



# RESEARCH REPORT

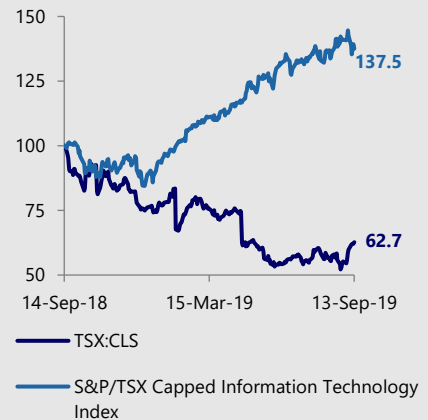
September 16, 2019

Stock Rating **PASS**  
Price Target **\$10.80**



Ticker	TSX:CLS
Market Cap. (MM CAD)	\$1,258
EV/EBITDA	5.7 x
EV/Revenue	0.2 x

## 52 Week Performance



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## Celestica Inc. Preliminary Views

Over the last year, Celestica has seen its value plummet by over 40%, despite favourable conditions in the Canadian tech universe. Resultingly, the TMT team chose to investigate the company in order to determine whether its price decline was justified.

While the electronic manufacturing services space that Celestica operates in is growing, the industry is plagued with intense competition and low margins. Since firms in the industry act as contractors for large clients, profitability is inherently limited; clients can set up their own large-scale production if prices are too high. Firms in the industry also face intense capital requirements to remain up to date with the latest manufacturing technology.

Although Celestica is a large and established player in the industry, its margins have been sliding consistently in recent years. Efforts to shift into more value-add spaces have been largely unsuccessful. Furthermore, Celestica's management appears to be misaligned with shareholders, which has resulted in a series of value-destroying acquisitions.

When considered holistically, the TMT team believes that Celestica's recent performance is justified. The drop in price does not represent a strong buying opportunity.

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## Industry Overview

### Overview

The Electronic Manufacturing Services (EMS) industry delivers supply chain solutions to clients across a diverse set of industries. In the past, players in the EMS industry were often pure-play manufacturing firms. They added value to clients by allowing them to remain capital-light and focus on their core competencies – typically sales, marketing, and product development. In order to create more value, EMS firms are now more involved in the product lifecycle by collaborating with clients in the design process, assisting with procurement and inventory management, and providing aftermarket services.

The increasing number of use cases for technology has meant that EMS firms no longer have a “typical” product or industry. Their services are used to manufacture thousands of different products in spaces such as healthcare, aviation, defense, and energy.

Given the sheer breadth and magnitude of the industry, there are few macroeconomic drivers that dictate industry performance. At a high level, consumer and business confidence are correlated to industry performance. Within niches, however, there are individual drivers of demand. Demand in the EMS industry for smart-energy products, for example, is largely fueled by government policy decisions as well as energy prices.

### Industry Dynamics

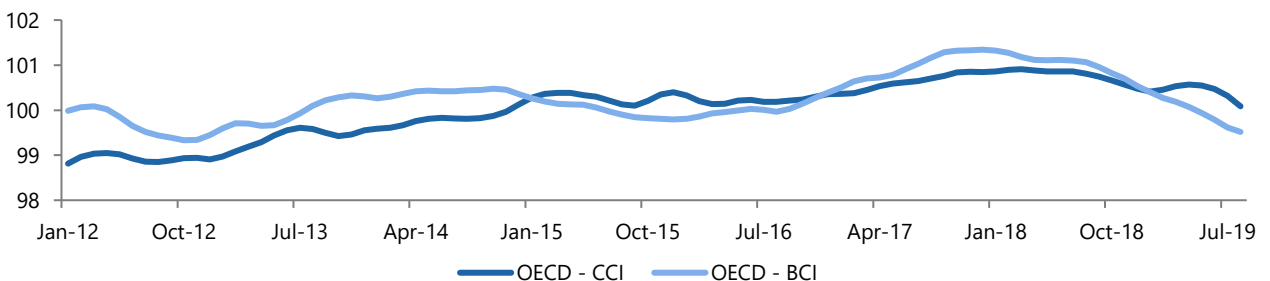
The EMS space is extremely saturated. There are numerous prominent firms such as Foxconn, Plexus, Benchmark Electronics as well as many niche players that specialized in specific products. Perhaps the largest competitor for firms in the industry, however, are the clients themselves, who can choose to establish their own production lines if their needs are not met at an attractive price. This considerably limits pricing power for firms.

Given that firms build and operate complex manufacturing plants, the industry is also very capital-intensive. Since both manufacturing technology and electronic products themselves change rapidly, continuous reinvestment is necessary for firms to stay at the forefront of the industry. In the consumer electronics subsector, for example, it is estimated that 48% of labour costs are spent on capital investments – far higher than the ~13% estimate across the economy. Given the operational similarities, other subsectors likely follow a similar trend.

On aggregate, EMS firms experience moderate levels of revenue volatility, as demand is driven by consumer and business spending. They are also vulnerable to trade and tariff changes since products are typically manufactured in regions with low wages and exported globally.

### EXHIBIT I

Consumer and Business Confidence in OECD countries



Source(s): OECD. Note: Score of 100 indicates neutral outlook on future.

## Company Overview

### History

Celestica Inc. (TSX:CLS) ("CLS") was initially formed and operated as an IBM manufacturing unit for over 75 years. In 1993, it began serving non-IBM customers. Onex purchased the unit from IBM in 1996 and the company had its IPO in 1998. Onex, and its founder Gerald Schwarz, remain heavily invested and involved in the company. Prior to 2018, CLS had one reportable segment: Electronic Manufacturing Services ("EMS"). For the 2018 fiscal year, EMS was split into two reportable segments, Advanced Technology Solutions ("ATS") and Cloud and Connectivity Solutions ("CCS"), to better reflect the markets CLS serves.

### Business Overview

Fundamentally, CLS is a manufacturer of electrical components and manufacturing equipment (which is used by customers in the manufacture of electrical components). It also offers services spanning design, engineering, logistics, systems integration and asset management, among others.

Celestica's major value proposition to clients is that they simplify supply chain operations. Instead of building and tooling and manufacturing facility, co-ordinating with hundreds of suppliers to obtain the right circuitry and components, and co-ordinating distribution, clients can simply pay Celestica to have a component manufactured. Clients also benefit from additional flexibility if they needed to scale orders up or down rapidly, access to cutting-edge manufacturing technology, and logistical expertise.

### Customers

The CCS segment serves the following end markets: enterprise communications, telecommunications, servers, and storage. This segment has come under significant pressure on pricing, shifts in technology, model obsolescence, and product commoditization. The ATS segment serves the following end-markets: aerospace and defense, industrial, smart energy,

healthcare technology, and capital equipment (semiconductors, display, power, and signal distribution). This segment typically earns higher margins than CCS and has longer product lifecycles. ATS generated about one-third of 2018 revenues and just under half of adjusted EBIAT.

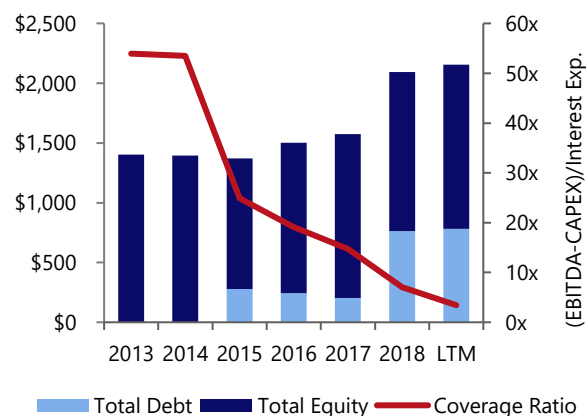
Over 70% of 2018 revenue was attributable to CLS' 10 largest customers. Cisco and Dell Technologies accounted for 14% and 10%, respectively. Customer relationships are generally governed by master service agreements ("MSAs") that do not contain minimum volume commitments ("MVCs") and do not impose significant obligations on either party. Resultantly, CLS bids for business on a program-by-program basis.

### Capital Structure

Although management verbally committed to reducing debt in 2018, it has made little progress (Exhibit II). Celestica's debt/equity is 57%, the same as its prior year. Declining operating conditions, however, have made this debt load more difficult to carry. Celestica's EBIT coverage ratio is currently only 3.2x, a sharp decline from 2017's ratio of 17.7x.

#### EXHIBIT II

Celestica's Evolving Capital Structure



Source(s): S&P Capital IQ, Company Filings

## Capital Allocation – M&A

### Acquisition Strategy

Celestica is actively engaged in the search of acquisitions that fulfill the following: a) expand the current revenue base and/or service offerings b) increase penetration in certain industries c) establish strategic relationships with new or existing customers d) enhance competitiveness and/or enhance the global supply chain network. In 2018, management completed the acquisition of two companies. The acquisition of Atrenne was pursued in order to broaden Celestica’s design and manufacturing capabilities in the Aerospace and Defense industries. The deal was closed in January 2018 for USD \$139mm cash using a combination of cash on hand and its revolving credit facility. The second acquisition of Impakt Holdings was completed in October 2018 to enhance Celestica’s industry-leading position in capital equipment manufacturing. Rob Mionis, President and CEO of Celestica, reveals the acquisitions are: “well aligned to our company strategy of growing and

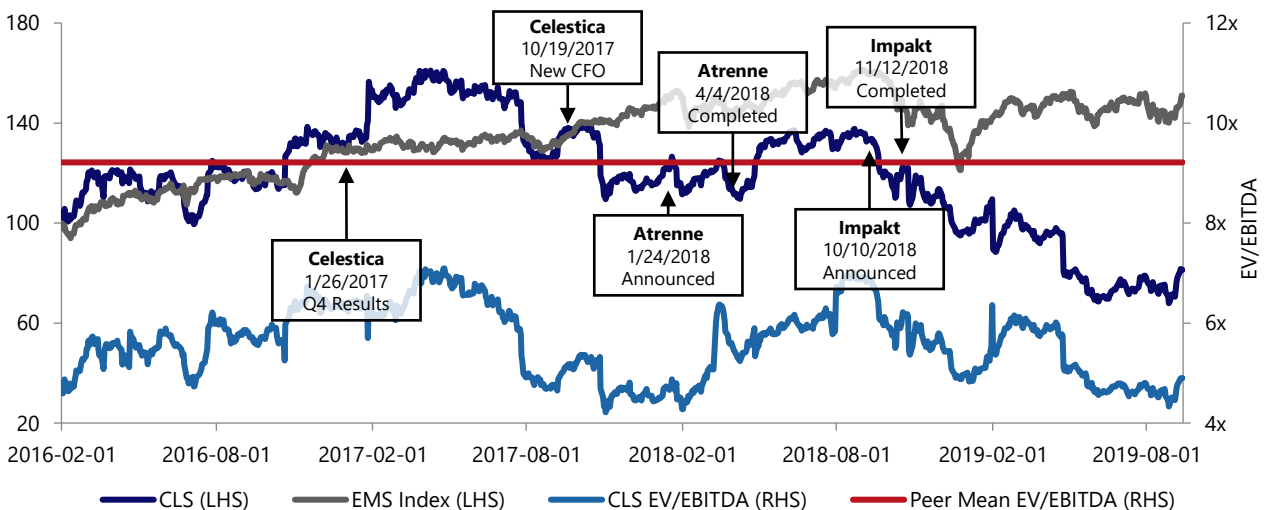
diversifying our overall revenue and margin mix through targeted investments and acquisitions”. The company was acquired for USD \$329mm with an undisclosed financing mixture.

### Acquisition Performance

As a firm, Celestica’s acquisition performance has been unfavorable. Since 1995, the firm has recorded a total of USD\$1.4B of goodwill impairment – an amount greater than the firm’s current market capitalization. After each of the last two acquisitions, investors reacted negatively and Celestica’s stock price dropped (Exhibit IV). It appears that management may be broadly focused on the act of add-ons for the purpose of increasing their size, product/solutions offerings, and geographic reach without focusing on deploying capital to the most effective levers.

### EXHIBIT III

Relative Performance Chart | M&A History



Sources: S&P Capital IQ, Celestica News, Celestica 10K, Celestica Management Information Circular

## Management Incentives

### Compensation Overview

Celestica uses a three-part compensation package to pay their executives. Management receives i) a base salary ii) a CTI (Celestica Team Incentives) cash pay-out which is contingent upon achieving performance targets and iii) equity-based incentives such as RSU's, PSU's, and stock options. The CTI is made up of three components: the Company Performance Factor (CPF), Individual Performance Factor (IPF), and the target award. The equity compensation is comprised of:

**Restricted Stock Unit (RSU)** – Shares that are issued to employees that can only be “redeemed” after achieving certain performance milestones or remaining at the company for a length of time.

**Performance Stock Unit (PSU)** – Similar to RSU's, they are shares that are given to managers and executives only if certain company-wide performance criteria, such as revenue targets or EPS, are met.

### Changes in Compensation Plan

During 2017, the compensation committee made changes to the program design. ROIC was eliminated as a performance measure from the “Company Performance Factor” (“CPF”) and replaced by revenue targets. The equity mix changed from 50% RSU and 50% PSU to 40% and 60%, respectively. Additionally, the number of PSUs granted was calibrated predominately to three-year EBIAT results rather than ROIC and share price over time.

The TMT team believes that these changes will encourage management to focus on short-term financial figures rather than making prudent strategic decisions that will generate a high ROIC over time.

### Challenges with Performance Metrics

While individual performance is measured through metrics such as profitable growth, expansion, financial strength, the “people metrics” are not well defined with measurable goals. For instance, the result for the

metric “Expand Market Offerings” is simply “Expanded our aerospace and defense and healthcare lifecycle offerings capabilities”.

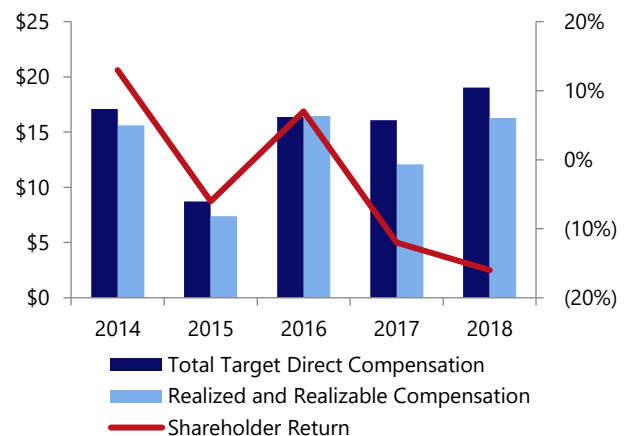
Another indicator of misaligned shareholder and executive goals is that “profitable growth” metrics for assessing CEO performance is measured in revenue and customer satisfaction, neither of which indicate if the growth is truly profitable. The TMT team concludes that the current management compensation plans do not promote long-term value generation decisions from the executives.

### Management Performance for Shareholders

For fiscal year 2018, the compensation committee made changes that shifted performance metrics for CTI from ROIC to revenue growth and operating margins (EBIAT). As such, revenue increased by 8.0%, but EBITDA margin dropped from 4.1% to 3.8% and net income margin from 1.7% to 1.5%. ROIC was 5.7%, the lowest in the past five years, which had an average of 6.9%. While shareholder return trended downwards, management compensation is near an all-time high.

#### EXHIBIT IV

Management Compensation & Shareholder Returns



Source(s): S&P Capital IQ

## Financial Performance

### Historical Performance

In FY 2018, Celestica generated USD \$6.3B in revenue, which represents an 8% increase over FY 2017. This improvement was driven by growth in the ATS segment, which expanded 13%.

Gross margins declined from 6.8% in FY 2017 to 6.5% in FY 2018. Similarly, EBIT margins (excluding unusual items) declined from 2.7% to 2.2% in the same time period, largely as a result of climbing cost of goods sold and interest expenses. These margin declines are concerning, particularly since Celestica has been shifting into the “high margin” ATS business.

Celestica generated USD \$81.9M in net income in FY 2018, a sharp decline from the USD \$133.1M

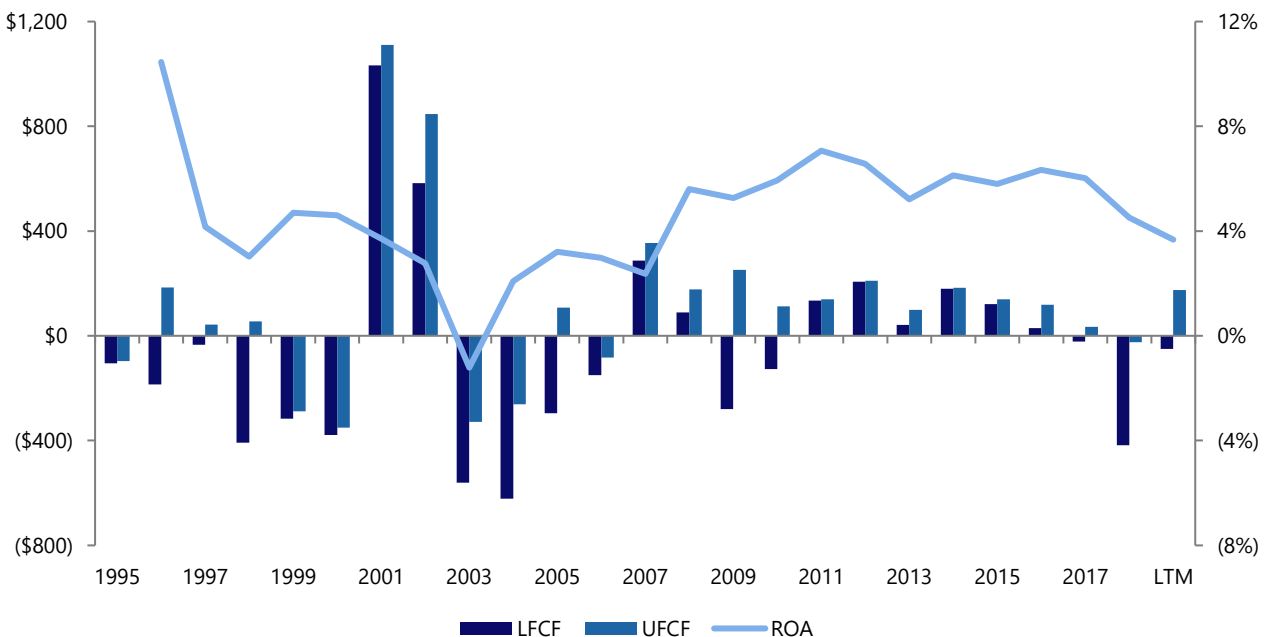
generated in 2017. It is worth noting, however, that this decline was amplified by a host of unusual items. Profitability in 2019 is expected to increase due to the sale of a large Canadian property that was recorded at a significant discount to current market value.

### Cash Flow

A summary of unlevered and levered free cash flow and return on assets across the company’s entire history as an independent company can be seen below (Exhibit IV). As one expects to see with anemic margin, highly cyclical and capital-intensive companies, cash flow is volatile and often negative or not meaningful. The cumulative LFCF from 1995 and 2010 is (\$1.3B) and \$96.4MM, respectively.

### EXHIBIT V

Historical Levered & Unlevered Free Cash Flow (\$MM) (LHS) and Return on Assets (RHS)



Source(s): CLS SEC filings



## Key Question: Hidden Gem or Value Trap?

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### Initial Stance

From an investor's standpoint, the EMS industry is not an ideal place to allocate capital. It is a risky, capital intensive industry that is plagued with low margins. Since most clients in the space have the resources to establish their own production, pricing power is extremely weak.

Within the space, Celestica is a formidable player and has market leadership in select end-markets. It does not, however, have a particularly defensible moat that offers the firm a lasting advantage. Celestica does not possess a robust patent portfolio of manufacturing technology - instead, they rely on "the knowledge and experience of management and personnel" and their "ability to develop, enhance and market electronics manufacturing service" to defend their position.

Furthermore, Celestica's broad product offerings and inconsistent contracting make it challenging to accurately forecast future results. This opacity adds risk to a business without large margins to absorb shocks.

Given this information, it is difficult to make the case for investing in Celestica without a very attractive entry price. If the firm was unfairly punished by the market for its performance, however, it may have potential.

### Valuation Methodology

Before fully committing to a comprehensive valuation, the Sector Team sought to determine the likelihood that current prices offered good value. The Team used three basic methods to assess valuation at this stage:

- A simple perpetuity based on management's long-term margin and capital intensity targets;
- Current multiples of average LFCF across various periods; and,
- Cumulative returns on invested capital

Assuming this research came back entirely positive,

there would still be concerns over product/technology obsolescence, downward pricing pressure, commoditization, trade policy, and FX risk that would need to be addressed. We would also need to conduct a detailed analysis of the end markets that it serves to ensure that the firm is well-poised to succeed. Furthermore, the firm's transition towards value-added services with higher margins would need to be scrutinized and evaluated. All of these items would need to be represented in our financial model, either directly or as a part of our assumptions.

### Valuation Summary and Conclusion

The perpetuity based on long-term guidance was viewed to be the most useful approach. The average LFCF multiples approach was not informative due to CLS' lack of meaningful cash flow across time. The cumulative investor returns analyses were intended to assess the company's ability to create value, rather than arrive at approximate valuation ranges.

The Team estimated stabilized UFCF based on an average of revenue from 2010 and management's long-term margin guidance of 3.75%-4.50% for consolidated adjusted EBIAT and capital intensity of 1.50%-2.00%. Applying a ~9.7% WACC, the Team sees potential upside of 16%-28%. These assumptions are aggressive, as the accuracy of management's guidance has been poor and revenue growth has been consistently negative. It is also unclear how and when this value would materialize.

The Team's preliminary valuation analysis does not indicate that CLS is undervalued to a degree that compensates for the risks. While the analysis at this stage was crude, the Team is not comfortable allocating more resources to studying the company considering its spotty financial history, exposure to many unrelated end-markets, tariffs and deteriorating industry fundamentals. Given that further analysis is unlikely to change our hypothesis, the Team believes its resources can be put to better use analyzing other companies with better risk/return profiles that are closer to its circle of competence.



### EXHIBIT VI

#### Management-Implied Valuation

##### Management Business Plan

	Low	High
Operating margin target range	3.75%	4.50%
Capital intensity	1.50%	2.00%
"Free cash flow margin"	2.25%	2.50%
Long-term average revenue	\$6,245	\$6,245
Long-term average "FCF"	\$141	\$156
<b>PV @ 9.67% NDR</b>	<b>\$1,453</b>	<b>\$1,615</b>
<b>Current discount/(premium)</b>	<b>16%</b>	<b>28%</b>

Source(s): Q2 conference call, SEC filings, QUIC estimates

### EXHIBIT VIII

#### Cumulative Investor Returns (excl. Equity Distributions)

Cumulative Returns on Capital	From '95	From '08
Capital invested, equity <sup>1</sup>	\$3,159	\$66
Cumulative equity cash flow <sup>2</sup>	(\$1,250)	(\$94)
Annual cum. return on equity invested	nmf	nmf
Capital invested, firm <sup>3</sup>	\$7,550	\$1,815
Cumulative firm cash flow <sup>4</sup>	\$2,910	\$1,616
Annual cum. return on invested capital	(4.1%)	(1.2%)

1. Cumulative equity issuance

2. Cumulative LFCF

3. Cumulative debt and equity issuance

4. Cumulative UFCF

Source(s): SEC filings

### EXHIBIT VII

#### Equity Value Multiples

2017 Period	LFCF	P/LFCF
5Y Average	70.1	13.0 x
7Y Average	98.7	9.3 x
10Y Average	37.4	24.4 x
2018 Period	LFCF	P/LFCF
5Y Average	(21.9)	nmf
7Y Average	19.8	46.1 x
10Y Average	(13.4)	nmf
LTM Period	LFCF	P/LFCF
5Y Average	(67.9)	nmf
7Y Average	(16.8)	nmf
10Y Average	9.6	94.8 x
<b>P/B</b>	0.7 x	
<b>P/TBV</b>	1.1 x	

Source(s): SEC filings, S&P Capital IQ

### EXHIBIT IX

#### Cumulative Investor Returns (incl. Equity Distributions)

Cumulative Returns on Capital	From '95	From '08
Capital invested, equity <sup>1</sup>	\$3,159	\$66
Cumulative equity cash flow <sup>2</sup>	\$256	\$991
Annual cum. return on equity invested	(10.4%)	31.2%
Capital invested, firm <sup>3</sup>	\$7,550	\$1,815
Cumulative firm cash flow <sup>4</sup>	\$4,416	\$2,702
Annual cum. return on invested capital	(2.3%)	4.1%

1. Cumulative equity issuance

2. LFCF + dividends + equity repurchases

3. Cumulative debt and equity issuance

4. LFCF + dividends + equity repurchases + debt amort. + interest payments

Source(s): SEC filings

## **Conclusion: Pass**

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The Sector Team believes that the best way to mitigate risk and perform adequately is to create a relatively concentrated portfolio of holdings which fit the following criteria:

1. Well within the Team's circle of competence
2. Have business models that are conducive to intrinsic valuation or otherwise have clear value catalysts (i.e. pending takeover/tender offer)
3. Have low probability of permanent capital loss

While a key purpose of QUIC is to facilitate learning, it is also to invest wisely. It is more efficient to allocate time and energy to understanding businesses which are undervalued for reasons other than their complexity.

CLS does not fit our basic criteria for investment. The sheer number of distinct end-markets it serves alone is enough to disqualify it. To understand CLS' future is to have a view on aerospace, defense, semiconductors, healthcare technology, power generation/distribution, telecommunications, cloud computing, and several other industrial activities. It also entails an analysis of Dell, Cisco, Juniper Networks, and other significant customers (recall that 70% of revenue is from top 10 customers).

Understanding these factors, the Team does not find today's valuation attractive, even taking management's most bullish case, given the risks inherent to the business.

## References

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1. Bloomberg
2. Capital IQ
3. Company Filings
4. IBISWorld