Danger Zone: Suspended Ratings

Check out this week's Danger Zone Interview with Chuck Jaffe of Money Life and Marketwatch.com

We review thousands of filings every day to alert clients to corporate events or disclosures that cause us to question the validity of a company's financial reporting or the efficiency of the market for its stock.

We suspend our ratings on certain stocks when we feel the company's latest reported financials are no longer reliable or indicative of the risk/reward of the stock. For example, an announcement of an acquisition or spin-off means the current financial statements could change significantly. Until the company gives us updated financials, we have no way of reliably modeling the current business. We also suspend our rating when certain events cause a stock to be driven by news instead of fundamentals.

We exclude stocks with suspended ratings from consideration for our Most Attractive and Most Dangerous stocks lists. We do not remove these stocks from coverage so that clients can still see our assessment of the risk/reward of the stock before the event that caused us to suspend the rating.

Notable Suspended Ratings

Beyond our standard Ratings, a Suspended Rating provides additional insight into the investment potential of a given stock. There are certain exogenous forces in business, as in all things in life, that cannot be ignored no matter how much analysis we have done on a company and its stock. When those forces are large enough, we recognize that our standard ratings based on the fundamentals of the company and the DCF valuation of the stock are not as relevant as we want them to be for our clients. Some examples of why we issue Suspended Ratings are below.

1. Pfizer (PFE) agrees to acquire Allergan (AGN) for $160 billion. This acquisition was announced in late November 2015. The $160 billion price tag, not only represented a 30% premium on AGN shares at the time of announcement, but also represents 62% of Pfizer's invested capital and 95% of its total assets. This acquisition will significantly alter the financials of Pfizer's business. There will also be material tax ramifications when the business relocates its headquarters to Ireland. Finally, we have found that the larger an acquisition, the more likely impairments are to take place, which means Pfizer is at great risk of taking shareholder damaging write-downs. Until they issue updated financials, we will not have the granular data required for the precision of our models. In the meantime, we must recognize that the current financials are not as representative as we need them to be to issue our ratings with adequate confidence. Most of the movement of the stock, until the acquisition closes, will be based on news of the acquisition's progress.

   We also suspend the rating of AGN due to the fact that it has become an "Acquisition Target". AGN will mainly trade on the progress of the acquisition and not the fundamentals of the business. Since the announcement, PFE is down 3%, AGN is down nearly 5%, while the S&P 500 is down over 11%.

2. Apple (AAPL) and its abnormally high ROIC. We recently highlighted there is a high correlation between ROIC and stock valuation. At the same time, by analyzing over 3000 company's 10-K's and calculating ROIC for each one, we can identify outliers. In this case, we have given Apple a "Custom" suspended rating due to its abnormally high ROIC. We first made note of this issue in May 2013, and while it was admittedly early, we felt that its 340% ROIC was not only abnormally high, but also unsustainable. A more normal, long-term ROIC for Apple is closer to 40-50%, which is similar to Microsoft (MSFT) or Google (GOOGL). As Apple's high ROIC declines, (from 340% in 2013 to 238% TTM) we expect to see similar action in the company's valuation. Without significant differentiation and innovation, Apple's current profitability and ROIC has reached a ceiling. It's worth noting that AAPL has fallen 22% over the past six months, compared to an 11% decline in the S&P 500. A further decline in ROIC could push shares even lower. As liquidity dries up, the market will begin to recognize true, long-term fundamentals. Ranking Apple as Attractive without noting its abnormally high ROIC would be misleading to clients and readers alike.

3. **Central European Media Enterprises (CETV) going concern warning.** While most investors are aware that auditors provide an opinion on whether or not the presented financials accurately reflect the financial position of a company, they may not be aware of the going concern opinion. In the case of CETV, its auditor, Deloitte, expressed substantial doubt over the company's ability to continue due to the expectation that operating cash flows will be insufficient to cover operating expenses and debt obligations. This going concern is present in CETV's 2013 and 2014 annual report. Why is this warning important? According to a recent study, over half of the companies that filed for bankruptcy from 2000-2009 had received a "going concern warning" the prior year. While this issue may have been resolved in late 2015, New Constructs flags all companies with going concern warnings and gives them a suspended rating until the going concern is removed by the company's auditor, which could occur when CETV releases its 2015 annual report. Investors are free to reach their own conclusion on the issue, but by issuing a suspended rating we are alerting all clients to any potential issues.

17 Reasons For Suspended Ratings

Figure 1 shows the reasons for the 404 stocks that currently get our Suspended Rating. Interesting to note that the most common reason for a suspended rating is Adverse Auditor's Opinion.

Figure 1: Suspended Ratings Breakdown

Suspended Rating Reason	Number of Companies	Cumulative Market Cap ($mm)
Acquisition Target	75	$661,485
Adverse Auditor's Opinion	111	$232,709
Bankrupt	3	$37
Bankruptcy Threat	1	$905
For Sale	18	$67,913
Fraud Risk	22	$9,869
Going Concern	27	$1,519
Hybrid REIT	17	$95,036
Large Acquisition	71	$1,580,617
Large Divestiture	20	$199,952
Late Filing	1	$248
Liquidation	0	$0
Other	25	$90,076
Pending Filing	2	$2,961
Poor Disclosure	10	$434,954
Receivership	0	$0
Custom (AAPL)	1	$539,636

Sources: New Constructs, LLC and company filings

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, sector, 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 forensic 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.

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