Featured Stock in February's Dividend Growth Model Portfolio

Eleven new stocks made February's Dividend Growth Stocks Model Portfolio, which was made available to members on February 28, 2023.

Recap from February's Picks

On a price return basis, our Dividend Growth Stocks Model Portfolio (-1.7%) outperformed the S&P 500 (-2.2%) by 0.5% from January 27, 2023 through February 24, 2023. On a total return basis, the Model Portfolio (-1.5%) outperformed the S&P 500 (-2.2%) by 0.7% over the same time. The best performing stock was up 15%. Overall, 19 out of 30 Dividend Growth stocks outperformed their respective benchmarks (S&P 500 and Russell 2000) from January 27, 2023 through February 24, 2023.

This report leverages our cutting-edge Robo-Analyst technology to deliver proven-superior[1] fundamental research and support more cost-effective fulfillment of the fiduciary duty of care.

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 favor long-term capital appreciation over current income, but still appreciate the power of growing dividends.

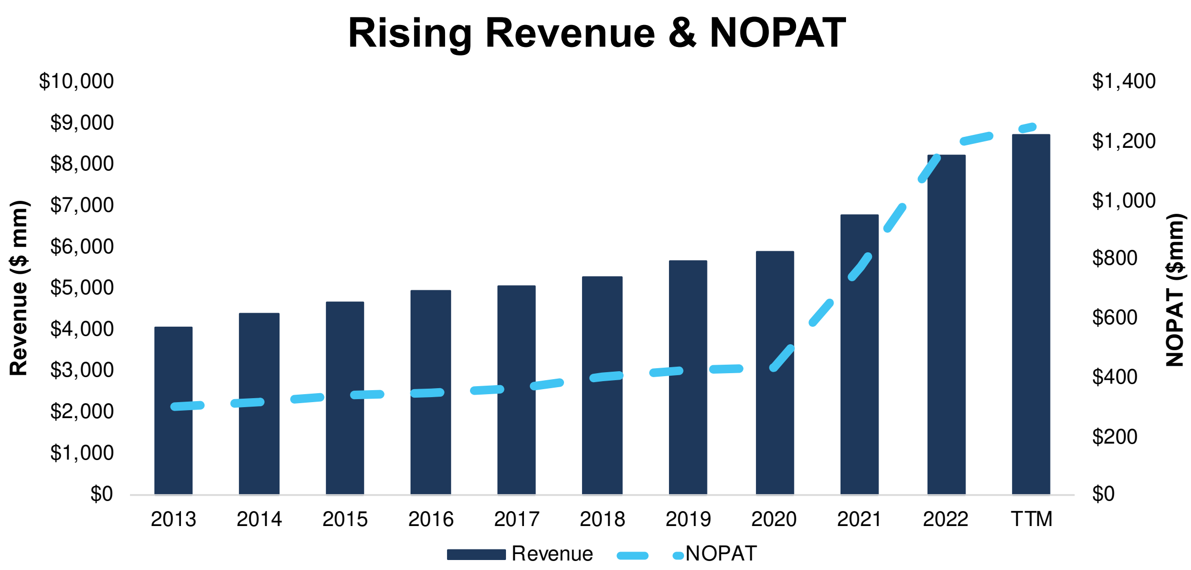
Featured Stock for February: Williams-Sonoma, Inc (WSM: $124/share)

Williams-Sonoma, Inc (WSM) is the featured stock in February's Dividend Growth Stocks Model Portfolio. We first made Williams-Sonoma a Long Idea in September 2016 and the stock has outperformed the S&P 500 by 83% since then. See our most recent report on WSM here.

Williams Sonoma has grown revenue by 10% compounded annually and net operating profit after tax (NOPAT) by a whopping 27% compounded annually from fiscal 2017 to fiscal 2022. The company's NOPAT margin has doubled from 7% in fiscal 2017 to 14% over the trailing-twelve-months (TTM), while invested capital turns improved from 1.8 to 2.6 over the same time. Rising NOPAT margins and invested capital turns drive return on invested capital (ROIC) from 12% in fiscal 2017 to 37% in the TTM.

[1] Our research utilizes our Core Earnings, a more reliable measure of profits, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan and published in The Journal of Financial Economics.

Figure 1: Williams Sonoma's Revenue & NOPAT Since Fiscal 2013



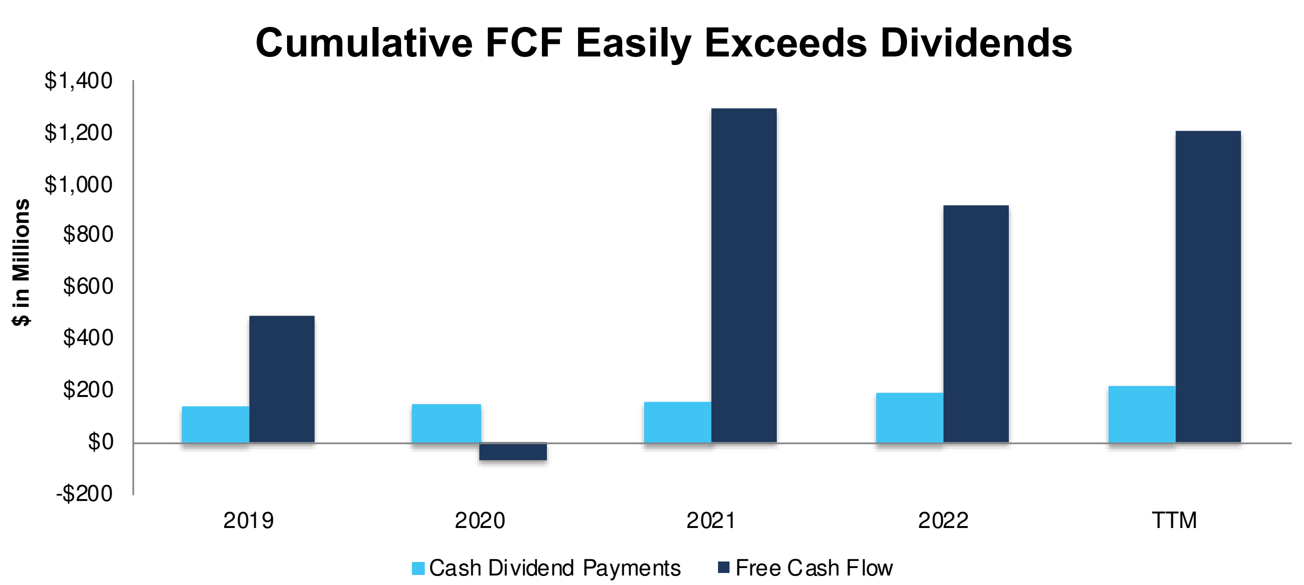
Sources: New Constructs, LLC and company filings

Free Cash Flow Supports Regular Dividend Payments

Williams Sonoma has increased its regular dividend from $1.56/share in fiscal 2017 to $2.60/share in fiscal 2022, or 11% compounded annually. The current quarterly dividend when annualized equals $3.12/share and provides a 2.5% dividend yield.

More importantly, Williams Sonoma's free cash flow (FCF) easily exceeds its regular dividend payments. From fiscal 2019 through the nine months ended fiscal 3Q23 (October 2022), Williams Sonoma generated $3.5 billion (36% of current enterprise value) in FCF while paying $855 million in dividends. Over the TTM, Williams Sonoma generated $1.2 billion in FCF and paid out $218 million in dividends. See Figure 2.

Figure 2: Williams Sonoma's FCF vs. Regular Dividends Since Fiscal 2019



Sources: New Constructs, LLC and company filings

Companies with FCF well above dividend payments provide higher-quality dividend growth opportunities. On the other hand, dividends that exceed FCF cannot be trusted to grow or even be maintained.

WSM Is Undervalued

At its current price of $124/share, Williams Sonoma has a price-to-economic book value (PEBV) ratio of 0.6. This ratio means the market expects Williams Sonoma's NOPAT to fall 40% permanently. This expectation seems overly pessimistic given that Williams Sonoma has grown NOPAT by 27% compounded annually since fiscal 2017 and 16% compounded annually since fiscal 2012.

Even if Williams Sonoma's NOPAT margin falls to 9% (below its TTM NOPAT margin of 14%) and revenue grows by just 5% compounded annually (below 8% compounded annually since fiscal 2012) over the next decade, the stock would be worth $161/share today – a 30% upside. In this scenario, Williams Sonoma's NOPAT would not grow at all through 2032. For reference, NOPAT is up 15% over the TTM. Should the company's NOPAT grow more in line with historical growth rates, the stock has even more upside.

Add in Williams Sonoma's 2.5% dividend yield and a history of dividend growth, and it's clear why this stock is in February's Dividend Growth Stocks Model Portfolio.

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

Below are specifics on the adjustments we make based on Robo-Analyst findings in Williams Sonoma's 10-Ks and 10-Qs:

Income Statement: we made $114 million in adjustments with a net effect of removing $62 million in non-operating expenses (<1% of revenue). Clients can see all adjustments made to Williams Sonoma's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $1.4 billion in adjustments to calculate invested capital with a net increase of $41 million. The most notable adjustment was $559 million (20% of reported net assets) in operating leases. See all adjustments made to Williams Sonoma's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

Valuation: we made $1.6 billion in adjustments, with a net decrease of $1.6 billion in shareholder value. Apart from total debt, one of the most notable adjustments to shareholder value was $177 million in operating leases. This adjustment represents 2% of Williams Sonoma's market value. See all adjustments to Williams Sonoma's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

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

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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.

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