Stock Pick of the Week: Intel Corporation (INTC)

It feels as if the longer interest rates remain depressed, the crazier company valuations become. As investors scramble to find returns in this stretched market, some are turning to IPOs, private equity, and other risky, often speculative investments. This makes finding quality stocks even harder. When valuations get out of touch with reality, it can be beneficial to look at companies that tend to get lost in all the noise. We're talking about large, mature companies that, while not growing at breakneck speeds, churn out consistent profits and create long-term shareholder value. This week's stock pick of the week, Intel (INTC), accomplishes just that.

What is Intel Doing?

Intel designs, manufactures, and sells integrated digital technology platforms. The company focuses on computing devices and is possibly best known for its processors for desktop computers, laptops, ultraportable devices, and mobile devices. The company is also directing its efforts toward data centers and now provides products for server, network, storage, and cloud computing platforms. Intel also develops technologies for use in numerous Internet of Things (IoT) related applications.

Why Invest Now?

Since early January, Intel shares have been undeservedly under selling pressure, pushing the stock down 19% on the year near the end of March. Much of this pressure was due to Intel warning of lower than expected PC sales having an adverse effect on overall results. However, these "adverse effects" were not nearly as bad as the market's reaction would have you believe, and the drop in share price has created an excellent investment opportunity in Intel.

What About Intel's Underlying Fundamentals?

In 2014, Intel saw slight revenue growth and impressive after tax profit (NOPAT) growth. Revenues grew 6% over 2013 and NOPAT increased 24% year over year. Intel increased its return on invested capital (ROIC) to a top quintile 20% in 2014, up from 17% the prior year. Intel also generated over $7.3 billion in free cash flow in 2014 and had a FCF yield of 4%.

Intel's strong NOPAT growth in 2014 coincided with its increasing NOPAT margin, up to 21% from 18% in 2013.

The supposedly "disappointing" 1Q15 earnings report was also much to do about nothing. Intel reported that overall revenues in the quarter were unmoved from the prior year. However, the weakness in Intel's Client Computing Group was more than offset by strong growth in other segments. The Data Center Group saw revenues grow 19%, while IoT segment revenues increased 11%. The growth of these two segments will be paramount for Intel going forward as the global PC market is expected to continue its low to negative overall growth. When combined, these two segments accounted for 33% of Intel's revenue in 1Q15.

On top of strong growth in the two segments noted above, Intel was able to increase its gross margin to 61%. Despite the lowered guidance, Intel's overall business is continuing to chug along, albeit slower than initially expected. The worries from the beginning of this year could very well be short-term concerns. It will be up to management to capitalize on the Data Center and IoT businesses and so far they are proving more than capable of doing so.

We Made These Adjustments to Intel's Operating Profitability and Valuation

We make several key adjustments to the earnings and balance sheets of companies to uncover the recurring cash flows of each company's core business and the value left for shareholders. We made the following adjustments to Intel's earnings in 2014:

- Removed $151 million in non-operating expense hidden in operating earnings.
- Removed a net of $81 million in reported non-operating items.

When considering Intel's valuation, we also added $902 million in off-balance sheet debt (5% of debt) from operating leases to Intel's total debt.

The Buying Opportunity is Now

As mentioned above, Intel's stock price has unjustly run down over the course of the year and we believe current share prices present a great buying opportunity. At its current price of $32/share, INTC has a price to economic book value (PEBV) ratio of only 0.9. This ratio implies that the market expects Intel's NOPAT to permanently decline by 10% from current levels. Given that Intel grew NOPAT by over 20% in 2014 alone, we believe the market's expectations are too pessimistic.

If Intel can grow NOPAT by just 5% compounded annually for the next seven years, the stock is worth $42/share today — a 31% upside. With such low expectations embedded into this quality company, it's easy to see why Intel earns our Very Attractive rating and made our Most Attractive Stocks list in May.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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2. Standard for all companies.
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