Featured Stock in March's Dividend Growth Model Portfolio

12 new stocks make our Dividend Growth Stocks Model Portfolio this month, which was made available to members on March 28, 2019.

The long-term success of our model portfolio strategies highlights the value of our Robo-Analyst technology[1], which scales our forensic accounting expertise (featured in Barron's) across thousands of stocks[2].

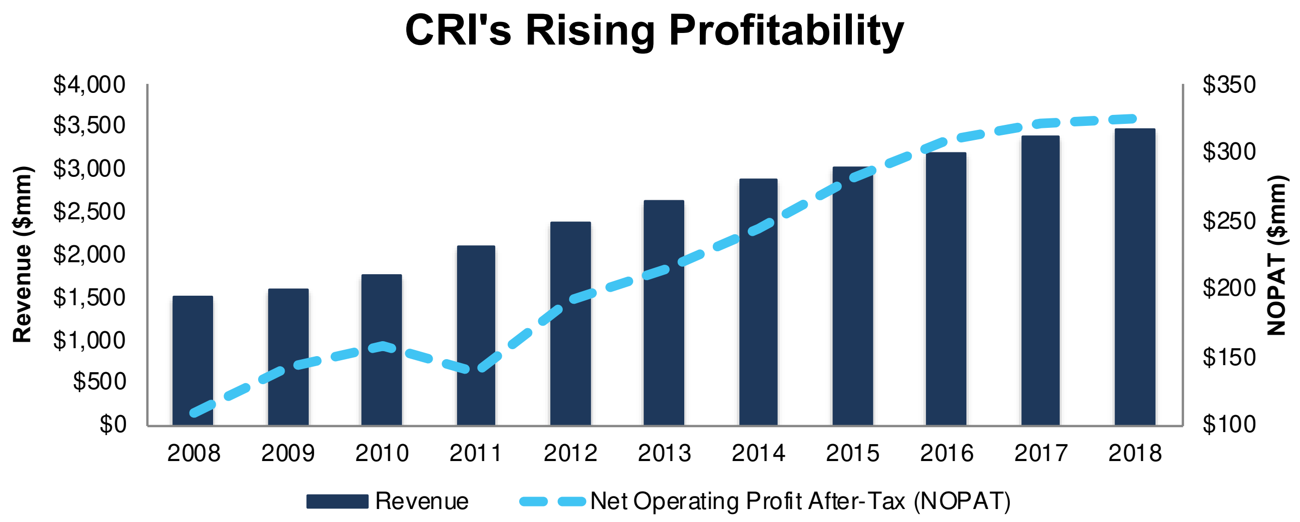
The methodology for this model portfolio mimics an All-Cap Blend style with a focus on dividend growth. Selected stocks earn an Attractive or Very Attractive rating, generate positive free cash flow (FCF) and economic earnings, offer a current dividend yield >1%, and have a 5+ year track record of consecutive dividend growth. This model portfolio is designed for investors who are more focused on long-term capital appreciation than current income, but still appreciate the power of dividends, especially growing dividends.

Featured Stock from March: Carter's Inc. (CRI: $99/share)

Carter's Inc. (CRI) is the featured stock from March's Dividend Growth Stocks Model Portfolio. We made CRI a Long Idea in April 2017 and closed the position in July 2018 after the stock outperformed the market (up 31% vs. S&P up 19%) and was downgraded to Neutral. CRI has since been upgraded to Attractive and once again offers compelling risk/reward.

Over the past decade, CRI has grown revenue by 9% compounded annually and after-tax operating profit (NOPAT) by 11% compounded annually. NOPAT margin increased from 7% in 2008 to 9% in 2018 while return on invested capital (ROIC) improved from 10% to 12% over the same time.

Figure 1: CRI Profit Growth Over Past Decade



Sources: New Constructs, LLC and company filings

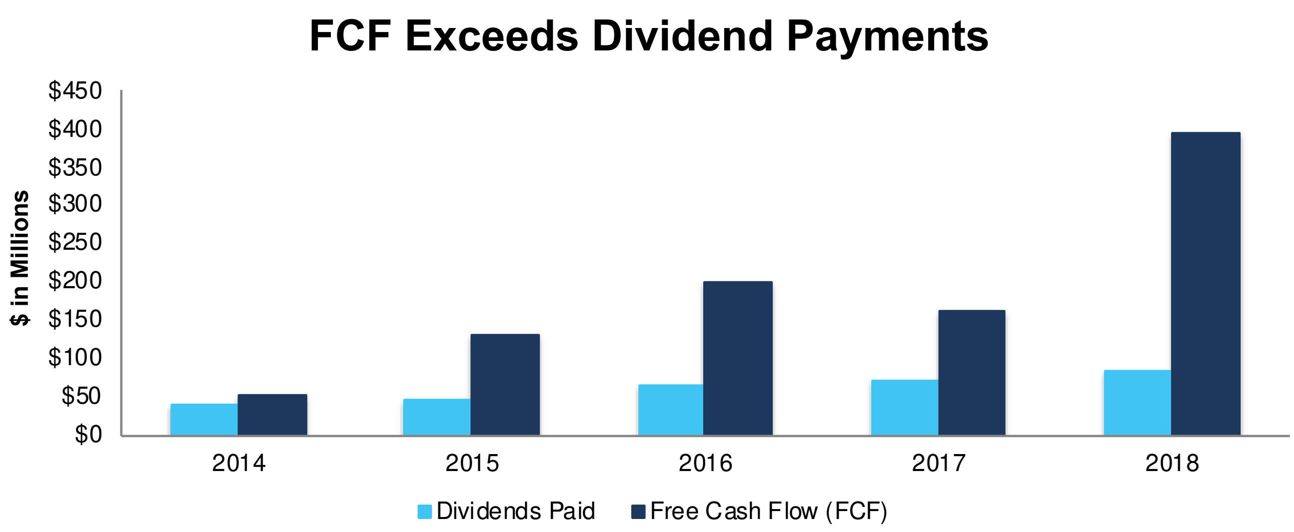
[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.
[2] Ernst & Young's recent white paper "Getting ROIC Right" demonstrates the superiority of our stock research and analytics.

CRI's Free Cash Flow Supports Dividend Growth

Carter's has increased its annual dividend in each of the past five years. The annual dividend has grown from $0.76/share in 2014 to $1.80/share in 2018, or 24% compounded annually. Carter's recently announced a further increase in the dividend to $2/share for 2019, giving the stock a 2% dividend yield. Positive free cash flow fueled dividend growth in the past and should continue to do so in the future. Since 2014, CRI has generated cumulative FCF of $938 million (21% of market cap) while paying $307 million in dividends.

Companies with FCF well in excess of dividend payments provide higher quality dividend growth opportunities because we know the firm generates the cash to support a higher dividend. On the other hand, the dividend of a company where FCF falls short of the dividend payment over time cannot be trusted to grow or even stay the same because of inadequate free cash flow.

Figure 2: Free Cash Flow (FCF) vs. Regular Dividend Payments



Sources: New Constructs, LLC and company filings

CRI Holds Significant Upside Potential

At its current price of $99/share, CRI has a price-to-economic book value (PEBV) ratio of 1.1. This ratio means the market expects CRI's NOPAT to grow by no more than 10% over the rest of its life. This expectation seems overly pessimistic for a firm that has grown NOPAT by 11% compounded annually over the past decade.

If CRI can maintain current NOPAT margins (9%) and grow NOPAT by just 4% compounded annually over the next decade, the stock is worth $123/share today – a 24% upside. See the math behind this dynamic DCF scenario. Add in Carters' 2.0% dividend yield and history of dividend growth, and it's clear why this stock is in March's Dividend Growth Stocks Model Portfolio.

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 Carters' 2018 10-K:

Income Statement: we made $145 million of adjustments with a net effect of removing $45 million in non-operating expense (1% of revenue). See all adjustments made to CRI's income statement here.

Balance Sheet: we made $1.1 billion of adjustments to calculate invested capital with a net increase of $945 million. The most notable adjustment was $750 million (43% of reported net assets) in off-balance sheet operating leases. See all adjustments to CRI's balance sheet here.

Valuation: we made $1.5 billion of adjustments with a net effect of decreasing shareholder value by $1.5 billion. Apart from $1.3 billion in total debt, which includes the operating leases noted above, the largest adjustment to shareholder value was $85 million in deferred tax liabilities. This tax adjustment represents 2% of CRI's market value. See all adjustments to CRI's valuation here. Despite the net subtraction from shareholder value, CRI remains undervalued.

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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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