



Stepan Co. (SCL)

Updated February 24th, 2019 by Josh Arnold

Key Metrics

Current Price:	\$94	5 Year CAGR Estimate:	1.6%	Volatility Percentile:	76.5%
Fair Value Price:	\$79	5 Year Growth Estimate:	4.0%	Momentum Percentile:	76.1%
% Fair Value:	119%	5 Year Valuation Multiple Estimate:	-3.5%	Growth Percentile:	21.9%
Dividend Yield:	1.1%	5 Year Price Target	\$96	Valuation Percentile:	24.6%
Dividend Risk Score:	A	Retirement Suitability Score:	C	Total Return Percentile:	7.7%

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 \$2.1 billion and should do \$2.1 billion in revenue this year.

Stepan reported Q4 earnings on 2/21/19 and results capped a year of strong growth that came with record earnings-per-share. Stepan reported a net sales decline of 2% in Q4 against the comparable period last year thanks to a 1% increase in volume that was offset by a 3% loss thanks to currency translation; pricing and mix was flat for the quarter. The core surfactants business, which was the primary growth driver throughout 2018, slowed in Q4 and posted flat year-over-year sales. The polymers business, which was weak throughout 2018, was even worse off in Q4 and came in with a 6% decline in net sales. The specialty products segment posted a strong 10% sales increase, but that segment is a small fraction of total sales, so it wasn't enough to move the needle.

On an operating income basis, surfactants posted an 11% gain thanks to higher sales volume – which was offset by currency headwinds – as well as lower manufacturing costs. Polymers operating income plummeted 44% thanks to lower sales volume, continued margin pressures and a scheduled maintenance shutdown on phthalic anhydride. Lower corporate expenses, which accrued almost entirely due to a large legal expense that occurred in last year's Q4 that didn't reoccur this year, fell by 14%. This helped consolidated operating income increase 25% year-over-year for the company and drove earnings-per-share from \$0.42 in last year's Q4 to \$1.16 in this year's Q4. Along with the absence of the significant legal charge, the company's net income was negatively impacted last year by tax reform, another nonrecurring item that fell off the income statement this Q4. Adjusting all of that out, earnings-per-share rose from \$1.02 to \$1.06 year-over-year, which is more in line with our growth expectations for Stepan moving forward.

We're out with an initial estimate of \$5.25 in earnings-per-share for this year as management sees favorable volumes and incremental gains in margins coming in 2019. Stepan also continued its focus on shareholder returns, boosting its dividend for the 51st consecutive year in late 2018. It also has 494,287 shares left on its repurchase authorization, good for around 2% of the float.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	\$2.92	\$2.95	\$3.21	\$3.49	\$3.18	\$2.49	\$3.32	\$3.73	\$3.92	\$4.88	\$5.25	\$6.39
DPS	\$0.45	\$0.49	\$0.53	\$0.58	\$0.65	\$0.69	\$0.73	\$0.78	\$0.86	\$0.93	\$1.00	\$1.30
Shares	20	20	20	22	22	22	22	22	23	23	24	25

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%, 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

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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. Q4's results would seem to support this conclusion.

The company's dividend has grown steadily in the past decade. 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 1.1%. We expect the payout will rise by ~5% annually as acquisitions and R&D take priority.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	8.0	10.9	11.3	13.2	18.6	21.0	14.0	16.3	19.1	16.5	17.9	15.0
Avg. Yld.	1.9%	1.5%	1.5%	1.3%	1.1%	1.3%	1.6%	1.3%	1.2%	1.1%	1.1%	1.4%

Stepan's price-to-earnings multiple remains stubbornly high. The company's multiple could come back to more normalized levels over time and we are forecasting a sizable 3.5% headwind to annual total returns for the next five years. While the valuation has come off of its recent highs, it is still at 119% of fair value.

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 1.4% in five years' time, up from the current 1.1%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	15%	16%	16%	16%	20%	27%	21%	21%	22%	19%	19%	20%

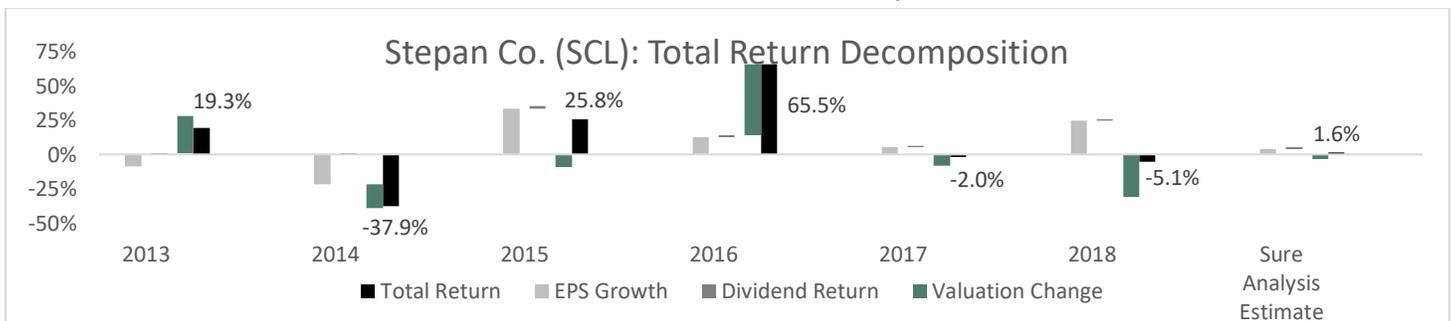
Stepan's payout ratio is just one-fifth of earnings and we don't see it moving from there given the company's focus on investing in future growth rather than paying cash out to shareholders.

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 still trading well in excess of fair value today. We are forecasting total annual returns for the next five years of just 1.6%, comprised of the 1.1% current yield, 4% earnings-per-share growth and a 3.5% 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. 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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