Gathering What Another Man Spills - Favored by Jefferies, Not by the Street

April 9, 2019

Key Takeaway

The market's focus on technology-enabled disruption plus persistent cycle fears have helped contribute to a wide gap between the most and least expensive stocks. With recent data suggesting an improvement in growth, a likely China/US trade deal and Jefferies' expectation for a sharp acceleration in 2Q US GDP growth, we offer 13 stocks generally disliked by the Street but well liked by Jefferies on the view that the excessive negativity presents opportunity.

Investors' obsession with growth and identifying the next technology-enabled business model change likely has something to do with the near 10Y high gap between valuations for the most expensive 10% of stocks and the least expensive 10%. Continued share gains for Amazon's retail e-commerce business, growth in ride sharing, the shift to passive management, rapid oil & gas production growth in the Permian, a shift to EVs and continued share gains for the largest Internet companies, all these themes are well trodden and the impact that the themes have had on the perceived "losers" is clear in Street ratings, multiples and in stock prices. Aside from tech disruption, the persistence of cycle fears have also contributed to the widening disparity, as stocks perceived to be more cyclical have trouble revaluing. The aim of this piece is not to merely surface some cheap stocks--that's easily done with a few commands in Bloomberg and doesn't answer the question as to whether something may be a value trap--it's to highlight stocks where we can quantify the Street's aversion and demonstrate Jefferies' propensity.

Importantly, performance is on your side with the less well-liked stocks. Equities with an average Street rating that puts them in quintile 4, the second to least liked quintile, have posted higher average quarterly performance and been the cumulative winner since the beginning of 2011. The lowest-rated names have indeed performed worst since 2011, likely driven partly by a skew toward defensive stocks in that quintile, but quintile 4 has performed best and better than the most highly rated quintile, probably having something to do with one group being crowded while the other is not.

With all this in mind, we screened Jefferies Equity Research's coverage universe for stocks that are currently trading below their 5Y average consensus rating, where the average Street rating is less than a Buy, which are trading at a discount to their 5Y average P/E and that are currently Buy-rated by Jefferies. Using this screen and considering other factors like short interest and input from analysts, we selected 13 names to highlight in this piece. This is not an exhaustive list, it could be argued that other stocks make sense too, but we also looked for some of the highest conviction picks, not merely stocks with Buy ratings. There's also a big skew to the bull/upside case vs. the downside case for this group, at better than 3:1. The stocks are as follows: BWA, COMM, CPRI, DGX, F, FCX, GPS, IVZ, KR, PCAR, RRC, TSLA and WYND.

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^Prior trading day closing price unless otherwise noted.

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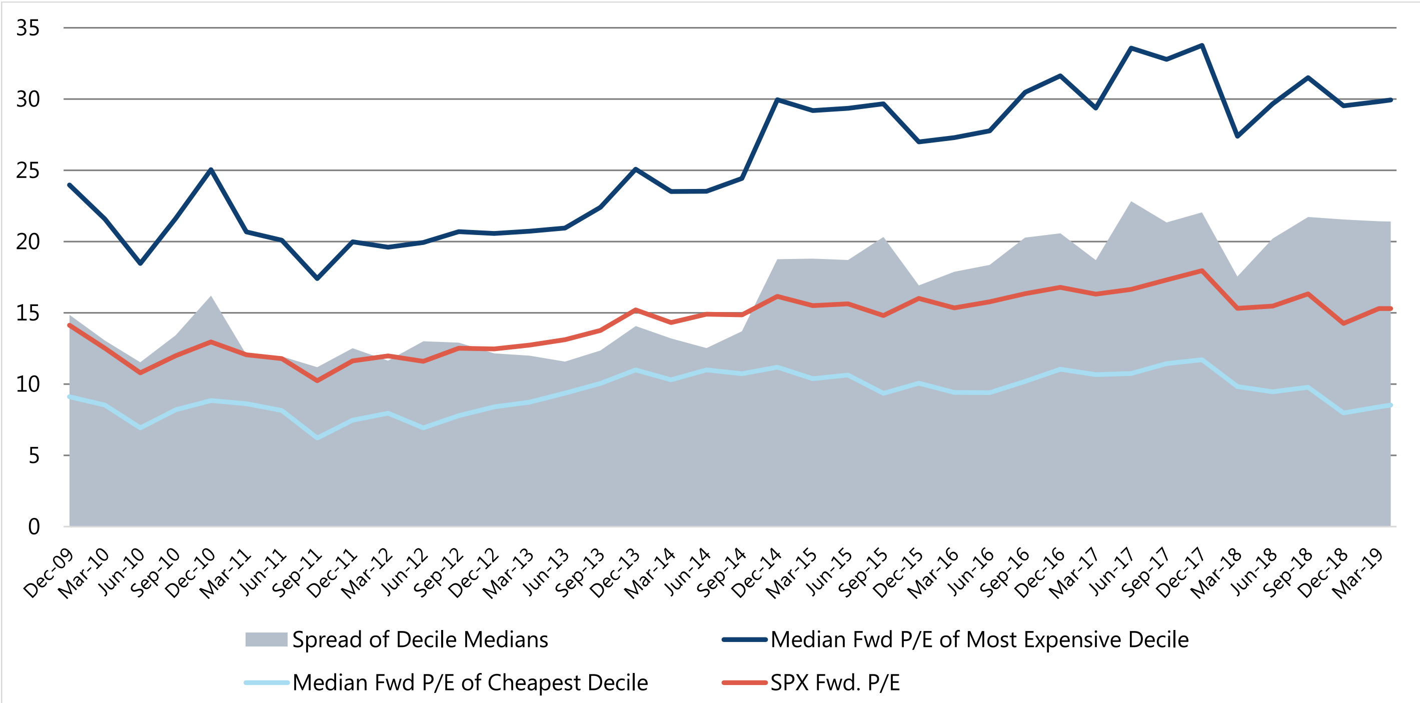
Cheap Stocks Haven't Seen the Re-valuation that Expensive Stocks Have, and Spread Between the Two Groups is Close to Post-Crisis Highs

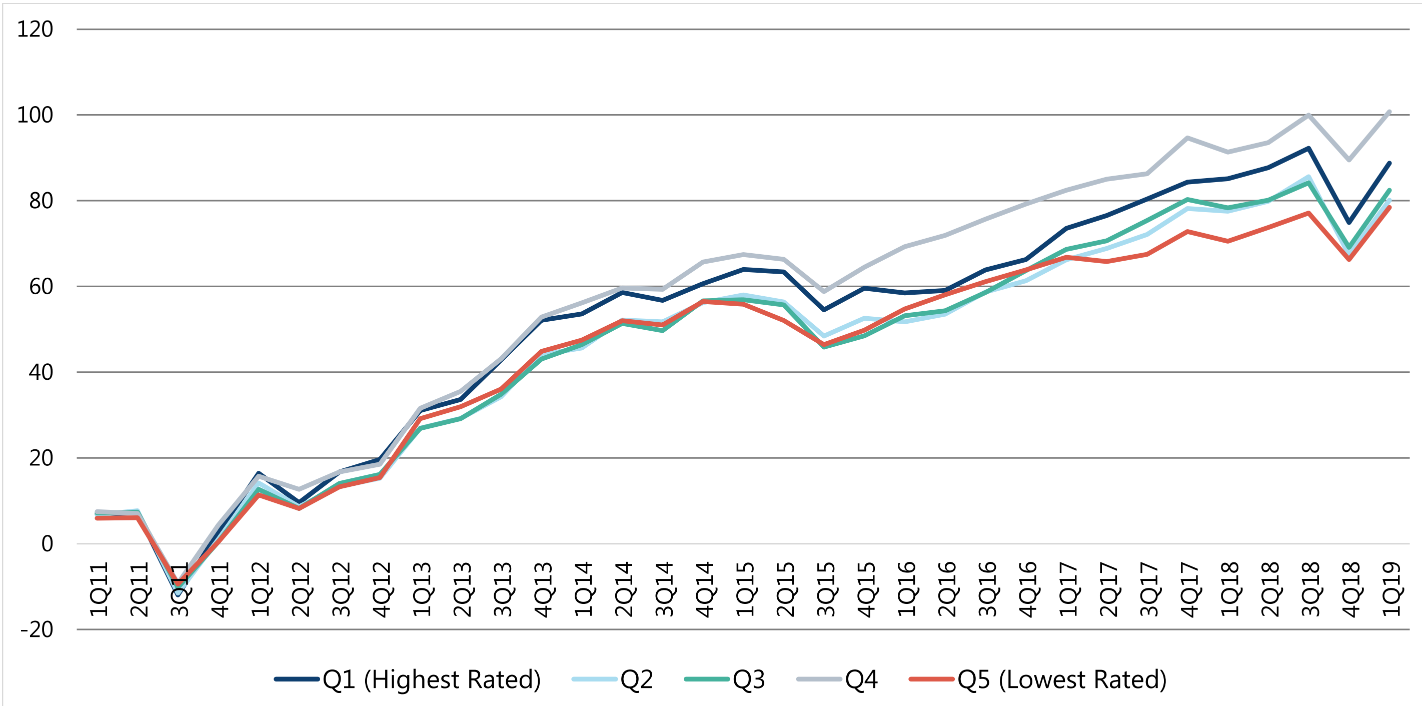
Chart 1 - Cheapest Decile of the SPX Was Getting Cheaper; Spread Still Near Post-GFC Highs



Source: Bloomberg, Jefferies

The Second Least Liked Quintile of Stocks, Based on Average Street Ratings, Has Performed Best Since the Start of 2011

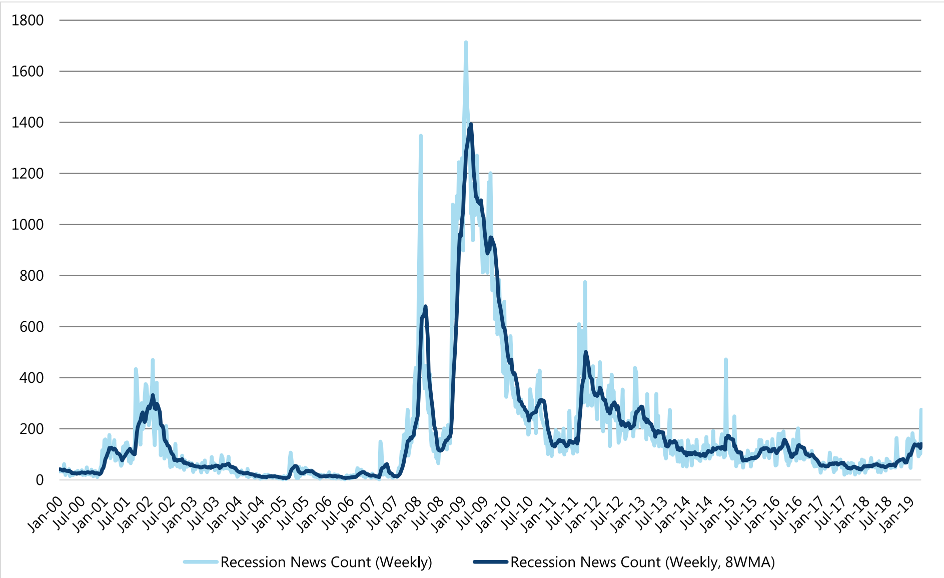
Chart 2 - Cumulative Performance of SPX by Consensus Rating Quintiles



Source: Bloomberg, Jefferies

Recession Fears are Rising Again, Something That's a Factor in Valuation Dispersion

Chart 3 - Count of News Stories Referencing Recessions

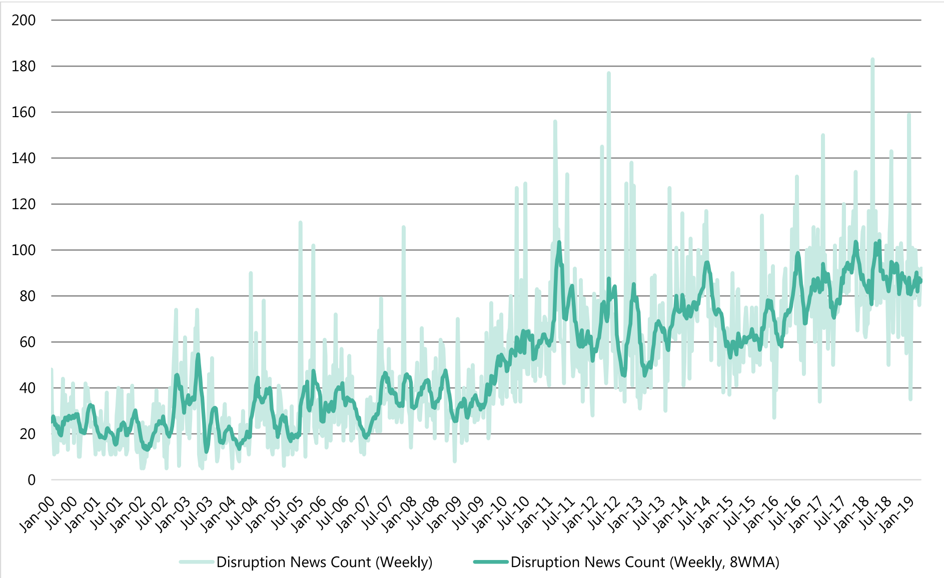


Source: Bloomberg, Jefferies

Note: NLP scans included "recession" and "late cycle."

Press Focus on Secular Change Has Trended Higher Over the Last Several Years, Also a Factor

Chart 4 - Count of News Stories Referencing Disruptions



Source: Bloomberg, Jefferies

Note: NLP scans included "disruption," "structural disadvantage," "grocery delivery," "startup" and "automating."

Commentary from Jefferies' Analysts

David Kelley – Auto Tech & Connected Mobility

BorgWarner (BWA, Buy, PT: $48) – As a leading powertrain supplier, David believes BWA is well positioned to benefit from incremental content associated with secular shift to electrification. **He thinks the current discounted valuation overestimates the shift to fully electric vehicles (hybrid is best-case scenario for BWA, in his view), and even when isolating BWA's EV opportunity, the market appears to overestimate market share loss to manufacturer insourcing.** Notably, 2019-2021 backlog of $2.0B-$2.4B implies 500-600 bps of market outgrowth. Hybrids and EV's account for 80% of backlog mix and total electrification backlog (hybrid+EV) has increased +60% Y/Y. Early electrification related returns appear favorable (in line with combustion ROIC) and the secular shift should not change the CapEx strategy (targeted 5.5%-6.5% of sales). David believes the backlog shift lends credence to BWA's electrification strategy and notes that management targets +40% electrification sales mix by 2023. While the cycle downshift should not be underestimated, he points out that **BWA's current '19 guidance, which actually implies positive organic growth, embeds a Y/Y global light vehicle production decline of -2% to -5% (and China production of -10%). Trading at 5.75x his '19 adj. EBITDA estimate ($1.69B) and only 7.6x his outyear adj. EPS estimate of $4.83 (vs. 5 year mean forward P/E of 11.4x), David believes a cycle downturn is baked in, while secular content penetration is underappreciated.** In his view, any signs of cycle stabilization or further organic growth outperformance should drive considerable upside while even flat margin performance (2017-2020) will likely be viewed positively.

Randy Konik – Lifestyle & Growth Platforms

Franchise Pick - Capri Holdings (CPRI, Buy, PT: $89) – Randy recently added to Jefferies' Franchise Picks list. Shares trade at <10x P/E while earnings revisions are likely to be biased higher. **Management has guided to zero synergies for Jimmy Choo and Versace, and Randy believes that is overly conservative. His EPS estimates remain ahead of the Street, and he sees potential for $6 in EPS over the next few years. Going forward, watch headwinds become less severe as the category gets closer to bottoming and China sales likely improve from stimulus/trade.** Pulling out the price paid for Versace and Choo gives $6B of EV for Core Kors, implying 5x EV/EBITDA. Randy believes the KORS brand alone should be worth >10x EBITDA and believes Jimmy Choo and Versace value will only grow as part of the CPRI group.

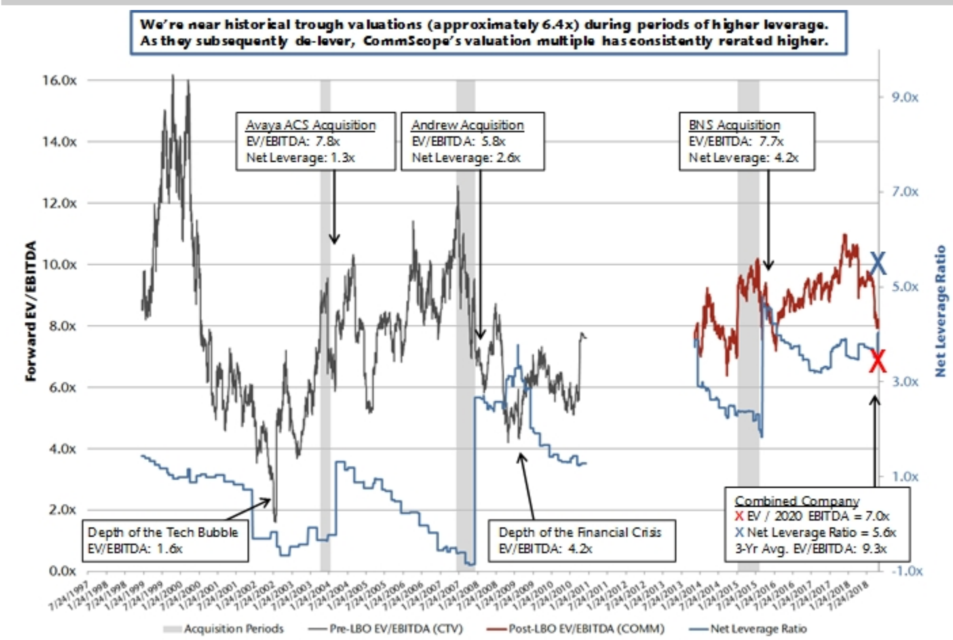
George Notter - Telecom & Networking Equipment

CommScope (COMM, Buy, PT: $28.50) – George continues to view the risk/reward for CommScope favorably and believes the company has potential to be the best performing stock in his research group in 2019. The company recently closed its acquisition of ARRIS while taking on significant leverage (~5.6x). **George sees the collapse of investor sentiment for CommScope around the deal as overdone and continues to feel very good about the outlook for the stock as the company moves forward with integration and executes on the de-leveraging story. Both heritage CommScope and heritage ARRIS historically had customer concentration issues, the combination now benefits from a more diversified revenue stream which should help to increase the multiple over time.** George believes both the CommScope side and the ARRIS side of the business will continue to benefit from

FTTX, Fiber Deep, DOCIS 3.1, and Wireless Densification related spending and increased competition between Telecom Operators and Cable MSOs. His positive view remains centered on: 1) poor but improving investor sentiment; 2) near-trough valuation; 3) ARRIS integration and ongoing proof points for de-leveraging and better-than-expected merger synergies; and 4) eventual sale of the ARRIS Set-Top business. Importantly, CommScope has a demonstrated history of adding leverage for sizeable acquisitions (ie. Avaya ACS, Andrew, BNS) while steadily de-levering and outperforming on synergies (see chart below). **Based on his combined company model, the business now trades near trough valuation at 8.0x '21E EV/EBITDA and 7.6x if we assign the full $150M in cost synergies to '21E and assume they divest the STB business.** This compares to the historical average of 9.3x. He's not forecasting topline growth for '19-'20E but believes the company will be able to de-lever as cash flow remains strong. Historically, the multiple has expanded when the company has de-levered but even without multiple expansion, he believes the stock can trade to $28.50 by YE '20 as the equity value expands.

CommScope EV/EBITDA (Forward Year) and Net Leverage Ratio History (1998 – 2018)

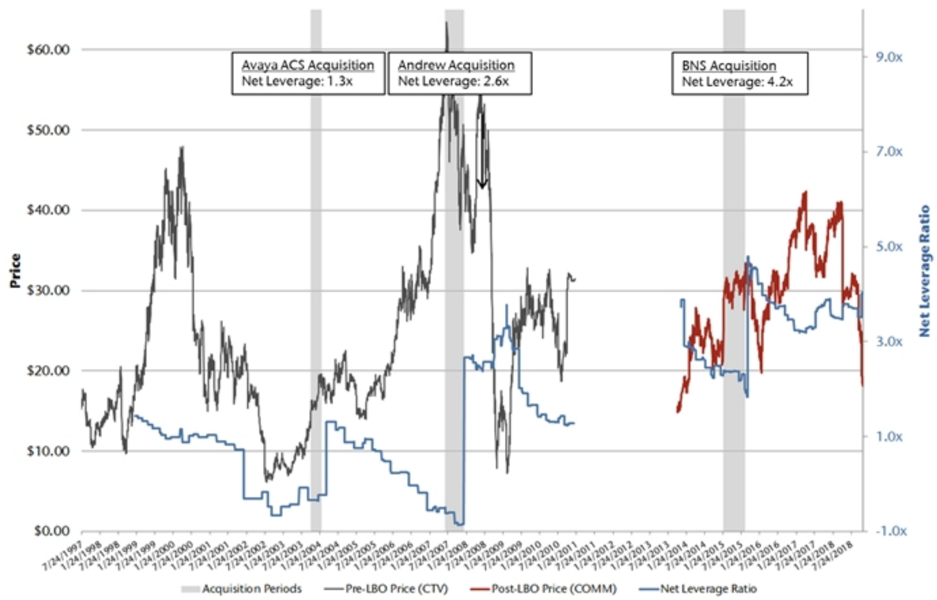
Chart 5 - CommScope EV/EBITDA (Forward Year) and Net Leverage Ratio History (1998 – 2018)



Source: Factset, Jefferies Research

CommScope Price and Net Leverage Ratio History (1998 – 2018)

Chart 6 - CommScope Price and Net Leverage Ratio History (1998 – 2018)



Source: Factset, Jefferies Research

Philippe Houchois – Autos & Auto Parts

Ford (F, Buy, PT: $11) – Philippe highlights that Ford has finally entered the execution phase of its turnaround plan with a number of announcements of product/market repositioning/discontinuation and headcount reduction plans. Announcements to date include refocusing product and manufacturing in LatAm, Europe and Russia, as well as adding production shifts for the new Ranger and committing to investments in EV in the US. All of these announcements were within the $11B of restructuring guidance ($7bn cash). **Philippe expects more announcements in Q2 regarding reducing engineering costs in NA through streamlining product development, and possibly more progress in discussions with VW on EV platforms and Autonomous vehicles. Ford made a number of key management changes including hiring Tim Stone as CFO (ex-Amazon).** In addition, Philippe believes Ford is under some pressure to show progress in 1H19 to protect its credit rating. He continues to see value in the scale of restructuring with **Ford's issue being adrift in cost over years and lack of product focus outside of NA. Meanwhile, the brand remains strong globally and NA product remains strong in mix/price.**

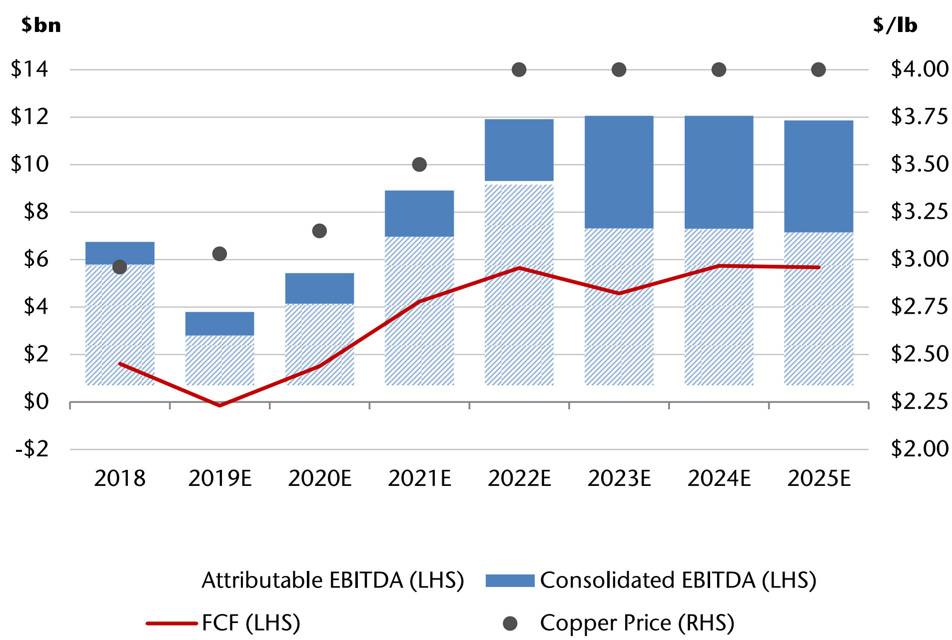
Chris LaFemina – Metals & Mining

Freeport (FCX, Buy, PT: $18) – Freeport has significantly underperformed copper and the other copper miners in the past year. **Chris attributes the disappointing performance of the Freeport share price to the expectation that 2019 will be a challenging year for Freeport as a result of low production volumes, high unit costs, high capex and a low copper price, in addition to concerns regarding operating risk as the company transitions to the underground mine at Grasberg.** While the operational risks at Grasberg are significant, Chris believes that the opportunity to buy FCX shares at a trough and get leverage to the potential operational upside and leverage to a recovery in the copper price is now.

Based on his estimates, which are above consensus, Freeport has significant potential EBITDA and free cash flow growth into the foreseeable future. **As the copper price rises and volumes grow, Chris expects attributable EBITDA to increase from $2.8B in 2019 to $7.1B in 2025 (EBITDA CGAR of 16.8%), while FCF grows from *negative* $154M to *positive* $5.7B over the same period.**

Freeport EBITDA and FCF Profile

Chart 7 - Freeport EBITDA and FCF Profile



Source: FactSet, Jefferies

Randy Konik – Lifestyle & Growth Platforms

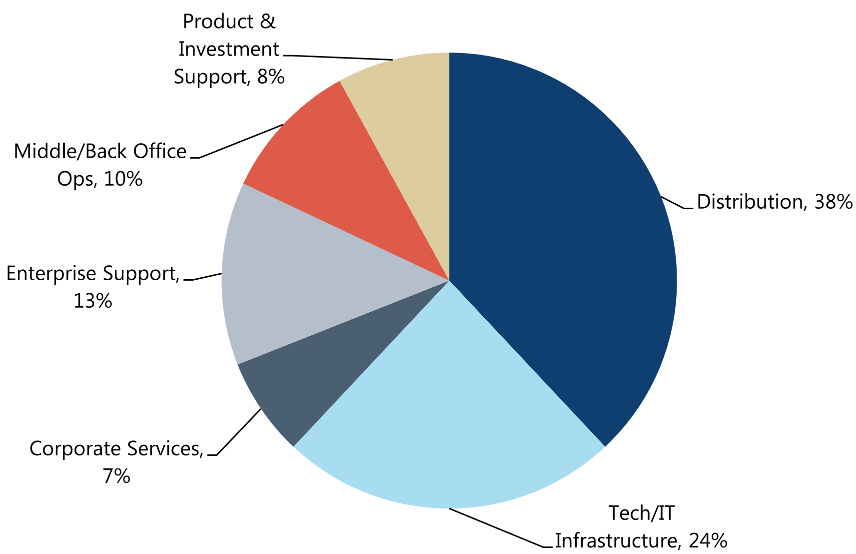
Franchise Pick - The Gap (GPS, Buy, PT: $50) – Randy remains bullish on GPS as **Old Navy is well-positioned given fast fashion/value exposure and a majority of company cash flows, strategic moves are value-enhancing LT and initiatives are in place for core Gap brand improvement.** His SOTP analysis shows ON continues to be undervalued by the market, with **his estimates suggesting that the EV for ON is greater than the EV for the company as a whole.** Old Navy currently represents ~3/4 of profits, with additional capital being dedicated toward this division going forward. Separating Old Navy to a standalone company is something Randy has advocated for over the past few years. Doing so allows the market to properly value ON for its high margins and strong cash flows. Randy believes ON should command a >10x EV/EBITDA multiple.

Dan Fannon – Brokers, Asset Mgrs & Exchanges

Invesco (IVZ, Buy, PT: $24) – The traditional asset management industry continues to face pressures from passive products, fee compression and a lack of organic growth. **While Invesco is not immune to these headwinds, the company has a leading smart beta franchise in PowerShares and recently made the acquisition of Oppenheimer Funds to increase its scale and operations in the U.S.** This transformative acquisition is not without its risks given the leverage of the pro forma company (2.3x-2.5x pro forma Debt/EBITDA inclusive of the preferred equity), **however there are substantial expense synergies ($475M) and the potential for revenue synergies over time as Oppenheimer benefits from IVZ's global distribution platform.** Dan believes this transaction will provide IVZ the scale to compete effectively in the U.S. while also removing a significant amount of redundant overhead.

IVZ Acquisition Synergy Capture

Exhibit 1 - IVZ Acquisition Synergy Capture



Source: Company Estimates, Jefferies

Chris Mandeville – Food Retail & Distribution

Kroger (KR, Buy, PT: $29) – Scanning for the most disliked stocks within his coverage universe, KR stands out to Chris due to the company's underwhelming comps vs. peers, meaningful investment that has weighed on EBIT%/FCF and growing debt leverage over the course of the past 3Y. **While the hate has been justified given these dynamics, Chris believes it has now reached levels where he finds strong value, especially since he expects trends to improve from here**. 2H19 fuel margin headwinds are a known (1QTD trending up nicely Y/Y), pricing tone from various parties would suggest less aggression (AMZN/WFM more bark than bite as work suggests only a ~2.5% "permanent" price cut to a ~75 item basket w/ a small amount of temporary promos on top of that), inflation is finally returning (proteins, dairy, and produce all firming up; major CPG all talking price increases), 2Y comp stacks are improving, investment spend is easing, debt is finally getting worked down and no one seems to be giving KR any credit for hitting its F20 EBIT target (cons. is $500M lower). Chris points out that this materially low expectation is inflating what is already attractive valuation on both an absolute and relative basis (nearing 10Y lows on latter). To be specific, as shown below in his EV/EBITDA matrices, if the company makes any progress on its $400M EBIT goal (on top of F17's $3.1B base) and the market is willing to reward KR w/ another quarter turn on the multiple, then Chris sees +20% upside.

KR EBIT Goal/Valuation Sensitivity

Exhibit 2 - KR EBIT Goal/Valuation Sensitivity

		EV/EBITDA				
		6.0x	6.3x	6.5x	6.8x	7.0x
EBIT$ Realized to F20 Goal	($100)	$24	$26	$27	$29	$31
	$50	$25	$27	$28	$30	$32
	$150	$26	$27	$29	$31	$33
	$300	$27	$29	$31	$32	$34
	$400	$27	$29	$31	$33	$35

		EV/EBITDA				
		6.0x	6.3x	6.5x	6.8x	7.0x
EBIT$ Realized to F20 Goal	($100)	(2%)	5%	12%	20%	27%
	$50	3%	10%	17%	25%	32%
	$150	6%	13%	21%	28%	36%
	$300	10%	18%	26%	33%	41%
	$400	13%	21%	29%	37%	45%

= Jef PT

Source: FactSet, Jefferies

Steve Volkmann – Machinery

PACCAR (PCAR, Buy, PT: $85) – **Steve points out that while investors have been stuck in an end of cycle mindset for the past 2Y, he continues to believe that industry volumes will remain at extended levels given this cycle is demand driven as opposed to emission/ regulatory driven.** Steve believes that NAFTA HD volumes can continue to improve in 2019 and remain elevated in 2020. Pent-up replacement demand and an equipment upgrade cycle should provide upside to Europe even as macro headwinds mitigate near-term growth. In addition, margins could expand as the company is beginning to realize the benefits of their integrated engine strategy, new products, parts penetration and pricing. Steve believes that '19 and '20 forecasts have upside both on volume and margin. He points out that PCAR is trading towards the lower end the historic range for EV/EBITDA and P/E (at 6x and 10.5x, respectively, on 2019E), suggesting further risk should be limited.

Brian Tanquilut - Healthcare Services

Quest Diagnostics (DGX, Buy, PT: $107) - Brian recently upgraded shares of DGX to Buy on the view that UNH's upcoming rollout of its preferred lab network (PLN) will be a positive catalyst for shares, as their likely inclusion should support meaningful share gain and robust organic growth beginning in 2020. Brian sees potential for participation in the rollout to boost DGX's earnings by ~2% beginning in 2021. In addition, DGX is trading at 13.8x forward P/E, a 3-turn discount vs. the S&P, a notably wider margin than the 10 year average discount of 1.4 turns. Brian believes management's guidance ranges are fairly conservative and his '19E and '20E earnings estimates of $6.50 and $6.90 are both ahead of consensus.

Mark Lear – Oil & Gas Exploration & Production

Range Resources (RRC, Buy, PT: $18) – While leverage remains a pushback on the RRC story, with YE19 strip leverage at ~3.4x, **Zach believes that the company's plan to (slowly) organically reduce debt over the next five years seems reasonable, and points out that an asset sale could accelerate this timeline. In addition, he sees the company generating over $100M in strip FCF in 2019 and closer to $200M in 2020, which implies FCFY of ~5% in '19 and 7% in '20, while growing production by 6% each year.** RRC will use FCF to reduce debt, and Zach estimates strip leverage falling to ~3.2x at YE20. RRC has over 30 years of inventory in the core of the SW Marcellus, and he believes execution on the five-year plan can restore investor confidence even in a depressed gas market. His $18 PT is based on his RRC NAV, which utilizes a LT gas price of $3/MMBtu.

Philippe Houchois – Autos & Auto Parts

Tesla (TSLA, Buy, PT: $400) – Philippe points out that shares have de-rated on slower growth, despite a shift to profitability and positive FCF. **Partly due to payback from the end of US federal credits, demand growth has slowed and the market has negatively viewed price cuts and the introduction of the lower range model at $35k.** While Philippe shares concerns about the way Tesla is making and announcing decisions, he thinks: 1) introducing more affordable versions is critical to growth and differentiation and 2) **lower growth near term is critical to improve manufacturing efficiency and therefore pricing.** Shares are trading near their historic $250 support level when Tesla structurally lost money and burned cash. Weak Q1 has been well flagged and probably priced in. Philippe expects

Q2 will show elasticity with demand improving with a lower priced and globally available Model 3.

David Katz – Leisure

Wyndham Destinations (WYND, Buy, PT: $62) – The timeshare industry is largely bifurcated by the believers and non-believers, and Wyndham Destinations (WYND) exemplifies this dynamic to a greater degree. The central debate for WYND is on its elevated loan loss provision, which was approximately 20.5% in 2018 versus the mid-single-digit range for brand-oriented comparable companies. While he thinks this will continue to weigh on investors' sentiment in the near term, **David believes consistent execution over the forthcoming quarters – led by its new CEO, leveraging Wyndham Hotels loyalty members and standalone corporate structure – will reverse the valuation disparity. WYND currently trades at a significant discount to peers – 6.3x '19 EBITDA vs. 7.4x-8.4x for peers and FCF yield of 14% vs. 3-10%.** David believes WYND's scale and earnings power, combined with the strength of the management team, warrant a multiple at least 2-3x higher than current.

Stocks Highlighted by Jefferies Research Analysts

Table 1 - Company Comparison Table

Ticker	Name	Analyst	Market Cap ($M)	Cons. Rating	JEF PT ($)	Current Price ($)	'19 Jef EPS	'19 Cons. EPS	'19 JEF P/E	Short Interest (% Float)	Wgt. Across All Top 100 HF Hldgs
BWA	BORGWARNER INC	David Kelley	8,785	4.30	$48.00	$42.62	4.28	4.24	9.89	2.10%	2.0%
CPRI	CAPRI HOLDINGS L	Randal Konik	7,326	3.89	$89.00	$48.86	5.24	4.80	9.28	5.58%	8.3%
F	FORD MOTOR CO	Philippe Houchois	36,963	3.29	$11.00	$9.30	0.50	1.20	18.53	2.76%	3.6%
FCX	FREEPORT-MCMORAN	Christopher Lafemina	19,669	3.58	$18.00	$13.74	0.85	0.46	15.97	2.18%	10.0%
GPS	GAP INC/THE	Randal Konik	10,040	3.00	$50.00	$26.43	2.57	2.46	10.32	8.96%	2.7%
IVZ	INVESCO LTD	Daniel Fannon	8,293	3.56	$24.00	$20.52	2.27	2.23	9.09	3.62%	1.5%
KR	KROGER CO	Christopher Mandeville	19,012	3.54	$29.00	$23.86	2.20	2.18	10.83	4.30%	5.8%
PCAR	PACCAR INC	Stephen Volkmann	23,946	3.16	$85.00	$68.94	6.50	6.38	10.62	2.73%	1.1%
RRC	RANGE RESOURCES	Mark Lear	2,741	3.55	$18.00	$10.91	0.58	0.53	18.82	20.31%	1.9%
TSLA	TESLA INC	Philippe Houchois	47,182	2.91	$400.00	$273.20	3.80	3.25	71.89	23.60%	6.6%
WYND	WYNDHAM DESTINAT	David Katz	3,969	4.00	$62.00	$42.19	5.18	5.33	8.18	2.95%	0.9%
DGX	QUEST DIAGNOSTIC	Brian Tanquilut	12,223	3.64	$107.00	$90.48	6.50	6.46	13.97	3.15%	4.6%
COMM	COMMSCOPE HOLDIN	George Notter	4,762	4.08	$28.50	$24.62	2.18	2.24	11.36	3.59%	7.8%

Source: Bloomberg, Factset, Jefferies

Company Valuation/Risks

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Distribution of Ratings						
			IB Serv./Past12 Mos.		JIL Mkt Serv./Past12 Mos.	
	Count	Percent	Count	Percent	Count	Percent
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