High Liner Foods (HLF) – Group 3, Section 1

Search Process

To determine if High Liner Foods' (HLF) stock is potentially undervalued, price/book value first was analyzed. The value of 1.34 is above the 1.2 threshold. HLF's market capitalization of $359 million is below the $450M threshold for Canadian small cap stocks. Additionally, HLF's price-to-earnings (P/E) ratio of 11x is below the maximum threshold of 13x. HLF is far below the industry average P/E of 28.5x. Finally, HLF experienced turnover among its executive team and missed financial projections this year, which led to the stock trading at a 5-year low. Based on the initial screens, a complete valuation would be performed, as the initial screen does meet most of the criteria identifying a value stock.

Business Analysis

HLF operates within the seafood processing and packaging industry, which is currently highly fragmented and undergoing consolidation due to low organic growth prospects. Seafood processers and packagers are very sensitive to changes in raw seafood prices, and it is difficult for processors to pass on increased costs to price-sensitive consumers. HLF is a dominant supplier (8.9% US market share) of private label seafood products and sells through two main channels: retail (such as Walmart or Kroger) and foodservice (casual restaurants). HLF owns ten brands that have strong recognition among consumers. HLF's top two customers represent 29% of total sales and the top ten customers represent 66% of total sales, so customer concentration is a risk. Overall, HLF has a **medium** business risk. A detailed breakdown of the decision criteria can be found in Exhibit 1.

Given this analysis, HLF's optimal capital structure is between 30-49% debt-to-capital. HLF's target debt-to-capital structure is 62% based on a five-year average. HLF's implied bond rating is between BBB-B. The decision criteria support the given bond rating of BB, resulting in **high** financial risk. The subsequent cost of debt is 5.2%, and after applying a 5.9% equity risk premium, the cost of equity is 11.1%, leading to a WACC of 6.5% (Exhibit 2). Due to the acquisition of Rubicon Resources in 2017, HLF's ROIC declined. We believe the three-year average of 8.4% is more representative. With ROIC greater than WACC, EPV is expected to be greater than NAV.

Valuation

Under the NAV approach, the reproduction value of HLF's net assets was found to be $487 MM, or $14.61 per share (Exhibit 3). The NAV was driven heavily by inventories, goodwill, intangibles and long-term debt. The recent acquisition of Rubicon Resources resulted in an increase in all four of these inputs. The EPV valuation returned an implied share price of $8.60 (Exhibit 4). This went against our initial assumption that that EPV would be greater than NAV. When dividing WACC (6.5%) by second pass ROIC of 6.2%, NAV is expected to be 105% greater than EPV. The actual calculation of NAV/EPV is 170% (Exhibit 5).

Catalyst

Competitive Disadvantage: Yes, this is an issue. HLF is over-leveraged, implying that should the need for capital arise, HLF would struggle to find flexibility within its capital structure. Additionally, the company has identified that it does not wish to become vertically-integrated because it does not believe the returns and capital requirements would payoff. This puts HLF at a further competitive disadvantage because other competitors are currently following a vertical integration strategy. Vertical integration would increase HLF's negotiating power in the supply chain, diversify revenue streams, and increase the overall value proposition. The probability of the catalyst occurring is low, at 20%.

Management: Yes, this is an issue. On Jan. 31st, 2018 the President & COO of Canadian operations announced his resignation. Senior leadership turnover led to difficulty meeting growth and profitability goals. Setting and maintaining a debt-to-capital ratio above optimal and lagging margins relative to industry peers suggest management could be the issue. Since HLF is 35% family owned, dethroning management does not appear to be a probable move. The probability of the catalyst occurring is low, at 20%.

Excess Capacity: No, this is no longer an issue. HLF had significant excess capacity in 2017, resulting in the closure of the New Bedford plant. Fixed asset turnover increased from 8.5x in 2016 to 9.2x in 2017, indicating a positive trajectory. However, the full benefit has yet to be realized. The probability of realizing this benefit is 80%.

Overall, there is a 50% chance that all catalysts will occur and converge HLF's EPV with its NAV.

Recommendation

HLF's intrinsic value is $11.61 per share. After applying a 33% margin of safety, the maximum entry price was determined to be $7.74 per share. HLF earns a "**Wait**" recommendation at the current share price $10.78 (Exhibit 5).