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CAPITAL MANAGEMENT

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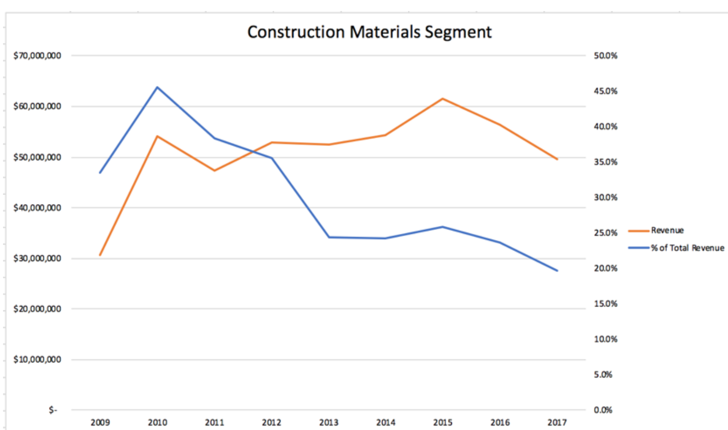
Summary

- The company has a defensible competitive moat and generates significant and recurring free cash flow
- The outstanding management team further separates the company from competition
- Recent high incremental returns on capital and accretive acquisitions point to the business continuing its path of strong but responsible growth

An Excellent Business

Chase Corporation (CCF) is in the business of manufacturing protective tapes, sealants, coatings, and other chemical products for use in a range of applications. Its diverse customer base operates in sectors ranging from automotive and semiconductors to energy and infrastructure. The company operates two segments: Industrial Materials and Construction Materials.

The Construction Materials segment, the smaller of the two at roughly 20% of F17 revenue and 21% of operating profit, consists mostly of waterproofing and anti-corrosion products. These revenues are non-recurring as they pertain to specific construction projects such as the use of one of Chase's asphalt additives to increase waterproofing of the Governor Mario M. Cuomo bridge in New York or the use of Chase's CIM coatings in the pool, spa, and other water features of a spec house in LA[i]. The one-time nature of this segment's revenues leads to higher volatility and unpredictability driven, in part, by the cyclicality and seasonality of infrastructure investment and homebuilding. As a redeeming point, the segment carries a respectable EBITDA margin of 32% in F17.



Revenues have compounded at a rate of roughly 5.5% since 2009 (when the company began reporting its two current segments) but have most recently decreased for several years due to various factors from less pipeline construction in the middle east to lower infrastructure spend domestically. The Construction Materials segment will continue to be buoyed about by temporary forces and, as management continues its focus on its more-predictable Industrial Materials, Construction is likely to become a proportionally smaller and smaller part of Chase's business.

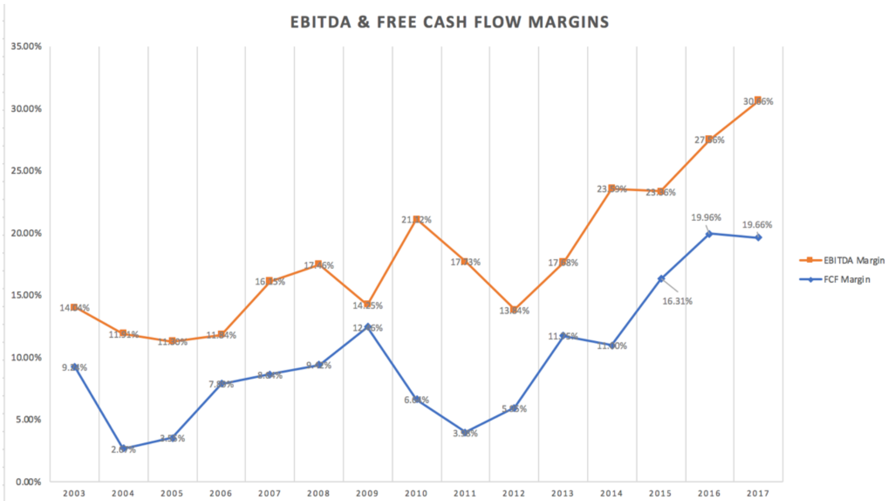
The Industrial Materials segment is the real gem in Chase's operations, with 80% and 79% of F17 revenue and operating profit, respectively, and compound annual revenue growth of 14.4% over the past 9 years. The segment is comprised of varying businesses providing products that are primarily incorporated into an OEM's products on a contract basis. Typically, Chase's tapes, sealants, and coatings account for only a small portion of the total cost of the end-product. And, Chase's offerings are not part of the active or critical part of the end-product. Instead, they are needed for durability and longevity as well as protection of the warranty. What's more, Chase has a reputation for delivering high-quality products offering little reason for doubt in customers' minds. All these factors add up to create very high switching costs for Chase's customers, giving the company a strong competitive moat.

Admirable Capital Allocators

Chase Corporation is helmed by Peter Chase as Executive Chairman and his son, Adam Chase, as President and CEO, descendants of founders Francis G. Chase, Francis M. Chase, and Edward Chase[ii]. Fortunately for shareholders, Peter and Adam are an increasingly rare breed: outstanding capital allocators who run the business from an owner-operator perspective. Together, they own approximately 16.2% of the outstanding shares worth many multiples of their yearly pay[iii]. It is also notable that management does not provide Wall Street with guidance, similar behavior to other outstanding owner-operators in the past.

Management has consistently grown the business on the back of accretive acquisitions, but the testament to their capital allocation is the almost 1:1 ratio of divestitures to acquisitions over the past ten years[iv]. Whenever a business' margins are too weak (Fiber Optics Cable Components sale in April '17) or it is worth more to another company than it is to Chase (Structural Composite Rod sale in April '18), management has no problem getting rid of it. Instead of growth for the sake of growth, the company's focus, evident from its M&A activity, has been on increasing margins – and it's worked.

Margins have been on the rise for the past 15 years, but this trend has become even more pronounced in the past five years. This led to the company's record EBITDA margin of 30.66% in F17. As cost-control measures are frequently referenced by management, internal frugality has undoubtedly contributed to the progress as well.



Management is clear on their intentions for excess capital in the future. Their primary goal is to grow shareholder value via acquisitions and internal initiatives with adequate margins or returns. Secondarily, shareholders can expect special dividends at times. However, based on the stock's existing low float, management has no intentions of implementing any share repurchases.

Chase Corporation's intelligent capital allocation decisions and owner-operator behavior originating from Peter and Adam Chase further expand and protect the company's competitive moat.

What It's Worth

Chase Corporation has achieved an excellent track record through their history, especially so in the past decade. The company has compounded earnings at approximately 20% and 13% annually for the past 5 and 10 years, respectively, an enviable feat. What's more, the company has grown their free cash flows at a compounded rate of 15% per year for the past decade (based on rolling 2-year periods)[v].

It is unlikely this performance will materially change as, even now, the company is earning excellent returns with a 5-year average ROIC of 15%. Even more important is that Chase's returns on the *incremental* capital employed in just the past 5 years has been an incredible 60%. So not only is the company earning strong returns on its asset base, but it is putting incremental capital to work very intelligently. This is key given the company retains over 75% of its earnings each year.

M&A continues to play a major role in deploying capital, and the pace has been sustained with the company making *year-one-accretive* (without synergy projections) acquisitions such as Resin Designs in September, 2016 and Zappa Stewart in December, 2017. Management has indicated that M&A will continue to be a key part of their strategy, and there is an adequate pipeline of targets. Chase's balance sheet supports further acquisitions as well with a negligible \$1.89mm in net debt as of May 31st.

Should the company's performance continue as it has over the past ten years (lower than the high-growth numbers achieved in just the past 5 years), \$133 per share would approximate a fair value. With a lower estimate of growth in free cash flow of 10% over the next five years, shares would be fairly valued at roughly \$109. This valuation range would result in an EV/EBITDA multiple of between 13.44 and 16.42 times, reasonable for a company of this caliber. With the shares trading in the middle of that range, Chase Corporation is an excellent business at a fair price.

Risks

Though Chase has performed well, there are risks to investing. Firstly, short-term results can be affected by a variety of factors including increases in the price of commodity inputs and changes in demand or overall economic conditions. Chase has been experiencing higher raw materials costs in the past few quarters primarily due to the rise in oil prices, which has eaten into their margins. Decreased middle-eastern pipeline construction lowered their Construction Materials segment revenue in several of the past few years, and a downturn in automotive demand, currently fairly strong, would undoubtedly have a negative effect on revenues as well. Overall, Chase is somewhat exposed to the conditions of the general economy with EBITDA falling 31.8% in 2009 vs the average of the prior 3 years.

These factors are, however, all related to the *short-term* performance of the company and, in all likelihood, will have little impact on long-term shareholder value. Yet, there are two major risks that would erode the company's competitive advantages. First, should the company have a substantial recall of one of its major products, its perception in the market as a high-quality provider may change. That perception is key to keeping customers' switching costs high, and thus a major recall could impair the firm's long-term value. Second, the company would have a weakened position in the case of a material management shakeup such that Peter or Adam Chase are no longer running the firm.

Conclusion

Chase Corporation is a company with significant recurring cash flows and runway for growth into the future fortified with virtually no net-debt. The firm has a wide moat due to its products' quality and position in OEM end-products leading to significant switching costs for customers. The moat is guarded by an excellent owner-operator pair, Peter and Adam Chase, who have a record of intelligent acquisitions and divestitures. Its shares trade at an appropriate price for the quality of the business, and investors will most likely be well-rewarded into the future.

Disclosures

I am/we are long CCF.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

This article does not constitute a recommendation to buy or sell any security nor does it contain every piece of relevant information regarding the topic discussed. Any reader should make his/her own decision regarding their investments after examining all available information.

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[i] Chase Corporation 2017 Annual Report: http://www.chasecorp.com/investor-relations/annual-reports/
[ii] Chase Corporation Website: http://www.chasecorp.com/about-us/
[iii] SEC-Reported Insider Transactions for Chase Corporation: https://www.sec.gov/cgi-bin/own-disp?action=getissuer&CIK=0000830524
[iv] Chase Corporation Investor Presentation: http://www.chasecorp.com/userfiles/file/Investor-Presentation-CCF-July-27-2018.pdf
[v] Chase Corporation 10-Ks: https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0000830524&type=10-k&dateb=&owner=exclude&count=40