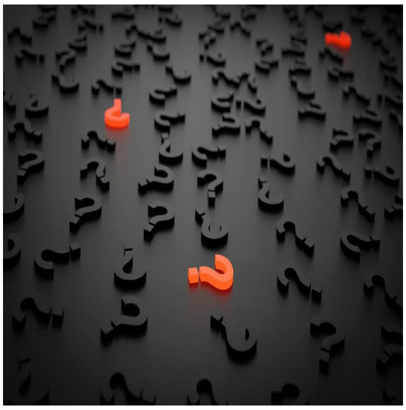

Is the +15% Drop a Value Opportunity?

Description

In April 2017, I'd warned investors that **ZCL Composites** (TSX:ZCL) stock was too expensive — that "[t]he market has bid up ZCL's price already. 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."

To be fair, ZCL's earnings per share experienced a growth of 23% in 2016, and the stock's price-to-earnings multiple expanded accordingly. But when companies grow, and their stocks climb high in a short time, you have to question if the growth will be sustainable. It was not for ZCL.

In fact, the stock fell +15% after reporting its Q2 results, which were pretty horrible.

ZCL's recent results

Here are some key metrics of Q2 compared to the same period in 2017:

	Q2 2017	Q2 2018	Change
Revenue	$53.3 million	$46.8 million	-12.2%
Gross profit	$11.9 million	$8.4 million	-29.4%
Net income	$6 million	$3.9 million	-35%
Diluted earnings per share	$0.19	$0.13	-31.6%
Adjusted EBITDA	$9.5 million	$6.2 million	-34.7%
Backlog	$51.5 million	$52.3 million	+1.6%
Quarterly dividend per share	$0.12	$0.135	+12.5%

Quarterly results can be bumpy. How are the numbers for the first half of the year? They still look horrible. A part of the reason was that the company experienced an exceptionally strong year in 2017.

Here are some key metrics of the first half of 2018 compared to the first half of 2017:

	First half of 2017	First half of 2018	Change

Revenue	$85 million	$78.7 million	-7.4%
Gross profit	$18 million	$13 million	-27.8%
Net income	$7 million	$4.4 million	-37.1%
Diluted earnings per share	$0.22	$0.14	-36.4%
Adjusted EBITDA	$12.6 million	$7.7 million	-38.9%

Management also pointed out that for the quarter, “increased resin input costs, competitive pricing pressures and expenditures on manufacturing and plant safety improvements, in combination with a tightening labour market, contributed to reduced profitability in the quarter compared to the prior year.”

Although ZCL’s backlog in Q2 remained steady compared to Q2 2017, its adjusted EBITDA margin fell from 17.8% to 13.2%. Not to mention that revenue declined as well.

ZCL’s dividend

ZCL’s Q2 dividend per share is 12.5% higher than it was in Q2 2017, but the company could be raising it at a much lower rate or even merely sustain the dividend in the near term because its payout ratio has been expanding. Based on its estimated adjusted earnings per share for this year, its payout ratio will be about 90%. In the worst-case scenario, there could be a dividend cut down the road.

Strong balance sheet

On a positive note, ZCL’s balance sheet remains strong with little debt. At the end of Q2, it had working capital of $37 million and debt of $1.1 million. The company expects to return to a net cash position in the second half of 2018.

Investor takeaway

ZCL’s payout ratio is hitting an all-time high. So, investors should question its dividend safety and certainly shouldn’t expect a dividend increase from the company anytime soon.

For the year, ZCL expects revenue to be comparable to 2017 but profitability to be lower. Perhaps the new CEO coming in next month will help turn the company around.

Conservative investors are better off avoiding this stock. Investors betting for a turnaround down the road could start nibbling here but really it would be much safer to buy the stock when it actually starts turning around.

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