Lear Corporation (NYSE:LEA)

Recommendation:	Long
Price:	$95.34
Price Target:	$129.15
Upside:	35%
Market Cap:	$5,162
Enterprise Value:	$8,013
52 Week High:	$147.11
52 Week Low:	$91.70

Executive Summary

We recommend that we long Lear (NYSE:LEA), an auto-parts manufacturer based in Detroit that currently trades at $95.34/sh, because we believe that the market fails to A. take into account Lear's potential in China and B. recognize the cyclical nature of the industry. Lear's intrinsic value is likely closer to $129.15 per share. Catalysts to our thesis include approval of pending contracts with Chinese manufacturers, increased E-System awards, and improved vehicle production and CPV figures in the long term.

Company Overview

Overview

Lear is a global automotive technology leader in seating and electronic systems in vehicles. The company started in 1917 as a metal producer and has since grown, both organically and through a series of acquisitions, to offer a variety of auto-parts products. Amidst the financial crisis in July 2009, the debt-saddled company filed for Chapter 11 bankruptcy. Four months later, the company emerged from bankruptcy, with a less top-heavy capital structure and a commitment to its two core segments.

Segments

Lear's primary segment is seating. The company's car seats offer technology such as warming and massaging, live adjusting seating support and customization, and safety sensors for collisions. All seating manufacturing is vertically integrated and carried out in-house.

The next segment is E-Systems. Lear produces a number of innovative E-system products, including high voltage wire harnesses fit for a vast selection of different car types, softwares including in-car services, applications, touch-screen capabilities, etc., and unique battery/power solutions technology.

Acquisitions

Some of Lear's most recent acquisitions include WIP Industrial Automation (announced July 2024), a company that specializes in customized automation solutions. This reflects Lear's ongoing efforts to strengthen robotics and AI-based capabilities, which are important for the company's efficiency and safety. The company acquired I.G. Bauerhin, which develops heating technology for car seats and was crucial for Lear's push into the thermal comfort systems space within seating. Throughout 2022, the company also acquired Thagora and Intouch Automation, companies geared at streamlining manufacturing processes and quality control. It is clear from from looking at Lear's history that the company regularly utilizes strategic acquisitions to acquire new technology or expand its production capabilities.

Management & Compensation

Management exhibits extensive experience at Lear and the automotive space. Raymond Scott, CEO, started his career at Lear over 20 years ago, and has spent more than 30 years in the automotive industry. Jason Cardew, CFO, was appointed in 2019 and began his career at Lear in 1992 as an accountant. Amy Doyle, CAO, oversees global accounting and internal control functions and began her career at Lear in 1999.

Most of Lear's executives' pay is performance-based. In 2023, base salary accounted for 8% of Scott's salary, with 73% being performance-based. This performance based pay is also divided into two sections: an annual incentive plan, which is paid out in cash for short-term goals, and long term incentive plans, which are paid in RSUs for long-term metrics. Calculations of performance are based on a combination of metrics including adjusted operating income (50%), and FCF (50%), for short term measures, and pretax income (50%), ROIC improvement (25%), and total shareholder return (25%) for long term plans.

Returning Value to Shareholders

In terms of stock repurchases, 1,875,000 shares were repurchased in this year's Q3, achieving their $325m target for repurchases in 2024. Lear targets another 50-100m in buybacks for the remaining 2024 fiscal year. In 2023, the company repurchased around $316m worth of shares. In terms of dividends, there were a total of $182m for dividend payments in 2023, a $4m decrease from 2022. Lear's commitment to a high level of dividends and share repurchases despite poor earnings expectations and volatility display the company's attempts to send positive signals to investors and reflect management's belief that the stock is undervalued.

Financial Overview

Income Statement and Earnings Analysis

3Q24 Results: Lear outperformed expectations with revenue of $5.58 billion, surpassing Deutsche Bank and consensus estimates by approximately 3%. Adjusted EPS came in at $2.89, significantly exceeding consensus estimates of $2.60. However, 4Q24 guidance reflected weaker margins, with EBIT forecasted at $227 million (4.2% margin) compared to consensus of $270 million (4.7% margin).

Key Drivers of Performance:

Strong performance in E-Systems, reflecting the growing profitability of high-margin components such as high-voltage power distribution systems and battery disconnect units. Management displays conservatism in guidance for 4Q24, citing -10% y/y decline in LV production, contrasting with more bullish market forecasts from BNP Paribas and S&P Global. Cost-saving initiatives, vertical integration, geographical diversification, and electrification are expected to offer long-term growth opportunities but are unlikely to offset short-term pressures.

Segmented Earnings and Trends

Seating Segment: continues to generate robust revenue but faces slower growth due to market maturity and cost pressures. 2023 net sales were $17.55 billion with a segment margin of 6.1%.
E-Systems Segment: exhibiting faster margin growth, aligning with increased focus on electric vehicles. 2023 net sales of $5.92 billion with a margin of 3.9%, up from 1.4% in 2022. Despite the strategic focus on electrification, margins remain under pressure due to commodity prices and supply chain challenges, with EBIT margins declining from 5% in 2019 to 4% in 2023.

Cash Flows and Capital Expenditures

- CFO increased to $1.2 billion in 2023, driven primarily by earnings growth.

- Net cash used in investing activities totaled $762 million in 2023, including $627 million for capital expenditures focused on expanding manufacturing capabilities in strategic markets like China.
- Lear continues to strategically invest in electrification trends and other growth markets.

Balance Sheet and Liquidity

- Liquidity Ratios: Asset-to-liability ratio: 1.14; Acid-test ratio: 0.83; Cash ratio: 0.21. These ratios suggest that Lear is solvent and capable of covering liabilities, though lower liquidity ratios indicate a reliance on operational cash flows to meet obligations.
- Leverage Metrics:
    - Long-term debt: $2.74 billion as of 2023, with interest rates ranging from 2.6% to 6.575%.
    - Shareholder equity and retained earnings consistently increasing, indicating reinvestment into business growth and consistent shareholder returns.

Key Strategic Insights

- Lear's focus on the Chinese market, supported by significant business awards from BYD, Xiaomi, Seres, and Dongfeng Group, demonstrates its commitment to leveraging geographic diversification for growth with an emphasis on China.
- Recent cost-saving initiatives, vertical integration efforts, and investments in advanced manufacturing support Lear's competitive positioning in the electrification space.

Analyst Opinions and Outlook

- Positive sentiment from firms like BNP Paribas and Wolfe, citing growth in E-Systems and strategic investments.
- More cautious views from Deutsche Bank and Barclays, highlighting challenges in European volumes and price-down pressures impacting profitability.
- Analysts expect EBIT margins to stabilize around 4-5% in the coming years, driven by cost-saving initiatives and electrification trends.

Industry Overview

Competitors

Lear is one of the leading suppliers in both seating and e-systems. In China it shares the seating market with Adient and Yanfeng. Lear particularly dominates luxury seating where it controls around 50% of the market. There are some smaller local suppliers as well but they mainly operate in the lower tier market. Outside China Lear competitors include Faurecia and Toyota Boshoku for seating and Robert Bosch GmbH, Mitsubishi Electric and Aptiv for e-systems. However, Lear seems to be the only tier 1 supplier that has both seating and e-systems manufacturing in house. These two segments work off of each other, allowing the company to make software that coordinates power adjustments, seat heating / cooling, and connection to the vehicle's infotainment system.

Cyclical Industry

The automotive industry that Lear supplies in is highly cyclical. The demand for vehicles and hence the demand for Lear's interior products moves in phase with the business cycle. This is one of the reasons why the recent earning reports

have been lower than expected. Another industry affecting Lear's production is the metal industry. Lear requires both steel and other rare earth metals to manufacture its electrical components and seating frames.

Competitive Advantages & Barriers to Entry

One of Lear's main competitive advantages is the established relations with the major OEMs (both in the US and abroad) allowing Lear to win contracts easier and with more favourable conditions. It has been present in China for over 30 years with an established operating team. Furthermore, Lear's recent acquisitions and investment in R&D allowed it to become the most vertically integrated seat company in the world. Lear can design, engineer, validate all of its products directly in China which minimises the risk of supply chain disruption. This fact along with just-in-time manufacturing brings the advantage of shorter cycle times highly valued by OEMs. Seating and e-systems manufacturing is very capital intensive so new entrants have to provide a lot of upfront investment. This barrier to entry will ensure that Lear retains its market share in the long term.

A significant factor that could harm the industry is the volatility of metal prices. Supply crunches in rare earth metals could increase Lear's cogs if it doesn't negotiate fixed contracts. However, this factor is overshadowed by a huge growth opportunity presented by the increased adoption of EVs. EVs require more complicated e-systems compared to petrol cars. Lear is in a strong position to tap into this developing market both in the US but especially in China.

Valuation

Incorporating our analysis as well as management estimates and consensus, we arrived at a price target of $129, an upside of 36% over the current stock price. We arrived at this price target via fundamental and comparative analysis.

Revenue Projections

We identified two drivers of revenue: content per vehicle and the number of vehicles. Content per vehicle translates to the revenue earned per vehicle (i.e. the price) and the number of vehicles, quantity.[1]

Although we have tried to simplify our analysis of Lear's revenues, the limited available information added significant noise to our model. We worked with three sources of information: revenues, which were segmented across businesses as well as regions; content per vehicle, segmented across two regions (North America and Europe & Africa); and number of manufacturing facilities, also segmented across businesses and regions. To reconcile the disparities across the data, we had to make some assumptions, such as determining the split of number of vehicles for a certain region from the number of factories in said region. We observed that the majority of consensus reports adopted a relative valuation, top-down approach, or an EBIT bridge, yet we adhered to the fundamental approach as we wanted to conduct an analysis with justifiable assumptions, even if doing so introduced some room for error into our valuation.

Vehicles: Our growth rates for vehicles in 2024 follows management's conservative Q3 forecasts of Light Vehicle Production (LVP) decline of -4% for North America, -8% for Europe and Africa, and -1% or the rest of the world. In 2025, we expect some recovery with a 1% increase. The following years follows the S&P vehicle production forecast, which overall assumes a growth rate close to 1%.

CPV: For seating, CPV saw significant gains in 2020-2021 (possibly due to supply chain constraints) but remained stable thereafter. Given the maturity of the seating segment, we assume a steady 1% growth rate in our forecast period. For E-Systems however, CPV has increased consistently in the last five years. We assume small increases (2-3%) for EU and NA regions, and 4% for China for 2025-26) given Lear's EV potential in the region.

[1] We understand that Lear is not producing complete "vehicles"; this terminology can be thought more of as components or seats

Expenses

COGS & OpEx: COGS and SG&A has been kept as a constant percentage of revenue, in line with historical trends. Restructuring expenses were increased to $150 for 2024, as per management expectations, and held constant thereafter. Other insignificant one-time charges were ignored.

CapEx: We projected CapEx to be a constant percentage of revenue during the forecast period because the company is consistently investing and expanding its footprint in various regions, most notably China and Mexico. CapEx has also remained a consistent amount of revenue in the last five years. Moreover, throughout the forecast period, we projected depreciation to become an increasing portion of CapEx. These assumptions yield us figures in accordance with company projections.

WACC and Growth Rate

We arrived at a WACC of 8.8%, which we believe is reasonable considering that Lear is a mature firm with cyclicality. We applied a conservative perpetuity growth rate of 1.5%, again considering the firm's maturity and limited growth potential in the seating segment. With these assumptions, we arrive at an implied share price of $129, a 36% upside. With a WACC of 9.85% and growth rate of 0.5%, we obtain $106/sh, and with a WACC of 7.85% and growth rate of 2.5%, we arrive at a $189/sh.

Relative Valuation

For our relative valuation, we identified five companies with similar segments to Lear. No company replicated the two businesses of Lear; companies such as Gentherm specialized in electronic climate control systems within vehicles, or much larger companies like Magna International provided a wider breadth of products, including both seating and E-Systems.

Looking at their EV/EBITDA ratios, Lear trades below its peers at 5.3x (vs. peer median of 5.8x). Applying the multiple to our forecast terminal year EBITDA, we arrive at an enterprise value of 9546 and an implied share price of $132, a 38.4% upside.

Investment Theses & Catalysts

Thesis 1: Chinese auto and EV market as a driver of growth

Markets view: The market doesn't place enough value on China's auto-market to sustain and grow Lear.

Our view: In the face of American/European slowness, we turn to China as a driver for growth, diversification, and risk mitigation. But more than that, China can be a major source of revenue regardless of what happens in the rest of the world.

There have been recent wins with Chinese domestic automakers such as BYD, Xiaomi, and Seres, Leapmotors. The collaborations with Chinese automakers are expected to contribute over $100 million in annual sales and help expand Lear's market share as these automakers pursue global growth. By 2027, the company projects a 6% annual revenue growth, with nearly 50% of its revenue coming from Chinese automakers, up from 30% in 2024. This is important because of uncertainties in the US EV market (lagging, disappointing, issues with incoming Trump admin.) and general

slowdown in auto production. If the Chinese market can deliver on this growth, it can not only make up for the US in the short term, but become a monumental growth driver in the long term.

Specifically looking at BYD, which is China's biggest car company with 1.6 million sales in 1H24, 600k more than second place. Lear expects to produce 30% of BYD's seats within the next few years. It's only about 10-15% right now. BYD's revenue was over 602 billion yuan ($83 billion), a 42% increase from the previous year. More than 80% of that revenue came from electric vehicles and related products.

The Chinese auto-market's size and future direction is also a proponent for growth. It's the world's largest as measured by vehicle sales. China's domestic light vehicle sales are predicted to increase by 2%-3% annually in 2024-2025, from 5.6% in 2023. Domestic electric vehicle sales to grow 15%-20% per annum over the same period, from over 30% last year. There has been some slowing in the Chinese auto-market (shown above—still robust growth, but the previous growth is unsustainable and we probably have to concede that), so China auto-makers are venturing overseas. The sector that experienced the most substantial export growth was the alternative-fuel car and automobile manufacturing industry, achieving a remarkable year-on-year increase of 48.3%. China also overtook Japan and became #1 in global vehicle exports in 2023.

A large proportion of China's automotive output is EVs (may be helpful to include statistics), which has larger CPV expansion potential (include what you said about the management interview here on CPV for EVs being higher). Should E-Systems contracts materialize with the Chinese EV automakers, this will unlock a new growth vertical for Lear.

In an attempt to recover from the housing market crash that financially crippled much of China, the government has rolled out lower interest rates, stimulus packages for local governments, and cuts to mortgage rates and down payment ratios. In a country where recovery from Covid-19 was slow and the economy lagged, especially factoring in the destruction the housing market crash caused, an effort by the government to stir up economic activity is crucial. Even during 2020-2023, the LV and EV car market didn't crash, so with more discretionary income and better economic conditions, we can only expect even more cars to sell.

Thesis 2: Growth inflection and cycle recovery
Short-term horizon is leading to overreaction

Markets view: The market has overreacted to the cyclical nature of the auto-industry and is keeping a near-sighted view on the stock. They are too worried about backlogs for Lear and earnings slashes for 2024. (backlog is about two-thirds with Chinese domestics and about one-third with Western OEMs)

Our view: Through tough times, Lear has shown resilience and has the market reach, technology, and financials to thrive. Longer-term, we believe Lear will succeed because of the e-systems growth potential and strategic acquisitions that will improve operational efficiency and better manage macroeconomic challenges.

With electric vehicles increasing, the advent of autonomous driving, and rise in SUVs, we see more content per vehicle (Lear is providing more "stuff" per vehicle). EV's, when compared to traditional gasoline-powered vehicles, require significantly more complex and sophisticated electrical systems. This is due to the need to power the electric motor, manage battery systems, and support a growing number of advanced features. "Yeah. So in a full electric vehicle, you have about $700 of additional CPV compared to an ICE vehicle, and in certain cases like a full-sized truck, it could be well above that. In a plug-in hybrid, you capture about a third of that, about $250 of additional CPV."
There has been robust growth in the EV market, with some figures being; in 2023, nearly ⅛ cars sold was electric, up from 2% in 2018. In the US, EV sales in Q3 2024 reached record highs, with an 8.9% share of sales.

SUVs and their growth represent an important part of the auto-market. The market share of new "cars" (made up mostly of sedans, but also coupes) sold in the US fell by a quarter, from 27.1% to 20.5%. In particular, midsize cars fell from a market share of 8.2% to 5.8%, and that of compact cars fell from 8.8% to 6.1%. Meanwhile, the overall sales of SUVs ballooned to 56.3% in 2023 from an already robust 48.5% in 2019, basically taking over half the market. Bigger cars like SUVs command premium content per vehicle (premium/ additional seating and more advanced electric content).

From looking at historical data, we were able to find that Lear's earnings closely correlate with large auto manufacturers whom they have had or currently hold contracts with. This may signal that Lear's earnings direction will be similar to that of the manufacturers. However, we see a mismatch when it comes to consensus surrounding Lear versus manufactures, with companies such as Ford and GM having neutral to strong buy recommendations, unlike Lear. This may again point towards a misjudgment from the market caused by cyclicality. (new point)

In the mid to long-term, Lear will benefit from the combined synergies of WIP, ASI, Thagora, and InTouch buyouts, gaining a robust portfolio of automation solutions and technical knowledge across all critical manufacturing areas, thereby accelerating innovation in developing next generation automation technologies. These acquisitions are enhancing the vertical integration capabilities of the Seating business. They are also on track to reduce seating headcount by 8% or more in 2024 while it has already achieved its 6% reduction target in E-Systems compared to the end of 2023.Lear has relocated some of its European operations to North Africa and shifted activities from Mexico's border region to other parts of the country or to Honduras to reduce labor costs. These restructuring actions will align Lear's capacity with industry volumes and provide cost savings in 2025 and beyond.

Risks & Mitigants

Risk 1:
Lear has a concentrated customer base. Five major customers, i.e., General Motors, Ford, Volkswagen, Mercedes-Benz and Stellantis accounted for over 60% of its total sales in 2023. Losing business with any of these customers would significantly impact the company's topline growth

Mitigant:

Are making partnerships with other companies such as BYD in China and are building them up to be a big part of their revenue in the future. So if a company like Ford or GM is no longer a partner, they have a buffer.

Risk 2:
The incoming Trump administration brings lots of questions and confusion. There has been a plan to cut the EV tax credit, which harms other EV companies more than it does Tesla. So if EV's are going to be a main driver of growth, and they aren't going to fare well in America, it'll significantly reduce Lear's advantages.

Mitigant:
It's hard to take a view on this as we have almost zero clue what will actually happen, but it's a risk to consider.

Risk 3:
Lower for longer global light vehicle production will continue to pose a significant threat to Lear's operations and will prevent synergies from recent acquisitions from being recognized. Backlogs will continue to shrink and production volumes will decline.

Mitigant:
It is highly unlikely that this is likely to occur unless an unexpected economic event occurs. We project that the cycle downturn will last at most one to two years.

Risk 4:
Slower EV adoption than expected. Certain traditionally Internal Combustion Engine (ICE) vehicle manufacturers are delaying plans to completely shift into EV production.

Mitigant:
Seating CPV will remain nearly unchanged; Lear loses some opportunity for higher CPV in E-Systems (as EVs offer more components and electrical systems, giving Lear higher revenue potential per unit), but we don't see a major risk to earnings. There is still significant overlap and opportunity in E-Systems for traditional ICE cars.