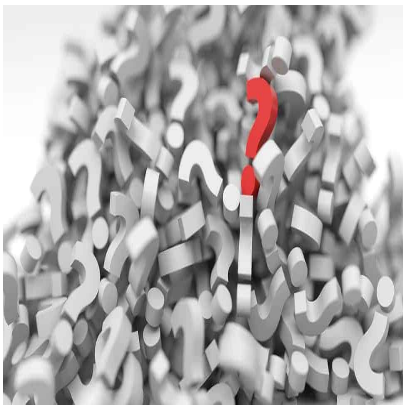

Domtar Corp.: Will This Profitable Contrarian Investment in 2017 Outperform Again Next Year?

Description

Pulp and paper giant **Domtar Corp.'s** (TSX:UFS)(NYSE:UFS) stock price return has outperformed that of the broader market in Canada this year after shares surged 26.23% in the last half of 2017 so far, outclassing the **S&P/TSX Composite Index's** 4.82% return for the same period by a wide margin.

The year-to-date price return on Domtar stock stands at 16.9% as of December 12, and coupled with a religious quarterly dividend payout of US$0.415 per share, yielding about 3.5% currently, the total holding period return on the stock almost quadruples that of the TSX for investors who picked the stock in January 2017.

Those investors who picked up shares around August 29, when I initially predicted a positive improvement in business outlook for the third quarter, have recorded ~23% in stock price gains, while locking in a 4% dividend yield at the time; the yield has since shrunk to 3.5%.

Why has the stock outperformed?

Domtar has been faced with an ongoing severe demand decline that is negatively affecting the global paper industry due to digital migration for over a decade now. However, the stock has shown some resilience after recording an earnings-growth rate of negative 7%, which was way better than the peer average decline of 13% in 2016.

The biggest positive this year has been the seemingly bottoming out of revenues by mid-year, where revenues came in as low as US$1,224 billion for the second quarter — a 3.4% decline from the prior year's sales levels.

Domtar recorded an almost 6% quarter-on-quarter increase in revenues to US$1.292 billion during the third quarter this year, and analysts polled by **Reuters** currently predict a further 2.7% increase in Domtar's net sales for this quarter and the first quarter of 2018 combined.

Most encouraging was the 31% jump in operating earnings and a significant 58% increase in net income over the first nine months of 2017 as compared to the same period in 2016, as well as a 9%

reduction in total debt over the period, improving total debt ratio from 22.55% to 20.14% by September this year.

The reduced leverage is well in line with the growing risk of the paper segment.

Management has been very proactive over the recent years through acquisitions of personal hygiene targets to create a new absorbent hygiene product segment with fundamental drivers for long-term growth due to the anticipated increase in healthcare spending as a result of an ageing population in Domtar's target market.

Most noteworthy, Domtar also decided to convert its Ashdown paper mill into a high-quality fluff pulp line last year, and the dividend is already paying off as its pulp shipments are increasing, just when world market pulp prices are rising in a sustainable manner, too.

There has been a return of positive sentiment to Domtar's future performance, and the stock has rebounded significantly.

In fact, institutional holdings in Domtar stock increased over the last quarter to 92.17% as 42 new institutional investors bought into the stock, and there was a net increase in smart money positions in the pulp and paper giant's equity.

Outlook

Domtar, which exports nearly half of its pulp production, was anticipating a further increase in market pulp shipment volumes for the last quarter of 2017 when it presented third-quarter results, and the higher world market pulp prices are very encouraging for revenue and profitability growth.

Furthermore, the company was anticipating benefiting from higher volume, lower raw material costs and seasonally lower marketing expenses for the personal care segment this quarter.

Investor takeaway

Even if the threat of a further decline in paper prices and lower sales volumes is still visible, the company's recent switch to increased market pulp production and the creation of a new personal hygiene products segment led to bottoming-out revenues and created a new hope for business growth in the near future.

Actually, one analyst among those polled by Reuters estimates a 5% long-term growth rate for Domtar.

The worst may be over, and Domtar could be a good income investment with some growth potential capable of outperforming the TSX again in 2018.

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