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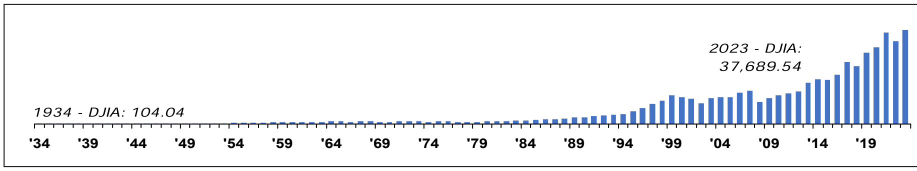
MARKET DIGEST



FRIDAY, NOVEMBER 1, 2024
OCTOBER 31, DJIA: 41,763.46
DOWN 378.08

Good Morning. This is the Market Digest for Friday, November 1, 2024, with analysis of the financial markets and comments on **GE HealthCare Technologies Inc., Ameriprise Financial Inc., Amgen Inc., Apple Inc., Mastercard Inc., Moody's Corp., Union Pacific Corp., Verisk Analytics Inc., Best Buy Co. Inc., Cognizant Technology Solutions Corp., Enterprise Products Partners LP and Pilgrim's Pride Corp.**

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WEBINAR ANNOUNCEMENT:

Argus Research will host a webinar for clients at 11 a.m. ET on Wednesday, November 6, 2024. The webinar is titled Financial Services Sector Outlook. The webinar will be hosted by Argus Director of Research Jim Kelleher, CFA. Jim will be joined by Argus Director of Financial Services Research Stephen Biggar and Argus Fixed Income Strategist Kevin Heal.

During the call, we'll discuss the outlook for the fed funds rate and yield curve into 2025 and share forecasts for industry groups such as banks, brokers, insurers, exchanges, and financial data providers.

Listeners are encouraged to submit questions that we'll address in a Q&A session at the conclusion of formal remarks.

Please note that the CFP Board has accepted Argus' Monthly Webinar for one (1) hour of continuing education (CE) credit.

Please visit https://attendee.gotowebinar.com/register/4299896849254698078 to register. If you have any problems registering, please contact us at clientservices@argusresearch.com or by calling (212) 425-7500.

The webinar, as always, will be interactive with a question-and-answer period. We will be recording the webinar, and a rebroadcast will be available on the password-protected portion of our website. Slides related to the presentation will be posted on our website the day of the webinar and will be available via the webcast itself.

MARKET REVIEW:

U.S. stocks fell on Thursday on disappointing results from Tech companies. Both the S&P 500 and the Nasdaq posted their largest one-day losses since the beginning of September.

The S&P 500 was down 1.9%, the Nasdaq lost 2.8% and the Dow fell 0.9%. Both crude oil and gold traded higher.

GE HEALTHCARE TECHNOLOGIES INC. (NGS: GEHC, $87.35) .... BUY

GEHC: Strong order flow in 3Q24, excluding China

* Despite headwinds in China, GEHC is delivering top-line growth, margin expansion, and solid commercial execution.
* The focus on new product launches and incorporating AI and digital technologies into its offerings will drive favorable sales mix and pricing as well as bolster margins.
* In particular, the company has launched new diagnostic solutions to enhance the care of patients with neurodegenerative diseases, cancers, and cardiovascular conditions.

ANALYSIS

INVESTMENT THESIS

Our BUY-rating on Focus List selection GE HealthCare Technologies Inc. (NGS: GEHC) is highlighted by management's solid execution to produce strong financial and operational results in the first 18 months following its separation from General Electric Co. As an independent company, GEHC is focusing its capital on new product launches and M&A. In our view, an improved management and commercial execution will lead to higher operating margins. GEHC provides advanced medical devices and related products that help in the screening, diagnosis, treatment, and monitoring of patients. It also focuses on precision care by utilizing new imaging and ultrasound technologies to bring diagnosis and treatments to individuals. Our target price is $110.

RECENT DEVELOPMENTS

GEHC delivered strong 3Q24 results on October 30. Excluding China, both sales and orders grew in the mid-single digits. Adjusted EPS was $1.14, beating the consensus estimate by $0.09 and increasing 15.2%.

GAAP net income was $470 million or $1.02 per share, compared to $375 million or $0.82 per share a year ago. Revenue was $4.863 billion, increasing 1% on a reported and organic basis. Excluding China, revenue growth was 5%.

Despite the ongoing economic weakness in China, the company modestly raised the midpoint of its 2024 guidance range for adjusted EPS and for adjusted EBIT margin. Notably, orders excluding China grew 4% organically (1% overall), indicating a healthy capital equipment market outside of China.

As further evidence of the strength of GEHC's business, the book to bill ratio was 1.04. The backlog reached $19.6 billion at the end of 3Q24, increasing 6.5% from the year-ago period.

The strong performance of Pharmaceutical Diagnostics (PDx) led the way for other business segments within the company. PDx, which makes contrast agents and radiotracers for imaging and molecular diagnostics, delivered 7% sales growth. The PDx segment will launch in early 2025 the Flyrcado, an imaging agent for scans using positron emission tomography (PET). Flyrcado is a myocardio perfusion imaging agent for enhanced diagnosis of coronary artery disease.

One product driving PDx results is the recent launch of Vizamyl, a radioactive diagnostic agent indicated for PET imaging of the brain to estimate beta amyloid plaque levels in adult patients with cognitive impairment who are being evaluated for Alzheimer's disease (AD) or other causes of cognitive decline. With several AD therapies already approved and more on the way, we expect demand for Vizamyl to increase as clinicians and patients seek diagnostic tools for accurate assessment of cognitive decline. Vizamyl is the only PET imaging tracer for detection of amyloid approved by the FDA for visual interpretation of color images rather than black and white assessment.

For the enterprise, the adjusted gross margin was 41.5%, up 150 basis points. The adjusted EBIT margin was 16.3%, up 90 basis points. The margin increase was driven by higher productivity, favorable mix, and positive pricing.

EARNINGS & GROWTH ANALYSIS

GEHC updated its guidance for 2024. For organic revenue growth, it now expects to be trending to the lower end of the 1%-2% range, largely due to economic weakness in China. It expects the adjusted EPS to be $4.25-$4.35 (implying a growth rate of 8%-11%), compared to a prior view of $4.20-$4.35. This update raises the midpoint by $0.025.

Based on the updated outlook, including the headwinds in China, along with strength in new orders, we are reducing our estimates for adjusted EPS to $4.28 from $4.32 for 2024 and to $4.72 from $4.80 for 2025.

Our five-year projected EPS growth rate is 9%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on GE HealthCare is Medium. Cash from continuing operations for the first half of 2024 was $ 1.042 billion, compared to $1.051 billion in the prior-year period.

The dividend is an annualized $0.12 for a yield of 0.15%. Our dividend estimates are $0.12 for 2024 and $0.16 for 2025.

Given the company's financial strength and increasing cash flow from operations, we think that GEHC has the resources to increase the dividend. Still, we believe the company is focusing its capital allocation on organic and inorganic investments (M&A) and deleveraging the balance sheet.

MANAGEMENT & RISKS

Peter J. Arduini is the president and CEO of GE HealthCare and previously served as CEO of medical device manufacturer Integra LifeSciences. The CFO is James Saccaro.

There are risks to owning GEHC shares. Competition is a threat, as the industry includes rivals such as Philips, Siemens, and Hologic. The company operates internationally and is thus subject to changes in global economic conditions as well as to negative currency effects. The company also faces risks related to the integration of acquired businesses.

COMPANY DESCRIPTION

GE HealthCare Technologies Inc., formerly part of General Electric, provides healthcare products and technologies worldwide. The company has four segments: Imaging, Ultrasound, Patient Care Solutions, and Pharmaceutical Diagnostics. GEHC has 50,000 employees. GE HealthCare was spun out of General Electric and began trading as an independent company in December 2022.

VALUATION

GEHC trades at 18.5-times our 2025 adjusted EPS estimate, below the average multiple of 23.0 for our coverage universe of MedTech stocks. Given the company's outlook for top-line growth and margin expansion, we consider the valuation attractive. Our target price is $110.

On October 31, BUY-rated GEHC closed at $87.35, up $0.15. (David Toung, 10/31/24)

AMERIPRISE FINANCIAL INC. (NYSE: AMP, $510.30) .... BUY

AMP: Raising target on leading asset manager

* On October 23, AMP reported 3Q24 adjusted operating earnings of $902 million, or $8.83 per share, compared with $823 million, or $7.68 per share. Adjusted net revenue rose 11% to $4.35 billion, and average advisor productivity rose 11% to $997,000.
* AMP shares have risen 61% over the past year, compared with a 37% advance for the S&P 500 and a 53% rise for the IAI ETF.
* Based on 3Q24 results, our expectations for growth in Advice & Wealth Management, and share repurchases, offset by the impact of potentially softer economic conditions going into 2025, we are slightly raising our 2024 EPS estimate to $34.80 from $34.75 and our 2025 EPS estimate to $38.47 from $38.42.
* Our revised target price of $560 assumes a peer-average multiple of 14.5-times our new 2025 estimate.

ANALYSIS

INVESTMENT THESIS

We are reiterating our BUY rating on Ameriprise Financial Inc. (NYSE: AMP) and raising our target price to $560, having surpassed our prior target of $470. Ameriprise has generated solid revenue in recent quarters, driven by net inflows, the addition of experienced advisers, and growth at the Ameriprise Bank, partly offset by equity and fixed income volatility. It recently posted 3Q24 adjusted operating earnings (excluding unlocking) of $8.83 per share, up from $7.68 a year earlier. AMP reports adjusted earnings excluding unlocking to highlight the underlying performance of the business. Unlocking refers to the recognition of deferred acquisition costs (DAC). Life insurers carry DAC on their books and amortize the expense over a set schedule.

We expect long-term growth at Ameriprise to be driven by expansion in the number of financial advisers, an increase in fee-based accounts, improving revenues from asset manager Columbia Threadneedle, and the acquisition of Bank of Montreal's EMEA asset management unit. In April 2024, the company raised its quarterly dividend by 10% and continues to return capital to investors via share repurchases.

RECENT DEVELOPMENTS

AMP shares have risen 61% over the past year, compared with a 37% advance for the S&P 500 and a 53% rise for the IAI ETF. Some 19% of the outstanding shares are held in various ETFs. The beta is 1.13.

On October 23, AMP reported 3Q24 adjusted operating earnings of $902 million, or $8.83 per share, compared with $823 million, or $7.68 per share. Adjusted net revenue rose 11% to $4.35 billion, and average advisor productivity rose 11% to $997,000. Total advisor headcount was 10,368, with the addition of 71 experienced advisors in the quarter.

AMP saw a 6% improvement in annualized flow rate into fee-based investment advisory accounts and improvement in other areas of client activity, indicating consumer preference was returning to advisory products.

In July 2023, the board authorized an additional $3.5 billion for stock repurchases through September 30, 2025.

EARNINGS & GROWTH ANALYSIS

Ameriprise organizes its business into four segments. We look at recent trends and forecasts for these segments below.

In Advice & Wealth Management, 3Q24 pretax adjusted operating earnings rose 13% to $826 million, driven by strong wealth management and banking performance.

Asset Management earnings rose 23% to $245 million. Total assets under management rose 14% to $672 billion, reflecting higher equity and bond valuations offset by legacy insurance partner outflows.

The Retirement & Protection segment saw adjusted earnings rise 2% to $208 million, reflecting stronger interest earnings and higher equity markets offset by higher sales distribution expenses.

In the Corporate & Other segment, the 3Q operating loss was $139 million.

We expect growth at Ameriprise to be driven by increased revenue in the Advice & Wealth Management and Asset Management segments. We also look for net interest income to increase on higher interest rates. In addition, we see the company's own retail bank as a driver of future growth.

Based on 3Q24 results, our expectations for growth in Advice & Wealth Management, and share repurchases, offset by the impact of potentially softer economic conditions going into 2025, we are slightly raising our 2024 EPS estimate to $34.80 from $34.75 and our 2025 EPS estimate to $38.47 from $38.42.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on AMP is Medium-High, the second-highest rank on our five-point scale. Moody's rates Ameriprise's debt at A3/stable, while S&P rates it as A/stable.

Long-term debt was $3.4 billion at the end of 3Q24.

In April 2024, Ameriprise raised its quarterly dividend by 10% to $1.48, or $5.92 annually, for a yield of about 1.15%. Our dividend estimates are $5.92 for 2024 and $6.10 for 2025.

In 3Q24, AMP repurchased $563 million of its stock.

MANAGEMENT & RISKS

AMP is led by Chairman and CEO James M. Cracchiolo, who has held these positions since 2005. Walter S. Berman is the CFO.

The company faces a range of business and economic risks, including changes in interest rates and credit quality, regulatory complexity, and market volatility.

COMPANY DESCRIPTION

Based in Minneapolis, Ameriprise Financial, through its subsidiaries, provides financial products and services to individual and institutional clients in the U.S. and internationally. It has four business segments: Advice & Wealth Management, Asset Management, Retirement & Protection, and Corporate & Other.

VALUATION

At prices around $510, Ameriprise shares are trading near the high end of their 52-week range of $308-$523. On a technical basis, year-to-date the shares have been in a pattern of higher highs and lower lows. We believe that the shares remain favorably valued at 13.4-times our revised 2025 EPS estimate, just below the peer average of 14-15. We expect future growth to be driven by the addition of experienced financial advisers, an increase in fee-based accounts, improving revenues from asset manager Columbia Threadneedle, and incremental revenue from the Bank of Montreal asset management purchase. Our revised target price of $560 assumes a peer-average multiple of 14.5-times our new 2025 estimate.

On October 31, BUY-rated AMP closed at $510.30, down $3.74. (Kevin Heal, 10/31/24)

AMGEN INC. (NGS: AMGN, $320.16) .... BUY

AMGN: BUY on strong product sales and pipeline advancements

* Amgen has a strong pipeline of potential new products, as well as a rapidly growing portfolio of existing products that saw volume growth of 29% during the third quarter.
* On this front, Amgen has announced a number of positive developments in recent months, including the Japanese approval of Tepezza for the treatment of active or high clinical activity score (CAS) Thyroid Eye Disease (TED) and the U.S. launch of Otezla for the treatment of moderate to severe plaque psoriasis in children and adolescents ages 6 and older.
* We expect future revenue to benefit from newly launched drugs, biosimilars, and products acquired from M&A and in-licensing.
* Our price target of $360 implies a total return, including the dividend, of roughly 15%.

ANALYSIS

INVESTMENT THESIS

Our rating on Amgen Inc. (NGS: AMGN) is BUY. The company has a strong pipeline of potential new products, as well as a rapidly growing portfolio of existing products that saw volume growth of 29% during the third quarter. On this front, Amgen has announced a number of positive developments in recent months, including the Japanese approval of Tepezza for the treatment of active or high clinical activity score (CAS) Thyroid Eye Disease (TED) and the U.S. launch of Otezla for the treatment of moderate to severe plaque psoriasis in children and adolescents ages 6 and older. Meanwhile, the company has announced positive clinical data for Uplizna for the treatment of adults with generalized myasthenia gravis (gMG) and has advanced its clinical study of a multispecific molecule, MariTide, that inhibits the gastric inhibitory polypeptide receptor (GIPR) and activates the glucagon like peptide 1 (GLP-1) receptor. We expect future revenue to benefit from newly launched drugs, biosimilars, and products acquired from M&A and in-licensing. The company has invested its strong cash flow in R&D and acquisitions. Our price target of $360 implies a total return, including the dividend, of roughly 15%.

RECENT DEVELOPMENTS

AMGN shares have underperformed over the past three months, falling 3% compared to a 3% gain for the S&P 500. The stock has underperformed the market over the past year, rising 25% compared to a 36% gain for the S&P 500. Over the past five years, the stock has gained 58% compared to an 86% advance for the market.

Amgen delivered 3Q24 results on October 30 that beat the consensus for both earnings and revenue. Adjusted EPS rose 13% to $5.58 from $4.96 in 3Q23, beating the consensus estimate by $0.47. GAAP net income was $2.83 billion or $5.22 per share, up from $1.73 billion or $3.22 per share a year earlier. Total revenue rose 23% to $8.50 billion, beating the consensus by $4 million. Product sales rose 24% as volume growth of 29% was partly offset by lower net selling prices. “Other revenue,” which includes collaboration revenue related to COVID antibody manufacturing, fell 1% to $352 million.

Amgen’s 3Q growth drivers included Evenity, Repatha, Tezspire, Blincyto, Tavneos, Vectibix, and Lumakras/ Lumykras — all of which posted double-digit volume growth.

The performance of Amgen’s stock is often driven in part by pipeline developments. On October 15, Amgen announced positive top-line Phase 3 results from a trial evaluating the efficacy and safety of Uplizna for the treatment of adults with generalized myasthenia gravis (gMG), a rare, chronic, B-cell-mediated autoimmune disorder that impairs neuromuscular communication and can cause muscle weakness, trouble breathing, difficulty swallowing, and impaired speech and vision. Based on these primary results, Amgen is planning to file for approval in the U.S. for this indication, followed by other key markets. Uplizna is currently approved for the treatment of neuromyelitis optica spectrum disorder (NMOSD) in adult patients who are anti-aquaporin-4 (AQP4) antibody positive in the U.S., EU, Brazil and Canada, among other countries.

Earlier, on September 24, Amgen announced the approval of Tepezza for the treatment of active or high clinical activity score (CAS) Thyroid Eye Disease (TED) in Japan. TED is a serious, progressive, and potentially vision-threatening rare autoimmune disease affecting approximately 25,000-35,000 people in Japan that can cause proptosis (eye bulging), diplopia (double vision), eye pain, redness and swelling. In addition to Japan, Tepezza is currently approved in the U.S., Brazil, and the Kingdom of Saudi Arabia, and is under regulatory review in Europe, Canada and Australia.

On August 20, Amgen announced the availability of Otezla in the U.S. for pediatric use. Approved by the FDA in April for the treatment of moderate to severe plaque psoriasis in children and adolescents ages 6 and older who weigh at least 20 kg and are candidates for phototherapy or systemic therapy, Otezla is the only oral medication for this patient population.

The company has also developed a multispecific molecule, MariTide, that inhibits the gastric inhibitory polypeptide receptor (GIPR) and activates the glucagon like peptide 1 (GLP-1) receptor. Amgen is currently studying MariTide in a Phase 2 study in adults with overweight or obesity with or without type 2 diabetes mellitus, for which topline data are anticipated in late 2024. Meanwhile, a Phase 2 trial investigating MariTide for the treatment of type 2 diabetes in patients with and without obesity has been initiated, while planning for a broad Phase 3 program across multiple indications remains on track.

EARNINGS & GROWTH ANALYSIS

Along with its 3Q24 results, Amgen updated its guidance for 2024. The company now expects 2024 revenue of $33.0-$33.8 billion, representing growth of 17%-20% from 2023 and raised at the low end from its earlier estimate of $32.8-$33.8 billion. It also expects adjusted EPS of $19.20-$20.00, representing growth of 2.9%-7.2% from the prior year and narrowed from its earlier estimate of $19.10-$20.10. Meanwhile, the company now looks for a non-GAAP tax rate of 14%-15%, lowered from its earlier estimate of 15%-16%, continues to expect capital expenditures of approximately $1.3 billion and share repurchases of up to $500 million.

Reflecting the company's third-quarter results, we are raising our 2024 adjusted EPS estimate to $19.90 from $19.55, implying 7% growth from the company's 2023 results. We expect growth to continue in 2025 based on the launch of new products, and are reiterating our adjusted EPS estimate of $20.95.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Amgen is Medium, the midpoint on our five-point scale. As of September 30, cash and cash equivalents were $9.0 billion, down from $10.9 billion at the end of 2023. Total debt was $60.4 billion, down from $64.6 billion at the end of 2023, while the debt/capital ratio rose to 91% from 89%. During the third quarter, cash flow from operations rose 29% to $3.6 billion, while free cash flow rose 32% to $3.3 billion.

The company plans to return approximately 60% of non-GAAP net income to shareholders through 2030 by way of dividends and share repurchases. Management noted that this includes up to $500 million in share repurchases in 2024. However, the company has not repurchased stock through the first three quarters of the 2024 year.

Amgen pays a dividend. In December 2023, the company announced a roughly 6% increase in its quarterly dividend to $2.25 per share, or $9.00 annually, from its previous payout of $2.13 per share, or $8.52 annually. The dividend holds a yield of about 2.8%. Our dividend estimates are $9.00 for 2024 and $9.50 for 2025.

MANAGEMENT & RISKS

Robert A. Bradway is Amgen's chairman and CEO. He has held these roles since January 2013 and May 2012, respectively. Prior to joining the company in 2006 as VP, Operations Strategy, he was a managing director at Morgan Stanley. Peter Griffith has served as EVP and CFO since January 2020.

Risks for Amgen include the high cost and long time horizon for the development of new biologic products. Development cycles for these products can extend for more than 10 years. Amgen also faces increased competition and pricing pressures for many products.

Amgen faces the risk that insurers and other payers may restrict reimbursement coverage for its drugs. In Europe and other overseas markets, national agencies typically make coverage decisions, with drug manufacturers negotiating for wider access and higher volume in return for lower pricing.

COMPANY DESCRIPTION

Amgen, based in Thousand Oaks, California, is a leading global biotech company. Its key products include Prolia, Enbrel, Xgeva, Otezla, Repatha, Tepezza, Evenity, Kyprolis, Aranesp, and Nplate. The shares are a component of the S&P 500.

VALUATION

AMGN shares trade at 16-times our adjusted EPS estimate for 2024, below the peer average of 18 for our coverage universe of biotech/pharma stocks. We think this is an attractive valuation. From a technical basis, while often volatile, the stock remains in a long-term trading pattern of higher highs and higher lows, a bullish trend for investors, and trades well above its 200-day moving average, offering downside protection. Our price target of $360 implies a total return, including the dividend, of roughly 15%.

On October 31, BUY-rated AMGN closed at $320.16, up $4.62. (Jasper Hellweg, 10/31/24)

APPLE INC. (NGS: AAPL, $225.91) .... BUY

AAPL: Return to growth as services shine

* Apple posted fiscal 4Q24 (calendar 3Q24) revenue that exceeded consensus expectations. GAAP EPS fell 34% due to a one-time charge, while non-GAAP EPS was up 12%.
* The new iPhone 16 family was introduced in September 2024, and Apple has now enabled "Apple Intelligence" features.
* Service revenue set another new all-time record in fiscal 4Q24, rising 12% year over year and 3% sequentially. The active installed base of Apple devices again reached a new record level.
* Apple's perpetually refreshed roster of highly desirable products provides a unique advantage over industry rivals.

ANALYSIS

INVESTMENT THESIS

BUY-rated Apple Inc. (NGS: AAPL) fell 1% in the aftermarket on 10/31/24 after posting fiscal 4Q24 (calendar 3Q24) revenue that topped consensus expectations and set an all-time record for any fiscal 4Q. GAAP EPS fell 34% due to a one-time charge; excluding that charge, non-GAAP EPS was up 12%. Fiscal 4Q24 revenue rose 6% from the prior year, capping a fiscal 2024 in which sales rose 2% to $391 billion.

Service revenue set another record in fiscal 4Q24, rising 12% year over year. iPhone revenue was up 6% year over year, better than expectations as demand growth in other regions more than offset weak China sales. The active installed base of Apple devices again reached a new record level.

Apple has lauded its version of AI as "Apple Intelligence." As of October, the technology has now been enabled for iPhone 16 devices, which were first introduced in September 2024. Amid speculation that Apple might raise prices for its first AI-enabled phones, pricing was unchanged for all iPhone 16 models compared with 2023's iPhone 15 family.

With the launch of the new iPhones, Apple has entered the generative AI space after being on the sidelines for nearly two years following ChatGPT's launch in November 2022. By mainly positioning these new enhancements on its highest end "Pro" series iPhones, the company seeks to drive a robust new upgrade cycle in 2025 and beyond. Although some view these products as "AI-Lite," the market believes product perfecter Apple will continue to enhance on-device generative AI in future models.

In June 2024, Apple hosted its worldwide developer conference (WWDC) with a focus on bringing artificial intelligence onto Apple devices. The company's "Apple Intelligence" aims to improve the user experience on iPhone, iPad, Mac and other devices while sustaining Apple's focus on user privacy. Apple Intelligence is integrated into new updates to Apple operating systems introduced at WWDC, including iOS 18 for iPhone, iPadOS for iPad, and macOS Sequoia, and new iterations for Watch and Vision Pro.

Apple, which is tracking the peer group and stock market in 2024, is on track for EPS growth over the next two years. This reflects a strong appetite for Apple's hardware, and its brand loyalty in turn spurs demand for Apple's services, including App Store, iCloud, and much more. The company, in our view, benefits from aggressive shareholder-return policies and from a perpetually refreshed roster of desirable product.

We believe the current environment represents an opportunity to establish or dollar-average into positions in AAPL. We are reiterating our BUY rating and our 12-month target price of $250.

RECENT DEVELOPMENTS

AAPL is up 20% year-to-date in 2024, while peers are up 17%. AAPL rose 48% in 2023, while the peer group of computing, storage, and information-processing companies in Argus coverage advanced 40%. AAPL fell 27% in 2022, slightly better than the 30% decline for peers; advanced 34% in 2021, in line with the 35% gain for peers; and rose 81% in 2020, compared to a 9% advance for peers.

For fiscal 4Q24 (calendar 3Q24), Apple posted revenue of $94.9 billion, which was up 6% year over year. Revenue beat the consensus forecast of $94.6 billion. GAAP earnings totaled $0.97 per diluted share, down 34% from a year earlier. On a non-GAAP basis excluding a large one-time charge, non-GAAP EPS of $1.64 rose 12% annually and exceeded the consensus estimate of $1.53. Apple did not guide on quarterly or annual sales or EPS for fiscal 4Q24.

Apple's geographic expansion is proving to be a strong positive for Apple as the company faces weakness in China due to challenging economic conditions (and, we believe, secular and demographic challenges) along with smartphone competition from Huawei and others. Regionally in 4Q24, Apple's revenue grew in all regions except China (16% of revenue). Greater China sales declined less than 1%, which was better than expected.

Sales grew 4% in the Americas, the largest region at 44% of revenue. Sales also rose 11% in Europe (26% of revenue), extending prior-quarter growth; 8% in Japan; and a robust 16% in Rest of Asia-Pacific. All-in Asia sales of $28.3 billion were up 5% annually.

On a segment basis for fiscal 4Q24, iPhone generated revenue of $46.2 billion (49% of total), which was up 6% year-over-year in GAAP. Sales were up 8% sequentially from the trough quarter of 3Q.

After six down quarters, global smartphone unit sales swung to positive annual comparisons in calendar 4Q23 and sustained that strength in calendar 1Q24, 2Q24, and 3Q24. According to IDC, global mobile device shipments grew 7.8% year over year in 1Q24, 6.5% year over year in 2Q24, and 4.0% growth in 3Q24.

Third-quarter global smartphone unit volumes of 316.1 million units for 3Q24 were up from 303.9 million units in 3Q23. Apple's share slipped to 17.7% from 17.8% a year earlier, while iPhone hung onto the second spot. Samsung's share eased to 18.3% in 3Q24 from 19.6%. Apple's iPhone unit shipments grew 3.5% annually, to 56.0 million in calendar 3Q24 from 54.1 million a year earlier. We calculate that iPhone ASPs were $825 in calendar 3Q24, up 20% from a year earlier but down 5% sequentially. That is normal seasonality as Apple discounts past iPhone models as it rolls out the new iPhone family, which was available for about half a month in fiscal 4Q24.

Apple sells its high-end phones such as Pro Max in developed markets, and uses its mature, lower-priced iPhones to build share in the developing world. We believe ASP trends are less important than global expansion of the iPhone base. Apple's seasonally strongest quarter for iPhone is calendar 4Q (fiscal 1Q25), and we look for unit and revenue growth and peak market share for the calendar year.

Also for fiscal 4Q24, Mac revenue of $7.74 billion (8% of total) was up 2% year over year in GAAP. The multi-year downturn in PC demand worldwide finally reversed in calendar 1Q24, according to IDC. Mac unit sales in calendar 2Q24 were up 21%, while overall global PC unit sales were up 3% in calendar 2Q24. Mac boosted its market share to 8.8% in calendar 2Q24 from 7.5% a year earlier.

Mac unit sales in calendar 3Q24, according to IDC, declined 24% to 5.8 million units, while overall global PC unit sales were down 3%. Given demand for Macs with Apple M series chips, ASPs rose in double-digits year over year and in high single-digits sequentially. We believe Mac is in a transition period ahead of broad availability of AI PCs, or in Apple's case PCs with Apple Intelligence.

iPad revenue of $7.0 billion (7% of total) was up 8% annually. During 3Q24, Apple launched new 11" and 13" iPad Air models, and a new iPad Pro with the M4 chip. Total compute revenue (mac and iPad) of $19.9 billion for 4Q24 rose 14%. Revenue from Wearables, Home, and Accessories of $9.0 billion (10% of total) was down 3% in GAAP and up 12% sequentially.

Services revenue set another all-time record in fiscal 4Q24, while rising 12% year over year to $25.0 billion; revenue also rose 3% sequentially. The active installed base of Apple devices again reached a new record level, according to CFO Maestri.

On 9/9/24, Apple hosted its "Glowtime" event to launch its new generation of devices and the new iPhone 16 family. At the company's annual Worldwide Developers Conference (WWDC) in June, Apple first rolled out its "Apple Intelligence," which builds personalized intelligence into iPhone, iPad, Watch, Mac and more while prioritizing privacy. In October, Apple Intelligence became available for iPhone users.

New features on iPhone 16 include elements of Apple Intelligence. Camera control is a flush-to-the surface side button that enables you to take pictures without opening the app. Visual search will enable the user to point the phone camera at a restaurant and immediately learn menu, hours, and more.

The all-new A18 chip is the most meaningful manifestation of Active Intelligence. This technology allows iPhone to run multiple generative AI models on the phone simultaneously. For more intensive tasks, Apple Intelligence reaches out to Apple's "Private Cloud Compute," which runs on Apple's in-house servers.

Made in second-generation 3 nm process, the A18's neural engine is twice as fast compared to the predecessor product and features 17% more memory bandwidth. Its six-core CPU is 30% faster than the CPU in iPhone 15, while consuming 30% less power. And its built-in GPU is 40% faster than the predecessor product.

The screen is a new Ceramic Shield glass (from Corning) that is 50% tougher than the prior generation. The new color lineup includes pink, ultramarine, white, teal, and black. iPhone 16 has a big boost to battery life, according to the company, but AI is a power hog. iPhone 16 starts at $799 and iPhone 16 Plus starts at $899, both with 128 Gb of storage.

Apple has always differentiated iPhone Pro from "plain old" iPhone, but over the past three years, we believe the differentiation has become more pronounced. A standard marketing strategy for Apple now is to introduce features to Pro phones in one model year, and then to make all or most of those features available in the next year's iPhone, while giving Pro a new set of differentiators.

Phone 16 Pro and iPhone 16 Pro Plus have all the iPhone 16 features and, as noted, differentiation. They are bigger, at 6.3" diameter 16 Pro and 6.9" for Pro Plus vs. 6.1" for iPhone 16 and 6.7" for 16 Plus, and have "the thinnest borders on any Apple product," according to the company. The Pro models are encased in titanium vs. aluminum for iPhone 16. Battery life was described as "best ever," though again the improvement was not quantified.

The A18 Pro chip is an upgrade on the A18 used on iPhone 16 and includes a 16-core neural engine designed to "excel" at generative AI workloads. On this chip, Apple Intelligence runs 15% faster than on iPhone 15 Pro. Many of its refinements will enable functionality of Apple's most advanced camera system ever.

Like the 15 family, iPhone 16 shows two camera lenses on the back of the device, while the Pro models have three lenses. The new 48 MP Fusion Camera has a faster quad-pixel sensor that enables 4K120 fps video recording in Dolby vision. The 48MP ultra-wide camera is designed for higher-resolution photography and has a 12 MP, 5x telephoto camera on both Pro models. The camera has a combination of "hardware and software intelligence," which will enable easier and more intuitive post-snap editing features.

iPhone 16 Pro starts at $999 with 128 Gb of storage, and iPhone 16 pro Plus starts at $1,199, with 256 Gb of storage. All iPhone 16 family products are available for pre-order on 9/13/24 and available in stores on 9/20/24.

Apple also introduced the new Watch Series 10, which has a new design, and new models of Ultra Watch Series 2, which was launched a year ago. Watch Series 10 is both thinner and possesses a bigger display compared with Series 9 – another amenity to Apple's first generation of users who are now well into boomer-hood.

The new Air Pods 4 series are made to ergonomically fit the ear with "the most comfortable Air Pods ever." According to Apple, the H2 chip in Air Pods 4 results in a massive improvement in audio quality, with richer bass. Like series 3, Air Pods 4 has active noise cancellation. "Conversation awareness" will reduce music volume when you start talking. Air Pods 4, available 9/20/24, are $129, or $179 with active noise cancellation.

Air Pods Pro 2 "will soon feature a clinical-grade hearing aid capability," according to literature on the Apple web site. This includes Hearing Test, the hearing aid feature, and active hearing protection. Apple calls the solution, which entails use of Air Pods Pro 2 and an iPhone or iPad, the world's first all-in-one hearing health solution. For Air Pods Pro 2 owners, it will be available with a free software upgrade.

Apple expects to receive clearance for the technology from the FDA and other regulators soon, and anticipates the software upgrade will be issued during autumn 2024. Air Pods Pro 2 begins at $249, although we believe the full hearing health model will retail for more.

Apple announced iPhone 16 and 16 Max in one article on its website, and announced iPhone 16 Pro and 16 Pro Max in a separate article. Apple has always differentiated Pro from "plain old" iPhone, but over the past three years, we believe the differentiation has become more pronounced. A standard marketing strategy for Apple now is to introduce features to Pro phones in one model year, and then to make all or most of those features available in the next year's iPhone, while giving Pro a new set of differentiators.

While that strategy remains intact, iPhone 16 did get some new features, including elements of Apple Intelligence. The Action button can quickly access in-demand features. Among the upgrades to the advanced camera system, the user can adjust the camera by sliding your finger. Visual search will enable the user to point the phone camera at a restaurant and immediately learn menu, hours, and more. Camera control is a flush-to-the surface side button that enables you to take pictures without opening the app.

Made in second-generation 3 nm process, A18's neural engine is twice as fast compared to the predecessor product, and features 17% more memory bandwidth. Its six-core CPU is 30% faster than the CPU in iPhone 15, while consuming 30% less power. And its built-in GPU is 40% faster than the predecessor product.

The all-new A18 chip is the most meaningful manifestation of Active Intelligence. This technology allows iPhone to run multiple generative AI models on the phone simultaneously. For more intensive tasks, Apple Intelligence reaches out to Apple's "Private Cloud Compute," which runs on Apple's in-house servers.

Several of the search, find and generate features using Apple Intelligence on iPhone 16 were shown or teased at WWDC. Many of these features will await future software upgrades. Siri in particular seems badly outdated but will receive a needed refresh in coming months.

The screen is a new Ceramic Shield glass (from Corning) that is 50% tougher than the prior generation. iPhone 16 has a "vibrant new look which celebrates color," according to the company. The new color lineup includes pink, ultramarine, white, teal, and black. iPhone 16 has a big boost to battery life, according to the company, but remember that AI is a power hog. The company's presentation was also unclear on which Apple Intelligence features would be available and the timing of that availability. iPhone 16 starts at $799 and iPhone 16 Plus starts at $899, both with 128 Gb of storage.

Phone 16 Pro and iPhone 16 Pro Plus have all the iPhone 16 features and, as noted, differentiation. They are bigger, at 6.3” diameter 16 Pro and 6.9” for Pro Plus vs. 6.1” for iPhone 16 and 6.7” for 16 Plus, and have “the thinnest borders on any Apple product,” according to the company. The Pro models are encased in titanium vs. aluminum for iPhone 16. Battery life was described as “best ever,” though again the improvement was not quantified.

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On balance, Apple was smart to hold the line on pricing; all four phones carry the same prices that iPhone 15 family phones carried one year earlier. That’s because the current level of Apple Intelligence on these devices is solid, even impressive, but not amazing. Apple plans to more deeply integrate OpenAI models, inference and other tools into its phones going forward. For now, we expect these devices to generate some interest but perhaps not fly off the shelves. Their performance in the 2024 holiday and 2025 year may have more to do with consumers’ financial health, Fed policy, and economic growth than with the underlying technology.

Apple, which is tracking the peer group and stock market in 2024, is on track for EPS growth over the next two years. This reflects strong appetite for Apple’s hardware, and its brand loyalty in turn spurs demand for Apple’s services, including App Store, iCloud, and much more.

EARNINGS & GROWTH ANALYSIS

For fiscal 4Q24 (calendar 3Q24), Apple posted revenue of $94.9 billion, which was up 6% year over year. Revenue beat the consensus forecast of $94.6 billion.

The GAAP gross margin was 46.2% in fiscal 4Q24 versus 46.3% in fiscal 3Q24 and 45.2% a year earlier. The GAAP operating margin was 31.26% in fiscal 3Q24, up from 29.6% in fiscal 3Q24, and up from 30.1% in the prior-year quarter.

GAAP earnings totaled $0.97 per diluted share, down 34% from a year earlier. On a non-GAAP basis excluding a one-time “back taxes” payment of over $10 billion to the EU, non-GAAP EPS of $1.64 rose 12% annually and exceeded the consensus estimate of $1.53. Apple did not guide on quarterly or annual sales or EPS for fiscal 4Q24.

For all of FY24, Apple posted revenue of $391.0 billion, up 2% from $383.3 billion in FY23. GAAP EPS totaled $6.07 for FY24 (including the one-time charge), down 1% from the $6.13 for FY23.

We have raised our FY25 GAAP EPS forecast to $7.14 per diluted share from $7.07. We are implementing a FY26 GAAP EPS projection of $7.75. We regard our estimates as fluid and subject to change. Our long-term EPS growth rate forecast for AAPL is 13%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Apple is High, the top point of our five-point scale. In the wake of the recent cut in the corporate tax rate and relaxed restrictions on repatriating overseas cash, Apple has stepped up its shareholder-return program with higher buybacks and an April 2023 dividend hike. It has also accelerated debt retirement.

Cash & short- and long-term investments were $156.6 billion at the end of fiscal 2024. Cash was $162.1 billion at the end of fiscal 2023, $169.1 billion at the end of fiscal 2022, and $196.3 billion at the end of fiscal 2021.

Debt was $106.6 billion at the end of fiscal 2024. Debt was $114.4 billion at the end of fiscal 2023, $120.1 billion at the end of fiscal 2022, $124.7 billion at the end of fiscal 2021, and $112.4 billion at the end of FY20.

For fiscal 2024, cash flow from operations was $118.2 billion. Cash flow from operations was $110.5 billion in FY23, $122.2 billion in FY22, $104.0 billion in FY21, and $80.7 billion in FY20.

Apple added $110 billion to its buyback authorization in April 2024. Prior increases in the repurchase authorization were $90 billion in April 2023, $90 billion in April 2022, $90 billion in April 2021, $50 billion in April 2020, $75 billion in April 2019, and $100 billion in April 2018.

In April 2024, Apple raised its quarterly dividend by 4% to $0.25 per share. Apple also raised its dividend by 4% to $0.24 per share in April 2023; by 5% to $0.23 in April 2022; by 7% in April 2021; by 6.5% in April 2020; by 5% in April 2019; and by 16% in April 2018. Apple declared its first quarterly dividend in April 2012.

Our dividend forecasts are $1.04 for FY25 and $1.12 for FY26.

MANAGEMENT & RISKS

Timothy Cook has served as CEO since industry legend Steve Jobs passed away in 2011. Former Apple controller and former Xerox CFO Luca Maestri became CFO in September 2013. He has announced plans to exit the CFO role in January 2025 and lead the corporate services team. At that time, VP of Financial Planning Kevan Parekh will become CFO. Jeff Williams is COO, and James Wilson is chief technology officer. Another long-term Apple executive, Greg Joswiak, is the SVP of marketing. Longtime head of worldwide marketing Phil Schiller retired from that role and has become an Apple fellow.

The DoJ lawsuit alleging anti-competitive behavior is a real risk in that a successful outcome by the DoJ could disrupt Apple's business model and closed eco-system. Currently, we do not expect the outcome of the DoJ action to dissuade the multitude of satisfied Apple device owners to shift to other operating systems and devices.

Several top executives, including design leader Jony Ive and SVP of retail Angela Ahrendts, have left the company in the past few years. However, Apple has a deep bench of executive, engineering, and marketing talent. We think the company will continue to attract high-quality talent, both from an engineering perspective as well as in the corporate leadership ranks.

Apple is in its familiar cadence of introducing new phones in the fall, just ahead of holiday spending, though that schedule was delayed slightly last year. The upcoming 5G cycle promises to be major. Apple is a product perfecter, not a product originator, and should eventually find a ready appetite for its iPhones whenever they are ready.

Apple sells phones around the globe; smartphones are now ubiquitous and in need of constant upgrades; and consumers are anxious to remain within the Apple ecosystem. For these reasons, we expect Apple's long-cycle demand to smooth any near-term demand bumps. Tariffs also represent a difficult-to-quantify risk, but all parties have a long-term interest in facilitating global trade flows.

Investors have criticized Apple for its closed ecosystem. That system, however, has the effect of prompting consumers to buy iPads and Macs for system compatibility. Even more compelling for brand loyalty are Apple's services, including iTunes, App Store, and iCloud, as consumers do not want the cost and complexity of pulling their media libraries out of the comfortable arms of Mother Apple.

The shares are always at risk from the perception that growth could slow as the law of large numbers catches up with Apple. The company has mitigated that risk, in our view, with aggressive shareholder-return policies, which likely will remain paramount. Despite the company's growing largesse, we expect institutional investors to continue to demand aggressive dividend growth and a larger share-repurchase plan.

COMPANY DESCRIPTION

Apple manufactures smartphones, tablets, PCs, software, and peripherals for a worldwide customer base. Its products include Mac desktop and mobile PCs, iPhone, iPad, Apple Watch, and various consumer products, including AirPods, Beats headphones, and Apple TV. Apple services include App Store, iTunes, iCloud, Apple TV+, Apple Arcade, Apple Music, Apple Pay, and more.

VALUATION

AAPL trades at 32.2-times our FY25 EPS estimate and at 29.7-times our FY26 forecast; the two-year average P/E of 30.9 is above the five-year (FY20-FY24) trailing multiple of 27.4. Apple is trading at a two-year forward relative P/E of 1.44, above its historical relative multiple of 1.37 over the past five years. We believe Apple deserves to trade at premiums to its historical comparables, as it sets itself further apart as a provider of premium electronic consumer devices and high-margined digital services, and notably as the age of on-device generative AI gets underway. On all comparable historicals, we calculate a value in the low-$200s, in a rising trend and near current prices.

AAPL trades at premiums to the technology hardware peer group on absolute and relative P/E, EV/EBITDA, P/S, and PEGY. While peer-indicated value of about $130 is below current prices, it is rising. We believe that AAPL warrants a significant premium to peers given the company's ability to expand globally and generate healthy demand for its products seemingly in every kind of economy. Apple also trades on GAAP results while peers trade on non-GAAP results.

Our more forward-looking two- and three-stage discounted free cash flow model renders a value around $320 per share, in a stable trend and well above current levels. Our blended fundamental valuation model points to a price of $285, in a stable to slightly higher trend and above current prices.

Appreciation to our 12-month target price of $250, along with the dividend yield of about 0.4%, implies a risk-adjusted total return in excess of our forecast for the broad market and is thus consistent with a BUY rating.

On October 31, BUY-rated AAPL closed at $225.91, down $4.19. (Jim Kelleher, CFA, 10/31/24)

MASTERCARD INC. (NYSE: MA, $499.59) .... BUY

MA: Raising target as operating margin expansion continues

* On October 31, Mastercard reported adjusted 3Q24 operating EPS of $3.89, up from $3.39 a year earlier and above the consensus of $3.75.
* Gross dollar volume rose 10%, a slight uptick from 9% in 2Q, while cross-border volume continued to impress, with 21% growth in 3Q24.
* The 3Q24 adjusted operating margin was 59.3%, up from 58.8% a year earlier. Margin improvement remains a key factor behind our thesis for a higher valuation for MA shares.
* Our target price is $550 (raised from $510), implying a multiple of 33-times our 2025 EPS estimate.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY rating on Mastercard Inc. (NYSE: MA). Third-quarter earnings reflected continued healthy growth in spending volume. The higher spending included a further rebound in cross-border transactions as international travel increased. We expect spending volume to continue to improve in nearly all categories, though at a slower pace than in 2023, as higher interest rates have taken a toll on the consumer.

Along with 3Q earnings, the company said it took a $190 million restructuring charge in the quarter related to organizational changes that include a realignment of its regional operations and payments and services designed to accelerate growth and allow it to continue to deliver positive operating leverage.

At its Investor Day in November 2021, management emphasized significant opportunities in the areas of commerce (accelerated digitization, new commerce, security and identity), society (payment modernization, localization, ESG), and technology (cybersecurity, AI and analytics, digital currencies). In the Payments area, it sees growth opportunities in consumer purchases (acceptance growth). Management offered 2022-2024 financial guidance, including compound annual net revenue growth in the high teens, an annual operating margin of at least 50%, and EPS growth in the low 20s. The company plans to hold its next Investor Day on November 13, 2024, at which time we expect management to lay out new financial goals.

We like Mastercard's long-term growth story, particularly relative to the broad market. In our view, the company will continue to benefit from the secular shift from cash to credit cards, driven by the rapid growth of online shopping, the security and convenience of cards, and the opportunity to take advantage of rewards programs. Mastercard should also benefit from growth in emerging markets and expanded merchant acceptance. Our new target price is $550 (up from $510).

RECENT DEVELOPMENTS

MA shares have risen 21% over the past year, compared with a 25% increase for the broad market.

On October 31, Mastercard reported adjusted 3Q24 operating EPS of $3.89, up from $3.39 a year earlier and above the consensus of $3.75. Net revenue rose 13%, to $7.4 billion, with a 14% increase in currency-neutral revenue.

Gross dollar volume rose 10% from the prior year to $2.5 trillion (7% growth in the U.S. and 12% in the rest of the world), while the number of switched transactions (formerly processed transactions, or transactions that Mastercard has authorized, cleared, or settled) rose 11% on an adjusted basis to 41.1 billion. The number of cards issued rose 6% to 3.44 billion.

Adjusted operating expenses rose 9%. The 2Q adjusted operating margin was 59.4%, up from 58.6% a year earlier. Adjusted net income increased 12% to $3.0 billion, while EPS rose a greater 15%, helped by a 2% decline in shares outstanding.

EARNINGS & GROWTH ANALYSIS

The rebound in cross-border volume continues to impress, with 21% growth in 3Q24, up from the 19% pace in 2Q. In the third quarter, gross dollar volume rose a healthy 10%. Spending volume continues to improve in nearly all categories, including travel & entertainment spending. After rising 27% year over year in 1Q amid intense competition, rebates and incentives grew only 9% in 2Q but accelerated again to 17% in 3Q and are likely to remain on the upswing.

On the 3Q earnings call, management offered guidance for a low teens revenue growth rate in 4Q, and operating expense growth at the high end of a low double-digit range.

After 13% growth in 2023, we look for 11% revenue growth in 2024, reflecting some slowing of economic growth due to higher interest rates. We expect cross-border transactions to remain a growth driver for spending volume, aided by a strong dollar that has boosted international travel by Americans. We also expect MasterCard to benefit from favorable secular trends in the payments industry as more spending moves online.

We are raising our 2024 EPS estimate to $14.51 from $14.32 as consumer spending continues to surprise on the upside. Our 2025 forecast remains at $16.63.

FINANCIAL STRENGTH & DIVIDEND

We rate Mastercard's financial strength as High, the highest point on our five-point scale.

Long-term debt decreased to $17.6 billion as of September 30, 2024, up from $14.3 billion at the end of 2023.

Mastercard repurchased 6.3 million shares for $2.9 billion in 3Q24 and 23.8 million shares for $9.0 billion in all of 2023. In 3Q24 through September 30, the company has repurchased 2.09 million shares for $983 million, leaving $5.6 billion on its buyback authorization.

In December 2023, Mastercard announced a 16% increase in its quarterly dividend to $0.66 per share, or $2.64 annually, for a yield of about 0.6%. Our dividend estimates are $2.64 for 2024 and $2.88 for 2025.

MANAGEMENT & RISKS

Mastercard is led by President and CEO Michael Miebach, who took over from Ajay Banga at the beginning of 2021. Sachin Mehra is the CFO.

Government regulation remains a risk for the company. Interchange fees in particular are constantly being reviewed in the U.S. as well as in other countries. In March 2024, the company said it had reached an agreement to reduce its U.S. credit card interchange rates for at least a five-year period (through 2030) as part of a legal settlement with merchants. However, the settlement was later rejected by a district court in June 2024. Mastercard said it will continue to work towards another settlement.

While the secular shift from cash to electronic payments remains a long-term tailwind, Mastercard's revenues remain subject to near-term trends in consumer spending. Cross-border transactions may also face pressure from geopolitical developments, exchange rates, and international travel restrictions.

COMPANY DESCRIPTION

Mastercard operates the world's second-largest electronic payments network, providing processing services and payment product platforms, including credit, debit, ATM, prepaid, and commercial payments under the Mastercard, Maestro, and Cirrus brands. Mastercard went public in 2006 and is a member of the S&P 500.

VALUATION

MA shares trade at 34-times our 2024 EPS estimate, slightly above the historical average in the high 20s but reflecting higher-than-normal operating margins. We expect revenue at Mastercard to continue to grow at least at a low-teens rate over the next several years given strong secular trends in the payments processing industry. Operating margins in the high 50s are also enviable, even if slightly below those of peer Visa Inc. We believe that Mastercard's overall operating metrics, particularly its record margins, merit a valuation above the stock's historical average. Our 12-month price target of $550 implies (up from $510) a multiple of 33-times our EPS estimate for 2025.

On October 31, BUY-rated MA closed at $499.59, down $14.10. (Stephen Biggar, 10/31/24)

MOODY'S CORP. (NYSE: MCO, $454.04) .... BUY

MCO: Raising target price

* Moody's recently reported 3Q24 adjusted EPS of $3.28, up 32% year-over-year and above the consensus forecast of $2.86.
* The shares have outperformed the market over the past year, gaining 49% while the S&P 500 has risen 37%.
* Along with the 3Q report, management updated its 2024 guidance. The company now projects adjusted diluted EPS of $11.90-$12.10 for the year, up $0.80 at the midpoint of the range.
* Our target price is $500, up from $490.

ANALYSIS

INVESTMENT THESIS

Our rating on Moody's Corp. (NYSE: MCO) is BUY. Moody's is a large-cap financial services company focusing on credit ratings and risk management and analytics. The company has an impressive track record, with historical compound annual growth rates for sales and EPS in the low double-digit range. We expect Moody's to benefit over the long run from the secular trends of global GDP growth and debt-market disintermediation. Management also has opportunities to develop new products and raise margins, and to expand through targeted acquisitions. The company now faces uneven conditions in corporate-debt issuance, given high interest rates and geopolitical concerns. However, we think that management will be able to navigate these challenges as it did during the 2009 financial crisis and COVID-19. The company has signaled confidence in its outlook with a 10% dividend hike. Our new target price is $500, increased from $490. We think the MCO shares are suitable as a core Financial Services holding in a diversified portfolio.

RECENT DEVELOPMENTS

MCO shares have outperformed the market over the past year, gaining 49% while the S&P 500 has risen 37%. They have underperformed over the past three months, declining 1% while the market has risen 5%. The shares have outpaced the market and the financial services industry ETF IYF over the past five years. Approximately 12.5% of the shares are held in various ETFs. The beta on MCO is 1.27.

Moody's recently reported 3Q24 adjusted EPS that rose 32% year-over-year and topped analyst expectations. Second-quarter revenue rose 7% from the prior year to $1.8 billion. The adjusted operating margin widened by 320 basis points to 47.8%. Adjusted EPS was $3.28, up 32% year-over-year, and above the consensus forecast of $2.86. Year-to-date, the company has earned $9.85 per share on an adjusted basis.

Along with the 3Q report, management updated its guidance for 2024. The company now projects adjusted diluted EPS of $11.90-$12.10 for the year, up $0.80 at the midpoint of the range. Moody's has a long history of setting the earnings bar low early in the year and raising it as the quarters roll along.

EARNINGS & GROWTH ANALYSIS

Moody's Corp. has two operating segments: Moody's Investor Service (MIS) and Moody's Analytics (MA). MIS, which publishes credit ratings on debt obligations, accounted for 54% of 3Q24 revenue. MA provides research and financial risk management for institutions; it accounted for 46% of 3Q revenue. Recent trends and outlooks are discussed below.

In 3Q24, MIS revenue rose 41% year-over-year, driven by improved market conditions and activities supporting strong issuance across asset classes. Overall, issuance was up 51% year-over-year in 3Q, led by investment grade, leveraged loans and high-yield bonds.

MA revenue rose 7% year-over-year on a constant-currency basis. Segment revenue was paced by KYC Solutions, where revenue rose 19%. Research & Insights revenue increased 6% on sales to corporate customers, and Data & Information revenue was up 6% on demand for ratings data feeds.

Moving to margins, the 3Q24 adjusted operating margin was 47.8%. Management has focused on holding down costs related to real estate and personnel.

Turning to our estimates, based on trends and forecasts for bond issuance and analytical services, as well as management's focus on margins, we are raising our 2024 adjusted EPS forecast to $12.12 from $11.40. Our estimate is at the high end of management's guidance range, and implies a year-over-year increase of 15%. We look for growth to continue in 2025, as interest rates come down, and are raising our preliminary adjusted EPS estimate to $13.46 from $12.65. Our long-term earnings growth rate forecast remains 10%.

FINANCIAL STRENGTH & DIVIDEND

We rate the financial strength of Moody's as Medium, the midpoint on our five-point scale. The company scores above average on key tests such as fixed-cost coverage and profitability, but debt levels are on the high side.

Cash and cash equivalents and short-term investments totaled $2.6 billion on September 30. Long-term debt totaled $7.6 billion.

Moody's pays a dividend. In February 2024, management raised the payout by 10%. The current quarterly dividend is now $0.85 per share, or $3.40 annually, for a yield of about 0.75%. We think the dividend is secure, and likely to grow. Our dividend estimates are $3.40 for 2024 and $3.80 for 2025.

The company also has a share-repurchase program. During 3Q, it repurchased 0.9 million shares totaling $428 million.

MANAGEMENT & RISKS

The company's CEO is Robert Scott Fauber, who was previously COO. Noemie Heulamd is CFO. The longtime CEO, Raymond McDaniel, is nonexecutive chairman. Stephen Tulenko is president of Moody's Analytics. Michael West is president of Moody's Investor Services.

Moody's is positioned to benefit from long-term secular trends such as global GDP growth and the disintermediation of credit markets in developed and emerging economies. The company continues to pursue targeted acquisitions and sees the opportunity for operating-margin expansion. Share buybacks are also expected to boost EPS.

Management's financial goals are double-digit revenue growth and low double-digit EPS growth over the medium term.

Investors in Moody's face numerous risks. The ratings industry may be affected by a slowing economy or by rising interest rates, both of which could reduce demand for corporate debt and ratings. The industry is also competitive.

As a global company, Moody's faces currency risk. A stable or lower dollar would be a positive development.

The company also faces regulatory risks, including regulatory oversight in Europe.

COMPANY DESCRIPTION

A large-cap financial services company, Moody's provides credit ratings on 11,000 corporate issuers and 18,000 public finance issuers in 120 countries. Its analytics division provides clients with financial analysis and risk management services. The stock is a component of the S&P 500. The company has 15,000 employees.

VALUATION

We think that MCO shares remain attractively valued at current prices around $455. The shares have traded between $308 and $490 over the past 52 weeks, and are currently toward the high end of the range. The technical trend has been bullish since October 2022.

Looking ahead, we expect low double-digit EPS growth, multiple expansion, and a higher share price over the long term as the company continues to expand in not-terribly-competitive markets. We have examined a group of the company's publicly traded peers, including, among others, MSCI, Morningstar, FactSet Research Systems, and S&P Global. Moody's trades at 34-times our 2025 EPS estimate, near the peer average. On price/sales, the stock is trading at a multiple of 12.2, close to the top of the peer group range of 6-13. Our dividend discount model produces a fair value of more than $500 per share. Blending our approaches, we arrive at our target price of $500.

On October 31, BUY-rated MCO closed at $454.04, down $4.92. (Kevin Heal, 10/31/24)

UNION PACIFIC CORP. (NYSE: UNP, $232.07)... BUY

UNP: Recent weakness offers buying opportunity

- * UNP shares have underperformed the market over the past three months, declining 5%, while the S&P 500 has risen 5%.
- * During the quarter, EPS rose 11% from the prior year period, volume was up 6%, and productivity rose 12%.
- * Management expects these positive trends to continue and believes that it will have the best operating margin in the industry.
- * The company pays an above-industry-average dividend that yields about 2.3% and has also been buying back its shares.

ANALYSIS

INVESTMENT THESIS

Our rating on Union Pacific Corp. (NYSE: UNP) is BUY. UNP is among the most efficient operators in the rail industry, which has been on a secular growth path compared with other transport options — i.e., water, pipelines, trucks — for the past 20 years. The company's freight business is diversified among Bulk, Industrial, and Premium, which reduces the impact of weakness in any single product segment. Management has been leveraging technology and automation to drive safety, efficiency, and productivity in its network. The efforts have offset higher labor expenses and helped to increase margins. The approach has also translated into better service for UNP customers, who are willing to pay higher prices for excellent service.

During the quarter, EPS rose 11% from the prior year period, volume was up 6%, and productivity rose 12%. Management expects these positive trends to continue and believes that it will have the best operating margin in the industry. The balance sheet is solid, and the company has a shareholder-friendly history of paying dividends and buying back stock. The shares are trading at 21-times our 2024 EPS estimate and 20-times our 2025 estimate compared to the five-year historical average of 20-22. Compared to a peer group, UNP trades at a discount on P/E and price/sales. Our target price remains $265.

RECENT DEVELOPMENTS

UNP shares have underperformed the market over the past three months, declining 5%, while the S&P 500 has risen 5%. Over the past year, the shares have also underperformed, advancing 14% compared to gains of 38% for both the index and the Industrial sector ETF IYJ. In the last five years, the shares have risen 35% compared to 86% for the index and 65% for the industry. The beta on UNP is 0.95.

The company recently reported third-quarter results that missed analyst expectations. Revenue rose 3% to $6.1 billion and was slightly lower than the consensus. Excluding fuel surcharges, revenue grew 5%. GAAP EPS came to $2.75 compared to $2.51 a year earlier but missed the Street estimate of $2.78. Operating income was up 11% versus the prior year, as the operating ratio (expenses/revenues) improved by 310 basis points to 60.3%. The results reflect volume growth of 6%. During the first nine months of 2024, the company earned $8.18 per share.

Management does not provide formal EPS guidance but does provide an informal outlook. For 4Q24, mangement looks for results to be consistent sequentially, implying an improvement in full-year-2024 results compared to 2023. It also plans for share repurchases to reach $1.5 billion for the year. Management said that the profitability outlook remains positive for 2024, and pricing is expected to exceed inflation while volume and margins continue to improve.

EARNINGS & GROWTH ANALYSIS

Results in the quarter benefited from higher volume, pricing that outpaced inflation, and operating efficiency. UNP has three primary segments: Bulk (31% of freight revenues), including grain, grain products, fertilizer, food & refrigerated products, and coal; Industrial (37%), including industrial chemicals and plastics, metals and minerals, forest products, and energy and specialized products; and Premium (32%), including intermodal and finished vehicles.

In the Bulk segment, revenue was up 2% year over year, reflecting a 3% decrease in volume and a 5% increase in revenue per carload from a positive mix and pricing gains. The Industrial segment saw revenue growth of 3% on a 2% decrease in volume and a 5% increase in average revenue per carload. The results were helped by strong pricing gains and a positive mix. For the Premium segment, revenue in the quarter was up 7% from a 14% increase in volume offset by a 6% decrease in average revenue per carload amid a 33% increase in intermodal shipments.

Overall in the third quarter, volume was up 6% year over year, compared to 1% in the prior quarter. By segment, volume grew 14% in Premium and fell 3% in Bulk and 2% in Industrial. Looking ahead, we expect to see a pickup in grain volume in the Bulk segment, higher petroleum shipments in Industrial, and higher automotive volume in Premium due to new business wins. Coal and rock demand are forecast to remain weak.

Management also uses statistics to measure the company's performance. The quarterly freight car velocity increased 5% to 210 miles per car. Locomotive productivity improved 5% as did terminal dwell (the amount of time a locomotive spends idle in a station). Workforce productivity rose 12%, and the reportable personal injury and derailment rates also both improved in the quarter.

Management keeps a close eye on expenses. The operating ratio is widely used by railroad investors to assess efficiency; a lower operating ratio signals a rising operating margin and is positive. Union Pacific's Unified Plan targets an eventual 55% ratio. The plan focuses on productivity gains that come from streamlining operations and fully leveraging railroad assets, including cars, train crews, and yards. In the latest quarter, UNP's operating ratio improved by 310 basis points from the prior year to 60.3%. The company noted that while cost per employee was up 8%, lower fuel costs and other expenses helped reduce total expenses.

Turning to our estimates, based on the latest volume and pricing and management's guidance, we are raising our 2024 adjusted EPS estimate to $10.98 from $10.95. Our estimate implies EPS growth of 5% for the year. We expect growth to accelerate for this well-managed company in 2025 but are lowering our preliminary adjusted EPS forecast to $11.82 from $12.05. Our long-term earnings growth rate forecast is 8%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Union Pacific is Medium, the midpoint on our five-point scale. The company generally receives average scores on our financial strength tests of debt levels, fixed-cost coverage, cash flow generation, and profitability. UNP haS a Baa1 credit rating from Moody's and an A- rating from both S&P and Fitch.

The company had $900 million of cash on hand at the end of the quarter compared to $1.1 billion at the end of 4Q23. Year-to-date free cash flow rose nearly 95% from the prior year, and the conversion rate in the latest quarter was 83% of net income. Total debt at the end of 3Q was $32 billion, and the debt to capitalization ratio was 66%, down from 71% a year earlier. Full-year cash flow in 2023 covered interest expense by a factor of 9. (Our average range is 10-12.)

UNP has a share buyback program. During 3Q, the company bought back $738 million of its shares for total of about $830 million in the first nine months of 2024.

The company has paid a dividend for 123 consecutive years. Earlier this month, management boosted the payout 3% to $1.34 per share per quarter, or $5.36 annually. The yield is about 2.3%, above the industry average. Our dividend estimates are $5.28 for 2024 and $5.52 for 2025.

MANAGEMENT & RISKS

Union Pacific recently underwent a management transition. Lance M. Fritz had been the company's president, CEO, and chairman since 2015. In February 2023, an activist investor, the hedge fund Soroban Capital Partners, wrote a letter to the UNP board requesting that it replace Mr. Fritz. Former COO Jim Vena is the new CEO. Beth Whited is the new president, having recently served as executive VP of sustainability and strategy. Michael R. McCarthy, a board member, is the new chairman. The CFO is Jennifer Hamann, who was appointed to the post in January 2020 and has worked at UNP since 1992.

UNP remains focused on improving its operating ratio, and while management stated that it is always looking for additional efficiencies, we note that the pace of ratio improvement has slowed in recent quarters. While UNP is still an industry leader on this metric, the new CEO will be tasked with rapid improvement.

Investors in UNP face risks. Railroads may face a period of industry consolidation — indeed, a bidding war erupted over Kansas City Southern — and pricing dynamics may change.

Railroads are also highly sensitive to the macroeconomic environment and are subject to risk from fluctuating fuel prices, fuel hedges, bad weather, strikes, and other labor actions. Union Pacific's main rival in the Western United States is BNSF Corp., which is owned by the deep-pocketed Berkshire Hathaway. UNP also faces risks related to government regulation and may incur extraordinary costs related to positive train control systems, the transportation of flammable liquids, and braking standards.

The company has a pension plan, which is not fully funded.

COMPANY DESCRIPTION

Union Pacific provides rail transportation services in North America. It has approximately 31,000 route miles and transports agricultural goods, automotive products, chemicals, coal, industrial products, and other commodities between ports on the West Coast and Eastern gateways, as well as to Mexico. Based in Omaha, Nebraska, Union Pacific was founded in 1862 and is.a component of the S&P 500.

VALUATION

We think that UNP shares offer value at current prices near $233, above the midpoint of their 52-week range of $208-$258. From a technical standpoint, the shares have been in a bullish pattern of higher highs and higher lows that dates to March 2023, though the trend has recently flattened out.

On the fundamentals, the shares are trading at 21-times our 2024 EPS estimate and 20-times our 2025 estimate compared to the five-year average range of 20-22. Compared to a peer group that includes Canadian Pacific Kansas City Ltd., Canadian National Railway Co., and Old Dominion Freight Line Inc., UNP trades at a discount on P/E and price/sales. We believe that current multiples are attractive based on the company's operating model and financial strength. Our target price remains $265.

On October 31, BUY-rated UNP closed at $232.07, down $0.10. (Kristina Ruggeri, 10/31/24)

VERISK ANALYTICS INC. (NGS: VRSK, $274.72) .... BUY

VRSK: VRSK delivers a strong third quarter

* On October 30, Verisk Analytics reported adjusted earnings for 3Q24 of $1.67 per share, above the consensus estimate of $1.60 and up from $1.52 in 3Q23.
* The beat reflected solid revenue growth and 9.4% higher EBITDA.
* Along with the 3Q earnings, Verisk reiterated its 2024 guidance, calling for revenue of $2.84 billion-$2.90 billion, adjusted EBITDA of $1.54 billion-$1.60 billion, an adjusted EBITDA margin of 54%-55%, and adjusted EPS of $6.30-$6.60.
* Our revised target price of $320, combined with the dividend, implies a potential total return of more than 16% from current levels including the dividend.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY rating on Verisk Analytics Inc. (NGS: VRSK) with a target price of $320, up from $305. Verisk provides data analytics and technology services that help insurers strengthen underwriting, improve operating efficiency, and combat fraud. We think that Verisk's accelerating revenue and strong business model will appeal to investors, even in a challenging environment for property and casualty (P&C) insurers.

VRSK has divested noncore business segments. In the first quarter of 2022, it sold its Financial Services unit to TransUnion for $515 million. In February 2023, it sold Wood Mackenzie (its Energy and Specialized Markets division) to private equity firm Veritas Capital for $3.1 billion. In the wake of these sales, Verisk is now focusing on its core insurance business. Our new target price of $320, combined with the dividend, implies a potential total return of more than 16% from current levels.

RECENT DEVELOPMENTS

On October 30, Verisk reported 3Q24 revenue of $725 million, above the consensus estimate of $722 million and up 7% from the prior-year period. The improvement reflected growth in both the claims and underwriting businesses. Underwriting revenues rose almost 7% from the prior year, to $507 million, reflecting in part growth in the company's life solutions and specialty businesses. Claim revenues rose just under 8% to $218 million, driven by higher sales of anti-fraud solutions and property estimating solutions.

Adjusted EBITDA rose 9.4% to $401 million, above the consensus estimate of $396 million. The adjusted EBITDA margin was 55.2%, up from 54.0% a year earlier and above the consensus of 54.9%. The EBITDA margin benefited from cost cutting and the sale of less profitable businesses.

Adjusted earnings totaled $1.67 per share, above the consensus estimate of $1.60 and up from $1.52 in 3Q23. The earnings beat reflected solid revenue growth and 9.4% higher EBITDA.

In 3Q, the company initiated a $400 million Accelerated Share Repurchase program which it completed in October 2024, resulting in the repurchase of 1,515,616 shares at an average price of $263.92. As of September 30, 2024, Verisk had $892 million remaining under its share repurchase authorization.

As discussed in a previous note, in 2023, revenue rose 7.4% to just under $2.7 billion. EPS rose to $5.71 from $5.01 in 2022.

EARNINGS & GROWTH ANALYSIS

Along with 3Q earnings, Verisk reiterated its 2024 guidance, calling for revenue of $2.84 billion-$2.90 billion, adjusted EBITDA of $1.54 billion-$1.60 billion, an adjusted EBITDA margin of 54%-55%, and adjusted EPS of $6.30-$6.60.

We believe that Verisk can achieve its target of 200-400 basis points of margin growth over the next two years as it trims expenses following the divestiture of less profitable businesses. We project 2024 and 2025 EBITDA margins of 55%-56%.

Our 2024 and 2025 EPS estimates are $6.86 and $7.90, respectively.

Based on prospects for high-single-digit organic revenue growth and margin improvement, our long-term earnings growth rate estimate is 11%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Verisk is Medium, the midpoint on our five-point scale. We typically measure a company's financial strength by reviewing its debt levels, cash position, interest coverage, and profitability.

Verisk ended the third quarter with cash of $458 million. It had $2.5 billion of long-term debt on its books at the end of 3Q and a long-term debt/capitalization ratio of 89.3%.

Operating income covered interest expense by a factor of 11.1. We like to see an interest coverage ratio above 5.

The EBITDA margin was 55.2% in the third quarter.

Verisk pays a dividend. On February 21, 2024, the board of directors raised the dividend to $0.39 from $0.34 per share. The new dividend was paid on March 29, 2024. Our dividend estimates are $1.56 for 2024 and $1.72 in 2025.

MANAGEMENT & RISKS

L.M. Shavel is the company's president and CEO, and Edith Mann is executive VP and CFO.

Verisk generates substantial revenue from U.S. P&C insurers and could be hurt by weakness in the insurance industry or by industry consolidation that results in the loss of customers. The company could also face pressure if its products lose popularity with insurers. In addition, Verisk faces integration risk from acquisitions.

We note that the company often requires substantial time both to win new business and to implement services for customers. It must also compete with financial services and communications firms for skilled employees and could be hurt by weak employee recruitment and retention.

COMPANY DESCRIPTION

Verisk Analytics Inc. provides data analytics services and related technology for insurance companies – helping them manage risk assessment, underwriting, and claims. The company primarily serves P&C insurers and focuses on the prediction of loss, the selection and pricing of risk, and compliance with state reporting requirements. The company has teams in more than 20 countries and is part of the S&P 500 index.

VALUATION

We think that VRSK shares are attractively valued at recent prices above $276, in the upper portion of their 52-week range of $170-$287. On a technical basis, the shares have been in a long-term bullish pattern of higher highs and higher lows over the past five years.

On valuation, VRSK shares are trading at 35.0-times our 2025 EPS estimate. Compared with the peer group (ADP, CRWD, FTNT), the shares are trading at premium multiples, which we think is warranted given the company's experienced management team and long-term performance record. We expect strong revenue and positive earnings surprises to result in a higher valuation. Our target price of $320 implies a multiple of 40.5-times our 2025 EPS estimate and a potential total return, including the dividend, of more than 16% from current levels.

On October 31, BUY-rated VRSK closed at $274.72, down $0.91. (John Staszak, CFA, 10/31/24)

BEST BUY CO. INC. (NYSE: BBY, $90.43) .... HOLD

BBY: Previewing fiscal 3Q25 earnings

* Best Buy is scheduled to report fiscal 3Q25 earnings on November 26. While the release is before Thanksgiving, the important "Black Friday Weekend," and "Cyber Week," management should have a pretty good sense of the competitive environment and shoppers' willingness to spend when it provides fiscal 4Q guidance.
* Our fiscal 3Q EPS estimate is $1.27, which is pretty close to the Capital IQ consensus of $1.29. Our fiscal 4Q estimate is $2.46. Consensus is $2.48.
* We would consider raising our rating on a pullback near $80, or if we could raise our 5-year EPS growth rate. Our 7% estimate is above the consensus of 4%. We believe the shares are fairly valued near $90.
* One factor that argues for an upgrade to our investment recommendation is that our membership in the company's My Best Buy program has led us to make additional purchases and recommend the service to others. The way this flows through to the value of the shares is that services are a higher-margin category that could increase in the revenue mix.

ANALYSIS

INVESTMENT THESIS

We are reiterating our HOLD rating on Best Buy Co. Inc. (NYSE: BBY). Best Buy's investments in its e-commerce infrastructure and management's ability to adapt give us confidence in the company's ability to launch new initiatives and handle recent softness in demand for discretionary merchandise. We believe the shares are fairly valued near $90. We would consider raising our rating on a pullback near $80, or if we could raise our 5-year EPS growth rate. Our 7% estimate is above the consensus of 4%. We are considering an increase to our financial strength assessment to Medium-High, which could also reduce our cost-of-equity estimate and raise our fair value forecast.

One factor that argues for an upgrade to our investment recommendation is that membership in the company's My Best Buy program has led us to make additional purchases at BBY and recommend the service to others. The inclusion of Apple Care with the purchase of an Apple product is a good incentive to become a "Total" member. The way this flows through to the value of the shares is that services, which are a higher-margin category, have the potential to become a higher percentage of the revenue mix than their current 7% in the U.S.

CEO Corie Barry was promoted to her current position after a successful tenure as CFO. Ms. Barry and former CEO Hubert Joly, who retired from the board at the calendar 2020 meeting of shareholders, have been instrumental in growing Best Buy's online sales channel and laying the foundation for future e-commerce growth. We believe that Ms. Barry, who led the Renew Blue turnaround program, will continue to position the business for the future and drive operating improvements by finding innovative ways to sell technology products for the home.

Management has taken a methodical approach to rejuvenating the company by reducing costs, divesting unproductive businesses, creating in-store "shops" for Apple and other key vendors, matching Amazon prices to stay competitive, and adopting more effective marketing and operating practices. Customers look to Best Buy for four shopping needs: inspiration, research, convenience and support. However, we believe that BBY faces three major challenges apart from the economy – intense competition from online and big-box retailers; product innovation that has consolidated music, video, computing, communications, gaming, and photography products in a small number of devices, like smartphones, which often carry low margins; and also the maturity of the smartphone market.

An offset is that new devices designed to use Artificial Intelligence products seem to be stimulating demand. The company is moving aggressively to be a destination for products in the "Smart Home," including senior (and baby) monitoring systems; fitness equipment that networks with outside classes or other athletes; and modules to control lights, thermostats and enabled appliances from a remote location. We believe this is a large opportunity that is addressable for BBY, but it will take considerable patience and selling skill.

While many workers have seen their wages catch up with higher prices, high credit card rates and slow housing turnover are weighing on sales of big-ticket discretionary products.

RECENT DEVELOPMENTS

We expect U.S. holiday retail sales to rise about 3% this year to almost $1 trillion. Our experience is that when U.S. consumers are employed, they go out of their way make the season special. The average annual sales gain during the past 20 holidays has been 4%, with a 3.8% increase last year and a high of 12% in the pandemic-recovery year of 2021. The only decline, of 4.7%, came as the economy entered a deep recession in 2008. We calculate holiday sales the same way the National Retail

Federation does, based on the year-over-year change in the Commerce Department's Retail Sales data for the combined months of November and December. Like the NRF, we exclude sales at gas stations, car dealers, and restaurants, and focus on core retail. There are three categories that represent two-thirds of holiday-season sales and drive our forecast: grocery stores, general merchandise stores, and e-commerce. Our forecasts for those categories are +2%, +3%, and +6.5%, respectively. We are modeling 3% growth for Electronics and appliance stores. This is in line with our overall forecast, but better than the category's 4.6% decline in September. Perhaps surprisingly, it isn't a big category. Category sales for the first nine months of the year were $66 billion. By comparison, groceries are $480 million, general merchandise is $657 million and "Nonstore retailers," which is dominated by online sales, is over $1 trillion.

Within our sales forecast, e-commerce is the biggest category, representing 30% of holiday sales. While e-commerce could grow faster than our 6.5% estimate, it has a tough comparison in an already big category.

Best Buy is scheduled to report fiscal 3Q25 earnings on November 26. While the release is before Thanksgiving, the important "Black Friday Weekend," and "Cyber Week," management should have a pretty good sense of the competitive environment and shoppers' willingness to spend when it provides fiscal 4Q sales and earnings guidance.

Our fiscal 3Q EPS estimate is $1.27, which is pretty close to the Cap IQ consensus of $1.29. Our fiscal 4Q estimate is $2.46. Consensus is $2.48.

EARNINGS & GROWTH ANALYSIS

We are raising our FY25 EPS estimate to $6.25 from $6.10 per share on better-than- expected results in fiscal 2Q. Our fiscal 2H EPS estimate is $3.73, down from $3.75, on a slightly softer sales forecast. Our estimate for full-year operating margin is 4.4%, up from 4.1. Full-year consensus is $6.27.

BBY expects adjusted EPS of $6.10-$6.35 per share in FY25. Comparable sales are now expected to decline in a range of 1.5% to 3.0%. Total revenue is expected to be $41.3-$42.6 billion. Best Buy expects profitability to be 4.1%-4.2%. The effective tax rate is forecast to be 24%.

For fiscal 3Q, the company expects comparable sales to decline about 1%, and non-GAAP operating margin to be approximately 3.7%.

BBY expects the computing and services businesses to grow for the year, while most other categories are expected to be down.

We are raising our FY26 EPS estimate to $6.88 from $6.76 based on our expectation of a slightly higher operating margin.

Our five-year EPS growth rate forecast is 7%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength assessment for BBY is Medium. At the end of fiscal 1Q25, the company had $1.6 billion in cash and investments. BBY did very well bolstering its finances both before and during the pandemic. Despite the company's relatively low margin structure, our bias is for raising our financial strength assessment.

Debt was 48% of capital at the end of fiscal 3Q21, down from 61% of capital at the start of the pandemic in fiscal 1Q21. Best Buy leases most of its stores and distribution facilities. Real estate is not a major asset compared with what we see at some other big-box retailers, such as Target, Home Depot, and Costco. Debt was about 57% of capital at the end of fiscal 2Q25.

In FY21, adjusted debt was less than 1-times EBITDAR, at about 90%. Debt was approximately 0.8-times EBITDA at the end of FY22, 1.35-times at the end of FY23 and 1.5-times at the end of FY24. Our FY25 estimate is also about 1.55-times, which still keeps BBY comfortably within our Medium assessment. What is the purpose of all of these numbers? When you are contemplating an investment in a cyclical, seasonal business in a competitive industry, you want to know how they have managed through some rough weather. We believe that the company has done a very solid and responsible job.

Standard & Poor's rates Best Buy's debt BBB+, which is solidly investment grade. The outlook is stable. Moody's rates the company even higher, at A3 with a stable outlook.

There were no borrowings under the company's $1.25 billion U.S. revolving credit facility at the end of FY18, FY19, or FY20. On March 19, 2020, as the COVID pandemic hit the U.S., the company drew the entire $1.25 billion on its credit facility, but it repaid the balance on July 27, 2020. There were no borrowings on the credit facility at the end of fiscal 4Q24 or fiscal 1Q25.

In FY24, the company generated $1.5 in cash from operations compared with $1.8 billion in FY23 and $3.25 billion in FY22.

On the fiscal 4Q22 earnings call, BBY announced a 26% dividend increase for FY23. FY23 dividends totaled $3.52. BBY raised the quarterly payout to $0.92 for FY24, for a total of $3.68. At the time of the fiscal 4Q24 earnings call, BBY raised the quarterly dividend by 2% to $0.94. Our FY25 dividend estimate is $3.76 per share. Our dividend estimate for the current year is approximately 60% of our new EPS estimate. Our FY26 dividend estimate of $3.84 per share. Over the last five years, the company has raised the dividend at a compound annual growth rate of 14%. The dividend yield is about 4.2%

The company repurchased $1 billion of its stock in FY20. Between the end of fiscal 4Q and the publication of the 10-K, the company made $56 million of additional repurchases. The company suspended the buyback plan on March 19 as a result of COVID-19. It had repurchased about $62 million of shares at that time. The company said in the10-Q for fiscal 3Q21 that it had resumed share repurchases in the fourth quarter. BBY repurchased $312 million of shares for FY21. In the fiscal 4Q release, it announced a new $5 billion authorization that replaced the $1.7 billion that remained on the previous plan. BBY repurchased $927 million of its stock in fiscal 1Q22, $396 million in 2Q, $405 million in 3Q and $1.77 billion in 4Q. The company announced a new $5 billion repurchase authorization on the 4Q earnings call. It repurchased $442 million of its stock in fiscal 1Q23 and just $10 million in 2Q. BBY had expected to repurchase about $1.5 billion in FY23, but the company put that plan on hold when it reduced its earnings guidance in July. BBY resumed share repurchases in fiscal 4Q23 and repurchased $1 billion of shares in FY23. Management repurchased $340 million of shares in FY24 and plans to repurchase approximately $500 million in FY25. BBY repurchased $150 million of shares in the first half of the year. At the end of fiscal 2Q25, BBY had $500 million remaining under its $5 billion repurchase plan.

MANAGEMENT & RISKS

Consumer spending has been challenged by high housing costs and increases to car insurance premiums. That said, employment remains solid, incomes are generally rising, and the majority of households have locked in low mortgage rates.

On April 15, 2019, Best Buy announced a succession plan in which Chairman and Chief Executive Officer Hubert Joly became executive chairman following the meeting of shareholders on June 11. Corie Barry, the company’s CFO, is now CEO. Ms. Barry also became a member of the board, which was expanded to 13 directors.

We have confidence in Ms. Barry. She has been an integral leader in Best Buy’s recovery. She ably replaced the irreplaceable Sharon McCollam as CFO. Ms. Barry joined Best Buy in 1999, and helped to engineer $1.4 billion in cost reductions as the leader of the successful Renew Blue program. At 45, she became one of the youngest CEOs of a major company.

In July 2019, the company promoted Matt Bilunas, the senior VP of Enterprise and Merchandise Finance to the position of CFO. He has been at Best Buy since 2006. He stands out as one of the most accessible CFOs in our coverage universe.

While members of the leadership team and the company’s strategy have changed over the last several years, the challenges Best Buy faces have not. The management team will still need to deal with the effect of intense internet competition on its big-box stores, grow its own online business, provide more exclusive products and services to differentiate itself from internet competitors, profitably grow the appliance business, maintain market share in televisions and mobile phones, and cope with the growing market power of vendors like Apple. To date, we believe BBY’s management team has done a superb job. At the start of the turnaround he initiated, Mr. Joly recognized the harsh reality of the competitive environment, made unsentimental decisions, and administered the hard medicine to position the company to survive. We expect the company to benefit as the remaining national big-box chain in consumer electronics.

Best Buy faces numerous risks. On a macro level, sluggish personal income growth could reduce the willingness and ability of Best Buy’s customers to make largely discretionary purchases such as a new home theatre system or a new video game system. High credit card rates could also constrain spending.

Another long-term risk is the deflationary nature of the company’s product mix. Best Buy could fail to recapture on volume the ongoing decline in the average selling price of products such as computers and televisions. New products are also forcing the company to rethink the usage of store space and promotions. There is probably no better example than CDs and DVDs, which were almost completely replaced by downloadable media. As a side note, downloadable songs and albums have been hurt by streaming music services. Years later the company is seeing a similar pattern, with gamers downloading new releases rather than buying them in shrink-wrapped packages. This has significantly changed the allocation of floor space and diminished a popular tool for driving store traffic – deeply discounted music and movies. The company currently stages big products like televisions and appliances along the outside of the building and uses the middle of the store for products that can be repositioned more easily. Health and fitness products seem to be gaining a greater share of space in the center of the store. Best Buy is emphasizing, “Yes, Best Buy Sells That,” so customers know that they can buy products like grills that they wouldn’t ordinarily associate with the name.

Another challenge is that the fourth quarter and the Christmas season is extremely important to BBY. Unfortunately, some broad line retailers bring in more electronics products to compete in 4Q, and are also willing to sell some electronics at very low margins to drive traffic to other departments, like clothing, decorations and home goods, which have higher margins than electronics.

The company has been aggressive in gaining market share in the appliance business. We believe that much of the gain came from Sears, which once had the number-one market share by a wide margin. Lowe’s and Home Depot are the other major players. We believe that appliances have a higher margin than a number of consumer electronics products, so it makes sense for BBY to grow the business. This is obviously a slightly different operating model, because delivery, installation and service are so important. We also think that BBY has an opportunity to sell more small appliances, like microwaves, vacuum cleaners and air conditioners.

One important question is whether BBY, or anyone else, can reap high returns from explaining, simplifying and integrating suites of products. The prospect makes intuitive sense and services tend to generate higher gross margin than products. The counterpoint is that companies like Apple are earning some of the profits by creating devices like the iPhone and iPad that already integrate a camera, a music player, a web browser, contact lists, calendars and gaming. Services represented about 4% of BBY's domestic sales in FY18, FY19, and FY20, almost 5% in FY21, 4% in FY22, and 5% in both FY23 and FY24. There is clearly upside in the fragmented market for services, and the company's Tech Support offerings could help.

Best Buy faces intense competition. The company competes against brick-and-mortar consumer electronics chains, a category it dominates following the demise of Circuit City; department stores and discounters, such as Walmart and Target; computer sellers; home office retailers, such as Staples; entertainment stores: high-end boutiques; and Lowe's, which aims to be the number-one seller of appliances. We also believe that Best Buy is likely to see pressure from Costco, Sam's Club and BJ's as the warehouse clubs sell more electronics. Costco has been having success with appliances. The company also faces online competition from Dell, Amazon, eBay, Apple and a range of niche players.

BBY gets approximately 80% of the merchandise it sells from its 20 largest suppliers and approximately 55% from five suppliers: Apple, Samsung, Sony, Hewlett-Packard and LG. Lenovo dropped out of the top five in the 2020 annual report. Apple is both a supplier and a competitor through its Apple retail stores.

Deloitte & Touche has been the company's auditor since fiscal 2006.

COMPANY DESCRIPTION

Best Buy Co. is a leading retailer of consumer electronics, with FY24 sales of $43.5 billion, down from $46.3 billion in FY23 and $51.8 billion in FY22. Approximately 8% of revenue is from international operations. The Minneapolis-based company ended FY24 with 965 stores in the U.S., which average about 40,000 square feet. The International segment ended FY24 with 160 stores. Total square footage is about 40.4 million, down from 50 million in FY11. In the Domestic segment, Consumer Electronics generated about 31% of FY24 revenue; Computing and Mobile, 42%; Entertainment, 10%; Services, 5%; and Appliances, 11%. The company's fiscal year ends on the Saturday closest to the end of January. FY24 was a 53-week year.

VALUATION

BBY shares are up about 37% in the last year and 15% in 2024. The shares are currently trading at 14-times our new FY25 estimate and 13-times our new FY26 estimate. Intuitively, we think that intense competition, margin pressure, the cyclical nature of the business, and online competition argue for a below-market multiple on a normalized basis. The S&P 500 currently trades at 23.5-times our estimate for calendar 2024. We believe the discount for Best Buy reflects concerns about the competitive environment for consumer-electronics retailers, as well as high multiples for a handful of stocks in the index.

The five-year average P/E for BBY is about 13-times forward earnings. The multiple rebounded from a low of less than 5 at the end of calendar 2012. We think a multiple of about 13, or the current 14, is fair to attractive, based on expectations for five years of growth at 7%, followed by steady growth of 3% with a 75% payout and an 8% discount rate. There are a number of points that could be argued here. Is 3% too low? Based on the investor day guidance of 3% sales growth and a flattish operating margin, it may not be, especially when we look out beyond five years, and with the assumption that 75% of earnings will be paid out as dividends rather than split between a lower dividend payout and buybacks. The Capital IQ consensus for five-year growth is 3.8%, based on five estimates ranging from a negative 3% to a positive 8%. Based on a 3.8% growth rate for the next five years and the assumption of 2% steady-state growth, the shares would be worth about 13-times. While this is a volatile sector, the strong balance sheet argues for a lower cost of equity rate than 9%, and we are currently using 8%. We believe that the shares could be worth 14- or 15-times earnings, but that could be a challenge for a stock that is perceived as being very cyclical.

Here is a way to understand the valuation with a very simple, but transparent discounted earnings model: if EPS reaches $10.00 in about five years and the shares trade at a terminal multiple of 13-times earnings, they would be worth $130 in about five years. While this is a nice round number, it represents a growth rate of almost 10% from adjusted consensus for FY25. Discounting $130 at 8%, the shares would be worth about $88, which is very close to the current share price.

A slightly more sophisticated scenario analysis with a three-stage dividend discount model puts the value of the shares in a range of $90-$95. Our rating on Best Buy remains HOLD.

On October 31, HOLD-rated BBY closed at $90.43, up $0.02. (Chris Graja, CFA, 10/31/24)

COGNIZANT TECHNOLOGY SOLUTIONS CORP. (NGS: CTSH, $74.59) .... HOLD

CTSH: Consulting challenges continue

* Cognizant exceeded consensus revenue and non-GAAP EPS expectations for 3Q24, with revenue up 3% year over year on a GAAP basis and 2.7% in constant currency.
* Cognizant's stock has lagged the peer group, reflecting lower operating margins partly related to a challenging environment for the consulting business.
* Cognizant guided for 4Q24 revenue to be up 5.1%-7.1%% on a GAAP basis or 4.7%-6.7% in constant currency. Non-GAAP EPS guidance for all of 2024 implies 2% growth from 2023.
* We would consider an upgrade on signs of sustained top-line acceleration and margin expansion. For now, a near-term HOLD rating appears appropriate.

ANALYSIS

INVESTMENT THESIS

HOLD-rated Cognizant Technology Solutions Corp. (NGS: CTSH) rose 3% in a down market on October 31, 2024, after 3Q24 results exceeded consensus revenue and non-GAAP EPS estimates. Revenue, at $5.04 billion, was above the high end of management's $4.89 billion-$4.96 billion guidance range. Sales increased 3% year over year on a GAAP basis and 2.7% in constant currency. The company reported 3Q24 non-GAAP EPS of $1.25, which was $0.10 above the $1.15 consensus estimate and up 7% annually.

In 3Q24 on a GAAP basis, Communications, Media, and Technology (CMT) GAAP revenue decreased 4%, Products & Resources revenue were up 5%, and Financial Services revenue edged up 1%. Healthcare remains the fastest-growth vertical, rising 8%. The company had flat sales in Europe, while its largest market, North America, was up 4%.

Cognizant's stock has lagged the peer group, reflecting lower operating margins and a challenging environment for the consulting business. The company has incurred restructuring charges in 2024 on top of $228 million in charges taken in 2023. Restructuring costs are associated with employee separation, facility exit costs, and third-party and other costs. Wage pressures, insufficient volume leverage, and employee turnover costs create a risk of reducing operating leverage.

Cognizant guided for 4Q24 revenue to be up 5.1%-7.1%% on a GAAP basis or 4.7%-6.7% in constant currency. For all of 2024, Cognizant forecast revenue of $19.7 billion-$19.8 billion, raised from July 2024 guidance of down 0.5% to up 1.0%. At the new guidance, sales would be up 2% from 2023. Full-year 2024 non-GAAP operating margin was guided to 15.1%, which would be down from 15.2% for 2023.

In our view, Cognizant could face a few more quarters of suboptimal growth, which could continue to weigh on margins. We will consider an upgrade if the company shows signs of sustained top- and bottom-line acceleration. For now, a near-term HOLD rating appears appropriate.

RECENT DEVELOPMENTS

CTSH is up 2% year to date in 2024, while peers have gained 17%. The shares rose 32% in 2023, while the Argus computing, information processing & storage peer group advanced 40%. CTSH declined 36% in 2022, while peers rose 35%; was up 8% in 2021, while peers rose 9%; and increased 32% in 2020, while peers were up 39%.

For 3Q24, Cognizant reported revenue of $5.04 billion, which was up 3% year over year on a GAAP basis and 2.7% in constant currency. Revenue was above the high end of management's $4.89 billion-$4.96 billion guidance range and topped the $4.99 billion consensus estimate. Non-GAAP diluted EPS of $1.25 per diluted share rose 7% year over year and bested the consensus estimate of $1.15. Management guides on quarterly revenue but not quarterly EPS.

In December 2023, Jatin Dalal became CFO. Mr. Dalal was the previous CFO and president of outsourcing rival Wipro and led its $300 million strategic investment arm. CEO Ravi Kumar has been in place for nearly two years. He took over abruptly in January 2023, signaling board dissatisfaction with prior management. Mr. Kumar is seeking to address slow growth in most verticals and reduce voluntary attrition.

CEO Kumar attributed revenue outperformance against expectations to strength in the company's biggest vertical markets of Health Sciences and Financial Services. Cognizant's investments in AI platforms are resonating with clients, he stated, and enabling the company to succeed in landing large deals.

During 3Q24, Cognizant signed six deals with total contract value of more than $100 million. For all of 2024 to date, the company has signed 19 deals with contract value exceeding $100 million – more than in all of 2023.

While the absolute number of $100 million deals lags the total from industry leader Accenture, Cognizant is gaining momentum in the large deal space partly due to its next-generation solutions. AI offerings currently include the Neuro Suite and Flowsource.

The company recorded trailing-12-month bookings of $26.2 billion, sequentially flat with 2Q24 though down 3% from $26.9 billion a year earlier. The trailing 12-month book to bill ratio was 1.3, down 7% from 1.4 a year earlier.

During 3Q24, Cognizant completed the acquisition of Belcan for $1.3 billion in cash and stock. Belcan is a leading provider of engineering research & development (ER&D) service for industry verticals including aerospace, space, marine, and other. The addition of Belcan is designed to enhance Cognizant's capabilities in digital engineering and IoT while strengthening its presence in aerospace and defense.

A key focus of the new CEO has been reducing voluntary attrition, an industry-wide issue in consulting and outsourcing, and one that has been particularly acute at Cognizant. The situation for the company and industry has been compounded by a reduction in visa travel. The company is now showing some progress in this area. Voluntary attrition – Tech Services on a trailing 12-month basis was 14.6%, compared to 16.2% for the 12-month period that ended September 2023. Total company headcount was down 6,500 from the end of 3Q23, even after adding employees from the Belcan acquisition.

For 3Q24 on a customer verticals basis, Financial Services revenue of $1.49 billion (29% of total) was up 0.7% on a GAAP basis and 0.5% in constant currency. Regionally, the best growth came in Rest of World, while Europe was down almost 3% in constant currency; North America was up about 1%.

Cognizant is transitioning Financial Services work to managed services as clients focus on taking out costs, consolidating vendors, and enhancing productivity; and is engaging with fintech companies to speed digital acceleration. Bookings growth within Financial Services has been stronger than for the overall company.

Health Sciences revenue of $1.51 billion (30% of total) increased 7.8% on a GAAP basis and was 7.6% in constant currency. Growth remains driven by demand from healthcare payer clients for integrated software solutions and was strongest in digital services for pharmaceutical and healthcare payer clients. Growth was strongest in North America, rising 8.5%. Revenue increased 1.7% in constant currency in the Rest of World and 3% for Europe.

Products & Resources revenue (24% of total) was up 5% on a GAAP basis and 4.6% on a constant-currency basis. Growth in North America was up 5.5% in constant currency. Europe rebounded from a weak 2Q with 5.5% growth in 3Q24. Consistent with recent quarter, this business in the Rest of World was down, falling 5.7%%. Growth was driven by the adoption of digital technologies among utility, travel & hospitality, and logistics customers. Acquisitions are also contributing to P&R growth.

CMT revenue (16% of total) was down 3.7% on a GAAP basis and 4.1% on a constant-currency basis. This industry vertical now includes some of Cognizant's largest clients. The market in the Rest of World grew the fastest in 3Q, at 15.9%. Europe fell 16.2%, and North America dipped 2.8%.

Cognizant believes it is well-positioned to be "the nucleus of an emerging healthcare ecosystem" by focusing on expanding service offerings and enhancing industry solutions, powered by new technologies such as generative artificial intelligence (AI). Management believes that investing in the expansion of the TriZetto platform and the healthcare-business-process as a service solution creates significant value for the company's health sciences portfolio and optimizes the offerings available to its clients.

During 2023, Cognizant opened a dedicated AI innovation studio in London and expects to open three more, in New York, Dallas, and Bangalore. The company is seeking to generate significant productivity gains through AI-powered platforms for design, engineering, and operations. Over 55,000 employees have been trained in generative AI, with an additional 40,000 undergoing training.

Cognizant is focusing on technology integration and expertise, enterprise platform development, and leveraging partnerships to support client engagements. In the next three years, it plans to invest approximately $1 billion in its generative AI capabilities.

Early in 2024, it announced a "groundbreaking" training program called the Cognizant Synapse Initiative, to provide over 1 million individuals with advanced technology skills, including generative AI. The company intends to create strategic partnerships for training and jobs to employ individuals through this initiative.

In October 2023, Cognizant renewed its five-year contract with ISS, one of the world's largest facility management organizations, to provide financial and accounting services. The partnership began in 2014 and consolidates a standard process with increased efficiency and reduced costs for multiple countries and services.

The CEO updated long-term performance objectives, which are making Cognizant an employer of choice in its industry, strengthening the company's ability to win large deals, and enhancing operating discipline and excellence. Making Cognizant an employer of choice will be a multiyear undertaking, as the demands of a diverse workforce spanning geographies, generations, and a range of work and life priorities will need to be met. The company is seeing positive returns from an employer-client feedback process.

Third-quarter results marked a step-up from 2Q24 but the company has further to go, in our view. Full-year 2024 adjusted operating margin was forecast down from 2023 levels. Cognizant could face a few more quarters of suboptimal growth, which could continue to weigh on margins. We will consider an upgrade if the company shows signs of sustained top- and bottom-line acceleration. For now, a near-term HOLD rating appears appropriate.

EARNINGS & GROWTH ANALYSIS

For 3Q24, Cognizant reported revenue of $5.04 billion, which was up 3% year over year on a GAAP basis and 2.7% in constant currency. Revenue was above the high end of management's $4.89 billion-$4.96 billion guidance range and topped the $4.99 billion consensus estimate.

The GAAP gross margin was 34.4% in 3Q24 vs. 33.9% in 2Q24 and 34.5% in the prior-year quarter. The non-GAAP operating margin was 15.3% in 3Q24, compared with 15.2% in 2Q24 and 15.5% in the prior-year quarter.

Non-GAAP diluted EPS of $1.25 per diluted share rose 7% year over year and bested the consensus estimate of $1.15. Management guides on quarterly revenue but not quarterly EPS.

Revenue of $19.35 billion for 2023 was little changed from $19.43 billion in 2022. Non-GAAP diluted EPS for 2023 came to $4.55, up 4% from $4.40 in 2022.

Cognizant guided for 4Q24 revenue to be up 5.1%-7.1%% on a GAAP basis or 4.7%-6.7% in constant currency.

For all of 2024, Cognizant forecast revenue of $19.7 billion-$19.8 billion, raised from July 2024 guidance of down 0.5% to up 1.0%. At the new guidance, sales would be up 2% from 2023. Full-year 2024 non-GAAP operating margin was guided to 15.1%, which would be down from 15.2% for 2023.

We are reiterating our 2024 non-GAAP diluted EPS estimate of $4.64 per diluted share. We are raising our non-GAAP diluted EPS forecast for 2025 to $4.91 from $4.82. We regard our estimates as subject to change, based on evolving economic conditions and company-specific billing and attrition trends. Our long-term EPS growth rate forecast is 10%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength ranking on Cognizant is Medium-High. Cognizant has used its strong cash flow to reduce debt and is repurchasing shares.

In response to the pandemic, Cognizant took steps to increase liquidity and financial flexibility. In March 2020, it drew down $1.74 billion on its revolving credit facility. The revolver, which was drawn for over three quarters and thus classified as long-term debt, has since been paid down.

Cash & short-term investments were $2.05 billion at 3Q24 vs. $2.6 billion at the end of 2023, $2.50 billion in 2022, $2.72 billion in 2021, and $2.72 billion in 2020.

Debt was $1.22 billion at 3Q24, up from $623 million at 2Q24. Year-end dept was $639 million in 2023, $646 million in 2022, $664 million in 2021, and $701 million in 2020.

Debt/capitalization remained below the peer average at 1.9% at the close of 2023. Year-end debt/cap was 5.0% in 2022, 5.2% in 2021, 6.1% in 2020, and 6.6% in 2019.

Net cash was $2.0 billion at the close of 2023. Year-end net cash was $1.86 billion in 2022, $2.06 billion in 2021, $2.03 billion in 2020, $2.65 billion in 2019, and $4.02 billion in 2018.

In February 2021, Cognizant updated its capital allocation policy. The company now intends to deploy 100% of annual free cash flow through a balanced program. Under the program, 50% of free cash flow will be allocated to M&A in areas aligned with strategic priorities. The remaining 50% will be allocated to buybacks and dividends, targeting a consistent dividend payout ratio of about 25%, along with repurchases to offset dilution.

In February 2024, the board announced a 3% hike in the quarterly dividend to $0.30 per share, or $1.20 annually. The increase brings the current annual yield to about 1.6%. Past quarterly dividend hikes include 7%, to $0.29 per share, in February 2023; 13%, to $0.27 per share, in February 2022; 9%, to $0.24, in February 2021; and 10%, to $0.22, in February 2020.

Our dividend estimates are $1.20 for 2024 and $1.24 for 2025.

MANAGEMENT & RISKS

CEO Ravi Kumar took over as chief executive in January 2023, succeeding Brian Humphries, who was ousted suddenly. Cognizant elevated Stephen J. Rohleder to the role of chairman; former chairman Michael Pataslos-Fox remains on the board as an independent director. Jan Siegmund retired as CFO. He was replaced by Jatin Dalal. Mr. Dalal was the previous CFO and president of Wipro, where he had led their $300 million strategic investment arm.

Although the new CEO was an outsider presumably facing a steep learning curve, he was brought in with deep industry experience as president of Infosys and in other roles. Additionally, given no entangling connections within the company, he can sweep out inefficiencies with a larger broom.

A main risk for Cognizant, as for other consulting and outsourcing companies, is the possibility of a general economic downturn and a corresponding dip in demand for professional services related to current macroeconomic softness. We believe that Cognizant has the financial strength, market leadership, and growth characteristics to weather this storm and emerge a stronger player. Further, the companies in Cognizant's blue-chip client base will need consulting and outsourcing help as they navigate a challenging environment.

Additional risks associated with an investment in Cognizant include the company's growth strategy, based on both organic business development and acquisitions. We think the company offsets these risks with a demonstrated ability to integrate acquired assets without sacrificing margins.

COMPANY DESCRIPTION

Cognizant Technology Solutions Corp., based in Teaneck, New Jersey, provides information technology outsourcing, consulting, and business process outsourcing services worldwide. The company operates in four operating segments: Financial Services, Health Sciences, Products & Logistics, and Communications, Media, and Telecom.

VALUATION

CTSH shares trade at 16.3-times our 2024 non-GAAP forecast and 15.4-times our 2025 non-GAAP EPS projection. The two-year average forward P/E multiple of 15.8 is below the trailing-five-year (2019-23) average multiple of 17.0. CTSH trades at an average relative P/E of 0.70-times the forward market multiple, below the trailing five-year relative P/E of 0.85. Higher P/Es were accorded during a period of consistent EPS growth; CTSH is now on track for a flat-to-slightly-positive EPS comp in 2024. Our comparable historical valuation model, along with peer-group analysis, gives a fair value of around $80, stabilizing above the current share price.

Peer-indicated value in the mid-$80s is now above the current share price and reflects peer-group appreciation. Our more forward-looking two- and three-stage discounted free cash flow model renders a value in the high $90s, stabilizing after having fallen sharply from peak levels. Our blended value is around $90, above current levels though declining slightly.

In our view, Cognizant faces near-term challenges related to revenue trends, particularly in financial services, rising costs, and the softening macroeconomy. Other issues include improving ? though still high ? voluntary attrition, which is impacting billable headcount.

Cognizant could face a few more slow-growth quarters. We would consider an upgrade on signs of sustained top-line acceleration and margin expansion resulting in meaningful EPS growth. At present, a near-term HOLD rating appears appropriate.

On October 31, HOLD-rated CTSH closed at $74.59, up $0.24. (Jim Kelleher, CFA, 10/31/24)

ENTERPRISE PRODUCTS PARTNERS LP (NYSE: EPD, $28.66) .... BUY

EPD: Raising target price

* On October 29, Enterprise Products reported adjusted 3Q24 net income attributable to common unitholders of $1.432 billion, or $0.65 per diluted unit, up from $1.350 billion, or $0.60 per diluted unit, a year earlier.
* The higher third-quarter 2024 earnings largely reflected volume growth in most of the company's business divisions.
* Enterprise Products reaffirmed its capital expenditure outlook for the year, with most of the expenditures going toward growth projects.
* We are maintaining our above-consensus 2024 earnings estimate of $2.74 per unit, which assumes generally supportive energy markets, with crude oil (WTI) prices in the $75-$80 per barrel range. Additionally, we forecast positive volume and margin growth for the year.

ANALYSIS

INVESTMENT THESIS

Our rating on Enterprise Products Partners LP (NYSE: EPD) is BUY, and we are raising our target price to $34 from $33 per share, implying a total return potential, including the dividend, of approximately 26% from current prices.

As we head into the last quarter of 2024, we expect Enterprise Products to post industry-leading revenue and EBITDA growth in just about any energy market (and oil price) environment and to maintain a healthy balance sheet with below-industry-average leverage. We also expect EPD to benefit from a continued recovery in gathering and processing (G&P) volumes, new growth projects, and the recent acquisition of Navitas Midstream Partners.

In addition, we note that Enterprise is trading meaningfully below its historical average P/E, price/book, and price/cash flow multiples, which we believe is unwarranted given the company's size, geographic reach, product portfolio, and record of consistent distribution growth. The company pays an industry-leading dividend, with a yield of about 7.2%. We believe that the dividend is very safe and sustainable, and note that Enterprise has raised its payout for 27 straight years.

RECENT DEVELOPMENTS

On October 29, Enterprise Products reported adjusted 3Q24 net income attributable to common unitholders of $1.432 billion, or $0.65 per diluted unit, up from $1.350 billion, or $0.60 per diluted unit, a year earlier. Earnings matched our quarterly estimate of $0.65 per unit, and beat the Street consensus forecast of $0.64 per unit.

The higher third-quarter 2024 earnings largely reflected year-over-year volume growth in most of the company's business divisions, including NGL fractionation, marine terminals, and natural gas liquids, crude oil, refined products and petrochemical pipelines, which more than offset lower realized commodity prices for both natural gas and crude oil.

Revenue (companywide) for the third quarter of 2024 reached $13.775 billion, up 15% from $11.998 billion in the third quarter of 2023 and higher than the Street consensus estimate of $13.770 billion. In addition, adjusted EBITDA improved 5% from the prior-year quarter to $2.327 billion, while total operating costs (and expenses) increased 16% from the prior year, partly reflecting higher employee medical/insurance costs and higher utility costs.

Enterprise reported adjusted 3Q24 distributable cash flow of $1.957 billion, up 5% from the prior year. Distributable cash flow covered the company's payout by a factor of 1.7-times. The gross operating margin (in dollars) was $2.454 billion, up 5% from 3Q23.

Our preferred financial metrics for evaluating EPD are adjusted EBITDA, distributable cash flow, and gross operating margin. Net income has little impact on our analysis, as we prefer to evaluate the company's performance on a cash flow basis, which excludes noncash charges, namely, depreciation expense.

EARNINGS & GROWTH ANALYSIS

Enterprise Products does not provide any "forward-looking" financial guidance; however, it reaffirmed its capital expenditure outlook for the year. The company anticipates spending $3.25 billion-$3.75 billion during the year, with most of the expenditures going toward growth projects. In 2023, capital expenditures totaled $3.3 billion, up from $2.2 billion in 2022.

We are maintaining our above-consensus 2024 earnings estimate of $2.74 per unit, which assumes generally supportive energy markets, with crude oil (West Texas Intermediate) prices in the $75-$80 per barrel range. Additionally, we forecast positive volume and margin growth for the year.

We are also reaffirming our above-consensus 2025 earnings estimate of $2.97 per unit, implying approximately 8% earnings growth from our 2024 estimate, reflecting our expectations for modestly higher commodity prices, higher natural gas volume throughput, and stronger NGL demand.

On the subject of future growth, we note that EPD has a leading position across the natural gas and NGL value chain in some of the largest-producing basins in the U.S. It also has about $4.0 billion in growth projects that are expected to enter service over the next several years, and continues to invest in shale play development.

The growth in hydrocarbon production from shale basins and unconventional drilling has resulted in structural cost advantages for petrochemical production in the U.S. and has increased NGL demand from the petrochemical industry. This should boost earnings visibility and support growth in the dividend. EPD has the highest distributable cash flow coverage ratio in our master limited partnership (MLP) coverage universe.

FINANCIAL STRENGTH & DIVIDEND

We currently rate EPD's financial strength as Medium-High, the second-highest rating on our five-point rating scale. The company's debt is rated A-/stable by S&P.

At the end of 3Q24, EPD's total debt/capitalization ratio was 50.4%, down from 51.4% a year earlier. The debt/cap ratio is in line with the peer average, and has averaged 52.2% over the past five years.

Enterprise Products has eliminated the incentive distribution rights previously held by the general partner and is transitioning to mainly fee-based businesses supported by long-term contracts. This allows the company to have one of the lowest costs of capital in its MLP peer group.

Total debt was $29.1 billion at the end of 3Q24, consisting of $27.6 billion in long-term debt and $1.5 billion in short-term debt. This compares with total debt of $29.4 billion at the end of 3Q23.

Cash and cash equivalents totaled $542 million at the end of 3Q24, compared with $532 million at the end of 3Q23. Net cash flow provided from operating activities (GAAP) increased to $2.108 billion in 3Q24 from $2.021 billion in the prior-year quarter.

On July 10, 2024, Enterprise Products raised its distribution for the 27th straight year, boosting the payout by 5% to $0.525 per unit, or $2.10 annually. The current yield is about 7.2%. Our distribution estimates are $2.08 for 2024 and $2.12 for 2025.

Enterprise Products has an active $2 billion share repurchase program that began in 2019. The company repurchased approximately $76 million of its common units in the third quarter of 2024, bringing total common unit repurchases in the first nine months of 2024 to $156 million. Including these purchases, the partnership has repurchased approximately $1.1 billion of common units under its authorized $2.0 billion common unit buyback program. The company repurchased $187 million of its common units in 2023 and has about $1 billion remaining on its current authorization.

MANAGEMENT & RISKS

W. Randall Fowler and A.J. Teague have served as co-chief executive officers since January 2020. A.J.R. Daniel Boss is chief financial officer.

We think that EPD management has performed well over the last several years through a combination of accretive acquisitions and internal growth. Its efforts have led to increased earnings and cash flow. We are also impressed that management purchases outside energy assets only after thorough due diligence.

MLPs face substantial funding risk, as they are required to pay out a significant portion of cash flow to unitholders and are thus dependent on external funding. Investment in pipelines also involves risks related to fires, explosions, and environmental issues. All of the company's pipelines are regulated by the Federal Energy Regulatory Commission.

The normal tax risks of investing in MLPs apply to this investment. Unitholders are responsible for the payment of taxes on their pro rata share of company earnings, whether or not any cash distribution is made. Unitholders have no control over the general partner or the election of officers of the general partner. In addition, investors' holdings could be diluted by the issuance of additional partnership units. The controlling unitholder of the partnership could also reduce the price by disposing of a large number of units.

COMPANY DESCRIPTION

Enterprise Products is a North American provider of midstream energy services to producers and consumers of natural gas, NGLs, crude oil, refined products, and petrochemicals. The partnership's assets include over 50,000 miles of natural gas, NGL, refined product, and petrochemical pipelines; 260 million barrels of storage capacity for NGLs, refined products, and crude oil; and 14 billion cubic feet of natural gas storage capacity. The company completed its IPO in July 1998.

VALUATION

EPD shares have traded between $25.88 and $30.05 over the past 52 weeks, and are currently above the midpoint of this range. To value the stock on a fundamental basis, we use peer group and historical multiple comparisons, as well as a dividend discount model.

The shares are trading at 10.5-times our 2024 earnings per unit estimate and at 9.7-times our 2025 forecast, compared with a 13-year annual average range of 14-19. On other valuation metrics, they are trading at the low end of their historical range for price/book (2.3 versus a range of 2.3-3.1) and price/sales (1.2 versus a range of 1.2-1.7). Additionally, they are trading below the low end of their historical range for price/cash flow (7.8 versus a range of 8.9-13.0) and price/EBITDA (7.2 versus a range of 9.0-12.1).

We believe that EPD shares are attractive based on the company's size, geographic reach, and broad product portfolio. We also believe that the distribution is safe and sustainable, and note that the company has raised its payout for 27 straight years.

On October 31, BUY-rated EPD traded at $28.66, down $0.08. (Bill Selesky, 10/31/24)

PILGRIM'S PRIDE CORP. (NGS: PPC, $48.44) .... BUY

PPC: Restricted beef supplies and higher chicken prices likely to benefit the shares

* Pilgrim's Pride Corp. produces, processes, and distributes fresh, frozen, and value-added chicken products to retailers, distributors, and food-service companies.
* Our BUY rating reflects high demand for chicken at both full-service restaurants and fast-food chains due to beef shortages and our expectation for low-single-digit supply increases over the next five years.
* In the U.S., we expect health-conscious consumers to favor chicken over beef and pork. In emerging markets, income growth bodes well for chicken consumption, and is likely to result in more rapid volume expansion than in mature markets.
* Our new target price of $60 implies a potential return of more than 22% from current levels.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY-rating on Pilgrim's Pride Corp. (NGS: PPC), with a $60 target price, up from $55. Our rating reflects high demand for chicken at both full-service restaurants and fast-food chains due to beef shortages, as well as our expectation of low-single-digit supply increases over the next five years. Pilgrim's Pride is planning to allocate its strong cash flow to growth initiatives, and we believe it will exceed its capital expenditures guidance. Following supply-chain headwinds early in 2023, we expect margins to improve, benefiting the share price.

Our long-term rating is also BUY. We expect chicken sales to exceed those of other proteins (beef, pork, and turkey) in both mature (Europe and the U.S.) and emerging markets. In the U.S., we expect health-conscious consumers to favor chicken over beef and pork. In emerging markets, income growth bodes well for chicken consumption and these markets are more likely to result in rapid volume expansion than mature markets are.

RECENT DEVELOPMENTS

On October 31, PPC reported 3Q24 revenue of $4.59 billion, up 5.2% from $4.36 billion a year ago. The consensus estimate had called for revenue of $4.66 billion. Adjusted EBITDA of $660 million was well above the consensus estimate of $324 million on nearly 40% higher EBITDA in Europe. In the U.S., the company saw increased sales to delicatessens and grocers. In Europe, revenue grew as a result of the launch of new branded products. In Mexico, revenue benefited from sales to retailers and restaurants. The gross margin rose 700 basis points to 14.9%. The adjusted EBITDA margin rose 700 basis points to 14.4%, supported by high-teens margins in Mexico and the U.S.

The operating margin rose 630 basis points to 11%, driven by a return to profitability in the U.S.

Adjusted earnings were $1.67 per share, up from $0.58 in the prior-year period and above the consensus estimate of $1.60 per share. GAAP earnings rose to $1.47 from $0.51 per share.

EARNINGS & GROWTH ANALYSIS

Cost-reduction initiatives are proving effective. In Europe, operations have become more productive following issues regarding rising energy prices and live pork segment losses. Meanwhile, we expect better crop yields and lower employee bonuses to boost domestic margins. Lastly, earnings in Mexico have been helped by favorable currency translations and lower wages.

We are raising our 2024 EPS estimate to $4.56 from $4.54, reflecting growing demand for chicken and reduced feedstock costs. We are increasing our 2025 estimate to $4.09 from $4.00 per share.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Pilgrim's Pride Corp. is Medium-High, the second-highest rank on our five-point scale. The company receives above-average scores on our four main criteria of cash and debt levels, interest coverage, and ROE.

The company ended 3Q24, with more than $1.9 billion in cash and cash equivalents, up from $698 million at the end of 2023.

In 3Q24, shareholders' equity rose to $4.3 billion from $3.34 billion at the end of 2023. In the third quarter of 2024, operating income was 23.1-times interest expense less interest income. We like to see an interest ratio of 5.0 or higher.

Pilgrim does not pay a dividend; however, in 2015 and 2016, it paid special dividends, and we think its strong cash flow could allow management to initiate a quarterly payout.

MANAGEMENT & RISKS

Currently, Fabio Sandri is CEO and president, and Matthew Galvanoni is VP, CFO, and chief accounting officer.

Risks for Pilgrim's Pride include exposure to cyclicality, disease outbreak among livestock, and product liability claims. Beginning with cyclicality, the commodity prices and market prices of ingredients that go into raising chicken and pork livestock can be quite seasonal, being determined by supply and demand factors. Prices of feed ingredients can also be negatively affected by adverse weather events. An increase in feed ingredients prices would drive up the company's expenses, which could result in earnings fluctuations. Pilgrim's Pride also faces the risk of disease outbreaks among livestock. While the company ensures that its production plants are safe and clean, unforeseen spreading of diseases is possible, and can hurt product demand. Along with the risk of livestock disease, Pilgrim's Pride could be subject to product liability claims due to contamination. There are pathogens that can be present in Pilgrim's processed products, which emphasizes the importance of sound manufacturing techniques and the proper handling of finished goods.

COMPANY DESCRIPTION

Pilgrim's Pride Corporation was founded in 1946 and produces, processes, and distributes fresh, frozen, and value-added chicken products to retailers, distributors, and food-service companies. It exports chicken products to about 120 countries, and operates a vertically integrated business model. This means that PPC controls almost all of its business operations, from raising livestock to distribution of final products. The company is broken down into three segments: 1) U.S., 2) U.K. and Europe, and 3) Mexico. The U.S. segment is the largest in net sales.

The company deals with poultry products in all segments, while it only deals with pork products in the U.K. Its two largest customers contributed just over an eighth of total revenue. Across 14 U.S. states, the U.K., Puerto Rico, Mexico, and Europe, Pilgrim's operates 39 production facilities and 27 prepared foods facilities. Pilgrim's owns Moy Park, a poultry and prepared foods company in the U.K. and Europe, as well as Tulip Limited, a pork and prepared foods company in the U.K. Headquartered in Greeley, Colorado, the company has over 61,200 employees. Pilgrim's has a market cap of more than $10.9 billion.

VALUATION

Trading at just over 12.0-times our revised 2025 earnings estimates, above the three-year average of 11.6, we think that the shares' current valuation inadequately reflects the company's attractive markets, strong product portfolio, and general tendency to beat earnings estimates by a significant margin. Our target price, if achieved, offers investors the prospect of a 22% return.

On October 31, BUY-rated PPC closed at $48.44, up $0.75. (John Staszak, CFA, 10/31/24)