Stepan Co. (SCL)

Updated March 2nd, 2020 by Josh Arnold

Key Metrics

Current Price:	$88	**5 Year CAGR Estimate:**	-0.1%	**Market Cap:**	$2.0 B
Fair Value Price:	$66	**5 Year Growth Estimate:**	4.0%	**Ex-Dividend Date:**	03/04/20
% Fair Value:	133%	**5 Year Valuation Multiple Estimate:**	-5.6%	**Dividend Payment Date:**	03/13/20
Dividend Yield:	1.3%	**5 Year Price Target**	$80	**Years Of Dividend Growth:**	52
Dividend Risk Score:	A	**Retirement Suitability Score:**	C	**Last Dividend Increase:**	10.0%

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 $2.0 billion and should do just under $2 billion in revenue this year.

Stepan reported Q4 and full-year earnings on February 20th and results were better than expected on both the top and bottom lines. Earnings for the year came to $119.4 million on an adjusted basis, or $5.12 per share, up 7% from the prior year. Surfactants continued to decline, as that segment's operating income was down -8% year-over-year thanks to weakness in North America. The Polymer segment saw its operating income rise 5% year-over-year, and Specialty Product's operating income was up from $11.7 million to $16.4 million in 2019.

Total sales volume declined -2% against 2018 as growth in Polymers and Specialty Products was offset by a -3% decline in Surfactants volume, -1% of which was from the exit of the sulfonation business in Germany.

The company has a solid financial position with a cash balance of $315 million exceeding total debt of $222 million.

The company said it expected a "challenging" first quarter and that Specialty Products, which was a source of growth in 2019, should be flat in 2020. Stepan also said additional headwinds could come from the coronavirus outbreak, as well as higher raw material and sourcing costs. We're cautious on Stepan for these factors and volume and pricing issues in its core Surfactant business, and our initial estimate is for $4.40 in earnings-per-share for 2020.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$2.95	$3.21	$3.49	$3.18	$2.49	$3.32	$3.73	$3.92	$4.88	$5.12	***$4.40***	***$5.35***
DPS	$0.49	$0.53	$0.58	$0.65	$0.69	$0.73	$0.78	$0.86	$0.93	$1.03	***$1.10***	***$1.62***
Shares[1]	20	20	22	22	22	22	22	23	23	23	***23***	***23***

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. 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.

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 1.3%. We expect the payout will rise by ~10% annually as the company has used its extra cash to fund dividend increases in recent years.

[1] Share count in millions

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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	10.9	11.3	13.2	18.6	21.0	14.0	16.3	19.1	16.5	18.0	***20.0***	***15.0***
Avg. Yld.	1.5%	1.5%	1.3%	1.1%	1.3%	1.6%	1.3%	1.2%	1.1%	1.1%	***1.3%***	***2.0%***

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 -5.6% headwind to annual total returns for the next five years. The valuation is back to near the highest levels in the past decade, and shares trade for 133% of our fair value estimate. Given the weak 2019 results, we see the stock rallying at just the wrong time.

The yield is likewise showing that Stepan is overvalued relative to its history. We see a potentially stagnant stock price and a rising payout moving the yield up to 2.0% in five years' time, up from the current 1.3%. Stepan raised its dividend on 10/23/19 to a new annualized payout of $1.10, a 10% increase over the prior level.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	16%	16%	16%	20%	27%	21%	21%	22%	19%	20%	***25%***	***30%***

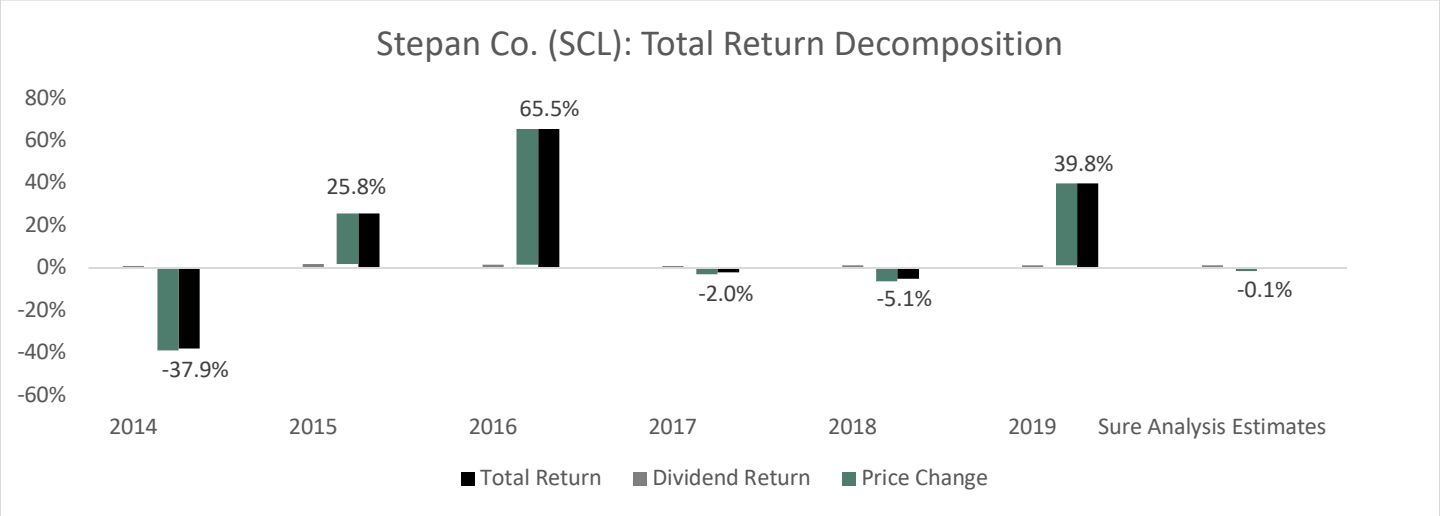
Stepan's payout ratio is just one-quarter of earnings, and we don't see it moving from there given the company's focus on investing in future growth.

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 our estimate of fair value. We are forecasting total annual returns for the next five years of -0.1%, comprised of the 1.3% current yield, 4% earnings-per-share growth and a sizable headwind from the valuation reset. Stepan's growth outlook continues to deteriorate due to the surfactants business, but the soaring valuation is the principal issue today. We see the stock as very unattractive, and continue to rate it a sell.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	1,431	1,843	1,804	1,881	1,927	1,776	1,766	1,925	1,994	1,859
Gross Profit	236	256	292	282	250	308	339	339	342	340
Gross Margin	16.5%	13.9%	16.2%	15.0%	12.9%	17.4%	19.2%	17.6%	17.1%	18.3%
SG&A Exp.	90	97	117	125	109	138	149	135	133	155
D&A Exp.	40	47	51	56	64	67	75	79	81	
Operating Profit	108	118	129	110	95	120	135	150	154	130
Operating Margin	7.5%	6.4%	7.1%	5.9%	4.9%	6.8%	7.6%	7.8%	7.7%	7.0%
Net Profit	65	72	79	73	57	76	86	92	113	103
Net Margin	4.6%	3.9%	4.4%	3.9%	3.0%	4.3%	4.9%	4.8%	5.7%	5.5%
Free Cash Flow	(8)	(6)	26	57	(19)	64	109	120	84	
Income Tax	36	32	36	23	18	27	28	48	27	23

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	811	901	985	1,167	1,162	1,238	1,354	1,471	1,485	1,579
Cash & Equivalents	111	84	77	133	85	176	226	299	300	
Accounts Receivable	199	261	256	266	270	250	263	294	280	
Inventories	97	111	162	172	183	170	174	173	200	
Goodwill & Int. Ass.	12	18	16	35	32	29	48	44	37	
Total Liabilities	458	496	505	613	625	680	718	730	700	687
Accounts Payable	115	138	142	157	157	129	158	205	206	
Long-Term Debt	192	199	182	271	274	331	317	291	276	199
Shareholder's Equity	336	388	477	552	536	557	635	740	784	892
D/E Ratio	0.55	0.50	0.38	0.49	0.51	0.59	0.50	0.39	0.35	0.22

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	9.1%	8.4%	8.4%	6.8%	4.9%	6.3%	6.6%	6.5%	7.6%	6.7%
Return on Equity	21.4%	19.9%	18.3%	14.1%	10.5%	13.9%	14.5%	13.3%	14.8%	12.3%
ROIC	13.9%	12.5%	12.5%	9.8%	7.0%	8.9%	9.4%	9.2%	10.8%	9.6%
Shares Out.	20	20	22	22	22	22	22	23	23	23
Revenue/Share	64.52	82.13	79.35	82.04	84.10	77.70	76.48	82.35	85.48	79.72
FCF/Share	(0.34)	(0.26)	1.14	2.51	(0.84)	2.82	4.72	5.14	3.62	

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