



Stepan Co. (SCL)

Updated October 26th, 2018 by Josh Arnold

Key Metrics

Current Price:	\$84	5 Year CAGR Estimate:	0.6%	Volatility Percentile:	80.4%
Fair Value Price:	\$65	5 Year Growth Estimate:	4.4%	Momentum Percentile:	67.1%
% Fair Value:	130%	5 Year Valuation Multiple Estimate:	-5.0%	Growth Percentile:	27.7%
Dividend Yield:	1.2%	5 Year Price Target	\$81	Valuation Percentile:	10.8%
Dividend Risk Score:	A	Retirement Suitability Score:	B	Total Return Percentile:	3.7%

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 most of its total revenue. It has a market capitalization of \$1.9 billion and should do \$2 billion in revenue this year.

Stepan posted a strong Q3 earnings reported on 10/24/18. Revenue was up 4% as volumes grew 6% globally. The acquisition of BASF's Mexico production facility contributed 2% to sales and 4% to volume. Surfactants continue to be the growth driver, up 8% during the quarter, offsetting lingering weakness in Polymers. Gross margins rose slightly while operating margins fell, with a lower tax rate leading to a 21% increase in adjusted earnings-per-share to \$1.11. We've reiterated our estimate of \$4.35 in earnings-per-share for this year after the Q3 report.

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	\$1.00	\$1.25
Shares	19	20	20	20	22	22	22	22	22	23	23	24

Stepan's earnings 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 severe consequences on earnings. It does boast a wide and deep array of customers, so concentration is not 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 earnings-per-share 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. Q3's results look much like what we expect in the near future.

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 less than a quarter of earnings and the high valuation in the stock has led to a current yield of just 1.2%. 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	19.4	15.0
Avg. Yld.	2.0%	1.9%	1.5%	1.5%	1.3%	1.1%	1.3%	1.6%	1.3%	1.2%	1.2%	1.5%

Stepan's price-to-earnings 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 5.0% headwind to annual total returns for the next five years. Stepan is trading well in excess of fair value at 130% of our estimate.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.



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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 1.2%.

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%	23%	23%
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%

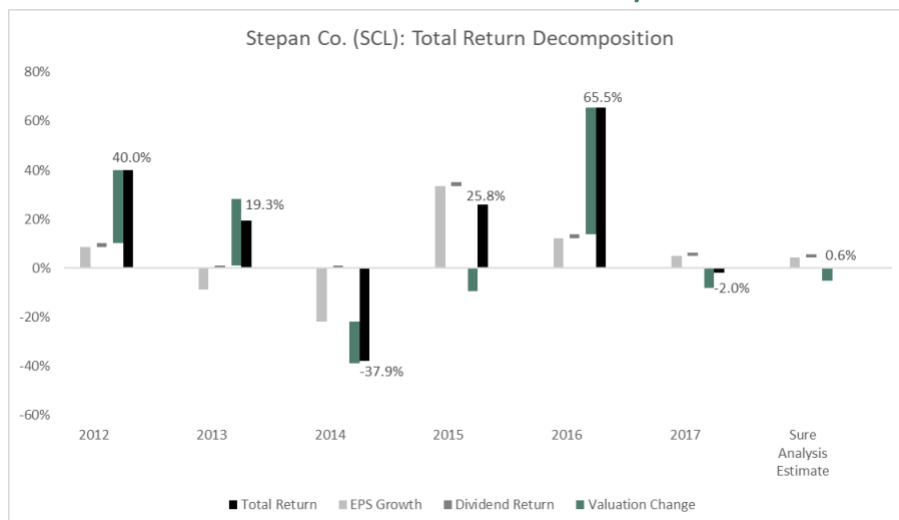
Stepan's quality metrics have drifted higher over time, although improvements have been small. Its debt-to-asset ratio and interest coverage are strong, and its payout ratio is less than a quarter of earnings. Gross margins remain at risk given the struggles of the polymers business and should Stepan 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 and revenue growth are the primary concerns.

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 earnings-per-share history shows that results can bounce around from one year to another.

Final Thoughts & Recommendation

Stepan is trading well in excess of fair value today. Its growth 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 just 0.6%. This is comprised of the 1.2% current yield, 4.4% earnings-per-share growth and a 5.0% 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 1.2% 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; we continue to rate it a sell.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	1600	1276	1431	1843	1804	1881	1927	1776	1766	1925
Gross Profit	170	233	236	256	292	282	250	308	339	338
Gross Margin	10.6%	18.3%	16.5%	13.9%	16.2%	15.0%	12.9%	17.4%	19.2%	17.6%
SG&A Exp.	83	92	90	97	117	125	109	138	149	135
D&A Exp.	37	37	40	47	51	56	64	67	75	79
Operating Profit	71	105	108	118	129	110	95	120	133	149
Operating Margin	4.4%	8.2%	7.5%	6.4%	7.1%	5.9%	4.9%	6.8%	7.5%	7.8%
Net Profit	37	63	65	72	79	73	57	76	86	92
Net Margin	2.3%	4.9%	4.6%	3.9%	4.4%	3.9%	3.0%	4.3%	4.9%	4.8%
Free Cash Flow	-21	124	-8	-6	26	57	-19	64	109	120
Income Tax	18	34	36	32	36	23	18	27	28	48

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	612	634	811	901	985	1167	1162	1238	1354	1471
Cash & Equivalents	8	99	111	84	77	133	85	176	226	299
Accounts Receivable	N/A	N/A	199	261	256	266	270	250	263	294
Inventories	103	75	97	111	162	172	183	170	174	173
Goodwill & Int. Ass.	11	9	12	18	16	35	32	29	48	44
Total Liabilities	403	344	458	496	505	613	625	680	718	730
Accounts Payable	117	95	115	138	142	157	157	129	158	205
Long-Term Debt	143	104	192	199	182	271	274	331	317	291
Shareholder's Equity	194	276	336	388	477	552	536	557	635	740
D/E Ratio	0.69	0.36	0.55	0.50	0.38	0.49	0.51	0.59	0.50	0.39

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	6.3%	10.1%	9.1%	8.4%	8.4%	6.8%	4.9%	6.3%	6.6%	6.5%
Return on Equity	19.2%	26.8%	21.4%	19.9%	18.3%	14.1%	10.5%	13.9%	14.5%	13.3%
ROIC	10.8%	16.9%	13.9%	12.5%	12.5%	9.8%	7.0%	8.9%	9.4%	9.2%
Shares Out.	19	20	20	20	22	22	22	22	22	23
Revenue/Share	75.84	59.11	64.52	82.13	79.35	82.04	84.10	77.70	76.48	82.35
FCF/Share	-0.98	5.73	-0.34	-0.26	1.14	2.51	-0.84	2.82	4.72	5.14

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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