

Magna International Inc.: 1 Huge Reason Why Investors Should Be Wary

Description

Back in 2011, gold was the sector to be in. The price of the yellow metal was surging to more than \$1,800 per ounce, eventually ending the year above \$1,600. Gold bugs were calling for the price of the commodity to eclipse \$5,000/oz., and companies in the sector were announcing mine expansions as fast as they could acquire financing.

Barrick Gold Corp. ([TSX:ABX](#))(NYSE:ABX) had absolutely stellar results that year. Buoyed by the price of gold, the company reported net earnings of more than US\$4.4 billion, or \$4.48 per share. Shares of the company traded at between \$45 and \$50 each for most of the year.

Think about the mindset of the average investor then: Barrick was on its way to making great profits and trading at a reasonable 11-12x earnings. In today's low interest rate world, that's a downright cheap valuation. As long as the price of gold cooperated, the company could easily ramp up production and make even more money.

We all know what happened next. The price of gold collapsed, and Barrick was in for a world of hurt. It ended up scrapping several high cost projects that it had already sunk billions into. It cut the dividend, and its massive debt load nearly suffocated the company into bankruptcy.

What does this have to do with **Magna International Inc.** ([TSX:MG](#))(NYSE:MGA)? More than you'd think, actually.

The risk

It's been a great few years for Magna International. The company finally got rid of Frank Stronach and his excessive compensation. It has been a leader in making components for hybrid vehicles, going as far as building a hybrid engine for **Ford** before it even got a contract from the company. You don't see that very often these days.

In 2010, Magna earned \$4.30 per share on US\$23.5 billion in revenue. In 2014, the company is on pace to eclipse US\$37 billion in revenue, and analysts project it will earn \$9.94 per share. 2015 is expected to be even better; analysts are estimating that earnings will increase another 11% to \$11.18 per share.

As I type this, Magna's stock trades at \$123.52. That puts the company at about 12x this year's earnings, and just 11x 2015's expected earnings. Considering the growth in the company's top and bottom lines since 2010, why is it trading at such a cheap price/earnings ratio?

The answer is the same reason why Barrick's shares only traded at 11x earnings back in 2011. The market realizes that the cyclicity of the auto industry is a risk, especially at this point in the cycle.

Should you buy Magna?

No matter where you look, auto stocks look really cheap right now.

General Motors just reported a great quarter, and raised its dividend 20%. The stock is up more than 9% this week alone. And yet it trades at just 8.2x 2015's expected earnings of \$4.47 per share. Ford is in the same boat, trading at just 10x 2015's expected earnings and 9x analysts' expectations in 2016.

There's a reason why auto companies don't get a premium valuation in the market. When things are rolling and new car sales are brisk, it's a good business to be in. But if the economy slows down, there's very little these companies can do to cut costs. Factories are still there, and it's hard to fire a unionized workforce. And since auto margins are so tight, even just a small slowdown can turn a profitable automaker into a struggling one.

When that happens, companies like Magna end up taking it on the chin. Not only do volumes go down, but pressure starts moving back up the supply chain to share some of the pain. Suddenly, price becomes the big decision when choosing a supplier.

If the U.S. economy continues to run on all cylinders for a couple of years, Magna (and the other names in the sector) will end up being a good buy. But if the economy stumbles at all, chances are Magna will fall more than the overall market.

I'd avoid the stock at these levels. Like the market, I just don't believe earnings are sustainable over the next business cycle.

CATEGORY

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2. NYSE:MGA (Magna International Inc.)
3. TSX:ABX (Barrick Mining)
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