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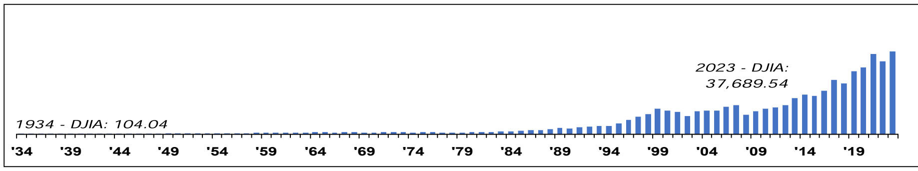
MARKET UPDATE



FRIDAY, NOVEMBER 1, 2024

Good Afternoon. This is the Market Update for Friday, November 1, 2024, with analysis of the financial markets and comments on **Amazon.com Inc., Coca-Cola Co., Lazard Ltd., Microsoft Corp., Public Storage, Phillips 66 and Quanta Services Inc.**

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DAILY INSIGHT

KEYCORP (NYSE: KEY) .... BUY

We see a better 2025 outlook for the lending business as interest rates move lower and the company undergoes a balance sheet repositioning, aided by a recent minority investment by Bank of Nova Scotia.Our target price of $19 (raised from $17) implies a multiple of about 12-times our 2025 EPS estimate. The stock also carries an attractive dividend yield of about 4.8%.

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:

Stocks are solidly higher Friday morning, led by good earnings from various companies (with Amazon and Intel leading the charge) as well as a jobs report that is being broadly interpreted as meaning that Fed will indeed cut interest rates further next week. Traders may finally be starting to look ahead, positioning themselves for a world in which the name of the next U.S. president will be known, the economy will remain on solid footing, interest rates will continue to head lower, and inflation will finally hit the magic 2% level.

AMAZON.COM INC. (NGS: AMZN, $199.48).. BUY

AMZN: Solid retail and AWS performance; raising target to $230

* Amazon reported above-consensus revenue and GAAP EPS for 3Q24 with both sales and EPS rising in double-digit percentages year over year.
* After a bad top-line miss in 2Q24, Amazon's revenue topped consensus estimates by about $1.5 billion, while GAAP profits beat Street expectations by $0.29.
* The AWS business has been energized by the global push to generative AI, once again delivering the highest quarterly margins in our model (dating back to 2015) along with high-teens annual growth.
* In a gradually improving consumer-retail environment, Amazon appears to have retained market-share gains that it built during the pandemic. We believe that AMZN warrants long-term accumulation in most equity accounts.

ANALYSIS

INVESTMENT THESIS

BUY-rated Amazon.com Inc. (NGS: AMZN) rose 6% in the aftermarket on 10/31/24 after the giant online retailer and cloud company posted above-consensus revenue and GAAP EPS revenue for 3Q24. Amazon provided cautious guidance for its all-important holiday quarter, but investors focused on improving operating leverage that drove strong EPS growth. Management reiterated its long-term upbeat outlook for both retail operations and AWS.

In retail operations, North America grew in high single digits. Third-party merchant sales continue to grow faster than overall retail revenue, but the quarter featured good balance with online retail also showing solid growth. International operations grew in low double digits; International remained profitable after returning to the green in 1Q24 for just the second time since 2021. With Amazon having invested in past quarters in streamlining operations, North American retail profit rose by 31% in 3Q24.

AWS revenue grew by 19% and AWS operating profits surged 50% year over year. CEO Andy Jassy stated that AI is growing three-times faster than cloud at this stage of its development.

AWS appears to be leveraging its leading market share in cloud to become a major player in the AI space, via internal architectures such as Amazon Bedrock, foundation models such as AWS Trainium and AWS Interfentia, and partnerships with Anthropic, Meta, and others. Amazon plans to invest up to $4 billion in Anthropic, a leading provider of AI foundation models and an advocate for the responsible deployment of generative AI. The Anthropic partnership meaningfully strengthens AWS at a key time in the AI gold rush.

Amazon generated record cash flow from operations for 2023, and in 2024 appears on track for another strong cash flow year. AMZN was a market and peer laggard in 2021 and 2022 and, after rising in 2023, is again lagging the broad market in 2024. The multi-year lagging performance provides an opportunity, in our view, to establish or dollar-average into undisputed category leader Amazon. We are reiterating our BUY rating on AMZN and raising our 12-month target price to $230 from $205.

RECENT DEVELOPMENTS

AMZN is up 27% year to date in 2024, while immediate peers are up 13%. AMZN rose 81% in 2023, while the peer group of Argus-covered internet, social media, and cloud company stocks advanced 70%. AMZN fell 50% in 2022, while immediate peers dropped 43%; inched up 2% in 2021, while peers rose 21%; and advanced 76% in 2020, while peers surged 89%.

For 3Q24, Amazon posted revenue of $158.9 billion, which was up 11% from a year earlier and 7% sequentially from 2Q24. Revenue was above the high end of management's $154-$158.5 billion guidance range and beat the $157.2 billion consensus estimate by over $1.5 billion. Amazon posted GAAP EPS of $1.43 per diluted share for 2Q24, up 50% from $0.94 a year earlier. The consensus GAAP EPS estimate was $1.14. Amazon does not guide on EPS. At the sales and operating profit guidance midpoints, we had modeled EPS in the $1.05-$1.20 range.

CEO Andy Jassy, who has experienced a tumultuous tenure since taking over the CEO post from founder Jeff Bezos, was able to celebrate a strong revenue quarter in 3Q24 after a disappointing and below-consensus top-line performance in 2Q24. Amazon has succeeded by focusing on "making our customers' lives better" and by continuing to think long-term to create a successful and sustainable business.

At a time when customers are being careful about how much they spend, Amazon continues to lower prices, the CEO stated, and to ship even more quickly. Amazon is pursuing multiple initiatives to lower cost. These include continuing to refine its outbound regionalization strategy to get items closer to consumers. Simultaneously, Amazon is making changes in its inbound network, opening more than 15 inbound buildings in the past several months. This is helping spread inventory across fulfillment centers more efficiently.

Same-day delivery is not only the fastest way to get products to consumers, but also one of the lowest-cost ways to deliver. Same-day deliveries rose 25% year over year in 3Q24 to more than 40 million packages. With its vast network of inbound, outbound, and fulfillment centers, Amazon continues to invest in robotics to shorten time to delivery, lower the cost to serve, and improve safety.

The CEO, who formerly served as CEO of AWS, noted that this business has now reached an annualized $110 billion revenue run rate. AWS has experienced significant top-line acceleration in the past. While there are "signs of recovery in every part of the AWS business," AI is emerging as a key driver. Over the past 18 months, according to the CEO, "AWS has released nearly twice as many machine learning and Gen AI features as other leading cloud providers combined."

Amazon is positioning its AI offering as providing value within three macro layers of the stack. At the bottom layer for large language model (LLM) and other model builders, AWS was the first to offer Nvidia's H200 GPUS through its EC2 P5e instance. At the middle layer, where companies want to leverage an existing foundation model, Amazon Bedrock has the widest selection of leading foundation models. These include Anthropic's Claude 3.5, Meta's Llama 3.2 models, and multiple AI models. At the top layer of the stack, the company is seeing strong adoption of Amazon Q, a generative AI-powered assistant for software development.

For 3Q24, total product and services sales excluding AWS were $131.4 billion, up 9% annually and 8% sequentially. The total product and services (ex. AWS) operating profit was $6.96 billion, up 58% from a year earlier in 3Q23. Product and services operating margin for all operations excluding AWS was 5.3% for 3Q24, up from 3.7% a year earlier.

North American retail revenue of $95.50 billion (60% of total revenue) was up 9% year over year and 6% sequentially. North American (NA) retail generated an operating profit of $5.66 billion in 3Q24, up 31% from $4.3 billion a year-earlier. The NA retail operating margin was 5.7% in 3Q24, up 10 basis points (bps) sequentially from 5.6% in 2Q24 and up from 4.9% a year earlier.

International retail revenue of $35.9 billion (22% of total) increased 12% annually and generated operating profit of $1.31 billion (3.6% margin). International was profitable for a third consecutive quarter, after being unprofitable through 4Q23 in every quarter but one (3Q23) since 2Q21. We believe this business is poised for sustained profits ahead, based on operational efficiencies put in place.

Digging deeper into the number, Online store sales — representing wholly owned products retailed by Amazon — were $66.4 billion in 3Q24, up 7% from 3Q23; the wholly owned retail category had averaged low-single-digit growth for most of the past two years. As Amazon continues to diversify its revenue streams, online stores represented 39% of 3Q24 revenue, down from more than 50% in 2020.

Within retail, the best growth continues to come from third-party merchants. Sales from this category of $37.9 billion (24% of total revenue) grew 10% year over year. Sales at physical stores (3% of total) were up 5% year over year, as Whole Foods stores and Amazon retail stores continue to generate more foot traffic. This formerly slow-growing category is seeing an upward trend aided by Amazon online, which is directing some Prime returns to Whole Foods sites.

Amazon is first and foremost a retailer, and total goods retail revenue (online stores, physical stores, and third-party merchants) grew 11% in 3Q24. This category represented 66% of revenue in 3Q24, versus 67% a year earlier.

In most quarters, Amazon's non-retail businesses grow faster than merchandising operations. In 3Q24, non-goods services — including subscription services, AWS, advertising and other — generated revenue of $54.4 billion (34% of total) and grew 17% year over year. Subscription services (7% of total) grew 11% annually, while advertising (9% of total) grew 19%.

Following some moderation in AWS sales growth and margin levels in 2021 into 2022, AWS has regained vigor as AI moves from the fascination phase to business use cases. AWS remains fast growing and high margined, and 3Q24 was another outstanding quarter as generative AI super-charges the leading provider of hybrid cloud services.

For 3Q24, Amazon Web Services (AWS) revenue of $27.5 billion (17% of total), rose 19% year over year, and was up 4% sequentially. AWS operating profit was $10.4 billion, increasing sequentially from $9.3 billion in 2Q24 and rising 50% from $7.0 billion a year earlier. AWS operating margin was 38.1% in 3Q24, compared with 35.5% in 2Q24 and 30.3% a year earlier. AWS in 3Q24 set quarterly records for both operating income and margin level.

CEO Jassy stated that AWS is at a $110 billion-plus revenue annual run rate. Cloud customers, who formerly were "optimizing" their spending, have started shifting to new workload deployment, reflecting urgency to position for the generative AI opportunity in its nascent stage. We believe AWS, which is globally No. 1 in cloud services, is positioned for long-term growth as the era of AI matures.

Amazon provided guidance for 4Q24 that was perceived as being below consensus, but Amazon tends to shoot past Street expectations for 4Q revenue. Amazon continues to grow its profits impressively and should grow its 4Q24 operating profit in the range of 40%-45% from 4Q23 levels. In our view, AMZN's multi-year lagging performance provides an opportunity to establish or dollar-average into this undisputed category leader.

EARNINGS & GROWTH ANALYSIS

For 3Q24, Amazon posted revenue of $158.9 billion, which was up 11% from a year earlier and 7% sequentially from 2Q24. Revenue was above the high end of management's $154-$158.5 billion guidance range and beat the $157.2 billion consensus estimate by over $1.5 billion.

The GAAP gross margin tightened to 49.0% in 3Q24 from 50.1% in 2Q24 and was up from 47.6% a year earlier. The GAAP operating margin was 11.0% in 3Q24, compared to 9.9% in 2Q24 and 7.8% a year earlier.

Amazon posted GAAP EPS of $1.43 per diluted share for 3Q24, up 50% from $0.94 a year earlier. The consensus GAAP EPS estimate was $1.14. Amazon does not guide on EPS. At the sales and operating profit guidance midpoints, we had modeled EPS in the $1.05-$1.20 range.

For all of 2023, revenue of $574.8 billion rose 12% from $514.0 billion in 2022. GAAP earnings totaled $2.91 per diluted share for 2023, up from a GAAP loss of $0.27 for 2022.

For 4Q24, Amazon projected revenue of $181.5-$188.5 billion, which at the $185.0 billion midpoint implies 9% annual growth. Management forecast operating profit of $16.0-$20.0 billion in 4Q24; the $18.0 billion midpoint of this range compares to $13.2 billion a year earlier. We believe that 4Q24 guidance is consistent with GAAP EPS of $1.35-$1.50. In 4Q23, Amazon earned $1.01 per diluted share on a GAAP basis.

We are raising our 2024 GAAP EPS estimate to $5.13 per diluted share from $4.57. We are raising our GAAP EPS forecast for 2025 to $6.14 per diluted share, from $5.63. We consider our estimates to be fluid, based on inflation, the global economy, post-pandemic spending patterns, AI development timing, and other factors. Our five-year earnings growth rate projection is 11%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Amazon is Medium-High, the second-highest rating on our five-point scale. Amazon has started a $10 billion share-repurchase program and is finalizing past investments in operating infrastructure, resulting in reduced cash.

Cash & marketable securities were $88.1 billion at the end of 3Q24. Cash & marketable securities were $86.8 billion at the end of 2023, $70.0 billion at the end of 2022, $96.1 billion at the end of 2021, and $84.4 billion at year-end 2020.

Total debt was $54.9 billion at the end of 3Q24. Total debt was $58.3 billion at the end of 2023, $67.2 billion at the end of 2022, $48.7 billion at the end of 2021, and $31.8 billion at year-end 2020.

Net cash was $33.1 billion at 3Q24. Net cash was $28.5 billion at year-end 2023, $2.88 billion at year-end 2022, $47.3 billion at year-end 2021, and $52.6 billion at year-end 2020.

Cash flow from operations was $85.0 billion in 2023, an all-time record. Cash flow from operations was $46.7 billion in 2022, $46.3 billion in 2021, $66.1 billion in 2020, and $38.5 billion in 2019.

Free cash flow was $32.2 billion in 2023. Free cash flow was $5.5 billion in 2022, recovering from a use of $9 billion in 2021. Free cash flow was $35.0 billion in 2020 and $21.7 billion in 2019.

The credit agencies rate Amazon's debt as investment grade. There is a substantial difference in agency ratings between the Baa1 at Moody's and the very strong AA- at S&P. Both agencies have stable outlooks.

Amazon does not pay and is unlikely to implement a dividend in the intermediate term. The company previously repurchased shares mainly to offset dilution.

MANAGEMENT & RISKS

In July 2021, Founder Jeff Bezos transitioned to executive chairman and former AWS leader Andy Jassy became the company's CEO. Brian Olsavsky is the CFO, and Jeffrey Wilke is the chief executive officer of the Worldwide Consumer business. In March 2021, Adam Selipsky was named CEO of Amazon Web Services. In May 2024, however, Selipsky was replaced by Matt Garman, based on concerns that AWS was falling behind industry leaders Alphabet, Microsoft, and Meta in generative AI.

Prior to leading AWS, Mr. Jassy was instrumental in developing the business. He played a key role in the development of cloud computing, infrastructure-as-a-service, and other elements of the cloud that we now take for granted. We believe he is the logical successor to Mr. Bezos.

Amazon, as a provider of online goods and services, may be better positioned than brick and mortar rivals, but is not immune to challenges including lower consumer spending. We believe that Amazon has the strength to sustain growth during a period of economic weakness; its plans to add employees signal management's confidence in its long-term operating model and strategy.

The addition of Whole Foods positions Amazon in a low-margin business. Amazon has extensive experience in operating efficiently in the low-margin online retail industry. We expect the company to pursue margin expansion at WFM, not from conservative pricing (AMZN is already aggressively pricing WFM goods), but through increased efficiency and leverage from customer growth.

We give management high marks for continually making Amazon's "store" cheaper, easier, and more secure for shoppers. We think the security and convenience of Amazon's site has given many former critics of e-commerce the confidence to shop online. In addition, innovations like Amazon Prime, Amazon Web Services, and Kindle have made Amazon an internet powerhouse.

Amazon is likely to face fierce competition over the next several years as more companies expand online sales and match Amazon's prices offline. Amazon has been able to stay in front of physical and online retail rivals with innovations such as Prime, along with expanded third-party sales.

The company could be hurt in the event of a significant security breach, theft of client information, or outages at its Amazon Web Services unit. This is a risk for all e-commerce businesses, but may be heightened in the case of a well-known consumer company like Amazon.

COMPANY DESCRIPTION

Amazon.com is the leading U.S. e-commerce retailer and among the top e-commerce sites globally. Amazon.com also includes Amazon Web Services (AWS), the global leader in cloud-based Infrastructure-as-a-Service (IaaS) platforms. The company's Prime membership platform is a key online retail differentiator, providing customers with free shipping (after an annual fee) along with exclusive media content (music, video, audible books, etc.). The company's Kindle reader and Alexa-based Echo and Dot digital voice assistants are category leaders.

VALUATION

While the growth engine at Amazon is unmatched, the stock has been difficult to analyze from a valuation perspective. Given recent price weakness, forward-looking (DFCF) valuations and price-based comparable valuations are increasingly attractive.

AMZN trades at 37.6-times our 2024 GAAP EPS forecast and at 31.4-times our 2025 GAAP projection. The two-year forward P/E of 34.5 is below the trailing five-year multiple (2019-2023) of 67.9. The relative P/E of 1.52 on our two-year average EPS forecast is below the historical relative P/E of 3.43.

AMZN trades at a two-year forward enterprise value/EBITDA multiple of 14.7 for 2024-2025, a significant discount to its trailing five-year (2019-2023) multiple of 18.4. We believe that AMZN merits a premium to historical EV/EBITDA given the company's growth in high-end offerings such as Prime and Prime Video; superior growth in AWS, digital advertising, and subscription services; and unmatched volume and vendor leverage. Our historical comparable valuation is in the low $300s, in a rising trend and above current levels.

On peer analysis value is in the $320s, AMZN appears inexpensive amid the AI-driven rally. Using our two- and three-stage discounted free cash flow model, we calculate a value in the $530 range, well above current prices. Based on our historical comparable analysis, peer indicated value, and discounted free cash flow valuation, our blended model points to a value around $440, well above current prices.

Appreciation to our 12-month target price of $230 (raised from $205) implies a risk-adjusted return that is greater than our forecast for the broad market and thus consistent with a BUY rating.

Given the company's indisputable franchise leadership, ability to leverage its vendor relationships in the retail space, and market dominance and superior growth in infrastructure-as-a-service, we believe that AMZN warrants long-term accumulation in most equity accounts. We recommending initiating new positions or dollar-averaging into existing positions on share price weakness.

On November 1 at midday, BUY-rated AMZN traded at $199.48, up $13.08. (Jim Kelleher, CFA, 11/1/24)

COCA-COLA CO. (NYSE: KO, $65.11) .... BUY

KO: Recent weakness provides buying opportunity

* KO shares have underperformed over the past quarter, declining 2% compared to gains of 4% for the S&P 500 and 1% for the industry ETF IYK.
* Coca-Cola recently reported 3Q24 earnings that topped consensus expectations.
* KO announced the launch of a new Bacardi & Coca-Cola ready-to-drink cocktail.
* Our target price of $75, implies a multiple of 25-times our 2025 EPS estimate.

ANALYSIS

INVESTMENT THESIS

Our rating on Coca-Cola Co. (NYSE: KO) is BUY. Management has recognized that it needs to diversify revenue away from sugary soda, and we expect it to make progress toward this goal. The company eliminated more than 600 unproductive items in 2019 and worked to reposition the business through changes in core products, pack sizes and serving sizes, as well as through deals such as the acquisition of coffee company Costa. The company's innovation has also improved in making the portfolio of brands less bloated and more profitable. In addition, it has been refranchising its bottling operations to drive margin growth. Despite a host of challenges, we expect Coca-Cola to adapt to keep consumers engaged with the brand and its products, as it did in 2023. The company has also partnered with brands including Jack Daniels and Bacardi to create ready-to-drink cocktails, driving growth with new products. We believe it is a stronger company than at the beginning of the pandemic. Management has signaled confidence with a 5% dividend hike. We expect the combination of more focused marketing and a more profitable brand portfolio to boost earnings and the share price over time.

From a technical standpoint, the shares have been in a bullish pattern of higher highs and higher lows since October 2023. However, the recent weakness provides a buying opportunity. On the fundamentals, the stock trades at 22-times our 2025 EPS forecast, slightly above the peer average of 21. Given the combination of more focused marketing and a more profitable brand portfolio, our rating remains BUY. Our target price of $75, implies a multiple of 25-times our 2025 EPS estimate.

RECENT DEVELOPMENTS

KO shares have underperformed over the past quarter, declining 2% compared to gains of 4% for the S&P 500 and 1% for the industry ETF IYK. Over the past year, the shares have risen 15%, compared to gains of 37% for the index and 12% for the industry. Over the past five years, the shares have climbed 21%, versus gains of 88% for the index and 62% for the industry. The beta on KO is 0.47.

Coca-Cola recently reported 3Q24 earnings that topped consensus expectations. The company posted revenue of $11.9 billion, down 1%. On an organic basis, revenue was up 9%, reflecting a 10% contribution from price/mix, partially offset by 1% lower case volume, and a 2% decrease in concentrate sales. Third-quarter adjusted EPS of $0.77 rose 5%, exceeding the consensus forecast of $0.74. The third-quarter gross margin widened by 70 basis points to 61.2%, while the adjusted operating margin widened by 100 basis points to 30.7%. In the first three quarters, the company has earned $2.33 per share.

Along with 3Q results, management raised its 2024 guidance. It now projects organic revenue growth of approximately 10%, up from the previous estimate of 9%-10%. It continues to expect adjusted EPS growth of 5%-6%, and free cash flow of $9.2 billion with capital expenditure of $2.2 billion.

The company continues to innovate through new products and partnerships. In September, Coca-Cola and Bacardi Limited announced plans to release a pre-mixed cocktail, Bacardi & Coca-Cola. This new partnership adds to Coca-Cola's ready-to-drink portfolio which also includes beverages featuring Jack Daniel's and Topo Chico Hard Seltzers.

EARNINGS & GROWTH ANALYSIS

Coca-Cola reports its results in six segments: EMEA (17% of 3Q revenue), Latin America (14%), North America (41%), Asia Pacific (11%), Global Ventures (6%), and Bottling Investments (11%).

Organic sales growth was positive in five of the six segments. By segment, organic sales were up 2% in EMEA; 24% in Latin America; 12% in North America; 3% in Asia Pacific; and 4% in Bottling Investments. Growth was primarily driven by price/mix. Organic sales were down 2% in Global Ventures, pressured by lower price/mix.

Volume varied across segments. By segment, volume rose 1% in Global Ventures. Volume was flat in Latin America and North America, while volume declined 2% in both EMEA and Asia Pacific.

Management keeps an eye on margins. The third-quarter gross margin widened by 70 basis points to 61.2%, while the adjusted operating margin widened by 100 basis points to 30.7%. Margins were driven by strong organic top-line growth and the effects of the refranchising bottling operations, partly offset by currency headwinds.

Based on recent trends and management's guidance, we are maintaining our 2024 adjusted EPS estimate of $2.85. Our estimate is at the high end of management's guidance range, and implies growth of 6%. We expect growth to continue in 2025 and are maintaining our adjusted EPS estimate of $3.05. Our five-year earnings growth rate forecast is 6%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Coca-Cola is Medium-High, the second-highest point on our five-point scale. The company's debt is rated A+ with a stable outlook by S&P.

At the end of 3Q, KO had cash and cash equivalents of $13.9 billion. The company had long-term debt of $43.0 billion, up from $35.5 billion at the end of 2023, and a debt/total capitalization ratio of 60%. Operating income in the third quarter covered interest expense by a factor of 8.6.

Coca-Cola repurchases stock. In the third quarter, it repurchased 5.1 million shares for $358 million. In the first three quarters, the company repurchased 18 million shares for $1.1 billion.

Coca-Cola pays a dividend. In February 2024, the company raised the dividend 5% to $1.94 per share, for a yield of 3.0%. KO has raised its dividend for 62 consecutive years, and we believe the dividend is secure and likely to grow. Our dividend estimates are $1.94 for 2024 and $2.02 for 2025.

MANAGEMENT & RISKS

James Quincey serves as Coca-Cola's CEO and Chairman. Mr. Quincey was appointed CEO in 2017 and chairman in 2019. John Murphy has served as the company's CFO since 2019.

The company continues to refranchise its bottling operations. In February, it completed its sale of the Coca-Cola Beverages Philippines, Inc. to Coca-Cola Europacific Partners and Aboitiz Equity Ventures Inc., with the transaction valued at $1.8 billion. The company also refranchised its bottling operations in Vietnam, in Bangladesh and in certain territories in India. Management expects these refranchising actions to further enable KO to develop a strong global footprint with a local touch in markets around the world.

As a major multinational corporation, Coca-Cola is exposed to substantial currency and commodity price risk. A bigger concern is that the company's core products are perceived as being unhealthy. There are growing concerns about obesity and the harm caused by sugar-sweetened beverages that may hurt demand for many of the company's core products. Harvard professor Vasanti Malik, who co-authored a paper on health issues related to sugary drinks told the New York Times that the "optimal intake of sugar-sweetened drinks is zero." The company is offering no-sugar versions of some of its most popular brands and smaller serving sizes to reduce total sugar content. Unfortunately, the press on "diet" beverages is not much better; a professor of pediatrics, also writing in the Times, said that a recent study and some of the related news stories on diet soda lacked important context and caused more worry than was warranted. Philadelphia, for example, has a tax of 1.5 cents an ounce on sweetened beverages, which adds about $1 to the price of a 2-liter bottle of Coke. Media reports said that sales of sweetened drinks dropped by 55% in Philadelphia; they increased by 38% in areas just outside the city. The Federal court ruled against a San Francisco ordinance to put a warning label on sugary drinks. The company has recently launched Coke Energy and Coke Plus Coffee. It is also putting more emphasis on tea. The company is also increasing its efforts to recycle the millions of plastic bottles and aluminum cans it produces.

Coke could be affected significantly if its independent bottlers run into credit or financial problems, or if the company's business interests do not align with the interests of bottling partners. It would also suffer if it is unable to defend its intellectual property rights, particularly as it expands to more emerging markets.

COMPANY DESCRIPTION

Coca-Cola, based in Atlanta, is a leading producer of soda, juices and juice drinks, and ready-to-drink teas and coffees. The company distributes its products in more than 200 countries. Core brands include Coca-Cola, Diet Coke, Sprite, Fanta, Coca-Cola Zero, Vitaminwater, Powerade, and Minute Maid. KO's operating groups are Europe, Middle East & Africa; Latin America; North America; Asia Pacific; Bottling Investments; and Corporate. The company sells beverage concentrates or syrups and finished beverages. The company has approximately 79,100 employees. The shares are a component of the S&P 500.

VALUATION

We believe KO shares are attractively valued at current prices near $66, above the midpoint of their 52-week range of $56-$74. The shares have been in a bullish pattern of higher highs and higher lows since October 2023. However, the recent weakness provides a buying opportunity.

On the fundamentals, the stock trades at 22-times our 2025 EPS forecast, slightly above the peer average of 21. The price/sales multiple of 6.1 is above the peer average of 4.8, while the dividend yield of about 3.0% is in line with the peer average. Given the combination of more focused marketing and a more profitable brand portfolio, our rating remains BUY. Our target price of $75, implies a multiple of 25-times our 2025 EPS estimate.

On November 1 at midday, BUY-rated KO traded at $65.11, down $0.20. (Taylor Conrad, 11/1/24)

LAZARD LTD. (NYSE: LAZ, $53.11) .... BUY

LAZ: Raising target to $64 as a rebound in financial advisory continues

* On October 31, Lazard reported 3Q24 EPS of $0.38, up from $0.10 a year earlier but below the consensus of $0.39. Results benefited from a 41% rise in financial advisory revenues.
* Management again referenced a more constructive market environment for M&A activity, noting a narrowing gap between buyer and seller valuation expectations that could facilitate more transactions.
* We are raising our target price to $64 and agree with an upward re-rating of the stock in 2024, which we believe reflects the substantially improving backdrop for the financial advisory segment.
* We note that the company's conversion to C-Corp. status as of January 1, 2024, a move intended to simplify shareholder tax reporting and enhance liquidity for the shares, remains an ongoing catalyst for the shares.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY-rating on Lazard Ltd. (NYSE: LAZ) while increasing our target price to $64 from $54. Results in 3Q showed a further rebound in the financial advisory segment. A re-rating of the stock since December likely reflects this improving backdrop, given pent-up demand for M&A activity.

In September 2023, new CEO Peter Orszag outlined an initiative named "Lazard 2030" that includes doubling the company's revenue base by 2030 while achieving average total shareholder returns of 10%-15%. The Asset Management and Advisory businesses are expected to contribute about evenly to the projected growth in revenue. We note that the seven-year initiative implies compound annual growth of about 11%, a not-so-easy task given challenges throughout the lifecycle of the advisory and asset management businesses. Our estimates imply revenue growth of about 17% between 2023 and 2024 amid an expected recovery in M&A activity and higher asset levels, giving a near-term boost toward 2030 goals.

In Asset Management, revenue growth is expected to come from improving global distribution, investment performance, and the company's entry into adjacent markets. In Advisory, management said that it would rely on U.S. and Europe for increased activity, while also citing the potential for growth in the Middle East and North Africa.

The company converted to C-Corp. status as of January 1, 2024, a move designed to simplify shareholder tax reporting and enhance liquidity for the shares. Newly eligible shareholders could include those unable to invest in partnerships. We note that several companies in our coverage, including Apollo Global, Blackstone Inc., and KKR & Co., have experienced higher valuations following conversion to C-Corp. status.

In our view, Lazard remains a compelling secular growth story with a clean balance sheet and a focused business model.

Our target price of $64 implies a multiple of about 16-times our estimate for 2025, as we expect a considerable rebound in revenues from the advisory business. The current dividend also yields a healthy 4.0%.

RECENT DEVELOPMENTS

LAZ shares are up 91% over the past year, compared to a 36% increase for the broad market.

On October 31, Lazard reported 3Q24 EPS of $0.38, up from $0.10 a year earlier but below the consensus of $0.39. Revenues were up 21% to $646 million, reflecting a 41% increase in financial advisory fees and 4% higher asset management fees. Following 17% greater compensation costs and a 1% rise in noncompensation expense, adjusted net income more than tripled to $39.7 million.

The financial advisory segment was aided by a significant rebound in M&A activity, while the asset management segment was helped by a 4% year-over-year increase in average AUM (to $246 billion).

EARNINGS & GROWTH ANALYSIS

On the 3Q earnings call, management noted that merger & acquisition (M&A) activity continues to rebound with valuation multiples improving and narrowing the gap between buyer and seller expectations. For the first three quarters of 2024, M&A announced volume is up over 20%, year over year. The company also noted that private equity had become increasingly active with an uptick in sponsor activity. We note that lower interest rates, better credit availability, and improving CEO confidence should further aid the advisory business moving into 2025.

We continue to believe that Lazard's broad and deep coverage – by geography and industry – distinguishes it from boutiques, while its focus on advisory distinguishes it from large banks. After a 12% decline in 2023, we look for revenues to rise 17% in 2024 and 13% in 2025, mainly as the advisory business rebounds.

In the asset management business, the company achieved a 4% year-over-year rise in AUM in 3Q. Fee rates remain under pressure, but new strategies and product extensions should provide some counter to that trend. Management has referenced three areas of growth for its asset management segment: demand for existing core and specialty offerings as central banks lower rates and the stock market rally broadens; the development of additional specialty products and strategies, such as a new U.S. small cap equity fund and the Lazard Global Listed Infrastructure Active ETF in Australia; and advancing opportunities outside of public markets, including growth through acquisition or partnerships into new products and strategies.

Compensation was 69.8% of revenue in 2023, up from 59.8% a year earlier, hurt by a lower revenue base. The company expects to achieve a compensation ratio over a cycle in the mid- to high 50s on an adjusted basis. On the 3Q earnings call, management noted that if the recovery in financial advisory fees continues, it believes the compensation ratio will be at or below 60% in 2025.

Noncompensation expense was 23.4% of revenue in 2023, up from 18.7% a year earlier, again hurt by weaker revenues; the company's goal is to keep this ratio between 16% and 20%.

While trends for financial advisory have been improving, we expect the speed of the recovery to moderate. We are lowering our 2024 EPS estimate to $2.19 from $2.66. Our 2025 forecast moves to $4.03 from $4.07.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Lazard is High. The company has a low long-term debt/cap ratio and high liquidity, with cash and cash equivalents of $1.17 billion on September 30. Lazard acts mainly as an advisor; it does not provide financing for transactions or otherwise commit its own capital to complete transactions. In 1Q24, the company issued $400 million of 6.0% Senior Notes due March 2031, refinancing 2025 Senior Notes.

Lazard raised its quarterly dividend by 6% in July 2022 to $0.50. The previous increase was in April 2019, to $0.47 per share. Lazard expects to gradually increase the dividend over time. We project dividends of $2.00 in 2024 and $2.08 in 2025. The company also declared a special $0.50 per share common stock dividend in January 2019. Special dividends have included $1.30 per share in January 2018, $1.20 per share in both January 2017 and February 2016, and $1.00 per share in February 2015. Special dividends have provided a healthy boost to total returns.

Lazard repurchased $3 million of its common shares in 3Q24, bringing first nine month repurchases to $44 million. In July 2024, directors authorized additional share repurchases of $200 million through December 2026, with total authorization remaining at $356 million at the end of 3Q24. Historically, share buybacks have primarily offset dilution from share issuance related to compensation.

MANAGEMENT & RISKS

Lazard is currently led by CEO Peter Orszag, who took over from Kenneth M. Jacobs in October 2023. Mr. Orszag previously headed the firm's advisory business. Mary Ann Betsch is the CFO.

While Lazard has diversified its revenue in recent years, revenue is still highly dependent on fees earned from advising clients on financial transactions and fees earned on assets under management. Lazard also earns fees if its investment funds exceed return hurdles, but these typically account for only 5%-10% of asset management revenues. Thus, Lazard's revenues can be volatile and tough to predict from quarter to quarter.

Advisory revenues are dependent on levels of CEO confidence as well as on stock valuations and conditions in the financing/credit markets. Large companies remain flush with cash, and financing markets are functioning well, although interest rates have marched dramatically higher since March 2022.

Regarding risks related to financial regulatory reform, we note that Lazard does not have a proprietary trading desk or commit its own capital to private equity or real estate funds. As a result, the Volcker Rule has no direct impact on the company.

COMPANY DESCRIPTION

Lazard Ltd., one of the world's leading financial advisory and asset management firms, provides advice on mergers and acquisitions, strategic matters, restructuring and capital structure, capital raising and corporate finance, as well as asset management services to corporations, partnerships, institutions, governments, and individuals.

VALUATION

Lazard derived about 57% of its revenues from corporate advisory in 3Q. The balance mostly came from institutional asset management. The financial advisory segment had a sharp rebound in the first nine months of 2024 after being weak for much of 2023, reflecting higher interest rates and lesser credit availability. We expect considerable improvement into 4Q24 and into 2025. The environment for asset levels has also shown improvement recently, although fee rates do face pressure from competition and increased investment in passive index strategies.

LAZ shares trade at about 25-times our 2024 EPS estimate. We are raising our target price to $64 (up from $54), implying a multiple of about 16-times our EPS estimate for 2025, when we expect a considerable rebound in revenues from the advisory business. We expect Lazard to continue to benefit from its leading market position in financial advisory and look for continued modest growth in asset management.

On November 1 at midday, BUY-rated LAZ traded at $53.11, up $0.12. (Stephen Biggar, 11/1/24)

MICROSOFT CORP. (NGS: MSFT, $414.77) .... BUY

MSFT: Strong fiscal 1Q, but market worries over Gen AI spend

* Microsoft reported 10.5% EPS growth on 16% revenue growth in fiscal 1Q25. The company is reporting strong revenue growth across its divisions.
* Azure Cloud within its Intelligent Cloud segment is driving strong revenue growth as Activision Blizzard contributed some points to revenue growth.
* Microsoft is doubling down on generative AI, ramping investments in the area both internally and by diversifying outside investments in AI start-ups.
* We are maintaining our FY25 EPS estimate at $13.30 and our FY26 forecast at $15.28.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY rating on Microsoft Corp. (NGS: MSFT) with a target price of $526. Microsoft continues to pursue long-term growth through its AI and cloud investments, and just may hold the premier position in business technology. CEO Satya Nadella sees Gen AI as a rare change to a fundamental computing paradigm and Microsoft is moving to exploit the opportunities opened up by Gen AI as quickly as possible, as demand currently outstrips the supply of its cloud services. However, the market, fickle as ever, may be concerned about the ramping costs and investments in Microsoft's Gen AI infrastructure as it races competitors Alphabet and Meta as well as a host of smaller AI startups to develop the new Gen AI models/applications that may drive the emerging Gen AI market as a whole.

Although not immune from macroeconomic challenges (such as declines in the PC OEM market and in digital advertising), Microsoft has about as diversified and strong a set of assets as any company in the technology industry – and may even be seen as a haven by investors in uncertain times. The company is one of few with a complete, integrated product set aimed at enterprise efficiency, cloud transformation, collaboration, and business intelligence. It also has a large and loyal customer base, a large cash cushion, and a rock-solid balance sheet.

While MSFT shares were hit by the 2022 Technology sector selloffs, they recovered in 2023 and 2024 as the company has reassumed its rightful place as an industry leader, though this has also driven the valuation modestly higher. Microsoft is also one of the only Tech companies in our coverage group that pays a growing dividend that we consider safe.

RECENT DEVELOPMENTS

Microsoft reported results for fiscal 1Q25 (ended September 30) on October 30 after market close. Revenue beat the high end of the company's guidance range by $785 million and consensus by $78 million. Adjusted EPS beat the consensus estimate by $0.11. MSFT shares fell about 6% on October 31. The market may be spooked at Microsoft's already large and still ramping investments in generative AI.

Fiscal first-quarter revenue rose 16% year over year to $65.6 billion. Microsoft's October 2023 acquisition of Activision contributed three percentage points to revenue growth. Two of the company's segments outperformed the 1Q guidance while the Intelligent Cloud segment came in at the high end. As has become customary, Intelligent Cloud led the way in the quarter, with 20% revenue growth, highlighting the traction of the company's Azure cloud and artificial intelligence applications in the market. Azure and other cloud services grew 33%, evidencing increased overall demand, with AI services contributing 12 percentage points of growth. Demand for AI services remains higher than available capacity. Microsoft is all-in on continuing to enhance its cloud solutions through integrating new artificial intelligence (AI) systems across its product portfolio, with a particular emphasis on its cloud solutions. The Productivity and Business Processes segment saw 12% revenue growth driven by expansion across business lines, with Microsoft 365 Commercial and Cloud revenue up 13% and Microsoft 365 Consumer and Cloud revenue up 5%. The E5 application bundle and Microsoft 365 Copilot, an AI assistant, boosted ARPU growth. The More Personal Computing segment saw 17% revenue growth, though the smallest increase in incremental dollars, with 15 percentage points of that growth from last year's the Activision acquisition. As the company has now lapped that acquisition, we would expect More Personal Computing segment growth to become more muted going forward and, indeed, management's fiscal 2Q guidance calls for segment revenue growth to decline 4% at the midpoint of the range. Windows OEM and Devices revenue rose at a better than expected 2% rate due to mix shift toward higher monetizing markets.

The consolidated gross margin was 69.4%, down 180 basis points from the prior-year quarter. Management attributed the decline to costs associated with scaling the company's AI infrastructure. These costs have been a major worry for investors and management is messaging that these costs will likely intensify in FY25, as Microsoft looks to build to meet market demand in the Gen AI space. Not exactly the message investors were hoping for. Operating income rose 14% to $30.55 billion. However, operating margin narrowed by one percentage point to 46.6%, impacted by Activision acquisition integration costs. Adjusting for Activision, pro forma operating margin would have expanded by a percentage point. Diluted EPS rose 10.5% to $3.30.

On September 16, Microsoft announced 10% or $0.08 increase in its quarterly cash dividend to $0.83 per share or $3.32 annually. The forward dividend yield is 0.81%. We are raising our FY25 dividend estimate to $3.32 and our FY26 forecast to $3.65. The company has consistently raised the dividend over the last five years at a compound annual growth of 10%.

Microsoft has again run into antitrust trouble, both in the U.S. and EU. In June, the U.S. Federal Trade Commission reportedly opened an investigation of a deal Microsoft made to hire Gen AI pioneer Mustafa Suleyman and his team from start-up Inflection AI. Mr. Suleyman was made CEO of a new Microsoft division called Microsoft AI, aimed at developing Gen AI tools for consumers. The FTC's concern is likely around whether the deal between Microsoft, Mr. Suleyman, and Inflection AI was, in effect, a disguised acquisition which may have required FTC review and approval before proceeding. Chairperson Lina Khan's FTC has been on something of a jihad against big Tech with limited effect, though this regulatory bias may have led to Microsoft looking for a workaround to an outright acquisition of Inflection AI. The Inflection AI deal does seem to warrant an antitrust review and, given the makeup of the current FTC, may lead to litigation – though the outcome of any possible litigation remains questionable.

On June 25, the European Commission sent a "Statement of Objections" to Microsoft alleging in a preliminary finding that Microsoft breached EU antitrust rules by tying its Teams application to its cloud-based Office 365 and Microsoft 365 business productivity software suites. Teams is Microsoft's business messaging, communications, and collaboration application, similar to Slack, Zoom, and Trello. The EC originally opened its investigation of this issue in July 2023, following a complaint from Slack. The crux of the allegation is that Microsoft, by bundling its own application, Teams, with its software suites, may have given Teams a distribution advantage by not giving customers a choice whether or not to access Teams. This was exacerbated by relative interoperability disadvantages of competitors versus the Teams integration with Microsoft's software suites. According to the EC, these actions prevented competition to the detriment of the EU. After the opening of the investigation, Microsoft began selling certain software suites without Teams, but the EC found this an insufficient remedy. If the EC decides that the allegations against Microsoft are valid, it can make a rule prohibiting the conduct, impose a fine of up to 10% of annual global Microsoft revenue (over $10 billion), and impose other remedies.

EARNINGS & GROWTH ANALYSIS

We are maintaining our FY25 EPS estimate at $13.30 and our FY26 forecast at $15.28. Our EPS estimates imply 14% growth over the next two years. Our long-term earnings growth rate is 12%.

The market has for the moment decided to push Microsoft's strong September quarter to the side in favor of a worried focus on its Gen AI spending. Management attributed the 180 basis point gross margin compression in fiscal 1Q to costs around scaling the company's AI infrastructure, mainly data centers and servers. We note that 1Q's margin compression follows a 50 basis point compression in fiscal 4Q24. Further capital expenditures, also driven by AI costs, have been ballooning, up 58% or $16.4 billion in FY24 and 50% or $5 billion just in fiscal 1Q25. While management does not give full year guidance, it did give general guidance for fiscal 2Q25 that gross margin would again decline due to AI infrastructure investments. Though management may skirt the issue, it is clear to us that Gen AI costs and investments continue to ramp higher as the company races to meet growing demand, acquire share in the new market for AI cloud services, and push the envelope on advancing its partner OpenAI's and its own Gen AI models. Further, the company expects to take a $1.5 billion non-operating loss in fiscal 2Q driven by its investment in AI leader OpenAI. Gen AI may indeed be the next computing paradigm and therefore a critical area of investment, though the market remains skeptical.

Azure revenue growth has become a key metric for Microsoft, watched closely by investors. The first step was Microsoft's rapid rollout of new Gen AI assistants, "Copilots," integrated across its tech stack, particularly in its Azure cloud service, though also including its Bing search engine, among others. Microsoft is now leaping into the next wave of Gen AI, "Agentic AI," the use of semi-autonomous Gen AI agents that have a deeper understanding of context and are capable of accomplishing more complex tasks without the need for human queries and direction.

Microsoft expects to continue making priority investments where it has a "long-term structural advantage." We see this as most applicable to enterprise cloud. Microsoft's strategic imperative has been to help businesses and consumers become more productive; Mr. Nadella sees the demand for productivity as even greater in a challenging macroeconomic environment and an opportunity for Microsoft to take share. Mr. Nadella is also looking to drive "operational leverage" (read cost cutting), which was most evident in the January 2023 round of layoffs.

Microsoft sees its Azure cloud as a competitive advantage for enterprise hybrid on-premise/cloud environments. Microsoft's new software-as-a-service (SaaS) products from Office 365 to Azure also enable the company to reach small- and medium-sized business customers. Initially, customers may subscribe for Azure cloud computing power and storage, and then move onto Microsoft's AI-powered "intelligent edge" platforms. Microsoft even introduced an (AI) Model as a service in Azure in December 2023. Mr. Nadella has refocused the company on investments in core commercial business productivity and platform development. This includes business systems like the company's Azure cloud service, Dynamics 365, SQL Server, Office 365, and new products like Teams. Meanwhile, traditional stalwarts like Windows have faded and essentially been downgraded.

While business productivity is undoubtedly Microsoft's core business, the company has moved aggressively in the separate area of consumer video gaming. Microsoft's Xbox series consoles have gone through many upgrade cycles, but management may see the future of videogaming in cloud-subscription games. The new paradigm of cloud subscriptions may depend on a steady stream of new high-quality content. This realization may have led management to acquire a series of videogame content companies, including the small ZeniMax Media acquisition in 2021 and the blockbuster $69 billion Activision Blizzard acquisition in October 2023. Microsoft's videogame strategy may also support possible ambitions around the metaverse, i.e., a fully realized digital world.

Artificial intelligence start-up and Microsoft partner OpenAI is currently considered the leader in Gen AI. On November 30, 2022, OpenAI launched its ChatGPT chatbot, capturing the tech world's imagination and generating excitement around AI. CEO and co-founder Sam Altman claimed over 1 million users within a few days of launch. A chatbot is a text-based application that generates answers to users' natural language questions and simply programmed versions are already in general use as a web-based customer service alternative. ChatGPT followed OpenAI's Dall-E 2, an artificial intelligence image generation program launched earlier in 2022. OpenAI continues to develop and release new more powerful versions of its Gen AI applications and is critically dependent on Microsoft computing power to do so.

Microsoft invested $1 billion in OpenAI in 2019, becoming its preferred partner for commercializing OpenAI technologies, and in January 2023, announced a new phase in the strategic partnership. Tech industry news site Semafor reported Microsoft was in discussions regarding an additional $10 billion investment in OpenAI as part of a new funding round, valuing the start-up at a remarkable $29 billion, with 49% ownership. While Microsoft has been silent on the actual terms of the deal, we think at a minimum, it is giving OpenAI substantial compute usage credits for its Azure Cloud Services Indeed, OpenAI's use of Microsoft's Azure Cloud Services creates a key strategic partnership given OpenAI's large and growing demand for compute services. CEO Nadella has made clear that Microsoft is interested in integrating ChatGPT AI across its product portfolio and tech stack, originally in the form of "copilot" services but also through its Azure Cloud compute service. It announced the general availability of Azure OpenAI Service on January 16, 2023. GitHub Copilot is another AI-powered tool for developers that is also in general release. In March of 2023, Microsoft announced plans to launch a cybersecurity copilot and in October of 2023 announced that an early access program was open to qualified customers. Despite the excitement around ChatGPT, this application is in its infancy. For example, it has been easily fooled and has given the wrong answers, something Mr. Altman has readily admitted. However, given the iterative nature of artificial intelligence improvements, what Mr. Nadella calls "nonlinear improvements in capability of foundation models," ChatGPT or a follow-on technology could, over time, become both a boon to Microsoft and a threat to other tech industry leaders such as Alphabet/Google. Microsoft's large investments in the technology put it on the right side of history as AI grows in capacity, accuracy, and importance.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Microsoft is High, the top of our five-point scale. Total debt stood at $43 billion at the end of fiscal 1Q25, all of it long term. Microsoft has $121 billion in cash and near cash, significantly above its level of total debt, which is remarkable; very few companies would be able to retire all their debt in one fell swoop. Trailing 12-month free cash flow was $72.7 billion, up 15% or about $9.4 billion year over year. Microsoft is triple A-rated by the credit agencies and outlooks are stable.

We are raising our FY25 dividend estimate to $3.32, from $3.28 and our FY26 forecast to $3.65, from $3.63. The forward dividend yield is 0.81%. The company has consistently raised the dividend over the last five years at a compound annual growth of 10%.

Microsoft repurchased $4.1 billion of its stock in fiscal 1Q25 after buying back $17.25 billion in FY24; $22.25 billion in FY23; $32.7 billion in FY22, $27.4 billion in FY21, $23 billion in FY20. The Activision acquisition was a drain on cash in FY24.

MANAGEMENT & RISKS

PC demand has been volatile, impacting Microsoft's key Windows operating system business. Microsoft remains exposed to macroeconomic risk and the risk that enterprises could cut back on technology spending in response to economic weakness. The company's Bing search engine and LinkedIn professional networking website are particularly exposed to volatility in advertising spending due to their high correlation with macroeconomic factors. While the macroeconomy may be in for a "soft landing," the outlook remains uncertain and, as a consequence, advertising spending is a risk factor.

Investors in Microsoft face potential losses if the company's operating performance falls short of expectations. For example, Microsoft took a $7.5 billion write-off for Nokia Devices and Services (NDS), writing down 80% of the purchase price in a little more than a year following the acquisition. The company has also taken additional large write-offs, including the $450 million charge related to the closure of its retail store locations. Microsoft's $1.17 billion fiscal 2Q23 write-off was just one more example. Other risks include the migration of consumers away from the PC to mobile devices that do not use a Microsoft-based operating system (e.g. Apple's iPad); the potential for a prolonged downturn in global software investment spending; the well-publicized security vulnerabilities in the company's products; the possible adoption of Linux and/or other open-source software applications; increased competition in the internet space; and legal risks. The ubiquity of Microsoft systems throughout government and industry has made its systems a prime target for both state and non-state cyber attackers and led to an unfortunate series of successful hacks. Also, the pirating of the company's software in developing markets, such as China and India, is an ongoing problem, and represents huge missed revenue opportunities for Microsoft. Another risk is management's ability to execute its business plan and deliver new products on schedule.

Microsoft is again facing regulatory antitrust pressure in the U.S., EU, and UK. On October 5, 2023, the UK Competition and Markets Authority (CMA) announced a new investigation of cloud services offered by cloud market leader AWS and second-place Microsoft. The UK regulators have found that AWS and Microsoft together comprise 70%-80% of the market for cloud infrastructure services in the U.K. They are focused on the so-called egress fees that cloud services companies charge customers to transfer data out of a particular cloud, the lack of interoperability and portability between different providers, and the committed-spend discount incentives to stay with a given provider. On December 8, 2023, the CMA opened an investigation of Microsoft's partnership with Open AI given management upheaval and subsequent Board of Directors changes at OpenAI in November 2023. All of these issues could become the basis for antitrust litigation against Microsoft. We see the investigations as more logs on the fire of antitrust and regulatory backlash against big Tech in the U.S. and abroad.

The New York Times sued OpenAI and Microsoft for copyright infringement in federal court on December 27, 2023. The Times claims that OpenAI's ChatGPT application was trained using Times' articles and offered some compelling examples of ChatGPT query answers that were taken from articles verbatim. As with many technological changes, the status of copyright law around generative AI is currently unsettled, and it may take a court ruling to settle the claims of creators big and small with regard to the new technology. Media organizations currently seem split between either litigation with or agreeing to license content to purveyors of Gen AI models, including OpenAI/Microsoft, with the Times lawsuit the most prominent to date.

When Microsoft pulled out of the mobile smartphone market, the company gave up on a critically important vector of future growth that underpins the success of tech titans Apple (iOS) and Alphabet (Android). Microsoft has tiptoed back into phone hardware with a handset that runs on Android. Microsoft could one day find itself and its application ecosystem at the mercy of competitors who control mobile systems and devices. The substantial negative initial impact of Apple's App Tracking Transparency change on iOS 14 for competitive platforms like Facebook and Snapchat, while not impacting Microsoft directly, must have sent a shudder through management in Redmond.

While Microsoft may be the second-largest public cloud provider (excluding China), it has about one-half the market share of industry leader Amazon Web Services, according to industry tracker Gartner. Amazon has achieved a scale that could make it difficult for Microsoft to reap a sustainable profit from its cloud services business.

In the case of the Xbox 360, highly aggressive pricing from both Sony and Nintendo may hamper Microsoft's efforts to generate acceptable long-term profits in this area.

The company also faces intense direct competition from Google in many areas, including internet search, operating system software, internet-based software applications, and generative AI. This competition could potentially erode the dominance of Microsoft's core operating system and Office applications. Google has established itself as the dominant online search player, and has leveraged its position to move into direct competition with Microsoft with its Chrome internet browser and operating system software. Microsoft has struck back through an alliance between its internet search engine Bing and Yahoo.

Microsoft noted in a regulatory filing in October 2023 that it had received a notice from the IRS stating that it owed an additional $28.9 billion in taxes for the years 2004-2013 plus penalties and interest. If Microsoft is forced to pay this bill, it could have a material impact on the company's finances. However, Microsoft disputes the amounts owed, asserting that the IRS has not accounted for at least $10 billion in taxes already paid, and is appealing the new tax bill. This will probably take several years to resolve.

Microsoft made a key hire in March 2024 when it announced the appointment of Mustafa Suleyman as EVP and CEO of a new organization called Microsoft AI. Mr. Suleyman was most recently a co-founder of AI startup, Inflection AI, and in 2010 a co-founder of DeepMind, an organization that did foundational research in generative AI and was acquired by Alphabet in 2014. Microsoft is also hiring Inflection AI's cofounder, Karen Simonyan, and other staff. In February, Microsoft became an investor in European AI startup, Mistral. While Microsoft's close relationship with generative AI leader OpenAI remains, the company's recent actions indicate that it is also diversifying its bets in the AI space. The management turmoil at OpenAI in November 2023 that led to first the firing and then rehiring of CEO Sam Altman by a new board among mass resignations may have been a wake-up call for Microsoft management that it needs to de-risk its generative AI strategy by diversifying its access to AI models.

COMPANY DESCRIPTION

Microsoft is the world's largest independent software developer. The company was founded on the MS Windows operating system and MS Office business applications suite for PCs. As it has grown, Microsoft has expanded into enterprise software with Windows Server, SQL Server, Dynamics CRM, SharePoint, Azure, and Lync; hardware with the Xbox gaming/media platform and the Surface tablet; and online services through MSN and Bing. Microsoft acquired Skype, the internet VoIP communications service, in October 2011. More than 50% of revenue is generated outside the U.S.

VALUATION

Microsoft shares have risen 9% year-to-date on a total-return basis, compared to a 21% increase for the S&P 500, and a 29% increase for the S&P Information Technology Index. With a trailing enterprise value/EBITDA multiple of 21.4, MSFT trades below the average of 22.2 of the five-year historical range. Microsoft's forward enterprise value/EBITDA multiple of 19.3 is 5% above the peer average, below the average 18% premium over the past two years. We are reaffirming our BUY rating to a target price of $526.

On November 1 at midday, BUY-rated MSFT traded at $414.77, up $8.47. (Joseph Bonner, CFA, 11/1/24)

PUBLIC STORAGE (NYSE: PSA, $326.86) .... HOLD

PSA: Third-quarter miss, lowering EPS estimates

* The REIT saw a 20% increase in costs over the first nine months of 2024, likely driving the appointment of an independent trustee to its auditing committee and the hiring of a new COO from outside the company.
* PSA reported 3Q24 core FFO of $4.20 per share, down 3% from $4.33 in 3Q23. The results missed the consensus estimate of $4.25 per share and were the third sequential quarter with negative year-over-year earnings.
* With a PEG ratio below peers and a 2024 P/FFO multiple of 20.0, equal to the share's five year average, we think that a HOLD rating is appropriate.
* The company pays a quarterly dividend of $3.00 per share, but has not had a hike since 1Q23. The current yield is about 3.6% is in line with peer REITs.

ANALYSIS

INVESTMENT THESIS

We are maintaining our HOLD rating on Public Storage (NYSE: PSA). The self-storage industry has historically benefited from city dwellers seeking extra storage space as well as from major life events, such as the death of a spouse, divorce, or downsizing in retirement. However, demand for storage has suffered amid reduced consumer discretionary spending and higher inflation. We expect consumer discretionary spending and storage demand to lag further until interest rates fall lower. PSA is also facing pressure from industry oversupply, and has seen lower rental rates, lower occupancy, and narrower margins in its key same-store segment. In response, the company continues to offer substantial discounts to attract new renters. We would like to see these trends reverse before considering a higher rating.

The self-storage sector has fewer barriers to entry and more competition from smaller companies than other REIT peers. PSA has continued to expand its portfolio through acquisitions, although the pace slowed in 2022 and 2023, compared to 2021. In 4Q23, the company acquired 11 self-storage facilities, following the acquisition of a smaller competitor with 127 facilities in 3Q23. This compares with 5 small acquisitions in the first nine months of 2024.

PSA last announced a quarterly dividend at the end of 2022, about six years after the previous increase. The REIT has made fewer dividend hikes than peers and the current yield is about 3.6%, which is in line with the average for REIT peers. With a low beta and weaker fundamentals, the shares may not participate as fully as peers to positive sector momentum.

RECENT DEVELOPMENTS

Over the last three months, PSA shares have gained 8% compared to a 5.6% advance for the S&P 500 and a 6% gain for the Real Estate ETF IYR. The shares have underperformed the broad market year to date with a gain of 8%, compared to a 22% gain for the index, and a 9.4% gain for the IYR.

PSA reported 3Q24 core FFO of $738 million or $4.20 per share, down 3% from $763 million or $4.33 per share in 3Q23. The results missed the consensus estimate of $4.25 per share. Net income decreased 32% to $381 in 3Q24 from $563 million in 3Q23. Driving the discrepancy was lower interest income and higher FX losses in 3Q24.

Consolidated 3Q24 revenue was $1.2 billion, flat from 2Q24, but up 4% from $1.1 billion in 3Q23. For the nine months ending in September, total revenue was $3.5 billion, up 5% from $3.4 billion for the same period a year ago. Compared with 3Q23, third-quarter storage revenue increased 3% to $1.1 million while ancillary revenue increased 19% to $78 million.

The company continues to battle growing costs. Third-quarter expenses increased 15% to $705 million from $612 million in 3Q23. This follows a 22% increase in 2Q24 to $687 million, versus 2Q23 and a 24% increase in 1Q24. For the year ending with the third quarter, consolidated costs increased 20% to $2.1 billion, up from $1.7 billion for the same period a year ago. Storage operating costs increased 7% to $287 million, while G&A expenses increased 24% to $26 million compared with 3Q23. Interest expense in 3Q24 was $74 million versus $58 million a year ago.

The company relies primarily on acquisitions for revenue growth. Unlike many peers, the uptick from PSA's 2023 asset pipeline was followed by slower activity thus far in 2024. During 4Q23, PSA acquired 11 facilities and added 0.8 million net rentable square feet. Thus far in 2024, there were no acquisitions in 1Q24, two small acquisitions in 2Q24, and three small acquisitions in 3Q24.

During the quarter, the company also opened one new construction and completed several redevelopment projects. As of the end of 3Q24, PSA had 4.0 million square feet of projects in development at a cost of $712 million. As of the end of 2H24, the company has 275,000 square feet of development projects and 384,000 square feet of expansion projects in progress.

PSA is beginning to offer roof space for solar panel installations. In 2H23, it began construction on the first of 130 planned rooftop solar projects in partnership with Solar Landscape. This adds to an existing 133 installations, primarily in Maryland, New Jersey, and Illinois. The program in Maryland includes 57 installations intended for use by low-income families. PSA plans to add 1,000 solar installations by 2025.

Along with 3Q24 earnings, Public Storage maintained its 2024 core FFO guidance of $16.50-$16.85 per share. From the $16.68 midpoint of the range, the guidance implies a decrease of 1% from 2023 core FFO of $16.89 per share. Management maintained the top end of its same-store revenue estimate with a projection of a possible decrease as much as 0.5%.

EARNINGS & GROWTH ANALYSIS

Public Storage consolidated revenues include storage rental and ancillary operations, representing insurance and storage supplies. The REIT reports results on same-store facilities (76% of 2023 revenue), acquired facilities, newly developed facilities, and other non-same-store locations.

Same-store revenue in 3Q24 was $926 million, compared with $939 million in 3Q23. Same-store gross margins also decreased to $78.4%, down 1% from 3Q23. Same-store occupancy decreased 0.5% in 3Q24 to 92.7%. As of September 30, annual contract rents also decreased 0.5% compared with the same period a year ago.

Rental revenues from acquired facilities increased to $61 million from $24 million, while revenues from newly developed facilities increased to $65 million from $63 million in 3Q23.

As for net operating income compared with a year ago: same store NOI decreased 3% to $700 million; acquired facility NOI increased to $40 million, up from $15.5 million; and newly developed facility NOI increased 7% to $43 million.

Public Storage has had modest top line growth in 2024, while earnings growth has struggled against significant increases in costs. PSA's current revenues have also been primarily driven by newly acquired assets as opposed to organic growth. While 2023 saw an uptick in PSA's pipeline, the REITs acquisition and development pace has slowed. In 4Q23, the company acquired 11 self-storage facilities, following the acquisition of a smaller competitor with 127 facilities in 3Q23. This compares with no acquisitions in 1Q24, two small acquisitions in 2Q24, and three small acquisitions in 3Q24.

With the sector facing lower demand as reduced consumer spending has tightened spending and increased oversupply in the sector. While the company continues to focus on acquisitions, it may not be enough to boost net income and the revenue growth from new assets will have to outpace borrowing costs and higher operating costs. Another steep hurdle to success lies in the nature of the sector.

The self-storage sector has lower barriers to entry and faces competition from both large and small competitors. Well-kept facilities remain competitive without the benefit that name recognition carries in other industries. Furthermore, storage rental prices are relatively equal, keeping larger companies from gaining pricing power. So, while relying on the addition of smaller storage facilities, PSA must face high interest rates and must rely on its borrowing power to compete. For the first nine months of 2024, interest expense was $215 million, up 62% from $133 million in 3Q23.

In the face of the sluggish economy and slower addition of assets, the company is also continuing to rely on discounts for organic growth. The company's website consistently offers steep promotions. Marketing costs increased 12% for same-store facilities in 3Q24 versus 3Q23 and increased over 21% for the first nine months compared with the same period in 2023. Annual 2023 marketing costs rose 45% over 2022 and the REIT continues to rely on promotions and discounts to attract new renters. Rental prices still remain a relatively low monthly expense for most consumers. However, with increased competition from other large storage REITs as well as from smaller operators, pricing power can be limited. This forces the storage sector to rely heavily on demand from new customers requiring space to house surplus furnishings, clothing, and holiday items — all of which are tied to robust consumer spending.

In general, self-storage REITs are facing pressure from lack of demand and oversupply. According to Neighbor.com, the number of U.S. storage units has more than doubled since 2016, while the percentage of Americans renting units held steady at about 10% until rising to 11% in 2H23. In addition, Boxbee.com estimates that 65% of storage renters have a garage and that almost 50% have an attic, suggesting that many of the items currently held in separate storage units could be transferred to these spaces, reducing the need for away-from-home storage. Therefore, we expect the supply of units to continue to exceed demand until homeowners are able to relocate or downsizing improves.

While Public Storage is one of the larger storage REITs, it has several large competitors. Storage statistics indicated that about 40% of self-storage is operated by the six largest companies. As most storage units are similar, it is difficult for storage REITs to gain a competitive advantage by providing higher-quality units. Furthermore, as most facilities offer similar insurance, national companies do not offer added security.

We are lowering our estimates to reflect the significantly fewer acquisitions in 2024 and the lower-than-expected 3Q24 results. Our revised 2024 core FFO estimate is $16.70, down from $16.80 per share. Our revised 2025 core FFO estimate is $17.30, down from $17.40 per share. Our estimates imply 4% growth in 2025 over our 2024 core FFO estimate.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on PSA is Medium, as the company has a simple capital structure and lower debt than its storage REIT peers. The company's senior notes are rated A2 by Moody's and A by Standard & Poor's.

At the end of 3Q24, the company had $599 million in cash, up from $370 million at the end of 2023. The value of land and buildings at cost was $28.1 billion versus $27.5 billion at year end. Long-term notes payable was $9.5 billion, up from $9.1 billion at the end of 4Q23. PSA's long-term debt/cap ratio was 49% at the end of 3Q24, flat with the end of 4Q23.

During 2Q24, PSA repurchased $200 million in common shares on the open market. As of the end of 1H24, the company had about $400 million in domestic debt and $260 million in euro-denominated debt maturing in 2025.

The REIT has been slower to raise its payout than some peers. Its regular annualized dividend of $12.00 yields about 3.6% which compares with 3.5% as the peer average for Argus-covered REITs. However, PSA has paid $3.00 per quarter for eight quarters without an increase. Our regular dividend estimates are $12.00 for 2024 and 2025. For the first nine months of 2024, FAD decreased 2.3% compared with the same period in 2023.

MANAGEMENT & RISKS

The president and CEO of Public Storage is Joseph Russell, Jr. He previously served as CEO of PS Business Parks for 13 years. Tom Boyle is the CFO and Natalia Johnson is the CAO. In October 2024, the company hired a new COO, Chris Sambar, formerly a president at AT&T Communications. In July, PSA announced that it had appointed a new trustee to its auditing committed with an initial term expiring in 2025. Members of the Hughes family own 14% of PSA.

Risks for PSA investors include economic weakness and reduced consumer spending, which could lower occupancy. In addition, the shift to suburban homes from city apartments during the pandemic decreased demand and created oversupply. PSA is also vulnerable to competition from new entrants because of minimal barriers to entry in the self-storage industry. The sector, in general, can be susceptible to sector trading trends relative to interest rates.

COMPANY DESCRIPTION

Public Storage, based in California, is a REIT that operates self-storage facilities. The company has about 3,049 self-storage facilities in the U.S. with 219 million rentable square feet. Public Storage also has a 35% equity stake in Shurgard Europe, with about 281 facilities and 16 million square feet of rentable space in Western Europe. The European storage market has underperformed the U.S. market.

PSA currently has self-storage properties in 40 states. At year-end 2023, stabilized properties account for approximately 75% of the company's portfolio, and acquisitions for 15%. Development and redevelopment properties make up the remainder. Of the REIT's stabilized portfolio, approximately one-third of same-store assets were in California, Texas, and Florida. The shares are a component of the S&P 500. PSA's market cap is $58.4 billion.

VALUATION

The real estate sector has enjoyed positive sector rotation. PSA shares are trading above the midpoint of their 52-week range of $240-$370, with a five-year average monthly beta of 0.67. While the shares have benefited from some sector rotation, lagging earnings could cause the shares to not fully participate in further positive sector momentum compared to peers.

The shares are trading unfavorably to peers on several valuation metrics. Shares are trading at 20.0-times our 2024 core FFO estimate and 19.4-times our 2025 estimate, compared with the share's five-year P/FFO ratio of 20-times. The PEG multiple is 6.1, above the peer average of 4.9, and the price/sales multiple of 10.4 is above the peer average of 7.2.

Annual earnings that are expected to be flat or below 2023. While last year's acquisitions boosted revenue, costs flattened earnings and new acquisitions have slowed. We expect PSA to continue to face challenges from weak consumer spending, high promotional expenses, and industry oversupply for the remainder of 2024 and 1H25. As such, we believe that the shares are fairly valued at current levels. We believe the fundamentals and the lack of dividend growth support our HOLD rating on this overbought stock.

On November 1 at midday, HOLD-rated PSA traded at $326.86, down $2.20. (Marie Ferguson, 11/1/24)

PHILLIPS 66 (NYSE: PSX, $121.58).. BUY

PSX: Share price weakness offers a buying opportunity

* On October 29, Phillips 66 reported a 3Q24 adjusted net profit of $859 million or $2.04 per diluted share, down from $2.070 billion or $4.63 per diluted share in the year-ago quarter.
* The lower third-quarter 2024 earnings reflected lower market crack spreads (in Refining), driven by less favorable commercial results, seasonal maintenance costs and lower equity earnings (in Midstream), along with negative inventory hedging impacts.
* Phillips 66 does not typically provide full-year EPS guidance, but noted on its 3Q24 earnings conference call that it plans to monetize assets that no longer fit its long-term strategy. These dispositions are expected to generate over $3 billion in proceeds, with some of the proceeds being directed to shareholders.
* In addition, the company highlighted that it continues to work on bringing its cost structure down, especially in the Refining segment, where it has already lowered costs by one dollar per barrel.

ANALYSIS

INVESTMENT THESIS

Our rating on Philips 66 (NYSE: PSX) is BUY. We believe that in a highly volatile energy market environment, such as this one, a company's balance sheet strength and position on the cost curve are critical, and we advocate owning shares in those refining and marketing companies that can manage their businesses in a wide range of oil price scenarios. We believe that PSX is one of these companies, as it benefits from its size, scale, and diversified business portfolio, which includes Refining, Midstream, Chemicals, and Marketing & Specialties. This diversification has made the company's cash flow less volatile than that of most "pure-play" refiners.

Interestingly, activist shareholder Elliott Investment Management is also a current shareholder of PSX shares (about a $1 billion stake) and has recently voiced opposition to the company's underperformance (in both earnings growth and margin expansion) compared with its closest rivals (Valero Energy and Marathon Petroleum). In response, PSX management has addressed the Elliott Investment complaints and has proposed a performance improvement plan including noncore asset disposals, increased shareholder distributions, and cost reduction initiatives.

We see further positive developments ahead for PSX as its performance plan scales up beginning with second-half 2024 results and accelerates as calendar year 2025 begins. We believe the recent 10% hike in the dividend rate (April 2024) is only the beginning of higher shareholder returns for the company. Our target price is $167.

RECENT DEVELOPMENTS

On October 29, Phillips 66 reported a 3Q24 adjusted net profit of $859 million or $2.04 per diluted share, down from $2.070 billion or $4.63 per diluted share in the year-ago quarter. EPS results fell short of our estimate of $2.34 but surpassed the consensus quarterly estimate of $1.63.

The lower third-quarter 2024 earnings reflected lower market crack spreads (in Refining), driven by less favorable commercial results, seasonal maintenance costs and lower equity earnings (in Midstream), along with negative inventory hedging impacts. This was partly offset by higher earnings in Chemicals, which benefited from higher margins and lower costs.

Revenue for the third quarter of 2024 decreased 10% to $35.528 billion from $39.643 billion in 3Q23 and topped the consensus forecast of $32.001 billion. On a sequential basis, sales decreased 7% from $38.129 billion in the second quarter of 2024. Segment results for the third quarter of 2024 are summarized below.

The Refining segment reported a 3Q24 (adjusted) pretax loss of $67 million compared to a (adjusted) pretax profit of $302 million in the year earlier quarter. The swing to an operating loss mostly reflected lower realized refining margins, driven by less favorable commercial results, inventory hedging impacts (losses), and lower Gulf Coast clean product price realizations. The company's worldwide crude utilization rate was 97%, up from 95% in the prior-year quarter.

The Chemicals business consists of Phillips 66's equity investment in Chevron Phillips Chemical Company LLC (CP Chem). Reported pretax income increased to $342 million in 3Q24 from $104 million in 3Q23. The improvement was mostly due to higher polyethylene margins, driven by improved sales prices and a decline in feedstock costs. Global olefins and polyolefins utilization was 99%, comparable to the prior-year quarter.

The Midstream division recorded 3Q24 pretax income of $672 million, up from $581 million in 3Q23 due to higher segment margins. The Transportation segment income was higher, reflecting an increase in throughput, while the natural gas liquids (NGL) business experienced an improvement in margins, largely the result of higher volumes, as well as lower costs.

In the Marketing & Specialties business, pretax income declined to $583 million from $605 million in the third quarter of 2023. The lower performance was mainly due to lower domestic marketing and lubricant margins.

And lastly, in the company's newest reporting segment, Renewable Fuels, the division reported a pro forma pretax operating loss of $116 million, compared with an operating profit of $22 million in the year-ago quarter. The swing to an operating loss was primarily attributable to start-up costs associated with the ramp of the Rodeo Renewable Energy Complex, partly offset by higher volumes.

As discussed previously, on May 20, 2024, Phillips 66 announced that it had agreed to acquire Pinnacle Midland Parent LLC from private equity firm Energy Spectrum Capital for cash consideration of $550 million. The company noted that the prospective acquisition was highly strategic and will expand its natural gas gathering and processing footprint in the Midland Basin. We believe that this "bolt-on" transaction should provide a boost to earnings in 2024. The transaction is expected to close in the second half of 2024 following satisfaction of customary closing conditions.

EARNINGS & GROWTH ANALYSIS

Phillips 66 does not typically provide full-year EPS guidance but noted on its 3Q24 earnings conference call that it plans to monetize assets that no longer fit its long-term strategy. These dispositions are expected to generate over $3 billion in proceeds, with some of the proceeds being directed to shareholders. In addition, the company highlighted that it continues to work on bringing its cost structure down, especially in the Refining segment, where it has already lowered costs by one dollar per barrel.

We are lowering our 2024 EPS estimate to $9.05 from $9.60 to reflect both third-quarter performance, which fell short of our estimate, and our expectations for a soft industry refining environment, due largely to slower economic growth during the remainder of 2024.

We are also reducing our 2025 EPS estimate to $10.44 from $13.06 per share. Our expectations are for generally flat global demand, weaker-trending refining margins and rising crude inventories.

FINANCIAL STRENGTH & DIVIDEND

We rate Phillips 66's financial strength as Medium-High, the second-highest rating on our five-point scale. The company's debt is rated BBB+/stable by S&P and A3/stable by Moody's.

At the end of the third quarter of 2024, PSX's total debt/capitalization ratio was 39.8%, up from 39.1% a year earlier. The total debt/cap ratio is slightly below the peer average. The company has a target debt/cap range of 20%-30%.

Total debt at the end of 3Q24 was $19.642 billion, consisting of $18.731 billion in long-term borrowings and $911.0 million in short-term obligations. This compared with $19.864 billion of total debt in 3Q23.

PSX had cash and cash equivalents of $1.637 billion at the end of 3Q24, down from $3.539 billion at the end of 3Q23. Cash from operating activities was $1.132 billion in 3Q24, compared to $2.685 billion in 3Q23.

PSX remains focused on balanced capital allocation. It continues to invest for growth but has also returned substantial capital to shareholders. During the third quarter of 2024, Phillips 66 funded $1.3 billion to shareholders ($840 million in share repurchases and $485 million in dividends paid). In 2023, PSX returned $5.9 billion to shareholders, and we expect similar results in 2024.

On April 3, 2024, Phillips 66 increased its quarterly dividend by 10% to $1.15 per share, or $4.60 annually. The current yield is 3.77%. Our dividend estimates are $4.50 for 2024 and $4.64 for 2025.

MANAGEMENT & RISKS

Mark Lashier became the new CEO of Phillips 66 on July 1, 2022, succeeding Greg Garland. Mr. Lashier is also chairman. PSX continues to maintain a 50% interest in the CP Chem joint venture following its separation from ConocoPhillips through a spin-off in May 2012.

Refining is a volatile and environmentally high-risk business. Earnings can swing sharply from quarter to quarter, and the risk of environmental problems is high. As a result, investors must be prepared for the possibility of lawsuits against the company. In addition, refining companies often have unexpected downtime, and even small operational changes can be dramatically amplified in a refiner's quarterly results.

The prices of crude oil and refined products materially affect PSX's profitability, and the actual prices of both the feedstock it uses and the finished goods it produces depend on many factors beyond its control, including general market demand and economic conditions, seasonal and weather-related factors, and government regulations and policies. The company's inability to control these factors can make margins, cash flow, and earnings unpredictable.

PSX has incurred and will continue to incur substantial costs to comply with environmental laws and regulations. This could weigh on earnings if the company is unable to offset these costs with higher selling prices.

COMPANY DESCRIPTION

Phillips 66 is a downstream energy company with assets in five segments: Refining, Marketing & Specialties, Chemicals, Midstream, and Renewable Fuels. Its Refining and Marketing operations include 14 refineries with net crude capacity of 2.2 million barrels per day. Its Chemicals operations are conducted through a 50% interest in CP Chem, which has more than 33 billion pounds of net annual processing capacity. Midstream operations are conducted through DCP Midstream and through the company's controlling stake in Phillips 66 Partners. Phillips 66 began trading on the New York Stock Exchange on May 1, 2012.

VALUATION

PSX shares have traded between $110.54 and $174.08 over the past 52 weeks and are currently below the midpoint of this trading 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 13.5-times our 2024 EPS estimate and at 11.7-times our 2025 forecast, compared with a 12-year annual-average range of 9-16. On other valuation metrics, the shares are trading near the high end of the historical range for price/book (2.1 versus 1.5-2.2), at the midpoint of the range for price/sales (0.4 versus 0.3-0.5), and below the midpoint of the range for price/cash flow (9.3 versus 6.6-13.4). They are also trading at a price/EBITDA multiple of 8.0, below the low end of the12-year range of 10.7-15.1.

We view these metrics as highly attractive based on PSX's size, geographic reach, and broad product portfolio. We also believe that the dividend is safe and sustainable. Our target price of $167 implies a multiple of 16-times our 2025 EPS estimate.

On November 1 at midday, BUY-rated PSX traded at $121.58, down $0.25. (Bill Selesky, 11/1/24)

QUANTA SERVICES INC. (NYSE: PWR, $305.06) .... BUY

PWR: Growth in Renewable Energy and investments in Power Grid likely to benefit

* Quanta is a provider of infrastructure solutions for the electric power, oil and gas, communications, and renewable energy industries.
* We have a favorable view of the company's prospects, and note that it ended 3Q24 with a record backlog of $34.0 billion.
* We expect Quanta to benefit from accelerated capital spending by utilities, the expansion of 5G services and rural broadband, the Infrastructure Investment and Jobs Act, and the Inflation Reduction Act.
* We are raising our 2024 estimate to $8.84 from $8.80 and increasing our 2025 estimate to $10.12 from $10.10

ANALYSIS

INVESTMENT THESIS

We are reiterating our BUY rating on Quanta Services Inc. (NYSE: PWR) with a revised target price of $360, increased from $340. Quanta is a provider of infrastructure solutions for the electric power, oil and gas, communications, and renewable energy industries. We have a favorable view of the company's near- and long-term prospects and note that it ended 3Q24 with a backlog of $34.0 billion. We expect Quanta to benefit from accelerated capital spending by electric and natural gas utilities and from the expansion of 5G services and rural broadband. Quanta completed five acquisitions during 2023 and one acquisition in 2022.

RECENT DEVELOPMENTS

On October 31, Quanta reported third-quarter results. Adjusted EPS rose to $2.72 from $2.24 in 3Q23 and topped the consensus estimate by $0.03 per share. Revenue rose to $6.49 billion from $5.62 billion and missed the consensus estimate of $6.56 billion. Higher revenue reflected strong growth in the Renewable Energy Solutions (up 29%) and Electric Power Infrastructure Solutions (up 20%) segments. The gross margin rose to 15.6% from 15.1% a year earlier, while the operating margin was 6.7%, down 40 basis points from the prior-year period. Adjusted EBITDA rose to $682 million from $592 million in the prior-year period. The backlog at the end of the quarter was $34.0 billion, up from $30.1 billion in the same period a year earlier.

Below the line, interest expense rose by $12.2 million to $45.3 million, while the share count rose to 150.6 million from 148.8 million.

PWR now expects adjusted EPS of $8.50-$8.80 compared to its prior estimate of $8.32-$8.87.

As discussed in a previous note, in 2023, revenue grew 16.4% to $20.9 billion and adjusted EPS rose to $7.16 from $6.34 in 2022.

EARNINGS & GROWTH ANALYSIS

Quanta's prospects appear favorable. PWR's $34.0 billion record backlog at the end of the third quarter of 2023 suggests strong demand for its infrastructure business, particularly its power and renewable energy segments. As a leader in the Engineering & Construction industry, Quanta is likely to gain from the construction of electric vehicle infrastructure, increasing demand for clean energy, and efforts to protect the electricity grid from outages.

Based on these factors, recent acquisitions and PWR's ability to tap into unused capacity quickly, we are raising our 2024 EPS estimate to $8.84 from $8.80 and increasing our 2025 estimate to $10.12 from $10.10,

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Quanta Services is Medium-High. We typically measure a company's financial strength by reviewing its cash position, leverage, interest coverage, and return on equity.

Cash and cash equivalents totaled $764 million at the end of 3Q24, down from $1.29 billion at the end of 2023. The company's total liabilities were $11.83 billion, up from just under $10.0 billion at the end of 2023, and the long-term debt/capital ratio was 36.6%, down from 37% in the prior quarter.

Operating income covered interest expense by a factor of 7.2, down from 8.3 in the prior-year period. Operating cash flow was $733 million, above the consensus estimate of $499 million.

On December 6, 2023, Quanta raised its quarterly dividend to $0.09 from $0.08 per share, which it paid to shareholders on April 12, 2024. Our dividend estimates are $0.36 for 2024 and $0.40 per share for 2025.

MANAGEMENT & RISKS

Earl C. Austin is the company's president and CEO, and Jayshee S. Desai is the CFO.

The company faces regulatory risk related to product quality, safety measures, and environmental protection. It may also have difficulty obtaining permits for new projects. Sales of Quanta's services are cyclical and are affected by both business capital spending and government spending.

COMPANY DESCRIPTION

Quanta Services provides infrastructure solutions for the utility, renewable energy, communications, pipeline and energy industries. It operates through the following segments: Electric Power Infrastructure Solutions, Underground Utility and Infrastructure Solutions, and Renewable Energy Infrastructure Solutions. The Electric Power segment provides network solutions for customers in the electric power industry. The Underground Utility segment provides infrastructure solutions for the development, transportation, distribution, storage, and processing of natural gas, oil, and other products. The Renewable Energy segment helps to build and maintain wind, solar, and hydropower generation facilities as well as battery storage facilities.

PWR has a market cap of $45.5 billion.

VALUATION

We believe that PWR shares are undervalued at 30.3-times our revised 2025 EPS estimate. Our revised target price of $360 implies a multiple of 35.6 times our new 2025 EPS estimate, above the average for other large Industrial companies, but justified, in our view by Quanta's entry into the markets for electric vehicle charging, renewable energy, and underground electrical infrastructure. Our target, combined with the dividend, implies a potential return of 17% from current levels including the dividend.

On November 1 at midday, BUY-rated PWR traded at $305.06, up $3.43. (John Staszak, CFA, 11/1/24)