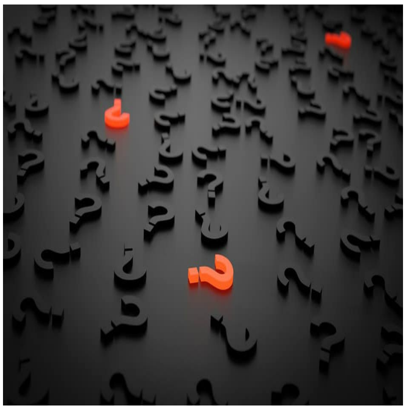

What’s Happening at ZCL Composites Inc.?

Description

What’s going on at **ZCL Composites Inc.** (TSX:ZCL)? The stock has been in a downward trend for more than a year, falling +30% since the peak in April last year.

Back then, I wrote that “In the last year alone, the company’s shares have appreciated 82%. At $14.70 per share, they now trade at a multiple of 21… it’ll be better to put the company on watch for now. If its shares pull back to a multiple of 18 or roughly $12 per share, it will be a more reasonable buy.”

Well, the stock has now fallen past the $12-per-share mark, and it’s now trading at $10 per share. Is ZCL a buy now or a falling knife that investors should avoid?

First, let’s take a look to see if it’s the kind of business you would like to own.

The business

ZCL manufactures and distributes fiberglass reinforced storage tanks. Its core business provides underground storage tanks that store gasoline and diesel fuel for North American retail outlets.

ZCL’s corrosion-resistant tanks are environmentally friendly and are ideal for storing fuel, water, wastewater, and oil and gas. Fuel is its biggest market. The company has seven manufacturing plants: two in Canada, four in the U.S., and one in The Netherlands.

Recent performance

ZCL generated $188 million of sales and net income of nearly $18 million in 2017. The company reported that its Q1 revenue was comparable with that of Q1 2017.

Its profitability was down due to higher input costs (higher resin prices), unfavourable foreign exchange rate, and investments in the business that are expected to benefit the company in the future.

Investing for the future

ZCL has been investing in areas such as sales and marketing, human capital management, information technology, employee safety, plant physical condition and operational improvements to prepare for the next phase of growth. So, its costs will be higher. We will have to see whether these investments will pay off.

That said, the company has a solid history of allocating capital in the right places. Since 2012, it has achieved returns on equity (ROE) and returns on asset (ROA) of +9% and +7%, respectively. Its recent ROE and ROA are 15.8% and 12.3%, respectively.

Dividend

Since 2013, ZCL's dividend has increased nearly 400%! Its regular dividend equates to a 5.3% yield at the recent quotation. However, its payout ratio has also expanded to ~90% this year.

So, it's interesting that ZCL has been paying a very generous special dividend every year since 2016. It seems like the company didn't have a better place to put that money. I suppose returning cash to shareholders is better than spending the money in the wrong places.

Notably

ZCL's CEO, Ronald Bachmeier, is going to retire soon, and we don't know who will step into his shoes. Moreover, the company's payout ratio is too high for conservative investors' comfort. Also, in Q1, ZCL's backlog declined 12% to $44.9 million year-over-year, which indicates that 2018 started off weaker than 2017 for ZCL.

Investor takeaway

Although **Thomson Reuter Corp.**'s consensus 12-month target is $12.50 per share, representing near-term upside potential of 23%, investors should hold off investing in ZCL for now because of the points in the previous paragraph.

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