



New Stocks on Exec Comp & ROIC Model Portfolio: June 2017

Two new stocks make [June's Exec Comp Aligned With ROIC Model Portfolio](#), available to members as of 6/15/17.

Recap from June's Picks

Our Exec Comp Aligned With ROIC Model Portfolio (+1.4%) underperformed the S&P 500 (+3.5%) last month. The best performing stock in the portfolio was Hasbro Inc. (HAS), which was up 11%. Overall, four out of the 15 Exec Comp Aligned With ROIC Stocks outperformed the S&P in May and 11 had positive returns.

Since inception, this model portfolio is up 24% while the S&P 500 is up 18%.

The success of this Model Portfolio highlights the value of our [Robo-Analyst technology](#), which scales our forensic accounting expertise ([featured in Barron's](#)) across thousands of stocks.

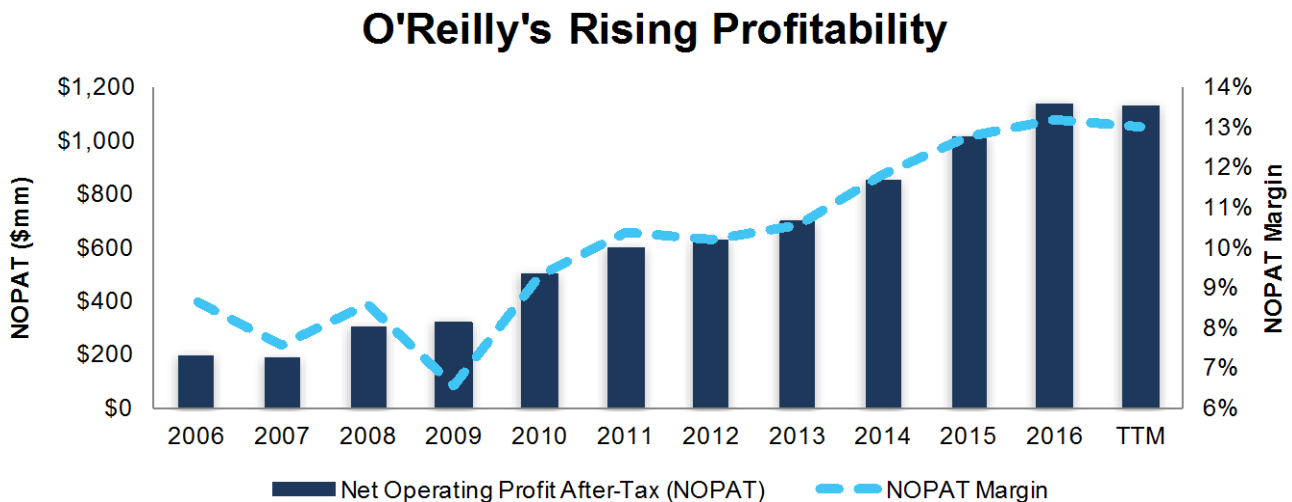
This Model Portfolio only includes stocks that earn an [Attractive or Very Attractive](#) rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas because return on invested capital (ROIC) is the [primary driver of shareholder value creation](#).

New Stock Feature for June: O'Reilly Automotive (ORLY: \$230/share)

O'Reilly Automotive (ORLY), an automotive aftermarket parts retailer, is one of the additions to our Exec Comp Aligned With ROIC Model Portfolio in June.

Over the past decade, O'Reilly has grown revenue by 14% compounded annually. Over the same time, the company has grown after-tax profit (NOPAT) by 19% compounded annually to \$1.1 billion in 2016. The accelerated NOPAT growth rate can be attributed to O'Reilly's rising NOPAT margin. Per Figure 1, NOPAT margin has improved from 9% in 2006 to 13% over the last twelve months (TTM).

Figure 1: O'Reilly's Decade of Profit Growth



Sources: New Constructs, LLC and company filings

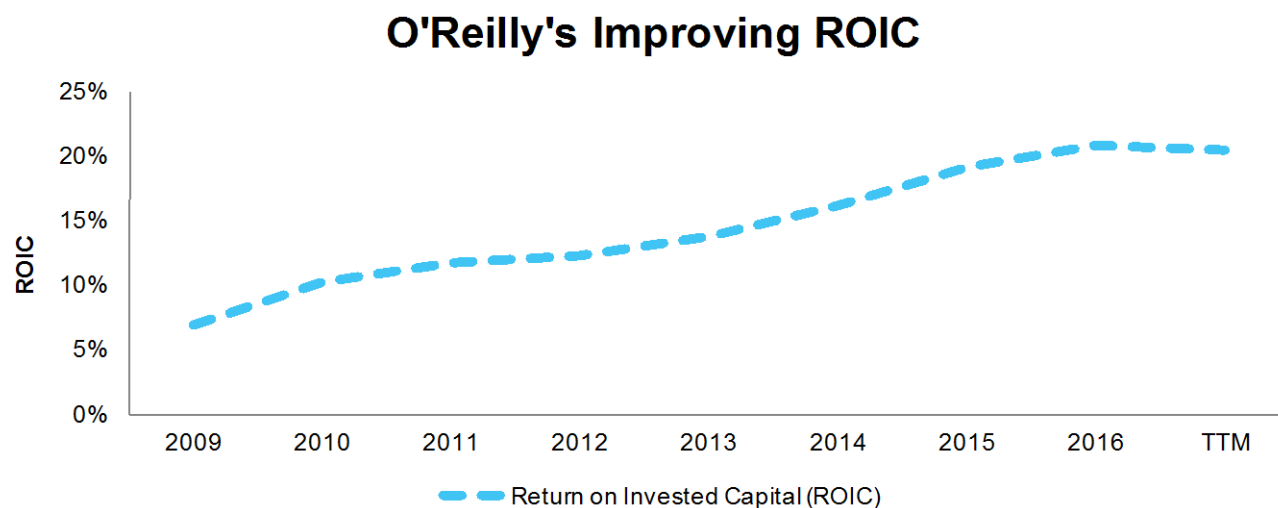
O'Reilly currently earns a top-quintile 20% return on invested capital (ROIC) and has generated a cumulative \$4 billion (19% of market cap) in free cash flow (FCF) over the past five years. O'Reilly's \$1.2 billion in FCF over the last twelve months equates to a 5% FCF yield.

Executive Compensation Plan Incentivizes Shareholder Value Creation

O'Reilly has aligned executive compensation with ROIC since 2013, when it replaced inventory turnover as a performance metric. In 2016, 20% of annual incentive compensation awards were based on ROIC. Incentive compensation represents around 40% of an executive's compensation package.

The focus on ROIC helps ensure executives are good stewards of capital. Per Figure 2, O'Reilly has improved its ROIC from 7% in 2009 to 20% TTM.

Figure 2: Improving ROIC Improves Shareholder Value



Sources: New Constructs, LLC and company filings

We've detailed ways in which ROIC is directly correlated to changes in shareholder value [here](#). ORLY's use of return on invested capital to measure performance ensures executives' interests are aligned with shareholders' interests.

Price Decline Leaves ORLY Undervalued

Over the past year ORLY is down nearly 15% while the S&P is up 17%. This price depreciation amidst improving fundamentals leaves ORLY undervalued.

At its current price of \$230/share, ORLY has a price-to-economic book value (PEBV) ratio of 1.2. This ratio means the market expects ORLY's NOPAT to only grow by 20% from current levels. This expectation seems to ignore O'Reilly has grown NOPAT by 19% compounded annually since 2006.

If O'Reilly can maintain current NOPAT margins (13%) and [grow NOPAT by just 5% compounded annually for the next decade](#), the stock is worth \$306/share today – a 33% upside.

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 a real shareholder value, we made the following adjustments to O'Reilly's 2016 10-K:

Income Statement: we made \$220 million of adjustments, with a net effect of removing \$99 million in non-operating expense (1% of revenue). We removed \$61 million in [non-operating income](#) and \$159 million in [non-operating expenses](#). You can see all the adjustments made to ORLY's income statement [here](#).

Balance Sheet: we made \$1.9 billion of adjustments to calculate invested capital with a net increase of \$1.6 billion. One of the largest adjustments was \$1.7 billion due to [operating leases](#). This adjustment represented 46% of reported net assets. You can see all the adjustments made to ORLY's balance sheet [here](#).

Valuation: we made \$4.1 billion of adjustments with a net effect of decreasing shareholder value by \$4.1 billion. There were no adjustments that increased shareholder value. Apart from [total debt](#), which includes the [operating](#)



[leases](#) noted above, one of the largest adjustments to shareholder value was \$231 million in [outstanding employee stock options](#). This adjustment represents 1% of ORLY's market cap. Despite the net decrease in shareholder value, ORLY remains undervalued.

This article originally published on [June 21, 2017](#).

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

Follow us on [Twitter](#), [Facebook](#), [LinkedIn](#), and [StockTwits](#) for real-time alerts on all our research.



New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide [tangible, quantifiable correlation](#) to stock, ETF or mutual fund performance.

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.

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.

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.