MARKETS

4 Undervalued Stocks to Buy After Earnings

Plus, earnings we'll be watching for and what we think of Nvidia after another blowout quarter.

David Sekera, CFA, Susan Dziubinski • Feb 26, 2024

Share

4 Undervalued Stocks to Buy After Earnings

Watch

Susan Dziubinski: Hi, I'm Susan Dziubinski with Morningstar. Every Monday morning, I sit down with Morningstar Research Services chief US market strategist Dave Sekera to discuss what's on his radar this week, some new Morningstar research, and a few stock picks or pans for the week ahead. Good morning, Dave. Your new office looks wonderful. The big economic report you'll be watching this week is the Personal Consumption Expenditures Index, or the PCE. Why are you keeping an eye on this report in particular? Why is it important?

David Sekera: Good morning, Susan. Thank you very much. Yes, it was about time that I changed up my office and got rid of that maroon red background that I had before. So as far as PCE goes, that is the metric that the Fed believes is the most accurate reflection of inflation. So while the CPI report is important and it provides clues as to personal consumption expenditures, it's the PC report

At the end of the day that the Fed is going to rely on to determine what they're going to do with monetary policy.

Dziubinski: Now, you referred to the CPI number. Let's talk a little bit about that. That number that came out a couple of weeks ago was a bit higher than expected, which reignited talk of interest rates staying higher for longer. And that in turn spooked the stock market. So what's the market expecting this week? And are we likely to see more stock market volatility ahead?

Sekera: Yeah. So I mean, I think right now what we're expecting is probably a slight reacceleration of inflation and PCE on a month-over-month basis. But I know after the CPI report came out, you know, our US economics team specifically told investors not to panic. They didn't think this one individual report was enough to really warrant much of a concern.

So when you dig in the CPI, they notice that shelter and healthcare inflation were really the two areas that really drove CPI the most. And so due to some differences in both how those are weighted and the methodologies used to calculate those, those two components have a smaller impact on PCE. So at this point, we still expect PCE to remain on a downward long-term trajectory.

Dziubinski: So were there any changes to Morningstar's interest-rate expectations for 2024, given that higher-than-expected CPI number?

Sekera: You know, at this point there is no change. So Preston Caldwell, who's our chief US economist, he still thinks the Fed is going to begin cutting the federal-funds rate here at the May meeting. We're still looking for 150-basis-point reduction in the Fed-funds rate over the course of the year. So that would actually take Fed funds all the way down to a 3.75% to 4% year-end range.

And as far as longer-term interest rates, we are looking for the 10 year to decline over the course of the year. So we're looking for the 10 year to average, about 3.5%, and we're then looking for the 10 year to decline even further into 2025, averaging 2.75% next year.

Now what has changed is the market implied probability of the cut. So when we take a look at like the CME like Fed fund futures, you know, that's dropped to only a 25% probability of a cut at that May meeting. And I would note that was as high as 80% probability just one month ago.

Dziubinski: Well, let's shift over to earnings. We're in the late innings of earnings season. This week, you're watching for earnings reports from a handful of technology companies. So let's go through them one by one, starting with Snowflake, which is ticker SNOW.

Sekera: Yes, we highlighted Snowflake last October. I really noted we thought that was actually a really good second derivative play on artificial intelligence. Now that stock is up over 50% since then. It's now a 3-star-rated stock. Trades pretty close to our fair value. For those of you that don't know or haven't heard of Snowflake, it's a data management provider.

And they host the products and the platforms that are used in order to run and train AI models. Now, I would say that while the stock is at fair value, I do think that with the market demand for anything AI related, yeah, we could see some pretty good upward movement on this one if the company were to come out or management provides some heightened guidance here.

Dziubinski: Now Salesforce, which is ticker CRM, reports this week, too. The stock's done quite well during the past few months, and it's a stock you recommended last year in 2023. What do you think of it heading into earnings?

Sekera: Yeah, we recommended that one almost exactly a year ago at this point. At that point, we'd noted that we thought Salesforce just had, the best combination of long-term growth in the software industry. Yeah, we expected that the firm would be able to generate earnings growth of over 20% annually. As you noted, the stock has done very well.

It’s up over 70% since then. So it’s now in that 3-star territory, meaning we think it’s pretty close to fair value. Now, as far as I know, I don’t see any reason why they’re probably not going to report good numbers. But I would say for long-term investors, at this point, with as much as the stock has run up and hitting kind of that fair value that we’re looking for, I’d say, looking forward, we’re looking for returns more kind of in line with its cost of equity.

Dziubinski: Now, Zoom Video Communications, which is ticker ZM, was an interesting story stock during the pandemic as we all worked from home, but it’s having a tough year. What’s going on?

Sekera: As you noted, Zoom really was one of those early pandemic plays. The stock soared in 2020. In fact, it went up so much, it was well in the 1-star-rated territory. In fact, I think it was one of the most overvalued stocks in our coverage back then. As you noted, that stock has been on a long-term downward trend since October 2020.

And I think when you look at the charts here, it’s down almost 90% from its peak. So at this point, we think it’s actually fallen too far. It’s a 4-star-rated stock. Trades at a 30% discount to fair value. So I would say that we do still expect a revenue growth rate to slow from here after several years of extremely rapid growth.

But I think that’s probably already baked into the stock price at this point. So I think if there’s any glimmer of hope that management provides out there that stock or that the growth rate could start to reaccelerate, we could see that as being a pretty good positive catalyst for the stock to start moving back up again.

Dziubinski: Now, Zscaler, which is ticker ZS, is a cybersecurity play, and that's a theme we've talked about on the show before. How does the stock look ahead of earnings?

Sekera: And that cybersecurity theme? I think we first started talking to that about a year ago, as well. And it's still an area that I just see long-term secular growth. I think the industry in and of itself does have very attractive industry dynamics when you think about it. Companies just have to protect themselves against geopolitical adversaries, ransomware attacks, hacking, corporate espionage, and so forth.

And one of the things I really like about cybersecurity is that spending on cybersecurity is actually a pretty small percent of the overall IT budget. But, of course, the cost of suffering any kind of cyberattack is both in terms of monetary damages and reputational costs very high. So our pick back then was actually CrowdStrike.

That stock's up 185% since then. But even Zscaler, that's up almost 80%. Zscaler is now a 2-star-rated stock. Trades at a 30% premium. So generally, I would say the cybersecurity stocks and our coverage have probably gotten ahead of themselves at this point. So, for example, if you looked at Palo Alto, you know, that did sell off following earnings last week.

Now that sold off enough that it did drop back into 3-star territory from 2 star. So my guess here is that I do think there's probably more downside risk to Zscaler reporting this week than to the upside of potentially outperforming.

Dziubinski: So any other companies you're eager to hear from this week, Dave?

Sekera: Well, there's a couple. So the first I would highlight is Devon Energy. It's ticker DVN, and it's a 4-star-rated stock. Trades at a 27% discount. Pays a pretty healthy 6.5% dividend yield. And the reason I'm watching this one is that the energy sector has been out of favor for quite a while now, and the energy sector does trade at about 8% discount to our fair value.

So for comparison, you know, the broad market is starting to get kind of stretched. The broad market itself is trading a couple percent above our fair value. So I do think for value investors, the energy sector has got a lot of good picks in it right now. Now, specifically for Devon, our equity team does expect comparatively subdued production out of the company here in the short term.

But we do expect going forward a more favorable operating environment. And the other one I'm going to highlight is going to be Park Hotels, ticker PK. That's one of our picks from last March. It's up 12.5% since then. Plus, investors have picked up over a 9% dividend yield since then. It's a 5-star-rated stock, still trades at a 40% discount to our fair value.

And Park Hotels is focused on upscale hotels. As such, it's really leveraged to the increase in international tourism. As you know, the international tourists are really the ones that typically are the ones that stay at the higher-end hotels and boutiques, such as Park. Now, generally occupancy is still improving, but it's not yet back to prepandemic levels.

I think to some degree, we're still waiting for more of a rebound in that higher-end tourism from Asia, especially from China, whose economy has been relatively sluggish over the past 12 to 18 months. So if we do see a reacceleration of Chinese tourists coming up here over the next 12 to 18 months, I do think that could be a really good catalyst for the stock going forward.

Dziubinski: So let's move on to some new research, starting with our analysts' take on some earnings releases from the past couple of weeks. And we really need to start with Nvidia NVDA, the most anticipated earnings report of this season. And the company didn't disappoint. Another blowout quarter. What did Morningstar think of what it heard?

Sekera: Yeah, Nvidia is just amazing. I mean, in my course of my career over the past 30-some years, I think it's probably the most amazing growth story for a company that's already this large that I've seen. I can't really think of any other examples that have grown this much this fast, but yet also still have a very long runway of substantial growth ahead of them.

As you mentioned, our equity research team really did make some substantial changes in our projections following the management guidance. And we lifted our fair value on that stock up to $730 a share. So I do want to provide you some background as far as why we raised our valuation and some of the things that we're thinking about.

So first of all, from the top line perspective, looking at revenue, we increased our 2025 revenue expectation up to $116 billion for the year. That's up from our prior projection of $86 billion. We increased our year-over-year growth rate to 91%. That had been 45% before. So essentially doubling that yea- over-year growth rate.

Now, by way of comparison, when you look at revenue, revenue in 2024 was $60 billion and that already was more than double the $27 billion that they reported in

2023. Now, we're also expanding our operating margin even further. So we're going up to 63%, was at 58%. So the end result is that we're looking for EPS now this year of $26.49 per share.

That's an increase from our prior projection of $18.27. So with where the stock is trading today, that puts us at about 29 times forecasted earnings. But the real upside from here still is future growth. We have instituted a new five-year forecast, and I just would note there that when we look at EPS over the next five years, it triples all the way to $39 per share from the $13 that it reported last year.

Dziubinski: So, Dave, if investors want to climb aboard the Nvidia train, what should they be considering before they do?

Sekera: Yeah, so with this one, again, our base case is really just an amazing growth story. But I would caution investors we do rate Nvidia with a Very High Uncertainty Rating. So what that means is that we do think that there is just a very wide range of potential outcomes here, and in my view, I think Nvidia is probably one of the most difficult situations to make long-term growth assumptions that I've seen really since the tech bubble.

So right now Nvidia does make the best products for artificial intelligence. They're selling everything that they can make. They're charging whatever price they want, and people are paying it. So I think there's really two main questions investors really need to think about going forward if they're going to get involved in that stock today.

So, first, how long will Nvidia remain the leader before a competitor catches up with some new products? And of course, competitors like Advanced Micro Devices and

Intel, they're not sitting still. They're working on developing new products themselves. But even some of the users of artificial intelligence, when you think about like Alphabet, Microsoft, Amazon, they're actually all working to develop their own solutions as well.

And then second, just trying to understand and think about what are those long-term dynamics for artificial intelligence chipsets? How much more will the market for AI grow? How long is that going to grow? At what point does supply catch up with demand? And in this case, I'd say there's really not much in the way of historical precedent.

So, analysts are making their best estimates, but there really is a very wide range of possibilities over the next couple of years of how this is going to turn out.

Dziubinski: Now, Cisco, which is ticker CSCO, also reported earnings last week, and management lowered its outlook and Morningstar lowered its fair value estimate.

Sekera: You know, it's funny that you mentioned Cisco. Yeah, I just been seeing a lot of people out there making commentary or kind of talking about and looking at Cisco stock from the late '90s and comparing that to Nvidia today. And of course, Cisco stock, 24 years later, it still has never returned, to that 2000 peak.

So I think a lot of people are trying to figure out is this still 1996 and 1997 as far as Cisco stock goes compared to Nvidia, or is this closer to 1999? As far as Cisco goes, specifically, we did lower our fair value on Cisco by 6% to $50 a share.

That was based on lower short-term guidance from the company. The stock's trading at just a hair under $50 right now. So it puts it firmly in the 3-star range. But I'd say in our opinion that lower short-term guidance really is more reflective of an inventory correction here in the short term and really doesn't impact our long-term outlook for the company or for the stock.

Dziubinski: Now in some non-earnings-related news, Capital One COF announced plans to buy Discover Financial Services DFS, and we've talked about Discover on the show before. So what's Morningstar's take on the news?

Sekera: That buyout price was a 28% premium to where the stock was trading prior to the announcement. That puts it right at our fair value estimate. So I think what investors need to understand is what makes Discover different than other credit card issuers is that it has its own network, whereas most of the other credit card issuers, other than AMEX, they all use, Visa and Mastercard in order to be able to do the exchange in the background.

So the strategic rationale for this acquisition is for Capital One to transfer up to, I think, $175 billion in purchasing volume to that Discover network by 2027. That, of course, both bolsters the scale of the Discover Payment network as well as going to save Capital One a lot of money. I think, you know, up to $1.2 billion is the current estimate there.

And then I would just note that for Capital One at this point there is no change to our fair value of $153 per share. That also puts that stock in that 3-star range.

Dziubinski: So let's move on to the picks portion of our program. This week you've brought viewers a handful of stocks to buy after earnings. Now Morningstar notched up its fair value estimates on these stocks after they reported, and the stocks look reasonably undervalued according to our metrics. So your first pick this week is Taiwan Semiconductor TSM. Tell us about it.

Sekera: Yeah. So Taiwan Semi is the world's largest contract chip manufacturer. And right now Nvidia is its most famous client at this point. So looking at the stock, it's actually up 24% year to date. It's up 50% over the past year. And when I look at what I consider to be really the obvious beneficiaries from artificial intelligence, from what I can see under our coverage, Taiwan Semi is really the last one that's still undervalued at this point.

So 4-star-rated stock. Trades at a 14% discount. Pays a 1.4% dividend yield. The company does have, in our view, a wide economic moat. I think what's really held the stock back compared to the other AI plays is that the fear that China at some point may invade Taiwan, which of course, you know, if that did happen, would just decimate the value of the company.

But when we look at it from just a purely fundamental point of view, we think that Taiwan Semi is still in the early stages of its long-term growth pattern from AI. So right now the focus on AI right now is just in those server chips. But that's really going to just be kind of the initial step when you think about kind of the progression of AI, thinking about it going forward, we will see AI need to be built out and integrated into other electronic devices.

So I think that's going to help provide Taiwan Semi some additional growth over the long term.

Dziubinski: Now, your next pick is from the utility sector. It's FirstEnergy FE. We've talked about the opportunities among utility stocks in prior shows, but I don't think we've talked about this stock in particular. So fill us in.

Sekera: The utility sector overall, still undervalued, still a lot of opportunities there. I think, though, the ones that we've talked about, we've really focused on the ones that had the larger discounts to fair value. So this stock, FirstEnergy, is a 4-star-rated stock. Trades at a 13% discount to fair value. Pays a pretty decent yield of 4.4%.

And like most utilities, we do rate it with a narrow economic moat. Now, that stock is up 2% year to date, which is actually just fine performance compared to the rest of the utility index, which is actually down a 2% year to date. We did increase our fair value to $43 a share from $40. And the reason for that is FirstEnergy disclosed a new five-year capital investment plan.

We did incorporate that into our model, and that investment plan is actually 44% higher than what their previous spending estimates were. And I would say that's probably the main reason for our fair value estimate increase at this point.

Dziubinski: Now, your third pick this week is Omnicom OMC, which is a big player in the advertising industry. Morningstar increased its fair value estimate on the stock by about 10% after earnings, yet the stock still looks pretty undervalued.

Sekera: It does. It's a 4-star-rated stock. Nice, healthy, 18% discount to our fair value. Pays a 3.3. 2% dividend yield and is a company that we rate with a narrow economic moat. As you mentioned, you know, they are actually the second-largest ad agency. And when we look at the quarterly results, I think our analyst noted they had pretty impressive organic growth, provided strong guidance for 2024, and it was really just driven on new account wins that they've already captured.

So we're looking for pretty good performance. But I'd say really the big difference here is our long-term investment thesis for Omnicom and for advertising, the large advertising companies specifically. So in this case, Omnicom provides a complete advertising solution across both traditional and digital space. And we are seeing clients still allocating more ad dollars toward targeted digital campaigns.

So I'd say Omnicom, when we think about its product lineup as able to not only provide that traditional part of the advertising, but the digital advertising. So some of the things that they're going to do is that they will do the media buying for their clients. They'll work on putting together the plans for ad placement, but they also have, some good data analytics and able to do some provides performance measurement services.

So I do think that they're able to use their scale to help customers purchase advertising at more attractive lengths as they go up against the other behemoths like Meta and Alphabet.

Dziubinski: And then your last pick this week, Dave, is Alphabet GOOGL. We notched up the fair value estimate on the stock a hair after earnings. And although the stock has certainly performed well over the past 12 months, Alphabet stock still looks pretty undervalued.

Sekera: Yeah, it does. It's still 4-star-rated stock. Trades at a 16% discount to fair value. And of course, a company that we rate with a wide economic moat. And I'd note here, in our view, according to our evaluations of the "Magnificent Seven," this is the only one that's still undervalued at this point. And the reason being is I think that there's still concern in the marketplace that Alphabet is lagging behind Microsoft and Amazon in the cloud business.

But we don't think so. We think it's really just a matter of the ramp-up with the type of clients that they've won as compared to the other two. From our point of view, Alphabet is really still hitting on all cylinders, still seeing good growth in search, seeing improved monetization out of YouTube, and still a long runway for growth in its cloud business.

Dziubinski: Thanks for your time this morning, Dave. Viewers interested in researching any of the stocks that Dave talked about today can visit morningstar.com for more analysis. We hope you'll join us again next Monday at 9 a.m. Eastern, 8 a.m. Central. In the meantime, please like this video and subscribe to Morningstar's channel. Have a great week.

The author or authors do not own shares in any securities mentioned in this article. Find out about Morningstar's editorial policies.

Securities Mentioned

Visa Inc Class A V	$283.16 −0.35%
Advanced Micro Devices Inc AMD	$177.99 +1.12%
Capital One Financial Corp COF	$136.84 +1.75%
Zscaler Inc ZS	$242.53 +0.32%
Devon Energy Corp DVN	$44.32 +1.13%
Intel Corp INTC	$42.74 −0.54%
Salesforce Inc CRM	$299.53 −0.30%
Cisco Systems Inc CSCO	$48.33 −0.10%
Microsoft Corp MSFT	$407.55 +0.02%
FirstEnergy Corp FE	$36.86 +1.04%
Alphabet Inc Class A GOOGL	$138.89 +1.00%
NVIDIA Corp NVDA	$787.00 −0.49%
Taiwan Semiconductor Manufacturing Co Ltd ... TSM	$128.61 −1.55%
Snowflake Inc Ordinary Shares - Class A SNOW	$233.90 +1.30%
Zoom Video Communications Inc ZM	$68.18 +8.00%

More on this Topic

What's Happening In the Markets This Week

Personal Income, PCE Inflation, and Salesforce earnings highlight a busy week ahead.

Bella Albrecht

CrowdStrike Holdings Inc Class A
CRWD
$321.13
+0.04%

Discover Financial Services
DFS

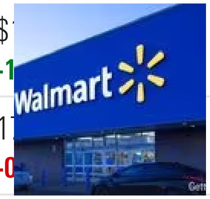
Mastercard Inc Class A
MA

$89.16
+0.10%

What Does Walmart's Stock Split Mean for Investors?

Shares of the retailer will carry a fair value estimate of $49 after its 3-for-1 split.

Sarah Hansen



A Top Contrarian Investment Idea for 2024

The time may be right for these out-of-favor stocks to finally reverse course.

Dan Lefkovitz

Are 'Higher for Longer' Interest Rates Back?

The path suddenly isn't so clear for the Fed and the bond market.

Sarah Hansen

How to Find Stocks Primed to Beat the Market

Wide moats and low valuations have been a winning combination for investors.

Bella Albrecht

MORNINGSTAR

United States