



Stantec Inc.

Thoughts on where multiples should go

Path of least resistance to the upside

HIGHLIGHTS

- **Multiple expansion takes hold for pure consulting peers.**
We have seen P/E multiples expansion on the part of the broader market ("blame" QE) while organic growth acceleration and percolations of fiscally-friendly topics are telling investors that "lower rates for longer" is beneficial to our coverage universe. Challenged performance of integrated E&C and construction-focused entities have also honed investors' attention on pure consulting business models; hence why TTEK is now trading at 25.2x P/E on next year's earnings (with Sweco at an even more egregious 27.8x).
- **We therefore believe Stantec multiples should expand over time.** 1) In times when STN organic momentum kept pace with that of WSP (Q3/19), its trading multiple would generally converge as was the case between 2012 and 2014; 2) Negative estimate revisions appear to be behind us; 3) The company sports a more balanced model; only infrastructure now represents a greater than 25% proportion of total revenue, but this is one of the verticals we remain bullish on.
- **Valuation & recommendation – pushing the target higher.**
Stantec was buying back shares in the open market at \$36.75 in December 2019. We believe investors are also embracing the company's strategy around capital allocation which can be summarized as bite-size deals helped with NCIB (see our in-depth notes on the subject [Here](#) and [Here](#)). Shares are undervalued vs. direct peers (16.5x P/E on 2020E vs. 20.0x+); the new management team appears to present a steady hand. Thematically, the company also screens well on ESG parameters. All-in, we are comfortable pumping up the EV/EBITDA multiple that we apply to 2021E forecasts to 11.0x (from previous 10.0x; our theoretical work – Figure 3 – supports the methodology). Our target price goes to \$45.00 (from previous \$40.00).

Stock Performance



Source: Refinitiv

STN (T,N)	\$39.05; US\$29.67
Stock Rating:	Outperform (Unchanged)
Target:	\$45.00 (From \$40.00)
Risk Rating:	Above Average (Unchanged)
Est. Total Return	16.7%

Stock Data:					
52-week High-Low (Canada)		\$26.67 - \$39.75			
52-week High-Low (U.S.)		NA			
Bloomberg/Reuters: Canada		STN CN / STN - T			
Bloomberg/Reuters: U.S.		STN US / STN			
(Year-End Dec 31)	Estimates	2018A	2019E	2020E	
Revenue (mln)		\$3,355	\$3,734	\$3,973	
EBITDA		\$370	\$568	\$623	
EBITDA (mln) ex. IFRS 16		\$370	\$427	\$479	
EPS (FD)		\$1.50	\$1.73	\$2.01	
CFPS		\$1.80	\$2.25	\$3.69	
Valuation					
EV/EBITDA		14.4x	12.5x	11.1x	
P/E		23.4x	20.0x	16.5x	
P/CFPS		21.7x	17.3x	10.6x	
Quarters					
		Q1	Q2	Q3	Q4
Revenue (mln)	2018A	\$877	\$908	\$902	\$836
	2019E	\$904	\$954	\$953	\$923
EBITDA (mln) with IFRS	2018A	\$95.9	\$89.6	\$98.8	\$61.2
	2019E	\$127.0	\$145.4	\$159.1	\$136.4
EPS (FD)	2018A	\$0.42	\$0.41	\$0.44	\$0.40
	2019E	\$0.41	\$0.50	\$0.59	\$0.45
Financial Data (as at Jun 30, 2018):					
Shares outstanding - Basic / FD (mln) - pro-forma		113.8 / 114.1			
Market Capitalization (mln)		\$4,361.0			
Enterprise Value (mln)		5,313.7			
Cash (mln)		\$106.7			
Debt (mln)		\$1,059.4			
Net Cash (Debt)		(\$952.7)			
BVPS / Price/Book		\$16.4 / 1.9x			
2019E ROE		11.4%			
Dividend yield		1.5%			

Industry Rating: Market Weight
(NBF Economics & Strategy Group)

Company Profile:

STN is one of the largest engineering and architecture firms in the world (top 12 in design according to ENR; 57% of topline comes from the US). M&A is an integral part of the business model

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Looking across the other side of (multiple) valley

Recently, an unfamiliar question is being posed on Stantec...when / what should driver further multiple expansion? As a reference point, Stantec shares are now trading at 11.1x 2020E EV/EBITDA and 10.4x on 2021 forecasts (note that we adjust for the IFRS 16 impact in both the numerator and the denominator); on P/E basis, they are fetching 16.5x and 15.1x, respectively (as a reference point TSX is trading at 15.5x and 14.3x). Note that TSX-listed companies are expected to generate a 12.4% ROE next year compared to Stantec's 13.3%.

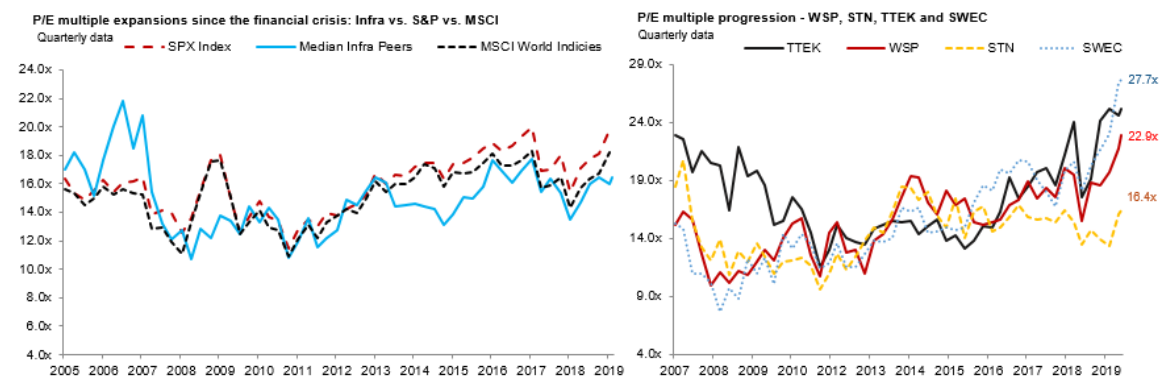
Explosion in trading multiples for leading engineering firms leaves Stantec in the dust

We have seen P/E multiples expansion on the part of the broader market ("blame" QE) while organic growth acceleration and percolations of such topics as:

- The Green New Deal (both in the US and now potentially in Europe),
- projected increase in infra spending in the UK (on the back of Conservatives wins) and
- Germany (to reignite the moribund economy due to manufacturing slump)

are all telling investors that "lower rates for longer" will have to be offset by fiscal policy during the next downturn (whenever that might come). Challenged performance of integrated E&C and construction-focused entities have also honed investors' attention on pure consulting business models. Hence why Tetra Tech (TTEK:Nasdaq, not rated) is now trading at 25.2x P/E on next year's earnings (with Sweco – SWECB:SS, not rated - at an even more egregious 27.8x).

Figure 1: Market and consulting industry peers' multiples have expanded



Source: NBF, company reports, Bloomberg

Theoretical underpinning of EV/EBITDA multiples; closer to 11.0x EV/EBITDA makes more sense; each multiple point moves NAV by 12%

While relative valuation provides an important yardstick, the company's own "theoretical" multiple decomposition can be enlightening, especially around which parts of the value-creation equation provide the most sensitivity to the output. Recall that we can decompose EV / EBITDA into STN's normalized assumptions around ROE, taxes, depreciation and working capital. The exact formula is the following:

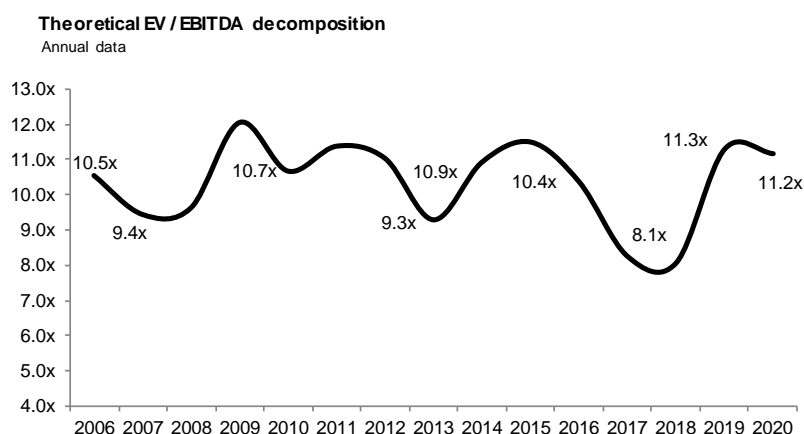
Figure 2: EV/EBITDA decomposition parameters

$$\frac{V_0}{EBITDA} = \frac{(1-t)}{WACC-g} + \frac{(Depr * t)/EBITDA}{WACC-g} - \frac{\frac{Capex}{EBITDA}}{WACC-g} - \frac{\Delta WC/EBITDA}{WACC-g}$$

Source: Aswath Damodaran

Using a WACC of 10.0% (a reasonable hurdle for investments / projects in the engineering space), ROE of 13.0% (historically the company has averaged an ROE of 12.6% since 2014) while making some adjustments to especially CAPEX (recall the head office spike) and working capital (2018 and 2019 were aberrations vs. historical trends), we get to a normalized multiple of 10.7x for the business (as a median since 2006); see Figure 3. As with any analysis of this type, the results are very sensitive to our assumptions but the numbers do suggest that there is enough scope now to sustain a greater than 10.0x EV/EBITDA multiple that we have historically applied to value this business. We want to stress the importance of working capital management; if we were to mechanically plug in the actual non-cash swing in working capital for 2018 in the above-provided formula, the multiple would swing to a non-sensical 4.2x.

Figure 3: ROE assumptions point to close to 11.0x EV/EBITDA multiple



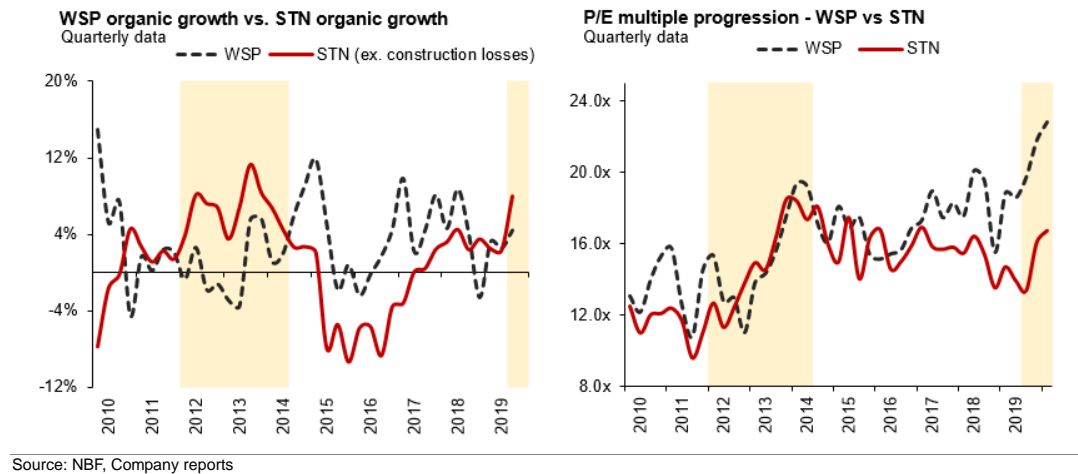
Source: NBF, Company reports, Refinitiv

Impetus parameters to sustaining (and potentially expanding) the company's trading multiples

We assess several factors that should help expand STN's trading multiple.

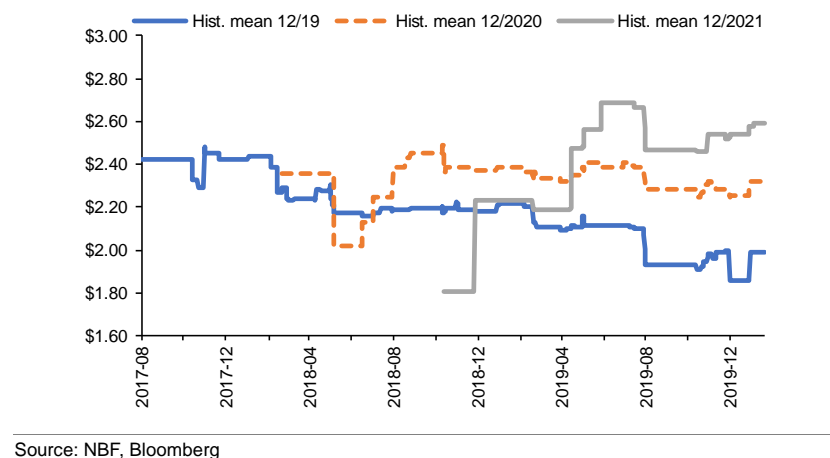
First, organic growth is one of the key drivers that "explains" share price performance. In Figure 4 (LHS), we overlay Stantec's organic momentum vs. that of WSP. The former for the first time since late 2014 bested WSP in Q3/19. It is instructive to note that in times of Stantec's stronger organic performance, that its trading multiple would generally keep up with WSP as was the case between 2012 and 2014 (Figure 4, RHS, the time of course when Stantec geared up its exposure to then fast-growing oil & gas vertical). While we are not making an argument that on a P/E basis (these numbers are based on rolling forward consensus EPS) STN will converge with WSP tomorrow, there is scope for playing catch-up.

Figure 4: WSP – organic growth vs. peers



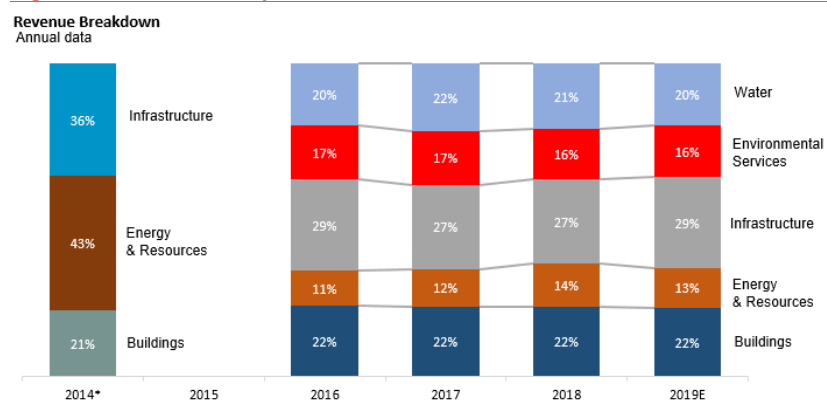
Second, estimate revisions are likely to stay neutral to positive, compared to multiple de-ratings we have experienced prior to Q3/19. Simply put, 2019 EPS started with \$2.40 level and now consensus is at \$2.00 (at 15.0x P/E that translates into a negative \$6.00 share price swing). 2020 forecasts now appear to be relatively stable and the Street is warming up to 2021 given the trajectory we show in Figure 5. We do not disagree with such an inflection.

Figure 5: Estimates for 2020 and 20201 have stopped falling (2019 was challenged vs. the original \$2.40 forecast)



Third, the company sports a more balanced model; only infrastructure now represents a greater than 25% proportion of total revenue (Figure 6), but this is one of the verticals we remain bullish on given the projected spending patterns on the part of US, Canadian, UK and Australian governments when it comes to horizontal structures (i.e. roads, rail, bridges, etc.). This is of course in contrast to 2014 when Energy & Resources (largely exposed to oil & gas gyrations) really hurt the company on subsequent basis when WTI collapsed.

Figure 6: More balanced platform vs. 2014



Source: NBF, company reports

Bottom line – path of least resistance is to the upside

Stantec was buying back shares in the open market at \$36.75 in December 2019. We believe investors are also embracing the company's strategy around capital allocation which can be summarized as bite-size deals helped with NCIB (see our in-depth notes on the subject [Here](#) and [Here](#)). Shares are undervalued vs. direct peers and even though over time we have seen mis-steps when it comes to over-committing capital to a given vertical (Urban Land, Oil & Gas) or strategically veering off the course by having exposure to construction, the new management team appears to present a steady hand. Last but not least, the ESG push that we have seen gathering momentum recently will only play into Stantec's hand over time given the company's consulting nature of business with significant and high-quality presence in Environmental Services and Water. All-in-all, we are comfortable pumping up the EV/EBITDA multiple that we apply to 2021E forecasts to 11.0x (from previous 10.0x). Our target price goes to \$45.00 (from previous \$40.00).

Figure 7: Stantec - NAV

EV/EBITDA multiple						Target
(\$000's, except per-share data)						2021E *
	2017A	2018A	2019E *	2020E *	2021E *	
Adjusted EBITDA	11.0x	\$377,932	\$345,500	\$426,708	\$479,144	\$512,452
Minus: net debt at period-end						\$618,719
Equity value						\$5,018,258
Shares outstanding						111,548
Net asset value						\$44.99
Current share price						\$38.89
Potential appreciation - all inclusive						17.2%

* 2019E / 2020E / 2021E EBITDA estimates are based on legacy definition (ex. IFRS 16 impact)

Source: NBF, Company reports, Refinitiv

Figure 8: Engineering comps

	Ticker	Rating	Local	Target	Dividend		Total	% Off 52-	Market	EPS		P/E		EBITDA (\$mm)		EV/EBITDA	
			Price	Price	Annual	Yield	Return	wk High	Cap (mm)	2019E	2020E	2019E	2020E	2019E	2020E	2019E	2020E
Canadian comps																	
SNC-Lavalin Group Inc.	SNC.TO	OP	\$30.53	\$42.00	\$0.02	0.1%	38%	-23%	5,360	-\$1.02	\$2.13	n.m	10.1x	381.1	714.7	24.0x	6.2x
Aecon Group Inc.	ARE.TO	OP	\$17.70	\$24.00	\$0.58	3.3%	39%	-20%	1,075	\$1.14	\$1.23	15.9x	15.5x	219.7	226.5	4.8x	4.6x
Stuart Olson Inc	SOX.TO	UP	\$1.91	\$1.25	\$0.00	0.0%	-35%	-63%	53	-\$0.16	-\$0.14	n.m	n.m	24.9	26.2	6.6x	6.3x
Stantec Inc	STN.TO	OP	\$39.05	\$45.00	\$0.58	1.5%	17%	-3%	4,361	\$1.95	\$2.37	20.0x	16.5x	426.7	479.1	12.5x	11.1x
IBI Group Inc	IBG.TO	OP	\$5.49	\$8.00	\$0.00	0.0%	46%	-9%	207	\$0.49	\$0.58	10.0x	9.4x	43.4	43.9	7.1x	7.0x
WSP Global Inc.	WSP.TO	OP	\$95.00	\$98.00	\$1.50	1.6%	5%	-1%	9,976	\$3.73	\$4.23	25.4x	22.5x	783.1	906.7	14.9x	12.8x
Bird Construction Inc	BDT.TO	OP	\$7.09	\$10.00	\$0.39	5.5%	47%	-18%	301	\$0.18	\$0.52	39.3x	13.7x	29.9	50.1	9.8x	5.8x
North American Construction Group Ltd	NOA.TO	OP	\$15.45	\$24.50	\$0.16	1.0%	60%	-20%	515	\$1.83	\$2.06	8.4x	7.5x	174.5	201.1	4.8x	4.2x
Median						1.3%	38%	-19%				18.0x	13.7x			8.4x	6.2x
U.S. comps																	
Fluor Corp	FLR	NR	\$19.02	NA	\$0.66	3.5%	NA	-55%	2,666	-\$9.44	\$1.60	nm	11.9x	-475.2	544.2	-5.4x	4.7x
AECOM	ACM	NR	\$49.22	NA	\$0.00	0.0%	NA	-3%	7,787	\$2.76	\$3.31	17.8x	14.9x	942.4	1060.4	10.9x	9.6x
Jacobs Engineering Group Inc	J	NR	\$94.84	NA	\$0.54	0.6%	NA	-3%	12,600	\$4.89	\$5.55	19.4x	17.1x	980.8	1113.0	13.7x	12.1x
KBR Inc	KBR	NR	\$28.03	NA	\$0.25	0.9%	NA	-10%	3,972	\$1.69	\$1.97	16.6x	14.2x	465.4	526.4	9.5x	8.4x
Tutor Perini Corp	TPC	NR	\$11.24	NA	\$0.00	0.0%	NA	-45%	565	\$1.44	\$2.42	7.8x	4.7x	239.0	316.1	4.9x	3.7x
Tetra Tech Inc	TTEK.O	NR	\$89.56	NA	\$0.44	0.5%	NA	-1%	4,900	\$3.13	\$3.43	28.7x	26.1x	267.1	295.0	18.8x	17.0x
Median						0.5%		-7%				17.8x	14.5x			10.2x	9.0x
International comps																	
WorleyLtd	WOR.AX	NR	\$15.50	NA	\$0.28	1.8%	NA	-6%	8,066	\$0.60	\$0.94	26.0x	16.6x	508.2	926.0	19.3x	10.6x
CIMIC Group Ltd	CMAX	NR	\$28.21	NA	\$1.56	5.5%	NA	-45%	9,132	\$2.46	\$2.48	11.4x	11.4x	2087.5	2140.1	4.4x	4.3x
Tecnicas Reunidas SA	TREMC	NR	\$22.24	NA	\$0.00	0.0%	NA	-18%	1,243	\$0.82	\$1.98	27.1x	11.2x	114.3	203.1	9.1x	5.1x
Acciona SA	ANA.MC	NR	\$101.40	NA	\$3.52	3.5%	NA	-5%	5,562	\$5.09	\$5.10	19.9x	19.9x	1259.4	1273.0	8.9x	8.8x
Saipem SpA	SPIMI	NR	\$4.00	NA	\$0.00	0.0%	NA	-21%	4,044	\$0.12	\$0.24	32.5x	17.0x	1,166.4	1,172.2	4.9x	4.9x
Sweco AB (publ)	SWEQ.ST	NR	\$370.60	NA	\$5.50	1.5%	NA	-5%	44,874	\$11.53	\$13.31	32.1x	27.8x	2816.5	3113.3	17.9x	16.2x
Balfour Beatty PLC	BALF.L	NR	\$2.58	NA	\$0.05	1.9%	NA	-13%	1,782	\$0.23	\$0.25	11.0x	10.3x	250.3	261.5	7.7x	7.4x
Arcadis NV	ARDS.AS	NR	\$20.36	NA	\$0.40	2.0%	NA	-5%	1,841	\$1.27	\$1.54	16.0x	13.2x	269.5	289.8	9.3x	8.6x
Median						1.8%		-9%				23.0x	14.9x			9.0x	8.0x

Source: NBF, Bloomberg, Refinitiv (note that SNC and Aecon estimates are compiled ex-concessions and Bermuda, respectively)

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