Acquiring Revenue Can Quickly Destroy Shareholder Value

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life.

This firm moved to bolster its position within its market by acquiring a competitor in 2016, but it paid too high a price. In addition, the expected synergies from the deal have not come to fruition and the profitability of the combined firm has fallen instead of rising. Despite the struggles, the expectations baked into the stock price remain overly optimistic and leave shares significantly overvalued. For these reasons and more, Diebold Nixdorf Inc. (DBD: $18/share) is in the Danger Zone.

DBD Struggled to Grow Profits Before the Acquisition

During the 10-year period prior to the acquisition (2005-2015), DBD's revenues and after-tax profit (NOPAT) declined 1% compounded annually. The company's NOPAT margin fell from 6% in 2011 to 4% in 2015 while its ROIC fell from 11% in 2011 to 6% in 2015. DBD's balance sheet efficiency, or invested capital turns, fell from 1.9 in 2011 to 1.5 in 2015.

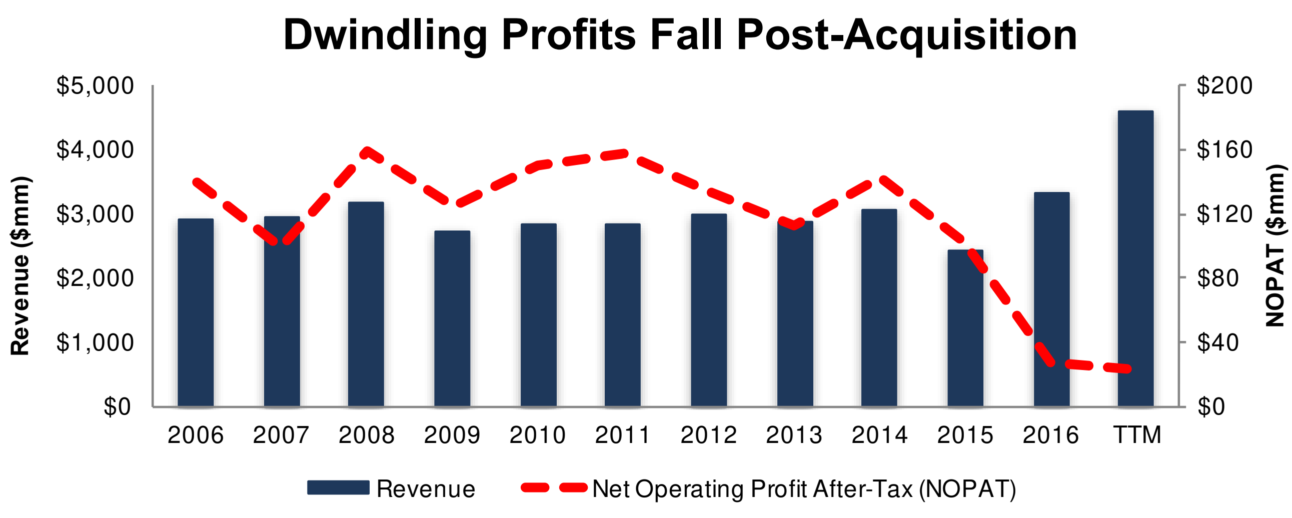
Post-Acquisition Results Have Been Even Worse

Management indulged in the common imprudent capital allocation mistake to purchase artificial growth in revenue and earnings by acquiring German competitor Wincor Nixdorf for $1.8 billion. The combined company created the largest maker of automated teller machines (ATM) and surpassed competitor NCR Inc. (NCR) in terms of installed ATMs (though revenues are still much lower $4.6 billion vs $6.5 billion for NCR). Based on the purchase price, and DBD's 5.1% WACC at the time, the deal would need to generate $92 million in additional NOPAT just to ensure the purchase price was value neutral, and not destructive to shareholders. Unfortunately, the required NOPAT failed to materialize. While DBD bought significant increases in revenue, the bottom line profits actually dropped as integration costs outpaced any synergies by a wide margin.

Per Figure 1, DBD's NOPAT fell 73% in 2016 to $28 million, and further, to $23 million over the last twelve months. The company's NOPAT margin fell to 0.8% in 2016 and 0.5% TTM while average invested capital turns fell to 1.2 TTM (down from 1.5 pre-acquisition). As a result, ROIC fell to 1% in 2016 and 0.6% TTM.

Meanwhile, the company's revenue soared 37% in 2016 to $3.3 billion and $4.6 billion TTM.

Figure 1: DBD's Profit Collapse After Acquiring Wincor Nixdorf



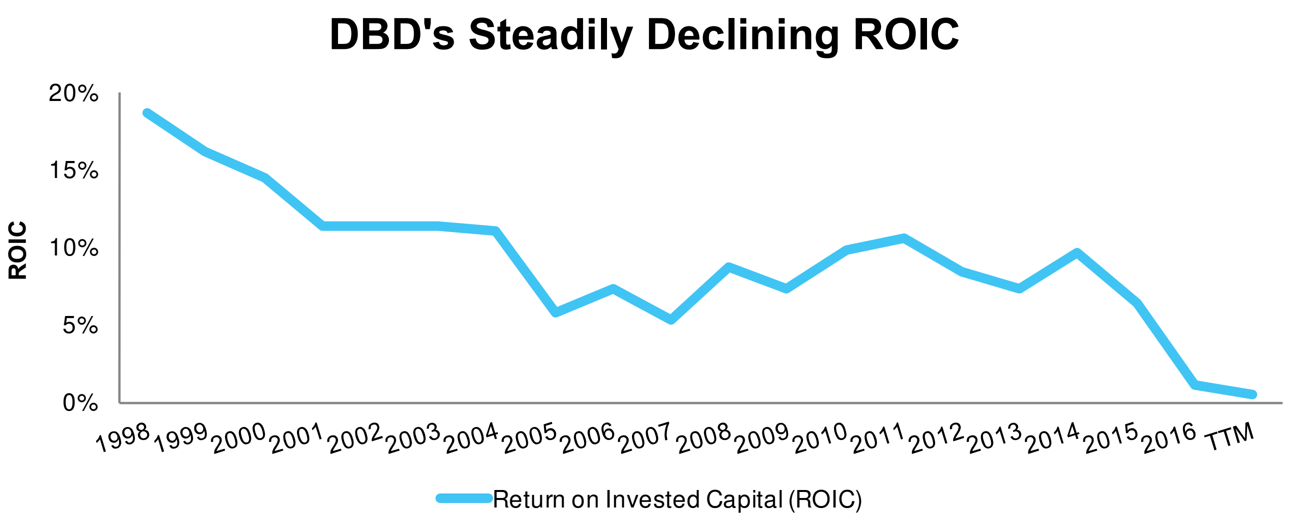
Sources: New Constructs, LLC and company filings

Compensation Plan Failed to Stop Damaging Acquisition

Diebold's executive compensation plan fails to properly align executives' interests with shareholders' interests. The misalignment helps drive poor decisions that destroy shareholder value while executives are eligible for large bonuses. Executives' annual cash bonuses are tied to non-GAAP operating profit, free cash flow, and "key initiatives." Performance based shares, which make up 50% of long-term equity incentives are tied to cumulative three-year total shareholder return.

Unfortunately for investors, non-GAAP operating profit excludes key operating expenses such as legal/acquisition expenses, acquisition integration charges, and Wincor Nixdorf purchase accounting adjustments. Essentially, executives receive bonuses on a metric that removes much of the cost of acquiring Wincor Nixdorf, while shareholder value is destroyed. Not surprisingly, DBD's economic earnings fell from $0 million in 2015 to -$95 million in 2016, and -$187 million TTM. Such poor allocation of capital is not new, either. Per Figure 2, DBD's ROIC has been in long-term decline. What else should we expect from a firm that allows executives to get big payouts while shareholder value is destroyed?

Figure 2: DBD's ROIC Since 1998



Sources: New Constructs, LLC and company filings

We've demonstrated through numerous case studies that ROIC, not total shareholder return, non-GAAP operating profit, key initiatives, or free cash flow, is the primary driver of shareholder value creation. A recent white paper published by Ernst & Young also validates the importance of ROIC (see here: Getting ROIC Right) and the superiority of our data analytics. Without major changes to this compensation plan (e.g. emphasizing ROIC), investors should expect further value destruction.

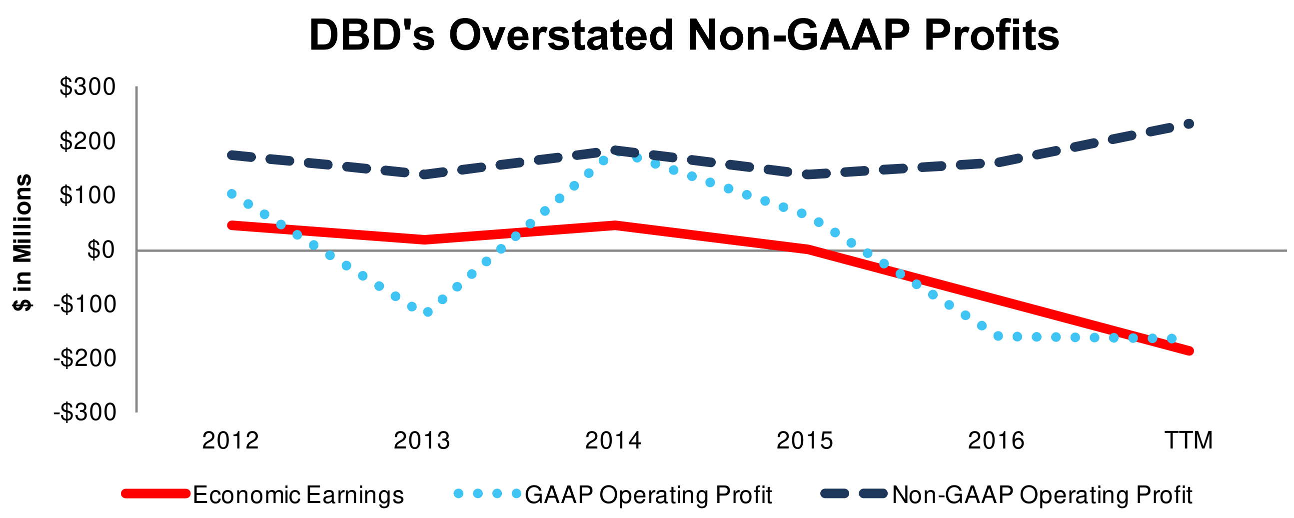
Non-GAAP Metrics Show Misleading Profit Growth

Diebold is among a long list of firms that use non-GAAP metrics, such as EBITDA and non-GAAP operating income, to mask the severity of declining profits. Our research digs deeper so our clients see through the illusory numbers. Below are some of the items Diebold removes to calculate its non-GAAP net income:

1. Restructuring charges
2. Impairment charges
3. Legal/ acquisition and divestiture expenses
4. Acquisition integration expenses
5. Wincor Nixdorf purchase accounting adjustments

These adjustments have a large impact on the disparity between DBD's reported GAAP operating profit, non-GAAP operating profit, and economic earnings. In fact, DBD's non-GAAP metrics have shown operating profit improving while the true economics of the business are in decline. In 2016, DBD removed over $59 million in restructuring charges, $118 million in acquisition expenses, and $128 million in purchase accounting adjustments (combined 9% of revenue). Combined with other adjustments, DBD reported non-GAAP operating profit of $159 million, compared to -$160 million in GAAP operating profit and -$95 million in economic earnings. In the TTM period, DBD reported $233 million in non-GAAP operating profit, -$164 million in GAAP operating profit, and -$187 million in economic earnings, per Figure 3.

Figure 3: DBD's Misleading Non-GAAP Metrics



Sources: New Constructs, LLC and company filings

Falling Margins are a Red Flag Against More Profitable Peers

Diebold provides the technology and hardware to enable millions of financial transactions each day around the globe. The company's acquisition of Wincor Nixdorf created the largest manufacturer in the global ATM market, as measured by RBR's Global ATM Market and Forecasts report. As of October 2017, DBD held a 32% share of the global market, just ahead of NCR Inc., which has a 27% market share. Apart from NCR, Diebold still faces competition from Hyosung, GRG Banking, and Triton systems. To diversify the business away from strictly hardware ATM's, DBD has increased its software and service offerings, which opens up competition to the likes of Fiserv (FISV), International Business Machines (IBM), HP (HPQ), Toshiba, FEC, and MICROS (acquired by Oracle (ORCL) in 2014).

Over the past five years, the industry has seen margins decline, as cashless options, such as virtual wallets and mobile app payments, have grown in popularity. DBD's margins were already below its peer group, as well as main competitor NCR, and the gap has only grown larger, as seen in Figure 4.

Success in the payment market is largely dependent on the ability to quickly process transactions, service equipment, sell new/upgraded equipment, and provide seamless software solutions that meet the many needs (omni-channel, self-service, security) of financial transactions. Despite purchasing a larger market share, DBD is expanding in a shifting market with lower margins than its main competitors, which puts the firm at a significant disadvantage.

Figure 4: Diebold's Margin Disadvantage is Growing Larger

Net Operating Profit After Tax (NOPAT) Margin						
Company / Peer Group	**2012**	**2013**	**2014**	**2015**	**2016**	**TTM**
DBD Peer Group Average	11%	11%	10%	10%	9%	9%
NCR Inc.	8%	7%	8%	4%	9%	8%
Diebold Nixdorf Inc.	5%	4%	5%	4%	1%	1%
Margin Disadvantage: DBD vs. Peers	**-6%**	**-7%**	**-5%**	**-6%**	**-8%**	**-8%**
Margin Disadvantage: DBD vs. NCR	**-3%**	**-3%**	**-4%**	**0%**	**-8%**	**-7%**

Sources: New Constructs, LLC and company filings

Bull Case Ignores Changing Payment Habits and Unprofitable Services Expansion

The largest threat to Diebold's business model is the rapidly changing ways in which we transact business. Whereas cash was once the only way to purchase goods, a slew of new technologies have been created to make cash nearly obsolete. To combat this shift, DBD has increased its services business, expanding its retail software and self-service software offerings. This shift is aimed at creating a higher margin business segment to offset any weakness in ATM & payment terminal hardware.

However, to buy into this bull case, one must ignore the shifting payment landscape, which brings an onslaught of competition, and DBD's failure to grow revenues faster than its expenses as it has grown its service business.

While the fears of cash becoming ancient history are likely overblown, there is no denying that cash has less importance in the current retail environment. Companies like Square (SQ) have provided low-cost terminals that allow business of all sizes to offer cashless payment and even new uses such as Apple Pay. Additionally, the rise of money-transfer apps, such as Venmo, Alipay, or Tenpay have removed the need for consumers to even carry credit/debit cards, much less cash. Don't forget about PayPal (PYPL), either.

A perfect example of the new transaction society is in this The New York Times article: "In Urban China, Cash Is Rapidly Becoming Obsolete". The author notes how nearly all payments in China can be done via smartphone. Richard Lim, managing director of GSR Ventures is quoted as saying "recent data shows that Ant Financial and Tencent were set to surpass Visa and MasterCard in total global transactions per day in the coming year." The rise of these services eliminates the need for new ATM machines, but instead increases demand for new types of payment terminals, a market in which DBD does not hold a leading market share (4% of Point of Sale market, compared to NCR's 18%, according to RBR's research). The point of sale terminal is also a very different market where new technology firms like Square have quickly taken share. We don't think DBD will ever be a force in these new markets.

More evidence of the erosion of the business model due to shifting technology could be seen in DBD's 2Q17 earnings, where the firm noted that key banking customers have deferred new hardware/software purchase decisions. Banks don't think they need DBD's products and services any more. Uncertainty regarding the future of cash vs. cashless transactions will continue to negatively impact DBD's revenue should customers continue putting off purchase decisions.

Furthering the issues, DBD's expansion into software has run into the same issues we've seen across many software-as-a-service firms, namely runaway costs. Per Figure 5, DBD's R&D and engineering costs, selling & administrative costs, and cost of revenue have all grown faster than revenue since 2012. We've seen firm's struggle when shifting from "on-site offerings" to "cloud-based" such as recent Danger Zone pick CommVault (CVLT), and Diebold's shift to software and away from hardware could see similar issues.

Figure 5: DBD's Expenses Outpacing Revenue Growth

Operating Item	2012	TTM	CAGR
R&D and Engineering Expense	$86	$157	13%
Selling & Administrative	$528	$947	12%
Cost of Revenue	$2,262	$3,651	10%
Revenue	$2,992	$4,603	9%

Sources: New Constructs, LLC and company filings

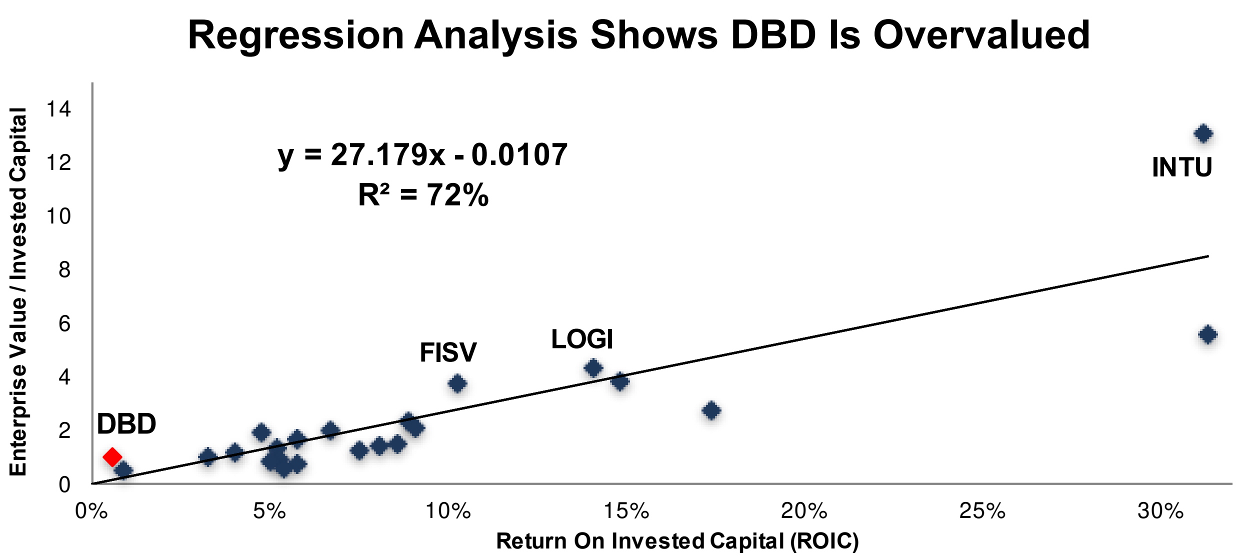
When put together, these issues are at odds with DBD's current valuation, which is a key risk to any bull thesis. As we'll show below, the expectations embedded in the current stock price imply that DBD will immediately grow profits at rates well above the recent trend.

DBD's Valuation Still Implies Unrealistic Profit Growth After Decline

DBD has fallen 32% year-to-date, while the S&P is up nearly 15% as investors have rightfully sold the stock after its poor acquisition. Despite the decline, shares could still have further to fall. With falling NOPAT, margins, and ROIC, there remains a disconnect between the company's current financial performance and the significantly higher profits implied by the stock's market value.

Figure 6 shows DBD and its peers compared on the basis of ROIC and enterprise value divided by invested capital (a cleaner version of price to book). As you can see, ROIC explains 72% of the changes in valuation for DBD's peers.

Figure 6: ROIC Explains 72% of Valuation for the DBD's Peer Group



Sources: New Constructs, LLC and company filings

DBD trades at a premium to its peers. If the stock were to trade a parity with the peer group, it would be less than $0/share, given the firm's large liabilities. After accounting for the firm's deteriorating fundamentals, it should be clear that DBD does not deserve its premium valuation.

Our discounted cash flow model quantifies the expectations baked into that premium valuation. To justify its current price of $18/share, DBD must immediately achieve NOPAT margins of 4% (five year average prior to acquisition) and grow NOPAT by 25% compounded annually for the next 10 years. This scenario seems overly optimistic given DBD's profit declines pre-and post-acquisition.

Even if we assume DBD can achieve a 3% NOPAT margin (compared to 0.5% TTM) and grow NOPAT by 20% compounded annually for the next decade, the stock is still worth only $6/share today – a 67% downside.

Is DBD Worth Acquiring?

The largest risk to any bear thesis is what we call "stupid money risk", which means an acquirer comes in and pays for DBD at the current, or higher, share price despite the stock being overvalued. While DBD's struggling business may scare off any potential suitors, a firm within its industry could see the lowered valuation (compared to beginning of the year) as a buying opportunity. Competitors would be better suited to use their competitive advantage to outmaneuver DBD rather than ignore prudent stewardship of capital and destroy substantial shareholder value in an acquisition.

We show below how expensive DBD remains even after assuming an acquirer can achieve significant synergies.

Walking Through the Acquisition Value Math

To begin, Diebold has liabilities of which investors may not be aware that make it more expensive than the accounting numbers suggest.

1. $525 million in minority interests (39% of market cap)
2. $278 million in underfunded pensions (21% of market cap)
3. $205 million in off-balance-sheet operating leases (15% of market cap)
4. $9 million in deferred compensation (1% of market cap)
5. $1 million in outstanding employee stock options (<1% of market cap)

After adjusting for these liabilities, which total 76% of DBD's market cap, we can model multiple purchase price scenarios. Even in the most optimistic of scenarios, DBD is worth no more than its current share price.

Figures 7 and 8 show what we think NCR Inc. (NCR) should pay for DBD to ensure it does not destroy shareholder value. NCR is Diebold's main competitor in the ATM industry and combining the two could create the consolidation needed to operate more profitably in a shifting industry. However, there are limits on how much NCR would pay for DBD to earn a proper return, given the NOPAT and free cash flows (or lack thereof) being acquired.

Each implied price is based on a 'goal ROIC' assuming different levels of revenue growth. In both scenarios, the estimated revenue growth rate is 38% in year one and 2.4% in year two, which is the consensus estimate of revenue growth for the next two years. For the subsequent years, we use 2.4% in scenario one because it represents a continuation of next year's expectations. We use 5% in scenario two because it assumes a merger with NCR would create revenue synergies thorough a streamlined installed base.

We conservatively assume that NCR can grow DBD's revenue and NOPAT without spending anything on working capital or fixed assets beyond the original purchase price. We also assume DBD immediately achieves a 4% NOPAT margin, which is the average of NCR's and DBD's current NOPAT margin. For reference, DBD's TTM NOPAT margin is 0.5%, so this assumption implies immediate improvement and allows the creation of a truly best-case scenario.

Figure 7: Implied Acquisition Prices for NCR to Achieve 6% ROIC

To Earn 6% ROIC On Acquisition		
Revenue Growth Scenario	DBD's Implied Stock Value	% Discount to Current Price
9% CAGR for 5 years	$12	30%
12% CAGR for 5 years	$17	2%

Sources: New Constructs, LLC and company filings.

Figure 7 shows the 'goal ROIC' for NCR as its weighted average cost of capital (WACC) or 6%. Even if DBD can grow revenue by 12% compounded annually with a 4% NOPAT margin for the next five years, the firm is worth no more than its current price of $18/share. It's worth noting that any deal that only achieves a 6% ROIC would be only value neutral and not accretive, as the return on the deal would equal NCR's WACC.

Figure 8: Implied Acquisition Prices for NCR to Achieve 7% ROIC

To Earn 7% ROIC on Acquisition		
Revenue Growth Scenario	DBD's Implied Stock Value	% Discount to Current Price
9% CAGR for 5 years	$6	68%
12% CAGR for 5 years	$10	44%

Sources: New Constructs, LLC and company filings.

Figure 8 shows the next 'goal ROIC' of 7%, which is NCR's current ROIC. Acquisitions completed at these prices would be truly accretive to NCR shareholders. Even in the best-case growth scenario, the most NCR should pay for DBD is $10/share (44% downside to current valuation). Any scenario assuming less than 12% compound annual growth in revenue would result in further capital destruction for NCR.

Another Revenue or Guidance Disappointment Could Send Shares Lower

Expectations for DBD's earnings have been significantly cut throughout 2017. 2018 EPS expectations have fallen 43% since the beginning of the year and while DBD has beaten lowered expectations, the stock continues to fall. DBD has met or beat EPS expectations in six consecutive quarters. However, over the same time, revenue has beat expectations only once. During this time, the stock has seen significant cuts in in price. The stock fell 27% in the two days following 2Q17 earnings, in which management lowered full year guidance. DBD fell another 8 % in the week following 3Q17 earnings after revenue missed expectations and GAAP EPS estimates were cut again for the full year.

While expectations have been lowered, the stock still reflects overly optimistic profit growth expectations, as highlighted above. If DBD fails to realize the promised synergies of the Wincor acquisition, the stock could see a similar crash to that of 2Q17, as investors realize the company's business, despite its market leading size, is struggling to find footing in a highly competitive market.

While we don't attempt to predict exactly when the market will recognize the disconnect between expectations and reality, we know the impact of failing to meet expectations can be dangerous to investors' portfolios. Even after a large drop in price throughout 2017, DBD still represents an unfavorable risk/reward tradeoff.

Insider Trading is Minimal While Short Interest is Rising

Over the past 12 months, 289 thousand insider shares have been purchased and 73 thousand have been sold for a net effect of 216 thousand insider shares purchased. These purchases represent less than 1% of shares outstanding.

Short interest is currently 15.2 million shares, which equates to 20% of shares outstanding and 13 days to cover. There has been a significant jump in short interest this year, as the number of shares sold short has increased from 8.5 at the end of 2016, a 79% increase. Growing short interest would seem to imply we're not the only ones who recognize the issues facing DBD and its lofty valuation.

Auditable Impact of Footnotes & Forensic Accounting Adjustments[1]

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 Diebold Nixdorf's 2016 10-K:

Income Statement: we made $623 million of adjustments with a net effect of removing $61 million in non-operating expense (2% of revenue). We removed $342 million related to non-operating expenses and $281 million related to non-operating income. See all the adjustments made to DBD's income statement here.

Balance Sheet: we made $3.3 billion of adjustments to calculate invested capital with a net decrease of $1 billion. The most notable adjustment was $1 billion (30% of reported net assets) related to mid-year acquisitions. See all adjustments to DBD's balance sheet here.

Valuation: we made $3.2 billion of adjustments with a net effect of decreasing shareholder value by $2.6 billion. Apart from $2.1 billion in total debt, which includes $205 in off-balance sheet operating leases, the largest adjustment to shareholder value was $525 million in minority interests. This minority interest adjustment represents 43% of DBD's market cap.

Unattractive Funds That Hold DBD

The following funds receive our Unattractive-or-worse rating and allocate significantly to Diebold Nixdorf.

1. Tocqueville Select Fund (TSELX) – 5.3% allocation and Unattractive rating
2. AMG SouthernSun Small Cap Fund (SSSFX) – 5.1% allocation and Unattractive rating
3. Tocqueville Trust: Delafield Fund (DEFIX) – 3.8% allocation and Unattractive rating
4. Cambiar Small Cap Fund (CAMZX) – 1.9% allocation and Unattractive rating

This article originally published on November 20, 2017.

Disclosure: David Trainer and Kyle Guske II 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.

[1] Ernst & Young's recent white paper, "Getting ROIC Right", proves the superiority of our research and analytics.

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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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