

## Cascades Inc. Value Analysis: Group 5

Sydney Gable-Cook, Danielle Moloughney, Harry Solomon, Alex Stretton, Mike Weir

### **Justification for Choosing Company Consistent with Value Investing Screening Principles (Exhibit 1)**

In terms of obscurity screening, Cascades has a market capitalization of \$1.34B, which is above the \$450M search criteria for Canada, and six analysts cover the stock. Cascade meets the low growth screening criteria as it is a mature company with an average ten-year growth rate of 1.4%. Cascades' current P/E and market/book ratio of 2.4x and 0.83x, respectively, both meeting the criteria of P/E less than 13.0x and market/book of less than 1.2x. Cascades market leadership position in a mature industry and simple business model is very attractive. Overall, Cascade meets most of the screening criteria, indicating the stock is **potentially undervalued** and warranting further analysis.

### **Industry and Business Risk Analysis**

Cascades operates in the maturing paper, packaging, and tissue products manufacturing industry with a 3.5% CAGR. Industry key success factors include manufacturing capabilities, economies of scale, customer relationships, product innovation and quality. The industry is consolidated and highly competitive, meaning it is driven by price and market share. Low-medium switching costs and medium-high barriers to entry are also apparent in the industry. Furthermore, the industry is exposed to commodity prices and environmental regulations. Overall, the industry has been assigned a **medium industry risk**.

Cascades has market leadership in Canada and North America, strong R&D capabilities, and is vertically integrated. Cascades is diversified through its customers, geography, and broad product offerings which helps mitigate business risk. Additionally, the company has strong customer relations and an extensive product portfolio achieved through operating one of the largest private Canadian research centers in the industry. However, Cascades faces foreign exchange, labour dispute, and trade risks, in addition to the risks inherent in the industry. Overall, Cascades has been assigned a **medium business risk**, in line with industry risk.

### **Financial Risk**

Based on Cascades' medium business risk, their optimal capital structure is 30-49%. However, Cascades' 8-year average capital structure is 59.1% (current year B/V ratio is 51.1%), which is above the optimal range (Exhibit 2). Therefore, we have assigned **high financial risk**. Based on this risk assessment, we would expect Cascades to have a debt rating in the BBB-B range. Cascades has a debt rating of BB- supported by Cascades' 8-year frequently traded bond with a BB- rating and YTM of 5.23%, which is used as the value of  $K_d$ . Accordingly, an ERP of 5.9% has been assigned, which gives a  $K_s$  of 11.13%. Overall, the company's WACC is 7.40% (Exhibit 3). The first-pass ROIC is 4.52% (Exhibit 4), which is less than WACC, indicating that NAV may be greater than EPV.

### **Valuation of Cascades**

NAV is \$32.35/share (Exhibit 5), which is driven primarily by \$3.5B in PP&E and \$432M reconstruction value of Goodwill, accounting for recurring impairment charges. Customer relations was assigned a 1.0x multiplier due to the commodity-like nature of the business, but slight importance of brand image (Exhibit 6). The life cycle of product portfolio was based on a weighted average based on Cascades' four product segments. (Exhibit 6).

EPV is \$4.92/share (Exhibit 7), driven mainly by Cascades' low operating margins and the substantial \$1.5B market value of long-term debt (Exhibit 6). Zero-growth CapEx was set equal to depreciation after two other approaches yielded values very far off from depreciation (Exhibit 7). EPV is less than NAV, which aligns with first pass ROIC analysis. Second pass ROIC is 2.92% (Exhibit 8), which is less than WACC, supporting the fact that NAV is greater than EPV.

### **Strategic Valuation Analysis**

Cascades has a potential total catalyst value of \$6.86/share. Excess capacity cannot be the driver of this catalyst value. Cascades' manufacturing capacity utilization rate is at 94% which is in line with the industry average capacity utilization rates of 97% in the containerboard segment and 93% in the tissue segment. Asset turnover metrics greater than industry medians, acquisitions related only to operations and internal promotions indicate that management is efficient at asset management and is not the underlying issue driving the catalyst.

Cascades' poor five-year average operating margins compared to competitors emphasize that the driver of this catalyst may be attributable to a competitive disadvantage (Exhibit 9). This may arise from lack of economies of scale due to small relevant market share in this high fixed cost industry, as seen in an analysis of competitive industry share of revenue.

The probability of catalyst realization is 25% as it is unlikely Cascades can overcome the competitive disadvantage concerning lack of scale if Cascades continues to operate in this industry. The only viable approach would be shrinking to compete in the specialized products industry segment in which they can acquire higher product margins.

### **Recommendation**

Cascades has an intrinsic value of \$11.78/share. The value of the catalyst is \$6.86/share. Cascades has a current market price of \$14.02, which is higher than the suggested entry price of \$7.85. It is recommended to not buy Cascades and instead wait. As a result, Cascades is **not currently viewed as a value play** (Exhibit 10).