Stella-Jones Inc. Drops to 52-Week Low: Time to Buy?

Description

Stella-Jones Inc. (TSX:SJ) announced January 13 that its fourth-quarter revenue and operating income would be lower than previously estimated, sending investors rushing for the exits.

The manufacturer of pressure-treated wood products used by railways and utility companies had been on a big run until 2016 when it had its first negative total return in eight years — down 16.2%. The recent announcement hasn't helped; SJ stock is down 9.4% year-to-date, and we're barely halfway through the first month of 2017.

Now trading within 6.3% of its 52-week low of $37.17, investors are faced with a difficult question: Is SJ stock a value play or a value trap? I'll examine this vexing question.

Value play

Over the past 10 years, Stella-Jones has been one of the top-performing stocks on the TSX, delivering shareholders a mouth-watering annualized total return of 17.8% — 12.8 percentage points higher the composite index itself. While it wasn't able to keep pace with **Alimentation Couche Tard Inc.**, the highest of TSX flyers, it's very good nonetheless.

I know what you're thinking.

Now that Stella-Jones's business and income statement are showing some signs of deterioration, it's probably best to move on to stocks that aren't as susceptible to market downturns. After all, no one wants to catch a falling knife.

Before moving on, you might want to first determine if its profit warning is indeed a deterioration in its business or simply a timing issue that couldn't be prevented. BNN (not Stella-Jones) were the ones to call the announcement a "profit warning." The company was simply letting investors know that its revenue and operating earnings wouldn't beat those achieved in the same quarter a year earlier.

The cause: lower railway tie demand — something investors had been warned about in its Q3 2016 management discussion and analysis: "Following strong railway tie demand through the first half of

2016 and given the current reduction in freight volume, the company anticipates demand to be lower on a year-over-year basis for the remainder of 2016 and the early stages of 2017."

Stella-Jones announced its earnings, including the anticipated slowdown in railway tie demand prior to the markets opening November 8. Its stock closed the previous day's trading at $47.98, opened the next day at $45.95, and it's been down ever since.

At the end of the day, Stella-Jones is expected to finish fiscal 2016 with operating income of at least $232 million on $1.8 billion in revenue, increases year over year of 5.4% and 18%, respectively.

It's not the double-digit increases in operating income like in previous years, but unless its Q4 2016 report provides some additional information about the lag in revenue, its Q3 2016 outlook expressed no concern about this situation.

Brian Acker, chief investment officer of Toronto-based Acker Finley, appeared in late August on BNN's *Market Call* program, reminding investors that Stella-Jones frequently corrects, adding that his firm would be a big buyer at $36.

Well, it's not quite there, and certainly the changes in revenue and operating profits would likely change where he'd buy, but it's hard not to notice that it hasn't traded this low since March 2015.

Value trap

Based on Stella-Jones's projections for fiscal 2016, its operating margins will be around 12.6% — 150 basis points lower than in 2015, its best year since 2008. As such, you'd expect a lower valuation today than in previous years. Its current P/E ratio is 16.3, which is much lower than the 27.6 P/E it finished 2015 with.

The unknown factor here is how much further operating profits will decline. The first quarter and fourth quarter are historically the weakest quarters, so it's very likely that Q1 2017 will also experience declines in operating profits year over year.

However, as Brian Acker also said in his August BNN appearance, Stella-Jones will announce an acquisition or provide some good news, and it will pop back up to $50.

Bottom line

Stella-Jones is a well-run company. The future, regardless of this short-term volatility, is excellent, in my opinion.

If you were thinking of putting $5,000 into Stella-Jones, I'd use half of it now and wait for it to drop some more — say below $36 — and then I'd buy some more.

Long term, Stella-Jones should come through for shareholders.

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