



Danger Zone: Jarden Corporation (JAH)

Check out this week's [Danger Zone interview](#) with Chuck Jaffe of [Money Life](#) and Marketwatch.com

What happens when executives are compensated based on "adjusted EPS?" They will run the business for the sole purpose of increasing EPS regardless of the effect on shareholders. This week's Danger Zone stock, Jarden Corporation (JAH: \$47/share) is executing a roll-up scheme that lines the pockets of insiders and Wall Street banks while destroying shareholder value.

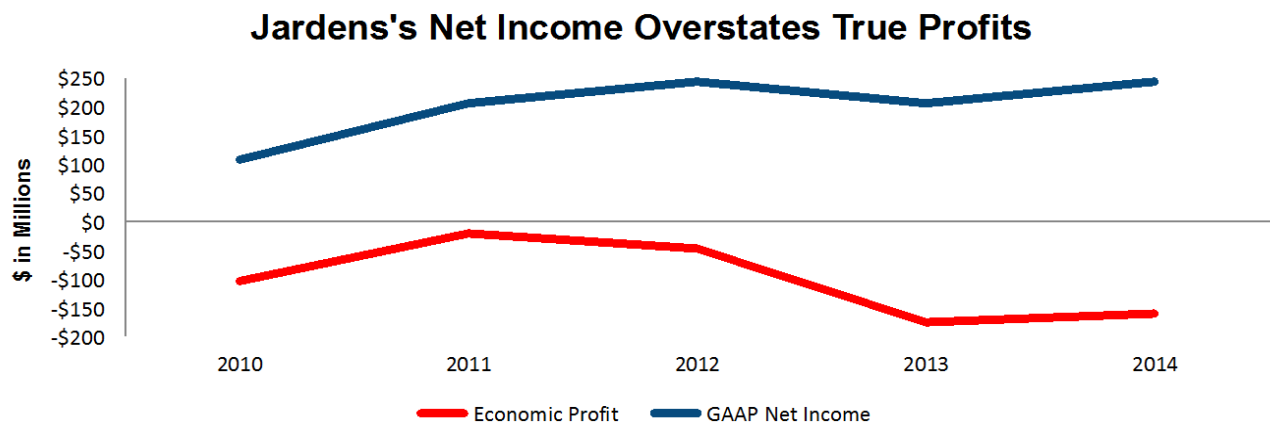
Misaligned Executive Compensation Hurts Shareholders

Jarden's executives' cash bonuses and equity awards are tied to meeting specific "adjusted EPS" criteria, which is the same as reported EPS except that it removes certain expenses, including stock compensation associated with restricted stock. It must be nice to have your own pay removed from the metric that determines your cash bonuses. As long as executives are rewarded for growing EPS, look for Jarden to keep making acquisitions that boost this flawed metric. Whenever the word adjusted appears in a metric used to measure performance, investors must remain skeptical.

Why Is EPS A Flawed Metric For Executive Compensation?

EPS is simply not consistent with cash flow or shareholder value creation. Many empirical studies have featured this fact for some time. Jarden provides an excellent example of how using EPS to measure performance is a mistake. From 2010-2014, Jarden Corporation reported a cumulative net income of \$1 billion while cumulative [economic earnings](#) are -\$507 million. See Figure 1. This situation parallels the one that led us to put InnerWorkings (INWK), another acquisition driven business, in [the Danger Zone in September 2013](#). INWK is down 32% since that report while the S&P 500 is up 19%.

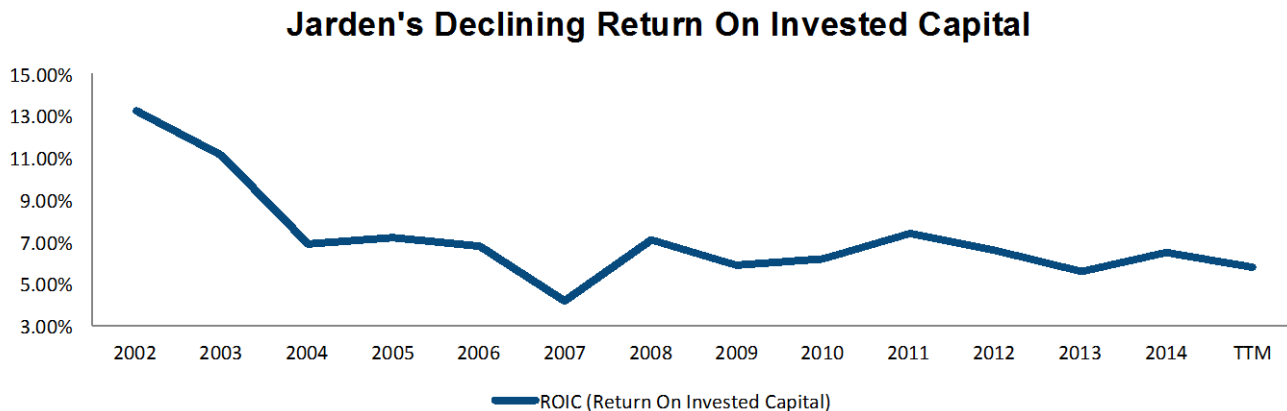
Figure 1: Economic Profit Remains Negative



Sources: New Constructs, LLC and company filings

The big disconnect here comes from the lack of analytical rigor around acquisitions, most of which are very costly while creating the illusion of profits through EPS growth. This issue is best known as the [High-Low Fallacy](#), which is an accounting loophole that allows companies to show acquisitions as earnings accretive with no regard to the underlying economics of the business. As you can see in Figure 2, the roll-up strategy has not benefited Jarden's true bottom line: return on invested capital ([ROIC](#)).

Figure 2: Acquisition's Are Becoming Less Profitable



Sources: New Constructs, LLC and company filings

Wall Street Wins Too...Investors Still lose

Wall Street investment banks benefit greatly from Jarden's roll-up merger scheme because (1) M&A fees are quite lucrative and (2) the scheme requires the company raise large amounts of capital. Meanwhile, existing shareholders see the value of their investment diluted with each new round of equity or debt. Note: if Jarden were making as much money as it reports, why would it need so much additional capital?

From 2002-2014, Jarden's weighted average diluted shares outstanding increased from 14.3 million to 189.8 million, which is an increase of over 1200% or 24% compounded annually. In 2015, Jarden has announced two new stock offerings and as of 3Q15, its weighted average diluted shares outstanding had grown to 195.4 million.

Additionally, the company's debt has risen nearly 2300%, or 30% compounded annually, from \$230 million in 2002 to \$5.5 billion on a trailing twelve-month (TTM) basis. Much like we noted in [our recent report on Netflix](#), investment banks are more than happy to help raise extra capital as these deals mean big profits for said banks.

Competition From Every Angle

In large part due to the many costly acquisitions, Jarden operates less profitably than its competition, as evidenced by its 6% ROIC. While Jarden owns over 120 brands ranging from outdoor equipment, to toasters, to baby care products, it faces competition in multiple different markets. As Figure 3 Shows, some of the largest home good competitors operate much more profitability than Jarden, which gives them many competitive advantages, including pricing power. It is hard to see how Jarden will be able to raise its ROIC considering the intense competition in this industry.

Figure 3: Jarden Is Less Profitable Than Competition

Company	Ticker	Return On Invested Capital
Procter & Gamble	PG	11%
Clorox	CLX	11%
Helen of Troy	HELE	10%
Jarden Corp	JAH	6%

Sources: New Constructs, LLC and company filings

Bull Case Running Out Of Room

The bull case for Jarden rests upon the company's ability to continue growing top and bottom lines at double digit rates each year. Bulls tout how prudent management has been in making past acquisitions (under the illusion highlighted above) as reason to believe Jarden will be able to repeat this success going forward. I think you can see how this movie ends

Making matters worse, as can be seen in Figure 2 above, Jarden's acquisitions have become an increasingly less efficient use of capital. Jarden's ROIC has fallen from 13% in 2002 to 6% on a TTM basis. In its effort to continue growing EPS, Jarden has been forced to make acquisitions that are successively less profitable. This trend must be reversed, by a large margin, if the bull case is to be believed.

Buyout Seems Unlikely

While Jarden has certainly been on the purchasing side of M&A activity, it seems unlikely that a suitor would surface and purchase Jarden outright. Jarden is conglomerate of many different consumer goods, ranging from vacuums, camping supplies, baseball gloves, to candles. With so many different product lines operating under one roof, any potential suitor would have to be willing to run or integrate a vast array of different businesses, which is inherently expensive and difficult. Additionally, as noted above, Jarden has significant amounts of debt, \$5.5 billion in all (52% of market cap), a net deferred tax liability over \$1 billion, and shares that are greatly overvalued, as we'll show below.

Inflated Valuation Has Significant Downside

The profit illusion created by Jarden's corporate strategy has driven shares up over 230% in the past five years, to the point where the company's underlying business simply cannot justify the share price. To justify the current price of \$47/share, Jarden must [grow NOPAT by 13% compounded annually for the next 16 years](#), at which point, Jarden would be generating over \$66 billion in revenue. To put this in perspective, consumer goods giant PepsiCo (PEP) generated \$66 billion revenue in 2014 and retail leaders TJX Companies (TJX) and Nike (NKE) only generated a combined \$60 billion in revenue in their last fiscal years.

Even if we assume that Jarden is able to find acceptable acquisition targets, shares are still overvalued. If Jarden can maintain its current 11% pre-tax margin, which is unlikely as acquisitions become harder to come by, and [grow NOPAT by 9% compounded annually for the next decade](#), the stock is only worth \$23/share today – a 51% downside.

However, if acquisition growth fails and investors are left with just the organic growth of Jarden, it could be a rough ride. If Jarden can [grow NOPAT by 4% compounded annually for the next decade](#), shares are only worth \$7/share today – an 85% downside.

Asset Write-Downs and Share Dilution Will Sink Shares

First, as Jarden moves into larger and more risky acquisitions to meet the lofty expectations it has created, the company will face further issues. As we noted in our [special report on goodwill/asset write-downs](#), the larger the acquisition, the more likely write-downs occur. As of 2014, the company has already recorded cumulative \$516 million in asset-write downs. Jarden has \$2.9 billion in goodwill and another \$2.6 billion in intangible assets, which represent 51% of total assets. With such a significant portion of assets wrapped up in goodwill and no profits to show, Jarden could be in store for more shareholder destructive write-downs in the near future.

Second, in order to fund these larger acquisitions, Jarden will need to raise additional capital, as noted earlier. Further shareholder dilution poses a large risk to existing shareholders and could cause many to dump their investment before the momentum in JAH runs out.

Insider Sales/Short Interest Raise Red Flags

Over the past 6 months 26,000 shares have been purchased and 670,000 shares have been sold for a net effect of 644,000 insider shares sold. These sales represent <1% of shares outstanding and 5% of insider shares held. Additionally, there are 10.9 million shares sold short, or 5% of shares outstanding. It looks like insiders and some short sellers already see the writing on the wall.

Impact of Footnotes Adjustments and Forensic Accounting

We have made several adjustments to Jarden's 2014 10-K. The adjustments are:

Income Statement: we made \$1.1 billion of adjustments with a net effect of removing \$336 million of [non-operating expenses](#) (9% of revenue). We made \$391 million [non-operating income](#) adjustments and \$727 million non-operating expense adjustments.

Balance Sheet: we made \$3.1 billion of balance sheet adjustments to calculated [invested capital](#) with a net increase of \$286 million. The most notable adjustment was the inclusion of \$516 million in [asset write-downs](#). This adjustment represented 6% of reported net assets.



Valuation: we made \$6.9 billion of valuation adjustments with a net effect of decreasing shareholder value by \$6.3 billion. The most notable adjustment to shareholder value was the removal of \$1 billion in [net deferred tax liabilities](#). This adjustment represents 11% of Jarden's market cap.

Dangerous Funds That Hold JAH

The following fund receives our Dangerous rating and allocates significantly to Jarden.

1. Advisors' Inner Circle Fund: FMC Strategic Value Fund (FMSVX) – 4.6% allocation and Dangerous rating

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.



New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our [forensics accounting expertise](#) across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our [stock rating methodology](#) instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our [forward-looking fund ratings](#) are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating ([details here](#)) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. [Accounting data must be translated into economic earnings](#) to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. [Economic earnings](#) are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, [New Constructs](#) is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. [NOPAT](#), [Invested Capital](#), and [WACC](#), to create [economic earnings models](#), which are necessary to understand the true profitability and valuation of companies. Visit the [Free Archive](#) to download samples of our research. New Constructs is a [BBB accredited](#) business and a member of the [Investorside Research Association](#).

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

New Constructs is affiliated with Novo Capital Management, LLC, the general partner of a hedge fund. At any particular time, New Constructs' research recommendations may not coincide with the hedge fund's holdings. However, in no event will the hedge fund receive any research information or recommendations in advance of the information that New Constructs provides to its other clients.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.