



# Stepan Co. (SCL)

Updated October 23<sup>rd</sup>, 2020 by Josh Arnold

## Key Metrics

<b>Current Price:</b>	\$115	<b>5 Year CAGR Estimate:</b>	2.6%	<b>Market Cap:</b>	\$2.6 B
<b>Fair Value Price:</b>	\$96	<b>5 Year Growth Estimate:</b>	5.0%	<b>Ex-Dividend Date:</b>	11/27/20
<b>% Fair Value:</b>	119%	<b>5 Year Valuation Multiple Estimate:</b>	-3.5%	<b>Dividend Payment Date:</b>	12/15/20
<b>Dividend Yield:</b>	1.1%	<b>5 Year Price Target</b>	\$123	<b>Years Of Dividend Growth:</b>	53
<b>Dividend Risk Score:</b>	A	<b>Retirement Suitability Score:</b>	C	<b>Last Dividend Increase:</b>	10.9%

## 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 revenue. It has a market capitalization of \$2.6 billion after a strong performance this year and should do about \$1.8 billion in revenue. Stepan is also a Dividend King, having increased its payout for 53 consecutive years.

Stepan reported third quarter earnings on October 21<sup>st</sup>, with results coming in much better than expected for both revenue and profits. Total sales were up 3% in Q3 as volumes increased globally by 5%, but pricing and mix were a slight headwind. Surfactant sales soared 11% to \$334 million, Polymer sales declined -14% to \$117 million, and Specialty Products struggled once more, declining -17% to \$14 million. Surfactant volume rose 8% due to higher consumer product sales, including cleaning, disinfectant, and personal wash products due to COVID-19. Rigid polyol sales were off by -5% as demand for industries like construction fell.

Gross margins ramped higher by 380bps to 20.9%, sending operating margins higher by 290bps to 9.1% of revenue. Stepan continues to have a negative net debt balance, ending the quarter at -\$103 million.

We've significantly boosted our estimate of earnings-per-share for this year following an outstanding third quarter report. We now expect \$5.35 in earnings-per-share for 2020 on very strong surfactant demand.

Stepan also raised its dividend by 11% to a new payout of \$1.22, marking the 53<sup>rd</sup> consecutive year of dividend increases.

## Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
<b>EPS</b>	\$2.95	\$3.21	\$3.49	\$3.18	\$2.49	\$3.32	\$3.73	\$3.92	\$4.88	\$5.12	<b>\$5.35</b>	<b>\$6.83</b>
<b>DPS</b>	\$0.49	\$0.53	\$0.58	\$0.65	\$0.69	\$0.73	\$0.78	\$0.86	\$0.93	\$1.03	<b>\$1.22</b>	<b>\$1.79</b>
<b>Shares<sup>1</sup></b>	20	20	22	22	22	22	22	23	23	23	<b>23</b>	<b>23</b>

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. Stepan was in the right place at the right time with its surfactant business, capturing additional demand, for 2020.

We are forecasting a five-year average earnings-per-share growth rate of 5%, 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, and we saw huge operating margin gains in Q3.

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 ~8% annually as the company has used its extra cash to fund dividend increases in recent years.

<sup>1</sup> 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	<b>21.5</b>	<b>18.0</b>
Avg. Yld.	1.5%	1.5%	1.3%	1.1%	1.3%	1.6%	1.3%	1.2%	1.1%	1.1%	<b>1.1%</b>	<b>1.5%</b>

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 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 119% of our fair value estimate. While we think the company is weathering the storm fairly well, the valuation is pricing in too much growth.

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 1.5% in five years' time, up from the current 1.1%.

## 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%	<b>23%</b>	<b>26%</b>

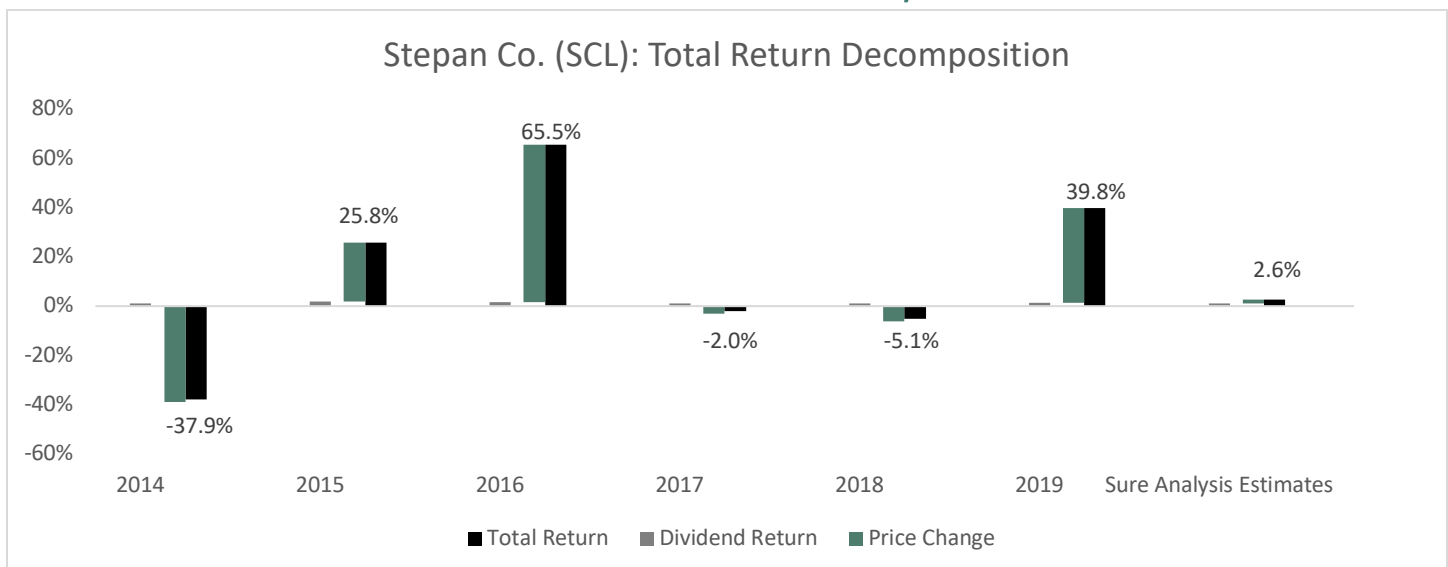
Stepan's payout ratio is just one-quarter of earnings, and we don't see it moving materially higher given the company's focus on investing in future growth.

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 in excess of our estimate of fair value. We are forecasting total annual returns for the next five years of 2.6%, comprised of the 1.1% current yield, 5% earnings-per-share growth and a headwind from the valuation reset. The high valuation is the principal issue today, as it has been for some time. We see the stock as 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
<b>Revenue</b>	1,431	1,843	1,804	1,881	1,927	1,776	1,766	1,925	1,994	1,859
<b>Gross Profit</b>	236	256	292	282	250	308	339	346	339	340
<b>Gross Margin</b>	16.5%	13.9%	16.2%	15.0%	12.9%	17.4%	19.2%	18.0%	17.0%	18.3%
<b>SG&amp;A Exp.</b>	90	97	117	125	109	138	149	135	133	155
<b>D&amp;A Exp.</b>	40	47	51	56	64	67	75	79	81	79
<b>Operating Profit</b>	108	118	129	110	95	120	135	158	152	129
<b>Operating Margin</b>	7.5%	6.4%	7.1%	5.9%	4.9%	6.8%	7.6%	8.2%	7.6%	7.0%
<b>Net Profit</b>	65	72	79	73	57	76	86	101	111	103
<b>Net Margin</b>	4.6%	3.9%	4.4%	3.9%	3.0%	4.3%	4.9%	5.2%	5.6%	5.5%
<b>Free Cash Flow</b>	(8)	(6)	26	57	(19)	64	109	120	84	113
<b>Income Tax</b>	36	32	36	23	18	27	28	46	27	23

## Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
<b>Total Assets</b>	811	901	985	1,167	1,162	1,238	1,354	1,471	1,515	1,579
<b>Cash &amp; Equivalents</b>	111	84	77	133	85	176	226	299	300	315
<b>Accounts Receivable</b>	199	261	256	266	270	250	263	294	280	277
<b>Inventories</b>	97	111	162	172	183	170	174	173	232	204
<b>Goodwill &amp; Int. Ass.</b>	12	18	16	35	32	29	48	44	37	41
<b>Total Liabilities</b>	458	496	505	613	625	680	718	730	706	687
<b>Accounts Payable</b>	115	138	142	157	157	129	158	205	206	194
<b>Long-Term Debt</b>	192	199	182	271	274	331	317	291	276	222
<b>Shareholder's Equity</b>	336	388	477	552	536	557	635	740	807	892
<b>D/E Ratio</b>	0.55	0.50	0.38	0.49	0.51	0.59	0.50	0.39	0.34	0.25

## Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
<b>Return on Assets</b>	9.1%	8.4%	8.4%	6.8%	4.9%	6.3%	6.6%	7.1%	7.4%	6.7%
<b>Return on Equity</b>	21.4%	19.9%	18.3%	14.1%	10.5%	13.9%	14.5%	14.7%	14.4%	12.1%
<b>ROIC</b>	13.9%	12.5%	12.5%	9.8%	7.0%	8.9%	9.4%	10.2%	10.5%	9.4%
<b>Shares Out.</b>	20	20	22	22	22	22	22	23	23	23
<b>Revenue/Share</b>	64.52	82.13	79.35	82.04	84.10	77.70	76.48	82.35	85.48	79.72
<b>FCF/Share</b>	(0.34)	(0.26)	1.14	2.51	(0.84)	2.82	4.72	5.14	3.62	4.84

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

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