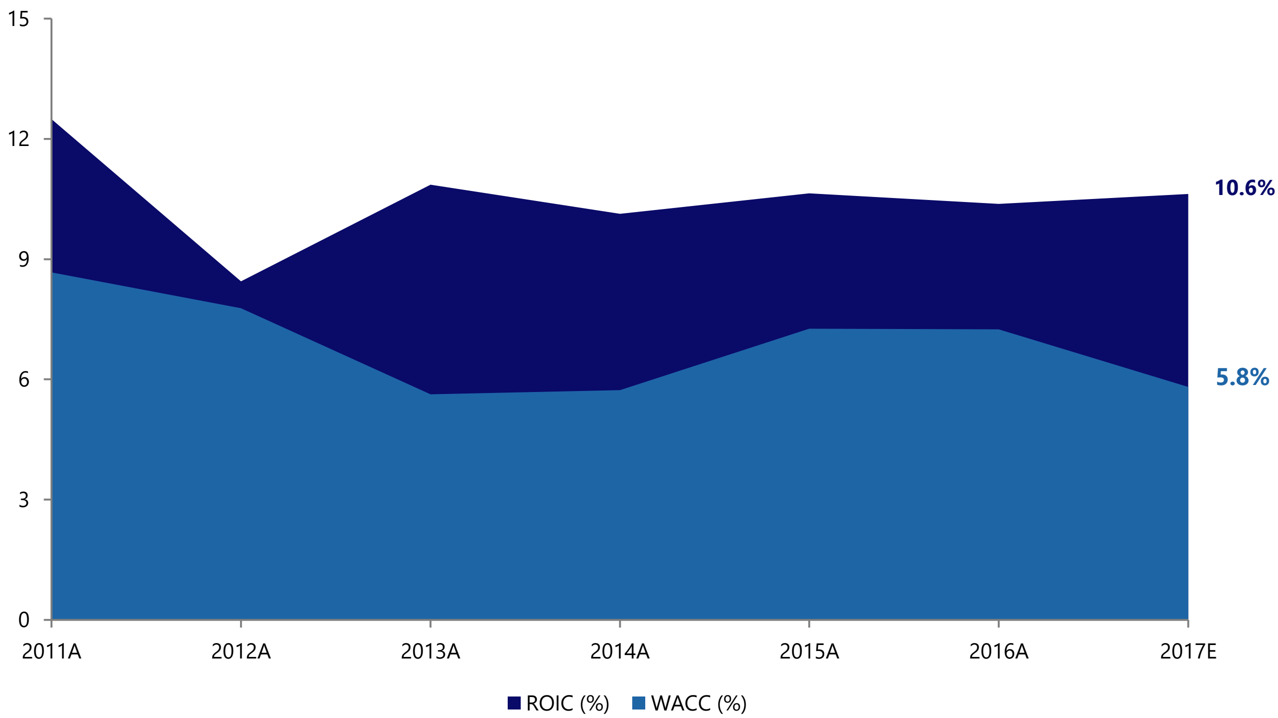
Investment Thesis III: Strong Record of Superior Capital Allocation

The most significant component of SJ's capital allocation strategy is acquisitions. The effects of M&A on a company's efficiency and profitability are often negative. Companies often overestimate the synergies in transactions, and overpay for companies. SJ's ability to complete a large amount of M&A transactions which have only served to improve its market position and efficiency is a rare competitive advantage. Revenues have grown at a 22.7% CAGR from 2006 to 2016, with earnings following closely. Unlike many companies that achieve growth through acquisitions, SJ had maintained a very manageable debt load, and has deleveraged significantly over the past year. Its debt to equity ratio stood at 42.7% at the end of 3Q17 (67.7% in 4Q16), with a net debt to EBITDA ratio of 1.8x (2.6x in 4Q16).

Whether SJ can continue to identify accretive acquisitions that expand its moat is key to Stella-Jones' growth prospects. Given SJ's track record, financial health, and liquidity position, it stands ready to capitalize on any volatility in lumber markets that may negatively affect competitors, such as Koppers, who carry substantially more debt than SJ (6.2x D/E, 3.5x net debt/EBITDA). Given SJ's ability to compound its capital at remarkable rates over the past decade, we continue to believe that SJ will offer attractive returns for the foreseeable future.

Exhibit X

Stella Jones' Return on Invested Capital Analysis



Source(s): Bloomberg, S&P Capital IQ

Catalysts & Risks

Catalysts:

1) **Wood is Good**: As previously mentioned, approximately 130 million of the 180 million existing utility poles across the U.S. are made of wood. As these poles are replaced at a rate of two to four million poles per year, there is an opportunity for wood to increase in popularity. As the most economic alternative, additional activity combined with increased price sensitivity could result in strong demand for Stella-Jones' products.

2) **Brewing acquisition potential**: With a 26% Q/Q reduction in total debt and a healthy cash position, SJ has ample flexibility for acquisitions. Management noted opportunities along the horizon, marking utility poles and railway ties as having more near-term potential. As such, we see increasing potential for acquisitions and note that these are not reflected in our estimates. Furthermore, recently completed acquisitions will likely lead to margin improvement in the near future during quarterly earnings. While consolidation of businesses in each end-market is attractive in our view, the stock will benefit based on the ability of management to continue allocating capital with a disciplined approach.

3) **Trump's Infrastructure Plan:** In January, Trump will reveal his infrastructure plan that is expected to have a great focus on rebuilding bridges, roads, and railways across the U.S. The infrastructure plan was among the forefront of Trump's campaign and his pro-business beliefs. Stella Jones has the opportunity to experience expedited growth in its industrial products segment, in addition to increased maintenance capex spending on railway ties by railroad businesses.

Risks:

1) **Dependency on Management:** When analyzing Stella-Jones, Industrials recognizes the importance of Brian McManus to the organization. With such a strong track record of successful acquisitions and sixteen years of earnings growth, the company trades at a premium multiple relative to historical measures and peers. While it is very unlikely, we believe that a change of CEO for any reason could result in multiple contraction and loss of confidence in the new management team to operate the business as successfully as McManus.

2) **Dependency on Key Customers:** In 2015, Stella-Jones' top 10 customers accounted for 46.3% of the company's sales with the two largest customers representing 10.1% and 6.7% respectively. This significant dependence on major customers poses a notable risk to SJ's earnings stability and the bargaining power. Further, due to the scale and scope of contracts, credit repayment and the financial stability of said customers is critical to Stella-Jones success. With no assurance that outstanding accounts receivable will be paid in a timely manner, Stella-Jones is exposed to the liquidity of its customers. A series of customer payment issues could quickly limit the company's cash position and its financial performance.

3) **Insider Ownership:** Over the past sixteen years, insider ownership has fallen from 58.4% to 38.3%. There is potential for additional sales of shares as they trade near all-time highs.

4) **Environmental Risk:** Due to Stella Jones' geographic scale and the nature of its business, the company has significant exposure to environmental regulation and varying environmental laws found in North America. Although SJ is relatively shielded from provincial and state-bound regulation due to its size, regulation at the federal level in both Canada and the United States could severely impact Stella Jones' performance. These risks not only include environmental changes put into law that force SJ to adjust its business model, but also the possible fines, capital expenditure and brand value costs incurred in the event of an environmental disaster. Additionally, increase in law and regulation tend to increase the cost of corporate compliance.

Discounted Cash Flow Analysis

DCF Output								
(In CAD 000s)	2015A	2016A	Q4 2017E	2017E	2018E	2019E	2020E	2021E
Revenue	**1,559,334**	**1,838,353**	**354,104**	**1,862,890**	**1,922,502**	**1,989,790**	**2,042,851**	**2,097,327**
YoY Growth	*24.8%*			*1.3%*	*3.2%*	*3.5%*	*2.7%*	*2.7%*
EBITDA	**246,571**	**270,339**	**48,103**	**250,000**	**313,368**	**332,295**	**318,004**	**326,484**
% of Revenue	*15.8%*	*14.7%*	*13.6%*	*13.4%*	*16.3%*	*16.7%*	*15.6%*	*15.6%*
EBIT	**223,237**	**238,752**	**41,635**	**218,460**	**282,608**	**300,458**	**285,318**	**292,927**
Less: Tax Expense	61,585	61,486	4,996	51,502	73,478	78,119	74,183	76,161
Effective Tax Rate	*27.6%*	*25.8%*	12.0%	28.3%	26.0%	26.0%	26.0%	26.0%
NOPAT	**161,652**	**177,266**	**36,639**	**166,958**	**209,130**	**222,339**	**211,135**	**216,766**
Plus: Depreciation and Amortization	23,334	31,587	8,028	33,100	30,760	31,837	32,686	33,557
Less: Capital Expenditure	(37,363)	(63,210)	(6,580)	(39,320)	(40,373)	(41,786)	(32,686)	(33,557)
Less: Change in Working Capital	(291,720)	(19,650)	(8,000)	198,610	19,225	19,898	20,429	20,937
Unlevered Free Cash Flow	**(144,097)**	**125,993**	**30,087**	**359,348**	**218,742**	**232,288**	**231,564**	**237,703**
Discount Period			0.125		0.75	1.75	2.75	3.75
Discount Factor			*98.8%*		*93.3%*	*85.0%*	*77.5%*	*70.7%*
Discounted Unlevered Free Cash Flow			**29,741**		**204,075**	**197,558**	**179,534**	**168,005**

Sensitivity Analysis

		EV/EBITDA NTM Exit Multiple				
Discount Rate (%)	0	12.7x	13.2x	13.7x	14.2x	14.7x
	8.7%	$57.28	$59.35	$61.42	$63.49	$65.57
	9.2%	$56.86	$58.92	$60.97	$63.02	$65.08
	9.7%	$56.45	$58.48	$60.52	$62.56	$64.60
	10.2%	$56.04	$58.06	$60.08	$62.10	$64.12
	10.7%	$55.63	$57.64	$59.64	$61.65	$63.65

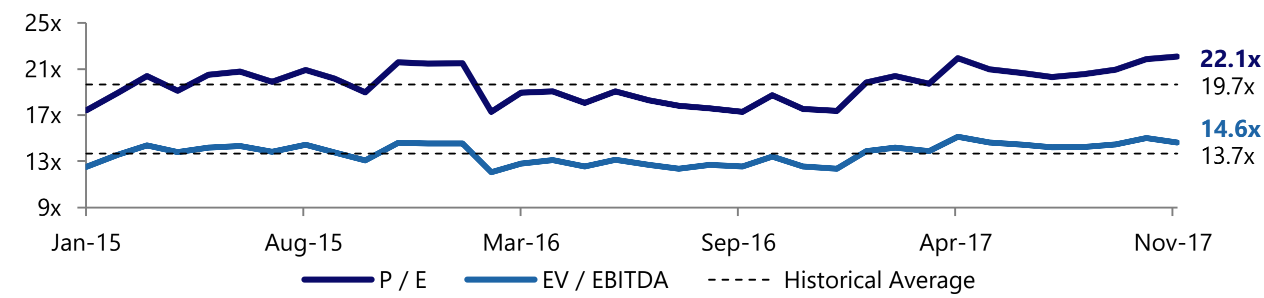
WACC & DCF Share Price Calculations

WACC Calculation	
Risk-Free Rate	2.48%
Market Risk Premium	6.08%
Beta	0.48
Five-Year Average ROE	17.18%
Cost of Equity	11.29%
Cost of Debt	4.50%
Tax Rate	26.00%
After Tax Rate Cost of Debt	3.33%
Capital Structure	
Equity	80.00%
Debt	20.00%
WACC	**9.70%**

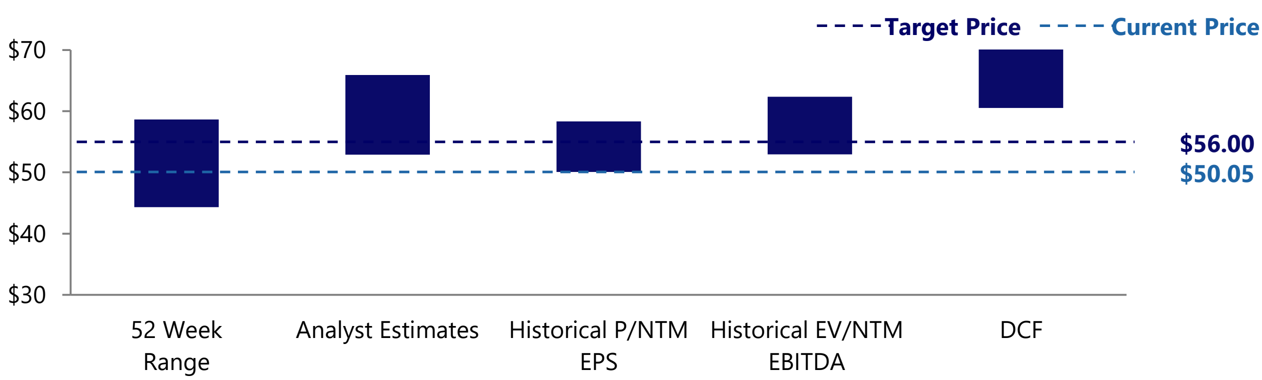
Share Price Calculation	
2019 EBITDA	332,295
EV/NTM EBITDA Exit Multiple	13.7x
Terminal Value	4,552,442
PV of Terminal Value	3,871,786
PV of UFCF	778,912
Enterprise Value	4,650,698
Less: Total Debt	454,149
Implied Equity Value	4,196,549
Shares Outstanding	69,340
Implied Share Price	$60.52
Current Share Price	$50.05
Dividend Yield	0.98%
All-in Return	**21.90%**

Target Price	
Historical P/E NTM	$ 54.97
Historical EV/EBITDA	$ 49.39
DCF	$ 60.52
Target Price	$ 56.00
Current Price	$ 50.05
Capital Return	11.89%
Dividend Yield	0.98%
All-in Return	**12.87%**

Historical Forward Multiples Analysis



Football Field Valuation



Valuation Commentary

Stella-Jones' leading market position, exposure to the U.S., and current valuation creates a unique opportunity to continue holding a reliable and defensible name at a reasonable price. Due to a lack of comparable companies, the firm's historical P/E and EV/EBITDA multiples were used. On a forward P/E and EV/EBITDA basis, SJ currently trades a slight premium due to the Company's attractive acquisition growth potential, stable recurring revenue profile, and durable competitive advantages. At first glance, after conducting a discounted cash flow analysis, the Company appears fairly valued by the market at this time. However, upon closer examination, it can be seen that the market is pricing in the future M&A growth that is associated with the Company's industry consolidation strategy, a factor that we are unable to integrate into our discounted cash flow model due to a lack of visibility. Ultimately, we believe that further upside to the current share price will largely be driven by management's ability to continue its disciplined acquisition approach in an accretive manner. The multiples valuation method makes it evident that the market applies a premium price on the stock as a result of the Company's competent management team and their historical success of acquisitions. When considering historical P/E, historical EV/EBITDA, and DCF analysis, a target price of $56.00 is achieved. After accounting for the firm's 0.98% dividend yield, a one-year return of 12.87% is expected – a figure that the Industrials sector remains confident in, given the firm's market leading position, defensibility, and potential for diversified growth.

Summary & Portfolio Fit

Summary

In conclusion, we plan on holding Stella-Jones for several reasons:

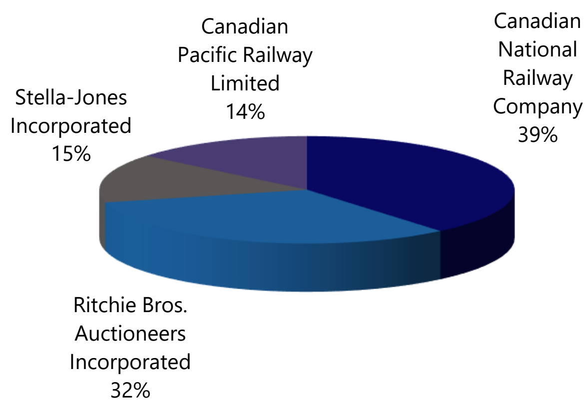
1) **Stability and Diversification:** Stella-Jones is exposed to non-cyclical growth unlike our major rail holdings that grow with the economy. Holding this business will help Industrials outperform in a down-cycle and continue to experience growth that is from maintenance-driven demand.

2) **Risks are unlikely and not short-term:** When evaluating the risks for Stella-Jones, we do not believe that these are near-term risks that can harm the stock but rather factors that will play out in the distant future.

3) **Upside Potential:** 50% of our target price is driven from a DCF that does not take into account future M&A growth, any acquisitions that the market views as accretive will have a positive impact on the stock price.

Portfolio Fit

Currently, Industrials remains overweight rail with 55% of our portfolio in the industry, relative to the benchmark of 47%. While 30-40% of Stella-Jones revenue is derived from railroad businesses, it is primarily maintenance-driven demand and a downturn in rail shipments will not have a significant impact on Stella-Jones. We believe holding our current position and potentially adding to it from CP if Stella-Jones share price falls.



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