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Ripening to re-rate

Sometimes short-term sentiment wanes towards companies where the structural drivers remain in place. This can be a buying opportunity and here we look at two stocks with enticing valuations and future profit drivers.

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There are many theories to investing. Some investors look for companies that have seen their share prices fall and bet the market hasn't spotted a potential recovery. Others choose the obviously fantastic companies, but are willing to pay the high price because they expect management to continue to compound through intelligent high return investments.

One of Berkshire Hathaway's most successful investments was its decisions to purchase Apple **(US:AAPL)** stock in 2016. For a while, its chairman Warren Buffett had refrained from buying tech stocks because he didn't feel he understood the companies in enough detail. However, by 2016 he concluded that Apple's brand strength and operating margins were too good to be looked over. Buffett might not have understood technology, but as his investment in **Coca-Cola (US:KO)** showed, he was a believer that a strong brand was an important economic moat.

Most importantly, there had just been a sell-off in Apple's shares. In 2016, its revenue dropped 7.7 per cent to $216bn. The iPhone 6 wasn't as popular as hoped and there was a concern the smartphone market was reaching saturation point. The result was that, despite having historical operating margins regularly over 30 per cent, Apple's forward price to earnings ratio dropped to 11, well below the S&P 500's then average of 17.

This was the ideal Buffett company. It generated a high return on its assets, had a strong brand but was valued well below the market and its historical average. His timing was impeccable. Since 2016, Apple revenue has increased 78 per cent, its operating profit has almost doubled, and its share price is up 700 per cent.

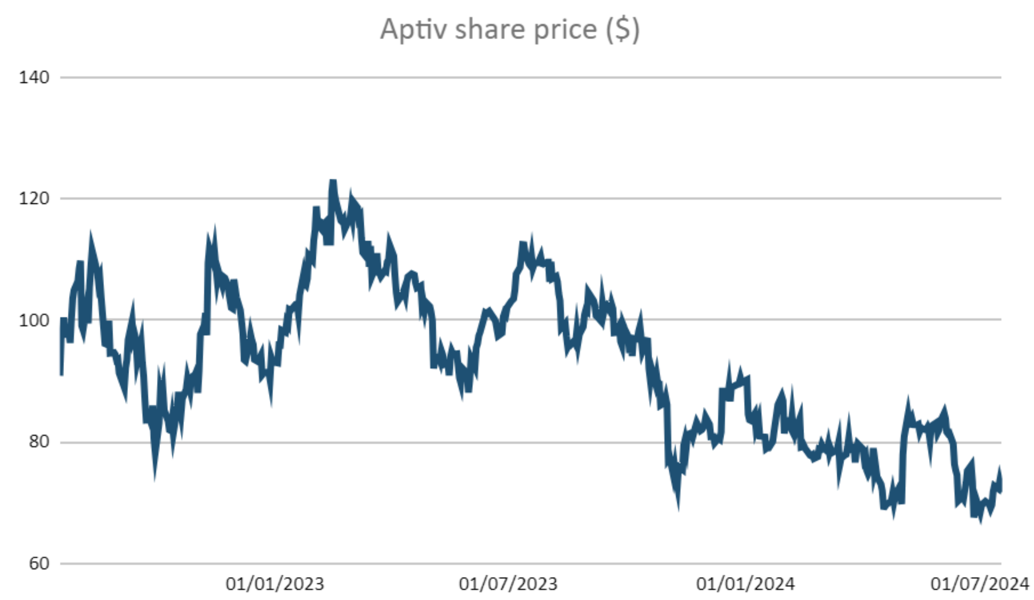
The assumption with Apple is that it has been on a continuous upwards trajectory since it released the iPhone in 2007. However, this investment from Buffett was a turnaround bet. The market thought its bad year in 2016 was indicative of a long-term weakness. Buffett believed it was an anomaly and Apple's strong return on invested capital meant it would find a productive way to reinvest its cash and re-accelerate growth.

In 2022, it was a similar high profile story with **Meta (US:META)**. The owner of Facebook, Instagram and WhatsApp had recently rebranded itself as Meta as a marketing ploy to promote its loss-making virtual reality business. This disturbed the market. Then in the three months to June 2022, Meta reported users had dropped fractionally quarter-on-quarter for the first time. The market responded by selling the stock dramatically.

On a forward earnings basis, Meta's valuation dropped from 23 at the start of the year to just 11 by November. This was despite a recent historical operating margin of over 30 per cent and return on invested capital consistently over 20 per cent. Meta then announced a cost-cutting programme, increased capex investment in AI and user growth returned. Its share price is up almost 200 per cent in the last two years.

It is not always possible to find exceptional companies trading on such reasonable valuations. However, often there are good companies that have been through a difficult year that offer great value. At the other end, there are fantastic companies that, although still expensive, will compound for years to come.

Aptiv (US:APTV)



Source: FactSet

Automotive software and hardware supplier **Aptiv (US:APTV)** has seen its valuation drop dramatically after a few quarters of slowing growth. The company's growth is tied to demand for electric vehicles (EV) and after rapid growth over the last few years, the excitement around the EV transition has waned.

Aptiv supplies car manufacturers with the hardware needed to electrify vehicles, including connectors, wiring and fuse boxes. It also sells the sensors, cameras and LiDAR (light detection and ranging systems) for parking, automated braking and full-autonomous driving, as well as the infotainment screens that display satellite navigation. Its customers include all the major car companies: **GM (US:GM)**, **Ford (US:F)**, **Volkswagen (DE:VOW)**, **Fiat (IT:FIA)** and **Tesla (US:TSLA)**.

Aptiv also provides software services that can be run from the cloud. This includes developing foundational AI models for autonomous driving, as well as vehicle-to-vehicle communications. In other words, it is trying to position itself as a one stop shop for the next generation of vehicle producers. It has a joint venture with **Hyundai (KO:5380)**. The venture is called Motional and designs and tests autonomous vehicle systems, including the software, hardware and sensor integration.

Slowdown offers buying chance

The future of cars is electric and autonomous, but the problem for investors is figuring out when this future will arrive. After a few years of rapid increase in electric vehicles (EV) sales, demand has pulled back, which has hit the share prices of companies involved across the EV supply chain. In the case of autonomous vehicles (AV), the picture is even less promising, with full self-driving technology yet to be proven.

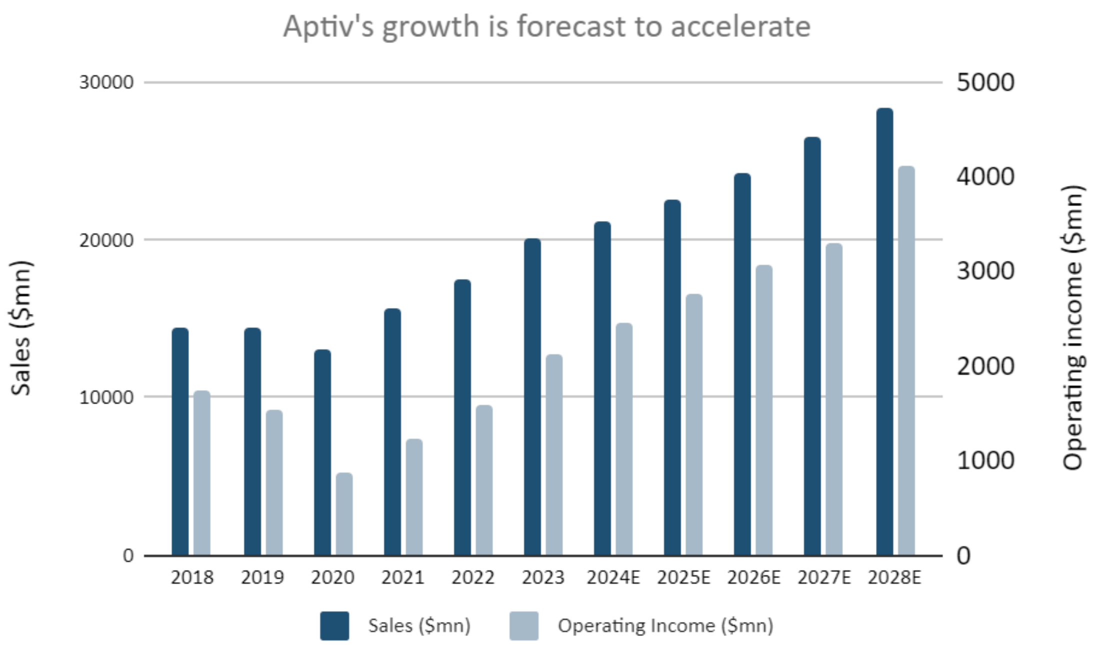
For the last few years, the issue for EV producers was making the vehicles fast enough. There was a significant chunk of the population that had been waiting to transition away from internal combustion engines and were just waiting to be supplied. Tesla's waiting lists were backed up for months and this came through in the overall numbers. In the first quarter of 2022, US electric EV sales rose 76 per cent year-on-year, according to data from Cox Automotive.

However, once these earlier adopters had been supplied and interest rate tightening started increasing the cost of financing, sales growth started to slow. In Q1 2023, sales rose 15 per cent year on year. However, things have slowed dramatically since then. In the same period in 2024, Y-o-Y sales growth dropped to just 1.7 per cent.

The market leader Tesla has suffered significantly. In the three months to March, revenue dropped 8.7 per cent from the same quarter a year earlier, to $21.3bn, and saw a big drop off from the 24 per cent rate of growth between Q1 2022 and Q1 2023 revenues.

Structural drivers still there

In the three months to March, Aptiv's revenue rose just 1.7 per cent from the same quarter a year earlier, to $4.9bn, and was down slightly from the $4.92bn it made in the final quarter of 2023 because of continued slowing of electric vehicle production. "The North American timeline has certainly been pushed out, and to some extent, maybe a bit of a pushout in Europe as well," said Aptiv's chief financial officer Joseph Massaro.



Source: FactSet

The uncertainty over the timeline of electrification means it has had to lower its full-year revenue guidance by $450mn. "We continue to believe that all regions are on the path to full electrification, some will move faster than others, so we consider it prudent to reduce near-term revenue expectations," said chief executive Kevin Clark.

The construction of a modern vehicle requires a lot more electronic parts than a traditional internal combustion engine vehicle. A Tesla Model 3 has 12 ultrasonic sensors, eight cameras and forward radar. There is also over a mile of wiring and more than 1,000 semiconductors. Ford, GM and Volkswagen are still playing catch-up in the EV and AV field, but this is what the modern car will look like.

Aptiv is the product of multiple spin-offs, starting in 1999 with Delphi Automotive from GM. It was part of GM's components group and then became an independent business selling a range of parts to other companies. Delphi went through a turbulent time. In 2005 it went bankrupt, before emerging again in 2009. In 2017 it split again: **Delphi Technologies (US:DLPH)** focused on power trains, while Aptiv would sell all the other components that go into a car, including safety systems, wiring, fuse boxes, cameras and software.

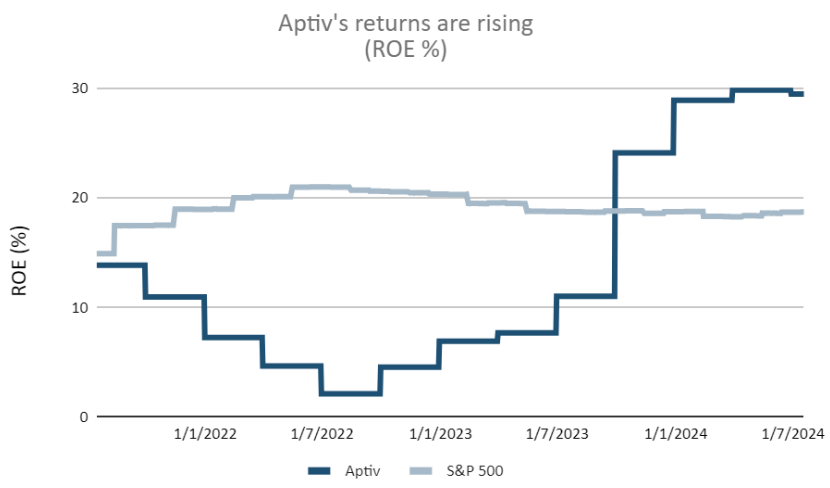
Post-Covid surge

In the first few years after the split Aptiv's revenue and profit growth was flat. However, the surge in investment in electronification, automation and connectivity, coupled with the pent-up savings consumers had to spend on cars, meant an acceleration in Aptiv's growth since the pandemic. Between year-ends 2020 and 2023, revenue rose 54 per cent to $20.1bn, while operating profit of $1.59bn is above pre-pandemic levels.

On top of this, car companies were investing heavily to speed up EV production as they tried to get in line with regulation timelines. For example, in the UK the government is requiring all manufacturers to produce zero emission cars and vans by 2035, with an interim target of 80 per cent by 2030.

However, in the short term, investment got ahead of itself and consumers have not yet caught up. Earlier this year, Ford cut back plans for its electric powered F-150 Lightning. Tesla is the only company yet to be able to make a significant profit on its cars, yet even it has seen its operating profit margin drop in the last year as it has had to cut prices to keep its inventory moving.

This has been reflected in Aptiv's slowing growth since its post-pandemic surge. Last quarter, revenue slowed because of a fall in revenue for high-voltage systems for EVs, which was down 2 per cent in North America and 6 per cent in Europe.

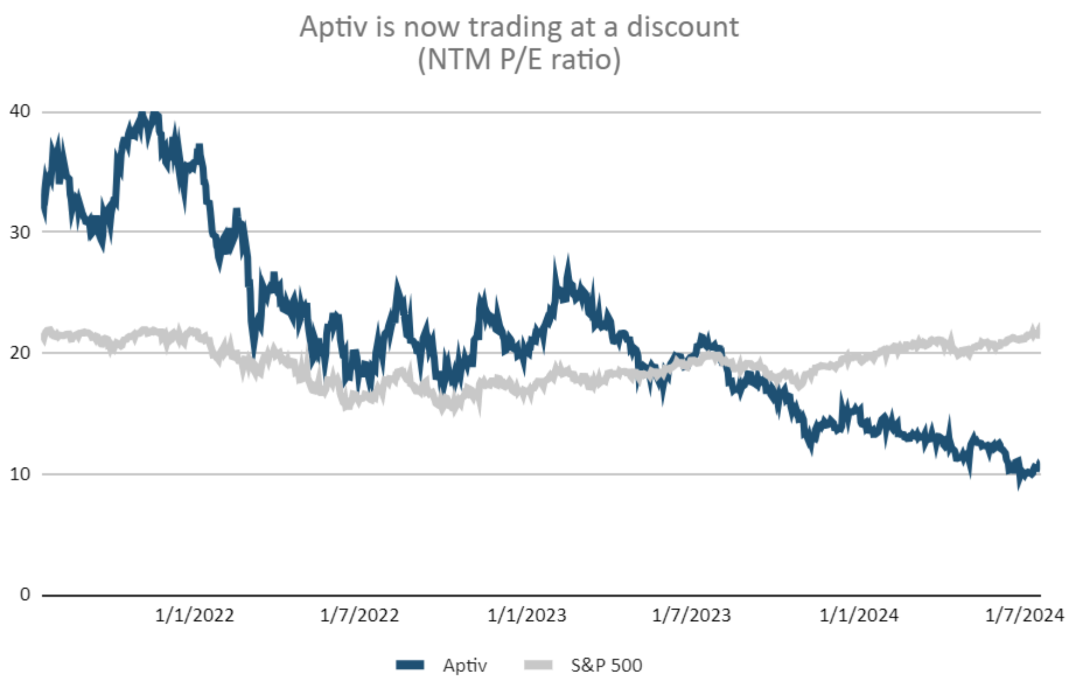


Source: FactSet

It has still managed to maintain profit growth by cutting back operating costs. Last year, it laid off 10 per cent of its workforce in response to the "softness of electric vehicle production schedules''. On top of this, a "rotation of engineering footprint to best cost locations", contributed to the adjusted operating profit rising 24 per cent from the same quarter a year earlier, to $544mn (GAAP operating profit was $419mn for the quarter).

Enticing valuation

Importantly for investors, this electric vehicle 'softness' means Aptiv's share price has fallen 34 per cent in the last year. This is despite the trend of profitability. Correspondingly, its valuation has dropped to an extremely affordable level. At the start of 2023, Aptiv was trading at 21 times its forward earnings and now it is down to just 10.



Source: FactSet

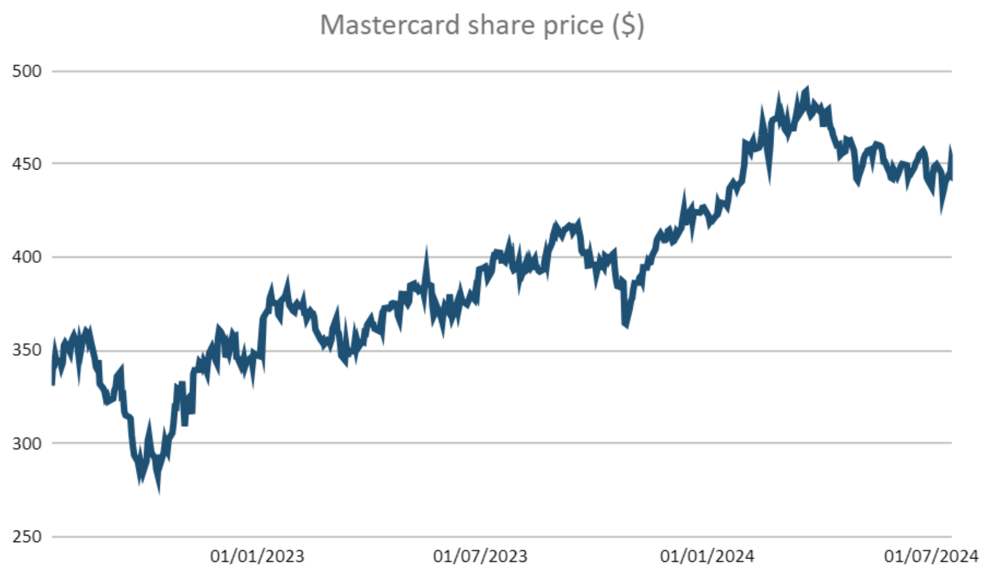
This fall in valuation means Aptiv appeared in the *Investors' Chronicle Alpha* 'growth at a reasonable price' screen at the end of May (although it has since dropped out). This looks at companies based on historical EPS growth, recent broker forecast upgrades and valuation. In 2025, the Factset consensus broker forecast is for EPS to rise to $6.02, up from $4.86 last year.

This 2025 forecast has risen 5 per cent since April. This is partly a reflection of analysts' confidence that the bottom of the EV market has been reached, but also because Aptiv sold a chunk of its Motional joint venture to Hyundai. "Exit Motional and cut the earnings losses from the joint venture and re-baseline expectations with a strong buyback and the stock can accelerate its recovery process," recommended Raymond James analysts in April.

Aptiv has since done all of this, and now looks set for a recovery. There is more than a fair argument that Tesla is overvalued at 90 times its forward earnings, but even if its forward PE contracted to 25 times it would still be more valuable than its three biggest rivals combined. Investors can quibble around the valuation gap and the relative speed of EV adoption, but the market has conviction because it's hard to deny that, at some point, automatically driven electric vehicles are the future.

For Aptiv, it benefits from the same fundamental thesis that underlines Tesla but at the fraction of the cost for investors. The other upside is that not all its business comes from EVs. Internal combustion engine vehicles are still using increasingly more electronics. The long-term growth drivers are structural, and the stock hasn't been this cheap for a decade, albeit the change in interest rate regime means we're in a fundamentally different environment for valuation.

Mastercard (US:MA)



Source: FactSet

Sometimes a successful company isn't that cheap, but if they can circulate strong cash flow back into high return investments then earnings will increase and the share price will keep rising. One sign a company is overly successful is that it is being litigated against, and **Mastercard (US:MA)** has been subject to actions.

A few years ago, Epic Games tried to sue **Apple (US:AAPL)** for its App Store fees, while last year the US Justice Department sued **Alphabet's (US:GOOGL)** Google for its monopoly position in the search market. For the last two decades, merchants have been trying to force Mastercard and **Visa (US:V)** to lower their transaction fees.

In March, Mastercard and Visa announced a settlement with US merchants which would lower and cap the fees they charge and allow small businesses to collectively bargain for rates. The credit card companies which dominate the payment industry charge a fixed fee on every transaction plus a percentage of the sales price. This deal which would cap the fee is estimated to reduce their combined swipe fees over the next five years by a total of $30bn.

However, this figure needs to be put into perspective. In 2023, Mastercard made $25.1bn in revenue, up 13 per cent from the year before. By 2027, FactSet broker estimates (which now include these legislated fee caps) is forecasting Mastercard's revenue to rise to $27.8bn.

Unbreakable duopoly

Alongside Visa, Mastercard is part of a duopoly which is almost impossible to break up. The issue is network effects. Mastercard has relationships with the banks and merchants. On top of this, almost 3.38bn consumers worldwide used Mastercard last quarter, which was up 8 per cent from last year. Banks and merchants can't afford not to accept them. Meanwhile, consumers can't afford to not have either a Visa or Mastercard as they want a guarantee their cards will be accepted everywhere.

So, the company is effectively a proxy for consumer spending and economic growth. The more people spend, the more money Mastercard makes. As its revenue is directly connected to spending, this also makes it an inflation hedge. This was Blue Whale Growth Funds' theory when it took its position in Mastercard last year. "The companies not only benefit from the structural changes to the world's payments systems, and the move to a cashless society, but they are also to benefit as inflation forces the consumer to ramp up their spend," wrote Blue Whale fund manager Stephen Yiu.

Given Mastercard is a proxy for economic growth there would be a concern it would be too dependent on one country and its administration. However, it is a global business. Of the $25bn Mastercard made last year, 33 per cent came from the US and the remaining 67 per cent came from international markets. Last quarter, US revenue grew 6 per cent year on year while the rest of the world was up 13 per cent. Of course, in this globalised world economies are rarely fully insulated from each other, but this geographic diversity provides a degree of resilience.

A main benefit of Mastercard is that it is effectively a technology company. This is reflected in its 96 per cent gross margins. In other words, each additional transaction costs almost nothing. This is why in the last few years, as revenue has increased its operating margin has expanded. Last year, it was 57.8 per cent, which was up for 56.6 per cent in 2022 and 53.9 per cent in 2021.

Strong return on investment

The high and improving margin is one of many signs that Mastercard is a high-quality business. In the last year, its return on invested capital (ROIC) was 57 per cent. In the 2023 fiscal year, cash conversion (cash flow from operations divided by net income) was 107 per cent. This strong cash generation helped its cash flow return on capital invested (CROCI) to 55 per cent. This basically means that for a dollar of investment it makes 55 cents back in cash. That's exceptionally high, and well ahead of the 20 per cent average for the S&P 500.

Recent Mastercard investments include building out its account-to-account (A2A) payments. This is a technology that allows businesses and consumers to transfer money directly between bank accounts. In 2020, Mastercard acquired North American open banking company Fincity for $825mn. Then in 2021, it bought European open banking Aiia. This recent acquisition spree is shown by the increase in goodwill on Mastercard's balance sheet, from $4bn in 2019 to being closer to $7.7bn last year.

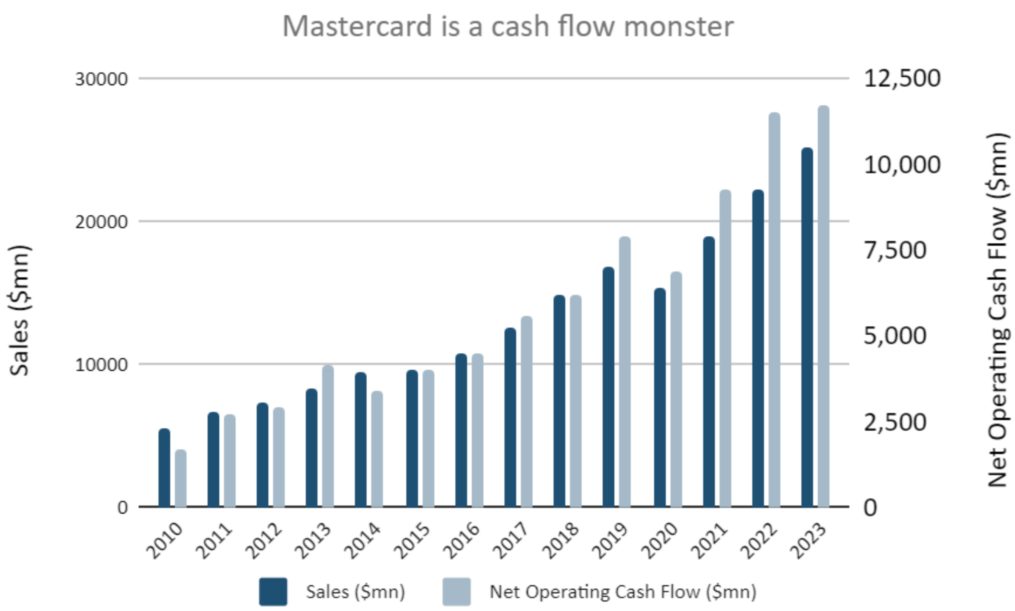
The benefit of A2A is it cuts out some of the middle parties. A2A are preferred for paying bills or setting up other forms of direct payment. The downside is it doesn't have the same protections as using a debit card, but the main thing for Mastercard is providing choice. "Consumers should get to choose what their preferred method of payment is at the end of the day, which is why we've made the advent into A2A payments," said chief financial officer Sachin Mehra.

The company will say it is trying to provide the best service possible to customers. The more cynical view is it's buying up potential competitors before they can reach a threatening size. A2A transactions could cut out the card companies but by acquiring these businesses Mastercard is preventing its duopoly position being disrupted.

The problem regulators have is that Mastercard and Visa provide the essential payment rails for commerce to function. And the system works better with only a few providers, rather than multiple parties all needing to negotiate with each other. Like other utilities providers, such as Thames Water, Mastercard is part of a natural monopoly. But unlike Thames Water, Mastercard doesn't have the same capital intensity. Meaning, it can generate significant cash flows.

Compared to the wider market, Mastercard looks expensive. It is trading at 31 times its forward earnings, compared to the S&P 500 at 22. However, alongside **Nvidia (US:NVDA)**, **Alphabet**

(US:GOOGL), **Microsoft (US:MSFT)** and **Meta Systems (US:META)**, it is one of the few companies that can claim true market dominance. That position in large part explains why its operating profit margin is 57 per cent compared to the S&P 500's 14 per cent, and its free cash flow margin is 43 per cent compared to the S&P 500's 11 per cent.



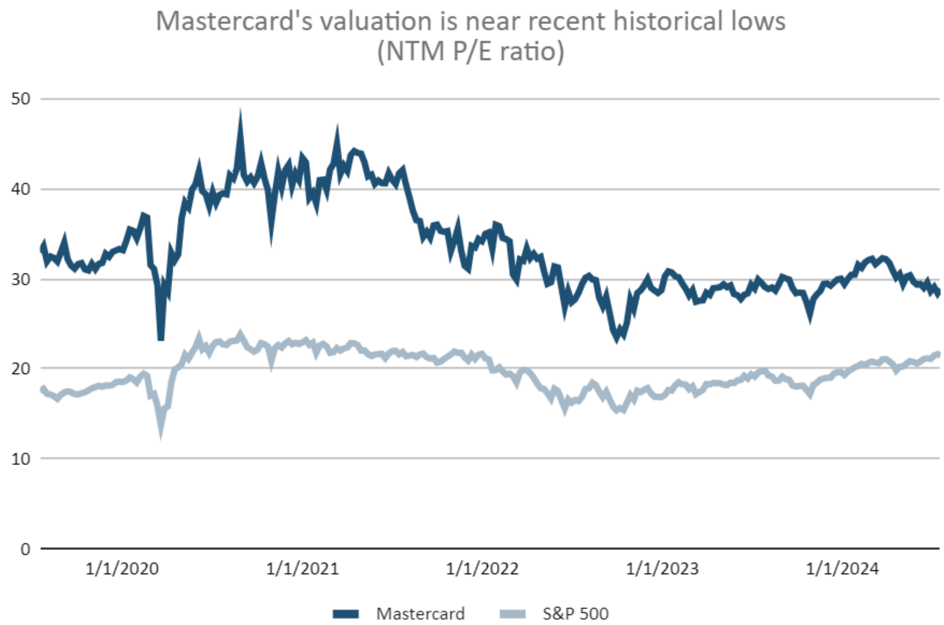
Source: FactSet

Mastercard might be expensive compared to the market, but compared to its own history is as cheap as it has been for eight years. In 2021, it was trading at 38 times its forward earnings, but the vastly different interest rate environment forced a rethink of the multiples investors were prepared to pay for the highest duration stocks (i.e. those on the longest multiples).

Profitability has been growing faster than its share price since then, with the valuation contraction reflecting how investors demand a higher implied rate of return from equities in a world where the risk-free yield to redemption on 10-year US Treasury bonds is north of 4 per cent .

The only time in recent history it hasn't grown profits was in 2020 when Covid-19 hit consumer spending. The biggest risk to Mastercard is a wider economic slowdown. If deflation hits, spending slows and consumers start saving then Mastercard's profits will drop and its relatively high level of fixed operating costs will become a burden rather than an advantage.

However, even in this situation, it would remain the dominant payments business. And as long as the economy eventually recovered, so would Mastercard. It's a bet on long-term economic growth and faith that crypto currency won't become the dominant payment method. And now the shares are as cheap as they've been for almost a decade, meaning US rate cuts would be a strongly bullish signal.



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