Position Update: Lear Corp (LEA)

Lear Corp (LEA: $173/share) – Maintaining Long Position – Up 54% vs. S&P +18%

Lear Corp was selected as a Long Idea on 6/22/16 and was reiterated on 9/22/17. The stock was downgraded to Neutral (from Very Attractive) on 10/26/17 due to lower profitability in its most recent 10-Q. Specifically, return on invested capital (ROIC) fell slightly to 18.6% TTM from 19.1% in 2016.

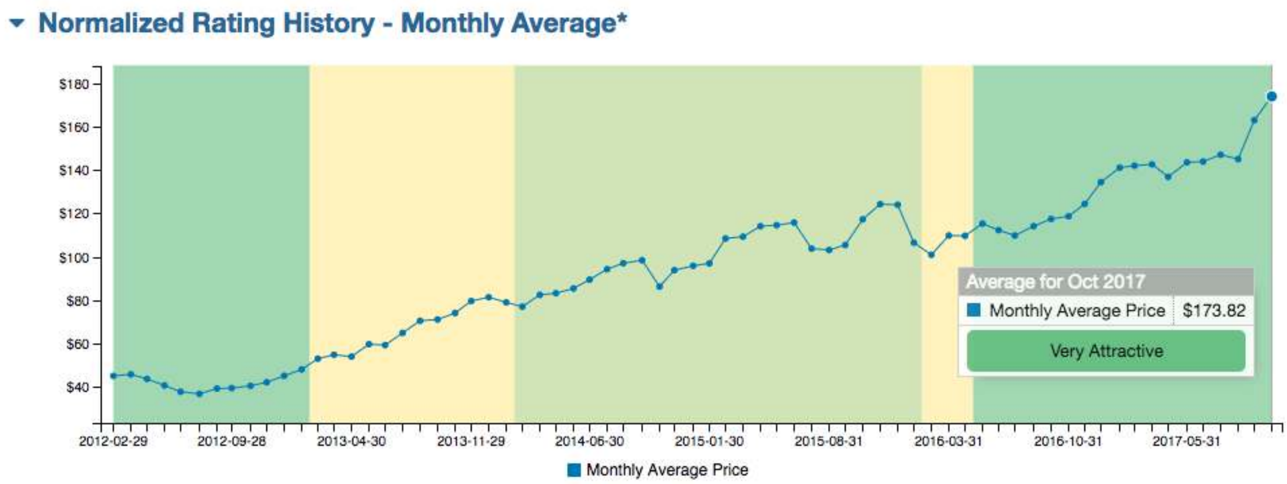
Despite the downgrade, we are maintaining our Long recommendation largely because LEA remains significantly undervalued and the business' fundamentals remain strong. In 3Q17, management increased their fiscal 2017 revenue guidance in part due to increased European production. Furthermore, the current 0.8 price-to-economic book value ratio (PEBV) means LEA is priced for a permanent 20% decline in after-tax profits (NOPAT). This expectation remains unduly pessimistic as LEA has grown after-tax profit 11% compounded annually since 2010.

As we noted in our prior update, there are strong market trends that support continued growth in Lear's profits:

1. Technology now standard in entry-level cars (once reserved for luxury vehicles) creates the need for additional electrical wiring.
2. Increased safety standards lead to increased demand for advanced seating systems.
3. The continued expansion of electric vehicles presents opportunity for Lear. Management noted in its 2Q17 conference call that an EV contains anywhere from $1,500-$2000 in Lear electronics, which is up from $500-$700 in average vehicles.

In light of these positive industry trends, we believe our original investment thesis remains intact. The thesis highlighted 1) history of consistent profit growth; 2) executive's incentivized to create shareholder value; 3) buyback and dividend providing a healthy yield; and 4) the company's undervalued stock price.

Figure 1: LEA Stock Price and Risk/Reward Rating History



Sources: New Constructs, LLC and company filings

As LEA remains positioned to grow profits the low valuation combined with a favorable fundamental outlook continues to present an attractive risk/reward trade-off for investors. If LEA can maintain TTM NOPAT margins (6%) and grow NOPAT by just 4% compounded annually over the next decade, the stock is worth $229/share today – a 33% upside. This expectation may prove conservative given the growth opportunities outlined above.

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

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