Featured Stocks in January's Safest Dividend Yields Model Portfolio

Eight new stocks make our Safest Dividend Yield Model Portfolio this month, which was made available to members on January 19, 2018.

Recap from December's Picks

Our Safest Dividend Yields Model Portfolio underperformed the S&P 500 last month. The Model Portfolio rose 1.6% on a price return basis and rose 2.4% on a total return basis. The S&P 500 rose 4.5% on a price return and total return basis. The best performing stocks in the portfolio were large cap stock Seagate Technology (STX), which was up 24%, and small cap stock, DineEquity Inc. (DIN), which was up 4%. Overall, four out of the 20 Safest Dividend Yields stocks outperformed the S&P in December, while 11 had positive returns.

This Model Portfolio leverages our Robo-Analyst technology, which scales our forensic accounting expertise (featured in Barron's) across thousands of stocks.[1]

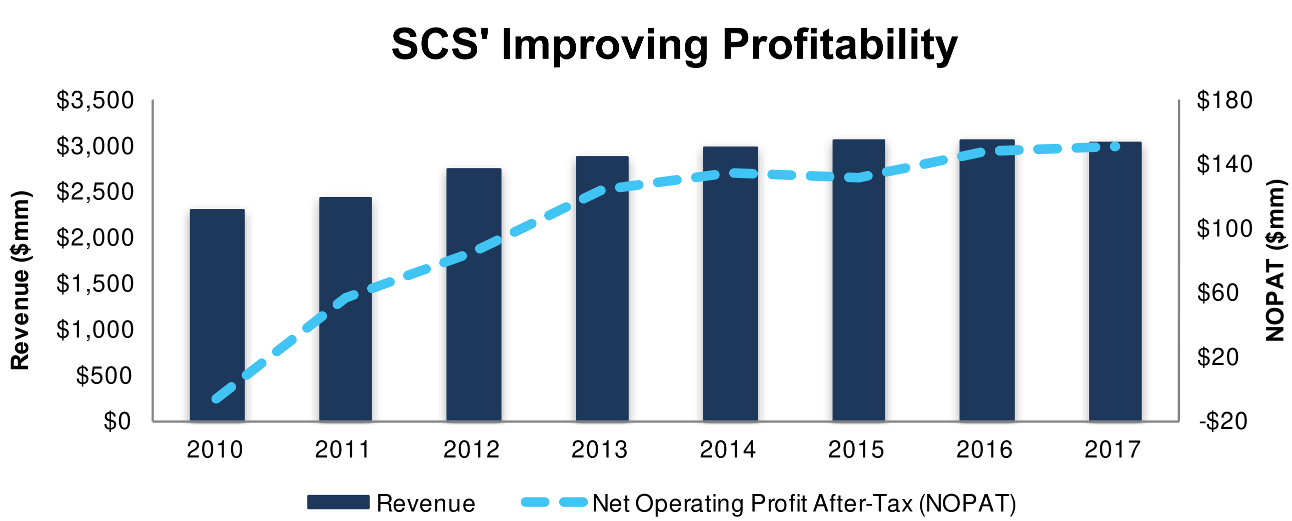
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating, have positive free cash flow and economic earnings, and offer a dividend yield greater than 3%. Companies with strong free cash flow provide higher quality and safer dividend yields because we know they have the cash to support the dividend. We think this portfolio provides a uniquely well-screened group of stocks that can help clients outperform.

Featured Stock for January: Steelcase Inc. (SCS: $16/share)

Steelcase Inc. (SCS), a manufacturer of office furniture and other interior architectural products, is the featured stock in January's Safest Dividend Yields Model Portfolio. SCS was previously featured in June 2017. Since then, the stock is up 12% while the S&P 500 is up 17%.

Since 2011, SCS has grown revenue 4% compounded annually while after-tax profit (NOPAT) has grown 18% compounded annually. NOPAT margins increased from 2% in 2011 to 4% over the last twelve months while the company's return on invested capital (ROIC) improved from 4% to 8%.

Figure 1: SCS' Revenue and Profit Growth Since 2010



Sources: New Constructs, LLC and company filings

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

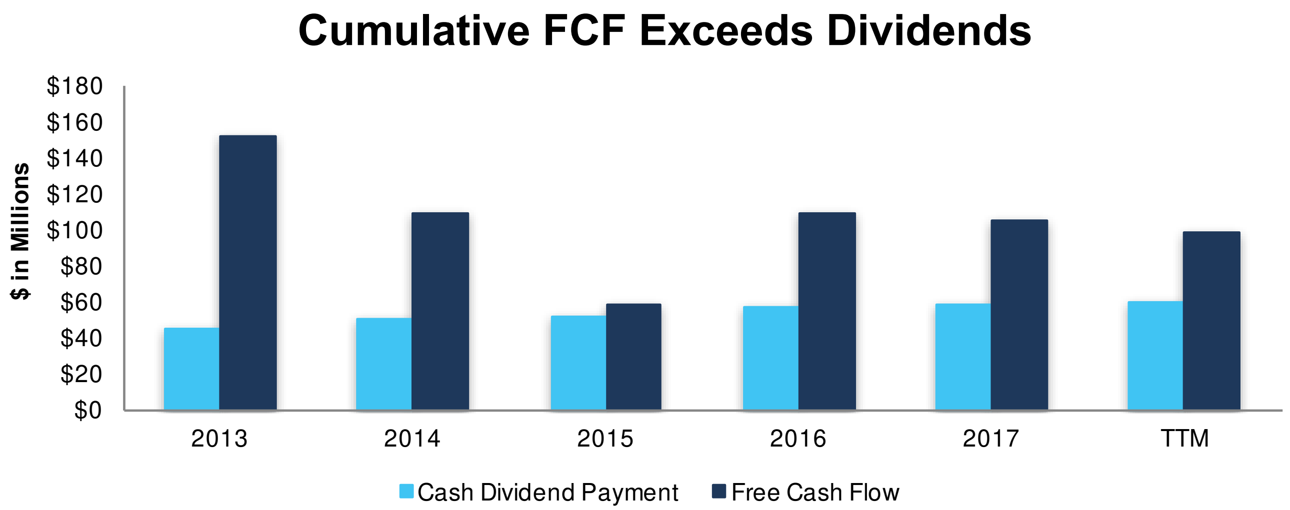
Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

Free Cash Flow Supports Dividend Growth

SCS has increased its dividend for eight consecutive years. The current dividend of $0.13/share provides investors with a 3.3% yield. The consistent dividend payment and growth has been supported by SCS' strong free cash flow. Per Figure 2, SCS has generated $535 million (29% of market cap) in FCF and paid out cumulative dividends of $264 million since 2013. Steelcase's TTM FCF of $99 million equates to a 5% FCF yield compared to 2% for the average S&P 500 stock.

Companies with strong free cash flow provide higher quality dividend yields because we know the firm has the cash to support its dividend. On the flip side, dividends from companies with low or negative free cash flow cannot be trusted as much because the company may not be able to sustain paying dividends.

Figure 2: SCS' FCF vs. Dividends Since 2013



Sources: New Constructs, LLC and company filings

SCS Remains Undervalued

At its current price of $16/share, SCS has a price-to-economic book value (PEBV) ratio of 1.1. This ratio means the market expects SCS' NOPAT to grow by no more than 10% over the remaining life of the firm. This expectation seems pessimistic for a firm that has grown NOPAT 18% compounded annually since 2011 and 10% compounded annually over the past 15 years.

If SCS can maintain TTM NOPAT margins (4%) and grow NOPAT by just 3% compounded annually over the next decade, the stock is worth $20/share today – a 25% upside from the current valuation.

Auditable Impact of Footnotes & Forensic Accounting Adjustments

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 Steelcase's 2017 10-K:

Income Statement: we made $61 million of adjustments with a net effect of removing $29 million in non-operating expense (1% of revenue). We removed $45 million related to non-operating expenses and $16 million related to non-operating income. See all adjustments made to SCS' income statement here.

Balance Sheet: we made $1.2 billion of adjustments to calculate invested capital with a net increase of $199 million. The most notable adjustment was $393 million (31% of reported net assets) related to asset write-downs. See all adjustments to SCS' balance sheet here.

Valuation: we made $832 million of adjustments with a net effect of decreasing shareholder value by $308 million. The largest adjustment to shareholder value was $179 million in off-balance sheet operating leases. This adjustment represents 10% of SCS' market value. Despite the decrease in shareholder value, SCS remains undervalued.

This article originally published on [January 26, 2018](#).

Disclosure: David Trainer and Kyle Guske II 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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