3 Outperforming Long Ideas with More Room to Run

Our Long Idea reports aim to identify firms that, despite market fears, unimpressive GAAP earnings, and other noise, have profitable businesses and highly undervalued stock prices.

Last week, we examined our worst Long Idea picks from 2019. This week, we're taking some victory laps and looking at picks that outperformed last year, each of which we remain bullish on heading into 2020. Lumentum Holdings (LITE), Builders FirstSource (BLDR), and Target (TGT) are the Long Idea highlights from 2019.

Highlight 1: Lumentum Holdings (LITE) – first published January 23: Up 72% vs. S&P up 22% through Dec 31, 2019

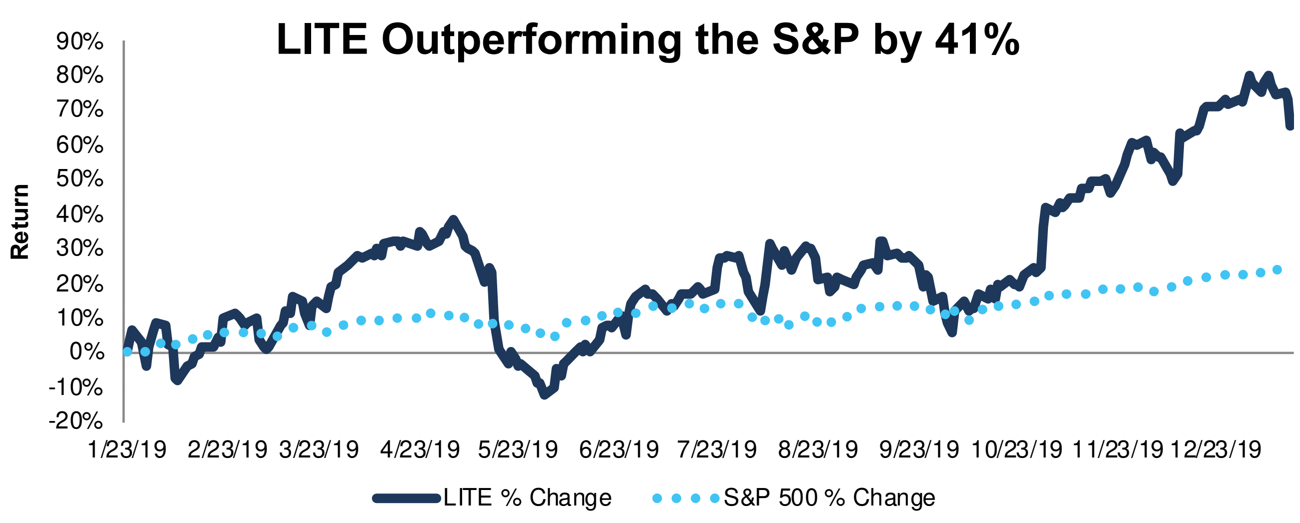
For the second straight year, the first Long Idea we published in 2019 was also our top performer.

In 2018, we made Oclaro our first Long Idea of the year and highlighted it as a potential acquisition target. Sure enough, our prediction came true, and Lumentum (LITE) acquired Oclaro just two months later, giving us a 39% gain.

At the time, we thought LITE was too expensive, but the stock dropped 35% over the rest of 2018. On January 23, 2019, we first made the stock a Long Idea in our article, "The Market Is Missing the Growth Potential For this Tech Leader."

We believed the company had significant growth opportunities for its vertical-cavity surface-emitting lasers (VCSELs) as more phone makers adopted the 3D sensing technology that powers the iPhone's FaceID. Sure enough, Samsung, Huawei, and Sony all announced plans to bring 3D sensing to their new high-end phones. These new products, along with continued strength in LITE's fiber-optic networking products due to the build out of 5G, drove the stock higher. Figure 1 shows the stock's outperformance vs. the S&P 500 since our article.

Figure 1: Stock Price Performance of LITE Vs. the S&P 500: 1/23/19-1/15/20



Sources: New Constructs, LLC and company filings

While the stock performed well based on this positive outlook, LITE's after-tax operating profit (NOPAT) declined by 59% over the trailing-twelve months (TTM) period. A cyclical downturn in demand for the company's semiconductor products, the impact of China tariffs, the ongoing integration of Oclaro, and the divestiture of a number of underperforming products all combined to drive the company's profits down over the past year.

Notably, these factors are temporary, which is why we remain bullish on LITE despite the fact that its declining profits and rising stock price cause the stock to earn an Unattractive rating in our system. While we usually close Long Ideas when they are downgraded by our stock rating methodology, if we think the issues are temporary and there are positive qualitative factors that outweigh the valuation, we may keep them open. Sanderson Farms (SAFM) – which was up 42% last year despite its Unattractive rating – is another good example of a Long Idea with an Unattractive Rating.

We don't want to take our gains too early on a stock that is on the forefront of two emerging trends – 3D sensing and 5G – that should continue to grow rapidly in the coming years. In the past, we've made the mistake of closing out positions too early on rapid gainers – most notably with Nvidia (NVDA) – due to valuation, and we don't want to repeat that mistake with LITE.

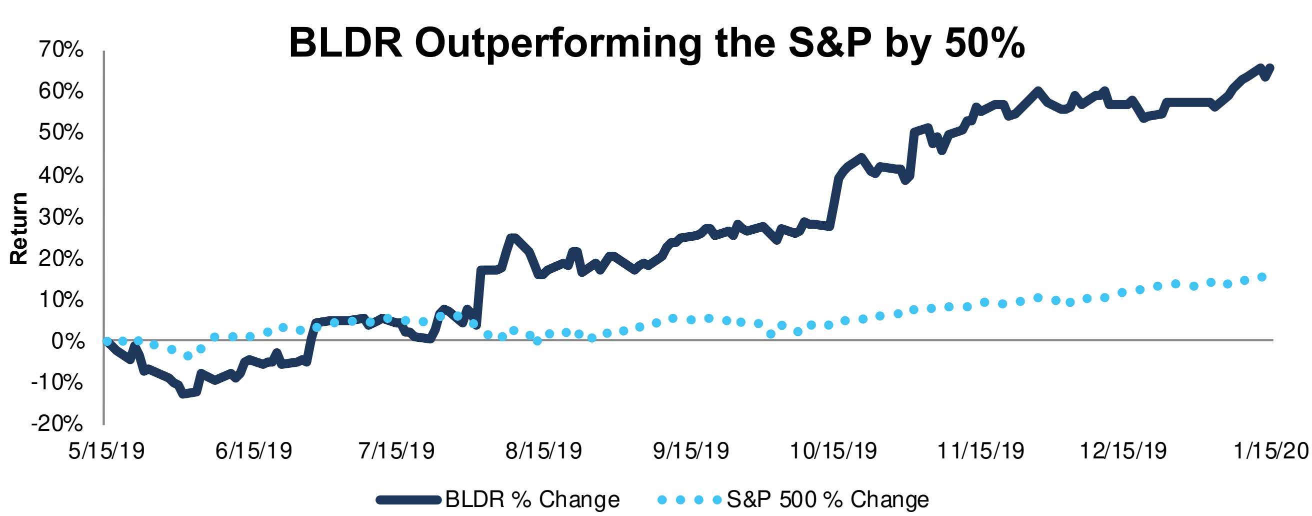
Highlight 2: Builders FirstSource (BLDR) – first published May 15: Up 57% vs. S&P up 13% through December 31, 2019

We first made BLDR a Long Idea in our May 15 article "Seeing Fundamental Value Through the Noise." We argued that investors were overrating the possibility of a housing market crash and underrating the fundamental strength of BLDR's business.

Specifically, we highlighted the shift to manufactured products and other higher-margin products – as opposed to simple lumber goods – as a boon to BLDR that would help offset any industry weakness. Sure enough, the shift to these higher margin products helped BLDR grow NOPAT by 16% over the trailing twelve month (TTM) period even as revenue declined by 5%.

This profit growth, combined with encouraging data on new housing construction at the end of the year, helped drive BLDR to an all-time high. Figure 2 shows the stock's outperformance vs. the S&P 500 since our article.

Figure 2: Stock Price Performance of BLDR Vs. the S&P 500: 5/15/19-1/15/20



Sources: New Constructs, LLC and company filings

Even after the increase in the stock price, BLDR remains a great value. At its current price of $26/share, BLDR has a price to economic book value (PEBV) of just 0.9. This ratio means the market expects NOPAT to permanently decline by 10%. This expectation seems pessimistic for a company that has grown NOPAT by 10% compounded annually since 2005.

If BLDR can maintain current NOPAT margins of 4% and grow NOPAT by just 2.5% compounded annually over the next decade (a quarter of its historical growth rate), the stock is worth $35/share today, a 32% upside to the current stock price. See the math behind this dynamic DCF scenario.

The combination of strong fundamentals and further upside implied by the valuation means BLDR continues to earn our Very Attractive rating.

Highlight 3: Target (TGT) – first published June 5 – updated August 28: Up 50% vs. S&P up 14% through December 31. 2019

We initially selected Target as a Long Idea on April 28, 2015. We were optimistic about the company's improving return on invested capital (ROIC), cheap valuation, and the prospect of continued growth in consumer spending.

We also liked that the company aligns executives' interests with those of shareholders by tying executive compensation to ROIC.

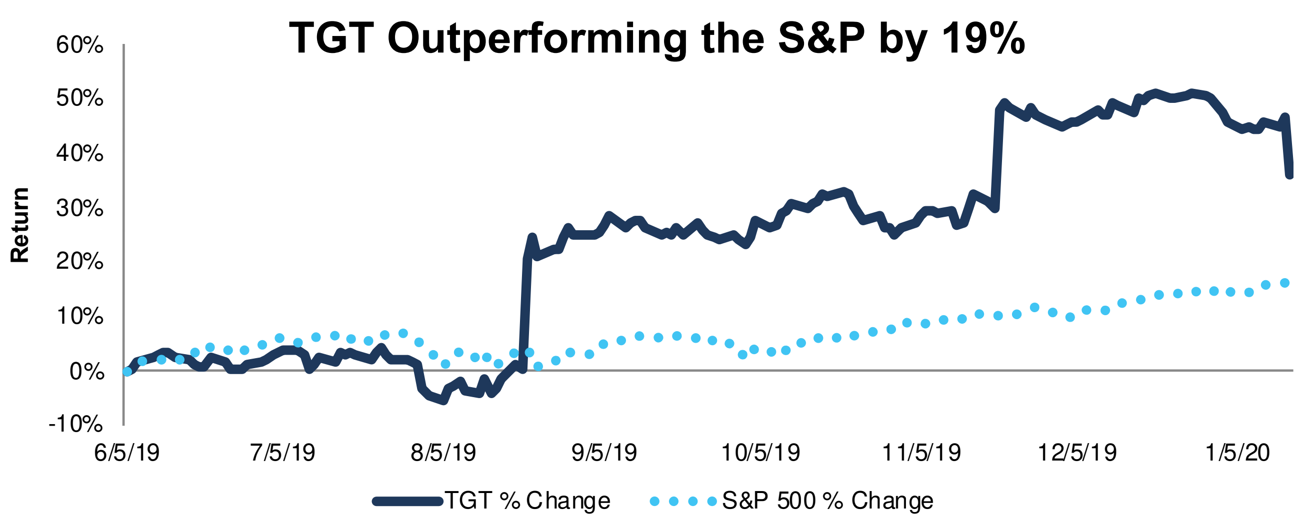
Over the following three years, TGT declined by 13%, and we closed our recommendation on May 7, 2018, after the company's ROIC declined from 10% to 9% due to a $300 million (9%) decline in NOPAT in 2017. It seemed as if our optimism had been misplaced and the company was losing ground to its competitors, most notably Walmart (WMT).

However, the company showed signs of a successful turnaround in 2019, so we re-opened the position on June 5 in our article "This Retail Giant Is Firing on All Cylinders." We focused on how the company's investments in store remodels and e-commerce were able to drive sales growth and higher margins.

Sure enough, TGT blew away expectations in each of its following two earnings report. The stock jumped 20% after reporting same-store sales growth of 3.4% in Q2, and then it jumped a further 14% after hitting 4.5% same-store sales growth in Q3.

The stock dropped 7% on January 15 after the company reported holiday comparable sales growth of 1.4%, which was below analyst expectations of 3.8%. Even after this drop, TGT has significantly outperformed the market. Figure 3 shows the stock's outperformance vs. the S&P 500 since our article.

Figure 3: Stock Price Performance of TGT Vs. the S&P 500: 6/5/19-1/15/20



Sources: New Constructs, LLC and company filings

Even though TGT's recent numbers disappointed, it's still growing sales and profits at a healthy rate. This growth, along with rising NOPAT margins, helped drive TGT's ROIC to 11% over the TTM period, its highest level since 2007. Since TGT added ROIC to its executive compensation plan in 2014, the company has increased its ROIC from 7% to 11% and improved its ROIC in every year but one. The stock is up 113% since that time, compared to the S&P 500 up 66%. This long-term outperformance shows the importance of corporate governance.

Target has opportunities to grow sales through store remodels, continued gains in e-commerce market share, and the opening of new small-format stores. We expect TGT to regain its momentum and continue to outperform in 2020.

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Disclosure: Sam McBride owns LITE. David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, sector or theme.

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