Stepan Co. (SCL)

Updated April 17th, 2018 by Josh Arnold

Key Metrics

Current Price:	$88	**5 Year CAGR Estimate:**	-0.3%	**Quality Percentile:**	N/A
Fair Value Price:	$66	**5 Year Growth Estimate:**	4.4%	**Momentum Percentile:**	N/A
% Fair Value:	133%	**5 Year Valuation Multiple Estimate:**	-5.7%	**Total Return Percentile:**	N/A
Dividend Yield:	1.0%	**5 Year Price Target**	$81	**Valuation Percentile:**	N/A

Overview & Current Events

Stepan Co. was founded in 1932 and at the outset, it sold only one product; a chemical to keep dust down on Illinois' country roads. Since that time it has grown to manufacture basic and intermediate chemicals, with surfactants making up the lion's share of total revenue. The company has a market cap of $2B and should do $2B+ in revenue this year.

Total revenue in Q4 grew by 13% as the company's surfactant and polymers businesses both saw mid-teens increases. SCL grows both organically and through acquisitions, with the latter powering recent results. Unfortunately, the polymers business makes up half of operating profits and has struggled for a few quarters with margins. That weakness is a sizable headwind for 2018 and beyond and is Stepan's biggest hurdle right now. On the bright side, a lower tax rate for 2018 should produce strong EPS growth this year.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$1.20	$2.92	$2.95	$3.21	$3.49	$3.18	$2.49	$3.32	$3.73	$3.92	***$4.35***	***$5.40***
DPS	$0.42	$0.45	$0.49	$0.53	$0.58	$0.65	$0.69	$0.73	$0.78	$0.86	***$0.90***	***$1.20***

Stepan's EPS have been somewhat inconsistent but over time, have grown at decent rates. The company is beholden to the world's manufacturers so any sort of economic weakness can have fairly severe consequences on earnings. It does boast a wide and deep array of customers so concentration isn't a problem, but as we've seen with the polymers business recently, weakness in just one business line can cause Stepan's results to vary widely from one year to another.

We are forecasting a five-year average EPS growth rate of 4.4%, consisting of mid-single digit sales growth and slightly weaker margins over time. Stepan has been able to grow its revenue but the polymers business makes up half of its total operating profit and thus, weakness there materially impairs its overall margin profile. In addition, the company's cost-saving program has been in place for some time and has yielded operating margin gains, but those gains appear to be plateauing. That means further margin expansion will be difficult to come by in the near term.

The company's dividend has grown steadily in the past decade as well, with Stepan reaching the 50-year mark in terms of consecutive dividend increases. However, the payout is only about one-fifth of earnings and the high valuation in the stock has led to a current yield of just 1%. We expect the payout will rise by 6% annually, congruent with Stepan's recent dividend growth rates. This is not a stock one buys for the yield, however, as acquisitions and R&D take priority.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	17.7	8.0	10.9	11.3	13.2	18.6	21.0	14.0	16.3	19.1	***20.1***	***15.0***
Avg. Yld.	2.0%	1.9%	1.5%	1.5%	1.3%	1.1%	1.3%	1.6%	1.3%	1.2%	***1.0%***	***1.5%***

Stepan's PE multiple has risen substantially since 2009 and is near its peak today. The company's multiple should come back to more normalized levels over time and we are forecasting a sizable 5.7% headwind to annual total returns for the next five years. Stepan is trading well in excess of fair value, a situation we expect to be rectified by a lower multiple.

The yield is likewise showing that Stepan is overvalued as it is at its lowest level in the past decade. We see the stagnant stock price and a rising payout moving the yield up to 1.5% in five years' time, up from the current 1%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	10.6%	18.3%	16.5%	13.9%	16.2%	15.0%	12.9%	17.4%	19.2%	17.6%	***17.0%***	***16.0%***
Debt/A	66%	54%	57%	55%	51%	53%	54%	55%	53%	50%	***50%***	***50%***
Int. Cov.	6.8	16.5	17.1	12.6	13.1	10.2	7.6	8.1	9.7	13.3	***14.0***	***15.0***
Payout	35%	15%	16%	16%	16%	20%	27%	21%	21%	22%	***21%***	***22%***
Std. Dev.	64.8%	53.8%	40.1%	36.2%	117%	20.1%	21.2%	33.1%	28.4%	26.0%	***28.0%***	***35.0%***

Stepan's quality metrics have drifted higher over time, although improvement has been small. That's okay because, its debt-to-asset ratio and interest coverage are strong and its payout ratio is only about one-fifth of earnings. Gross margins remain at risk given the struggles of the polymers business and should Stepan do a large acquisition, it may borrow heavily to do so, sending its debt higher and interest coverage lower. However, there is plenty of room for both to deteriorate without concern; Stepan is a well-financed company today; margins are the chief concern.

The company's competitive advantage is in its diverse, global customer base and many decades of engineering experience. Stepan's competitors cannot easily supplant its position with existing customers given the often custom nature of what Stepan engineers for them. However, Stepan is certainly not immune to economic weakness and as we've seen, its EPS history shows that results can bounce around from one year to another.

Final Thoughts & Recommendation

Stepan looks like it is trading well in excess of fair value today. Its growth from here will depend upon how many acquisitions it completes and whether or not it can turn the polymers business around. We are forecasting total annual returns for the next five years of -0.3%. This is comprised of the 1% current yield, 4.4% EPS growth and a 5.7% headwind from the valuation reset. Stepan's growth outlook has deteriorated somewhat due to the polymers business but the soaring valuation is the principal issue today. Therefore, Stepan looks unattractive on both a growth and value basis, and its 1% yield makes it unattractive for income investors. Outstanding returns in 2015 and 2016 are still being digested by the market and that means Stepan should be avoided for now.

Total Return Breakdown by Year