Eaton Corporation (ETN)

Updated February 4th, 2020 by Nathan Parsh

Key Metrics

Current Price:	$101	**5 Year CAGR Estimate:**	2.0%	**Market Cap:**	$41.7 billion
Fair Value Price:	$83	**5 Year Growth Estimate:**	3.0%	**Ex-Dividend Date:**	3/6/20[1]
% Fair Value:	122%	**5 Year Valuation Multiple Estimate:**	-3.9%	**Dividend Payment Date:**	3/20/20[2]
Dividend Yield:	2.8%	**5 Year Price Target**	$96	**Years Of Dividend Growth:**	10 years
Dividend Risk Score:	C	**Retirement Suitability Score:**	C	**Last Dividend Increase:**	8%

Overview & Current Events

Eaton Corporation is a diversified industrial equipment and parts manufacturer. The company's 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 today has annual sales of more than $20 billion. The company employs more than 95,000 people. Eaton has 6 divisions: Electrical Products, Electrical Systems & Services, Hydraulics, Aerospace, Vehicle, and eMobility.

Eaton released fourth quarter and full-year earnings results on 2/4/2020. The company earned $1.37 per share, which was $0.01 below estimates and a 6% decline from the previous year. Revenue declined 4% to $5.24 billion, which missed estimates by $130 million. For 2019, earnings-per-share increased 7% to $5.76 while revenue declined 1% to $21.4 billion. Currency exchange reduced revenue results by 0.5% for the quarter and 1% for the year.

For the quarter, organic growth declined 4%, though acquisitions added 0.5% to results. Segment margins of 17.8% were a record for the fourth quarter. Organic growth for the Electrical Products segment declined 2%, primarily due to lighting. Excluding lighting, which is in the process of being sold, organic growth was up 1% due to higher demand in residential and commercial construction in the Americas. Operating margins improved 210 bps to 20.3%. The Electrical Systems & Services segment had 2% organic growth and acquisitions added 2% as well. Operating margins of 17.1% were a 50 bps improvement. All geographic regions contributed to growth. The Hydraulics segment experienced a 13% decline in organic growth due to a sustained weakness in mobile equipment orders worldwide. Margins were lower by 340 bps to 9.6%. Eaton announced that it would be selling its Hydraulics business, which contributes ~85% of sales for this segment, for $3.3 billion in cash to a Danish industrial company. The deal is expected to close by the end of 2020. Revenue for the Aerospace segment improved 3% and operating margins increased 130 bps to 24.2%. Orders were up 6% due to strong demand for military, business jets and aftermarket services. The Vehicle segment had an 18% decrease in organic sales due to a warranty charge and a General Motors (GM) strike. Light vehicle markets remain a headwind for this segment as well. Margins declined 90 bps to 17%. eMobility was lower by 6% and margins decreased from 11.3% to 1.3% from the previous year. R&D expenses and manufacturing costs for a new electric vehicle program had a severe impact on margins. Operating margins for the full year were up 80 bps to 17.6%, an all-time record for Eaton.

For 2020, Eaton expects adjusted earnings-per-share of $5.60 to $5.90 with organic growth ranging from down 1% to up 1%. Shares closed trading up nearly 6% after earnings.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$2.73	$3.96	$3.96	$4.19	$4.67	$4.30	$4.21	$4.65	$5.39	$5.76	***$5.75***	***$6.67***
DPS	$1.08	$1.36	$1.52	$1.68	$1.96	$2.20	$2.28	$2.40	$2.64	$2.84	***$2.84***	***$3.29***
Shares[3]	339.9	334.4	470.7	475.1	467.9	458.8	449.4	439	433	416	***414***	***400***

[1] Estimated date
[2] Estimated dividend payment date
[3] In millions of shares

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While Eaton has delivered mid-single-digit organic growth in recent years, the company's earnings-per-share decreased dramatically during the last recession. To strike a balance between current organic growth and the company's performance during the last recession, we expect earnings-per-share to grow at a rate of 3% through 2025.

Eaton paused dividend growth in 2009, as this was prudent given the earnings decline. Following the 8% dividend increase for the 3/22/2019 payment, Eaton has now increased its dividend for 10 consecutive years.

Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	14.2	12.1	11.8	15.6	15.2	14.6	14.6	16.1	13.1	16.4	***17.6***	***14.4***
Avg. Yld.	2.8%	2.8%	3.2%	2.6%	2.8%	3.5%	3.7%	3.2%	3.7%	3.0%	***2.8%***	***3.4%***

Shares of Eaton have increased $12, or 13.5%, since our 10/29/2019 update. Based off of guidance for 2020, the stock now trades with a price-to-earnings multiple of 17.6. Eaton's stock has an average price-to-earnings ratio of 14.4 over the past decade. Given the steep drop in earnings that the company had in 2009, it appears that investors aren't usually 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 by 2025, then valuation would be a 3.9% headwind to total returns over this time frame. Eaton has a current yield of 2.8%, which is below the stock's 10-year average yield of 3.1%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

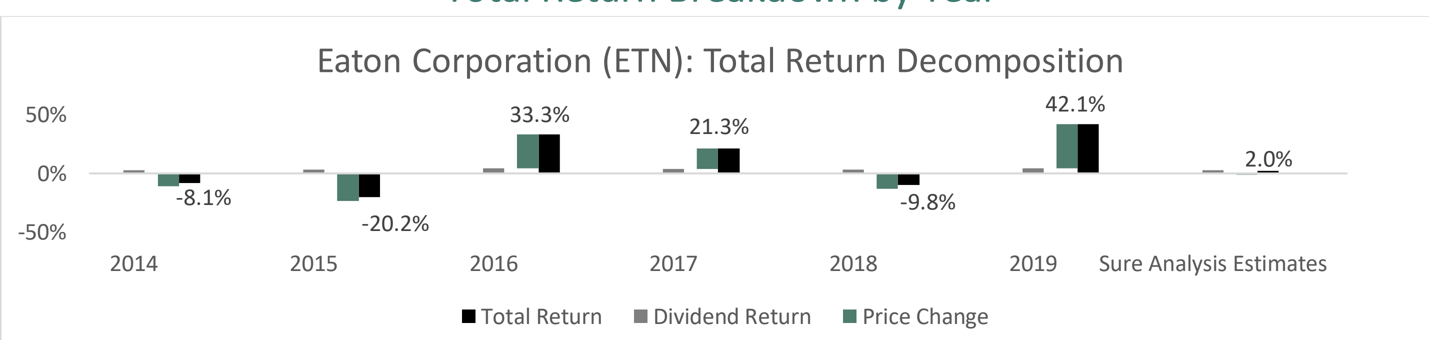
Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	40%	34%	38%	40%	42%	51%	54%	52%	49%	49%	***49%***	***49%***

Eaton suffered an extreme decline in earnings during the last recession that forced the company to pause its dividend growth. The company would likely experience a decline in earnings in another recession due to the nature of its business and could pause its dividend increases again. Eaton's key competitive advantages are its expertise and understanding of the businesses that it operates. The company specializes in providing highly engineered products to customers in niche end markets. Switching to a different provider could prove costly and comes with a risk of failure. While Eaton is not recession-proof, the company is likely to do well in an improving economy due to these factors.

Final Thoughts & Recommendation

Following fourth quarter and full year results, Eaton Corporation is projected to return 2% annually through 2025, down from our prior estimate of 4.5%. Eaton is in the process of divesting certain businesses, such as its lighting and hydraulics businesses. We believe this to be a positive development as the company is removing those businesses that have been a headwind to results. Still, shares trade at valuation not seen since 2009. We have raised our 2025 price target $1 to $96, but suggest investors consider taking profits due to expected total returns in the near future, and rate the stock a sell.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	11873	13715	16049	16311	22046	22552	20855	19747	20404	21609
Gross Profit	3091	4082	4788	4863	6677	6906	6551	6338	6648	7098
Gross Margin	26.0%	29.8%	29.8%	29.8%	30.3%	30.6%	31.4%	32.1%	32.6%	32.8%
SG&A Exp.	2252	2486	2738	2894	3886	3810	3596	3505	3565	3548
D&A Exp.	573	551	556	598	997	983	925	929	914	N/A
Operating Profit	444	1171	1633	1530	2147	2449	2330	2244	2499	2966
Op. Margin	3.7%	8.5%	10.2%	9.4%	9.7%	10.9%	11.2%	11.4%	12.2%	13.7%
Net Profit	383	929	1350	1217	1861	1793	1972	1916	2985	2145
Net Margin	3.2%	6.8%	8.4%	7.5%	8.4%	8.0%	9.5%	9.7%	14.6%	9.9%
Free Cash Flow	1213	888	680	1071	1671	1246	1903	2073	2146	N/A
Income Tax	-82	99	201	31	11	-42	159	199	382	278

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	16282	17252	17873	35810	35491	33529	30996	30476	32623	31092
Cash & Equivalents	340	333	385	577	915	781	268	543	561	283
Acc. Receivable	1899	2239	2444	3474	3648	3667	3479	3560	3943	3858
Inventories	1326	1564	1701	2336	2382	2428	2323	2346	2620	2785
Goodwill & Int.	7876	7726	7729	22023	21681	20449	19493	18715	18833	18174
Total Liabilities	9464	9849	10381	20632	18628	17690	15765	15478	15333	14950
Accounts Payable	1057	1408	1491	1879	1960	1940	1758	1718	2166	2130
Long-Term Debt	3467	3458	3773	10836	9549	9034	8414	8277	7751	7521
Total Equity	6777	7362	7469	15113	16791	15786	15186	14954	17253	16107
D/E Ratio	0.51	0.47	0.51	0.72	0.57	0.57	0.55	0.55	0.45	0.47

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	2.3%	5.5%	7.7%	4.5%	5.2%	5.2%	6.1%	6.2%	9.5%	6.7%
Return on Equity	5.9%	13.1%	18.2%	10.8%	11.7%	11.0%	12.7%	12.7%	18.5%	12.9%
ROIC	3.7%	8.8%	12.2%	6.5%	7.1%	7.0%	8.1%	8.2%	12.4%	8.8%
Shares Out.	332.4	339.9	334.4	470.7	475.1	467.9	458.8	449.4	439	433
Revenue/Share	35.36	40.40	46.82	46.48	46.25	47.30	44.65	43.26	45.65	49.46
FCF/Share	3.61	2.62	1.98	3.05	3.51	2.61	4.07	4.54	4.80	N/A

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.