

Final Report: Cervus Equipment

1-Page Valuation

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Search Process: Cervus Equipment (TSX: CERV) is a potentially undervalued stock across most screening measures - With a P/E ratio of 9.56, Cervus is under the screening criteria of 13. The stock is a small cap company, at \$222.61 M market capitalization likely protecting it from institutional investors. The P/B is 0.99, which is also below the 1.2 screening criteria. There is fair analyst company coverage including CIBC, TD, NB and other boutique firms (Screening summary shown in Figure 1).

Business Risk: Medium - Cervus Equipment is a Canadian agricultural, industrial and transportation equipment dealer. Founded in 1982, Cervus built its company by acquiring independent agricultural equipment dealerships scattered in Western Canada (Alberta and Saskatchewan) currently commanding about 10% market share of John Deere dealership in the region. This business line accounts for 66% of its revenues and is exposed to the moderate business risk of the agricultural sector (weather, commodity prices, cyclicity) as well as to the commitment and performance of its main OEM, John Deere Equipment. Cervus diversified its business and entered the construction and industrial (C&I) sector of Western Canada in 2005. This segment, around 8% of revenues, exposes Cervus to the cyclicity and high business risk of the oil and gas sector that powers the regional economy, however the company has diversified this segment to servicing wholesale, grocery, and other businesses. Cervus' last product line is Transportation, accounting for 26% of revenues, this unit is exposed to the oil and gas sector (oil transportation in Saskatchewan) and competition in Ontario. With a relatively lower business risk, this business depends on the age of the fleet and the overall consumer sentiment (Figure 2) Cervus has also continued expanding by buying dealerships in Australia and NZ (2010), and in Ontario (2014). Besides the capital equipment sale business (73% of sales), Cervus' business risk is buffered by its complementary and stable business offerings in parts (18%), service and rentals (9%). Cervus' consolidated gross margin is stable at around 18% and EBIT margins fluctuate between 2.5% and 4% depending on the price of oil and overall economic performance (transportation and agriculture) This medium business risk indicates that Cervus Equipment optimal capital structure is between 30-50%.

Financial Risk Analysis: High - The company's target D/V ratio is 54% as maintained for the past two years, from a more leverage position in prior years, (Figure 3 and 4) which is slightly above the upper limit of its optimal capital structure, indicates that the company is assuming more financial risk that it should. This combination of business and financial risk corresponds to a bond rating of BB and equity risk premium of 5.9%. A risk-free interest rate of 2.29% and corresponding (BBB) corporate bond spread of 2.24% give Cervus a cost of debt (kd) of 4.53%, cost of equity (ks) of 10.43% and a WACC of 6.57%. First pass ROIC leads to ROIC1 of 6.39%, which is slightly less than WACC (Figure 9 and 10), suggesting that Cervus should have an NAV slightly greater than EPV.

Net Asset Value (NAV): \$24.72 per share. To determine this value, adjustments needed to be made to the company's assets and liabilities (Figure x and Figure x) and this value is divided by the number of shares outstanding (Figure 5).

Earnings Power Value (EPV): \$18.35 per share. The company was not assessed for growth since the industry was not seen as rapidly changing or expanding, ROIC<WACC, and EBIT per share had decreased or remain stable in the past 5 years (even with year over year revenue per share growth) (Figure 14). The second pass ROIC versus WACC (Figure 10), leads to ROIC2 =5.43% which is also lower than the WACC=6.57%.

Catalyst Value: Catalyst Probability of 40%

Since NAV>EPV, the probability of a catalyst needs to be examined. Cervus gross margins are almost fully determined by its OEM partners and will likely continue to remain stable. However, its other costs could potentially decrease if they manage to achieve economies of scale as they consolidate more dealerships. To management's credit, it has improved its operations in many areas, such as inventory turns, overhead SG&A and increased its asset turnover consistently year after year by divesting its real estate assets and focusing on their core business of dealership operation. These efficiencies are partially offset as the business expands to seemingly unrelated dealership activities in distant geographies. It is also not clear if this business can truly achieve economies of scale or if dealerships are better off as stand-alone businesses due to extremely low operating leverages in the dealership business. Moreover, expanding its service component of its business will not likely be enough to improve the margins since it still accounts for less than 10% of its revenues. Since management has remained in its positions for the past 10 years and ownership is concentrated, this catalyst component is low. It is unclear what new management may be able to do, besides further consolidate the business and move to higher margin businesses. (Figure 2). Since we do not foresee these changes as highly likely, a probability of catalyst value of 40% is selected.

Intrinsic Value and Entry Price:

$IV = \min(EPV, NAV) + \text{abs}(NAV - EPV) * \text{Catalyst Probability} = (18.35 + 0.4 \times (24.72 - 18.35)) = \$ 20.90$
 $EP = 2/3 * IV = 2/3 * 20.90 = \13.93 Entry price is 27 cents lower than the current stock price of \$14.20

Recommendation: Do not purchase Cervus Equipment. The entry price is marginally lower than the current market price. Buy or not buy based on reasons beyond valuation of company.