Danger Zone Highlights & Lowlights From 2017

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

Our Danger Zone reports aim to identify firms that, despite more sanguine indications from GAAP and non-GAAP metrics, have struggling businesses and highly overvalued stock prices.

It pays to read our Danger Zone reports. In 2017, 14 out of our 27 Danger Zone picks saw negative returns and 18 underperformed the market (S&P 500). All in, the Danger Zone stocks averaged a 5% return in 2017 versus the S&P 500's 18% rise, and outperformed as a short portfolio.

However, the thesis does not always play out as we expect and, at times, some stocks only get more overvalued.

Below, we present the Danger Zone highlights of 2017, followed by the lowlights.

Danger Zone Highlights

1. **Highlight 1: Acadia Healthcare (ACHC) – published August 7 – Closed October 31: Down 40% vs. S&P up 4%**

We originally featured Acadia Healthcare in July 2016 and noted the company had all the makings of a Wall Street roll-up scheme. After ranking as one of the Danger Zone highlights of 2016, we doubled down on our Danger Zone call on ACHC in August 2017. We highlighted the misleading nature of Acadia's non-GAAP metrics, particularly adjusted EBITDA. These contrived metrics showed rising profits while real cash flows were in severe decline. Specifically, ACHC's adjusted EBITDA rose from $35 million in 2011 to $699 million in 2016. Meanwhile, economic earnings had fallen from -$2 million to -$71 million over the same time.

The troubling acquisition strategy we noted in our original report remained a problem. Acadia's return on invested capital (ROIC) continued to rank near the bottom of peers, and had fallen from 9% in 2012 to 4% in August 2017.

The big decline for ACHC came in late October, when the firm missed top and bottom line expectations and lowered guidance in the process. Subsequent downgrades from analysts at Deutsche, Jefferies, and Baird helped drive the stock down 26% the day after the earnings report. After this precipitous fall, we made the decision to close this Danger Zone pick on October 31.

In the end, ACHC fell 40% from August 7 to the day we closed the position, October 31, while the S&P rose 4%.

2. **Highlight 2: TrueCar Inc. (TRUE) – published August 21 – revisited November 7: Down 32% vs. S&P up 10%**

TrueCar reminded us of a previous Danger Zone pick, Angie's List (ANGI), which at one point fell 50%. The similarities between their business models included lack of profitability, declining return on marketing spend, strong competition, and an inherent conflict between the success of its users (car consumers) and its suppliers (car dealers). TrueCar struggles to provide value to either, and it is impossible to provide significant value to both at the same time.

Early on, the company ran ads promoting the benefit for consumers and highlighted the stereotypical sleazy and greedy car salesman. Unfortunately, this negative depiction led to dealers dropping TrueCar en masse. When the founder was replaced by a new CEO (Chip Perry) in 2015, the switch in favor to dealers was clear. Perry mentioned dealers nearly three times as often as consumers during the company's earnings calls. However, in providing more value to dealers, the consumer benefit was severely diminished.

The results of this struggle manifested in TrueCar's rising marketing costs per visitor, and its overall sales & marketing costs, which grew faster than revenue in 3Q17. Further fueling the bear case, TrueCar ranked near the bottom of its peer group in regards to page views and the internet/commerce giant, Amazon (AMZN), had plans to start a car program in Europe.

Just like with Angie's List in 2013, the problems with TRUE's broken business model revealed themselves in a quarterly earnings report. The company reported 3Q17 revenue that missed expectations and lowered full-year guidance. In the quarter, monthly unique visitor rose just 1% and the amount TrueCar earned per transaction fell by 4%. The stock fell 35% the day after earnings.

TRUE ended 2017 down 32% while the S&P was up 10%. TRUE still earns our Unattractive rating and, despite the decline, its valuation implies significant future profit growth. This combination of weak business model and overvalued stock price landed TrueCar in our current Focus List – Short Model Portfolio.

3. **Highlight 3: Snap Inc. (SNAP) – published February 6 before IPO on March 2: Down 39% from IPO price vs. S&P up 13%**

In a year that included significant debate over the Fiduciary Duty of Care, SNAP highlighted the need to protect investors from misleading research.

Out of the gates, SNAP revealed major cash losses in its S-1. The company's filings revealed NOPAT fell from -$344 million in 2015 to -$498 million in 2016. Its NOPAT margin was a staggering -123%, and it earned a bottom-quintile ROIC of -34%. Snap's non-GAAP metrics couldn't even hide the firm's large losses.

Despite the clear issues, SNAP generated enough interest as the "next big tech IPO" that its IPO priced above its initial range. At its IPO, SNAP's valuation implied it would grow profits at the same level as Facebook (FB) in its first years as a public company. Subsequent earnings reports revealed this expectation to be far too optimistic.

The discrepancy between underwriters' and non-underwriters' research also provided the perfect cautionary tale on Sell-Side ratings in 2017. When the quiet period on underwriters' research ended, nine of the 13 underwriters issued "buy" ratings and four issued "hold" ratings. This positive sentiment was in stark contrast to the 11 non-underwriter analysts who initiated coverage prior to the IPO with a "Hold" or "Sell" ratings. The conflicted nature of Wall Street research was on full display as IPO underwriters did not want to publish negative reports just weeks after selling clients on an IPO's potential nor did they want to offend the bankers that worked hard to win the IPO deal in the first place.

In April, one of the underwriting firms' analysts was forced to correct an error in his model that inflated SNAP's forecasted earnings by $5 billion over five years. Despite the significant reduction in projected cash flows, the analyst kept the same $28 price target and "Buy" rating.

As the "saga" unfolded, SNAP's first earnings report proved many of the skeptics right. SNAP missed on both top and bottom line expectations, and user growth came in below estimates. The stock fell 21% the following day. Furthering concerns, Facebook reported positive results of its Instagram Stories (a Snapchat like service), and it became clearer to everyone that Snap faced an uphill battle.

As the year went on, SNAP's prospects failed to improve. It missed again on both top and bottom line in its 2Q17 earnings. In November, Morgan Stanley, one of the company's IPO underwriters, downgraded the stock to Underweight. All told, SNAP ended 2017 down 39% from its IPO of $24/share while the S&P was up 13%. SNAP still earns our Unattractive rating and is in our Focus List – Short Model Portfolio.

Honorable Mention: Pandora Media (P) – published March 13 – closed May 9: Down 18% vs. S&P up 1%

When reports surfaced in May 2017 that the firm was looking to sell itself we decided to close the position. Stupid money risk can ruin any solid short thesis and heavily impact the risk/reward scenario. While the stock was already down 18%, the closing of this position would prove too early. The sale of Pandora never materialized and the stock ended 2017 down 60% from the time our Danger Zone report was published while the S&P was up 13%.

Danger Zone Lowlights

While reviewing some of the most successful calls, we also highlight Danger Zone picks that did not work. Even where we were wrong, we think our reasoning for putting these stocks in the Danger Zone was solid and made them especially risky investments despite their good performance.

1. **Lowlight 1: Redfin (RDFN) – published July 24: Up 109% from opening IPO price vs. S&P up 8%**

Redfin's stock rise played out as a near polar opposite to Snap when it came to IPOs in 2017. However, the underlying fundamentals remain just as weak. Prior to the IPO, Redfin faced an important question; is the company a traditional brokerage or a tech firm? In order to justify its lofty IPO valuation, it needed to convince the market it was the latter. Despite generating roughly 90% of its revenue from traditional brokerage commissions, the market gave RDFN the tech valuation it was seeking.

Regardless of the firm's -$21 million NOPAT, -8% NOPAT margin, and -17% ROIC, the stock soared nearly 50% on its IPO date. Investors were willing to overlook the problems in the business in the hopes that Redfin's technology could significantly alter the longstanding realtor business model.

Moving forward, the firm's negative profitability would appear to make future profit growth a challenge, especially when competitors such as Zillow (ZG) and Realogy (RLGY) have higher margins. Ultimately, the initial valuation, and subsequent doubling in price have made RDFN even more overvalued. While we underestimated the IPO pop in 2017, we still believe RDFN presents significant downside. It still earns an Unattractive rating and after rising 109% from its opening IPO price, finds itself in our Focus List – Short Model Portfolio.

We believe the price increase in 2017 could swing the other way this year as Redfin reports additional quarterly earnings. The beginnings of such a turnaround may have already begun as the stock is down 12% in 2018.

2. **Lowlight 2: LivePerson Inc. (LPSN) – published March 20: Up 65% vs. S&P up 13%**

In our report on LivePerson, we noted, "as the market commoditized, this firm's negative margins and limited service offering undermined its ability to compete." The company's profits would reflect as much, as NOPAT had fallen from $13 million in 2011 to -$9 million in 2016. The decline in profit came despite revenue growing 11% compounded annually over the same time.

When we placed LivePerson in the Danger Zone, we felt its lagging margins, misaligned executive compensation, and inability to scale would send shares falling. Instead, LPSN reported revenue growth above expectations in its first three fiscal quarters, and the market rewarded it with a higher valuation.

At the time we wrote our report, the firm's valuation implied it would immediately achieve positive margins and grow revenue by 10% compounded annually for 12 years. While the firm's TTM margin is slightly higher than in 2016, it remains negative. Additionally, TTM revenue remains down year over year and consensus estimates call for only 7% revenue growth in 2018

However, as with Redfin above, our miss on LPSN seems to be more about timing, rather than any significant improvement in the fundamentals of the business. At the end of the year, LPSN was up 65% while the S&P was up just 13%. LivePerson still earns our Unattractive rating and could see a significant cut in its stock price should the revenue growth momentum stall in 2018.

3. **Lowlight 3: Tableau Software (DATA) – published March 6: Up 36% vs. S&P up 13%**

Tableau Software represents many of the same conundrums seen in the analysis of LivePerson. The company provides data visualization tools to help clients understand and interpret datasets. It faces strong competition from the likes of Oracle, (ORCL), Amazon (AMZN), and Microsoft (MSFT), and has seen profits fall from $4 million in 2012 to -$119 million in 2016. Tableau truly tests the limits of how long investors are willing to forgo profits in return for hyper revenue growth and "future profitability" of the software-as-a-service business model.

After rising over 20% in the two months prior to publishing our Danger Zone report, we felt that DATA's valuation had reached a peak because it implied the firm would achieve 9% NOPAT margins (vs -14% in 2016) and grow revenue by 20% compounded annually for 11 years. Meanwhile, consensus estimates for revenue growth in 2017 and 2018 were 5% and 9% respectively.

Despite the disconnect between fundamentals and valuation, DATA continued to rise throughout the year. The firm beat revenue expectations in February and August. Overall, DATA ended 2017 up 36% since our Danger Zone report was published while the S&P was up 13%.

We've seen such rapid price appreciation before, and a subsequent downfall. From mid 2014 to mid 2015, DATA rose over 140%, only to fall 70% in the second half of 2015. Could 2018 bring a fall in DATA's stock price similar to that of 2015? The stock still earns our Unattractive rating and its valuation still implies unrealistic profit growth.

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

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