New Constructs®
Diligence | Independence | Performance

FEATURED STOCKS
5/13/21

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

Recap From April's Picks

Our Most Attractive Stocks (+3.9%) outperformed the S&P 500 (+2.8%) from April 7, 2021 through May 3, 2021 by 1.1%. The best performing large cap stock gained 18% and the best performing small cap stock was up 23%. Overall, 21 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (+1.4%) outperformed the S&P 500 (+2.8%) as a short portfolio from April 7, 2021 through May 3, 2021 by 1.4%. The best performing large cap stock fell by 13% and the best performing small cap stock fell by 14%. Overall, 11 out of the 21 Most Dangerous stocks outperformed the S&P 500 as shorts.

The Most Attractive/Most Dangerous Model Portfolios outperformed as an equal-weighted long/short portfolio by 1.3%.

More reliable & proprietary fundamental data, proven in The Journal of Financial Economics, drives our research. Our proprietary Robo-Analyst Technology[1] scales our forensic accounting expertise (featured in Barron's) across thousands of stocks[2] to produce an unrivaled database of fundamental data.

13 new stocks make our Most Attractive list this month, and 13 new stocks fall onto the Most Dangerous list this month. May's Most Attractive and Most Dangerous stocks were made available to members on May 5, 2021.

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 May: Quest Diagnostics Inc. (DGX: $136/share)

Quest Diagnostics Inc. is the featured stock from May's Most Attractive Stocks Model Portfolio.

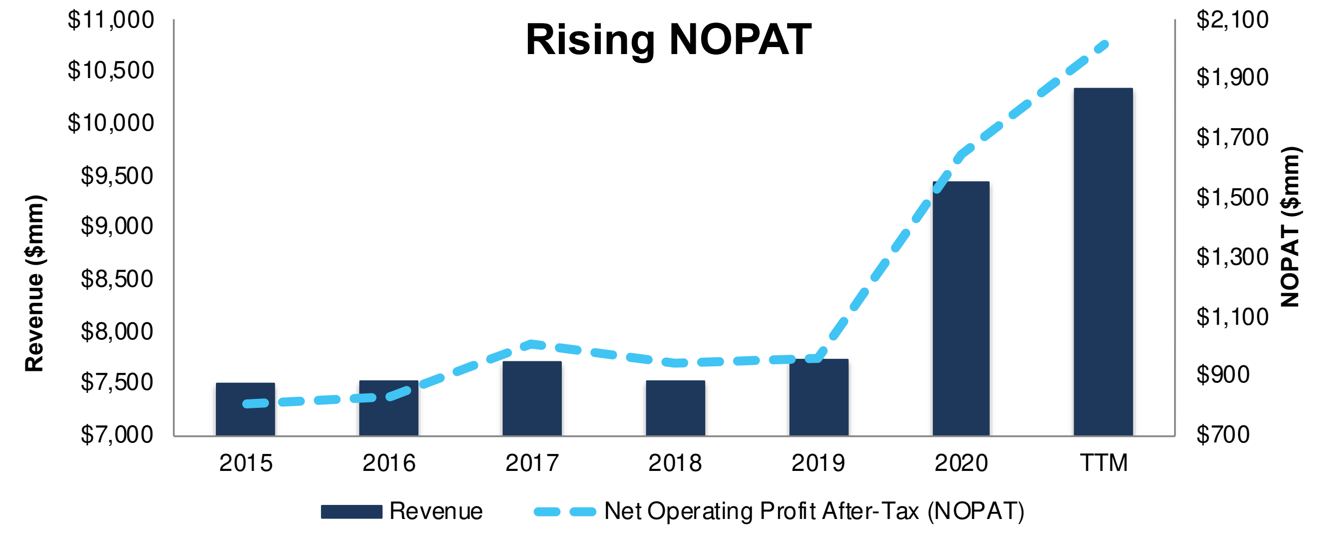
Quest Diagnostics grew revenue by 5% compounded annually and net operating profit after-tax (NOPAT) by 15% compounded annually over the past five years.

The firm's NOPAT margin increased from 11% in 2015 to 20% over the tailing twelve months (TTM), while its invested capital turns increased from 0.8 to 0.9 over the same period. Rising margins and invested capital turns drive the increase in Quest Diagnostics ROIC from 8% in 2015 to 17% TTM.

Over the past five years, Quest Diagnostics generated $2.9 billion (16% of market cap) in cumulative free cash flow (FCF). Over the TTM, Quest Diagnostics has generated $1.6 billion in FCF.

[1] Harvard Business School features our research automation technology in the case Disrupting Fundamental Analysis with Robo-Analysts.
[2] See how our models overcome flaws in Bloomberg and Capital IQ's (SPGI) analytics in the detailed appendix of this paper.

Figure 1: Revenue & NOPAT Since 2015



Sources: New Constructs, LLC and company filings

DGX Is Undervalued

At its current price of $136/share, DGX has a price-to-economic book value (PEBV) ratio of 0.3. This ratio means the market expects Quest Diagnostics' NOPAT to permanently decline by 70%. This expectation seems overly pessimistic for a firm that grew NOPAT by 5% compounded annually over the past two decades.

Even if Quest Diagnostics' NOPAT margin falls to 13% (equal to its five-year average, compared to 20% TTM) and the firm grows revenue by just 1% compounded annually for the next decade, the stock is worth $268/share today – a 97% upside. See the math behind this reverse DCF scenario. This scenario assumes lower profit growth after the COVID-19 driven increase in 2020, but should Quest Diagnostics grow profits in line with historical levels, the stock has even more upside.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

Fact: we provide more reliable fundamental data and earnings models – unrivaled in the world.
Proof: Core Earnings: New Data & Evidence, forthcoming in The Journal of Financial Economics.

Below are specifics on the adjustments we make based on Robo-Analyst findings in Quest Diagnostics' 10-K and 10-Q:

Income Statement: we made $584 million of adjustments, with a net effect of removing $218 million in non-operating expenses (2% of revenue). You can see all the adjustments made to Quest Diagnostics' income statement here.

Balance Sheet: we made $1.7 billion of adjustments to calculate invested capital with a net decrease of $518 million. One of the most notable adjustments was $215 million in asset write-downs. This adjustment represented 2% of reported net assets. You can see all the adjustments made to Quest Diagnostics' balance sheet here.

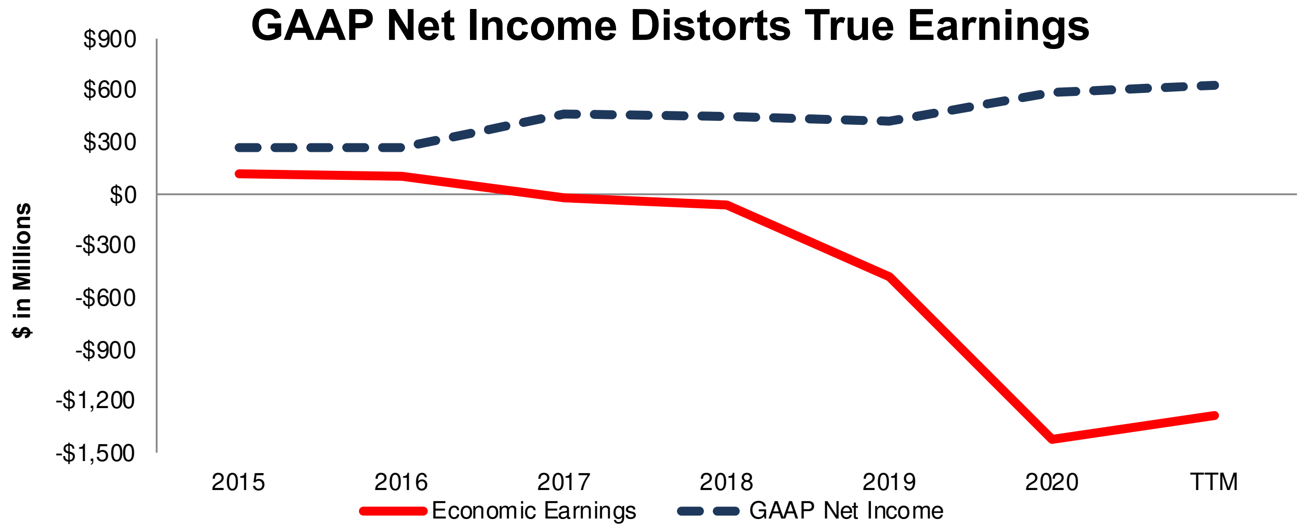
Valuation: we made $6.7 billion of adjustments with a net impact of decreasing shareholder value by $5.3 billion. Apart from total debt, one of the most notable adjustments to shareholder value was $713 million in excess cash. This adjustment represents 4% of Quest Diagnostics' market cap. See all adjustments Quest Diagnostics' valuation here.

Most Dangerous Stocks Feature: Global Payments, Inc. (GPN: $195/share)

Global Payments, Inc. (GPN) is the featured stock from May's Most Dangerous Stocks Model Portfolio.

Global Payments' GAAP net income improved from $278 million in 2015 to $638 million TTM. However, the firm's economic earnings, the true cash flows of the business, fell from $127 million to -$1.3 billion over the same time. The firm's invested capital turns fell from 0.9 in 2015 to 0.2 TTM while ROIC fell from 11% to 3% over the same time.

Figure 2: Misleading GAAP Net Income vs. Economic Earnings



Sources: New Constructs, LLC and company filings

GPN Provides Poor Risk/Reward

Despite its poor fundamentals, GPN is still priced for significant profit growth and is overvalued.

To justify its current price of $195/share, Global Payments must maintain its TTM NOPAT margin of 16% (vs. 10-year average of 14%) and grow NOPAT by 16% compounded annually for the next decade. See the math behind this reverse DCF scenario. This scenario assumes Global Payments' ROIC improves from 3% in 2020 to 12% in 2030. Given Global Payments' ROIC has fallen year-over-year in seven of the past eight years, and the destruction of shareholder value since 2015 (See Figure 1), we think these expectations are overly optimistic.

Even if Global Payments maintains its TTM NOPAT margin of 16% and grows NOPAT by 11% compounded annually for the next decade, the stock is worth just $113/share today, a 42% downside to the current stock price. See the math behind this reverse DCF scenario. This scenario assumes Global Payments grows revenue by 10% (equal to consensus revenue estimate CAGR of 10% from 2021 to 2023) over the next 10 years. Should Global Payments' revenue grow at a slower rate, the stock has even more downside.

Each of these scenarios also assumes Global Payments is able to grow revenue, NOPAT, and FCF without increasing working capital or fixed assets. This assumption is unlikely but allows us to create best-case scenarios that demonstrate how high expectations embedded in the current valuation are.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

Fact: we provide more reliable fundamental data and earnings models – unrivaled in the world.
Proof: Core Earnings: New Data & Evidence, forthcoming in The Journal of Financial Economics.

Below are specifics on the adjustments we make based on Robo-Analyst findings in Global Payments' 10-K and 10-Q:

Income Statement: we made $869 million of adjustments, with a net effect of removing $547 million in in non-operating expenses (7% of revenue). You can see all the adjustments made to Global Payments' income statement here.

Balance Sheet: we made $3.8 billion in adjustments to calculate invested capital with a net increase of $154 million. One of the largest adjustments was $202 million in other comprehensive income. This adjustment represented 1% of reported net assets. You can see all the adjustments made to Global Payments' balance sheet here.

Valuation: we made $15.8 billion in adjustments with a net effect of decreasing shareholder value by $11.9 billion. Apart from total debt, the most notable adjustment to shareholder value was $2.9 billion in net deferred tax liabilities. This adjustment represents 5% of Global Payments' market cap. See all adjustments to Global Payments' valuation here.

This article originally published on May 13, 2021.

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

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

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 two 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.