Danger Zone: The Advisory Board Company (ABCO)

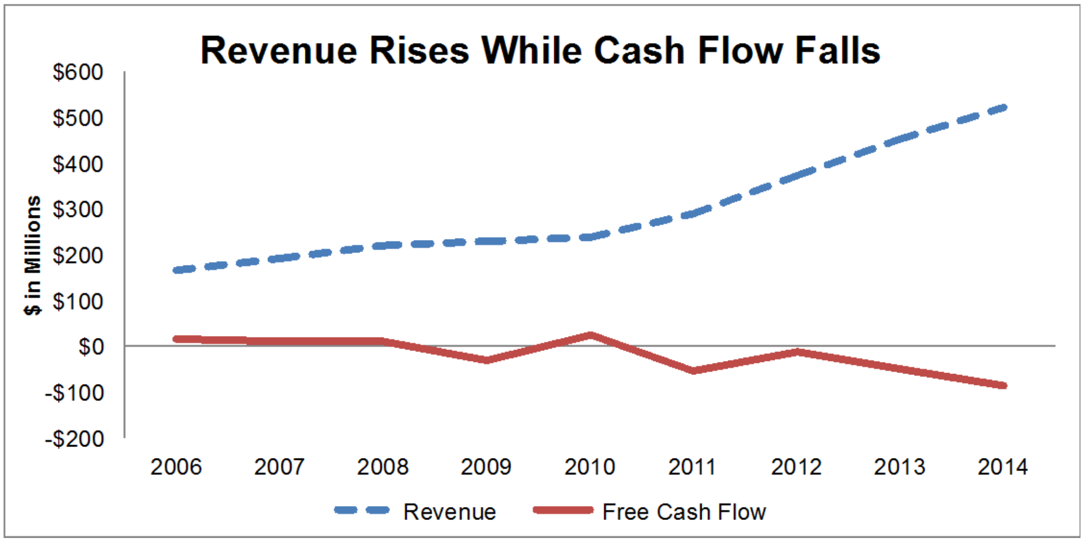
The Advisory Board (ABCO: $48/share) is on our Most Dangerous List for November. Investors who heeded our warning and sold this stock saved themselves from a nearly 15% drop last Friday. This article reiterates our warning because the stock has even farther to fall.

It's Been Eight Years — Where Are the Profits?

Advisory Board's revenue has grown almost every single quarter since 2002 at a rate of nearly 17% compounded annually. However, this revenue growth has not produced profits. After-tax operating profit (NOPAT) has grown by just 1% compounded annually since 2006. More recently, profits have taken a nosedive and declined -12% compounded annually over the past two years.

The company's free cash flow (FCF) has been negative for five out of the past six years. The only positive results during that time came in 2010 from the company's sale of $12 million of PPE. Figure 1 contrasts the revenue increases with negative FCF.

Figure 1: Focus On Cash Flows, Not the Top Line



Sources: New Constructs, LLC and company filings

Acquisitions Are Destroying Value

Simply put, management is spending money that is not producing results, i.e. profits. Most of Advisory Board's spending has been on value-destroying acquisitions. From 2009 to 2013, the company's acquisitions include 360 Fresh, Medical Referral Source, ActiveStrategy, PivotHealth, Cielo, Southwind, and Crimson.

This aggressive acquisition strategy has propped up revenue while cash flows have declined. As a result, the company's return on invested capital (ROIC) has fallen every year since 2008 to a low of 7% in 2014.

These Hidden Dangers Threaten to Drag Cash Flow Even Lower

Advisory Board has $59 million in off-balance sheet debt from operating leases. Only investors who dug through the footnotes would be aware of this liability, which makes up 12% of Advisory Board's net assets and 3% of its market value.

The company also has over $31 million (2% of market value) in outstanding employee stock option liabilities.

Competition Has Big Competitive Edge

Advisory Board operates in the loose space of consulting, primarily for health care companies. Its main competitors are Accenture (ACN), Huron Consulting (HURN), Navigant Consulting (NCI), and Gartner (IT).

Figure 2: Lagging in Terms of Profitability

Company	Ticker	2-Year NOPAT CAGR	NOPAT Margin	Return on Invested Capital
Accenture	ACN	8%	10%	48%
Gartner	IT	12%	11%	35%
Huron Consulting	HURN	13%	9%	8%
Advisory Board	ABCO	-12%	4%	7%
Navigant Consulting	NCI	11%	7%	4%

Sources: New Constructs, LLC and company filings.

Notice that Advisory Board is the only company on this list with falling profits. Health care consulting is clearly not a struggling industry when almost every other player is posting double-digit profit growth. Advisory Board also has the lowest profit margins and the second-lowest ROIC. Advisory Board's competitors' superior margins give them pricing power over the company in an era when hospitals are slashing budgets.

Valuation Implies Sudden and Never-Before-Seen Levels of Profitability

To justify its current valuation of $48/share, ABCO must grow NOPAT by 21% compounded annually for the next 15 years.

The Advisory Board hasn't been able to grow its profits at all over the past eight years despite tripling its balance sheet. I am not confident at all that the company can come close to meeting the expectations embedded in its current stock price.

Failure to Sustain Revenue Growth Will Lead to Another Drop in Stock Price

The bull case for Advisory Board focuses on the company's revenue growth, and we think that story is coming to an end. Advisory Board's client list already includes 98 of the 100 largest health systems and all of the top 20 hospitals in the country. If the richest and most successful health care providers are already spending on Advisory Board's services, how much more revenue growth is possible without additional value-destroying acquisitions?

Acquisitions are expensive. As its cash flows fall deeper into negative territory, Advisory Board must face the reality that spending more money than you make is not sustainable.

Without a cash flow miracle, another earnings miss is just around the corner. Around 40% of the company's business closes in the fourth quarter. Advisory Board must cut its out-of-control spending, and the company's sales mix is shifting toward larger and fewer contracts. These factors increase the risk of another revenue miss in the next few quarters. Remember that when the company missed on revenue in early November, the stock tanked nearly 15%.

Buyback Risk

Advisory Board has repurchased $380 million of stock since May 2013 for a total of 16,391,288 shares. This has worked out well because the company's share price has risen over that timeframe. Advisory Board still has $69 million in buybacks left, which could be used to support the stock in the short term. Nonetheless, only profits can support stocks in the medium and long term.

Short Interest

ABCO's unsustainable strategy has caught the eye of other short sellers. Short interest is 2,899,000 shares, or just under 8% of shares outstanding.

Insiders Are Bailing

Over the past 6 months, insiders have bought zero shares and sold 119,623 shares, a total of 29% of total insider holdings. Insiders are bailing and so should you.

Avoid Funds That Hold ABCO

Morgan Stanley Institutional Small Company Growth Portfolio (MSSLX) allocates 2.6% of its assets to ABCO and earns our Dangerous rating. We recommend avoiding funds that hold stocks that have high risk of blowing up.

André Rouillard contributed to this report.
Disclosure: David Trainer and André Rouillard receive no compensation to write about any specific stock, sector, or theme.

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