New Stocks on Most Attractive/Most Dangerous: June 2017

Recap from May's Picks

Our Most Attractive Stocks (+1.5%) underperformed the S&P 500 (+2.0%) as a long portfolio last month. Most Attractive Large Cap stock Best Buy (BBY) gained 15%. Most Attractive Small Cap stock Maui Land & Pineapple (MLP) was up 28%. Overall, 19 out of 40 Most Attractive stocks outperformed the S&P 500 in April.

Our Most Dangerous Stocks (-0.1%) outperformed the S&P 500 (+2.0%) as a short portfolio last month. Most Dangerous Large Cap stock SVB Financial Group (SIVB) fell 7%. Most Dangerous Small Cap stock Matrix Service Company (MTRX) fell 22%. Overall, 25 out of 40 Most Dangerous stocks outperformed the S&P 500 as shorts in April.

The successes of the Most Attractive and Most Dangerous stocks highlight the value of our Robo-Analyst technology, which helps clients fulfill the fiduciary duty of care when making investment recommendations.

17 new stocks make our Most Attractive list this month and 20 new stocks fall on the Most Dangerous list. June's Most Attractive and Most Dangerous stocks were made available to members on June 7, 2017.

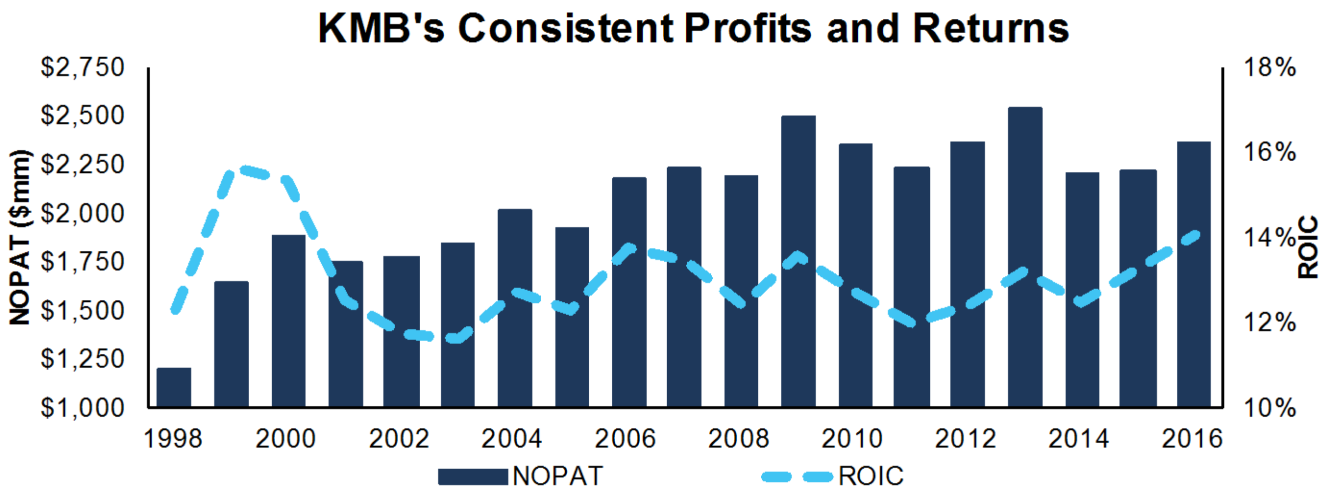
Our Most Attractive stocks have high and rising returns on invested capital (ROIC) and low price to economic book value ratios. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

Most Attractive Stocks Feature: Kimberly Clark (KMB: $130/share)

Kimberly Clark (KMB) is an addition to our Most Attractive stocks for June. KMB is a consumer staples company with a broad portfolio of widely recognized personal care products. KMB is a classic cash cow franchise that offers limited growth potential but delivers consistent, above-average profitability over time.

Per Figure 1, revenue has grown 2% compounded annually and after-tax profit (NOPAT) has grown 4% compounded annually since 1998. Since 2011, revenue growth has slipped to -3% compounded annually. NOPAT growth has remained positive, however, as NOPAT margin improved to 13% in 2016 from 11% in 2011.

Figure 1: KMB's NOPAT & ROIC Since 1998



Sources: New Constructs, LLC and company filings

KMB's return on invested capital (ROIC) of 17% (TTM) has been trending higher for over two years and ranks in the top quintile of our coverage universe. In addition, KMB is a free cash flow (FCF) machine, generating $14 billion of cumulative FCF over the past five years (30% of market cap). KMB's current 5% FCF yield compares favorably to 2% for the average S&P 500 stock.

Low Expectations Embedded in Valuation

At its current price of $130/share, KMB has a price-to-economic book value (PEBV) ratio of 1.2 compared to 2.1 for the S&P 500. This ratio means the market expects S&P 500 profits to more than double from current levels while KMB profits are expected to grow by only 20% from current levels. These divergent expectations seem too pessimistic considering KMB's strong competitive position and long-term track record of profit growth.

If KMB can grow NOPAT just 3% compounded annually over the next decade, the stock is worth $165/share today – 27% upside. For reference, this scenario assumes KMB maintains its current (TTM) NOPAT margin of 13% and grows revenue 2% compounded annually for the next ten years.

Furthermore, with a current 3% dividend yield and the company's targeted ~$250 million per quarter in share repurchases, the total shareholder yield for KMB investors is likely to exceed 5%.

Impacts of Footnotes Adjustments and Forensic Accounting

Our Robo-Analyst technology enables us to perform forensic accounting with scale and provide the research needed to fulfill fiduciary duties. In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to KMB's 2016 10-K:

Income Statement: we made $1.2 billion of adjustments, with a net effect of removing $200 million in non-operating expense (1% of revenue). We removed $472 million in non-operating income and $677 million in non-operating expenses. You can see all the adjustments made to KMB's income statement here.

Balance Sheet: we made $8.3 billion of adjustments to calculate invested capital with a net increase of $8.2 billion. One of the largest adjustments was $3.5 billion related to other comprehensive income. This adjustment represented 40% of reported net assets. You can see all the adjustments made to KMB's balance sheet here.

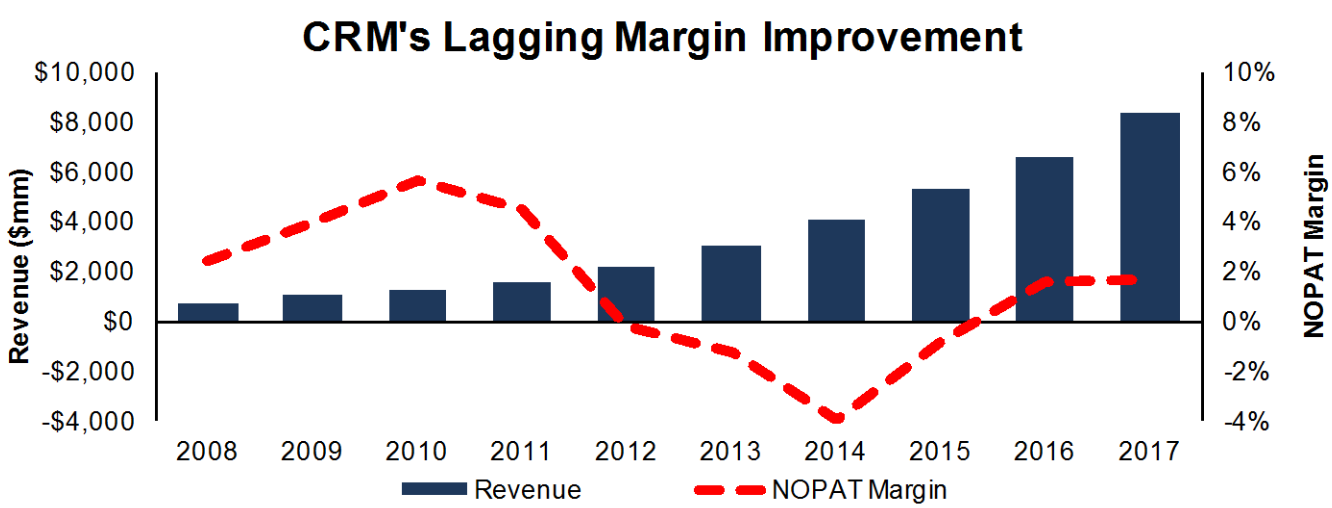
Valuation: we made $10.5 billion of adjustments with a net effect of decreasing shareholder value by $10.5 billion. Apart from $8.3 billion of total debt, which includes $521 million in off-balance sheet operating leases, the most notable adjustment was $1.4 billion (3% of market cap) for pension net funded status.

Most Dangerous Stocks Feature: Salesforce.com (CRM: $86/share)

Salesforce.com, Inc. (CRM) is an addition to our Most Dangerous stocks for June and was featured as a Danger Zone pick in December 2013. CRM is a technology company that provides software focused on customer relationship and sales process management. CRM has generated strong revenue growth for years but has yet to see meaningful profits fall to the bottom line.

Per Figure 2, revenue increased from $750 million in 2008 to $8.4 billion in FY2017, or 31% compounded annually. This impressive revenue growth had an unimpressive impact on profit margins. CRM's 2016 NOPAT margin of 2% was well off the 6% 2010 high and has been in negative territory four of the past six years.

Figure 2: CRM's Ten-Year Revenue and NOPAT Margin



Sources: New Constructs, LLC and company filings

CRM's ROIC has averaged -1% over the past five years and is a bottom-quintile 1% over the trailing twelve months (TTM). In addition to a low NOPAT margin, ROIC has also faced an uphill climb against (potentially) value destroying acquisitions which have added nearly $7 billion of goodwill to CRM's balance sheet over the past five years. CRM has burned through $9 billion of FCF over the same period.

High Expectations Embedded in Valuation

Investors may be catching onto the revenue growth without profits story. CRM shares (+5%) have lagged the S&P 500 (+16%) and the tech sector (+32%) over the past year. However, the stock remains significantly overvalued, especially after a +25% YTD move.

To justify its current price of $86/share, CRM must improve NOPAT margin to 12% over the next five years (compared to 1% TTM) and grow revenue 20% compounded annually over the next decade. This scenario seems rather optimistic given NOPAT margin trends during the past decade of strong revenue growth.

Even if CRM improves NOPAT margin to 10% over the next five years and grows revenue by 15% compounded annually over the next decade, the stock is worth only $48/share today – 44% downside.

Each of these scenarios assume CRM is able to grow revenue and NOPAT/FCF without increasing working capital or investing in fixed assets. This assumption is very unlikely but allows us to create scenarios that demonstrate how high expectations embedded in the current valuation truly are. For reference, CRM's invested capital has grown by an average of $1 billion per year (12% of FY2017 revenue), or 60% compounded annually, over the past decade.

Impacts of Footnotes Adjustments and Forensic Accounting

Our Robo-Analyst technology enables us to perform forensic accounting with scale and provide the research needed to fulfill fiduciary duties. In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to CRM's 2017 10-K:

Income Statement: we made $488 million of adjustments, with a net effect of removing $38 million in non-operating income (<1% of revenue). We removed $263 million in non-operating income and $225 million in non-operating expenses. You can see all the adjustments made to CRM's income statement here.

Balance Sheet: we made $4.8 billion of adjustments to calculate invested capital with a net increase of $49 million. The largest adjustment was $2.3 billion due to off-balance sheet operating leases. This adjustment represented 22% of reported net assets. You can see all the adjustments made to CRM's balance sheet here.

Valuation: we made $7.8 billion of adjustments with a net effect of decreasing shareholder value by $2.3 billion. Apart from total debt, which includes the $2.3 billion in off-balance sheet operating leases noted above, one of the largest adjustments to shareholder value was the removal of $879 million in outstanding employee stock options. This adjustment represents 1% of CRM's market cap.

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

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Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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