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DILIGENCE PAYS 9/16/15

New Stocks on Most Attractive/Most Dangerous: September 2015

Recap from August Picks

Our Most Attractive Stocks (-6.4%) fell less than the S&P 500 (-8.9%) last month and outperformed as a long portfolio. Most Attractive Large Cap stock NVIDIA Corporation (NVDA) gained 5% and Most Attractive Small Cap stock MBIA Inc. (MBI) was up 17%. Overall, 26 out of the 40 Most Attractive stocks outperformed the S&P 500 in August.

Our Most Dangerous Stocks (-9.5%) fell by more than the S&P 500 (-8.9%) last month and outperformed as a short portfolio. Most Dangerous Large Cap stock, Charles Schwab Corp. (SCHW), fell by 18% and Most Dangerous Small Cap Stock, El Pollo Loco Holdings, Inc. (LOCO), fell by 35%. Overall, 18 out of the 40 Most Dangerous stocks outperformed the S&P 500 in August.

The successes of the Most Attractive and Most Dangerous stocks highlight the value of our forensic accounting. Being a true value investor is an increasingly difficult, if not impossible, task considering the amount of data contained in the ever-longer annual reports. By analyzing key details in these SEC filings, our research protects investors' portfolios and allows our clients to execute value-investing strategies with more confidence and integrity.

22 new stocks make our Most Attractive list this month and 28 new stocks fall onto the Most Dangerous list this month. September's Most Attractive and Most Dangerous stocks were made available to members on September 2.

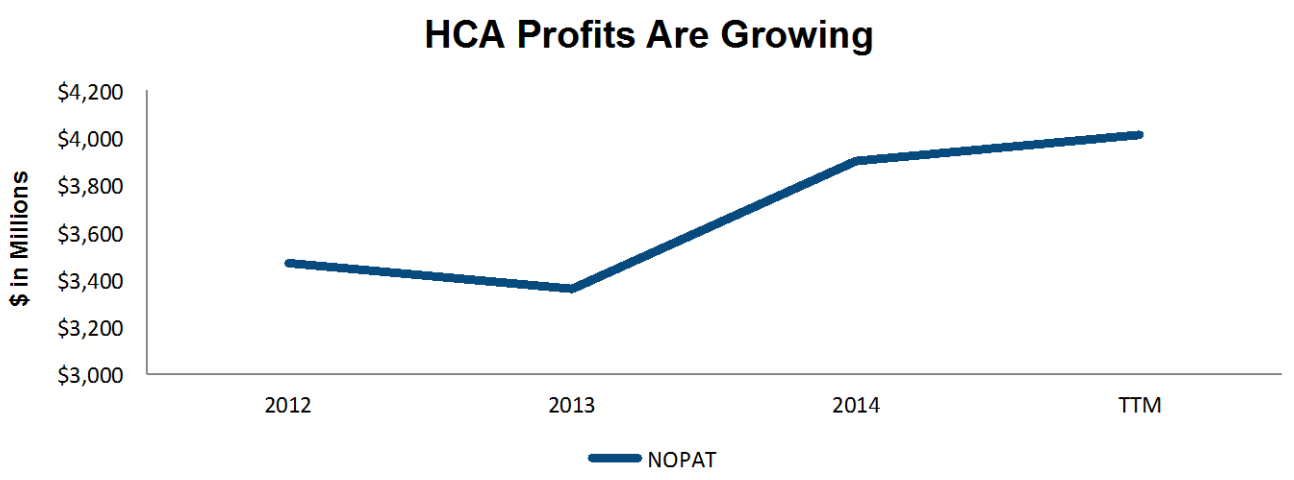
Our Most Attractive stocks have high and rising return on invested capital (ROIC) and low price to economic book value ratios. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

Most Attractive Stock Feature for September: HCA Holdings (HCA: $85/share)

HCA Holdings (HCA), which operates hospitals and surgery centers across the nation, is one of the additions to our Most Attractive stocks for September.

HCA Holdings has used its market leading position, believed to be the largest hospital operator in the world, to build a highly profitable business. Since 2012, HCA has grown revenue and after-tax profit (NOPAT) by 5% compounded annually.

Figure 1: HCA Holdings Increasing NOPAT



Sources: New Constructs, LLC and company filings

In addition to growing profits, HCA has maintained efficiency over the capital invested into its business, which has contributed to HCA's top-quintile return on invested capital (ROIC) of 15%. Best of all, HCA Holdings has generated positive economic earnings every year since 2011.

Impacts of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we made the following adjustments to HCA Holding's 2014 10-K:

Income Statement: we made $3.5 billion of adjustments with a net effect of removing $2 billion of unusual expenses (5% of revenue). We removed $2.7 billion related to non-operating expenses and $726 million related to non-operating income.

Balance Sheet: we made $3.6 billion of adjustments to calculate invested capital with a net increase of $478 million. The largest adjustment was $1.4 billion added back to invested capital (5% of net assets) due to off balance sheet debt in the form of operating leases.

Valuation: we made four adjustments with a net effect of decreasing shareholder value by $34.7 billion. There were no value increasing adjustments. One of the largest adjustments was a $1.5 billion (4% of market cap) decrease to shareholder value related to the fair value of minority interests.

HCA Holdings Shares Remain Undervalued

Despite increasing 16% year-to-date, HCA still has great upside. At its current price of $85/share, HCA has a price to economic book value (PEBV) of 1.1. This ratio implies that the market expects HCA's NOPAT to only grow by 10% over the life of the corporation. Such low expectations are at odds with the company's NOPAT growth since 2012 and should be easily surpassed.

If HCA Holdings can continue growing NOPAT by 5% compounded annually for the next five years, the stock is worth $105/share today – a 24% upside.

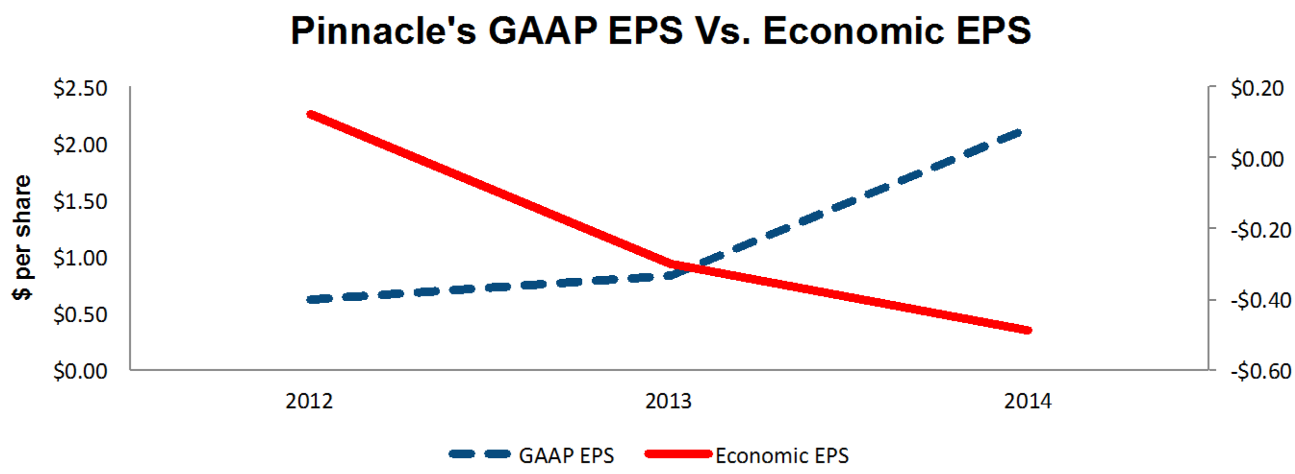
Most Dangerous Stock Feature: Pinnacle Foods, Inc. (PF: $45/share)

Pinnacle Foods, Inc. (PF), provider of an assortment of packaged food products, is one of the additions to our Most Dangerous stocks for September and was in the Danger Zone in March 2015.

The market has rewarded Pinnacle Foods for acquisitions that have helped grow the company's top and bottom line, but have come at a cost ignored by most traditional analysis. Despite GAAP net income growing nearly 70% compounded annually since 2012, economic earnings, the true cash flows available to equity investors have drastically declined.

The big difference between net income and economic earnings is the cost of off balance sheet liabilities and equity capital, something GAAP earnings ignore. In 2014, the capital charge for Pinnacle's off balance sheet liabilities and equity capital equaled $2.38/share. After adjusting reported earnings for this charge, we find that Pinnacle's economic earnings per share were -$0.49 compared to a GAAP EPS of $2.13 in 2014. While growing EPS and propping the stock price up, Pinnacle has been destroying true shareholder value, as shown in Figure 2.

Figure 2: Disconnect Between GAAP Earnings and Economic Earnings



Sources: New Constructs, LLC and company filings

Forensic Accounting Reveals Overstated EPS

The following adjustments were made to Pinnacle Food's 2014 10-K:

Income Statement: we made $306 million of adjustments with a net effect of removing $26 million in unusual income. The largest adjustment was the removal of $153 million (6% of revenue) in non-operating income received as a termination fee of Hillshire Farms' withdrawn buyout.

Balance Sheet: we made $465 million of total adjustments to calculate invested capital with a net decrease of $101 million. The largest adjustment was the removal of $184 million (4% of net assets) due to midyear acquisitions.

Valuation: we made four adjustments with a net effect of decreasing shareholder value by $3 billion. There were no value increasing adjustments. The largest adjustment was the removal of $627 million (13% of market cap) from shareholder value due to deferred tax liabilities.

After Making Adjustments, It's Clear Pinnacle Is Overvalued

Year-to-date, PF has increased 26%, buoyed by increasing GAAP EPS. This price increase has left shares significantly overvalued. To justify its current price of $45/share, Pinnacle must grow NOPAT by 9% compounded annually for the next 17 years. While this may not seem like much, keep in mind that Pinnacle has only grown NOPAT by 2% compounded annually since 2012.

Even if Pinnacle is able to achieve a more realistic, but still optimistic compared to its past, NOPAT growth of 4% compounded annually for the next decade, the stock is worth only $15/share today – a 67% downside. With such lofty growth expectations baked into the stock, it's easy to see why Pinnacle lands on Septembers' Most Dangerous Stocks list.

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

New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensics accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

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

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