3 Reasons Why Investors Should Avoid SNC-Lavalin Group Inc.

Description

In the value investing community, one of the more popular ideas out there is **SNC-Lavalin Group Inc.** (TSX:SNC). The company has been in the news lately because of a bribery scandal. According to RCMP charges, it paid more than $47 million in bribes to get contracts in Libya, while defrauding the government of the country out of nearly $130 million.

This isn't the first time the company has been involved with these sorts of allegations either, with question marks surrounding projects in Bangladesh, Mexico, and Montreal. The big issue coming from the charges is what happens if the company is convicted. While I think the chance of management negotiating some sort of settlement with government officials is very high, there's always the possibility the feds might want to use SNC-Lavalin to send a message to other companies in the sector.

But it isn't just the scandal that's affecting the company. Here are three reasons investors might want to avoid SNC-Lavalin in favour of other opportunities.

Cheaper competitors

Because SNC-Lavalin sold off some power assets in Alberta back in 2014, the company trades at an artificially low P/E ratio of just 4.5. Instead, let's take a look at analysts' expectations for 2016 earnings. The picture doesn't look so bad. Analysts expect the company to earn $2.58 in 2016, good enough for a forward P/E ratio of 15.5.

Remember, the company still has lots of projects in the pipeline, deals that were signed before the bribery allegations came to light. To really get an accurate picture, we have to look at what competitors are expected to do. Why buy SNC-Lavalin and its potential problems when you could buy a scandal-free competitor?

In 2016, **Aecon Group Inc.** (TSX:ARE) is expected to earn $0.99 per share. Based on the current share price of $12.63, that puts Aecon at a much lower forward P/E ratio, just 12.8. SNC-Lavalin'sother main competitor, **Canam Group Inc.** (TSX:CAM), is even cheaper. The company is projected toearn $1.35 in 2016, giving it a forward P/E ratio of 10.1. Both companies also feature robust backlogsand solid balance sheets.

The value of 407

SNC-Lavalin owns approximately 17% of Highway 407, a well-known toll road in the Greater Toronto Area. SNC-Lavalin has announced its stake of the road is for sale, and analysts are expecting the sale to fetch as much as $20 per SNC-Lavalin share, or $3 billion.

But I'm not sure Highway 407 is worth that much. Sure, I understand the value of owning a toll road, especially one where the owners have free rein to raise tolls annually. But analysts are expecting a very rich price tag for the asset.

Through the first six months of 2015, the entire highway earned $139 million. Since toll earnings are pretty steady, let's assume the highway will earn $280 million in 2015. SNC-Lavalin's 17% stake of earnings would then be worth $47.6 million. At a price tag of $3 billion for just SNC-Lavalin's portion of the highway, that means analysts are valuing it at 63 times earnings. That's a rich price tag for any asset.

There's an argument to be made for buying Highway 407. I'm not sure the argument holds much water at 63 times earnings.

Potential disaster with contracts

Although I think the chances of the company getting completely shut out of bidding on government contracts is remote, investors still have to consider the possibility of such an event happening. Most governments in Canada have a simple policy: if a company has been convicted of any bribery or corruption charges, governments will refuse to do business with it for at least a decade.

Right now, SNC-Lavalin has only been charged with a crime, not convicted. And like I mentioned earlier, I think the chance of the company settling with the RCMP without admitting guilt is high. But investors need to at least consider the possibility of the company getting shut out of future government contracts.

There's certainly an argument to be made for buying SNC-Lavalin. It's a good company going through what appears to be a rough patch. But perhaps there are better buys in the sector, companies with good prospects and reasonable valuations without the handicap of a huge scandal.

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