

Buy Herbalife And Get A Piece Of the Good Life

an article from blog.newconstructs.com

Almost every investor knows the Herbalife (HLF) story by this point. Star hedge fund manager Bill Ackman took a short position last December. He very publicly called the company a pyramid scheme and gave it a price target of \$0. Longtime rival Carl Icahn got in on the long side soon after, and the two have traded barbs back and forth since. George Soros has also reportedly taken a large long position in the stock recently.

In the past five years, the SEC has twice looked into Herbalife's operations and twice it has concluded its investigations without any action.

With stock up over 100% year-to-date, no findings of wrongdoing from regulators, and the seal of approval from two highly sophisticated investors, Ackman's short thesis is looking pretty weak.

This article will not try to argue the legality of HLF's business model. I think it is a moot point. My fund has owned the stock since its big drop in May 2012.

The focus of this article is on the value that Herbalife has and will create for shareholders.

Herbalife is a very profitable company with significant long-term competitive advantages that not only position the company to continue to create shareholder value but also to be very attractive as a potential acquisition target for large health insurers.

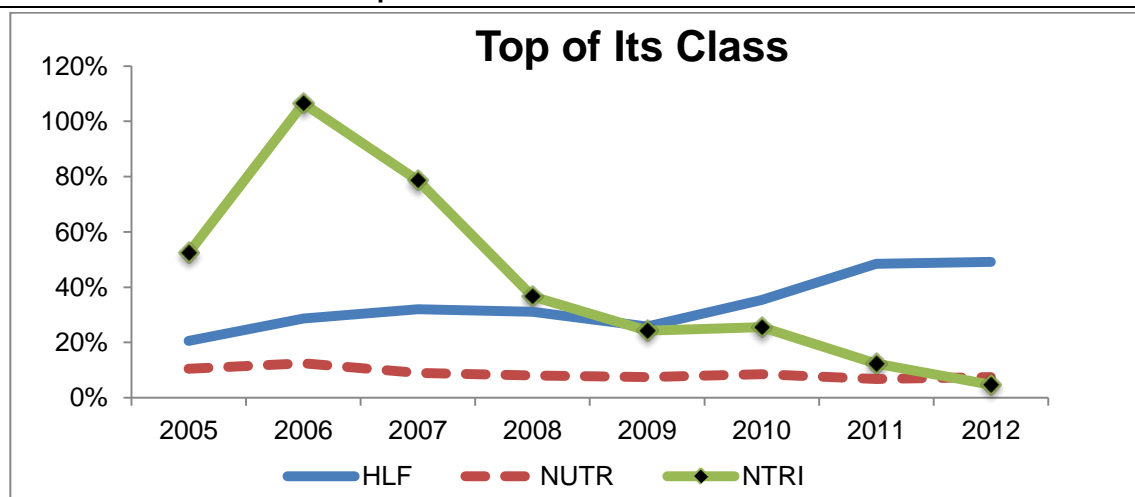
Analyzing the Key Metrics For Shareholder Value Creation

Regular readers know that my favorite measure of profitability is return on invested capital (ROIC). Calculated by taking net operating profit after tax (NOPAT) and dividing it by average [invested capital](#), ROIC measures the efficiency of a company in utilizing its assets to create value for shareholders.

HLF's multi-level marketing strategy allows it to have less invested capital and earn a higher [ROIC](#) than its competitors in the diet and nutrition industry with more traditional marketing and selling strategies. For example, in 2012, HLF earned an ROIC of 49% compared to Nutraceutical International (NUTR) with an ROIC of 8% and NutriSystem Inc. (NTRI) with an ROIC of only 5%.

While both NUTR and NTRI have had their brief spells of success, Figure 1 shows that HLF has done better than both at steadily increasing its [ROIC](#).

Figure 1: ROIC of Herbalife and Competitors



Sources: New Constructs, LLC and company filings

Over the past eight years, HLF has grown [NOPAT](#) by an impressive 27% compounded annually. GAAP net income for the last fiscal year actually significantly understates HLF's true profitability. An unusual [\\$16.7 million](#)

[loss](#) due largely to the devaluation of Venezuela's currency, along with a few other hidden items, decreased reported earnings to \$477 million while HLF's NOPAT was actually \$508 million.

The Power Of Healthy Relationships

In addition to requiring less invested capital, HLF's business model leverages the benefits of the innate human desire to be part of a community. And in the case of Herbalife, it is a healthy community, which means it can last.

In a world where many traditional community structures are in decline or have vanished, Herbalife sells more than just a product. The company marries its product offering with the opportunity to be part of a community of like-minded individuals endeavoring to achieve similar goals. Desire to be part of community is a powerful human impulse, and HLF offers that to consumers while simultaneously promoting a healthy lifestyle.

The result is a win-win for Herbalife clients. They get a good product and membership in a community that espouses healthy living. And from all indications, people appear to be buying into the community HLF provides. If the growth in sales is not convincing enough, just look at the reviews from consumers and employees online. For every one complaining that HLF is a scam, there are dozens of reviews praising the company's products and its corporate culture. This evidence suggests that Herbalife's value proposition is increasingly attractive to people.

How many other companies with HLF's scale have managed to create a community around healthy living? The only other one I can think of is Weight Watchers (WTW). [I've highlighted WTW before](#) and have been especially intrigued by the potential for acquisition by a major insurance provider. How many insurance companies would jump at the chance to build a stronger relationship with their customers while also promoting healthier lifestyles? Despite major efforts, none of the major insurers have had any success building any sort of positive community with their subscribers. In fact, the venture capital world is full of start-ups looking to help insurers engage with subscribers and help them live healthier life styles, and, therefore, lower insurers costs. Maybe the problem is that the insurers are too focused on cutting costs and not focused enough on improving peoples' lifestyles. Either way, WTW and HLF could offer insurers a compelling off-the-shelf solution to connecting with customers and offering a variety of products and services that support a healthy lifestyle.

The Value Of Healthy Relationships

HLF's network of distributors can grow sales organically through relationships and word of mouth rather than depending on advertising to target new customers. In 2012, HLF grew revenue by 18% while spending only 1% of revenue on advertising. In 2011, the average company selling food and kindred products spent 11% of sales on advertising.

HLF's ability to grow its product sales without significant ad spending touches on the core competitive advantage of the company. HLF offers clients a sense of community and a healthy lifestyle that perpetuates the growth and value of the community.

Attractive Valuation

Despite HLF's 77% run-up this year, the stock is still fairly cheap. At its current valuation of ~\$67/share, HLF has a [price to economic book value ratio](#) (price-to-EBV) of 1.2 That ratio means that the market expects only 20% growth in [NOPAT](#) for the remainder of HLF's existence. Given the company's impressive growth rate over the past few years, such a pessimistic expectation seems unwarranted. Throughout its history, HLF has typically traded at a price-to-EBV of closer to 1.5. The large short interest and lingering concerns over the possibility of regulatory action have succeeded in keeping HLF's stock cheap.

Given the recent strong earnings report and great stock momentum, it appears that the downward pressure of over 30 million shares short could quickly turn into a short squeeze and drive the stock up.

HLF offers consistent growth in profits and revenue at a significant discount. In addition, it's a potential acquisition target by deep-pocketed insurers. Unless you believe the SEC (or FTC) will reverse its position and take concrete action against HLF, there is very little downside risk to this stock.

While a few ETFs and mutual funds allocate a significant portion of their assets to HLF, none of them earn an Attractive-or-better rating. Investors would be better served buying the stock directly than trying to get exposure to it through an ETF or mutual fund.

Sam McBride contributed to this article.

Disclosure: David Trainer is long HLF. David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, or theme.

New Constructs® – Profile

How New Constructs Creates Value for Clients

1. **Superior Recommendations** – Our [stock picks](#) consistently outperform. See our track record in our [stock-picking accolades](#) and [Proof Is In Performance](#) reports.
2. **More Accurate Research** – Our [patented Research Platform](#) for [reversing accounting distortions](#) and [discounted cash flow analysis](#) leverages better data to deliver smarter research.
3. **Time Savings** – We check the fine print in thousands of corporate filings so you don't have to. As reported by [Barron's](#), our expertise in analyzing SEC filings delivers [Hidden Gems and Red Flags](#) that drive long-term stock-picking success.
4. **Transparency** – We are proud to share the results of our analysis of over 50,000 10Ks. See the [Corporate Disclosure Transgressions](#) report we provided the SEC. Our reports detail all data and assumptions. [Company Models](#) enable users to change them.
5. **Objectivity** – New Constructs is an independent research firm, not tied to Wall Street or investment banking services. Our models are driven by comprehensive high-quality data not stories. See our [presentation to the Senate Banking Committee](#), the SEC and many others in DC.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. [Accounting data must be translated into economic earnings](#) to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. [Economic earnings](#) are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, [New Constructs](#) is an independent publisher of investment research that provides clients with consulting, advisory and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. [NOPAT](#), [Invested Capital](#), and [WACC](#), to create [economic earnings models](#), which are necessary to understand the true profitability and valuation of companies. Visit the [Free Archive](#) to download samples of our research. New Constructs is a [BBB accredited](#) business and a member of the [Investorside Research Association](#).

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 15 days after New Constructs issues a report on that security.

New Constructs is affiliated with Novo Capital Management, LLC, the general partner of a hedge fund. At any particular time, New Constructs' research recommendations may not coincide with the hedge fund's holdings. However, in no event will the hedge fund receive any research information or recommendations in advance of the information that New Constructs provides to its other clients.

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.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.