Eaton Corporation (ETN)

Updated August 10th, 2018 by Nate Parsh

Key Metrics

Current Price:	$82	**5 Year CAGR Estimate:**	4.9%	**Volatility Percentile:**	42.5%
Fair Value Price:	$77	**5 Year Growth Estimate:**	3.0%	**Momentum Percentile:**	59.9%
% Fair Value:	106%	**5 Year Valuation Multiple Estimate:**	-1.3%	**Valuation Percentile:**	51.2%
Dividend Yield:	3.2%	**5 Year Price Target**	$88	**Total Return Percentile:**	29.4%

Overview & Current Events

Eaton Corporation is diversified industrial equipment and parts manufacture. The company's highly engineered electrical systems and components are used by customers in the industrial, vehicle, commercial, and aerospace markets. The Ireland based Eaton was founded in 1916 and has a current market capitalization of more than $35 billion. The company employs more than 95,000 people. Eaton is considered a cyclical company because its products are sold to industries that are in high demand in strong economic climates and in low demand when the economy is weak. Eaton has 6 divisions: Electrical Products, Electrical Systems & Services, Hydraulics, Aerospace, Vehicle and eMobility.

Eaton reported 1st quarter 2018 earnings on July 31st. The company earned $1.39 per share, $0.06 ahead of analysis' estimates and improved 21% year over year. Revenue improved 7% to $5.49 billion, $40 million higher than estimates.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$3.42	$1.30	$2.73	$3.96	$3.96	$4.19	$4.67	$4.30	$4.21	$4.65	***$5.30***	***$6.14***
DPS	$1.00	$1.00	$1.08	$1.36	$1.52	$1.68	$1.96	$2.20	$2.28	$2.40	***$2.64***	***$3.06***

Eaton has grown earnings per share at a rate of 3% over the past decade. The company saw its earnings drop dramatically during the last recession and took Eaton several years to recover.

Eaton saw all six of its divisions show growth in the 2nd quarter. Segment margins were 17%, a quarterly record for the company. Eaton's long cycles businesses (Aerospace and Electrical Systems & Services) had particular strong growth. The Electrical Systems & Services division had 7% revenue growth due to strong demand for products in Asia and North and South America. Aerospace sales grew 6% as orders for aftermarket services, business jets and military aircraft had an 18% increase in orders. Hydraulics sales improved 14% as the company was able to add more capacity to its hydraulic hose business. The added capacity will likely prove beneficial as the Hydraulics backlog grew 26% year over year. One issue to note is that orders for Hydraulic products dropped 21% from the Europe, Middle East and Asia regions as long dated orders were not needed due to the extra capacity that the company added. Eaton raised the midpoint of its earnings-per-share guidance for the year to $5.30 from $5.20 previously.

One area that could help accelerate growth is the company's newest division, eMobility. This division will focus on parts and systems for electric vehicles. This division saw sales climb 15% in the 2nd quarter. While a small component today ($83 million in sales during Q2), Eaton believes that this could be a $2-$4 billion opportunity in the future.

Eaton has increased its dividend for the past 9 years. The company paused growth in 2009, as this was the prudent thing to do given the earnings decline. Eaton raised its dividend on February 28th by 10%, which is very close to the 10-year average increase of almost 11%. The company will most likely need to increase earnings at a faster pace if it wants to keep this level of dividend growth up in future years.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	10.5	19.4	14.2	12.1	11.8	15.6	15.2	14.6	14.6	16.1	***15.4***	***14.4***
Avg. Yld.	2.8%	4.0%	2.8%	2.8%	3.2%	2.6%	2.8%	3.5%	3.7%	3.2%	***3.2%***	***3.5%***

Disclosure: This analyst has no position in the security discussed in this report and no plans to initiate one in the next 72 hours.

Eaton's stock has increased $8, or 10.8%, since our May 2nd update. Based off of updated guidance, the stock now trades with a price to earnings multiple of 15.4. Eaton's stock has an average price to earnings multiple of 14.4 over the past decade. Given the steep drop in earnings that the company had in 2009, it appears that investors haven't been willing to pay a high multiple for shares given that the company is far from recession proof. If shares were to trade at the average P/E, the stock could have multiple reversion of 1.3% per year through 2023. Eaton has a current yield of almost 3.2%, which is above the stock's 10-year average yield of 3.1%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

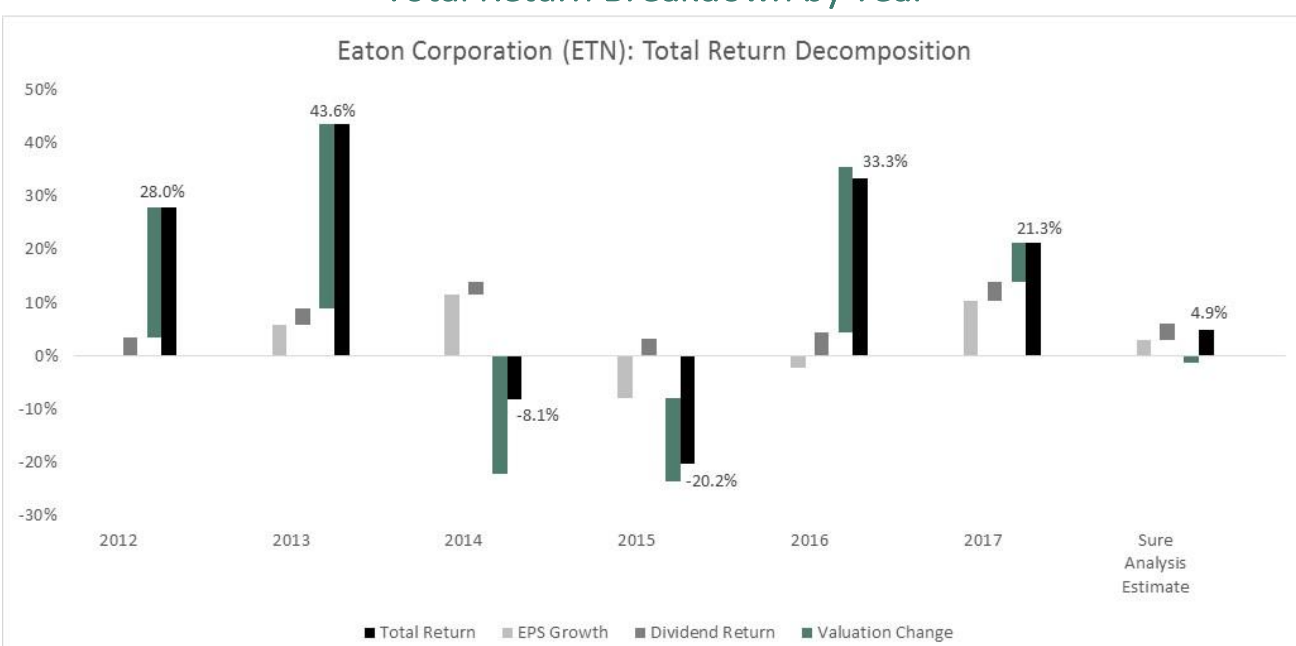
Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	25.1%	19%	23.7%	26.8%	13.6%	18.8%	20.6%	21.1%	20.8%	20.4%	***20.5%***	***21%***
Debt/A	61.8%	58.1%	57.1%	58.1%	57.6%	52.5%	52.8%	50.9%	50.8%	47%	***48.5%***	***48.5%***
Int. Cov.	8	3	8.6	14.2	7.4	7.9	10.8	10	9.6	10.2	***9.9***	***9.0***
Payout	29.2%	76.9%	39.6%	34.3%	38.4%	40.1%	42%	51.2%	54.2%	51.6%	***49.8%***	***49.8%***
Std. Dev.	41.8%	46.1%	28.5%	35.5%	29.9%	19.4%	22.4%	23.2%	22.3%	15.2%	***17.8%***	***28.4%***

Eaton suffered an extreme earnings decline during the last recession that forced the company to pause its dividend growth. Eaton would likely experience a decline in earnings in another recession due to the nature of its business and could pause its dividend increases again. We reiterate that the company is definitely not recession proof. Eaton has seen its debt to asset ratio show sharp improvements over the past decade. The company has managed its debt levels well and is not overleveraged. The company's gross profit to asset ratio has varied somewhat over the same time frame, but has stabilized in recent years. Outside of 2009, Eaton has maintained a fairly low payout ratio. As dividend growth has climbed in recent years, that ratio has moved to the 50% range. Outside of a steep earnings decline, this ratio is not likely to climb much higher than current levels. If Eaton wishes to maintain its double-digit dividend increases, the company will have to grow earnings at a faster rate than they have over the past decade.

Final Thoughts & Recommendation

After the increase in share price since our last update we now expect Eaton to offer annual returns of 4.9% through 2023, down from 6.9% previously. This return is a combination of earnings growth (3%), dividends (3.2%) and a multiple contraction (1.3%). Eaton reported solid numbers across almost every division, but the rise in stock price has removed a large portion from our previous total expected returns. We have raised our five-year price target $1 to $82 due to the increase in earnings estimates, but maintain our hold rating on Eaton.

Total Return Breakdown by Year



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