New Constructs®
Diligence | Independence | Performance

DILIGENCE PAYS 3/5/18

Filing Season Finds: Week of February 26 – March 3

Our latest featured stock is a consumer finance company with significant hidden non-operating income and material weakness in its internal controls.

We pulled this highlight from last week's research of 593 10-K filings, from which our Robo-Analyst technology collected 92,555 data points. Our analyst team used this data to make 14,753 forensic accounting adjustments with a dollar value of $4.2 trillion. The adjustments were applied as follows:

- 6,332 income statement adjustments with a total value of $329 billion
- 6,000 balance sheet adjustments with a total value of $1.7 trillion
- 2,421 valuation adjustments with a total value of $2.2 trillion

Figure 1: Filing Season Diligence for Week of February 26-March 3

	Filings Parsed	Data Points Collected	# of Adjustments	Total Value of Adjustments ($Billions)
Filing Season Week 2	593	92,555	14,753	$4,205
Filing Season Total	996	157,741	25,197	$11,129

Sources: New Constructs, LLC and company filings.

Every year in this six-week stretch from mid-February through the end of March, we parse and analyze roughly 2,000 10-Ks to update our models for companies with 12/31 and 1/31 fiscal year ends. This effort is made possible by the combination of expertly trained human analysts with what we call the "Robo-Analyst." The Robo-Analyst uses machine learning and natural language processing to automate much of the financial modeling process.

A Fiduciary Level of Diligence

Our technology enables us to deliver fundamental diligence at a previously impossible scale. We believe this research is necessary to fulfill the Fiduciary Duty of Care. Ernst & Young's recent white paper, "Getting ROIC Right", demonstrates how these adjustments contribute to materially superior models and metrics.

Only by reading through the footnotes and making adjustments to reverse accounting distortions can advisors go beyond the suitability standard and provide a fiduciary level of service to their clients.

One Company to Watch in 2018

Based on our analysis of Santender Consumer USA Holdings' (SC) 2017 10-K, we have downgraded the stock from Neutral to Unattractive. Analyst Eric Roll identified three significant red flags buried in the footnotes.

On page 119, SC reported a $678 million tax benefit (57% of GAAP net income) due to the revaluation of its deferred tax liabilities as a result of tax reform. This non-cash, one-time benefit allowed SC to report an effective tax rate of -44%. We adjusted for this non-operating item to keep SC's tax rate at its average of ~35%.

On page 100, the company disclosed a $148 million decrease to its credit loss allowance (12% of GAAP net income). This decrease in reserves artificially inflated SC's reported net income in 2017.

Finally, on page 79, SC's auditor, Pricewaterhouse Coopers, stated its opinion that SC "did not maintain, in all material respects, effective internal control over financial reporting." Specifically, PwC raised concerns over the models SC used to estimate its credit loss allowance.

Any material weakness in internal controls should be a red flag for investors as these weaknesses are correlated with an increased risk of a stock price crash. In SC's case, the red flag is even larger due to the fact that its material weakness is related to the change in its credit loss allowance that artificially boosted net income by $148 million.

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

In total, we made the following adjustments to Santender Consumer USA Holdings' 2017 10-K:

Income Statement: we made $805 million of adjustments, with a net effect of removing $796 million in non-operating income (12% of revenue). You can see all the adjustments made to SC's income statement here.

Balance Sheet: we made $3.4 billion of adjustments to calculate invested capital with a net increase of $3.3 billion (43% of reported net assets). Aside from the credit loss allowance referenced above, our largest adjustment was to add back $86 million in off-balance sheet debt. You can see all the adjustments made to DFS's balance sheet here.

Valuation: we made $988 million of adjustments with a net effect of decreasing shareholder value by $988 million. The largest adjustment to shareholder value was $897 million in deferred tax liabilities. This adjustment represents 15% SC's market cap.

After making all these adjustments, we found that SC's return on invested capital (ROIC) decreased from 10% to 4% in 2017, even as its GAAP net income increased by 55%. These misleading earnings make SC a high-risk stock for investors.

This article originally published on March 5, 2018.

Disclosure: David Trainer, Eric Roll, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

Follow us on Twitter (#filingseasonfinds), 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.