Long Idea Highlights From 2018

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 2018. This week, we're taking some victory laps and looking at our picks that outperformed in a down market last year. These are the Long Idea highlights from 2018.

Highlight 1: Oclaro, Inc. (OCLR) – published January 17 – closed April 5: Up 39% vs. S&P down 6%

Our first Long Idea of 2018 was also our best performer. We felt that the market was underrating the value of Oclaro's first mover advantage in 100 gigabit/second optical transmission components. We argued that, even if margins declined from their record-high levels, Oclaro had enough growth opportunities to make up for the decline.

We also touted the stock as a potential acquisition target, writing:

"OCLR's cheap valuation could make it an appealing acquisition target. A number of larger names in the industry might jump at the chance to expand their 100 Gbps capability at a discount. The most rumored names are Finisar (FNSR) and Lumentum (LITE)."

Our thesis was vindicated in less than two months when Lumentum (LITE: $46/share) announced that it would buy Oclaro for $1.7 billion, a 25% premium to its valuation at the time. We kept the position open for another month, in hopes that a bidding war would materialize, but we eventually closed the position on April 5 for a 39% gain.

At the time, we said that the acquisition was positive for LITE, but that its valuation was too expensive for us to recommend the stock. However, LITE has dropped 25% since then due, in large part, to fears over slowing iPhone sales – Apple (AAPL) is LITE's largest customer and accounted for 30% of revenue in 2018. As a result of this cheaper valuation, LITE now earns our Very Attractive rating.

Investors can no longer buy OCLR, but at its newly cheap valuation, LITE shows signs of being a good investment as well. Look for us to dig into this stock more deeply in the near future.

Highlight 2: Amgen (AMGN) – published March 21 – reiterated December 19: Up 7% vs. S&P down 8%

We first recommended Amgen (AMGN: $199/share) on May 8, 2017, and it's been one of our top picks ever since. On March 21 of this year, we featured AMGN as one of three stocks with understated earnings.

At the time, AMGN's economic earnings had grown 4% year-over-year while its GAAP net income was down 74% from the previous year. This disconnect was the byproduct of a number of accounting distortions, including:

- A $6.1 billion (27% of revenue) non-operating tax charge due to the 2017 tax reform law
- A $400 million (2% of revenue) write-down due the discontinuation of a prospective drug
- $234 million (1% of revenue) in other non-recurring expenses

The disconnect between economic and accounting earnings clouded the market's judgement and left AMGN undervalued. Despite a long-term track record of consistent net operating profit after tax (NOPAT) growth, the market valued the company as if it would never grow profits again.

Instead, AMGN has maintained its steady profit growth rate throughout 2018 while improving its capital allocation. TTM NOPAT is up 4% over the prior TTM period, and invested capital is down 6% over the same time. As a result, AMGN's TTM return on invested capital (ROIC) of 23% is its highest since 2001, and its free cash flow of $11.4 billion is the best of any year in our model, which goes back to 1998.

Best of all, in 2019, the company will begin using ROIC as an executive compensation performance metric, which will better align management's incentives with investors' interests.

Even though Amgen has outperformed both since our feature in March and since our original article (up 19% vs. S&P up 4%), we remain bullish on the stock and are keeping this position open.

Highlight 3: National Presto (NPK) – published June 6: Up 2% vs. S&P down 10%

A 2% gain may not be much to write home about, but considering that we recommended National Presto (NPK: $119/share) just a few months before the stock market entered a correction, we think it's a pretty solid return.

Just as with AMGN, our bullish thesis on NPK rested on misleading accounting earnings understating the firm's true profitability. When we wrote the article, GAAP EPS was down 18% TTM, but economic earnings were growing steadily. The main reason for this disconnect was an $8 million (3% of revenue) gain on sale from the first quarter of 2017 that artificially inflated the prior year's earnings.

In addition, earnings for the current year were artificially low due to $1.5 million in decreased reserves and other non-operating expenses.

Our segment analysis also showed that results for the company were dragged down by the underperforming Housewares segment. When we separated the two segments out, we found the Defense segment was one of the most profitable in the industry and worth more than the market cap of the entire company.

We also wrote that the pessimism over modifications to its 40mm ammunition contract with the Department of Defense were overblown, and that Defense segment should be able to maintain its high level of profitability.

At its current valuation of $119/share, NPK has a price to economic book value (PEBV) of 1. This ratio means that the market expects NPK's NOPAT to never grow from its present level. We believe this is an overly pessimistic expectation for a company with a long-term track record of growth and over $160 million (39% of market cap) in excess cash to invest in future growth opportunities. Our Long Idea thesis on NPK remains open.

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

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