Lin Capital Management Inc.

Equity Research

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Industrials (Homebuilding & Construction Supplies)

ADENTRA Inc.

(ADEN-T) C$29.15

Q1/F23 Results: Challenging Quarter, Resilient Demand

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Event

Q1/F23 results was released on May 11, 2023. It completed its rebranding of the company from Hardwoods Distribution Inc. (HDI) to ADENTRA Inc. (ADENTRA) in 2022.

Impact: MODERATE

Generated sales of $579.9 million (C$783.6 million)**,** a 10.1% decrease from Q1 2022. The change in sales includes a $88.7 million decrease in organic sales primarily driven by lower volumes, partially offset by a $26.4 million of contribution from acquisitions (Mid-Am & Rojo). An unfavorable FX impact related to the translation of CAD to USD for reporting purposes accounted for the remaining.

Gross profit was $117.0 million, as compared to $147.8 million in the same period last year. The $30.8 million, or 20.8%, year-over-year decrease reflects lower organic sales and a gross profit percentage of 20.2%, as compared to 22.9% in Q1 2022.

Operating expenses as a percentage of sales were 15.9%, and grew by just $3.4 million organically, or 4.0% despite higher inflationary conditions prevalent in the economy (13.1% in the same period last year).

Adjusted basic EPS were $0.48 (C$0.65)**,** and **Adjusted EBITDA** was $42.9 million (C$58.0 million).

Cash flow from operating activities was $69.8 million (C$94.3 million), and supported by a decrease in inventory in the first quarter of $49.1 million. This was to finance the purchase of Rojo Distributors, and repurchase almost 2% of the issued and outstanding shares, pay out a **quarterly dividend of C$0.13 per share**, and **pay down net bank debt by $42.9 million in the quarter**.

Management anticipates that previous inflation and interest rate hikes are expected to have a continued **near-term** negative impact on economic activity. As a result, they expect the 2023 financial performance will not be as strong as the record-setting levels achieved last year. **Over the longer term**, management continues to see a return to robust demand levels, supported by strong fundamentals in the end markets. They continue to see a multi-year runway for growth in the repair and remodel, residential, and commercial markets.

Investment Recommendation

We issue a **BUY** recommendation based on a target price of C$35.24.

Recommendation:	**BUY**
Risk:	**MEDIUM**
12-Month Target Price:	**C$35.24**
12-Month Dividend (Est.):	**C$0.52**
12-Month Total Return:	**20.9%**

Market Data (C$)	
Current Price	29.15
52-week range	22.66 - 35.88
Market Cap(f.d)(mm)	651.33
Current Dividend ($)	0.13
Dividend Yield	1.81%
Avg. Daily Trading Vol.	41,369

Financial Data ($)	
Fiscal Y-E	December
Shares O/S (f.d)(mm)	23.31
Diluted Shares O/S (f.d)(mm)	23.50
Net Debt ($mm)	$407.4
P/E (TTM)	5.3x
EV/EBITDA	4.8x

Estimates ($)

Year	2021A	2022A	2023E	2024E
Sales ($mm)	1,616.2	2579.6	2321.6	3482.4
EBITDA ($mm)	148.3	196.6	116.1	174.1
EBIT ($mm)	111.8	131.2		
Net Income ($mm)	142.0	128.7		
EPS ($)	4.81	5.50		
Return on Assets (%)	12.3	9.0		

EPS (f.d.) Quarterly Estimates ($)

Year	2021A	2022A	2023E	2024E
Q1	0.08	0.10	-	-
Q2	0.08	0.09	-	-
Q3	0.08	0.12	-	-
Q4	0.09	0.13	-	-

Valuations

Year	2021A	2022A	2023E	2024E
EV/Sales	0.75x	0.72x	0.53x	-
EV/EBITDA	8.8x	6.2x	4.7x	-
P/E (f.d.)	11.0x	5.4x	7.4x	-

All figures in US $, unless otherwise specified

Company Profile

Founded in 1967, ADENTRA Inc. is a Canada-based distributor of architectural products.
The company is engaged in the business of distributing its products to fabricators, home centers, and professional dealers servicing the new residential, repair and remodel, and commercial construction end markets.

Please see the following pages for more information.

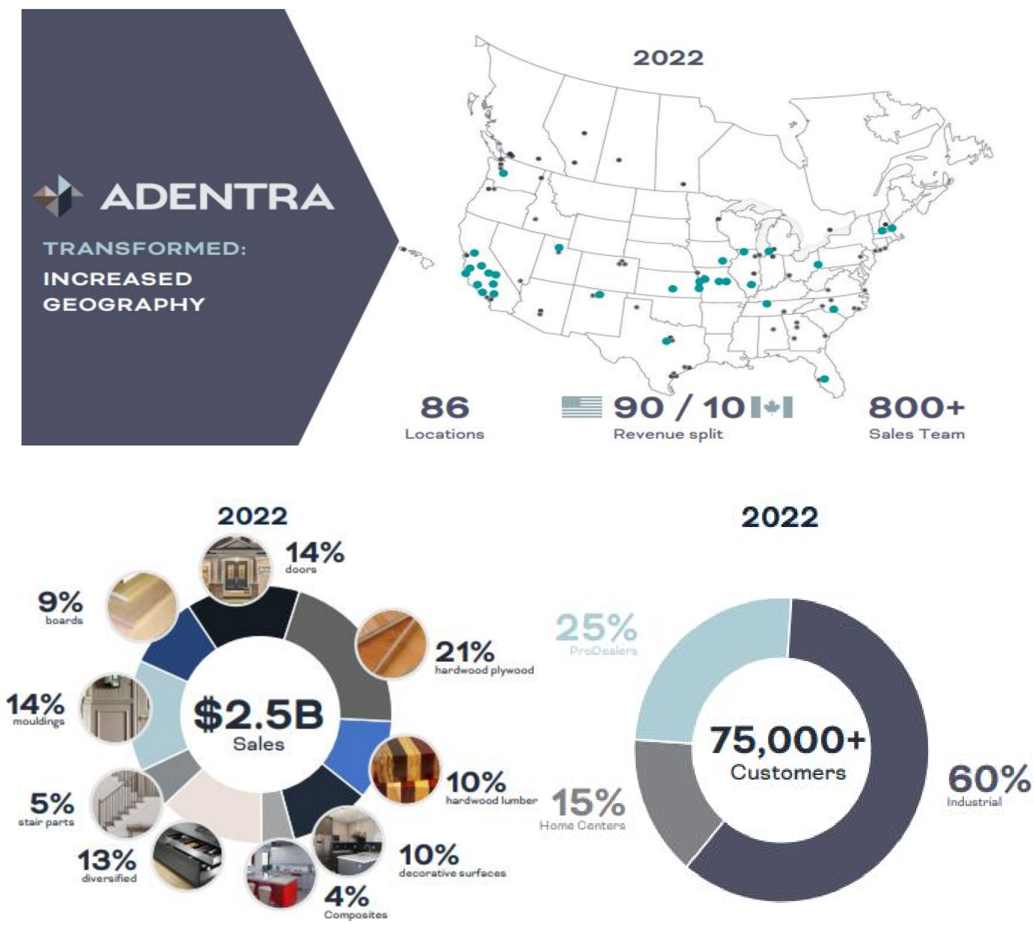
Details

Company Overview

ADENTRA Inc. Is one of North America's largest suppliers of specialty building products to fabricators, home centers, and professional dealers servicing the repair and remodel, residential, and commercial construction end-markets. The company currently operates a network of 87 facilities in the United States and Canada. And it provides supply solutions to approximately 75,000 customers and clients and uses over four channels to market, which include industrial, home center, ProDealer, and architects and designers. The company's portfolio includes architectural panels, trim and millwork, stair parts and railings, interior and exterior doors, windows, kitchen cabinets, decorative surfaces, decorative and functional hardware, plywood, hardwood lumber and boards, veneers, fasteners and adhesives, roofing, decking, and siding.

The company was formerly known as Hardwoods Distribution Inc., and changed its name to ADENTRA Inc. in December 2022. It was incorporated in 2012 and is headquartered in Langley, BC. The company is listed on TSX under the ticker ADEN, and it reports its financial results in US dollars.

Exhibit 1: Revenue Breakdown



Source: Annual reports, MD&A

Industry Outlook

A downward shift in economic momentum from interest rate hikes and continued inflationary pressure has been reflected in the recent slowdown in new housing activity. Since 1950, residential spending typically rebounds quickly after recessionary periods. Long-term averages support residential spending representing 4-7% of the total US GDP.

The **repair and remodel market (~40% of sales)** are expected to moderate this year following two years of higher-than-normal growth. The Joint Center for Housing Studies of Harvard University anticipates a decrease of 2.8% for the US repair and remodel market by the fourth quarter of 2023. Market fundamentals are well supported by record levels of home equity in the US and a median home age of over 40 years. Disaster repairs and mitigation projects following Hurricane Ian are also expected to support the home remodeling market in fiscal 2023.

In the **residential construction market (~40% of sales)**, new building starts decreased 17% in March 2023 as compared to March 2022 as affordability headwinds weigh on consumers. Over the longer term, leading indicators for the residential construction market remain highly favorable. Housing starts have meaningfully lagged population growth this past decade and this supply deficit, combined with positive demographic factors, is expected to underpin long-term demand for new housing.

The demand outlook for US **commercial markets (~15% of sales)** is mixed, with some sectors showing strength and others recovering at a slower pace. Commercial market participation is highly diverse for ADENTRA and includes construction activity in healthcare, education, public buildings, hospitality, office, retail facilities and recreational vehicles. We expect this market to be flat in 2023.

Overall construction spending will soften in the near term, however, opportunities exist in remodeling (digital transformation continues), and nonresidential construction (in the Southern US).

Exhibit 2: Key Assumptions

Assumptions	Projection periods				
	2023	**2024**	**2025**	**2026**	**2027**
Income Statement Assumptions					
Sales (% growth)	(10.0%)	50.0%	10.0%	5.0%	5.0%
Cost of Goods Sold (% sales)	80.0%	80.0%	80.0%	80.0%	80.0%
SG&A (% sales)	15.0%	15.0%	15.0%	15.0%	15.0%
Depreciation & Amortization (% sales)	2.6%	2.6%	2.6%	2.6%	2.6%
Cash Flow Statement Assumptions					
Capital Expenditures (% of sales)	0.3%	0.3%	0.3%	0.3%	0.3%
Current Assets					
Days Sales Outstanding (DSO)	26.6	26.6	26.6	26.6	26.6
Days Inventory Held (DIH)	120.0	85.0	85.0	85.0	85.0
Prepaid and Other Current Assets (% of sales)	1.3%	1.3%	1.3%	1.3%	1.3%
Current Liabilities					
Days Payable Outstanding (DPO)	16.0	16.0	16.0	16.0	16.0
Accrued Liabilities (% of sales)	3.0%	3.0%	3.0%	3.0%	3.0%
Other Current Liabilities (% of sales)	2.5%	2.5%	2.5%	2.5%	2.5%

Source: Analyst estimates

Exhibit 3: WACC Calculation

WACC Calculation		Note
Target Capital Structure		
Debt-to-Total Capitalization	50.0%	Leverage increases due to acqusitions. Use historical average.
Equity-to-Total Capitalization	50.0%	
Cost of Debt		
Cost-of-Debt	5.50%	Use BoC 10Y bond yield + credit spread for BBB corp bond
Tax Rate	25.0%	Historical average tax rate
After-tax Cost of Debt	**4.13%**	
Cost of Equity		
Risk-free Rate	3.2%	Interpolated yield on 10-year BoC bond on May 31, 2023
Market Risk Premium	6.0%	Historical equity risk premium was about 6% based on data since 2001
Beta	1.60	Regress ADEN against SPTSX to obtain raw beta.
Cost of Equity	12.8%	
WACC	**8.45%**	

Source: Capital IQ, analyst estimates

Valuation (Absolute and Relative)

We used Free Cash to Firm (FCFF) method due to changes in the capital structure for the past few years (e.g. acquisitions), and we believe the firm will continue to do so in the foreseeable future. The target price under the FCFF method was $25.28 (C$33.86).

We used comparable companies from Capital IQ. Due to the nature of the business (capital intensive), we prefer EBITDA over EBIT. The average target price under relative valuation was C$40.71. Note that there were not many truly comparable companies in this case, therefore, we would rely more on our absolute valuation.

Exhibit 4: Discounted Cash Flow Analysis

	Historical Period			Projection Period			
	2021	2022	2023	2024	2025	2026	2027
Sales	**$1,616,199.0**	**$2,579,568.0**	**$2,321,611.2**	**$3,482,416.8**	**$3,830,658.5**	**$4,022,191.4**	**$4,223,301.0**
% growth	*74.1%*	*59.6%*	*(10.0%)*	*50.0%*	*10.0%*	*5.0%*	*5.0%*
Cost of Goods Sold	(1,243,289.0)	(2,022,819.0)	(1,857,289.0)	(2,785,933.4)	(3,064,526.8)	(3,217,753.1)	(3,378,640.8)
Gross Profit	**$372,910.0**	**$556,749.0**	**$464,322.2**	**$696,483.4**	**$766,131.7**	**$804,438.3**	**$844,660.2**
% margin	*23.1%*	*21.6%*	*20.0%*	*20.0%*	*20.0%*	*20.0%*	*20.0%*
Selling, General & Administrative	(224,579.0)	(360,117.0)	(348,241.7)	(522,362.5)	(574,598.8)	(603,328.7)	(633,495.1)
EBITDA	**$148,331.0**	**$196,632.0**	**$116,080.6**	**$174,120.8**	**$191,532.9**	**$201,109.6**	**$211,165.0**
% margin	*9.2%*	*7.6%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
Depreciation & Amortization	36,579.0	65,455.0	60,361.9	90,542.8	99,597.1	104,577.0	109,805.8
EBIT	**$111,752.0**	**$131,177.0**	**$55,718.7**	**$83,578.0**	**$91,935.8**	**$96,532.6**	**$101,359.2**
% margin	*6.9%*	*5.1%*	*2.4%*	*2.4%*	*2.4%*	*2.4%*	*2.4%*
Taxes	28,013.7	27,482.9	11,673.6	17,510.5	19,261.5	20,224.6	21,235.8
EBIAT	**$83,738.3**	**$103,694.1**	**$44,045.0**	**$66,067.5**	**$72,674.3**	**$76,308.0**	**$80,123.4**
Plus: Depreciation & Amortization	36,579.0	65,455.0	60,361.9	90,542.8	99,597.1	104,577.0	109,805.8
Less: Capital Expenditures	(4,463.0)	(7,859.0)	(6,036.2)	(9,054.3)	(9,959.7)	(10,457.7)	(10,980.6)
Less: Inc./(Dec.) in Net Working Capital			(95,051.0)	(32,892.5)	(63,296.6)	(34,813.1)	(36,553.8)
Unlevered Free Cash Flow			**$3,319.7**	**$114,663.6**	**$99,015.1**	**$135,614.2**	**$142,394.9**
WACC	8.45%						
Discount Period			1.0	2.0	3.0	4.0	5.0
Discount Factor			0.92	0.85	0.78	0.72	0.67
Present Value of Free Cash Flow			**$3,061.0**	**$97,486.9**	**$77,621.6**	**$98,027.2**	**$94,906.6**

Source: Company Documents, Capital IQ, analyst estimates

Enterprise Value	
Cumulative Present Value of FCF	**$371,103.4**
Terminal Value	
Terminal Year EBITDA (2027E)	$211,165.0
Exit Multiple	5.5
Terminal Value	**$1,161,407.8**
Discount Factor	0.67
Present Value of Terminal Value	**$774,081.9**
% of Enterprise Value	*67.6%*
Enterprise Value	**$1,145,185.2**

Implied Equity Value and Share Price	
Enterprise Value	$1,145,185.2
Less: Total Debt	(616,290.0)
Less: Preferred Stock	-
Less: Noncontrolling Interest	-
Plus: Cash and Cash Equivalents	65,068.0
Implied Equity Value	**$593,963.2**
Fully Diluted Shares Outstanding	23,496.7
Implied Share Price	**$25.28**

Source: Company Documents, Capital IQ, analyst estimates

Exhibit 5: Relative Valuation

Relative Valuation			
Company Name	**EV/ LTM Revenues**	**EV/LTM EBITDA**	**P/LTM Diluted EPS**
Doman Building Materials Group Ltd. (TSX:DBM)	0.4	7.2	7.2
Interfor Corporation (TSX:IFP)	0.4	1.8	2.3
Richelieu Hardware Ltd. (TSX:RCH)	1.3	8.4	13
Toromont Industries Ltd. (TSX:TIH)	2.1	11.5	20.6
Russel Metals Inc. (TSX:RUS)	0.5	4	6.2
West Fraser Timber Co. Ltd. (TSX:WFG)	0.6	1.8	-
Louisiana-Pacific Corporation (NYSE:LPX)	1.1	3	5.1
Taiga Building Products Ltd. (TSX:TBL)	0.1	2.3	3.5
Finning International Inc. (TSX:FTT)	0.8	7	10.9
Grafton Group plc (LSE:GFTU)	0.9	5.6	10.1
Mean	0.8	5.3	8.8
Median	0.7	4.8	7.2
ADENTRA Inc. (TSX:ADEN)	0.43	5.50	3.60
LTM stats	2520.2	257.2	5.4
Implied price per share	48.5	26.18	47.44
Average	**40.71**		

Source: Company Documents, Capital IQ, analyst estimates

Justification of Target Price

Based on the above, the weights we assigned to absolute and relative valuation were 80% and 20%. This gives the weighted average target price of **C$35.24.**

Half of the revenue growth was organic (the other half was through acquisition), so we expect sales will be -10% for FY 2023 (given -10% for Q1 FY 2023). Other variables are in line with historical average.

The exit EV/EBITDA multiple we used was 5.5x, and it is in line with the historical average. We view as appropriate due to near-term macro uncertainty and acquisitions, and we believe that the resiliency and growth potential of the business have meaningfully sustainably improved over the past two years.

This target price represents a **20.9%** return in the next twelve months. Therefore, we issued a **BUY** recommendation.

Exhibit 6: Sensitivity Analysis

Enterprise Value

WACC	Exit Multiple 4.5x	5.0x	5.5x	6.0x	6.5x
7.45%	1,046,814	1,120,530	1,194,246	1,267,961	1,341,677
7.95%	1,025,402	1,097,427	1,169,451	1,241,475	1,313,499
8.45%	1,004,546	1,074,925	**$1,145,304**	1,215,684	1,286,063
8.95%	984,228	1,053,007	1,121,786	1,190,565	1,259,344
9.45%	964,432	1,031,655	1,098,877	1,166,099	1,233,322

Implied Equity Value

WACC	Exit Multiple 4.5x	5.0x	5.5x	6.0x	6.5x
7.45%	21.1	24.2	27.4	30.5	33.6
7.95%	20.2	23.2	26.3	29.4	32.4
8.45%	19.3	22.3	**25.3**	28.3	31.3
8.95%	18.4	21.4	24.3	27.2	30.1
9.45%	17.6	20.4	23.3	26.2	29.0

PV of Terminal Value % of Enterprise Value

WACC	Exit Multiple 4.5x	5.0x	5.5x	6.0x	6.5x
7.45%	63.4%	65.8%	67.9%	69.8%	71.4%
7.95%	63.2%	65.6%	67.7%	69.6%	71.3%
8.45%	63.1%	65.5%	**67.6%**	69.5%	71.1%
8.95%	62.9%	65.3%	67.4%	69.3%	71.0%
9.45%	62.7%	65.2%	67.3%	69.2%	70.9%

WACC Sensitivity Analysis

Debt-to-Capital	Pre-tax Cost of Debt 4.5%	5.0%	5.5%	6.0%	6.5%
30.0%	10.0%	10.1%	10.2%	10.3%	10.4%
40.0%	9.0%	9.2%	9.3%	9.5%	9.6%
50.0%	8.1%	8.3%	**8.5%**	8.6%	8.8%
60.0%	7.1%	7.4%	7.6%	7.8%	8.0%
70.0%	6.2%	6.5%	6.7%	7.0%	7.2%

Source: Analyst estimates

Key Risks to Target Price

Economic growth (US housing markets); Acquisitions that do not create shareholder value; Interest rate uncertainty; Foreign exchange exposure (CAD/USD).