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BARRON'S ROUNDTABLE

Oscar Schafer: Loading Up on Auto Parts, Off to the Movies

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PHOTO: JEREMY LIEBMAN FOR BARRON'S

Barron's : ***Oscar, we've all been looking forward to your ideas.***

Oscar Schafer: My first pick is Cinemark Holdings [ticker: CNK]. It's the third-largest movie exhibitor in the U.S. Cinemark controls 4,500 screens in the U.S. and operates 190 theaters in Latin America. After posting record box-office results in 2015, 2016, and the first quarter of

2017, the studios released a string of terrible movies this past summer. Box-office receipts declined 4% in the second quarter of 2017 and plunged by 15% in the third. It was the worst summer box office in 17 years.

Wall Street analysts were quick to blame Netflix [NFLX], Amazon.com [AMZN], videogames, high ticket prices, and millennials. They declared that the industry was in "secular decline," and identified the final death blows lurking in the form of premium video on demand and the money-losing subscription service MoviePass. As a consequence Cinemark's stock declined 25% from its peak. Having followed the industry for years, I believe these fears are overblown. I expect the industry to recover. In short, we have seen this movie before. Despite recent headlines to the contrary, the domestic movie business remains healthy. Over the past 30 years, the domestic box office has grown at a compounded annual rate of 4%. Last year, it was down just 2%. Attendance has been a headwind, with ticket sales falling by 1% annually over the past 10 years. Still, Cinemark has continued to grow revenue at a 6% compounded annual rate.

How has the company managed that?

Schafer: Through higher ticket prices and concessions per patron, and modest screen growth. Cinemark has invested in its businesses, adding digital projectors, 3-D, large-format screens, leather recliner seating, improved food choices, and alcohol. History shows that, despite increased competition from entertainment inside the home, movie theaters continue to offer consumers a compelling outside-the-home entertainment experience. But growth hasn't always been in a straight line, as the performance of a few hit movies each year drives the theater business.

In addition to the weak box office, one major concern for theater owners is that certain studios will pursue premium video-on-demand deals, with streaming and pay-TV providers drastically reducing the exclusive 90-day "theatrical window." I believe the PVOD threat isn't existential. As the DVD business has dried up, the theatrical window has been more important for the movie studios, giving the consolidating industry a strong voice and more likely economic stake in any new formats. Disney [DIS] is already on record opposing premium video on demand.

What does all this mean for Cinemark?

Schafer: At $34 a share, Cinemark trades at just over seven times enterprise value to 2018 Ebitda [earnings before interest, taxes, depreciation, and amortization], versus its peak multiple of 10 times EV/Ebitda and a longtime average of eight times. Anticipating a box-office rebound in 2018 and 2019, I see 60% upside for the shares, plus a 3% dividend yield while you wait. Last month, competitor Regal Entertainment Group [RGC] agreed to buy

United Kingdom–based Cineworld Group [CINE.UK] for 9.5 times EV/Ebitda, representing a 40% premium to Regal's pre-deal trading price.

Oscar Schafer

Chairman

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My next pick, O'Reilly Automotive [ORLY], is the third-largest retailer of aftermarket auto parts in the U.S. It operates close to 5,000 stores that serve both retail and commercial customers in 47 states. In 2017, the company reported disappointing same-store sales. That, coupled with reports of Amazon's aggressive entry into the market, sent O'Reilly's stock down in the first half of the year. While I never want to underestimate Amazon's ability to disrupt a market, attributing most of the industry's softness last year to Amazon misses how defensive the aftermarket auto segment is. It has provided investors with a great opportunity.

Did the stock recover, or fall further?

Schafer: It recovered, and has been trading at $260. I believe there is still 30% to 40% upside. O'Reilly has been a superbly run company in a growing segment. The O'Reilly family started the company in 1957, and David O'Reilly remains chairman. He has built a culture where the focus on the customer is the priority. Prior to 2017, O'Reilly averaged 5% same-store sales growth and 22% earnings-per-share growth over 10 years. It improved its

operating profit margin to more than 20% and now generates a return on invested capital of almost 30%. The company used the cash flow it generated during that period to continue to open stores, make some acquisitions, and buy back shares. It has reduced its share count by close to 40% since 2010.

Last year was difficult for the industry, and O'Reilly wasn't immune. It has guided for a 1% to 2% decline in same-store sales with only 11% growth in earnings per share. As we have seen with other segments of retail this year, the market attributed the softness to Amazon. But that misses certain attributes that make auto-parts retailing a bit more immune to Amazon than some other retail concepts.

View Oscar Schafer's Picks

Such as?

Schafer: For one thing, about 40% of auto-parts sales are to mechanics and body shops. At body shops, there is constant concern about the speed of delivery; some demand delivery in 30 minutes or less. A large retail footprint, coupled with an elaborate hub and distribution presence, positions companies such as O'Reilly for the industry's quick delivery demands and makes it harder for Amazon to penetrate this market. And, most parts sold are of a highly technical nature. This isn't to say that Amazon hasn't had any impact on the industry, but last year's weakness was much more a result of a second consecutive mild winter and summer, and fewer cars on the road entering the seven-to-nine-year sweet spot when they break down and need fixing. This is further confirmed by looking at various parts suppliers, which showed similar weaknesses throughout the year. Putting it all together, the structural advantages of the O'Reilly business model have helped the company generate some of the highest returns in retail, including 20% compounded growth in earnings per share since the company's initial public offering in 1993.

Where does this leave O'Reilly for 2018?

Schafer: The business will rebound in 2018 and beyond as cyclical factors help. Also, O'Reilly is a major beneficiary of corporate tax reform. The company will generate more than $20 a share in earnings by 2020. Applying a multiple of 17.5, the stock could be worth $350 a share by the end of next year. We bought both Cinemark and O'Reilly because they had what we considered to be near-term blips. That is one way we identify opportunities in this market.

Next, I'd like to discuss three companies I've recommended before.

Shares of CommScope Holding [COMM], which I last recommended in the 2017 Midyear Roundtable, are still down 10% from their peak after the company lowered guidance multiple

times, due to weaker-than-expected demand. A provider of telecommunications infrastructure, CommScope remains well-positioned for telecom spending growth, despite its notoriously lumpy end markets. Demand slowed last year as AT&T [T] paused its spending ahead of its multiyear buildout of the First Responder Network, or FirstNet. It won the contract to build and manage the network.

ROUNDTABLE PART 2

- Henry Ellenbogen: The Case for a Credit Bureau, a Ski Resort, and More
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- Jeffrey Gundlach: Bullish on Commodities and Bank Loans
- Abby Joseph Cohen: Drilling for Oil and Making Gadgets
- William Priest: Bullish on Screen Technology and Chip Gear
- Scott Black: Making Chips and Crushing Sand
- Meryl Witmer: Used Cars and Carbon Black
- Oscar Schafer: Loading Up on Auto Parts, Off to the Movies
- Paul Wick: How to Play the Big Trends in Tech

What will this year bring?

Schafer: CommScope's wireless business will snap back in 2018. AT&T is beginning to build FirstNet, a national network. Additionally, the company could benefit from increased spending by Sprint [S], following the abandonment of its planned merger with T-Mobile US [TMUS]. I also expect renewed growth in CommScope's fiber business as AT&T connects to the 12.5 million homes mandated by regulators in relation to its acquisition of DirecTV. CommScope could generate more than $4 a share of free cash flow in 2020. At 15 times free cash, the stock, now $38, could have 60% upside. As the company continues to delever, there is optionality from the potential future mergers and acquisitions, where management has a very successful track record.

At the 2016 Roundtable, I outlined the thesis for Evertec [EVTC]. It is the dominant transaction-processing company in Puerto Rico. While I discussed some of the risks that come along with investing in a business domiciled on the island, I didn't anticipate a category 4 hurricane hitting Puerto Rico directly, as happened last year. Hurricane Maria was the strongest storm to hit the island in 85 years. It left much of Puerto Rico without power. Evertec's business has been negatively impacted, as many customers were unable to use credit or debit cards after the storm. Many are using cash now, while others have fled to the U.S. Amid the uncertainty, Evertec's shares have traded down almost 30%. I am still optimistic about the long-term outlook.

Why?

Schafer: Half of the company's revenue is generated from bank processing and IT [information technology] services, which weren't significantly impacted by the storm. As of October, credit- and debit-processing services were back to 70% of pre-storm levels. I am hopeful that the rebuilding efforts will provide some much-needed stimulus to the local economy. Regardless, Evertec should continue to benefit from increased penetration of electronic payments, as management pursues an acquisition strategy across the region. At the end of the day, Evertec remains a highly resilient business, with a dominant share in a critical service. The stock, trading at a modest nine times cash flow, or $14 a share, is comparable to companies that command more than 20 times cash flow. We see 100% upside in three years.

Finally, ANI Pharmaceuticals [ANIP] is a specialty generic and branded pharmaceutical company. It was trading in 2013 at $6 a share. It is now at $70, when shares of many other generic-drug companies have all but collapsed. Ebitda went from nothing in 2013 to an estimated $100 million this year. The stock trades for about eight times enterprise value to Ebitda, whereas other generic-drug companies have been acquired for 12 to 15 times Ebitda. This company potentially could become an acquisition candidate. In a year or two, ANI will launch a corticotropin product that competes in a $1.2 billion market. The company has said the product could yield $200 million of Ebitda.

What is it used to treat?

Schafer: It is a drug for treatment of infantile spasms and multiple sclerosis. ANI bought its product from Merck in 2016 for $75 million. It had already been approved by the Food and Drug Administration, and ANI will have to prove to the FDA that it can manufacture the same product that was on the market in the 1990s. ANI's other new product is Vancocin, which addresses a $450 million market. The stock could be $120 in a year without the corticotropin, and $200 after the company launches it. ANI isn't highly levered, and it has the ability to make acquisitions, while its competition doesn't. For example, last year, it paid AstraZeneca [AZN] $46 million for a variety of products that had $19 million of sales, 80% gross profit margins, and no incremental costs. So it paid $46 million for $16 million of Ebitda.

Meryl Witmer: Where is the company domiciled?

Schafer: It is based in Baudette, Minn., and manufactures there. That's it from me.

Thank you, Oscar, and everyone.

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