Clearwater Paper Corporation **Group 7** **Section 1**

Step 1: Screening

The Clearwater Paper Corporation's P/E and P/B ratios as of March 23, 2018 stand at 6.29 and 1.06, respectively. Clearwater's P/E ratio is below our benchmark of 13, P/B is also below our 1.3 cut-off. With a market cap of $575.42M, Clearwater is a small-cap US stock. Analyst coverage in 2018 is low, with only three covering the stock. Clearwater has recently underperformed its peers in terms of net margin and ROA and has been punished by the market. Clearwater's recent underperformance, obscurity, and low P/E pass initial screening to be a potential value stock.

Step 2: Valuation

Business Risk: Clearwater's business is divided between consumer paper products (54.43% of 2017 revenue), and pulp & paperboard products (45.57% of 2017 revenue) (Exhibit 1). Structural similarities exist between the consumer paper & paperboard industries, specific differences imply CPP and paperboard industries should be analyzed individually. In CPPs, Clearwater is a leading manufacturer of private label products. Clearwater is the only US CPP manufacturer focusing exclusively on the private label segment, allowing them to produce an above-average quality product at prices competitive in the private label segment. Clearwater's unique private label value proposition has attracted high-profile US retailers as customers, with Kroger representing 15.3% of 2017 revenues. In paperboard, Clearwater is a high quality player. Clearwater avoids price-based competition in the lower quality segments. Overall, we believe Clearwater is medium business risk. Stable ROA figures and stable company wide margins over the 10 year period of 2007-2017 validate our analysis and indicate business risk is medium.

Financial Risk: Given medium business risk, Clearwater's optimal capital structure is between 30% and 49% B/V. We capitalized operating leases given data from 2010-2017 to add calculate capital structure. Given relatively stable B/V over the previous 8 years and the absence of management direction, we believe and 8-year average capital structure is appropriate. Clearwater's 8-year average B/V is 55.66% (Exhibit 6), putting B/V above optimal range, implying high financial risk. Medium business and high financial risk would suggest a credit rating of between B and BBB, which aligns with our analysis. 2017 debt to EBITDA ratio is 4.37x, also aligning with intuition. Based on credit analysis, we used a BB corporate spread of 2.38% in addition to a 10-year US Government bond yield of 2.82%. to arrive at pre-tax Kd of 5.20%. Clearwater's tax rate is 21% federally & 3% state, resulting in a post-tax Kd of 3.95%. Using a 5.9% ERP yields a WACC of 7.12% (Exhibit 9). First-pass ROIC is 3.90% in 2017, suggesting NAV will be above EPV.

NAV: Standard adjustments were made to arrive at a reproduction value of current assets of $545M. Land is taken at book value and appreciated at 3% for 20 years, while land improvements are taken at book value as land improvements do not appreciate over time. Buildings & improvements are taken at book value and appreciated at 3% per year, for 10 years. Office equipment and construction in progress were reduced by 20% to reflect true replacement cost. Machinery and equipment were reduced by 30% due to technology & automation's increasing prevalence in North American industry. Customer relationships are important for Clearwater and are capitalized at a 1.25x multiplier. Clearwater does not participate in R&D and therefore none is capitalized. Total reproduction cost of Clearwater's assets is $2.997 Billion (Exhibit 12).

Current liabilities are taken at book value. Capitalized operating leases were discounted at the cost of debt of 5.2%. Deferred tax liabilities are taken at the book value and multiplied by 0.9 after 2000. Market value of long-term debt was calculated to be $568M. The market value of stock options is calculated using the Black-Scholes model. Underfunded pension obligation and other long-term obligations are taken at the book value. Total reproduction value of NAV liabilities of $1.28 billion. Subtracting the reproduction cost of liabilities from assets yields a NAV per share of $104.12 (Exhibit 15).

EPV: Clearwater's 10-year average operating margin of 7.4% is applied to current sales, resulting in normalized operating profit of $127.996M. An OTA penalty of $4.256M is applied due to assets impairment charges and a loss on divested assets in 2014. Next, $3.208M of implied operating lease interest and $6.453M of stock options expense is added back, arriving at adjusted EBIT of $133.4M. 24% statutory tax rate is applied (21% federal, 3% state) to arrive at NOPLAT of $101.474M. Next, D&A of $104.99M is added back. As no-growth CAPEX did not converge with D&A, it is assumed to be equal (Exhibit 17). Present-valuing no-growth FCF of $101.474M results in an EPV of $1.425B. We've arrived at an equity value of $573.097M after accounting for ECMS, debt, operating leases, and stock options, resulting in EPV-based equity price-per-share of $34.84 (16.4M undiluted shares). Second pass ROIC is 4.1%, which is about 57% of WACC at 7.12%. EPV per share of $34.84 is 34% of NAV per share, 23% lower than the ratio we would expect.

Catalyst: Larger competitors in have a cost advantage as a result of economies of scale. Since Clearwater operates at a smaller scale, it has a cost disadvantage, particularly when it comes to labor. From an operating margin perspective, 49% of Clearwater's employees are unionized, contributing to higher labor cost relative to the industry (16% vs 8.8%). This suggests that experienced management who are strong in cost management might be a potential catalyst as well. Strong institution holdings suggest management could potentially be shaken-up, and a team capable of decreasing costs installed.

Step 3: Recommendation

Based on NAV of $104.12 and EPV of $34.77, and a 40% probability that Clearwater will be able to improve asset management and cost control by replacing management, we arrive at an IV of $65.21/share. Applying 1/3 margin of safety, our buy price is $41.67 which is above our current share price of $37.00 (Exhibit 20). We recommend buying CLW.