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ValueInvestor INSIGHT

The Leading Authority on Value Investing

A Breed Apart?

Given the usual cyclical and competitive dynamics of their business, investing in auto-supply firms can be a harrowing experience. Does Sensata Technologies offer a differentiated opportunity? By Philip Weiss

Auto suppliers don't enjoy a great reputation among quality-conscious value investors. Margins in the business tend to be thin and capital costs high, so sharp cycle turns – which happen with some regularity – can inflict significant pain and quickly wipe out perceived margins of safety.

Sensata Technologies would appear a potential anomaly. Its sensors for cars help manage a number of functions, from triggering windshield wipers when it rains to improving emission control and fuel efficiency. It holds entrenched market shares in many of its product categories, providing high value for low cost, and its own cost base is 80% variable. While many auto-parts suppliers imploded in 2008 and 2009, Sensata remained cash-flow positive and was strong enough in 2010 for its private-equity owners to bring it public.

Such resilience is a key reason Sean Stannard-Stockton of Ensemble Capital sees opportunity in Sensata's shares, which are down 35% on cyclical concerns over the past 18 months. He's neither bull nor bear on the cycle, arguing that global auto-production rates are in line with historical levels and should remain there. He balances concern that U.S. production is late in the cycle with optimism that lagging volumes in Europe will improve and that Asian production, while choppy, is more likely to grow than contract.

He is bullish on the secular growth he sees for Sensata as overall sensor content per vehicle increases as manufacturers are tasked to meet increasingly stringent government-mandated requirements for safety, fuel efficiency and emission control. In Europe, where regulations are toughest but still expanding, high-end cars have some $100 per vehicle in sensor content, twice the amount in the U.S. and ten times the norm in China. "This is not a company just at the whim of the cycle," he says.

He expects the rise of hybrid and all-electric cars to eventually be positive for Sensata as well. Hybrids have higher-than-average sensor content, so Sensata benefits as such cars' market share expands. The story with all-electric is less

INVESTMENT SNAPSHOT

Sensata Technologies
(NYSE: ST)

Business: Provider of sensors and controls to original equipment manufacturers in automotive and other industrial end markets.

Share Information (@9/28/16):

Price	**38.27**
52-Week Range	29.92 – 49.73
Dividend Yield	0.0%
Market Cap	$6.54 billion

Financials (TTM):

Revenue	$3.08 billion
Operating Profit Margin	15.5%
Net Profit Margin	12.9%

Valuation Metrics
(@9/28/16):

	ST	S&P 500
P/E (TTM)	16.4	24.8
Forward P/E (Est.)	12.0	18.4

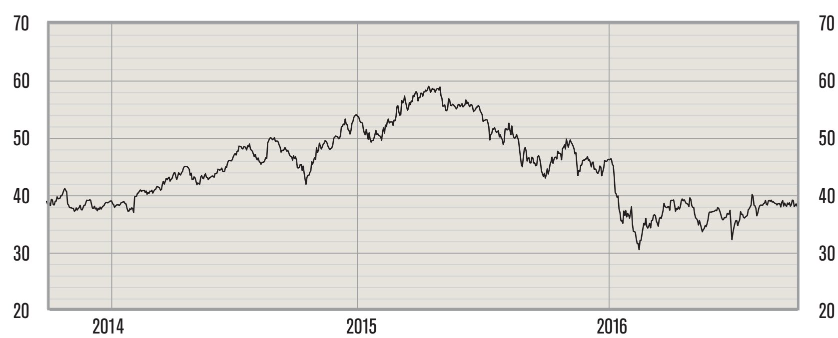
Largest Institutional Owners
(@6/30/16):

Company	% Owned
T. Rowe Price	13.1%
Capital Research & Mgmt	11.2%
Vanguard Group	7.0%

Short Interest (as of 9/15/16):

Shares Short/Float	6.0%

ST PRICE HISTORY



THE BOTTOM LINE

The company is in a cyclical business but the market isn't fully recognizing the secular tailwinds that should continue to drive its growth and unusually high returns on tangible capital, says Sean Stannard-Stockton. His DCF-derived fair value for the shares: $70.

Sources: Company reports, other publicly available information clear. Many sensors support a gasoline engine's drivetrain, so early electric cars were light on sensors. Stannard-Stockton credits Sensata with addressing that through smart product development, to the point that sensor content per electric car is now in the $30-40 range and rising. As for self-driving cars, he expects their impact – positive with respect to content-per-vehicle, negative if fewer cars are built – to be felt beyond his current investment horizon.

Now $38.25, what are Sensata shares more reasonably worth? Assuming mid-to-high single-digit annual revenue growth, sensor operating margins of 25-30%, a normalized tax rate in the mid-20% range, and returns on tangible capital of 50%, his discounted-cash-flow analysis yields a fair value of $70 per share. "It may not be the smoothest ride," he says, "but we think it's definitely one worth taking." VII

ENSEMBLE CAPITAL

Ensemble Capital Management, LLC is a San Francisco/ Bay Area asset manager since 1997. We are long term investors building focused portfolios to help our clients preserve their success and enhance their future using a common-sense approach to discover intrinsically valuable companies.

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