VALUE INVESTING FINAL PROJECT SCHWEITZER MAUDUIT INTERNATIONAL

SECTION 3 TEAM 7

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Screening
Schweitzer-Mauduit International (SWM) is a small canalization stock as it has a market capitalization of US$1.2 Billion which meet the benchmark of US$1.2B. It also has a low analyst coverage as it is only covered by two analysts. Its adjusted P/E ratio of 15.77X is marginally higher than 13X benchmark, but its P/B of 2.19X is a lot higher than the benchmark of 1.2X. The stock is on the verge of meeting the qualitative and quantitative value criteria, and it could be potentially undervalued.

Business Risk
SWM operates in two different niche segments: Engineered Paper (EP) and Advanced Materials & Structures (AMS). 89% of the EP segment's sales comes from tobacco-related products such as cigarette paper and reconstituted tobacco products. The AMS segment of the business manufactures and sells a variety of highly engineered resin-based nets, films, and other non-woven. These specialty materials are often used in different markets such as Filtration, Construction, and Oil and Gas. During economic downturns, smokers don't really stop consuming cigarettes. In fact, they might increase smoking with the increased stress. Therefore, the EP industry won't be as heavily impacted. On the other hand, the AMS would be more effected by the economy. AMS industry supplies to various other industry that would be affect by the economy such as Construction and Oil & Gas, and the demand would change in economic downturns. However, since the products provided by both industries requires specialized equipment, expertise, and R&D investments to meet the different demand of the customers, there are barriers to entry, and the competitive is relatively low. Although SWM as a company has a lot of expertise, is a leader in the industries that they are operating in, and operates manufacturing plants around the world, their customer base is not as diverse with three big cigarette manufacturers accounting for 31% of its total sales, and raw materials such as resin and wood required for production are subject to fluctuating commodity prices. For the above reasons, we gave the company a medium business risk, and the optimal capital structure would be between 30-49%.

Financial Risk
Since the corporate strategy and structure have changed significantly after the 2013 transformation, we believe a five-year average for the capital structure of 50.01% is more representative. As a result, SWM is not within the optimal capital structure. Intuitively, SWM should have a credit rating of BBB-BB. Based on our ratio analysis, SWM should have a BBB rating which is consistent with the intuition. With medium business risk and high financial risk, the ERP should be 6%. After the analysis, SWM should have a cost of debt of 4.12%, a cost of equity of 10.12%, and a WACC of 6.63%. (Exhibit 1) We calculated the First Pass ROIC using the tax rate of 37.2% (pre-tax cut) and compare it with the WACC with the same tax rate. (Exhibit 2) The five-year average First Pass ROIC is 10.66% which is higher than the adjusted WACC of 6.34%, and we expect EPV to be higher than NAV.

NAV & EPV
SWM's NAV price per share (PPS) is $27.94, and its EPV PPS is $35.28. (Exhibit 3, 4) The EPV is higher than NAV, which is consistent with the First Pass ROIC and we expect the Second Pass ROIC to be higher than WACC as well. After computing the Second Pass ROIC, we got 7.07%, and it is higher than WACC that is adjusted for the new tax rate (Exhibit 5). Therefore, franchise value exists.

Strategic Analysis
Government License: There are no government licenses at play for the company.

Management: The management had realized the importance of diversifying the business and decreasing its reliance on the tobacco industry. However, the succession planning of the company is lacking. Most of the senior executives are hired from the outside and not promoted internally.

Barriers to Entry: SWM has a cost advantage due to its patents and manufacturing know-how. The company also has a demand advantage as its customers has a high searching cost due to the highly customizable product and required expertise and a high switching cost due to the limited number of companies in the niche markets and high cost of getting supplier from another region. Lastly, the company has economies of scale since it is a leader in the industries it plays in and it could source raw materials in bulk. Because the barriers to entry to the two industries are high and the company has been making continuous R&D investments, we believe that the sustainability of the franchise value is 80%.

Growth Analysis

The company has meet all of the three growth criteria. Frist, the eight years average revenue/share, EBIT/shares, and EPS are 4.55%, 3.67%, and 8.22% respectively. (Exhibit 6) Second, the Second Pass ROIC is 7.07% which is higher than the WACC of 6.63%. Third, as discussed above, its franchise sustainability is more than 80%. As a result, we proceed with the growth valuation. After conducting the breakeven analysis, we believe a growth rate of 2.5% and VGM of 1.16x is more reasonable. The Third Pass ROIC from the new EPV is 9.04% which is higher than WACC and consistent with the intuition. (Exhibit 7)

Intrinsic Value and Recommendation

Given 1.16x of VGM, SWM has an intrinsic value $58.12, entry price of $38.74. It is lower than the current price of $38.92 so the recommendation is to wait. (Exhibit 8)