

## Brampton Brick Limited - Team 4

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**Initial Screening:** Brampton Brick (BB) has a market cap of \$88.2M (CAD) which is within the desirable range of less than \$500M for small-cap Canadian stocks. The company has a P/E of 8.1x, well below our max limit of 13x, and the company is trading at a significant discount to book value as it has a P/B ratio of 0.56 although the company turns a positive net income and net cash flow. The company currently has very low analyst coverage. The stock has been declining in the last year and is currently trading at its 52-week low. For these reasons, we believe that BB's stock may be undervalued.

**Business Risk Analysis:** BB operates in the construction materials industry. BB has two main business lines: masonry products, which includes clay and concrete bricks, and landscape products. The masonry products industry is cyclical as it experiences volatility subject to new residential and commercial construction, which is in return subject to general economic conditions and interest rates. In addition, the industry is a high-fixed-cost industry with margins severely affected by sale volumes as unit costs decrease with higher volumes. For BB, since a large percentage of its customers are home builders/contractors, the firm has direct exposure to the business risk of the home builders' industry segment which is highly cyclical and associated with high business risk. Although BB's landscape segment is less affected by cyclical and has higher margins, over 70% of revenues come from Masonry products, and therefore we assign Brampton Brick a **high business risk**.

**Financial Risk Analysis:** The optimal capital structure for high business risk is 10-29% debt-to-value (D/V). After capitalizing operating leases (Exhibit 3), the company's current D/V is 19.1%. This capital structure has been consistent for the past ten years. We thus concluded that BB's target capital structure is the ten-year average of 21.5%. This is within the optimal range, so the company has medium financial risk. This suggests that the company's credit rating is in the BBB-BB range which converges with our credit rating analysis performed using Moody's "Building Materials" rating methodology and BB's financial ratios. Cost of debt is 3.8% (Average of Canadian corporate BBB and BB bond yield), and ERP is 7%, leading to a cost of equity of 10.8%. Using a tax rate of 26.5%, WACC is 9.11% (Exhibit 1).

**Valuation:** The 1<sup>st</sup>-pass ROIC is 6.23% for 2017 (average is 5.1% for last three years) using a NOPLATPA of \$12.7M and invested capital of \$203.2 (Exhibit 2). Since ROIC is lower than WACC, EPV is expected to be lower than NAV. The NAV was calculated to be \$34.4/share (Exhibit 4). In calculating NAV, accounts receivables were divided by 95%. Net PP&E was increased to \$343.3M by adding back depreciation and accounting for land and buildings appreciation, and equipment obsolescence (Exhibit 7). In addition, customer relations was given a value of \$12.4M (Exhibit 8) using a multiplier of 1x because although BB's products can be considered a commodity, their sales and current market-share leadership position, in Canada, depends on building relationships with residential and commercial clients through a sales force, as well as a distribution retail network for landscape products. Moreover, the clay and concrete industry segments in Canada are not highly concentrated with the top three players accounting for less than 40% of the market share. Product portfolio was given a value of zero as the company doesn't record any research and development expenses or capitalize any development costs, which means that R&D is not essential for generating sales. Market value of debt was calculated at \$34.8M which is very close to the book value because of debt tranches with floating rates and short term maturity, 2 years, of tranches with fixed rates (Exhibit 10). Stock options were valued at \$5.8M. BB has an excess land that was bought in 2006 for \$3.6M, however, comparison to similar properties in the same location revealed a current market value of \$33.8M which was recorded in NAV at \$29.8M after accounting for capital gains tax. EPV was calculated to be \$6.6/share, which is lower than NAV as expected. EPV was reached using an adjusted FCF of \$6.3M (Exhibit 5), after normalizing operating profits over the past five years, and including one-time adjustments resulting from goodwill impairments and asset write downs. 2<sup>nd</sup>-pass ROIC was 1.56%, explaining the big difference between EPV and NAV (Exhibit 6).

**Strategic Valuation Analysis:** At a 2<sup>nd</sup>-pass ROIC of 1.56%, management is not using the assets optimally to produce sufficient earning levels. The company's income statement shows several impairments, asset write downs and losses on asset sales in the last 10 years. In addition, management has been unable to properly forecast the US demand for its product resulting in a far below average asset turnover on US assets even after 10 years of Indiana plant construction competition. In addition to asset turnover, BB's EBIT margins are lagging behind the typical margins in the industry. In addition, the industry passes through periods of excess capacity when sale volumes drop due to economic conditions. This is due to the capital-intensive nature of the industry. Moreover, While the company is the market leader in Canada, it is at a competitive disadvantage in the U.S as it is considered a small undifferentiated player in a highly-fragmented market. We believe that there is a low probability for a management change as the Kerbel family's 3<sup>rd</sup> generation is currently involved in the company, and the family along with insiders control 86% of the voting rights. We also believe that the company will remain at a competitive disadvantage in the U.S as it doesn't have sufficient volumes to achieve economies of scale, doesn't have a cost advantage in labour or technology, and it is difficult to build demand preference because of the nature of the product. For these reasons, the probability of realizing the catalyst is 20%.

**Recommendation:** Given the 20% catalyst probability,  $IV = \$6.6 + (\$34.4 - 6.6\$) \times 0.2 = \$12.2$ . Our entry price, with a 1/3 price margin of safety is \$8.1. Alternatively, IV can be calculated excluding the excess real estate price per share (\$2.7) from EPV and NAV. In that case,  $IV = \$3.9 + (\$31.7 - \$3.9) \times 0.2 = \$9.5$ , and entry price with margin of safety is  $\frac{2}{3} * \$9.5 + \$2.7$  "Excess Real Estate" = \$9.0. Therefore, our recommendation is that Brampton Brick is a BUY as the current stock price is \$8.04.