Stock Pick of the Week: Alliance Fiber Optic Products (AFOP)

Our stock pick this week is a small, quickly growing company in an increasingly important industry. This company designs, manufactures, and sells the basic components that are building the network of the future: fiber optic switches, connectors, filters, and other items. This company's stock is currently on the uptick after concerns over its industry's M&A activity has given way to rising sales. With some of the highest returns on capital in our system, this week's stock pick of the week is Alliance Fiber Optic Products (AFOP).

Why You Should Care About Fiber Optic Products

The demand for data and internet-based services around the world is constantly increasing, and with that increase comes a need for an infrastructure that is able to accommodate all of that data. This is where fiber optic comes in. While traditional copper-based telecom networks were designed to accommodate low-data voice traffic, fiber optic networks have much greater bandwidth that is able to handle the increased amount of data being sent by businesses, governments, and individuals. Alliance Fiber Optic makes key high-performance components of fiber optic networks, catering especially to data-hungry businesses. The number of fiber optic connections in the United States grew 12% from June 2012-2013.

What Makes Alliance Fiber Optic So Special?

Alliance Fiber Optic's selling point is that it is specifically focused on designing the best and most flexible fiber optic components at scale. Management's previous experience in manufacturing operations backs up this claim and allows the company to achieve high margins and returns on capital in a business that otherwise would be prone to commoditization.

This expertise has translated well into financial success. Alliance Fiber Optic Products currently has a return on invested capital (ROIC) of 82%, one of the top 15 stocks in this respect out of the 3,000 or so stocks we cover. Alliance's ROIC has risen almost every single year from 5% since 2007. Since 2007, the company has grown its annual after-tax profits (NOPAT) at a rate of 46% compounded annually and its margins from 5% to 25%. On a trailing 12-month (TTM) basis, Alliance has earned a NOPAT of $29 million and NOPAT margins of 25%.

With this profitability has come cash: Alliance brought in $20 million in free cash flow on a TTM basis and $77 million since 2007.

Quarterly Results Indicate Now is the Time to Go Long

In its last quarterly earnings update on February 4, Alliance missed slightly on revenues, which were down 14% year over year, but posted full year 2014 revenues that were up 13% over 2013. Alliance also upped its guidance for 2015 and said that it expects sequential quarterly sales growth for a record 2015. Given Alliance's high margins, this should translate into record profits as well.

Not Without Its Risks

Alliance, with its $313 million market value, is a small cap company, and these companies tend to be prone to larger jumps and drops over the short term. Long-term investors should be prepared to weather the storms that come with the territory in smaller cap stocks. Only three Wall Street analysts only cover the company, so earnings forecasts for the company will likely be even less reliable than for other companies with larger coverage. As a result, investors should give even less credence to EPS beats and misses than usual.

In its latest SEC filing, AFOP states that its top 10 customers accounted for 76% of its revenues in the last nine months, and that its largest and second-largest customers accounted for 41% and 10% of its revenues, respectively. This means that changes at any the company's top customers could result in a dramatic swing in Alliance's revenues. A good sign is that this concentration seems to be fading, as over the past three months Alliance's top customer accounted for just 36% of revenues.

The top customer is widely rumored to be Google (GOOGL) (some sources like Zacks have confirmed this rumor), whose new rollout of its Google Fiber product in several new cities this year bodes well for Alliance. This rumor is strengthened by the timing of Alliance's increased guidance and Google's Fiber rollout. In addition, the further rollout of Google Fiber will pressure larger telecom companies like Comcast (CMCSA) and AT&T (T) to upgrade their network to compete.

Current Valuation Provides Attractive Entry Point

AFOP is trading 16% higher since its earnings release, but the good news is that the company is still significantly undervalued and that plenty of upside remains in 2015.

At its current price of $17/share, AFOP has a price to economic book value (PEBV) ratio of under 0.9. This implies that the market expects Alliance's NOPAT to permanently decline by over 10%. This seems extremely pessimistic given the general trajectory of the fiber optic component industry and Alliance's recently issued guidance. While AFOP trades at a rich price to earnings ratio of 19, we believe that this simplistic ratio neglects the value in 1) Alliance's growing cash balance and 2) its NOPAT, which is 12% higher than the company's GAAP earnings on a TTM basis.

If Alliance can grow NOPAT by just 8% compounded annually for the next 12 years (far below its historical average), and when accounting for the lower margins due to the increased taxes Alliance will need to pay, the stock is worth $27/share — a 59% upside from current levels. Even with minimal growth expectations, AFOP is worth much more than its current share price would indicate.

Disclosure: David Trainer André Rouillard receive no compensation to write about any specific stock, style, or theme.

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