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Search Process

Acadian Timber Corp. (AT) must be first screened to decide whether the firm appears undervalued (**Exhibit 1**). AT's P/E ratio, M/B ratio, and market cap are 10.53, 1.18, and $324 million respectively. Business operations are simple as AT supplies primary forest products. In addition, analyst coverage is low as five firms cover the stock. Since AT meets the screening criteria, valuation will be continued as AT has the potential to be undervalued.

Industry & Company Analysis – Business Risk, Financial Risk, WACC

AT is a timberland operator in New Brunswick and Maine, that supplies primary forest products to downstream wood, paper, and pulp manufacturing industries. As most timber is used in downstream residential construction markets, this increases AT's volatility to the business cycle. As economic conditions worsen, new housing starts will decline and ultimately will reduce consumer demand for timber. For suppliers of forest products, the recent strength of the residential construction market and seasonal conditions has offset the weaknesses in other industries, such as paper and pulp manufacturing. Another major business risk is the dependence on the prices of commodities. If prices decline significantly, it becomes uneconomical for paper and pulp mills to maintain operations, which will hurt demand for AT's products. There is also uncertainty in the future in regards to exports of softwood and hardwood to the US. With the ongoing NAFTA negotiations, the US is trying to impose countervailing duties and antidumping rates for most Canadian suppliers in the timber industry. This would negatively impact sales volume and profit margins for AT, as a major portion of their consumer base resides in the US. However, AT has reduced its exposure to industry risk by having long term contracts in place with two of its primary customers. Furthermore, AT has diversified its business by earning revenues through management services relating to 1.3 million acres of Crown licensed timberlands. Considering these qualitative factors and that AT's operating margin volatility remains at medium-high levels (**Exhibit 2**), business risk is classified at a medium-high level. This suggests that the optimal capital structure should be between 30-49%. Over the past five fiscal years, AT has maintained a target capital structure of 26.7% (**Exhibit 3-4**). This target capital structure is below the optimal range, indicating that AT has low financial risk and may be an acquisition target. This would imply an intuitive bond rating between AA-A, which converges with the AA-A bond rating calculated from AT's financial ratios (**Exhibit 5**). By assigning an A rating to AT, due to the high end of medium business risk, the firm's cost of debt is 3.78% and ERP is 4%. This results in a cost of equity of 7.78% and WACC of 6.42% as seen in **Exhibit 6**. In analyzing the first pass ROIC in **Exhibit 7**, AT has an ROIC of 5.04%, which is less than its WACC. This is a preliminary indication that AT is not generating value creation, and it is expected that EPV will be less than NAV.

NAV & EPV

Exhibit 8 calculates AT's value using the NAV method, indicating a $18.06/share value. **Exhibit 9** calculates AT's value using the EPV method, suggesting a $15.10/share value. To check for consistency, the second pass ROIC of 3.93% (**Exhibit 10**) is less than WACC, which indicates that the relationships does hold and that the firm is not generating value creation.

Strategic Analysis, Probability & Recommendation

Potential catalysts that AT can realize that are driving the difference between NAV and EPV are excess capacity and management. Although approximately 44% of their timber is non-operating and could be sold to realize value, AT still has excess operating merchantable timber inventory which is driving down ROIC, compared to competitors (**Exhibit 11**). They are selling on average between 15-20% of the operating merchantable timber inventory each year over the past 10 fiscal periods. This stems from management's strategy to harvest the merchantable inventory at the maximum sustainable yield. By harvesting at the maximum sustainable yield the timber will replenish and they can continue to harvest from the same timberlands indefinitely. As a result, this is the cause for a low sales/invested capital ratio compared to competitors. Typically, competitors harvest the maximum amount of timber to meet demand of their customers. Although this is unsustainable, once they have fully harvested the timberland they sell the land and move on to acquire another timberland. Ultimately, this gives competitor's full utilization of the asset. Since management is harvesting at the maximum sustainable yield (1.042 million cubic meters), they require this large asset (37.8 million cubic meters) which has strong margins to provide only for a small volume of EBIT. Furthermore, as management has a target payout ratio of 94%, they do not keep cash which could be used to purchase a new timberland asset once this one has been depleted. Overall, a probability of realizing the catalyst is low at 20% since management has no intention to utilize or sell the excess operating merchantable timber inventory. Although Brookfield has 45% ownership and could replace management to implement a new strategy this does not seem likely as Brookfield has stood by this sustainable strategy which is why revenues and operating margins have remained fairly constant for the past 10 years. By establishing the probability in **Exhibit 12**, the intrinsic value is $15.69/share and with a margin of safety of 1/3, the entry price is $10.46/share. As the market price of $19.40 is higher than the entry price, it is recommended to wait on AT.