New Stocks on Most Attractive/Most Dangerous: September 2016

Recap from August's Picks

Our Most Attractive Stocks (+2.6%) outperformed the S&P 500 (+1.0%) last month. Most Attractive Large Cap stock Primerica (PRI) gained 15% and Most Attractive Small Cap stock Kforce (KFRC) was up 16%. Overall, 23 out of the 40 Most Attractive stocks outperformed the S&P 500 and 31 out of 40 had positive returns in August.

Our Most Dangerous Stocks (+1.8%) underperformed the S&P 500 (1.0%) last month. Most Dangerous Large Cap stock Ternium S.A. (TX) fell by 13% and Most Dangerous Small Cap Stock Marchex (MCHX) fell by 11%. Overall, 17 out of the 40 Most Dangerous stocks outperformed the S&P 500 in August.

The successes of the Most Attractive and Most Dangerous stocks highlight the value of our forensic accounting as featured in Barron's. Being a true value investor is an increasingly difficult, if not impossible, task considering the amount of data contained in the ever-longer annual reports. By analyzing key details in these SEC filings, our research protects investors' portfolios and allows our clients to execute value-investing strategies with more confidence and integrity.

21 new stocks make our Most Attractive list this month and 23 new stocks fall onto the Most Dangerous list this month. September's Most Attractive and Most Dangerous stocks were made available to members on September 8, 2016.

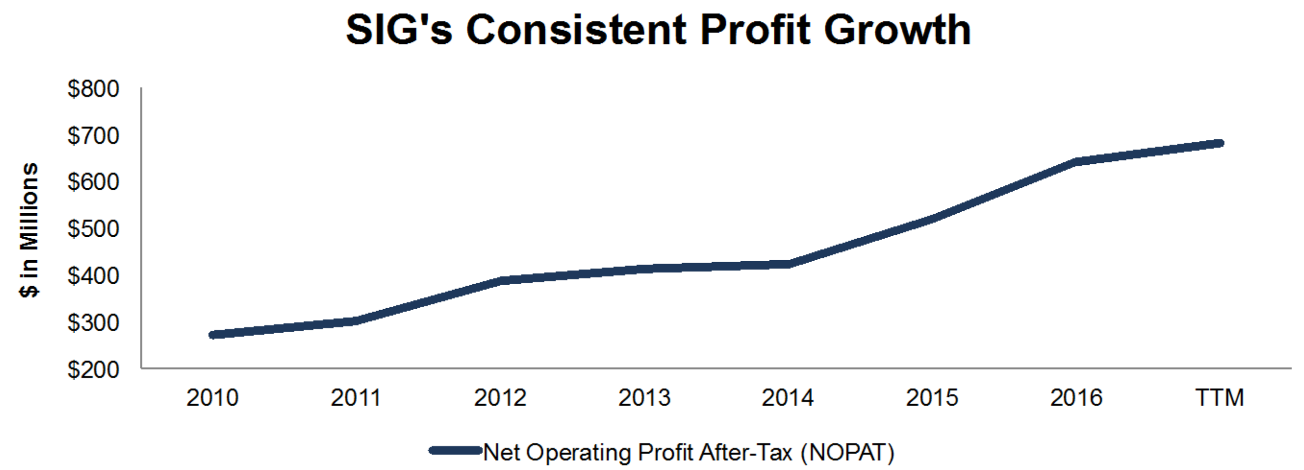
Our Most Attractive stocks have high and rising return on invested capital (ROIC) and low price to economic book value ratios. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

Most Attractive Stock Feature for September: Signet Jewelers (SIG: $79/share)

Signet Jewelers (SIG), international jeweler consisting of Kay Jewelers, Jared, and Zales, among others, is one of the additions to our Most Attractive stocks for September.

Since 2010, Signet has grown after-tax profit (NOPAT) by 15% compounded annually to $640 million in 2016 and $679 million over the last twelve months (TTM), per Figure 1. The company's NOPAT margin has improved from 8% in 2010 to just over 10% TTM. Signet's return on invested capital (ROIC) has improved from 6% in 2010 to 8% TTM

Figure 1: Achieving Profit Growth At Signet



Sources: New Constructs, LLC and company filings

Impacts of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to Signet's 2016 10-K:

Income Statement: we made $355 million of adjustments, with a net effect of removing $173 million in non-operating expenses (3% of revenue). We removed $91 million in non-operating income and $264 million in non-operating expenses. You can see all the adjustments made to SIG's income statement here.

Balance Sheet: we made $3.4 billion of adjustments to calculate invested capital with a net increase of $2.9 billion. One of the largest adjustments was $2.2 billion due to operating leases. This adjustment represented 42% of reported net assets. You can see all the adjustments made to SIG's balance sheet here.

Valuation: we made $3.9 billion of adjustments with a net effect of decreasing shareholder value by $3.8 billion. Apart from total debt, which includes the operating leases noted above, one of the notable adjustments was the removal of $37 million in net deferred compensation. This adjustment represents <1% of Signet's market cap. Despite the decrease in shareholder value, SIG remains undervalued.

Valuation Implies Permanent Profit Decline

SIG's 43% decline over the past year, despite the fundamentals of the business improving (per Figure 1 above) leaves the shares greatly undervalued. At its current price of $79/share, SIG has a price-to-economic book value (PEBV) ratio of 0.8. This ratio means the market expects SIG's NOPAT to permanently decline by 20%. Such pessimistic expectations seem off base with Signet's profit growth over the past few years.

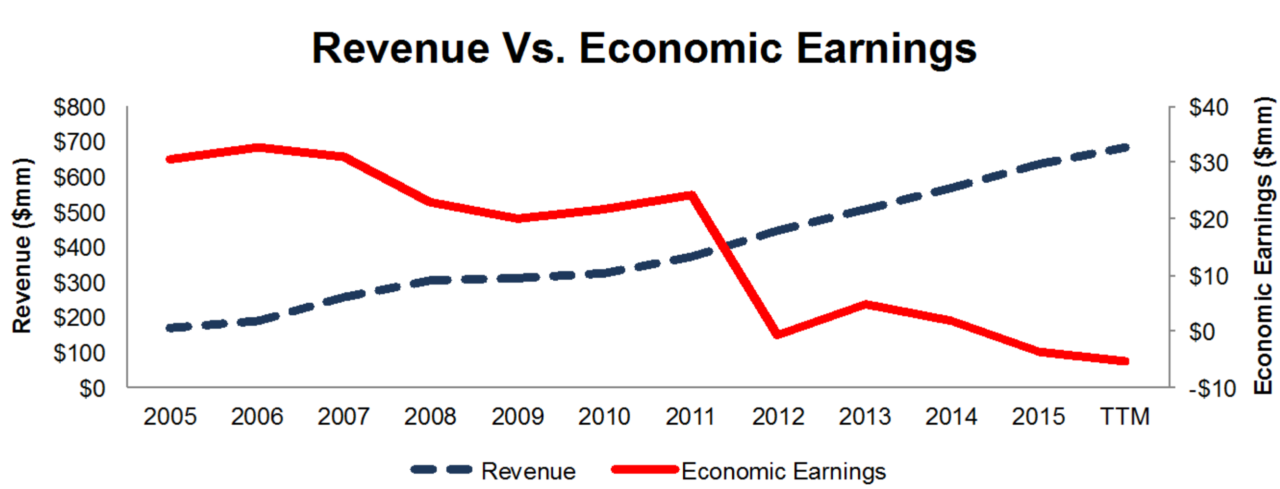
If Signet can maintain 2016 pre-tax margins of 14% (below TTM of 15%) and grow NOPAT by just 4% compounded annually for the next decade, the stock is worth $100/share today – a 27% upside. This scenario also assumes that Signet's spending on working capital and fixed assets will be 5% of revenue, which is consistent with management's 2017 capex estimate as a percent of consensus revenue estimates.

Most Dangerous Stock Feature: Blackbaud Inc. (BLKB: $67/share)

Blackbaud (BLKB), software provider for non-profit, education, and charitable giving entities, is one of the additions to our Most Dangerous stocks for September. Blackbaud has previously been in the Danger Zone, and CNBC recently featured Blackbaud as one of the most dangerous stocks when the network interviewed our CEO, David Trainer.

Since 2005, Blackbaud's revenue has grown by 14% compounded annually to $638 million in 2015 and $684 million TTM. Such revenue growth has failed to grow economic earnings, the true cash flows of the business, which have declined from $31 million in 2005 to -$4 million in 2015 and -$5 million TTM, per Figure 2.

Figure 2: Blackbaud's Hollow Revenue Growth



Sources: New Constructs, LLC and company filings

The company's ROIC has also seen a drastic deterioration, from 123% in 2007 to 6% TTM. Blackbaud's NOPAT margin has followed a similar path, declining from 18% in 2005 to 6% TTM. Across all facets of the business, Blackbaud's fundamentals are in clear decline.

Forensic Accounting Reveals Overstated EPS

In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to Blackbaud's 2015 10-K:

Income Statement: we made $29 million of adjustments, with a net effect of removing $16 million in non-operating expenses (3% of revenue). We removed $7 million in non-operating income and $22 million in non-operating expenses. You can see all the adjustments made to BLKB's income statement here.

Balance Sheet: we made $244 million of adjustments to calculate invested capital with a net decrease of $41 million. One of the largest adjustments was $139 million due to midyear acquisitions. This adjustment represented 21% of reported net assets. You can see all the adjustments made to BLKB's balance sheet here.

Valuation: we made $505 million of adjustments with a net effect of decreasing shareholder value by $505 million. There were no adjustments that increased shareholder value. The largest adjustment was $477 million in total debt, which includes $73 million in off-balance sheet operating leases. This lease adjustment represents 2% of Blackbaud's market cap.

Share Price Remains Overvalued

When we put BLKB in the Danger Zone, we noted how overvalued its share price was. Since then, the stock is up almost 6%, despite no improvement in business fundamentals, and shares are even more overvalued now. To justify its current price of $67/share, BLKB must maintain TTM NOPAT margins (6.3%) and grow NOPAT by 20% compounded annually for the next 12 years. This expectation seems rather optimistic given that BLKB has only grown NOPAT by 3% compounded annually over the past decade.

Even if BLKB can maintain TTM NOPAT margins (6.3%) and grow NOPAT by 10% compounded annually for the next decade, the stock is worth only $15/share today – a 78% downside. This scenario assumes BLKB can grow revenue in EY1 and EY2 at consensus estimates and can continue growing revenue at EY2 estimates indefinitely.

Each of these scenarios conservatively assumes that BLKB can grow revenue and NOPAT without spending on working capital or fixed assets, an assumption that is unlikely, but allows us to create a very optimistic scenario. For reference, BLKB's invested capital has grown on average $124 million yearly (19% of 2015 revenue) over the past five years.

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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 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.

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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.

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