



RESEARCH REPORT

February 24, 2020

Stock Rating	SELL
Price Target	CAD \$36.41
Current Price	CAD \$36.81



Ticker	SJ
Market Cap (MM)	\$2,440
P/E NTM	14.5x
EV/EBITDA NTM	9.6x

52 Week Performance



Industrials

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Stella-Jones Inc. Tying It Together

Introduction:

In early 2017, the Industrials team decided to make a public equity investment in Stella-Jones Inc. (TSX:SJ) at an average price per share of \$38.75. Since then, the value of the shares has remained relatively range-bound. While certain aspects of the original investment thesis still hold true today, we believe the current share price appropriately captures the risk / reward dynamic of the company.

Thesis I: Defensible Moat With Competitive Advantages

Thesis II: Stable Core Markets & Growth Opportunities

Thesis III: Strong Record of Good Capital Allocation

Conclusion:

The Industrials team used a net asset valuation and a comparables company analysis to value Stella-Jones. After reviewing the company fundamentals, management incentives, recent developments, as well as valuation movements, the team has decided to sell the entirety of its 240 shares and will look to deploy the additional capital into high conviction equities within the Industrials coverage universe.

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Company Overview

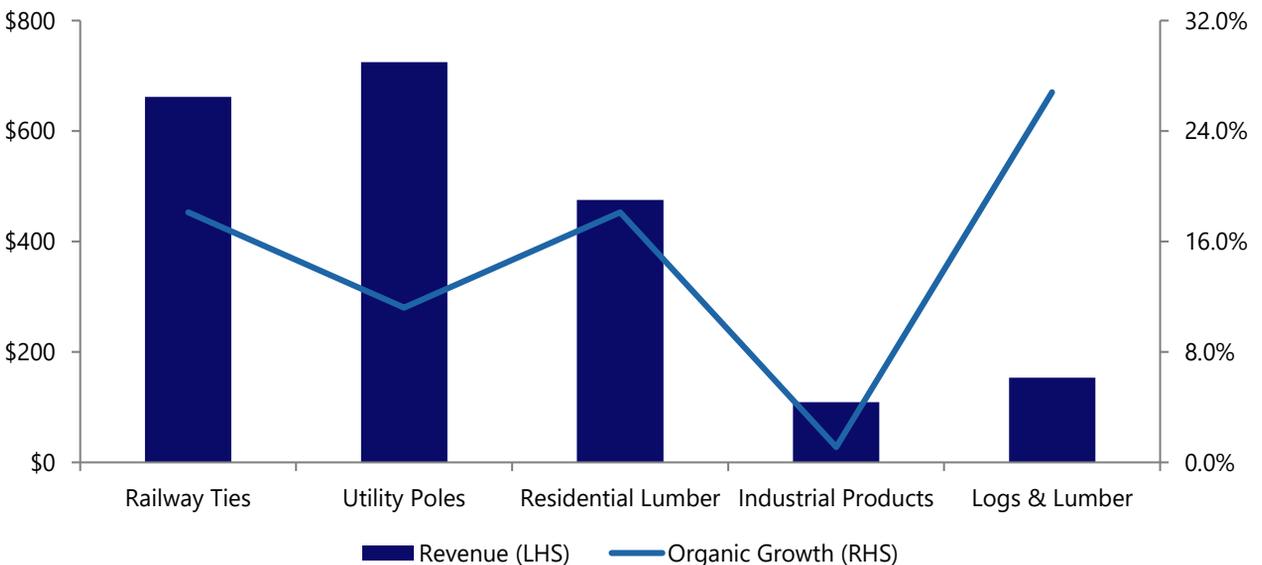
Stella-Jones Inc. (“Stella-Jones”, “Corporation”, “SJ”) (TSX:SJ) is North America’s leading producer of industrial pressure-treated wood products. This consists of manufacturing and distributing railway ties, utility poles, residential lumber, and industrial wood products across the continent. The company has 2,110 employees, 39 wood treating plants, 12 pole peeling facilities, and a coal tar distillery across North America.

The Corporation has five business units. First, railway ties involves the production of quality pressure treated railroad ties and timbers. In 2018, organic growth increased modestly, primarily as a result of price increases. Second, the utility poles segment provides over one million pressure-treated poles per year to replace, upgrade, and develop new electrical utility and telecommunications lines. In 2018, organic growth was driven by greater market reach in the Southeast U.S. and higher prices. Third, the residential lumber

segment provides lumber to North American retailers. In 2018, organic growth increased significantly due to higher selling prices, stemming from increased lumber costs passed through to customers, and to increased volume due to the company’s expanding market presence. Fourth, the industrials products unit supplies pressure treated wood products to the marine, industrial, and civic sectors for outdoor applications. In 2018, organic growth increased modestly, driven by rail-related products. Fifth, the logs & lumber segment is used to optimize procurement, does not generate margin, and is fairly tied to the price of lumber. In 2018, organic growth increased significantly as a result of higher lumber prices, which are passed through to customers as well as increased harvesting for poles, which has generated more log sales.

Exhibit I

2018 Revenue (\$M) & Organic Growth by Segment



Source(s): Company Filings

Management Compensation

Stella-Jones has five components of executive pay structure, which include base salary, short-term incentive compensation, long-term incentive plans, retirement saving plans, and pension benefits.

Additionally, in March 1994, the company formed a Remuneration Committee. The committee is made up of three independent board members. The committee's goal is to establish compensation policies pertaining to wages, bonuses, and any other form of compensation for all employees. Although, primarily, the committee focuses on evaluating the performance of senior executives and granting stock options and restricted stock units (RSUs).

First, the base salary of executives takes into account performance, the complexity of duties and experience, and correspondingly, positioning the salary within the salary range for that position within the organization.

Second, the short-term incentive compensation is based on the completion of objectives agreed upon by

management and the Board of Directors.

Third, the long-term incentive plans (LTIP) of executives are usually in the form of RSUs; however, the Board of Directors also has the power to issue stock options (the last time they issued options was in March 2009). The number of RSUs granted under the LTIP is a fixed number recommended by the Remuneration Committee. Additional RSUs may be issued annually conditional upon the Company attaining a minimum 12.5% return on capital employed (ROCE or ROIC). Although, the Board of Directors has the discretion to waive the ROCE threshold requisite in a given year. The Board of Directors has recently exercised its right to waive the ROCE threshold in 2018 due to the challenging market conditions. Furthermore, the CEO may also petition the committee to offer senior management one-time incentives. This was completed in 2018, where the CEO received over 200,000 RSUs despite failing to meet the 12.5% ROCE benchmark.

Exhibit II

2018 Executive Compensation Summary

Name and Principal Position	Year	Salary (\$)	Share-Based Awards (\$)	Option-Based Awards (\$)	Annual Incentive Plans	Long-Term Incentive Plans	Pension Value (\$)	All Other Compensation (\$)	Total Compensation (\$)
Brian McManus <i>President and CEO</i>	2018	750,000	7,592,000	--	1,200,000	--	--	13,250	9,555,250
	2017	650,000	--	--	1,000,000	--	--	13,115	1,663,115
Eric Vachon <i>Vice-President and CFO</i>	2018	353,130	--	--	270,000	--	--	13,250	636,380
	2017	331,500	1,074,720	--	260,000	--	--	13,115	1,679,335
Ian Jones <i>Vice-President</i>	2018	390,150	--	--	275,000	--	116,000	--	781,150
	2017	382,500	1,074,720	--	260,000	--	30,000	--	1,747,220
Michael Sylvester <i>Vice-President</i>	2018	489,512	--	--	327,408	--	--	7,907	824,827
	2017	441,322	1,074,720	--	301,080	--	--	18,341	1,835,463
Kevin Comerford <i>Vice-President</i>	2018	326,442	--	--	225,093	--	--	19,623	571,158
	2017	294,306	537,360	--	194,448	--	--	20,323	1,046,437

Source(s): Company Filings

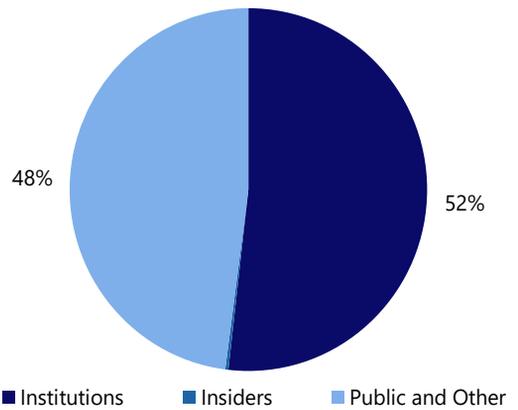
Management Compensation

The Retirement Savings Plan and Pension Benefits are not material to the analysis of the named executive officers' compensation.

Overall, Stella-Jones compensation structure has very standard components for any publicly listed company. However, the Board of Directors' ability to waive shareholder-friendly objectives of management and grant a significant amount of compensation is concerning and is not aligned with our interests.

Exhibit III

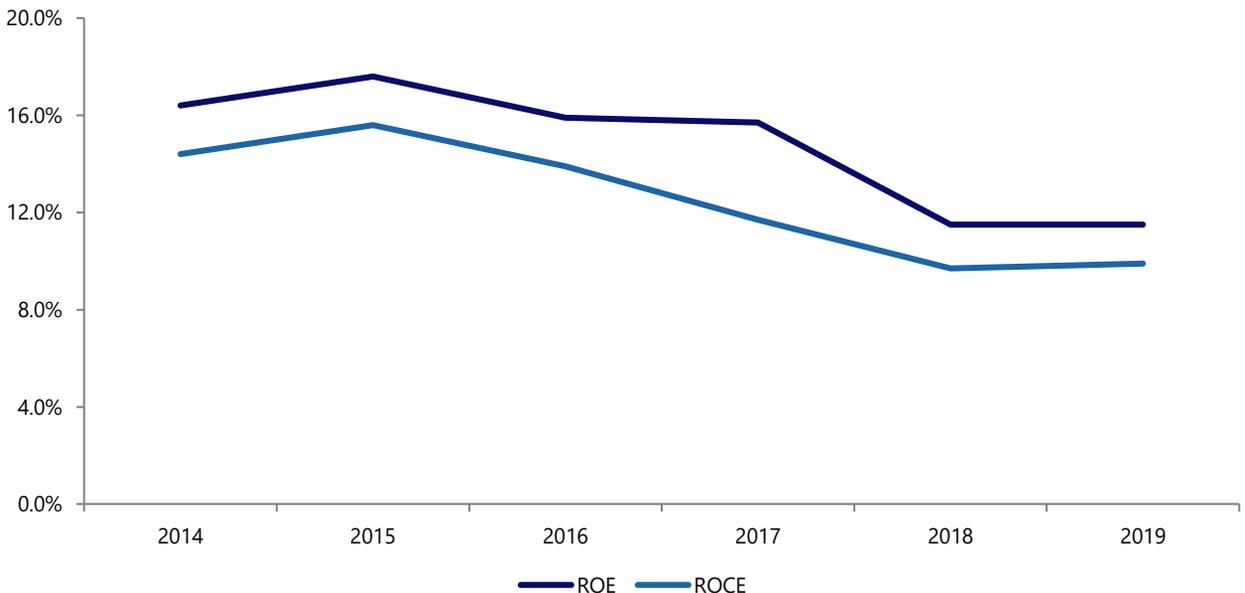
Ownership Summary



Source(s): Capital IQ

Exhibit IV

Return on Equity (ROE) and Return on Capital Employed (ROCE) Comparison



Source(s): Capital IQ

Recent Events

In August 2018, Stella-Jones’s principal shareholder, Stella-Jones International S.A., divested from 8.45M shares of Stella-Jones at \$40.63 per share through a secondary offering to the public.

Stella-Jones International S.A.’s voting securities are held at 51% by Stella International S.A. and at 49% by James Jones & Sons Limited. Mr. Gianni Chiarva, the Vice-Chairman of the Board, together with his associates, exercise control or direction over all the voting shares of Stella International S.A. Mr. Tom A. Bruce Jones owns ~32% of the votes attached to the shares of James Jones & Sons Limited. Upon closing of the transaction, founding partners Tom A. Bruce Jones and Gianni Chiarva stepped down as Chairman and Vice-Chairman, respectively, of the Board. While both shareholder families were not involved in the day-to-day operational side of Stella-Jones, they were clearly an instrumental part of Stella-Jones’ history, having founded the firm 25 years ago.

British Columbia Investment Management Corporation (BCI), the Caisse de dépôt et placement du Québec (CDPQ), the Fonds de solidarité FTQ, GPI Capital, OMERS and CEO Brian McManus purchased 13,126,925 common shares on a private placement basis. Following the completion of the public offering and private placement,

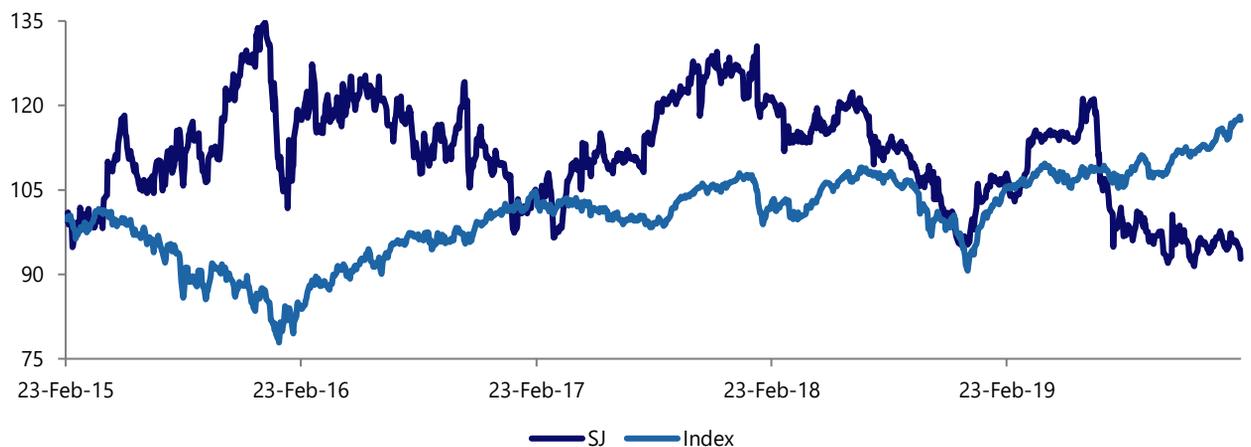
CDPQ became the largest shareowner, owing ~10.9% of total shares outstanding (CDPQ owned 4.5% of total shares outstanding of Stella-Jones as at December 31, 2017) and will have the right to propose one independent director to the Board. Brian McManus, Stella-Jones’ Former President and Chief Executive Officer, purchased 50,000 common shares as part of the Private Placement.

At the time, the QUIC Industrials team viewed the new shareholder base comprised of large pension funds with long-term investment time horizons as a positive. However, we understood that it is widely considered that insiders selling stock in their own companies is potentially a bearish signal. A research paper published in The MIT Press (1998) concluded that stocks following insider selling fell 2.7% compared to the market.

Next year on July 15, 2019, Stella-Jones unexpectedly announced that Brian McManus was stepping down as President and CEO, effective October 11, 2019. Furthermore, upon his departure, Eric Vachon, Senior Vice-President and CFO, will be serving as interim CEO. Given Mr. McManus’ stellar execution on a growth and acquisition strategy over the past 18 years and overall reputation in the Canadian business community, the shares fell 10% on the news.

Exhibit V

Share Price Performance



Source(s): Capital IQ

Investment Thesis Revisited

Introduction

At the start of 2017, the Industrials sector presented its investment memo on Stella-Jones. Ultimately, the team concluded that Stella-Jones' stable recurring revenue profile, durable competitive advantages, and attractive acquisition growth potential created an opportunity to enter a reliable and a defensible name at a reasonable price. The thesis that informed this decision follows:

I: Defensible Moat With Competitive Advantages

In the original report, the Industrials team identified Stella-Jones' continental network as a critical economic moat. A wide operating footprint enabled Stella-Jones to satisfy customer orders in both a quick and low-cost manner. By maintaining locations across the continent and through its massive scale, Stella-Jones could buy resources and transform them into sellable products at lower costs versus competitors. The size of Stella-Jones also allowed it to command a substantial amount of bargaining power within the value chain and to limit its encounters with supply challenges.

II: Stable Core Markets & Growth Opportunities

The Industrials team explained that demand for railway ties was reliable since the largest source of sales was driven by replacement and maintenance requirements. Utility poles also displayed a high degree of visibility as revenue was derived from multi-year contracts with regional telecommunication and electrical companies. Meanwhile, as the fastest growing segment, residential lumber provided Stella-Jones with a diversified channel to pursue rapid expansion, both organic and inorganic.

III: Strong Record of Good Capital Allocation

The Industrials team argued that stewards of capital as prudent as the management committee at Stella-Jones was a rare occurrence. The executive team consistently boasted a high economic value add spread (i.e. ROIC less WACC) which allowed it to compound value as it grew. In addition to returning cash to its shareholders, Stella-Jones demonstrated its ability to complete and integrate a large number of M&A transactions for the direct purpose of improving profitability and efficiency.

Exhibit VI

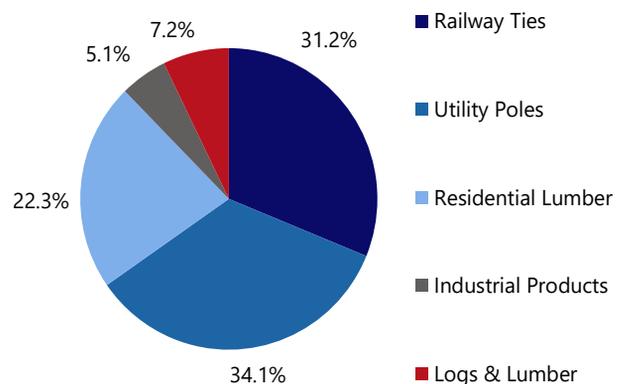
Operating Network Breakdown



Source(s): Company Filings

Exhibit VII

2018 Revenue Segmentation



Source(s): Company Filings

The “Smart” Acquisition Strategy

When the Industrials team first purchased Stella-Jones in early 2017, the sector bought an ownership stake in one of the highest quality businesses in the Industrials coverage universe. The company boasted a dominant industry position and attractive end market exposures. However, a fundamental factor in our decision to enter the name revolved around the management team and the long-term vision of the company. Specifically, the Industrials team saw the “smart” acquisition strategy of the former CEO as a major driver of shareholder value.

“McManus’s formula [was] simple: Identify target niches, stick to [the niches] like glue and steadily consolidate a fragmented market to become the undisputed number one player. Each acquisition [Stella-Jones] undertook, roughly one per year, brought greater scale and cost-efficiency to Stella-Jones’ supply network and enabled it to provide more turnkey offerings to clients.”

So, when the long-term CEO, McManus, unexpectedly left the company the Industrials team raised questions, especially with respect to the multiple expansion. For Stella-Jones, M&A has been the cornerstone of share price appreciation for over a decade with the company

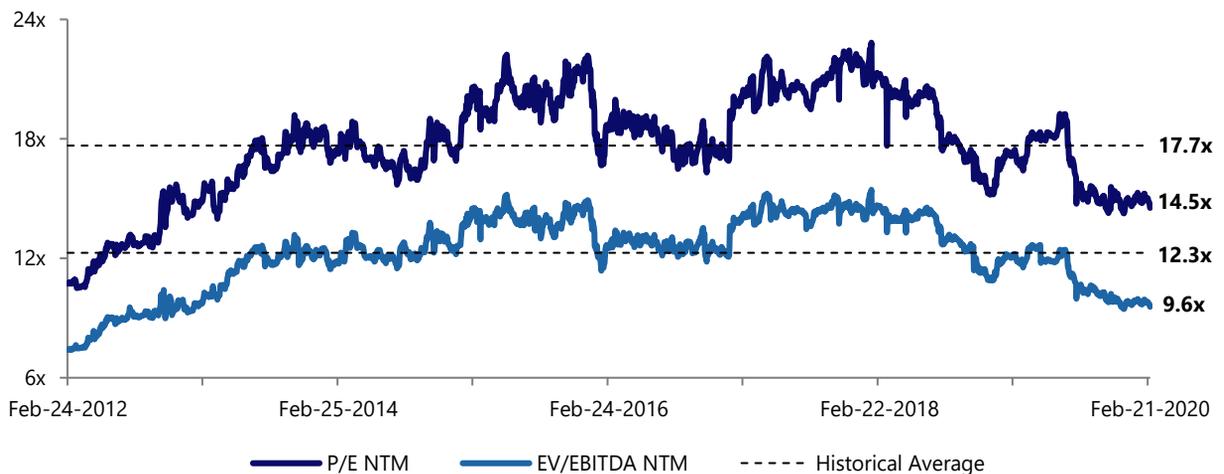
consistently executing deals below the 1.0x EV / Sales range while trading above the 10x EV / EBITDA range.

With estimated market shares of 50% and 40% in its core verticals, rail ties and utility poles, respectively, the Industrials team believes that the consolidation across these industries is in the late innings. The same level of quality and size in the M&A pipeline is unlikely, yet the market continues to ascribe a premium multiple. While management can opt to scale up in residential lumber, increased top line exposure to this arena raises implied cyclicity and margin volatility.

Therefore, the Industrials team thinks Stella-Jones may experience further multiple compression as the pace of M&A activity slows. We do recognize the effectiveness of the “smart” acquisition strategy in growing headline revenue by double digits. But, when we singled out the organic expansion of the company, a rather GDP-type tempo rate seems more likely in its core segments.

Exhibit VIII

Historical Multiple Analysis



Source(s): Bloomberg

Exhibit IX

Net Asset Valuation

EV / EBITDA Multiple	Adjusted EBITDA					Target
<i>(\$ 000's, except per-share data)</i>	2016A	2017A	2018A	2019E	2020E	2020E
EBITDA	267,700	239,800	244,300	313,940	336,810	3,199,695
Minus: net debt at period-end						684,100
Equity value						2,515,595
Shares outstanding (Diluted)						69,100
Net asset value						\$36.41
Current share price						\$36.81
Potential appreciation to NAV (dividend-inclusive)						0.40%

Source(s): FactSet

Exhibit X

Comparables Companies Analysis

Company Name	Market	Enterprise	EV / EBITDA		Net Debt / EBITDA		Price / Earnings	
	Cap (\$MM)	Value (\$MM)	2019E	2020E	2019E	2020E	2019E	2020E
Koppers Holdings Inc.	594	1,629	7.5x	7.2x	4.8x	4.6x	8.0x	6.5x
Trinity Industries, Inc.	2,733	7,523	10.8x	10.6x	6.9x	6.8x	18.9x	17.9x
Norbord Inc.	3,506	4,211	9.8x	10.0x	1.6x	1.7x	16.3x	17.1x
Valmont Industries, Inc.	2,888	3,322	9.7x	8.8x	1.3x	1.1x	17.7x	15.4x
L.B. Foster Company	186	257	5.6x	5.2x	1.6x	1.4x	9.3x	8.4x
High	3,506	7,523	10.8x	10.6x	6.9x	6.8x	18.9x	17.9x
Low	186	257	5.6x	5.2x	1.3x	1.1x	8.0x	6.5x
Mean	1,981	3,388	8.7x	8.4x	3.2x	3.1x	14.1x	13.1x
Median	2,733	3,322	9.7x	8.8x	1.6x	1.7x	16.3x	15.4x
Stella-Jones Inc.	2,483	3,168	10.1x	9.4x	2.2x	2.0x	15.7x	14.1x
Premium / (Discount) to Mean			16.2%	12.5%	(32.5%)	(35.0%)	11.8%	7.8%
Premium / (Discount) to Median			4.3%	6.9%	32.8%	21.7%	(3.8%)	(8.7%)

Source(s): FactSet

Valuation & Conclusion

The QUIC Industrials team currently values Stella-Jones using a net asset valuation (NAV) and a comparables company valuation. The key value drivers in the net asset valuation are the 2020 estimated EBITDA and EV / EBITDA multiple. Our assumed EV / EBITDA multiple is 9.5x, and our estimated 2020E EBITDA is \$336.8M.

Given the recent company developments and ongoing uncertainty with Stella-Jones, we sensitized both key drivers to ensure we were foreseeing the full range of possibilities within our valuation.

At Stella-Jones' current trading price, we are no longer convinced that the stock remains undervalued. Based on our valuation, we estimate the market is attributing ~10-12% of Stella-Jones' value to their M&A growth opportunities. Given the uncertainty of these events, we are not comfortable attributing this much value to them. With further uncertainty surrounding corporate governance, management, and no obvious valuation gap, the team does not have high enough conviction to continue holding Stella-Jones at its current price and will look to sell the name in the immediate future.

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