Danger Zone Highlights From 2015

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life and Marketwatch.com

It pays to read our Danger Zone reports. In 2015, 21 out of our 35 Danger Zone stock or mutual fund picks underperformed the market (S&P 500) while 26 stocks saw negative returns. As 2015 is now in the rear view, we'd like to highlight a few of the many examples in which our Danger Zone reports could have saved investors from serious price declines.

1. **Men's Wearhouse (MW) - published February 23: Down 72% while the S&P 500 was down 3%**

Our report explicitly pointed out that the acquisition of Jos. A Bank was a clear destruction of value. Our thesis came true when Men's Wearhouse pre-announced 3Q15 results and the Jos. A Bank division came in well below even the most pessimistic expectations.

Prior to the Jos. A Bank acquisition, Men's Wearhouse had grown after-tax profits (NOPAT) by 16% compounded annually from 2009-2013. Profit growth began to decline in 2014 and Men's Wearhouse viewed Jos. A Bank as a way to boost sales and return to profit growth. However, the price paid for Jos. A Bank was too high and proved to be a poor use of capital. Based on the purchase price of $1.8 billion, and the $63 million NOPAT Jos. A Bank earned in the year prior to acquisition, the deal offered a paltry 4% return on invested capital (ROIC), which was half the ROIC Men's Wearhouse earned in 2014.

What could have pushed Men's Wearhouse to pursue an acquisition with such a poor ROIC? None other than pressure from activist investors. Eminence Capital, the largest shareholder of MW, began pushing for the acquisition in late 2013. When the deal closed in June 2014, MW shares had soared over 70%. Not a bad (short-term) return. Turns out Eminence Capital also held a 5% stake in Jos. A Bank. Heads they win, tails they win. Eminence Capital was clearly incentivized to see this deal through, regardless of the economics of the acquisition or the implications for the average investor.

Our report also focused on the large rise in MW's valuation and the attendant expectations for future cash flows implied by the new price levels. For years MW had traded near its economic book value, or no growth value. As the bidding process for Jos. A Bank began, investors pushed MW shares well above the economic book value, which caused MW to be highly overvalued. Without perfect integration and execution of the Jos. A Bank business, Men's Wearhouse shares had nowhere to go but down.

And down shares would go. When MW pre-announced poor 3Q15 results, shares fell 40% in one day. Later when the 10-Q was released, the stock fell even further and ended 2015 down 72% since our February 23 report.

2. **El Pollo Loco (LOCO) – published March 23: Down 53% while the S&P 500 was down 3%**

El Pollo Loco was once billed as the next Chipotle, a fast growing and healthier alternative to fast food. We questioned whether this could be true, as the growth story of Chipotle is not easily replicable. When digging deeper into the details, it became clear El Pollo Loco was simply an overvalued stock with little differentiation from other fast food stores.

From 2013 to 2014, El Pollo Loco's NOPAT fell 37% and its NOPAT margin fell from 16% to 9%. Despite claims of rapid growth, Loco was growing store count and revenues at a slower pace than the more mature Chipotle while margins were falling. Furthermore, 86% of Loco's stores were in California, which showed little success in growing the business in new markets.

A red flag in Loco's "growth story" was that the company had previously attempted an eastward expansion in 2009. However, by 2012, all those stores had closed. Meanwhile, investors still believed Loco could achieve nationwide success. Comparing the company to Chipotle, we found that Loco's ROIC was less than half that of CMG, but its valuation (as measured by price to economic book value or PEBV), implied nearly double the profit growth of Chipotle. In sum, Loco was a business with declining profitability, highly concentrated revenue, and a stock valuation with impossibly high growth expectations.

All told, LOCO shares dropped significantly when the company reported slowing same store sales, guided for lower margins, and lowered the expectation of system-wide growth in both 2Q15 and 3Q15. It total, shares ended 2015 down 53% since our March 23 report.

3. **Groupon (GRPN) – published June 9: Down 48% while the S&P 500 was down 2%**

Groupon's goal of revolutionizing how consumers interact with merchants never materialized. Our Danger Zone report noted that not only was Groupon's initial "daily coupon" business failing, its expansion towards acting as a traditional retailer would only further depress margins and profitability as the company faced steep competition in that space as well. At the end of 2014, it was clear that Groupon's revenue growth had come at the expense of profits, which cratered to -$6 million NOPAT in 2014, down from $42 million the year before.

Compounding the issues with its middleman business model, Groupon relied heavily on its user base remaining active and interested in the daily coupon market. However, with only 48 million active users at the time of our initial report, Facebook, Twitter, and even LinkedIn dwarfed Groupon's user base. With relatively few users, it was hard to see why investors had valued Groupon for such significant future profit growth.

The failings of Groupon's business became clear when the company began reporting results in the second half of 2015. Expected revenues and earnings were continually being lowered as Groupon failed to profitability grow its new retail operations. All the issues came to a head when, in 3Q15, Groupon reported year over year revenue decline, guided 4Q15 metrics below expectations, and CEO Eric Lefkofsky stepped down from his position. At this point, shares were down 55% since our June 9 Danger Zone call. Shares slightly rebounded after the appointment of a new CEO. GRPN ended 2015 down 48% since we placed it in the Danger Zone.

4. **Twitter (TWTR) – published June 1: Down 37% while the S&P 500 was down 3%**

Twitter went public in 2013 touting excellent customer growth, revenue growth, and had the makings of "the next big thing." Investors seemed willing to overlook the fact that the company had failed to operate the business in a profitable manner, and, therefore, the stock had plenty of room to fall.

We identified two big problems with Twitter's business. The first was its cost structure. Despite achieving impressive revenue growth, Twitter's cost of sales and marketing expenses were growing nearly as fast. Compounding the growth in costs was the increased use of stock based compensation, which had grown from 6% of total expenses in 2012, to nearly one third of the company's expenses in 2014. Twitter conveniently removed this compensation expense when reporting its non-GAAP earnings.

The second, and bigger problem was Twitter's flawed business model. The best interests of the users (i.e. quick, easy access to the content of their choosing) were not (and still not) aligned with the best interests of advertisers (i.e. getting more attention of users not necessarily looking for them). This conflict made us wonder how successful Twitter's business could be long-term.

The stock dropped when Twitter reported it would have trouble growing its user base in the near-term and that CEO Dick Costolo was departing from his position. Despite a slight bounce in October, when Jack Dorsey was confirmed as permanent CEO, TWTR ended 2015 down 37% since our June 1 Danger Zone report.

5. **Box (BOX) – published January 27: Down 34% while the S&P 500 was up 1%**

The story of Box, a high profile cloud-based company, would come to exemplify much of 2015, a year in which we saw numerous unprofitable companies go public due to the availability of cheap capital. Large investors had nowhere else to put their cash, and it found its way into startups and tech companies with "promising futures". However, the Box IPO served the best interest of insiders and Wall Street banks while hanging IPO investors out to dry.

When Box went public, it was burning cash at an alarming rate and needed the IPO proceeds to continue operations. But, what sense does it make to continue operations that are burning -$156 million in NOPAT in 2014, worse than the -$108 million the year before? The lack of profits helped drive Box's ROIC down to -100%. In other words, Box burned $1 for every dollar invested into its business.

Making matters worse, Box went public with little in the way of competitive advantage or differentiation from the numerous other cloud storage providers. With 32 million users, the company was nearly 1/10th the size of Dropbox and still smaller than Google Drive and Microsoft's OneDrive. With a -100% ROIC, Box had no pricing power either to fight off the large amount of competition.

Investors realized the inherent problems with Box and shares tanked post IPO. When the dust settled, BOX ended 2015 down 34% since our January 27 Danger Zone report.

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

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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.

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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.

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