



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

Five new stocks make [August's Exec Comp Aligned With ROIC Model Portfolio](#), available to members as of 8/16/17.

Recap from July's Picks

Our Exec Comp Aligned With ROIC Model Portfolio (-3.9%) underperformed the S&P 500 (+0.7%) last month. The best performing stock in the portfolio was NVR Inc. (NVR), which was up 9%. Overall, four out of the 15 Exec Comp To ROIC Stocks outperformed the S&P in July.

Since inception, this model portfolio is up 17% while the S&P 500 is up 18%.

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.

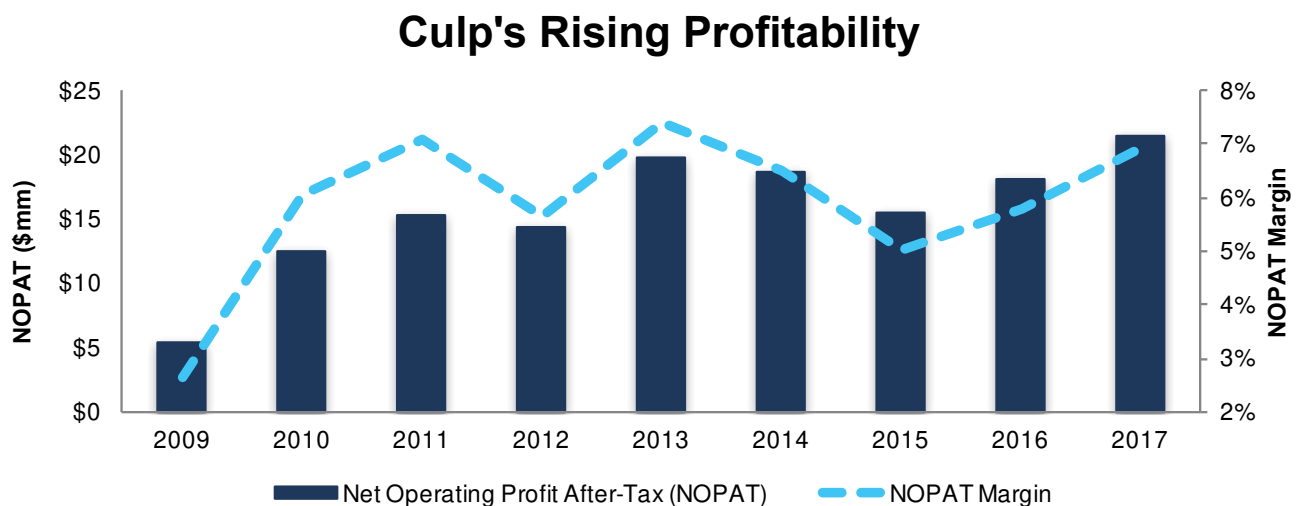
This Model Portfolio only includes stocks that earn an [Attractive or Very Attractive](#) rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas because return on invested capital ([ROIC](#)) is the [primary driver of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

New Stock Feature for August: Culp Inc. (CULP: \$28/share)

Culp Inc. (CULP), manufacturer of bedding and home fashion products, is one of the additions to our Exec Comp Aligned With ROIC Model Portfolio in August. Culp is also in August's [Most Attractive Stocks Model Portfolio](#).

Since 2009, Culp has grown revenue by 5% compounded annually. Over the same time, the company has grown after-tax profit ([NOPAT](#)) by 19% compounded annually. The accelerated NOPAT growth can be attributed to Culp's rising NOPAT margin. Per Figure 1, NOPAT margin has improved from 3% in 2009 to 7% in 2017.

Figure 1: Culp's Profit Growth Since 2009



Sources: New Constructs, LLC and company filings

Culp currently earns an 11% return on invested capital ([ROIC](#)) and has generated \$56 million (16% of market cap) of cumulative free cash flow ([FCF](#)) over the past five years. Culp's \$12 million of FCF in 2017 equates to a 4% FCF yield, which is much higher than the -1% average of stocks in the Russell 2000.

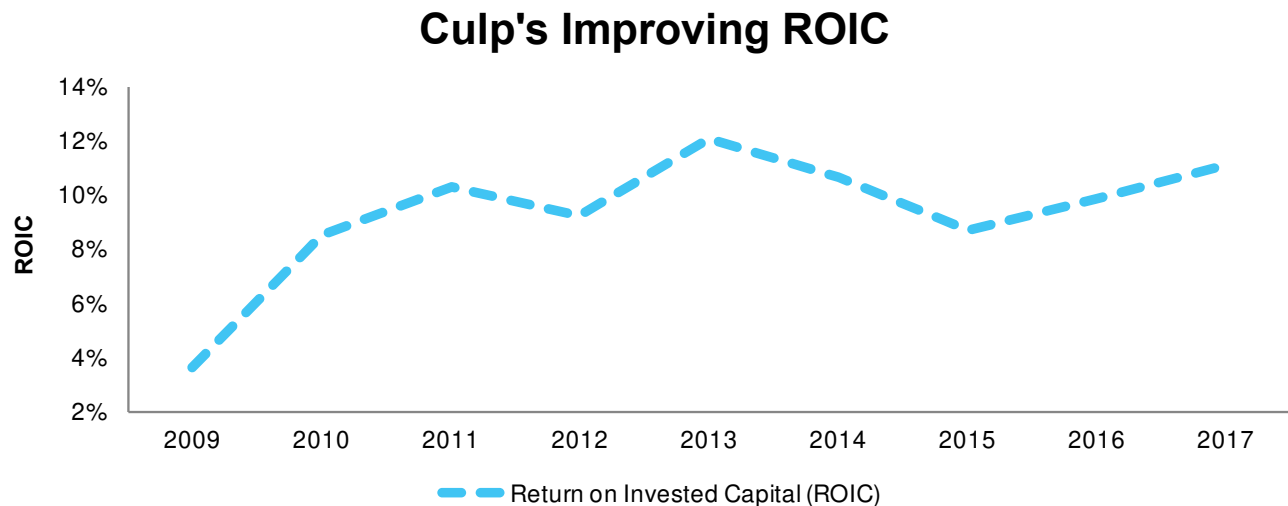
Executive Compensation Plan Incentivizes Shareholder Value Creation

Culp has aligned executive compensation with economic value added (EVA), aka [economic earnings](#), since 2011. EVA was added to the compensation plan to replace operating income, net sales, and free cash flow as

performance measures. EVA was the sole metric used to determine annual cash bonuses in 2017. Depending upon the executive, cash bonuses represent anywhere from 30%-47% of total compensation.

The focus on EVA helps ensure executives continue to be good stewards of capital. Per Figure 2, Culp's ROIC has improved from 4% in 2009 to 11% in 2017. Culp has also efficiently deployed capital and improved its average invested capital turns, a measure of balance sheet efficiency, from 1.4 in 2009 to 1.6 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](#). CULP's use of economic value added to measure performance ensures executives' interests are aligned with shareholders' interests.

Price Decline Leaves CULP Undervalued

Year-to-date, CULP is down 26% while the S&P is up 8%. This price depreciation amidst improving fundamentals leaves CULP undervalued.

At its current price of \$28/share, CULP has a price-to-economic book value (PEBV) ratio of 0.8. This ratio means the market expects CULP's NOPAT to permanently decline by 20%. This expectation seems to overlook the fact that Culp has grown NOPAT by 19% compounded annually since 2009.

If Culp can maintain current NOPAT margins (7%) and [grow NOPAT by just 3% compounded annually for the next decade](#), the stock is worth \$37/share today – a 32% 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 Culp's 2017 10-K:

Income Statement: we made \$5 million of adjustments, with a net effect of removing \$1 million in non-operating income (<1% of revenue). We removed \$3 million in [non-operating income](#) and \$2 million in [non-operating expenses](#). You can see all the adjustments made to CULP's income statement [here](#).

Balance Sheet: we made \$133 million of adjustments to calculate invested capital with a net increase of \$33 million. One of the largest adjustments was \$67 million due to [asset write downs](#). This adjustment represented 42% of reported net assets. You can see all the adjustments made to CULP's balance sheet [here](#).

Valuation: we made \$47 million of adjustments with a net effect of increasing shareholder value by \$31 million. The largest adjustments to shareholder value was \$39 million in [excess cash](#). This adjustment represents 11% of CULP's market cap.



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

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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.

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