

Equity Analysis for
Delphi Technologies (DLPH)

Published by **Jonathan W. Jones** on **January 15, 2020**

Company Overview

Delphi Technologies engineers, designs, and manufactures parts for the automotive industry. Their products optimize engine performance, increase vehicle efficiency, reduce emissions, improve driving performance, and support the increasing electrification of vehicles. Their operations serve 23 of the largest automotive manufacturers across the world.

Delphi operates in two segments; *Powertrain Systems* and *Aftermarket*.

Operations

Powertrain Systems

In their Powertrain segment, Delphi produces engine components for Original Equipment Manufacturers (OEM). Parts from this segment have been contracted out to Delphi, and are just a small component of a new car's production.

Nevertheless, Delphi's Powertrain Systems segment can be further broken down into two major sub-categories: Engine components (1) and engine management systems(2).

Delphi refers to their engine components as "Internal Combustion Engine" products, or ICE. Products under this category include fuel injection systems, for both gas and diesel engines. Their portfolio also includes products for hybrid electric vehicles, variable valve timing, powertrain sensors, ignition products, etc.

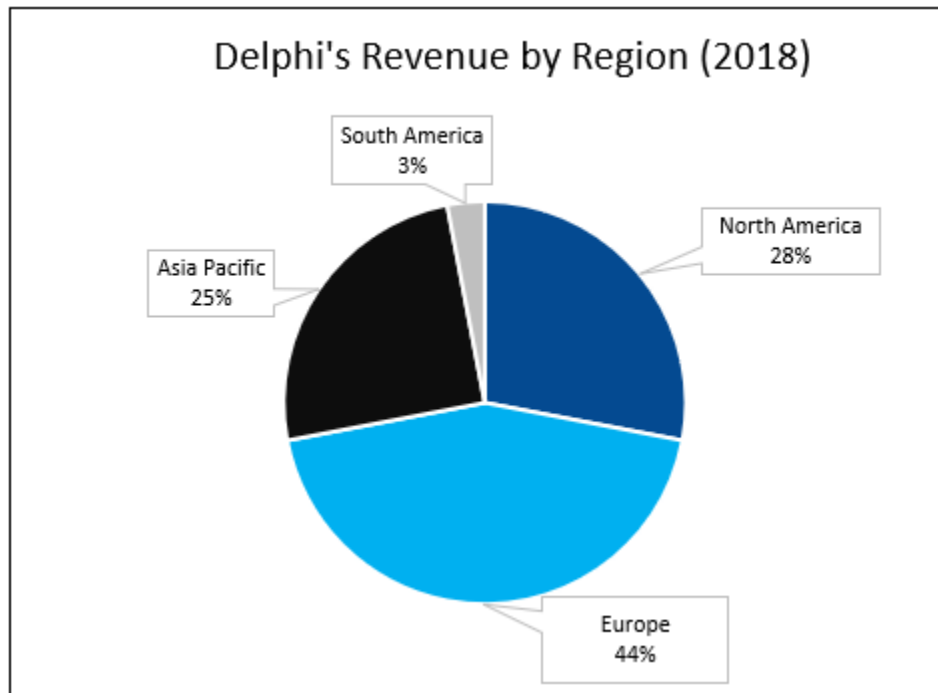
For engine management, the company produces the control modules for both gasoline and diesel engines. These control modules "enable the integration and operation of powertrain products throughout the vehicle."

In the Powertrain Systems segment, 72% of sales come from light vehicles, while 28% stem from commercial.

Aftermarket

Delphi's Aftermarket product portfolio is comprised of essentially the same products that are in their Powertrain Systems segment. The only difference is that sales in this segment are made to independent shops, dealerships, etc. Parts that are sold in this segment are identical to the original parts that are put on the car when it's on the assembly line.

Geography



Industry

The three areas of the auto industry that influence Delphi, are light vehicle sales, commercial sales, and aftermarket replacement parts.

In the company's Powertrain Systems segment, demand for new vehicles are what drives Delphi's revenues. Total new-car sales are typically reliant on macro-economic factors such as credit availability, interest rates, fuel prices, consumer confidence, etc. Overall, this OEM market is very cyclical.

For the commercial vehicle market, sales are still somewhat cyclical. However, sales here are insulated from consumer credit and spending. Rather, purchases are made based off of business spending, and how those businesses perceive the economic outlook.

In contrast to Powertrain Systems, Delphi's Aftermarket segment provides very consistent revenues. As the economy slows, consumers tend to fix their current vehicles instead of fueling sales in the OEM market.

It's also important to note, that growth in the automotive manufacturing industry has been in the low single digits. Although there is no sign of rapid growth anytime soon, companies like Delphi

have the opportunity to expand within their industry. Larger companies also benefit from their scale, which allows them to be more operationally efficient.

Furthermore, growth in the automotive sector varies by region. For example, China and India have been two of the fastest growing markets in the world. Whereas, developed markets have significantly lagged behind.

Lastly, the parts manufacturing industry is highly competitive. As a result, margins stay relatively thin. Additionally, companies like Delphi find themselves competing with cheaper, non-labeled, alternatives more and more often.

It's also important to realize the future that electrification will play in the automotive sector. The number of total vehicles that will be powered by electricity is estimated to be 35% by 2025. Today, electrification only represents about 5%.

This shift is being pushed by OEMs continuing to focus on improving fuel efficiency, whilst also reducing emissions to meet regulatory requirements.

Short Term Outlook

Like most stocks in the automotive industry, DLPH shares have suffered over the last few years.

The main problem Delphi is having, is that they're seeing a large decrease in revenues. In quarter 3 of 2019 alone, the company's revenues fell by over 8% from the year prior.

Delphi now expects their full-year revenues to fall between \$4.3 billion, and \$4.325 billion. Similarly, this represents a 7.5% to 8% year-over-year decline

Global Automotive Market

The primary reason that Delphi has been struggling, is because of a global slowdown in the automotive sector.

Though the company did see growth in their Gasoline Direct Injection (GDI) and their aftermarket business, revenues related to diesels-powered vehicles in Europe, and overall revenue declines from China and India more than offset any gains.

Total net revenue saw a 6% decline in Europe, and a 15% decline from China.

Nonetheless, Delphi's sales figures have consistently followed trends occurring in the broader automotive sector. That is, a move away from diesel-powered engines in Europe, and thus a shift towards gasoline. Furthermore, in the last few quarters there has been lower global light-vehicle production. In correlation, a slowdown in OEM sales has spiked demand for more aftermarket parts.

Finally, the recent GM strike has also influenced demand for Delphi's products. As a result of the strike, Delphi management now expects global light vehicle production to decline by 7%, instead of the previously forecasted 5%. This of course, has a direct impact on the demand for manufactured parts. The expected cost to Delphi, was approximately \$20 million in revenues.

Unfortunately, most economists don't see light vehicle production picking up any time soon. We've already entered into the final stages of the economic cycle, and there are no signs that the European, or Asian Pacific markets are going to quickly rebound.

Therefore, softness in both the retail and commercial markets will most likely continue beyond 2020, and probably well into 2021. Some areas that have seen growth despite this global slowdown, are high-pressure fuel injection systems (mostly for gasoline engines), as well as Power Electronics; specifically, all-in-one control modules. These areas both fall under Powertrain Systems.

Even though the revenue from Power Electronics will continue to grow, in the most recent quarter, it declined by approximately 15%. This was because of ongoing changes in government regulations and incentives in China. The company expects revenues here to return back to normal in Q4, and beyond.

A separate problem that has plagued Delphi, is the US-China trade war. When the tariffs were in effect, it put a massive strain on the company. In addition, the Chinese economy was struggling anyways. Fortunately, the company doesn't have to worry about tariffs again for the foreseeable future.

Delphi Automotive

On December 5, 2017, Delphi Automotive spun off a fragment of their company to become what we know today as Delphi Technologies (DLPH). In addition, the company renamed themselves as Aptiv (APTIV). The new spin off, Delphi Technologies (DLPH), was to be home to the powertrain and the aftermarket segments of the original business.

The new stand-alone company began with a market capitalization of around \$5 billion. Aptiv on the other hand, kept the majority of the original segments. Thus, they started off at around a \$24 billion market cap.

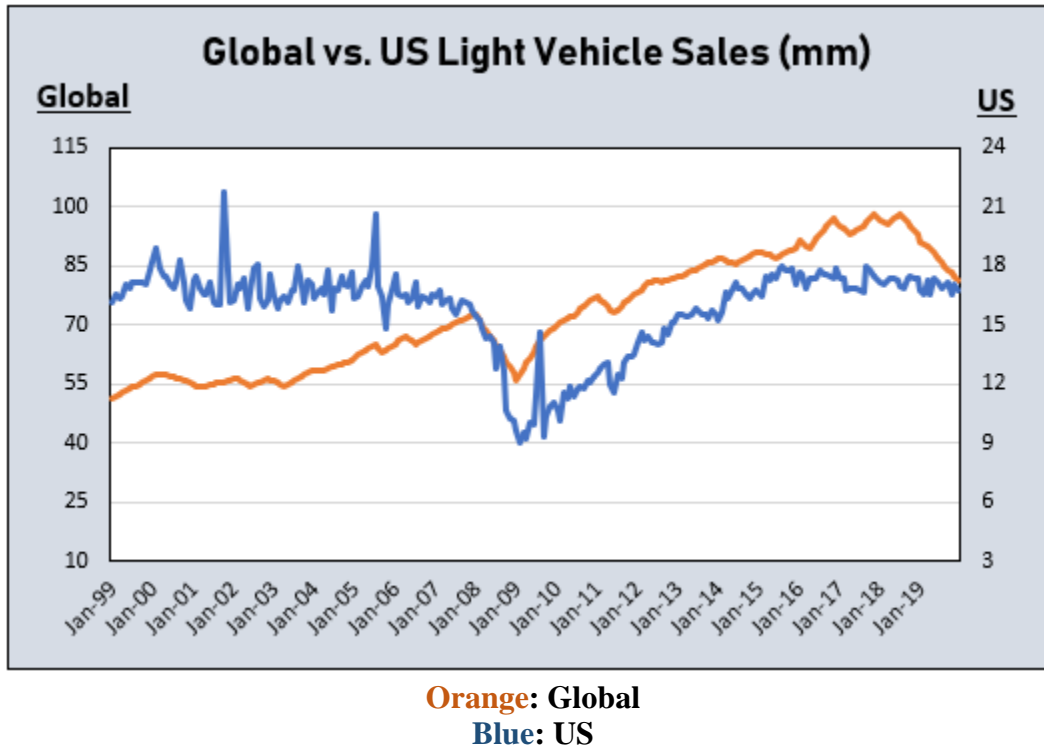
Quarter 3 of 2019 represented the first quarter where DLPH really became their own company. They could finally begin to make their own decisions regarding company structure, and other long-term shifts.

Long Term Outlook

Economists have generally agreed that light vehicle production is going to grow at a slow, but steady, rate of 2% per year until 2025. A 2% growth rate per year keeps Delphi's growth aspirations relatively low. Yet, this growth rate is an aggregate of the global industry. If you

section the numbers out by region, you start to see some outliers. India, South America, and China, for example, have much higher growth rates; with China leading globally.

As you can see below, the growth in global vehicle sales (orange) has outpaced growth in US sales (blue) since the early 2000's.



Furthermore, there are opportunities for companies like Delphi to expand within the industry itself. In fact, companies that are larger will have the upper hand. This is because of cost efficiencies, deeper market penetration, and global reach.

Three-Year Transformation Plan

In the next several years, the largest shifts that will take place at Delphi are the changes that stem from the company's Three-Year Transformation Plan.

This restructuring plan, aims to improve cash flows, improve operational efficiency, and reduce debt levels. By 2022, the company plans to be able to reduce costs by up to \$150 million.

To do this, management intends to completely eliminate more than 40% of their "engineering footprint". This includes nine engineering sites, and roughly 1,500 engineering jobs; which represents around 30% of their current engineering employment. Further, the company plans to slash more than 500 additional positions.

Delphi conceptualized this plan, because they believed that there was no need to have 23 engineering sites in 13 different countries. Thus, the company chose to consolidate the sites that were being under-utilized.

They estimate that by the end of 2022, long-term cash flows will be positively improved by \$300 million. Furthermore, in the short term the company will see significantly higher cash flows from Changes in Working Capital. This is because they will be selling assets from their restructuring plan.

Nevertheless, the bulk of the long-term benefits will start to be seen in 2021 and 2022.

Powertrain Systems

A long-term shift that's happening in the Powertrain segment, is that manufacturers are choosing to centralize power control modules into one unit. This makes control units for vehicles more simple, and also helps on Delphi's end. It enables the company to use more effective packaging, and lowers their total cost that they have into each unit. These centralized products will experience increased demand as vehicle electrification accelerates.

Aftermarket

In their Aftermarket segment, Delphi has seen, and will continue to see, revenue loss to private label competition. These private label companies have become more popular mainly because of cheap prices and availability. The consumer has been willing to trade-off certain quality and technological aspects, for the cheaper prices.

With that being said, as global OEM sales struggle, Delphi's Aftermarket segment will serve as a steady flow of income.

Risk Factors

Debt

One of the primary risk factors affecting Delphi, is the level of debt that they have found themselves in. To date, the company has \$1.45 billion in outstanding long-term debt.

Annual interest payments range from \$40-\$70 million over the next few years, with the principal amount from their \$750 million Term Loan A facility coming due in 2022. The company also has their \$800 million Senior Notes at 5.00%, coming due in 2025. The company's \$500 million revolving credit facility with JP Morgan will be of help when the company's interest payments are up.

Macro Factors

One large macro factors that Delphi faces, are the currency headwinds from other countries that they do business in. Because 72% of their revenues come from outside of the United States, there

is always the risk of a strengthening US Dollar. Although the company does hedge, these practices typically don't cover any major devaluations of foreign currency.

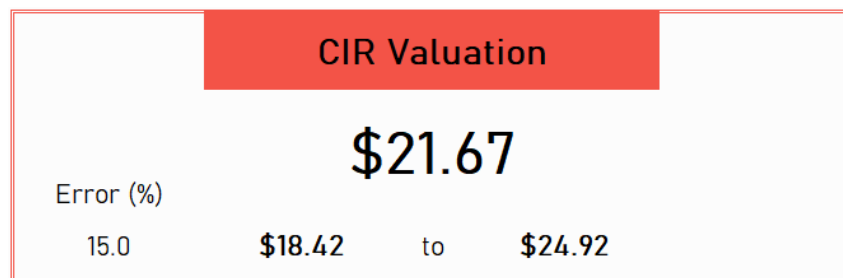
International operations are also subject to other risks, including:

- - unexpected changes in laws, regulations, taxes, trade or monetary or fiscal policy
 - exposure to local economic, political and labor conditions
 - tariffs, quotas, customs and other import or export restrictions and other trade barriers

Other than international risk factors, Delphi is also exposed to price fluctuations in the raw materials markets. Some of these materials include carbon steel, ferrochrome, iron core, etc.

Lastly, Delphi's Powertrain Solutions segment is highly susceptible to shifts in the broader automotive market. Specifically, when it comes to OEM car sales.

Valuation



Growth at Delphi has been mostly stagnant. Until the company can begin to create more organic growth, we only see their earnings growing by around 1% annually. Unfortunately, the global outlook of the automotive industry has the largest impact on the company's growth in earnings.

For the next few years, it is likely that Delphi will continue to hold back capital expenditures. In turn, this pattern will continue to lead reinvestment rates to be lower than the company can sustain in the long term. Thus, we chose to expand the company's reinvestment rate to 45% to find their terminal value.

Lastly, the company has made it a point to start paying down their debt. Although the industry average debt/equity is around 0.55, it will be several years before Delphi can achieve this ratio. We used the industry average for their terminal value.

	<u>Short Term</u>		<u>Long Term</u>
Unlevered Beta:		0.82	
Levered Beta:	2.13	→	2.43
Growth Rate:	1.1%	→	1.1%
Discount Rate:	12.5%	→	14.2%

Cash Flows

	ADJ 0	1	2	3	4	5
Net Income	296	299	303	306	309	313
FCFE		394	398	351	355	333

Terminal Value

$$\frac{313 \quad (1.01) \quad (0.98)}{(0.1423 \quad - \quad 0.01)} = 2,368$$

Disclaimer

Strond Capital provides in-depth, unbiased, analyses of public and private equity investments. Our intent is to inform our clients with valuable information and transparency in our decisions to invest or not in companies in our portfolio. Our analysis of any security - and especially the respective valuation on said security – serves as our professional opinion and/or recommendation.