Domtar Corp. Shares Hit a 52-Week Low

Description

Domtar Corp. (TSX:UFS) is the definition of a boring business. It processes wood pulp to produce materials for publishing, personal hygiene products, and other technical purposes. Basically, it makes paper. Shares are down over 20% in the past 90 days, pushing its growing dividend yield up to around 5%. Is this a buying opportunity?

Fundamentals look weak

To many, this looks like a dying industry with projections for traditional paper consumption (around 50% of Domtar's sales) to decline at around 3-5% annually over the long term. This demand headwind has been slowly deteriorating the company's revenue base; it has fallen around 2% a year since 2010. Still, management believes they have a plan to move further into specialty and technical papers, which typically come with higher margins. This portion of sales (roughly the remaining 50%), is growing at a higher, but still paltry, rate of 2-4% annually.

While many are looking at shares based on its current 5% dividend yield, that payout looks fairly unsustainable if long-term macro conditions persist. For example, since 2011 Domtar has raised its annual dividend from $1.62 per share to its current $4.34 per share. Clearly, management is aiming to shift its share base to income-oriented investors.

Its free cash flow, however, has been falling nearly every year, from over $1 billion in 2010 to just $221 million in the last 12 months. With dividends costing the company around $100 million a year, it's doubtful that there's much room for any further growth.

Will things pick up?

Management is trumping its move into specialty papers, but in reality it can only hope to replace the losses it will likely experience in its core business. At best, its new markets will grow at GDP rates, around 2-4% a year. Half of its sales, however, are falling by 3-5% annually.

The only thing that new acquisitions and facilities will do is increase capital expenditures to keep sales flat. This is easily demonstrated by looking at historical results. In the past five years alone, capital expenditures have doubled to about $300 million a year. Meanwhile, revenues have dipped 8% and net income has fallen by almost two-thirds. Spending more money to make less money isn't a viable long-term plan.

Last month **Citigroup Inc.** warned that prices may continue to erode for paper manufacturers. While "producers could potentially increase prices in spring or summer," writes Citigroup analysts, "these upside risks are balanced by the possibility of further price erosion."

Long-term margins have gone nowhere but down. In 2011 Domtar's EBITDA margins were around 20%, and the industry averaged about the same. In 2015 company EBITDA margins fell to just 13% with the industry coming within a similar range.

No matter how Domtar management spins it, paper is a tough industry. Any benefits the company will experience over the next few years are likely to be offset by strong industry headwinds. If you're interested in sustainable high yields, Domtar is not the answer.

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1. TSX:UFS (Domtar Corporation)

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rvanzo