THE GLOBE AND MAIL

July 29, 2016

Three automotive stocks that deserve a closer look under the hood

David Milstead

There's always something making the stocks of Magna International Inc. and its smaller Canadian auto-parts peers cheap.

Inextricably yoked to the volatile auto-making industry, Magna, Linamar Corp. and Martinrea International Inc. perpetually trade at lower earnings multiples than the broader market. Sometimes, however, the discount is extreme – such as in the immediate aftermath of the Brexit vote, when investor fears drove the stocks' forward price-to-earnings ratios to their lowest marks in years, well into the mid-single digits.

That particular buying opportunity is gone, as the shares of the three companies jumped roughly 20 per cent in the month since. But this week, Ford Motor Co. was happy to provide the latest bid of bad news: Its disappointing earnings combined with a forecast for stalling U.S. vehicle sales clipped the parts-makers' shares once again.

For long-term investors with a positive view of the auto industry, the stocks' cheaper-than-normal valuations may still represent a buying opportunity. (KeyBanc Capital Markets analyst Brett Hoselton calls Magna his best long-term automotive pick, with upside of nearly 60 per cent.)

But be forewarned: There's also a bear case that suggests that Magna and its cohorts, which begin to report earnings later next week (Magna on Aug. 5), may stay stuck in a rut for the next couple of years.

Let's start with the happy talk. Efraim Levy of S&P Global Market Intelligence calls Magna a "strong buy," with a $57 (U.S.) target price, versus Friday's close of $38.57. (Since Magna trades on the New York Stock Exchange as well as the TSX, analysts typically use the U.S. price for their forecasts.)

Mr. Levy believes Magna's problematic European plants are turning around as the company places a greater emphasis on their profitability. With a healthy balance sheet – the company was able to pay mostly cash for its acquisition of German transmission company Getrag in the first quarter – and "solid manufacturing capabilities," Magna should have a valuation higher than most peers, he argues.

And yet it does not, notes RBC Dominion Securities analyst Steve Arthur, who agrees with Mr. Levy that the discount is inappropriate. Mr. Arthur, whose $59 target price is a hair below the $60 of Mr. Hoselton at KeyBanc, wrote in May that Magna simply moving to the peer-average multiple represents upside of roughly 20 per cent. "The wide discount to peer multiples seems at odds with continued solid operating performance and growth," he says.

Thanks to even deeper discounts, Todd Coupland of CIBC World Markets Inc. recommends Linamar and Martinrea over Magna. He writes that Linamar has sector-leading margins and return on equity, yet trades sharply lower than North American auto-supplier peers (specifically, a forward P/E of seven, based on his 2016 estimate, versus 10 for the group). "Linamar is benefiting from above-market growth in revenue and margins," he wrote. "As a result, we expect its valuation to expand to our target." His 12-to-18-month target price is $71 (Canadian), versus Friday's close of $51.83.

Martinrea, Mr. Coupland says, trades at an even bigger discount, but that's appropriate given what he calls "the company's lack of consistent execution to date." He sees a turnaround progressing, however, and sees the Martinrea multiple gap narrowing, if not closing. His 12-to-18-month target price is $14, versus Friday's close of $8.71.

Thursday's Ford news, however, underscored one of the chief worries about the investment theses for these names: What if the record 2015 level for auto sales is the high mark for the next few – or even many – years?

That's part of the reason BMO Nesbitt Burns analyst Peter Sklar downgraded all three stocks in late June, just after the Brexit vote. He says he'd previously believed that the stocks' multiples deserved to be higher during this part of the auto-sales cycle than in past years because the Detroit manufacturers have improved their finances, large suppliers are winning business from small suppliers and Magna's corporate governance has improved.

Mr. Sklar's downgrades came when he identified several factors that were blunting those benefits. One is tepid U.S. economic data that he believes suggest sales of U.S. light vehicles (cars, not trucks) "will likely remain range-bound for the next few years." Also, "economic uncertainty from Brexit over the next several years will likely dampen consumer confidence across Europe, which would negatively impact new vehicle sales." (An unrelated factor: Mr. Sklar believes suppliers who aren't "pure plays" in the trendy fields of battery electric vehicles, autonomous driving and "ride hailing" are now being penalized by investors.)

Now, Mr. Sklar has "market perform" ratings on Magna and Linamar, with target prices of $36 (U.S.) and $50 (Canadian), respectively. Martinrea, the most debt-heavy of the three, moved to "underperform," with a $7 target price.

If one were to combine auto-industry pessimism with a buy case, what might it look like? ***Dan Fong***, new to the Magna beat at ***Veritas Investment Research***, provides the answer. ***Mr. Fong*** says Magna's guidance, which implies U.S. sales of 18 million light vehicles in 2018, "appears unachievable." Instead, ***Mr. Fong*** forecasts 15.2 million light-vehicle sales that year, saying that we are currently approaching "peak auto."

And yet: "Even under pessimistic 2018 forecasts, Magna is undervalued," he says. "Rather than trading Magna on cyclical sentiment, we believe investors are best served looking at Magna's cash-flow potential over a full business cycle. While 'peak-auto' risks and a near-term downturn in auto sales remain on the table, our analysis suggests that Magna can still deliver attractive returns over the next several years." ***Mr. Fong*** has a modest $40 (U.S.) target price, but combined with Magna's annual dividend yield of 2.5 per cent, he suggests double-digit returns are achievable.

That's not enough to get Magna or any of its peers to a market multiple. But it also suggests limited downside from here, particularly for investors who don't have the need for speed.

Trading at a discount

As suppliers to the volatile auto-making industry, Magna International, Linamar and Martinrea typically trade at lower earnings multiples than the broader market. Recently, though, the discount has been even bigger than normal. While that may make the stocks a long-term buy, there's a good chance they'll stay cheap for a while.

In millions of Canadian dollars. Magna International reports in U.S. dollars, but its financial results are converted to CAD here for comparability. Net debt is debt minus cash. Revenue, EBITDA and net income are for the past 12 months. EBITDA is earnings before interest, taxes, depreciation and amortization. EV is enterprise value, or market capitalization plus net debt. EV/EBITDA and P/E are based on analysts' estimates of future earnings.