New Constructs®
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STOCK PICKS AND PANS

4/8/20

Featured Stocks in April's Most Attractive/Most Dangerous Model Portfolios

Recap from March Picks

Our Most Attractive Stocks (-25.5%) underperformed the S&P 500 (-17.4%) from March 4, 2020 through March 31, 2020 by 8.1%. The best performing large cap stock fell 9% and the best performing small cap stock was up 14%. Overall, 14 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (-22.9%) outperformed the S&P 500 (-17.4%) as a short portfolio from March 4, 2020 through March 31, 2020 by 5.5%. The best performing large cap stock fell by 32% and the best performing small cap stock fell by 47%. Overall, 13 out of the 20 Most Dangerous stocks outperformed the S&P 500 as shorts.

The Most Attractive/Most Dangerous portfolios underperformed as an equal-weighted long/short portfolio by 2.6% last month.

Only our research utilizes the superior data and earnings adjustments featured by the HBS & MIT Sloan paper, "Core Earnings: New Data and Evidence." The successes of these model portfolios highlight the value of our machine learning and AI Robo-Analyst technology[1], which helps clients fulfill the fiduciary duty of care and make smarter investments[2].

25 new stocks make our Most Attractive list this month, and 13 new stocks fall onto the Most Dangerous list this month. April's Most Attractive and Most Dangerous stocks were made available to members on April 2, 2020.

Our Most Attractive stocks have high and rising returns on invested capital (ROIC) and low price to economic book value ratios. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

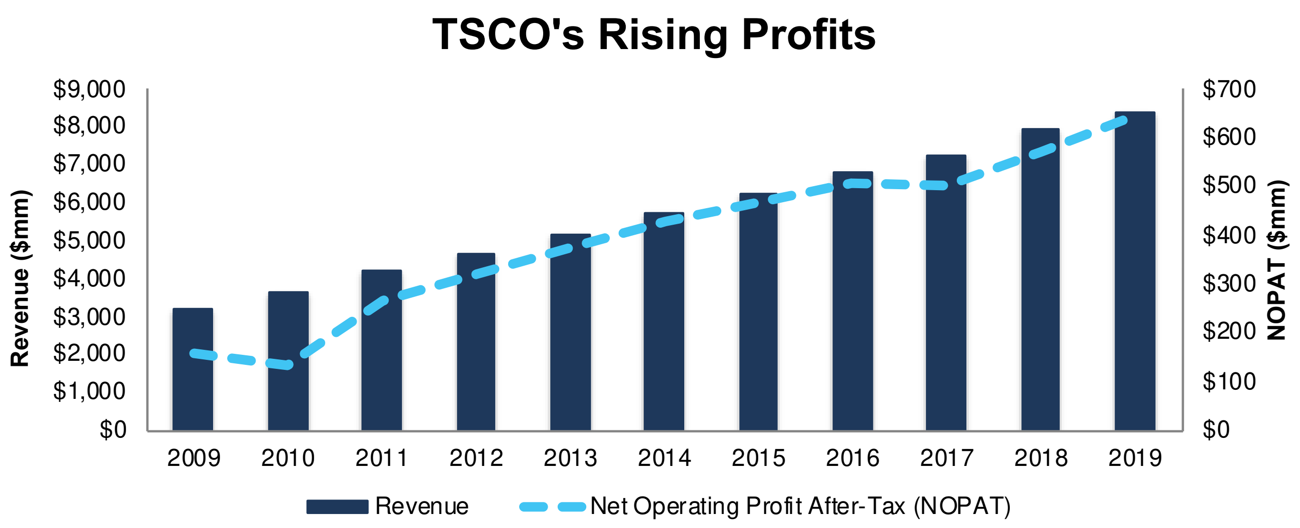
Most Attractive Stocks Feature for April: Tractor Supply Company (TSCO: $87/share)

Tractor Supply Company (TSCO) is the featured stock from April's Most Attractive Stocks Model Portfolio.

TSCO has grown revenue by 10% compounded annually and after-tax profit (NOPAT) by 15% compounded annually over the past decade. TSCO's NOPAT margin increased from 5% in 2009 to 8% in 2019 while its ROIC increased from 8% to a top-quintile 15% over the same time.

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 This paper compares our analytics on a mega cap company to Bloomberg and Capital IQ (SPGI) in a detailed appendix.

Figure 1: TSCO's Revenue & NOPAT Since 2009



Sources: New Constructs, LLC and company filings

TSCO's Valuation Offers Upside Potential

At its current price of $87/share, TSCO has a price-to-economic book value (PEBV) ratio of 1.1. This ratio means the market expects TSCO's NOPAT to grow by no more than 10% over the remaining life of the firm. This expectation seems overly pessimistic for a firm that has grown NOPAT by 15% compounded annually over the past decade and 18% compounded annually over the past two decades. Furthermore, TSCO may be one of the retailers uniquely benefitting during the COVID-19 pandemic. The firm recently reported 1Q20 sales above estimates as a result of consumers stocking up on merchandise.

If TSCO can maintain its 2019 NOPAT margin (8%) and grow NOPAT by just 5% compounded annually for the next decade, the stock is worth $116/share today – a 33% upside. See the math behind this reverse DCF scenario.

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 as shown in the Harvard Business School and MIT Sloan paper, "Core Earnings: New Data and Evidence".

Below are specifics on the adjustments we make based on Robo-Analyst findings in Tractor Supply Company's 2019 10-K:

Income Statement: we made $180 million of adjustments, with a net effect of removing $82 million in non-operating expenses (1% of revenue). You can see all the adjustments made to TSCO's income statement here.

Balance Sheet: we made $2.3 billion of adjustments to calculate invested capital with a net increase of $2.3 billion. One of the largest adjustments was $2.2 billion in operating leases. This adjustment represented 54% of reported net assets. You can see all the adjustments made to TSCO's balance sheet here.

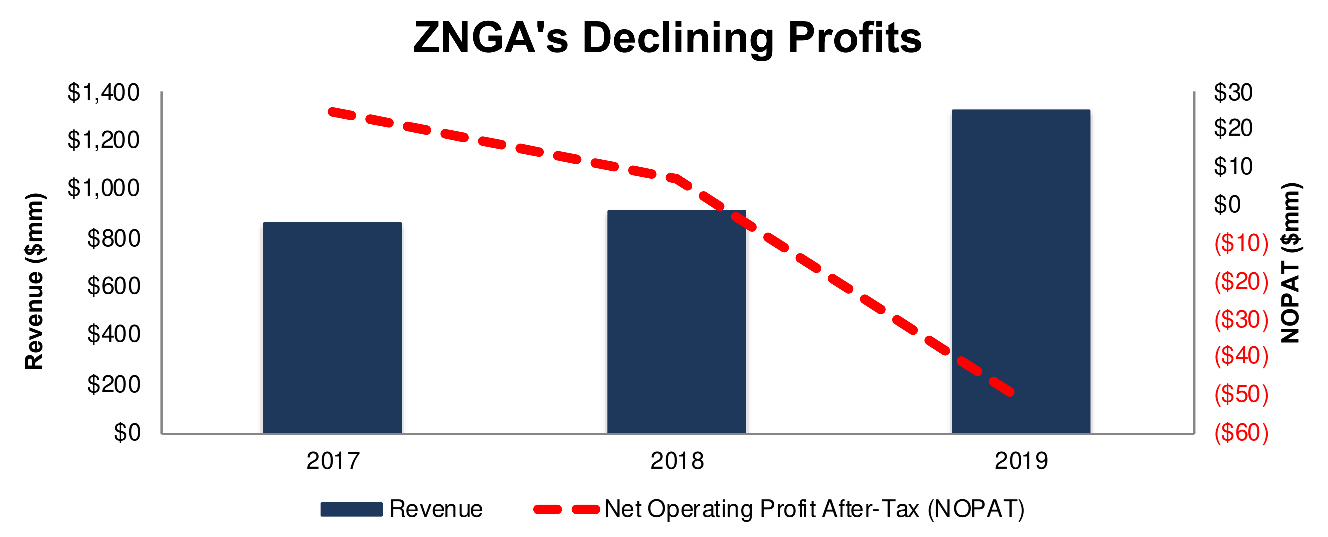
Valuation: we made $2.7 billion of adjustments with a net effect of decreasing shareholder value by $2.7 billion. There were no adjustments that increased shareholder value. Apart from total debt, which includes the operating leases noted above, the most notable adjustment to shareholder value was $58 million in outstanding employee stock options. This stock option adjustment represents <1% of TSCO's market cap. See all adjustments to TSCO's valuation here.

Most Dangerous Stocks Feature: Zynga Inc. (ZNGA: $7/share)

Zynga Inc. (ZNGA) is the featured stock from April's Most Dangerous Stocks Model Portfolio. We first placed ZNGA in the Danger Zone in September, 2013 and warned again of its significantly overstated earnings in November, 2019. While the stock has outperformed the S&P 500 since both reports were published, ZNGA remains significantly overvalued.

ZNGA has grown revenue by 24% compounded annually since 2017. However, NOPAT has declined from $25 million to -$51 million over the same time. ZNGA's NOPAT margin has fallen from 3% in 2017 to -4% in 2019 while ROIC declined from 2% to -3% over the same time.

Figure 2: ZNGA's Revenue & NOPAT Since 2017



Sources: New Constructs, LLC and company filings

ZNGA Provides Poor Risk/Reward

Despite its deteriorating fundamentals, ZNGA is still priced for significant profit growth and is overvalued.

To justify its current price of $7/share, ZNGA must achieve a 5% NOPAT margin (compared to -4% in 2019) and grow revenue by 17% compounded annually for the next 13 years. See the math behind this reverse DCF scenario. This expectation seems overly optimistic given that consensus estimates expect ZNGA's revenue to grow ~13% in 2020 and 2021, or well below the 17% compound annual growth rate required in the above scenario.

Even if ZNGA can achieve a 3% NOPAT margin (company high in 2017) and grow revenue by 12% compounded annually for the next decade, the stock is worth just $2.50/share today, a 63% downside to the current stock price. See the math behind this reverse DCF scenario.

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 as shown in the Harvard Business School and MIT Sloan paper, "Core Earnings: New Data and Evidence".

Below are specifics on the adjustments we make based on Robo-Analyst findings in Zynga's 2019 10-K:

Income Statement: we made $601 million of adjustments, with a net effect of removing $93 million in non-operating income (7% of revenue). You can see all the adjustments made to ZNGA's income statement here.

Balance Sheet: we made $2.3 billion of adjustments to calculate invested capital with a net decrease of $736 million. One of the largest adjustments was $1.5 billion in excess cash. This adjustment represented 51% of reported net assets. You can see all the adjustments made to ZNGA's balance sheet here.

Valuation: we made $2.3 billion of adjustments with a net effect of increasing shareholder value by $632 million. Apart from the excess cash noted above, the largest adjustment to shareholder value was $708 million in total debt, which includes $138 million in operating leases. This lease adjustment represents 2% of ZNGA's market cap. See all adjustments to ZNGA's valuation here.

This article originally published on [April 8, 2020](#).

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

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Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

HBS & MIT Sloan research reveals that:

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Corporate managers hide gains/losses in footnotes to manage earnings.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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