



## Featured Stocks in August's Exec Comp & ROIC Model Portfolio

Five new stocks make August's Exec Comp Aligned with ROIC Model Portfolio, available to members as of August 15, 2018.

### Recap from July's Picks

Our Exec Comp Aligned with ROIC Model Portfolio (+1.6%) outperformed the S&P 500 (+0.7%) last month. The best performing stock in the portfolio was up 14%. Overall, eight out of the 15 Exec Comp Aligned with ROIC Stocks outperformed the S&P in July.

Since inception, this model portfolio is up 29% while the S&P 500 is up 28%.

The success of this Model Portfolio highlights the value of our [Robo-Analyst technology<sup>1</sup>](#), which scales our forensic accounting expertise ([featured in Barron's](#)) across thousands of stocks.

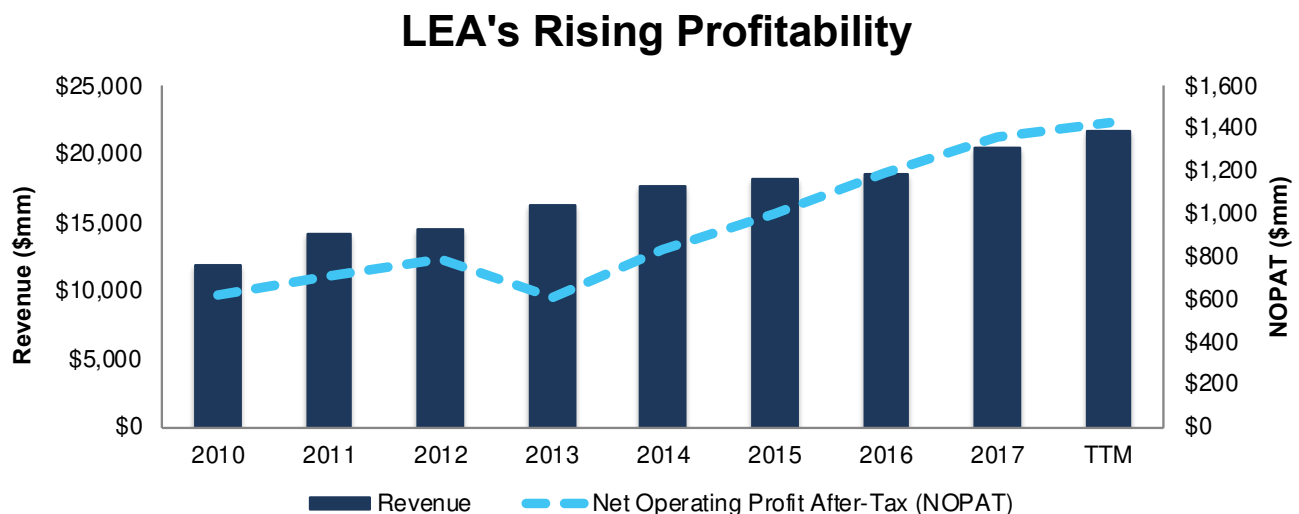
This Model Portfolio only includes stocks that earn an [Attractive or Very Attractive](#) rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas because return on invested capital (ROIC) is the [primary driver of shareholder value creation.<sup>2</sup>](#)

### Stock Feature for August: Lear Corp (LEA: \$173/share)

Lear Corp (LEA), an automotive seating and electrical systems manufacturer, is the featured stock in August's Exec Comp Aligned with ROIC Model Portfolio. Lear Corp was previously featured as a Long Idea on [June 22, 2016](#) and reiterated on [September 22, 2017](#) and again on [October 31, 2017](#). Since the original Long Idea report, LEA is up 54% (vs. S&P up 32%) and still remains undervalued.

Since 2010, LEA has grown revenue by 8% compounded annually. It has grown after-tax operating profit (NOPAT) by 12% compounded annually, to \$1.35 billion in 2017. NOPAT has increased to \$1.43 billion over the trailing twelve months (TTM). LEA's NOPAT margin increased from 5% in 2010 to 7% TTM and it has generated free cash flow (FCF) of \$2.1 billion (18% of market cap) over the past five years.

Figure 1: LEA Revenue & NOPAT Since 2010



Sources: New Constructs, LLC and company filings

<sup>1</sup> Harvard Business School features the powerful impact of our research automation technology in the case [New Constructs: Disrupting Fundamental Analysis with Robo-Analysts](#).

<sup>2</sup> Ernst & Young's recent white paper, "[Getting ROIC Right](#)", proves the superiority of our research and analytics.



### Executive Compensation Plan Helps Drive Shareholder Value Creation

Lear Corp has included ROIC as a performance metric in its [executive compensation plan](#) since 2010. In 2017, two-thirds of long-term incentive awards were tied directly to achieving a target ROIC. Long-term awards made up 54% of the CEO's pay and 44% of other executives' pay in 2017.

LEA management believes that tying executive compensation to ROIC “provides long-term focus on generating adequate returns on capital balanced by the goal of profitable growth embedded in the annual incentive performance measures.” The company notes that the “desired goal is to generate returns in excess of the company's cost of capital.”

This focus on ROIC has led to Lear Corp earning an average ROIC of 19% since 2010. ROIC has actually improved from 14% in 2013 to 20% TTM. Lear Corp's executive compensation plan lowers the risk of investing in the company's stock because we know executives' interests are tied to shareholders' interests.

### Valuation Still Provides Upside Potential

At its current price of \$173/share, LEA has a price-to-economic book value ([PEBV](#)) ratio of 0.7. This ratio means the market expects LEA's NOPAT to permanently decline by 30%. Such an expectation seems pessimistic given LEA's ability to grow NOPAT by 12% compounded annually since 2010.

If LEA can maintain TTM NOPAT margins (7%) and grow NOPAT by just 5% compounded annually for the next decade, the stock is worth \$279/share today – a 61% upside. [See the math behind this dynamic DCF scenario here.](#)

### Critical Details Found in Financial Filings by Our [Robo-Analyst Technology](#)

As investors [focus more](#) on fundamental research, research automation technology is needed to analyze all the critical financial [details in financial filings](#). Below are specifics on the adjustments we make based on Robo-Analyst findings in Lear Corp's 2017 10-K:

Income Statement: we made \$762 million of adjustments, with a net effect of removing \$70 million in non-operating expense (<1% of revenue). You can see all the adjustments made to LEA's income statement [here](#).

Balance Sheet: we made \$2.7 billion of adjustments to calculate invested capital with a net decrease of \$280 million. One of the largest adjustments was \$647 million in [deferred tax assets](#). This adjustment represented 9% of reported net assets. You can see all the adjustments made to LEA's balance sheet [here](#).

Valuation: we made \$3.2 billion of adjustments with a net effect of decreasing shareholder value by \$3 billion. The largest adjustment to shareholder value was \$2.4 billion in [total debt](#), which includes \$451 million in [operating leases](#). This lease adjustment represents 4% of LEA's market cap. Despite the net decrease in shareholder value, LEA remains undervalued.

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

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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.



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