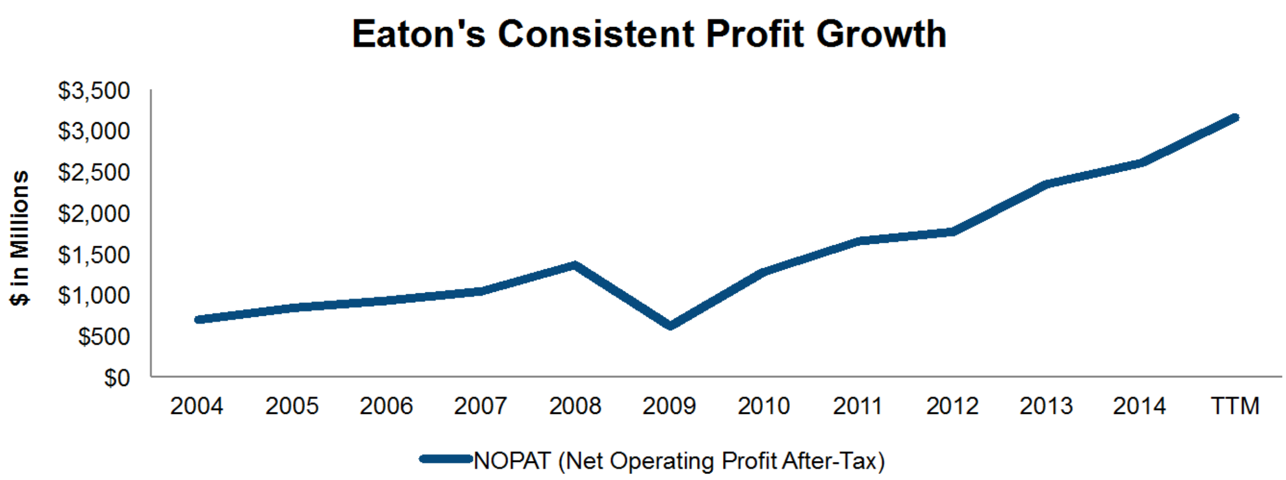
Long Idea: Eaton Corporation (ETN)

Global economic concerns can have widespread effects across entire industries and drive share prices to significantly undervalued levels. Identifying which companies are worth buying among the macro damage can result in excellent potential returns. With a long history of profit growth, overly pessimistic expectations baked into the stock, and a 6% (dividend plus share buybacks) yield, this week's Long Idea is Eaton Corporation (ETN: $53/share)

Highly Profitable Through The Years

Eaton Corporation's diversified profit streams enable it to generate excellent profit growth through multiple economic cycles. Since 2004, Eaton has grown after-tax profit (NOPAT) by 14% compounded annually. In fact, the only year in which Eaton failed to grow profits year-over-year was 2009, which can be seen in Figure 1.

Figure 1: Eaton's History of Growing NOPAT



Sources: New Constructs, LLC and company filings

With the exception of 2012, in which Eaton acquired Cooper Industries for $15 billion, the company has also been free cash flow positive each year since 2009 and generated over $5 billion in FCF over the past two years alone. Best of all, Eaton currently earns a return on invested capital (ROIC) of 10%, up from 8% in 2013 and well above the 4% earned in 2009.

Diversified Business Model Creates Success In All Economic Cycles

Eaton has achieved the success highlighted above by building an industrial business that serves numerous different markets in a multitude of geographic locations. By diversifying product lines between Electrical Products, Electrical Systems, Hydraulics, Aerospace and Vehicles, Eaton has the ability to withstand the peaks and troughs of economic cycles while still generating a profit. In 2014, no one business segment made up more than 32% of sales and the United States made up just over 51% of sales. The rest of sales were split between Canada, Europe, Latin American, and the Asia Pacific. Barring any unforeseen global economic crisis (similar to 2009), Eaton has proven its ability to generate profits consistently.

Management Taking Advantage of Low Growth Environment

While we are currently in an economic cycle that many would argue is stagnant, Eaton's management is streamlining the business. Under the current restructuring program, the company expects to reduce structural costs to the tune of $80 million annually, beginning in 2016. When growth begins to stagnate, quality companies look within to create leaner operations so that when economic growth returns, the company will be even more profitable than before.

Bear Concerns Have Driven Valuation to 2009 Recession Levels

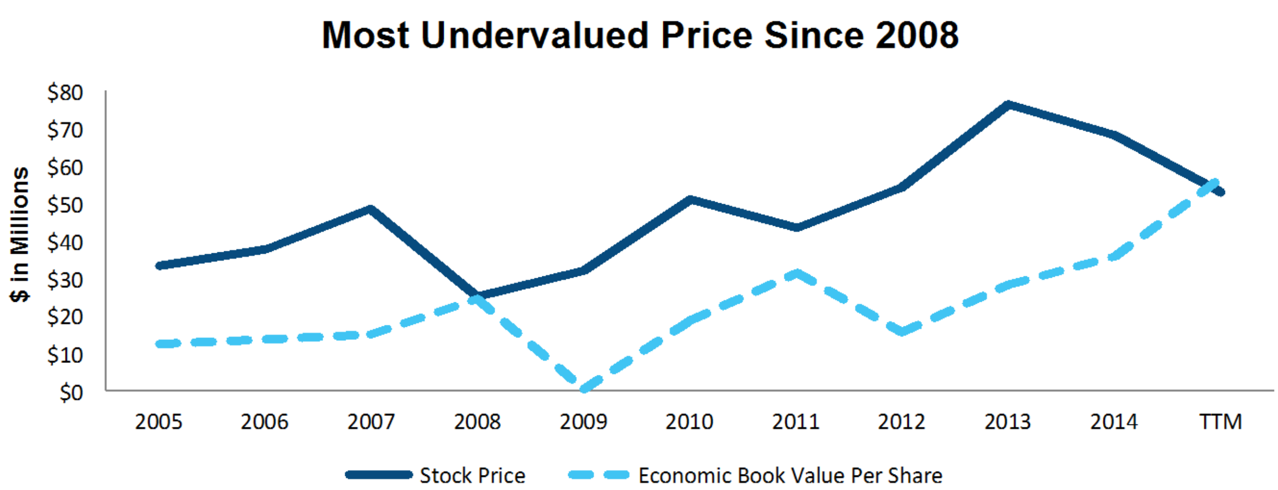
The biggest concerns regarding Eaton's business revolve around the current state of the global economy and the effects it is having across the entire industrial industry. While the economy has certainly not performed at peak levels, the IMF still expects the global economy to expand by 3.1% in 2015 and 3.6% in 2016, which is the slowest level since the 2009 recession. This distinction is important because bear concerns have pushed ETN to price levels that would imply another global recession, such as 2009, would occur, despite best estimates showing otherwise. While investors and consumers alike would prefer much higher economic growth levels, we must make take a look at whether the pessimism in ETN's valuation is warranted. We believe the selling is overdone.

Share Price Is Significantly Undervalued

If you just look at Eaton's share price you might think the sky was falling, as shares are down 20% year-to-date. This drastic share decline is much worse than the 4% decline in the Industrials industry (measured by Industrial Select Sector SPDR ETF (XLI)), and it has also left shares significantly undervalued. At its current price of $53/share, Eaton Corporation has a price to economic book value (PEBV) ratio of 0.9. This ratio means that the market expects the company's profits to permanently decline by 10% over its remaining corporate life. This expectation seems rather pessimistic given that Eaton has consistently grown profits between multiple economic cycles during the past decade.

Expectations also look pessimistic compared to historical levels. For the first time since 2008, ETN trades below its economic book value, or no growth value. Details are in Figure 2. We think shares are set to return to a more normal valuation.

Figure 2: ETN's Economic Book Value Surpasses Share Price



Sources: New Constructs, LLC and company filings

If Eaton can grow NOPAT by just 7% compounded annually for the next decade, the stock is worth $69/share today – a 30% upside. This scenario seems reasonable given that Eaton has grown NOPAT by 14% compounded annually over the preceding decade.

Insider Trends/ Short Sales Raise No Red Flags

Over the past six months, insiders have purchased ~3,000 shares and sold ~40,000 shares for a net effect of ~37,000 insider shares sold. This amount represents less than 1% of shares outstanding. Additionally, short interest sits at just 7.2 million shares, or just above 1% of shares outstanding.

Executive Compensation Passes The Test

Eaton's executive compensation could be improved if the performance metrics focused on a better determinant of shareholder value such as ROIC. Nevertheless, the current executive compensation plan is no cause for alarm. Eaton executives receive nearly 90% of their pay in performance-based awards, either cash or stock units. Short-term cash awards are given based upon meeting target net income, earnings per share (EPS), and cash flow return on gross capital metrics. Long-term cash incentives and equity awards are given based upon the above metrics as well as the compound growth rate of operating EPS over a four-year period and the average annual cash flow return over a four-year period.

Share Repurchases and Dividends Provide Excellent Yield

In 2013, Eaton authorized a 40 million-share repurchase program. Under this authorization, Eaton repurchased 9.6 million shares in 2014 ($650 million) and another 2.4 million ($170 million) in 2015. Eaton currently has 28 million shares remaining for repurchase under the 2013 authorization. At current prices, the 28 million-share buyback would represent $1.5 billion. If Eaton were to buyback shares consistent with 2014 levels, the current authorization would last another three years and cost ~$509 million each year. $509 million represents 2% of the current market cap, which provides investors a total yield of ~6.1% when combined with Eaton's 4.09% dividend yield. A 6.1% yield provides a nice margin of safety for investors while current economic conditions remain suppressed.

Overly Negative Expectations Will Cause Shares To Rise

Taking all the above into account, it is clear that the market expects Eaton to struggle for quite some time. With such low expectations, and management being upfront about their muted revenue and profit growth guidance, we think all the bad news is more than fully priced in. Between restructuring savings, additional savings from the integration of Cooper Industries, or the share repurchase and dividend yield outlined below, there are many catalysts on the horizon that should push ETN higher. Each of these catalysts also ignores the potential for any uptick in global economic growth, which unless you believe we will forever be in a stagnating economy, is likely to occur in the near future. Buying a company like Eaton while shares are beaten down this low should provide an excellent long-term holding.

Impact of Footnotes Adjustments and Forensic Accounting

We have made several adjustments to Eaton Corporation's 2014 10-K. The adjustments are:

Income Statement: we made $2.3 billion adjustments with a net effect of removing $817 million of non-operating expenses. The largest adjustment was the removal of $154 million (1% of revenue) in hidden non-operating expenses related to acquisition integration charges. This non-operating charge must be removed to calculate the true recurring cash flows from operations.

Balance Sheet: we made $5.8 billion of balance sheet adjustments to calculate invested capital with a net increase of $4.1 billion. The largest adjustment made was the removal of $2.9 billion due to other comprehensive income/loss. This adjustment represented 10% of reported net assets.

Valuation: we made five adjustments that decreased shareholder value by $12.2 billion. There were no value-increasing adjustments. The most notable adjustment to shareholder value was the removal of $2.3 billion due to underfunded pensions, which represents 9% of Eaton Corporation's market cap.

Attractive Funds That Hold ETN

The following funds receive our Attractive-or-better rating and allocate significantly to Eaton Corporation.

1. Advisors' Inner Circle Frost Value Equity Fund (FIDVX) – 3.8% allocation and Attractive rating
2. Matrix Advisors Value Fund (MAVFX) – 3.2% allocation and Very Attractive rating
3. Wasatch Funds Large Cap Value Fund (WILCX) –3.1% allocation and Attractive rating.

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

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

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Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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