

Two Men and a Scrub

Tired of Wall Street indifference, one Franklin research firm decides it's time to hedge its bets

Osman Sloan and David Trainer, who launched a stock research firm called New Constructs from a converted tobacco barn in Franklin, Tenn., in May 2003, have found that Wall Street has far less interest in their services than they expected. It's perplexing given that New Constructs has collected several accolades for stock picking. In October 2005, for instance, *Institutional Investor* magazine highlighted New Constructs for being the #1-ranked research firm for stock picking over the prior four-year period. That ranking included the small independent research firms as well as the Wall Street sell-side firms.

Why the silence? As Trainer sees it, the established investment banks and brokerage firms prefer research that falsifies corporate earnings and sacrifices investors' returns to fill their own pockets. "Most people do not realize that the opportunities marketed to 'Main Street America' have been passed on by many people higher on the financial food chain," Trainer says. "The super-rich hedge-fund managers usually get first dibs, leftovers go to their fund, any additional leftovers go to the managers of the large sell-side firms, any additional leftovers go to the large sell-side firms, any additional leftovers go to the super-rich clients of the large sell-side firms, any additional leftovers go to the small buy-side firms, then, finally, any additional leftovers go to the individual investor. Wall Street is focused on making money for themselves and their super-rich clients, not the investing public."

As a result, Trainer says, there are very few money managers who actually care about performance and even fewer that do any real analysis. That hardly appears to be the case with Trainers' research offerings. New Constructs eschews company press releases and Wall Street research reports, most of which tend to focus on accounting earnings, and devotes its efforts instead to actually reading, or "scrubbing" the reports that companies submit to the Securities and Exchange Commission. Once New Constructs gets its hands on those reports, it parses all relevant financial data to understand the true profitability of the company. That, according to Trainer, means much more than pulling the Net Income from the Income Statement or Cash Flow from Operations from the Cash Flows Statement. "There are far too many accounting loopholes that enable companies

to manipulate those numbers," Trainer says. "To get to the truth about the profitability of the company, one must gather data from all statements—most importantly, the Notes to the Financial Statements." Those financial footnotes, Trainer says, are like buried financial treasure—the place where accountants are required to disclose all the dirty financial details that are omitted from the Financial Statements.

Once again this year, as part of *BusinessTN's* annual tn250 coverage, New Constructs has provided its research on the Tennessee public companies it covers. Company snapshots combine five equally weighted criteria: economic versus reported earnings per share (EPS), return on invested capital ranked by quintile, two-year average free cash flow yield, price-to-economic book value ratio, and the market-implied growth appreciation period (GAP). The results are used to construct a risk/reward investment rating for each company. In this system, companies are ranked "1" through "5" as either "very attractive" (1), "attractive" (2), "neutral" (3), "dangerous" (4) or "very dangerous" (5). Each individual criterion is ranked 1 through 5 against the performance of over 3,000 companies. These rankings identify disconnects between the market's expectations for future cash flows and current cash flows. A very dangerous company, then, has poor economic profits versus misleading accounting profits that exaggerate earnings. This has the potential to artificially increase stock valuation. A very attractive company, on the other hand, has a cheap valuation with strong economic profits, suggestive of a hidden value the market did not recognize.

The accompanying chart, then, depicts New Constructs' findings for 50 publicly traded Tennessee companies it scrubs, along with some notes from Trainer himself. (Note, this analysis took place around May 1.)

In the absence of a major Wall Street splash, where is the New Constructs business going? Underwhelmed by its experience selling New Constructs research, Trainer and Sloan have launched a hedge fund. "We are quite confident that our competitive edge over the marketplace will last for some time," Trainer sums up, "given that we offered our product to our competitors in the money management business and they could not utilize it."

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► Disclosure

(New Constructs has received funding from several Tennessee investors, including Solidus Co., an investor in the company that publishes *BusinessTN*.)

According to Trainer

We believe that stock market investment decisions should be based on a rigorous risk/reward analysis. Because stock prices are dependent on future cash flows, there is no such thing as a “sure thing” in the stock market. Accordingly, the best an investor can do is make sure his investments offer the most upside reward versus downside risk.

There is a lot more “red” than “green” on this chart, which shows, in general, that we do not see many attractive investment opportunities in Tennessee stocks.

Of particular note are the companies with an Economic vs. Reported EPS Rating of 5. Such a rating means these companies have “Misleading Earnings”—their reported accounting income is positive and rising while their true economic cash flows are negative and declining.

When companies have Misleading Earnings and Expensive Valuations (as measured by the Valuation Metrics), they qualify for our Most Dangerous Stocks list. On the other hand, companies that make our Most Attractive Stocks list have strong economic cash flows and cheap valuations as measured by the criteria above.

top findings

NHC Only one Wall Street Rating is a Strong Buy on NHC as recently as January. That rating moved to a “Hold” in February. Their analysis probably overlooks the \$366 of off-balance sheet debt carried by the company. Note that NHC’s off-balance sheet debt is over 50% of its market value. This stock is much riskier than anyone realizes before they read the Notes to the Financial Statements.

GET 10 out of the 11 Wall Street firms that cover GET have Buy or Strong-Buy ratings. The other rating is a Hold. Those analysts are likely missing the fact that even though GET reported that its earnings rose by nearly \$200 million last year, their true economic earnings actually declined by \$47 million. What’s more, our analysis shows that GET’s management has a very poor record in making capital allocation decisions. Over the past 10 years, management has written off over \$230 million of its balance sheet, which equates to 10 cents on every dollar of

investment it has made. This means the company is throwing away \$10 for every \$100 of shareholder value. Management has a long way to go to overcome these losses before it can create value for shareholders.

CXW All five Wall Street firms that cover CXW have Buy or Strong Buy ratings. Four of them have Strong Buy ratings. Over the past 10 years, management has written off over \$734 million of its balance sheet, which equates to 33 cents on every dollar of investment it has made. It is well known that this company is engaged in turnaround. However, investors looking to profit from a rapid turnaround in the business may have to wait a long, long time, given that such turnaround has yet to manifest in the economics of the business and that the current stock market valuation already implies that the company’s profits will increase by 250% next year. Accordingly, as our Risk/Reward Rating shows, CXW offers investors too much downside risk compared to very little upside potential.

DK Four of the seven Wall Street firms that cover DK have a Hold or Sell Rating. Once sentiment shifts toward the negative, Wall Street firms tend to throw the baby out with the bath water and downgrade for fear of being the last analyst on the Street to warn their institutional clients about a bad stock. Because Wall Street research analysts tend to move in packs, they often overlook key details. For example, DK’s current market valuation implies the company’s profits will permanently decline by 70% and the company will never grow profits from that depressed level. At the same time, our economic earnings analysis reveals that DK’s economic earnings rose by \$9.7 million versus an increase in accounting income of only \$3.4 million. Risk/Reward is Very Attractive for DK because DK’s valuation already implies a permanent 70% decline in the company’s profits and our analysis reveals that profits are actually rising.

RT Nine of the 11 Wall Street analysts have a Hold or Under-perform Rating on RT. Most of those analysts likely blame the decline in reported earnings last year and poor prospects for their negative opinions. They are not aware that economic earnings actually rose by \$15.6 million. (Net income fell by \$9.3 million.) These different results are caused by excluding non-operating expenses and charges from our assessment of the ongoing operations of the business. As for the poor prospects, we believe the markets’ valuation is already pricing in a virtually worst-case scenario as the current stock price implies the company’s profits will permanently decline by 50% and the company will never grow profits from that depressed level. Accordingly, our Risk/Reward analysis reveals that downside risk is limited, given that the market is already forecasting a permanent 50% decline in profits. Reward is strong given that the economic profits of the company are rising despite reported numbers that do not show it. —D.T.