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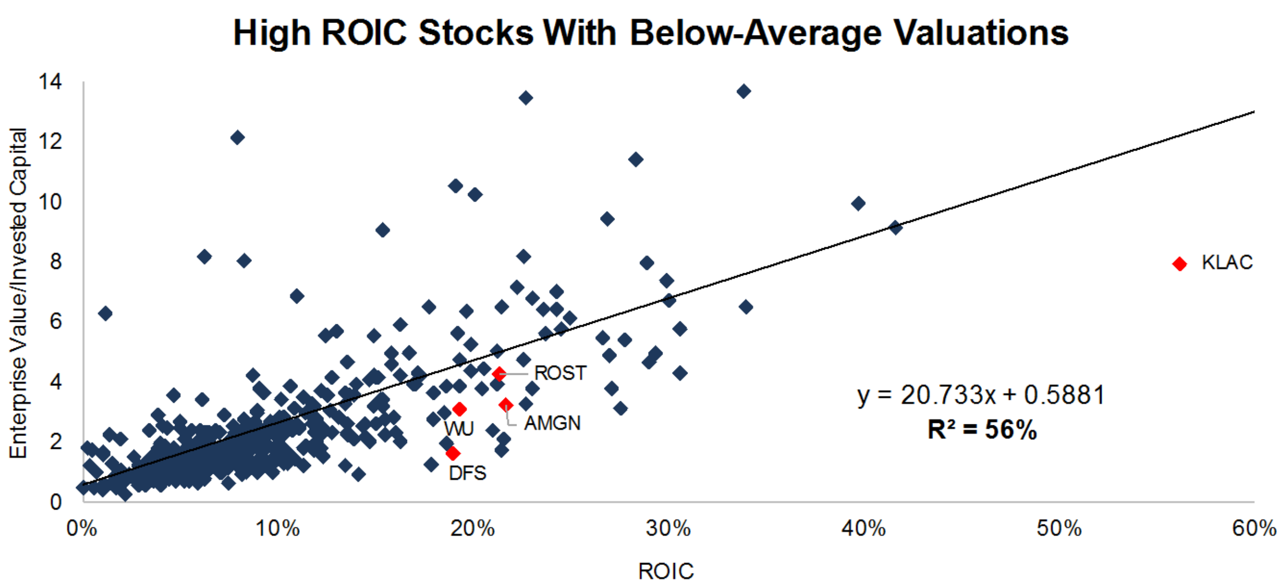
5 Unappreciated Stocks With High ROICs

These are difficult times for value investors. Stock prices keep rising as profits stagnate. Overvalued stocks such as Netflix (NFLX: $147/share) continue to make new highs. Even legendary value investor Jeremy Grantham seems to have thrown in the towel. Earlier this month, Goldman Sachs issued a report titled "The Death of Value."

Our message to value investors: don't despair. Value investing isn't dead—but it has gotten harder. In order to find value, investors need to look beyond the widely-available and misleading accounting results on which most people focus. It's time to get back to the basics of reading footnotes and focusing on economic earnings and return on invested capital (ROIC), the true drivers of valuation.

Figure 1 shows that changes in ROIC explain 56% of the difference in enterprise value per invested capital (a cleaner version of price-to-book) for the S&P 500. It also identifies five stocks with high ROIC's trading well below their implied valuation.

Figure 1: ROIC Vs. Valuation For The S&P 500



Sources: New Constructs, LLC and company filings.

These five stocks are not only undervalued according to this regression analysis, they also share a couple other positive traits:

- All five of these stocks have ROIC's in the top 20% of the roughly 3,000 stocks under our coverage.
- They all have increased their ROIC over the past twelve months.
- All five earn our Very Attractive rating.

Investors looking for value in this overextended market should start with these stocks.

KLA-Tencor (KLAC: $93/share)

KLA-Tencor is the largest player in the semiconductor process control segment, owning over 50% of the market. This dominant share has allowed the company to earn impressive margins and grow its ROIC from 29% in 2013 to its current level of 56%.

If KLAC was valued at the level implied by the trend line in Figure 1, it would be worth ~$148/share today, 59% above its current valuation. KLAC's current price implies that its ROIC will permanently decline to 36%.

With the positive tailwinds in the semiconductor equipment industry, KLAC should be able to surpass the market's pessimistic expectations.

Amgen (AMGN: $171/share)

We recommended Amgen to investors back in May, and the stock continues to be one of our top picks. Amgen's 22% ROIC is among the best in the large-cap pharmaceutical industry, and it's undervalued against both its peers and the broader market.

If AMGN was valued at the level implied by the trend line in Figure 1, it would be worth ~$270/share today, 58% above its current valuation. AMGN's current price implies that its ROIC will permanently decline to 13%, a lower level than the company has earned in any year since 2004.

Ross Stores (ROST: $57/share)

Ross is one of the few retailers still thriving in an Amazon-dominated world. The company has maintained an ROIC at or above 20% for seven straight years while growing revenue at about 8% a year compounded annually.

Despite this strong operating performance, ROST still trades at a discount price. According to the regression in Figure 1, ROST should be worth ~$67/share, 19% above its current valuation. ROST's current price implies that its ROIC will permanently decline to 18%.

Western Union (WU: $19/share)

Despite its reputation as an outdated relic, Western Union still has a highly profitable money transfer business and a digital channel growing at 22% a year. The company's ROIC declined over the past several years, but it seems to have reached an inflection point, especially as global remittances look to reverse their recent downtrend in 2017.

With its 19% ROIC, WU should be valued at $31/share according to Figure 1, 64% above its current stock price. The company's current valuation implies that its ROIC will permanently decline to 12%.

Discover Financial Services (DFS: $61/share)

Customer loyalty is crucial in the credit card business, and Discover has ranked first in credit card customer satisfaction for three straight years. This loyalty has helped DFS maintain a consistent ROIC of ~19% over the past several years while steadily increasing its invested capital.

If DFS was valued at the level implied by the trend line in Figure 1, it would be worth ~$167/share today, 174% above its current valuation. Even if investors think consumer credit is due for another pullback, this stock looks cheap. Its valuation implies ROIC will decline to 5%, even below the company's profitability in 2009.

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Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

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