Danger Zone Highlights From 2018

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

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

It pays to read our Danger Zone reports. In 2018, 26 out of our 31 Danger Zone picks saw negative returns and 19 underperformed the market (S&P 500). All in, the Danger Zone stocks averaged a -12% return in 2018 versus the S&P 500's 8% decline, and outperformed as a short portfolio.

Last week, we examined our worst Danger Zone picks from 2018. This week, we're taking some victory laps and looking at the blowups we successfully predicted last year. These are the Danger Zone highlights from 2018.

Highlight 1: Snap, Inc. (SNAP) – published August 13: Down 56% vs. S&P down 11%

We originally featured Snap (SNAP: $6/share) in February 2017, prior to its IPO, and questioned the company's ability to compete against existing social media giants. This IPO provides a cautionary tale on Sell-Side ratings as the same investment banks that underwrote the IPO issued conflicted research to support the IPO. Nine of the 13 underwriters issued "Buy" ratings, and one even maintained its Buy rating after discovering an error in its original financial model.

These bullish sell-side ratings could do nothing to stop growing losses and slowing user growth. By the end of the year, most of the sell-side analysts capitulated and downgraded the stock. SNAP ended 2017 down 39% from its IPO price, making it one of the Danger Zone highlights of 2017.

Even after 2017's dismal year, SNAP remained overvalued going into 2018, and we doubled down on our bearish call by making the stock part of the "Micro-Bubble" of overvalued tech stocks. We pointed out that the company's best features had all been successfully co-opted by Facebook (FB), its valuation remained overly optimistic, and its dual-class share structure made it nearly impossible for investors to oust flailing CEO Evan Spiegel.

Since we reiterated our call in August, the stock is down 56%, driven by declining daily active users, ongoing management turbulence, and the company's insistence on relaunching the Spectacles product that led to a $40 million write-down on the first version.

SNAP's 56% decline is more than 5 times the 11% drop for the S&P 500. Despite two years of significant underperformance, we still believe SNAP is overvalued, and the stock currently earns our Unattractive rating.

Highlight 2: Installed Building Products (IBP) – published May 21: Down 46% vs. S&P down 8%

Installed Building Products (IBP: $34/share) is a classic "roll-up" that buys up smaller competitors to manufacture EPS growth. The "High-Low Fallacy" allows these types of companies to grow accounting earnings even as they destroy shareholder value.

From the beginning of 2015 to when we published our article in May 2018, IBP made over 30 acquisitions. Theoretically, these acquisitions were supposed to create value by reducing competition and increasing economies of scale. In reality, our analysis showed that these acquisitions led to declining margins and return on invested capital (ROIC).

As is so often the case for roll-up schemes, IBP blew-up when the overall market, and the housing market in particular, began to slow. Investors were fine just looking at the company's high EPS growth in 2017, but with increased stock market volatility and the housing market raising red flags, investors are digging deeper.

In particular, two numbers stand out when analyzing IBP. The first is its ROIC, which declined from a peak of 13% in 2016 to 9% over the trailing twelve months (TTM). The second is its total debt of $500 million (46% of market cap), which is up from $190 million in 2016. These two numbers make it clear that management's acquisition strategy has made IBP a less profitable, more risky company over the past two years.

In a volatile market, it's no surprise that IBP has struggled. The stock has been in a steady downward trend for most of the year, falling 46% since our article vs. an 8% decline for the S&P 500. Even after the decline, IBP still earns our Unattractive rating.

Highlight 3: Spotify Technology (SPOT) – published April 2 before direct listing on April 3: Down 37% from direct listing price vs. S&P down 12%

Spotify (SPOT: $110/share) debuted on the public markets in 2018 with a unique "direct listing." Rather than selling new shares to the public, the company simply began allowing existing shareholders to sell on the public market without a traditional IPO.

Ahead of this unique debut, we attempted to quantify how much investors should be willing to pay for SPOT shares. The most bullish scenario we could imagine – one in which Spotify managed to displace the existing record labels and take full ownership of its streaming content – yielded a price target of $185/share, close to the $180/share level where the stock ultimately began trading.

Clearly, investors had high hopes for Spotify. These expectations were so optimistic that SPOT was one of our inaugural members in the "Micro-Bubble."

So far, those high hopes have not been met. Shares have tumbled 37% due to growing competition from Apple Music (AAPL), the major record labels (who were among the earliest investors) dumping shares, and international expansion plans facing roadblocks.

The biggest problem for Spotify, as we've said all along, is its lack of leverage versus the four major record labels that control 85% of its content. Although the market values SPOT like a tech company, it has more in common with the movie theater business in terms of limited leverage versus the content owners and extremely thin margins.

As noted above, SPOT debuted with a valuation near our most bullish scenario for the company. Despite its 37% decline, the stock still has 28% downside to our neutral scenario, and an 87% downside to our bearish scenario. It also still earns our Unattractive rating, and we believe investors should continue to avoid this stock.

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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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