Stock Pick of the Week: Lear Corporation (LEA)

Unless you live in an area with ample amounts of public transportation, odds are you drive a car at least once a day. If you ever pause to think about all the components being used by your car, it can be quite astonishing. The number of electrical components, amount of individual pieces, and materials going into a car would probably surprise most of us. Identifying these components, however, could lead you to a great investing opportunity. This identification process has led us to this week's stock pick of the week: Lear Corporation (LEA).

What is Lear Corporation?

Lear Corporation, founded in 1917 in Detroit, is a leading supplier to the global automotive industry. The company supplies seating and electrical distribution systems to every major automotive manufacturer in the world. They have operations in 34 countries and are one of only two independent seat suppliers with global scale. In the electrical segment Lear is one of only four suppliers with operations in every major auto region. This large global reach gives Lear a unique advantage in the industry, mainly the ability to provide products so such a wide customer base at any location. Lear's seating products make up around 75% of the company's total sales with the electrical components consisting of the rest of revenues.

Why Invest Now?

Lear Corporation's success is heavily tied to the success of the global automotive market. This ultimately comes down to the global demand for new automobiles. 2014 continued the growth in the automotive market that has been seen since 2008, and IHS Automotive estimates the market will continue to grow into 2015. While demand is expected to vary from region to region, Lear will benefit from overall market growth as it supplies many of the different regions across the globe. Growing demand for vehicles will increase demand for Lear's products.

Aside from vehicle sales, the continued evolution and innovation within cars stands to benefit Lear as well. As cars become more complex with new features to meet consumer demands, so does their electrical and wiring systems. The more wiring needed in a car, the more Lear's products and services will be required.

How Fundamentally Strong is Lear?

In 2014, Lear saw strong growth in both revenues and profits. Sales of seating components were up 11% year over year (YOY) and electrical sales were up 5%. Even better, Lear grew after-tax profit (NOPAT) by 36% in 2014 when compared to the prior year. Lear currently earns a top quintile return on invested capital (ROIC) of 17%.

This recent growth is nothing new to Lear either. Due to increased consumer demand and growth in the overall technological complexity of cars mentioned above, Lear has had an excellent track record since going public in 2009. Over this time frame, Lear has grown NOPAT by 7% compounded annually, and has generated positive economic earnings every year since going public.

We Made These Adjustments to Lear'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 major adjustments to Lear's earnings in 2014:

- Removed $98 million in non-operating expense hidden in operating earnings.
- Removed $142 million in reported non-operating items.
- Adjusted taxes by $127 million due to the removal of certain non-operating expenses.

When considering Lear's valuation, we also added $368 million in off-balance sheet debt (17% of Lear's total debt) from operating leases to Lear's total debt.

Buying Opportunity

Lear's stock price has been on a great run in 2015 and is up over 18%, but we think shares could go much higher. At its current price of $115/share, Lear has a price to economic book value (PEBV) ratio of only 1.2. This ratio implies that the market expects Lear's NOPAT to grow by only 20% from current levels. Given that Lear grew NOPAT by over 30% in 2014 alone, we the market's expectations are too pessimistic.

If Lear can grow NOPAT by 7% compounded annually for the next eight years, the stock is worth $140/share today — a 22% upside. This growth would also represent the average NOPAT growth of the last five years, something Lear could be poised to repeat or even exceed moving forward.

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

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