BMC Stock Holdings, Inc. (BMCH)
1Q20: Cycle Overwhelms Company-Specific Positives for Now

Maintain Neutral rating. BMCH is trading higher after reporting strong 1Q20 results. Looking forward, although April organic sales were down just ~5%, management expects additional deceleration in May/June, driving 2Q20E organic sales down low-double-digits to mid-teens. Cost actions have been surgical to date, but contingency plans call for mothballing/closing certain locations if trends worsen further. Net, although we believe BMCH is well-positioned to weather the current storm, we see inline performance for the stock given what we see as a challenging fundamental setup for single-family construction through 2021.

- **Maintain Neutral rating with a new $23 price target** representing 20x theoretical 2022 EPS power. Key points from BMCH’s 1Q20 report as follows:

- **2Q20 organic sales seen down low-double-digits to mid-teens**
  - April organic sales were down mid-single-digits, primarily reflecting declines in states where construction activity was shut down (Washington, Pennsylvania, and portions of Northern California)
  - Organic sales declines are expected to accelerate in May/June, driving 2Q20 organic sales down low-double-digit to mid-teens overall
  - Falling new home orders/cancellations are expected to more than offset easing restrictions on construction activity, with management citing a “dearth” of starts over the last 4-6 weeks
  - Management also referenced external projections calling for 650-750K single-family starts SAAR (down ~20% vs. 888K starts in 2019)
  - Our estimates assume residential construction will remain depressed through 2021

- **Several actions taken in response to the current environment**
  - Overall operating expenses are approximately 50% fixed / 50% variable
  - BMCH has realigned staffing at individual locations via both permanent headcount reductions (400 positions) and temporary furloughs (550 positions)
  - Other actions taken to reduce employee costs include a hiring freeze, suspended 401(K) match, and reduced salaries for executive leadership
  - If additional cost actions are necessary, contingency plans call for mothballing or closing certain locations
  - Full-year capex guidance was reduced by ~$20 million at the midpoint and the company’s share repurchase program has been temporarily suspended, although BMCH remains opportunistic on acquisitions
  - As previously announced, the company drew $144 million on its revolving credit facility with total cash outstanding of $283 million at quarter-end

- **We remain Neutral on the shares**
  - We believe BMCH is well-positioned to weather the current storm (and to play offense in an eventual recovery), as recent execution has been excellent and the balance sheet is in outstanding shape
  - However, we are cautious on BMCH’s high single-family residential construction exposure (~75% of revenue), where we see declines extending into 2021 due to a weak consumer/high unemployment
  - Our $23 price target represents 20x theoretical 2022 EPS power of ~$1.15 – equal to the 2014-2016 NTM average – assuming 15-17% sales growth and 20-23% contribution margins vs. our 2021 estimates

BMC Stock is a leading regional Lumber and Building Materials (LBM) distributor to the U.S. residential construction and remodeling market.

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Investment Thesis

Quick Summary:

- **The call.** We rate BMCH Neutral. We believe BMCH is well-positioned to weather the current storm, but see in-line performance for the stock given what we see as a challenging fundamental setup for single-family construction through 2021.

- **Price target and valuation.** Our $23 price target is 11x depressed 2021 EBITDA and also represents 20x theoretical 2022 EPS power of ~$1.15 – equal to the 2014-2016 NTM average – assuming 15-17% sales growth and 20-23% contribution margins vs. our 2021 estimates.

Near-term thesis:

- **Well-positioned to weather the current storm.** We believe BMCH is well-positioned to weather the current storm, as recent execution has been excellent and the balance sheet is in outstanding shape. Cost actions taken to date have been more surgical in nature, but contingency plans call for mothballing or closing certain locations of declines worsen.

- **Challenging setup for single-family construction.** We are cautious on BMCH’s high single-family residential construction exposure (~75% of revenue) given our expectations for a “U-shaped” demand pattern, which we believe will lead to volume declines extending into 2021.

- **Capital allocation focus.** We expect BMCH to be ready to play offense once industry trends stabilize, with the company having recently been active in the repurchase market while M&A had been ramping after management repeatedly signaled a more aggressive posture mid last year. Net debt to EBITDA is targeted in the 2.0x-2.5x range (vs. 0.8x at 1Q20 quarter-end), allowing for flexibility in an eventual upturn.

- **Recent results and trends.** 1Q20 results were strong, including slightly better core organic growth, gross margin, and SG&A leverage (operating expenses -20bps y/y). Resulting adjusted EBITDA was 17% above our recently-slashed estimate. April organic sales were down ~5%, with May/June expected to decelerate further.

Longer-term thesis:
Consolidated footprint focused on strongest legacy markets. BMCH is well positioned as the number-one, -two or -three distributor in 80%+ of its markets. This reflects a significant footprint rationalization following legacy SBS’s 2009 Chapter 11 bankruptcy, when the company exited approximately two-thirds of its markets. The remaining markets were chosen based on SBS’ market position, competitive intensity, long-term demographic trends and near-term outlook. With the BMC merger, the combined company further increased its scale and capabilities in key MSAs (as we believe BMC went through a similar process).

Opportunity to gain share. Management has targeted additional growth from share gains historically, which we believe appears appropriate given recent trends and company-specific initiatives, including product/solutions additions (Ready-Frame, expansion of the company’s millwork and structural components manufacturing capabilities), investments in the sales force, and various e-business solutions, as well as expansion of the repair and remodel business (likely a longer-term opportunity).

Balance sheet provides flexibility. The company’s spin-out from Wolseley and pre-packaged bankruptcy left legacy SBS with a flexible balance sheet, providing opportunities to supplement organic growth via acquisitions and greenfields in new/adjacent markets. With the merger with privately held BMC and subsequent executive management change, the continued consolidation of the industry is likely to continue, with BMCH potentially playing a larger role.

Additional operational improvements. The company’s operating philosophy is driven by Lean principles, which were first implemented in 2011 and recently re-emphasized, driving minimal fixed cost additions and improved distribution efficiency. Adjusted EBITDA “pull-through” margins should exceed 50% as volume ramps up, translating to low-double-digit to mid-teens organic contribution margins.

Risks & Caveats

Residential construction cyclicality. Residential construction spending is cyclical, as industry growth is dependent on overall economic trends, employment levels, consumer confidence, interest rates and credit availability, among other factors. As these factors tend to be interrelated, cyclicality can be magnified greatly both to the upside and downside.

Overall economic cyclicality. Given that BMCH’s sales are also tied to the overall U.S. economy, changes in underlying GDP growth may impact business trends – even in the relatively more stable repair & remodel end market.

Lumber pricing. Primary exposure to lumber pricing is within lumber and lumber sheet goods (~30% of sales). As prices rise, lower-margin lumber is a greater percentage of the mix, reducing gross margins, despite adding to growth and cost leverage optics. Conversely, falling prices depress sales growth and reduce cost leverage, while likely leading to higher gross margins, all else equal.

Pricing power/competitive pressures. Given the company’s significant exposure to sophisticated large-scale production homebuilders, there is inherent pricing pressure and somewhat impaired pricing power.

Weather. The timing of spring and fall can meaningfully impact the duration of the main building season (both positively and negatively) in the company’s Northern markets.

Geographic concentration. Although BMCH is present in most of the fastest-growing geographies, there is high exposure to the states of Texas, California, and Georgia, which represented 31%, 14%, and 10% of 2018 sales, respectively.

High customer/supplier concentration. Given the presence of large-scale national homebuilders, customer concentration at BMCH is somewhat higher (top 10 customers ~20% of sales), while the supplier base is fairly diversified (no supplier accounts for >6% of COGS).
- **Acquisition integration.** Acquisitions focused on value-added products, R&R/custom builder customers, and/or expanding geographic density remain a key pillar of the company's strategy. While there are integration risks with any acquisition strategy, we expect most future acquisitions to be tuck-ins, however, and therefore lower risk in nature.

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**Company Description**

BMC Stock Holdings is a leading regional Lumber and Building Materials (LBM) distributor, with a low-single-digit share of the estimated $100+ billion U.S. market. Based in Raleigh, North Carolina, the company serves 12,000+ customers via 150 locations in 19 U.S. states, encompassing 45 targeted metropolitan areas. The company’s portfolio of 39,000+ SKUs addresses roughly 50% of the cost of a typical new home, spanning lumber & lumber sheet goods, windows & other exterior products, millwork & other interior products, construction services and structural components.
## BMC Stock Holdings, Inc.

*(BMCH - NASDAQ)*

Recent Price: $21.95  
Fiscal Year End: December  
Date Printed: May 5, 2020

($ in thousands, except per share)

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<th>Adjusted Diluted EPS</th>
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To request our full working excel model, click: [here](#)

Source: Company reports, Robert W. Baird & Co. estimates

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Approved on 05 May 2020 14:03EDT/ Published on 05 May 2020 14:08EDT.

Robert W. Baird & Co. Incorporated makes a market in the securities of BMCH.

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