Parker-Hannifin Corporation (PH)

Updated April 13th, 2018 by Nick McCullum

Key Metrics

Current Price:	$173	**5 Year CAGR Estimate:**	5.5%	**Quality Percentile:**	N/A
Fair Value Price:	$148	**5 Year Growth Estimate:**	7.0%	**Momentum Percentile:**	N/A
% Fair Value:	117	**5 Year Valuation Multiple Estimate:**	-3.0%	**Total Return Percentile:**	N/A
Dividend Yield:	1.5%	**5 Year Price Target**	$200	**Valuation Percentile:**	N/A

Overview & Current Events

Parker-Hannifin is a diversified industrial manufacturer specialized in motion and control technologies. The company was founded in 1917 and has grown to a market capitalization of $23 billion and annual revenues of $12 billion. Parker-Hannifin has paid a dividend for 68 years and has increased that dividend for a remarkable 61 consecutive years.

In early February, Parker-Hannifin reported financial results for the second quarter of fiscal 2018 (which ends on June 30th). Second quarter sales increased by 26%, while adjusted earnings-per-share increased by 12.6%. The company's remarkable revenue growth was driven by the acquisition of CLARCOR, a filtration system and packing material manufacturer, which closed on February 28, 2017. Ex-acquisition, Parker-Hannifin delivered 10% organic sales growth, the best growth rate the company has experienced in more than half a decade. The company's financial performance was excellent, but shares fell following the announcement amid widespread volatility in the capital markets.

Parker-Hannifin also updated its financial guidance with the release of second quarter earnings. The company now expects to generate adjusted earnings-per-share between $9.65 and $10.05 for the full fiscal year. This updated guidance reflects a reduction in the U.S. Federal income tax rate as well as expected business realignment expenses and CLARCOR integration costs. For context, Parker-Hannifin reported adjusted earnings-per-share of $8.11 in fiscal 2017. The midpoint of this new guidance band represents 21.4% growth over the prior year's figure.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$5.53	$3.13	$3.40	$6.37	$7.45	$6.26	$6.45	$7.25	$6.46	$8.11	***$9.85***	***$13.32***
DPS	$0.84	$1.00	$1.01	$1.25	$1.54	$1.70	$1.86	$2.37	$2.52	$2.58	***$2.81***	***$4.35***

Parker-Hannifin compounded its adjusted earnings-per-share at a rate of 4.3% per year over the last decade. We believe that the company's historical growth grossly understates its potential moving forward. More specifically, we expect Parker-Hannifin to deliver annualized earnings growth of about 7% per year, driven by acquisitions. The company's 2018 financial guidance implies 2018 adjusted earnings-per-share of $9.85 at the midpoint. Applying a 7% annual growth rate to this earnings estimate allows us to calculate a 2023 earnings-per-share estimate of $13.32.

Parker-Hannifin's growth will primarily come from acquisitions. The $4.3 billion CLARCOR transaction is an example of this. The purchase is expected to generated $140 million in annual run rate cost synergies three years after closing. Importantly, the acquisition was immediately accretive to the pro-forma company's cash flow, earnings-per-share, and EBITDA margins after adjusting for one-time costs. We expect similar acquisitions moving forward.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	13.2	14.5	16.7	12.6	10.8	13.9	18.0	16.6	16.3	17.3	***17.5***	***15.0***
Avg. Yld.	1.2%	2.2%	1.8%	1.6%	1.9%	2.0%	1.6%	2.0%	2.4%	1.8%	***1.5%***	***2.0%***

Using the midpoint of 2018's financial guidance, Parker-Hannifin is trading at a price-to-earnings ratio of 17.5. The company has traded at an average price-to-earnings ratio of 15 over the last decade. We expect valuation contraction will have a negative impact on the future returns of this security. If Parker-Hannifin's valuation reverts to 15 times earnings over a period of 5 years, this will reduce its returns by 3% per year during this time period.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	27.0%	21.6%	21.7%	27.2%	28.5%	23.4%	22.8%	24.9%	21.1%	18.3%	***20.0%***	***20.0%***
Debt/A	49.4%	56.7%	55.9%	50.5%	56.2%	54.2%	49.8%	58.4%	62.0%	66.0%	***65.0%***	***60.0%***
Int. Cov.	14.4	7.1	8.3	15.2	18.0	15.3	19.9	13.1	9.2	9.2	***10.0***	***12.0***
Payout	15.2%	31.9%	29.7%	19.6%	20.7%	27.2%	28.8%	32.7%	39.0%	31.8%	***28.5%***	***32.7%***
Std. Dev.	52.1%	42.3%	31.0%	38.1%	27.6%	20.5%	22.7%	22.9%	23.1%	17.1%	***22.0%***	***22.0%***

Parker-Hannifin's gross profits as a proportion of its total assets have declined over time. At the same time, its debt as a percent of total assets has increased. Still, the company's interest expense is still well-covered by its operating earnings. Although Parker-Hannifin's stock price volatility is higher than many other blue-chip stocks, investors who are able to stomach this volatility should benefit from continued dividend growth moving forward. The company's below-average payout ratio leaves plenty of room for incremental dividend growth in the event that earnings growth stalls temporarily.

Qualitatively, Parker-Hannifin has a number of competitive advantages, including its scale, global distribution network, and its technical experience in solving engineering problems. Parker-Hannifin manufactures components that are relatively obscure yet absolutely critical to the operations of heavy machinery, factory equipment, aircrafts, and other large industrial devices. This is appealing because the company operates in a profitable niche that is sufficiently boring to discourage potential competitors.

Final Thoughts & Recommendation

Parker-Hannifin has many of the characteristics of a high-quality business. The company has increased its dividend for more than six decades and operates in a very boring industry within the industrial manufacturing sector.

Although the company's acquisition-based growth prospects are bright, it is critical to recognize that Parker-Hannifin is trading at a premium to its long-term average valuation multiple. Valuation contraction should be a meaningfully negative factor in the company's total returns moving forward. Accordingly, we recommend investors wait for a better price before buying into this high-quality business, as it is unlikely to generate satisfactory returns over the next several years.

Total Return Breakdown by Year